Current Federal Tax Developments

Week of July 1, 2019

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ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF JULY 1, 2019
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Current Federal Tax Developments

Kaplan Financial Education

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SECTION: SECURITY
IRS SENDS EMAIL TO PREPARERS OUTLINING STEPS TO TAKE WHEN A DATA BREACH OCCURS

Citation: "Data Breach! Contact the IRS!," IRS Return Preparer Office, electronic mail, 6/24/19

The IRS has sent an email to tax professionals discussing what to do if the professional becomes aware of a data breach.[1]

The email begins by reminding tax professionals that the IRS had sent out an email in March (which I suspect many overlooked due to coming in the middle of a generally very trying filing season) about the need to develop a data security plan. But the email continues that even with such a plan in place, a data breach can still occur.

IRS email then outlines the agencies that should be notified of the breach as soon as the professional becomes aware of the breach:

> *If you experience a data breach, here's how to report your data loss:*
>
> - *Contact the IRS and law enforcement:*
> - *Report client data thefts to your local IRS Stakeholder Liaison. The liaison will notify IRS Criminal Investigation and others within the agency on your behalf. If reported quickly, the IRS can take steps to block fraudulent returns in your clients' names.*
> - *Federal Bureau of Investigations (FBI), your local office (if directed by IRS)*
> - *Secret Service, your local office (if directed by IRS)*
> - *Local police to file a report on the data breach*
> - *Contact the states in which you prepare returns:*
> - *A breach of personal information could affect the victim's tax accounts with the states. You should email the Federation of Tax Administrators at StateAlert@taxadmin.org to get information on reporting victim information to the states.*
> - *Also, you may need to contact the State Attorney General for each state where you prepare tax returns. Most states require that the attorney general be notified of data breaches.*
> - *Contact experts:*
> - *Security expert - to determine the cause and scope of the breach, stop the breach and prevent future breaches.*

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[1] "Data Breach! Contact the IRS!," IRS Return Preparer Office, electronic mail dated June 24, 2019

    - *Insurance company - to report the breach and determine if your policy covers data breach mitigation expenses.*
- *Contact clients and other services:*
    - *Clients - Send a letter to all victims to inform them of the breach however, work with law enforcement on timing.*
    - *Federal Trade Commission - Can help businesses victimized by data thefts, including providing resources on notifying clients that a data loss has occurred.*
    - *Credit/ID theft protection agency - Some states require offering credit monitoring/ID theft protection to victims of ID theft.*
    - *Credit bureaus - To notify them of a data compromise since clients may seek their services.*

The email is correct in warning that any organization can be subject to a data breach, since a single mistake can open up systems to takeover or expose confidential tax information.

In Verizon's *2018 Data Breach Investigations Report, 11th Edition* the report noted that for professional, technical and scientific services noted that, in this industry group, "detection and containment times are dismal."[2]

The most significant action varieties detected in the security incidents investigated in this report were, in order of number times seen:

- Use of stolen credentials (this could be due to reuse of credentials for multiple accounts)
- Phishing
- Misdelivery (sending the information to the wrong client)
- Privilege abuse (an account had access to data the user had no reason to have access to)
- Pretexting (contact via phone or other means to obtain information to allow attacker to impersonate an employee)
- Misconfiguration (as firms move information to the web, too often data moved to the cloud is put into databases where no or default account login credentials are used)[3]

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[2] *2018 Data Breach Investigations Report, 11th Edition,* Verizon, p. 38, https://enterprise.verizon.com/resources/reports/DBIR_2018_Report.pdf accessed June 25, accessed June 25, 2019

[3] *Ibid*

SECTION: 199A

IRS OFFICIAL CONFIRMS MIXED-USE RENTAL PROPERTIES CAN BE A SINGLE TRADE OR BUSINESS

Citation: Eric Yauch, "Mixed-Use Property Could Be One Business for 199A Purposes," Tax Notes Today Federal, 6/28/19

An issue that has confused taxpayers since the IRS has issued guidance on IRC §199A is whether a taxpayer has to treat commercial and residential rentals as different trades for businesses, especially in the context of mixed-use property. *Tax Notes Today Federal* reported on comments from Holly Porter, IRS associate chief counsel (passthroughs and special industries) where she said that such combinations were not prohibited under the general rules for determining the trades or businesses of a taxpayer.[4]

The IRS had included a prohibition on combining commercial and residential rentals into a single *enterprise* under the proposed safe harbor test regarding whether a rental is a trade or business under Notice 2019-07. Since it is only a safe harbor, not being able to come under its conditions did not necessarily mean that the undertaking could be a trade or business—just that the taxpayer could not use the safe harbor to establish it was a §162 trade or business eligible for the 20% §199A deduction.

As well, the IRS in Example 17 found at Reg. §1.199A-4(d) had provided that residential and commercial properties were not the "same type of property" for purposes of the election to aggregate multiple trades or businesses under §199A. Again, this only applied to activities already determined to be a trade or business, so it did not clearly indicate that commercial and residential properties could not be part of the same §162 trade or business for §199A reporting.

But some advisers were concerned that these pieces of guidance indicated that the IRS was taking the view that commercial and residential properties could never be part of the same trade or business purposes of §199A.

The *Tax Notes Today Federal* article reported on Ms. Porter's comments at the New York University Real Estate and Partnerships Tax Conference in Washington that indicated this was not necessarily the case. The article provides:

> *Commercial and residential property within the same building can be treated as a single trade or business for purposes of the passthrough deduction, according to an IRS official.*

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[4] Eric Yauch, "Mixed-Use Property Could Be One Business for 199A Purposes," *Tax Notes Today Federal*, June 28, 2019, https://www.taxnotes.com/tax-notes-today-federal/partnerships-and-other-passthrough-entities/mixed-use-property-could-be-one-business-199a-purposes/2019/06/28/29nw5 (subscription required), retrieved June 29, 2019

For example, a building with a grocery store on the ground floor and residential apartments above it could be considered one business under section 199A, Holly Porter, IRS associate chief counsel (passthroughs and special industries), said June 27 at the New York University Real Estate and Partnerships Tax Conference in Washington.

The determination depends on the facts and circumstances, but it is possible, Porter added.[5]

SECTION: 274
TAX COURT DID NOT BELIEVE TAXPAYER'S LOGS THAT SHOWED HE DROVE FROM FLORIDA TO SOUTH AFRICA

Citation: Burden, et al v. Commissioner, TC Summary Opinion 2019-11, 6/24/19

Taxpayers who try to reconstruct records when faced with an IRS exam often make obvious mistakes. But in the case of *Burden, et al v. Commissioner*, TC Summary Opinion 2019-11[6] the taxpayers may have set a new standard for creating records that clearly did not reflect reality.

The key issues in this case revolved around the taxpayers' attempt to deduct $41,950 for unreimbursed employee business expenses for both spouses. Of those expenses $20,334 represented vehicle expenses computed at the standard mileage rate, $10,897 represented travel expenses and $2,904 represented meals and entertainment expenses.

All of those expenses are subject to the strict substantiation rules of IRC §274(d). That provision provides:

(d) Substantiation required

No deduction or credit shall be allowed—

(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

(2) for any expense for gifts, or

(3) with respect to any listed property (as defined in section 280F(d)(4)),

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of the person receiving the benefit. The Secretary may by regulations provide that some or all of the

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[5] *Ibid*

[6] https://ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=11982, retrieved June 24, 2019

> *requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations. This subsection shall not apply to any qualified nonpersonal use vehicle (as defined in subsection (i)).*

With regard to the listed property issue for the vehicle, the taxpayers' records were particularly questionable. The taxpayer had claimed the standard mileage rate on miles of 35,989. The taxpayers had a calendar log of mileage that showed 43,996 miles and a pure mileage log that reflected 44,093 miles.[7]

As you might expect, those three different figures suggest that the taxpayer might not have the best records. A look at the records showed this expectation was correct. The IRS had a series of complaints about the records, all of which the Tax Court agreed were major problems with these records:

> *Respondent argues that the logs fail to substantiate adequately the mileage claimed under the strict substantiation requirements of section 274(d). First, he claims the logs are not reliable because they are not in agreement as to the business miles traveled during the year and petitioners have offered no explanation of the discrepancy. Second, he claims that neither log was prepared or maintained contemporaneously with the travel recorded. Indeed, Pastor Burden testified that there was another record, "a small calendar", that contained the source information for the calendar and the mileage log. Petitioners, however, did not produce the small calendar. Third, respondent claims the logs lack specificity as to the starting and ending points of the trips reported. Fourth, respondent claims that the logs contain patently wrong or dubious entries. For instance, respondent points out, the logs purport that Pastor Burden drove for business purposes 360 days out of 365 days during 2013, and, on average, he drove more than 100 business miles a day in and around Columbus, Ohio. The travel log also appears to indicate that Pastor Burden drove to and from the Dominican Republic, once in January 2013, leaving on a Sunday and returning the next Wednesday, and again in September 2013, leaving on a Sunday and returning eight days later. And the log also indicates he drove to and from South Africa in December 2013. Also, while the logs claim business trips to Alabama, Florida, and Texas, petitioners failed to produce gas receipts or other records that would substantiate that the travel actually occurred. They also offered nothing other than Pastor Burden's testimony to prove the business purpose of any of the trips.*[8]

The taxpayers did not have a good explanation for these problems, including how their car managed to drive through the Atlantic Ocean, only pointing out they had claimed less mileage than either of their logs showed as business travel.[9]

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[7] *Ibid*, p. 10

[8] *Ibid*, pp. 11-12

[9] *Ibid*, p. 12

The Tax Court found that merely claiming less than what the very inaccurate logs showed as mileage was not the level of support required under IRC §274(d). Thus, the entire deduction for vehicle expenses were disallowed.[10]

The taxpayer did not fare better with regard to their travel expenses. In addition to not having substantiation for the business related travel, the taxpayer also did not produce a copy of the reimbursable travel plan for the taxpayer's employer and the court noted that if the taxpayer was eligible to have the expenses reimbursed under that plan they would not be allowed as a deduction—thus, the failure to produce that plan was fatal to that deduction.[11]

As well, the taxpayer claimed deductions for trips to South Africa and the Dominican Republic. While the taxpayer (who is a minister) performed certain religious duties on the trips, it was also clear the taxpayers had significant personal time on each trip, with family in one location and visiting many tourist locations in the other. Since the taxpayers did not show that any of the trips were primarily related to the taxpayer's trade or business, the entire deduction was denied.[12]

For the meals expenses claimed, the taxpayers produced only credit card receipts from restaurants. While these receipts documented the amounts paid, the taxpayer produced no records to explain the business purpose of the meals or how they related to the taxpayer's employment.[13]

As if these §274(d) issues aren't enough, the return also managed to be prepared in a form that caused the taxpayer to be treated as failing to elect to claim §179 expensing on assets the Court had found were related to the taxpayer's business. As the opinion explains:

> *Office furniture is a capital asset, and, barring an election under section 179, petitioners were not entitled to deduct for 2013 the full cost of the furniture. See secs. 167(a), 263(a)(1)(G); Ellis Banking Corp. v. Commissioner, 688 F.2d 1376, 1379 (11th Cir. 1982), aff'g in part, remanding in part on other grounds T.C. Memo. 1981-123. Petitioners' accountant testified at trial that he had not capitalized the cost of the furniture because he "just used the 179 deduction." Section 179(a) provides an election to treat the cost of certain property as an expense not chargeable to a capital account. The election is made on IRS Form 4562, Depreciation and Amortization, which, the form specifies, is to be attached to the taxpayer's return. A taxpayer who fails to make the election is denied the*

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[10] *Ibid*, p. 13

[11] *Ibid*, p. 14

[12] *Ibid.*, pp. 15-16

[13] *Ibid*, p. 20

> *benefits of section 179. E.g., Jackson v. Commissioner, T.C. Memo. 2008-70, 2008 WL 731318, at *7.*[14]

While, given the amount of claimed deductions (and the driving through the ocean problem), it seems reasonable to assume the taxpayer had claimed more as deductions than were actually incurred, it's also just as clear that the taxpayer lost deductions that could have been claimed had the taxpayer and preparer been more diligent in keeping documentation and preparing the tax return.

SECTION: 6707A
TRANSACTION SUBSTANTIALLY SIMILAR TO LISTED TRANSACTION, TAXPAYER SUBJECT TO PENALTIES FOR FAILING TO DISCLOSE

Citation: Interior Glass System, Inc. v. United States, CA9, No. 17-15713, 6/26/19

The cry that the program being promoted to the client is "different" from those that have either lost in court or been identified as a listed transaction is one that most advisers have heard. But in the case of *Interior Glass System, Inc. v. United States*[15], CA9, No. 17-15713, IRC §6707A's disclosure rule is one thing that is like horseshoes and hand grenades—close counts and transactions that are close to listed ones must be disclosed.

IRC §6707A provides for penalties to be imposed on a taxpayer who fails to disclose a reportable transaction, with additional penalties imposed if the transaction is a listed transaction.

The definitions of reportable and listed transactions are found at IRC §6707A(b) which provide:

> *(c) Definitions*
>
> *For purposes of this section:*
>
> > *(1) Reportable transaction*
> >
> > *The term "reportable transaction" means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of*

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[14] *Ibid*, p. 17

[15] http://cdn.ca9.uscourts.gov/datastore/opinions/2019/06/26/17-15713.pdf, retrieved June 27, 2019

> *a type which the Secretary determines as having a potential for tax avoidance or evasion.*
>
> *(2) Listed transaction*
>
> *The term "listed transaction" means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011.*

The question in this case revolved around whether the transaction the taxpayer participated in was "substantially similar to" a transaction identified by the IRS as a listed transaction in Notice 2007-83[16].

The notice described transactions being promoted as trust arrangements that claimed to be welfare benefit funds that used cash value life insurance that were being promoted to provide federal income tax and employment tax benefits.

As IRS describes the promoted programs in the Notice:

> *Trust arrangements utilizing cash value life insurance policies and purporting to provide welfare benefits to active employees are being promoted to small businesses and other closely held businesses as a way to provide cash and other property to the owners of the business on a tax-favored basis. The arrangements are sometimes referred to by persons advocating their use as "single employer plans" and sometimes as "419(e) plans." Those advocates claim that the employers' contributions to the trust are deductible under §§ 419 and 419A as qualified cost, but that there is not a corresponding inclusion in the owner's income.*

The Notice goes on to offer a more complete description of the program:

> *A promoted trust arrangement may be structured either as a taxable trust or a tax-exempt trust, i.e., a voluntary employees' beneficiary association (VEBA) that has received a determination letter from the IRS that it is described in § 501(c)(9). The plan and the trust documents indicate that the plan provides benefits such as current death benefit protection, self-insured disability benefits, and/or self-insured severance benefits to covered employees (including those employees who are also owners of the business), and that the benefits are payable while the employee is actively employed by the employer. The employer's contributions are often based on premiums charged for cash value life insurance policies. For example, contributions may be based on premiums that would be charged for whole life policies. As a result, the arrangements often require large employer contributions relative to the actual cost of the benefits currently provided under the plan.*
>
> *Under these arrangements, the trustee uses the employer's contributions to the trust to purchase life insurance policies. The trustee typically purchases cash value life insurance policies on the lives of the employees who are owners of the business (and sometimes other key*

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[16] https://www.irs.gov/pub/irs-drop/n-07-83.pdf, retrieved June 27, 2019

> *employees), while purchasing term life insurance policies on the lives of the other employees covered under the plan.*
>
> *It is anticipated that after a number of years the plan will be terminated and the cash value life insurance policies, cash, or other property held by the trust will be distributed to the employees who are plan participants at the time of the termination. While a small amount may be distributed to employees who are not owners of the business, the timing of the plan termination and the methods used to allocate the remaining assets are structured so that the business owners and other key employees will receive, directly or indirectly, all or a substantial portion of the assets held by the trust.*
>
> *Those advocating the use of these plans often claim that the employer is allowed a deduction under § 419(c)(3) for its contributions when the trustee uses those contributions to pay premiums on the cash value life insurance policies, while at the same time claiming that nothing is includible in the owner's gross income as a result of the contributions (or, if amounts are includible, they are significantly less than the premiums paid on the cash value life insurance policies). They may also claim that nothing is includible in the income of the business owner or other key employee as a result of the transfer of a cash value life insurance policy from the trust to the employee, asserting that the employee has purchased the policy when, in fact, any amounts the owner or other key employee paid for the policy may be significantly less than the fair market value of the policy. Some of the plans are structured so that the owner or other key employee is the named owner of the life insurance policy from the plan's inception, with the employee assigning all or a portion of the death proceeds to the trust. Advocates of these arrangements may claim that no income inclusion is required because there is no transfer of the policy itself from the trust to the employees.*

Under IRC §6707A(b), the penalty for failing to report this transaction, or one substantially similar to it, falls is 75% of the decrease is tax shown on the return as a result of the transaction (or which would have resulted had the transaction been respected for tax purposes).[17] The minimum amount of the penalty is $200,000 ($100,000 if a natural person)[18] and the minimum amount of penalty for failing to report is $5,000.[19] The penalty applies to each return where the transaction has (would have for federal tax purposes if the transaction were considered acceptable for federal tax purposes) a tax consequence.[20]

For purposes of the case before the Court, the key tests for the listed transaction under Notice 2007-83 summarized in the opinion are:

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[17] IRC §6707A(b)(1).

[18] IRC §6707A(b)(2)(A)

[19] IRC §6707A(b)(3)

[20] Reg. §1.6011-4

- *the transaction involved "a trust or other fund described in [26 U.S.C.] § 419(e)(3) that is purportedly a welfare benefit fund";*
- *contributions to the trust or other fund were not governed by the terms of a collective bargaining agreement;*
- *the trust or other fund paid premiums on one or more cash-value life insurance policies that accumulated value; and*
- *the employer took a deduction that exceeded the sum of certain amounts.*[21]

Reg. §1.6011-4(c)(4) defines *substantially similar* for these purposes as:

> ***(4) Substantially similar.*** *The term substantially similar includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Receipt of an opinion regarding the tax consequences of the transaction is not relevant to the determination of whether the transaction is the same as or substantially similar to another transaction. Further, the term substantially similar must be broadly construed in favor of disclosure. For example, a transaction may be substantially similar to a listed transaction even though it involves different entities or uses different Internal Revenue Code provisions. (See for example, Notice 2003-54 (2003-2 CB 363), describing a transaction substantially similar to the transactions in Notice 2002-50 (2002-2 CB 98), and Notice 2002-65 (2002-2 CB 690).)*

The panel's opinion outlines the transaction that the corporation entered into which was different from the plan outlined in Notice 2007-83 for only one of the four tests:

> *Interior Glass joined the Group Term Life Insurance Plan (GTLP) to fund a cash-value life insurance policy owned by its sole shareholder and only employee, Michael Yates. All agree that this transaction satisfies three of the Notice's four elements. The GTLP transaction lacks the first element because its intermediary was a tax-exempt business league, rather than a trust or § 419(e)(3) welfare benefit fund. The business league, however, performed the same functions as the trust or welfare benefit fund described in the Notice.*[22]

The taxpayer claimed that because it used a business league, rather than a trust for welfare benefit fund, this transaction is not required to be reported and no penalty is due. In fact, the taxpayer cited two differences:

> *First, as noted above, the GTLP transaction was filtered through a tax-exempt business league instead of a trust or welfare benefit fund. Second, rather than invoking 26 U.S.C. §*

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[21] http://cdn.ca9.uscourts.gov/datastore/opinions/2019/06/26/17-15713.pdf, retrieved June 27, 2019, p. 6

[22] *Ibid*, p. 7

> *419's rules for welfare benefits, the GTLP transaction purported to provide § 79 group-term life insurance benefits, even though it also involved a cash-value life insurance policy.*[23]

The District Court did not agree with that view, imposing the penalty on the taxpayer. The taxpayer did not find a sympathetic ear at the Ninth Circuit Court of Appeals on the matter either, finding that, despite these differences, the transaction was substantially similar to the one described in Notice 2007-83.[24]

The panel's opinion outlined why this was deemed a similar transaction:

> *First, the GTLP transaction was "expected to obtain the same or similar types of tax consequences." 26 C.F.R. §1.6011-4(c)(4). The transaction identified in the Notice seeks to "provide cash and other property to the owners of the business on a tax-favored basis." 2007-2 C.B. at 960. Those favorable tax consequences are achieved through (1) a deduction of the contributions by the business and (2) a failure by the business owner to declare the payments as income. The GTLP transaction promised similar tax benefits. On that score, the plan documents represented that "[c]ontributions [were] currently deductible" by Interior Glass and that only the cost of group-term life insurance (in contrast to the premium on the cash-value policy) may have been includible in Yates' income.*
>
> *Second, the GTLP transaction is both "factually similar" to the listed transaction described in the Notice and "based on the same or similar tax strategy." 26 C.F.R. §1.6011-4(c)(4). As to factual similarity, the GTLP transaction involved a small business, a cash-value life insurance policy that benefits the business owner, and payment of the premiums on the policy through an intermediary. The GTLP combined those three aspects in pursuit of the same tax strategy discussed in the Notice. By using the intermediary, the business and its owner attempted to do what they could not do outright: deduct payments made to the owner's investment vehicle without declaring the benefits as income.*[25]

The taxpayer complained that Congress had passed an unconstitutionally vague statute which meant they couldn't determine if such reporting was required. This argument also did go over well with the panel:

> *Interior Glass contends that, if read to encompass the GTLP transaction, the definition of "substantially similar" is unconstitutionally vague. That contention is without merit. For a civil penalty like 26 U.S.C. § 6707A, the definition is constitutionally valid so long as "a person of ordinary intelligence" could determine which transactions are substantially similar to the listed transaction identified in Notice 2007-83. Fang Lin Ai v. United States, 809 F.3d 503, 514 (9th Cir. 2015). As explained above, the regulation's definition of*

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[23] *Ibid*, p. 9

[24] *Ibid,* p. 8

[25] *Ibid*, p. 8

"substantially similar" is detailed enough to make that determination an easy one in this case. The only differences between the GTLP transaction and the listed transaction are expressly addressed — and expressly rejected as immaterial — in the definition itself.[26]

[26] *Ibid*, p. 9