Current Federal Tax Developments

Week of November 25, 2019

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ACCOUNTING
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KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF NOVEMBER 25, 2019

Published in 2019 by Kaplan Financial Education.

Printed in the United States of America.

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Kaplan Financial Education

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SECTION: SECURITY
IRS DISCUSSES DATA SECURITY ISSUES FACING TAX PROFESSIONALS

Citation: Nathan J. Richman, "Tax Hackers Coming Up With New Traps for the Unwary," Tax Notes Today, 11/22/19

Information regarding methods being used to perpetrate tax refund frauds using preparer's systems were discussed by IRS representatives at the New England IRS Representation Conference in North Haven, Connecticut, per a report published in *Tax Notes Today Federal*.[1]

One method, described by Margaret Romaniello, area manager, IRS stakeholder liaison division, is for intruders on the network to modify bank account information on returns that are awaiting transmission to the IRS for electronic filing. The refund would end up being deposited somewhere other than where the taxpayer intended it to be deposited, such as a Green Dot prepaid debit card in the words of Romaniello.

When the client signs the authorization to send the returns, the now modified return would be the one actually forwarded by the preparer to the taxing agency. The fraud would likely go unnoticed until and unless the client begins to ask why their refund has not appeared in their bank account.[2]

The article also described information provided by David Lyons, a tax professional who suffered a data breech in 2013. He noted that he had to deal with multiple state level rules regarding what a firm must do in the case of a data breech. He notes that each state will have unique rules on credit monitoring services that may be required to be provided to affected individuals. David, like many professionals, had clients scattered across the United States—in his case in 40 different states.[3]

He also noted that the requirement to provide monitoring services is not limited to direct clients of the firm—information in his files that held personally identifiable

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[1] Nathan J. Richman, "Tax Hackers Coming Up With New Traps for the Unwary," *Tax Notes Today,* November 22, 2019, 2019 TNTF 227-5, https://www.taxnotes.com/tax-notes-today-federal/tax-system-administration/tax-hackers-coming-new-traps-unwary/2019/11/22/2b52x (subscription required)

[2] Nathan J. Richman, "Tax Hackers Coming Up With New Traps for the Unwary," *Tax Notes Today,* November 22, 2019

[3] Nathan J. Richman, "Tax Hackers Coming Up With New Traps for the Unwary," *Tax Notes Today,* November 22, 2019

information about non-clients also required him to provide monitoring for those individuals.[4] Why would a firm have such information? There are numerous reasons such as:

- Information on employees of clients where the firm is involved with payroll processing;
- Information obtained by the firm about employees, vendors and customers of the client when the firm also performs auditing and other attest services;
- Information on partners, shareholders and beneficiaries when the firm prepares a tax return for a partnership, S corporation, trust or estate for which K-1s are prepared; and
- Many other cases where information related to non-clients is obtained from the client to perform professional services.

Quite often it is not possible to say for sure that such data was not accessed by the outside party—so the firm must operate under the assumption that such data was obtained by the unauthorized parties.

Surprisingly, David did not suffer a large loss of clients, stating that less than 10 clients left his firm due to the breach. But that didn't mean there was no cost to David—he notes that his firm had to spend about $500,000 over six years to deal with the effects of the breach.[5]

Tax preparers should have noticed that when they went to renew their PTIN for the upcoming tax season they were required to answer a new question. Question 11 on Form W-12 and the electronic equivalent on the IRS website asks the applicant to check a box agreeing with the following statement:

> As a paid tax return preparer, I am aware of my legal obligation to have a data security plan and to provide data and system security protections for all taxpayer information. Check the box to confirm you are aware of this responsibility.[6]

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[4] Nathan J. Richman, "Tax Hackers Coming Up With New Traps for the Unwary," *Tax Notes Today,* November 22, 2019

[5] Nathan J. Richman, "Tax Hackers Coming Up With New Traps for the Unwary," *Tax Notes Today,* November 22, 2019

[6] Form W-12, 2019, Question 11, page 2, https://www.irs.gov/pub/irs-pdf/fw12.pdf (retrieved November 22, 2019)

The article contained the following warning issued by Ms. Romaniello:

> "If you become a victim because the security systems aren't what they should be and it's determined that you are liable, one of the things that the IRS will say to you is 'Look at your PTIN application,'" Romaniello said.[7]

Those expected precautions can be found on the IRS website in the "Security Six" list.[8] The six items listed are:

- Anti-virus software;
- Firewalls;
- Two-factor authentication;
- Backup software or services;
- Drive encryption; and
- Virtual private network.[9]

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[7] Nathan J. Richman, "Tax Hackers Coming Up With New Traps for the Unwary," *Tax Notes Today,* November 22, 2019

[8] "Tax pros: Follow the "Security Six" steps to help protect taxpayer data," IRS Website, August 27, 2019, https://www.irs.gov/newsroom/tax-pros-follow-the-security-six-steps-to-help-protect-taxpayer-data (retrieved November 22, 2019)

[9] "Tax pros: Follow the "Security Six" steps to help protect taxpayer data," IRS Website, August 27, 2019

SECTION: 199A
IRS EXPANDS §199A FAQ PAGE TO INCLUDE ISSUES RELATED TO RENTALS

Citation: "Tax Cuts and Jobs Act, Provision 11011 Section 199A - Qualified Business Income Deduction FAQs," IRS Website, 11/20/19

The IRS has continued to add more questions to the set of frequently asked questions on IRC §199A.[10]

For those hoping that this might mean the IRS has changed its answer regarding the treatment of S corporation shareholders and the self-employed health insurance deduction—you will be disappointed. The answer to question 33 remains unchanged from the version first posted on April 11, 2019.[11]

However, in the most recent revision, the IRS added 12 questions related to rentals. For the most part there is nothing terribly surprising in the IRS guidance on rentals posted on this site, but it is useful to have the information all in one place. That is, there is nothing like the question 33 surprise that practitioners ran into with the April 11 revisions.

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[10] "Tax Cuts and Jobs Act, Provision 11011 Section 199A - Qualified Business Income Deduction FAQs," *IRS Website*, Revised November 20, 2019, https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs

[11] For those who don't know what the issue is related to question 33, see the article that posted on April 20, 2019 at https://www.currentfederaltaxdevelopments.com/blog/2019/4/20/irs-greatly-expands-frequently-asked-questions-for-199a-on-website-and-s-corporation-owners-arent-going-to-like-the-final-answer.

The guide begins by listing the three ways that a rental may be treated as a trade or business for §199A purposes.

> **Q48. When is rental real estate treated as a trade or business for purposes of determining the QBI deduction?**
>
> A48. Rental real estate is treated as a trade or business for purposes of the QBI deduction under section 199A if it meets any of the following three tests:
>
> - The rental real estate rises to the level of a section 162 trade or business.
> - The rental real estate is a rental real estate enterprise meeting the requirements of the safe harbor provided in Revenue Procedure 2019-38. See Q49.
> - The rental or licensing of property is to a commonly controlled trade or business operated by an individual or a passthrough entity as described in Treas. Reg. § 1.199A-1(b)(14). This is often referred to as a self-rental.

The FAQ goes on to give a summary of the safe harbor found in Revenue Procedure 2019-38.

> **Q49. When is a rental real estate enterprise eligible to rely upon the safe harbor provided in Revenue Procedure 2019-38?**
>
> *A49. Revenue Procedure 2019-38 provides a safe harbor under which a rental real estate enterprise that meets certain requirements will be treated as a trade or business for purposes of section 199A. In order to rely upon the safe harbor, the enterprise must meet all requirements of the Revenue Procedure.*
>
> *A rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in a single property or interests in multiple properties. The interest must be held directly or through a disregarded entity by the individual or relevant passthrough entity (RPE) relying on the safe harbor. Multiple properties of the same category (residential or commercial) can be treated as a single enterprise if the individual or RPE also includes all other properties of the same category in the enterprise. Residential and commercial property cannot be combined into a single property except for mixed-use property as*

discussed in Q 51. To qualify under the safe harbor, the rental real estate enterprise must satisfy all of the following requirements:

- *Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise. If a rental real estate enterprise contains more than one property, this requirement may be satisfied if income and expense information statements for each property are maintained and then consolidated;*

- *For rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed (as described in Revenue Procedure 2019-38) per year with respect to the rental real estate enterprise. For rental real estate enterprises that have been in existence for at least four years, in any three of the five consecutive taxable years that end with the taxable year, 250 or more hours of rental services are performed (as described in Revenue* Procedure 2019-38) per year with respect to the rental real estate enterprise; and

- The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. If services with respect to the rental real estate enterprise are performed by employees or independent contractors, the taxpayer may provide a description of the rental services performed by such employee or independent contractor, the amount of time such employee or independent contractor generally spends performing such services for the enterprise, and time, wage, or payment records for such employee or independent contractor. Such records are to be made available for inspection at the request of the IRS.

- The taxpayer or RPE attaches a statement to a timely filed original return, including extensions, (or an amended return for the 2018 taxable year only) for each taxable year in which the taxpayer or RPE relies on the safe harbor. An individual or RPE with more than one rental real estate enterprise relying on this safe harbor may submit a single statement but the statement must list the required information separately for each rental real estate enterprise. The statement must include the following information:

- A description (including the address and rental category) of all rental real estate properties that are included in each rental real estate enterprise;
- A description (including the address and rental category) of rental real estate properties acquired and disposed of during the taxable year; and
- A representation that the requirements of this revenue procedure have been satisfied.

Certain rental real estate arrangements are excluded from the safe harbor and may not be included in a rental real estate enterprise. These include real estate used by the taxpayer as a residence under section 280A; real estate rented under a triple net lease; real estate rented to a trade or business conducted by a taxpayer on an RPE which is commonly controlled under section 1.199A-4(b)(1)(i) and rental real estate where any portion of the property is treated as a specified service trade or business (SSTB).

The FAQ goes on to give more information on the records requirement of Revenue Procedure 2019-38:

Q50. How can I meet the records requirement of the safe harbor contained in Revenue Procedure 2019-38 and what happens if I don't meet it?

A50: Reliance upon the safe harbor requires the maintenance of contemporaneous records, including time reports, logs or similar documents, regarding the hours of all services performed, a description of services performed, dates on which such services were performed and who performed the services.

If an employee or independent contractor performed the services with respect to the rental real estate enterprise, the taxpayer may provide a description of the rental services performed, the amount of time the employee or independent contractor generally spent performing the services for the enterprise, and time, wage or payment records for the employee or independent contractor.

The safe harbor is not available to taxpayers that fail to meet the contemporaneous records requirement. However, the rental real estate may still be treated as a trade or business for purposes of the QBI deduction if the rental real estate otherwise rises to the level of a

> section 162 trade or business or meets the self-rental rule. Whether rental real estate rises to the level of a trade or business under section 162 depends on all facts and circumstances.
>
> The contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2020. However, taxpayers bear the burden of showing the right to any claimed deductions in all taxable years. *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84; 112 S.Ct. 1039, 1043) (1992); *Interstate Transit Lines v. Comm'r,* 319 U.S. 590, 593, 63 S.Ct. 1279, 1281 (1943). See also I.R.C. § 6001; Treas. Reg. § 1.6001-1(a) and (e).

The FAQ also summarizes the mixed-use rules added in the final Revenue Procedure:

> **Q51. How does the safe harbor provided for in Revenue Procedure 2019-38 apply to mixed-use properties?**
>
> A51. Mixed-use property, as defined in Revenue Procedure 2019-38, is a single building that combines residential and commercial units. An interest in mixed-use property may be treated as a single rental real estate enterprise or may be split into separate residential and commercial properties. If treated as a single rental real estate enterprise, it may not be treated as part of the same enterprise as other residential, commercial or mixed-use property.
>
> For example, a taxpayer has three mixed-use buildings and each includes a storefront and an apartment. For purposes of the safe harbor, the buildings can be included in a rental real estate enterprise in any of the following ways:
>
> - Each mixed-use building is treated as two separate interests in rental real estate, one commercial and one residential. The taxpayer treats these as six separate rental real estate enterprises, three commercial and three residential.
>
> - Each mixed-use building is treated as two separate interests in rental real estate, one commercial and one residential. The taxpayer treats the three commercial interests as a single rental real estate enterprise and also treats the three residential interests as a separate single rental real estate enterprise. The taxpayer has two rental real estate enterprises, one commercial and one residential.
>
> - Each mixed-use building is treated as two separate interests in rental real estate, one commercial and one residential. The taxpayer treats the three commercial interests as a single rental

real estate enterprise but treats the residential interests as three separate single rental real estate enterprises. The taxpayer has four rental real estate enterprises, one commercial and three residential.

- Each mixed-use building is treated as two separate interests in rental real estate, one commercial and one residential. The taxpayer treats the three residential interests as a single rental real estate enterprise but treats the commercial interests as three separate single rental real estate enterprises. The taxpayer has four rental real estate enterprises, three commercial and one residential.

- Each mixed-use property is treated as a stand-alone enterprise containing both residential and commercial properties. The taxpayer has three rental real estate enterprises, three mixed-use.

If other non-mixed-use properties are also owned or subsequently acquired, the similar properties rule under Revenue Procedure 2019-38 still applies. In other words, if the mixed-use properties are split into residential and commercial properties, the requirement to either treat all similar properties as their own enterprises or as a single enterprise will include these properties, as well. For example, if the taxpayer described in example b above acquires an additional commercial property, that new property must also be added to the existing commercial real estate enterprise. The taxpayer may not treat the newly acquired commercial property as its own enterprise.

Once an enterprise determination is made, the rules of the safe harbor are applied to each enterprise in the manner outlined in Revenue Procedure 2019-38.

The FAQ also reminds us that having rental real estate as a trade or business does not require the taxpayer to move the rental to Schedule C or treat the income as income from self-employment.

Q52. If rental real estate is treated as a trade or business for purposes of the QBI deduction (discussed in Q 48), do I report the rental real estate on Schedule C of my Form 1040, and is it subject to self-employment tax?

A52. In general, the answer to both questions is no. How rental real estate is reported on Form 1040 has NOT changed due to the QBI deduction. Rental real estate is usually reported on Schedule E, Part I, and is not subject to self-employment tax.

> Even if rental real estate rises to the level of a section 162 trade or business, it is generally reported on Schedule E, Part I, because rental real estate is generally excluded from self-employment taxable income under section 1402(a)(1).
>
> However, some rental real estate is subject to self-employment tax (e.g., boarding house, hotel or motel, and bed and breakfast, where substantial services are rendered for the convenience of the occupants). Rental real estate subject to self-employment tax is reported on Schedule C.

Taxpayers are also reminded that real estate trades or businesses that otherwise qualify can be aggregated under Reg. §1.199A-4:

> **Q53. Can rental real estate that is a trade or business for purposes of section 199A be aggregated using the rules in Treas. Reg. § 1.199A-4?**
>
> A53. Rental real estate that is a trade or business can be aggregated with other trades or businesses, including other rental real estate trades or businesses, if the rules of section 1.199A-4 of the Regulations are met. This includes rental real estate that rises to the level of a section 162 trade or business, rental real estate enterprises that meet the safe harbor requirements of Revenue Procedure 2019-38 and self-rentals as described in section 1.199A-1(b)(14).

The FAQ also reiterates prior guidance on passive activity issues with rentals, just making it clear the general rules apply to rentals:

> **Q54. Do I have to materially participate in rental real estate for it to qualify for the QBI deduction?**
>
> A54. No. Section 199A does not have a material participation requirement. Eligible taxpayers with income from a qualified trade or business may be entitled to the QBI deduction regardless of their level of involvement in the trade or business.
>
> **Q55. If my rental real estate generates a net loss that is limited by section 469, passive activity loss limitations, what do I do with those losses for QBI purposes?**
>
> A55. Any losses from a trade or business that are suspended and not available for use in computing taxable income in the year incurred are not included in QBI for that year. The suspended loss will be treated as qualified business net loss carryover from a separate trade or business in the year the loss is allowed for purposes of determining taxable income.

> For example, Taxpayer A owns rental property that rises to the level of a section 162 trade or business. The rental property generates a $20,000 net loss in Tax Year 2018. The loss would be includable in QBI in Tax Year 2018 if it were not fully limited by section 469, passive activity loss limitations. The $20,000 loss is not included in the calculation of taxable income in Tax Year 2018, so it is not included in A's QBI for Tax Year 2018. However, if the loss is allowed for use in computing A's Tax Year 2019 taxable income, the loss will be treated as qualified business net loss carryover from a separate trade or business and will be used to calculate A's Tax Year 2019 QBI deduction.
>
> See Q23 for more information on suspended losses.

The FAQ also deals with the Form 1099 issue, though it simply says nothing has changed.

> **Q56. Do I need to file information returns, such as Form 1099-MISC, if I take a QBI deduction from income generated by my rental property?**
>
> A56. As provided in section 6041, persons engaged in a trade or business and making payment in the course of such trade or business to another person of $600 or more in any taxable year may be required to file an information return reflecting the details of such transactions. Application of section 199A and its rules do not change any existing requirement for information reporting as provided under section 6041.

However, please remember that the preamble to the final §199A regulations contained the following warning about filing the Forms 1099 for a rental.

> In cases in which other Code provisions use a trade or business standard that is the same or substantially similar to the section 162 standard adopted in these final regulations, taxpayers should report such items consistently. For example, if taxpayers who own tenancy in common interests in rental property treat such joint interests as a trade or business for purposes of section 199A but do not treat the joint interests as a separate entity for purposes of §301.7701-1(a)(2), the IRS will consider the facts and circumstances surrounding the differing treatment. Similarly, taxpayers should consider the appropriateness of treating a rental activity as a trade or business for purposes of section 199A where the taxpayer does not comply with the information return filing requirements under section 6041.[12]

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[12] T.D. 9847, February 8, 2019

The IRS in the FAQ states that it *is* possible for triple-net leases to become part of a trade or business, but this will not generally be true of a single triple-net lease.

> **Q57. Triple net leases do not qualify for the safe harbor of Revenue Procedure 2019-38. Does this mean that income, gains, deductions and losses from a triple net lease can never be included in QBI?**
>
> A57. No. As explained in Q 48, rental real estate is treated as a trade or business for purposes of the QBI deduction if it rises to the level of a section 162 trade or business, is a self-rental as described in Treas. Reg. § 1.199A-1(b)(14) or is a rental real estate enterprise described in Revenue Procedure 2019-38. Revenue Procedure 2019-38 only excludes triple net leases from being included in a rental real estate enterprise (and are therefore not eligible for the safe harbor).
>
> A single triple net lease does not generally rise to the level of a section 162 trade or business. See Notice 2006-77. However, if rental real estate involving a triple net lease is otherwise treated as a trade or business under section 199A, then the income, gains, losses and deductions would be included in QBI.

The FAQ also discusses the implication of the "anti-crack and pack" rule when a taxpayer rents property to a specified service trade or business (SSTB).

> **Q58. If real estate is rented to a SSTB does that mean the rental real estate is also considered an SSTB?**
>
> A58. It depends. If real estate is rented to a commonly owned SSTB, meaning 50 percent or more common ownership including direct or indirect ownership by related parties within the meaning of sections 267(b) or 707(b), the portion of real estate rented to the commonly owned SSTB is a separate SSTB with respect to the related parties, only. Any portions not rented to the commonly owned SSTB, as well as any interests held by an unrelated party, would not be a SSTB.
>
> For example, Taxpayer A owns 100 percent of a commercial office building and leases the entire building to an S corporation, of which Taxpayer A is a 50 percent shareholder. The lease of the building is treated as a trade or business for purposes of section 199A under the self-rental rule. S corporation operates a medical practice which is an SSTB. The lease of the building to the S corporation is treated as a separate SSTB of Taxpayer A.

As you may recall, the final regulations changed the self-rental rule from what as found in the proposed regulations under §199A. No longer does renting to a controlled C corporation automatically create a trade or business. But the FAQ notes that a rental to a C corporation could still be a trade or business—but it has to meet the standard requirements.

> **Q59. If real estate is rented to a C corporation, are the income, gain, deduction and losses from the rental QBI?**
>
> A59. It depends. Rentals to a C corporation can generate QBI if the rental real estate is conducted by an individual or a relevant passthrough entity (RPE) and is a section 162 trade or business or a rental real estate enterprise under Revenue Procedure 2019-38. The self-rental rule in Treas. Reg. § 1.199A-1(b)(14) does not apply to rentals to C corporations.

The posting continues the IRS's expanded use of informal guidance, such as FAQs on its webpage, publications, forms and form instructions, to provide guidance on TCJA issues. Note that such guidance, unlike that found in Revenue Rulings, Revenue Procedures, and other items that appear in the Internal Revenue Bulletin, are technically informational only. Thus, the IRS is not barred from arguing a different position in a case if the agency determines that a different result is the proper one under the law.

But it is most likely the IRS will follow these FAQs during an exam, so clients need to be informed about any proposed position at odds with the positions found in the FAQ. The adviser should also carefully consider if there is a need to also file a Form 8275 with the return to disclose a position with a reasonable basis, but which lacks substantial authority.

SECTION: 2001
ANTI-CLAWBACK REGULATIONS FINALIZED AND CLARIFIED

Citation: TD 9884, 11/26/19

The first item of the guidance promised by Assistant Treasury Secretary David Kautter to be released by the end of January 2020 has been published. In TD 9884[13] the IRS finalized regulations on the anti-clawback rules that IRC §2001(g)(2) required the IRS to develop to prevent issues when the exclusions are scheduled to be reduced in 2026.

The problem is simple—generally a taxpayer's estate tax is computed by combining his/her taxable estate at death with his/her lifetime taxable gifts. A gross tax is

[13] TD 9884, November 26, 2019 publication date in *Federal Register*, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-25601.pdf (retrieved November 23, 2019)

computed using that figure. It is then reduced by a credit based on the appropriate exclusion amount plus any gift tax actually paid on taxable gifts. If the exclusion amount at death is lower than it was when gifts were made, it's possible that tax would be due at death with no assets available to pay the tax.

EXAMPLE

Harry gave his son Wayne a gift of $11,000,000 in 2019, the only taxable gift Harry made during his lifetime. No gift tax is due in 2019, since the gift is less than the basic exclusion amount (BEA) in place at that date. In 2026 the exclusion is reduced back to the lower amount in place before the Tax Cuts and Jobs Act, adjusted for inflation. We will assume that amount would be computed to be $6,000,000. Harry has a zero taxable estate on hand at his death.

The total estate tax would be based on the $11,000,000 gift Harry made in 2019. However, only $6,000,000 of exclusion would be available to compute a credit, which would result in a tax due being shown on the Form 706 unless an anti-clawback rule is in place to solve this problem.

The final regulations adopt, with some clarifications, the proposed regulations issued last year.[14]

The final regulations provide at Reg. §20.2010-1(c) that the exclusion amount used in the computation will be the greater of the exclusion at the date in question or the total of gifts previously excluded from tax due to the use of the exclusion amount in place at the time of the transfer. Specifically, the regulation states:

> If the total of the amounts allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts, within the meaning of section 2001(b)(2), to the extent such credits are based solely on the basic exclusion amount as defined and adjusted in section 2010(c)(3), exceeds the credit allowable within the meaning of section 2010(a) in computing the estate tax, again only to the extent such credit is based solely on such basic exclusion amount, in each case by applying the tax rates in effect at the decedent's death, then the portion of the credit allowable in computing the estate tax on the decedent's taxable estate that is attributable to the basic exclusion amount is the sum of the amounts attributable to the basic exclusion amount allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts.[15]

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[14] REG–106706–18, published November 23, 2019, https://www.govinfo.gov/content/pkg/FR-2018-11-23/pdf/2018-25538.pdf

[15] Reg. §20.2010-1(c)

The regulation provides the following computational rules:

- In determining the amounts allowable as a credit:

  - The amount allowable as a credit in computing gift tax payable for any calendar period may not exceed the tentative tax on the gifts made during that period; and

  - The amount allowable as a credit in computing the estate tax may not exceed the net tentative tax on the taxable estate.

- In determining the extent to which an amount allowable as a credit in computing gift tax payable is based solely on the basic exclusion amount:

  - Any deceased spousal unused exclusion (DSUE) amount available to the decedent is deemed to be applied to gifts made by the decedent before the decedent's basic exclusion amount is applied to those gifts;

  - In a calendar period in which the applicable exclusion amount allowable with regard to gifts made during that period includes amounts other than the basic exclusion amount, the allowable basic exclusion amount may not exceed that necessary to reduce the tentative gift tax to zero; and

  - In a calendar period in which the applicable exclusion amount allowable with regard to gifts made during that period includes amounts other than the basic exclusion amount, the portion of the credit based solely on the basic exclusion amount is that which corresponds to the result of dividing the basic exclusion amount allocable to those gifts by the applicable exclusion amount allocable to those gifts.

- In determining the extent to which an amount allowable as a credit in computing the estate tax is based solely on the basic exclusion amount, the credit is computed as if the applicable exclusion amount were limited to the basic exclusion amount.[16]

[16] Reg. §20.2010-1(c)(1)

The IRS provides the following two examples to illustrate the application of this provision to a taxpayer who has never been married.

EXAMPLE 1 - REG. §20.2010-1(C)(2)

Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $11.4 million in basic exclusion amount allowable on the dates of the gifts. The basic exclusion amount on A's date of death is $6.8 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million of basic exclusion amount used to determine those credits) exceeds the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, this paragraph (c) applies, and the credit for purposes of computing A's estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on A's post-1976 gifts.

EXAMPLE 2 – REG. §20.2010-1(C)(2)

Assume that the facts are the same as in Example 1 of paragraph (c)(2)(i) of this section except that A made cumulative post-1976 taxable gifts of $4 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts is less than the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing A's estate tax is based on the $6.8 million basic exclusion amount as of A's date of death, subject to the limitation of section 2010(d).

Since 2011, a surviving spouse has been able to make use of a deceased spouse unused exclusion amount (DSUE) if the estate of the deceased spouse made the appropriate election. The application of the anti-clawback rules where a DSUE is involved is outlined in the following examples in the regulations.

EXAMPLE 3 – REG. §20.2010-1(C)(2)

Individual B's predeceased spouse, C, died before 2026, at a time when the basic exclusion amount was $11.4 million. C had made no taxable gifts and had no taxable estate. C's executor elected, pursuant to §20.2010-2, to allow B to take into account C's $11.4 million DSUE amount. B made no taxable gifts and did not remarry. The basic exclusion amount on B's date of death is $6.8 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on B's post-1976 gifts attributable to the basic exclusion amount (zero) is less than the credit based on the basic exclusion amount allowable on B's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing B's estate tax is based on B's $18.2 million applicable exclusion amount, consisting of the $6.8 million basic exclusion amount on B's date of death plus the $11.4 million DSUE amount, subject to the limitation of section 2010(d).

EXAMPLE 4 – REG. §20.2010-1(C)(2)

Assume the facts are the same as in Example 3 of paragraph (c)(2)(iii) of this section except that, after C's death and before 2026, B makes taxable gifts of $14 million in a year when the basic exclusion amount is $12 million. B is considered to apply the DSUE amount to the gifts before applying B's basic exclusion amount. The amount allowable as a credit in computing the gift tax payable on B's post-1976 gifts for that year ($5,545,800) is the tax on $14 million, consisting of $11.4 million in DSUE amount and $2.6 million in basic exclusion amount. This basic exclusion amount is 18.6 percent of the $14 million exclusion amount allocable to those gifts, with the result that $1,031,519 (0.186 x $5,545,800) of the amount allowable as a credit for that year in computing gift tax payable is based solely on the basic exclusion amount. The amount allowable as a credit based solely on the basic exclusion amount for purposes of computing B's estate tax ($2,665,800) is the tax on the $6.8 million basic exclusion amount on B's date of death. Because the portion of the credit allowable in computing the gift tax payable on B's post-1976 gifts based solely on the basic exclusion amount ($1,031,519) is less than the credit based solely on the basic exclusion amount ($2,665,800) allowable on B's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing B's estate tax is based on B's $18.2 million applicable exclusion amount, consisting of the $6.8 million basic exclusion amount on B's date of death plus the $11.4 million DSUE amount, subject to the limitation of section 2010(d).

Thus, if a person dies before 2026 and a DSUE election is made to transfer the unused exclusion to the surviving spouse, that higher DSUE will survive the reduction in the basic exclusion amount (BEA) in 2026 if the surviving spouse dies after that date. The preamble to the final regulations state:

> The regulations in §§20.2010-1(d)(4) and 20.2010-2(c)(1) confirm that the reference to BEA is to the BEA in effect at the time of the deceased spouse's death, rather than the BEA in effect at the death of the surviving spouse. A DSUE election made on the deceased spouse's estate tax return allows the surviving spouse to take into account the deceased spouse's DSUE amount as part of the surviving spouse's AEA. Section 2010(c)(5); §20.2010-2(a). AEA is the sum of the DSUE amount and the BEA. Section 2010(c)(2). A decrease in the

> BEA after 2025 will reduce the surviving spouse's AEA only to the extent that it is based upon the BEA, but not to the extent that it is based on the DSUE amount. Therefore, the sunset of (or any other decrease in) the increased BEA has no impact on the existing DSUE rules and the existing regulations governing DSUE continue to apply.[17]

Although the IRS declined to have these regulations directly address generation skipping transfer tax (GST) issues, the preamble contained the following guidance on the impact on GST issues:

> Several commenters asked for confirmation that, during the increased BEA period, donors may make late allocations of the increase in GST exemption to inter vivos trusts created prior to 2018. An increase in the BEA correspondingly increases the GST tax exemption, which is defined by reference to the BEA. Section 2631(c). The effect of the increased BEA on the GST tax is beyond the scope of this rulemaking.
>
> A commenter requested confirmation and examples showing that allocations of the increased GST exemption made during the increased BEA period (whether to transfers made before or during that period) will not be reduced as a result of the sunset of the increased BEA. There is nothing in the statute that would indicate that the sunset of the increased BEA would have any impact on allocations of the GST exemption available during the increased BEA period. However, this request is beyond the scope of this project.

[17] TD 9884, Summary of Comments and Explanation of Revisions, Section 3

SECTION: 6677
TAXPAYER WHO WAS BOTH BENFECIARY AND OWNER OF FOREIGN TRUST ONLY LIABLE FOR OWNER PENALTY FOR FAILURE TO FILE FORM 3520

Citation: Wilson, et. al. v. United States, Case No. 2:19-cv-05037, US District Court, Eastern District of New York, 11/17/19

In the case of *Wilson, et. al. v. United States*, Case No. 2:19-cv-05037, US District Court, Eastern District of New York,[18] the Court found that the sole owner/beneficiary of a trust could only be assessed the 5% penalty under §6677 as the owner. The Court denied the IRS's attempt to impose the 35% penalty under that section on distributions received.

The issue involves the requirement under IRC §6048 for information reporting by certain foreign trusts. If a party fails to file the required reports, penalties are imposed under IRC §6677.

Generally, IRC §6677 requires a beneficiary failing to report a distribution from the trust on Form 3520 to pay a penalty equal to 35% of the distribution amount. However, IRC §6677(b) modifies the penalty in the case of the owner of the trust who fails to file such a report, imposing a 5% penalty on the balance in the trust at year end when a report is not filed.

The case notes the following information about the facts of this case:

> …Joseph Wilson established an overseas trust in 2003. Wilson named himself the grantor of the trust and was its sole owner and beneficiary. The singular purpose of the trust was to "place assets beyond the reach of his then-wife, who he had reason to believe was preparing to file a divorce action against him." (She did.) Wilson funded the trust with approximately $9 million in U.S. Treasury bills, accruing annual interest of 5% or less. All principal had previously been taxed in the United States.
>
> From 2003-2007, Wilson filed "various income tax and information returns" with the IRS, reporting the trust's assets and the interest it accrued. In 2007, upon conclusion of the divorce proceedings, Wilson

[18] *Wilson, et. al. v. United States*, Case No. 2:19-cv-05037, US District Court, Eastern District of New York, https://ecf.nyed.uscourts.gov/doc1/123116103015 (Pacer registration required)

> terminated the trust and transferred the assets — at that point $9,203,381 — back to his bank accounts in the United States.
>
> Despite general compliance with IRS requirements, Wilson was late in filing his Form 3520 for calendar year 2007. Form 3520 is an annual report disclosing distributions from a foreign trust, with different requirements for trust grantors/owners and for trust beneficiaries. After Wilson filed his 2007 Form 3520, the IRS assessed a late penalty of $3,221,183, representing 35% of the distributions from the trust during the 2007 calendar year. Because Wilson had transferred 100% of his trust's funds back to his own domestic accounts during 2007, the penalty also amounted to 35% of his total trust assets.[19]

The taxpayer paid the penalty the IRS asked for, but filed a claim for refund on two separate bases:

- That there was reasonable cause for the taxpayer's untimely filing of Form 3520; and
- That, since Joseph Wilson was the owner of the trust, the proper penalty was the penalty for the owner failing to report the trust (the 5% penalty); not the penalty on unreported distributions of 35%.[20]

The IRS agreed that the 5% penalty would apply to Joseph as the owner, but argued that the two penalties are separate and can be applied independently.[21]

IRC §6048 clearly required the filing of the Form 3520 to report at least some information about the trust for 2007 and Joseph White had not filed that information return. The opinion summarized the law on the consequences of failing to file such an information return as follows:

> Penalties for violating the provisions of 26 U.S.C. § 6048 are codified under 26 U.S.C. § 6677. Subsection (a) of that statute prescribes the penalty for untimely filing "any notice or return required to be filed by section 6048." In relevant part, 26 U.S.C. § 6677(a)(1) states:
>
>> [T]he person required to file such notice or return shall pay . . . 35 percent of the gross reportable amount. . . . At such time as the gross reportable amount with respect to any failure can be determined by the Secretary, any subsequent penalty

[19] *Wilson, et. al. v. United States*, pp. 1-2

[20] *Wilson, et. al. v. United States*, p. 3

[21] *Wilson, et. al. v. United States*, pp. 9-10

> imposed under this subsection with respect to such failure shall be reduced as necessary to assure that the aggregate amount of such penalties do not exceed the gross reportable amount (and to the extent that such aggregate amount already exceeds the gross reportable amount the Secretary shall refund such excess to the taxpayer).
>
> That provision is modified by 26 U.S.C. § 6677(b)(2), which provides that "subsection (a) shall be applied by substituting '5 percent' for '35 percent'" for returns required to be filed by the owner of a foreign trust.[22]

The Court then starts its analysis of how the penalty rules are going to apply in this case where the taxpayer is both a beneficiary of the trust and the owner of the trust:

> At the outset, it is imperative to understand that a person in Wilson's situation — i.e. a sole grantor/owner and sole beneficiary of a foreign trust — would have only been required to file a *single* Form 3520 for fiscal year 2007. So the question then becomes, whether 26 U.S.C. § 6677 permits a single person untimely filing a single IRS form to be penalized as two different people — as an owner and as a beneficiary.

The opinion rejects the IRS's view that both penalties could apply in this situation, arguing such a holding is contrary to the plain language of the statute:

> A plain language reading of 26 U.S.C. § 6677 counsels that a trust owner cannot be penalized as a beneficiary for violating a provision of 26 U.S.C. § 6048(b). There is a clear instruction under 26 U.S.C. § 6677(b)(2) to "substitute" 5% for 35%, not to choose between the two or to simply apply a 5% assessment without reference to an otherwise applicable penalty. Therefore, the statute mandates that the 5% replace the 35% whenever there is a "case of a return required under section 6048(b)."
>
> When a foreign trust owner is required to file Form 3520, it falls under 26 U.S.C. § 6048(b)'s purview of "such information as the Secretary may prescribe with respect to" an owner of a foreign trust. Undeniably, then, a violation of that section should be treated under 26 U.S.C. § 6677(b)(2)'s substitution clause, which replaces "35 percent" with "5 percent." But even if this were not inescapably evident, "in case of doubt [in the interpretation of statutes levying taxes,] they are construed most strongly against the Government, and in favor of the citizen." *Gould v. Gould*, 245 U.S. 151, 153 (1917).

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[22] *Wilson, et. al. v. United States*, pp. 9-10

> Moreover, the Government's argument, if accepted, would result in an irreconcilable textual conflict. Section 6677(a)(1) of Title 26 states that once the Secretary determines the gross reportable amount "with respect to any failure," the Secretary must ensure that the taxpayer's penalties under § 6677 "do not exceed the gross reportable amount." Although this language is primarily concerned with subsequent late fees, the underlying directive appears to limit all penalties for a violation to no more than the "gross reportable amount." Therefore, it follows that a taxpayer should not be liable for any two penalties if their combined assessment would add up to more than the gross reportable amount for any one violation.
>
> But that would be the case if the Government got its way. Because the gross reportable amount for an owner's untimely filing Form 3520 under § 6677(c)(2) is "the gross value of the portion of the trust's assets at the close of the year," Wilson's $0 in trust assets at the end of 2007 yields a $0 gross reportable amount. Any additional penalty resulting from the same "failure" would violate the statute. The Government seeks $3,221,183 above $0, which violates the statute.[23]

And the Court finds in this case the proper penalty is 5% of the zero balance in the trust at the end of the tax year, noting:

> Plaintiffs next ask the Court for summary judgment as to whether "the 5% penalty should properly be based on the amount of the [trust's] account balances, if any, at the close of 2007, pursuant to [26 U.S.C. §] 6677(c)(2)." It should. Because Wilson is treated as the owner of the foreign trust for the purpose of his Form 3520 filing, he is liable for penalty under 26 U.S.C. § 6677(b) for a violation of 26 U.S.C. § 6048(b)(1). Under 26 U.S.C. § 6677(b), the proper assessment is "5% of the gross reportable amount." The gross reportable amount for "a failure relating to section 6048(b)(1)" is "the gross value of the portion of the trust's assets at the close of the year treated as owned by the United States person."[24]

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[23] *Wilson, et. al. v. United States*, pp. 11-12

[24] *Wilson, et. al. v. United States*, pp. 13-14