THE ELITE QUARTERLY – Taxation

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We hope that you had a successful 2017 filing season. Many of you have renewed your newsletter subscriptions or special course offer for 2017 – we thank you very much! All eight of our courses are being updated for 2017. See pages 22 and 23 for details of all of our packages. Based on our feedback from customer comments, we have added a "Special Topics" section. This section reviews one or more popular tax provisions that affect many taxpayers each year. Testing online at our website is more convenient than ever. Thank you for being a customer – we appreciate your business!

What's Inside This Issue

INSTRUCTIONS – Read the content on pages 1-17, the quiz questions on pages 18-20, and the quiz instructions on page 21. Select the best answer for each quiz question and record the answers either on the answer sheet on page 21 or on-line at www.cpelite.com.

COURSE COMPONENTS, CONTENT LEVEL, AND LEARNING OBJECTIVES – The components of this newsletter are divided in order among IRS rulings, court decisions, a Treasury item, two special topics, and this issue's *Elite Possibility* dealing with related parties. The content level of the newsletter is an update of these items. For the IRS and the Treasury item, the learning objectives are: (1) Determine the inflation-adjusted amounts for selected 2017 provisions; (2) Know the 2016 retirement plan limitations; (3) Identify the 2017 standard mileage rates; (4) Know major items in the National Taxpayer Advocate's 2016 Annual Report; (5) Know the income tax consequences of principal residence debt that is forgiven in 2017; (6) Know whether liquidity concerns are a defense against the corporate accumulated earnings tax; and, (7) Know the backup withholding requirements when a payee fails to provide a TIN. For each court ruling, the learning objectives are: (1) Differentiate the taxpayer's argument from the IRS's position; (2) Identify the factors used in the court's decision; and, (3) Recognize the decision reached by the court. For the special topics, the learning objectives are (1) Compute the gain realized and gain recognized for property sold under the like-kind exchange provisions and compute the basis of the replacement property; (2) Know the circumstances which nullify the like-kind exchange provisions involving related party transactions; and, (3) Know when an IRA distribution is subject to income tax and the 10% penalty tax. The learning objective for the Elite Possibility is to identify which parties are considered related parties under Section 267. There are no prerequisites or additional materials needed nor is advance preparation required for our newsletters.

Key Terms in This Issue of THE ELITE QUARTERLY

[Item 5] Qualified Principal Residence Indebtedness (QPRI): Any debt incurred by a borrower to buy, build, or substantially improve the borrower's principal residence where the debt is secured by the residence.

[Item 6] Accumulated earnings tax: A corporate level tax of 20% of accumulated taxable income for corporations former or availed of for the purpose of avoiding income tax with respect to its shareholders.

[Item 6] Consent dividends: By agreement of the shareholders, a hypothetical transaction whereby a dividend is deemed "paid" to the shareholders on the last day of the year and "recontributed" as a capital contribution on the same day.

[Item 8] Tax Benefit Rule: The requirement under Section 111 that a taxpayer include a previously deducted amount in a later year's income when an event occurs that is fundamentally inconsistent with the deduction that was claimed in the previous year.

Key Terms - Continued

[Item 9] Passive activity grouping regulations: Treasury regulations that permit a taxpayer to group business or rental activities as a single activity if they constitute an appropriate economic unit.

[Item 10] Administrative Adjustment Request (AAR): A request for an administrative adjustment of partnership items for any partnership taxable year within 3 years after the later of (1) the date the partnership return was filed, or (2) the last day for filing the partnership return (not including extensions).

[Item 12] Abandonment: A tax event that occurs when the taxpayer demonstrates both an intention to abandon and some act that evidences that intention.

[Item 12] Worthlessness: A tax event that occurs when a taxpayer demonstrates his subjective determination of worthlessness in a given year, coupled with a showing that in that year the asset in question is in fact essentially valueless.

[Item 13] Conservation easement: Voluntary legal agreements between a landowner and a trust in which the property owner places restrictions on the use of the property in order to protect the natural or historic values of the property.

[Item 14] Backup withholding: A requirement to withhold federal tax at a rate of 28% for payments made to a payee who has not furnished a proper taxpayer identification number (TIN). Payments include rents, non-employee compensation for services, royalties, and income payments reportable on Form 1099-MISC.

[Item 15] Relinquished property: Like-kind property that is disposed of in a qualified like-kind exchange.

[Item 15] Replacement property: Like-kind property that is acquired in a qualified like-kind exchange.

[Item 17] Related party: Depending on the Code section, certain family members, entities owned by common owners, and trust fiduciaries and beneficiaries or trust grantors. Some Code provisions do not apply or are limited for certain transactions between related parties.

IRS

[ITEM 1] CERTAIN 2017 INFLATION-ADJUSTED AMOUNTS AFFECTING INDIVIDUALS ARE PROVIDED

Revenue Procedure 2016-55 [10/25/16] contains inflation-adjusted amounts for some key items for 2017. For married couples filing jointly, the amounts of taxable income at which the various income tax rates begin to apply are: over $18,650 – 15%; over $75,900 – 25%; over $153,100 – 28%; over $233,350 – 33%; over $416,700 – 35%; and, over $470,700 – 39.6%. For single taxpayers, the amounts of taxable income at which the various income tax rates begin to apply are: over $9,325 – 15%; over $37,950 – 25%; over $91,900 – 28%; over $191,650 – 33%; over $416,700 – 35%; and, over $418,400 – 39.6%. The personal and dependent exemption deduction for 2017 is $4,050, the same as for 2016. The AGI amount for the phaseout of personal and dependent exemption amounts for 2017 begins above $313,800 for married couples filing jointly and above $261,500 for single taxpayers. The 2017 standard deduction amounts are: married couple filing jointly – $12,700; married taxpayer filing separately – $6,350; head of household – $9,350; single – $6,350; and, dependent – the greater of $1,050, or the sum of $350 and the individual's earned income, not to exceed $6,350. The 2017 standard deduction for a joint return is up $100 from 2016 while the remaining amounts are up $50. For purposes of calculating the "kiddie tax," the net unearned income of the child is reduced by $1,050. The additional standard deduction for age and blindness is $1,250 for married taxpayers, and $1,550 for an unmarried taxpayer who is not a surviving spouse. As in the case of the personal and dependent exemption phaseout, the AGI amount for the phaseout of itemized deductions begins above $313,800 for married couples filing jointly and above $261,500 for single taxpayers. The income limit for the maximum earned income tax credit for 2017 is $6,670 for a qualifying individual with no children, $10,000 for a qualifying individual with one child, and $14,040 for a qualifying individual with either two or three or more children. The maximum 2017 earned income tax credit amounts are as follows: no child – $510; one child – $3,400; two children – $5,616; and, three or more children – $6,318. The taxpayer is not eligible for the earned income tax credit if certain investment income exceeds $3,450 in 2017. The modified AGI phaseout range for the $2,500 maximum deduction for interest paid on qualified education loans remains the same as for 2016 for single taxpayers at $65,000 - $80,000, and is up $5,000 from 2016 for married taxpayers filing a joint return at $135,000 - $165,000. The annual gift exclusion for 2017 remains the same as for 2016 at $14,000.

[ITEM 2] IRS ISSUES KEY LIMITATIONS COVERING 2017 RETIREMENT PLANS

In IRS News Release IR-2016-141 [10/27/16], the IRS announces revised 2017 dollar limitations on benefits under qualified retirement plans that took effect on January 1, 2017. Many more limitations for 2017 have increased compared to 2016. Here are selected amounts that have increased from 2016: (1) the AGI limitation for determining the maximum Roth IRA contribution increased $2,000 to $186,000 for joint return taxpayers, and increased $1,000 to $118,000 for single taxpayers; (2) the applicable dollar amount for determining the deductible amount for a taxpayer who is not an active retirement plan participant but whose spouse is an active participant increased $2,000 to $186,000 for a joint return; (3) the annual benefit under defined benefit plans increased $5,000 to $210,000; (4) the limitation for defined contribution plans increased $1,000 to $54,000; (5) the annual compensation limit increased $5,000 to $270,000; and, (6) the applicable dollar amount for determining the deductible amount for taxpayers who are active retirement plan participants increased $1,000 to $61,000 for single taxpayers, and increased $1,000 to $99,000 for joint taxpayers who both are active participants. Certain retirement amounts which have not changed from 2016 include the following: (1) the maximum exclusion for elective deferrals for IRC Section 401(k) plans, the federal government's Thrift Savings Plans, and IRC Section 457(b) government plans – $18,000 ($24,000 for individuals age 50 or older); (2) the limitation used in defining a highly-compensated employee – $120,000; (3) the compensation amount regarding simplified employed pensions – $600; (4) the general limitation regarding SIMPLE contributions – $12,500; and, (5) the maximum IRA contribution for taxpayers less than age 50 – $5,500.

[ITEM 3] IRS PROVIDES 2017 MILEAGE RATES

In Notice 2016-79 [12/13/16], the IRS updates the optional standard mileage rates for use by employees, self-employed individuals, and other taxpayers to compute the deductible costs to operate a passenger automobile for business, charitable, medical, or moving expense purposes in 2017. Here are the rates: 53.5 cents per mile for business (down .5 cents per mile from 2016); 14 cents per mile for charitable contributions – this rate is set by the Internal Revenue Code, and is the same as for 2016; and, 17 cents per mile for medical and moving expenses (down 2 cents per mile from 2016). The depreciation component of the business standard mileage rate is 25 cents per mile (up 1 cent from 2016). The IRS states that for automobiles that are placed into service, and for which the business mileage rate has been used for any year, depreciation will be considered to have been allowed at the following rates for the year in which the business mileage rate was used: 2013 – 23 cents per mile, 2014 - 22 cents per mile, and 2015 - 2016 - 24 cents per mile.

[ITEM 4] NATIONAL TAXPAYER ADVOCATE ISSUES 2016 ANNUAL REPORT

IRS News Release IR–2017-2 [1/10/17] reports on the National Taxpayer Advocate's (TA) 2016 Annual Report to Congress. She makes recommendations to the IRS and Congress, identifies the 20 most serious problems encountered by taxpayers, and provides the 10 most frequently litigated issues. The TA states: "This is arguably the most important piece I have written about the IRS in my fifteen years serving as the National Taxpayer Advocate." She urges the IRS to change its culture from one that is enforcement-oriented to one that is service-oriented. She is concerned with the IRS's past and current "enforcement first" approach as its view of itself. Supporting this concern are several observations, including the IRS's current budget which appropriates 43% to enforcement and less than 6% to outreach and education. In addition, for telephone calls routed to its telephone assistors during Fiscal Year 2016, the IRS was able to answer only 53% of the calls, with an average hold time of 18 minutes. Even more evidence is the focus of the IRS's 4 business operating divisions where each division developed its own *Future State* plan and an accompanying *"taxpayer vignette"* posted on the IRS's website. Remarkably, each vignette shows the IRS contacting a taxpayer to conduct an audit or other challenge to a taxpayer's return and, in every case, the vignette shows the taxpayer ultimately conceding the IRS is correct and consenting to the IRS's proposed adjustment. Since 2001 alone, Congress has made more than 5,900 Code changes – an average of more than one a day! The Code's complexity is evident in that it contains more than 200 tax deductions, credits, exclusions, and similar tax breaks ("tax expenditures"). She urges Congress to seek comprehensive tax simplification. She recognizes that the elimination of many tax expenditures could have undesirable effects, for example, less health insurance, less retirement savings, smaller charitable contributions, and less home ownership, but she recommends that Congress aim to simplify the tax code significantly and use a "zero-based budgeting" approach to tax expenditures. She highlights 8 areas of complexity that Congress should address, 3 of which are: (1) consolidation of the family status provisions (for example, filing status, exemptions, child tax credit, earned income credit, and child and dependent care credit) in the Code; (2) consolidation of at least 12 incentives to save or spend for education; and, (3) consolidation of at least 15 incentives to save for retirement. Three of the items in the list of the most serious problems that taxpayers encounter are: (1) the IRS does not do enough to incorporate the Taxpayer Bill of Rights into its operations; (2) the IRS fails to establish goals to reduce high false positive rates for its fraud detection programs; and, (3) the IRS fails to properly evaluate taxpayers' living expenses and places taxpayers into installment agreements that they cannot afford. Three items included in the list of most litigated issues are: (1) the Section 6662 accuracy-related penalty; (2) gross income; and, (3) Section 162 trade or business expenses.

[ITEM 5] IRS EXPLAINS PRINCIPAL RESIDENCE DEBT FORGIVENESS EXTENSION IN THE PATH ACT OF 2015

The Federal Housing Finance Agency directed Fannie Mae and Freddie Mac to implement a program ("Principal Reduction Modification Program" – PRMP) that offers one-time mortgage loan modifications to qualifying delinquent borrower-homeowners. The mortgage loan servicer solicits the borrower-homeowner's participation. If specified conditions are met within a required time frame, the borrower-homeowner is offered a permanent modification of the terms of the mortgage loan. Loan modification includes a provision for monthly mortgage payments that are lower than or equal to those under the old mortgage loan and, generally, a principal reduction. There is a similar program called the "Home Affordable Modification Program" – HAMP. While generally gross income includes income from debt discharge, it does not include discharge of a taxpayer's debt if the debt that is discharged is "qualified principal residence indebtedness" (QPRI) discharged before January 1, 2017. The PATH Act added QPRI subject to an arrangement entered into and evidenced in writing before January 1, 2017, though not discharged before January 1, 2017. The PATH Act provision was added to protect a borrower-homeowner who was in the process of obtaining a permanent modification of the mortgage loan before 2016, but where the permanent modification of the mortgage loan resulting in debt discharge did not occur until after 2016. QPRI is any debt incurred by a borrower to buy, build, or substantially improve the borrower's principal residence where the debt is secured by the residence. A loan that refinances QPRI also qualifies to the extent of the refinanced debt. The maximum amount a borrower may exclude is $2 million ($1 million for a married filing separately filer). If only part of the discharged debt is QPRI, the exclusion applies only to the amount of the discharged debt that exceeds the amount of the loan that is not QPRI. The basis of the taxpayer's principal residence is reduced by the amount of any discharged debt excluded from gross income. A debt discharge that does not qualify for the QPRI exclusion may qualify for another exclusion under Section 108. Under Notice 2016-72 [11/28/16], QPRI is treated as discharged before January 1, 2017, if 3 conditions are met: (1) before January 1, 2017, the mortgage loan servicer sends the borrower-homeowner the required notice under the PRMP (or the HAMP) in conjunction with a written Trial Period Program (TPP), or in an active TPP; (2) the borrower-homeowner satisfies all of the PRMP (HAMP) and TPP conditions; and, (3) the borrower-homeowner and servicer enter into a permanent modification of the mortgage loan on or after January 1, 2017.

[ITEM 6] IRS FINDS LACK OF LIQUIDITY NOT A FACTOR IN DETERMINING WHETHER A TAXPAYER MAY AVOID ACCUMULATED EARNINGS TAX

In Chief Counsel Advice 201653017, the taxpayer was a corporation with only one shareholder. The shareholder transferred his entire interest in several partnerships to the corporation. Partnership 1 served as the manager for all of the entities contributed to the corporation. Partnership 1 was managed by a board consisting of six members, including the corporation. Each of the partnership agreements contained a provision allowing the partnership to make distributions to its partners sufficient to pay the respective partner's federal and state tax liability, but the remainder of the respective partner's distributive share of the partnership income was retained in the partnership. Accordingly, the corporation reported its share of partnership income but only received distributions sufficient to pay its tax liability. Essentially all of the income reported by partnerships that flowed through to the corporation was investment income (dividends, interest, capital gain), and trade or business income. The corporation conducted no business activity other than holding and maintaining the various partnership interests contributed to it by the shareholder. It had no employees and paid no wages or expenses, other than a minimal amount for accounting and other fees. The corporation neither declared any dividends nor made any distributions to its sole shareholder. The corporation did not provide the IRS with any information to show reason for the accumulation of retained earnings and a review of the minutes did not reveal plans or information relating to the reasons for the accumulation. Section 531 imposes a tax on the accumulated taxable income of each corporation described in Section 532. Under Section 532, the 20% tax is imposed on every corporation formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being distributed. Avoidance of tax need not be the sole, dominant, controlling, or impelling motive; it is sufficient if it is one of the motives for the accumulation. The IRS indicated that since the corporation had no activity other than holding and maintaining the various partnership interests, there were no reasonable needs to accumulate the earnings and profits of the corporation. The corporation argued that it was not liable for the accumulated earnings tax because it did not have control over distributions from the partnerships in which it invests. In addition, it noted that it did not have liquid capital from which to distribute earnings to its shareholder and, therefore, should not be subject to the accumulated earnings tax. The IRS countered that the Code uses taxable income as the starting point for computing accumulated taxable income and the accumulated earnings tax, and it is not concerned with the liquid assets of the corporation. To the contrary, for illiquid corporations, Section 565 provides for the use of consent dividends to reduce accumulated taxable income. That is, if the shareholder of the corporation had elected, consent dividends could have been made by the corporation. Consent dividends are treated as dividend distributions to the shareholder on the last day of the year followed by a capital contribution by the shareholder to the corporation. Such an election could have reduced or eliminated the accumulated earnings tax. The Chief Counsel concluded that the corporation was formed to avoid income tax with respect to its shareholder. It is subject to the accumulated earnings tax irrespective of its lack of liquidity and lack of control over the partnerships in which it invests.

REVIEW QUESTIONS AND SOLUTIONS

1. Regarding the inflation-adjusted amounts for 2017, **which one** of the following statements **is true**?

    a. A single taxpayer with an AGI of $90,000 in 2017 is allowed a deduction for interest expense on qualified student loans.

b. A single taxpayer with an AGI of $250,000 in 2017 is not subject to the phaseout of the personal exemption deduction.

c. The 2017 maximum earned income tax credit for taxpayers with two qualified children is $3,400.

2. **Which one** of the following amounts **is** the **correct** IRS mileage rate for 2017?

a. 25 cents per mile for the depreciation component of the business standard mileage rate.

b. 14 cents per mile for medical and moving expenses.

c. 17 cents per mile for charitable contributions.

3. Regarding the National Taxpayer Advocate's 2016 Annual Report, **which one** of the following statements **is false**?

a. The IRS should incorporate more of the Taxpayer Bill of Rights into its operations.

b. The Code's retirement saving incentives should not be consolidated.

c. The Section 6662 accuracy-related penalty is a highly litigated issue.

4. For a recent Chief Counsel Advice, **which one** of the following **was not** one of the corporation's arguments against being assessed an accumulated earnings tax?

a. The earnings were reinvested in the reasonable needs of the business.

b. The corporation did not have control over distributions from the partnerships in which it invested.

c. The corporation noted that it did not have liquid capital from which to distribute earnings to its shareholder.

Solutions

1. **"B" is the correct response**. A single taxpayer is not subject to the phaseout of the personal exemption deduction in 2017 until the AGI exceeds $261,500.

"A" is an incorrect response. For single taxpayers, the AGI phaseout range for the student loan interest deduction in 2017 is $65,000 - $80,000. An AGI of $90,000 is above the range so there is no interest expense deduction.

"C" is an incorrect response. The 2017 maximum earned income tax credit for taxpayers with two qualified children is $5,616. For one qualified child it is $3,400. *Revenue Procedure 2016-55.*

2. **"A" is the correct response**. The 2017 depreciation component is 25 cents per mile.

"B" is an incorrect response. The medical and moving expenses mileage rate is 17 cents per mile.

"C" is an incorrect response. The charitable contributions mileage rate is 14 cents per mile. *Notice 2016-79*.

3. **"B" is the correct response**. The TA recommends consolidation of at least 15 retirement saving incentives.

"A" is an incorrect response. The TA noted that the IRS does not do enough to incorporate the Taxpayer Bill of Rights into its operations

"C" is an incorrect response. The Section 6662 accuracy-related penalty is included in the TA's list of most litigated issues. *IRS News Release IR–2017-2.*

4. **"A" is the correct response**. The corporation did not provide the IRS with any information to show reason for the accumulation of earnings.

"B" is an incorrect response. The partnership distributions were limited to the amount necessary for the partner to pay tax on the partnership's earnings. The remainder of the earnings was retained by the partnerships.

"C" is an incorrect response. Since the corporation's only investments were in the partnerships, it had little cash to pay dividends. *Chief Counsel Advice 201653017.*

COURT DECISIONS

[ITEM 7] TAX COURT RULES THAT A FINANCIAL CONSULTANT'S COMMISSIONS COULD NOT BE RUN THROUGH HIS S CORPORATION

The Tax Court decision in Fleischer [12/29/16] is bound to cause a great deal of consternation for the insurance and financial planning industries. Typically, financial planners who sell insurance products and investment securities enter into broker contracts with a licensed broker/dealer. Many financial planners operate their business as an S Corporation. Generally, broker/dealers cannot pay commissions to an entity unless the entity formally registers as a licensed broker/dealer. Instead, the broker/dealer pays the commission to the financial planner and the financial planner assigns the commission to the S Corporation. This was the case in the current decision. On February 2, 2006, the taxpayer entered into a representative agreement with a financial services company whereby his relationship with the company was that of an independent contractor. Later he entered into a broker contract with another broker dealer. On February 7, 2006, the taxpayer formed an S Corporation but did not enter into an employment agreement with the S Corporation until February 28, 2006. The taxpayer was paid an annual salary to perform duties in the capacity of a financial advisor. The duties consisted of: (1) acting in the clients' best interests in managing client investment portfolios; (2) expanding the corporation's client base; (3) drafting and reviewing financial documents; and, (4) representing the corporation diligently and responsibly at all times. The agreements included other common provisions found in employment agreements, but did not include a provision requiring the taxpayer to remit any commissions or fees from the financial services company to the corporation. During the taxable years 2009-2011, the S Corporation reported net income of $11,924, $147,642, and $115,327, respectively. During the same period, the taxpayer reported annual wages from the S Corporation of about $35,000. The IRS issued a notice of deficiency for nearly $42,000 for the three years in question claiming that the taxpayer should have reported the S Corporation's gross receipts as self-employment income on Schedule C. Since a taxpayer's share of S Corporation income is not considered self-employment income, the deficiency consisted primarily of self-employment tax that would arise if the income was reported on Schedule C versus on Schedule E (page 2). The Tax Court first noted that it has long been held that income is taxed to those who have earned it. However, when a corporation is involved, the question of who earned the income is not so easily answered. In this situation, this question has evolved to one "who controls the earning of the income." Under a previous Tax Court decision (Johnson, 1982), the court held that for the corporation to be the controller of the income, two elements must be found: (1) the individual providing the services must be an employee of the corporation whom the corporation can direct and control in a meaningful sense, and (2) there must exist between the corporation and the person or entity using the services a contract or similar indicium recognizing the corporation's controlling position. In the current case, the Tax Court observed that the S Corporation was not a party with either of the contracts between the taxpayer and broker/dealers. The taxpayer countered that it was impossible for the broker dealers to contract directly with the S Corporation because the S Corporation was not a registered entity under the securities laws and regulations. The Tax Court responded that the S Corporation was not prohibited from registering and the fact it had not registered does not allow the taxpayer to assign the income he earned in his personal capacity to the S Corporation. The court found no indicium for the broker dealers to believe that the S Corporation had any meaningful control over the taxpayer. Having failed the second test in the Johnson decision, the Tax Court ruled it was not necessary to determine whether the first element in the Johnson decision was satisfied. Accordingly, it ruled that the income earned under the representative agreement with the financial services company and broker contract with the broker dealer should have been reported by the taxpayer, not the S Corporation. **Note**: Unfortunately, the case does not provide any details regarding the S Corporation's activities and expenses. If the S Corporation has employees providing substantial services in assisting the financial planner, the S Corporation's "controlling position" could be established. To help establish this controlling position, the corporation should document through its employment contracts or otherwise the responsibilities of each employee and how the services of each employee including the financial planner are essential in earning the commission income. **Note:** It probably did not help that the taxpayer's wages in each year was only $35,000, particularly in 2010 and 2011, when the net income increased substantially from 2009.

[ITEM 8] TAX BENEFIT RULE DOES NOT RECAPTURE DECEASED FARMER'S DEDUCTIONS FOR PROPERTY INHERITED BY SPOUSE AND USED IN HER FARM ACTIVITIES

In Estate of Backemeyer [12/8/16], the taxpayer's husband was a sole proprietor, cash-basis farmer. In 2010 he bought seed, chemicals, fertilizer, and other farm inputs that he planned to use to plant crops in 2011. He died on 3/13/11 before using the inputs, after which his wife became actively involved in farming. The inputs were listed on his estate tax return, using their purchase price as fair market value. The inputs ultimately were distributed to a family trust, from which they were distributed to the wife for use in her Schedule F farming business in 2011. The taxpayer and her husband filed a joint return in 2010 and 2011. The husband claimed a deduction for the inputs on his Schedule F on their 2010 return. The 2011 return contained the husband's Schedule F for his farming activities to his death, and the wife's Schedule F for her farming activities after his death. The wife claimed deductions on her 2011 Schedule F for the inputs that the husband had claimed as deductions on his 2010 Schedule F. The IRS audited the 2010 and 2011 tax returns. The IRS denied the wife a deduction for the inputs she deducted on her 2011 Schedule F. Later, the IRS changed its position and conceded the wife was permitted a deduction for the stepped-up basis (fair market value at her husband's death). Then, it maintained that the tax benefit rule required that the inputs which her husband had deducted on their 2010 return be included as income on his Schedule F on their 2011 return. The issue was whether the tax benefit rule required that the deductions the husband claimed for the inputs on his Schedule F on their 2010 return (and inherited by his wife and used on her Schedule F on their 2011 return) be recaptured as income on his Schedule F for their 2011 return. The IRS stated that the Section 111 tax benefit rule requires a taxpayer to include a previously deducted amount in the current year's income when an event occurs that is fundamentally inconsistent with the claimed deduction for the previous year. The IRS argued that when the husband died not having used the farm inputs in his farming business, the inputs were converted from a business use to a nonbusiness personal use when they were distributed to the family trust, and then from personal use back to business use when the wife put them in her farming business. So, if the wife were permitted a deduction for the inputs, the husband was required to recognize income related to the conversion of the property from one use to another. The taxpayer argued that when she inherited the farm inputs and used them in her own farming operation, she was deemed to have simultaneously sold the inputs and then purchased them for use in farming. She further argued that the deemed sale resulted in no gain because she had a full stepped-up basis in the farm inputs. In a previous Tax Court case, the court developed a 4-part test in applying the tax benefit rule. Under that test, an amount must be included in gross income in the current year to the extent that: (1) it was deducted in a prior year, (2) the deduction resulted in a tax benefit, (3) an event occurs in the current year that is fundamentally inconsistent with the premises on which the deduction was originally based, and (4) a Code nonrecognition provision does not prevent inclusion in gross income. The wife argued that the 3rd and 4th parts of the test were not satisfied. The wife argued that if her husband died in 2010 instead of 2011 and she used the inputs that year, he still would have been entitled to the deduction. Further, since a taxpayer is required to recognize gain only to the extent sales proceeds exceed basis, she recognized no gain on the sale of the farm inputs since she received a basis step-up for them at her husband's death. The Tax Court stated that under the tax benefit rule a current event is considered fundamentally inconsistent with the premises on which the deduction was originally based when the current event would have foreclosed the deduction if that event had occurred in the year in which the deduction was taken. The court noted that if the taxpayer converts an expensed asset to some other use (for example, nonbusiness use), that action is inconsistent with the earlier deduction, and the tax benefit rule requires inclusion in income of the amount of the unwarranted deduction. But, the court stated that the application of the tax benefit rule in this case presents a special situation where there is a transfer of the property at death. It concluded that while the first two criteria for the 4-part test are met, the 3rd and 4th criteria are not. Regarding the 3rd criterion, the court stated that had the husband died and his wife inherited and used the farm inputs in the same year, the initial Section 162 deduction would not have been recaptured for purposes of the income tax. The estate tax effectively "recaptures" Section 162 deductions by way of its normal operation, reducing effectively any need to separately apply the tax benefit rule. It noted the inputs were included in the husband's estate at their purchase price. Since the farm inputs before then had a zero basis, and they were subject to the estate tax on the same basis as their purchase price, recapturing the deduction by increasing the wife's farming income under the tax benefit rule would result in double taxation of the value of the farm inputs. The Tax Court noted the 4th criterion is not met since nonrecognition on death is among the strongest principles in the income tax: when an individual dies, his assets are not included in income and taxed under the income tax, but rather are taxed under the estate tax regime. Property an heir inherits is taxed at disposition by the heir only to the extent it exceeds the stepped-up basis from the decedent. The court decided the tax benefit rule does not require that the deductions that the husband claimed for the inputs on his Schedule F on their 2010 return (and inherited by his wife and used on her Schedule F on their 2011 return) be recaptured as income on his Schedule F for their 2011 return.

[ITEM 9] TAX COURT DENIES IRS'S EFFORT TO REGROUP TAXPAYER'S ACTIVITIES

In Hardy [1/17/17], the taxpayer was a plastic surgeon who conducted his medical practice through his single-member PLLC. He operated on his patients at his office or two local hospitals. If the operation required only local anesthesia, the procedure was done at his office, but if an overnight stay was required he performed the operation at a hospital. There was a limited availability of operating rooms for him to use in the hospitals. In 2006, he bought a 12.5% interest in a surgery center, joining 7 other physician / members who had formed an LLC to operate a surgery center. The center was professionally managed, hired its own employees (none was shared with the taxpayer's medical practice), directly billed patients for facility fees, and distributed to each LLC member his share of earnings based on the facility fees less expenses. He never managed the surgery center, had no day-to-day responsibilities, had no input into management decisions, and generally was not involved in hiring or firing decisions. He received a distribution from the surgery center, regardless of whether he performed surgeries there or not. For 2006 and 2007, the couple reported their surgery center income as nonpassive, relying on their K-1 from the surgery center showing the income was from a trade or business. They paid self-employment tax on the income. The taxpayers did not group the taxpayer's medical practice with his surgery center ownership interest. For the two years, the taxpayer showed at least $199,000 of nonpassive income from the surgery center. He had total unallowed passive activity losses of at least $58,000 from other activities. In 2008, the taxpayer's CPA determined that the surgery center was passive, and changed reporting the income from nonpassive to passive, determining that the taxpayer's relationship to the surgery center was passive. The CPA did not amend the couple's 2006 or 2007 returns. On their 2008 and 2009 returns, the taxpayers reported passive income from the surgery center of $250,494 and $245,012, respectively. For 2008, the couple reported a total passive activity loss of $256,411.

They used their passive income to offset all of the passive losses except $5,917, which they carried over to 2009. For 2009, they reported a total passive activity loss of $104,224. Their 2009 passive income absorbed all of the 2009 passive activity loss. The surgery center passive income on their 2010 return absorbed all of their passive activity loss for that year. For both 2008 and 2009, the taxpayers reported self–employment tax on his practice and surgery center income. The IRS issued a notice of deficiency for 2008 - 2010, disallowing the taxpayers' passive activity loss deduction. The taxpayers argued they could use their passive activity losses against their surgery center income. At trial, the taxpayers also argued they overpaid their self-employment tax for 2008 and 2009. One issue in the case was whether the taxpayers properly reported the surgery center income as passive and, if so, were they permitted to deduct passive activity loss carryovers from previous years. Another issue was whether the taxpayers overpaid their self-employment tax. The IRS argued that the surgery center income was nonpassive for years 2008 through 2010. The Tax Court noted that the passive activity grouping regulations permit business or rental activities to be treated as a single activity if they constitute an appropriate economic unit. It sought to determine if the taxpayer's medical practice and surgery interest were one activity, or two separate activities. The court stated that the regulations permit taxpayers to use any reasonable method in grouping activities. Among regulation factors that the taxpayer may use in grouping activities are business similarities, extent of common control and common ownership, geographical location, and interdependencies between or among activities. The court noted that once the taxpayer has grouped activities, generally he cannot regroup unless the original grouping was clearly inappropriate, or there has been a material change in the original facts and circumstances. The IRS argued that since the taxpayer had previously reported his surgery center income as nonpassive, he had grouped his medical practice and his interest in the surgery center. The taxpayer had not explicitly grouped the activities, and for the years in question he was not required to do so. The court refused to infer that the taxpayer originally had grouped his practice and his surgery center interest, and further found there was no regrouping in 2008 when he began reporting the surgery center income as passive. It ruled the taxpayer had consistently treated the activities as separate economic units.
The court found a number of facts supported treating the doctor's practice and his surgery center interest as separate economic units, some of which were: (1) he solely owned his medical practice, but was only a minority owner in the surgery center; (2) he managed his medical practice, but had no management responsibilities for the surgery center; (3) his medical practice and the surgery center did not share things, e.g., building space, employees, and billing functions; and, (4) he was a surgeon providing care, while the surgery center provided space and associated services. The court found the taxpayer had no principal purpose of circumventing the underlying purposes of the passive activity loss rules in treating the activities as separate activities. The court ruled that the IRS could not regroup the taxpayer's activities as one activity. Next, the court considered the amount of the taxpayer's passive activity carryover loss to 2008. It noted that the taxpayer erroneously treated his surgery center income share as nonpassive for 2006 and 2007. Had he reported the surgery center income as passive in those years, there would have been no carryforward of passive activity losses to 2008. Finally, the court considered whether the taxpayer was subject to the self-employment tax for his share of surgery center income for 2008 and 2009. The IRS argued that since the taxpayer performed surgeries at the surgery center, he was not acting as a limited partner. The court found that the taxpayer was an investor in the surgery center. It observed that although the taxpayer performed surgeries at the surgery center, he was not involved in the operations of the surgery center as a business. The court ruled that the taxpayer's surgery center distributive shares were not subject to self-employment tax because he received his share of income from the surgery center in his capacity as an investor, and so he could treat his surgery center income as passive. It ruled that the taxpayers were not permitted to deduct passive activity loss carryovers from those years in which they treated the surgery center income as nonpassive. For 2008 and 2009, it ruled the taxpayers overpaid their self-employment tax because the husband's surgery center distributive share should be excluded from net earnings from self-employment.

[ITEM 10] FIFTH CIRCUIT RULES PARTNERSHIP DID NOT FOLLOW THE PROPER STEPS FOR AMENDING ITS TAX RETURN

Amended returns for individuals generally are accepted by the IRS if the amended tax return is filed within 3 years (including extensions) after the date the tax return is filed or within 2 years after the date the tax is paid, whichever is later. As illustrated in the Stewart [10/13/16] case, amending a partnership return is a little more complicated. In this case, the taxpayer was one of five partners in a partnership that was engaged in managing a portfolio of oil and gas properties owned by an LLC. In 2004, the LLC sold its portfolio and the partnership received a 20% interest worth about $20 million. The partnership originally filed its 2004 return in 2005 and reported ordinary income of about $20 million, and the taxpayer's share was nearly $6 million. In 2007, the partnership determined that the 2004 income was capital gain rather than ordinary income. It amended its 2004 return and reissued amended Schedule K-1 forms to its partners. Four of the partners, including the taxpayer, received refunds after filing amended returns. However, the IRS denied the fifth partner's refund request as it concluded that the 20% interest received by the partnership was compensation for services, and therefore the fifth partner's earnings should be taxed as ordinary income, not as capital gains. The investigation also brought to the IRS's attention the refunds it had issued to the other partners. It determined that it had erred in approving the other refunds and brought suit in 2010 for return of the refunds it granted the other four partners. In 2015, a district court granted summary judgment in full for the partners, holding that because the income was properly characterized as capital gains, the amended tax returns were correct, and the tax refunds were not erroneous. So far so good for the taxpayers until the rules for amending a partnership return were analyzed. A partner of a partnership or the tax matters partner in the partnership must file an Administrative Adjustment Request (AAR) under Section 6227. It must be filed within 3 years after the later of (1) the date the partnership return was filed or (2) the last day for filing the partnership return (not including extensions). Form 8082 must be filed in conjunction with the AAR. Because neither the partnership nor any of its partners filed a Form 8082, the Fifth Circuit concluded that no proper request for an administrative adjustment was made. It reversed the District Court and made the following ruling: (1) none of the amended returns qualified as an AAR; (2) the partnership income should not have been adjusted from ordinary income to capital gains; and, (3) the refund issued to the taxpayer was erroneous.

[ITEM 11] S CORPORATION MAY NOT DEDUCT TRUST FUND RECOVERY PENALTY PAID FOR ITS SHAREHOLDERS

In Brown [1/24/17], the taxpayer founded Quantum Group, LLC (LLC), in which his wife and he (taxpayers) held 100% until 2012, when the company added two additional members. The couple also claimed to own 100% of Quantum, Inc. (INC), an S Corporation formed in March 1996. INC was administratively dissolved by the State of Arizona on 11/26/07 for failure to file an annual report. It was not registered as an active entity with any state during 2012. INC provided no services nor generated any income during 2012. For 6 quarters during 2000 - 2002, INC accumulated unpaid payroll tax liabilities for which the Trust Fund Recovery Penalty (TFRP) was assessed against the taxpayers. In 2012, the taxpayers owed at least $180,911 in TFRPs. On 12/31/12, the taxpayers transferred $215,000 from LLC's bank account to their attorney's trust account. On the same day, the attorney sent a letter and a $215,000 certified check to the IRS to cover the taxpayers' TFRPs and any interest. The IRS applied the amount against the TFRPs owed by the taxpayers for the 2000 - 2002 tax years. INC did not have any bank accounts at any point in 2012, nor did it transfer any funds directly to anybody. INC did not file income tax returns for the 2003 - 2011 tax years. On 9/16/2013, INC filed Form 1120S for the 2012 tax year, noting it was the company's final return. The return showed INC held no assets, no income, and no deductions except for a $180,911 salary and wage deduction, resulting in an ordinary business loss on the return. Each taxpayer was allocated one-half of the ordinary business loss on their Schedule K-1, which they included on their 2012 individual income tax return. INC did not issue Forms W-2, and the taxpayers did not report any salary or wage income from INC on their 2012 return. The taxpayers contended, and the IRS disputed, that the deduction for salaries and wages reported on INC's 2012 return was for salary and wage expenses not deducted by INC for its 2000 - 2002 tax years. The IRS disallowed INC's 2012 deduction for salaries and wages. The issue was whether INC was permitted a deduction for the TFRPs owed by the taxpayers and paid in 2012, and whether the taxpayers could use the Quantum Inc., loss on their 2012 return. The taxpayers argued their entitlement to the $180,911 deduction on the basis that INC's payment represented the employees' portion of payroll tax withholding, deductible by the corporation as an ordinary and necessary business expense. It stated that, its 2007 dissolution notwithstanding, it still had liabilities for outstanding employment taxes. They contended that INC still was carrying on a trade or business in 2012 because it paid payroll tax expenses related to the previous operations of its business. They argued the act of filing a tax return proved that INC was carrying on a trade or business and that employment taxes paid by INC were not TFRPs because INC did not owe any TFRPs. The IRS based its disallowance of INC's deduction on two arguments: (1) the salaries and wages expense INC reported in 2012 was not an expense that it incurred in 2012 while carrying on a trade or business; and, (2) the expense was for nondeductible TFRPs. The Tax Court held that for a Section 162 business expense to be deductible, the taxpayer must be involved in the activity with continuity and regularity. It held INC was not engaged in any activity during 2012 in that it had no assets or income, nor did it have any customers or perform any services. The court was not satisfied INC still existed in 2012 for federal tax purposes. In this regard, it noted the corporation's apparent inactivity after 2002, its administrative dissolution by the State of Arizona in 2007, it had not filed any returns after 2002, and there was no evidence INC had any assets or engaged in any activities after 2002. Further, the court noted INC was not entitled to a deduction for an amount that it did not actually pay. Finally, the court noted that the amount paid was for the taxpayers' TFRP liabilities. It stated that Section 162(f) denies a deduction for fines or similar penalties to a government for the violation of any law. The court denied INC the 2012 deduction, and did not permit the taxpayers to use the INC loss on their 2012 return.

[ITEM 12] 11TH CIRCUIT DETERMINES YEAR OF LOSS DEDUCTION FOR S CORPORATION'S DISTRESSED PROPERTIES

A single-owner S Corporation (Paragon) was in the business of real estate acquisition, development, and sales. Paragon was formed in 11/97, and was active until 9/28/12. It was solvent at the beginning of 2008. Paragon had bank recourse mortgages which it used to buy real property. In 2007 and 2008, the local residential real estate market sharply declined. Paragon had no sales or revenue in 2008. With a little over $12,000 in its bank account at the end of 2008, Paragon closed its office, dismissed its employees, and stopped making payments on its mortgages, insurance premiums, and taxes. At that time, Paragon owned 13 properties, all with mortgages (aggregate FMV around $6.8 million, aggregate mortgage balance around $8.6 million). Six of the properties were under water, and Paragon owed more than $2 million on those properties. A real estate appraiser stated that there was value to all properties, and some demand for them. In the summer of 2009, Paragon's owner transferred more than $1.3 million to Paragon. During 2008 - 2010, Paragon was relieved of a number of the liabilities under foreclosure lawsuits through varying cash payments by Paragon or through sale of the properties. For two of the properties the corporation filed a "Notice of Commencement" to enable it to complete a residence on the property and sell it to help mitigate damages. On 11/30/09, there was $839,745 in the corporation's bank account. In 12/09, the owner established an LLLP, and transferred $358,256 from Paragon to the LLLP, then transferred a little over $400,000 from Paragon to himself. On Paragon's 2008 federal income tax return, it reported a loss of about $10.8 million, around $8.9 million of which was attributable to a write down of the corporation's real estate inventory to its 12/31/08 market value. The owner claimed a $6.78 flowthrough loss on his 2008 individual income tax return, generating a 2008 NOL of more than $6.7 million which he carried back to generate almost $2 million of refunds. The IRS audited Paragon's return and asserted that Paragon's 2008 loss was only $1.5 million, and issued the owner a Notice of Deficiency disallowing carrybacks resulting in tax deficiencies totaling around $1.5 million. The issue in Tucker [11/21/16] was when an S Corporation is permitted a loss deduction for real estate properties subject to recourse loans that are foreclosed on by the mortgagees. Section 165 allows deductions for losses that stem from "closed and completed transactions," which include an asset's being abandoned or becoming worthless. The Tax Court stated the general rule that, when a taxpayer's real property is secured by a recourse obligation, the taxpayer is not entitled to a loss deduction until the year of the foreclosure sale, regardless of abandonment or worthlessness. The court rejected the taxpayer's argument that the test for "closed and completed transactions" that applies to casualty and theft losses is the same for losses on abandonment and worthlessness of real property. The court rejected the taxpayer's argument that the properties were abandoned in 2008 (the year Paragon claimed the loss), noting Paragon's attempts in 2009 and 2010 to sell the properties, construct homes, and settle claims with the banks. The court rejected the taxpayer's claim the properties were worthless at the end of 2008, and they could not be used to reduce Paragon's liability exposure for a deficiency judgment. Paragon's owner's own expert witness testified the properties had some value and there was some demand for the properties at the end of 2008. The Tax Court ruled against the taxpayer in concluding that abandonment or worthlessness of the properties had not occurred by the end of 2008. The taxpayer appealed the case to the 11th Circuit. The circuit court stated that a closed and completed transaction occurs on sale or other disposition of the property, or there is abandonment of worthlessness of the property. The court noted that, regarding abandonment, the taxpayer must show both an intention to abandon, and some act evidencing that intention. It agreed with the Tax Court that even though the taxpayer had closed its office, dismissed its employees, and stopped making payments on its obligations by 12/31/08, the record showed Paragon continued to develop and sell the properties throughout 2009 and 2010. As to a deduction for worthlessness, the circuit court stated the taxpayer must show his subjective determination of worthlessness in a given year, coupled with a showing that in that year the asset in question is in fact essentially valueless. The court stated that Section 165 law permits a loss claim in the year that the amount of the loss becomes readily ascertainable. It stated Paragon's total losses were not ascertainable or fixed at the end of 2008, as none of the homes had been formally foreclosed upon or sold. It ruled that, in the case of recourse debts, the loss deduction must be taken in the year that the foreclosure sale occurs, regardless of whether the property has been abandoned or become worthless.

[ITEM 13] ANOTHER CONSERVATION EASEMENT FAILS THE RULES

While it seems that charitable deductions for conservation easements continue to be a popular tax planning strategy, a fair number of cases have denied the charitable contribution deduction because the letter of the law was not followed precisely. Because there usually is a lot at stake, particularly with "syndicated" conservation easements, we recommend that tax professionals counsel their clients about the potential tax risks of claiming a charitable deduction for a conservation easement. In Partita Partners LLC [10/25/16], the taxpayer claimed a charitable deduction of nearly $4.2 million in 2008 for the preservation easement of the facade of a building located in an historic district of New York City. The four-story building was purchased by the partners for $4.05 million. The building was constructed in 1872 and it has been designated as an historic structure since 1981. In 2008, the taxpayers signed a "Historic Preservation Deed of Easement" (deed) agreement with a nonprofit trust to preserve the building's facade. The deed permitted the taxpayer to undertake additional construction on the property with the trust's approval. Specifically, development rights were reserved to add two or three floors and to potentially extend the ground floor of the structure. The IRS denied the deduction on the basis of Section 170(h)(4)(B). This provision applies specifically to buildings in registered historic districts. It provides that a contribution of qualified real property will not be considered to be exclusively for conservation purposes unless it (1) includes a restriction which preserves the entire exterior of the building (including the front, sides, rear, and height of the building), and (2) prohibits any change in the exterior of the building which is inconsistent with the historical character of such exterior. The District Court focused on the word "height" and concluded that the statute was clear as it expressly preserves the entire exterior of the building, including its height. The fact that the construction could not be done without the approval of the trust was moot. The court granted the IRS summary judgment and denied the charitable conservation easement deduction.

****REVIEW QUESTIONS AND SOLUTIONS****

5. In a recent court decision deciding whether Form 1099 commissions should be reported by an S Corporation or its sole shareholder, **which one** of the following statements **is false**?

    a. The S Corporation was not allowed to directly receive the commissions because it was not registered under the securities laws and regulations.

    b. Because the S Corporation's employees were providing the services, the Tax Court ruled the commissions should be reported by the S Corporation.

    c. The shareholder's employment agreement with the S Corporation did not require the commissions to be assigned to the S Corporation.

6. In a recent Tax Court decision, the court used a 4-part test in applying the tax benefit rule. **Which one** of the following **is not** one of the factors?

    a. The item was included in income in a prior year.

    b. An event occurs in a later year that is fundamentally inconsistent with the premises on which a deduction taken in a prior year was originally based.

    c. A Code nonrecognition provision does not prevent inclusion in gross income.

7. For a recent Tax Court case dealing with grouping activities under the passive activity loss rules, **which one** of the following responses **is false**?

    a. The court ruled that the doctor's income from his surgery center interest was subject to self-employment tax.

    b. The court found one reason supporting the doctor's medical practice and surgery center interest as separate activities was that he managed his medical practice, but he had no management responsibilities in the surgery center.

    c. The IRS argued that since the surgeon reported his surgery center income as nonpassive in earlier years, he had grouped his medical practice and his interest in the surgery center as one activity.

8. In a recent court decision involving amended partnership and partner tax returns, what crucial factor lead to the 5th Circuit's deciding against the taxpayer?

    a. The amended return was filed after the statute of limitations.

    b. Because the corporation provided investment services, the 5th Circuit ruled that the $20 million dollar payment should be characterized as ordinary income.

    c. Neither the partnership nor any partner filed Form 8082.

9. For a recent case in which the 11th Circuit determined the year of the loss deduction for an S Corporation's distressed real estate, **which one** of the following responses **is false**?

    a. The corporation had abandoned the properties by the end of the tax year for which it sought the deduction.

    b. The facts that the corporation had closed its office and dismissed its employees did not mean that it had abandoned the properties.

    c. The property was not worthless under Section 165 loss law at the end of the year for which the corporation sought the deduction because its total losses were not ascertainable or fixed then.

Solutions

5. **"B" is the correct response**. Because the court found no indicium for the broker dealers to believe that the S Corporation had any meaningful control over the taxpayer, it ruled the commissions should be reported by the taxpayer, not the S Corporation.

    "A" is an incorrect response. The corporation was not registered as a licensed broker dealer.

    "C" is an incorrect response. While the employment agreement contained many of the common provisions found in employment agreements, it did not include a provision requiring the taxpayer to remit any commissions or fees from the financial services company to the corporation. *Fleischer.*

6. **"A" is the correct response**. The item was **deducted** in a prior year.

   "B" is an incorrect response. This is item # 3 in the list of the 4 factors in the test.

   "C" is an incorrect response. This is item # 4 in the list of the 4 factors in the test. *Estate of Backemeyer*.

7. **"A" is the correct response**. Finding that the doctor's interest in the surgery center was that of an investor, it ruled his distributive income share from the center was not subject to self-employment tax.

   "B" is an incorrect response. This is item # 2 in the 4-item list in the case writeup that the court found supported treating the doctor's practice and his surgery center interest as separate economic units.

   "C" is an incorrect response. The IRS argued that since the taxpayer had previously reported his surgery center income as nonpassive, he had grouped his medical practice and his interest in the surgery center. *Hardy*.

8. **"C" is the correct response**. A partner of a partnership or the tax matters partner in the partnership must file an AAR under Section 6227. Form 8082 must be filed in conjunction with the AAR. Since this was not done, the 5th Circuit ruled the refund from filing an amended return was erroneous.

   "A" is an incorrect response. The amended return was timely filed.

   "B" is an incorrect response. Finding the amended return was invalid, the court did not rule on the proper characterization of the $20 million payment. *Stewart*.

9. **"A" is the correct response**. The court believed that the corporation had not shown an intention to abandon and some act evidencing that intention, items which are necessary to support abandonment.

   "B" is an incorrect response. The corporation continued to develop and sell the properties throughout 2 years after the year it sought the deduction, thus indicating the properties were not abandoned in the year it sought the deduction.

   "C" is an incorrect response. The court found the losses were not ascertainable or fixed at the end of the year the deduction was sought, thus worthlessness had not occurred then. *Tucker*.

TREASURY

[ITEM 14] TIGTA FINDS BACKUP WITHHOLDING NOT BEING DONE ON INFORMATION RETURNS WITH INVALID OR MISSING TINS

The purpose of backup withholding is to assure that the government is able to collect taxes on all appropriate income, particularly income that is not subject to withholding. The law requires backup withholding in several instances, including when a payee fails to furnish a Taxpayer Identification Number (TIN). Information returns with missing TINs fail validation because the IRS has no ability to match the amounts reported in the information return with the amounts reported on individual tax returns. The Treasury Inspector General for Tax Administration (TIGTA) noted that while a majority of information returns report valid TINs, there still is a substantial number of TINs that are incorrect or missing. For example, for the 2013 taxable year, there were over 91.1 million 1099-MISC forms filed with the IRS and over 5.3 million of the forms contained missing or incorrect TINs. Section 3406 requires payers to immediately backup withhold at a rate of 28% on reportable payments to a payee who refuses or neglects to provide a TIN. In Report Number 2016-40-078 [9/14/16], the TIGTA reports the results of its investigation of a sample of information returns filed in 2013. The sample of information returns was selected from the following reported forms: 1099-B; 1099-INT; 1099–MISC; 1099-DIV; W-2G, and 1099-K. Its review identified 130,358 payers that submitted 310,779 information returns for which the payee TIN was missing. These returns reported payments totaling $145 billion. Although payers were required to withhold almost $41 billion from these payees, only $5 million was withheld. Next, the TIGTA examined 13,647 payers that submitted 27,576 returns with the same missing payee TIN, payee name, and payee ZIP code for two consecutive years. Nearly $4 billion should have been withheld from these returns, yet only $1 million actually was withheld. Finally, it expanded its research for incorrect information for four consecutive years and found similar results – only $1 million was withheld when $5 billion should have been withheld. The TIGTA made several recommendations including that the IRS Small Business/Self Employed Division establish a service-wide information returns backup withholding strategy, and document the criteria which are used to exclude payers from receiving a notice. The IRS agreed with all of the recommendations.

REVIEW QUESTIONS AND SOLUTIONS

10. ABC pays $100,000 for legal services rendered by James Jones in 2016. Assuming James is an independent contractor who failed to provide his taxpayer identification number to ABC, what is the required amount of federal taxes that ABC should withhold from his payment?

a. $39,600.
b. $35,000.
c. $28,000.

Solutions

10. **"C" is the correct response**. Section 3406 requires payers to immediately backup withhold at a rate of 28% on reportable payments to a payee that refuses or neglects to provide a TIN. In this case, the required withholding is $28,000 ($100,000 x 28%).

    "A" is an incorrect response. $39,600 would be correct if the law required the withholding rate to be the current highest income tax rate of 39.6%.

    "B" is an incorrect response. $35,000 would be correct if the law required the withholding rate to be the second highest income tax rate of 35%. *TIGTA Report Number 2016-40-078.*

SPECIAL TOPICS

[ITEM 15] LIKE-KIND EXCHANGES

Like-kind exchanges, particularly investment real property, continue to be a popular way of deferring gain on the disposition of investment property. In the first section of this "Special Topic," we provide a basic review of the like-kind exchange provisions, including the computation of the gain recognized and basis of the acquired (replacement) property. In the second section, we discuss a recent court case which illustrates the danger of engaging in a like-kind exchange with a related party.

BASIC REVIEW OF THE LIKE-KIND EXCHANGE PROVISIONS

Section 1031 governing like-exchanges is one of several "nonrecognition" provisions included the Code. Nonrecognition provisions should be distinguished from exclusion provisions. Generally, exclusion provisions permanently exclude gain from a transaction whereas nonrecognition provisions defer gain to a latter event. In order to defer the entire gain, the replacement (acquired) property must be of like-kind to the relinquished property. In addition, both properties must be held for productive use in a trade or business or investment. Like-kind refers to realty and personal property. For example, investment land for an office building which will be used in the taxpayer's business would satisfy the like-kind requirement since they are both real estate property and are held either for investment or business use. A business warehouse for heavy duty machines used in the taxpayer's business would not qualify since one property is realty property and the other is personal property. There are certain types of property that are specifically excluded from the like-kind exchange provisions, including: (1) stocks and bonds; (2) other securities or evidences of indebtedness; and, (3) interests in a partnership.

Very rarely will the value of the relinquished property equal the value of the replacement property, so many times other property (normally cash) will be used to equalize the values of the like-kind properties. Since cash is not like-kind property, it is considered boot received to the party receiving the cash and boot given to the party paying the cash. In this case, gain is recognized by the party receiving the cash. The gain recognized is the lower of (1) the gain realized (fair market value of the property surrendered less its basis) or (2) the boot received. The basis of the replacement property can be computed two ways. First, it equals (1) the basis of the property surrendered, plus (2) the gain recognized, less (3) the boot received. Second, it equals (1) the fair market value of the property received, less (2) the deferred or unrecognized gain. The deferred gain equals the gain realized less the gain recognized. As an example, assume the taxpayer's relinquished property is worth $300,000 and its basis is $200,000. The replacement property is worth $280,000 so the taxpayer receives $20,000 of cash as part of the consideration in the like-kind exchange. The taxpayer's recognized gain is $20,000, the lower of the $100,000 realized gain ($300,000 - $200,000) and $20,000 boot received. The basis of the replacement property is $200,000 ($200,000 + $20,000 - $20,000). The deferred gain is $80,000 ($100,000 - $20,000) so method two for the basis calculation also yields $200,000 ($280,000 fair market value less $80,000 of deferred gain). In other words, the deferred gain is "imbedded" in the basis of the replacement property.

Normally a seller of property is not interested in taking property owned by the buyer for all or part of the consideration. As a result, most like-kind exchange transactions are not simultaneous and are accomplished through a qualified intermediary. A qualified intermediary is a person (other than a disqualified person) who enters into a written exchange agreement with the taxpayer to acquire and transfer the relinquished property and to acquire the replacement property and transfer it to the taxpayer. If a taxpayer wants to sell her property via a like-kind exchange, a time clock starts once she sells the property or acquires the replacement property. If first she sells the relinquished property, the sale proceeds must be deposited into an escrow account and she must identify potential replacement property within 45 days from the date of sale. Multiple properties can be identified and at least one of the properties must be acquired and received by the earlier of (1) 180 days from the date of sale, and (2) the due date of the tax return (including extensions, so in most cases the earlier date is 180 days) for the taxable year in which the relinquished property was sold. If the replacement property is acquired first, the taxpayer has 180 days to sell the relinquished property.

REPLACEMENT PROPERTY ACQUIRED FROM RELATED PARTY NULLIFIES GAIN DEFERRAL UNDER THE LIKE-KIND EXCHANGE PROVISIONS

In Malulani [11/16/16], the taxpayer was a corporation whose primary operations consisted of leasing commercial property in various states. It filed consolidated returns with a wholly owned subsidiary corporation (sub). It also owned nearly 70% of a second corporation (C2) which also held real estate property throughout the country. On January 10, 2007, the sub through an intermediary sold one of its real estate properties to an unrelated third party resulting in a realized gain of $1.89 million. In order for the sale to qualify for like-kind exchange treatment, the sub had to identify replacement property by February 24, 2007. Between October 31, 2006, the date the buyer expressed an interest in purchasing the relinquished property, and February 23, 2007, brokers presented the sub with numerous properties owned by unrelated parties as potential replacement properties, and the sub attempted to negotiate the purchase of an office building and an apartment building for that purpose. However, the purchase did not materialize and one day before the deadline, the sub identified three properties owned by C2. On July 3, 2007, barely within the 180-day replacement requirement, the sub purchased replacement property from C2. Although C2's realized gain was $3.13 million, it had sufficient net operating losses (NOLs) to offset the gain, resulting in no regular tax liability and an alternative minimum tax of $44,774. The taxpayer filed a consolidated tax return with its sub and pursuant to Section 1031 deferred the $1.89 million gain from the sale of the sub property.

The IRS denied like-kind exchange treatment on the basis of Section 1031(f). Section 1031(f)(1) generally provides that the like-kind exchange provisions will not apply if a taxpayer and a related person exchange like-kind property and within two years either one disposes of the property received in the exchange. This provision was enacted primarily to prevent the potential abuse where related parties engage in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. For example, assume two related corporations (C3 and C4) each own land investments that would qualify for like-kind exchange treatment. C3 owns parcel A which is worth $1,000,000 and has a basis of $600,000. Parcel B was purchased by C4 for $980,000 and it is currently worth $1,000,000. The related corporations would like to sell parcel A for cash but wish to avoid the gain, so they first engage in a like-kind exchange and swap the two properties. C4 now owns parcel A and its basis has now been stepped up from $600,000 to $980,000 (fair market value of $1,000,000 less $20,000 of deferred gain). Three months later C4 sells parcel A for $1,000,000 to an unrelated party for cash. After closing costs, the net gain is minimal. If it were not for Section 1031(f), essentially, $380,000 of gain would be deferred from the sale of parcel A even though it was sold for cash. However, since C3 and C4 are related, the deferred gain from the exchange of A's property is recognized under Section 1031(f) since it was disposed of within two years.

In the current case, Section 1031(f)(1) is not applicable because it does not involve direct exchanges between two related parties. That is, only one of the property transactions in this case involved related parties (the sale of the property from C2 to the sub). However, Section 1031(f)(4) provides that like-kind exchange treatment will not apply to any related party exchange which is part of a transaction or series of transactions "structured to avoid the purposes of" Section 1031(f). Because C2 paid little tax on the transaction and the sub deferred a sizable gain from the exchange, the IRS argued that they structured the exchanges for tax avoidance purposes. The taxpayer countered that Section 1031(f)(2) provides that any disposition of the relinquished or replacement property within two years of the exchange is disregarded if the taxpayer establishes that neither the exchange nor disposition had as one of its principal purposes the avoidance of tax. It argued that it had no preconceived plan to conduct an exchange with C2 and it diligently sought a replacement property held by an unrelated party and only turned to the property held by C2 when the deadline to complete a deferred exchange was imminent. The Tax Court did not buy the taxpayer's arguments. It noted that C2 essentially cashed out its investment virtually tax-free while significant tax savings resulted from the sub's acquisition of the replacement property from C2. The Tax Court concluded that the taxpayer failed to demonstrate that the avoidance of tax was not one of the principal purposes of the exchange with C2. Consequently, it ruled that Section 1031 did not apply. **Note:** We believe the decision was harsh for several reasons. First, the transactions were not consistent with the so-called abuses that Congress was concerned with – the stepping up of basis of appreciated property using the like-kind exchange rules and then selling it a short time later. Second, C2's realized gain of $3.13 million from the sale of its property to the sub was offset by large NOLs unrelated to any tax benefits derived from Section 1031. Third, the very purpose of Section 1031 is tax avoidance. So it is nearly impossible in this case to satisfy Section 1031(f)(2) – that the like-kind exchange did not have as one of its purposes the avoidance of tax. **Note:** We are reminded of other related party provisions in the Code that may result in taxpayers' losing major tax benefits because they did not understand the rules before they engaged in related party transactions. Some of these provisions are discussed later in this issue's *Elite Possibility*.

[ITEM 16] IRA DISTRIBUTIONS AND THE 10% PENALTY TAX ON PREMATURE IRA DISTRIBUTIONS

Generally, distributions from a regular IRA before reaching age 59 ½ are subject to a 10% additional tax. In the first section of this "Special Topic," we review a recent court case dealing with the 10% additional tax and whether the tax applies if the distribution were made because of an economic hardship. In the second section, we provide three IRA distributions which are not taxable and a summary of the common exceptions to the 10% penalty tax.

IRA DISTRIBUTIONS DUE TO ECONOMIC HARDSHIP SUBJECT TO INCOME TAX AND 10% PENALTY TAX

In Cheves [1/30/17], the taxpayer / husband lost his job in 2010. In 2011, after being unemployed for 1 ½ years, he found a job with insufficient earned income to cover his wife's and his living expenses. He depleted his personal savings, and then they began withdrawing funds from their traditional IRAs. Both were under age 59 ½ at the time. There was sufficient withholding to cover the Section 72(t) early withdrawal tax from the wife's retirement accounts. When the husband withdrew $27,721 from his retirement accounts, he requested that his insurance agent withhold amounts to pay taxes triggered by the early withdrawals. Withholding was done only with respect to $3,221 of the husband's withdrawals. During the time the husband was making withdrawals, he also made payments to the insurance agent, mistakenly believing that some of those payments were reimbursements for funds withdrawn from his IRAs. When the husband self-prepared their 2011 joint tax return, he relied on Forms 1099-R that showed the correct amount withdrawn from the wife's retirement accounts, but underreported $15,221 of his retirement accounts withdrawal. The issue was if amounts distributed from an IRA that are used to pay for basic living necessities are subject to income tax and the Section 72(t) penalty tax. The IRS asserted the taxpayers owed income tax and the 10% Section 72(t) early distribution penalty on the $15,221 of unreported income. The taxpayers asserted that they should be excused from income tax and the 10% tax on the underreported amount because they believed the amount they reported was correct, taxes had been withheld from all withdrawals, the 2011 underreporting was a one-time error in more than 30 years of tax filing, the retirement funds were used only to cover their basic necessities, and they could not pay the proposed tax and penalty. The Tax Court stated that the several exceptions to the Section 408(d) general rule that IRA distributions are included in gross income do not include an exception for ordinary living expenses during times of economic hardship. The court stated that distributions made from IRAs for certain purposes are excluded from the Section 72(t) 10% penalty tax for premature distributions. But, it stated that using funds to meet basic living expenses during times of economic hardship is not one of the purposes. The court ruled that amounts distributed from an IRA that are used to pay for basic living necessities are subject to income tax and the Section 72(t) penalty tax. In neither case is there an exception for economic hardship.

INCOME TAX AND PENALTY TAX CONSEQUENCES OF IRA DISTRIBUTIONS

Generally, any deductible contributions made to a traditional IRA are fully taxable when distributed to the IRA owner or beneficiary as ordinary income. There are several exceptions to this general rule. One exception is for "qualified charitable distributions" (QCDs). QCDs not exceeding $100,000 in a taxable year are not included in gross income. A QCD is a distribution from a traditional IRA made directly from the IRA trustee to a qualified charitable organization. A QCD applies to individuals who are 70 ½ years of age or older. Another exception is for a "qualified HSA funding distribution" (QHSAFD). A QHSAFD is a one-time election the taxpayer makes to transfer funds from the traditional IRA to his or her health savings account. The transfer applies only to IRA distributions that otherwise would be taxable. The amount excluded from gross income cannot exceed the annual limitation on the taxpayer's HSA contribution for the year. Another Code exception is for qualified rollover contributions (traditional IRA distributions if rolled over to another traditional IRA or returned to the same IRA) within the 60-day period that begins following the day of receipt. The Code also provides separately that the time for making a rollover may be postponed in the case of service in a combat zone, or in the case of a Presidentially-declared disaster or a terroristic or military action. Also, the IRS has its own regulatory authority to grant a waiver of the 60-day rule for situations where the failure to waive would be against equity or good conscience, including casualty, disaster or other events that are beyond the taxpayer's reasonable control. Early distributions of taxable amounts from an IRA may be subject to an additional 10% tax under Section 72(t). Generally, if the taxpayer is under age 59 ½, he must pay a 10% additional tax on the amount of the IRA distribution ("early distribution") that is includible in gross income. There are several exceptions to the 10% premature distribution penalty. Two common examples are distributions received if the taxpayer is totally and permanently disabled and distributions made to the deceased's beneficiary or estate. For the later, if the IRA beneficiary is the deceased spouse who elects to treat the IRA as his or her own, the exception does not apply. A more complicated exception which has been highly litigated deals with certain annuity distributions which start before reaching age 59 ½. In this case, the distributions must be part of a series of substantially equal payments over the life of the

IRA owner, or the lives of the owner and his or her beneficiary. If the IRA owner changes the amount of the distribution, the 10% penalty may apply. Although IRA distributions to pay education expenses are includible in gross income, the 10% penalty does not apply as long as the distribution does not exceed the amount of qualified higher education expenses. If a taxpayer becomes unemployed, any IRA distribution which covers the cost of medical insurance escapes the 10% penalty. A "first-time" homeowner also may use up to $10,000 of IRA proceeds to buy, build, or rebuild a home without paying the penalty. "First-time" means that you have not owned a home within two years of the acquisition. If the distribution is due to an IRS levy of the IRA, the penalty does not apply. Finally, a "qualified reservist distribution" is not subject to the 10% penalty. The individual must be called to active duty and serve more than 179 days and the distribution must be made during the period of active duty.

REVIEW QUESTIONS AND SOLUTIONS

11. Regarding the like-kind exchange provisions discussed in the special topics sections, **which one** of the following statements **is true**?

    a. For taxpayers who engage in like-kind exchanges with related parties, the like-kind exchange provisions will not apply if the replacement property is disposed of within 3 years.

    b. For taxpayers who sell relinquished property in a deferred like-kind exchange, they must acquire replacement property within 180 days from the date of sale.

    c. An exchange of XYZ stock for ABC stock qualifies as like-kind under the like-kind exchange provisions.

12. **Which one** of the following statements about traditional IRA distributions **is true**?

    a. Distributions received if the taxpayer is totally and permanently disabled are included in gross income and subject to the 10% additional tax penalty.

    b. "Qualified HSA funding distributions" are not included in gross income.

    c. Up to $20,000 of the distribution used to rebuild one's first home are not subject to the 10% additional tax.

Solutions

11. **"B" is the correct response**. For deferred like-kind exchanges, there are two time limitations involving the acquisition of the replacement property – (1) 45 days to identify potential replacement property, and (2) 180 days to finalize the purchase of the replacement property.

    "A" is an incorrect response. The time period at which the related party rules for dispositions nullify the like-kind exchange provisions is 2 years rather than 3.

    "C" is an incorrect response. There are certain types of property that are excluded from the like-kind exchange provisions. Stocks are one of the types of property. *Special Topics - Like-Kind Exchanges.*

12. **"B" is the correct response**. "Qualified HSA funding distributions" are not included in gross income

    "A" is an incorrect response. The distributions are not subject to the 10% additional tax penalty.

    "C" is an incorrect response. For a first-time homebuyer, up to $10,000, not $20,000, of an IRA distribution used to rebuild a home is not subject to the 10% additional tax penalty. *Special Topics - IRA Distributions and the 10% Penalty Tax on Premature IRA Distributions.*

[ITEM 17] AN ELITE POSSIBILITY

In the Malulani case discussed above, we learned about the dangers of engaging in a like-kind exchange transaction with related parties. This *Elite Possibility* reviews the definition of related party and provides some examples of related party transactions that could result in negative tax consequences. Related party transactions generally fall into two major categories. The first category is family members. Under the general definition of related party (Section 267), family members include brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. If the taxpayer owns property with his or her spouse, transactions involving one or more family members of the taxpayer's spouse are related party transactions. The second major category of related party under this provision involves corporations. A related party includes: (1) an individual and a corporation where the individual owns more than 50% of the stock; (2) two corporations which are members of a controlled group (generally more than 50% common ownership); and, (3) a corporation and partnership with more than 50% common ownership. While an individual who is a partner in a partnership is not included in the definition of related party in Section 267, the partner and partnership are considered related in another Code section (Section 707) if the partner owns more than 50% of the partnership. Ownership includes direct and indirect ownership. For example, if a taxpayer owns 30% of a corporation and the taxpayer's child owns 25% of the corporation, both the taxpayer and child are considered related to the corporation (combined ownership is 55%, which is greater than 50%). Under Section 267 if a taxpayer sells property for a loss to a related party, the loss is not deductible. Consider Jane and John, who are married and own a 25% interest in a beach house. The remaining interests in the beach house are owned by Keith (25%), who is Jane's brother, and Ginny (50%). Ginny is a great friend of Jane but is not related to any of the owners of the beach house. Keith and John (brother-in-laws) have managed the beach house for several years, renting it out most of each year. Keith is moving away and wants John to buy him out. They obtain two independent appraisals. Keith's share is valued at $150,000. The beach house was purchased at the height of the real estate market in 2007 at considerably more than its current value. His basis is $225,000 and his suspended losses from the passive activity loss rules are $50,000. If he sells the property to John and Jane, his $75,000 loss is disallowed. If John and Jane eventually sell the portion of the beach house acquired from Keith, their gain realized can be reduced by some or all of the $75,000 disallowed loss (gain reduction is limited to the gain realized – can not generate a loss by using the entire disallowed loss). Keith never gets to deduct the loss! Generally, suspended losses from a passive activity are allowed in the year of disposition. However, for sales to a related party, the suspended loss is not allowed until Keith's former interest is acquired by an unrelated party. Not a good result for Keith! If Keith sells his interest to Ginny, all is well. Keith will be able to deduct the $75,000 loss and the suspended loss is also deductible in the year of sale in accordance with the passive activity loss rules. Section 267 also postpones deductions paid by an accrual-basis taxpayer to a cash-basis taxpayer if the two taxpayers are related. For example, if Craig is the sole owner of Craig Inc., a C Corporation, and Craig Inc. declares a $100,000 salary bonus to Craig on December 31, 2016, payable on January 2, 2017, Craig Inc. is not allowed a deduction for the $100,000 bonus until 2017, the year it is paid. This is called the "matching rule" where the deduction and income recognition are reported in the same taxable year. Other provisions where the tax treatment can be affected by related parties include: (1) stock redemptions; (2) business deductions for payments to related parties which are classified as compensation, rent expense, or interest expense (must be reasonable); (3) gifts; (4) whether a corporation may be subject to the accumulated earnings tax; and, (5) whether a corporation may be subject to the personal holding company tax. **Note**: While IRC Section 267 provides a general definition of related party, there are other definitions of related party which apply to specific transactions, such as stock redemptions (Section 318) and stock ownership in a personal holding company (Section 544).

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***** QUIZ QUESTIONS *****

*Place your answers to the following 20 Multiple Choice Questions on the enclosed answer sheet (**page 21**).*

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1. Regarding the inflation-adjusted amounts for 2017, **which one** of the following statements **is true**?

   a. The personal exemption amount for 2017 is the same as the 2016 amount.

   b. The standard deduction for taxpayers filing head of household in 2017 is $12,700.

   c. The annual gift exclusion amount for 2017 increased $1,000 from the 2016 amount.

2. Regarding 2017 retirement plan limitations, **which one** of the following statements **is true**?

   a. The maximum exclusion for Section 401(k) contributions for taxpayers less than age 50 increased $2,000 from 2016 to 2017.

   b. The maximum IRA contribution for taxpayers less than age 50 is $6,000 for 2017.

   c. The AGI limitation for determining the maximum Roth IRA contribution for single taxpayers is $118,000 for 2017.

3. How much is the business mileage rate for 2017?

   a. 54 cents per mile.
   b. 24 cents per mile.
   c. 53.5 cents per mile.

4. **Which one** of the following items **is not** included in the National Taxpayer Advocate's 2016 Annual Report?

   a. In Fiscal Year 2016, the IRS answered 18% of telephone calls routed to its telephone assistors.

   b. Since 2001, Congress has made more than 5,900 Code changes.

   c. She urges Congress to address consolidation of at least 12 incentives in the Code to save or spend for education.

5. Regarding the forgiveness of qualified debt on a principal residence (QPRI), **which one** of the following statements about a recent IRS notice **is false**?

   a. All QPRI forgiven in 2017 is included in gross income.

   b. For QPRI that is forgiven in 2017, the basis of the taxpayer's principal residence is reduced by the amount of forgiven debt that is excluded from gross income.

   c. For QPRI forgiven in 2017, the QPRI must be subject to a written debt modification agreement that was entered into before January 1, 2017, to be excluded from 2017 gross income.

6. Based on a recent Chief Counsel Advice involving the accumulated earnings tax, **which one** of the following statements **is false**?

   a. The corporation did not provide any information to document its reasons to accumulate earnings.

   b. The corporation had large cash reserves to pay dividends.

   c. The Chief Counsel found that the corporation was formed to avoid income tax with respect to its shareholder.

7. What was the **major** reason that the Tax Court ruled in a recent decision that the individual rather than the individual's corporation must report the commissions received for rendering services?

   a. The S Corporation paid the shareholder a relatively low salary for the shareholder's services.

   b. The court found no indicium that the S Corporation had any meaningful control over the taxpayer.

   c. The individual never entered into an employment agreement with the S Corporation.

8. In a recent Tax Court decision on the tax benefit rule, **which one** of the following arguments **was made** by the court?

   a. The item was not deducted in a prior year.

   b. The estate tax effectively recaptured the deduction taken in an earlier year.

   c. The 4^{th} criterion was met since no nonrecognition provision prohibits gross income inclusion.

9. A surgeon operates his solely-owned medical practice as a PLLC. He also has a 12.5% LLC interest in a surgery center where he performs surgeries not requiring an overnight hospital stay. He does not manage the surgery center, and he has no day-to-day responsibilities for the operation of the center. For his current tax year, his PLLC earnings are $350,000, his LLC income share is $100,000, and he has $120,000 of passive activity losses from other activities. The surgeon does not group his medical activities. Based on a recent Tax Court decision, what is the surgeon's net income from the three activities?

   a. $350,000.
   b. $450,000.
   c. $330,000.

10. For a recent Tax Court case dealing with grouping activities under the passive activity loss rules, **which one** of the following responses **is true**?

    a. With respect to treating the doctor's practice and his surgery center ownership interest as separate economic units, the court found it unimportant that the surgeon owned his medical practice, but was only a minority interest in the surgery center.

    b. The IRS argued that since the taxpayer had previously reported his surgery center income as nonpassive, he had grouped his medical practice and his surgery center ownership interest as one activity.

    c. The court agreed with the IRS that it could regroup the taxpayer's medical practice and surgery center interests as one activity.

11. In a recent court decision involving amended partnership and partner tax returns, **which one** of the following statements **is false**?

    a. Although the partnership filed an Administrative Adjustment Request, the partners did not.

    b. The Fifth Circuit ruled that the refund issued to the taxpayer was erroneous.

    c. The partnership's amended return recharacterized a $20 million payment as capital gain rather than ordinary income.

12. Regarding a recent case dealing with the trust fund recovery penalty, **which one** of the following **was** a reason that the Tax Court denied a corporation a deduction for the amount it paid for the penalty owed by its owners?

    a. Fines and penalties are not deductible under Section 162(f).

    b. The S Corporation was engaged in an active trade or business in the year the penalty was paid and a deduction was taken.

    c. The S Corporation did not pay the penalty timely.

13. Regarding a recent S Corporation case on the timing for a loss deduction for real estate subject to recourse loans that are foreclosed on, **which one** of the following responses **is true**?

    a. The 11^{th} Circuit held that the corporation had abandoned the real estate in the year in which it sought the loss deduction.

    b. The 11^{th} Circuit ruled that the loss must be taken in the year the foreclosure sale occurs.

    c. The 11^{th} Circuit held that the corporation's properties were worthless in the year in which it sought the loss deduction.

14. What was the **major** reason that the District Court ruled against the taxpayer in a recent conservation easement decision?

    a. The building was not located in a historic district.

    b. The trust had no right to prohibit changes to the building's facade.

    c. The taxpayer could change the height of the building with the trust's approval.

15. In a recent TIGTA investigation involving backup withholding for invalid or missing TINs, **which one** of the following statements **is true**?

    a. The TIGTA found that only a small fraction of the required withholding was made on payments to taxpayers with missing or invalid taxpayer identification numbers (TINs).

    b. In cases where there were missing or invalid TINs in two consecutive years for the same taxpayer, backup withholding compliance increased substantially to over 50%.

    c. Backup withholding of 15% of the payment is required for all payments to taxpayers who have missing TINs.

16. Pursuant to the like-kind exchange provisions, Taxpayer A relinquishes investment land #1 worth $1,000,000 and a basis of $750,000 and receives investment land #2 worth $950,000 and $50,000 cash. What is Taxpayer A's basis in land #2 after the exchange?

    a. $950,000.
    b. $800,000.
    c. $750,000.

17. What was a **crucial** reason that the Tax Court in a recent decision denied like-kind tax treatment for an exchange involving related parties?

    a. The subsidiary corporation sold the relinquished property to a related party.

    b. The related party (C2) selling the replacement property to the subsidiary corporation was able to offset the realized gain by net operating losses.

    c. The subsidiary corporation failed to identify replacement property within 45 days after selling the relinquished property.

18. For a recent case on traditional IRA distributions, **which one** of the following responses **is false**?

    a. The IRS argued that the unreported IRA distribution amount was subject to income tax but not the 10% early distribution penalty.

    b. The taxpayer argued that the unreported IRA distribution amount was subject to neither income tax nor the 10% penalty.

    c. The court agreed with the IRS's position.

19. **Which one** of the following statements about traditional IRA distributions **is true**?

    a. A "qualified charitable distribution" provides for an exclusion from gross income for certain distributions if the taxpayer is age 70½ or older.

    b. Even though a taxpayer lives in a Presidentially-declared disaster area, there is no provision for extending the 60-day period requirement for qualified rollover contributions.

    c. If a distribution is used to pay for qualified higher education expenses, it is not subject to either inclusion in gross income or the 10% penalty.

20. With respect to related party transactions covered under the Code, **which one** of the following statements (last sentence for each response) **is true**?

    a. If mother sells investment land at its fair market value to her daughter at a loss, mother may deduct the loss as a capital loss on her tax return.

    b. Bill and Pete are unrelated parties who each owns 50% of A Corporation and 30% of B Corporation. An unrelated party owns the remaining 40% of B Corporation. Corporations A and B are considered related parties.

    c. Granite Inc., a calendar-year, accrual basis C Corporation, is 100% owned by Howard, who reports on the cash basis. If Granite declares a $100,000 bonus to Howard on December 31, 2016, and pays it on January 3, 2017, the corporation may deduct the bonus in 2016.

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**Course # 1 [ ] [ ] 2 [ ] 3 [ ] 4 [ ] [ ] 5 [ ] 6 7 [ ] 8 [ ] Delivery - PDF [ ] Or Mail [ ] On-line Testing - Yes No

2. AMOUNT DUE: Total of all Options (Payable by Check to CPElite T.M. Inc. or VISA, MC, Discover below) $__________

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OPTION 2 - ***2017 EA Package - 24 hrs***

OPTION 3 - ***2017 Annual Subscription Package -18 hrs***

OPTION 4 - ***Single Newsletter - 4 hrs***

OPTION 5 - ***Special Course Offer - 20 hrs***

OPTION 6 - ***Individual Course(s) - 6 hrs per course***

OPTION 1 – ***2017 Unlimited CPE Online Package*** – up to 66 hours of CPE - $175. *Courses available in PDF format in your online account or emailed by request. Quizzes online.* Covers four quarterly 4-hour issues of *The Elite Quarterly – Taxation* (including Ethics issue for enrolled agents) and all eight ***courses.*** Refer to page 24 for course descriptions. The 2017 courses (available by April 30) must be completed by December 31, 2017, under this option.

OPTION 2 – ***2017 EA Package*** - 24 hours of CPE – $155. This satisfies the average annual continuing education requirement for Enrolled Agents. Includes four quarterly 4-hour issues of The Elite Quarterly – Taxation issued 4 times per year (plus 2 hour Ethics issue for enrolled agents) and **one** 6-hour 2017 course (available by April 30) by mail or PDF format. Make course selection for option 2 on the order form on page 22.

OPTION 3 – ***2017 Annual Subscription to The Elite Quarterly*** – 18 hours of CPE - $135). For those wishing to complete only newsletters for CPE credit. Includes four quarterly 4-hour issues of *The Elite Quarterly – Taxation* issued 4 times per year (plus 2-hour Ethics issue for enrolled agents).

OPTION 4 – ***Single Quarterly Newsletter*** – Select Option 4 on the order form, and enclose your check for $40 payable to **CPElite,**[T.M.] or provide your credit card authorization.

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OPTION 6 – ***Individual Course(s)*** - We offer eight 6-hour CPE credit courses which are updated annually. Each course costs $60 under this option. Make course selection for option 6 on the order form on page 22.

ENROLLED AGENTS – Our CPE newsletters and courses qualify for EA's. Our "ethics" newsletter satisfies the 2-hour ethics component for EA's.

CPAs AND LICENSED ACCOUNTANTS – Our newsletters and courses conform to the enhanced AICPA/NASBA Standards for providers of continuing professional education. We are a NASBA-approved QAS Learning Provider.

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ONLINE TESTING – **Current online testers** – Go to www.cpelite.com, and log in to your account. New customers CLICK "Online Testing Available" at our website for instructions. **Our online testing system is integrated into our website.**

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Questions? E-mail us at cpeliteinc@aol.com. Or, call us at 1-800-950-0273, or for more information regarding administrative policies such as complaint and refund, please contact our offices at 1-800-950-0273.

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A DESCRIPTION OF CPElite's[T.M.] CPE MATERIALS

The recommended CPE hours for our newsletters are based on length of written material, level of difficulty, and input from reviewers and pilot testers. Each hour of credit specified below is based on a 50-minute hour per CPE hour. The content level of materials is an update [U] for our newsletters and basic [B] for each course. **Notes:** There are no prerequisites nor is advanced preparation required for our products. The learning objectives of each CPE product are provided below and on page 24. All our materials are available for download and on-line testing.

NEWSLETTERS

[1] THE ELITE QUARTERLY – Recommended CPE Credit – 4 Hours per issue [U]

To make practitioners aware of recent tax developments in legislation, the IRS, judicial decisions, and the Treasury. The four issues typically are available on-line, by email, or mail by the following dates: May 1, July 15, September 15, and November 30. Each issue costs $40. An annual subscription to all four issues costs $135. The 2-hour ethics issue for enrolled agents is included in the subscription.

[2] ETHICS FOR ENROLLED AGENTS – Recommended CPE Credit – 2 Hours per issue [U]

To provide recent developments affecting tax professionals which satisfy the ethics and professional conduct component required for enrolled agents only. The 2017 issue costs $20 and is **free to annual subscribers** to *The Elite Quarterly* and Option 5 orders.

THE ELITE QUARTERLY NEWSLETTER
Published by CPElite,T.M. Inc.
P.O. Box 721, White Rock, 29177-0721 or
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COURSES – Field of Study: Federal Tax

[1] INCOME ITEMS AND PROPERTY TRANSACTIONS. Recommended CPE Credit: 6 HRS [B]

To provide an explanation of (1) selected income items affecting individual income taxpayers, including social security income, alimony, and scholarships, and (2) common property transactions involving individual income taxpayers, such as capital gains, sale of personal residence, and like-kind exchanges.

[2] ABOVE-THE-LINE DEDUCTIONS. Recommended CPE Credit: 6 HRS [B]

To provide an explanation of (1) expenses commonly deducted by Schedule C taxpayers, including travel, transportation, and home office deductions, and (2) and common above-the-line deductions.

[3] ITEMIZED DEDUCTIONS. Recommended CPE Credit: 6 HRS [B]

To provide an explanation of medical expenses, taxes, residence interest, charitable contributions, nonbusiness casualty and theft losses, miscellaneous itemized deductions, and the standard deduction.

[4] RATES, CREDITS AGAINST TAX, AND SPECIAL ISSUES. Recommended CPE Credit: 6 HRS [B]

To provide an explanation of the tax rate structure, selected credits (including the earned income tax credit and the education credits), estimated tax payments, and selected special issues (including filing status and exemptions).

[5] PARTNERSHIP TAXATION – PART I. Recommended CPE Credit: 6 HRS [B]

To provide an explanation of (1) the tax implications of formation, including gain or loss, basis of partnership interest, and basis of partnership assets after formation and (2) general reporting procedures of partnership items.

[6] PARTNERSHIP TAXATION – PART II. Recommended CPE Credit: 6 HRS [B]

To provide an explanation of the special topics involving partnership operations and the tax implications of sales of partnership interests, partnership distributions, and redemptions of a partner's interest.

[7] S CORPORATION TAXATION – PART I. Recommended CPE Credit: 6 HRS [B]

To provide an explanation of (1) considerations in being an S Corporation, (2) requirements and election to be an S Corporation, (3) elections and operations, (4) shareholder basis issues, and (5) reporting and compliance.

[8] S CORPORATION TAXATION – PART II. Recommended CPE Credit: 6 HRS [B]

To provide detailed coverage of S Corporation shareholder basis issues, and an explanation of loss limitation issues, distributions made by an S Corporation to its owners, and S Corporation shareholder changes and income taxes.