Current Federal Tax Developments

Week of June 11, 2018

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CURRENT FEDERAL TAX DEVELOPMENTS
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Section: 152
Court, Relying Primarily on Taxpayer's Testimony, Finds Child Resided with Him Over One-Half of the Year

Citation: Engesser v. Commissioner, TC Summary Opinion 2018-29, 6/4/18

Ultimately the case of *Engesser v. Commissioner*, TC Summary Opinion 2018-29, turned on the question of whether the taxpayer's testimony regarding where his child lived in the year in question would be believed by the Court. And, in this case, the Tax Court found the taxpayer's testimony believable.

The issue of where H.E. (the child in this case) lived was complicated by the fact that when the child's mother moved out of Mr. Engesser's apartment in early 2014, she moved to a nearby apartment. Both Mr. Engesser and the mother claimed the child as a dependent on their 2014 income tax returns. Neither parent attached a Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent*, with their individual tax return.

As the Court pointed out, under the law the following requirements must be met for H.E. to be Mr. Engesser's qualifying child:

> *Generally, a "qualifying child" must (1) bear a specified relationship to the taxpayer (e.g., be the taxpayer's child), (2) have the same principal place of abode as the taxpayer for more than one-half of the taxable year, (3) meet certain age requirements, (4) not have provided over one-half of such individual's own support for the relevant period, and (5) not have filed a joint return for that year. Sec. 152(c)(1).*

The IRS found that H.E. met all the requirements under IRC §152 to be dependent of Mr. Engesser except for one. The IRS argued that the taxpayer failed to show that H.E. had the same place of abode as Mr. Engesser for over one-half of the year.

Aside from Mr. Engesser's testimony, the Court found itself faced with the following pieces of information that could be useful in determining where H.E. resided. The following developments took place in 2014 as outlined by the Court:

> *A letter dated October 14, 2015, from Messina Pediatrics states that H.E. was seen in that office on November 10, 2014, December 5, 2014, and March 25, 2015, and that according to the records of that office, H.E. resided at apartment E.*
>
> *A U.S. Postal Service (USPS) change of address form dated December 4, 2014, purports to change H.E.'s address from apartment S to apartment E. Petitioner did not prepare the change of address form, and the record does not show who prepared it and submitted it to the USPS.*

The Court then went on to detail the following developments that took place in 2015 and 2016:

> *A letter from Old Bridge Township Public Schools dated August 26, 2015, states that H.E. lived at apartment E, presumably meaning in August 2015.*
>
> *Petitioner initiated a custody proceeding in 2015 in the Superior Court of New Jersey. On October 28, 2015, the superior court ordered joint custody over H.E. for petitioner and Ms. Anthony. Under this schedule each parent had custody over H.E. about one-half of the time. The October 28, 2015, order also said that Ms. Anthony could claim H.E. as a dependent for 2015 and all odd-numbered years and petitioner could claim her as a dependent for 2016 and all even-numbered years. On September*

> *20, 2016, the superior court revised the custody schedule, reducing the time H.E. would be with petitioner.*

The IRS raised the following objections based on the information the Court had before it:

> *Respondent points out that (1) the letter from Messina Pediatrics does not say where H.E. lived during most of 2014; (2) the 2015 and 2016 custody orders do not give petitioner custody over H.E. for more than one-half of the time after October 28, 2015; (3) the USPS change of address form of unknown authorship says H.E.'s address changed from apartment S to apartment E in December 2014; (4) petitioner did not include a Form 8332 with his Form 1040 for 2014; and (5) there were anomalies in petitioner's testimony.*

The Court first looked at the IRS's last contention—that there were issues with the taxpayer's testimony and rejected that view:

> *Petitioner testified that H.E. resided with him in apartment E throughout 2014. Petitioner also testified that Ms. Anthony sometimes asked whether she could take H.E. for a period, such as one or two days, and that he always agreed to those requests. Respondent points out that saying H.E. lived with him during "all" of 2014 is inconsistent with petitioner's testimony that H.E. sometimes spent some days with Ms. Anthony, but we do not believe those two statements undermine petitioner's contention that H.E. had the same principal place of abode as petitioner for more than one-half of 2014.*

The Court then considers the limited documentary information before the Court and finds it does not undermine the taxpayer's testimony on this issue:

> *The letter from Messina Pediatrics shows that H.E. lived with petitioner during November and December 2014. The letter from H.E.'s school shows that H.E. lived with petitioner in August 2015. We do not consider the December 4, 2014, USPS change of address form because the record does not show who provided that information.*
>
> *Respondent infers from the 2015 and 2016 joint custody orders, which resulted from a custody suit brought by petitioner, that H.E. did not have the same principal place of abode as petitioner for more than one-half of 2014 and that petitioner brought the custody case in order to expand the extent of his custody for H.E. However, petitioner testified, in effect, that he initiated that suit because he wanted a more formalized custody arrangement. Petitioner's account is credible on the basis of this record.*
>
> *Respondent points out that Ms. Anthony claimed H.E. as a dependent and did not provide a Form 8332 to petitioner waiving her right to do so, but this seems no more noteworthy in establishing H.E.'s residence than the fact that petitioner also claimed her as a dependent and, apparently, did not provide a Form 8332 to Ms. Anthony.*
>
> *The gaps in the documentary evidence for 2014, the documentary evidence for 2015-16, and the anomalies in petitioner's testimony do not undermine petitioner's overall testimony.*

The Court found, therefore, that the taxpayer was entitled to claim H.E. as a dependent in 2014, as well as claim the child tax credit, the earned income credit and qualify for a filing status of head of household for 2014.

While not stated by the Court, the key here is that the taxpayer's testimony had no inconsistencies, either internally or with the documents that were brought to the Court's attention. Had the taxpayer been caught "stretching the truth" or making hard to believe claims with no support, the result likely would not have turned as well as it did in this case.

Section: 162
Father Denied Business Deduction for Payments to Son Who Lacked General Contractor License

Citation: Gaunt v. Commissioner, TC Memo 2018-78, 6/6/18

Sometimes individuals want to take shortcuts to get around certain non-tax rules and regulations. In the case of *Gaunt v. Commissioner*, TC Memo 2018-78, the couple ran into tax issues when attempting to assist their son who lacked a general contractor's license.

The exact situation was described as follows by the Tax Court:

> *During the years in issue James Gaunt (petitioner) was the sole proprietor of All American Pool and Spa (AAPS). AAPS built in-ground pools (and to a lesser extent, spas). Most of its clients were homeowners in Los Angeles. Petitioner's role at AAPS was that of a general contractor: He would negotiate a fee for a project, then hire and supervise subcontractors to perform whatever tasks were required. These subcontractors included excavators, steelworkers, electricians, cement masons, tilers, and landscapers. In most instances AAPS paid the subcontractors by check.*
>
> *Petitioner's son, David, owned a plumbing company called David Gaunt Pool Services (DGPS). DGPS designed plumbing systems for pools and often worked on the same projects as AAPS. DGPS was not a subcontractor to AAPS and negotiated its fee directly with customers. But this arrangement was complicated by the fact that David lacked a general contractor's license. Petitioner, who had the required license, sometimes agreed to accept payments on his son's behalf. He deposited each payment into an AAPS bank account and then remitted it, either in cash or by check, to David. He remitted at least $20,745 to David or DGPS during 2008.*

Presumably, Dad did this to cover the fact that his son was doing work that required a general contractor's license. Dad picked up the income and then claimed an offsetting deduction for the payment to his son.

But the IRS questioned whether, given that David was not a subcontractor, whether the payment represented an ordinary and necessary business expense.

The Tax Court agreed, holding:

> *…because DGPS was not a subcontractor to AAPS, checks issued to it (or to David on its behalf) were not "ordinary and necessary" expenses of AAPS' business and hence were not deductible. We therefore find that petitioners are entitled to a deduction for contract labor of only $55,700 ($80,845 - [$4,400 + $20,745]).*

Section: 965
IRS Announces Relief on Certain 965 Transition Tax Issues

Citation: News Release IR-2018-131, 6/4/18

The IRS continues to revise its guidance with regard to the Section 965 transition tax adopted as part of the Tax Cuts and Jobs Act. In News Release IR-2018-131 the IRS announced waivers of certain penalties impacted by that tax and revisions to its frequently asked questions regarding the tax maintained on the IRS web site.

The IRS has added three new questions and answers to the 965 tax frequently asked questions (FAQs) page on its website (Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns).

In some ways the changes are a combination of good news and bad news. The IRS last visited this set of FAQs just before the April 15 deadline when it announced, among other things, that any overpayments on 2017 tax returns for affected taxpayer would be applied against any remaining balance due on the transition tax, even if the installment election was made under §965(h) and the proper payment had been made on that first estimate.

The AICPA had requested that the IRS reconsider the "no refund" policy after it was announced back in April 2018. This change to the FAQs does not modify that position but does give some relief for taxpayers who had planned to apply that overpayment to 2018 taxes. The IRS will now grant a waiver of the underpayment of estimated taxes for such taxes.

The new question and answer reads as follows:

> ***Q15: If a taxpayer that has made a section 965(h) election for 2017 filed a 2017 income tax return that calculated an overpayment without including the taxpayer's total net tax liability under section 965, and the taxpayer attempted to elect to credit the calculated overpayment to its estimated tax liability for 2018, will the IRS determine an addition to tax for an underpayment of taxpayer's 2018 estimated taxes because the credit elect won't be available for the first required 2018 estimated tax installment?***
>
> *A15: No. The IRS has determined that no addition to tax for an underpayment of estimated taxes under section 6654 or 6655 will apply (nor be increased) if a taxpayer makes an estimated tax payment sufficient to satisfy both the underpayment of the first required estimated tax installment for 2018 and the full amount of the second required estimated tax installment for 2018 on or before the due date for the second installment (that is, June 15, 2018, for calendar year taxpayers). This relief from the addition to tax for the underpayment of estimated taxes applies only to taxpayers whose first required installment for 2018 was due on or before April 18, 2018.*
>
> *If the IRS sends a taxpayer a notice of an addition to tax for underpayment of estimated tax under section 6654 or 6655 and the taxpayer meets all the conditions for relief described above (including making the required payment by the due date for the second installment), the taxpayer should contact the IRS office that issued the notice and request abatement of the addition to tax for underpayment of estimated taxes in accordance with the provisions in these FAQs and updated instructions to Forms 2210 and 2220.*
>
> *Posted: 06/04/2018*

In many cases taxpayers found at April 17, 2018 that they did not yet have the proper information to correctly compute the amount of the first estimate due in order to pay the 965 transition tax in installments. Such taxpayers had to estimate, as best as they could, the amount that should be paid.

Under IRC §965(h)(3), if the taxpayer ended up with a penalty imposed for late payment on an installment, the entire balance of the installment is due. Thus, the concern arose that if a taxpayer found that he/she had under-estimated the amount of tax due, the entire balance would come due once the failure to pay penalty was applied. Similarly, some taxpayers may not

have been aware of this late December law change and had not made any payment at the April deadline.

The IRS has provided automatic relief for such taxpayers, finding that if the taxpayer's net tax liability under 965 in the individual's 2017 tax year is less than $1 million, no penalty will be imposed if the first estimate is paid by the unextended due date for the taxpayer's 2018 return.

The FAQ reads as follows:

> ***Q16: If an individual fails to timely pay his or her first installment of tax due under section 965(h), will the IRS assess an addition to tax for failure to pay? Will the taxpayer's requirement to pay all subsequent installments be accelerated under section 965(h)(3)?***
>
> *A16: If an individual meets the criteria in this paragraph and pays the total amount of the first installment on or before the due date for the second installment, the IRS will not assess an addition to tax for failure to timely pay the first installment and will not accelerate subsequent installments under section 965(h)(3). An individual with a net tax liability under section 965 is required to report the liability on his or her tax return for the year in which or with which the inclusion year of the deferred foreign income corporation ends and pay the full amount of that liability on the unextended due date of that return, unless the individual elects to pay the liability in eight annual installments pursuant to section 965(h)(1). However, the IRS has determined that, if an individual's net tax liability under section 965 in the individual's 2017 taxable year is less than $1 million, the individual makes a timely election under section 965(h), and the individual did not pay the full amount of the first installment by the due date under section 965(h)(2), the failure to make the payment will not result in an acceleration event under section 965(h)(3) so long as the individual pays the full amount of the first installment (and its second installment) by the due date for its 2018 return (determined without regard to extensions). For this purpose, the relevant due date generally is April 15, 2019. In the case of United States citizens or residents whose tax homes and abodes, in a real and substantial sense, are outside the United States and Puerto Rico, and United States citizens and residents in military or naval service on duty, including non-permanent or short term duty, outside the United States and Puerto Rico, the relevant due date is June 17, 2019, which is provided by Treas. Reg. §1.6081-5(a)(5) and (6). Although the IRS will not assess an addition to tax for failure to timely pay the first installment, a taxpayer will be liable for interest on such amount from the due date of the installment. See I.R.C. §6601.*
>
> *If the IRS sends a taxpayer a notice of an addition to tax for failure to timely pay the first installment, and the taxpayer meets all the conditions for relief described above (including making the required payment by the due date for the second installment due under section 965(h)), the taxpayer should contact the IRS office that issued the notice and request abatement of the addition to tax for failure to timely pay the first installment in accordance with the provisions in these FAQs.*
>
> ***Posted: 06/04/2018***

Finally, what if the taxpayer filed his/her 2017 income tax return without attaching the election to pay the 965 transition tax in installments under IRC §965(h)? Tax software generally was not able to handle the 965 filings by the original April due date for tax returns and, as most of us can attest to, some taxpayers just have an irrational fear of ever filing a tax return on extension.

The IRS allows such taxpayers to make a late election by filing an amended income tax return on Form 1040X by what would have been the extended due date of the tax return. That FAQ reads as follows:

> ***Q17: If an individual has filed his or her 2017 tax return, but has not made the section 965(h) election, may the individual file another 2017 return on which he or she makes the election?***
>
> *A17: Yes. If an individual with a net tax liability under section 965 in the individual's 2017 tax year has already filed his or her tax return and did not make an election under section 965(h), such individual can make the section 965(h) election by filing a Form 1040X that complies with the procedures set forth in these FAQs (including, for example, the IRC 965 Transition Tax Statement(s) described in Q&A 3 and the election statement described in Q&A 7) on or before the due date of the individual's 2017 return, taking into account any additional time that would have been granted if the individual had made an extension request. For this purpose, the IRS will treat the individual as if he or she had requested…and received the extension.*
>
> *Posted: 06/04/2018*

Section: 6413
Email Explains Difference Between Filing a Claim and an Adjusted Return on Payroll Withholding Issues

Citation: Chief Counsel Email 201822028, 6/1/18

The problems of attempting to develop summary explanations for training purposes (like this article) of tax material was discussed in Chief Counsel Email 201822028. A person inside the IRS was raising questions about IRS training materials related to the question of when an employer may "claim" an "adjustment" for income tax withholding and additional Medicare tax.

Specifically, the email begins by noting the matter that had led to the request for clarification:

> *Your initial inquiry was whether certain training materials were correct in stating that "[a]n employer CANNOT claim an adjustment for [Income Tax Withholding] and additional Medicare taxes after the close of the calendar year for the employee." The training materials cite to § 31.6413(a)-2(c)(2).*

One key issue with writing training materials is that often words that have a common meaning in the English language are imbued with a very specific and potentially quite different technical meaning by provisions of the law. That was part of what lead to the confusion that was addressed in this email.

As the email continues:

> *In answering your question, it became clear that there is wide-spread confusion concerning the actions an employer must take by calendar year end and what actions are permitted after the calendar year end. The confusion is due in large part to the imprecise use of terms, including "claim" and "adjustment." Of note, it is misleading to use the phrase "claim an adjustment" given that the claim process and the adjustment process are different.*

In reality, the author of the materials was using "claim" as a common English language term, while the term adjustment maintained its detailed technical definition. But, as the email notes, in the tax law a *claim* is also a specific action—so saying one "claims" an "adjustment," where it

is not clear which of the two terms is being used in its official technical sense, leads to a significant level of confusion.

A claim is a specific reference in tax law to a taxpayer asking for money from the government due to a purported overpayment. As the email notes, claims are very limited in the payroll tax context:

> *An employer cannot file a "claim" for income taxes except for administrative errors — in which the amount reported on Form 941, line 3 (Federal income tax withheld from wages, tips, and other compensation), does not agree with the amount the employer withheld. See § 31.6414-1.*

So, for instance, if ABC Company has a single employee from which it withheld $1,000 for the year, but it had erroneously reported on Forms 941 a total amount of taxes withheld of $1,250, ABC could file a *claim* for the excess $250 that it paid over what had actually been withheld. The time period for filing this *claim* is tied to the standard periods for claiming a refund of overpaid taxes.

But what if ABC has erroneously withheld $1,250 of FICA taxes when, in fact, the actual amount of FICA that should have been withheld from the employee's check was $1,000. ABC again had reported the amount of taxes withheld on Form 941 as $1,250. In this case, ABC *cannot* file a *claim* for the overpayment—this was not the type of administrative error for which a claim is allowed.

But there is still a way to fix the matter, by looking to an adjustment if certain requirements are met. As the email continues:

> *But, the employer can file an "adjusted return" if the error is discovered in the same calendar year employer paid the wages and if the employer also repaid or reimbursed the employees in the same year. See §§ 31.6413(a)-2(c)(2)(i) and 31.6413(a)-1(b).*

Note that the adjustments have a secondary time limit—the error must be discovered in the same calendar year as the wages were paid and the employer must also make the employee whole (by repaying him/her) in order to file an *adjusted return*. But if discovered before December 31, that does not require the adjusted return itself to be filed before December 31.

The email uses Situation 2 from Revenue Ruling 2009-39 to help illustrate the matter:

> *Situation 2: Employer S timely filed its 2011 third quarter Form 941 on October 10, 2011, and timely paid all employment tax reported on the return. On December 2, 2011, Employer S ascertains that it overwithheld and overpaid ITW in the third quarter of 2011 and reported the overpayment on its 2011 third quarter Form 941. Employer S repays the overcollected amounts to its affected employees on December 29, 2011. Employer S files Form 941-X on January 6, 2012, to correct the overpayment using the adjustment process.*
>
> *Because Employer S repaid its employees the amount of the overcollection of ITW in the same year that the wages were paid, Employer S may correct the overpayment of ITW using the adjustment process even though the adjusted return is filed in a year after the wages were paid. Employer S may not use the refund claim process to correct the error because the ITW was actually withheld from the employees' wages.*
>
> *As indicated in Situation 2, the employer is NOT required to file Form 941-X using the adjustment process by the end of the calendar year. However, the discovery of the error and the repayment/reimbursement must occur by the end of the calendar year.*

A key skill that needs to be developed by a seasoned tax practitioner is to take care to take "inventory" of any terms in the area you are researching for which Congress (in the IRC) or the IRS (in regulations) have created area specific definitions for. If you aren't careful, you can easily fall into the trap that befell these materials.

It's very possible the confusion was introduced when someone, attempting to make the document easier to understand, decided to use the wording "claim for adjustment" to make the materials easier to understand. The problem, of course, was that a party doing that runs the risk of accidentally using a specially defined word in a non-specially defined manner.