Current Federal Tax Developments

Week of March 25, 2019

Edward K. Zollars, CPA
(Licensed in Arizona)

ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF MARCH 25, 2019
© 2019 Kaplan, Inc.
Published in 2019 by Kaplan Financial Education.

Printed in the United States of America.

All rights reserved. The text of this publication, or any part thereof, may not be translated, reprinted or reproduced in any manner whatsoever, including photocopying and recording, or in any information storage and retrieval system without written permission from the publisher.

Current Federal Tax Developments

Kaplan Financial Education

Table of Contents

Section: 107
Seventh Circuit Rules Minister's Housing Allowance is Constitutional, Overturning District Court Ruling

Citation: Gaylord v. Mnuchin, et al, Case No. 18-1277 & 18-1280, 3/15/19

The Seventh Circuit Court of Appeals overturned a District Court ruling that the exclusion from income of a minister's housing allowance under IRC §107(2) violated the Establishment Clause of the First Amendment to the United States Constitution (*Gaylord v. Mnuchin, et al*, Case No. 18-1277 & 18-1280).

IRC §107 provides:

> *In the case of a minister of the gospel, gross income does not include—*
>
> > *(1) the rental value of a home furnished to him as part of his compensation; or*
> >
> > *(2) the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.*

The challenge was to the second part of §107, where a minister is paid an excludable housing allowance. That allowance is excludable from income unless it is used for a home, as provided by Reg. §1.107-1(c):

> *(c) A rental allowance must be included in the minister's gross income in the taxable year in which it is received, to the extent that such allowance is not used by him during such taxable year to rent or otherwise provide a home. Circumstances under which a rental allowance will be deemed to have been used to rent or provide a home will include cases in which the allowance is expended (1) for rent of a home, (2) for purchase of a home, and (3) for expenses directly related to providing a home. Expenses for food and servants are not considered for this purpose to be directly related to providing a home. Where the minister rents, purchases, or owns a farm or other business property in addition to a home, the portion of the rental allowance expended in connection with the farm or business property shall not be excluded from his gross income.*

The question that was raised was whether granting this benefit that is limited to "ministers of the gospel" violated the First Amendment's initial clause which reads:

> *Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof;*

While the District Court that heard this matter ruled it did violate that standard, the Seventh Circuit panel unanimously overturned that decision.

The panel noted that there are multiple provisions in the IRC that grant certain classes of employees an exclusion from income for payments related to housing or the provision of housing by the employer, so that this is not a special benefit. While the standard rule for employer provided housing found at IRC §119 imposed conditions that aren't part of the §107(2) rule, the other provisions show that it is not unusual for Congress to carve out more generous exceptions for specific situations.

The opinion notes:

> *Myriad provisions in Title 26 employ this categorical approach and exempt any form of housing benefits, whether in cash or in kind: § 132 and § 162 exclude housing provided to an employee away on business for less than a year; § 134 excludes housing provided to current or former members of the military; § 911 excludes housing above a certain level provided to citizens or residents living abroad; § 912 excludes housing provided to government employees living abroad; and, of course, § 107 excludes housing provided to ministers. These categorical exemptions allow hundreds of thousands of employees (including ministers) to receive tax-exempt housing every year without needing to satisfy the proof requirements of § 119(a)(2).*
>
> *These parallel provisions show an overarching arrangement in the tax code to exempt employer-provided housing for employees with certain job-related housing requirements. Congress has exempted certain categories of employees from complying with the specific requirements of § 119(a)(2) to simplify the application of the convenience-of-the-employer doctrine to those occupations. Section 107, including subsection (2), recognizes ministers often use their homes as part of their ministry. This provision thus eases the administration of the convenience-of-the-employer doctrine by providing a bright-line rule, instead of requiring that ministers and the IRS repeatedly engage with a fact-intensive standard.*

Section: 183
Tax Court Finds Pilot Did Not Have a Profit Motive in Aircraft Business

Citation: Kurdziel v. Commissioner, TC Memo 2019-20, 3/21/19

A taxpayer was denied current deductions and a net operating loss arising from his claimed business related to a restored vintage World War II fighter plane in the case of *Kurdziel v. Commissioner*, TC Memo 2019-20. The Tax Court agreed with the IRS that the losses were barred by what is referred to as the hobby loss rule under IRC §183.

IRC §183(a) provides:

> *(a) General rule*
>
> *In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.*

Mr. Kurdziel is a commercial airline pilot and engineer who found a rare vintage World War II aircraft that he restored. The aircraft, a Fairey Firefly, went into service late in World War II. As such, many fewer of this aircraft were built than were built of aircraft that were used throughout the war. In 1993 the taxpayer acquired one of the few remaining Fireflies.

The aircraft was no longer in a condition where it could be flown—in fact, at that point in time there were no remaining Firefly aircraft that were still flight worthy. Mr. Kurdziel had to create replacement parts on his own, and eventually was able to restore the aircraft to the point where the FAA issued an air worthiness certificate. He also was able to obtain a license to fly the plane.

Acquiring and restoring the aircraft was not an inexpensive undertaking. Mr. Kurdziel ended up with a cost basis in the aircraft of approximately $1.6 million.

He initially believed he would make money off the aircraft by selling rides on the vintage plane. But he discovered FAA regulations would make that impossible.

He also took the plane to airshows. When he initially completed the restoration, the plane attracted significant attention and won prizes. It won the title of grand champion at the nation's premiere airshow in Oshkosh, Wisconsin and won another such prize at the National Aviation Heritage Invitational in Reno, Nevada.

Sometime after the restoration was completed Mr. Kurdziel began reporting an airplane leasing business on his personal tax returns, claiming losses in excess of $100,000 from the business in each of the years before the Tax Court. The term "airplane leasing" was not a correct description of the business as Mr. Kurdziel never leased the aircraft to any other party. What income the business had arose from prizes from appearing at air shows.

While depreciation made up a significant amount of the loss (about $80,000 per year), the income Mr. Kurdziel received in each year never came close to covering the year's cash out of pocket expenses.

Not surprisingly, the IRS challenged the losses, claiming that this was merely an expensive hobby being carried on by the taxpayer, with the expenses used to offset other income.

The Tax Court noted that Reg. §1.183-2(a) provides a nine-factor test that is used to determine if an activity is carried on with the required profit motive. This test has been subject to criticism, with the Seventh Circuit Court of Appeals referring to the test as "goofy" when it rejected the test and used a more general approach.[1]

But the Tax Court notes that this case is appealable to the Ninth Circuit Court of Appeals which has not indicated that it would reject the "goofy" standard. So, the opinion notes that the nine tests still would be used to analyze Mr. Kurdziel's motive in this case. The nine tests are:

- The manner in which the taxpayer carries on the activity;
- The expertise of the taxpayer or his advisors;
- The time and effort expended by the taxpayer in carrying on the activity;
- The expectation that assets used in the activity may appreciate in value;
- The success of the taxpayer in carrying on other similar or dissimilar activities;
- The taxpayer's history of income or losses with respect to the activity;
- The amount of profits earned, if any;
- The financial status of the taxpayer; and
- Any elements of personal pleasure or recreation.

The Court found most of the tests either clearly favored the government or were neutral. But the Court did note that such aircraft did have substantial value that Mr. Kurdziel was aware of and that it was possible the aircraft could be sold for a gain that would allow Mr. Kurdziel to recover both the costs of the restoration and the operating costs as the plane was shown at airshows in order to gain exposure.

---

[1] *Roberts v. Commissioner*, 820 F.3d 247, 250, 254 (7th Cir. 2016), *rev'g* T.C. Memo. 2014-74.

But the Court found that this possible appreciation did not override the other factors in this case—Mr. Kurdziel did not have a clear business plan for the plane (noting the "airplane leasing" description), did not change what we was doing when he discovered he could not sell rides on the aircraft as he initially planned, and clearly just enjoyed restoring and flying this unique aircraft.

The Court then decided that even under the Seventh Circuit's standard the taxpayer would fail to show a profit motive, because his overall actions weren't consistent with a taxpayer looking to make money off selling the plane. The Court pointed out that the aircraft today is no longer airworthy, being involved in a crash in 2012—a very real risk when flying such vintage aircraft.

The opinion notes:

> *Given the risks that Kurdziel admitted are associated with flying the Firefly, we find it suspect that he didn't try to sell it. We can reasonably see him holding the Firefly for a few years after restoration to enter airshows and increase exposure. But Kurdziel didn't seem to even think of selling it in the years before us, and affirmatively represented to local tax authorities that he didn't intend to do so.*
>
> *He instead continued to hold the plane for nearly 15 years after its restoration was complete and it was awarded grand champion titles — a time when it was arguably at its most valuable — all while using the considerable expenses of its upkeep to offset his significant other income.*

Thus, the Court concludes that Mr. Kurdziel lacked a profit motive in his "aircraft leasing" business.

Section: 355
IRS Suspends Two Active Trade or Business Rulings Under §355 Pending the Results of a Study

Citation: Revenue Ruling 2019-09, 3/21/19

The IRS announced that it is taking the relatively rare step of suspending two prior revenue rulings in Revenue Ruling 2019-09. The ruling being suspended are Revenue Rulings 57-464 and 57-492 which relate to the active trade or business requirement of IRC §355.

Internal Revenue Manual Section 32.2.2.8 (08-11-2004) defines what suspended status is for a Revenue Ruling:

> *9. **Suspended** is used only in rare situations to show that previously published guidance will not be applied pending some future action, such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.*

Thus, suspension is not a revocation of the rulings. Presumably this leaves the door open for the IRS to determine that one or both rulings will be put back in force unchanged at the end of the study. But, more likely, the agency doesn't want to imply that both of the situations describe cases where it will be held there clearly is an active trade or business once the study is complete.

In this case the rulings are being suspended pending the results of study of active trade or business (ATB) requirements under IRC §355(a)(1)(C) and (b). The study is being conducted by the Department of Treasury and the Internal Revenue Service.

IRC §355 relates to the tax treatment of a corporation distributing to its shareholders stock and securities of a controlled corporation. If properly structured, no gain or loss is recognized by the shareholder on the receipt of the stock.[2]

One of the key requirements, found at IRC §355(a)(1)(C), to obtain this preferable treatment is the requirement that both the distributed corporation and the distributing corporation must have conducted and continue to conduct an active trade or business. The requirements for an active trade or business are found at IRC §355(b).

The two rulings dealt with situations where the IRS determined that the activities in question did not meet the requirements of IRC §355(b). The current ruling notes:

> *In Rev. Rul. 57-464, the Service considered the section 355 qualification of a corporation's separation of a manufacturing business from a group of real estate assets consisting of an old factory building used for storage and four other buildings: a duplex apartment building rented to employees of the corporation, a small office building rented to a single tenant, and two houses, one of which was occupied by a sister-in-law of the president of the corporation. The use of the old factory building for storage "was not in itself the active operation of a business as defined in the regulations." The rental activities "produced only a nominal rental" and "negligible" net income, and the properties "were acquired either as an investment or as a convenience to employees of the manufacturing business." The Service held that the separation did not satisfy the ATB requirement.*
>
> *In Rev. Rul. 57-492, a corporation engaged in refining, transporting, and marketing petroleum products began a separate operation to explore for and produce oil. The exploration and production operation incurred substantial expenditures but "did not include any income producing activity or any source of income" until less than five years preceding its separation from the primary refining, transportation, and marketing operation. The Service held that the exploration and production operation failed to qualify as an ATB because, "[b]efore oil was discovered in commercial quantities …, the venture … did not include any income producing activity or any source of income."*

The IRS explains in the ruling why the agency felt it was necessary to suspend those two rulings pending the outcome of this study:

> *The Treasury Department and the Service are conducting a study to determine, for purposes of section 355, "whether a business can qualify as an ATB if entrepreneurial activities, as opposed to investment or other non-business activities, take place with the purpose of earning income in the future, but no income has yet been collected." See IRS statement regarding the active trade or business requirement for section 355 distributions, dated September 25, 2018, available at http://www.irs.gov/newsroom/statements-from-office-of-the-chief-counsel. The ATB analysis underlying the holdings in Rev. Rul. 57-464 and Rev. Rul. 57-492 focuses, in significant part, on the lack of income generated by the activities under consideration. Consequently, these rulings could be interpreted as requiring income generation for a business to qualify as an ATB.*

---

[2] IRC §355(a)(1)

Section: 6654
Special 2018 Underpayment Penalty Relief Expanded to Apply to Those That Paid in At Least 80% of Total Tax Due

Citation: Notice 2019-25, 3/22/19

The IRS has revised the relief from the underpayment of estimated tax penalty for 2018 returns it first provided in Notice 2019-11, now granting relief to taxpayer that paid in at least 80% of the total tax actually due for 2018, up from 85%. Notice 2019-25 also provides information on how taxpayers who may have already filed and paid the penalty may obtain relief.

The new notice provides the relief applies in the following cases:

> *Pursuant to the authority in section 6654(e)(3)(A), the addition to tax under section 6654 for failure to make estimated income tax payments for the 2018 taxable year otherwise required to be made on or before January 15, 2019, is waived for any individual whose total withholding and estimated tax payments made on or before January 15, 2019, equal or exceed eighty percent of the tax shown on that individual's return for the 2018 taxable year.*

A taxpayer requests the application of the relief by following these procedures:

> *To request this waiver, an individual must file Form 2210, Underpayment of Estimated Tax by Individuals, Estates, and Trusts, with his or her 2018 income tax return. The form can be filed with a return filed electronically or on paper. Taxpayers should complete Part I of Form 2210 and the worksheet included in the form instructions to determine if the waiver in this notice applies. If the waiver applies, check the waiver box (Part II, Box A), include the statement "80% Waiver" next to Box A, and file page 1 of Form 2210 with the return. Forms, instructions, and other tax assistance are available on IRS.gov. The IRS toll-free number for general tax questions is 1-800-829-1040. This waiver is in addition to any other exception that section 6654 provides to the underpayment of estimated income tax.*

Given that this relief was announced late in tax season (on March 22 to be exact), the IRS provided information on how taxpayers who had already paid the underpayment penalty who now qualify for relief may get back the penalty they had paid:

> *Taxpayers who qualify for relief under Notice 2019-25 may have already paid additions to tax under section 6654 for tax year 2018. If the waiver under this notice applies to a taxpayer and the taxpayer has already paid additions to tax under section 6654 for the 2018 tax year, to claim a refund of the additions to tax under section 6654 for the 2018 tax year, the taxpayer should file Form 843, Claim for Refund and Request for Abatement. Taxpayers should complete the form and include the statement "80% Waiver of estimated tax penalty" on Line 7.*

Advisers may not appreciate the use of Form 843, since many tax software programs are not equipped to generate that form. Others may wonder why the IRS is not able to recognize affected returns and simply refund the penalties. But, for now, this is the relief option that has been made available.