Current Federal Tax Developments

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SECTION: SCAMS
E-FILING PIN SYSTEM SUBJECT OF AUTOMATED ATTACK BASED ON INFORMATION OBTAINED FROM NON-IRS SOURCES

Citation: IRS Statement on E-Filing PIN, 2/9/16

The IRS web systems were again attacked using information that the perpetrators had acquired from other services. In a statement the IRS described the attack on their system.

In this case the system under attack was the IRS's Electronic Filing PIN web application used by some taxpayers to obtain a PIN to file a tax return when the taxpayers are not using a preparer and don't have access to their tax year 2014 tax return information.

A return can be signed electronically using one of three methods:

- Self selected PIN – Taxpayer provides date of birth and either their prior year adjusted gross income or self-select PIN at the time of signing the return, at which point the taxpayer provides a self-select PIN for the current year return.
- Practitioner PIN – Taxpayer provides a tax preparer registered for electronic filing with the IRS with a Form 8879 which the taxpayer signs along with a PIN the taxpayer has selected. No prior year information is required for this method.
- Electronic Filing PIN – This option is the one that was attacked. If a taxpayer lacks the information to use the self-selected PIN method and is not giving a paid preparer a Form 8879, the taxpayer can use the IRS website to obtain a PIN. To prove identity the taxpayer needs:
    - The taxpayer's name
    - Address used on the prior year tax return
    - Taxpayer's social security number
    - Taxpayer's filing status on prior year's return
    - Copy of the prior year's tax return

Given that the IRS tells the taxpayer they need a copy of the prior year's return to use this service, this option appears to be of use primarily for taxpayers who can't figure out what number on the return is their adjusted gross income.

The IRS has determined that an automated attack had attempted to get self-selected PINs for 464,000 social security numbers and was granted such a PIN in 101,000 cases.

The IRS statement indicated that malware was involved in the attack. That suggests the perpetrators may have used a botnet to carry out the attack. A botnet is a network of computer that have been infected with software that allows a third party to control them in the background to undertake various attacks. The owners of these computers will be unaware that their systems have been used to mount such an attack.

The use of the botnet would provide the attackers a few advantages, one of which is being able to mount attacks from computers that are on networks in the United States and from numerous different computers. This makes it more difficult to spot the attack since the attack is not seeming to originate outside the United States, nor will any one address appear to be requesting an inordinate number of PINs.

As with the transcript attack in 2015, this attack involved attackers who had some information on the individuals involved. Such databases of information are being assembled by parties looking to impersonate individuals for financial gain. In this case it would seem likely the attackers had social security numbers and likely addresses, but not the adjusted gross income details from the prior year returns (if they had that, they could simply sign a fraudulent return under the standard self-select PIN system) nor did they have access to a paid preparer's credentials (when they could file a fraudulent practitioner PIN return).

This appears to be yet another case of the conflict between making electronic filing "easy" for taxpayers and making it secure. Taxpayers who can't figure out what "adjusted gross income" is but want to use electronic filing services (which is something Congress has pushed for the IRS to strongly encourage) need an "idiot proof" way to do so if they aren't going to hire a tax professional. If the IRS were to turn off the third option, these individuals would likely complain to their Congressional representative about how difficult the IRS made it for them to get their refund.

The problem, though, is that it means a fraudulent return can be filed for any taxpayer by a party who has access to the more limited information necessary to answer these questions. And under the current system there's no way to tell the IRS not to issue an electronic filing PIN via the web application for a taxpayer.

The IRS will be notifying affected taxpayers that personal information obtained from some source had apparently been used by third parties to try and gain access to an identity protection PIN from the IRS. Any client receiving such a notice should be counseled that the perpetrators may not have only gone after tax information, and a check on their credit reports as well as careful scrutiny of any activity in accounts accessible online should be undertaken. That is, their data is "in the wild" and that means they are at risk for a number of problems, including identity theft as well as take overs of their accounts (normally to empty them out).

The IRS will also flag the returns in question as potentially subject to fraudulent filings. The downside of that will be that these returns will take a while to process when the real return is later filed.

Advisers should expect such issues to continue to affect the tax system. The conflicting goals of making electronic filing easy and making it secure are going to continue to create opportunities for nefarious parties to find ways to be able to file fraudulent returns and/or otherwise get access to systems meant to be limited to access by the actual individuals.

The problem so far has not been an actual breech of the IRS systems, but rather simply the fact that so many leaks of personal information have now taken place that it's easy to produce information that makes it appear the party accessing a site is the person in question. Thus any system that attempts to "confirm" a party's identity based on information that is believed to only be known by the actual person before giving access to sensitive information or options is at risk to this sort of attack.

SECTION: 62
COURT FINDS JUDGE NOT COMPENSATED BY FEES, BUSINESS DEDUCTIONS MUST BE TAKEN AS AN ITEMIZED DEDUCTION

Citation: Jones v. Commissioner, 146 TC No. 3, 2/9/16

Some provisions of the Internal Revenue Code aren't referenced very often and even though they may have existed for years have never actually had a court analyze in depth. One such provision in the Code was the subject in the case of *Jones v. Commissioner*, 146 TC No. 3.

Generally the expenses of employee are required to be deducted as an itemized deduction which poses several disadvantages vs. other business expenses which are deducted in computing adjusted gross income. If the taxpayer must itemize a deduction, the deduction is subject to the 2% floor on miscellaneous itemized deductions before any benefit can be received and entirely nondeductible in computing the alternative minimum tax.

The Code does provide a few exceptions to the "below the line" treatment for an employee, and the one in question today is found at IRC §62(a)(2)(C). That provision allows such business expenses to be deducted above the line for those who meet the definition below:

> (C) Certain expenses of officials
>
> The deductions allowed by section 162 which consist of expenses paid or incurred with respect to services performed by an official as an employee of a State or a political subdivision thereof in a position compensated in whole or in part on a fee basis.

The case in question involves a judge in Arizona who sat on the Maricopa County Superior Court, which is a trial court of general jurisdiction in Arizona. Judges in the court are paid a salary by the county, but the court itself is funded in part by the collection of fees from members of the public (such as for case filings, licenses, etc.). However, the county does not receive fees for wedding ceremonies, rather the judges are allowed to collect those fees directly.

In this case the judge had taken the deductions above the line, relying on the fact that his salary, paid from the Maricopa County Superior court budget, was partially funded by fees. The IRS contended that this was not a proper reading of the provision—that, rather, the public needed to pay fees directly to the judge to trigger this provision. The only fee available to the judge were wedding fees—but this judge had never actually collected such a fee, waiving the fee for each wedding he performed.

When the County ran into budget troubles, many of the expenses previously reimbursed by the County to the judge were no longer reimbursable. The judge continued to incur many of these fees as well spending personal funds to upgrade his office and replace equipment and even paying for gift cards for his staff after they were no longer able to receive bonuses.

The judge consulted with a CPA when it came time to prepare his 2008 returns, and the CPA in question determined that his deduction should go above the line in 2008 based on that provision. The CPA did the same in 2009, but died before he prepared the judge's 2010 return. Another CPA took over the return preparation for 2010 and arrived at the same conclusion.

The fundamental distinction in the positions of the taxpayer and the IRS is presented in the opinion as follows:

> The Commissioner wants us to interpret "compensated on a fee basis" to mean something like "paid by a member of the public for a service rendered by a judge who receives the fee." Judge Jones argues that "in a position compensated in whole or in part on a fee basis" means something like "a position funded in whole or in part by fees paid by members of the public for services rendered by judges."

Unfortunately, as the opinion continues, "[n]either the Code nor the regulations define what "fee basis" means, and the case law is similarly stubborn in its silence." Thus the Tax Court judge embarked on his own voyage to resolve this matter.

The Court first turns to determine what should be the proper definition of "fee basis" and "compensation" for these purposes.

For purposes of determining what is meant by compensation the Court consults not just the dictionary but continues on with citations from Henry Thoreau and Ralph Waldo Emerson to determine the general meaning of compensation is "something of value given in exchange for" some service.

The Court then notes that a "fee basis" test[1] also exists in the self-employment tax provisions of IRC §1402(c)(1). While the Code contains no definition, Revenue Ruling 74-608 does look to define this. The Court references this definition noting:

> It says that a public official is compensated by "fees" if he receives them directly from members of the public, but not if he is paid from a government fund. *Id*. If the "public official receives his remuneration or salary from a government fund and no portion of the monies collected by him belongs to or can be retained by him as compensation, the remuneration is not 'fees' under section 1402(c)(1)." *Id*., 1974-2 C.B. at 276.

The opinion goes on to note that a similar distinction is found in Reg. §31.3401(a)-2(b)(1) when defining payments that aren't subject to withholding vs. those which are, again looking again at a difference between fees

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[1] Under this provision the compensation must be *solely on a fee basis* but, as the Court notes, a fee basis would arguably be the same definition even though for the provision in question here the compensation only needs to be "in part" on a fee basis.

paid directly for services to the public official vs. receiving a salary from the government. The Court goes on to cite similar distinctions found in the Social Security Act and the Fair Labor Standards Act.

Thus the Court concludes the IRS's reading is the more reasonable one—the fact that the Court collected fees that may have been partially used to pay his salary did not mean, for these purposes, that the judge was "compensated in whole or in part on a fee basis."

But what about those marriage fees the judge could have, but did not, collect? The judge argues that while he may not have collected fees, his *position* is one that is allowed to collect fees and so if any Superior Court judge collected fees then he can make use of this provision.

However the opinion determined this is not the proper way to read the statute. The Court determined:

> We think that the possibility that one of his colleagues was more mercenary than he at weddings can't convert his own position into one "compensated in whole or in part on a fee basis" any more than the collection of even one filing fee by the clerk of his court would
>
> Section 62(a)(2)(C) tells us to look at the particular situation of individual taxpayers. Is he "an official?" Is he "an employee of a State * * * in a position compensated in whole or in part on a fee basis?" Singular terms in the Code can include their plural form unless "the context indicates otherwise." See *Commissioner v. Driscoll*, 669 F.3d 1309, 1311 (11th Cir. 2012) (quoting *United States v. Hayes*, 555 U.S. 415, 422 n.5 (2009)), *rev'g* and remanding 135 T.C. 557 (2010). But, as in Driscoll, we think "a" and "an" are function words used before singular nouns and indicate a singular meaning here. See *id*. at 1312.
>
> No portion of Judge Jones's compensation for his role as a public officer was provided on a fee basis. Rather, he was an employee of the State of Arizona and paid a salary for his work. Thus, his expenses are deductible as unreimbursed employee expenses under section 162 and should be reported as miscellaneous itemized deductions subject to a 2% floor.

SECTION: 179
IRS RELEASES PATH INFLATION ADUSTED 2016 NUMBERS FOR §179, TRANSIT BENEFITS AND ABOVE THE LINE EDUCATOR DEDUTIONS

Citation: Revenue Procedure 2016-14, 2/5/16

The IRS has released a number of inflation adjusted figures for 2016 that were added by the Protecting Americans from Tax Hikes Act of 2015 in Revenue Procedure 2016-14. With the relatively low rate of inflation, adjustments either are zero or a relatively small amount for the affected items.

The limitation for §179 expensing for 2016 will remain at $500,000, but the phase-out starting point will rise by $10,000 to $2,010,000 in 2016.

For taxable years beginning in 2016 the monthly limitation under IRC §132(f)(2)(A) for qualified transit benefits will be $255.

For taxable years beginning in 2016 the limitation on the above the line deduction of expenses for elementary and secondary school teachers will remain at $250.

SECTION: 752
IMPACT OF GUARANTEES ON TREATMENT OF PARTNERSHIP DEBT DISCUSSED IN MEMORANDUM

Citation: Chief Counsel Advice 201606027, 2/5/16

The IRS took a look at a number of issues related to liabilities and at-risk rules related to partnership interest in the Chief Counsel Advice 201606027. The advice relates to a partnership that acquired existing hotels and

renovated them, but did not operate the hotels. One of the partners executed a guarantee on the otherwise nonrecourse debt that could be triggered if certain conditions were met.

The partnership agreement also provided that, should the partner who signed the guarantee actually make a payment under the guarantee, that partner could make a call for non-guaranteeing partners to make capital contributions. If a partner failed to make that payment, either the partners' fractional interest in the partnership would be adjusted downward, the amount would be treated as a loan to those partners or enter into a subsequent allocation agreement under which the risk of guarantee would be shared among the partners.

As likely is clear to many readers, a number of questions come to mind regarding this partnership. The memorandum looks at the following four questions:

- Is the operation of the partnership's acquisition and renovation of the hotels an "activity of holding real property" under §465(b)(6)(A) that would allow it to have "qualified nonrecourse debt" that would not be subject to the at-risk rules that would otherwise limit partners' ability to claim losses on basis arising from that debt?
- Does the guarantee by the one partner transform the debt in question from non-recourse debt to recourse debt under §752?
- If the debt would be converted to recourse debt, does the right of the guarantor to issue a call for contributions under the terms provided give all of the partners economic risk of loss for purpose of allocating the debt under the recourse debt allocation rules?

The memo concludes that the activity in question does qualify as an "activity of holding real property" that would allow certain nonrecourse debts to be treated as qualified nonrecourse debts that sidestep the at risk rules that would normally be triggered by a nonrecourse debt. Although the memorandum does not actually provide a detailed analysis of the why it comes to this conclusion, it certainly seems to make sense given the fact that the partnership does not actually operate the hotels.

However all that finding does is potentially allow partners to treat their allocation of qualified nonrecourse debt as not limited by the at-risk rules of §465. But the other issues raise the question of whether, given the guarantee arrangement, the debt in question actually is nonrecourse debt.

What about the guarantee of the nonrecourse debt by the LLC member? Generally if any partner has "economic risk of loss" with regard to a debt then the debt is considered a recourse rather than nonrecourse debt.

The memorandum describes the application of the regulations regarding the existence of an "economic risk of loss" as follows:

> Section 1.752-2(b)(1) provides generally that, except as otherwise provided, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.

The memorandum goes on to describe how it is determined if a partner has such an obligation to make a payment:

> Section 1.752-2(b)(3) provides that the determination of the extent to which a partner or related person has an obligation to make a payment under § 1.752-2(b)(1) is based on the facts and circumstances at the time of the determination. All statutory and contractual obligations relating to the partnership liability are taken into account for these purposes, including (i) contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or other partners, or to the partnership; (ii) obligations to the partnership that

are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership, and (iii) payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute. To the extent that the obligation of a partner to make a payment with respect to a partnership liability is not recognized under § 1.752-2(b)(3), § 1.752-2(b) is applied as if the obligation does not exist.

However, the memorandum notes that under Reg. §1.752-2(b)(4) a contingent liability to make payments is not considered if it either:

- Is subject to contingencies that make it unlikely that the obligations will ever actually be discharged *or*
- A payment obligation would not arise until the occurrence of a future event that is not determinable with reasonable certainty.

In the latter case, the obligation is not considered until such time as the event actually takes place.

The memorandum concludes that a bona fide guarantee given to a lender that is enforceable under local law generally will create an obligation that give rise to economic risk of loss. As the memorandum notes:

> As a threshold matter, a bona fide guarantee that is enforceable by the lender under local law generally will be sufficient to cause the guaranteeing partner to be treated as bearing the economic risk of loss for the guaranteed partnership liability for purposes of § 1.752-2(a). For purposes of § 1.752-2, we believe it is reasonable to assume that a third-party lender will take all permissible affirmative steps to enforce its rights under a guarantee if the primary obligor defaults or threatens to default on its obligations.

The memorandum goes on to conclude that when an LLC member guarantees the debt of the LLC, he/she becomes "like" a general partner in a limited partnership. Unlike a limited partner who guarantees debt, this member has no recourse against a real general partner, but rather has to look to the assets of the LLC itself for any recovery of payments on the guarantee.

The memorandum therefore continues:

> Therefore, in the case of an LLC treated as a partnership or disregarded entity for federal tax purposes, we conclude that an LLC member is at risk with respect to LLC debt guaranteed by such member, but only to the extent that
>
> (1) the guaranteeing member has no right of contribution or reimbursement from other guarantors,
> (2) the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts, and
> (3) the guarantee is bona fide and enforceable by creditors of the LLC under local law.

But this guarantee serves to remove the debt from treatment as qualified nonrecourse debt for the other LLC members. As the memorandum continues:

> Under § 465(b)(6)(B)(iii), a liability is qualified nonrecourse financing only if no person is personally liable for repayment. When a member of an LLC treated as a partnership for federal tax purposes guarantees LLC qualified nonrecourse financing, the member becomes personally liable for that debt because the lender may seek to recover the amount of the debt from the personal assets of the guarantor. Because the guarantor is personally liable for the debt, the debt is no longer qualified nonrecourse financing as defined in § 465(b)(6)(B) and § 1.465-27(b)(1).
>
> Further, because the creditor may proceed against the property of the LLC securing the debt, or against any other property of the guarantor member, the debt also fails to satisfy the requirement in § 1.465-

> 27(b)(2)(i) that qualified nonrecourse financing must be secured only by real property used in the activity of holding real property.

The memorandum notes that if a guarantee was issued on a debt that was previously a qualified nonrecourse debt, the at-risk amounts for each of the members not part of the guarantee would be reduced, creating potentially a trigger of income recognition by the member.

As well, the transaction would also raise issues with regard to basis, as the debt would effectively be reallocated to the member who provided the guarantee.

How about the capital call option should the guarantee be called upon? Does that "save" the day by allowing a portion of the now recourse debt to be allocated to the other members?

This time the memorandum notes that this has to be considered based on the facts and circumstances, including economic realities. As the memorandum notes:

> We believe that *Pritchett* and *Melvin* stand for the proposition that the relevant inquiries when dealing with guarantees of partnership debt, for purposes of § 465, are whether the guarantee causes the guaranteeing partner to become the "payor of last resort in a worst case scenario" for the partnership debt, given the "economic realities" of the particular situation, and whether the guarantor possesses any "mandatory" rights to contribution, reimbursement, or subordination with respect to any other parties, as a result or consequence of paying on the guarantee, that would cause these other parties to be considered the "payors of last resort in a worst case scenario" with respect to that debt.

And, in this particular case, the memorandum concludes that in this case that test is not met. As the memorandum notes:

> We do not believe section 7.5(e) of the Operating Agreement imposes a mandatory payment obligation on A and B to make additional contributions to X if C is called upon to pay on C's personal guarantees. Rather, section 7.5(e) permits C to call for additional capital from A and B, but if A and/or B chooses not to contribute additional capital, C's remedies are limited to the remedies identified in paragraphs (i) and (ii) of that section. As a result, we do not believe the Operating Agreement gives C the right to bring an action against A and B to require them to contribute additional capital to X if they choose not to. Further, because we believe C's remedies are limited to paragraphs (i) and (ii) of section 7.5(e) if C calls for additional capital contributions from A and B if C is required to pay on C's personal guarantee, we believe section 7.7 of the Operating Agreement is not applicable. In addition, because a separate contribution agreement was not entered into by the parties, section 7.9 is also inapplicable.
>
> Accordingly, because neither remedy available to C under section 7.5(e) requires A or B to make additional contributions to X if C is called upon to pay on C's personal guarantees, we conclude that A and B do not bear the ultimate economic risk of loss for the guaranteed debt of X for purposes of § 752.

What this case illustrates is the complexities that arise when dealing with LLC, debts and guarantees—risks that can be accidentally triggered when a client goes to renegotiate a debt or enter into a refinancing arrangement. The potential to trigger an income even is very real—and it likely won't be obvious to the client that this could be a result of their entering into a new or revised debt agreement, or just a separate guarantee that is given.

SECTION: 6035
IRS DELAYS DUE DATE FOR BASIS STATEMENTS ONE ADDITIONAL MONTH TO ALLOW FOR PUBLICATION OF PROPOSED REGULATIONS

Citation: Notice 2016-19, 2/11/16

The IRS delayed the due date for filing the first Forms 8971 in Notice 2016-19. Previously in Notice 2015-57 the IRS had delayed the date for initial filings of any return due prior to February 29, 2016 to February 29, 2016.

The IRS has pushed that date back by one month in this ruling, along with the required notices to beneficiaries. As the Notice provides:

> Statements required under sections 6035(a)(1) and (a)(2) to be filed with the IRS or furnished to a beneficiary before March 31, 2016, need not be filed with the IRS and furnished to a beneficiary until March 31, 2016.

The IRS, recognizing that many executors and their advisers were not clear on exactly what was to be reported and were unclear on properly completing the form, have also suggested that advisers wait for the issuance of proposed regulations before preparing the statements required.

> The Treasury Department and IRS recommend that executors and other persons required to file a return under section 6018 wait to prepare the statements required by section 6035(a)(1) and (a)(2) until the issuance of proposed regulations by the Treasury Department and the IRS addressing the requirements of section 6035. The Treasury Department and the IRS expect to issue proposed regulations under sections 1014(f) and 6035 very shortly.

Under a new provision added to the IRC last summer by Congress any executor of an estate required to file a Form 706 is required to furnish statements to the IRS and any person acquiring any interest in property from the estate detailing information regarding the value of the property included in the taxable estate. Such a statement under the law is due by earlier of 30 days after the Form 706 is filed or 30 days after the return was required to be filed (taking into account any extensions of time to file the return actually obtained).

At the beginning of February the IRS published the final version of Form 8971 and its related instructions. Form 8971 is to be used to report this information to the IRS, and Schedule A of the form contains the information that will be given to each person receiving an interest in property from the estate.

The information reporting requirement affected Forms 706s actually filed on or after July 31, 2015.

SECTION: 6651
MINIMUM PENALTY FOR FAILURE TO FILE RETURNS INCREASED

Citation: Trade Facilitation and Trade Enforcement Act of 2015, 2/12/16

In the *Trade Facilitation and Trade Enforcement Act of 2015* (HR 644), Congress has raised the minimum penalty amount for the case where a taxpayer fails to timely file certain returns (including income, estate and gift tax returns) within 60 days of the date they are due to $205 or 100% of the tax due (whichever is less).

The failure to file penalty under IRC §6651(a) normally applies at a rate of 5% of the tax due per month (or fraction of a month) the return goes unfiled, maxing out at 25% of the tax due. The penalty can be avoided if the taxpayer shows that the failure to file was due to reasonable cause and not willful neglect.

A special rule serves to increase that penalty on returns filed more than 60 days late where there is a relatively small amount of tax due. This minimum penalty previously was equal to the lesser of 100% of the tax due or $135. The increase in the penalty applies to returns required to be filed in calendar years after 2015.

The increase was part of a bill that, in addition to the trade provisions, included a permanent extension of the Internet Tax Freedom Act.

SECTION: 6662
LAW FIRM HAD NO SUBSTANTIAL AUTHORITY NOR REASONABLE CAUSE FOR DEDUCTING UNREASONABLE LEVEL OF COMPENSATION

Citation: Brinks, Gilson & Lione a Professional Corporation v. Commissioner, TC Memo 2016-20, 2/10/16

The only issue remaining to be decided by the Tax Court in the case of *Brinks, Gilson & Lione a Professional Corporation v. Commissioner*, TC Memo 2016-20 was whether the corporation could escape the accuracy related penalty under IRC §6662 for a substantial understatement of tax.

In this case the corporation had conceded the issue of whether a portion of what it had paid in salaries to shareholders should be treated as dividends. The resulting tax assessments for each of the years in question exceeded 10% of the tax required to be shown on the return[2], in which case the penalty will automatically apply unless the taxpayer can show it qualifies for one of the exceptions.

A taxpayer is not subject to this penalty if it can be shown:

- The position that lead to the assessment had substantial authority [as defined in Reg. §1.6662-4(d)] *or*
- The taxpayer had reasonable cause for the factors leading to the understatement and acted in good faith [IRC §6664(c)(1)]

The corporation (a law firm) had paid annual bonuses to each of its shareholders in each of the years in question that were (with minor adjustments) based on that shareholder's ownership interest in the corporation and which managed to zero out taxable income in the years in question.

The law firm in question was not a small operation. As the Tax Court noted:

> Petitioner is an intellectual property law firm organized as a corporation. When it filed the petition, it maintained its principal offices in Chicago, Illinois. It computes its taxable income on the basis of a calendar year, using the cash method of accounting. For the years in issue, it prepared its financial statements on that basis and using that method. During those years, it employed about 150 attorneys, of whom about 65 were shareholders. It also employed a nonattorney staff of about 270. Its business and affairs are managed by a board of directors (board).

As well, the operation had substantial equity on its balance sheet, sitting at $8 million for 2007 and $9.3 million for 2008. As the Court noted, these balance sheets did not reflect the value of any intangible assets of the corporation, and the firm's own expert admitted that "a firm's reputation and customer lists could be valuable entity-level assets, even though determining their precise worth might be difficult."

As the Court noted, it is possible to have "substantial authority" even if a position fails to prevail:

> The determination of substantial authority requires a weighing of the authorities that support the taxpayer's treatment of an item against the contrary authorities. *Id*. subpara. (3)(i). A taxpayer can have substantial authority for a position that is unlikely to prevail, as long as the weight of the authorities in support of the taxpayer's position is substantial in relation to the weight of any contrary authorities. See *id*. subpara. (2) (substantial authority standard is less stringent than the more likely than not standard).

The question was whether, in the area of reasonable compensation being paid to the shareholders of the firm, the position taken on the tax return met that standard.

[2] Actually, the specific trigger for a corporation varies depends on the exact facts of the case. The 10% test is the general test for a C corporation, but this particular penalty will not apply if the assessment is less than $10,000, and will be triggered regardless of the 10% test if the assessment is more than $10,000,000. In this case it was the "pure" 10% test that applied.

The IRS cited a number of cases that hold that merely because the entity in question is a service firm it doesn't mean that it's reasonable to pay all amounts as compensation to the shareholders if there are substantial numbers of non-shareholder employees and/or there is substantial invested capital.

> In support of its position, respondent relies primarily on this Court's opinion in *Pediatric Surgical Assocs., P.C. v. Commissioner*, T.C. Memo. 2001-81, and that of the U.S. Court of Appeals for the Seventh Circuit in *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*, 680 F.3d 867 (7th Cir. 2012), *aff'g* T.C. Memo. 2011-74. In *Pediatric Surgical*, we determined that compensation payments to shareholder employees attributable to the services of nonshareholders were nondeductible dividends. In *Mulcahy*, the Court of Appeals for the Seventh Circuit denied a corporation's deduction of consulting fees paid to entities owned by the taxpayer's founding shareholders. The taxpayer sought to justify the deduction of the consulting fees on the grounds that they were, in effect, additional compensation to its shareholders. The Court of Appeals upheld this Court's disallowance of the deduction, reasoning that "[t]reating * * * [the consulting fees] as salary reduced the firm's income, and thus the return to the equity investors, to zero or below in two of the three tax years at issue, even though * * * the firm was doing fine." *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*, 680 F.3d at 872. "[W]hen a thriving firm that has nontrivial capital reports no corporate income," the court observed, "it is apparent that the firm is understating its tax liability." *Id*. at 874.

The Court notes that the key test being used in reasonable compensation cases has moved towards a "reasonable investor" test and that this test was applied in *Mulcahy*. Under this test the inquiry is whether a theoretically independent investor would receive a reasonable return on his/her investment in the entity and, as well, would approve the payment of compensation in the amount in question. An investor would presumably object to the corporation paying out as compensation amounts that should more reasonably be available to the investor as a return on his/her invested capital.

Since the corporation in this case did not pay out dividends and had zeroed out income by paying out all earnings as Tcompensation, the Court found that, in fact, a reasonable investor would not have approved this level of compensation. As the Court noted:

> Regardless of the possibility that petitioner might own valuable intangible assets, it had invested capital, measured by the book value of its shareholders' equity, of about $8 million at the end of 2007 and about $9.3 million at the end of 2008. Invested capital of this magnitude cannot be disregarded in determining whether ostensible compensation paid to shareholder employees is really a distribution of earnings. We do not believe that petitioner's shareholder attorneys, were they not also employees, would have forgone any return on invested capital that at least approached, if it did not exceed $10 million. Thus, petitioner's practice of paying out year-end bonuses to its shareholder attorneys that eliminated its book income fails the independent investor test.

The Court rejected the corporation's argument that, because the shareholders held their stock only as long as they remained employees of the firm and had to sell their stock back at book value, they lacked the normal rights of equity owners and thus the independent investor test should not apply.

The Court disagreed, holding:

> …[P]etitioner's argument that its shareholder attorneys have no real equity interests in the corporation that would justify a return on invested capital proves too much. If petitioner's shareholder attorneys are not its owners, who are? If the shareholder attorneys do not bear the risk of loss from declines in the value of its assets, who does? The use of book value as a proxy for fair market value deprives the shareholder attorneys of the right to share in unrealized appreciation upon selling their stock -- although they are correspondingly not required to pay for unrealized appreciation upon buying the stock. But acceptance of these concessions to avoid difficult valuation issues does not compel the shareholder attorneys to forgo, in addition, any current return on their investments based on the corporation's

profitable use of its assets in conducting its business. Petitioner's arrangement effectively provides its shareholder attorneys with a return on their capital through amounts designated as compensation. Were this not the case, we do not believe the shareholder attorneys would be willing to forgo any return on their investments.

Ultimately the Court rejected all of the authorities cited by the corporation in support of its position, finding none of them justified the position taken. The Court noted:

> We do not doubt the critical value of the services provided by employees of a professional services firm. Indeed, the employees' services may be far more important, as a factor of production, than the capital contributed by the firm's owners. Recognition of those basic economic realities might justify the payment of compensation that constitutes the vast majority of the firm's profits, after payment of other expenses—as long as the remaining net income still provides an adequate return on invested capital. But petitioner did not have substantial authority for the deduction of amounts paid as compensation that completely eliminated its income and left its shareholder attorneys with no return on their invested capital.

The Court thus concluded the firm did not have substantial authority for the position it took that all payments to the shareholders represented deductible compensation rather than dividends representing a return on capital.

The corporation argued that, if that was the case, it should still escape the penalty because it had reasonable cause for having claimed the deduction and acted in good faith. The corporation noted that it had a well-known major accounting firm prepare its corporate tax return each year and that the CPA firm had not objected to the position on the returns.

The Court found that, as it has often before, merely paying a professional to prepare a taxpayer's return does not automatically provide there is reasonable cause and good faith on the part of the taxpayer for an understatement.

Reasonable cause and good faith based on reliance on the advice of a tax professional generally has required a showing of the following:

- The taxpayer consulted an adviser that the taxpayer reasonable believed was competent to deal with the issue at hand
- The taxpayer provided the adviser with complete and accurate information with regard to the matter in question *and*
- The taxpayer asked for advice from the adviser on the matter in question and followed that advice.

In this case the Court found issues with the latter two requirements. First, the actual error was that of the taxpayer. They provided the firm with books and records, as well as Forms W-2, that showed the payments were compensation. They did not bring the accounting firm in to the decision making process regarding year bonuses, but rather presented them to the firm as an accomplished fact.

Second the corporation did not show it ever asked for or received advice from the firm on the question of reasonable compensation. As the Court noted:

> Silence cannot qualify as advice because there is no way to know whether an adviser, in failing to raise an issue, considered all of the relevant facts and circumstances, including the taxpayer's subjective motivation. Indeed, an adviser's failure to raise an issue does not prove that the adviser even considered the issue, much less engaged in any analysis, or reached a conclusion.

The Court notes that an adviser preparing a return generally can accept the representations of the taxpayer and has only limited requirements "to make inquiries in the case of manifest errors."

Thus, the Court concludes, the corporation did not have either substantial authority for the position nor reasonable cause for having taken the position on the return. Therefore it found that corporation was liable for substantial understatement liability related penalty of IRC §6662.

SECTION: 7605
IRS HAS RIGHT TO LOOK AT RECORDS FOR YEAR PREVIOUSLY EXAMINED TO VERIFY NET OPERATING DEDUCTION FOR EXAM OF LATER YEAR

Citation: United States v. Titan International, No. 14-3789, 117 AFTR 2d ¶ 2016-389, 2/1/16

Beyond the simple issue that it may lead to an IRS claim that the taxpayer owes additional taxes, an IRS inspection of the taxpayer's books and records is also simply a huge (and often expensive) inconvenience. IRC §7605(b) is meant to limit that disruption by giving the IRS "one shot" at the records on an audit.

The provision reads as follows:

> (b) Restrictions on examination of taxpayer
>
> No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

However, in the view of the Seventh Circuit in the case of *United States v. Titan International*, No. 14-3789, 117 AFTR 2d ¶ 2016-389, (7th Cir. Feb. 1, 2016) that is one review of any specific books per exam not one inspection of that year's books covering all exams.

The IRS had inspected Titan's 2009 books and records as part of its examination of Titan's 2009 income tax return. That year Titan had incurred a net operating loss that was carried to Titan's 2010 return.

In February of 2014 the IRS, now conducting an examination of Titan's 2010 income tax return, issued an administrative summons for those same 2009 books and records. Titan refused to comply with the summons, citing §7605(b)'s above provision to hold that the IRS had already had their chance to look at the 2009 records and the IRS had not notified Titan that an additional inspection was necessary.

The appellate panel agreed with the District Court that the provision was not applicable in this case. While Titan claimed the provision should limit the IRS to one inspection of the records created for each taxable year, the Court found that this isn't the proper interpretation of the provision.

As the panel writes:

> Titan's interpretation is disjointed and curiously omits some of the language of the statute. The key statutory phrase is this: "[O]nly one inspection of a taxpayer's books of account shall be made for each taxable year." The more natural reading of this language limits the IRS to one inspection of a taxpayer's books per audit of a given year's tax return (subject, of course, to notice and a finding by the Secretary that a second inspection is necessary). Read in this more natural way, § 7605(b) does not bar the summons of Titan's 2009 records for the purpose of auditing its 2010 tax return.

The Court looked at two prior cases to illustrate the differences and limitations of what the IRS can do with the records. The key issue is the IRS going back into the same records for another shot at adjusting that year and assessing tax on that year when there is no connection to the new year under exam. The Court notes:

> In *Reineman v. United States*, the taxpayers purchased six horses in 1954 for their horse-breeding business. 301 F.2d 267, 268 (7th Cir. 1962). They then deducted the entire cost of the horses on their 1954 tax return. *Id*. In 1956 the IRS audited the 1954 tax return and adjusted that deduction. *Id*. at 269. Later the IRS audited the taxpayers' 1955 tax return; in the process the agency reopened the 1954 audit (without written notice from the Secretary) and again adjusted the deduction for the six horses. *Id*. at

> 269-71. The 1954 records inspected by the IRS to adjust the deduction for the second time were wholly irrelevant to the 1955 audit. *Id*. at 271. We concluded that the second inspection of those records violated § 7605(b) because it was an "additional inspection" of the taxpayers' books for the purpose of reopening the 1954 tax return. *Id*. at 272.

In contrast the panel cited another case, this time involving basis:

> The second relevant case is *Digby v. Commissioner*, 103 T.C. 441 (1994). There the IRS audited a married couple's 1987 tax return and allowed them to claim a pass-through loss for that year from their S corporation. Id. at 443. In the course of that audit, the IRS inspected records showing the couple's basis in its S corporation stock. See *id*. at 444. The IRS later audited their 1988 tax return, a year in which the couple claimed another pass-through loss from the same S corporation. Id. To complete this audit, the IRS necessarily summoned the same basis records it inspected for the 1987 audit; as the tax court explained, the agency was "in possession of the information necessary to make a [basis] determination for 1988 and/or 1987." *Id*. at 448. Based on these summoned records, the IRS determined that the couple's basis was inadequate to support the pass-through loss for 1988 and 1987, despite its prior 1987 audit. *Id*. at 445-46. The IRS therefore disallowed the pass-through loss for both years. *Id*. at 446.
>
> The tax court concluded that the second inspection of the records was not a violation of § 7605(b) because that inspection was undertaken for the purpose of examining the 1988 tax return, and—unlike Reineman —those records were necessary to complete that audit. *Id*. at 448-49. The court ruled that an additional *adjustment* of the tax return for an earlier taxable year is not a violation of § 7605(b) so long as it was not coupled with an additional *inspection* of the taxpayer's books for the purpose of adjusting that year's tax liability. *Id*.

The panel then concludes that Titan's situation is closer to the second than the first, noting:

> The IRS first inspected Titan's 2009 records to verify its net operating loss in connection with an audit of its 2009 tax return. The IRS now seeks to inspect those same records for the purpose of auditing Titan's 2010 tax return in order to determine the validity of its 2010 net-operating-loss carryforward. Much like the pass-through loss at issue in *Digby* (and unlike the deduction at issue in *Reineman*), the net-operating-loss carryforward on the 2010 tax return cannot be verified unless the IRS inspects the 2009 records.