Current Federal Tax Developments

Nichols Patrick CPE a Division of the Loscalzo Institute

Contents

LOSCALZO INSTITUTE
A KAPLAN COMPANY

SECTION: 36B
IRS RELEASES INFLATION ADJUSTED INDIVIDUAL AFFORDABLE CARE PERCENTAGES FOR 2018

Citation: Revenue Procedure 2017-36, 5/4/17

In Revenue Procedure 2017-36 the IRS provided the 2018 inflation adjusted amounts for provisions related to the individual health care mandate and credit rules under the Affordable Care Act for 2017.

Matters are clearly in flux, as the IRS published this table on the same day that the House of Representatives passed the American Health Care Act of 2017 and sent it on to its fate in the United States Senate. But, for now, these numbers are scheduled to be in effect for 2018.

The ruling updates the Applicable Percentage Table for 2017. The able is used to compute the percentage which is individual is responsible for when purchasing the Second Lowest Cost Silver policy, with the premium amount in excess of that being potentially available as a credit. The percentage increases linearly over the ranges specified in the table.

Household income percentage of Federal poverty line:	Initial percentage	Final percentage
Less than 133%	2.01%	2.01%
At least 133% but less than 150%	3.02%	4.03%
At least 150% but less than 200%	4.03%	6.34%
At least 200% but less than 250%	6.34%	8.10%
At least 250% but less than 300%	8.10%	9.56%
At least 300% but not more than 400%	9.56%	9.56%

The percentage used to test for whether a taxpayer had available affordable employer sponsored minimum essential coverage under IRC §36B(c)(2)(i)(II) will be 9.56% of the taxpayer's household income in 2018.

Finally, the percentage of household income that is used under IRC §5000A to determine if the individual qualifies for the exception from the shared responsibility penalty for not having available affordable coverage will decrease to 8.05%

SECTION: 223
HSA LIMITS INCREASED FOR 2018
Citation: Revenue Procedure 2016-28, 5/4/17

In Revenue Procedure 2017-37 the IRS provided updated numbers for 2018 for health savings accounts and the related high deductible health plans.

The annual contribution limits for 2018 for health savings accounts under IRC §223(b)(2)(A) will be:

- Self-only coverage: $3,450
- Family coverage: $6,900

The minimum deductible for a high deductible health plan under IRC §223(c)(2)(A) for 2018 will be:

- Self-only coverage: $1,350
- Family coverage: $2,700

The maximum out of pocket expenses, including deductible, co-payments and other items *except* premiums for a high deductible health plan for 2018 may not exceed:

- Self-only coverage: $6,650
- Family coverage: $13,300

SECTION: 355
NORTH SOUTH SPINOFF FOUND TO BE TAX FREE BY IRS
Citation: Revenue Ruling 2017-9, 5/3/17

In Rev. Rul. 2017-9 the IRS ruled on two different transactions involving three related corporations, one of which gives the IRS position on "North-South" spinoff transactions that the IRS had placed on its no rule list in 2013.

The first situation, and the one which proves to be the most taxpayer friendly, involved three related corporations involved in a North-South spinoff. P, the parent corporation, owns 100% of D, what will eventually be the distributing corporation in this arrangement. D owns 100% of C, a corporation whose stock the taxpayer wishes to transfer upstream to P.

P has an operating business (Business A) which P has been engaged in for more than five years and qualify under the active conduct of a trade or business rule of IRC §355(b). C also has an operating business (Business B) which C has also been engaged in for than 5 years and which also qualifies under IRC §355(b). D, however, does not have any operating trade or business.

That's a problem because the taxpayer wishes to transfer stock in C to P in a tax-free manner. Section 355 would fit the bill but D must distribute stock of a company with an active trade or business and retain a qualified active trade or business. D is missing the latter.

The fair value of Business A is $100X, while the fair value of the C stock is $25X.

P attempts to solve the Section 355 active business problem for D by transferring the assets and activities of Business A to D. P believes this transaction qualifies for tax free treatment under IRC §351 and D would inherit P's activities in conducting the business. Following that transfer, D, which now has an active business to retain, transfers the stock of C to P in a transaction that the group believes qualifies for Section 355 nonrecognition treatment.

The potential issue would be if the IRS used the step transaction doctrine to treat those transaction as a single transaction where P exchanged its operating business, receiving C stock in payment from D. In that case, the group has a taxable exchange and, potentially, a lot of tax due.

The IRS notes this as the agency begins its discussion of this transaction:

> The federal income tax consequences to P and D in Situation 1 will depend on whether the Date 1 and Date 2 transfers are treated as separate transactions. Because they are undertaken pursuant to the same overall plan, a question arises as to whether the two transactions are part of a single reciprocal transfer of property — an exchange.

The IRS also outlines the disastrous consequences to the parties if this is treated as a single transaction:

> If the Date 1 and Date 2 transfers are integrated into a single exchange for federal income tax purposes, P would be treated as transferring its Business A property to D in exchange for a portion of the C stock in an exchange to which § 1001 applies. In such an exchange, gain or loss would be recognized

> to P on the transfer of its property to D; gain or loss would be recognized to D, under § 1001(a), upon its transfer of 25 percent of the C stock to P in exchange for the property transferred to it. In addition, § 355 would not apply to any part of the distribution of C stock because D would not have distributed stock constituting § 368(c) control of C. Gain would be recognized to D, under § 311(b), upon the distribution of the remaining 75 percent of the C stock with respect to P's stock in D to which § 301 would apply.

Realistically, with that result it is highly unlikely anyone would enter into a transaction like this except out of ignorance. But is that the proper result?

Interestingly, rather than using standard analyses to determine if the step transaction doctrine should apply (such as the "but-for" test which this transaction would appear to fail—the transfer from P would not have taken place but for the need to get an operating business into D to allow for a 355 distribution), the IRS analyzed the matter differently:

> The determination of whether steps of a transaction should be integrated requires review of the scope and intent underlying each of the implicated provisions of the Code. The tax treatment of a transaction generally follows the taxpayer's chosen form unless: (1) there is a compelling alternative policy; (2) the effect of all or part of the steps of the transaction is to avoid a particular result intended by otherwise-applicable Code provisions; or (3) the effect of all or part of the steps of the transaction is inconsistent with the underlying intent of the applicable Code provisions. See *H.B. Zachry Co. v. Comm'r*, 49 T.C. 73 (1967); *Makover v. Comm'r*, T.C. Memo 1967-53; Rev. Rul. 78-330, 1978-2 C.B. 147. Sections 351, 355, and 368 generally allow continued ownership of property in modified corporate form without recognition of gain. See *American Compress & Warehouse Co. v. Bender*, 70 F.2d 655 (5th Cir. 1934), *cert. denied*, 293 U.S. 607 (1934); § 1.1002-1(c); Rev. Rul. 2003-51.

The IRS did not find that the steps taken were contrary to the intent of Sections 351 or 355, and thus the IRS granted that the transfer of stock from D to P would be a valid Section 355 transfer.

The IRS also clarified that the operating business could also have come from a subsidiary of P, noting:

> The federal income tax consequences would be the same (qualification under § 355) if, instead of acquiring an active trade or business in a § 351 transfer from P to D, D acquired an active trade or business from a subsidiary of P in a cross-chain reorganization under § 368(a)(1). See Rev. Rul. 74-79.

SECTION: 905
FACT THAT TAXPAYER MIGHT HAVE TO REPAY TAXES RECEIVED BACK FROM UK DID NOT MAKE THE PAYMENT NOT A REFUND

Citation: Sotiropoulos v. Commissioner, TC Memo 2017-75, 5/1/17

In the case of *Sotiropoulos v. Commissioner*, TC Memo 2017-75 argued that amounts she received from the United Kingdom for claims she submitted related to what the UK government was claiming in UK courts as tax shelters were not tax refunds. She noted that the UK government was challenging those shelters in court and she believed it was likely she would need to repay those funds.

When a taxpayer claims a foreign tax credit under IRC §905(c)(1), she is required to notify the IRS of any later refund of some or all of the taxes used to compute the credit pursuant to IRC §905(c)(3), normally by filing an amended return.

The taxpayer in this case had taxes withheld from her wages when she worked in the United Kingdom, claiming credits for the amounts withheld from her wages. However, having invested in UK film partnerships, she filed claims for refund of a large portion of the taxes withheld from wages.

The UK government paid those claimed amounts to the taxpayer, but the government still had the right to later challenge those refunds and, in fact, court challenges related to those film partnerships are now underway. Ms. Sotiropoulos pointed that her legal counsel had informed her the UK government was likely to prevail in court and she would eventually have to repay the amounts she had received from the UK government.

Since it was possible and, indeed, likely she would need to pay back those payments, she did not believe she yet had to inform the IRS of those amounts and, as well, she did not yet owe the U.S. government any amounts for a reduction in foreign tax credits. And, in any event, the law allows the IRS to collect such excess foreign tax payments at the time of the refund regardless of the regular statute (see IRC §905). She also believes that its likely that if she is ordered to pay back the UK taxes, she would no longer have income that would allow her to take advantage of the tax benefit of a foreign tax credit for that year.

The IRS argued, first, that she could not challenge this issue in Court. Although the agency had issued a notice of deficiency in the case, the Code provides that the tax due under the refund rule is not subject to the deficiency provisions of the IRC (IRC §905(c)(3)). Thus, the IRS argued, the Tax Court had no jurisdiction to rule on this matter.

The Tax Court did not buy that argument. The Court had held earlier in this case (see the opinion in *Sotiropoulos v. Commissioner*, 142 TC 269 (2014)) that while it was true if the payment were a tax refund the Tax Court did not have jurisdiction, the Court always has jurisdiction to determine if it had jurisdiction. Since the issue was whether this payment really *was* a tax refund, the Court had to answer the question of whether the payment was a refund to determine if it had jurisdiction.

While the taxpayer won on that issue, the remainder of the case did not go so well for her. The Tax Court noted that references in U.S. tax should be "read to incorporate domestic tax concepts absent a clear congressional expression that foreign concepts should control."

The Tax Court looked first at the definition of a refund:

> A "refund" is commonly defined to include "[t]he return of money to a person who overpaid, such as a taxpayer who overestimated tax liability or whose employer withheld too much tax from earnings." *Black's Law Dictionary 1472* (10th ed. 2014); see also *Paulson v. United States*, 78 F.2d 97, 99 (10th Cir. 1935) ("Refund means to pay back, return, restore, make restitution. That is the ordinary and popular concept of the word."). The amount returned to petitioner by HMRC for each year, which represented U.K. income tax withheld by her employer in excess of the tax shown as due on her U.K. return, falls easily within the ordinary meaning of the word "refund."

The fact that the UK government could later challenge her right to the payment and force her to pay it back did not make such payments different from what are commonly referred to as refunds under U.S. tax principles. As the Court notes:

> For U.S. tax purposes, the term "refund" does not connote finality or the final determination of a tax liability. Every year millions of Americans file Forms 1040 showing an overpayment and indicating the amount of the overpayment they want "refunded" to them. In the absence of concerns about identity theft or other unusual circumstances, the IRS usually pays such refunds more or less automatically. Notwithstanding payment of such refunds, the IRS routinely examines such returns and, if it concludes that the taxpayer incorrectly computed the tax, it may assess additional tax after exhausting deficiency procedures. In short, the fact that a taxpayer may ultimately have to repay the money initially refunded to her does not mean that she did not get a "refund."

The Court also found irrelevant her assertion that due to the facts in her case, forcing to pay tax on the refund would result in double tax when later paid the money back. The potential for the lack of a tax benefit later doesn't change the result as the Court noted:

> It often happens that taxpayers, because of individual circumstances or passage of time, are unable to derive full benefit from contingent tax assets they have booked or expect to receive, such as carryforwards of foreign tax credits, net operating losses, passive losses, or investment interest. This does not demonstrate any structural defect in the Code and does not give rise to "double taxation." It simply reflects the facts that the future is unpredictable and that taxable income must be determined on an annual basis.

Thus, the Tax Court found that she had received a refund and that the IRS had the right to force her to pay back a large portion of her foreign tax credits previously claimed.

SECTION: 1202
LABORATORY FOUND NOT TO BE HEALTH SERVICE BUSINESS FOR §1202 STOCK PURPOSES

Citation: PLR 201717010, 4/28/17

The exclusion for gain from the sale of qualified §1202 stock now is at 100% for stock acquired after September 27, 2010 so long as the taxpayer holds it for five years. But a number of businesses are excluded from issuing such favored stock. In PLR 201717010 the IRS looks at whether a taxpayer's business would cause it to fail the test.

The potential benefit of §1202 is one of the reasons a small business might still consider forming as a C corporation (S corporation stock does not qualify for §1202 treatment) if it can otherwise meet the requirements, which will include a limit on gross assets, an "active business" test and the business cannot be on the list of "prohibited" businesses found at IRC §1202(e)(3).

The businesses that cannot qualify for §1202 stock treatment are:

- Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services,
- Any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,
- Any banking, insurance, financing, leasing, investing, or similar business,
- Any farming business (including the business of raising or harvesting trees),
- Any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A (percentage depletion), and
- Any business of operating a hotel, motel, restaurant, or similar business.

This PLR involved a business that was concerned it might be deemed to be performing health services and sought a ruling that its operations were not health services for purposes of IRC §1202.

The Company's business is described in the ruling as follows:

> Specifically, Company uses proprietary X and other technologies for the precise detection of B. You represent that Company is the only person that can legally perform X testing and that its expertise is limited to its patented X testing.

> Company analyzes the results of X testing and then prepares laboratory reports for healthcare providers. Company's clients are doctors and other healthcare providers. You represent that the information the Company provides in a typical laboratory report only includes a summary of z detected and z tested for and not detected. Company's laboratory reports do not diagnose or recommend treatment. You represent that Company does not discuss diagnosis or treatment with any healthcare provider, and is not informed by the healthcare provider as to the healthcare provider's diagnosis or treatment. Company's sole function is to provide healthcare providers with a copy of its laboratory report. Company receives compensation for reporting results of tests to healthcare providers, which is based on each test performed.
>
> Company accepts orders for tests only from health care professionals. Patients cannot order tests from Company. Although Company in rare instances may provide a copy of a test to a patient, it does not explain its laboratory reports to patients. Instead, Company directs patients to contact their healthcare provider if they have any questions. The only other contact Company has with a patient is in billing situations. Company will bill a patient directly if the patient is self-insured, uninsured, or if the insurance company pays the patient directly.

The IRS agreed with the taxpayer's view that its business did not qualify one providing health services as that term is defined for IRC §1202 purposes. The IRS's answer helps outline what the Service saw as key factors that made this organization <u>not</u> a health care business:

> Company provides laboratory reports to health care professionals. However, Company's laboratory reports do not discuss diagnosis or treatment. Company neither discusses with, nor is informed by, healthcare providers about the diagnosis or treatment of a healthcare provider's patients. Company's sole function is to provide healthcare providers with a copy of its laboratory report.
>
> Company neither takes orders from nor explains laboratory tests to patients. Company's direct contact with patients is billing patients whose insurer does not pay all of the costs of a laboratory test.

> In addition, you represent that the skills employees bring to Company are not useful in performing X tests and that skills they develop at Company are not useful to other employers.
>
> Further, none of Company's revenue is earned in connection with patients' medical care. Other than the laboratory director, Company's laboratory technicians are not subject to state licensing requirements or classified as healthcare professionals by any applicable state or federal law or regulatory authority.
>
> Although Company's laboratory reports provide valuable information to healthcare providers, Company does not provide health care professionals with diagnosis or treatment recommendations for treating a healthcare professional's patients nor is Company aware of the health care provider's diagnosis or treatment of the healthcare provider's patients. In addition, the skills that Company's employees have are unique to the work they perform for Company and are not useful to other employers.

Unfortunately, the ruling talks about so many factors that it's clear exactly which ones were key to the decision. But most of the factors concentrate on the fact that the organization did not deal directly with patients, but rather only performed their services for licensed healthcare professionals. Clearly, if the business had provided a diagnosis, treatment recommendation or had dealt directly with the public it seems very possible the answer would have been different.

SECTION: 6662 WHERE TAXPAYER FAILED TO REPORT ITEMS ON PARTNERSHIP K-1, IRS COULD ASSERT NEGLIGENCE PENALTY IN PARTNER LEVEL PROCEEDING

Citation: Malone v. Commissioner, 148 TC No. 16, 5/1/17

Although the TEFRA Partnership audit rules are now living on borrowed time, cases looking at new issues continue to arise under those rules, and many involve concepts that likely will carry over to the new partnership audit regime. One such issue arose in the case of *Malone v. Commissioner*, 148 TC No. 16.

Congress in 1997 modified the TEFRA partnership audit rules to bring certain issues involving penalties applicable to partnership items under the TEFRA rules where the matter had to be decided in a partnership proceeding, and not in proceedings for individual partners.

As the Tax Court commented:

> Before 1997 the categorization of accuracy-related penalties as factual affected items was clear. "The additions to tax for negligence and valuation overstatement are affected items requiring factual determinations at the individual partner level"; normal deficiency procedures apply. *Crowell v. Commissioner*, 102 T.C. 683, 689 (1994) (citing *N.C.F. Energy Partners v. Commissioner*, 89 T.C. at 745); *Crystal Beach Dev. of Destin, Ltd. v. Commissioner*, T.C. Memo. 2000-170, 79 T.C.M. (CCH) 2068, 2069 n.2 (2000) (concluding that the Court lacked jurisdiction in a partnership-level proceeding and noting that "we are satisfied that Congress intended for accuracy-related penalties to be treated similarly to additions to tax; i.e., as affected items"). Section 6662(a) and (b)(1) penalties for negligence based on partnership items were and continue to be factual affected items.
>
> Through the 1997 Act, however, Congress modified the Court's deficiency jurisdiction with respect to certain penalties. Before the 1997 Act, following a partnership-level proceeding, the Commissioner was required to issue a notice of deficiency to each of the partners to assert penalties relating to the adjustment of partnership items. This was inefficient because the predicate for the penalty was often related events that occurred at the partnership level, which would be common to all of the partners. The 1997 Act streamlined this process by bypassing deficiency procedures for penalties attributable to adjustments of partnership items. To effect this change, Congress amended several TEFRA provisions to expand the scope of TEFRA to include "the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item". Sec. 6221; see also sec. 6226(f) (expanding a court's jurisdiction in a TEFRA proceeding to include penalties).

In this case, the taxpayers had failed to report items contained on the Schedule K-1 received from the partnership, arguing instead they had disposed of their interest. They had not filed a notice of inconsistent treatment and the IRS found that they had not disposed of their interest.

The IRS thus adjusted the taxpayer's return to remove the gain on sale they reported, but added the much larger gains shown on the partnership K-1. The notice of deficiency issued to the taxpayer also asserted the accuracy related penalty under IRC §6662(a), asserting both a substantial understatement of tax and negligence on the part of the taxpayers.

The taxpayers argued that the IRS, following the 1997 changes in the law, could not attempt to assert a §6662(a) penalty against them for items arising from the partnership, as those had to be raised in the partnership's own TEFRA exam.

But the Tax Court found that Congressional changes only had an impact when there are *adjustments* made to partnership items—here they had simply failed to report the items that, under the TEFRA partnership rules, they were required to report in the absence of filing a notice of inconsistent treatment.

The Court concluded:

> But in this case there are no adjustments to partnership items. There is no dispute that the partnership items reported by MBJ were not adjusted--the Commissioner did not attempt to dispute the items as reported on MBJ's Form 1065. The Malones argue, however, that the inconsistently reported partnership items on their 2005 Form 1040 were "adjusted" within the meaning of section 6230(a)(2)(A)(i). We disagree.
>
> The adjustments made to the liability reported on the Malones' 2005 Form 1040 were computational adjustments to their tax liability to take into account the partnership items as originally reported by MBJ. There were no adjustments to partnership items. Accordingly, the section 6230(a)(2)(A)(i) exclusion from deficiency procedures is inapplicable to the section 6662(a) and (b)(1) negligence penalty before the Court in this case.