Current Federal Tax Developments

Week of September 23, 2019

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ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF SEPTEMBER 23, 2019
© 2019 Kaplan, Inc.
Published in 2019 by Kaplan Financial Education.

Printed in the United States of America.

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Current Federal Tax Developments

Kaplan Financial Education

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SECTION: 168
FINAL AND ADDITIONAL PROPOSED REGULATIONS FOR BONUS DEPRECIATION UNDER TCJA RELEASED BY IRS

Citation: TD 9874, REG-106808-19, 9/13/19

Just before the extended filing deadline for 2019 partnerships and S corporations the IRS has finalized the proposed regulations issued in August of 2018 for bonus depreciation (TD 9874)[1]. Proposed regulations to implement the changes to bonus depreciation made by the Tax Cuts and Jobs Act have were originally released by the IRS in REG-104397-18.

At the same time the IRS issued more proposed regulations related to bonus depreciation (REG-106808-19)[2] that propose rules for property not eligible for bonus depreciation, a *de minimis* use rule for previously used property and rules related to components of larger property.

The preamble to the original proposed regulations provided that taxpayers may rely upon the proposed regulations until final regulations are issued:

> Pending the issuance of the final regulations, a taxpayer may choose to apply these proposed regulations to qualified property acquired and placed in service or planted or grafted, as applicable, after September 27, 2017, by the taxpayer during taxable years ending on or after September 28, 2017.

The 2019 additional proposed regulations provide a similar "taxyapers may rely" provision to allow use of the proposed rules pending their finalization:

> Pending the issuance of final regulations, a taxpayer may choose to rely on these proposed regulations, in their entirety, to qualified property acquired and placed in service or planted or grafted, as applicable, after September 27, 2017, by the taxpayer during taxable years ending on or after September 28, 2017. Pending the issuance of final regulations, a taxpayer also may choose to rely on these proposed regulations, in their entirety, to components acquired or self-constructed after September 27, 2017, of larger self-constructed property for which the manufacture, construction, or production begins before September 28,

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[1] TD 9874, https://www.irs.gov/pub/irs-drop/td-9874.pdf, September 13, 2019, retrieved September 15, 2019.

[2] REG-106808-19, https://www.irs.gov/pub/irs-drop/nprm-reg-106808-19.pdf, September 13, 2019, retrieved September 15, 2019

> 2017, and that is qualified property under section 168(k)(2) as in effect before the enactment of the Act and placed in service by the taxpayer during taxable years ending on or after September 28, 2017. If a taxpayer chooses to rely on these proposed regulations, the taxpayer must consistently apply all rules of these proposed regulations.[3]

Some of the key features of the final and second set of final regulations are discussed below.

Qualified Improvement Property Issues (the "Retail Glitch")

One of the known drafting errors in the Tax Cuts and Job Act (often referred to as the "retail glitch") involves the accidental treatment of qualified improvement property as 39-year property not eligible for bonus depreciation, despite the intent outlined in the Conference Committee Report for TCJA that these assets should be 15-year property eligible for bonus depreciation. The new category replaces the prior categories of qualified restaurant property, qualified retail property, and qualified leasehold improvement property.

The defining section provides:

> (6) Qualified improvement property
>
> (A) In general
>
> The term "qualified improvement property" means any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service.
>
> (B) Certain improvements not included
>
> Such term shall not include any improvement for which the expenditure is attributable to—
>
> (i) the enlargement of the building,
>
> (ii) any elevator or escalator, or
>
> (iii) the internal structural framework of the building.

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[3] *Ibid*, p. 28

The replaced categories did qualify as 15-year property and was eligible for bonus depreciation.

However, there is a difference in the date that 100% bonus depreciation became effective (assets placed in service after September 27, 2017) and when the new, unified "qualified improvement property" category replaced the older categories (property placed in service after December 31, 2017).

The final regulations thus provide a special rule for that interim period, found in Reg. 1.168(k)-2(a)(2)(i)(A). Property that falls into the older categories qualify for the 100% bonus if acquired during that period:

> (A) MACRS property, as defined in § 1.168(b)-1(a)(2), that has a recovery period of 20 years or less. For purposes of this paragraph (b)(2)(i)(A) and section 168(k)(2)(A)(i)(I), the recovery period is determined in accordance with section 168(c) regardless of any election made by the taxpayer under section 168(g)(7). This paragraph (b)(2)(i)(A) includes the following MACRS property that is acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer after September 27, 2017, and before January 1, 2018:
>
>> (1) Qualified leasehold improvement property as defined in section 168(e)(6) as in effect on the day before amendment by section 13204(a)(1) of the Act;
>>
>> (2) Qualified restaurant property, as defined in section 168(e)(7) as in effect on the day before amendment by section 13204(a)(1) of the Act, that is qualified improvement property as defined in § 1.168(b)-1(a)(5)(i)(C) and (a)(5)(ii); and
>>
>> (3) Qualified retail improvement property as defined in section 168(e)(8) as in effect on the day before amendment by section 13204(a)(1) of the Act;

Absent action by Congress to change the law, the new combined and revised category will not qualify for bonus deprecation for assets acquired after December 31, 2017 and the cost will be recovered over a 39-year period.

In finalizing the regulations the IRS specifically refused to take action to treat such property as being qualified for bonus deprecation by regulatory action despite comments requesting that the IRS either provide for this treatment or state that they would not challenge such a position on a return. The IRS did not adopt these comments to give relief for qualified improvement property:

> For property placed in service after December 31, 2017, section 13204 of the Act amended section 168(k) to eliminate qualified improvement

> property as a specific category of qualified property, and amended section 168(e) to eliminate the 15-year MACRS property classification for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. The legislative history of section 13204 of the Act provides that the MACRS recovery period is 15 years for qualified improvement property. Conf. Rep. No. 115-466, at 367 (2017). However, section 168(e), as amended by section 13204 of the Act, does not classify qualified improvement property as having a recovery period of 20 years or less. Consequently, a legislative change must be enacted to provide for a recovery period of 20 years or less for qualified improvement property placed in service after 2017 to be qualified property. Accordingly, the Treasury Department and the IRS decline to adopt these comments.[4]

Electing Real Property Trade and Business, Electing Farming Business and Businesses with Floor Plan Interest

Property required to be depreciated under the alternative depreciation system (ADS) of IRC §168(g) is not eligible for bonus depreciation, but generally allows taxpayers to claim bonus depreciation if they voluntarily elect to use ADS depreciation under IRC §168(g)(7). TCJA provides for two elections where certain real property and farming businesses may escape the limitations on deducting business interest, but to do so the business must make a permanent elect to depreciate certain property under ADS.

The regulations note that, despite a taxpayer voluntarily electing to subject the property to ADS depreciation in those two cases, IRC §168(k)(9) bars the use of bonus depreciation on the property from electing real property and farming businesses. The loss of bonus depreciation is the trade-off for not being subjected to the interest limit.

Although not an election, TCJA also barred businesses with qualified flooring plan interest (which is generally not subject to the interest limit) with average revenue of more than $25 million from taking advantage of bonus depreciation. However, note that the 2019 proposed regulations provide for a special test to determine if this rule applies to a taxpayer.[5]

The final regulations bar the use of bonus depreciation on property on affected businesses (subject to the new revision for floor plan interest found in the 2019 proposed regulations). [Reg. §1.168(k)-2(a)(2)(ii)]

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[4] TD 9874, pp. 9-10

[5] Proposed Reg. §1.168(k)-2(b)(ii)(G)

However, the IRS issued several items of proposed additional guidance in this area in response to comments received in this area.

Property Leased to a §168(k)(9)(A) Businesses

The IRS noted that there was concerned expressed regarding whether the "taint" of a business disqualified from using bonus depreciation by being listed in §168(k)(9)(A) could carry over to a party leasing property to such a business.

> Several commenters to the August Proposed Regulations requested guidance on whether a taxpayer that leases property to a trade or business described in section 168(k)(9) is eligible to claim the additional first year depreciation for the property, and they recommend allowing the additional first year depreciation deduction (assuming all other requirements are met). The Treasury Department and the IRS agree with the commenters' recommendation, provided the lessor is not described in section 168(k)(9)(A) or (B). Accordingly, these proposed regulations amend §1.168(k)-2(b)(2)(ii)(F) and (G) to provide that such exclusion from the additional first year depreciation deduction does not apply to lessors of property to a trade or business described in section 168(k)(9) so long as the lessor is not described in such Code section.[6]

Specifically, the new proposed regulations proposed to add the following language to the end of Reg. §1.168(k)-2(b)(2)(ii)(F):

> For purposes of section 168(k)(9)(A) and this paragraph (b)(2)(ii)(F), the term primarily used has the same meaning as that term is used in §1.167(a)-11(b)(4)(iii)(b) and (e)(3)(iii) for classifying property. This paragraph (b)(2)(ii)(F) does not apply to property that is leased to a trade or business described in section 163(j)(7)(A)(iv) by a lessor's trade or business that is not described in section 163(j)(7)(A)(iv) for the taxable year;

And, similarly, propose to add the following language to the end of Reg. §1.168(k)-2(b)(2)(ii)(G):

> This paragraph (b)(2)(ii)(G) does not apply to property that is leased to a trade or business that has had floor plan financing indebtedness by a lessor's trade or business that has not had floor plan financing indebtedness during the taxable year or that has had floor plan financing indebtedness but did not take into account floor plan

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[6] REG-106808-19, p. 5

> financing interest for the taxable year pursuant to this paragraph (b)(2)(ii)(G).

The revised proposed regulations add the following example to illustrate the proposed leasing rules:

EXAMPLE 6, PROPOSED REG. §1.168(K)-2(B)(III)(F)

In 2019, a financial institution buys new equipment for $1 million and then leases this equipment to a lessee that primarily uses the equipment in a trade or business described in section 163(j)(7)(A)(iv). The financial institution is not described in section 163(j)(7)(A)(iv). As a result, paragraph (b)(2)(ii)(F) of this section does not apply to this new equipment. Assuming all other requirements are met, the financial institution's purchase price of $1 million for the new equipment qualifies for the additional first year depreciation deduction under this section.

Floor Plan Financing and Bonus Depreciation - Exception

The 2019 proposed regulations provide for a special rule applicable to taxpayer with floor plan interest, determining when it is "taken into account" for purposes of the §163(j) business interest limitations. Specifically, the 2019 proposed regulations address the following:

> A commenter to the August Proposed Regulations requested guidance on when floor plan financing is "taken into account" for purposes of section 168(k)(9)(B). The commenter believed that section 168(k)(9)(B) does not apply when a taxpayer does not deduct interest in excess of the sum of the amounts calculated under section 163(j)(1)(A) and (B). The Treasury Department and the IRS do not believe that section 163(j) is optional. However, the Treasury Department and the IRS agree that, for purposes of section 168(k)(9)(B), floor plan financing interest is not taken into account by a trade or business that has had floor plan financing indebtedness if the sum of the amounts calculated under section 163(j)(1)(A) and (B) for the trade or business for the taxable year equals or exceeds the business interest, as defined in section 163(j)(5) (including carryforwards of disallowed business interest under section 163(j)(2)), which includes floor plan financing interest of the trade or business, for the taxable year. Accordingly, these proposed regulations amend §1.168(k)-2(b)(2)(ii)(G) to provide that solely for purposes of section 168(k)(9)(B) and §1.168(k)-2(b)(2)(ii)(G), floor plan financing interest is not taken into account for the taxable year by a trade or business that has had floor plan financing indebtedness if the sum of the amounts calculated under section 163(j)(1)(A) and (B) for the

> trade or business for the taxable year equals or exceeds the business interest, as defined in section 163(j)(5), for the taxable year.[7]

The proposed revision to Reg. §1.168(k)-2(b)(ii)(G) reads as follows:

> Solely for purposes of section 168(k)(9)(B) and this paragraph (b)(2)(ii)(G), floor plan financing interest is not taken into account for the taxable year by a trade or business that has had floor plan financing indebtedness if the sum of the amounts calculated under section 163(j)(1)(A) and (B) for the trade or business for the taxable year equals or exceeds the business interest, as defined in section 163(j)(5), of the trade or business for the taxable year (which includes floor plan financing interest).

Thus, even though a business may have incurred floor plan interest, that interest is not deemed to be "taken into account" for §163(j) purposes if the total of:

- Business interest income (as defined by §163(j)(6)) and
- 30% of *adjusted taxable income* (as defined by §163(j)(8))

is greater than the total of business interest (as defined at §163(j)(5), including floor plan interest in the amount) for the year. To put it more simply, the floor plan interest isn't taken into account if the special rule allowing for a deduction for floor plan interest isn't actually necessary for the business to claim a deduction for such interest.

Taxpayers that have already filed 2018 returns that failed to claim bonus depreciation due to the existence of floor plan interest and did not claim bonus depreciation should review their return to see if, in fact, under this new standard they are still barred from claiming bonus depreciation.

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[7] *Ibid*, p. 6

The IRS provides two examples to illustrate this new exemption for businesses with floor plan interest.

EXAMPLE 7, PROPOSED REG. §1.168(K)-2(B)(III)(G)

In 2019, F, an automobile dealer, buys new computers for $50,000 for use in its trade or business of selling automobiles. For purposes of section 163(j), F has the following for 2019: $1,000 of adjusted taxable income, $40 of business interest income, $400 of business interest (which includes $100 of floor plan financing interest). The sum of the amounts calculated under section 163(j)(1)(A) and (B) for F for 2019 is $340 ($40 + ($1,000 x 30 percent)). F's business interest, which includes floor plan financing interest, for 2019 is $400. As a result, F's floor plan financing interest is taken into account by F for 2019 pursuant to paragraph (b)(2)(ii)(G) of this section. Accordingly, F's purchase price of $50,000 for the computers does not qualify for the additional first year depreciation deduction under this section.

EXAMPLE 8, PROPOSED REG. §1.168(K)-2(B)(III)(H)

The facts are the same as in Example 7 in paragraph (b)(2)(iii)(G) of this section. In 2020, F buys new copiers for $30,000 for use in its trade or business of selling automobiles. For purposes of section 163(j), F has the following for 2020: $1,300 of adjusted taxable income, $40 of business interest income, $400 of business interest (which includes $100 of floor plan financing interest). The sum of the amounts calculated under section 163(j)(1)(A) and (B) for F for 2020 is $430 ($40 + ($1,300 x 30 percent)). F's business interest, which includes floor plan financing interest, for 2020 is $400. As a result, F's floor plan financing interest is not taken into account by F for 2020 pursuant to paragraph (b)(2)(ii)(G) of this section. Assuming all other requirements are met, F's purchase price of $30,000 for the copiers qualifies for the additional first year depreciation deduction under this section.

Election for Self-Constructed Property Which Started Before September 28, 2017

The 2019 proposed regulations contain a special set of rules that apply to self-constructed property for which the manufacture, construction or production began before September 27, 2017. The IRS notes that the point of these rules, found in the 2019 proposed regulations at Proposed Reg. §1.168(k)-2(c), is to allow taxpayers the right to make an election similar to that found in section 3.02(2)(b) of Rev. Proc. 2011-26 (2011-16 I.R.B. 664).[8]

The preamble to the 2019 proposed regulations describes this election as follows:

> The Treasury Department and the IRS have determined that it is appropriate to allow a taxpayer to elect to treat one or more components acquired or self-constructed after September 27, 2017, of certain larger self-constructed property as being eligible for the additional first year depreciation deduction under section 168(k). The larger self-constructed property must be qualified property under

[8] *Ibid*, p. 25

> section 168(k)(2), as in effect before the enactment of the Act, for which the manufacture, construction, or production began before September 28, 2017. However, the election is not available for components of larger self-constructed property when such property is not eligible for any additional first year depreciation deduction under section 168(k) (for example, property described in section 168(k)(9) and placed in service by the taxpayer in any taxable year beginning after December 31, 2017, or qualified improvement property placed in service by the taxpayer after December 31, 2017). These proposed regulations amend §1.168(k)-2 by adding paragraph (c) to provide for this election. These proposed regulations also provide rules regarding installation costs and the determination of the basis attributable to the manufacture, construction, or production before January 1, 2020, for longer production period property or certain aircraft property described in section 168(k)(2)(B) or (C). Additionally, these proposed regulations provide the time and manner of making the election, and examples to illustrate the proposed rules.
>
> These proposed regulations also amend §1.168(k)-2(e)(1)(iii) to provide rules regarding the determination of the basis attributable to the manufacture, construction, or production before January 1, 2027, for longer production period property or certain aircraft property described in section 168(k)(2)(B) or (C).[9]

The IRS has inserted the election and provisions at Proposed Reg. §1.168(k)-2(c) in the 2019 proposed regulations. This has the effect of renumbering the 2018 Proposed Regulation sections beginning §1.168(k)-2(c) and later, so that 2018 Proposed Reg. §1.168(k)-2(c) becomes Reg. §1.168(k)-2(d) and so on.

Elections to Use 50% Bonus Depreciation for Year Containing September 28, 2017

The regulations contain rules related to the special election for the year containing September 28, 2017 to use a 50% rather than 100% bonus depreciation amount.

In the preamble to the 2018 proposed regulations the IRS explained that, in their view, the law requires this election to be an "all or nothing" election. If made, the 50% amounts are used in lieu of the 100% amount for all property. Taxpayers are not able to use the 50% amount on one class of property, but the 100% amount on other classes.

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[9] *Ibid*, pp. 25-26

As the IRS explains:

> …[T]he proposed regulations provide rules for making the election under section 168(k)(10) to deduct 50 percent, instead of 100 percent, additional first year depreciation for qualified property acquired after September 27, 2017, by the taxpayer and placed in service or planted or grafted, as applicable, by the taxpayer during its taxable year that includes September 28, 2017. Because section 168(k)(10) does not state that the election may be made "with respect to any class of property" as stated in section 168(k)(7) for making the election out of the additional first year depreciation deduction, the proposed regulations provide that the election under section 168(k)(10) applies to all qualified property.

However, the regulation indicates that a separate election can be made to take the 50% vs. 100% when making the election with regard to specified plants under IRC §168(k)(5).

The rules for the election are found at Reg. §1.168(k)-2(f)(3)[10]. The election is required to be made by the due date, including extensions, for the tax year containing September 28, 2017.[11] The election is to be made in the manner prescribed on Form 4562 and its related instructions. The election is made at the partnership or S corporation level rather than at the equity holder level.[12]

A taxpayer that wishes to use the 50% rate must make a timely election. A taxpayer cannot late file a request to change its method of accounting for the assets to obtain the 50% deduction.[13]

Qualified Used Property

Aside from the increase in the percentage for bonus depreciation from 50% to 100%, the most significant change for most taxpayers in the rules governing bonus depreciation is the inclusion of used property as qualifying property so long as the property has never been used previously by the taxpayer. The regulations outline the situations when used property will or will not qualify for bonus depreciation.

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[10] As was noted, due to the insertion of 2019 Proposed Reg. §1.168(k)-2(c), this provision was labeled as Proposed Reg. §1.1168(k)-2(e) in the 2018 proposed regulations.

[11] Reg. §1.168(k)-2(f)(3)(ii)(A).

[12] Reg. §1.168(k)-2(f)(3)(ii)(B)

[13] Reg. §1.168(k)-2(f)(3)(ii)(C)

Used property must meet the following requirements to qualify for bonus depreciation under the new rules:

- Such property was not used by the taxpayer or a predecessor at any time prior to such acquisition;
- The property is acquired by purchase, as that term is used for purposes of IRC §179; and
- The cost of property does not include so much of the basis of such property as is determined by reference to the basis of other property held at any time by the person acquiring such property. (the rules of IRC §179(d)(3) are applied).[14]

The third requirement means that there is a different result if a taxpayer involuntarily exchanges or enters into a like kind exchange depending on whether the property acquired is used or new. As Reg. §1.168(k)-2(g)(5)(iii) notes:

> If the replacement MACRS property or the replacement computer software, as applicable, meets the original use requirement in paragraph (b)(3)(ii) of this section and all other requirements of section 168(k) and this section, the remaining exchanged basis for the year of replacement and the remaining excess basis, if any, for the year of replacement for the replacement MACRS property or the replacement computer software, as applicable, are eligible for the additional first year depreciation deduction.

The regulation describes the test to see if property had previously been used by the taxpayer as follows:

> …[T]he property is treated as used by the taxpayer or a predecessor at any time prior to acquisition by the taxpayer or predecessor if the taxpayer or the predecessor had a depreciable interest in the property at any time prior to such acquisition, whether or not the taxpayer or the predecessor claimed depreciation deductions for the property.[15]

The regulation establishes a *depreciable interest*

If a taxpayer previously leased the property, any portion that property that the taxpayer had previously had a depreciable interest in would not be eligible for bonus depreciation. The regulation states:

> If a lessee has a depreciable interest in the improvements made to leased property and subsequently the lessee acquires the leased property of which the improvements are a part, the unadjusted depreciable

[14] Proposed Reg. §1.168(k)-2(b)(3)(iii)(A)

[15] Reg. §1.168(k)-2(b)(3)(iii)(B)(1)

> basis, as defined in §1.168(b)-1(a)(3), of the acquired property that is eligible for the additional first year depreciation deduction, assuming all other requirements are met, must not include the unadjusted depreciable basis attributable to the improvements. [16]

The regulations also provide rules for a situation where a taxpayer initially had a partial interest in the property but later acquires an additional interest, generally allowing the taxpayer to claim the additional depreciation on that property.

> If a taxpayer initially acquires a depreciable interest in a portion of the property and subsequently acquires a depreciable interest in an additional portion of the same property, such additional depreciable interest is not treated as used by the taxpayer at any time prior to its acquisition by the taxpayer. This paragraph (b)(3)(iii)(B)(2) does not apply if the taxpayer or a predecessor previously had a depreciable interest in the subsequently acquired additional portion. For purposes of this paragraph (b)(3)(iii)(B)(2), a portion of the property is considered to be the percentage interest in the property. [17]

However, if the taxpayer disposes of the partial interest first and then later acquires a new interest in the property, the rules are different.

> If a taxpayer holds a depreciable interest in a portion of the property, sells that portion or a part of that portion, and subsequently acquires a depreciable interest in another portion of the same property, the taxpayer will be treated as previously having a depreciable interest in the property up to the amount of the portion for which the taxpayer held a depreciable interest in the property before the sale. [18]

If a member of a consolidated group previously had a depreciable interest in the property, the other members of the consolidated group will be treated as having previously used the property. For these purposes, even depreciable interests held by previous members of the consolidated group will create the disqualifying taint. [19]

A special rule is provided at Reg. §1.168(k)-2(b)(3)(ii) to combat what the IRS appears to believe might be an attempt to “game” the system when a corporation is being added to the group:

> (ii) Certain acquisitions pursuant to a series of related transactions. Solely for purposes of applying paragraph (b)(3)(iii)(A)(1) of this section, if a series of related transactions includes one or more

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[16] Reg. §1.168(k)-2(b)(3)(iii)(B)(1)

[17] Reg. §1.168(k)-2(b)(3)(iii)(B)(2)

[18] Reg. §1.168(k)-2(b)(3)(iii)(B)(2)

[19] Reg. §1.168(k)-2(b)(3)(iii)(B)(3)(i)

> transactions in which property is acquired by a member of a consolidated group and one or more transactions in which a corporation that had a depreciable interest in the property becomes a member of the group, the member that acquires the property will be treated as having a depreciable interest in the property prior to the time of its acquisition.

The IRS goes on to add another "anti-abuse" provision for consolidated groups in Reg. §1.168(k)-2(b)(3)(iii):

> (iii) Time for testing membership. Solely for purposes of applying paragraph (b)(3)(iii)(B)(3)(i) and (ii) of this section, if a series of related transactions includes one or more transactions in which property is acquired by a member of a consolidated group and one or more transactions in which the transferee of the property ceases to be a member of a consolidated group, whether the taxpayer is a member of a consolidated group is tested immediately after the last transaction in the series.

The IRS also adds a more general anti-abuse rule at Reg. §1.168(k)-2(b)(3)(C) which reads:

> Special rules for a series of related transactions. Solely for purposes of section 168(k)(2)(E)(ii) and paragraph (b)(3)(iii)(A) of this section, in the case of a series of related transactions (for example, a series of related transactions including the transfer of a partnership interest, the transfer of partnership assets, or the disposition of property and the disposition, directly or indirectly, of the transferor or transferee of the property)-
>
> > (1) The property is treated as directly transferred from the original transferor to the ultimate transferee; and
> >
> > (2) The relation between the original transferor and the ultimate transferee is tested immediately after the last transaction in the series.

In response to a request made in the comments, the IRS added a definition of a *predecessor* for purposes of the determination of used property at Reg. §1.168(k)-2(a)(2)(iv). The regulation provides that a predecessor includes:

- A transferor of an asset to a transferee in a transaction to which section 381(a) applies (carryovers in certain corporate acquisitions);
- A transferor of an asset to a transferee in a transaction in which the transferee's basis in the asset is determined, in whole or in part, by reference to the basis of the asset in the hands of the transferor;

- A partnership that is considered as continuing under section 708(b)(2) and §1.708-1 (partnership merger or division);
- The decedent in the case of an asset acquired by the estate; or
- A transferor of an asset to a trust.

As well, the final regulations provide a safe harbor five year look back rule to determine if the taxpayer previously had a depreciable interest in the property at Reg. §1.168(k)-2(b)(3)(iii)(B)(1). The regulation provides:

> To determine if the taxpayer or a predecessor had a depreciable interest in the property at any time prior to acquisition, only the five calendar years immediately prior to the taxpayer's current placed-in-service year of the property is taken into account. If the taxpayer and a predecessor have not been in existence for this entire five-year period, only the number of calendar years the taxpayer and the predecessor have been in existence is taken into account.

Application to Partnerships

The fact that used property now qualifies for bonus depreciation complicates earlier IRS guidance that had used depreciation calculations for various purposes. In early May of 2018 the IRS had modified the safe harbor calculations for recognized built in gain and recognized built in loss under IRC §382 in Notice 2018-30 because the use of 100% bonus depreciation for such calculations created results that the IRS no longer believed made sense.

Several partnership rules, specifically those under IRC §§704(c), 734 and 754, would be impacted by the fact that bonus depreciation is now allowed on used assets. In all three cases, a calculation of depreciation is made in certain cases that passes out to one or more partners. In the past such depreciation was always computed using MACRS without a bonus depreciation deduction since the assets were, virtually by definition, used assets.

But now used assets, unless they had previously been used by the taxpayer, are not barred from 100% bonus depreciation. Thus, the IRS gives guidance in the regulations about whether or when the 100% bonus depreciation calculation will be allowed in the various cases.

As the IRS noted in the preamble of the 2018 proposed regulations:

> Because the Act amended section 168(k) to allow the additional first year depreciation deduction for certain used property in addition to new property, the Treasury Department and the IRS have reconsidered whether basis adjustments under sections 734(b) and 743(b) now qualify for the additional first year depreciation deduction. The

> Treasury Department and the IRS also have considered whether certain section 704(c) adjustments as well as the basis of distributed property determined under section 732 should qualify for the additional first year depreciation deduction.

Section 704(c) Remedial Allocations

Under Section 704(c), a partner contributing property to the partnership where the partner's basis differs from fair value at the time of contribution will trigger a §704(c) allocation. Roughly, a §704(c) allocation (which is required unless certain *de minimis* rules are met) seeks (though sometimes not successfully) to put the other partners is the same position in terms of taxable income and types of income as if the partnership's unadjusted basis in the asset was the fair value at the date of contribution.

One method allowed for making such §704(c) allocations is the remedial allocation method under Reg. §1.704-3(d)(2) for depreciable assets. In that case, the excess of the fair value over the unadjusted basis of the asset contributed is treated as if it were a separate asset acquired on the date of contribution. The other partners receive their share of the computed depreciation on that asset each year, while the contributing partner has an equivalent amount reported to him/her as additional ordinary income.

If bonus depreciation was allowed on the assets, the contributing partner would find that all of excess of the fair value of the asset over its basis on contribution would be allocated back to him/her, reduced only his/her share of that gain. Such a result would effectively remove the deferral of gain on contributed assets under §721 to the contributing partner for the most part an illusion.

In the TCJA-related regulations under §168(k) the IRS rules that any such "deemed asset" created by a 704(c) remedial allocation will not be eligible for bonus depreciation.[20] The IRS reasoning, found in the preamble to the 2018 proposed regulations, states:

> Notwithstanding the language of §1.704-3(d)(2) that any method available to the partnership for newly purchased property may be used to recover the portion of the partnership's book basis in contributed property that exceeds its adjusted tax basis, remedial allocations do not meet the requirements of section 168(k)(2)(E)(ii). Because the underlying property is contributed to the partnership in a section 721 transaction, the partnership's basis in the property is determined by reference to the contributing partner's basis in the property, which violates sections 179(d)(2)(C) and 168(k)(2)(E)(ii)(II). In addition, the partnership has already had a depreciable interest in the contributed property at the time the remedial allocation is made, which is in

[20] Reg. §1.168(k)-2(b)(3)(iv)(A), Reg. §1.704-3(d)(2)

> violation of section 168(k)(2)(E)(ii)(I) as well as the original use requirement.

The preamble to the 2018 proposed regulations continued to note that the same rule applies in the case of revaluations of partnership property, otherwise referred to as reverse 704(c) allocations.

The same prohibition on the use of bonus depreciation will apply to the zero basis property rule found at Reg. §1.704-19(b)(2)(iv)(g)(3). As the preamble to the 2018 proposed regulations explained:

> Section 1.704-1(b)(2)(iv)(g)(3) provides that, if partnership property has a zero adjusted tax basis, any reasonable method may be used to determine the book depreciation, depletion, or amortization of the property. The proposed regulations provide that the additional first year depreciation deduction under section 168(k) will not be allowed on property contributed to the partnership with a zero adjusted tax basis because, with the additional first year depreciation deduction, the partners have the potential to shift built-in gain among partners.

Property Distributed from a Partnership with Basis Determined Under IRC Section 732

Generally, property distributed by a partnership to a partner ends up with a carryover basis, as the IRS explains in the preamble to the 2018 proposed regulations:

> Section 732(a)(1) provides that the basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest is its adjusted basis to the partnership immediately before the distribution. Section 732(a)(2) provides that the basis determined under section 732(a)(1) shall not exceed the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction. Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is equal to the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction.

In this situation, the regulations under IRC §168(k) provide that this property will not be eligible for bonus depreciation treatment when received by the partner.[21] As the preamble continues:

> Property distributed by a partnership to a partner fails to satisfy the original use requirement because the partnership used the property

[21] Reg. §1.168(k)-2(b)(3)(iv)(B)

> prior to the distribution. Distributed property also fails to satisfy the acquisition requirements of section 168(k)(2)(E)(ii)(II). Any portion of basis determined by section 732(a)(1) fails to satisfy section 179(d)(2)(C) because it is determined by reference to the partnership's basis in the distributed property. Similarly, any portion of basis determined by section 732(a)(2) or (b) fails to satisfy section 179(d)(3) because it is determined by reference to the distributee partner's basis in its partnership interest (reduced by any money distributed in the same transaction).

Section 734(b) Adjustments

The Sections 734 and 743 adjustments take place when a partnership either has a §754 election in place made in a prior year or makes such an election in the affected year. In both cases an adjustment is computed to take into account some differences between "inside" and "outside" basis upon the occurrence of certain transactions.

The IRS explains a §734(b) adjustment as follows in the preamble to the proposed regulations:

> Section 734(b)(1) provides that, in the case of a distribution of property to a partner with respect to which a section 754 election is in effect (or when there is a substantial basis reduction under section 734(d)), the partnership will increase the adjusted basis of partnership property by the sum of (A) the amount of any gain recognized to the distributee partner under section 731(a)(1), and (B) in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732(d)) over the basis of the distributed property to the distributee, as determined under section 732.

The IRS concludes that a §734(b) adjustment fails to qualify for bonus depreciation because the property in question that is receiving the adjustment is property previously owned by the partnership.[22] The preamble explains:

> Because a section 734(b) basis adjustment is made to the basis of partnership property (i.e., non-partner specific basis) and the partnership used the property prior to the partnership distribution giving rise to the basis adjustment, a section 734(b) basis adjustment fails the original use clause in section 168(k)(2)(A)(ii) and also fails the used property requirement in section 168(k)(2)(E)(ii)(I). The proposed regulations therefore provide that section 734(b) basis

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[22] Reg. §1.168(k)-2(b)(3)(iv)(C)

> adjustments are not eligible for the additional first year depreciation deduction.

Section 743(b) Adjustments

Given that the IRS decided that the bonus depreciation options do not apply to §704(c) allocations, reverse §704(c) allocations, property distributed to a partner and to §734(b) adjustments, you might assume the same answer would apply to §743(b) adjustments. But such a conclusion would be in error—in this case the IRS allows the use of bonus depreciation for the §743(b) adjustment.

A §743(b) adjustment is what comes to mind most often when CPAs are thinking about a §754 election. The IRS explains the situations where a §743(b) adjustment is appropriate in the preamble to the 2018 proposed regulations:

> Section 743(b)(1) provides that, in the case of a transfer of a partnership interest, either by sale or exchange or as a result of the death of a partner, a partnership that has a section 754 election in effect (or if there is a substantial built-in loss immediately after such partnership interest transfer under section 743(d)), will increase the adjusted basis of partnership property by the excess of the transferee's basis in the transferred partnership interest over the transferee's share of the adjusted basis of partnership's property. This increase is an adjustment to the basis of partnership property with respect to the transferee partner only and, therefore, is a partner specific basis adjustment to partnership property. The section 743(b) basis adjustment is allocated among partnership properties under section 755.

But the IRS concludes that, because this being allocated to only a new partner, the taxpayer in question does not have a disqualifying prior ownership interest.[23]

> As stated above, prior to the Act, a section 743(b) basis adjustment would always fail the original use requirement in section 168(k)(2)(A)(ii) because partnership property to which a section 743(b) basis adjustment relates would have been previously used by the partnership and its partners prior to the transfer that gave rise to the section 743(b) adjustment. After the Act, while a section 743(b) basis adjustment still fails the original use clause in section 168(k)(2)(A)(ii), a transaction giving rise to a section 743(b) basis adjustment may satisfy the used property clause in section 168(k)(2)(A)(ii) because of the used property acquisition requirements of section 168(k)(2)(E)(ii), depending on the facts and circumstances.

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[23] Reg. §1.168(k)-2(b)(3)(iv)(D)(1)

> Because a section 743(b) basis adjustment is a partner specific basis adjustment to partnership property, the proposed regulations take an aggregate view and provide that, in determining whether a section 743(b) basis adjustment meets the used property acquisition requirements of section 168(k)(2)(E)(ii), each partner is treated as having owned and used the partner's proportionate share of partnership property. In the case of a transfer of a partnership interest, section 168(k)(2)(E)(ii)(I) will be satisfied if the partner acquiring the interest, or a predecessor of such partner, has not used the portion of the partnership property to which the section 743(b) basis adjustment relates at any time prior to the acquisition (that is, the transferee has not used the transferor's portion of partnership property prior to the acquisition), notwithstanding the fact that the partnership itself has previously used the property. Similarly, for purposes of applying section 179(d)(2)(A), (B), and (C), the partner acquiring a partnership interest is treated as acquiring a portion of partnership property, and the partner who is transferring a partnership interest is treated as the person from whom the property is acquired.

The preamble to the 2018 proposed regulations continued to note that some rules could still bar the use of bonus depreciation.[24] The preamble notes:

> For example, the relationship between the transferor partner and the transferee partner must not be a prohibited relationship under section 179(d)(2)(A). Also, the transferor partner and transferee partner may not be part of the same controlled group under section 179(d)(2)(B). Finally, the transferee partner's basis in the transferred partnership interest may not be determined in whole or in part by reference to the transferor's adjusted basis, or under section 1014

Since inherited property has basis determined under IRC §1014, there is no option to claim the additional first year depreciation under §168(k) on a §743(b) adjustment arising from the death of a partner—even if the interest passes to an unrelated third party.

The preamble to the 2018 proposed regulations also noted that the issue of whether the acquiring party is or is not currently a partner in the partnership doesn't matter.

> The same result will apply regardless of whether the transferee partner is a new partner or an existing partner purchasing an additional partnership interest from another partner. Assuming that the transferor partner's specific interest in partnership property that is acquired by the transferee partner has not previously been used by the transferee partner or a predecessor, the corresponding section 743(b) basis

[24] Reg. §1.168(k)-2(b)(3)(iv)(D)(2)

> adjustment will be eligible for the additional first year depreciation deduction in the hands of the transferee partner, provided all other requirements of section 168(k) are satisfied (and assuming §1.743-1(j)(4)(i)(B)(2) does not apply). This treatment is appropriate notwithstanding the fact that the transferee partner may have an existing interest in the underlying partnership property, because the transferee's existing interest in the underlying partnership property is distinct from the interest being transferred.

The IRS also ruled that an election out of bonus depreciation for classes of property can be made independently by the partnership for §743(b) adjustment "property" created during the year and the assets the partnership placed in service generally during the year.[25]

> Finally, the [2018] proposed regulations provide that a section 743(b) basis adjustment in a class of property (not including the property class for section 743(b) basis adjustments) may be recovered using the additional first year depreciation deduction under section 168(k) without regard to whether the partnership elects out of the additional first year depreciation deduction under section 168(k)(7) for all other qualified property in the same class of property and placed in service in the same taxable year. Similarly, a partnership may make the election out of the additional first year depreciation deduction under section 168(k)(7) for a section 743(b) basis adjustment in a class of property (not including the property class for section 743(b) basis adjustments), and this election will not bind the partnership to such election for all other qualified property of the partnership in the same class of property and placed in service in the same taxable year.

[25] Reg. §1.743-1(j)(4)(i)(B)(1)

The IRS gives a series of examples to show how to test to see if a §743(b) transaction qualifies for the additional first year depreciation under IRC §168(k).

EXAMPLE 13, REG. §1.168(K)-2(B)(3)(VI)

Q, R, and S form an equal partnership, QRS, in 2019. Each partner contributes $100, which QRS uses to purchase a retail motor fuels outlet for $300. Assume this retail motor fuels outlet is QRS' only property and is qualified property under section 168(k)(2)(A)(i). QRS makes an election not to deduct the additional first year depreciation for all qualified property placed in service during 2019. QRS has a section 754 election in effect. QRS claimed depreciation of $15 for the retail motor fuels outlet for 2019. During 2020, when the retail motor fuels outlet's fair market value is $600, Q sells all of his partnership interest to T in a fully taxable transaction for $200. T never previously had a depreciable interest in the retail motor fuels outlet. T takes an outside basis of $200 in the partnership interest previously owned by Q. T's share of the partnership's previously taxed capital is $95. Accordingly, T's section 743(b) adjustment is $105 and is allocated entirely to the retail motor fuels outlet under section 755. Assuming all other requirements are met, T's section 743(b) adjustment qualifies for the additional first year depreciation deduction.

EXAMPLE 14, REG. §1.168(K)-2(B)(3)(VI)

The facts are the same as in Example 13 of this paragraph (b)(3)(vi), except that Q sells his partnership interest to U, a related person within the meaning of section 179(d)(2)(A) or (B) and §1.179-4(c). U's section 743(b) adjustment does not qualify for the additional first year depreciation deduction.

EXAMPLE 15, REG. §1.168(K)-2(B)(3)(VI)

The facts are the same as in Example 13 of this paragraph (b)(3)(vi), except that Q dies and his partnership interest is transferred to V. V takes a basis in Q's partnership interest under section 1014. As a result, section 179(d)(2)(C)(ii) and §1.179-4(c)(1)(iv) are not satisfied, and V's section 743(b) adjustment does not qualify for the additional first year depreciation deduction.

EXAMPLE 16, REG. §1.168(K)-2(B)(3)(VI)

The facts are the same as in Example 13 of this paragraph (b)(3)(vi), except that QRS purchased the retail motor fuels outlet from T prior to T purchasing Q's partnership interest in QRS. T had a depreciable interest in such retail motor fuels outlet. Because T had a depreciable interest in the retail motor fuels outlet before T acquired its interest in QRS, T's section 743(b) adjustment does not qualify for the additional first year depreciation deduction.

Syndication Transactions

The IRS provides special rules for syndication transactions to avoid allowing a short-term holder to claim additional first year depreciation. Reg. §1.168(k)-2(b)(3)(vi) provides:

> If a lessor has a depreciable interest in the property and the lessor and any predecessor did not previously have a depreciable interest in the property, and the property is sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor (or, in the case of multiple units of property subject to the same lease, within three months after the date the final unit is placed in service, so long as the period between the time the first unit is placed in service and the time the last unit is placed in service does not exceed 12 months), and the user of the property after the last sale during the three-month period remains the same as when the property was originally placed in service by the lessor, the purchaser of the property in the last sale during the three month period is considered the taxpayer that acquired the property for purposes of applying paragraphs (b)(3)(ii) and (iii) of this section.

As the preamble to the 2018 proposed regulations provided:

> Thus, if a transaction is within the rules described above, the purchaser of the property in the last sale during the three-month period is eligible to claim the additional first year depreciation for the property (assuming all requirements are met), and the earlier purchasers of the property are not.

SECTION: 851
IRS OFFERS SETTLEMENT OPTION TO UP TO 200 TAXPAYERS UNDER EXAM FOR MICROCAPTIVE TRANSACTIONS

Citation: IR 2019-157, 9/16/19

We've previously discussed the issue of microcaptive insurance companies, such as the IRS's successful attack on such an arrangement in the case of *Avrahami, et al v.*

Commissioner, 149 TC No. 17.[26] The IRS has continued to go after taxpayers who had entered into such arrangements, with *Tax Notes Today Federal* reporting on September 17, 2019 that 500 cases involving this matter were pending before the Tax Court and even more were in process in Exam and Appeals.[27] Such structures were identified as listed transactions in Notice 2016-66.[28]

The IRS has now decided to offer a settlement option to up to 200 taxpayers with such issues outstanding, per a press release issued by the agency.[29] The release notes that:

> Taxpayers eligible for this offer will be notified by letter with the applicable terms. Taxpayers who do not receive such a letter are not eligible for this resolution.[30]

The IRS notes the broad classes from which the 200 will and will not be drawn:

> The initiative is currently limited to taxpayers with at least one open year under exam. Taxpayers who also have unresolved years under the jurisdiction of the IRS Appeals may also be eligible, but those with pending docketed years under Counsel's jurisdiction are not eligible.[31]

The notice points out the IRS's successes in challenging this strategy:

> Following wins in three recent U.S. Tax Court cases, the IRS has decided to offer settlements to taxpayers currently under exam. In recent days, the IRS started sending notices to up to 200 taxpayers.

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[26] See "No Deduction Allowed for Premiums Paid to Related Entity in Microcaptive Structure," *Current Federal Tax Developments* website, August 22, 2017, https://www.currentfederaltaxdevelopments.com/blog/2017/8/22/no-deduction-allowed-for-premiums-paid-to-related-entity-in-microcaptive-structure

[27] Emily Foster, "IRS Initiates Settlement Offer for Select Microcaptive Insurers," *Tax Notes Today Federal*, September 17, 2019, https://www.taxnotes.com/tax-notes-today-federal/insurance/irs-initiates-settlement-offer-select-microcaptive-insurers/2019/09/17/29y9z (subscription required), retrieved September 17, 2019

[28] https://www.irs.gov/pub/irs-drop/n-16-66.pdf, retrieved September 17, 2019

[29] IR 2019-157, "IRS offers settlement for micro-captive insurance schemes; letters being mailed to groups under audit," IRS website, https://www.irs.gov/newsroom/irs-offers-settlement-for-micro-captive-insurance-schemes-letters-being-mailed-to-groups-under-audit, September 16, 2019, retrieved September 17, 2019

[30] *Ibid*

[31] *Ibid*

> Tax law generally allows businesses to create "captive" insurance companies to protect against certain risks. Under section 831(b) of the Internal Revenue Code, certain small insurance companies can choose to pay tax only on their investment income. In abusive "micro-captive" structures, promoters, accountants or wealth planners persuade owners of closely held entities to participate in schemes that lack many of the attributes of genuine insurance.
>
> The IRS has consistently disallowed the tax benefits claimed by taxpayers in abusive micro-captive structures. Although some taxpayers have challenged the IRS position in court, none have been successful. To the contrary, the Tax Court has now sustained the IRS' disallowance of the claimed tax benefits in three different cases.[32]

The news release also contains a warning that taxpayers who decline the invitation to accept the settlement offer should not expect a better result in Appeals:

> Although taxpayers who decline to participate will have full Appeals rights, the IRS Independent Office of Appeals is aware of this resolution initiative. Given the current state of the law, it is the view of the IRS Independent Office of Appeals that these terms generally reflect the hazards of litigation faced by taxpayers, and taxpayers should not expect to receive better terms in Appeals than those offered under this initiative.[33]

The news release also warns that those who are offered the settlement agreement but decline to enter it will not be eligible for later settlement agreements.

The Tax Analysts article cited earlier on the issue notes that the worst case result for a taxpayer who loses on this issue at the end of the day is a denial of all deductions for payments made to the captive insurance carrier and recognition of the premiums as income. [34]

The article quotes Stephen T. Miller, a former acting IRS commissioner and now with Alliantgroup, LP, regarding what taxpayers are currently being offered in Appeals—full disallowance of the deduction of any premiums, but being will to take a less severe line on taxability of the premiums to the captive and potentially even on the return of the funds from the captive to the owners. Mr. Miller suggested that it is likely the program

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[32] *Ibid*

[33] *Ibid*

[34] Foster, *Tax Notes Today*

has been designed to offer terms similar to those being given in Appeals to those who agree to participate.[35]

Taxpayers who receive the letter will need to make a decision on whether to take the IRS up on the offer (the exact terms of which are far from clear in the press released) or to continue to press their case, hoping for a more favorable outcome.

SECTION: 6501
FAILURE OF IRS TO SIGN CONSENT TO EXTEND STATUTE BEFORE STATUTE EXPIRATION DUE TO GOVERNMENT SHUTDOWN MEANT STATUTE EXPIRED

Citation: Chief Counsel Email ECC 201937017, 9/13/19

The federal government shutdown this past winter apparently caused an extension of a statute agreed to by the taxpayer to be nevertheless invalid when the IRS did not also sign off on the extension prior to the expiration of statute due to the shutdown, the Chief Counsel's office ruled in Email Advice ECC 201937017.[36]

The question presented in the email is relatively simple:

> You asked us first whether, where the IRS did not timely sign a Form 872 *Consent to Extend the Time to Assess Tax*—due to a government shutdown at the time—but the taxpayer did sign the Consent, the consent is valid.[37]

The email concludes that the failure of the IRS to sign the Consent before the statute expired renders that Form 872 invalid:

> The consent is invalid. The period of limitations to assess a tax may only be extended by consent "prior to the expiration" of the time to assess, and consent to extend "shall become effective when the agreement has been executed by both parties." Treas. Reg. § 301.6501(c)-1(d). Here, the consent at issue was not executed by the IRS prior to the expiration of the period of limitations, at which point

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[35] *Ibid*

[36] ECC 201937017, https://www.irs.gov/pub/irs-wd/201937017.pdf, September 13, 2019, retrieved September 17, 2019

[37] *Ibid,* p. 1

> it can no longer be extended. That the failure to execute the extension was justified does not change this answer.[38]

Anticipating this answer, the questioner then asked the attorney to give his view on the validity of a power of attorney where a date range was mentioned, rather than listing the specific years, and where the POA did not explicitly grant the holder the right to sign a Consent. The question was presented as follows:

> If it is invalid, you also asked whether a prior Consent signed by a Power of Attorney (POA) is valid when the POA (1) lists a date range that includes all years at issue but does not mention them explicitly, and (2) conveys only the boilerplate POA authorities and does not go beyond that to list authority to sign consents.[39]

The attorney found that while the IRS may not like accepting such a POA, the attorney's view is that the POA is valid:

> The prior Consent is valid for extending excise tax. (1) The POA gives a range of years that included all years at issue,and therefore the POA had authority to act on the taxpayers behalf for all years at issue. While the Internal Revenue Manual cautions against accepting POAs that grant general authority such as "all years," I.R.M. 25.6.22.5.8.1(2)(a), in this case a specific range of years is specified, and that suffices. (2) The boilerplate POA form language explicitly grants the POA authority to sign "any agreements, consents, or similar documents" (emphasis added). This satisfies the Manual's requirement that POAs be "specific in authorizing the representative to sign consents for the taxpayer." I.R.M. 25.6.22.5.8.1(2)(b). Note:Because the POA only conveys authority to extend excise tax and not income tax, only excise tax was validly be extended by the Consent.[40]

SECTION: 6511
EXISTENCE OF POWER OF ATTORNEY NOT CURRENT

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[38] *Ibid*

[39] *Ibid*

[40] *Ibid*

BEING USED FOUND TO BAR FINDING OF FINANCIAL DISABILITY

Citation: Stauffer v. IRS, United States Court of Appeals, First Circuit, Case No. 18-2105

A "zombie" power of attorney proved costly for the estate of a taxpayer in the case of *Stauffer v. IRS*, United States Court of Appeals, First Circuit, Case No. 18-2105.[41] By "zombie" we're referring to a power of attorney that was not being actively used by the power holder, who announced he wasn't going to act under it, and which the grantor drafted letters to revoke but never actually got around to sending to the power holder. This power that never died would enter into the question of whether the statute of limitations was still open for the estate to claim a refund of taxes due to the decedent.

The law involved is IRC §6511(h) which suspends the statute for claiming a refund for the period an individual is financially disabled. But there is an exception to this suspension of the statute, found at IRC §6511(h)(2)(B), that provides a person is not financially disabled during any period where another person "is authorized to act on behalf of such individual in financial matters."

Carlton Stauffer had executed a durable power of attorney (DPA), naming his son, Hoff, to hold the power. Mr. Stauffer granted the power as he was both elderly and mentally ill.[42] However, less than six months after the power was granted, the father and son had a falling out. The friction resulted in the father and son taking the following actions:

> Hoff claims to have told Carlton at the March 15 meeting that he would no longer be exercising any rights granted to him under the DPA. Then, Carlton drafted three notices revoking the DPA. However, he never sent these notices, and Hoff never received them. Carlton and Hoff also stopped talking. Carlton would not pick up Hoff's calls or return his calls or messages. The fallout led Hoff to tell his sister (Carlton's daughter), Carlton's accountant, and Carlton's attorneys that he was no longer acting as his father's agent under the DPA.[43]

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[41] *Stauffer v. IRS*, September 16, 2019, http://media.ca1.uscourts.gov/pdf.opinions/18-2105P-01A.pdf, Retrieved September 18, 2019

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

[43] *Ibid*, p. 4

Beginning with the year that Hoff announced he would no longer exercise rights under the DPA, Carlton stopped filing income tax returns. While Hoff and Carlton did reconcile a few years later, Hoff did not handle any matters under the DPA.

When Carlton died, Hoff was appointed as personal representative, and he discovered the fact that income tax returns had not been filed from 2006-2012 (the last being the year that Carlton died). Carlton filed all of these returns in April 2013.

The 2006 return had an overpayment of $137,403, from which the estate requested a refund of $97,364 and requested the remaining balance be applied to Carlton's 2007 liability. The IRS found that the claim for refund was late, being after the time period prescribed for filing for such a refund under IRC §6511(a) and then later denied the taxpayer's claim following an internal appeal.[44]

The IRS argued that even if Carlton was financially disabled as defined at IRC §6511(h), his son held a valid durable power of attorney that granted him the right to act on his father's behalf, including the right to file income tax returns. [45]

The opinion notes that the statute does not contain a definition regarding what is meant by someone being *authorized* to act on behalf of the taxpayer. The estate argues that the provision should be read to require that a person meet all three of the following criteria to be considered authorized to act on behalf of the taxpayer.

- The person must have the authority to file the tax returns on behalf of the financially disabled person;
- The person must have a duty to file the financially disabled person's tax returns; and
- The person must have actual or constructive knowledge of the fact that returns for a particular tax year have not been filed.[46]

The appellate panel rejected these criteria as going far beyond the statute in imposing conditions for a person to be authorized to act on behalf of the individual.

The panel skips over the first claim, noting that neither party had suggested that Hoff was not authorized to file the returns on Carlton's behalf—the power of attorney explicitly granted Hoff this authority.[47]

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[44] *Ibid*, p. 5

[45] *Ibid,* pp. 9-10

[46] *Ibid*, p. 9

[47] *Ibid*, p. 10

The Court then looks to find a definition of *authorized* since none is found in the statute itself. The Court turns to dictionary definitions to find the expected meaning of the word, noting:

> The root word for "authorized" is "authority," which is defined as: (1) "[t]he official right or permission to act, esp. to act legally on another's behalf; esp., the power of one person to affect another's legal relations by acts done in accordance with the other's manifestations of assent," Authority, Black's Law Dictionary (11th ed. 2019); (2) "the power delegated by a principal to an agent," id.; (3) "power to influence or command thought, opinion, or behavior, "Authority, Merriam-Webster Online Dictionary, https://www.merriam-webster.com/dictionary/authority (last visited Aug. 15, 2019); and (4) "freedom granted by one in authority," id. These dictionary definitions reveal no ambiguity.[48]

The panel points out that nowhere in that definition is there a reference to a requirement there be a duty—rather being authorized gives a person a power to act, not necessarily a requirement the person do so.[49]

The panel similarly found no support for the view that the use of the word *authority* imposes a requirement the person holding the power be aware of the failure to file a return, noting that "[t]he statute's plain language does not include any term into which such a requirement can plausibly be read, nor does the Estate point to any contextual basis (e.g., provisions of the whole law) from which it can be inferred."[50]

The panel also found the District Court had not erred in finding the DPA had not been properly terminated, and thus remained in force during the time period that it was claimed the decedent was financially disabled. The opinion notes:

> Carlton and Hoff's execution of the DPA gave rise to a principal-agent relationship. See generally 20 Pa. Cons. Stat. § 5601 (2015).14 Under Pennsylvania law, an agent's renunciation of the duties and obligations of such relationship must be positive, unequivocal, and made known to the principal for it to be effective. *Bergner v. Bergner*, 67 A. 999, 1001 (Pa. 1907). Furthermore, "the burden of proving renunciation of one's obligations rests on the party asserting it." *Shafer v. A. I. T. S., Inc.*, 428 A.2d 152, 155 (Pa. Super. Ct. 1981).

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

[49] *Ibid*, p. 13

[50] *Ibid,* p. 15

The district court found that the Estate did not meet its burden of proving that Hoff renounced the DPA. Our review of the record leads us to conclude the same. Thus, we find no error in the district court's finding, much less a clear error.

We agree with the district court's assessment of the deposition testimony upon which it primarily relied to reach its finding that Hoff did not renounce the DPA. See *Stauffer*, 2018 WL 5092885, at *10. During the deposition, which was taken for a separate Pennsylvania state court proceeding, Hoff was asked, "Do you recall ever discussing the possible termination of the power of attorney directly with your father?"; to which he responded, "I don't, but I could have said . . . I'm not doing anything with it now, it's really a non-issue, but it would hurt my feelings if it were terminated." Below and now before us, the Estate attempts to save itself from Hoff's deposition testimony by contradictorily asserting that Hoff actually told Carlton during the March 15 meeting that "he would no longer be exercising any rights granted to him under the [DPA]." But, as the district court noted, "if true, this [purported statement] would not constitute a renunciation" because it "only expresses an intent not to use the [DPA], not a 'positive and unequivocal' renunciation of it." Id. (quoting *Bergner*, 67 A. at 1001); see 20 Pa. Cons. Stat. § 5604(b) (2017) ("Unless the power of attorney states a time of termination, it is valid notwithstanding the lapse of time since its execution."). As such, Hoff's purported March 15 meeting statement is — as a matter of law — inconsequential to the question of whether he renounced the DPA.[51]

SECTION: 7216
SINCE INFORMATION NOT AVAILABLE FROM ANOTHER SOURCE, CPA ORDERED TO TURN OVER TAX RETURN OF CLIENT TO PLAINTIFF IN SUIT AGAINST CLIENT

Citation: Anyclo International Inc. v. Yang-Sup Cha, et al, US District Court District of New Jersey, Case No. 18-5759, 9/3/19

A CPA firm may be faced with a subpoena related to a client to produce various documents, including tax returns, when a client is a party to a suit. The validity of the subpoena is a key issue, since generally CPAs are not allowed to voluntarily disclose client information in most cases under state law and tax-related information under the

[51] *Ibid*, pp. 17-19

federal law, but the CPA must produce those documents when the law does mandate such production.

In the case of *Anyclo International, Inc. V. Cha*, US District Court District of New Jersey, Case No. 18-5759[52], the question arose regarding whether a plaintiff in a civil suit could obtain a copy of the defendant's income tax returns from the defendant's CPA. Or, in the alternative, would such production be a violation of the defendant's privacy rights.

In the case before the court, Anyclo alleged that Cha had misappropriated funds sent to the defendant to assist the plaintiff in incorporating a subsidiary in New York. The Court describes the allegations as follows:

> In 2016, Anyclo International, Inc., hired Yang-Sup Cha to assist in incorporating a subsidiary of it in the State of New York. (Am. Compl. ¶¶ 16-17, ECF No. 25; Answer to Am. Compl. ¶¶ 16-17, ECF 30.) Plaintiff claims it wired Defendant Stafford Cha seed money and additional funds for operating costs and other expenses. (Am. Compl. ¶¶ 18, 24, 32-34.) According to Plaintiff, "Defendants conspired to make it appear as if Defendant [Yang-Sup] Cha was following Anyclo International' s directives when i[n] fact Defendants created Anyclo USA as a corporation owned by one or more of the Defendants .... " (Am. Compl. ¶ 30.) Plaintiff alleges Defendants improperly misappropriated Plaintiff's funds and improperly withheld "payments received from third-parties for goods manufactured and delivered by" Plaintiff. (Am. Compl. ¶ 83.) As part of that claim, Plaintiff alleges it gave money to Anyclo USA for rental expenses, later learning that Anyclo USA did not rent a space at its reputed address and that the entity to which Anyclo USA was purportedly paying rent, Mojo Moto, LLC, did not own a space there. (Am. Compl. ¶¶ 69, 106-07, 123.) Mojo Moto, LLC, is allegedly owned by Defendant Nam-Hee Kim. (Am. Compl. ¶ 69.)[53]

A CPA was engaged during this process, and the plaintiff sought information from that CPA:

> Certified public accountant, Daniel Cho, was obtained to assist in establishing Anyclo USA. (Am. Compl. ¶¶ 20-21; Answer to Am. Compl. ¶¶ 20-21, ECF 30.) On March 27, 2019, Plaintiff served Cho with a subpoena, commanding he produce "[a]ll communications (electronic and otherwise) with Yang-Sup Cha, Nam-Hee Kim and

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[52] https://ecf.njd.uscourts.gov/doc1/119115087690, (Pacer registration required), September 3, 2019

[53] *Ibid*, pp. 1-2

> Stafford Cha as it relates to Anyclo USA, Inc. and/or Mojo Moto, LLC" and "[c]opies of all documents prepared for the benefit of Yang-Sup Cha, Nam-Hee Kim, Stafford Cha, Anyclo USA, INC., and/or Mojo Moto, LLC." (Certification of Gregory J. Cannon, Esq. Ex. A, at 1, Ex. B, ECF No. 32-1.)

The issue in dispute is whether Mr. Cho should be required to provide individual income tax returns for certain defendants in this action.

The Court begins by noting that the Third Circuit Court of Appeals, to which any appeal would be taken, has provided that generally tax returns are not subject to disclosure, but also that there are some exceptions to that general rule. As the Court notes:

> In *DeMasi*, the Third Circuit recognized that public policy favors the non-disclosure of income tax returns because "Congress has guaranteed that federal income tax returns will be treated as confidential communications between a taxpayer and the government," 669 F.2d at 119 (citing 26 U.S.C.A. § 6103), and because confidentiality removes the pressure taxpayers may otherwise feel to refrain from reporting all of their income or from taking advantage of all of the tax-saving measures to which they are entitled, id. at 120 (citing *Fed. Sav. & Loan Ins. Corp. v. Krueger*, 55 F.R.D. 512, 514 (N.D. Ill. 1972)). "A party's income tax returns, even if containing some relevant financial information, are protectable from discovery as confidential documents if the party seeking protection demonstrates good cause to uphold its expectation of confidentiality, as well as the availability of reliable financial information from other sources." *Farmers & Merchants Nat. Bank v. San Clemente Fin. Grp. Sec.*, Inc., 174 F.R.D. 572, 585 (D.N.J. 1997).[54]

The Court, citing a number of cases, determines that it must apply a two-part test to determine if, despite the individual's right to privacy, the tax returns are subject to disclosure. To require disclosure of the returns, the Court must find:

- The returns are relevant to the litigation at hand and
- The party objecting to disclosure does not demonstrate the availability of reliable financial information from other sources.

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[54] *Ibid*, p. 4

The party seeking the returns has the burden of demonstrating the relevance, while the party seeking to avoid disclosure has the burden of showing the availability of information from other sources.[55]

The Court finds that the plaintiff had demonstrated the information in the returns would be relevant to the matter being litigated, noting:

> First, the Court agrees with Plaintiff that Defendants' tax returns are relevant to determining whether Defendants improperly diverted funds paid by Plaintiff and relevant to determining the truth of Defendants' asserted explanations and the validity of their defenses. As Plaintiff contends, the contemporaneous treatment of monies allegedly paid to support Anyclo USA' s business operations on Defendants' individual tax returns may support or undermine each parties' contentions. While unlikely to provide a clear accounting, Defendants' reported income is likely to show whether Yang-Sup Cha, Nam-Hee Kim, or Stafford Cha reported Plaintiff's wire transfers as personal income, which would support Plaintiff's diversion and embezzlement claims.[56]

The Court also found that the defendants had not shown the existence of alternative sources of the financial information:

> Second, it does not appear to the Court that the same information discoverable in Defendants' individual tax returns is discoverable by other means. Defendants submit "Plaintiff's own records can be the source of its prima facie proof of loss," (Mot. to Quash Subpoena 3, ECF 36), and while that may be true, the value in Defendants' tax returns extends beyond proving loss. The crux of Plaintiff's claims are the allegations of diversion and embezzlement. The treatment of the funds paid by Plaintiff is vital to proving those claims. The Court does not perceive-and Defendants do not proffer an alternative method of showing how Defendants treated Plaintiff's monetary transfers.[57]

Unfortunately, CPAs often find themselves drawn into disputes that clients get themselves embroiled in. As this case demonstrates, whether or not the Form 1040 must be turned over to the party offering up a subpoena is not something the CPA will be able to determine on his/her own. When such a situation arises, the CPA should seek counsel and follow counsel's advice about how to respond to avoid either failing to

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

[56] *Ibid*, p. 5

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

turn over documents that are required to be turned over, or denying the CPA's client the ability to timely object to the production of such documents.