Current Federal Tax Developments

Week of April 8, 2019

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Section: 199A
IRS Sends Proposed Regulations on §199A(g) to OIRA

Citation: RIN 1545-BO90, 4/2/19

Although we have been through proposed regulations and final regulations issued along with some additional proposed regulations under IRC §199A, the IRS had not yet issued regulations on one portion of the section—IRC §199(g), a provision added as part of the grain glitch fix by the 2018 Consolidated Appropriations Act.

The change provided agricultural cooperatives with a deduction very similar to the old law IRC §199 qualified domestic production activity deduction. Now the IRS has now sent proposed regulations under IRC §199(g) to the Office of Information and Regulatory Affairs of the Office of Management and Budget (RIN 1545-BO90).

The IRS was directed by Congress to write regulations under this provision by Reg. §199A(g)(6):

> *The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this subsection, including regulations which prevent more than 1 taxpayer from being allowed a deduction under this subsection with respect to any activity described in paragraph (3)(D)(i). Such regulations shall be based on the regulations applicable to cooperatives and their patrons under section 199 (as in effect before its repeal).*

The directions to the IRS make clear that Congress's intent is to attempt to restore old §199 treatment in this area. The regulations presumably will look very much like what previously existed under old, now repealed, IRC §199.

OIRA now reviews all proposed and final Treasury regulations prior to their release. Since OIRA began reviewing these submissions last year, the agency has taken varying amounts of time to complete the reviews. Most likely, though, this process will be completed sometime in May, followed shortly thereafter by the release of the proposed regulations.

Section: 280A
PMTA Outlines Interaction Between $10,000 SALT Cap and Home Office Deduction

Citation: Program Manager Technical Advice PMTA 2019-001, 12/7/18 (published to IRS website on 4/5/19)

In a Program Manager Technical Advice that must be parsed carefully (PMTA 2019-001), the IRS discusses the interplay between the office in home deduction under IRC §280A and the $10,000 cap on state and local taxes under IRC §164(b) added by the Tax Cuts and Jobs Act (TCJA). If the reader is not careful, he/she may jump to a very taxpayer unfriendly conclusion.

The PMTA comes to the following conclusion that may alarm readers at first:

> *If a taxpayer's total individual state and local taxes meet or exceed the $10,000 limitation of §164(b)(6), or if the taxpayer chooses to take the standard deduction instead of itemizing deductions, none of the taxpayer's state and local taxes relating to taxpayer's business use of the home are included as expenses under §280A(b). If a taxpayer's total individual state and local taxes do not meet or exceed the $10,000 limitation of §164(b)(6), and the taxpayer does not opt to take the standard*

> *deduction in lieu of itemized deductions, then the taxpayer can include as expenses under §280A(b) the business portion of the state and local taxes up to the difference between the limitation under §164(b)(6) and the amount of individual state and local taxes that the taxpayer actually deducted under §164.*

The first sentence may suggest to those that don't read carefully that a taxpayer could never get a deduction for real estate taxes allocable to the home office if he/she is already deducting over $10,000 in state and local taxes. But the conclusion paragraph has a footnote reference at the end of that first sentence. The footnote reads:

> *Expenses relating to the taxpayer's exclusive use of a portion of the taxpayer's home for business purposes could still be deductible under a different exception to the general disallowance in §280A(a), for example, under §280A(c), but such deductions would be subject to the specific limitations in that exception.*

IRC §280A(a) generally prevents taxpayers from deducting as business expenses any deduction which is incurred with respect to property used by the taxpayer as a residence during the year. However, the rest of IRC §280A contains various exceptions to this prohibition, as well as conditions that must be met to claim an office in home deduction.

The first exception, found at IRC §280A(b), provides the following special rule for items that would otherwise be deductible on the taxpayer's return:

> *(b) Exception for interest, taxes, casualty losses, etc.*
>
> *Subsection (a) shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity).*

The PMTA explains the purpose behind this initial exception:

> *Section 280A(b) excepts from §280A(a) deductions allowable to the taxpayer without regard to the deduction's connection with the taxpayer's trade, business, or income-producing activity (i.e., mortgage interest, certain taxes, certain casualty losses that are allowable to individuals under other provisions of the Internal Revenue Code). Section 280A(b) is essentially a parity provision that prevents §280A(a) from limiting home expenses that would otherwise be allowable to individuals who are not using part of their home for trade, business, or other income-producing activity.*

Deductions that cannot fit within IRC §280A(b)'s exception may still be allowed pursuant to the rules of IRC §280A(c). But §280A(c) imposes limits on the deductions that work to prevent such expenses (other than those the taxpayer would have qualified to deduct even without a home office) to no more than the income from the trade or business or rental.

The PMTA gives the following explanation of how the limit under IRC §280A(c) is computed:

	Gross income from trade, business or rental
Minus	Deductions identified under IRC §280A(b)
Minus	Deductions not incurred in connection with the dwelling unit used as a residence (e.g., advertising, office supplies)
Equals	Gross income from which taxpayer can deduct IRC §280A(c) expenses

The PMTA explains how the $10,000 cap interacts with these provisions:

> *Because the limitation under §164(b)(6) is calculated by combining the taxpayer's state and local taxes, a taxpayer using a portion of the taxpayer's residence for an income-producing purpose must first calculate the percentage of the business use of the home and then apply that percentage to the total amount of state and local taxes paid in connection with the ownership of that home to determine the portion of the state and local taxes attributable to the business use of the home and the portion attributable to the individual use of the home. Once that determination is made, the taxpayer combines the individual use portion with the taxpayer's other individual state and local taxes paid (income taxes or sales taxes, personal property taxes, war profits, excess profits taxes, and other real property taxes) to determine the taxpayer's total individual state and local taxes. If that amount meets or exceeds the $10,000 limitation under §164(b)(6), then the taxpayer does not have any additional taxes that would be deductible under §164(b)(6). In that case, the entire business portion of the state and local taxes would be considered a §280A(c) expense subject to the gross income limitation under §280A(c)(5). Similarly, if a taxpayer opts to take the standard deduction in lieu of itemizing deductions, then the taxpayer is not entitled to any deduction under §164(b)(6), and the entire business portion of the state and local taxes would be considered a §280A(c) expense subject to the gross income limitation under §280A(c)(5).*
>
> *In the case of a taxpayer whose individual state and local taxes do not meet or exceed the $10,000 limitation under §164(b)(6), if that taxpayer had state and local taxes attributable to the income-producing activity, the taxpayer could deduct as a §280A(b) expense the amount of state and local taxes attributable to the business, up to the difference between the $10,000 limitation under §164(b)(6) and the taxpayer's total individual taxes under §164. The rest of the state and local taxes attributable to the business would be expenses under §280A(c) and would be subject to the gross income limitation under §280A(c)(5).*

Taxpayers with state and local taxes in excess of the $10,000 limit will be forced to treat the real estate taxes allocable to home office as a §280A(c) limited expense—the amount can be deducted, along with other §280A(c) expenses, to the extent there is sufficient income from the trade, business or rental. If not, the unused portion of the deduction is carried forward to be potentially used in future years when the taxpayer has income from the trade, business or rental.

The PMTA contains the following examples of applying its holdings:

> ***Example 1:*** *Taxpayer has a home that he rents for 1/3 of the year. Taxpayer's real estate taxes on the home are $12,000. Taxpayer also pays $5,000 in state and local income taxes. The real estate taxes are allocated $8,000 to the individual use of the home and $4,000 to the rental use of the home. Taxpayer's total individual state and local taxes paid equal $13,000 (i.e., $8,000 individual real estate taxes plus $5,000 state and local income taxes). Under §164(b)(6), Taxpayer's individual itemized deduction for state and local taxes is limited to $10,000. Because Taxpayer's actual individual state and local taxes exceeds to the $10,000 limit under §164(b)(6), Taxpayer's $4,000 of real estate taxes attributable to the rental are expenses under §280A(c) and are subject to the gross income limitation under §280A(c)(5). None of Taxpayer's real estate taxes attributable to the rental use of the Taxpayer's home are expenses under §280A(b).*
>
> ***Example 2:*** *The facts are the same as Example 1, except that Taxpayer rents the home for 2/3 of the year. In this example, the real estate taxes are allocated $4,000 to the individual use of the home and $8,000 to the rental use of the home. Taxpayer also paid $12,000 in mortgage interest on the home but had no other itemized deductions. Therefore, Taxpayer's total individual state and local taxes equal $9,000 ($4,000 individual real estate taxes plus $5,000 state and local income taxes) and*

Taxpayer's total individual itemized deductions equal $13,000 ($9,000 in state and local taxes plus $4,000 in mortgage interest (1/3 of the total mortgage interest paid)). Taxpayer's itemized deductions exceed the standard deduction amount of $12,000, so Taxpayer chooses to itemize his deductions. Taxpayer's total individual state and local taxes do not meet or exceed the $10,000 limitation in §164(b)(6). If Taxpayer had not rented his home, Taxpayer would have been able to deduct an additional $1,000 of the real estate taxes, which are currently attributable to the business use of the home, as individual state and local taxes under §164(b)(6). As such, Taxpayer can include as a §280A(b) expense the $1,000 (the difference between the $10,000 limitation under §164(b)(6) and $9,000 (Taxpayer's total individual state and local taxes)), and such amount will not be subject to the gross income limitation of §280A(c)(5). The rest of Taxpayer's real estate taxes attributable to the rental use of the home ($7,000) are §280A(c) expenses and are subject to the gross income limitation under §280A(c)(5).

Example 3: *The facts are the same as Example 2, except that Taxpayer did not pay any mortgage interest on the home. As such, Taxpayer had a total of $9,000 in individual itemized deductions and opted to take the standard deduction of $12,000 under §63(c) instead of itemizing his deductions. Because Taxpayer opted to take the standard deduction in lieu of itemized deductions, there is no amount of state and local taxes that would have otherwise been allowable to Taxpayer under § 164 but for the rental use of the home. As such, all of the real estate taxes attributable to the rental use of the home are §280A(c) expenses and are subject to the gross income limitation of §280A(c)(5).*

The PMTA ends by noting that similar logic would apply to other deductions subject to various limitations or disallowances, including home mortgage interest and casualty losses. Thus interest on the mortgage balance in excess of the acquisition debt limitations would become §280A(c) limited expenses when claiming a home office deduction.

Section: 461
AICPA Suggests Changes Be Made to Definition of a Trade or Business Found in Instructions to Form 461

Citation: AICPA Letter to IRS Regarding Form 461 Instructions, 4/3/19

The AICPA Tax Executive Committee has sent a letter to the IRS suggesting changes be made to the instructions for Form 461, *Limitation on Business Losses.* The form is used to compute the limitation on business losses that was added by IRC §461.

Generally, under IRC §461 a taxpayer is limited to net business losses in excess of business income of $250,000 in a single year ($500,000 for a married couple filing a joint return). The AICPA comment addresses a concern that the definition of a trade or business in the instructions may be too limiting. The current definition in the regulations reads as follows:

An activity qualifies as a trade or business if your primary purpose for engaging in the activity is for income or profit and ***<u>you are involved in the activity</u>*** *with continuity and regularity.*

That definition can be read to require an individual to be directly involved with an activity for it to be a trade or business. However, such an individual level of involvement is not generally required for an activity to be a trade or business under the IRC, so long as someone (or ones) is involved in the activity with continuity and regularity.

Thus, the AICPA suggests the instructions be changed to read as follows:

> *An activity qualifies as a trade or business if your primary purpose for engaging in the activity is for income or profit and the activity is conducted with continuity and regularity.*

The letter explains:

> *The language in the instructions should specify that the "activity" is conducted with regularity and continuity. The taxpayer's "involvement" in the regularity and continuity is not one of the tests for a trade or business. The taxpayer may have a passive role as an investor in a partnership, but he/she is still "in" a trade or business if the business itself is conducted with regularity and continuity. Likewise, a sole proprietor may not have involvement in her sole proprietorship in the quantitative sense of hours, but nonetheless the business is conducted with regularity and continuity (through agents hired by the sole proprietor).*

Section: 6512
Second Circuit Reverses Tax Court, Removing "Black Hole" for Claiming Refunds

Citation: Borenstein v. Commissioner, Case No. 17-3900, CA2, 4/2/19

The Second Circuit Court of Appeals eliminated the six month "black hole" that the Tax Court believed existed for refunds of taxpayers who failed to timely file a return when it reversed that Court's decision in the case of *Borenstein v. Commissioner*, Case No. 17-3900.

The details of the original case were discussed in our blog post in August 2017 when the original decision was issued ("Taxpayer's Refund on Unfiled Return Falls Into "Black Hole" Based on Date IRS Issued Deficiency Notice"[1]). The Tax Court found that IRC §6512(b)(3), added by Congress in the Taxpayer Relief Act of 1997, created a six month "black hole" during which, if no return had originally been filed and the IRS issues a notice of deficiency before such a return is filed, the taxpayer would be barred from claiming a refund by filing a return following the issuance of the notice. The problem is triggered if the taxpayer, while not filing a return, had filed for an extension of time to file such return. The six month extension created, in the view of the Tax Court, a six month black hole for such refunds.

The issue is the flush language found at IRC §6512(b)(3) that was meant to expand the period when a taxpayer who had not filed a return could claim a refund that Congress added to reverse the U.S. Supreme Court's decision in the case of *Commissioner v. Lunder*, 516 US 235 (1996).

That language provides:

> *…where the date of the mailing of the notice of deficiency is during the third year after the due date (with extensions) for filing the return of tax and no return was filed before such date, the applicable period under subsections (a) and (b)(2) of section 6511 shall be 3 years.*

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[1] "Taxpayer's Refund on Unfiled Return Falls Into "Black Hole" Based on Date IRS Issued Deficiency Notice," *Current Federal Tax Developments*, August 31, 2017, https://www.currentfederaltaxdevelopments.com/blog/2017/8/31/taxpayers-refund-on-unfiled-return-falls-into-black-hole-based-on-date-irs-issued-deficiency-notice?rq=borenstein

The IRS had issued a notice of deficiency in June of 2015 for the taxpayer's 2011 return that had an original due date of April 15, 2012 and an extended due date of October 15, 2012—and the Tax Court found that, in its view, the plain language of the statute placed that notice outside the "third year" but after the standard two year statute for claims for refunds:

> *The "third year" after that date began on October 15, 2015. But the notice of deficiency was mailed on June 19, 2015. That date was during the second year, not during the third year, "after the due date (with extensions) for filing the return," as the 1997 amendment requires. Respondent accordingly contends that the exception set forth in the final sentence of section 6512(b)(3) does not apply, with the result that a refund or credit of petitioner's $32,411 overpayment is barred by the two-year lookback rule generally applicable to nonfilers.*[2]

The Second Circuit did not agree the provision was quite so plain, finding the phrasing was open to multiple interpretations. The Second Circuit notes it was clear Congress's intent was to eliminate the distinction between filers and nonfilers in that third year, but the Tax Court's decision created, in that Court's own words, a "black hole" into which the taxpayer loses a right to claim a refund that would have reopened later had the IRS issued the notice of deficiency a bit later.

Thus, the panel states:

> *…the interpretation we adopt is consistent with the language of 26 U.S.C. § 6511(b)(2)(A), which provides for a look-back period "equal to 3 years plus the period of any extension of time for filing the return." 26 U.S.C. § 6511(b)(2)(A) (emphasis added). In view of our obligation to resolve doubtful language in tax statutes against the government and in favor of the taxpayer, we conclude that "(with extensions)" has the same effect as does the similar language that existed in § 6511(b)(2)(A) at the time of § 6512(b)(3)'s amendment — that is, the language expands the Tax Court's jurisdiction to order refunds and credits.*

In this case, the taxpayer retained the right to pursue the refund even though the IRS issued the notice of deficiency more than two years after the original due date but before the date two years after the extended due date that was created when the taxpayer originally applied for an extension of time to file the return in question.

One thing to note about this case—the original Tax Court opinion is a reported Tax Court decision. While the holding now won't be applied in for taxpayers in the Second Circuit who go to Tax Court, the Tax Court will not necessarily reverse its position on cases arising outside the Second Circuit if the IRS decides to pursue this position outside that Circuit.

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[2] *Borenstein v. Commissioner*, 149 TC No. 10