

Recent Developments in Federal Income Taxation

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Shea Homes, Inc. v. Commissioner, 118 A.F.T.R.2d 2016-5593 (9th Cir. 8/24/16) *Outline: item 1.a, page 4*

- The taxpayer, a home builder engaged in developing planned residential communities:
 - Entered into contracts for the sale of houses and lots
 - Was obligated by contract and by state law to complete common improvements such as landscaping, parks and roads; this obligation was secured by performance bonds.
- The contracts were “home construction contracts” under § 460(e)(6), thus entitling the taxpayer to use the completed contract method of accounting
- Issue: is the subject matter of each sales contract only the house and lot, or instead the larger development?
- Held: The larger development, including amenities and common improvements.

Howard Hughes Co., L.L.C. v. Commissioner, 805 F.3d 175 (5th Cir. 10/27/15)

Outline: item 2.a, page 5

- In connection with a planned residential community, the taxpayer:
 - Sold land for construction of homes
 - Was contractually obligated to develop water service, traffic signals, landscaping, parks etc.
 - Did not construct any homes
- Issue:
 - Are the contracts for the sale of land “home construction contracts” under § 460(e)(6), thus entitling the taxpayer to use the completed contract method of accounting?
- Held: No. Taxpayer was not constructing homes or apartments or installing integral components.

T.D. 9771

81 F.R. 37504 (7/26/16)

Outline: item 2, page 8

- Final regulations under § 108 provide that, if debt of a grantor trust or disregarded entity is discharged, the determination whether the bankruptcy and insolvency exclusions apply is determined by looking to the owner.
 - For the bankruptcy exclusion to apply, the owner of the grantor trust or disregarded entity must be a debtor in bankruptcy.
 - For the insolvency exclusion to apply, the owner of the grantor trust or disregarded entity must be insolvent.
- If the owner of the grantor trust or disregarded entity is a partnership, these rules are applied at the partner level.
 - The partners must be insolvent or debtors in bankruptcy.⁴

Notice 2015-82
2015-50 I.R.B. 859 (11/24/15)
Outline: item 2, page 9

- De minimis safe harbor in the 2013 final regulations on deduction and capitalization of expenditures related to tangible property. Reg. § 1.263(a)-1(f).
- The safe harbor permits a taxpayer to deduct currently, rather than capitalize, an amount paid for the acquisition or production of a unit of tangible property.
 - Must have a written accounting procedure
 - Must treat as an expense for financial accounting
 - The expense must not exceed a specified amount.
- Notice 2015-82 increases the specified amount for taxpayers *without* an applicable financial statement from \$500 to \$2,500.

Brinks, Gilson & Lione P.C. v. Commissioner, T.C. Memo. 2016-20 (2/10/16)

Outline: item C.1, page 9

- The taxpayer, a law firm, zeroed out its book income each year with bonuses to the shareholder-attorneys.
- The taxpayer conceded that some of the compensation paid to shareholders was properly recharacterized as nondeductible dividends.
- Issue:
 - Can the taxpayer avoid accuracy-related penalties because it had either substantial authority for its position or had a reasonable basis for its position and acted in good faith?
- Held: No. Taxpayer had neither substantial authority nor a reasonable basis for its position.

H.W. Johnson, Inc. v. Commissioner, T.C. Memo. 2016-95 (5/11/16)

Outline: item 2, page 10

- The taxpayer, an extraordinarily successful C corporation engaged in concrete work in the construction industry:
 - Had annual contract revenue of \$24 mill. to \$38 mill.
 - Paid bonuses to two shareholder-employees of \$4 mill. to \$7 mill.
 - Had pre-tax net income of \$370,000.
- Issue:
 - Can the corporation deduct the bonuses as reasonable compensation?
- Held: Yes. The corporation had a return on equity of 10%, which satisfies the independent investor test.

Bonus Depreciation—Section 168(k)

Outline: item 1.a, page 13

- The Protecting Americans from Tax Hikes Act of 2015 (“2015 PATH Act”), § 143 (12/18/15):
 - Extended 50% bonus depreciation through 2019 (2020 for certain property).
 - Phased down to 40% in 2018 and 30% in 2019.
 - For property placed in service after 2015, expanded the types of property eligible for bonus depreciation by including:
 - “qualified improvement property” (formerly qualified leasehold improvement property).
 - certain trees vines and plants bearing fruits or nuts.

Section 179

Outline: item 1.e, page 14

- The Protecting Americans from Tax Hikes Act of 2015 (“2015 PATH Act”), § 124 (12/18/15):
 - Restored for 2015 and made permanent:
 - The \$500,000 limit on the section 179 deduction
 - The \$2 million phase-out threshold
 - Adjusts the above amounts for inflation for tax years beginning after 2015
 - Restored and made permanent the § 179 deduction for qualified real property and off-the-shelf computer software.
 - For tax years beginning after 2015 qualified real property: (1) is no longer subject to a \$250,000 limit, and (2) includes AC and heating units.

Section 41 Research Credit

Outline: item 1.a, page 15

- The Protecting Americans from Tax Hikes Act of 2015 (“2015 PATH Act”), § 121 (12/18/15):
 - Restored for 2015 and made permanent the § 41 research credit
 - For tax years beginning after 2015, allows a “qualified small business” to:
 - Use the research credit to reduce either regular tax or AMT liability
 - Claim up to \$250,000 of the research credit as a credit against payroll tax liability (social security portion of employer’s FICA taxes)

**Fargo v. Commissioner,
T.C. Memo. 2015-96 (5/26/15)
*Outline: item A.1, page 16***

- Taxpayers, through a limited partnership, acquired a parcel of real property in La Jolla, California
- Planned to develop 72-unit apartment complex and retail space
- Received unsolicited offer and sold the property for a gain of over \$12 million
- Issue:
 - Is the taxpayer's gain ordinary or capital?
- Held: An ordinary gain. Taxpayers continually engaged in efforts to plan and develop the property up until the date of sale.

Boree v. Commissioner,
118 A.F.T.R.2d 2016-5742 (11th Cir. 9/12/16)
Outline: item A.1.a, page 17

- Taxpayers, through a limited liability company, acquired 1,892 acres of land in Baker County, Florida
 - Submitted a proposal for a planned residential development to be developed and sold in phases
 - Baker County adopted a series of land-use restrictions that affected development, such as a requirement that all roads within and leading to subdivisions be paved.
- Taxpayers sold to a developer and realized a gain of approximately \$8.5 million.
- Issue: Is the taxpayer's gain ordinary or capital?
- Held: An ordinary gain. Taxpayers held the property for sale in the ordinary course of business until they sold it.

Section 1014(f)/Notice 2016-27

Outline: item 2, pages 18-20

- The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2004(a) (7/31/15):
 - Enacted new § 1014(f)
 - Requires that heir's § 1014 basis in property not exceed value as finally determined for estate tax purposes.
 - Applies only if estate tax return is required to be filed.
 - Does not apply if a return is filed solely to enable surviving spouse to claim the deceased spouse's unused credit under portability rules.
 - Enacted new § 6035, which requires executor to report to IRS and heir the value of the property.
 - IRS issued final Form 8971 on 1/29/16.
- Proposed regulations issued 3/4/16: 81 F.R. 11486

Section 1202

Outline: item 4, page 20

- The Protecting Americans from Tax Hikes Act of 2015 (“2015 PATH Act”), § 126 (12/18/15):
 - Restored for 2015 and made permanent the 100% § 1202 exclusion for gain realized on the sale of qualified small business stock
 - Applies when a noncorporate shareholder acquires stock of a C corporation at original issuance and holds for 5 years or more
 - Limit on exclusion is greater of 10 times the taxpayer’s basis or \$10 million

T.D. 9779
81 F.R. 48707 (7/26/16)
Outline: item C.1, page 28

- Taxpayers no longer need to file a copy of their election under § 83(b) with their tax return.
 - This facilitates electronic filing.
 - Applies to property transferred on or after 1/1/16, but taxpayers can rely on this rule for property transferred after 1/1/15.
- The § 83(b) election is made by filing a written statement with the internal revenue office with which the person who performed the services files his return.
- The election must be filed no later than 30 days after the date the property is transferred to the service provider.

McGaugh v. Commissioner, T.C. Memo. 2016-28 (2/24/16)

Outline: item 1, page 28

- At taxpayer's request, taxpayer's self-directed IRA made a wire transfer to First Personal Financial Corp.
- More than 60 days later, First Personal Financial Corp. issued stock in the name of the IRA.
- The IRA custodian attempted to deliver the stock certificate to the taxpayer and issued a 1099-R reporting a taxable distribution.
- Issue:
 - Was the wire transfer a taxable distribution of IRS funds?
- Held: No. Taxpayer was, at most, a conduit of the IRA funds. *Dabney v. Commissioner*, T.C. Memo. 2014-108, distinguished.

Thiessen v. Commissioner, 146 T.C. No. 7 (3/29/16) *Outline: item 4, page 30*

- Taxpayers rolled over funds from 401(k) accounts to self-directed IRAs.
- The IRAs contributed the funds to a newly formed corporation, which acquired the assets of an existing business.
- The corporation borrowed to fund the asset acquisition.
- Taxpayers guaranteed the corporation's debt.
- Issue:
 - Is the guaranty a prohibited transaction under § 4975?
- Held: Yes. All IRA assets treated as distributed to taxpayers, who were under age 59-1/2. *Peek v. Commissioner*, 140 T.C. 216 (2013), followed.

Roberts v. Commissioner, 820 F.3d 247 (7th Cir. 4/15/16) (Posner, J.) *Outline: item 1, page 34*

- The taxpayer had been a successful owner of bars, restaurants and nightclubs.
- He withdrew from those businesses to begin breeding, training, and racing thoroughbred horses.
- He acquired a 180-acre farm and made \$500,000 in improvements, spent 8 to 12 hours each day working with the horses, and was active in professional organizations.
- Issue:
 - Are the taxpayer's losses from this activity disallowed as hobby losses under § 183?
- Held: No. Although the factors in Reg. § 1.183-6 are “goofy,” they all favor the taxpayer.

Voss v. Commissioner, 796 F.3d 1051 (9th Cir. 8/7/15) *Outline: item 1.b, page 36*

- Taxpayers, an unmarried couple, had approximately \$2.7 million of acquisition indebtedness and home equity indebtedness on homes that they jointly owned.
- Issue:
 - Does the \$1.1 million limit on the amount of home mortgage debt that produces deductible interest apply to an unmarried couple per taxpayer, or per residence?
- Held: Per taxpayer. The taxpayers can deduct the interest on up to \$2.2 million of home mortgage debt.
- Note: the IRS has acquiesced in the Voss decision. AOD 2016-02, 2016-31 I.R.B. 193 (8/1/16).

Belot v. Commissioner,
T.C. Memo. 2016-113 (6/13/16)
Outline: item E.1, page 38

- The taxpayer and his wife jointly owned three businesses.
- They planned to continue operating the businesses together following their divorce. **[?]**
 - January 2007: judgment of divorce entered.
 - September 2007: wife brings legal action to remove husband as director and compel his sale of shares to her.
 - April 2008: settlement in which taxpayer sells his interest in the businesses to former wife for \$1.5 million
- Issue: was the transfer “incident to divorce”? See § 1041(c).
- Held: Yes. Although the transfer occurred more than 1 year after the cessation of the marriage, it was related to the cessation of the marriage.

Section 1374

Outline: item D.1, page 41

- The Protecting Americans from Tax Hikes Act of 2015 (“2015 PATH Act”), § 127 (12/18/15):
 - Restored for 2015 and made permanent the 5-year recognition period during which an S corporation that converted from a C corporation is subject to tax on “recognized built-in gain”
 - Previously, the recognition period had been temporarily reduced from 10 years to 7 years to 5 years.

Section 1367(a)(2)

Outline: item D.2, page 41

- The Protecting Americans from Tax Hikes Act of 2015 (“2015 PATH Act”), § 115 (12/18/15):
 - Restored for 2015 and made permanent the rule that, when an S corporation makes a charitable contribution of property, the shareholder’s stock basis is reduced by the shareholder’s pro rata share of the contributed property’s adjusted basis.

Proposed and Final Regulations Under § 385

Outline: item H.2, page 47

- On April 4, 2016, Treasury published proposed regulations on the treatment of certain related-party interests in a corporation as stock or indebtedness. REG-108060-15, 81 F.R. 20912 (4/8/16).
- Treasury published final regulations on October 21, 2016. 81 F.R. 72858 (10/21/16).

T.D. 9788
81 F.R. 69282 (10/5/16)
Outline: item B.1, page 51

- Final regulations provide guidance on:
 - Disguised Sales: The allocation of partnership liabilities for purposes of the § 707 disguised sale rules.
 - Bottom-Dollar Guarantees: The extent to which a partner is treated as having a payment obligation with respect to a partnership liability (and therefore whether the liability is treated as recourse under § 752) as a result of making a “bottom-dollar” guarantee.

REG-122855-15

81 F.R. 69301 (10/5/16)

Outline: item B.2, page 53

- Proposed regulations provide guidance on:
 - Payment Obligations for Purposes of § 752: The extent to which a partner is treated as having a payment obligation with respect to a partnership liability (and therefore whether the liability is treated as recourse under § 752).
 - Would move the recognition factors (set forth in 2014 proposed regulations) to an anti-abuse rule.
 - Would remove rule of § 1.752–2(k) that a payment obligation of a disregarded entity is taken into account only to the extent of the disregarded entity's net value.
 - DRO for Purposes of § 704: The extent to which a partner is treated for purposes of § 704 as having an obligation to restore a capital account deficit.

T.D. 9787

81 F.R. 69291 (10/5/16)

Outline: item C.2, page 56

- Final regulations :
 - Disguised Sales: Provide a number of clarifications of the § 707 disguised sale rules.
 - Partners' Shares of Liabilities: Provide that, for purposes of determining a partner's share of partnership liabilities in applying the disguised sale rules of § 707(a)(2)(B) and Reg. § 1.707-5(a)(2), only the default rule for allocating partnership “excess nonrecourse liabilities”—in accordance with the partners' interests in partnership profits—applies, unless another partner bears the economic risk of loss.
 - Applies regardless of whether the liability is recourse or nonrecourse.

Repeal of TEFRA Audit Rules

Outline: item 1, page 57

- The Bipartisan Budget Act of 2015, § 1101 (11/2/15):
 - Repeals the TEFRA audit rules for years beginning after 2017.
 - Replaces with a new regime under which tax will be collected from the partnership (not the partners), unless the partnership elects to pass the liability to the partners.
- All partnerships are subject to the new regime unless they can and do elect out.
- Partnerships with 100 or fewer partners can elect out of the new regime, provided they don't have certain kinds of partners.
- Need to look at partnership agreements now.
- Partnerships can opt in for tax years beginning after 11/2/15. T.D. 9780, 81 F.R. 51795 (8/5/16).

**Atkinson v. Commissioner,
T.C. Memo. 2015-236 (12/9/15)
*Outline: item B.1, page 65***

- Held: a conservation easement on golf course property did not satisfy the conservation purpose requirement of § 170(h). Therefore, the taxpayer's charitable contribution deduction was disallowed.

**United States v. Titan Int'l, Inc.,
811 F.3d 950 (7th Cir. 2/1/16)
*Outline: item 4, page 75***

- Held: despite the “one inspection” rule of § 7605(b), the IRS can inspect the same books and records a second time if it does so in connection with the audit of a different year.

Hampton Software Develop't, LLC v. Comm'r

T.C. Memo. 2016-38 (3/5/16)

Outline: item 7, page 83

- Issue: when a taxpayer in a worker classification case files a protest and has a conference with IRS Appeals, can the taxpayer later contest the existence or amount of the tax liability in a Collection Due Process hearing?
- Section 6330(2)(B): permits taxpayer to contest the existence or amount of the tax liability in a CDP hearing only “if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability.”
- Held: a notice of determination of worker classification is “generally subject to deficiency procedures.” Therefore, a pre-notice conference with IRS Appeals does not preclude challenging the tax liability in the CDP hearing₃₀

Romano-Murphy v. Commissioner, 816 F.3d 707 (11th Cir. 3/7/16)

Outline: item 8, page 84

- Held: when the taxpayer timely files a protest requesting a conference with IRS Appeals, the IRS's failure to respond might render the assessment invalid.
- Remanded for determination whether the IRS's failure to respond was harmless error or rendered the assessment invalid.

**In re Mallo,
774 F.3d 1313 (10th Cir. 12/29/14)
*Outline: item 3, pages 88-90***

- Held: if an individual taxpayer files his or her federal tax return late, the tax debt can never be discharged in bankruptcy.
- Agrees with prior decision in *In re McCoy*, 666 F.3d 924 (5th Cir. 2012) (late-filed Mississippi state tax return).
- Recent developments:
 - *Justice v. United States*, 116 A.F.T.R.2d 2016-1191 (11th Cir. 3/30/16).
 - *In re Smith*, 118 A.F.T.R.2d 2016-5127 (9th Cir. 7/13/16)
 - *Justice* and *Smith* both apply multi-factor test to determine whether taxpayer's late return qualifies as a "return," and both held the tax debt non-dischargeable.

Revocation of Passports

Outline: item 7, page 93

- The Fixing Americas Surface Transportation Act of 2015, § 7345 (12/4/15):
 - Adds new Code § 7345, which provides that having a “seriously delinquent tax debt” is grounds for denial, revocation, or limitation of a passport.
 - A “seriously delinquent tax debt” is generally defined as:
 - an unpaid, legally enforceable federal tax liability of an individual
 - that has been assessed and exceeds \$50,000 (to be adjusted in future years for inflation), and
 - for which a notice of lien has been filed in public records pursuant to § 6323 or a notice of levy has been filed pursuant to § 6331.

T.D. 9766

81 F.R. 26693 (5/4/16)

Outline: item B.1, page 98

- IRS's longstanding position: a partner is self-employed and any remuneration the partner receives for services rendered to the partnership are not wages subject to FICA, FUTA, and income tax withholding. Rev. Rul. 69-184, 1969-1 C.B. 256.
- These proposed and temporary regulations clarify that partners are self-employed, even if they are employees of a disregarded entity owned by the partnership.

Delay of Cadillac Tax

Outline: item 1.b, page 99

- Division P, Title 1, § 101 of the Consolidated Appropriations Act, 2016, Pub. L. No. 114-113 (12/18/15) :
 - Delays the effective date of the Cadillac Tax to taxable years beginning after 12/31/19.
 - The legislation also amends Code § 4980I(f)(10) to make payments of the tax deductible for income tax purposes.

Suspension of Medical Device Tax

Outline: item 2, page 99

- The Protecting Americans from Tax Hikes Act of 2015 (“2015 PATH Act”), § 174 (12/18/15):
 - Imposes a two-year moratorium on the 2.3 percent excise tax on medical devices of § 4191.
 - Pursuant to the moratorium, the tax will not apply to medical devices sold during calendar years 2016 or 2017.