Current Federal Tax Developments

Week of July 8, 2019

Edward K. Zollars, CPA
(Licensed in Arizona)

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Table of Contents

SECTION: STATE TAX
SUPREME COURT DECLINES TO HEAR APPEAL OF MINNESOTA TRUST CASE

Citation: Petition for Certioria Denied, Minnesota Department of Revenue v. Fielding, 6/28/19

After having decided that North Carolina could not tax a trust based solely on residence of a beneficiary in the *Kaestner Trust* case, the Court had to decide what to do with another case. Shortly after the North Carolina Supreme Court ruled against the North Carolina Department of Revenue in the *Kaestner* case the Minnesota Supreme Court ruled against the state of Minnesota's ability to impose its tax on a trust on different grounds.

On June 28, 2019, the Court decided not to hear the Minnesota Department of Revenue's appeal of the Minnesota Supreme Court's ruling in the *Fielding* case.[1] The Minnesota Supreme Court ruled that the state could not impose an income tax on a trust when the only connection with Minnesota was the fact that the settlor had been a Minnesota resident when the trust became irrevocable.[2]

The fact that the U.S. Supreme Court decided not to hear the case does not mean the Court is taking the position that the decision was the correct one, just that the Court has chosen not to hear that particular case. The U.S. Supreme Court has full discretion regarding which cases it does and does not hear.

Thus, at this point while Minnesota is barred by its highest court from imposing a tax on a trust in such a situation, other states with the same rule that have not had their highest court strike down the law will be able to continue to collect the tax (at least for now).

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1 https://www.supremecourt.gov/search.aspx?filename=/docket/docketfiles/html/public/18-664.html, retrieved June 29, 2019

2 Ed Zollars, "Two States Find Their States' Statutes for Taxing Trusts Violate Due Process Clause," Current Federal Tax Developments, July 19, 2018

SECTION: 413
PROPOSED REGULATIONS ISSUED TO ALLOW MULTIPLE EMPLOYER PLANS TO AVOID CONSEQUENCES OF ACTION OF UNCOOPERATIVE EMPLOYER

Citation: REG-121508-18, 7/3/19

The IRS has issued proposed regulations that would apply to defined contribution multiple employer plans (MEPs) in REG-121508-18[3] in response to an executive order[4] issued by the President in August 2018. The EO directed the IRS and related agencies to take actions to encourage the use of MEPs, specifically to limit the consequences should one of the employers participating in the MEP fail to take actions required to allow the plan to remain qualified.

Concerns had been expressed that the above rule (often referred to as the "one bad apple rule" and officially referred to as part of the overall unified plan rule) discouraged employers from joining an MEP plan, since the actions of an unrelated employer over which they would have no control could jeopardize the qualified status of the plan, putting the innocent employer and its employees at risk for the tax consequences of plan disqualification.[5]

Retirement plans and sponsoring employers must comply with certain requirements in order for the retirement plan to receive the tax favored qualified plan status. A MEP allows multiple employers to join together in a single plan, hopefully reducing the costs of administering a plan that must be born by the employers compared to sponsoring their own independent retirement.

MEPs are specifically authorized by IRC §413(c). Reg. §1.413-2(a)(3)(iv) provides that, for purposes of determining the qualified status of an MEP, all employers that are part of the plan are considered, including actions that they take or fail to take (the "unified plan rule"). The preamble notes:

> Consequently, §1.413-2(a)(3)(iv) provides that "the failure by one employer maintaining the plan (or by the plan itself) to satisfy an applicable qualification requirement will result in the disqualification of the MEP for all employers maintaining the plan." Section 1.416- 1,

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[3] REG-121508-18, 7/3/19, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-14123.pdf?utm_source=federalregister.gov&utm_medium=email&utm_campaign=pi+subscription+mailing+list, retrieved July 2, 2019

[4] Executive Order 13847 (83 FR 45321 (Sept. 6, 2018)), 8/31/18

[5] REG-121508-18, 7/3/19, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-14123.pdf?utm_source=federalregister.gov&utm_medium=email&utm_campaign=pi+subscription+mailing+list, retrieved July 2, 2019, p. 6

> Q&A G-2, includes a similar rule relating to the qualification of a MEP, providing that a failure by a MEP to satisfy section 416 with respect to employees of one participating employer means that all participating employers in the MEP are maintaining a plan that is not a qualified plan.[6]

The preamble outlines the general structure of the relief that would be provided if the proposed regulations are adopted without change in final form:

> Under the proposed regulations, a defined contribution MEP would be eligible for the exception to the unified plan rule on account of certain qualification failures due to actions or inaction by a participating employer, if the conditions set forth in the proposed regulations are satisfied. The exception generally would be available if the participating employer in a MEP is responsible for a qualification failure that the employer is unable or unwilling to correct. It would also be available if the participating employer fails to comply with the section 413(c) plan administrator's request for information about a qualification failure that the section 413(c) plan administrator reasonably believes might exist. For the exception to the unified plan rule to apply, certain actions are required to be taken, including, in certain circumstances, a spinoff of the assets and account balances attributable to participants who are employees of such an employer to a separate plan and a termination of that plan.[7]

That is, the MEP would be able to kick out the uncooperative employer by moving the assets related to that employer and the accounts in question to a separate plan that would then be treated as terminated if, in fact, the employer refuses to cooperate and take necessary remedial actions.

That would create issues for the uncooperative employer and its employees, but it would preserve the qualified status of the MEP for the other employers who were not out of compliance.

The proposed regulations would add subsection (g) to Reg. §1.413-2 that would contain the rules for qualification of an MEP, as well as the steps to be taken to avoid the impact of the one bad apple rule. As well, the IRS has reserved guidance in two additional subsections added to Reg. §1.413-2 ((e) and (f)).

The regulations would apply on and after the date they are published in final form in the *Federal Register*. Taxpayer are ***not*** allowed to rely upon these rules prior their publication in final form (that is, the one bad apple rule will be in full force until such time).[8]

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[6] *Ibid,* p. 5

[7] *Ibid*, p. 8

[8] *Ibid*, p. 21

Note the SECURE Act, which was passed by the House in May but has not yet cleared the Senate, has its own similar provisions to remove the one bad apple rule for MEPs and create "pooled plans" to encourage wider adoption of qualified retirement plans by employers by reducing administrative costs.[9] If that bill eventually passes the Senate and is signed into law, presumably the IRS will adjust these proposed regulations as necessary to take into account the language in that bill.

SECTION: 1400Z-2
UPDATED FAQ PROVIDES RELIEF FOR TAXPAYERS WHO REINVESTED 2018 §1231 GAINS PRIOR TO DECEMBER 31, 2018

Citation: Opportunity Zones Frequently Asked Questions, IRS Website, 6/28/19

The IRS is back at modifying frequently asked questions (FAQ) on its website for TCJA related changes, this time related to the Qualified Opportunity Zone investments under IRC §1400Z-2. But unlike the significant additions made to the §199A FAQ just before the filing deadline for 2018 returns, this time the IRS added a single question and answer to its Opportunity Zones Frequently Asked Questions page.[10]

The second set of proposed regulations for Qualified Opportunity Zone funds published in the *Federal Register* on May 1[11] provides the following rule on the reinvestment of §1231 gains, specifically providing a rule for when the 180-day period begins that took some taxpayers by surprise:

> (iii) Gains from section 1231 property. The only gain arising from section 1231 property that is eligible for deferral under section 1400Z-2(a)(1) is capital gain net income for a taxable year. This net amount is determined by taking into account the capital gains and losses for a taxable year on all of the taxpayer's section 1231 property. <u>The 180-day period described in paragraph (b)(4) of this section with respect to any capital gain net income from section 1231 property for a taxable year begins on the last day of the taxable year.</u>[12]

Why the IRS did this is because the actual determination of whether a §1231 gain will be treated as a capital gain takes place at the end of year, taking into account all other §1231 transactions that took place during the year.[13]

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[9] SECURE Act, Section 101, as passed by the House of Representatives

[10] https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions, revision date June 28, 2019, retrieved July 2, 2019

[11] REG-120186-18; 84 F.R. 18652-18693; 2019-21 IRB 1193

[12] Prop. Reg. §1.1400Z2(a)-1(b)(2)(iii)

[13] IRC §1231(a)

EXAMPLE

Harry sells a rental property for a \$125,000 §1231 gain on January 10, 2018. On December 28, 2018 he sells a second rental property, incurring a \$200,000 §1231 loss.

To determine the nature of these gains and losses, Harry must combine all §1231 gains and losses. When Harry does that, he finds he has incurred a net §1231 loss of \$75,000 for the year. Per IRC §1231(a)(2), none of Harry's §1231 gains or losses for the year are treated as capital gains or losses.

This created issues for taxpayers who invested in qualified opportunity zone funds based on §1231 gains incurred in 2018, since they were not aware the 180-day period did not begin until December 31, 2018 for calendar year taxpayers.

In fact, such taxpayers who incurred a §1231 gain prior to July 1, 2018 likely believed they had to reinvest the gain in a qualified opportunity fund prior to December 31—if they had waited until December 31 or later to make the investment, they assumed they would have been investing after the end of the 180-day period.

In the FAQ updated on June 28, 2019 the IRS provided the following limited relief via a new question and answer added at the end of the document:

> Q: Before the last day of my 2018 tax year but during the 180-day period beginning with the realization of a section 1231 gain, I invested the amount of that section 1231 gain into a QOF. The amount that I invested was less than my 2018 net section 1231 gain. Can I make a valid deferral election based on that investment, even though proposed regulations say that the 180-day period for my net section 1231 gain began on December 31, 2018?
>
> A: Yes. Under these facts, because your tax year ended before May 1, 2019, your QOF investment can support a valid deferral election. Making that election will not impair your ability consistently to rely on all other aspects of proposed regulations published on May 1, 2019.[14]

That is, for tax years ending before the publication of the proposed regulations, the taxpayer may start the 180-day period on the date the §1231 transaction giving rise to the gain took place. Note that this will not necessarily save the investment for all taxpayers who may have rushed out to reinvest gains incurred early in 2018.

EXAMPLE

Assume Harry had rushed out to reinvest the \$125,000 gain he had incurred in early 2018, believing the 180-day period would end in July 2018. Since at the end of the year it was determined that Harry had a net §1231 loss, the amount he put into the

[14] https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions, revision date June 28, 2019, retrieved July 2, 2019

qualified opportunity fund (QOF) will not qualify for the special benefits provided for reinvested gains.

That not only means that Harry's $125,000 gain will offset the $200,000 loss, but also that he will not be eligible to treat the basis of the QOF as equal to the selling price if he holds the interest for more than ten years. Rather, the disposition will be taxed under the standard rules for sales of the interest in the type of entity that Harry invested in.

Advisers should remember that the IRS asked specifically for comments on the §1231 gain treatment, so the final regulations may revise the proposed treatment of §1231 gains.[15]

SECTION: 6052
FINAL REGULATIONS WILL PERMIT EMPLOYERS TO TRUNCATE SSNS ON W-2S PROVIDED TO EMPLOYEES BEGINNING WITH FORMS FOR 2020

Citation: TD 9861, 7/3/19

Beginning with the 2020 Forms W-2, employers will be allowed to issue Forms W-2 to employees with truncated social security numbers, though the copies sent to the social security administration will continue to have the employee's complete social security number on them. The IRS has issued final regulations on the issue, adopting with little change the proposed regulations previously issued on this topic.[16]

Under the revised regulations, described in the following paragraphs, an employer:

- May (but does not have to) use truncated SSNs on the employee's copies of Form W-2;
- May not truncate the employer's own EIN on the Forms W-2 given to employees; and
- May not truncate the employee's SSN on the copy of the W-2 filed with the Social Security Administration.

The preamble provides that the IRS has taken this step to aid in employers' efforts to protect their employees from identity theft.[17]

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[15] REG-120186-18, Preamble Explanation of Provisions, Section IV

[16] TD 9861, 7/3/19, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-11500.pdf?utm_source=federalregister.gov&utm_medium=email&utm_campaign=pi+subscription+mailing+list, retrieved July 2, 2019

[17] *Ibid*, p. 1

The guidance allows the use of truncated taxpayer identification numbers (TTIN) as described in the previously released Reg. §301.6109-4(a):

> An IRS truncated taxpayer identification number (TTIN) is an individual's social security number (SSN), IRS individual taxpayer identification number (ITIN), IRS adoption taxpayer identification number (ATIN), or IRS employer identification number (EIN) in which the first five digits of the nine-digit number are replaced with Xs or asterisks. The TTIN takes the same format of the identifying number it replaces, for example XXX-XX-1234 when replacing an SSN, or XX-XXX1234 when replacing an EIN.

Under Reg. §301.6109-4 use of such a number is voluntary and not mandatory, and use of an ITIN will not subject the taxpayer to a penalty for failure to provide a taxpayer identification number (TIN) on a required statement to the recipient.[18] However, a TTIN cannot be used in the following cases:

- If use of a TTIN is prohibited by statute, regulation or guidance found in the Internal Revenue Bulletin, IRS forms or instructions for the forms;
- Any statement or document if the law, regulations or other guidance (including forms and instructions) require the use of an SSN, ITIN, ATIN or EIN and the guidance does not state that an ITIN may be used;
- Any form required to be filed with the IRS or Social Security Administration (such as the IRS copy of Form 1099-INT); and
- The taxpayer cannot truncate his/her own TIN on any form he/she provides to another person (such as the EIN for the issuer of a Form 1099R).

The new regulations provide relief for those issuing W-2s to employees, providing "[a]n employer may truncate an employee's social security number to appear in the form of an IRS truncated taxpayer identification number (TTIN) on copies of Forms W-2 furnished to the employee."[19] A similar revision is made to Reg. §31.6051-1, Statements for employees and to Reg. §31.6051-3, Statements required in case of sick pay paid by third parties.

However, the employer must continue to provide the full social security number for employees on the Form W-2 sent to the Social Security Administration.[20]

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[18] Reg. §301.6109-4(b)(1)

[19] Reg. §1.6052-2(a)

[20] Reg. §31.6051-2(a)

The IRS provides the following example of the proper use of TTINs on Forms W-2:

EXAMPLE (REG. §301.6109-4(B)(3)(I))

Pursuant to section 6051(d) and §31.6051-2(a) of this chapter, Employer files the Social Security Administration copy of Employee's Form W-2, Wage and Tax Statement, with the Social Security Administration. Employer may not truncate any identifying number on the Social Security Administration copy. Pursuant to section 6051(a) and §31.6051-1(a)(1)(i) of this chapter, Employer furnishes copies of Forms W2 to Employee. There are no applicable statutes, regulations, other published guidance, forms, or instructions that prohibit use of a TTIN on Form W-2, and §31.6051-1(a)(1)(i) specifically permits truncating employees' SSNs. Accordingly, Employer may truncate Employee's SSN to appear in the form of a TTIN on copies of Forms W-2 furnished to Employee. Employer may not truncate its own EIN on copies of Forms W-2 furnished to Employee.

Generally these rules are effective for forms required to be filed or furnished after December 31, 2020.[21] The delayed effective will allow time for states to revise any requirements they might have to conform with this change—though employers will need to confirm when January 2021 rolls around that the states the employer files in will allow truncated ID numbers on W-2s issued to employees for state income tax purposes.

The additional time will also presumably allow most software vendors to build in support for printing TTINs on employee copies of Forms W-2 and, hopefully, handle printing full social security numbers on the employees' state copies for any states that have not moved to allow the use of TTINs by January of 2021.

[21] TD 9861, 7/3/19, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-11500.pdf?utm_source=federalregister.gov&utm_medium=email&utm_campaign=pi+subscription+mailing+list, retrieved July 2, 2019, p. 10

SECTION: 7701

IRS FINALIZES REGULATIONS THAT BAR PARNTERSHIPS FROM USING DISREGARDED ENTITIES TO TREAT PARTNERS AS EMPLOYEES

Citation: TD 9869, 6/28/19

The IRS has issued final regulations that bar partnerships from treating partners working for a disregarded entity owned by the partnership as employees.[22] The final regulations replace identical temporary regulations that were issued in May of 2016.[23]

Some partnerships had argued that since single member LLCs are treated as separate entities, and therefore "like" C corporations, for payroll tax purposes, partners of a partnership holding 100% of the interests in the LLC could be employees of the disregarded entity. By doing so, the partners could qualify for various tax benefits, such as tax favored benefits available to employees but not self-employed persons.

In Rev. Rul. 69-184 the IRS held that a partner of a partnership cannot be an employee of that partnership. This can create issues, since some partners may prefer to have taxes withheld from a regular paycheck, while others might want to avail him/herself of employee benefits such as participation in a cafeteria plan sponsored by the partnership.

The final regulations make clear that using a disregarded entity will not allow partners to end up on a payroll. Reg. §301.7701-2(c)(2)(iv)(C)(2) provides:

> (2) Paragraph (c)(2)(i) of this section applies to taxes imposed under subtitle A of the Code, including Chapter 2 — Tax on Self-Employment Income. Thus, an entity that is treated in the same manner as a sole proprietorship under paragraph (a) of this section is not treated as a corporation for purposes of employing its owner; instead, the entity is disregarded as an entity separate from its owner for this purpose and is not the employer of its owner. The owner will be subject to self-employment tax on self-employment income with respect to the entity's activities. Also, if a partnership is the owner of an entity that is disregarded as an entity separate from its owner for any purpose under this section, the entity is not treated as a corporation for purposes of employing a partner of the partnership that owns the entity; instead, the entity is disregarded as an entity separate from the partnership for this purpose and is not the employer of any partner of the partnership that owns the entity. A partner of a partnership that owns an entity that is disregarded as an entity separate from its owner for any purpose under this section is subject to the same self-employment tax rules as a partner of a partnership that does

[22] TD 9869, 6/28/19, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-14121.pdf retrieved June 29, 2019

[23] TD 9766, 5/4/16

> not own an entity that is disregarded as an entity separate from its owner for any purpose under this section.[24]

The IRS also notes in the preamble to the regulations that the agency discovered some taxpayers had interpreted a later effective date than the IRS feels is the proper interpretation of the effective date of the regulations. The preamble notes:

> The temporary regulations provided that their applicability date would be the later of August 1, 2016, or the first day of the latest-starting plan year following May 4, 2016 of an affected plan (based on the plans adopted before, and the plan years in effect as of, May 4, 2016) sponsored by an entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2. It has come to the attention of the Treasury Department and the IRS that some taxpayers may have read the applicability date to begin on the first day of the last plan year prior to the termination of an affected plan (as defined in §301.7701-2(e)(8)), which may have been a date after May 4, 2017. This is not a proper reading of the applicability date.
>
> In the case of an entity with several affected plans that may have different plan years, the applicability date was the first day of the plan year of the affected plan that had the latest plan year beginning after May 4, 2016, and on or before May 4, 2017 (assuming that date is after August 1, 2016). For example, an entity may have had two affected plans, with one plan year that began on September 1, 2016, and another plan year that began on January 1, 2017. In this case, the applicability date for this entity would have been January 1, 2017. The applicability date for any entity affected by these regulations should not have been delayed beyond May 4, 2017 in any case. For this reason, the final regulations clarify in §301.7701-2(e)(8) that the applicability date of §301.7701-2(c)(2)(iv)(C)(2) is the later of August 1, 2016, or the first day of the latest-starting plan year beginning after May 4, 2016, and on or before May 4, 2017, of an affected plan (based on the plans adopted before, and the plan years in effect as of, May 4, 2016) sponsored by an entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2.[25]

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[24] TD 9869, p. 7

[25] TD 9869, p. 5-6