# Current Federal Tax Developments

Week of February 4, 2019

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## Section: 172
## Ignorance of the Existence and Impact of Election to Waive Carryback Period Placed in Return By Preparer Does Not Allow Taxpayers to Escape Its Effect

### Citation: Bea v. Commissioner, CA11, Case No. 18-10511, 1/31/19

The Eleventh Circuit Court of Appeals, in the case of *Bea v. Commissioner*, Case No. 18-10511, held that a married couple could not obtain relief from making an irrevocable election with their tax returns merely because they were not aware of the election. Rather, the Court found that the taxpayer had signed and submitted a return that had the election on it, and the fact they failed to review the return before filing did not allow them to obtain relief.

The taxpayers had engaged an EA to prepare their tax returns for 2011-2014 and made significant errors those returns. The returns as prepared showed a substantial net operating loss for 2013, which the taxpayers carried back and obtained refunds on their 2011 and 2012 income tax returns.

The 2014 return prepared by this preparer also showed a large net operating. The preparer believed that no tax liabilities remained in the years to which the loss would be carried under the default rules. In that case, the loss would naturally have been carried forward to 2015 and later years.

However, for whatever reason, the preparer decided to attach an election to the tax return under IRC §172(b)(3) to irrevocably elect to have the loss carried forward and waive the right to any carryback.

The IRS commenced an examination of the taxpayer's returns and asserted deficiencies for 2011 and 2012. The taxpayers looked to apply their 2014 net operating loss against the proposed deficiency for 2012, but the IRS denied that request. The IRS pointed out that the taxpayer had attached the election to waive the carryback period and only carry the 2015 loss forward.

The Tax Court agreed with the IRS's position. The opinion noted the election had been made on their 2014 income tax return that the taxpayers had reviewed and signed. The panel agreed with that decision:

> *The Beas paid a professional to prepare their tax returns in 2014. That professional return preparer took all the steps required by Treas. Reg. § 301.9100-12T(d) to make a valid election under § 172(b)(3) on the Beas' joint tax return, a point that the Beas do not deny. The Beas affirmed with their signatures that they had examined their tax return, and subsequently filed the return containing this unambiguous election — which is expressly described as "irrevocable" by statute. The Beas contend that they neither knew nor understood the implications of the §172(b)(3) election on their 2014 tax return, but they did not ask their tax return preparer about the § 172(b)(3) election on the return that they signed.*

Unfortunately for the taxpayers, ignorance is not bliss in this situation—nor does it serve as a valid reason for the taxpayers to be able to escape the consequences of that election.

As the opinion continues:

> *Though it was the error of the Beas' return preparer that put the Beas in this undesirable tax position, the Beas may not now disavow the unambiguous language of the irrevocable election they made on their*

> *signed 2014 tax return. The Tax Court correctly interpreted § 172(b)(3) and found that nothing in the statute requires the IRS or courts to consider a taxpayer's subjective intent in making the election. The Tax Court also found that the Beas did not make an ambiguous election under that section, and therefore the court correctly determined that the Beas could not revoke or disavow their election.*

The taxpayers argued that the Tax Court should have considered their ignorance of the nature or consequences of the election and granted relief. However, the Eleventh Circuit panel disagreed, finding that ignorance of the consequences was not relevant in this case:

> *The Beas stated in their motion that the primary issue before the Tax Court was whether their ignorance regarding the § 172(b)(3) election in their 2014 tax return permitted them to disavow or revoke the election, and their "Additional Material Facts" were relevant to this issue. The Tax Court disagreed, however, and reasoned that the Beas' knowledge was irrelevant to whether the Beas could revoke their § 172(b)(3) election because the Beas' signed 2014 tax return contained the explicit, irrevocable election, and there was nothing in the statute or regulations to suggest that taxpayer knowledge might affect the revocability of that election. The Tax Court therefore did not view further evidence of the Beas' lack of knowledge to be relevant to its inquiry. The Tax Court did not clearly err in this finding.*

The panel specifically referenced in a footnote the fact that the taxpayers had signed the jurat that contains a reference to reviewing the return.

> *The Beas' signed statement on Form 1040 stated: "Under penalties of perjury, I declare that I have examined this return and the accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete."*

As well, the Court found that requiring the IRS to divine whether taxpayers understood such elections would put an undue burden on the IRS:

> *If the IRS was required to determine the individual knowledge of each taxpayer making an unambiguous election under § 172(b)(3), the IRS would bear the risk of taxpayers' selection of — and reliance on — return preparers, as well as the administrative burden of determining subjective intent for all § 172(b)(3) elections. Nothing in relevant provisions of the Tax Code indicates that Congress intended to place this burden on the IRS.*

## Section: 199A
## IRS Changes "Separate" to "Separable" in Describing Requirements for Separate §199A Trade or Business - Do We Care?

### Citation: Corrected Version of Final Regulations Under §199A, 2/1/19

What difference can one word make? That is a question being asked after the IRS published a corrected version of the final regulations under §199A after the IRS modified the preamble to change the word "separate" to "separable" when discussing the conditions under which a taxpayer may be seen to have two trades or businesses.

The IRS Guidewire email that announced the changes as follows:

> *These corrections include, among other edits, corrections to the definition and computation of excess section 743(b) basis adjustments for purposes of determining the unadjusted basis immediately after an acquisition of qualified property, as well as corrections to the description of an entity disregarded as*

> *separate from its owner for purposes of section 199A and §§1.199A-1 through 1.199A-6. The corrected draft has been submitted to the Federal Register for publication.*

The corrections to the excess §743(b) basis adjustment portions of the regulations appear extensive at first glance, but do not appear to change the calculation of the amount ultimately. Rather, the change simply shortens the description of the calculation.

However, more interest was generated by the change found in the preamble. At Section I.A.3.d of the Summary of Comments and Explanation of Revisions, the original version published on January 18, 2019, in discussing multiple trades or businesses, contained the following representation of the rules under Reg. §1.446-1(d) which the IRS would later reference in discussing when a taxpayer would not be deemed to have separate trades or businesses:

> *Section 1.446-1(d)(2) provides that no trade or business will be considered separate and distinct unless a complete and separate set of books and records is kept for such trade or business.*

The IRS goes on to state at the end of its discussion of whether a taxpayer will be found to have multiple trades or businesses by saying:

> *The Treasury Department and the IRS also believe that multiple trades or businesses will generally not exist within an entity unless different methods of accounting could be used for each trade or business under §1.446-1(d).*

In the revised document, the IRS changed the word in the description of Reg. §1.446-1(d) from "separate" to 'separable":

> *Section 1.446-1(d)(2) provides that no trade or business will be considered separate and distinct unless a complete and separable set of books and records is kept for such trade or business.*

Note that the actual text at Reg. §1.446-1(d)(2) uses the word "separable" rather than "separate" and immediately following the sentence that indicated a taxpayer must meet the §1.446-1(d) tests to have multiple trades or businesses did describe the §1.446-1(d)(2) provision using the word "separable" rather than "separate."

A truly separate set of books and records is a much higher bar for a small business than merely separable sets of books and records. For instance, a veterinarian might have a dog grooming business she operates along with her veterinary practice. If she operates as a proprietorship, she likely will keep a single *Quickbooks* ledger that would record activities from both operations, even if they each had separate bank accounts and assets. Using classes she would be able to separate the two fully, but she reasonably would see no reason to keep two distinct ledgers files in *Quickbooks*.

In that case, the books would be separable (we could get the information for each entity easily out of the system) but not separate.

This is all well and good, but the IRS does not say that having separable books (or even separate books) by itself is enough to have separate trades or businesses. The one example the IRS gives us of separate books and records suggests the bar may be much higher, involving far more than merely separable books and records.

In Example 2 to Reg. §1.199A-5(c)(1)(iii) the IRS provides the following example of what would be a separate trade or business, allowing the taxpayer to avoid the de minimis rule of Reg.

§1.199A-5(c)(1) that would require treating the entire combined operation as a specified service trade or business:

> *Animal Care LLC provides veterinarian services performed by licensed staff and also develops and sells its own line of organic dog food at its veterinarian clinic and online. The veterinarian services are considered to be the performance of services in the field of health under paragraphs (b)(1)(i) and (b)(2)(ii) of this section. Animal Care LLC separately invoices for its veterinarian services and the sale of its organic dog food. Animal Care LLC maintains separate books and records for its veterinarian clinic and its development and sale of its dog food. Animal Care LLC also has separate employees who are unaffiliated with the veterinary clinic and who only work on the formulation, marketing, sales, and distribution of the organic dog food products. Animal Care LLC treats its veterinary practice and the dog food development and sales as separate trades or businesses for purposes of section 162 and 199A. Animal Care LLC has gross receipts of $3,000,000. $1,000,000 of the gross receipts is attributable to the veterinary services, an SSTB. Although the gross receipts from the services in the field of health exceed 10 percent of Animal Care LLC's total gross receipts, the dog food development and sales business is not considered an SSTB due to the fact that the veterinary practice and the dog food development and sales are separate trades or businesses under section 162.*[1]

In this case, in addition to keeping separate books (which by definition would be "separable") the IRS also notes that the operations had:

- Separate invoicing of customers and
- Separate employees who are unaffiliated with the veterinary clinic and who only work on the formulation, marketing, sales, and distribution of the organic dog food products.

While the regulation does not state that such separation is required, the fact that this example goes far beyond merely having separable books suggests the IRS sees the requirements for a taxpayer to have multiple trades or business to be a more complex issue and that the agency is looking for clear evidence of "separateness" of the businesses.

While this change is an improvement, it still seems that taxpayers will a difficult time showing there are truly separate trades or businesses even if the activities can be separately reported upon by the taxpayer's accounting system.

So to go back to the question posed at the beginning of this discussion—what difference does this single word make? Probably not a whole lot-the issue remains virtually as murky and uncertain as it was when the original version of the final regulations was published in January.

[1] Reg. §1.199A-5(c)(1)(iii)(B)

## Section: 280E
## Simplified Inventory Election for Small Businesses May Be a Tax Disaster for Marijuana Businesses

### Citation: Nathan J. Richman, "Small Business Inventory Accounting Exception May Not Fit Pot," Tax Notes Today, February 1, 2019, 2019 TNT 22-5

An interesting article appeared in *Tax Notes Today* on February 1, 2019[2] that raised a question regarding whether a business that is deemed to be trafficking in a federally controlled substance might significantly increase its federal tax if it makes the election added by the Tax Cuts and Jobs Act to escape the provisions of IRC §471(a) and account for its inventory either:

- By accounting for such inventory as non-incidental materials and supplies pursuant to Reg. §1.162-3, or
- Conforms to such taxpayer's method of accounting reflected in an applicable financial statement of the taxpayer with respect to such taxable year or, if the taxpayer does not have any applicable financial statement with respect to such taxable year, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures.[3]

This election is open to businesses that have average annual gross receipts of $25 million or less for the prior three years (adjusted for inflation[4]) and which is not a tax shelter as defined by IRC §448(a)(3).[5]

The most significant of such controlled substance trafficking businesses that are arising in tax controversies are those selling marijuana in states where such sales are now legal (either for medical or recreational use, depending on the state).

IRC §280E strictly limits deductions for such businesses, providing:

> *No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.*

The bar on deduction of expenses does not extend to cost of goods sold.

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[2] Nathan J. Richman, "Small Business Inventory Accounting Exception May Not Fit Pot," *Tax Notes Today*, February 1, 2019, 2019 TNT 22-5

[3] IRC §471(c)

[4] IRC §448(c)(4)

[5] IRC §471(c)

In the case of *Patients Mutual Assistance Collective Corp. et al. v. Commissioner,* 151 TC No. 11, the Tax Court pointed out that:

> *All taxpayers — even drug traffickers — pay tax only on gross income, which is gross receipts minus the cost of goods sold (COGS). See, e.g., New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934); CHAMP, 128 T.C. at 178 n.4; secs. 1.61-3(a), 1.162-1(a), Income Tax Regs. Congress understood that when it enacted section 280E. See S. Rept. No. 97-494, supra at 309, 1982 U.S.C.C.A.N. at 1050. We've understood it ourselves. See Olive, 139 T.C. at 32-36.*

But that same opinion continues on to determine that such deductions are determined under the provisions of IRC §471 without regard to the uniform capitalization rules of §263A. As the Court notes:

> *The section 263A capitalization rules don't apply to drug traffickers. Unlike most businesses, drug traffickers can't capitalize indirect expenses beyond what's listed in the section 471 regulations. Section 263A expressly prohibits capitalizing expenses that wouldn't otherwise be deductible, and drug traffickers don't get deductions. Because federal law labels Harborside a drug trafficker, it must calculate its COGS according to section 471.*

The question that is poised in the article regards the impact of making the election to avoid the use of the provisions of §471(a) added by the Tax Cuts and Jobs Act on such enterprises. In the *Patients Mutual Assistance Collective Corp.* case the Court specifically applied the provisions of Reg. §1.471-3 to determine the type of costs that were included in the cost of sales of the taxpayer.

But such rules would not appear to be applicable to a taxpayer that elects under IRC §471(c) to avoid IRC §471(a). So the question then arises regarding what expenditures, if any, would now be part of cost of goods sold for purposes of §280E?

The article cited above quotes Scott H. Rabinowitz of Skadden, Arps, Slate, Meagher & Flom LLP, that making this small business inventory simplification election could significantly increase the amount of taxable income for a seller subject to §280E. As the article notes from the author's conversation with Mr Rabinowitz:

> *Losing the potential argument that inventory accounting proves cost of goods sold would probably override any other relief from the exception, he said.*
>
> *However, even without the inventory accounting rules, which allow indirect costs for some businesses, there would still be a question whether a small marijuana business would be allowed to account for direct costs as cost of goods sold offsets, Rabinowitz said. Without the section 471 rules, indirect costs would clearly not be deductible, but the constitutional mandate to pare gross receipts down to gross income would leave treatment of particular direct cost items uncertain, he said.*[6]

The article goes on to cite other advisers who conclude that this level of uncertainty regarding what would happen to cost of sales under §280E suggests that such sellers should avoid making

[6] Nathan J. Richman, "Small Business Inventory Accounting Exception May Not Fit Pot," *Tax Notes Today*, February 1, 2019, 2019 TNT 22-5

this simplifying election[7]—at least until such time as either the IRS or the courts clarify the impact of switching away from the rules under §471(a) on what is considered cost of sales under §280E.

Although this election to avoid §471(a)'s provisions would arguably simplify accounting for inventories (that was the reason Congress put it into the law), most likely at least some of the costs currently rolled into inventory by the rules developed by the IRS under §471(a) would not be captured under the simplified inventory methods allowed by §471(c). Any client that wants to push forward regardless should be warned in writing about the potential risks of making this election.

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[7] Nathan J. Richman, "Small Business Inventory Accounting Exception May Not Fit Pot," *Tax Notes Today*, February 1, 2019, 2019 TNT 22-5