Current Federal Tax Developments

Week of August 5, 2019

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ACCOUNTING
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SECTION: 61
IRS SENDS OUT 10,000 LETTERS TO VIRTUAL CURRENCY INVESTORS, SOME OF WHICH DEMAND A RESPONSE

Citation: IRS News Release IR-2019-132, 7/26/19

The IRS has announced a program to send letters to taxpayers it believes had virtual currency transactions which the taxpayers have failed to report on their tax returns.[1] The news release contains the following comments from the Commissioner:

> "Taxpayers should take these letters very seriously by reviewing their tax filings and when appropriate, amend past returns and pay back taxes, interest and penalties," said IRS Commissioner Chuck Rettig. "The IRS is expanding our efforts involving virtual currency, including increased use of data analytics. We are focused on enforcing the law and helping taxpayers fully understand and meet their obligations."

The news release indicates the IRS began sending these letters out the week before the news release came out (July 26, 2019) and more than 10,000 taxpayers will receive these letters. The release indicates the names were obtained via "various compliance efforts."

The release notes that affected individuals will receive one of three letters from the IRS.

Kay Bell on her blog "Don't Mess with Taxes" (https://www.dontmesswithtaxes.com/more-of-kays-copy.html) posted copies of the each of the three letters. The letters are:

- **Letter 6173**[2] – This letter indicates that the IRS believes it's likely that the taxpayer has failed to report cryptocurrency transaction, noting the agency hasn't received a federal tax return for one or more years from 2013-2017, or the returns they have appear to be missing a form or schedule the agency believes should be there. This letter tells the taxpayers they need to respond to the letter even if the taxpayer believes everything has been properly reported.

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[1] IR 2019-132, July 26, 2019, https://www.irs.gov/newsroom/irs-has-begun-sending-letters-to-virtual-currency-owners-advising-them-to-pay-back-taxes-file-amended-returns-part-of-agencys-larger-efforts, retrieved July 26, 2019

[2] https://dontmesswithtaxes.typepad.com/IRS%20Virtual%20Currency%20Letter%20l6173--2019-06-00.pdf, Retrieved July 26, 2019

- **Letter 6174**[3] – This letter indicates only that the IRS knows the taxpayer has one or more accounts containing cryptocurrency. It contains information about the reporting requirements and taxation of cryptocurrency and indicates if the taxpayer believes there is an error in prior returns or if returns should have been filed that have not yet been filed, the taxpayer should take corrective action.

- **Letter 6174-A**[4] – This is appears to be a letter sent to taxpayers where the IRS has some reason to believe there might be a failure to report transactions, but not enough reason to send the taxpayer the "required response" Letter 6173. This letter states the IRS states the IRS is aware the taxpayer has one or more cryptocurrency accounts (the same language as Letter 6174) but then goes to state the individual "may not have properly reported your transactions involving virtual currency" rather than just saying the taxpayer may not be aware of the reporting. But, like Letter 6174, Letter 6174-A provides information on proper reporting and taxation and then requests the taxpayer take corrective action if there are any issues.

The release continues with the following information about prior IRS guidance and activities underway at the IRS regarding virtual currencies:

> Last year the IRS announced a Virtual Currency Compliance campaign to address tax noncompliance related to the use of virtual currency through outreach and examinations of taxpayers. The IRS will remain actively engaged in addressing non-compliance related to virtual currency transactions through a variety of efforts, ranging from taxpayer education to audits to criminal investigations.
>
> Virtual currency is an ongoing focus area for IRS Criminal Investigation.
>
> IRS Notice 2014-21[5] states that virtual currency is property for federal tax purposes and provides guidance on how general federal tax principles apply to virtual currency transactions. Compliance efforts follow these general tax principles. The IRS will continue to consider and solicit taxpayer and practitioner feedback in education efforts and future guidance.

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[3] https://dontmesswithtaxes.typepad.com/IRS%20Virtual%20Currency%20Letter%20l6174--2019-06-00.pdf, Retrieved July 26, 2019

[4] https://dontmesswithtaxes.typepad.com/IRS%20Virtual%20Currency%20Letter%20l6174-a--2019-06-00.pdf, Retrieved July 26, 2019

[5] https://www.irs.gov/pub/irs-drop/n-14-21.pdf, Retrieved July 26, 2019

The IRS anticipates issuing additional legal guidance in this area in the near future.

Taxpayers who do not properly report the income tax consequences of virtual currency transactions are, when appropriate, liable for tax, penalties and interest. In some cases, taxpayers could be subject to criminal prosecution.

SECTION: 168
IRS ALLOWS FOR LATE CHANGE OF BONUS DEPRECIATION ELECTIONS FOR TAX YEARS CONTAINING SEPTEMBER 28, 2017

Citation: Revenue Procedure 2019-33, 7/31/19

The IRS has granted relief related to last minute decisions taxpayers had to make regarding bonus depreciation following the passage of the Tax Cuts and Jobs Act. For the tax year that contained September 28, 2017 (the first day the new 100% bonus depreciation applied), the IRS will allow taxpayers to make or revoke elections related the various bonus depreciation issues. The relief is provided in Revenue Procedure 2019-33.[6]

The affected elections are:

- Election to deduct additional first year depreciation on certain plants (IRC §168(k)(5));
- Election to not deduct additional first year depreciation for any particular class of qualified property placed in service during the year (IRC §168(k)(7)); and
- Election to allow the taxpayer, for certain qualified property, to elect to deduct 50-percent, rather than 100-percent, additional first year depreciation for the tax year that includes September 28, 2018 (§168(k)(10).[7]

The revenue procedure applies to taxpayers that:

- Acquired qualified property after September 27, 2017, and placed in service such property during the taxpayer's taxable year beginning in 2016 and ending on or after September 28, 2017 (2016 taxable year);

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[6] https://www.irs.gov/pub/irs-drop/rp-19-33.pdf, July 31, 2019, retrieved July 31, 2019

[7] *Ibid*, p. 1

- Acquired qualified property after September 27, 2017, and placed in service such property during the taxpayer's taxable year beginning in 2017 and ending on or after September 28, 2017 (2017 taxable year); or

- Planted or grafted a specified plant after September 27, 2017, and during the taxpayer's 2016 taxable year or 2017 taxable year.[8]

The ruling then takes a look at each specific election and the type of relief granted.

Bonus Depreciation on Qualified Plants Election Under §168(k)(5)

For taxpayers who had a specified plant that was planted or grafted after September 27, 2017 in a covered year, the procedure provides for the following relief:

- A taxpayer who did not follow the specific steps outlined in Rev. Proc. 2017-33 (the initial IRS guidance on electing bonus depreciation on qualified plants) will still be treated as having made a valid election to claim bonus depreciation on the plants if:

  - On the return the taxpayer claimed 100% bonus depreciation on the the plant or, if the taxpayer elected to use 50% bonus in lieu of 100% bonus by electing under IRC §168(k)(10), by claiming 50% bonus depreciation on the plant and

  - Does not revoke that election under this same revenue procedure.[9]

- If the taxpayer timely filed its tax return for the affected year, did not deduct either bonus depreciation amount on such plants and did not make the §168(k)(5) election to take bonus depreciation on such plants, the taxpayer may make a late election by *either*

  - Filing an amended return (or administrative adjustment request (AAR) for a partnership subject to the centralized partnership audit regime) for the affected year before filing a tax return for the subsequent year *or*

  - Filing a Form 3115, *Application for Change in Accounting Method*, with the taxpayer's timely filed tax return for the first, second or third year succeeding the affected year. The late election will be treated as a change of method solely during this period and a §481(a) adjustment will be available.[10]

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[8] *Ibid*, p. 7

[9] *Ibid*, p.8

[10] *Ibid*, p. 8-9

- If the taxpayer, on its timely filed tax return for the affected year, made the §168(k)(5) election under Revenue Procedure 2017-33, the taxpayer may revoke the election by *either*:

  – Filing an amended return (or administrative adjustment request (AAR) for a partnership subject to the centralized partnership audit regime) for the affected year before filing a tax return for the subsequent year *or*

  – Filing a Form 3115, *Application for Change in Accounting Method*, with the taxpayer's timely filed tax return for the first, second or third year succeeding the affected year. The late election will be treated as a change of method solely during this period and a §481(a) adjustment will be available.[11]

EXAMPLE

Late Election Made Via Amended Return

Angie Agriculture, Inc., an S corporation, did not make the §168(k)(5) election to claim bonus depreciation on qualified plants on its 2017 income tax return. Once it had time to review the proposed regulations, the corporation determined that it should have made the election.

As of July 31 (the date of the Revenue Procedure) Angie Agriculture had not yet filed its 2018 S corporation income tax return. Angie had filed for an extension of time to file its return for 2018. Angie prepares and amended S corporation return for 2017 to make this election following the revenue procedure and distributes amended K-1s to its shareholders for 2017. On the amended return it recalculates the depreciation to claim the 100% bonus depreciation.

EXAMPLE

Late Election as a Change in Accounting Method (Form 3115)

Assume the same facts except Angie Agriculture had filed its 2018 tax return on March 15, 2019. Since the return for the year following the affected year (2018) has already been filed, the time for amending the 2017 return has passed.

However, Angie Agriculture, Inc. will be allowed to make an automatic accounting method election change on its 2019 return. Assuming that Angie elects to use 100% bonus depreciation on the qualified plants from 2017, the adjusted basis of the plants as of the end of 2018 will be the §481(a) adjustment (change in taxable in in the prior years if the election had been made originally). Since the adjustment is negative (a reduction of income), the entire balance will be deductible on the 2019 return.

Angie Agriculture will be required to attach a Form 3115 to its 2019 return, as well as send a copy to the address provided in the instructions to the Form 3115. The corporation will also need to follow the steps outlined in Section 7 of this revenue procedure for obtaining the automatic consent to a change in method.

[11] *Ibid*, p. 10

Election Not to Deduct Additional First Year Depreciation Under §168(k)(7)

The procedures for making a late election not to claim additional first year depreciation under IRC §168(k)(7) has similar steps to allow a taxpayer to either make or revoke the election.

The revenue procedure applies to the treatment in the tax year of the taxpayer that includes September 28, 2017.

The following options are available to taxpayers:

- **Deemed Election** – If the taxpayer did not make the §168(k)(7) election to not claim bonus depreciation on a class of assets for the year that included September 30, 2017, the taxpayer will be treated as making the election if:
  - On the timely filed affected return the taxpayer did not claim the 100% bonus depreciation on the class of property;
  - Did not revoke a §168(k)(7) election for the class of property under this revenue procedure; and
  - Did not make the election under §168(k)(10) (option to claim the reduced 50% depreciation) for the affected year under this revenue procedure.[12]
- **Making a Late §168(k)(7) Election** – This option is available to taxpayers who timely filed its affected year return and who initially claimed the 100% bonus depreciation on affected property. Such taxpayers may make a late §168(k)(7) election to not claim the bonus depreciation by either:
  - Filing an amended return (or administrative adjustment request (AAR) for a partnership subject to the centralized partnership audit regime) for the affected year before filing a tax return for the subsequent year taking into account the removal of the bonus depreciation *or*
  - Filing a Form 3115, *Application for Change in Accounting Method*, with the taxpayer's timely filed tax return for the first, second or third year succeeding the affected year. The late election will be treated as a change of method solely during this period and a §481(a) adjustment will be available.[13]
- **Consent to Revoke a §168(k)(7) Election** - This option is available to taxpayers who timely filed its affected year return and who initially made the election to

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[12] *Ibid*, p. 12-13

[13] *Ibid*, p. 13

waive bonus depreciation on at least one class of property. The election may be revoked by either

- Filing an amended return (or administrative adjustment request (AAR) for want a partnership subject to the centralized partnership audit regime) for the affected year before filing a tax return for the subsequent year taking into account the removal of the bonus depreciation *or*

- Filing a Form 3115, *Application for Change in Accounting Method*, with the taxpayer's timely filed tax return for the first, second or third year succeeding the affected year. The late election will be treated as a change of method solely during this period and a §481(a) adjustment will be available.[14]

Election Under §168(k)(10) to Claim 50% Bonus Depreciation

The final category of relief available is for taxpayers who want to change the choice the entity made or failed to make with regard to electing to claim 50% bonus depreciation rather than the 100% bonus depreciation on property placed in service after September 27, 2017. Again, the affected year will be the taxpayer's tax year that includes September 28, 2017.

As with the prior two issues, the following options are available to qualified taxpayers:

- **Deemed Election** – If the taxpayer did not make the §168(k)(10) election to claim 50% bonus depreciation in lieu of 100% on qualified property for the year that included September 30, 2017, the taxpayer will be treated as making the election if:

  - On the timely filed affected return the taxpayer did claimed only 50% bonus depreciation on qualified property; and

  - Did not revoke a §168(k)(10) election under this revenue procedure.[15]

- **Making a Late §168(k)(10) Election** – This option is available to taxpayers who timely filed its affected year return and who initially claimed the 100% bonus depreciation on affected property. Such taxpayers may make a late §168(k)(10) election to reduce bonus depreciation to 50% on qualified property by either:

  - Filing an amended return (or administrative adjustment request (AAR) for a partnership subject to the centralized partnership audit regime) for the affected year before filing a tax return for the subsequent year taking into account the adjustment of the bonus depreciation *or*

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[14] *Ibid*, p. 14

[15] *Ibid,* p. 16

- Filing a Form 3115, *Application for Change in Accounting Method*, with the taxpayer's timely filed tax return for the first, second or third year succeeding the affected year. The late election will be treated as a change of method solely during this period and a §481(a) adjustment will be available.[16]

- **Consent to Revoke a §168(k)(10) Election** - This option is available to taxpayers who timely filed its affected year return and who initially made the election to reduce bonus depreciation on qualified property to 50%. The election may be revoked by either

  - Filing an amended return (or administrative adjustment request (AAR) for want a partnership subject to the centralized partnership audit regime) for the affected year before filing a tax return for the subsequent year taking into account the adjustment of the bonus depreciation *or*

  - Filing a Form 3115, *Application for Change in Accounting Method*, with the taxpayer's timely filed tax return for the first, second or third year succeeding the affected year. The late election will be treated as a change of method solely during this period and a §481(a) adjustment will be available.[17]

Change in Method of Accounting Procedures

The procedure concludes with information on the automatic accounting change procedures for those organizations who use that method of handling these election changes. The standard automatic change procedures found in Rev. Proc. 2015-13 that cover automatic changes will apply to changes under this procedure as well.[18]

A new automatic change, with a designated automatic accounting change number (DCN) of 241 is added by the procedure.[19] Taxpayers are directed to make all changes under this procedure using a single Form 3115 and provide a single combined net §481(a) adjustment for all of the changes.[20]

For this change, the following will *not* make the taxpayer ineligible to make an automatic change:

- The year of change would be the final year of the trade or business; and

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[16] *Ibid*, pp. 16-17

[17] *Ibid*, p. 14

[18] *Ibid*, p. 19

[19] *Ibid*, p. 19

[20] *Ibid*, p. 20

- The taxpayer had made a request or actually changed its method for the affected items in the prior five years.[21]

SECTION: 199A
DRAFT SCHEDULE K-1, FORM 1120S CONSOLIDATES §199A INFORMATION TO A SINGLE CODE FOR 2019

Citation: Draft Schedule K-1, Form 1120S, 7/25/19

Glen Birnbaum, CPA[22] posted on Twitter a note that the IRS's draft Form 1120S K-1 form for 2019 has reduced the number of codes for items related to §199A from 5 codes that existed on the 2018 form to just one for the current years.

The draft released by the IRS on July 25[23] has the following items listed for codes for line 17, other information:

V Section 199A information	
W through **Z**	Reserved for future use
AA Excess taxable income	
AB Excess business interest income	See the Shareholder's Instructions
AC Other information	

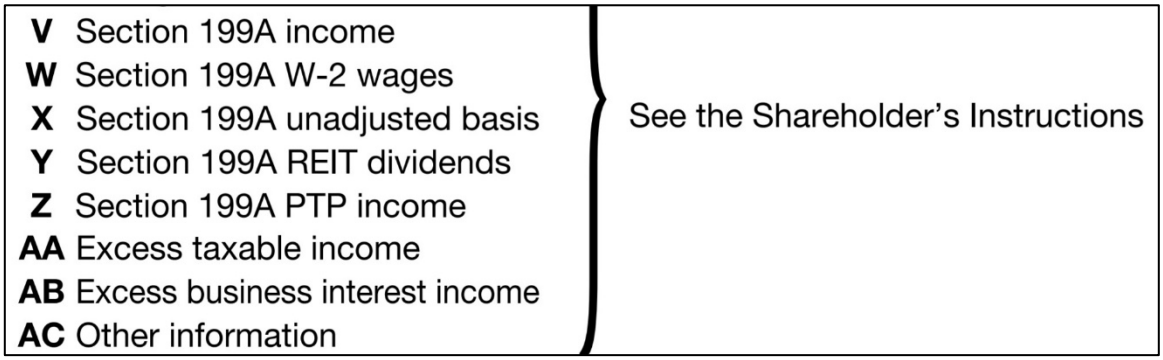
Note that code V refers not to a number, but rather to "information" related to the §199A deduction.

[21] *Ibid*

[22] https://twitter.com/GlenBirnbaum/status/1155821911756218368?s=20, July 29, 2019

[23] https://www.irs.gov/pub/irs-dft/f1120ssk--dft.pdf, July 25, 2019, retrieved July 29, 2019

The 2018 version[24] of the form referred to five specific pieces of information:



Why has the IRS decided to do this? Likely because the information that a relevant passthrough entity (RPE, which is the term used in the §199A regulations for partnerships, S corporations and trusts with §199A income that is being passed through on Schedule K-1) should be presenting on the information return often is far more than simply the five items listed on the 2018 set of codes.

In the article on the expansion of IRS's frequently asked questions posted here earlier in 2019,[25] the IRS provided the following guidance in question 28 that clearly required more information than could be provided if a K-1 only gave information for those five codes:

> A28. The pass-through entity is required to provide the owners QBI information necessary for the owner to compute the deduction. If the entity only has ordinary income from a single trade or business, it may be appropriate to reflect one QBI amount. Items from a pass-through entity are required to be separately stated due to the potential of unique treatment on one or more owners' returns. Items not included in current year taxable income are not included in QBI. Therefore, additional details will also need to be provided for the owners. If for example, in addition to ordinary income the owner is allocated a section 179 deduction, since the 179 deduction may be limited, the

[24] https://www.irs.gov/pub/irs-pdf/f1120ssk.pdf, retrieved July 29, 2019

[25] Ed Zollars, "IRS Greatly Expands Frequently Asked Questions for §199A on Website - And S Corporation Owners Aren't Going to Like the Final Answer," *Current Federal Tax Developments* website, April 20, 2019, https://www.currentfederaltaxdevelopments.com/blog/2019/4/20/irs-greatly-expands-frequently-asked-questions-for-199a-on-website-and-s-corporation-owners-arent-going-to-like-the-final-answer, retrieved July 29, 2019

> detail would be required in order for the owner properly to determine the current year QBI.[26]

The revised instructions for 2019 for the S corporation Schedule K-1 were not yet available at the time this article was written, but presumably they will require the S corporation to provide all necessary information for the shareholder to calculate the Section 199A qualified business income deduction.

EXAMPLE

Information for 2019 Form 1120-S Schedule K-1 Code V

SAB Enterprises, Inc. is an S corporation with a single shareholder. The corporation has a single trade or business. It has various items of qualified business income and deductions. The net qualified business income related to items not subject to shareholder level calculations (aside from basis and at risk limits) is $42,000.

The business of the corporation is not a specified service trade or business. The business had unadjusted basis of assets immediately after acquisition of $450,000 as of the end of the year, and it paid $140,000 of W-2 wages.

The corporation also has $14,000 of §179 expense claimed on the return that is related to qualified business income and paid health insurance premiums of $12,000[27] that were included in the shareholder's W-2 potentially allowable as a self-employed health insurance deduction and were deducted in calculating the $42,000 of QBI referred to above.

The corporation will provide the following information related to QBI on the K-1 for line 17 , code V:

The single qualified business of SAB Enterprises is not a specialized service trade or business.

Net QBI not including item subject to separate limitations at the shareholder level is $42,000. The $14,000 of §179 expense and the $12,000 of self-employed health insurance related to the shareholder are both expenses related to SAB trade or business and, to the extent the shareholder is determined to be able to deduct those items, will reduce QBI from SAB for the shareholder.

Allocable UBIA for the shareholder is $450,000 and the shareholder's allocation of W-2 wages is $140,000.

At the time this article was written the IRS has not yet released the draft Form 1065 Schedule K-1 for 2019, but it seems likely the same change will be made to that form along with the Schedule K-1 that will accompany Form 1041 for 2019.

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[26] https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs, Last reviewed or updated July 16, 2019, retrieved July 29, 2019, Answer 28

[27] Question 33 of the FAQ referred to above provided that the self-employed health insurance deduction in this case reduces QBI a second time if it is ultimately allowed as a deduction.

SECTION: 213
IRS ISSUES PLR HOLDING A PORTION OF DNA TEST KIT REPRESENTS DEDUCTIBLE MEDICAL EXPENSE

Citation: Private Letter Ruling to 23andMe, Issued by IRS on May 16, 2019, Released by 23andMe 7/22/19

The *Wall Street Journal* reported that genetic testing service 23andMe has received a private letter ruling from the IRS that allows a portion of the payment made to the entity to be treated as a medical expense.[28] A redacted copy of the ruling has been posted by the company on its website.[29] The *Wall Street Journal* article noted that the IRS will publish the standard redacted PLR in August.[30]

23andMe offers two different services to customers on its website:

- Ancestry Service – cost of $99 as of August 1, 2019
- Health + Ancestry Service – cost of $199 as of August 1, 2019.[31]

The ruling involves someone paying for a "health-and-ancestry" kit from the organization. Per the organization, in addition to ancestry information, the more expensive service provides information on health predispositions, wellness, carrier status and traits that are impacted by your DNA. As well, an individual cannot purchase just the health service, but always will have to include the ancestry service.[32]

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[28] Richard Rubin and Amy Dockser Marcus "IRS Greenlights Tax Breaks for Buyers of 23andMe Genetic Tests," *Wall Street Journal* online, July 22, 2019, https://www.wsj.com/articles/irs-greenlights-tax-breaks-for-buyers-of-23andme-genetic-tests-11563800520, retrieved August 1, 2019 (subscription required)

[29] https://permalinks.23andme.com/pdf/IRS_PLR132576_18.pdf, retrieved August 1, 2019

[30] Richard Rubin and Amy Dockser Marcus "IRS Greenlights Tax Breaks for Buyers of 23andMe Genetic Tests," *Wall Street Journal* online, July 22, 2019, https://www.wsj.com/articles/irs-greenlights-tax-breaks-for-buyers-of-23andme-genetic-tests-11563800520, retrieved August 1, 2019 (subscription required)

[31] https://www.23andme.com/, retrieved August 1, 2019

[32] https://www.23andme.com/dna-health-ancestry/, retrieved August 1, 2019

The ruling immediately begins by noting that the taxpayer was not asking for a ruling on the treatment of the ancestry service as a medical expense for federal tax purposes.[33] Rather, the ruling being sought deals with two issues:

- Are some or all of the additional services provided through the "health + ancestry service" medical expenses for purposes of IRC §213(d)(1)(A) and subject to reimbursement from a healthcare flexible spending account? And

- If a portion of the health + ancestry service qualifies as medical expense for federal tax purposes, what portion of the fee would be allowed as a deduction?

The ruling concludes that a portion of the health + ancestry service does constitute medical expenses for federal tax purposes under IRC §213(d)(1)(A). The IRS notes that Revenue Ruling 71-282 provides that the fee paid for storage of medical information in a computer bank qualified as a deductible medical expense, and that Revenue Ruling 2007-72 found that diagnosis (one of the items that qualifies for a medical deduction) includes cases where an individual, without a recommendation from a physician, has diagnostic tests such as a full body scan performed. The ruling finds that some of the services provided are similar to those discussed in those rulings.[34]

But the fact that some of the services are medical services does not allow a deduction for the entire cost of the package. The ruling notes that the ancestry services are clearly not medical expense items. Citing Revenue Ruling 51-457, the IRS holds that when a lump-sum is charged that encompasses medical and non-medical services, the cost must be allocated between medical items with qualify under IRC §213 and non-medical expenses that do not.[35]

The ruling holds that a taxpayer that only purchases the ancestry service has not incurred a §213 medical expense and cannot claim any of the cost on Schedule nor be reimbursed from a healthcare FSA for any of the cost. However, if the taxpayer purchases the ancestry + health service, then the price of the kit must be allocated between the two categories. The deductible percentage is computed as follows:

$$\frac{\text{Cost of Health Services}}{\text{Total Cost of Ancestry + Health Services}}$$ [36]

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[33] https://permalinks.23andme.com/pdf/IRS_PLR132576_18.pdf, p. 1

[34] *Ibid*, pp. 2-3

[35] *Ibid*, p. 2

[36] *Ibid*, p. 3

Of course, that begs the question of how a taxpayer is supposed to come up with the cost of health services to enter into that equation. The ruling provides the following:

> As to the health services, the taxpayer may use a reasonable method to value and allocate the cost of the health services between services that are medical care (such as the testing at the laboratory) and non-medical services or items (such as the reports that provide general information on a test result).[37]

The company is offering up its view of what is a reasonable allocation per the *Wall Street Journal* article. The article indicate 23andMe states that customers can claim "up to $117.74" of the $199 cost of the ancestry + health service as medical care. The article quotes Jacquie Haggarty, the company's deputy legal counsel, as stating that any 2019 purchases should be eligible expenses.[38] Those same figures are cited by the company on its blog article about the IRS ruling, along with a link to a calculator for those purchasing an upgrade service or other special cases.[39]

Of course, those number are not part of the ruling, so it remains to be seen if the IRS questions that allocation on exam. And, as well, a private letter ruling only applies directly to the party that requested it. But with those caveats in mind, private letter rulings are regularly requested to get an IRS ruling on an issue the agency has not yet addressed and IRS agents generally will respect the ruling unless the agency has indicated it has revoked the ruling or issues contrary guidance.

Similarly, while the IRS could question the allocation of expenses on Schedule A, it is likely most agents will accept that allocation. Getting an administrator of an FSA to accept the allocation may prove more difficult in some cases—cautious administrators may balk at the split without additional data to back up that division or even not want to trust a single private letter ruling (especially one that, at the date this was written, has not made its way onto the IRS's publicly released rulings on their website).

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[37] *Ibid*

[38] Richard Rubin and Amy Dockser Marcus "IRS Greenlights Tax Breaks for Buyers of 23andMe Genetic Tests," *Wall Street Journal* online, July 22, 2019, https://www.wsj.com/articles/irs-greenlights-tax-breaks-for-buyers-of-23andme-genetic-tests-11563800520, retrieved August 1, 2019 (subscription required)

[39] "A Predisposition to Save on 23andMe Health + Ancestry Service," 23andMeBlog, July 22, 2019, https://blog.23andme.com/health-traits/a-predisposition-to-save-on-23andme-health-ancestry-service/

SECTION: 501
ORGANIZATION OPERATED FOR SIGNIFICANT PURPOSE TO BENEFIT FOR PROFIT BUSINESS, EXEMPT STATUS RETROACTIVELY LOST

Citation: Giving Hearts, Inc. v. Commissioner, TC Memo 2019-94, 7/29/19

To retain status as a §501(c)(3) charitable organization, an entity must not only have been organized for charitable purposes (a requirement for initial qualification), it must also be operated exclusively for charitable purposes in order to retain that status. A failure on the second test caused the organization in the case of *Giving Hearts, Inc. v. Commissioner*, TC Memo 2019-94[40] to retroactively have its status revoked by the IRS.

The case involves an attempt by a business that was negatively impacted by the National Do Not Call Registry, a program conducted jointly by the Federal Trade Commission and the Federal Communications Commission, to blunt the impact of that program. The business, Windows Plus, relied primarily upon telemarketing calls to sell replacement windows and other home improvement services to homeowners.[41]

The Do Not Call Registry barred businesses from making unsolicited calls to any number an individual placed upon that list. Not surprisingly, a large portion of numbers on the lists that Windows Plus used to generate leads through unsolicited calls quickly end up on that list. Windows Plus eventually reduced its telemarketing staff to one half the size it had been before the registry came into existence over the next few years.[42]

Ronald Carrier, a shareholder of Windows Plus, came up with a method he felt would allow the company to work around the National Do Not Call Registry. The restrictions on calling phone numbers on the list did not apply to charitable organizations seeking to raise money. Mr. Carrier decided that he could combine phone calls on behalf of a charitable organization with a method to enable him to generate sales leads for Windows Plus.[43]

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[40] https://www.ustaxcourt.gov/USTCInOP/OpinionViewer.aspx?ID=12008, July 29, 2019, retrieved July 30, 2019

[41] *Ibid*, p. 2-4

[42] *Ibid*, p. 3

[43] *Ibid*, p. 3-4

Giving Hearts, Inc. was established to be the charity that would enable this program to proceed. The organization applied for an application for exemption from taxation, filing Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, with the IRS. The IRS subsequently granted the application for exemption, effective December 21, 2009.[44] Its exempt purpose was to collect money and disburse it to charitable organizations. For 2010-2016 it did collect contributions of $1,102 to $8,334 each year, and the overwhelming majority of those funds went to charitable organizations.[45]

Mr. Carrier set up a corporate sponsorship program that Giving Hearts would be a part of.[46] Ultimately, while Mr. Carrier attempted to get other businesses to participate, Windows Plus was the only business that actually entered into a corporate sponsorship program with Giving Hearts, Inc.[47]

Windows Plus agreed to have its telemarketing staff make calls on behalf of Giving Hearts, Inc. They solicited donations using the following script:

> Hello * * * this is _____ calling on behalf of Giving Hearts. We are a non-profit organization helping to fund local children's charities. We have sponsored the Window Plus company for the purpose of fund raising. For every home owner that accepts a product demonstration and free estimate our charity [Giving Heart] will receive a donation from Window Plus. * * *
>
> Well, for a limited time Window Plus is offering a onetime special offer of 30% off their triple-pane insulated replacement window which is guaranteed in writing to save a minimum of 40% on your annual heating cost. * * *
>
> Not only will you be helping a charity receive a donation, you'll also be getting the right advice and the right price on energy efficient products that will help save the planet while saving money off your ever increasing monthly utility bills. A Window Plus representative will leave you with a free estimate that is good for one full year. Please understand that you are under no obligation to purchase anything. They just want to show you their products and get you that free estimate so in the future if you decide to replace any windows, you'll

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[44] *Ibid*, p. 4

[45] *Ibid*, p. 9

[46] *Ibid*, p. 5

[47] *Ibid,* p. 8

> get back in touch with them. So, with this in mind, I will have the representative stop by DAY and TIME.[48]

Note that the charitable organization only received funds from Windows Plus if the person being called agreed to have an in-home demonstration and sales pitch.

A number of the recipients of the phone solicitations appear to not take kindly to being called. The Michigan attorney general's office contacted the IRS in December 2011, indicating it received a number of complaints that Giving Hearts was operating as "a front for a window sales operation." In April 2012 the IRS contacted Giving Hearts, indicating that it was starting an examination to look at the organization's exempt status.[49]

The IRS concluded at the end of the exam that the exempt status should be revoked since the organization had not been operated exclusively for exempt purposes, as required under IRC §501(c)(3) and Reg. §1.501(c)(3)-1. Rather, it was operated for substantial private and commercial purposes.[50]

The Tax Court agreed with Giving Hearts that it operated in part to further a charitable purpose, and that the IRC does not bar a charity from using a for profit organization to solicit contributions. But the Court notes that the law requires more than this.

Rather, IRC §501(c)(3) provides (note the highlighted section):

> (3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office. (emphasis added)

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[48] *Ibid*, p. 7

[49] *Ibid*, p. 5

[50] *Ibid*, p. 9

Reg §1.501(c)(1)-1(c)(1) goes on to give more details about operating exclusively for a charitable purpose:

> (c) Operational test — (1) Primary activities. — An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. (emphasis added)

The Tax Court notes that there was clearly a second purpose to this call operation beyond simply soliciting contributions:

> Petitioner's corporate sponsorship agreement, by design and in effect, permits for-profit businesses (such as Window Plus) to invoke its name as part of a telemarketing pitch intended, first and foremost, to generate sales leads and revenues. In other words, although telemarketing calls are ostensibly made on petitioner's behalf, the real purpose of the calls is business promotion. As the corporate sponsorship agreement and the telemarketing pitch make clear, see supra ap. 6-7, a participating business would be obliged to make a charitable contribution to petitioner only when a potential customer agreed to an in-home product demonstration. Considering all of the facts and circumstances, the Court concludes that petitioner was primarily engaged in generating sales leads (and ultimately revenues) to advance a commercial enterprise, with charitable donations arising only as a function of the businesses' success in securing in-home product demonstrations and presenting project estimates to potential customers.[51]

Generating sales leads for a for profit company is not an exempt purpose and it is not substantially related to any exempt purpose per the Court.[52]

The Court also dismisses the organization's complaint that they meant for other businesses to participate and that the investigation by the Michigan attorney general and referral to the IRS is why only their controlled businesses benefited. The problem in this case was not that a related business was the only one that benefitted.

Rather the Court noted that "whether other for-profit enterprises participated in petitioner's corporate sponsorship program would not alter the fact that petitioner was

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[51] *Ibid*, p. 13

[52] *Ibid*

not operated exclusively for one or more exempt purposes as discussed herein."[53] That is, even if Windows Plus had not participated at all in this program, and only wholly unrelated businesses had taken part, Giving Hearts would still have faced the loss of its exemption.

[53] *Ibid*, p. 14