Current Federal Tax Developments

Week of May 28, 2019

Edward K. Zollars, CPA
(Licensed in Arizona)

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Section: 61
IRS Commissioner Indicates IRS to Issue New Virtual Currency Guidance Soon

Citation: Letter to Rep. Tom Emmer, Commissioner Charles Rettig, 5/16/19

In letter to Rep. Tom Emmer, R-Minn., IRS Commissioner Charles Rettig indicated that the agency plans to release additional guidance on issues related to virtual currencies soon in three areas raised by a letter the Congressman had sent to the agency on April 11, 2019.

The IRS has previously issued guidance on the taxation of virtual currencies in Notice 2014-21, a notice discussed on the *Current Federal Tax Developments* website when the IRS issued News Release IR-2018-71 to remind taxpayers of the agency's stated position on the taxation of virtual currencies such as Bitcoin (BTC).[1]

That news release repeated the following summary of key elements found in Notice 2014-21:

- *A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property.*
- *Payments using virtual currency made to independent contractors and other service providers are taxable, and self-employment tax rules generally apply. Normally, payers must issue Form 1099-MISC.*
- *Wages paid to employees using virtual currency are taxable to the employee, must be reported by an employer on a Form W-2 and are subject to federal income tax withholding and payroll taxes.*
- *Certain third parties who settle payments made in virtual currency on behalf of merchants that accept virtual currency from their customers are required to report payments to those merchants on Form 1099-K, Payment Card and Third Party Network Transactions.*
- *The character of gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer.*[2]

However, there are a number of questions left unanswered by Notice 2014-21 which the Representative's office raised with the Commissioner.

The Commissioner specifically referenced three issues in his letter. Those issues included:

- Acceptable methods for calculating stock basis
- Acceptable methods for cost basis assignment
- Tax treatment of forks

Basis issues are troubling because of the nature of virtual currencies--they exist, but not in a physical form (at least if you aren't counting electrons stored in silicon). While a client might have a certain number of bitcoin, that number is likely not an pure integer number (more likely 5.287 or something similar), and were acquired in various ways—some may have been

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[1] Ed Zollars, "IRS Reminds Taxpayers About Agency's Position on Taxation of Virtual Currencies Published in 2014," March 30, 2018, https://www.currentfederaltaxdevelopments.com/blog/2018/3/30/irs-reminds-taxpayers-about-agencys-position-on-taxation-of-virtual-currencies-published-in-2014?rq=Notice%202014-21

[2] IR-2018-71, https://www.irs.gov/newsroom/irs-reminds-taxpayers-to-report-virtual-currency-transactions, March 23, 2018

purchased on exchanges, some may have been received as payment for services, and some may have been mined.[3] Guidance on the methods to be used to determine the initial cost basis would prove helpful.

More of an issue is the second matter--how the taxpayer assigns a portion of that basis to the Bitcoin that is sold or exchanged in a transaction. Can (or even must) a specific identification method be used? Is a first-in, first-out or average cost methodology acceptable?

One of the more troubling issues is a fork of a currency, such as occurred with the creation of Bitcoin Cash (BCH) on August 1, 2017 when each holder of Bitcoin received 1 Bitcoin Cash. Was that a taxable transaction and, if it was, what value should be assigned to the BCH received? Or was this really all the same "asset" with the even being nontaxable. If that is the case, how much of the BTC basis should have been assigned to the BTC, if any?

The Commissioner's letter notes:

> *I share your belief that taxpayers deserve clarity on basic issues related to the taxation of virtual currency transactions and have made it a priority of the IRS to issue guidance. … We have been considering these issues and intend to publish guidance addressing these and other issues soon.*

Section: 223
2020 Inflation Adjusted Numbers for HSAs Released by IRS

Citation: Revenue Procedure 2019-25, 5/24/19

The IRS has issued the inflation adjusted amounts for Health Savings Accounts (HSAs) for 2020 in Revenue Procedure 2019-25. The inflation adjusted numbers for HSAs are generally released much earlier in the year than other inflation adjusted numbers that will impact the following year's taxes.

The annual contribution limitation to an HSA for an individual with self-only coverage will be $3,550 for 2020 and $7,100 for an individual with family coverage.

For 2020, an HSA qualifying high deductible health plan (HDHP) must have a deductible of at least $1,400 for self-only coverage and $2,800 for family coverage.

The maximum annual out of pocket expenses (which includes deductibles, co-payments and other amounts, excluding the premiums for the policies) in 2020 is $6,900 for an HDHP offering self-only coverage and $13,800 for an HDHP offering family coverage.

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[3] The concept of mining is not an issue I will attempt to explain in this brief article. Suffice it to say it is the way that new Bitcoin (or other virtual currencies) are created.

Section: 280F
IRS Announces Depreciation and Lease Inclusion Amounts on Vehicles for 2019

Citation: Revenue Procedure 2019-26, 5/21/19

The IRS has released Revenue Procedure 2019-26 which provides the limitation on depreciation for passenger automobiles first placed in service in 2019 under §280F, as well as the amounts required to be included in income by lessees of passenger automobiles first leased in 2019.

Three tables are included in the Revenue Procedure. The first one covers passenger automobiles acquired before September 28, 2017 and placed in service in 2019 for which bonus depreciation under IRC §168(k) applies. The limitations for those cars are:

Tax Year	Amount
1st Tax Year	$ 14,900
2nd Tax Year	$ 16,100
3rd Tax Year	$ 9,700
Each succeeding tax year	$ 5,760

The second table covers passenger automobiles acquired after September 27, 2017 and placed in service in 2019 for which bonus depreciation under IRC §168(k) applies:

Tax Year	Amount
1st Tax Year	$ 18,100
2nd Tax Year	$ 16,100
3rd Tax Year	$ 9,700
Each succeeding tax year	$ 5,760

The third table is for passenger automobiles for which §168(k) does not apply placed in service in 2019:

Tax Year	Amount
1st Tax Year	$ 10,100
2nd Tax Year	$ 16,100
3rd Tax Year	$ 9,700
Each succeeding tax year	$ 5,760

As well, the updated table for the lease inclusion amount for automobiles with a lease term beginning in 2019 is found in this Revenue Procedure.

Section: 409
Congress Appears to Be Seriously Considering Bill That Would Greatly Impact Inherited Retirement Account Payout Terms

Citation: HR 1994, Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act), 5/16/19

It's always risky to put much stock in a bill in Congress that hasn't yet passed, but it's beginning to look like the SECURE Act ("Setting Every Community Up for Retirement Enhancement" - Congress is back to full word acronyms...) might actually move forward at this point, with something similar to it being enacted into law.

When the §529 provisions were pulled it looked like that might cause Republican support to go away (and thus kill any chance in the Senate), but the addition of a full Kiddie Tax fix (roll back the provision to the pre-TCJA version now that unintended consequences are coming out of the woodwork outside of just the Gold Star families problem) and the apparent endorsement of ranking minority member and previous Ways & Means Chair Kevin Brady seem to have gotten both sides on board.

Specifically, Rep. Brady is quoted as saying the following:

> *"This represents years of really good, solid, constructive bipartisan work on retirement savings. I'm excited about a number of those provisions," Brady told reporters before adding that he was "disappointed" because the measure "should not have been hijacked on the way to the floor."*[4]

On May 23, 2019 the House did overwhelmingly vote in favor of this bill (417-3), and the *Wall Street Journal* reported that a GOP aide indicated that the Senate plans to vote on this bill rather

[4] Bernie Becker, "Passing bills," Politico Morning Tax, May 23, 2019, https://www.politico.com/newsletters/morning-tax/2019/05/23/passing-bills-439562

than a slightly different version that had been introduced in that chamber.[5] The path to passage hit a bump in the road at the end of the week, as Senator Cruz of Texas objected to waiving the rules to allow a vote before the Senate left town for the Memorial Day recess. He was upset that the House had removed the provision from the bill that would have allowed 529 plan funds to be used for home schooling and other items not currently allowed. So action on the bill will be delayed until Congress comes back from the recess.

Why is this bill potentially important? Well while the bill has a lot of "good" items for qualified retirement plans (we can first adopt a plan up to the extended due date of the return, simplified multiple employer plan constructs, raising RMD age to 72, changing the 5 year payout on inherited balances to 10 years, no maximum age for making a contribution to an IRA, etc.) there are some offsets that could be troubling.

The big one will involve pretty much wiping out the "stretch IRA" planning option for those inheriting an IRA for a death following December 31, 2019. As currently drafted, the 10-year method is now made to apply to all inherited interests (so even if past the required beginning date) and the use of the life expectancy payouts are limited to the following beneficiaries:

- Surviving spouse
- Disabled individuals (per Section 72(m)(7))
- Chronically ill individuals (if condition is an indefinite one reasonably expected to be lengthy in nature)
- Individuals not more than 10 years younger than the decedent

Minor children also get the lifetime payout, but only until reaching the age of majority. At that point, a new 10 year payout period starts.

If a designated beneficiary dies before the payout period is complete, the succeeding beneficiary will only have access to the 10-year rule.

In the past, advisers would discuss the option of "stretching" the payout of an IRA by leaving the account to a substantially younger beneficiary. In some cases, to insure the payout really only took place over that longer term, a conduit trust would be made the beneficiary of the IRA so that a trustee (rather than the person inheriting the IRA) had control over the amount of distribution taken each year.

Now that same conduit trust in most cases could only hold the balance in the retirement account for a period that would end 10 years after the later of the year following the year of death of the original owner of the account or when the designated beneficiary attains the age of majority.

There's nothing to do right now but watch the bill's progress in the Congress. Similarly, you might want to hedge a bit if you are working on any long term plans that involve retirement accounts, so that you have flexibility should Congress pass this into law.

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[5] Anne Tergesen, "House Passes Bill Making Big Changes to U.S. Retirement System," *Wall Street Journal* website, May 23, 2019, https://www.wsj.com/articles/house-on-track-to-pass-bill-making-big-changes-to-u-s-retirement-system-11558625474?mod=e2tw (subscription required)

While the Senate passed a simple Kiddie Tax fix by unanimous consent, it only solves the problem for Gold Star families. The problem occurs when a child with excess unearned income has parents who are not in the highest tax bracket. Due to the narrow trust tax brackets that the revised Kiddie Tax uses, those children quickly end up in the 37% bracket, resulting in a much higher tax liability.

In addition to children of those who died in the armed services receiving benefits, certain taxable aid providing to students attending college is also being swept up by this provision, resulting in much greater tax liabilities. Concern that additional sets of affected children might end up being discovered has now lead to many in Congress wanting a fix that is broader than just the simple patch to correct the issue for Gold Star families.

The version that is being attached to the SECURE bill would simply restore the prior version of the Kiddie Tax rules to the law, tying the child's tax to parents' tax brackets rather than using the trust rates.

The full bill (as it stood when this article was written without the Kiddie Tax amendment) can be viewed at:

https://www.congress.gov/116/bills/hr1994/BILLS-116hr1994rh.xml

The Senate has been working on a similar bill and there will likely be some different ideas incorporated in a bill that emerges from the Senate, but for the moment this looks like a bill that has a reasonable chance of being enacted this session.

Section: 7602
Assistant US Attorney Comments on Issues Related to Preparer's Criminal Exposure Under §7602(2)

Citation: Kristen Parillo, "Preparers Warned to Be Vigilant About Documenting Loans," Tax Notes Today, 5/20/19

An article in *Tax Notes Today* outlining comments made by an assistant U.S. attorney based in New Haven, Connecticut highlighted that tax preparers may get entangled in criminal tax prosecutions when they fail to insure clients are properly documenting loans from a business.[6]

Christopher W. Schmeisser was speaking at a criminal tax conference held at Quinnipiac University School of Law in North Haven, Connecticut. Mr. Schmeisser indicated that loans are often used as part of a scheme for a taxpayer to avoid paying taxes.

Under the IRC, §61 generally requires any accession to wealth to be treated as gross income, subject to tax, absent a provision elsewhere in the IRC that excludes the transaction from being taxable. Receipt of funds from a loan is not treated as an accession to wealth since the taxpayer's net worth does not immediately change as a result of the transaction.

[6] Kristen Parillo, "Preparers Warned to Be Vigilant About Documenting Loans," *Tax Notes Today,* May 20, 2019, 2019 TNT 97-6, https://www.taxnotes.com/tax-notes-today/criminal-violations/preparers-warned-be-vigilant-about-documenting-loans/2019/05/20/29j26 (subscription required)

However, for receipt of funds from a loan to be excluded from income, there must be an actual loan being made. While the test of whether an actual loan is being made is based on all available facts and circumstance, factors that indicate a transaction is a loan include:

- A document outlining the terms of the loan that is executed by the parties;
- Actual intent of the parties to enter into a loan agreement which includes, among other things,
    - A review of the capability of the borrower to repay the loan by the lender;
    - An appropriate rate of interest being set on the loan, given the term and risks involved;
    - Considering the need for security for the loan, and taking normal steps to secure the debt (such as recording the lien for a debt that claims real property as security for the debt);
    - Enforcement of the terms of the loan by both parties to the agreement; and
    - Intent on the part of the borrower to repay the loan at the time it is made.

As with any other related party transactions, loans between related parties are subject to special scrutiny to insure the transaction's substance is what the parties claim.

Mr. Schmeisser notes that taxpayers looking to avoid paying tax may look to attempt to classify cash receipts as "loans" when such receipt would otherwise be a taxable transaction. He notes a crucial item that is used to decide if the preparer was criminally assisting in the preparation of fraudulent returns is whether the preparer took the basic step of looking at documentation that should have been prepared for the loan.

As the article notes:

> *Schmeisser said that in some of the cases he has handled, "there's just no effort by the preparer to actually do any of the appropriate paperwork."*
>
> *"Year after year, there is substantial monies coming out of entities where there is no loan documentation prepared, no actual reflection of interest accrued, no recording of any payment of interest because no interest was paid," Schmeisser continued. "Everything is just sort of thrown into a loan file bucket, which is pretty obviously just an effort to delay and defer the payment of taxes on income."*[7]

Before you decide that this is "outlier" thinking from one U.S. Attorney's office, you should consider a case that led to a long discussion on the TaxTalk discussion group sponsored by the California Society of CPAs last year. In that case, a Bay Area CPA was convicted of aiding and abetting the filing of a false tax return based largely on accepting the client's position that the funds he had obtained were "loans" representing advances on management fees from an investment fund rather than income that should have been taxed currently.

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[7] *Ibid*

The Justice Department issued a press release in July of 2018 publicizing the conviction.[8] The *Mercury News* reported in December of 2018 that the CPA was eventually sentenced to eight months in prison, one year of supervised release following that term and fined $20,000.[9]

The CPA was convicted of violating IRC §7602(2) which provides:

> *Any person who—*
>
> …
>
> *(2) Aid or assistance*
>
> *Willfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document;*
>
> …
>
> *shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.*

Peter J. Reilly in his *Forbes* blog described the transactions that led to the CPA's problems as follows:

> *Beginning in 2007, Burrill Capital began taking its management fees a little early to deal with "cash flow" problems. By 2012, it had taken more than it could possibly earn before the fund's scheduled closing - over $18 million. In 2012, there was a capital call on the investors purportedly to fund investments. but some of that went to the prepaid management fee.*[10]

The CPA handling the tax return did attempt to analyze the taxability of these "advances" on the management fee. The client insisted the payments were in the nature of loans. The CPA handling the tax return noted that the audit of the Fund which had paid this "loan" to the taxpayer's business had issued an unqualified opinion on the Fund treating these as loans. Eventually the CPA who issued that unqualified opinion was subject to discipline by the SEC and the California Board of Accountancy, but those actions had not begun when the tax return was being prepared.[11]

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[8] The United States District Attorney's Office, Northern District of California, "Bay Area CPA Convicted of Fraud," July 18, 2018, https://www.justice.gov/usao-ndca/pr/bay-area-cpa-convicted-tax-fraud

[9] "Walnut Creek Accountant Sentenced in Tax Fraud Case," *The Mercury News,* December 15, 2018, https://www.mercurynews.com/2018/12/15/sf-walnut-creek-accountant-sentenced-in-tax-fraud-case/

[10] Peter J. Reilly, "CPA Convicted Of Assisting On False Tax Return - Did He Get A Raw Deal?," *Forbes* website, November 23, 2018, https://www.forbes.com/sites/peterjreilly/2018/11/23/cpa-convicted-of-assisting-on-false-tax-return-did-he-get-a-raw-deal/#17d221346198

[11] *Ibid*

Mr. Reilly's article notes, this was not a case where the CPA simply moved an entry to loans to get rid of the income, nor did he even just accept the client's orders to report it as nontaxable:

> *The deferred revenue was noticed by the staff and that raised a tax concern, because even though something might not be income under GAAP, it can be taxable income when received. The problem escalated to Mr. Berger, the tax partner on the account and it got a lot of attention. Here he is just trying to get somebody's tax return done. Somebody who has done something that he should not have done. He still has to file a tax return.*
>
> *At the end of the day, when you are looking at Burrill's return, you have to decide- was he borrowing from Peter to pay Paul or was he robbing from Peter to pay Paul. After a lot of agonizing Berger concluded it was the former, in which case the returns he signed were correct. He encouraged the client to document the loan status of the payments, which they did do, drafting a note form Burrill to the fund. Subsequently, the note was torn up because it was not consistent with the story coming out of the other side of the mouth that was being fed to PwC to hoodwink the investors.*
>
> *Berger did not believe that Burrill was avoiding tax on the $18 million - just deferring it.*[12]

However, the downside was that it was pretty clear the client did want it reported as a loan and reports from the trial indicate that the client was a "demanding" client. Whether or not it truly was the case, it's not that difficult to see a jury deciding that the decision to treat it as a loan was "tainted" by the knowledge a different answer would result in the loss of a major client (and the fees related to the same).

Similarly, when the CPA discovered that there was no documentation to support the loan (and thus recommended the client draft a note), that arguably undercut the CPA's reliance on the audit report of the fund this was truly a loan--rather, arguably, the CPA had now discovered a reason to believe there had been deficiencies in the audit with regard to these payments. That is, why hadn't the lack of documentation troubled the auditor? Again, in retrospect it's not hard to see how a prosecutor could put this to the jury in a very bad light.

While I have no doubt the CPA had no bad intent--and thus, that the jury should have acquitted based on lack of criminal intent--I also can easily see how a non-accountant might have a difficult time believing that. All reports on the CalCPA TaxTalk from individuals who had interactions with this CPA suggested that he was a well-respected and upstanding professional. Nevertheless, he ended up with a conviction.

To be sure, criminal charges most often occur when there is a substantial amount of income in question--in this case it was $18 million. It also didn't help that the client also ended up being charged with other crimes related to having obtained the $18 million from the fund. The client also clearly had indicators of being a "bad" client that makes impossible demands by bringing data in late so all decisions must be rushed and pushing back against any treatment that results in higher taxes. That sort of client is one that your malpractice carrier will tell you is the most likely to generate a claim-and, quite often, be the one filing the claim against the CPA.

But, conceptually, the above issue has likely confronted other CPAs in various situations. Even for non-demanding clients, CPAs too often go overboard in attempting to avoid having to give

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12 *Ibid*

bad news by "adjusting" transactions after the fact to have them fit a more tax favorable fact pattern.

For instance, the author knows of discussions made in public forums over the years where CPAs discussed using a journal entry after the fact to treat distributions from an S corporation in excess of the shareholder's basis as a "loan" from the shareholder to the corporation. The same discussion makes it clear that the plan is to treat it as "paid off" via a distribution (again made with journal entries rather than an actual exchange of checks) when the corporation later has income.

The problem with that plan is that:

- There was no intent to enter into a loan when the original payment was made since
  - No documents were drawn up at that time and
  - The shareholder had no intent to repay the amounts advanced;
- At the time of the journal entry, the CPA's own workpapers and statements most often make clear there is still no intent to repay the funds; and
- The real reason for this revised view of the transaction to avoid taxes that the taxpayer clearly owes taxes if the original form and substance of the transaction is respected.

In many ways, that "tax planning" is far less defensible than what the CPA was sentenced to prison time for.

Even if we accept that it's "OK" to do this since the numbers are relatively small (let's assume it's $18,000 rather than $18 million),[13] it becomes that much harder the next time to refuse to do the same thing when the numbers are larger. After enough iterations, a CPA can find him/herself now making that $18 million adjustment (something, again, the CPA in this case did not do) to avoid admitting (to him/herself as much or more than to the client) that doing the smaller "fixes" in earlier years were not allowable under the law.

[13] And, to be clear, I do not agree with that view.