

Current Federal Tax Developments

Week of January 13, 2020

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ACCOUNTING
CONTINUING EDUCATION

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF JANUARY 13, 2020
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Kaplan Financial Education

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SECTION: 170

POTENTIALLY OVERLOOKED PROVISIONS IN THE 2019 YEAR END TAX BILL

Citation: Further Appropriations Act, 2020, 12/20/19

Now that we have had some time to look at the SECURE Act, some provisions that failed to get a lot of attention initially can be looked at in more detail. Specifically, I wish to look at the interesting provision that reduces qualified charitable distributions if a taxpayer makes a post-age 70 ½ deductible contribution to an IRA under the new law and a change made to the kiddie tax provision between the time the original SECURE bill passed the House earlier in 2019 and when it finally passed the entire Congress in December.

QCDs and Post-Age 70 ½ Deductions for IRA Contributions

The new tax law does come with one negative that occurs if a taxpayer makes a deductible IRA contribution after attaining age 70 ½. The taxpayer's ability to claim a qualified charitable contribution from the IRA is reduced to take into account any previous post-70 ½ deductible IRA contributions.

IRC §408(d)(8)(A) provides that the qualified charitable distribution for any tax year is reduced by:

- The total deductions allowed under IRC §219 for all tax years ending on or after the date the taxpayer attained age 70 ½ over
- The total actual reductions in QCDs already taken into account under this rule in prior years.

Some examples of the application of this provision are provided below.

EXAMPLE 1

Wayne attained age 70 ½ in 2020. He makes a \$5,000 contribution to a traditional IRA in 2019 for which he claims a \$5,000 contribution in 2020 under IRC §219 on his Form 1040. He also makes an otherwise qualified charitable distribution (QCD) under IRC §408(d)(8) of \$50,000.

Since he was allowed a \$5,000 deduction on his tax return for 2020 and no reductions could have taken place on prior year returns, he must treat only \$45,000 of the distribution as a qualified charitable contribution, excluded from his gross income for the year. The first \$5,000 of that distribution will be a standard taxable distribution. However, Wayne should

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now be able to claim that \$5,000 as a charitable deduction on Schedule A, assuming he otherwise itemizes deductions on his return for 2020.

EXAMPLE 2

Continuing with EXAMPLE 1, assume Wayne makes no contribution to a traditional IRA in 2020 and, thus, claims no deduction under §219 in 2020. He makes another \$50,000 otherwise qualified charitable distribution in 2021. Since the \$5,000 deductible contribution had already been fully absorbed by reducing his 2020 QCD amount, the entire \$50,000 is treated as a QCD on Wayne's 2021 return.

EXAMPLE 3

Assume the same facts as in EXAMPLES 1 and 2 except Wayne does not make any QCD in 2020. Now when Wayne makes the \$50,000 otherwise qualified charitable contribution in 2021, he must reduce that year's QCD by \$5,000 since none of Harry's post-age 70 ½ deductions under §219 had been offset against prior year charitable distributions.

Kiddie Tax

The Act removes the special alternative minimum tax rules under IRC §59(j) that apply to the Kiddie Tax from 2018 to 2025.¹

One change made in the SECURE Act included in the Further Appropriations Act, 2020 as compared to the version that passed the House of Representatives earlier in 2019 involves the option to choose between using trust rates or the parents' rates when computing the kiddie tax. In the bill that passed the House, the option was only available for tax years of the taxpayer that began in 2018.

The final version of the bill expanded that to cover tax years of the taxpayer beginning in 2019 as well as 2018, so the taxpayer can elect to use trust rates in either or both years, rather than using the rates of the parents.²

¹ IRC §55(d)(4)(A)(iii) as revised

² Act Section 501(c)(3)

SECTION: 401

ESOP WITH NUMEROUS DOCUMENTATION AND OPERATIONAL ISSUES LOSES QUALIFIED PLAN STATUS

Citation: Ed Thielking Inc. v. Commissioner, TC Memo 2020-5, 1/9/20

A series of problems led to the Tax Court agreeing with the IRS that an employee stock ownership plan (ESOP) and trust (ESOT) were not qualified in the case of *Ed Thielking Inc. v. Commissioner*, TC Memo 2020-5.³

The case involved an S corporation that was wholly owned by Ed Thielking. His father, a CPA, developed a plan for the S corporation to adopt an ESOP.⁴ The plan was adopted on March 31, 2006 with an effective date of March 10, 2006.⁵ The Court describes the following details of the plan's terms and implementation:

Article 2 of the ESOP agreement states in pertinent part that participation in the ESOP begins immediately after one year of service, provided the participant is at least 21 years old on that date. In addition to the year of service, article 4 of the ESOP agreement states that employer contributions to the plan require at least 1,000 hours of service during a plan year. The ESOP agreement defines an hour of service as an hour for which an employee is paid or entitled to payment by the employer.

³ *Ed Thielking Inc. v. Commissioner*, TC Memo 2020-5, January 9, 2020, <https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=12130> (retrieved January 10, 2020)

⁴ His father had been involved in three prior cases before the Tax Court, including one from 2018 that was the subject of an article on the Current Federal Tax Developments site when it was issued. See Ed Zollars, "Use of CPA Who Did Significant Other Work for ESOP and Sponsor as Appraiser Did Not Run Afoul of Independent Appraiser Requirements," *Current Federal Tax Developments* website, June 28, 2018, <https://www.currentfederaltaxdevelopments.com/blog/2018/6/28/use-of-cpa-who-did-significant-other-work-for-esop-and-sponsor-as-appraiser-did-not-run-afoul-of-independent-appraiser-requirements>

⁵ *Ed Thielking Inc. v. Commissioner*, p. 3

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Further, article 4 of the ESOP agreement incorporates the limitations under section 415(e). With regards to distributions, article 14 of the ESOP agreement states in pertinent part:

If distribution has begun on or before the Required Beginning Date and if the Participant dies before his entire Accrued Benefit has been distributed to him the remaining portion of his Accrued Benefit which is not payable to a beneficiary designated by the Participant's will shall be distributed within five years after the Participant's death or over the life of the beneficiary or over a period certain not extending beyond the life expectancy of the beneficiary, commencing not later than the end of the calendar year following the calendar year in which the Participant would have attained the age 70 ½.

The record contains no restatements or amendments to either the ESOP or the ESOT agreements, despite respondent's repeated requests for those documents on January 28, 2010, October 26, 2011, and January 31, 2012.⁶

Mr. Thielking contributed his ½ interest in Gray Thielking Electric (GTE) to the S corporation, and the flow through income from that partnership made up the primary source of the S corporation's income.⁷ Contributions were made to the plan as described by the Court:

Petitioner's primary source of income in FYE 2007 was an income allocation from GTE. Petitioner did not report any compensation of officers or salaries and wages as deductible expenses. Nothing in the record indicates that petitioner filed employment and unemployment tax returns, or that it issued and filed Forms W-2, Wage and Tax Statement, or Forms 1099-MISC, Miscellaneous Income, for FYE 2007.

In FYE 2007 petitioner's board of directors resolved to issue a dividend payable in capital stock to the participants of the ESOP or at their election to their ESOT accounts. The only plan participant, Mr. Thielking, elected for petitioner to contribute the dividend to his ESOT account. Petitioner claimed a deduction with respect to the ESOT contribution, which largely offset the income allocation to it from GTE. With no material variance, petitioner followed this course of action for all the years at issue. Petitioner issued share certificates

⁶ *Ed Thielking Inc. v. Commissioner*, p. 4

⁷ *Ed Thielking Inc. v. Commissioner*, pp. 3-4

representing the following class B capital stock dividends to Mrs. Thielking, as trustee for the ESOT...⁸

The only other contribution occurred on or about November 6, 2007, when the ESOT received a purported rollover contribution of \$15,634 from a section 401(k) account of Mrs. Thielking. Petitioner's board of directors authorized the purchase by the ESOT of an additional 15,635 class B shares with the funds contributed in the section 401(k) rollover.⁹

The Court also described key factors related to the plan's reporting as follows:

Petitioner reported on Form 5500, Annual Return/Report of Employee Benefit Plan, for PYE February 28, 2007, only one participant, Mr. Thielking. Mr. Thielking's account consisted of 23,000 shares of petitioner's stock. Stephen Thielking prepared a written appraisal that valued each share of petitioner's stock at \$1, resulting in a valuation of \$23,000 for Mr. Thielking's ESOT account. The appraisal, however, did not include Stephen Thielking's signature or his qualifications as an appraiser.

Petitioner also reported Mr. Thielking as the only participant in the ESOP5 on Form 5500 for PYE February 28, 2008. The plan received a rollover contribution on behalf of Mrs. Thielking during PYE February 28, 2008, even though she was not reported as a plan participant for that period. The plan reported total assets of 59,434 shares of petitioner's stock. Again, Stephen Thielking valued each share at \$1, resulting in a net plan asset value of \$59,434, but he again failed to sign the appraisal or include his qualifications.

Petitioner finally reported a second participant for the first time, Mrs. Thielking, on its Form 5500 for PYE February 28, 2009. Once again petitioner relied on an unsigned appraisal prepared by Stephen Thielking, valuing the 66,234 shares of petitioner held by the ESOT at \$1 each, or \$66,234.¹⁰

Readers who work with qualified retirement plans may have noticed a number of issues, and those with a background in ESOPs may have found some others. These issues did not fail to attract the attention of the IRS or the court.

⁸ *Ed Thielking Inc. v. Commissioner*, p. 5

⁹ *Ed Thielking Inc. v. Commissioner*, p. 6

¹⁰ *Ed Thielking Inc. v. Commissioner*, pp. 6-7

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For a retirement plan to be treated as a qualified plan (and thus eligible for the various tax benefits available for such plans), it must comply with the numerous requirements found in IRC §401(a)—which has subsections that number from (1) to (37). Many of those subsections have additional long and detailed provisions. Suffice it to say there are a lot of ways to create plan qualification issues—and if the plan fails badly enough to be treated as no longer qualified, the results are rather nasty, not of the least of which is the loss of tax deferral on contributions and earnings in the plan.

The Tax Court describes the matters as follows:

Section 401(a) lists requirements that must be met for a plan and its underlying trust to qualify for preferential tax treatment under section 501(a). A plan must meet the section 401(a) requirements in both form and operation. *Ludden v. Commissioner*, 620 F.2d 700, 702 (9th Cir. 1980), aff'g 68 T.C. 826 (1977); sec. 1.401-1(b)(3), Income Tax Regs. In addition, the terms of the plan must be in writing. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, sec. 402(a)(1), 88 Stat. at 875; see also sec. 1.401-1(a)(2), Income Tax Regs. Congress established the writing requirement so that every employee, on examining the plan document, may determine exactly what his or her rights and obligations are under the plan and who is responsible for operating the plan. See *Curtiss-Wright Corp. v. Schoonejongen*, 514 U.S. 73, 83 (1995); H.R. Conf. Rept. No. 93-1280, at 297 (1974), 1974-3 C.B. 415, 458.

A qualification failure pursuant to section 401(a) is a continuing failure because allowing a plan to requalify in subsequent years would allow a plan “to rise phoenix-like from the ashes of such disqualification and become qualified for that year.” *Pulver Roofing Co. v. Commissioner*, 70 T.C. 1001, 1015 (1978).¹¹

As the Court notes, there are two key issues:

- Form Issues: The plan document must contain all terms required under the law. A failure of the plan document to contain the necessary terms will potentially trigger disqualification. As well, since Congress changes the rules from time to time, plans must be regularly amended to take into account new rules; and
- Operational issues: Even if the plan document is pristine and totally up to date, if the plan is not operated in accordance with the plan terms and the law, the plan also faces potential disqualification.

¹¹ *Ed Thielking Inc. v. Commissioner*, pp. 9-10

Statute of Limitations

The taxpayer believed that the IRS had made a fundamental error—many of the items being questioned about the plan’s documentation and operation had occurred more than three years prior to the IRS raising the issues. However, the Court notes, the statute only applies to assessment of tax against years, and the basic issue of qualification of a plan does not fall directly into that category:

Before we reach the merits of respondent’s determination to disqualify the plan, we must address petitioner’s contention that respondent “erred in issuing its revocation letter because the statute of limitations has run with respect to one or more of the plan years at issue.” Petitioner’s limitations contention is misplaced. Section 6501(a) limits only the assessment and collection of tax; it does not limit respondent’s broad authority to audit retirement plans and, if appropriate, to issue a final nonqualification letter. The period of limitations prescribed by section 6501(a), therefore, does not apply to proceedings under section 7476 or to respondent’s determinations regarding the qualification of retirement plans under section 401(a), as they do not involve the imposition of any tax. *Christy & Swan Profit Sharing Plan v. Commissioner*, T.C. Memo. 2011-62, 2011 WL 913190, at *3. Accordingly, respondent’s determination to disqualify the ESOP is not barred by any period of limitations set forth in section 6501.¹²

This is crucial because, as was noted earlier, once a plan is disqualified due to form and/or operational issues, it remains permanently disqualified.

In this case it means the IRS has the right to consider events that took place all the way back to the origination of the plan in determining if the plan remains (or ever was) a qualified plan.

Form Issues

As was noted earlier, a plan must have all terms required by §401(a) in order to be considered a qualified plan. When the law changes, the IRS or Congress will generally set a date by which plan documents must be updated and provide that, in the interim, the plan is to be operated as if it has the required terms. But once that deadline hits, the fact that a plan might have never in operation violated the revised rules under the law won’t help if the plan document still contains contrary provisions.

The taxpayer may feel that all is well because they have a determination letter received when the plan was adopted that indicates the terms comply with the law. But such a letter only deals with the law that existed as of the determination letter date. And, as

¹² *Ed Thielking Inc. v. Commissioner*, p. 9

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the Court notes in this case, the taxpayer never actually produced the determination letter the taxpayer claimed to rely on.

Under section 6110(k)(3), determination letters may not be used or cited as precedent, and this Court has refused to consider determination letters proffered by taxpayers. See *Derby v. Commissioner*, T.C. Memo. 2008-45, 2008 WL 540271, at *20 (concluding that a taxpayer could not rely on a determination letter issued to another taxpayer); see also *Reserve Mech. Corp. v. Commissioner*, T.C. Memo. 2018-86, at *49 (refusing to consider 39 determination letters because they cannot be used as precedent under section 6110(k)(3)). Consistent with section 6110(k)(3) and our precedent, petitioner cannot rely on a determination letter issued to a different taxpayer. Moreover, petitioner has failed to actually identify the determination letter on which it attempts to rely; even if it had identified it, petitioner failed to provide any evidence that both plans were identical.¹³

More importantly, the plan never showed that it had adopted any of the amendments that were necessary following the plan's initial adoption in 2006:

Petitioner contends that it amended the ESOP agreement as required. Petitioner stated that it failed to provide respondent with the amendments because respondent did not request them and later because the Government seized its accountant's records. These contentions are unsupported by the record. First, the plan documents and all amendments were repeatedly requested on at least three occasions — January 28, 2010, October 26, 2011, and January 31, 2012. Second, O&T's records were not seized until September 12, 2012, months after the third request for the amendments. Finally, a taxpayer has a responsibility under section 6001 to maintain adequate records. Petitioner's reliance on its accountant to maintain records does not relieve it of its responsibility to maintain its own records.¹⁴

While the Court did not rely solely on this failure to update the plan to find the IRS was justified in revoking the plan's qualified status, clearly being unable to show the plan had been updated since 2006 was not a factor working in the plan's favor.

¹³ *Ed Thielking Inc. v. Commissioner*, pp. 22-23

¹⁴ *Ed Thielking Inc. v. Commissioner*, pp. 23-24

Operational Issues

While the plan documentation issues were troubling, there were a number of significant operational issues.

A key issue that's seen too often is the owner ignoring the participation rules in the plan when it comes to his/her own coverage. In this case the Court had trouble finding that either Mr. or Mrs. Thielking had actually performed the 1,000 hours of service for one year prior to entering the plan.

The Court pointed out that, based on the terms of the plan, it would have been impossible for anyone to qualify to enter it in the first year, which Mr. Thielking did:

Eligibility to participate in the ESOP began “immediately after one year of service”. Eligibility for contributions also required the purported participant to complete at least 1,000 hours of service within the plan year. Petitioner was [*12] incorporated on March 10, 2006, and reported Mr. Thielking as a plan participant on its Form 5500 for PYE February, 28, 2007.

Petitioner had not been incorporated for one full year when it reported Mr. Thielking as a plan participant; therefore, it is impossible for Mr. Thielking to have attained a year of service as of February 28, 2007. Moreover, the record contains no credible evidence establishing that Mr. Thielking performed services for petitioner that met the 1,000 hours of service requirement. The ESOP agreement defines an hour of service as each hour for which an employee is paid for the performance of duties. Petitioner did not report as deductions either officer compensation or salaries and wages for FYE February 28, 2007, and failed to otherwise provide any evidence that it compensated Mr. Thielking for any duties performed for petitioner. Because Mr. Thielking failed both prongs of the test for eligibility, his admission as a plan participant in PYE February 28, 2007, created an operational failure.¹⁵

And, although Mrs. Thielking did not enter the plan until the following year via a rollover, the Court had similar issues with her:

...[T]he ESOT accepted a rollover contribution from Mrs. Thielking during PYE February 28, 2008, but petitioner did not report Mrs. Thielking as a participant until PYE February 28, 2009. Because Mrs.

¹⁵ *Ed Thielking Inc. v. Commissioner*, pp. 11-12

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Thielking was not a participant when the ESOT accepted the rollover contribution, an operational failure occurred.¹⁶

The Court also did not accept the taxpayer's explanation for the lack of salaries paid not being evidence that, in fact, there was not 1,000 hours of service performed and these individuals were not employees. The Court notes:

We are not persuaded by petitioner's perfunctory contention that both Mr. and Mrs. Thielking performed substantial services for petitioner and were compensated in the form of year-end bonuses only if circumstances permitted. In the absence of any credible evidence in the record of the services performed or any material yearend bonuses paid in PYE February 28, 2007, we conclude that neither individual performed the requisite 1,000 hours of service.¹⁷

The IRS also contended that the contributions made to the ESOP were in excess of the amounts allowed under IRC §401(a)(16) and allocations to participants' accounts were in excess of the amounts allowed under IRC §415(c). The Tax Court agreed, noting:

Employee stock option plan contributions and other additions with respect to a participant are limited to the lesser of \$40,000 (adjusted for inflation, see sec. 415(d)) or 100% of the participant's compensation. Secs. 401(a)(16), 415(c)(1). As mentioned above, petitioner did not claim as deductions either officer compensation or salaries and wages for FYE February 28, 2007. See sec. 415(c)(3). Additionally, it failed to provide any evidence that Mr. Thielking performed any duties for petitioner. Consequently, Mr. Thielking's contribution limit for PYE February 28, 2007, was zero.

Because petitioner contributed property with an alleged value of \$23,000 to the ESOT for the account of Mr. Thielking, it exceeded the contribution limit under sections 401(a)(16) and 415(c). This excess contribution constitutes an operational failure for PYE February 28, 2007.¹⁸

¹⁶ *Ed Thielking Inc. v. Commissioner*, p. 12

¹⁷ *Ed Thielking Inc. v. Commissioner*, p. 13

¹⁸ *Ed Thielking Inc. v. Commissioner*, pp. 13-14

As well, the IRS argued that the appraisal performed by Mr. Thielking's father failed to satisfy the independent appraiser requirements imposed by IRC §401(a)(28)(C). IRC §401(a)(28)(C) reads:

(C) Use of independent appraiser.—

A plan meets the requirements of this subparagraph if all valuations of employer securities which are not readily tradable on an established securities market with respect to activities carried on by the plan are by an independent appraiser. For purposes of the preceding sentence, the term "independent appraiser" means any appraiser meeting requirements similar to the requirements of the regulations prescribed under section 170(a)(1).

The first problem was that the appraiser was Mr. Thielking's father, and the use of a related party as the appraiser is barred by the regulations:

An "independent appraiser" means any appraiser meeting the requirements of a "qualified appraiser" under the section 170(a)(1) regulations. Sec. 401(a)(28)(C). The regulations provide a list of persons who cannot serve as a "qualified appraiser". Sec. 1.170A-13(c)(5)(i)(C), Income Tax Regs. Specifically, the regulations exclude the donor of the property, any party to the transaction in which the donor acquired the property, and the donee of the property from the list of persons eligible to serve as "qualified appraisers". Sec. 1.170A-13(c)(5)(iv)(A), (B), and (C), Income Tax Regs. Any person related to any of the above within the meaning of section 267(b) is also excluded as a qualified appraiser (the constructive ownership rules of section 267(c) apply to this determination). See sec. 267(c); sec. 1.170A-13(c)(5)(iv)(E), Income Tax Regs.

Under section 267(c), stock owned by a trust is considered owned proportionately by its beneficiaries. Sec. 267(c)(1). Stock owned by an individual is constructively owned by his family members, including ancestors and lineal descendants. Sec. 267(c)(2), (4). Finally, stock owned by a corporation is considered owned by any individual owning more than 50% of the stock of the corporation. Sec. 267(b)(2).

As a starting point, petitioner, the donor of the property, is an excluded person. Mr. Thielking, as the sole beneficiary of the ESOT (in PYE February 28, 2007), constructively owned all of petitioner's stock. See sec. 267(c)(1). Stephen Thielking, as Mr. Thielking's father, constructively owns all the stock of petitioner that his son owns. See sec. 267(c)(2), (4). Because Stephen Thielking constructively owns

more than 50% of petitioner, he is a related person and is not an independent appraiser.¹⁹

In addition to being a related party, Mr. Thielking's father also failed to sign the appraisal, another requirement imposed for a proper independent appraisal.

In addition to the independence requirement the regulations impose certain collateral requirements: (1) the appraisal must include a declaration that the individual holds himself out to the public as an appraiser and (2) the qualified appraiser who signs the appraisal must list his or her background, experience, education, and membership, if any, in professional appraisal associations. Sec. 1.170A-13(c)(5)(i)(A) and (B), Income Tax Regs. The appraisal letters covering PYE February 28, 2007, through PYE February 28, 2009, state that "[t]he undersigned holds himself out to be an appraiser." However, because there is no signature below that statement or elsewhere on the letters, the appraisals fail the first collateral requirement. See *Hollen v. Commissioner*, 2011 WL 13637, at *4; see also *K.H. Co., LLC Emp. Stock Ownership Plan v. Commissioner*, T.C. Memo. 2014-31, at *27-*32. The appraisals fail the second collateral requirement because Stephen Thielking did not list his qualifications. See *Churchill, Ltd. Emp. Stock Ownership Plan & Tr. v. Commissioner*, T.C. Memo. 2012-300, at *20-*23.²⁰

The taxpayer argued that the plan should be excused what it viewed as violations of these technicalities, arguing that the plan had achieved substantial compliance with the law. The Court did not agree, noting:

Petitioner relies on *Bond v. Commissioner*, 100 T.C. 32 (1993), where the Court found the regulations under section 170(a) are directory and not mandatory with respect to the section 170 statutory purpose. In *Bond* the Court did not, however, address the independence requirement of section 401(a)(28)(C). We conclude that the independence requirement of section 1.170A-13(c)(5)(iv), Income Tax Regs., which bars certain related people from serving as qualified appraisers, relates to the essence of section 401(a)(28)(C) — therefore the doctrine of substantial compliance cannot excuse the independence requirement.²¹

¹⁹ *Ed Thielking Inc. v. Commissioner*, pp. 15-16

²⁰ *Ed Thielking Inc. v. Commissioner*, pp. 16-17

²¹ *Ed Thielking Inc. v. Commissioner*, p. 17

The taxpayer also argued that the Court had previously ruled that his father's appraisals in another case met the substantial compliance requirement—but the Tax Court found that the facts of that case were different in important ways, noting:

...[P]etitioner contends that, in *Val Lanes Recreation Ctr. Corp. v. Commissioner*, at *23-*24, this Court previously found that Stephen Thielking was an independent appraiser. But see *Churchill, Ltd. Emp. Stock Ownership Plan & Tr. v. Commissioner*, at *24-*25 (finding that Stephen Thielking was not an independent appraiser because, inter alia, he failed to sign the appraisals and include his qualifications). *Val Lanes*, however, is distinguishable on multiple grounds. First, Stephen Thielking had no familial relationship with the primary beneficiary of the employee stock option plan in *Val Lanes*. Second, while the appraisals in the record did not include a signature, the Court there found on the basis of credible testimony — absent here — that signed appraisals were in fact provided to the Department of Labor. In contrast, here, Stephen Thielking valued stock beneficially owned by his son, and nothing in the record indicates that the appraisals were ever signed.²²

Given the multiple problems found, it's not surprising the opinion concludes:

Because of the operational and form failures set forth above, we find no abuse of discretion in respondent's determination that the plan does not qualify under section 401(a) for PYE February 28, 2007, and because it is a continuing failure, all subsequent plan years. See, e.g., *Martin Fireproofing Profit Sharing Plan & Tr. v. Commissioner*, 92 T.C. 1173, 1184 (1989). We sustain respondent's determination that the ESOP and the ESOT were disqualified for the 2007 plan year and for all plan years thereafter.²³

SECTION: 6012 INDIVIDUAL ELECTRONIC FILINGS TO BE ACCEPTED BY IRS BEGINNING ON JANUARY 27

Citation: “IRS opens 2019 tax filing season for individual filers on Jan. 27,” IRS News Release IR-2020-02, 1/6/2020

After announcing the start of business electronic filing on a Friday, the IRS came back from the weekend on Monday to give taxpayers the date when individual returns will be

²² *Ed Thielking Inc. v. Commissioner*, p. 18

²³ *Ed Thielking Inc. v. Commissioner*, p. 24

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accepted.²⁴ However, while the announcements may have come only three days apart, the actual starting dates are much further apart.

While business returns will be accepted by the IRS on January 7,²⁵ the agency will not begin accepting individual returns until January 27, 2020.²⁶

The news release explains the reason for holding off the start until nearly the end of January as follows:

The IRS set the January 27 opening date to ensure the security and readiness of key tax processing systems and to address the potential impact of recent tax legislation on 2019 tax returns.

While taxpayers may prepare returns through the IRS' Free File program as well as many tax software companies and tax professionals before the start date, processing of those returns will begin after IRS systems open later this month.²⁷

²⁴ "IRS opens 2019 tax filing season for individual filers on Jan. 27," IRS News Release IR-2020-02, January 6, 2020, <https://www.irs.gov/newsroom/irs-opens-2019-tax-filing-season-for-individual-filers-on-jan-27> (retrieved January 6, 2020)

²⁵ Ed Zollars, "IRS Announces Business E-Filing Start Date, Individual Return Remains to Be Announced," Current Federal Tax Developments website, January 3, 2020, <https://www.currentfederaltaxdevelopments.com/blog/2020/1/3/irs-announces-business-e-filing-start-date-individual-return-remains-to-be-announced> (retrieved January 6, 2020)

²⁶ IRS News Release IR-2020-02

²⁷ IRS News Release IR-2020-02

SECTION: 6012

IRS ANNOUNCES BUSINESS E-FILING START DATE, INDIVIDUAL RETURN REMAINS TO BE ANNOUNCED

**Citation: “Modernized e-File (MeF) Status,” IRS website,
1/3/20**

The IRS has posted on their website that the agency will begin accepting electronically filed business returns on Tuesday, January 7, 2020.²⁸ CPAs will need to watch their tax software to determine when their vendor has updated their software to be able to handle the filings.

The site still lists the beginning date for individual returns as to be determined early in 2020. Very likely the problem for individual returns involves modifications that will need to be taken into account due to the law changes made by Congress late in 2019.

SECTION: 6502

DATE IRS RECORDS THE ASSESSMENT, NOT DATE TAXPAYER CONSENTS TO IMMEDIATE ASSESSMENT, CONTROLS STATUTE FOR IRS TO COLLECT THE TAX

**Citation: United States v. Kohls, Case No. 3:18-cv-00225,
US DC SD Ohio, 1/2/20**

In the case of *United States v. Kohls*, Case No. 3:18-cv-00225, US DC SD Ohio²⁹ the executor of the estate argued that the IRS had failed to file its action timely. The IRS was looking to collect over \$320,000 in unpaid estate taxes, penalties and interest due on the estate tax return. The issue turns on the date when the tax had been assessed, and whether the IRS was still within the time period imposed under IRC §6502(a)(1) to collect the tax following assessment.

²⁸ “Modernized e-File (MeF) Status,” IRS website, January 3, 2020 update, <https://www.irs.gov/e-file-providers/modernized-e-file-mef-status> (retrieved January 3, 2020)

²⁹ *United States v. Kohls*, Case No. 3:18-cv-00225, US DC SD Ohio, <https://ecf.ohsd.uscourts.gov/doc1/14317812186> (Registration required - retrieved January 4, 2020)

IRC §6502(a)(1) provides:

§ 6502. Collection after assessment

(a) Length of period. — Where the assessment of any tax imposed by this title has been made within the period of limitation properly applicable thereto, such tax may be collected by levy or by a proceeding in court, but only if the levy is made or the proceeding begun —

(1) within 10 years after the assessment of the tax

The statute date is complicated in this case because the estate had received three one year extensions of time to pay the tax from the IRS under §6161(b)(2), the first one granted when the estate agreed to the balance due at the end of the estate tax exam, followed by two additional extensions agreed to by the IRS.

The granting of extensions of time to pay the tax extends the statute under §6502(a)(1) by the amount of time granted under that provision. So, in this case, we are looking at a 13 year period for the IRS to take action to collect the tax, which in this case was looking to obtain a judgment personally against the executor for having distributed all estate assets without having paid the estate tax.

The executor did not file a response to the IRS's arguments regarding why he should be personally liable—rather, the executor's defense was that the IRS had waited too long to bring the action.

The executor had originally signed Form 890, *Waiver of Restriction on Assessment and Collection of Deficiency and Acceptance of Overassessment — Estate Gift and Generation Skipping Transfer Tax* on or about May 27, 2005. The taxpayer claimed that the IRS received this signed form on June 2, 2005. The IRS recorded the assessment on July 4, 2005.³⁰

The taxpayer argued that the statute began running no later than June 2, 2005 (the date the IRS received the Form 890), so the IRS had to file its action to obtain a judgment no later than June 2, 2018. The IRS had filed the action thirty days after that date and, in the executor's view, had lost its right to pursue collection.³¹

The IRS and the court disagreed. While the Form 890 may have given a consent to immediate assessment, the controlling date is when the IRS records the assessment in its

³⁰ *United States v. Kohls*, pp. 3-4

³¹ *United States v. Kohls*, p. 9

records per IRC §6203. That date was July 4, 2005 and thus the statute continued to run beyond the date the IRS filed its action.³²

The Court found the date the IRS records shows the assessment as being recorded is presumed to be correct. The Court did not find that the fact that this assessment indicates it was recorded on a federal holiday (Independence Day) was sufficient to overcome that presumption.³³

As the executor had not otherwise challenged the claims made by the IRS in its complaint, the Court found that the IRS should be granted summary judgment, as the Court found that the executor had allowed the assets of the estate to be depleted even though he was aware of the outstanding tax due.³⁴

SECTION: 6751

IRS DOES NOT HAVE TO PROVE IT DID NOT SEND PRIOR FORMAL COMMUNICATION OF PENALTIES BEFORE SUPERVISORY APPROVAL WAS GIVEN

Citation: Frost v. Commissioner, 154 TC No. 2, 1/7/20

The Tax Court issued its third decision in two days dealing primarily with penalties, and the second published case on the matter, in the case of *Frost v. Commissioner*, 154 TC No. 2.³⁵

The case generally is a rather standard case where the taxpayer fails to have records to back up deductions claimed on his Schedule C, as well as failing to show he had basis in the partnership in which he had claimed losses.

But the taxpayer was not the only sloppy party in this case—the IRS lost the ability to assess penalties for two years because the agency had failed to get the supervisory approval for such penalties required by IRC §6751(b)(1).

But the unique question arose for the penalties in the final year. The initial burden falls on the IRS to show that penalties should be applied in a case, and that includes showing that the agency complied with the requirement that supervisory approval was received

³² *United States v. Kohls*, p. 9

³³ *United States v. Kohls*, p.10

³⁴ *United States v. Kohls*, pp. 10-12

³⁵ *Frost v. Commissioner*, 154 TC No. 2, January 7, 2020, <https://www.ustaxcourt.gov/USTCInOP/OpinionViewer.aspx?ID=12134> (retrieved January 7, 2020)

prior to formal communication to the taxpayer of the IRS proposed assessment of the penalty.³⁶

In this case the IRS introduced a Civil Penalty Approval Form signed on May 20, 2014 for the penalties proposed on the taxpayer's 2012 return. That date was over one year before the notice of deficiency was issued. That was the only document the IRS claimed to have sent that met the burden of being the formal communication of the penalty to the taxpayer.

The key question is whether this showing is sufficient for the IRS to carry its initial burden, or if the agency must also show that no other formal communication of the penalty to the taxpayer took place before the approval was obtained to carry its initial burden.³⁷

The Court determined that the IRS did not have the burden to prove the negative—that is, that no other communication was made to the taxpayer that would amount to a formal communication of the penalty. Rather, the burden now shifts to the taxpayer on this issue, requiring the taxpayer to show that he had received some communication that would rise to the level of the formal communication of the penalty prior to the date of the approval of the penalty by the supervisor.³⁸

The opinion justifies the holding as follows:

The burden now shifts to petitioner to offer evidence suggesting that the approval of the substantial understatement penalty was untimely--e.g., that there was a formal communication of the penalty before the proffered approval. If a taxpayer makes that showing, we will weigh the evidence before us to decide whether the Commissioner satisfied the requirements of section 6751(b)(1). This rule is faithful to the requirement that the Commissioner come forward initially with evidence of written penalty approval. By shifting the burden to the taxpayer after the Commissioner makes the initial showing, we avoid imposing the burden of proving a negative (i.e., that there were no prior formal communications). If the taxpayer introduces sufficient evidence to contradict the Commissioner's initial showing, then the Commissioner can respond with additional evidence and argument, and the Court can weigh all of the evidence (that is after all the business of judging). And evidence of prior formal communication (if it exists) would be available to the taxpayer since he would have received such a communication and therefore could introduce it to

³⁶ *Frost v. Commissioner*, p. 21

³⁷ *Frost v. Commissioner*, p. 21

³⁸ *Frost v. Commissioner*, p. 22

challenge a claim that the supervisory approval was timely. In other words, the rule we articulate today will not require the Commissioner to show that there was no prior formal communication as part of his initial burden.³⁹

Since the taxpayer introduced no such evidence of prior communications, the Court found that the IRS had complied with the supervisory review requirements of IRC §6751(b) and the Court could now move to look at the facts surrounding whether actual imposition of the penalty was appropriate.⁴⁰

The taxpayer didn't fare well there. First, the amount of tax the Court found was due exceeded the \$5,000/10% amount necessary to trigger the imposition of the substantial understatement penalty of IRC §6662(b)(2).⁴¹ There was no suggestion that the position had substantial authority as a matter of law or that it had a reasonable basis in the law and was properly disclosed—all of the issues that led to the tax being imposed were based on factual determinations of the Court, not issues of law.

So that left the only defense available to the taxpayer that he had reasonable cause for the understatement and had acted in good faith per §6664(c)(1).

But the taxpayer suffered from some significant disadvantages in his attempt to seek refuge under the provision. The taxpayer was a former IRS revenue agent and an enrolled agent who had been preparing returns for profit for 25 years.⁴² Clearly, he would be expected to know the requirements for having proper documentation.

The taxpayer did have mitigating circumstances that might have worked better had he not been a tax professional—he had health issues, his brother-in-law was diagnosed with cancer and died and he was attempting to reconcile with his wife who now lived in a state other than that in which the taxpayer resided.⁴³

The Court noted, though, that this taxpayer wasn't your average taxpayer and the bar for reasonable cause is higher than he could clear with his facts:

But petitioner was an enrolled agent who prepared tax returns for about 25 years and had been an IRS revenue agent for 15 years. He therefore had a better understanding of tax matters, including the need for documentation, than do members of the general public. See Green

³⁹ *Frost v. Commissioner*, pp. 22-23

⁴⁰ *Frost v. Commissioner*, p. 23

⁴¹ *Frost v. Commissioner*, p. 23

⁴² *Frost v. Commissioner*, p. 5

⁴³ *Frost v. Commissioner*, p. 4

v. Commissioner, T.C. Memo. 2010-109. He continued to prepare returns for others during the years in issue. See *Fitch v. Commissioner*, T.C. Memo. 2012-358, supplemented by T.C. Memo. 2013-244. And he failed to explain how his difficulties in obtaining records affected his preparation of his 2012 Form 1040. While we are sympathetic to the challenges he faced over this period, cannot excuse his failure to substantiate his business expenses. We therefore hold that petitioner is liable for the section 6662(a) penalty for 2012.⁴⁴

SECTION: 6751 INITIAL DETERMINATION OF A PENALTY ASSESSMENT DOES NOT TAKE PLACE UNTIL TAXPAYER GETS REPORT WITH RIGHT TO PROTEST TO APPEALS

Citation: Belair Woods LLC et al. v. Commissioner, 154 TC No. 1, 1/6/20

The Tax Court has attempted to create a bright line test to deal with the issue of how to handle the requirement under IRC §6751(b) that supervisory approval must be obtained before the “initial determination of a penalty assessment” in the case of *Belair Woods LLC et al. v. Commissioner*, 154 TC No. 1.⁴⁵

IRC §6751(b) reads as follows:

(b) Approval of assessment

(1) In general

No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.

(2) Exceptions Paragraph (1) shall not apply to—

(A) any addition to tax under section 6651, 6654, or 6655; or

⁴⁴ *Frost v. Commissioner*, pp. 24-25

⁴⁵ *Belair Woods LLC et al. v. Commissioner*, 154 TC No. 1, January 6, 2020, <https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=12159> (retrieved January 7, 2020)

(B) any other penalty automatically calculated through electronic means.

In this case the IRS had sent the taxpayer a Letter 1807 in December of 2012 inviting the tax matters partner and other partners to a closing conference to discuss the IRS's proposed adjustments. The summary report enclosed with the letter proposed to deny a \$4.778 million charitable deduction and proposed either a gross overvaluation penalty under §6662(h) or the penalties for negligence and substantial understatement of income tax under IRC §§6662(c) and (d). The report did contain information on potential defenses against the penalty.⁴⁶

Later the agent prepared a Civil Penalty Approval Form. That form contained boxes for the agent's supervisor to indicate her approval or lack of approval for each proposed penalty. The agent indicated she was in favor of imposing the gross overvaluation penalty under §6662(h) as the "primary position," as well as penalties under §§6662(c) and (d) as an "alternative." In August of 2014 the agent forwarded the case file to Cheryl Mixon, her then-supervisor. Ms. Mixon signed the form indicating her approval of the penalty.⁴⁷

Ms. Mixon had not been the agent's supervisor at the start of the exam. In fact, the agent had a discussion regarding the penalties with her previous supervisor in late 2012, but that supervisor was not involved in the final approval.⁴⁸

Following Ms. Mixon's approval, the IRS sent the taxpayer a "TMP 60-Day Letter" (60-day letter). The letter indicated the IRS planned to assert the penalties listed on the Civil Penalty Approval Form along with the tax assessment. The letter indicated the taxpayer could accept the adjustments or appeal them to the IRS Appeals Office.⁴⁹

The taxpayer argued that the initial determination of assessment of the penalty contemplated by the statute took place when the Letter 1807 was issued indicating the IRS was proposing penalties as their position entering the conference. At that time there had been no approval by a supervisor of the penalties and, thus, the penalties now could not be asserted by the IRS.⁵⁰

The IRS contended that no such approval was needed prior to the 60-day letter, as that should be held to be the initial determination of the assessment of the penalty. As the

⁴⁶ *Belair Woods LLC et al. v. Commissioner*, pp. 6-7

⁴⁷ *Belair Woods LLC et al. v. Commissioner*, pp. 8-9

⁴⁸ *Belair Woods LLC et al. v. Commissioner*, p. 6

⁴⁹ *Belair Woods LLC et al. v. Commissioner*, p. 9

⁵⁰ *Belair Woods LLC et al. v. Commissioner*, p. 14

approval was received before that date, the IRS argued that they were not barred from asserting the penalties that Ms. Mixon had approved.

The majority opinion begins by noting the phrase “initial determination of an assessment” is not completely clear:

The phrase “initial determination of * * * [an] assessment” appears nowhere else in the Code. It is what scholars of ancient Greek call a “hapax legomenon,” a word or phrase that occurs only once in a document or corpus. *Graev v. Commissioner*, 149 T.C. 485, 500 (2017) (Lauber, J., concurring), supplementing and overruling in part 147 T.C. 460 (2016). And the phrase has no ordinary meaning, at least not in tax law, because the words “determine” and “assessment” are not normally joined together. See *Chai v. Commissioner*, 851 F.3d 190, 218-219 (2d Cir. 2017) (“[O]ne can determine a deficiency * * * and whether to make an assessment, but one cannot determine an assessment.” (internal citations and quotation marks omitted)), *aff’g in part, rev’g in part* T.C. Memo. 2015-42.

Confronted with this ambiguity, this Court and others have looked to the statute’s legislative history as a possible guide to its interpretation. See *id.* at 219; *Clay*, 152 T.C. at 248; *Williams v. Commissioner*, 151 T.C. 1, 8-10 (2018). The Senate Finance Committee stated Congress’ belief that penalties should not be used to gain inappropriate leverage over taxpayers, but “should only be imposed where appropriate and not as a bargaining chip.” S. Rept. No. 105-174, at 65 (1998), 1998-3 C.B. 537, 601.

Given this legislative purpose, the Second Circuit reasoned in *Chai* that managerial approval would not be meaningful if deferred until after the taxpayer’s liability had been determined, e.g., by a decision of this Court. To be meaningful, supervisory approval must be secured at a time “when the supervisor has the discretion to give or withhold it.” *Chai*, 851 F.3d at 220. The Second Circuit accordingly interpreted section 6751(b)(1) to “require[] written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty.” *Id.* at 221. In partnership cases, we have ruled similarly that supervisory approval must be obtained no later than the date on which the IRS issues the FPAA. See *Palmolive Bldg. Inv’rs, LLC v. Commissioner*, 152 T.C. 75, 89 (2019); *Sugarloaf Fund, LLC v. Commissioner*, T.C. Memo. 2018-181, at *22; *Endeavor Partners Fund*,

LLC v. Commissioner, T.C. Memo. 2018-96, at *65, aff'd, 943 F.3d 464 (D.C. Cir. 2019).⁵¹

The majority concludes that in this case the 60-day letter is the appropriate point at which to force the IRS to have met the supervisory approval standard.

In *Clay* the penalties were formally communicated to the taxpayers in a revenue agent report (RAR) accompanied by a 30-day letter, which entitled them to appeal by filing a protest with the Appeals Office. We concluded that the “initial determination for purposes of section 6751(b) was made no later than * * * when * * * [the Commissioner] issued the RAR * * * proposing adjustments including penalties and gave * * * [the taxpayers] the right to protest those proposed adjustments.” Ibid. Because the IRS agent neglected to secure supervisory approval for the penalties before the Examination Division, by issuing a 30-day letter, formally communicated to the taxpayers its definite decision to assert penalties, we held that the Commissioner had failed to show compliance with section 6751(b)(1).

In the instant case the 60-day letter determining penalties under section 6662(b), (c), and (h) was issued on March 9, 2015. That letter, like the 30-day letter in *Clay*, formally communicated to Belair the Examination Division’s definite decision to assert those penalties, thus concluding the Examination Division’s consideration of the case. See Internal Revenue Manual (IRM) pt. 8.19.1.6.8.4(3) (Oct. 1, 2013) (“The 60-day letter is the equivalent of a 30-day letter in deficiency proceedings. It gives the partners the opportunity to appeal the findings of the examiner.”).

Group Manager Mixon, RA Pennington’s immediate supervisor, signed a Civil Penalty Approval Form approving assertion of the first three penalties on September 2, 2014. That date was more than six months before the 60-day letter was issued. The IRS thus secured supervisory approval for those penalties before formally communicating to Belair the Examination Division’s definite decision to assert the penalties. Respondent accordingly contends that, with respect to those penalties, he has shown compliance with section 6751(b)(1).⁵²

⁵¹ *Belair Woods LLC et al. v. Commissioner*, pp. 11-12

⁵² *Belair Woods LLC et al. v. Commissioner*, pp. 12-13

But what about the initial IRS proposal before the conference where the agency indicated it intended to propose penalties? The majority found that no decision had been made at that point:

But the summary report did not notify petitioner of a definite decision to assert penalties. Rather, it set forth the exam team’s tentative proposals and invited Belair’s partners to a conference to discuss them. See IRM pt. 8.19.1.6.8.4(2) (Dec. 1, 2006). The Letter 1807 launched a lengthy communication and fact-gathering process during which Belair had the opportunity to present its side of the story. Only after that process concluded did the Examination Division finalize its penalty determination by issuing the 60-day letter.

The statute requires approval for the initial determination of a penalty assessment, not for a tentative proposal or hypothesis. As the Second Circuit noted in *Chai*, a “determination” denotes a “consequential moment” of IRS action. See *Chai*, 851 F.3d at 220-221 (analogizing the “initial determination” of a penalty to the “first determination made by the Social Security Administration of a person’s eligibility for benefits” (quoting Black’s Law Dictionary 460 (7th ed. 1999))). The natural place to look for an initial “determination” of a penalty assessment is a document that formally communicates to the taxpayer a definite decision to assert penalties.⁵³

However, this case split the court. Eight judges joined in the majority opinion, while one concurred in result. There were two dissenting opinions in which the other judges joined. The dissenters generally found that the majority had pushed the approval far too late into the process to do much to discourage the IRS from using the threat of penalties as a bargaining chip.

That is, the fact that the IRS indicated they were considering asserting penalties prior to the initial conference could easily be read by a taxpayer that if the taxpayer is “cooperative” and consents to the tax assessment that the penalties might go away—the very bargaining chip the statute looked to prevent.

Given the close decision, as well as the fact that one judge agreed in result only, it isn’t clear that this case, despite being a published decision, actually will do a lot to clarify ultimately how this provision is applied in other cases—or even this one if the taxpayer decides to pursue an appeal.

⁵³ *Belair Woods LLC et al. v. Commissioner*, pp. 14-15