Current Federal Tax Developments

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SECTION: STATE TAX
COLORADO LAW REQUIRING OUT OF STATE SELLERS TO REPORT ON COLORADO CUSTOMERS WHO MAY OWE USE TAX UPHELD BY TENTH CIRCUIT

Citation: Direct Marketing Association v. Brohl, CA10, Case No. 12-1175, 2/22/16

Normally in this venue we discuss federal tax matters, but in this case the applicability of a Constitutional provision (or perhaps lack of a provision, given the issue is the Dormant Commerce Clause) may have a broad impact. The case in question is a challenge to a Colorado provision requiring out of state sellers to report to the state customers who are residents of the state to assist in collection of use tax from those individuals (*Direct Marketing Association v. Brohl*, CA10, Case No. 12-1175).

Specifically the challenged Colorado law provided for the following:

> To assist the state in collecting use tax from in-state purchasers, most seemingly unaware of their tax responsibility, the Colorado legislature passed a law in 2010 that imposes three obligations on retailers that do not collect sales taxes -- "non-collecting retailers": (1) to send a "transactional notice" to purchasers informing them that they may be subject to Colorado's use tax, see Colo. Rev. Stat. § 39-21-112(3.5)(c)(I); 1 Colo. Code Regs. § 201-1:39-21-112.3.5(2);5 (2) to send Colorado purchasers who buy goods from the retailer totaling more than $500 an "annual purchase summary" with the dates, categories, and amounts of purchases, reminding them of their obligation to pay use taxes on those purchases, Colo. Rev. Stat. § 39-21-112(3.5)(d)(I); 1 Colo. Code Regs. § 201-1:39-21-112.3.5(3); and (3) to send the Department an annual "customer information report" listing their customers' names, addresses, and total amounts spent, Colo. Rev. Stat. § 39-21-112(3.5)(d)(II); 1 Colo. Code Regs. § 201-1:39-21-112.3.5(4).

The Direct Marketing Association challenged this requirement, claiming that the imposition of this requirement violated the Supreme Court's decision in the case of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). *Quill* dealt with the state of North Dakota's attempt to require a mail order office supply vendor to collect taxes on its sales to residents of the state despite having no physical presence there.

Specifically, as the opinion notes "DMA argues the Colorado Law unconstitutionally discriminates against and unduly burdens interstate commerce."

However, the Tenth Circuit panel did not find this case governed by *Quill*, nor did it find that the law unconstitutionally discriminates against and burdens interstate commerce. The Court noted that the Supreme Court has generally not expanded upon *Quill* beyond the situation of forced collection of sales and use taxes for businesses not having a physical presence in the state.

The Court notes that this provision does not give in-state sellers a competitive advantage over out-of-state sellers, since in-state sellers must actually collect and pay over a sales tax. In fact, as Judge Gorsuch notes in a concurring opinion:

> If anything, by asking us to strike down Colorado's law, out-of-state mail order and internet retailers don't seek comparable treatment to their in-state brick-and-mortar rivals, they seek more favorable treatment, a competitive advantage, a sort of judicially sponsored arbitrage opportunity or "tax shelter." *Quill*, 504 U.S. at 329 (White, J., concurring in part and dissenting in part).

The concurring opinion goes on to note that, assuming this position is adopted by other circuits, many states will move to impose reporting obligations on out-of-state sellers:

> It is a fact—if an analytical oddity—that the *Bellas Hess* branch of dormant commerce clause jurisprudence guarantees a competitive benefit to certain firms simply because of the organizational form they choose to assume while the mainstream of dormant commerce clause jurisprudence associated with *West Lynn Creamery* is all about preventing discrimination between firms. And the

> plaintiffs might well complain that the competitive advantage they enjoy will be diluted by our decision in this case. Indeed, if my colleagues and I are correct that states may impose notice and reporting burdens on mail order and internet retailers comparable to the sales and use tax collection obligations they impose on brick-and-mortar firms, many (all?) states can be expected to follow Colorado's lead and enact statutes like the one now before us.

Taxpayers who make out of state sales will need to keep abreast of developments in this area. At the very minimum it would appear that businesses in state subject to the Tenth Circuit's jurisdiction will need, at least for now, to respect the Colorado rule (along with Colorado, they include Kansas, New Mexico, Oklahoma, Utah and Wyoming).

SECTION: 162
EXPENSE PAID TO RELATED ENTITY FOUND NOT TO BE ORDINARY AND NECESSARY, AS ENTITY CLAIMING DEDUCTION DID NOT RECEIVE ANY BENEFITS

Citation: Key Carpets, Inc. v. Commissioner, TC Memo 2016-30, 2/25/16

Taxpayers may form related entities for various purposes, some tax related and some not tax related. But they may try and assign expenses between the various entities for reasons that don't appear to have support based on the facts of the case, often in order to achieve a tax advantage. But under the tax law a business deduction under IRC §162 is only allowed to an entity to the extent the expense represents an ordinary and necessary business expense of the entity claiming the deduction.

The Tax Court found that was not the case for certain expenses claimed in the case of *Key Carpets, Inc. v. Commissioner*, TC Memo 2016-30.

Key Carpets was owned by a married couple. A year after its formation, the husband formed a second corporation, Clean Hands, of which he was the sole shareholder. Initially it was meant to reserve the name for a hand washing system that was to be used in food handling facilities being developed by Key Carpets. The system Key Carpets was working on would have used radio frequency identification tags (RFID tags) that an employee would present to the machine to record that the employee had washed his/her hands to document compliance with food handling rules.

Clean Hands was dormant for 11 eleven years. During that time Key Carpets, which had hired five to six employees to attempt to develop this RFID machine. Eventually the company determined that this machine was not feasible.

However another idea occurred to the husband—perhaps the better idea would be to develop a machine that was voice actuated. Just before coming up with this idea he had hired an employee as a Clean Hands employee. This employee was a computer technician who was to assist with the development of the hand washing machine.

Key Carpets paid Clean Hands $130,000 in 2007 and $128,222 in 2008, purportedly to develop the hand cleaning machine under contract with Key Carpets. The IRS balked at these payments, arguing that, in fact, there was no evidence that Key Carpets actually had any ownership interest in the new hand washing machine.

The Tax Court agreed that the portion of the payment purportedly paid for the hand washing machine by Key Carpets was no deductible, as there was no evidence that Key Carpets had any rights in the new machine.

The Court noted:

> Mr. Johnson did not present any credible evidence that Key Carpets owned the voice-activated hand washing monitoring system. His testimony that Key Carpets owned the voice-activated hand washing monitoring system was vague, unclear, and not credible. Mr. Johnson's testimony contradicts his statements that he owned the patent on the voice-activated hand washing monitoring system. Additionally, the parties stipulated that Mr. Johnson was the sole owner of Clean Hands. Although Key Carpets had an ownership interest in the initial RFID badge-activated hand washing system, Key

> Carpets had no interest in the new voice-activated system that the computer technician developed as a Clean Hands employee. The Court therefore finds that Key Carpets did not own the voice-activated hand washing monitoring system.
>
> …Mr. Johnson owned all the stock of Clean Hands, and he owned the patent on the voice-activated hand washing monitoring system. Key Carpets received no benefits from the payments for the development of the system. Therefore, the expenses were not ordinary and necessary. Key Carpets may not deduct the amounts paid to Clean Hands for the development of the voice-activated hand washing monitoring system.

The case points out a number of pitfalls that are easy for the client to fall into. It is easy to see how the husband may have failed to realize that when he established multiple entities, he had to respect those specific entities. A taxpayer can choose whatever form he wishes for his affairs, but once chosen he has to live with the consequences.

Likely the husband looked at Key Carpets, Clean Hands and himself as the same thing—so it did not "really" matter that he held the patent and that Clean Hands hired the employee. He could "assign" the whole thing to Key Carpets, which likely could use the deduction while Clean Hands very likely had no income aside from that it received from Key Carpets—thus, any loss might be "useless" currently if it remained in that entity.

SECTION: 170
QUALIIFIED APPRAISAL REQUIRED FOR COLLECTIBLE COINS DONATION, EVEN IF COINS CONSTITUTE LEGAL U.S. TENDER

Citation: Chief Counsel Email 201602012, 2/19/16

Under IRC §170(f)(11) a taxpayer who donates a contribution of property in excess of $5,000 must obtain a qualified appraisal of the property and attach it to his/her return in order to obtain a charitable contribution deduction. However, under IRC §170(f)(11)(a)(ii), no appraisal is required for readily valued property—and, cash would seem to be the best example of "readily valued property."

But what if the cash, while being legal U.S. tender, consisted of collectible coins whose value was in excess of the face amount of the coins? Does the fact that the coins represented "cash" mean that no appraisal is necessary?

Chief Counsel Email 201608012 concludes that answer is no, such a contribution does require an appraisal if the taxpayer claimed a deduction for an amount in excess of the face amount for coins that represent legal tender.

The email reasons:

> Section 170(f)(11) was enacted with the purpose of requiring qualified appraisals to ensure that contributions of property are not overvalued. See Staff of J. Comm. on Taxation, 108th Cong., General Explanation of Tax Legislation Enacted in the 108th Congress 461 (Comm. Print 2005) ("Congress believed that requiring C Corporations to obtain a qualified appraisal for charitable contributions of certain property in excess of $5,000 . . . would reduce valuation abuses."); see also Staff of J. Comm. on Taxation, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 502-510 (Comm. Print 1985) (Discusses how tax shelters were promoting inflated donation valuations, oftentimes using "independent" appraisals from promoters; notes that the qualified appraisal rules will "prove more effective in deterring taxpayers from inflating claimed deductions than relying solely on the uncertainties of the audit process and on penalties imposed on those overvaluations that detected on audit.").
>
> When the deduction claimed exceeds the face amount of the coins, there is a potential valuation issue, and therefore the "cash" exception to the appraisal requirements does not apply.

SECTION: 401
CERTAIN QUESTIONS ON 2015 5500 SERIES FORMS ARE NOT TO BE ANSWERED

Citation: IRS Compliance Questions on the 2015 Form 5500-Series Returns, 2/25/16

The IRS posted information on its website, "IRS Compliance Questions on the 2015 Form 5500-Series Returns," indicating that certain portions of the 2015 Form 5500 series forms should not be completed.

The notice provides that the following lines/sections on the particular forms noted below should not be completed on 2015 returns:

- Form 5500, Preparer Information (page 1 bottom)
- Schedule H, Lines 4o-p, 6a-d
- Schedule I, Lines 4o-p, 6a-d
- Schedule R, New Part VII (Lines 20a-c, 21a-b, 22a-d, and 23)
- Form 5500-SF, Preparer Information (page 1 bottom), Lines 10j, 14a-d, and New Part IX (Lines 15a-c, 16a-b, 17a-d, 18, 19, and 20)

SECTION: 752
PAYMENTS TO PROCEED UNDER CONSTRUCTION CONTRACT FOUND BY IRS TO CONSTITUTE PARTNERSHIP LIABILITIES UNDER §752

Citation: PLR 201608005, 2/19/16

The contracting partnership (which had two construction companies as partners) asking for the ruling in PLR 201608005 was looking to see if certain payments the contractor received prior to actually beginning work on portion of a project could be considered partnership liabilities.

The contract in question referenced two types of payments to be made by the customer. One type of payment would be made under standard progress payment terms—if the partnership was in compliance with the contract at the time each payment milestone was reached, a payment would be due. These payments were not the ones the contractor was asking to be ruled as liabilities.

The other type of payment was a "Notice to Proceed" payment that the customer was to make when it gave the partnership notice to proceed to the next phase of construction. These payments were made before the completion of the work and, in fact, before any expenses were incurred by the partnership on that phase of the project.

Additional terms are described as follows in the letter ruling:

> Before P is entitled to receive payments under the contracts and, explicitly, to receive the Notice to Proceed payments, P is required to provide certain guarantees and also to deliver to O irrevocable standby letters of credit. The letters of credit secure P's obligations to perform under the contracts and cover O's damages in the event of non-performance or default by P. The amount of the letters of credit securing P's obligations roughly corresponds to the amount of the Notice to Proceed payments.
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> The contracts provide that if P fails to prosecute the work in a diligent and efficient manner, or if P abandons the project or repudiates any of its obligations, a default occurs. In that event, O is entitled to several remedies, including seeking specific performance (that is, obtaining judicial enforcement requiring P to make good on its obligation to perform the work) and recovery from P of costs, damages, losses, and expenses (that is, requiring P to make good on its obligation to cover O's damages in the event of nonperformance). Specifically, the contracts allow O to draw-down directly against the letters of credit in the event of a default by P.

The partnership is reporting income from the contract on the percentage of completion basis of accounting.

If the payment creates a liability it would serve to increase the partner's basis in the partnership under IRC §722. Under IRC §752(a) an increase in a partner's share of liabilities is treated as a contribution by the partner of cash to the partnership. So if these payments create liabilities, the increased basis would allow for the partners to either deduction losses that otherwise would be basis limited or receive distributions tax free that otherwise would become taxable.

As is often true with the tax law, a liability for this purpose is subject to its own special definition as provided by the Code and Regulations. Specifically, Reg.§1.752-1(a)(4)(i) provides that a liability is:

> An obligation is a liability for purposes of section 752 and the regulations thereunder (§ 1.752-1 liability), only if, when, and to the extent that incurring the obligation—
>
> (A) Creates or increases the basis of any of the obligor's assets (including cash);
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> (B) Gives rise to an immediate deduction to the obligor; or
>
> (C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

Thus, the item must be an "obligation" to meet this test, a concept that is defined as the regulation continues [Reg. §1.752-1(a)(4)(ii)]:

> For purposes of this paragraph and § 1.752-7, an obligation is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps.

The letter ruling does conclude that a liability exists to the customer, even though no specific loan took place. The ruling considers this similar to the case of closing a short sale obligation described in Revenue Ruling 95-26 where the fact that an obligation exists to deliver back the borrowed securities was found to lead to a partnership liability under IRC §752. Thus the ruling concludes:

> …P's obligations under the contracts to proceed with performing work and to incur costs in performing the work, and the corresponding obligations to satisfy O's remedies in the event P were to default or suspend work, constitute liabilities under section 752 upon and to the extent P receives the Notice to Proceed payments but has not yet reported the related income.

SECTION: 6038D
FINAL REGULATIONS ON REPORTING OF SPECIFIED FOREIGN ASSETS BY CERTAIN ENTITIES ISSUED

Citation: TD 9752, 2/22/16

Final regulations have been issued by the IRS on the requirements for certain domestic entities under IRC §6038D to report specified foreign assets to the IRS in TD 9752.

Individuals have been reporting such assets under the same IRC provision on Form 8938, "Statement of Specified Foreign Assets" but the requirements for certain entities to file these forms were delayed pending final regulations.

The law provides that some, but not all, entities must file this form. Specifically IRC §6038D(f) provides:

> (f) Application to certain entities
>
> To the extent provided by the Secretary in regulations or other guidance, the provisions of this section shall apply to any domestic entity which is formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets, in the same manner as if such entity were an individual.

Originally the proposed regulations had provided for a pair of tests to determine if an entity was "formed or availed of for purposes of holding" such assets. An entity would come under IRC §6038D(f)'s reporting requirements if it either had more than 50% passive income/assets *or* 10% of the assets were passive and it was formed with the principal purpose of avoiding reporting under this provision.

The final regulations eliminated the principal purpose test. The IRS explained:

> The Treasury Department and the IRS believe that a 50-percent passive assets or income threshold appropriately captures situations in which specified individuals may use a domestic corporation or partnership to circumvent the reporting requirements of section 6038D. Furthermore, the Treasury Department and the IRS have concluded that taxpayers should be able to determine their reporting requirements under section 6038D based on objective requirements rather than a subjective principal purpose test. Therefore, these final regulations eliminate the principal purpose test for determining whether a corporation or partnership is a specified domestic entity. However, the Treasury Department and the IRS will continue to monitor whether domestic corporations and partnerships not required to report under these final regulations are being used inappropriately by specified individuals to avoid reporting under section 6038D. If needed, the Treasury Department and the IRS may expand the definition of a specified domestic entity in future guidance.

Under Reg. §1.6038D-6(b)(1)(ii) the "50% asset test" is computed as follows:

> …[T]he percentage of passive assets held by a corporation or partnership for a taxable year is the weighted average percentage of passive assets (weighted by total assets and measured quarterly), and the value of assets of a corporation or partnership is the fair market value of the assets or the book value of the assets that is reflected on the corporation's or partnership's balance sheet (as determined under either a U.S. or an international financial accounting standard).

Passive income is generally defined in a fashion that is the same as that found in IRC §1472. Specifically passive income includes [Reg. §1.6038D-6(b)(3)(i)]:

> (A) Dividends, including substitute dividends;
>
> (B) Interest;
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> (C) Income equivalent to interest, including substitute interest;
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> (D) Rents and royalties, other than rents and royalties derived in the active conduct of a trade or business conducted, at least in part, by employees of the corporation or partnership;
>
> (E) Annuities;
>
> (F) The excess of gains over losses from the sale or exchange of property that gives rise to passive income described in paragraphs (b)(3)(i)(A) through (b)(3)(i)(E) of this section;
>
> (G) The excess of gains over losses from transactions (including futures, forwards, and similar transactions) in any commodity, but not including --
>
> > (1) Any commodity hedging transaction described in section 954(c)(5)(A), determined by treating the corporation or partnership as a controlled foreign corporation; or

(2) Active business gains or losses from the sale of commodities, but only if substantially all the corporation or partnership's commodities are property described in paragraph (1), (2), or (8) of section 1221(a);

(H) The excess of foreign currency gains over foreign currency losses (as defined in section 988(b)) attributable to any section 988 transaction; and

(I) Net income from notional principal contracts as defined in § 1.446-3(c)(1).

Reg. §1.6038D-6(b)(3)(ii) contains a special that exempts, in certain cases, such income from the definition of passive income for qualifying dealers.

The entity reporting provisions apply to years beginning after December 31, 2015.

SECTION: 6511
TAXPAYER SUFFERING FROM FINANCIAL DISABILITY UNABLE TO USE THAT TO GAIN EXTRA TIME TO FILE FOR EXTENDED NOL CARRYBACK PERIOD

Citation: McAllister v. United States, US Court of Federal Claims, No. 1:13-cv-01026, 2/23/16

The limited reach of the financial disability tolling provisions added by Congress to §6501 was again highlighted in the case of *McAllister v. United States*, US Court of Federal Claims, No. 1:13-cv-01026.

IRC §6511(h) provides an exception to the general statute of limitations provisions under §6511 for filing a claim for refund in cases of financial disability. In April of 2015 the IRS, in Chief Counsel Memorandum 201515019 (which we discussed in an article posted back in April of 2015), concluded that the provision did not extend the general rule for when a taxpayer must file a claim for refund from years losses are carried to from a "financial disability" year.

Now we have a court opinion looking at another matter arising for a taxpayer claiming financial disability. In this case the "disability" year was 2009 and, as with the taxpayer in the Chief Counsel Advice, that year generated a net operating loss.

That year a special provision, found at IRC §172(b)(1)(H), allowed certain taxpayers to carry net operating losses back for up to five years. However under that provision an election to use an extended loss period had to be filed no later than the due date, including extensions, for the year generating the loss—and that due date was specifically provided for in the statute. Thus for the taxpayers, who had obtained an extension to file their 2009 return, the election needed to be filed by October 15, 2010.

The taxpayers did not timely file their 2009 tax return, and the Form 1040X they filed to claim a five year carryback, filed before their 2009 return actually ended up being filed, was filed in January of 2011. Eventually the taxpayers filed their 2009 return in October of 2011.

The IRS disallowed the carryback, noting the election found on the amended return was made months after the extended due date for filing the 2009 return, thus failing to meet the requirements of §172(b)(1)(H).

The taxpayers sought refuge in the financial disability provisions of IRC §6511(h). As the Court explained:

> Plaintiffs contend that the tolling provided by section 6511(h) applies to the special provision under which plaintiffs attempt to carry back their loss, and that they were financially disabled because they were "unable to manage [their] financial affairs by reason of a medically determinable physical or mental impairment" during 2009 and 2010. § 6511(h). As support for their claim of financial disability, plaintiffs had initially detailed their alleged financial disability in an attachment to their 1040X amended return for the year 2005. Def.'s App. 3. The attachment explained that Mr. McAllister handles the operations of their businesses, while Mrs. McAllister handles the accounting, bookkeeping, and finances. Id. It further noted that during 2009 and 2010, taxpayers "were not able to attend to their respective functions" because Mr. McAllister suffered from recurring eye illness and other conditions throughout those years,

> and Mrs. McAllister suffered from debilitating symptoms which were eventually diagnosed as a tumor of the neck. *Id*.

The Court notes that the financial disability provisions of §6511(h) apply solely to the periods of limitations referenced in subsections (a), (b) and (c) of §6511, but in this case their problem arises from an entirely different IRC provision (that found at IRC §172(b)(1)(H)).

The Court concludes:

> We decline to extend the tolling provisions beyond what Congress clearly specified. Therefore, contrary to plaintiffs' argument, it cannot be applied to section 172(b)(1)(H).

This narrow reading of §6511 is consistent with the reading provided in the Chief Counsel Advice referred to earlier. So while the financial disability provisions provide some relief for taxpayers who otherwise would be denied a refund, it is far from absolute protection in such cases.