Current Federal Tax Developments

Week of July 2, 2018

Edward K. Zollars, CPA
(Licensed in Arizona)

ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF JULY 2, 2018

Published in 2018 by Kaplan Financial Education.

Printed in the United States of America.

Current Federal Tax Developments

Kaplan Professional Education

Table of Contents

Section: Tax Reform
IRS Shows Off Draft of Postcard Form 1040 and Six New Schedules

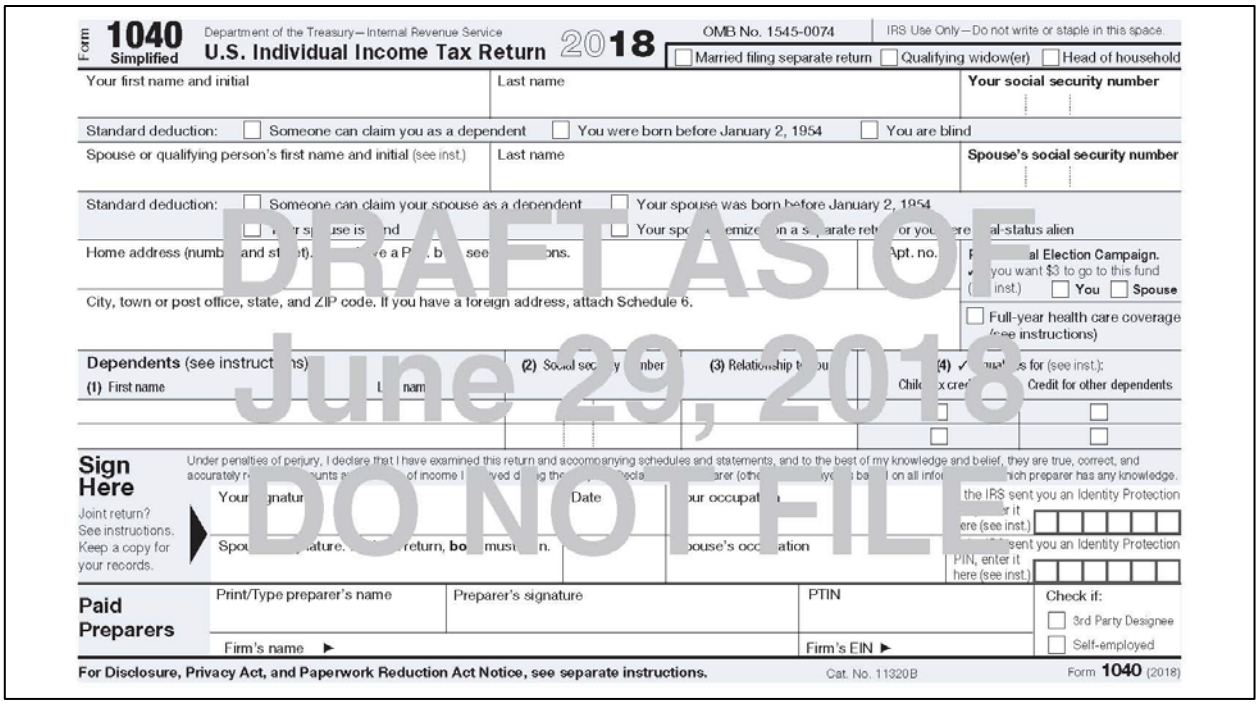
Citation: Draft Forms 1040 and Schedules 1-6, 6/29/18

The new "simplified" postcard Form 1040 was issued in draft form by the IRS with only minor changes from the internal version leaked a few days earlier. Unfortunately, simplification means that Treasury has managed to take a 2 page form and convert it into eight pages (or maybe six pages and two half-pages). However, most taxpayers won't need to complete all six attachments.

With the issuance of the new "postcard" 1040, the IRS will retire the Forms 1040A and 1040EZ. However, the Congressionally mandated Form 1040-SR would appear to still be showing up for 2019 returns, at least unless Treasury can convince Congress that the new postcard form eliminates the need for the Form 1040-SR and it is removed from the law.

The new Form 1040 moves virtually all numeric entries onto the second half page of the Form 1040 postcard, with the front portion of the postcard containing what is now the very top information portion of Form 1040. The reduction in lines from the 2017 Form 1040 is accomplished mainly by moving lines to a series of six schedules that will be attached to the Form 1040.

The Draft Form 1040 is reproduced below:



Form **1040** Simplified — Department of the Treasury—Internal Revenue Service — **U.S. Individual Income Tax Return** 2018 — OMB No. 1545-0074 — IRS Use Only—Do not write or staple in this space.

Married filing separate return ☐ Qualifying widow(er) ☐ Head of household

Your first name and initial | Last name | **Your social security number**

Standard deduction: ☐ Someone can claim you as a dependent ☐ You were born before January 2, 1954 ☐ You are blind

Spouse or qualifying person's first name and initial (see inst.) | Last name | **Spouse's social security number**

Standard deduction: ☐ Someone can claim your spouse as a dependent ☐ Your spouse was born before January 2, 1954

☐ Your spouse itemizes on a separate return or you were dual-status alien

Home address (number and street). If you have a P.O. box, see instructions. | Apt. no. | Presidential Election Campaign. ✓ you want $3 to go to this fund (see inst.) ☐ You ☐ Spouse

City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6. | ☐ Full-year health care coverage (see instructions)

Dependents (see instructions) | (2) Social security number | (3) Relationship to you | (4) ✓ Qualifying child for child tax credit (see inst.): Credit for other dependents

(1) First name | Last name

Sign Here — Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately reported. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature | Date | Your occupation | If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

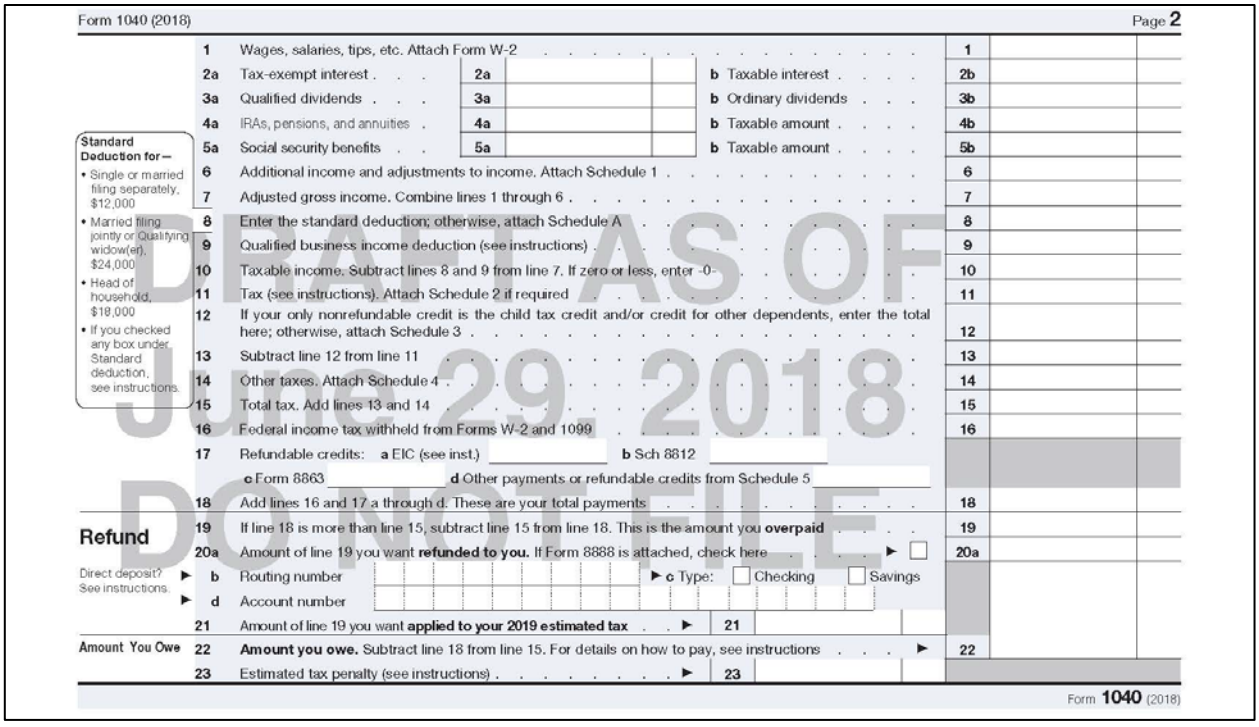
Spouse's signature. If a joint return, both must sign. | Spouse's occupation | If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparers — Print/Type preparer's name | Preparer's signature | PTIN | Check if: ☐ 3rd Party Designee ☐ Self-employed

Firm's name ► | Firm's EIN ►

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2018)

DRAFT AS OF June 29, 2018 DO NOT FILE



Form 1040 (2018) Page 2

	1	Wages, salaries, tips, etc. Attach Form W-2			1	
	2a	Tax-exempt interest	2a	b Taxable interest	2b	
	3a	Qualified dividends	3a	b Ordinary dividends	3b	
	4a	IRAs, pensions, and annuities	4a	b Taxable amount	4b	
Standard Deduction for— • Single or married filing separately, $12,000 • Married filing jointly or Qualifying widow(er), $24,000 • Head of household, $18,000 • If you checked any box under Standard deduction, see instructions.	5a	Social security benefits	5a	b Taxable amount	5b	
	6	Additional income and adjustments to income. Attach Schedule 1			6	
	7	Adjusted gross income. Combine lines 1 through 6			7	
	8	Enter the standard deduction; otherwise, attach Schedule A			8	
	9	Qualified business income deduction (see instructions)			9	
	10	Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0-			10	
	11	Tax (see instructions). Attach Schedule 2 if required			11	
	12	If your only nonrefundable credit is the child tax credit and/or credit for other dependents, enter the total here; otherwise, attach Schedule 3			12	
	13	Subtract line 12 from line 11			13	
	14	Other taxes. Attach Schedule 4			14	
	15	Total tax. Add lines 13 and 14			15	
	16	Federal income tax withheld from Forms W-2 and 1099			16	
	17	Refundable credits: a EIC (see inst.)		b Sch 8812		
		c Form 8863		d Other payments or refundable credits from Schedule 5		
	18	Add lines 16 and 17 a through d. These are your total payments			18	
Refund	19	If line 18 is more than line 15, subtract line 15 from line 18. This is the amount you **overpaid**			19	
	20a	Amount of line 19 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐			20a	
Direct deposit? See instructions.	b	Routing number		▶ c Type: ☐ Checking ☐ Savings		
	d	Account number				
	21	Amount of line 19 you want **applied to your 2019 estimated tax** ▶	21			
Amount You Owe	22	**Amount you owe.** Subtract line 18 from line 15. For details on how to pay, see instructions ▶			22	
	23	Estimated tax penalty (see instructions) ▶	23			

Form 1040 (2018)

One key item of interest that is added by the Tax Cuts and Jobs Act is the new line 9 where the qualified business income deduction under IRC §199A will be reported.

Form 1040 Schedule 1 (Additional Income and Adjustments to Income) contains what was removed from the old page one, with the net result going to line 6 on the new Form 1040.

SCHEDULE 1 (Form 1040)
Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

► Attach to Form 1040.
► Go to *www.irs.gov/Form1040* for instructions and the latest information.

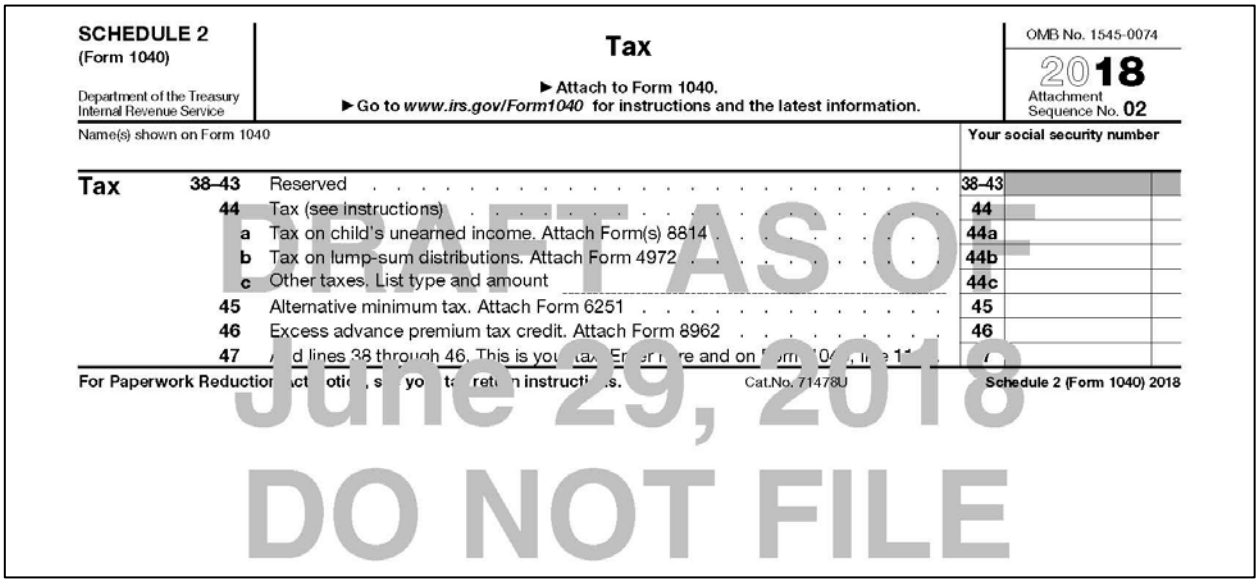
OMB No. 1545-0074
2018
Attachment Sequence No. **01**

Name(s) shown on Form 1040 | **Your social security number**

Additional Income	1–9b	Reserved	1–9b	
	10	Taxable refunds, credits, or offsets of state and local income taxes	10	
	11	Alimony received	11	
	12	Business income or (loss). Attach Schedule C or C-EZ	12	
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ► ☐	13	
	14	Other gains or (losses). Attach Form 4797	14	
	15a	Reserved	15b	
	16a	Reserved	16b	
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
	18	Farm income or (loss). Attach Schedule F	18	
	19	Unemployment compensation	19	
	20a	Reserved	20b	
	21	Other income. List type and amount ►	21	
	22	Combine the amounts in the far right column. If you don't have any adjustments to income, enter here and on Form 1040, line 6. Otherwise, go to line 23	22	
Adjustments to Income	23	Educator expenses	23	
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	24	
	25	Health savings account deduction. Attach Form 8889	25	
	26	Moving expenses for members of the armed forces. Attach Form 3903	26	
	27	Deductible part of self-employment tax. Attach Schedule SE	27	
	28	Self-employed SEP, SIMPLE, and qualified plans	28	
	29	Self-employed health insurance deduction	29	
	30	Penalty on early withdrawal of savings	30	
	31a	Alimony paid **b** Recipient's SSN ►	31a	
	32	IRA deduction	32	
	33	Student loan interest deduction	33	
	34	Reserved	34	
	35	Reserved	35	
	36	Add lines 23 through 35	36	
	37	Subtract line 36 from line 22. Enter here and on Form 1040, line 6	37	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2018**

Form 1040 Schedule 2, titled simply "Tax," contains the various taxes that might apply. Interestingly enough, the top of the form shows lines 38-43 as "reserved".



SCHEDULE 2 (Form 1040)
Department of the Treasury Internal Revenue Service

Tax

► Attach to Form 1040.
► Go to *www.irs.gov/Form1040* for instructions and the latest information.

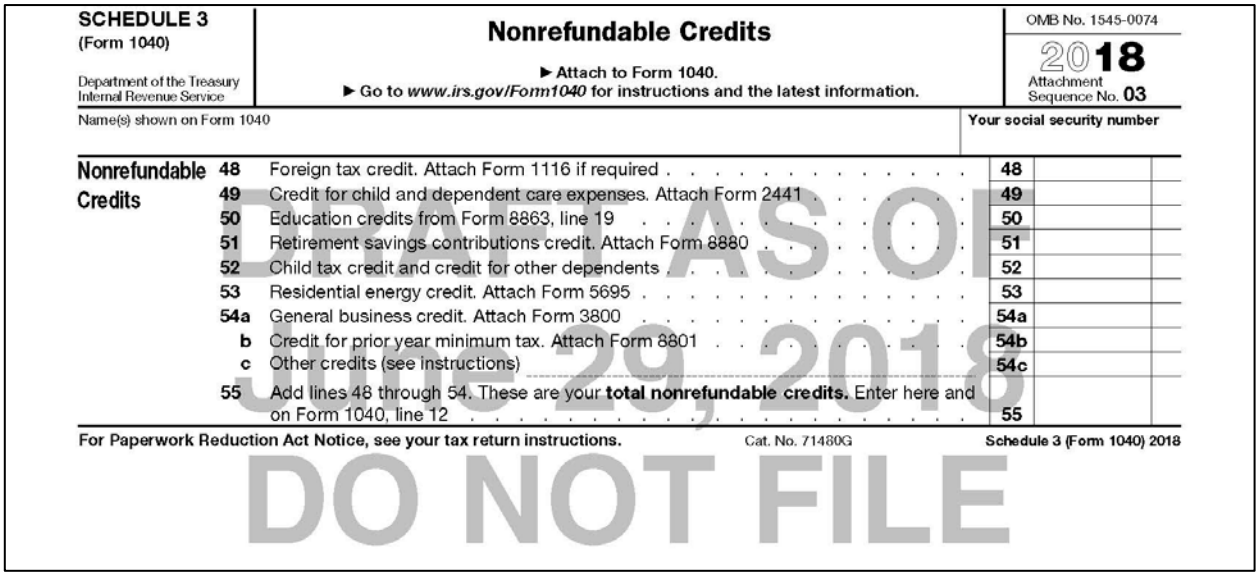
OMB No. 1545-0074
2018
Attachment Sequence No. 02

Name(s) shown on Form 1040 | Your social security number

Tax	38–43	Reserved	38–43	
	44	Tax (see instructions)	44	
	a	Tax on child's unearned income. Attach Form(s) 8814	44a	
	b	Tax on lump-sum distributions. Attach Form 4972	44b	
	c	Other taxes. List type and amount	44c	
	45	Alternative minimum tax. Attach Form 6251	45	
	46	Excess advance premium tax credit. Attach Form 8962	46	
	47	Add lines 38 through 46. This is your total tax. Enter here and on Form 1040, line 17	47	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat.No. 71478U Schedule 2 (Form 1040) 2018

Form 1040 Schedule 3 ("Nonrefundable Credits") contains, as its title suggests, the various nonrefundable credits.



SCHEDULE 3 (Form 1040)
Department of the Treasury Internal Revenue Service

Nonrefundable Credits

► Attach to Form 1040.
► Go to *www.irs.gov/Form1040* for instructions and the latest information.

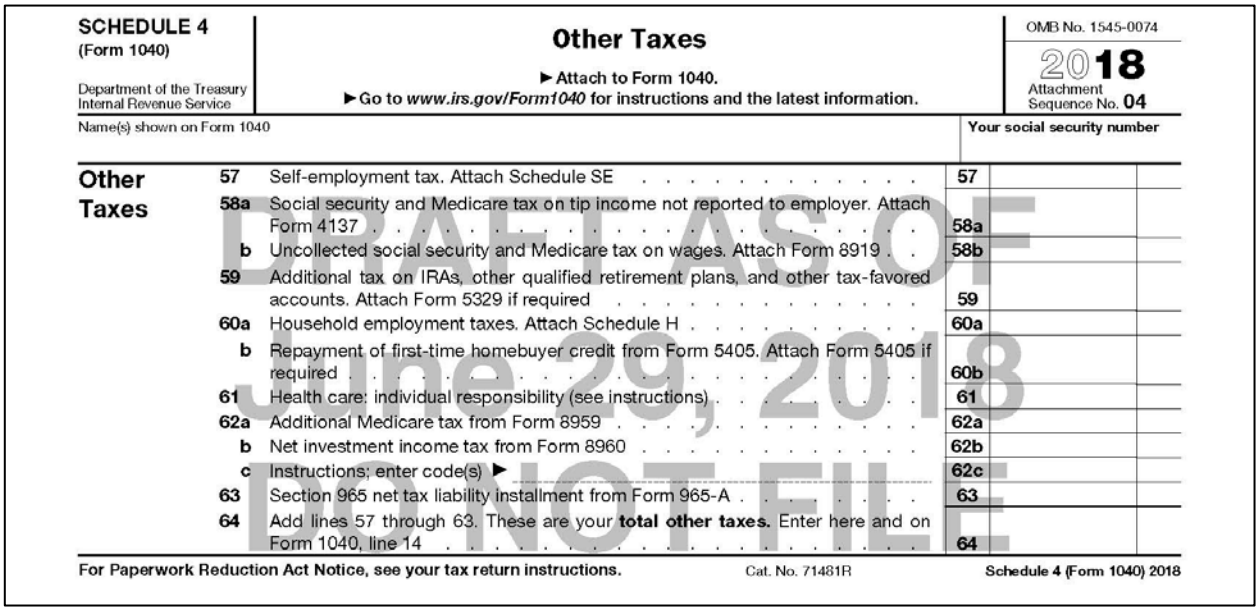
OMB No. 1545-0074
2018
Attachment Sequence No. 03

Name(s) shown on Form 1040 | Your social security number

Nonrefundable Credits	48	Foreign tax credit. Attach Form 1116 if required	48	
	49	Credit for child and dependent care expenses. Attach Form 2441	49	
	50	Education credits from Form 8863, line 19	50	
	51	Retirement savings contributions credit. Attach Form 8880	51	
	52	Child tax credit and credit for other dependents	52	
	53	Residential energy credit. Attach Form 5695	53	
	54a	General business credit. Attach Form 3800	54a	
	b	Credit for prior year minimum tax. Attach Form 8801	54b	
	c	Other credits (see instructions)	54c	
	55	Add lines 48 through 54. These are your **total nonrefundable credits.** Enter here and on Form 1040, line 12	55	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71480G Schedule 3 (Form 1040) 2018

Form 1040 Schedule 4 ("Other Taxes") contains various additional taxes, including self-employment taxes, the net investment income tax and the additional Medicare tax.



SCHEDULE 4 (Form 1040)
Department of the Treasury Internal Revenue Service

Other Taxes

► Attach to Form 1040.
► Go to *www.irs.gov/Form1040* for instructions and the latest information.

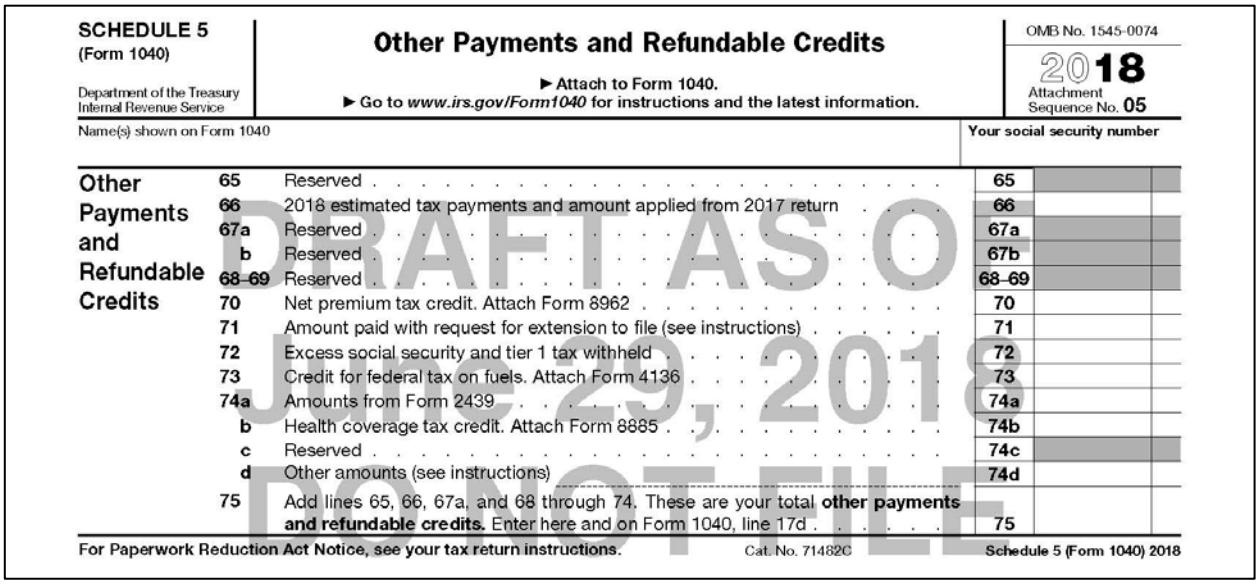
OMB No. 1545-0074
2018
Attachment Sequence No. 04

Name(s) shown on Form 1040 | Your social security number

Other Taxes	57	Self-employment tax. Attach Schedule SE	57	
	58a	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	58a	
	b	Uncollected social security and Medicare tax on wages. Attach Form 8919	58b	
	59	Additional tax on IRAs, other qualified retirement plans, and other tax-favored accounts. Attach Form 5329 if required	59	
	60a	Household employment taxes. Attach Schedule H	60a	
	b	Repayment of first-time homebuyer credit from Form 5405. Attach Form 5405 if required	60b	
	61	Health care: individual responsibility (see instructions)	61	
	62a	Additional Medicare tax from Form 8959	62a	
	b	Net investment income tax from Form 8960	62b	
	c	Instructions; enter code(s) ►	62c	
	63	Section 965 net tax liability installment from Form 965-A	63	
	64	Add lines 57 through 63. These are your **total other taxes.** Enter here and on Form 1040, line 14	64	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71481R Schedule 4 (Form 1040) 2018

Form 1040 Schedule 5 ("Other Payments and Refundable Credits") contains payments other than withholdings, as well as most (but not all) refundable credits (the earned income credit, for instance, has its own box on the Form 1040 itself).



SCHEDULE 5 (Form 1040)
Department of the Treasury Internal Revenue Service

Other Payments and Refundable Credits

► Attach to Form 1040.
► Go to *www.irs.gov/Form1040* for instructions and the latest information.

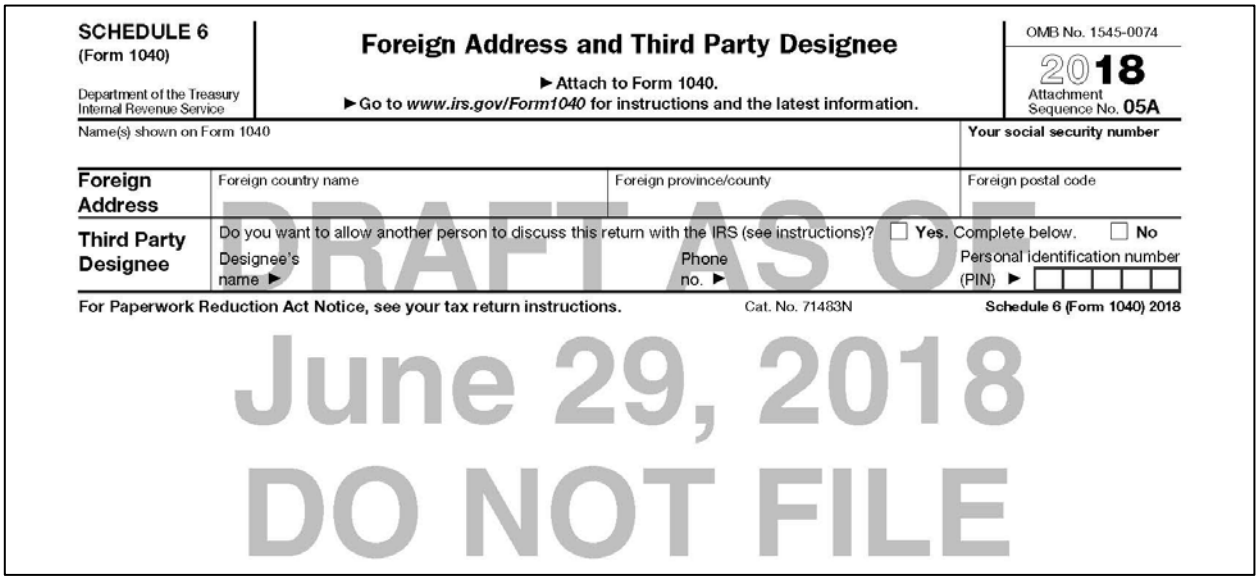
OMB No. 1545-0074
2018
Attachment Sequence No. 05

Name(s) shown on Form 1040 | Your social security number

Other Payments and Refundable Credits	65	Reserved	65	
	66	2018 estimated tax payments and amount applied from 2017 return	66	
	67a	Reserved	67a	
	b	Reserved	67b	
	68–69	Reserved	68–69	
	70	Net premium tax credit. Attach Form 8962	70	
	71	Amount paid with request for extension to file (see instructions)	71	
	72	Excess social security and tier 1 tax withheld	72	
	73	Credit for federal tax on fuels. Attach Form 4136	73	
	74a	Amounts from Form 2439	74a	
	b	Health coverage tax credit. Attach Form 8885	74b	
	c	Reserved	74c	
	d	Other amounts (see instructions)	74d	
	75	Add lines 65, 66, 67a, and 68 through 74. These are your total **other payments and refundable credits.** Enter here and on Form 1040, line 17d	75	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71482C Schedule 5 (Form 1040) 2018

Finally, Form 1040 Schedule 6 ("Foreign Address and Third Party Designee") contains only the very limited data noted in its title.



SCHEDULE 6 (Form 1040)
Department of the Treasury Internal Revenue Service

Foreign Address and Third Party Designee

► Attach to Form 1040.
► Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2018
Attachment Sequence No. 05A

Name(s) shown on Form 1040 | Your social security number

Foreign Address	Foreign country name	Foreign province/county	Foreign postal code
Third Party Designee	Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ Yes. Complete below. ☐ No Designee's name ►	Phone no. ►	Personal identification number (PIN) ►

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71483N Schedule 6 (Form 1040) 2018

While few returns will contain all six schedules, most returns that CPA firms will prepare will contain one or more of these schedules, with Schedule 1 being especially prevalent due to the large number of items moved from the front page of the Form 1040 to this subsidiary schedule. We also can likely expect calls from clients who won't be able to find, for instance, their rental activity on the new forms.

Section: 401
Use of CPA Who Did Significant Other Work for ESOP and Sponsor as Appraiser Did Not Run Afoul of Independent Appraiser Requirements

Citation: Val Lanes Recreation Center Corp. v. Commissioner, TC Memo 2018-92, 6/26/18

At first glance, the case would not have appeared promising for the taxpayer in *Val Lanes Recreation Center Corp. v. Commissioner,* TC Memo 2018-92. The IRS had revoked the exempt status of the ESOP of the taxpayer and had done so partially based on the agency's position that the CPA who performed the appraisal was not an "independent appraiser" as required by IRC §401(a)(28)(C).

The reason for the grim outlook was that the taxpayer had used the same appraiser as had been used in the case of *Churchill, Ltd. Emp. Stock Ownership Plan & Tr. v. Commissioner*, TC Memo 2012-300 where the Court had agreed with the IRS that the appraiser, who also handled many other duties for the plan, failed both as to his qualifications and his independence under this test, resulting in the loss of tax exempt status of the employee trust. Another client of the same appraiser had ended up with a similar result in case of *Hollen v. Commissioner*, TC Memo 2011-2.

But this time the Tax Court found that while there were many similarities in the cases, key facts were different this time that saved the day for the exempt trust.

IRC §401(a)(28)(C) provide the following regarding the independent appraiser requirement for an ESOP:

> *(C)Use of independent appraiser.—*
>
> *A plan meets the requirements of this subparagraph if all valuations of employer securities which are not readily tradable on an established securities market with respect to activities carried on by the plan are by an independent appraiser. For purposes of the preceding sentence, the term "independent appraiser" means any appraiser meeting requirements similar to the requirements of the regulations prescribed under section 170(a)(1).*

The Court opinion summarizes what those regulations, found at Reg. §1.170A-13(c), provide:

> *Those regulations specify several requirements for a "qualified appraiser" including that the individual provide a declaration on the appraisal summary that the individual holds himself or herself out to the public as an appraiser or performs appraisals regularly and is qualified to make appraisals of the type of property being valued based on his or her background, experience, education, and membership, if any, in professional organizations. Sec. 1.170A-13(c)(3)(ii)(F), (c)(5), Income Tax Regs.*

The appraiser in this case was the CPA that had been working with the taxpayer on various tax matters. The plan (the ESOP) and the trust holding plan assets (the ESOT) were formed at the CPA's recommendation, as well as the related entities formed as part of the revised business structure to be used.

The CPA took charge of applying for the favorable initial determination letter and revising the plan document as requested by the IRS during that process. In addition, each year the CPA prepared the Forms 5500 for submission to the Department of Labor and IRS.

Finally, the CPA (Mr. Thielking) undertook the annual appraisals of the closely held stock for the ESOP. As the Court noted:

> *In addition to preparing Form 5500, Mr. Thielking performed and submitted appraisals valuing petitioner's stock and Essy Management's stock as of the end of the plan year. Each appraisal included the following declaration:*
>
> > *The undersigned holds himself out to be an appraiser.*
> >
> > *The undersigned is a certified public accountant who is familiar with the assets being appraised.*
> >
> > *The undersigned is not a party to any transaction related to this appraisal.*
> >
> > *The undersigned understands that a false or fraudulent overstatement of the value of the property being appraised may subject the appraiser to a civil penalty under Internal Revenue Code section 6701 for aiding and abetting an understatement of tax liability, and consequently, the appraiser may have appraisals disregarded pursuant to 31 U.S.C. 330(c).*
> >
> > *The fee charged for this appraisal is not based upon a percentage of the appraisal value of the property.*
> >
> > *Appraisals prepared by the appraiser are not being disregarded pursuant to 31 U.S.C. 330(c) on the date the appraisal summary is signed.*

The IRS pointed out that the opinion in *Churchill* had found that "it appears that Thielking was not independent as he was the author and preparer of most of the trust records and returns." Mr. Thielking was, yet again, the author and preparer of most of the trust records and returns and, in the IRS's view, based on those facts alone the trust should be found to have failed to have the assets appraised by an independent appraiser as required by the law.

But the Tax Court did not accept that view. The plans in *Churchill* and *Hollen* were found wanting in numerous respects and the line cited above was one stated in passing by the Court in the *Churchill* opinion. In the case before the Court now, the opinion noted:

> *In Churchill, at *21-*24, the Court first found that the administrative record contained insufficient evidence as to Mr. Thielking's background, education, and experience in valuing the type of business at issue in the case even before stating that Mr. Thielking was not independent. The Court in Churchill, therefore, did not analyze section 1.170A-13(c)(iv), Income Tax Regs., excluding certain persons as "qualified appraisers", nor did it ultimately rely on its statement regarding Mr. Thielking's involvement in the plan and trust.*

The passage from *Churchill* represented, in the view of the judge hearing this case, something referred to in legal circles as "*dicta*." That term, as defined by Wex on the Cornell University Legal Information Institute website, means:

> *A statement of opinion or belief considered authoritative because of the dignity of the person making it. The term is generally used to describe a court's discussion of points or questions not raised by the record or its suggestion of rules not applicable in the case at bar. Judicial dictum is an opinion by a court on a question that is not essential to its decision even though it may be directly involved.*[1]

Judges will often dismiss items of *dicta* in a cited case since they had no direct impact on the decision in the case. In essence, it just becomes the original author's musings on a point that, in the end, was not relevant to how the case was decided.

The Court then turned to the specific issues the IRS had raised in this case. First, the IRC claimed the CPA did not hold himself out to the public as an appraiser of securities. The Court did not agree that the IRS's evidence backed up the claim the he failed that part of the test. The Court noted:

> *Respondent specifically referenced his listing in the Des Moines telephone directory, which only advertised Mr. Thielking as a CPA. However, the record also contains a Des Moines Yellow Pages listing in which Mr. Thielking's firm identified "Business & Estate Appraisals" as one of its available services. Additionally, there is no requirement in the regulation for an advertisement to the public. Rather, the regulation requires that the individual hold himself out to the public as an appraiser or perform appraisals regularly. Sec. 1.170A-13(c)(5)(i)(A), Income Tax Regs. In the May 28, 2008, protest to respondent's proposed revocation of the FDL, petitioner explained Mr. Theilking's background and education. Petitioner also specified that Mr. Thielking taught courses on the appraisal of closely held corporations and performed "literally thousands of appraisals of all sorts." During the hearing petitioner introduced evidence that Mr. Thielking annually performed approximately 40 appraisals of ESOT-owned closely held business stock. The Court finds that Mr. Thielking did have*

[1] https://www.law.cornell.edu/wex/dicta, June 28, 2018

> *the appropriate background, education, and experience to value petitioner's stock and Essy Management's stock.*

But what about the fact that he did significant other work for the plan? The IRS contended this meant he could not be viewed as an *independent* appraiser for these purposes. But, again, the Court did not agree, holding:

> *Respondent determined in the FRL that Mr. Thielking could not be considered "independent of either the ESOP sponsor or the administration of the ESOP" because he performed various services for the ESOP throughout the year. The regulations regarding "qualified appraisers" specifically exclude those who were donors or donees of the property (or their employees), parties to the transaction in which the donor acquired the property, related parties within the meaning of section 267(b), or an appraiser who is regularly used by any person listed above who does not perform a majority of his or her appraisals made during his or her taxable year for other persons. Sec. 1.170A-13(c)(5)(iv), Income Tax Regs. Respondent appears to argue in favor of a broader reading of the regulations, citing Mr. Thielking's services as a CPA and overall involvement with the ESOP as evidence as to his lack of independence.*
>
> *… (Unlike in the Churchill case) [h]ere, the Court reviews the additional exhibits and testimony petitioner introduced in this case and finds that Mr. Thielking was qualified to value petitioner's stock and Essy Management's stock. Therefore, the Court must consider whether section 1.170A-13(c)(iv), Income Tax Regs., excludes persons beyond those specifically listed and finds that it does not. Section 401(a)(28)(C) provides that the term "independent appraiser" is similar to the requirements of the regulations for section 170(a)(1), which in turn define "qualified appraiser". Section 1.170A-13(c)(iv), Income Tax Regs., excludes certain persons from being appraisers because of their inherent lack of independence. Petitioner has established that Mr. Thielking was not disqualified under any of the exclusions.*

The Court concludes that the IRS had abused its discretion by revoking the final determination letter for the plan on the basis of the plan not making use of an independent appraiser.

Section: 1400Z-1
IRS Publishes List of Designated Qualified Opportunity Zones

Citation: Notice 2018-48, 6/20/18

The IRS has released the list of designated qualified opportunity zones under IRC §1400Z-1 in Notice 2018-48. The 383-page list defines areas for investment that can be used for qualified investments under IRC §1400Z-2 added by the Tax Cuts and Jobs Act.

The purpose of IRC §§1400Z-1 and 1400Z-2 was to offer significant tax incentives to encourage investment in certain disadvantaged areas identified by state and local officials. The designated areas are submitted to the IRS for listing.

The qualified opportunity zone fund provides several benefits to investors in a qualified fund. Those include:

- The ability to defer gains from the sale of property held by the taxpayer sold to a third party so long as the gain is invested in a qualified opportunity zone fund within 180 days beginning on the date of sale of the gain producing property. [IRC §1400Z-1(a)]
- The deferred gain is includable in income on the earlier of the date the investment in the fund is sold or December 31, 2026. However, this deferred gain is slowly transformed to

tax-exempt gain over time. If the investment is held over 5 years, the basis in the deferred gain (which starts out at zero) is increased to 10% of the deferred gain. If the taxpayer holds the property more than 7 years, the excluded gain increases by an additional 5% of the deferred gain. [IRC §1400Z-2(a)(2)(B)]

- If the qualified opportunity fund investment is held for at least 10 years, the taxpayer may elect to have the basis of such property set as equal to the fair market value of the investment on the date the investment is sold or exchanged. [IRC §1400Z-2(c)]

Section: 6663
Original Return Amounts, Rather Than Those on Amended Return, Used to Compute Fraud Penalty

Citation: Gaskin v. Commissioner, TC Memo 2018-89, 6/20/18

In the case of *Gaskin v. Commissioner*, TC Memo 2018-89, a taxpayer was fighting the imposition of the fraud penalty by the IRS on its assessment of taxes. The taxpayer admitted that he had originally filed a fraudulent return that lead to an IRS criminal investigation, indictment and plea agreement. However, he had filed amended returns during that process that reported virtually all the income he had fraudulently omitted—but the still computed the 75% penalty under IRC §6663 based on amounts reported on the originally filed returns and not based on the amended returns he later filed.

IRC §6663 provides the following:

> (a) Imposition of penalty
>
> If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.

For most penalties, a taxpayer who files what is referred to by Reg. §1.6664-2(c)(3) as a "qualified amended return", is allowed to substitute the numbers on that return for the numbers on the originally filed return, thus reducing the penalties the IRS may impose.

The general rule for filing a qualified amended return are found at Reg. §1.6664-2(c)(3)(i) which provides:

> *(3) Qualified amended return defined*
>
> *(i) General rule.*
>
> *A qualified amended return is an amended return, or a timely request for an administrative adjustment under section 6227, filed after the due date of the return for the taxable year (determined with regard to extensions of time to file) and before the earliest of --*
>
> > *(A) The date the taxpayer is first contacted by the Internal Revenue Service (IRS) concerning any examination (including a criminal investigation) with respect to the return;*
> >
> > *(B) The date any person is first contacted by the IRS concerning an examination of that person under section 6700 (relating to the penalty for promoting abusive tax shelters) for an activity with respect to which the taxpayer claimed any tax benefit on the return directly or indirectly through the entity, plan or arrangement described in section 6700(a)(1)(A);*

> *(C) In the case of a pass-through item (as defined in § 1.6662-4(f)(5)), the date the pass-through entity (as defined in § 1.6662-4(f)(5)) is first contacted by the IRS in connection with an examination of the return to which the pass-through item relates;*
>
> *(D)*
>
> > *(1) The date on which the IRS serves a summons described in section 7609(f) relating to the tax liability of a person, group, or class that includes the taxpayer (or pass-through entity of which the taxpayer is a partner, shareholder, beneficiary, or holder of a residual interest in a REMIC) with respect to an activity for which the taxpayer claimed any tax benefit on the return directly or indirectly.*
> >
> > *(2) The rule in paragraph (c)(3)(i)(D)(1) of this section applies to any return on which the taxpayer claimed a direct or indirect tax benefit from the type of activity that is the subject of the summons, regardless of whether the summons seeks the production of information for the taxable period covered by such return; and*
>
> *(E) The date on which the Commissioner announces by revenue ruling, revenue procedure, notice, or announcement, to be published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter), a settlement initiative to compromise or waive penalties, in whole or in part, with respect to a listed transaction. This rule applies only to a taxpayer who participated in the listed transaction and for the taxable year(s) in which the taxpayer claimed any direct or indirect tax benefits from the listed transaction. The Commissioner may waive the requirements of this paragraph or identify a later date by which a taxpayer who participated in the listed transaction must file a qualified amended return in the published guidance announcing the listed transaction settlement initiative.*

However, Reg. §1.6664-2(b) provides that such relief does not apply to any fraudulent position claimed on the original return.

The Tax Court notes that courts have upheld this rule that denies relief to a taxpayer who amends what was initially a fraudulent return:

> *Courts at every level have held that a taxpayer who filed a fraudulent return cannot avoid the fraud penalty by filing an amended return. In Badaracco v. Commissioner, 464 U.S. 386, 394 (1984), the U.S. Supreme Court held that "a taxpayer who submits a fraudulent return does not purge the fraud by subsequent voluntary disclosure; the fraud was committed, and the offense completed, when the original return was prepared and filed." In Badaracco the taxpayer argued that an amended return restarted the period of limitations for that year. While the facts in this case differ, the same principle applies. In Brown v. Commissioner, T.C. Memo. 1996-416, 72 T.C.M. (CCH) 620 (1996), we held that a taxpayer was liable for a fraud penalty even after he filed an amended return. The subsequent filing of an amended return after an audit had begun did not purge the original fraudulent filing or fraudulent intent.*

The Tax Court then goes on to note that Mr. Gaskin had conceded, as part of his plea agreement, to filing a fraudulent return:

> *In his plea agreement Mr. Gaskin admitted to filing fraudulent returns. He agreed that from 2008 to 2011 he underpaid his taxes by over $100,000 and that the underpayment for each year was due to fraud. As a result the fraud penalty applies to each of the fraudulent returns. An amended return cannot erase the fraud he committed.*

Section: 7121
Despite Belief Had Settled Audit With No Penalties, IRS Allowed to Later Raise Issue of §6707A Penalties

Citation: Hinkle, et al v. United States, US DC NM, Case No. 1:16-cv-01048 KG/SCY, 6/16/18

Anyone that has ever represented a taxpayer in an IRS exam eventually has seen the IRS Form 4549 which is used by the IRS agent to indicate the proposed assessment in cases where the parties are expected to agree to the amounts. The second page of the form contains a signature block for the taxpayer to sign to agree not to contest the amounts on the form.

In the case of *Hinkle, et al v. United States*, US DC NM, Case No. 1:16-cv-01048 KG/SCY the taxpayer protested that they signed the Form 4549 after receiving what they believed were assurances from the IRS agent that no penalties would be assessed for the years in question. Despite that, just after they had signed the forms they were notified the IRS was considering assessing penalties under IRC §6707A.

As the Court outlines the steps leading up to the signing of the Form 4549s in this case:

> *In April and May 2009, Plaintiffs were notified by Internal Revenue Agent ("IRA") Russell Gadway, on behalf of the IRS, that their 2007 tax return had been selected for examination.4 (Doc. 34-1) at 1-2, 23-24, and 44-45. On June 14, 2010, each set of Plaintiffs received a letter from IRA Gadway referencing tax years 2007 and 2008, stating, in pertinent part: "[t]his correspondence is to see if I can convince you to agree to the enclosed examination change report. This report is different from previous ones in that the penalties have been waved (sic) if you agree at my level when you relied on your preparer for taking the deduction." Id. at 3, 25, and 46. Each letter was accompanied with a Form 4549 document titled "Income Tax Examination Changes," and this form assessed an accuracy-related penalty under 26 U.S.C. § 6662. Id. at 4-5, 26-27, and 47-48. On July 7, 2010, William D. Hinkle signed a Form 4549 document which assessed neither a § 6662 penalty nor any other penalty. Id. at 49-50. On July 11, 2010, Gene E. and Betty L. Hinkle also signed a Form 4549 document which assessed neither a § 6662 penalty nor any other penalty; and, R. Bryan Hinkle and Matilda Garcia signed their Form 4549 document which assessed neither a § 6662 penalty nor any other penalty on July 12, 2010, and July 13, 2010, respectively. Id. at 6-7, and 28-29.*

Thus, the taxpayers were unpleasantly surprised just a few days later. As the opinion continues:

> *On July 19, 2010, the IRS notified R. Bryan Hinkle and Matilda Garcia, and William D. Hinkle, that it was considering assessing penalties under 26 U.S.C. § 6707A for failure to disclose a listed transaction under 26 C.F.R. § 301.6011-4(b)(2) and 26 U.S.C. § 6111 and § 6112. (Doc. 34-1) at 31, 51.*

Things didn't get less confusing when yet more correspondence arrived in September:

> *On September 4, 2010, Gene E. and Betty L. Hinkle received a letter from Deborah M. Daub on behalf of William P. Marshall, North Atlantic Area Director of the IRS, stating "[w]e've reviewed and accepted the examination report that we previously gave to you regarding the examination of your tax return for [2007 and 2008]. We do not plan to make any additional changes to your return(s) unless we change a partnership, S-Corporation, trust, or estate tax return in which you have an interest."5 Id. at 8.*

The matter remained in this state until the following year when the IRS decided to propose the penalties under IRC §6707A:

> *In late March 2011, each Plaintiff received a Form 4549-A titled "Income Tax Discrepancy Adjustments" assessing a civil penalty under § 6707A.6 (Doc. 34-1) at 9-10, 32-33, and 52-54. On April 10, 2011, Robert E. Bivins, the Plaintiffs' accountant, sent a letter to IRA Gadway protesting the § 6707A penalty in the March 2011 Form 4549-A documents. Id. at 11-12, 34-35, and 55-56. Mr. Bivins notes "[t]he taxpayer was further assured no penalties would be assessed through acceptance and payment of taxes alleged to be due, which assurance has apparently been broken." Id. at 12, 35, and 56.*

The IRS took a while to make its next move, but when it did so it wasn't one the taxpayers liked:

> *Over a year later, on September 3, 2012, the Plaintiffs received "Notice of Penalty Charge" from the IRS for tax years 2007 and 2008. Id. at 13-16, 36-39, and 57-60. A week later, Mr. Bivins responded with a letter protesting the assessment of § 6707A penalties against Plaintiffs in the Notice of Penalty Charges. Id. at 17, 40, and 61. On September 19, 2013, Mr. Bivins completed and submitted Form 843 documents for the Plaintiffs for tax years 2007 and 2008, requesting an abatement of the § 6707A penalty. Id. at 19-20, 42-43, and 63-64.*

The IRS issued a response in December of 2013 to the taxpayers:

> *On December 26, 2013, Gene E. and Betty L. Hinkle received a letter from Jeffrey E. Barrett, Operations Manager, AM Operations 1, on behalf of the IRS, referencing correspondence on September 19, 2013.7 Id. at 21. This letter states, in pertinent part: "Dear Taxpayer: Thank you for your correspondence dated 09/09/13. In reviewing your account, our records show that all penalties have been waived for the tax years listed above, as agreed by Internal Revenue Agent Mr. Russell Gadway." Id.*

Despite the statement that "all penalties have been waived as agreed" by the IRS agent, no refund of the §6707A penalty payments were forthcoming. Thus, the matter ended up before the court.

One fact readers may have noticed is that the IRS was looking at two different penalties—one was the 20% accuracy related penalty under §6662 which had initially been proposed in the examination and which was later removed and, separately, the penalty under IRC §6707A for the failure to disclose a listed transaction. And, in their various correspondence, never actually dealt with both penalties, resulting in the rather confusing correspondence.

However, by the time this is in Court it's clear which penalties are in dispute—the IRS's ability to go after the §6707A penalties after having obtained the taxpayer's consent to the other examination changes on a Form 4549 along assurances that penalties would be removed.

The Court first looked at whether the Form 4549 and additional correspondence had created an enforceable contract with the taxpayer that barred the later imposition of the IRC §6707A penalties. The Court concluded that IRC §§7121 and 7122 contained the exclusive means by which the IRS could be bound contractually to settle tax matters.

The opinion notes:

> *Under § 7121(a), "[t]he Secretary is authorized to enter into an agreement in writing with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any*

> *internal revenue tax for any taxable period." Further, "[a]ll closing agreements shall be executed on forms prescribed by the Internal Revenue Service." 26 C.F.R. § 301.7121-1(d)(1). The appropriate forms are Form 866 or Form 906. Rev. Proc. 68-16, Sec. 6.*

The Form 4549 is not one of the designated forms that provides for such a binding agreement on the IRS.

But the taxpayers argue that the IRS had offered to remove any penalties if they would agree to the proposed assessments, and that offer is documented in the December 2013 letter that showed "all penalties had been waived" in accordance with their agreement with the IRS Agent.

But the Court did not accept this view. The opinion holds:

> *The Court disagrees for at least two reasons. First, the December 26, 2013, letter does not amount to an offer as there is no promise by the IRS to take or forego some action. At most, this letter implies an agreement to waive penalties, as defined by IRA Gadway's June 14, 2010, letter accompanying the Form 4549 documents. The June 14, 2010, letter refers to previous Form 4549 documents, and the only previous Form 4549 documents show an accuracy-related penalty under § 6662 and not a § 6707A penalty. In other words, Plaintiffs have failed to provide evidence of a Form 4549 document assessing a § 6707A penalty prior to IRA Gadway's June 14, 2010, letter.*
>
> *Second, neither the Form 4549 documents nor the December 26, 2013, letter are in a form required to create a binding closing agreement under 26 C.F.R. § 301.7121-1(d)(1). Plaintiffs cite Haiduk v. Commissioner of Internal Revenue, and other similar United States Tax Court memorandum opinions, as authority to navigate around this closing agreement standard. See Haiduk, 60 T.C.M. (CCH) 864 (1990) ("Formal stipulations of settlement or decision documents are not absolute prerequisites to a binding agreement to settle pending litigation if the intent of the parties to settle and the terms of the settlement are otherwise ascertainable."). However, cases like Haiduk only apply to agreements in docketed cases. See also Mueth v. United States, 2008 WL 2625909, at *8 (S.D. Ill.) ("In other words, the § 7121 statutory framework (providing for closing agreements) is the exclusive method to administratively settle a tax liability until a suit is docketed in Tax Court or District Court. Once suit is filed, settlement need not be accomplished via § 7121 closing agreement and can be effected by other means."). The cases cited by Plaintiff are inapplicable because the supposed agreement occurred before this case was filed in September 2017. Therefore, the Court concludes there is no genuine issue of material fact as to whether there was an enforceable contract precluding the IRS from assessing the § 6707A penalty.*

In the absence of a contractual agreement, the Court could still find the IRS was barred from assessing the penalty based on the concept of equitable estoppel. The opinion, citing *United States v. Browning*, 630 F.2d 694, 702 (10th Cir. 1980), provides that the taxpayers need to prove four assertions to be able to obtain equitable estoppel relief against the IRS:

- The party to be estopped (the IRS in this case) must know the facts;
- The IRS must intend that its conduct will be acted upon or must so act that the party asserting the estoppel has the right to believe that it was so intended;
- The taxpayer must be ignorant of the true facts; and
- The taxpayer must rely on the IRS's conduct to his injury.

The opinion goes to note that if there "affirmative misconduct" that can create estoppel against the government.

The Court does not find that there was any evidence of an affirmative misrepresentation by the IRS. The opinion notes:

> *The evidence establishes that IRA Gadway waived the § 6662 accuracy-related penalty. IRA Gadway's June 14, 2010, letter states that previous penalties would be waived for signing the accompanying Form 4549 documents. (Doc. 34-1) at 3-5, 25-27, and 46-48. The accompanying 4549 documents assess the § 6662 penalty.*
>
> *Plaintiffs argue the § 6707A penalty also was waived and they offer the deposition testimony from Mr. Bivins, who testified that IRA Gadway represented to him that IRA Gadway had settlement authority on behalf of the IRS. (Doc. 37-1) at 7 (depo. at 72). Mr. Bivins also testified that he discussed the § 6707A penalty with IRA Gadway and that there were previous examination change reports, presumably Form 4549 documents, assessing a § 6707A penalty. Id. at 2 (depo. at 27); id. at 3-5 (depo. at 29-31). While this Court considers the evidence, including the documents, in the light most favorable to Plaintiffs, it concludes Mr. Bivins' reliance was not reasonable, specifically that the § 6707A penalty was included in a Form 4549 document prior to IRA Gadway's June 14, 2010, letter. Thus, based on the evidence before the Court, a reasonable jury could only find that IRA Gadway's June 14, 2010, letter waived the § 6662 penalty, and not the § 6707A penalty.*

The Court also did not find that the December 2013 letter provides any evidence of affirmative misconduct regarding the §6707A penalties:

> *The December 26, 2013, letter does not specifically mention the § 6707A penalty but does reference correspondence dated September 19, 2013, the date the Form 843 documents were filed. (Doc. 34-1) at 21-22. This letter references a waiver of "all penalties" as agreed by IRA Gadway. Id. at 21. Construed in the light most favorable to Plaintiffs, this letter raises a question whether Manager Barrett, on behalf of the IRS, included the § 6707A penalty in the December 26, 2013, letter. Even so, this letter does not demonstrate affirmative misrepresentation or concealment necessary for a reasonable jury to find the IRS engaged in affirmative misconduct. Thus, Plaintiffs have not established a genuine issue of material fact requiring their claim of equitable estoppel to proceed to trial.*

The key problem here was not getting an explicit explanation of what the IRS agent meant by removing the penalties. The taxpayers appear to have assumed that all penalties the IRS planned to assert would be on the examination report. While that assumption appears reasonable on its face, the §6707A penalty is in a somewhat different category.

As well, the agent had agreed to remove the penalties on the report—and only §6662 penalties showed on the report.

Finally, as the Court notes, absent a formal closing agreement the IRS is not barred from asserting additional tax for the year in question. While it is not the norm for the IRS to go back to the same year to go after penalties under a new issue, it clearly is something the IRS can do.