Current Federal Tax Developments

Week of May 20, 2019

Edward K. Zollars, CPA
(Licensed in Arizona)

ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF MAY 20, 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: 1 New Worksheet for Calculating Tax on Schedule D, Correcting Error in Prior Version 1

Citation: Error in Tax Calculation in Schedule D Tax Worksheet (Form 1040), IRS website, 5/16/19 1

Section: 131 IRS Improperly Ruled Payments Were Nontaxable, Taxpayer Did Qualify for EITC and Refundable Child Credit 2

Citation: Feigh v. Commissioner, 152 TC No. 15, 5/15/19 2

Section: 267 No Accrued Wage Deduction to S Corporation for Participants in ESOP 4

Citation: Petersen v. Commissioner, CA 10, Cases Nos. 17-9003 and 17-9004, 5/15/19 4

Section: 469 Taxpayer Found to Materially Participate in Activity Based on Facts and Circumstances 6

Citation: Barbara v. Commissioner, TC Memo 2019-50, 5/13/19 6

Section: 1
New Worksheet for Calculating Tax on Schedule D, Correcting Error in Prior Version

Citation: Error in Tax Calculation in Schedule D Tax Worksheet (Form 1040), IRS website, 5/16/19

The IRS announced the agency has discovered an error that existed in the worksheets for calculating tax due that were in the Schedule D instructions for 2018 returns (Error in Tax Calculation in Schedule D Tax Worksheet (Form 1040)[1]). Most tax software followed the erroneous worksheet for returns prepared during the filing season.

The IRS noted the impacted returns as follows:

> *The tax calculation did not work correctly with the new TCJA regular tax rates and brackets for certain Schedule D filers who had 28% rate gain (taxed at a maximum rate of 28%) reported on line 18 of Schedule D or unrecaptured section 1250 gain (taxed at a maximum rate of 25%) reported on line 19 of Schedule D.*

More specifically, the IRS notice on their website states:

> *We corrected the Schedule D Tax Worksheet in the Instructions for Schedule D (Form 1040) by renumbering line 18 as line 18a, adding new lines 18b and 18c, and updating the text on line 19 to reflect those changes. A Form 1040 taxpayer's regular tax calculation using the worksheet is potentially impacted if:*
>
> 1. *Form 1040, Schedule D, lines 15 and 16 are both more than zero;*
> 2. *Schedule D, line 18 or line 19 is more than zero (or both are more than zero);*
> 3. *The taxpayer's taxable income is more than $38,600 if single or married filing separately, $51,700 if head of household, or $77,200 if married filing jointly or a qualifying widow(er);*
> 4. *Line 15 of the Schedule D Tax Worksheet is not more than line 14 of the Schedule D Tax Worksheet (those lines were not impacted); and*
> 5. *Line 18 of the original Schedule D Tax Worksheet (line 18 a of the corrected Schedule D Tax Worksheet) is not more than $157,500 ($315,000 if married filing jointly or a qualifying widow(er)).*

The IRS indicates that it is reviewing returns that were filed before the correction was released. While the agency does not indicate how it will handle the correct, it did note that "[a]ffected taxpayers need not file an amended return with the IRS or call the IRS." Rather the agency stated that additional information will be provided later.

The IRS also indicated that it had provided software vendors with information on this error prior to the release of the new forms. The release states:

> *All returns filed after May 15 should reflect the new calculation; the IRS will update any returns filed after May 15 to reflect the correct tax using the new calculation. Because the IRS has already provided*

[1] https://www.irs.gov/forms-pubs/error-in-tax-calculation-in-schedule-d-tax-worksheet-form-1040, May 16, 2019

> *the corrected worksheet to its tax software partners, anyone filing a 2018 return, including those with extensions, after May 15, 2019, are not affected by the error.*

Note that the IRS did not provide information regarding *when* this information was provided to vendors. CPAs who use Wolters Kluwers products may be concerned since an update to their software was released the day before the malware incident that began on May 6, and the organization indicated it was delaying an update scheduled for this weekend.

Some of the users of the on-site version of the software who did not update before the systems were taken down likely have not yet updated their software, waiting to assure no "surprises" might exist in that package. It seems likely that 1040s processed under the software release that was current until May 5 would contain the erroneous calculation.

The article indicates that most affected taxpayers would face a lower tax, but some will find their tax liability increased.

Section: 131
IRS Improperly Ruled Payments Were Nontaxable, Taxpayer Did Qualify for EITC and Refundable Child Credit

Citation: Feigh v. Commissioner, 152 TC No. 15, 5/15/19

In the case of *Feigh v. Commissioner*, 152 TC No. 15, the IRS was found to have effectively created an unintended double tax benefit for receipt of a Medicaid waiver payment for care of a taxpayer's adult disabled children. The Court found that the plain language of IRC §131 did not support the conclusion the IRS arrived at in Notice 2014-7, which treated such a payment as nontaxable to the recipient.

IRC §131(a) provides for an exclusion from income for qualified foster care payments. Such excludable payments include payments which are a *difficulty of care payment* as defined by IRC §131(c).

IRC §131(c) provides:

> *(c) Difficulty of care payments*
>
> *For purposes of this section—*
>
> > *(1) Difficulty of care payments*
> >
> > *The term "difficulty of care payments" means payments to individuals which are not described in subsection (b)(1)(B)(i), and which—*
> >
> > > *(A) are compensation for providing the additional care of a qualified foster individual which is—*
> > >
> > > > *(i) required by reason of a physical, mental, or emotional handicap of such individual with respect to which the State has determined that there is a need for additional compensation, and*
> > > >
> > > > *(ii) provided in the home of the foster care provider, and*
> > >
> > > *(B) are designated by the payor as compensation described in subparagraph (A).*

To be excludable, the payment must be made under a state's (or political subdivision's) foster care program.

Prior to the issuance of Notice 2014-7, the IRS had routinely taken the position that payments of a difficulty care payment to the parent of a disabled child was not excluded, because the "ordinary meaning" of foster care excludes care by a biological parent.[2]

In this case the taxpayer had received a W-2 reporting such a difficulty care payments. The taxpayer had not included the payment in income, following Notice 2014-7, but did include the amount as earned income in computing an earned income credit under IRC §32 and in computing the refundable child tax credit under IRC §24.

The IRS argued that, since the amount was not taxable under Notice 2014-7, it did not count as earned income for computing those credits. Under IRC §32(c)(2)(A)(i), earned income includes wages, salaries, tips, and other employee compensation, *but only if such amounts are includible in gross income for the taxable year*."

The taxpayer argued that nothing in IRC §131 authorized the IRS to treat the payment as not includible in gross income. The Tax Court agreed with the taxpayer's analysis. The Court notes:

> *Section 131(c)(1)(A) defines "difficulty of care payments" as, inter alia, "compensation for providing the additional care of a qualified foster individual". A "qualified foster individual" is "any individual who is living in a foster family home" and who was placed there by an agency of the State or a qualified foster care placement agency. Sec. 131(b)(2). While "[s]ection 131 does not explicitly address whether payments under Medicaid waiver programs are qualified foster care payments", the IRS reasoned that "Medicaid waiver programs and state foster care programs * * * share similar oversight and purposes." Notice 2014-7, 2014-4 I.R.B. at 446. As an initial matter, the plain text of section 131 renders it inapplicable to the care of biological adult children. (emphasis added)*

The opinion points out that Notice 2014-7 itself concedes that the IRS had previously interpreted the statute to disallow the exclusion when the amounts were paid to the biological parents of an adult child.

The Court also notes that the definition of earned income in §32 cited earlier applies to income *includible* in taxable income, rather than to income actually *included* in taxable income. Thus, the fact that the taxpayers had not included the amount in their income did not render it not earned income for purposes of §32.

The IRS protested that the taxpayers should not be allowed a double benefit by obtaining an earned income tax and refundable child tax credit, as there is no statutory provision evidencing that Congress intended recipients of such payments to obtain a double benefit. But the Court noted this double benefit was being created by an erroneous ruling of the IRS, not by Congress:

> *Respondent's argument, however, misses that he, not Congress, has provided petitioners with a double tax benefit. Petitioners' income cannot be reclassified by respondent, through a notice, to fall outside the plain text of section 32. If left alone section 32 would allow petitioners the benefits of earned income for their Medicaid waiver payment, but that payment would remain subject to taxation under section 61.*

---

[2] Program Manager Technical Advice 2010-007

> *Respondent, however, has decided to disturb this equilibrium by telling taxpayers like petitioners that they need not pay tax on their Medicaid waiver payments.*

The opinion also notes that the IRS failed to raise the protective argument in the case that if the amounts were earned income for EITC purposes, the taxpayer should have to include them in income for the year in question.

So, in the end, the taxpayer was able to both exclude the amounts from taxable income and obtain credits based on that (now untaxed) earned income.

Section: 267
No Accrued Wage Deduction to S Corporation for Participants in ESOP

Citation: Petersen v. Commissioner, CA 10, Cases Nos. 17-9003 and 17-9004, 5/15/19

The Tenth Circuit Court of Appeals, sustaining a 2017 published Tax Court Decision[3], held that an ESOP plan is a trust for tax purposes, and thus the corporation was barred from accruing wages to be paid to participants in the ESOP under the provisions of IRC §267. In *Petersen v. Commissioner*, CA 10, Cases Nos. 17-9003 and 17-9004.

We had covered this case on the Current Federal Tax Developments website when the Tax Court issued its opinion in 2017.[4]

IRC §267(a) contains a special rule meant to prevent taxpayers from obtaining a tax benefit for a related accrual basis taxpayer for an item that won't be treated as income for the related party until a later year. The law states at §267(a)(2):

> *(2) Matching of deduction and payee income item in the case of expenses and interest*
>
> *If—*
>
>> *(A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and*
>>
>> *(B) at the close of the taxable year of the taxpayer for which (but for this paragraph) the amount would be deductible under this chapter, both the taxpayer and the person to whom the payment is to be made are persons specified in any of the paragraphs of subsection (b),*
>
> *then any deduction allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made (or, if later, as of the day on which it would be so allowable but for this paragraph). For purposes of this paragraph, in the case of a personal service corporation (within the meaning of section 441(i)(2)),*

---

[3] *Petersen v. Commissioner*, 148 TC No. 22

[4] Ed Zollars, "ESOP Participants Accrued Compensation Found Not Deductible Until Paid," *Current Federal Tax Developments* website, https://www.currentfederaltaxdevelopments.com/blog/2017/6/15/esop-participants-accrued-compensation-found-not-deductible-until-paid?rq=Petersen, June 15, 2017

> *such corporation and any employee-owner (within the meaning of section 269A(b)(2), as modified by section 441(i)(2)) shall be treated as persons specified in subsection (b).*

IRC §267(e) provides that, for an S corporation, the relationship denying the deduction exists between the S corporation and a holder of *any* interest in the corporation, whether it be a direct or indirect interest, no matter how small.

IRC §267(c) provides constructive ownership rules for stock. Under §267(c)(1), a beneficiary of a trust is deemed to constructively own his/her proportionate share of any stock held by a trust.

In the original case, the Tax Court held that an employee stock ownership plan (ESOP) was to be treated as a trust for these purposes. The Court noted that such entities were legally treated as a trust under state law, though ERISA does pre-empt state law for many purposes related to the trust. While the trust is treated differently from other trusts, the Court found nothing in §267 indicated that such differences were relevant in treating the shares as being constructively held by the beneficiaries.

In this case, the corporation was denied a current deduction for any accrued wages or bonus for amounts due to any beneficiary of the ESOP even if that beneficiary did not personally hold any shares of the corporation.

The taxpayer in this case appealed the decision to the Tenth Circuit. The Tenth Circuit panel's opinion begins by noting that the Employee Retirement Income Security Act of 1974 (ERISA) requires that the assets of the ESOP be held in a trust to protect the employees' interests.

The panel was not impressed with the taxpayers' attempts to argue that the ESOP plan should not be treated as a trust for tax purposes, noting:

> *Taxpayers' brief has a jumble of arguments that an ESOP trust is not a "trust" within the meaning of the term in IRC § 267. But to the extent that we can understand these arguments, they are unconvincing.*

Fundamentally, the panel did not accept the argument that an ERISA trust should be treated as anything other than a trust for §267 purposes. The opinion states:

> *Taxpayers argue that an ERISA trust is distinguishable from a common-law trust (and thus is not covered by § 267) because it protects the interests of "participants," who are distinguished from "beneficiaries" in ERISA. But this argument relies on semantics rather than substance. As previously noted, a beneficiary "is the person for whose benefit the trustee holds the trust property." Bogert § 1. The property in an ERISA trust "shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan." 29 U.S.C. § 1103(c)(1). Both participants in the plan and their beneficiaries satisfy the definition of beneficiary in trust law. All ERISA does is use different terminology to describe two distinct classes of beneficiaries — those employees or former employees who participate in the plan, and the beneficiaries whose interests derive from a participant. See 29 U.S.C. § 1002(7) (defining participant), (8) (defining beneficiary as "a person designated by a participant, or by terms of an employee benefit plan, who is or may become entitled to a benefit thereunder."). The common law of trusts allows for different beneficiaries "whose interests may be enjoyable concurrently or successively." Restatement Third § 44 cmt. a. ERISA's use of the term participant to describe certain beneficiaries does not remove ERISA trusts from the IRC definition of trusts. The term beneficiary in § 267 has been interpreted quite broadly, see Wyly v. United States, 662 F.2d 397, 402 (5th Cir. 1981) (taxpayers were beneficiaries of trust even though they would receive nothing unless their four children*

> *died without issue); and in any event, there is no need for such a broad construction here, since every participant easily satisfies the common-law definition of beneficiary.*

The panel also did not accept the argument that they were different under the IRC because they are referred to as qualified trusts at points in the IRC. The opinion continues:

> *Taxpayers argue that an ERISA trust is distinguishable from a common-law trust (and thus is not covered by § 267) because it protects the interests of "participants," who are distinguished from "beneficiaries" in ERISA. But this argument relies on semantics rather than substance. As previously noted, a beneficiary "is the person for whose benefit the trustee holds the trust property." Bogert § 1. The property in an ERISA trust "shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan." 29 U.S.C. § 1103(c)(1). Both participants in the plan and their beneficiaries satisfy the definition of beneficiary in trust law. All ERISA does is use different terminology to describe two distinct classes of beneficiaries — those employees or former employees who participate in the plan, and the beneficiaries whose interests derive from a participant. See 29 U.S.C. § 1002(7) (defining participant), (8) (defining beneficiary as "a person designated by a participant, or by terms of an employee benefit plan, who is or may become entitled to a benefit thereunder."). The common law of trusts allows for different beneficiaries "whose interests may be enjoyable concurrently or successively." Restatement Third § 44 cmt. a. ERISA's use of the term participant to describe certain beneficiaries does not remove ERISA trusts from the IRC definition of trusts. The term beneficiary in § 267 has been interpreted quite broadly, see Wyly v. United States, 662 F.2d 397, 402 (5th Cir. 1981) (taxpayers were beneficiaries of trust even though they would receive nothing unless their four children died without issue); and in any event, there is no need for such a broad construction here, since every participant easily satisfies the common-law definition of beneficiary.*

Section: 469
Taxpayer Found to Materially Participate in Activity Based on Facts and Circumstances

Citation: Barbara v. Commissioner, TC Memo 2019-50, 5/13/19

The IRS argued that the taxpayer in *Barbara v. Commissioner*, TC Memo 2019-50 did not materially participate in the trade or business of lending money, leading to a proposed assessment of tax of over $536,000 along with a 20% substantial underpayment penalty under §6662(a). But the Tax Court did not agree with the IRS's view in this case.

After selling his trucking business, Fred Barbara used the money to start a money lending business. The office of the money lending business was in Chicago, IL. The business employed two full time employees: an accountant and a secretary.

Mr. Barbara performed the executive functions of the lending business, including deciding to make loans and how to handle defaulted loans. He handled over 40 outstanding loans during the years in question and did not have other major work-related responsibilities that would require his time and attention.

However, Mr. Barabara only spent 40% of the year in Chicago, living in Florida the remainder of the year. Presumably this made the IRS suspicious that Mr. Barabara was truly not materially participating in the business. Under IRC §469, if Mr. Barabara did not materially participate in the business, the losses claimed would have been suspended until such time as Mr. Barbara had passive income or disposed of this activity in a fully taxable transaction.

A person is treated as materially participating in an activity if he meets any one of the seven tests found in Reg. §1.469-5T(a). In situation this the Tax Court focused on the seventh test, which provides that a taxpayer materially participates if he:

- Participates more than 100 hours in the activity during the year and
- Facts and circumstances show that his participation was regular, continuous and substantial.[5]

The Tax Court first looked at the hours that Mr. Barbara had participated in the activity during the years in question. The Court found initially that he worked 200 days during the year in the activity, with 40% of the work days being in Chicago and 60% in Florida.

The Court found that when Mr. Barabara was in Chicago, he spent 5.75 hours for each workday in the Chicago office. When he was in Florida, during his workdays he spent 2 hours working on the business. The Court found this meant he had worked 460 in Chicago and 240 hours in Florida each year, for a total of 700 hours. The Court noted this exceeded the 100 hours necessary to meet this test.

The Court also considered that what Mr. Barabara did in the business amounted to regular, continuous and substantial participation. Thus, the Court concluded Mr. Barbara had materially participated in the activity and should be allowed to deduct his losses.

The opinion is interesting in that the Court did not use the test at Reg. 1.469-1T(a)(1) to sustain the finding that Mr. Barbara materially participated in the years in question. That test provides a taxpayer materially participates in any activity that he/she participates in more than 500 hours in a year. Since the Court found that Mr. Barbara participated for 700 hours (which clearly is more than 500), why did the Court resort to the facts and circumstances test?

While the Court doesn't comment specifically why it ignored the simpler test, it's interesting to note that the Court did not comment on the documentation for Mr. Barbara's hours and participation in this case. The lack of documentation has been used multiple times to deny taxpayers material participation when they claimed more than 500 hours.

The Tax Court had similarly resorted to using the "facts and circumstances" rather than the 500-hour test previously in the case *Wade v. Commissioner*, TC Memo 2014-169, even though in that case the taxpayer argued that he met the 500-hour test. Again, documentation was not mentioned in that case, just a finding that he had participated more than 100 hours and had regular, continuous and substantial participation.

It appears that the Tax Court is indirectly opening up a limited exception to the documentation rules—if the Court determines that a taxpayer had at least 100 hours per year and that it appears he/she was truly involved in the activity in a significant way, it is resorting to the facts and circumstances test rather than take the position that this sort of "estimated hours" reconstruction justifies qualifying under the 500 hour test of Reg. §1.469-5T(a)(1).

[5] Reg. 1.469-5T(a)(7), (b)(2)(iii)