Current Federal Tax Developments

Week of May 29, 2018

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Section: FBAR Reporting
Penalty Limited to Maximum Amount Stated in Regulation Not Updated for Later Increase in Maximum Penalty

Citation: United States v. Colliot, Case No. 1:16-cv-01281, Western District of Texas, 5/16/18

A U.S. District Court in the case of *United States v. Colliot*, Case No. 1:16-cv-01281, Western District of Texas, found that Treasury failure to update a regulation served the limit the amount of penalty the IRS could assess against an individual who willfully failed to report accounts on FBAR reports.

The case involves the penalty provisions found at 31 USC 5321(a)(5) for those who fail to report offshore accounts on annual FBAR reports. That provision provides:

> *(5) Foreign financial agency transaction violation.—*
>
> > *(A)Penalty authorized.—*
> >
> > *The Secretary of the Treasury may impose a civil money penalty on any person who violates, or causes any violation of, any provision of section 5314.*
> >
> > *(B) Amount of penalty.—*
> >
> > > *(i) In general.—*
> > >
> > > *Except as provided in subparagraph (C), the amount of any civil penalty imposed under subparagraph (A) shall not exceed $10,000.*
> > >
> > > *(ii)Reasonable cause exception.—No penalty shall be imposed under subparagraph (A) with respect to any violation if—*
> > >
> > > > *(I) such violation was due to reasonable cause, and*
> > > >
> > > > *(II) the amount of the transaction or the balance in the account at the time of the transaction was properly reported.*
> >
> > *(C)Willful violations.—In the case of any person willfully violating, or willfully causing any violation of, any provision of section 5314—*
> >
> > > *(i) the maximum penalty under subparagraph (B)(i) shall be increased to the greater of—*
> > >
> > > > *(I) $100,000, or*
> > > >
> > > > *(II) 50 percent of the amount determined under subparagraph (D), and*
> > >
> > > *(ii) subparagraph (B)(ii) shall not apply.*
> >
> > *(D)Amount.—The amount determined under this subparagraph is—*
> >
> > > *(i) in the case of a violation involving a transaction, the amount of the transaction, or*

> *(ii) in the case of a violation involving a failure to report the existence of an account or any identifying information required to be provided with respect to an account, the balance in the account at the time of the violation.*

That text was last modified by Congress in 2004. Prior to the 2004 changes, the law provided the penalty would be capped at the greater of:

- The amount (not to exceed $100,000) in the account at the time of the violation or
- $25,000

In 1987 Treasury promulgated regulations that provided for above limits on penalties. Treasury had not modified the regulations following the 2004 law changes, so 31 CFR §103.57 still provides for those penalty caps despite the Congressional action to raise the caps in 2004.

In this case, the following undisputed facts were before the Court:

> *In December 2016, the Internal Revenue Service (IRS) initiated this lawsuit to reduce to judgment outstanding civil penalties assessed against Colliot. Compl. [#1] at 1. The penalties were assessed for Colliot's repeated and willful failures to timely file Form TD F 90-22.1, entitled "Report of Foreign Bank and Financial Accounts" and commonly referred to as an "FBAR," from 2007 to 2010. Mot. Summ. J. [#52]. For 2007, the IRS assessed penalties of $548,773 for four separate FBAR violations. Resp. Mot. Summ. J. [#57] at 15. For 2008, the IRS assessed penalties of $196,082 for another four FBAR violations. Id. at 16. The IRS also assessed smaller penalties in 2009 and 2010. Id. at 17. In forms provided to Colliot in connection with the assessment of these penalties, the IRS stated the penalties were authorized under 31 U.S.C. § 5321(a)(5) and 31 C.F.R. § 1010.820(g)(2). Mot. Summ. J. [#52-12] Ex. L at 2.*

Mr. Colliot argues that the IRS miscalculated the penalties in this case, with the limits found in the old 31 CFR §103.57 (now renumbered 31 CFR §1010.820) still being applicable to his situation since the Treasury has not, in the nearly 14 years since Congress changed the law, gone back and revised the underlying regulation to reflect the higher limits.

The IRS disputes that view, holding that Congress's action in 2004 served to obsolete the regulations issued under the prior version of the law.

The Court did not agree, holding:

> *Unfortunately for the IRS, there is little reason to believe § 5321(a)(5)(C) implicitly superseded or invalidated § 1010.820. Section 5321(a)(5) sets a ceiling for penalties assessable for willful FBAR violations, but it does not set a floor.2 31 U.S.C. § 5321(a)(5). Instead, § 5321(a)(5) vests the Secretary of the Treasury with discretion to determine the amount of the penalty to be assessed so long as that penalty does not exceed the ceiling set by § 5321(a)(5)(C). Id. And § 1010.820 — a regulation validly issued by the Treasury via notice-and-comment rulemaking — purports to cabin that discretion by capping penalties at $100,000.3 31 C.F.R. § 1010.820. Thus, considered in conjunction with § 5321, § 1010.820 is consistent with § 5321's delegation of discretion to determine the amount of penalties to be assessed. See US. Pipe & Foundry Co. v. Webb, 595 F.2d 264, 272 (5th Cir. 1979) ("Regulations are presumed valid unless they are shown to be unreasonable or contrary to the provisions of the enabling statute."). Since § 1010.820 can be applied consistent with § 5321(a)(5), the Court concludes § 5321(a)(5) does not implicitly invalidate or supersede § 1010.820.*

The court found that, because of this, the $100,000 cap found in the old regulation must still be applied until the regulation is repealed via notice-and-comment rulemaking. That is, the old regulation is not inherently inconsistent with the underlying law, even if it now may not reflect Treasury's thinking on the matter.

Section: 162
No Deductions Allowed to Taxpayer Since Business Had Not Yet Commenced

Citation: Samadi v. Commissioner, TC Summary Opinion 2018-27, 5/24/18

While the tax law allows deductions for expenses incurred in a trade or business, it does not allow a taxpayer to claim a current deduction while the taxpayer is merely investigating the possibility of entering into a trade or business. In the case of *Samadi v. Commissioner*, TC Summary Opinion 2018-27 the Tax Court determined the taxpayer was in just such an investigatory stage and not actually conducting a trade or business.

In this case the taxpayer's proposed business was described as follows by the Court:

> *In 2010 petitioner husband decided to invest in homes with his friends and family (hereinafter referred to as the group). The group consisted of five individuals, including petitioner husband's brother. The group intended to buy homes, renovate them, and sell them for a profit (i.e., to flip houses). Petitioner husband became a licensed real estate agent in 2010 and continued to be licensed during 2013 and 2014. He did not earn any commissions from selling real estate in 2013 or 2014. Petitioner husband researched potential investment properties for the group; and because he was a licensed real estate agent, he had access to properties that were for sale.*

While their plan was to buy real estate to flip, the group never got past looking at real estate, for which the taxpayer was claiming auto mileage. As the Court outlines their activities for the years in question.

> *The mileage logs reflect that every Saturday from January 5 through August 27, 2013, and every Saturday from January 4 through August 16, 2014, petitioner husband drove 192 miles from his home in West Sacramento to the same "client's house" in Marina, California; drove back about 190 miles to the Sacramento area for a "house showing with client"; drove back about 190 miles to "return client to his home" in Marina; and then drove 192 miles back home to West Sacramento. The "client's home" in Marina was the home of petitioner husband's brother. The "house showing" consisted of picking up his brother or one of the other individuals in the group (i.e., the "client") from his brother's home in Marina and driving that individual to the Sacramento area to look at a potential investment property.*
>
> *Petitioner husband did not show any potential investment property to the group from late August through December in either 2013 or 2014. The group did not buy any investment property in either 2013 or 2014; its members could not agree on any of the potential investment properties petitioner husband had shown them.*

The IRS argued that no deduction is possible in this case because the taxpayer had not yet commenced operation of a trade or business, a position with which the Court agreed.

The taxpayer attempted to argue that the showing of these properties to the other members of the group were part of his activity as a real estate agent. After all, he held an active license to act

as a real estate agent. But merely having the license isn't enough to create a trade or business. The Court noted:

> *Petitioner husband argues that he was a real estate agent during 2013 and 2014, that he was acting in that capacity when he showed the group the potential investment properties, and that any expenses incurred in helping the group see the potential investment properties are deductible business expenses. Although petitioner husband was a licensed real estate agent during 2013 and 2014, he was not in the trade or business of being a real estate agent during the years at issue. Petitioner husband testified that he did not earn any commissions during 2013 or 2014 as a real estate agent. There is no other evidence in the record to suggest that he was continuously and regularly buying and selling real estate as a real estate agent to clients.*

That left only the house-flipping business—but the Court found this business had not actually commenced in the years in question.

> *At best, petitioner husband's activity in 2013 and 2014 was in the exploratory or formative stages of forming a business of flipping houses. Carrying on a trade or business requires more than initial research into a potential business opportunity; it requires that the business have actually commenced. Dean v. Commissioner, 56 T.C. 895, 902-903 (1971); Frank v. Commissioner, 20 T.C. 511, 513-514 (1953); see Christian v. Commissioner, T.C. Memo. 1995-12, 1995 Tax Ct. Memo LEXIS 12, at *10-*12 (finding that activities relating to only "exploratory or formative stages" do not rise to the level of a trade or business). Section 162(a) does not permit current deductions for startup or preopening expenses incurred by a taxpayer before beginning business operations. See sec. 195(a).*

Under IRC §195, these expenses will be held until such time as the business begins. At that time, under IRC §195(b) the expenses will be deducted and/or amortized over 180 months. If the business never begins, the expenses end up never being deductible.

Section: 164
IRS to Issue Guidance on SALT Workarounds, Raises Issue of Substance over Form

Citation: Notice 2018-54, 5/23/18

The IRS has now fired its first salvo in the SALT workaround controversy. Notice 2018-54 announces the IRS's intention to propose regulations to deal with some types of SALT workarounds.

In one sense this notice gives us little information about exactly what can and cannot pass muster when taxpayers make charitable contributions that reduce their state income taxes in an effort to shift from a nondeductible expense (state and local taxes in excess of $10,000) to fully deductible items (charitable contributions). But it does indicate that the IRS does not plan to sit by quietly and not issue guidance in this area.

The tone of the notice makes it clear we should expect the IRS to determine certain arrangements will not achieve their desired goals. As Section 2 of the Notice states:

> *Despite these state efforts to circumvent the new statutory limitation on state and local tax deductions, taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes.*

Section 3 outlines the guidance the IRS plans to release:

> *The Treasury Department and the IRS intend to propose regulations addressing the federal income tax treatment of transfers to funds controlled by state and local governments (or other state-specified transferees) that the transferor can treat in whole or in part as satisfying state and local tax obligations. The proposed regulations will make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers. The proposed regulations will assist taxpayers in understanding the relationship between the federal charitable contribution deduction and the new statutory limitation on the deduction for state and local tax payments.*

The notice does not give any information on the likely timing of the release of such proposed regulations, let alone whether they will be issued in a form taxpayers may rely upon.

Most likely the ultimate decision on what does or does not work will be finally determined in litigation that will arise as taxpayers who give to programs that are deemed not charitable contributions under such regulations (very conceivably with help from the state governments in question) challenge the regulations.

But since most clients would prefer not to find themselves parts of cases discussed in this forum, it seems likely that many clients will want to await this guidance before committing to any such transfer from income taxes to charitable contribution program—and most will likely shy away from a program that is clearly on the wrong side of the eventual regulations.

A related concern may impact taxpayers in states other than those have adopted SALT workarounds. About two-thirds of states have at least one (if not more) tax credits that give 100% or a close to 100% credit against state taxes for various charitable contributions. Advisers in those states will want to pay close attention to how these regulations define "other state-specified transferees" in this context. It is at least conceivable that this guidance might rope in some pre-existing programs depending on how that definition is structured.

For now all advisers can do is advise clients about the risks, especially of donating to the charitable funds established following the passage of the Tax Cuts and Jobs Act that were clearly enacted to work around the $10,000 state and local tax limitation.

Section: 6231
Agreeing with the Ninth Circuit, DC Circuit Upholds IRS Position that SMLLC Partner Renders a Partnership Subject to TEFRA Procedures

Citation: Mellow Partners v. Commissioner, Case No. 16-1454, CA DC, 5/22/18

In a TEFRA case that may have continuing implications under the new Centralized Partnership Audit Regime (CPAR) taking effect for partnership tax years beginning in 2018, the DC Circuit, following suit with a similar opinion last year from the Ninth Circuit, found that having a disregarded entity as a partner meant a partnership could not avoid being examined under the TEFRA partnership examination provisions.

The case, *Mellow Partners v. Commissioner*, Case No. 16-1454, CA DC appealed the Tax Court's holding that the TEFRA audit provisions applied to a partnership where each partner held his interest in a single member LLC.

The facts of how the interests were held are outlined as follows in the opinion:

> *The partnership agreement also states that the partnership was formed "by and between" MB 68th Street Investments LLC ("68th Street") and WNM Hunters Crest Investments LLC ("Hunters Crest") (collectively, "the single-member LLCs" or "the LLCs"). Id. Mr. Myer Berlow, the sole member of 68th Street, and Mr. William Melton, the sole member of Hunters Crest, signed the partnership agreement on behalf of their respective LLCs. The single-member LLCs did not elect to be treated as associations under the check-the-box tax-classification regulations and therefore were treated as disregarded entities separate from their owners. Accordingly, the LLCs did not file federal income tax returns for the 1999 tax year.*

The Court of Appeals describes the basic rules for partnerships that are covered by TEFRA and those that qualify as exempt in the paragraph below:

> *As a general rule, the TEFRA procedures apply to all business entities that are required to file a partnership return. Bedrosian v. Comm'r, 143 T.C. 83, 104 (2014) (citing 26 U.S.C. § 6231(a)(1)(A)). However, there is a limited exception for "small partnerships," which are defined as having "10 or fewer partners each of whom is an individual . . ., a C corporation, or an estate of a deceased partner." 26 U.S.C. § 6231(a)(1)(B) (2012). In 1987, the Treasury Department promulgated temporary regulations setting forth rules governing the small-partnership exception. See Miscellaneous Provisions Relating to the Tax Treatment of Partnership Items, 52 Fed. Reg. 6,779, 6,789 (Mar. 5, 1987). As relevant here, one of the temporary regulations provided that, "[t]he [small-partnership] exception provided in section 6231(a)(1)(B) does not apply to a partnership for a taxable year if any partner in the partnership during that taxable year is a pass-thru partner." Id. In 2001, the Treasury Department issued a final regulation, which stated, inter alia, that the small-partnership exception "does not apply to a partnership for a taxable year if any partner in the partnership during that taxable year is a pass-thru partner as defined in section 6231(a)(9)." Unified Partnership Audit Procedures, 66 Fed. Reg. 50,541, 50,556 (Oct. 4, 2001) (codified at Treas. Reg. § 301.6231(a)(1)–1(a)(2)); see id. at 50,544 (stating that the final regulations apply to partnership proceedings concerning partnership taxable years beginning on or after October 4, 2001). The Code, in turn, defines "partner" as "a partner in the partnership" and "any other person whose income tax liability . . . is determined in whole or in part by taking" partnership items "directly or indirectly" into account, 26 U.S.C. § 6231(a)(2) (2012), and "pass-thru partner" as "a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership," id. § 6231(a)(9) (2012).*

But the issue remained open regarding whether a single member LLC or a grantor trust would be treated as a pass-thru partner under these rules. Many hoped that since, in such cases, a person other than the entity is treated "as if" they were the owner for tax purposes, that regulatory (for an SMLLC) or statutory (for a grantor trust) fiction would apply for these purposes as well.

However, the IRS disagreed with that view, holding that these are pass-thru entities and, thus, remove any partnership with such partners from the category of partnerships that qualify for the small partnership exception to TEFRA applicability. As Circuit Court opinion explains:

> *IRS presented a thorough explanation of its reasoning on this point in Revenue Ruling 2004–88, 2004–2 C.B. 165 (Aug. 9, 2004). The Revenue Ruling makes it clear that a partnership cannot qualify as a small partnership under § 6231(a)(1)(B) if it has pass-thru partners, and it concludes that a single-member LLC constitutes a pass-thru partner. In reaching this conclusion, the Revenue Ruling highlights that "'pass-thru partner' is defined in section 6231(a)(9) as 'a partnership, estate,*

> *trust, S corporation, nominee or other similar person through whom other persons hold an interest in the partnership.'" Id. (quoting § 6231(a)(9)). The Revenue Ruling then explains that "[i]f legal title to a partnership interest is held in the name of a person other than the ultimate owner, the holder of legal title is considered a pass-thru partner within the meaning of section 6231(a)(9)." Id.*
>
> *The Revenue Ruling goes on to apply these principles to a hypothetical set of facts:*
>
>> *[A]lthough LLC is a disregarded entity for federal tax purposes, LLC is a partner of [Partnership ("P")] under the law of the state in which P is organized. Similarly, although [individual "A"], LLC's owner, is a partner of P for purposes of the TEFRA partnership provisions under section 6231(a)(2)(B) because A's income tax liability is determined by taking into account indirectly the partnership items of P, A is not a partner of P under state law. Because A holds an interest in P through LLC, A is an indirect partner and LLC, the disregarded entity, is a pass-thru partner under the TEFRA partnership provisions.* ***Consequently, the small partnership exception does not apply to P because P has a partner that is a pass-thru partner.***
>
> *Id. (emphasis added).*

After reviewing a number of ways of viewing the validity of the IRS's interpretation, including the Ninth Circuit 2017 ruling in *Seaview Trading, LLC v. Commissioner*, 858 F.3d 1281 that upheld the IRS position, the panel concludes that the IRS position is justified. The agency had consistently taken this position regarding the interpretation of the provision, it was in line with the statutory language and not clearly unreasonable.

As the opinion concludes:

> *In sum, Mellow has "provide[d] no compelling reason to contravene the consistent stance of the IRS and the tax courts, which have uniformly treated disregarded single-member LLCs as pass-thru partners." Seaview Trading, 858 F.3d at 1287. We therefore defer to the agency's reasonable construction of the term "pass-thru partner" and reject Mellow's claim that the Tax Court lacked jurisdiction.*

Readers likely are aware that TEFRA audits are on their way to extinction, with the new CPAR regime taking effect for tax years beginning in 2018. But the same issue regarding the status of disregarded entities rears its head under the new regime as well.

Under CPAR, certain entities can, at the time they file their partnership income tax return, file an election to "opt-out" of the CPAR regime under IRC § 6221(b). Under Reg §301.6221(b)-1(b)(3) under the new CPAR rules the existence of any of the following partners will bar the partnership from making an "opt-out" election:

- A partnership
- A trust
- A foreign entity that would not be taxed as a C corporation if it were a domestic entity
- A disregarded entity described in § 301.7701-2(c)(2)(i)
- An estate of an individual other than a deceased partner

- Any person who holds an interest in the partnership on behalf of another person (Reg. § 301.6221(b)-1(b)(3)(ii))

Given that two Circuits found that such an interpretation was proper under the TEFRA rules even when contained in a Revenue Ruling rather than a regulation, it seems unlikely taxpayers will be able to successfully challenge the IRS treatment for CPAR of such entities.