



Current Federal Tax Developments

July 10, 2023

Kaplan Financial Education



Copyright 2023, Kaplan Inc.

This Week We Look At:

S corporation loses on research credit claim and gets hit with penalties - risks of a credit study

Exempt organization status denied for organization formed to raise funds for one person's medical bills

Discussion of tax research hierarchy in this short week

2

<https://www.currentfederaltaxdevelopments.com>





S Corporation Denied Research Credit, Penalties Applied



Photo by [Photoholic](#) on [Unsplash](#)

- *Mark Betz et al. v. Commissioner*, TC Memo 2023-84, July 6, 2023
 - Issue involves the research credit under IRC §41
 - Designs and supplies air pollution control systems
 - Had a research credit study undertaken by outside consultant
 - Corporation's CPA used consultant's draft Form 6765, *Credit for Increasing Research Activities*, to prepare return claiming credit

<https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/s-corp-shareholders-denied-research-credits%2c-liable-for-penalties/7gy77>



S Corporation Denied Research Credit, Penalties Applied



Photo by [Photohoic](#) on [Unsplash](#)

- *Mark Betz et al. v. Commissioner*, TC Memo 2023-84, July 6, 2023
 - Some key problems
 - Could not show products they produced were pilot models
 - Did not keep time records on employees, but rather estimated time spent on research
 - For some projects, did not retain ownership of intellectual property

<https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/s-corp-shareholders-denied-research-credits%2c-liable-for-penalties/7gy77>



S Corporation Denied Research Credit, Penalties Applied



Photo by [Photoholic](#) on [Unsplash](#)

- *Mark Betz et al. v. Commissioner*, TC Memo 2023-84, July 6, 2023
 - Pilot model problem
 - Defined by regulations as “any representation or model of a product that is produced to *evaluate and resolve uncertainty* concerning the product.”
 - Regulation does provide these could be sold to customers but must show evaluation and resolution of uncertainty was why it was produced

<https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/s-corp-shareholders-denied-research-credits%2c-liable-for-penalties/7gy77>



S Corporation Denied Research Credit, Penalties Applied



Photo by [Photoholic](#) on [Unsplash](#)

- *Mark Betz et al. v. Commissioner*, TC Memo 2023-84, July 6, 2023
 - Pilot model problem
 - Did not test the “model” to see if uncertainty was resolved until all plans had been finalized (so more like standard quality control testing)
 - Simple customization is not sufficient to qualify for the credit - must resolve true uncertainty

<https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/s-corp-shareholders-denied-research-credits%2c-liable-for-penalties/7gy77>



S Corporation Denied Research Credit, Penalties Applied



Photo by [Photoholic](#) on [Unsplash](#)

- *Mark Betz et al. v. Commissioner*, TC Memo 2023-84, July 6, 2023
 - Employee records problem
 - Attempted to use a *Cohan* estimate of time
 - Before allowed to use *Cohan*, must show employee actually performed qualified research services (which they did not)
 - Court does not have to “take on faith” the claim employees did research-*Little Sandy Coal Co. v. Commissioner*, 62 F.4th 289, (7th Cir. 2023)

7

<https://www.currentfederaltaxdevelopments.com>



<https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/s-corp-shareholders-denied-research-credits%2c-liable-for-penalties/7gy77>



S Corporation Denied Research Credit, Penalties Applied



Photo by [Photoholic](#) on [Unsplash](#)

- *Mark Betz et al. v. Commissioner*, TC Memo 2023-84, July 6, 2023
 - Subcontractor retained rights
 - Funded research exclusion problem
 - Payment depends on success of the project *or*
 - Contactor retains substantial rights in the research
 - Tax Court found some (but not all) projects violated second rule

<https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/s-corp-shareholders-denied-research-credits%2c-liable-for-penalties/7gy77>



S Corporation Denied Research Credit, Penalties Applied



Photo by [Photoholic](#) on [Unsplash](#)

- *Mark Betz et al. v. Commissioner*, TC Memo 2023-84, July 6, 2023
 - With all credits disallowed turned to penalties (under either negligence or substantial underpayment)
 - Court found liable for a 20% accuracy penalty regardless of which test is used
 - Taxpayer could not qualify for the reasonable cause exception under IRC §6664(c)(1)

<https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/s-corp-shareholders-denied-research-credits%2c-liable-for-penalties/7gy77>



S Corporation Denied Research Credit, Penalties Applied



Photo by [Photoholic](#) on [Unsplash](#)

- *Mark Betz et al. v. Commissioner*, TC Memo 2023-84, July 6, 2023
- First problem - taxpayer simply asked court to look at “overall record” to justify substantial reliance
 - Was nothing more than an assertion they qualified
 - Court refused to search to build arguments for the taxpayer

<https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/s-corp-shareholders-denied-research-credits%2c-liable-for-penalties/7gy77>



S Corporation Denied Research Credit, Penalties Applied



Photo by [Photoholic](#) on [Unsplash](#)

- *Mark Betz et al. v. Commissioner*, TC Memo 2023-84, July 6, 2023
- Second problem - reliance could not have been proved
 - Admitted they did not seek or rely upon advice from CPA who prepared the return
 - Court in a footnote dismisses entire the thought that reliance on the consultant's work could have been reasonable

<https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/s-corp-shareholders-denied-research-credits%2c-liable-for-penalties/7gy77>



S Corporation Denied Research Credit, Penalties Applied



Photo by [Photoholic](#) on [Unsplash](#)

- *Mark Betz et al. v. Commissioner*, TC Memo 2023-84, July 6, 2023
 - Key problems
 - Lack of records would have been fatal in and of itself in this case - but consultant went ahead and tried to build estimates
 - The fact that a pilot model *could* be the eventual product delivered to a customer doesn't mean that such a product always qualifies (just means doing so won't disqualify one that meets the requirements)

<https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/s-corp-shareholders-denied-research-credits%2c-liable-for-penalties/7gy77>



S Corporation Denied Research Credit, Penalties Applied



Photo by [Photoholic](#) on [Unsplash](#)

- *Mark Betz et al. v. Commissioner*, TC Memo 2023-84, July 6, 2023
 - Key problems
 - Contracts with some subcontractors had clauses that meant the research wasn't the taxpayers (they had no rights to use the results of the research, just deliver a product)
 - Failed to get truly independent opinions from a party without a vested interest in stating they qualified for the credit

<https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/s-corp-shareholders-denied-research-credits%2c-liable-for-penalties/7gy77>



S Corporation Denied Research Credit, Penalties Applied



Photo by [Photoholic](#) on [Unsplash](#)

- *Mark Betz et al. v. Commissioner*, TC Memo 2023-84, July 6, 2023
- Likely to see similar issues raised for any such credit studies (such as ERC studies)

<https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/s-corp-shareholders-denied-research-credits%2c-liable-for-penalties/7gy77>



No Exempt Status for Organization Devoted to Raising Funds for One Person's Medical Expenses



Photo by [Julia Zvablova](#) on [Unsplash](#)

- LTR 202327019, July 7, 2023
 - Raising money to pay medical bills of a single cancer patient
 - The secretary/treasurer of the organization has the same last name as the patient
 - Section 1.501(c)(3)-1(d)(1)(ii) requires that the entity must service public rather than private interests

<https://www.taxnotes.com/research/federal/irs-private-rulings/letter-rulings-%26-technical-advice/organization-serving-private-interests-is-denied-tax-exempt-status/7gy9b>



No Exempt Status for Organization Devoted to Raising Funds for One Person's Medical Expenses



Photo by [Julia Zvablova](#) on [Unsplash](#)

- LTR 202327019, July 7, 2023
 - Rev. Rul. 67-367 blocked qualification for an entity formed to grant scholarships to pre-selected, named individuals
 - *Wendy L. Parker Rehabilitation Foundation, Inc. v. Commissioner*, T.C. Memo. 1986-348 had facts very similar to this situation (but only 30% would go to a family coma victim) - still denied §501(c)(3) status
 - Found organization failed as it had a substantial non-exempt purpose

<https://www.taxnotes.com/research/federal/irs-private-rulings/letter-rulings-%26-technical-advice/organization-serving-private-interests-is-denied-tax-exempt-status/7gy9b>



No Exempt Status for Organization Devoted to Raising Funds for One Person's Medical Expenses



Photo by [Julia Zvablova](#) on [Unsplash](#)

- LTR 202327019, July 7, 2023
 - Same reasoning applies when clients want to claim a deduction for amounts given to GoFundMe
 - Note that a 501(c)(3) organization could give support to an individual (though always watch for private inurement)

<https://www.taxnotes.com/research/federal/irs-private-rulings/letter-rulings-%26-technical-advice/organization-serving-private-interests-is-denied-tax-exempt-status/7gy9b>



Tax Research Hierarchy

- Not all sources cited in tax services, CPE courses, this weekly update, etc. are created equal
- Context of where we are in the tax process matters as well
- Top of the hill - US Constitution (but is rarely an issue)
- Internal Revenue Code/Tax Treaties normally top authority (if law is unambiguous, then it is the answer unless SCOTUS has told you that you are reading it wrong 😊).
- Regulations - Courts will not often throw out a regulation, so be aware that being contrary to a regulation is a very aggressive position in most cases and would pretty much require litigation if challenged (and requires disclosure)



Tax Research Hierarchy

- Items in the IRB - Revenue Rulings, Revenue Procedures, Announcements, Notices, etc. - generally IRS will be stuck with them, Courts more likely to question *but* you still need support for your contrary position (not enough to say the IRS position is only based on a notice)
- PLRs, TAMs, CCAs, etc. - technically not binding on anyone, but IRS is less likely to take contrary position and they often can stand on their own as a legal analysis (so, again, need your own backed up position)



Tax Research Hierarchy

- Court cases - a key normal problem is proper application of the concept of differentiation (why do your facts mean this decision does or doesn't apply in your situation)
- US Supreme Court cases are the gold standard
- Circuit Court of Appeals which would hear your client's case if it gets there will control absent SCOTUS overruling
- Tax Court
 - Reported full Tax Court decisions will control with the same facts
 - Memorandum decisions - not precedent but still likely to be followed if facts same



Tax Research Hierarchy

- Tax Court
 - Summary Opinions - less useful since they can't be appealed, but still may provide a useful analysis. However, rarely cited by Courts
 - Desk Opinions - truly just useful for an analysis but of little/no use
- US Court of Federal Claims - national court - don't see a lot of cases go this route, but is the one alternative to your Circuit
- US District Court - general purpose courts, tax decisions can be very "hit or miss" on how much they can be relied upon
- In all cases must check to be sure your authority has not been overruled (see a Citator for case law)

KAPLAN