Current Federal Tax Developments

Week of December 2, 2019

Edward K. Zollars, CPA
(Licensed in Arizona)

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SECTION: 165
IRS COMMISSIONER DESCRIBES PROPER TREATMENT OF INSURANCE REIMBURSEMENT FOR PYRRHOTITE RELATED DAMAGES

Citation: Letter from Charles P. Rettig, IRS Commissioner, Tax Notes Today Federal, 2019 TNTF 229-20, 11/20/19

IRS Commissioner Charles Rettig, in a letter to members of Connecticut's Congressional delegation, indicated that the Connecticut Foundation Solutions Indemnity Company, Inc. (CFSIC) is not required to issue Forms 1099 to homeowners who receive reimbursement from the state-chartered insurer, for pyrrhotite related foundation damage.[1]

The *Journal Inquirer*'s website reported that the CFSIC had previously issued such Forms 1099 to recipients of such payments, which led to inquiries asking why such payments would be deemed to be taxable income. Officials of the CFSIC then wrote to the Congressional delegation seeking clarification, who then forwarded the question on to the IRS.[2]

As the letter notes, Revenue Procedures 2017-14 and 2017-60 had previously provided a safe harbor for taxpayers impacted by deterioration of a concrete foundation due to the mineral pyrrhotite.

> IRS guidance provides a safe harbor that allows certain homeowners to treat amounts paid to repair damage to their personal residence caused by a concrete foundation, that has deteriorated due to the mineral pyrrhotite as a casualty loss under section 165 so long as the taxpayer was not fully reimbursed by insurance or otherwise before filing a return for the year the loss was sustained. See Revenue Procedure 2017-60, 2017-50 I.R.B. 559; Revenue Procedure 2017-14, 2018-9 I.R.B. 378. If a homeowner deducted a loss and in a subsequent taxable year receives reimbursement for the loss, the homeowner does not recompute the tax for the taxable year in which the deduction was taken. Instead, the homeowner must include the amount of the reimbursement in gross income for the taxable year in

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[1] Letter from Charles P. Rettig, IRS Commissioner, *Tax Notes Today Federal*, 2019 TNTF 229-20, November 20, 2019, https://www.taxnotes.com/tax-notes-today-federal/return-preparation/captive-insurer-doesnt-need-issue-forms-1099-rettig-says/2019/11/26/2b5bj (subscription required, retrieved November 26, 2019)

[2] Eric Bedner, "Captive insurance payments not considered income: IRS," *Journal Inquirer* website, November 26, 2019 https://www.journalinquirer.com/politics_and_government/captive-insurance-payments-not-considered-income-irs/article_7e43c9c4-0fa5-11ea-aff4-27bea84c05f6.html (retrieved November 26, 2019)

> which the reimbursement is received, subject to the provisions of Section 111, relating to recovery of amounts previously deducted. See Treasury Regulation Section 1.165-1(d)(2)(iii); Section 4.02 of Rev. Proc. 2017-60; IRS Publication 547, *Casualties, Disasters, and Thefts*. Reimbursement for a casualty loss that a taxpayer does not deduct is generally not income to the taxpayer if the reimbursement amount does not exceed the taxpayer's basis in the property.[3]

The letter goes on to summarize the proper treatment of these payments:

> Therefore, homeowners who are reimbursed by CFSIC for previously deducted repair costs must include the reimbursed amount in income in the year of receipt. In addition, homeowners who receive reimbursement that exceeds their basis in the property must include the excess amount in income.[4]

However, since the insurance company will generally not possess the information to know if such payments are taxable to the recipient, the letter concludes that the CFSIC is not required to issue Forms 1099 in this case.

> As used in Section 6041, the term "gains, profits, and income" means gross income and not the gross amount paid. Section 6041 does not generally require a payor to file or furnish a Form 1099 for payments that are not includible in the recipient's income. Further, a payor is not required to file or furnish a Form 1099 if the payor does not have a basis to determine the amount of a payment that the recipient should include in gross income.
>
> … Under Section 1.6041-1(c), however, if CFSIC does not possess the information about previous deductions and basis necessary to determine whether or how much of the reimbursement will be includible as income by a homeowner, then the reimbursement to that homeowner will not constitute fixed and determinable income for the purpose of information reporting. In those cases, CFSIC will not be required to file an information return under section 6041.[5]

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[3] Letter from Charles P. Rettig, IRS Commissioner, *Tax Notes Today Federal*, 2019 TNTF 229-20

[4] Letter from Charles P. Rettig, IRS Commissioner, *Tax Notes Today Federal*, 2019 TNTF 229-20

[5] Letter from Charles P. Rettig, IRS Commissioner, *Tax Notes Today Federal*, 2019 TNTF 229-20

SECTION: 183
TAXPAYER FOUND TO HAVE PROFIT MOTIVE FOR CUTTING HORSE BUSINESS, BUT LOSES NOL DEDUCTION

Citation: Den Besten v. Commissioner, TC Memo 2019-154, 11/25/19

A taxpayer, representing himself in Tax Court, was able to convince the Tax Court that, despite years of losses, he operated his cutting horse business with a proper profit motive, escaping the hobby loss rules of IRC §183.[6]

IRC §183 provides the following treatment for expenses for undertakings that fall within its reach:

> **(a) General rule**
>
> In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.
>
> **(b) Deductions allowable**
>
> In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed—
>
> (1)the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and
>
> (2)a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

Note that the IRC §183(b)(2) deductions are not listed as being allowed in computing adjusted gross income per IRC §62, meaning they would be itemized deductions. As well, they are not mentioned in the list found at IRC §67(b) as an itemized deduction that is *not* a miscellaneous itemized deduction.

For the year in question, that would have subjected such expenses to the 2% of adjusted gross income floor for all miscellaneous itemized deductions and no amount would be allowed in computing alternative minimum taxable income. Post-TCJA (at

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[6] *Den Besten v. Commissioner*, TC Memo 2019-154, November 25, 2019 https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=12085 (retrieved November 26, 2019)

least until 2026), such deductions would be disallowed entirely by IRC §67(g). Note that in both cases, all income from the undertaking would be included in calculating adjusted gross income.

Mr. Den Besten was an accomplished cutting horse competitor. He also had been operating a seed business since 1964. In 2002 he sold the seed business to his son and looked to concentrate on building a complete cutting horse business.[7] His cutting horse operation included breeding, raising, boarding, training, selling and registering cutting horses, as well as showing horses in national competitions.[8]

His ability to concentrate on the cutting horse business did cause those results to improve, but other problems arose before the cutting horse business could turn a profit. The first one was that his son wasn't able to profitably run the business that had been sold to him. As the opinion notes:

> In 2002 petitioner sold the original seed business to his son for $4,283,000 and reported the sale proceeds using the installment method. At the time of sale he intended to focus all his effort, time, and money on his cutting horse activity, but his son did not succeed in the seed business and defaulted on the installment payments on the corporate stock sale. Only three payments — $424,007 in 2002, $42,483 in 2003, and $259,180 in 2004 — were made on the installment sale.[9]

The taxpayer reacted to this situation by returning to the seed business to attempt to bring it back to profitable operations:

> In 2005 petitioner returned to the seed business in an attempt to salvage what was left of it. Petitioner was once again in the seed business but now operated it as a new limited liability company. For each year in issue petitioner reported the new seed business on a Schedule C, Profit or Loss From Business, attached to his Form 1040, U.S. Individual Income Tax Return. The first year after petitioner returned to the seed business it reported a $193,371 loss. The seed business subsequently generated net profits of $109,247, $106,552, $234,176, $151,175, and $84,772 in 2006, 2007, 2008, 2009, and 2010, respectively.[10]

In addition, his hopes for the cutting horse business were also negatively impacted by the unexpected death of a champion cutting horse, Si Olena, that he could have expected to have obtained substantial income in the future from breeding.[11]

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[7] *Den Besten v. Commissioner*, p. 3

[8] *Den Besten v. Commissioner*, p. 5

[9] *Den Besten v. Commissioner*, p. 3

[10] *Den Besten v. Commissioner*, p. 4

[11] *Den Besten v. Commissioner*, pp. 12, 28

The taxpayer decided to cut back on the operations of the cutting horse business when faced with this adversity:

> Petitioner sold the Yellow Rose facility and invested the proceeds in the assets of the seed business in an attempt to stabilize the seed business. As a result petitioner began to scale back the cutting horse activity. While he continued to own, breed, and train horses and compete in cutting horse competitions, he significantly reduced the operation. At one time petitioner had at least 20 broodmares and multiple stallions. Although he continued to devote considerable time breeding approximately 12 mares per season along with foal delivery and veterinary work, he reduced his livestock numbers after he returned to the seed business, which consumed more and more of his time in his attempt to save it. As of 2006 petitioner owned approximately 10 horses, and by 2016 he had 7 or fewer horses. Among petitioner's current remaining horses was a champion-bred promising young stallion in training, and petitioner had high hopes for the horse. Despite petitioner's nationally recognized cutting horse activity, he has reported a loss for every taxable year since 1997 when he purchased the Yellow Rose.[12]

The Court considered the nine factors found in Reg. §1.183-2(b), but clearly the Court was mainly influenced by the problems that the taxpayer had encountered and his response to those issues, noting:

> After his championships in 1997 and 1998, petitioner acquired and remodeled the Yellow Rose, expanding his operation. This significant acquisition enabled him to expand into hosting cutting horse competitions and production sales. It also increased his boarding and training capacities. He sold his seed business in order to increase the effort and time he needed to coordinate these efforts and to train potential foals. The Court concludes these actions are strongly indicative of petitioner's having a profit motive during this timeframe preceding the years in issue. The actions are consistent with an intent to improve profitability through new operating methods.
>
> Even though petitioner owned and operated the Yellow Rose outside the years in issue, he recognized he had to sell it to generate time and capital to save the seed business. Petitioner reduced his operation on the basis of economic realities and entered into a winding-down period with respect to the cutting horse activity. Petitioner's realization he needed to scale down his operation is also indicative of a profit motive.[13]

Quite often taxpayers have money losing undertakings they claim as a trade or business from which they derive substantial personal pleasure, suggesting that making money might not be the driving force for continuing the undertaking. While riding horses

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[12] *Den Besten v. Commissioner*, pp. 12-13

[13] *Den Besten v. Commissioner*, pp. 23-24

often is treated as such an activity, in this case the Court found that was not an issue, noting:

> Petitioner's cutting horse activity was physically demanding. He coordinated multi-State production sales and competition events. His breeding operation required constant attention to the mares and stallions for a successful breeding cycle. While he surely derived personal pleasure from the recreational aspects of the cutting horse activity, his efforts went well beyond the leisurely aspects of horseback riding or the routine tasks of caring for horses.
>
> At trial petitioner testified he was born in 1942, so he was approximately 64 years old in 2006, the first year in issue. He was 56 in 1998, when he acquired the Yellow Rose. Though petitioner admitted he enjoyed riding the horses during the years in issue, he also stated that his enjoyment has lessened as he has aged. Additionally, petitioner hired multiple trainers to aid in training his horses; he could not be deemed to have engaged in the cutting horse activity solely for personal enjoyment when the horses were not always in his care.
>
> Petitioner rode to train his horses, not for recreation. He worked to prepare his horses for competitions in hopes of raising profitability and his overall reputation in the cutting horse industry.[14]

As well, another key factor is whether the taxpayer's financial condition was such that he/she could continue the operation regardless of its profitability. The Court found that such was not the case for the taxpayer:

> From 2006 to 2010 petitioner reported average Schedule C business income from the seed business of approximately $137,000. Petitioner's returns showed substantial tax losses for each year in issue, attributable to claimed NOL carryovers and losses. However, petitioner's son had defaulted on payments with respect to the 2002 sale of the corporate seed business. Additionally, petitioner sold assets and expended significant funds attempting to salvage the seed business. By 2006 the seed business once again earned profits, so petitioner reported income from the seed business and offset it with losses from the cutting horse activity. However, the Court finds that petitioner was not in a financial position that would have enabled him to continue suffering losses without a bona fide profit motive. Moreover, the Court is not persuaded that petitioner abandoned his profit motive with respect to the cutting horse activity. Petitioner had a promising champion-bred stallion in training. Petitioner genuinely believes that one good horse could turn a profit for his horse activity.[15]

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[14] *Den Besten v. Commissioner*, pp. 35-36

[15] *Den Besten v. Commissioner*, pp. 34-35

This led the Court to conclude:

> …[P]etitioner's actions, coupled with his sincere and credible testimony as to his business goals, overwhelmingly support his claim that he has a bona fide profit objective.[16]

But not all turned out well for the taxpayer—again the Tax Court reminded us that more than just copies of prior years' federal income tax returns are necessary to prove the taxpayer's right to carryovers into the current year. In this case the problem related to net operating losses. As the opinion notes:

> The Court may consider facts related to years not in issue that are relevant to the claimed NOLs. Sec. 6214(b). The record is devoid of testimony and other evidence specifying the details pertaining to petitioner's NOL carryforwards from 2003 and 2005, and the Court is left with only petitioner's Federal income tax returns. Petitioner's tax returns set forth only his claim of the NOLs and do not reflect the details needed to establish his entitlement to those NOLs, other than general statements about his seed business losses. See *Roberts v. Commissioner*, 62 T.C. at 837. Even though the returns are signed under penalty of perjury, the signatures are insufficient to substantiate the deductions claimed. See *Wilkinson v. Commissioner*, 71 T.C. at 639; *Emerson v. Commissioner*, T.C. Memo. 2001-186. The Court concludes that petitioner did not meet his burden of establishing both the existence and the amounts of the 2003 and 2005 NOL carryforwards.[17]

SECTION: 274
IRS UPDATES PER DIEM RULES TO TAKE INTO ACCOUNT TCJA CHANGES

Citation: Revenue Procedure 2019-48, 11/26/19

With Revenue Procedure 2019-48[18] the IRS has updated the rules regarding the use of per diem rates to substantiate, under IRC §274(d) and Reg. §1.274-5, the amount of ordinary and necessary business expenses paid or incurred while traveling away from home. The update incorporates the revisions made as part of the Tax Cuts and Jobs Act (TCJA), including the temporary suspension of the deduction for miscellaneous itemized deductions under IRC §67(g).

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[16] *Den Besten v. Commissioner*, p. 37

[17] *Den Besten v. Commissioner*, pp. 41-42

[18] Revenue Procedure 2019-48, November 26, 2019, https://www.irs.gov/pub/irs-drop/rp-19-48.pdf (retrieved November 26, 2019)

The procedure reminds us of the limited nature for the use of the per diem methods:

> This revenue procedure provides rules for using a per diem rate to substantiate the amount of an employee's expenses for lodging, meal, and incidental expenses, or for meal and incidental expenses only, that a payor (an employer, its agent, or a third party) reimburses. Certain specified employees and self-employed individuals that deduct unreimbursed expenses for travel away from home may use a per diem rate for meals and incidental expenses, or incidental expenses only, under this revenue procedure. This revenue procedure does not provide rules for using a per diem rate to substantiate the amount of lodging expenses only.[19]

Section 3.16 provides the following explanations of the modifications made to the provisions of Revenue Procedure 2011-47 which previously governed per diem programs:

> .16 This revenue procedure includes modifications to Rev. Proc. 2011-47 as follows:
>
> (1) The definition of "incidental expenses" in section 3.02 is updated to reflect the definition of this term in the current Federal Travel Regulations, 41 C.F.R. 300-3.1.
>
> (2) Sections 7.05, 7.06, and 7.07 are deleted to reflect changes made by the TCJA: (a) unreimbursed employee travel expenses that are miscellaneous itemized deductions subject to the two-percent of adjusted gross income floor are not permitted during the suspension period, and (b) a deduction for expenses with respect to entertainment, amusement, or recreation is generally disallowed. New sections 7.05, 7.06 and 7.07 are added to clarify that employees described in § 62(a)(2)(B)-(E), may continue to use the methods allowed under sections 4.03 and 4.05 of this revenue procedure to substantiate their expenses.[20]

The first change mentioned is the change to the definition of incidental expenses. Per Section 3.02(3), *incidental expenses* now refers to fees and tips given to porters, baggage carriers, bellhops, hotel staff, and staff on ships. The term has the same meaning as found in the Federal Travel Regulations, 41 C.F.R. 300-3.1. Future changes to the definitions found in those regulations will be announced in the annual notice providing the special per diem rates.[21]

The other changes are found in Section 7.05 - .07, which allows the per diem deductions to continue to be used by employees who are in the classes allowed to

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[19] Revenue Procedure 2019-48, p. 2

[20] Revenue Procedure 2019-48, p. 7

[21] Revenue Procedure 2019-48, pp. 8-9

deduct some or all of their expenses above the line. Such expenses defined in IRC §67(a)(2)(B)-(E) are:

- Certain expenses of performing artists;
- Certain expenses of state and local officials;
- Certain expenses of elementary and secondary school teachers (the $250 above the line amount); and
- Certain expenses of reserve components of the Armed Forces of the United States.

The clarification was deemed necessary since most employees will be barred any such employee business expense deductions by §67(g) during the suspension period.[22]

[22] Revenue Procedure 2019-48, pp. 25-26