Current Federal Tax Developments

Nichols Patrick CPE, Incorporated

CONTENTS

SECTION: SECURITY
IRS SENDS OUT WARNINGS ON MULTIPLE ATTACKS ON PREPARERS AND THEIR SYSTEMS

Citation: IRS News Release IR-2016-103, 8/11/16, IRS News Release-2016-119, 9/2/16

Warnings regarding actual cyber-attacks on preparers and their systems keep coming from the IRS. This has included phishing scams masquerading as critical tax updates a preparer must install immediately and taking over remote access options to enter a preparer's network to access the firm's tax software and file fraudulent returns using the firm's own client data.

Phishing Attack

The IRS issued a warning regarding attempts to trick tax professionals to install malware on their systems by clicking on an "update" link for their tax software. [IR-2016-103] Once clicked, the "update" will install a keystroke logger that will send all of the preparer's keystrokes (which will likely include important client information) to a third party—and we can presume that party is planning to use that information for various nefarious purposes.

The use of email to trick users into installing malware is very common—because it's very effective. If the email fits the general context that users expect (email from the software provider we use for tax software that is formatted as expected) and the message itself seems reasonable (there's an important software update—perhaps even an extremely important one to avoid having your systems compromised) we will often click through on the email and follow its instructions without a second thought.

Given the limited number of software providers for professional tax software, this particular attack doesn't really require the attacker to know what software a firm uses—if the attacker blankets all CPA firm addresses it has with an email claiming to be from, say, Lacerte or ProSystemfx, the "guess" will be right for a significant portion of the audience.

The IRS describes the attack as follows:

> In the new scheme identified as part of the IRS Security Summit process, tax professionals are receiving emails pretending to be from tax software companies. The email scheme requests the recipient to download and install an important software update via a link included in the e-mail.
>
> Once recipients click on the embedded link, they are directed to a website prompting them to download a file appearing to be an update of their software package. The file has a naming convention that uses the actual name of their software followed by an ".exe extension."
>
> Upon completion, tax professionals believe they have downloaded a software update when in fact they have loaded a program designed to track the tax professional's key strokes, which is a common tactic used by cyber thieves to steal login information, passwords and other sensitive data.

So what should preparers do? First, never click on email links to update software but rather visit the vendor's website to obtain updates and/or use the vendor's own software update system that is installed on your computer. Second, be sure all of your staff and partners are aware of this rule—because you should expect these scams will begin to include text that suggests that the "fix" must be undertaken immediately to avoid certain disaster (infiltration of your systems, client refunds being sent to the wrong bank accounts, etc.) to attempt to stampede someone in the firm to start the update.

Remote Access Attacks

The IRS stated in September of 2016 in News Release IR-2016-119 that the IRS had become aware of approximately two dozen cases of preparer's systems taken over by identity thieves. As the IRS described the issue:

> Thieves are able to access tax professionals' computers and use remote technology to take control, accessing client data and completing and e-filing tax returns but directing refunds to criminals' own accounts.
>
> Victims in the tax community learned of these thefts while reconciling e-file acknowledgements.

The IRS recommends specific steps that advisers should take to deal with this issue, in addition to the standard advice to run security scans and educate staff on phishing scams.

For this attack two specific steps would mitigate or eliminate the problem. First, tax advisers should use strong, unique passwords to access tax software. At least in that event a third party who gains access to the computer system will still face problems attempting to use the tax software. Second, firms should review any and all remote access software used by anyone—and that includes your outside IT consultant in addition to your employees.

Many advisers have been using remote access software for years to enable the CPA to work outside the office. But with that convenience comes a responsibility to insure the access is secured.

If the office is using the built-in remote access in Windows to handle this issue it is extremely important to keep Windows updated, use complex passwords to gain access to the system and have the service run through your router on a port other than the default one of 3389.

An attacker can scan ports to find Remote Desktop Protocol servers, though the experiences of some who have looked at logs suggest most potential attackers are lazy and simply try only the default port—so using a different port will reduce (but certainly not eliminate) the number of attempted attacks. A more determined attacker will likely just scan ports on the portion of your network exposed to the internet to find a port that responds to the RDP protocol.

If the firm is using a VNC based systems, many of the same issues will arise with that protocol as with RDP—and similar protections will apply.

An issue with both of these firm hosted solutions is that they require opening ports on your network to the internet and it will take little time for scanning bots to recognize the fact that your network responds to certain traffic. At the point your system has to be able to withstand attacks—and if the attacker becomes aware of an unpatched or known only to the attacker vulnerability in your solution, he/she will be able to gain access (thus the key requirement to patch immediately).

The use of third party web based solutions (Citrix GotoMyPC, LogMeIn, Chrome Remote Desktop) would eliminate having an opening into your network, but it provides a single point of access. For those services the use of strong, unique passwords is crucial.

As well, the use of two factor authentication (using systems like Google Authenticator) is strongly recommended to block access even if the passwords get loose. Be sure to look at how you can "recover access" if you claim to have lost your two factor device—too often organizations provide all too easy backdoor ways to assist customers regain access in those cases. You <u>want</u> your staff to be unable to access the system and not quickly regain access if they can't provide the two-factor authentication, so a process that takes days (not minutes) to turn off two factor authentication is to be strongly preferred.

It also makes sense to assume these parties will get to the "front door" (that is, as if sitting in front of your machine) so CPAs should make sure their machines quickly go to a lock screen if a session goes inactive for a period of time and that a password is required to gain access again. As well, the CPA should make a habit of always locking their machine whenever the CPA leaves his/her desk or gets ready to log out of a remote session (the Windows key and L pressed simultaneously by default will lock a Windows machine).

Finally, remind all members of your staff that the passwords they use to access your systems and tax software should be unique, complex passwords used only for this level of high risk access. Users are all too apt to use the same password everywhere—so when a high profile site loses control of its password database (LinkedIn and DropBox in 2012, Adobe in 2013) attackers will try that password/email combination on other sites—in fact, there are automated tools attackers can buy to test such lists of usernames passwords automatically on multiple sites.

These attacks will not be the only types of attacks firms will face and it seems likely the number of attempts to obtain firm information will increase in the future. The only real way to mitigate this risk is to combine both security software, hardware and policies and to remind staff and vendors of the various attack methods that can be used. Neither method by itself will be able to stop all attacks—rather, firms need a layered approach to securing client's data.

SECTION: 469
TAM FINDS TAXPAYER'S GROUPING NOT TAX MOTIVATED AND LEAD TO APPROPRIATE ECONOMIC UNITS

Citation: Technical Advice Memorandum 2016334022, 8/19/2016

How activities are grouped can have a major impact on a taxpayer's ultimate tax liability under the passive activity regulations provided under IRC §469. Generally, a proper grouping is governed by Reg. §1.469-4(c)(2).

That regulation provides the following test for proper grouping of activities:

> (2) Facts and circumstances test.
>
> Except as otherwise provided in this section, whether activities constitute an appropriate economic unit and, therefore, may be treated as a single activity depends upon all the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities. The factors listed below, not all of which are necessary for a taxpayer to treat more than one activity as a single activity, are given the greatest weight in determining whether activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469--
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> > (i) Similarities and differences in types of trades or businesses;
> >
> > (ii) The extent of common control;
> >
> > (iii) The extent of common ownership;
> >
> > (iv) Geographical location; and
> >
> > (v) Interdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

While the taxpayer has the right to designate an appropriate grouping, the IRS has the right to regroup activities on exam if the IRS can show that the current grouping is “inappropriate” as provided for in Reg. §1.469-4)(f)(1):

> (f) Grouping by commissioner to prevent tax avoidance
>
> > (1) Rule.
> >
> > The Commissioner may regroup a taxpayer's activities if any of the activities resulting from the taxpayer's grouping is not an appropriate economic unit and a principal purpose of the taxpayer's grouping (or failure to regroup under paragraph (e) of this section) is to circumvent the underlying purposes of section 469.

In Technical Advice Memorandum 2016334022 the IRS National Office was asked to determine if the agency could force a physician to combine an activity that was being reported as passive with his medical practice. If the IRS could succeed in doing that the income from the activity would no longer be passive—and presumably the physician would no longer able to deduct losses from other passive activities.

The physician owed a small interest in a partnership which itself owned an interest in a partnership that operated outpatient surgery services. Although the physician was not allowed to refer patients directly to that facility. Despite this fact, patients often chose this facility over a hospital due to lower costs.

The memorandum goes on to describe the arrangement as follows:

> According to the taxpayers’ submission, the income generated from H's indirect ownership in R (through P) is not tied to the number of surgeries he performs at R's facility or to the revenue generated by those surgeries. Moreover, even if H did not perform any surgeries at R, he would still receive the same proportionate share of R's profits allocable to his ownership interest in P. Prior to the opening of R in Year3, the surgeries that could not be performed in H's practice office were performed at the local Hospital. The opening of R did not affect H's income from his medical practice, but his patients were given a choice as to where to have the surgery performed. Moreover, the taxpayers argue that there are no interdependencies between X, Y, and R. H was compensated for his surgical services to patients through medical charges made by X or Y. The revenue generated by R through facility charges are separate from the charges for medical services rendered by H to his patients.

The examining agent believed that this situation was similar to one described in Reg. §1.469-4(f)(2) and the activities must be grouped together:

> **Example.** (i) Taxpayers D, E, F, G, and H are doctors who operate separate medical practices. D invested in a tax shelter several years ago that generates passive losses and the other doctors intend to invest in real estate that will generate passive losses. The taxpayers form a partnership to engage in the trade or business of acquiring and operating X-ray equipment. In exchange for equipment contributed to the partnership, the taxpayers receive limited partnership interests. The partnership is managed by a general partner selected by the taxpayers; the taxpayers do not materially participate in its operations. Substantially all of the partnership's services are provided to the taxpayers or their patients, roughly in proportion to the doctors' interests in the partnership. Fees for the partnership's services are set at a level equal to the amounts that would be charged if the partnership were dealing with the taxpayers at arm's length and are expected to assure the partnership a profit. The taxpayers treat the partnership's services as a separate activity from their medical practices and offset the income generated by the partnership against their passive losses.
>
> (ii) For each of the taxpayers, the taxpayer's own medical practice and the services provided by the partnership constitute an appropriate economic unit, but the services provided by the partnership do not separately constitute an appropriate economic unit. Moreover, a principal purpose of treating the medical practices and the partnership's services as separate activities is to circumvent the underlying purposes of section 469. Accordingly, the Commissioner may require the taxpayers to treat their medical practices

> and their interests in the partnership as a single activity, regardless of whether the separate medical practices are conducted through C corporations subject to section 469, S corporations, partnerships, or sole proprietorships. The Commissioner may assert penalties under section 6662 against the taxpayers in appropriate circumstances.

The National Office did not agree that this case was of the type described in the above example, noting that a key issue was that the doctor did not control the entity and had not established the entity to take an activity that he had been conducting in the practice and put it in an entity aiming to skirt the passive activity rules:

> In this case, an unrelated entity, Q, is majority owner of R and controls the day-to-day management of the surgical facility. H and the other partners of P do not have any direct or indirect control over the day-to-day operations of R, unlike H's clear control over Y. In addition, the services provided by R to patients of P's partners likely do not comprise substantially all of R's patient services, and it is even less clear that the services provided by R to the patients of P's partners will be roughly in proportion to the partners' interests in P (or their indirect interests in R).

The memorandum, noting that the reclassification regulation requires showing a principal purpose is avoiding the passive activity rules, thus concludes:

> Thus, while the example in § 1.469-4(f)(2) concludes that the partnership's activities do not separately constitute an appropriate economic unit, it is not necessarily inappropriate to treat P's activity as a separate economic unit in this case. Furthermore, we do not believe that the facts clearly demonstrate that H acquired his interest in P with a principal purpose of circumventing the underlying purpose of § 469. Accordingly, we conclude that the Commissioner would not have the authority to regroup the taxpayers' interests in X, Y, and P as a single activity under § 1.469-4(f) to prevent tax avoidance, even if we were to otherwise conclude that taxpayers' other groupings of activities do not constitute appropriate economic units under § 1.469-4(c).

The memorandum goes on to find, in addition, that the taxpayer's grouping in this case creates appropriate economic units, noting:

> We further conclude that an analysis under the five-factor test of § 1.469-4(c) demonstrates that there may be more than one reasonable method for grouping the taxpayers' activities into appropriate economic units in this case. While the trade or business activities of X, Y, and R (held by H through P) are similar in that they are all in the medical industry and involve the provision of medical services to patients, X, Y, and R provide different types of medical services. Certain surgeries cannot be performed at X's or Y's practice office, and diagnostic and post-operative care is not provided through P or R. H does not have the same kind of management control over R that H exercises over his own medical practice conducted through X or Y. H has different ownership interests among X, Y, and P. It also appears from the facts that X, Y, and R are in different locations and do not share employees or recordkeeping. Accordingly, we conclude that an analysis of the facts and circumstances of this case under § 1.469-4(c) does not result in a determination that the taxpayers' grouping of the interests in X, Y, and P as separate activities is clearly inappropriate for purposes of either § 1.469-4(e)(2) or § 1.469-4(f).

The memorandum provides some insight into applying the appropriate economic grouping provisions in the regulations, and a reminder that agents have to both show an intent to evade §469's limitations and an inappropriate economic grouping if the agent seeks to regroup activities on exam. It also provides a reminder that just because a case or example seems somewhat similar to a taxpayer's situation, an analysis must always be undertaken to note any differences in the taxpayer's facts and those in case/example—and then decide if those differences would lead to a different result.

SECTION: 1234A
INCOME RECEIVED FROM FORFEITURE OF DEPOSITS ON THE SALE OF A §1231 ASSET DOES NOT REPRESENT CAPITAL GAINS UNDER §1234A

Citation: CRI-Leslie LLC et al. v. Commissioner, 147 T.C. No. 8, 9/7/16

The taxpayer in *CRI-Leslie LLC et al. v. Commissioner*, 147 T.C. No. 8 reported the forfeiture of $9.7 million deposits it retained when a buyer failed to close on the sale of a hotel property of the taxpayer as a capital gain. The taxpayer argued that this treatment was the one provided for payments received for contract terminations of this sort by IRC §1234A.

Many CPAs may not immediately recognize that particular reference in the Internal Revenue Code, though some readers may recognize that section as the one that created a bit of stir when the Tax Court turned to in its later reversed opinion in the case of *Pilgrim's Pride Corporation v. Commissioner* (141 TC No. 17, reversed, CA 5, 115 AFTR 2d ¶ 2015-477).

Similar to *Pilgrim's Pride*, the taxpayer argued that because, in its view, the transaction fit the definition found in §1234A, the result was treatment as capital gain (in *Pilgrim's Pride* the Tax Court had ruled on a loss). And, again, the question is whether that view of §1234A's reach is correct.

To relieve the suspense for those who can't wait to see the details of this mysterious §1234A, the provision provides:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—
>
> > (1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
> >
> > (2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,
>
> shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation arrangement).

There is no question that a right or obligation had expired in this case and generated a gain of $9.7 million. The IRS objected that the classification of the asset to which the right existed—that it simply wasn't a capital asset in the hands of the taxpayer.

The taxpayer had been operating a hotel in the property in question, thus using the property in its trade or business.

IRC §1221 is entitled "Capital asset defined" so the IRS argued this is where will find the definition of a capital asset. While §1221 provides initially that any property owned by the taxpayer is a capital asset, it then goes on to exclude specific types of property from that classification. The IRS pointed to the exception found at IRC §1221(a)(2) which excludes from the definition of capital assets "property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business…" The hotel property falls squarely within this definition, the IRS pointed out, rendering the property not a capital asset and, therefore, the expiration of these contract rights outside the reach of §1234A.

But the taxpayer points out that the property is covered by IRC §1231. That includes real property "used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year…" which is not inventory in the hands of the taxpayer.

IRC §1231(a) provides specifically:

(a) General rule

(1) Gains exceed losses

If—

(A) the section 1231 gains for any taxable year, exceed

(B) the section 1231 losses for such taxable year,

such gains and losses shall be treated as long-term capital gains or long-term capital losses, as the case may be.

Thus, the taxpayer argues, since the sale would have generated what was effectively a long term capital gain had the sale gone through, Congress must have intended to include this sort of property in the type covered by §1234A. And, the taxpayers argued, the legislative history of §1234A supports the view that Congress had just this intent.

The Tax Court noted that while legislative history and other evidence of Congressional intent may be useful in interpreting ambiguous provisions in the law, if the law itself is unambiguous then the law is applied as Congress wrote it, not as some evidence might suggest Congress intended to write the law.

While, as the Court concedes, some commentators have referred to §1231 assets as “quasi-capital assets,” §1221(a)(2), cited above, clearly classifies these assets as not capital assets.

Rather, §1231 provides that, if certain conditions are met on the sale of this non-capital asset, the standard “ordinary gain” treatment won’t apply and the gain will be treated as long-term capital gains or losses.

Based on this, the Court holds:

> Since section 1234A expressly refers to property that is "a capital asset in the hands of the taxpayer" and no other type of property, and since property described in section 1231 is excluded explicitly from the definition of “capital asset” in section 1221, we must conclude that the plain meaning of “capital asset” as used in section 1234A does not extend to section 1231 property. We therefore are not convinced by petitioner's argument that the statute is inherently ambiguous.

That doesn’t mean that a forfeited deposit on the sale of real property would never fall under §1234A’s rule—but it does mean how the property is used is key. As the opinion continues:

> If one looks to the plain meaning of section 1234A, it is true that the treatment of gains and losses from terminations of rights or obligations relating to property will depend on whether that property is a capital asset or is described in section 1231. Forfeited deposits from the termination of a contract to sell a hotel are taxed at capital gain rates if the hotel is held as a passive investment. The same forfeited deposits are taxed as ordinary income if the hotel is used in a trade or business. But regardless of any potential intellectual inconsistency in this disparate treatment, the plain meaning of section 1234A remains inescapable. We do not see any ambiguity in the apparent meaning of the statute.

It’s very easy for practitioners to see real property §1231 asset as capital assets since, from a practical perspective, sales of such assets by taxpayers generate a gain that eventually is treated on the tax return just like it was a gain from the sale of a true capital asset. But this case reminds us that the asset is not itself a capital asset—it only gets this special treatment upon sale, and then only when §1231 gains exceed §1231 losses.

In this case the details of the Code section being relied upon by the taxpayer mattered—it did not state that it applied to assets where a gain on a sale would be treated as capital, but rather that it applied only to related assets that were capital assets in the hands of the taxpayer. The Tax Court held that this was a distinction with a difference in this case.

SECTION: 1362
SHAREHOLDER THAT BOUGHT BACK FORMER S CORPORATION DENIED EARLY RE-ELECTION RELIEF BY IRS

Citation: PLR 201636033, 9/2/16

A taxpayer that ended up buying back his S corporation stock from a corporation he had sold it to found the IRS was not willing to waive the requirement under IRC §1362(g) that the corporation would not be allowed to re-elect S status for five years (PLR 201636033).

In this case the individual, holder of 100% of the S corporation's stock, sold the stock to another corporation. The transfer of the shares to the corporation resulted in a termination of the corporation's S status at that time. Less than five years later the shareholder bought the stock back from the buyer—but now had a C corporation.

IRC §1362(g) provides:

> (g) Election after termination
>
> If a small business corporation has made an election under subsection (a) and if such election has been terminated under subsection (d), such corporation (and any successor corporation) shall not be eligible to make an election under subsection (a) for any taxable year before its 5th taxable year which begins after the 1st taxable year for which such termination is effective, unless the Secretary consents to such election.

In Reg. §1.1362-5(a) the IRS outlines the general requirements a corporation must meet to obtain the IRS's consent via a private letter ruling:

> **(a) In general.**
>
> Absent the Commissioner's consent, an S corporation whose election has terminated (or a successor corporation) may not make a new election under section 1362(a) for five taxable years as described in section 1362(g). However, the Commissioner may permit the corporation to make a new election before the 5-year period expires. The corporation has the burden of establishing that under the relevant facts and circumstances, the Commissioner should consent to a new election. The fact that more than 50 percent of the stock in the corporation is owned by persons who did not own any stock in the corporation on the date of the termination tends to establish that consent should be granted. In the absence of this fact, consent ordinarily is denied unless the corporation shows that the event causing termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation and was not part of a plan on the part of the corporation or of such shareholders to terminate the election.

The taxpayer in this case asked the IRS, considering the situation, to allow for an early election back into S status. The IRS declined to do so.

As the ruling explained:

> In the present case, based on all of the facts submitted and representations made, all of the stock in X is currently held by A, who owned all of the stock in X on the date of the termination. Thus, not more than 50 percent of the stock in X is owned by persons who did not own stock in X on the date of the termination. Further, the event causing the termination, the acquisition by a C corporation, Y, of the stock of X, was reasonably within the control of X and its shareholders.
>
> Accordingly, X is denied permission to reelect to be an S corporation prior to the expiration of the 5-year period prescribed by § 1362(g) of the Code.

We certainly don't know all of the facts in this case, but presumably the taxpayer did not intend to buy the stock back after he sold the stock to the corporation in question, but some event or events lead to that eventuality. But it's important to note that the regulation only addresses whether the event causing termination was under the control of the shareholder. Clearly the taxpayer sale of stock to a C corporation was an event which could easily be foreseen to terminate the S election.

Similarly, the regulation simply looks at the shareholders at the termination and those shareholders at the time relief is requested. The fact that this individual was not a shareholder in the interim is also not a factor provided for in the regulations.

While the regulation does not absolutely state that relief will not be granted if neither of these conditions are met, the IRS did not decide to grant relief in this ruling as an "out of the ordinary" case.

SECTION: 3121
PAYMENTS TO S CORPORATION SHAREHOLDER WERE LOAN REPAYMENTS, NOT DISGUISED WAGES

Citation: Scott Singer Installations, Inc. v. Commissioner, TC Memo 2016-161, 8/24/16

Normally when we discuss a case of an S corporation shareholder who performed services for the entity, reported no salary but received cash we end up with a finding by the Court that the payments represented disguised salary. But that is because, normally, the shareholder has been trying to argue the payments represented a distribution from the S corporation.

In the case of *Scott Singer Installations, Inc. v. Commissioner*, TC Memo 2016-161 the taxpayer did not argue that the payments represented distributions and, in fact, the taxpayer agreed that, as a corporate officer, he would be an employee of the corporation. But the taxpayer argued in this case that the payments amounted to repayments of loans he had made to the corporation—and the Tax Court agreed with the taxpayer.

The IRS was skeptical of the view that there had actually been loans made to the S corporation, though not that funds had been advanced to the corporation. Rather the IRS found that those advances were capital contributions instead of loans—and, thus, the payments were not repayments of loans.

The Tax Court noted that the question of whether advances are capital contributions or loans must be evaluated on a case by case basis, taking into account all facts and circumstances. The opinion notes:

> Courts have established a nonexclusive list of factors to consider when evaluating the nature of transfers of funds to closely held corporations. Such factors include: (1) the names given to the documents that would be evidence of the purported loans; (2) the presence or absence of a fixed maturity date; (3) the likely source of repayment; (4) the right to enforce payments; (5) participation in management as a result of the advances; (6) subordination of the purported loans to the loans of the corporation's creditors; (7) the intent of the parties; (8) identity of interest between creditor and stockholder; (9) the ability of the corporation to obtain financing from outside sources; (10) thinness of capital structure in relation to debt; (11) use to which the funds were put; (12) the failure of the corporation to repay; and (13) the risk involved in making the transfers. *Calumet Indus., Inc. v. Commissioner*, 95 T.C. 257, 285 (1990); see also *In re Lane*, 742 F.2d 1311, 1314-1315 (11th Cir. 1984).

The Court then boils down the test to a simple question:

> However, the ultimate question is whether there was a genuine intention to create a debt, with a reasonable expectation of repayment, and whether that intention comported with the economic reality of creating a debtor-creditor relationship. *Litton Bus. Sys., Inc. v. Commissioner*, 61 T.C. 367, 377 (1973).

In this case, the Court outlined the facts as follows:

> In order to fund petitioner's growth, Mr. Singer began raising money from various sources. In 2006 Mr. Singer established a $224,000 home equity line of credit. In less than a year Mr. Singer had drawn on the entire line of credit and advanced the funds to petitioner. In 2006 Mr. Singer also established an $87,443 line of credit by refinancing a home mortgage. He likewise advanced the entire amount to petitioner within the same year. In 2008 Mr. Singer established a 115,000 general business line of credit and advanced all the funds to petitioner. Mr. Singer also borrowed $220,000 from his mother and her boyfriend and advanced all the funds to petitioner throughout 2007 and 2008. In sum, Mr. Singer advanced a total of $646,443 to petitioner between 2006 and 2008. Petitioner reported all of the advances as loans from shareholder on its general ledgers and Forms 1120S, U.S. Income Tax Return for an S Corporation, but there were no promissory notes between Mr. Singer and petitioner, there was no interest charged, and there were no maturity dates imposed.

The Court noted, though, that while the business was initially profitable, following the 2008 real estate crisis the company's fortunes took a nasty turn for the worse. That forced the taxpayer, who no longer could obtain any commercial financing, rather now obtaining money from this mother and her boyfriend.

The Court noted that the corporation had always reported the amounts in question on its books as loans on its books and tax returns, though no interest had been charged, no notes signed and no maturity dates established. Despite those issues, the Court found that through 2008 the advances did represent loans—the evidence suggested the shareholder intended to be repaid these funds and it was reasonable to believe the corporation would do so.

However, the Court found that the later advances represented capital contributions, as the large operating losses no longer made it reasonable to assume that the corporation would be able to repay the advances. Even though the Court found the shareholder still intended for these advances to be loans, the lack of a reasonable prospect for repayment rendered the payments capital contributions.

As the opinion notes:

> When neither petitioner nor Mr. Singer was able to raise funds from unrelated third parties, Mr. Singer must have recognized that the only hope for recovery of the amounts previously advanced to petitioner was an infusion of capital subject to substantial risk. After 2008 the only source of capital was from Mr. Singer's family and Mr. Singer's personal credit cards. No reasonable creditor would lend to petitioner. Accordingly, we find that advances made in 2008 and earlier were bona fide loans and that advances made after 2008 were more in the nature of capital contributions.

But the good news for the taxpayer was that the amount of payments in question for the years under exam were less than the amounts the Court had found represented loans—and thus the Court found no salary payments to the shareholder.

SECTION: 4973
TAXPAYER MISUNDERSTOOD RELIEF PROVISION FOR TAKING EXCESS CONTRIBUTION DISTRIBUTION BY DUE DATE OF RETURN

Citation: Wu v. United States, 118 AFTR 2d ¶2016-5154, CA 7, 8/29/16

The taxpayers in the case of *Wu v. United States*, 118 AFTR 2d ¶2016-5154, CA 7 the taxpayers recognized they had made an error and made excess contributions to their IRAs in 2007, failed to grasp the error of their position for a number of years, and then withdrew the excess funds and earnings in 2010. The taxpayers recognized that they owed an excess contribution tax of 6% (IRC §4973) for each year there remained an excess contribution.

But what they disputed was whether that excess contributions tax of 6% should apply to 2009 since they had withdrawn the funds by the unextended due date of their 2009 income tax return. IRC §4973(b) provides that "any contribution which is distributed from the individual retirement account or the individual retirement annuity in a distribution to which section 408(d)(4) applies shall be treated as an amount not contributed."

IRC §408(d)(4) is the section related to taking a repayment of excess contributions and earnings prior to the due date of a taxpayer's tax return. That section provides:

> (4) Contributions returned before due date of return
>
> > Paragraph (1) does not apply to the distribution of any contribution paid during a taxable year to an individual retirement account or for an individual retirement annuity if—
> >
> > > (A) such distribution is received on or before the day prescribed by law (including extensions of time) for filing such individual's return for such taxable year,
> > >
> > > (B) no deduction is allowed under section 219 with respect to such contribution, and
> > >
> > > (C) such distribution is accompanied by the amount of net income attributable to such contribution.
> >
> > In the case of such a distribution, for purposes of section 61, any net income described in subparagraph (C) shall be deemed to have been earned and receivable in the taxable year in which such contribution is made.

The taxpayer's view was that since they took the funds out before April 15, 2010, the 6% additional tax would not apply to 2009.

The appellate panel, agreeing with the trial court, found that the Wu's interpretation was not correct.

The panel holds:

> That provision, as we have noted, literally applies when a contribution paid into an IRA "during a taxable year" is distributed "on or before the day prescribed by law (including extensions of time) for filing such individual's return for such taxable year." As the government points out, the phrase "such taxable year" refers to the taxable year in which the contribution was made to the account. The Wus made their excess contributions in 2007, so for that tax year they could have avoided incurring the annual tax on excess contributions by withdrawing the excess before the return-filing deadline for that taxable year, i.e., April 15, 2008. But for any later year the Wus could avoid the annual tax only by taking the distribution before the taxable year ended.
>
> The position advocated by the Wus ignores the language in § 408(d)(4) and also is an ill fit with the text of § 4973(b). Under § 4973(b), the consequence of taking a qualifying distribution under § 408(d)(4) is that the amount of the withdrawal "shall be treated as an amount not contributed." But the Wus are not asking that their 2007 contributions be treated as if they were never contributed (after all, they conceded liability for tax years 2007 and 2008); they are asking that those contributions be eliminated from the calculation for 2009 alone.

SECTION: 6230
MANAGING PARTNER NOT BARRED BY TEFRA FROM RAISING PARTNER LEVEL REASONABLE CAUSE PENALTY DEFENSE

Citation: McNeill v. United States, CA10, No. 15-8095, 9/6/16

A majority of a Tenth Circuit panel ruled, in the case of *McNeill v. United States*, CA10, No. 15-8095, that the managing partner in a TEFRA partnership was not barred, as a matter of law, from raising a reasonable cause/good faith penalty defense in his individual proceeding. That was despite the fact that the IRS had rejected the defense when raised by the partnership, with Mr. McNeill as the Tax Matters Partner, in the examination of the partnership.

The District Court had dismissed the case, holding that Mr. McNeill was barred from raising this defense by TEFRA. The Court did not use any judicial doctrine to bar this matter (such as *res judicata,* holding the matter had already been litigated), but rather found that TEFRA itself barred the defense.

As the majority opinion points out:

> Instead of passing on the question whether Mr. McNeill could prove reasonable cause and good faith for his tax position, the district court held it was precluded from doing so. Not by operation of the judicial doctrines of claim or issue preclusion. The judicial order dismissing the partnership level case expressly indicated that it was without prejudice and no order in that case ever passed on the reasonable cause/good faith question. Neither the district court in its decision nor the government in its brief before us suggests this was sufficient to trigger claim or issue preclusion principles. Instead, the district court held only that TEFRA itself – as a matter of statute – precludes a managing partner like Mr. McNeill from pursuing at the partner level a reasonable cause/good faith defense where (as here) the IRS in administrative proceedings has rejected the partnership's assertion of reasonable cause/good faith at the partnership level.

The provision the District Court invoked is found at IRC §6230(c)(4) which provides:

> No review of substantive issues. – For purposes of any claim or suit under this subsection, the treatment of partnership items on the partnership return, under the settlement, under the final partnership administrative adjustment, or under the decision of the court (whichever is appropriate) shall be conclusive. In addition, the determination under the final partnership administrative adjustment or under the decision of the court (whichever is appropriate) concerning the applicability of any penalty… which relates to an adjustment to a partnership item shall also be conclusive. Notwithstanding the preceding sentence, the partner shall be allowed to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment.

The majority points out the last sentence allows a partner to raise partner specific defenses and that judicial precedent has held that this is both a partnership and partner level issue:

> The Supreme Court itself has suggested that under TEFRA a partner's reasonable cause and good faith defense cannot be "conclusively" determined at the partnership level. *Woods*, 134 S. Ct. at 564 ("[T]he partner may nonetheless have acted in good faith with reasonable cause, . . . see § 6664(c)(1). [This issue cannot] be conclusively determined at the partnership level."). And the lower court cases the government attempts to rely upon are perhaps even less helpful to its cause. In *Stobie Creek Investments, LLC v. United States*, 82 Fed. Cl. 636 (2008), the partnership argued that "the partnership-level trial should resolve conclusively the reasonable cause defenses of each of the individual partners." *Id*. at 658. Meanwhile, the government (consistent with its regulations, of course) contended that the reasonable cause/good faith defense is more properly adjudicated at the partner level -- and it prevailed upon the court to agree, for the court proceeded to hold that TEFRA "explicitly disallows adjudication of partner-level defenses" like reasonable cause/good faith "in a partnership-level proceeding." *Id*. Much the same story played out in *Klamath Strategic Investment Fund ex rel. St. Croix Ventures v. United States*, 568 F.3d 537, 548 (5th Cir. 2009), where the government again argued that the reasonable cause/good faith defense "is a partner-level defense that can only be asserted in separate refund proceedings." Id. at 547.

The Court noted that their ruling was a limited one, and certainly hinted that *res judicata* might have been a better way to address the problem:

> In saying this much we do not mean to deny that there's often a strong identity of interests between a managing or tax matters partner and a partnership. Neither do we mean to suggest that issues addressed in partnership level proceedings always may be contested by individual partners in partner level proceedings. So, for example, our case doesn't involve the question whether TEFRA would (or could) permit parties to relitigate matters that the doctrine of issue preclusion might otherwise forbid thanks to their final determination in an earlier judicial proceeding by parties with sufficient commonality of interests to qualify as privies. See *Entek GRB, LLC v. Stull Ranches, LLC*, 763 F.3d 1252, 1258 (10th Cir. 2014) (discussing use of offensive issue preclusion against parties and their privies). The only question before us is whether, when no party argues that a final judicial ruling exists that triggers judicial preclusion principles, an adverse decision in a TEFRA administrative partnership level proceeding prevents a managing (or tax matters) partner from pursuing a reasonable cause/good faith defense in later partner level proceedings.

The dissenting opinion argued that, in fact, he was not asserting any actual reasonable-cause defense that had not been asserted in the partner level proceedings—and thus, the opinion reasoned the District Court had properly concluded that, as a matter of law, those issues were not up for reconsideration:

> I don't read the third sentence as making the second sentence's conclusive penalty determinations inconclusive for partner-level defenses in penalty-refund actions. Instead, I read the third sentence as ensuring that partners can always bring partner-level defenses subject to any conclusive determinations being applied in those partner-level proceedings. And many times, partners can prevail at the partner level because none of the FPAA's conclusive determinations defeat their partner-level defense. For instance, those partners may not have known or done all that the partnership's managing partner knew and did. And even here, if Mr. McNeill had somehow asserted that his own reasonable-cause defense differed from Dulwich's reasonable-cause defense based on his own conduct and intent, he might still have prevailed despite the conclusive effect TEFRA gives to the FPAA's penalty determinations.
>
> Nor does the TEFRA regulation guarantee all partners an absolute right to assert reasonable-cause defenses in their partner-level refund actions. It does, however, allow partner-level defenses based on reasonable cause if the defenses are personal to the partner and "cannot be determined at the partnership level." 26 C.F.R. § 301.6221-1(d). Here, because the reasonable cause Mr. McNeill asserted for Dulwich and later for himself are the same, Mr. McNeill's partner-level defense based on his reasonable cause for his tax activity could be and was determined at the Dulwich partnership level.