Current Federal Tax Developments

Week of September 9, 2019

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SECTION: 199A
DRAFT INSTRUCTIONS TO 2019 FORM 8995 CONTAIN MORE INFORMAL IRS GUIDANCE ON COMPUTING QBI

Citation: Draft Instructions to 2019 Form 8995, Qualified Business Income Deduction Simplified Computation, 8/29/19

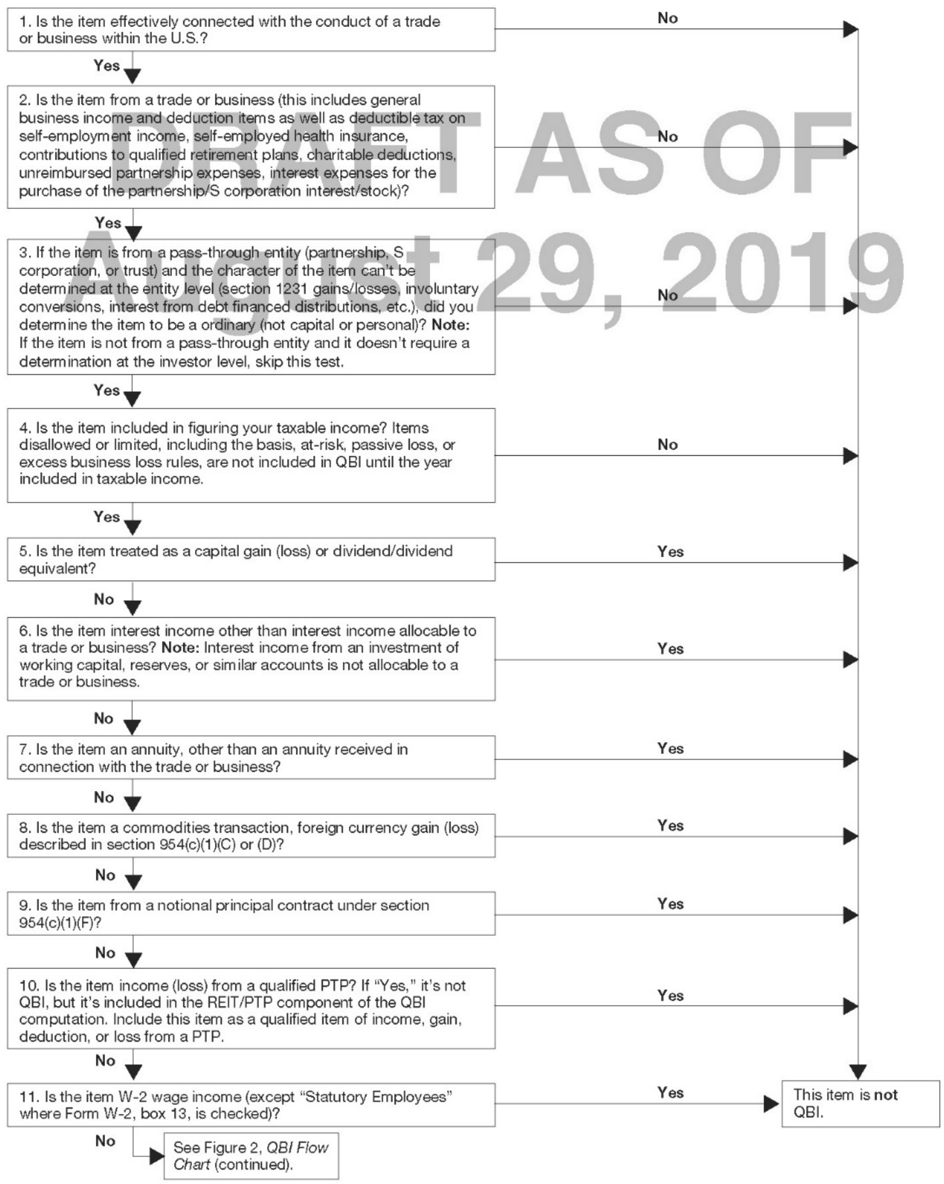
The IRS has released a draft of the instructions for the 2019 Form 8995, *Qualified Business Income Deduction Simplified Computation*.[1] The instructions contain some additional information about items that are/are not considered part of QBI, at least in the of the IRS authors of the forms.

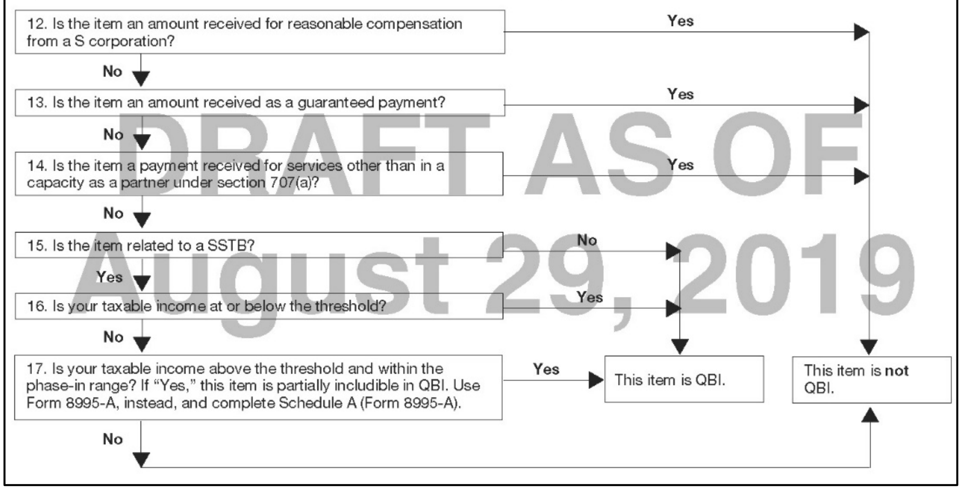
[1] https://www.irs.gov/pub/irs-dft/i8995--dft.pdf, August 29, 2019, retrieved August 30, 2019

One key addition is a 2-page, 17 step flowchart to compute QBI on pages 4 and 5.

QBI Flow Chart

Figure 1. **Use this chart to determine if an item of income, gain, deduction or loss is included in QBI.**





QBI Flow Chart *(continued)*
Figure 2. **Use this chart to help you determine if an item of income, gain, deduction or loss is included in QBI.**

The instructions also contain additional information that may clarify the agency's position on certain deductions. For instance, the instructions contain the following details on items to be included in computing QBI:

> **Determining Your Qualified Business Income**
>
> Your QBI includes items of income, gain, deduction, and loss from your trades or businesses that are effectively connected with the conduct of a trade or business in the U.S. This includes income from partnerships (other than PTPs), S corporations, sole proprietorships, certain estates and trusts that are included or allowed in figuring your taxable income for the year. To figure the total amount of QBI, the taxpayer must consider all items that are related to the trade or business. <u>This includes, but not limited to, charitable contributions, unreimbursed partnership expenses, business interest expense,</u> deductible part of self-employment tax, self-employment health insurance deduction, and contributions to qualified retirement plans.[2]

The inclusion of charitable contributions had been a matter of speculation, but the instructions would indicate that a charitable contribution made on behalf of a business would reduce qualified business income, even though it is not a deduction under IRC §162.

As well, box 2 of the flowchart explicitly states that interest expense paid by a taxpayer for the purchase of a partnership interest or S corporation stock would impact QBI,

[2] *Ibid*, p. 2

presumably to the extent that the partnership or S corporation has a §162 trade or business and therefore is creating QBI.[3]

The instructions also explicitly provide that a failure of a rental undertaking to meet the safe harbor found in Notice 2017-09 does *not* mean the rental may not otherwise be a §162 trade or business for purposes of §199A.

> The ownership and rental of real property may constitute a trade or business if it meets the standard described above. Also, Notice 2019-07 provides a safe harbor under which a rental real estate enterprise will be treated as a trade or business for purposes of the QBI deduction. Rental real estate that doesn't meet the requirements of the safe harbor may still be treated as a trade or business for purposes of the QBI deduction if it's a section 162 trade or business.[4]

The instructions also contain the reminder that an item does not impact QBI until it is included in computing taxable income:

> **Note.** Your QBI doesn't include any losses or deductions disallowed under the basis, at-risk, passive loss, or section 461(l), excess business loss rules as losses limited or suspended under these rules aren't included in determining your taxable income for the year. These losses are taken into account in the tax year they are included in determining your taxable income.[5]

The draft instructions also contain a hint about what the instructions to passthrough entities will require to be included with K-1s in 2019. In July the IRS released a draft Form 1120S Schedule K-1 that contained only a single code for §199A information for 2019, down from the four codes that reported single numbers on 2018 K-1s.[6]

While the instructions for that form are not yet available, the Form 8995 instructions indicate some of what those instructions will require of passthrough entities to be provided to those receiving K-1s:

> **Determining if items included on Schedule K-1 are included in QBI.** The amounts reported on your Schedule K-1 as "QBI/Qualified PTP Items Subject to Taxpayer-Specific Determinations" from a

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[3] *Ibid*, p. 4

[4] *Ibid*, p. 1

[5] *Ibid*, p. 2

[6] Ed Zollars, "Draft Schedule K-1, Form 1120S Consolidates §199A Information to a Single Code for 2019," *Current Federal Tax Developments* website, July 29, 2019, retrieved August 30, 2019

partnership, S corporation, estate, or trust aren't automatically included in your QBI. To figure if the item of income, gain, deduction, or loss is included in QBI you must look to how it's reported on your federal income tax return. For example, ordinary business income or loss is generally included in QBI if it was used in computing your taxable income, not excluded, suspended, or disallowed under any other section of the Code. Also, a section 1231 gain or loss is only includible in QBI if it is not capital gain or loss. See the QBI Flow Chart, below to figure if an item of income, gain, deduction, or loss is included in QBI.[7]

SECTION: 404 MEMORANDUM OUTLINES WHAT THE IRS SEES AS BEING REQUIRED TO HAVE A DEDUCTIBLE PAYMENT TO A QUALIFIED RETIREMENT PLAN

Citation: CCA 201935011, 8/30/19

In Chief Counsel Advice 201935011,[8] the IRS discusses when a contribution other than cash to a qualified retirement plan has been paid to determine if the contribution is deductible under IRC §404(a).

The term "payment" or "paid" is referenced multiple times in IRC §404(a) regarding what would constitute a deductible contribution to a qualified retirement plan. The memo notes that the U.S. Supreme Court had addressed this matter in the 1977 case of *Don E. Williams v. Commissioner,* 429 US 569.[9] In that case, the plan sponsor had delivered to the plan an interest-bearing promissory note before the due date for a contribution to be made but did not pay off that note until after that date.

The Supreme Court in that case settled a division among the Circuit Courts of Appeal, finding that the issuance of a promissory note to the plan was not an amount "paid" to the plan and, as such, no deduction was allowed if the balance was not paid before the extended due date, regardless of whether the taxpayer was on the accrual or cash basis.[10]

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[7] https://www.irs.gov/pub/irs-dft/i8995--dft.pdf, August 29, 2019, pp. 2-3

[8] CCA 201935011, August 30, 2019, https://www.irs.gov/pub/irs-wd/201935011.pdf, retrieved September 1, 2019

[9] https://supreme.justia.com/cases/federal/us/429/569/, retrieved September 1, 2019

[10] *Williams*, 429 U.S. at 582-583

The IRS seeks in this memo to clarify what types of transactions do and do not meet the standard outlined in the *Williams* case. Specifically, the ruling provides:

> For a contribution by an employer to the trust of a qualified retirement plan maintained by the employer to be deductible under § 404(a) for the employer's taxable year in which the contribution is made, the contribution must be a payment of cash (or its equivalent) or property to the trust.[11]

With regard to whether a payment has been made in the equivalent of cash, the memorandum concludes:

> Whether a contribution is paid for purposes of § 404(a) is determined under the objective outlay-of-assets test set forth in *Don E. Williams*. The employer must experience an outlay of, or reduction in, its assets when the contribution is made. Moreover, the trust must receive the full advantage of the contribution (and thus there must be no retention by the employer of significant control over the contributed asset or imposition of a significant encumbrance on the trustee's ability to dispose of the asset). Whether these elements are satisfied depends on the facts and circumstances of the particular contribution.[12]

In support of this position, the CCA looks at the *Williams* case and the later Tax Court case of *Reed Smith Shaw & McClay v. Commissioner*, T.C.M.1998-64 (1998). The memo states:

> The objective outlay-of-assets test includes a requirement that, as a result of the contribution for which it claims a deduction under § 404(a), an employer must experience an outlay of, or reduction in, its assets and the trust must receive the full advantage of the contribution. A promise to pay, even if secured and certificated, is not payment for purposes of § 404(a) if there is no outlay of cash or property by the employer.[13]

The memorandum goes on to note that not only must assets be transferred, but the plan must also have full control of those assets:

> In addition, *Don E. Williams* and later decisions highlight the relevance of control over the asset following its contribution as a factor in determining whether a contribution satisfies the objective outlay-of-

[11] CCA 201935011, p. 2

[12] *Ibid*

[13] *Ibid*, p. 6

> assets test. Thus, the degree of control or influence retained by an employer over the contribution is an important element of the objective outlay-of-assets test, as is the degree of encumbrance on the asset restricting the trustee's flexibility to use it to best fit the needs of the plan. These elements of the objective outlay-of-assets test apply in order to determine whether the trust has received the full advantage of the contribution at the time the contribution is made. An employer who retains significant control over the contributed asset has not actually made a payment to the trust, because no amount is “irrevocably set aside” for the plan.[14]

The memo also finds that an encumbrance on the asset also prevents the transfer of the asset from being a payment:

> Similarly, the degree of encumbrance on the contributed asset is evidence of the extent to which the trustee has the ability to use the asset in a way that best meets the plan's needs, taking into account the nature of the asset. A trustee's ability to liquidate a trust asset is necessary for a qualified trust to be able to pay benefits; for example, if contributed property cannot be sold on account of restrictions placed by the employer, then the trust may not have the liquidity necessary to pay participant benefits in a timely manner. This danger is avoided if the contributed property is not significantly encumbered. As the Supreme Court has noted, “the apparent policy behind the statutory provision [is to] insure the integrity of the employees' plan and insure the full advantage of any contribution which entitles the employer to a tax benefit.” *Don E. Williams*, 429 U.S. at 579.[15]

The memo derives a two-factor test to determine if a transfer represents a payment to the plan allowing for a deduction. The memo finds that the outlay-of-assets test from the *Williams* case requires:

- An outlay of, or reduction in, the employer’s assets and
- That the trust is entitled to full advantage of such assets.[16]

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[14] *Ibid*

[15] *Ibid*

[16] *Ibid*. p. 7

The memo concludes with a number of illustrations of the application of each of the tests. The memo provides the following illustrations related to the outlay-of-assets first test, which is based on facts and circumstances:

> Employer's promissory note. An employer contributes its own promissory note to the plan obligating the employer to pay cash (or its equivalent) or property to the trust at a later date. The contribution is not deductible as an actual payment under § 404(a) regardless of whether the note is secured or transferable, because the note's contribution is not an outlay of, or reduction in, the employer's assets.10
>
> Employer debt. An employer contributes its own publicly traded debt to the plan. The contribution of the debt instrument is essentially the same as the contribution of a promissory note because the debt instrument reflects the employer's promise to make payments to the instrument's owner at a later date and thus is not an outlay of, or reduction in, the employer's assets. Similarly, the contribution by the employer of debt of a member of its controlled group (within the meaning of § 414(b), (c) or (m)) is not an outlay of, or reduction in, the employer's assets.
>
> Book entry. An employer's designation of its liability for a plan contribution as a debit on its books and an accrual on the books of the plan, without a corresponding transfer of assets to the plan, is not an actual payment of the contribution, because the book entry, by itself, is not an outlay of, or reduction in, the employer's assets.
>
> Treatment of contributed asset as an asset of the employer for accounting purposes. An employer's continued treatment for purposes of its financial statements of an asset contributed to the qualified trust as an asset of the employer, or its inability otherwise to treat the asset solely as an asset of the plan, is a factor to be taken into account in determining whether there is an outlay of, or reduction in, the employer's assets.[17]

The memo continues with the following illustrations of issues to be considered when determining if the trust is entitled to take full advantage of the assets:

> Asset inaccessible. A trustee's inability to access a contributed asset (including an asset that is cash or otherwise unencumbered) indicates the trust has not received the full advantage of the contribution, because the trustee's use of the asset is significantly encumbered for as

[17] *Ibid*, pp. 7-8

long as the asset continues to be inaccessible following its contribution. The asset may be inaccessible, for example, if the cash or property is placed in escrow; the asset is available first to other creditors of the employer; or the property is not transferrable for a number of years or without the prior approval of the employer.

Employer option to repurchase property (call option). A contribution of property (such as shares of employer stock, whether or not publicly traded) that includes an employer option to repurchase the property at the employer's discretion, or for a set number of years following the contribution, is a factor to be taken into account in determining whether the employer has retained significant control over the asset, even if the repurchase price is to be determined by an independent fiduciary or is set to be equal to or exceed the asset's fair market value.

Option to require employer to repurchase contributed property (put option). A contribution of property (such as shares of employer stock, whether or not publicly traded) subject to a put option requiring the employer to repurchase the contributed property is a factor to be taken into account in determining whether the trust has received the full advantage of the contribution (for example, if the asset is significantly encumbered because the trustee cannot exercise the put option without the employer's consent or for a set number of years following the contribution). This may be true even if the asset subject to the put option is to be sold at a price equal to or exceeding its fair market value. Similarly, a put option that includes a right for the employer to delay the settlement date for a significant period of time is a factor to be taken into account in determining whether the trust has received the full advantage of the contribution on account of the employer's retaining significant control over the asset.

Other restrictions on trustee's ability to transfer the asset. Other restrictions on the trustee's ability to transfer or optimize the use of the contributed asset are also factors to be taken into account in determining whether the trust has received the full advantage of the contribution (because the employer has retained significant control over the asset or the trustee's use of the asset is significantly encumbered). Examples of other restrictions include a prohibition on the trustee's transferring the contributed asset to a third party or the trustee's pledging the asset as security for a loan.[18]

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[18] *Ibid*, pp. 8-9

SECTION: 446
IRS GRANTS RELIEF TO ALLOW LATE FILING OF COPY OF FORM 3115 FOR ACCOUNTING METHOD CHANGE-BUT AT A COST

Citation: PLR 201935002, 8/30/19

Filing a Form 3115 to request an automatic change of accounting methods is something almost every CPA eventually has to do, but it's also an rather unusual process that isn't like a normal tax return filing. Not surprisingly, this is just the sort of thing where steps get missed by accident—resulting in the taxpayer failing to obtain the required permission to change its accounting method, a failure that can be both costly to the client and embarrassing to the CPA firm.

PLR 201935002[19] reminds us that the problem can be corrected—but also that the way to do so requires the formal process of requesting a private letter ruling and the user fee related to the application (currently set at $11,800 per Appendix A(3)(ii) of Revenue Procedure 2019-01).

In this case the taxpayer was asking for a change of accounting method that was available under the automatic change procedures found in Revenue Procedure 2018-31, changing its method for accounting for prepaid liabilities under Section 11.05 of that procedure.[20]

When such a request for an automatic change of accounting method is filed, the taxpayer submits the original Form 3115 with the tax return for the year of change and, at the same time, mails a copy of the signed Form 3115 to the designated IRS office (in Covington, KY at the time this change was requested).[21]

What happened is described in the ruling as follows:

> Taxpayer engaged A, a certified public accounting firm, to prepare and file its federal tax return and Form 3115 for the taxable year ending Date2. Taxpayer, with the assistance of A, electronically filed its Form 1120, U.S. Corporation Income Tax Return (with original Form 3115 application attached), for the taxable year ended Date2. However, because of unusual circumstances and administrative oversight, the

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[19] https://www.irs.gov/pub/irs-wd/201935002.pdf, August 30, 2019, retrieved August 30, 2019

[20] *Ibid*, p. 2

[21] *Ibid*

> copy of the signed Form 3115 was not mailed to the IRS Covington, KY office.[22]

Such a failure to follow the procedures results in the loss of the automatic permission to change accounting methods. Under IRC §446(e), a taxpayer must have the IRS's permission to change its accounting method, so without that permission the taxpayer would have to continue to use its prior method—meaning the current year's return is in error with additional tax due on the return since the taxpayer was barred from using the method the taxpayer actually used.

So now the taxpayer looks to get permission to make a late election under the relief provisions found in Reg. §301.9100-3. That rule provides:

> **(a)In general.** Requests for extensions of time for regulatory elections that do not meet the requirements of § 301.9100-2 must be made under the rules of this section. Requests for relief subject to this section will be granted when the taxpayer provides the evidence (including affidavits described in paragraph (e) of this section) to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government.

One key limitation is that this only works for *regulatory elections*, which are elections where the date to make the election is set by the IRS and not by Congress writing a date into the IRC. But the automatic accounting change election is governed by dates set by the IRS, so it qualifies for this relief. In this case, the date is set by Reg. §1.263(a)-5(f).[23]

The IRS also generally accepts that a mistake by the tax adviser will meet the good faith requirements. Example 2 found in Reg. §301.9100-3(f) specifically deals with a situation very close to the one faced by this taxpayer:

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[22] *Ibid*

[23] *Ibid*, p. 4

EXAMPLE 2, REG. §301.9100-3(F)

Reliance on Qualified Tax Professional

Taxpayer B hires a qualified tax professional to advise B on preparing B's 1997 income tax return. The professional was competent to render advice on the election and B provided the professional with all the relevant facts. The professional fails to advise B that a regulatory election is necessary in order for B to report income on B's 1997 return in a particular manner. Nevertheless, B reports this income in a manner that is consistent with having made the election. In 2000, during the examination of the 1997 return by the IRS, the examining agent discovers that the election has not been filed. B promptly files for relief in accordance with this section, including attaching an affidavit from B's professional stating that the professional failed to advise B that the election was necessary. Assume paragraphs (b)(3) (i) through (iii) of this section do not apply. Under paragraph (b)(1)(v) of this section, B is deemed to have acted reasonably and in good faith because B reasonably relied on a qualified tax professional and the tax professional failed to advise B to make the election.

The error was discovered after the return was filed. Once the error was discovered, the CPA notified the taxpayer and the process was started to request late election relief.

After the fee was paid and, likely, significant uncompensated time was devoted by the CPA firm to getting this request through the PLR process, the IRS granted the relief, holding:

> Based upon our analysis of the facts and representations provided, Taxpayer acted reasonably and in good faith, and granting relief will not prejudice the interests of the Government due to unusual or compelling circumstances. Therefore, the requirements of §§ 301.9100-1 and 301.9100-3 have been met.
>
> Taxpayer is granted an extension of 60 days from the date of this ruling to file a duplicate copy of a completed automatic Form 3115 with the IRS office in Covington, Kentucky as required.[24]

SECTION: 469
USE OF MANAGEMENT COMPANY DID NOT ALLOW REAL

[24] *Ibid,* p. 4

ESTATE PROFESSIONAL TO INCLUDE VACATION PROPERTIES IN RENTAL GROUPING UNDER §469(C)(7)

Citation: Eger v. United States, USDC Northern District California, Case No. 18-cv-00199-DMR, 8/30/19

In what may initially seem like an odd argument for both parties to make, the IRS successfully argued that vacation homes were not rentals in the case of *Eger v. United States*, USDC Northern District California, Case No. 18-cv-00199-DMR.[25]

Greg Eger was a real estate professional, meeting the requirements under IRC §469(c)(7). The Eger owned three properties that were offered for rent at points during the year, located in Mexico, Colorado, and Hawaii. [26] In each case they entered into contracts with management companies that would seek to offer these properties up for rent, although in each case the Egers had the right to remove days from the rental pool for their own personal use.[27]

The agreement with the management company for the property in Mexico was described as follows:

> The Egers entered into a "2006 Consulting Agreement" with SH Consulting, LLC ("SH") to rent out and manage the property (the "Mexico Agreement"), pursuant to which SH was granted the "exclusive right to market [the Mexico Property, hereinafter "the Unit,"]3 to third parties for use." [Docket Nos. 43 (2-7), 44-48 (Declaration of Smith ("Smith Decl.")), Ex. 8 at ¶ 2.] As part of the agreement, the Egers elected to join a program called "Free Sell." Under the Free Sell program, SH would "black out any and all dates that [the Egers] do not wish to offer the Unit for use." Id. ¶ 3. The Egers could update the blackout dates at any time in writing, as long as there was not a conflicting confirmed reservation for the Unit. Id. SH agreed to use its efforts to market the Unit "for use by third parties on the Available Days," and was allowed to "enlist the services of one or more subcontractors or other third parties to assist SH in such efforts." Id. ¶ 6. SH was also entitled to request up to five complimentary nights from the Egers. Id. ¶ 7. SH would execute a "Use Agreement" with third-party guests who wanted to rent the Mexico Property, and

[25] https://ecf.cand.uscourts.gov/doc1/035118366526, August 30, 2019, Pacer registration required

[26] *Ibid*, p. 3

[27] *Ibid*, pp. 4-6

> could make changes to the Use Agreement as SH "deemed appropriate," except that SH could not change the daily use fee without the Egers' consent. Id. ¶ 8. SH was authorized to collect payment from third-party guests and allocate 70% to the Egers and 30% to SH, after subtracting service fees. Id. ¶ 9. The Egers occupied the Mexico Property for 13 nights in 2007, 12 nights in 2008, and 12 nights in 2009. JS ¶ 24.[28]

The agreement for rental of the Colorado property was described as follows:

> The Egers entered into a "Rental Program Agreement" (the "Colorado Agreement") with Bachelor Gulch Operating Company, LLC, which was labeled as "Resort Owner" in the agreement. Smith Decl., Ex. 15. Pursuant to the Colorado Agreement, the Resort Owner owned the resort under the Ritz-Carlton name. Id. at 1. The Egers could elect to place their property into a "voluntary rental program" to rent the Unit to "guests of the Resort." Id. By opting into the rental program, the Egers allowed the Resort Owner to "act as the sole and exclusive rental agent to offer the Subject Unit for rental." Id. The Colorado Agreement granted the Resort Owner "the exclusive authority to rent, operate and manage the [ ] Unit as agent of Unit Owner." Id. at 2. The rental program placed the Unit in a rotating unit reservation system "designed to fairly and equitably allocate Unit reservations and occupancy among Participating Units." Id. The Resort Owner was responsible for "rent[ing] the [ ] Unit to Resort Guests on a transient basis for and on behalf Resort Owner (sic) and [the Egers]," and for collecting the owed amounts from the guests. Id. at 3. The Resort Owner would also help market the Unit; provide a central reservation system for the entire Resort and process all reservations received through this system; and negotiate all terms and conditions including setting room rates, negotiating group rates, and offering incentives to prospective guests. Id. The Resort Owner was responsible for setting the rental rate for the Unit and could modify the rate at its "sole and absolute discretion." Id. at 7. The Resort Owner was also entitled to seven complimentary nights, to be used at its discretion. Id. The Egers had the right to use the property subject to several restrictions. First, they were allowed to request the Unit for up to 56 nights in a calendar year. Id. at 8. Anything beyond the 56 nights would be subject to an additional fee owed to the Resort Owner. Id. at 5. The Egers could not reserve the Unit more than 365 days in advance. Id. at 8. If the Egers were to reserve their Unit, they would have to register at the Resort. Id. at 9. If any guests were to stay with them in their Unit, they would have to notify the Resort Owner of the names and occupancy dates of

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[28] *Ibid*, p. 4

> all guests no less than 15 days prior to the date of arrival of any such guest(s). Id. The Egers could not accept payment or other consideration for the use of the Unit during any nights on which they decide to use the Unit. Id. They could not enter the Unit without prior notification, approval from, or coordination with the Resort Owner, and could not make alterations to the Unit. Id. at 11-12. The Egers never occupied the Colorado Property during the Relevant Years. JS ¶ 25.[29]

And, finally, the taxpayers entered into the following agreement with regard to the property in Hawaii:

> They entered into a "Rental Program Agreement" (the "Hawaii Agreement") with Honolua Associates, LLC to rent out and manage the property for the Egers. Smith Decl., Ex. 28. Pursuant to the Hawaii Agreement, the management company became the exclusive rental agent, and agreed to "endeavor to offer for rent" the Unit "to Resort Guests on a transient basis for and on behalf of [the Egers]." Id. at 4. As with the Colorado Property, the management company was responsible for collecting room rental from guests and marketing the Unit under the Ritz-Carlton name. Id. at 5. Indeed, the Hawaii Agreement is substantially similar to the Colorado Agreement, with two notable differences. First, unlike the Colorado Property, there was no limit on the number of nights the Egers could reserve the Hawaii Property, except that in the initial six months the Egers were subject to a 30-night cap. Id. at 10-11. Second, the Egers had to reserve use of the Unit at least 180 days in advance, id., while the Colorado Agreement required that they make reservations no earlier than 365 days in advance. The Egers never occupied the Hawaii Property during the Relevant Years. JS ¶ 26.[30]

Mr. Eger sought to group the three properties together, having made the election to treat all of his rental properties as a single activity per IRC §469(c)(7), which included 30 other properties in addition to these three.[31] By making such a grouping, it becomes much easier to qualify for material participation under §469, since all hours of participation in any of the rentals counts towards showing material participation in the activity as a whole.

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[29] *Ibid,* pp. 4-5

[30] *Ibid*, pp. 5-6

[31] *Ibid,* p. 6

But the IRS objected to the inclusion of the three rentals described earlier, arguing that, for purposes of IRC §469, they were not rental properties.

The IRS argued that the arrangements were such that the properties were excluded from being treated as a rental activity by Reg. §1.469-1T(e)(3)(ii)(A) since it met the "less than seven days" test.[32] The regulation states:

> **(ii) Exceptions.** For purposes of this paragraph (e)(3), an activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year -
>
> (A) The average period of customer use for such property is seven days or less;

Initially, the fight revolved around who was the customer in this case. As the opinion notes:

> The Government contends that this exception applies to the three properties at issue because the average period of customer use for each of them was seven days or less. See, e.g., Def.'s Opp'n & X-Motions at 4. Under the Government's approach, the customers are the end-user guests who stayed in the rental properties. According to the Government, the IRS correctly determined that the three properties do not constitute rental activity because the end-user guests stayed an average of less than seven days. For their part, the Egers assert that the customers are the three management companies with whom the Egers had a contractual relationship. See, e.g., Pltfs' Mot. at 12. Therefore, according to the Egers, the average period of customer use was far greater than seven days, which means that the exception does not apply, and they appropriately treated the three properties as rental activity in their tax returns.[33]

The District Court found, however, that even if you viewed the management companies as the customer, the taxpayers still failed the seven-day test. The retained rights the Egers had to use the property meant that the management companies did not actually have a continuous or recurring right to use the property when applying the test at Reg. §1.469-1(e)(3)(iii)(D) which provides for measuring the period of customer use.

The taxpayers had cited the cases of *White v. Commissioner*, TC Summary Opinion 2004-139, and *Hairston v. Commissioner*, TC Memo 2000-386 to show the management company should be treated as the customer rather than the end-user under

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[32] *Ibid*, p. 3

[33] *Ibid*

an arrangement similar to theirs. But the District Court found that there was an important difference between their agreements and those in the cited cases, noting:

> *White* and *Hairston* are distinguishable from this case because the taxpayers in those cases entered into contracts that conveyed exclusive access to their properties, including the right to rent to third party end-users. See *White*, 2004 WL 2284383, at *5; *Hairston*, 2000 WL 1862902, at *2. The taxpayers in *White* and *Hairston* did not retain any rights to use their properties throughout the duration of the agreements. By contrast, the Egers retained significant rights to use the Resort properties and therefore did not convey exclusive access rights to the management companies.[34]

The opinion continues:

> The language of the management agreements lend support to the court's conclusion that the management companies were not customers who had a continuous right to use the Resort Properties. Rather, the management companies provided marketing and rental services for the Egers to rent out the Resort Properties. The agreements state in relevant part that the companies entered into contracts to rent out the Resort Properties on behalf of the Egers.Smith Decl., Ex. 8 at 1 (allowing the company "exclusive right to market [the Mexico Property] to third parties for use"); Ex. 15 (Colorado Agreement) at 3 (the company was responsible for "rent[ing] the [ ] Unit to Resort Guests on a transient basis for and on behalf [of the management company] and [Plaintiffs]"); Ex. 28 (the Hawaii Agreement) at 4 (company provide the service of "endeavor[ing] to offer for rent" the property "to [end-user guests] on a transient basis for and on behalf of [Plaintiffs]). In sum, the record demonstrates that the management companies did not have the continuous right to use the Resort Properties.[35]

The Court also found that the math didn't work if you tried to argue that they had recurring use in excess of seven days.

> …[E]ven if the court were to find that exclusive control over the right to rent out the Resort Properties constitutes a "recurring right" to use them, the Egers have not demonstrated that the average period of customer use is more than seven days for each of them. This is because

[34] *Ibid*, pp. 10-11

[35] *Ibid*, pp. 12-13

> the Egers' retained rights to use the Resort Properties throughout the Relevant Years exceed the seven-day average as a simple mathematical proposition. Specifically, the Egers retained the right to use the Mexico and Hawaii Properties for an unlimited number of days. With respect to the Colorado Property, the Egers retained the right to use it for up to 56 nights, which results in an annual average period of use of less than seven days. The Egers again respond that the court should look to actual conduct to determine whether the managing companies had a recurring right. They point to the fact that they never used the Colorado and Hawaii Properties, and only exercised their right as to the Mexico Property for a few nights each year. According to the Egers, by those calculations, the management companies' recurring use would be more than an average of seven days per year. This "actual conduct" argument fails here for the same reasons as discussed above, because the regulations clearly discuss a right to use the property, rather than actual use. In sum, the Egers have not provided legal or factual support for their position that the management companies had a "recurring right to use" the Resort Properties.[36]

The Court found that the taxpayers had attempted to take the results in the cases they cited further than they could be taken. The key factors the Court focused on were that:

- The management companies had only the right to attempt to rent out the properties for the taxpayers, not the right to use the properties, including the right to sublease them and
- The taxpayers' retained rights (even if not used) to use the property got in the way of being able to show the right to use the property for more than seven days.

The bottom line is that the IRS did what litigants virtually always will do when the other party cites a case—work to show how the facts in the cited cases are different from the situation currently before the Court. That's much simpler (and far more likely to succeed) than attempting to argue there was an error made by the earlier court in its findings since cases are always distinguishable in some manner. So the question then moves to why the differences do or do not matter.

When planning with a client, if the position relies upon case law it's very important to fully understand the facts of the case that was decided, as well as objectively look at the differences in your client's situation. Too often we read a summary or article (like this one), and believe we know what need to know to take action. In reality, no summary or article can cover all details, nor does the author of the summary or article know your client's facts. That's why it's so crucial to actually read the underlying case and

[36] *Ibid*, p. 14

understand how an adverse party (most often the IRS) could use the differences in the facts to overcome the case law that you believe supports the taxpayer's position.

SECTION: 1361
SALE OF S CORPORATION APPEARS TO HAVE BEEN PUT IN HOLD UNTIL IRS RULES INEFFECTIVE S ELECTION WAS INADVERTANT, S STATUS RECOGNIZED

Citation: PLR 201935010, 8/30/19

I've often run into CPAs when discussing S corporations and the various ways they can lose their S status who remark that, while that may be true, they've never seen the IRS actually revoke the corporation's status on an exam, or even question the issue. While that may be true, the author notes that a lot of private letter ruling requests are paid for to correct issues that would have terminated the S status, but which the IRS had not become aware.

A major reason for this is noted explicitly in PLR 201935010.[37] The problem often arises when a buyer is interested in acquiring the business and during the review of the organization, the potential liability for taxes for prior years comes to light due to an issue that rendered the organization ineligible to have received or to have continued with S corporation status.

In this case, the problem was the accidental creation of a second class of stock. Per IRC §1361(b)(1)(D), one of the conditions for a corporation to be an S corporation is that the corporation only have a single class of stock, as defined under federal law.

In this case, an issue arose from recapitalizations of the corporation. The ruling describes these two recapitalizations as follows:

> On Date2, X undertook a recapitalization, and X's Board of Directors amended X's Articles of Incorporation to divide X's common stock into N1 shares of class A stock and N2 shares of class B stock. The class A shares retained voting power and the class B shares held no voting power. The class A and class B shares otherwise conferred identical rights to distribution and liquidation proceeds. On Date3, X's Board of Directors amended X's Articles of Incorporation for a second time to change the liquidation rights of X's stock. After this amendment, the class A and class B shares were entitled to receive equal shares of any assets of X in liquidation until the amount of $N3

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[37] https://www.irs.gov/pub/irs-wd/201935010.pdf, August 30, 29, retrieved August 30, 2019

> had been paid to each share. Upon reaching $N3 in liquidation proceeds per share, the class B shares were entitled to receive the balance of any remaining assets of X.[38]

Those who haven't looked into the one class of stock rule may believe the first recapitalization was the problem--after all, when that was over the corporation had issued "class A" and "class B" stock. A reader might think that since there are two classes of stock, that violates the prohibition on issuing more than one class of stock. But that is not the case.

Reg. §1.1361-1(l)(2)(i) treats stock as being of one class for purposes of meeting the S corporation one class of stock rule so long as the shares have identical rights to distributions and in liquidation. A difference in voting rights, while a key differentiator of classes for state corporate law purposes, is not relevant in an S corporation context.

Rather, it is the second recapitalization that made this corporation ineligible to have S status. Even though the differing rights had never been triggered, their existence rather than use barred the corporation from obtaining or retaining S status.

Ignorance being bliss, the corporation went ahead and made an S election with those rights in place, an election the IRS never seems to have questioned:

> On Date4, X filed an election to be taxed as an S corporation. X represents that at time this election was filed, X's Board of Directors were either unaware or had forgotten that the distribution and liquidation rights had been changed and differed for class A and class B shares as a result of the Date3 amendment to X's Articles of Incorporation. In addition, X represents that X's tax advisors were unaware of this amendment. On Date4, X had two shareholders, A and B. A and B remained the only shareholders of X from Date4 through Date6.[39]

All good things must come to an end, and the corporation's blissful ignorance was shattered when the shareholders were completing a sale of their stock. As the ruling continues:

> X represents that X's legal counsel discovered the Date3 amendments to X's Articles of Incorporation that created two classes of stock, in connection with due diligence performed prior to the sale of X stock by A and B that occurred on Date6. Upon learning about this Date3 amendment, X's Board of Directors amended X's Articles of Incorporation on Date5 to reconstitute the class A and class B shares

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[38] *Ibid*, p. 2

[39] *Ibid*

> into a single class of stock with identical rights to distribution and liquidation proceeds, in order to rectify the ineffectiveness of X's S corporation election.[40]

It is important to note that if, in fact, X had never been an S corporation, it owed C corporation taxes for the purported S years. A buyer of the stock clearly would not want to take over a corporation with a potentially large tax bill due. Thus, likely as a condition of closing the sale, the buyer insisted that the corporation get an IRS waiver on the issue.

Eventually, the problem was resolved and, as was noted in the ruling, the sale went through. The IRS held:

> Based solely on the facts submitted and the representations made, we conclude that X's S corporation election was ineffective on Date4 as a result of the second class of stock created by the Date3 amendment to X's Articles of Incorporation. We conclude that this ineffectiveness was inadvertent within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as an S corporation beginning on Date4 and continuing thereafter, unless X's S corporation election otherwise terminated under §1362(d) for other reasons.[41]

All is well, so this is not a big deal, correct? Not so fast—a private letter ruling involves paying a not insignificant IRS user fee and a lot of professional time to get the ruling through the process. As well, a sale the taxpayer thought was a done deal gets put on hold while waiting for a formal IRS decision (likely a number of months).

The taxpayer is likely not happy about the situation and will most likely believe that one or more professionals failed them in this case. After all, why wasn't this problem caught until a due diligence review was undertaken and someone read the Articles of Incorporation, as amended, and ran across the rather clear violation of the one class stock rule? Presumably, no one had looked closely enough (or at all) when the S election was made, and that error continued each year when the return was prepared.

That unhappiness may translate to claims being made against counsel(s) and/or the CPA(s) for the costs of getting a ruling and the delay in closing the sale—and there is a reasonable chance the client's claim will be successful in extracting funds from one or all professionals involved.

The discovery of issues during a due diligence review of a sale is a major reason why these rulings are sought by taxpayers. So while it is potentially true, the IRS is unlikely

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[40] *Ibid*

[41] *Ibid*, p. 4

to raise this issue on exam (though clearly they *can* do so), that doesn't mean this is not a real problem that could bring very negative consequences to the professionals involved.