Current Federal Tax Developments

Week of January 20, 2020

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ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF JANUARY 20, 2020
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Kaplan Financial Education

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SECTION: 61
TAX RELIEF EXPANDED FOR STUDENT LOAN DEBT DISCHARGE

Citation: Revenue Procedure 2020-11, 1/15/20

The IRS announced an expansion of relief to additional individuals who borrowed funds to attend school and later had that debt cancelled in Revenue Procedure 2020-11.[1]

The IRS had previously granted relief to those who attended schools owned by Corinthian College, Inc. (CCI) or American Career Institutes, Inc. (ACI) and had their loans discharged by the Department of Education under the "Closed School" or "Defense to Repayment" programs. This relief was limited to those who had attended schools owned by CCI or ACI.[2]

The Revenue Procedure describes this prior relief as follows:

> .04 Rev. Proc. 2018-39 provides relief for taxpayers who took out private student loans to finance attendance at a school owned by CCI or ACI and whose loans were discharged based on a settlement of a legal cause of action resolving various allegations of unlawful business practices, including unfair, deceptive, and abusive acts and practices against CCI, ACI, and certain private lenders.
>
> .05 Rev. Proc. 2015-57, Rev. Proc. 2017-24, and Rev. Proc. 2018-39 provide the following relief: (1) the Internal Revenue Service (IRS) will not assert that these taxpayers must recognize gross income resulting from the discharge of these Federal and private student loans; (2) the IRS will not assert that these taxpayers must increase their gross income by the amount of certain tax credits or deductions related to the discharged Federal and private student loans; and (3) the IRS will not assert that the creditors of these discharged loans must file information returns and furnish payee statements under section 6050P of the Code as a result of discharging these Federal and private student loans.[3]

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[1] Revenue Procedure 2020-11, January 15, 2020, https://www.irs.gov/pub/irs-drop/rp-20-11.pdf (retrieved January 16, 2020)

[2] Revenue Procedure 2020-11, Section 2

[3] Revenue Procedure 2020-11, Section 2

Since that relief was issued, other students who attended schools not owned by either CCI or ACI have had their loans discharged under similar circumstances or under legal settlements relating to a school's business practices. The IRS has now decided to extend relief to more than just those students that attended other institutions:

> .08 The Treasury Department and the IRS have determined that it is appropriate to extend the relief provided in Rev. Proc. 2015-57, Rev. Proc. 2017-24, and Rev. Proc. 2018-39 to taxpayers who took out Federal and private student loans to finance attendance at nonprofit or other for-profit schools not owned by CCI or ACI where the Federal loans are discharged by ED under the Closed School or Defense to Repayment discharge process, or where the private loans are discharged based on a settlement of a legal cause of action against nonprofit or other for-profit schools and certain private lenders. As in Rev. Proc. 2015-57, Rev. Proc. 2017-24, and Rev. Proc. 2018-39, the Treasury Department and the IRS believe that most Federal and private student loan borrowers would be able to exclude from gross income all or substantially all of the discharged amounts based on the insolvency exclusion under section 108(a)(1)(B) of the Code; fraudulent or material misrepresentations made by such nonprofit or for-profit schools or certain private lenders to the students; or other tax law authority. However, determining whether one or more of these exclusions is available to each affected borrower would require a fact intensive analysis of the particular borrower's situation to determine the extent to which the discharged amount is eligible for exclusion under each of the potentially available exceptions. The Treasury Department and the IRS are concerned that such an analysis would impose a compliance burden on taxpayers, as well as an administrative burden on the IRS, that is excessive in relation to the amount of taxable income that would result. Accordingly, the IRS will not assert that a taxpayer within the scope of the safe harbor in this revenue procedure recognizes gross income as a result of the discharge.[4]

Section 3 of the Revenue Ruling provides information on the scope of the relief offered:

> .01 The treatment provided in section 4 of this revenue procedure applies to any taxpayer who took out Federal or private student loans to finance attendance at a nonprofit or for-profit school described in section 3.02 of this revenue procedure and (a) whose Federal loans are discharged by ED based on the Closed School or Defense to Repayment discharge process, or (b) whose private loans are discharged based on a settlement of a legal cause of action resolving various allegations of unlawful business practices, including unfair, deceptive,

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[4] Revenue Procedure 2020-11, Section 2

> and abusive acts and practices against a nonprofit or for-profit school or private lenders that made student loans to finance attendance at these schools. This revenue procedure also applies to any applicable entity, as defined by section 6050P of the Code and the regulations thereunder, that discharges these loans.
>
> .02 Section 3.01 of this revenue procedure applies to nonprofit schools that meet the definition of an "institution of higher education" under 20 U.S.C. § 1001(a) or (b), or for-profit schools that meet the definition of a "proprietary institution of higher education" under 20 U.S.C. § 1002(b).[5]

Note that the second category in Section 3.01 expands relief to individuals that had their debts discharged due to a legal settlement involving allegations of unlawful business practices—so the relief goes beyond just those who had debt discharged under the Department of Education programs covered by the earlier Revenue Procedures.

Of course, taxpayers may be concerned about whether the IRS will agree that they are eligible for this relief under the provisions of Section 3 and their exact circumstances. The Revenue Procedure provides for three safe harbors under which taxpayers will automatically qualify.[6]

Borrowers Participating in the Closed School Discharge Process

The first safe harbor covers borrowers that are participating in the Department of Education's closed school discharge process. The ruling provides the following guidance on when a borrower will meet this safe harbor:

> The Closed School discharge process allows ED to discharge a Federal student loan obtained by a student, or by a parent on behalf of a student, who was attending a school at the time it closed or who withdrew from the school within a certain period prior to the closing date. The HEA provides statutory exclusions from gross income for Federal student loans discharged under the Closed School discharge process.
>
> A taxpayer whose Federal student loan is discharged under the Closed School discharge process will not recognize gross income as a result of the discharge, and the taxpayer should not report the amount of the

[5] Revenue Procedure 2020-11, Section 3

[6] Revenue Procedure 2020-11, Section 4.01

> discharged loan in gross income on his or her Federal income tax return.[7]

This was one of the programs for which relief was given for those attending schools owned by CCI or ACI in the older Revenue Procedures.

Borrowers Participating in the Defense to Repayment Discharge Process

The IRS also has extended relief outside of the schools owned by CCI and ACI for those participating in the Defense to Repayment discharge process. The requirements to meet this safe harbor are detailed as follows in the ruling:

> The Defense to Repayment process allows ED to discharge a Federal Direct Loan obtained by a student, or by a parent on behalf of a student, if the borrower establishes, as a defense against repayment, that a school's actions would give rise to a cause of action against the school under applicable state law. Most of these borrowers would be able to exclude from gross income the discharged amounts based on the insolvency exclusion, fraudulent or material misrepresentations, or other tax law authority.
>
> A taxpayer whose Federal student loan is discharged under the Defense to Repayment discharge process will not recognize gross income as a result of the discharge, and the taxpayer should not report the amount of the discharged loan in gross income on his or her Federal income tax return.[8]

Like the first safe harbor, this is merely an expansion of relief offered under the prior Revenue Procedures to students aside from those who had attended ACI or CCI owned schools.

Borrowers Participating in Legal Settlement Discharge Actions

The final category is the "legal settlement discharge" category. The IRS describes those qualifying for this safe harbor as follows:

> Federal and state governmental agencies have brought legal causes of action that have resulted in settlements resolving various allegations of unlawful business practices, including unfair, deceptive, and abusive acts and practices, against for-profit schools and certain private lenders that made student loans to finance attendance at these schools. Most of

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[7] Revenue Procedure 2020-11, Section 4.01(a)

[8] Revenue Procedure 2020-11, Section 4.01(b)

> these borrowers would be able to exclude amounts discharged as a result of these settlements from gross income based on the insolvency exclusion, fraudulent or material misrepresentations, or other tax law authority.
>
> A taxpayer whose private student loan is discharged based on a settlement of a legal cause of action resolving various allegations of unlawful business practices against nonprofit or for-profit schools or private lenders that made student loans to finance attendance at these schools will not recognize gross income as a result of the discharge, and the taxpayer should not report the amount of the discharged loan in gross income on his or her Federal income tax return.[9]

Unfortunately, it's not clear from this description found in the Revenue Ruling if the legal cause of action must be initiated by a governmental agency. The first paragraph only discusses such actions, but the second paragraph and the general rule found in Section 3 make no mention of government only actions.

Waiver of Recapture of Prior Tax Credits or Deductions

The ruling also provides that the IRS will not attempt to force covered borrowers to increase their taxes in the year of discharge or a prior year to recapture various education benefits. The ruling provides:

> The IRS will not assert that a taxpayer within the scope of this revenue procedure must increase his or her taxes owed in the year of a discharge, or in a prior year, as a result of a discharge described in section 4.01 of this revenue procedure, if in a prior taxable year he or she received an education tax credit under section 25A of the Code attributable to payments made with proceeds of the discharged loan. In addition, the IRS also will not assert that a taxpayer within the scope of this revenue procedure must increase his or her gross income in the year of the discharge as a result of a discharge described in section 4.01 of this revenue procedure, if in a prior taxable year he or she took a deduction under section 221 of the Code attributable to interest paid on a discharged loan or a deduction in a prior taxable year under section 222 of the Code attributable to payments of qualified tuition and related expenses made with proceeds of the discharged loan.[10]

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[9] Revenue Procedure 2020-11, Section 4.01(c)

[10] Revenue Procedure 2020-11, Section 4.02

Form 1099-C Issues

Finally, the IRS provides that lenders who have discharged such a debt will not be penalized for failing to file a Form 1099-C and, in fact, should refrain from filing the document in cases covered by this ruling:

> The IRS will not assert that a creditor that is an applicable entity, as defined by section 6050P of the Code and the regulations thereunder, must file information returns and furnish payee statements pursuant to section 6050P of the Code for the discharge of any indebtedness within the scope of this revenue procedure. The filing of such information returns with the IRS could result in the issuance of underreporter notices to taxpayers and the furnishing of such payee statements to taxpayers could cause confusion.[11]

Retroactive Effective Date

The relief provided by this Revenue Ruling is generally retroactive all the way back to tax year 2016. As the ruling provides:

> This revenue procedure is effective for Federal student loans discharged by ED in taxable years beginning on or after January 1, 2016, under the Closed School or Defense to Repayment discharge process, and for private student loans discharged in taxable years beginning on or after January 1, 2016, based on a settlement of a legal cause of action resolving various allegations of unlawful business practices, including unfair, deceptive, and abusive acts and practices against the nonprofit or for-profit schools or certain private lenders. Taxpayers to whom this revenue procedure applies may claim a credit or refund for an overpayment of tax for taxable years for which the period of limitations under section 6511 of the Code has not expired.[12]

Taxpayers who have included such a discharge in income in a prior year should consider filing a claim for refund before the statute of limitation for claiming the refund expires—as it will come mid-April for those who filed their 2016 individual return without going on extension and have paid tax on debt discharge in that year.

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[11] Revenue Procedure 2020-11, Section 4.03

[12] Revenue Procedure 2020-11, Section 6

SECTION: 162
IRS EXAMPLE SUGGESTS POSSIBLE STATE TAX WORKAROUND FOR CERTAIN PASSTHROUGH CREDITS

Citation: REG-107431-19, 12/17/19

Online tax discussion groups, many of which are sponsored by state CPA societies for their members, offer useful places to discuss tax issues and become aware of what is going on in taxes. It was when participating in such a group discussion that I became aware of a theory being proposed to allow working around the state and local tax deduction cap based on the proposed regulations[13] issued by the IRS in December regarding payments to charitable organizations not treated as charitable contributions under Proposed Reg. §1.162-15.

Arizona Credit at the Center of the Issue

The particular credit that gave rise to this discussion is unique to the state of Arizona, though if the workaround works other states clearly could establish a similar structure. The key provision is found at Arizona Revised Statutes §43-1089.04, which allows an S corporation making a private tuition organization donation described at ARS §43-1183.F or §43-1184.F to pass that credit against state income taxes to its shareholders.

The credit is limited only in the aggregate—it is awarded to corporations on a "first-come, first-served" basis until the total allocated to the fund for a year is exhausted.

The claim being made is that such contributions could be treated as trade or business expenses in at least some circumstances on the S return. The theory goes that under the rules of Proposed Reg. §1.162-15, this amount would be deducted in full in arriving at the S corporation's non-separately stated income that flows to Schedule E, despite the shareholder receiving a tax credit against his/her Arizona income taxes in an amount exactly equal to what was paid.

My take—if we take the language of an example that isn't replicated in the main text of the regulation as green-lighting the option, then it is possible. But the practical hurdle of meeting the requirement to show a reasonable expectation of income in excess of the contribution may create an insurmountable hurdle in many cases.

The Proposed Regulation

Most observers believed that the regulations first proposed in August of 2018 had closed down any opportunity to use this to work around the $10,000 state and local tax deduction cap on Schedule A of Form 1040. And that the door was firmly slammed

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[13] REG-107431-19, December 17, 2019

shut by Revenue Procedure 2019-12 that, while providing a safe harbor for claiming payments to a charity as a deduction even if a credit was received in a business context, it specifically did not allow such a credit if the entity was a passthrough and the tax in question was an income tax.

Apparently, donors felt the door was shut as well—while the fund had received the maximum allotted amount of contributions within minutes of accepting applications in the summer of 2018, the same was not true when applications began to be accepted in 2019.

But now the idea has been floated that Proposed Reg. §1.162-15, issued in December of 2019, would, if made final, allow the program to spring back to life.

Those pushing this theory would point to revised Proposed Reg. §1.162-15(a)(1) which reads:

> (a) Payments and transfers to entities described in section 170(c) — (1) In general. A payment or transfer to or for the use of an entity described in section 170(c) that bears a direct relationship to the taxpayer's trade or business and that is made with a reasonable expectation of financial return commensurate with the amount of the payment or transfer may constitute an allowable deduction as a trade or business expense rather than a charitable contribution deduction under section 170. For payments or transfers in excess of the amount deductible under section 162(a), see §1.170A-1(h).

And the regulation gives the following example of such an expenditure by a passthrough:

EXAMPLE 2. PROPOSED REG. §1.162-13(A)(2)

P, a partnership, operates a chain of supermarkets, some of which are located in State N. P operates a promotional program in which it sets aside the proceeds from one percent of its sales each year, which it pays to one or more charities described in section 170(c). The funds are earmarked for use in projects that improve conditions in State N. P makes the final determination on which charities receive payments. P advertises the program. P reasonably believes the program will generate a significant degree of name recognition and goodwill in the communities where it operates and thereby increase its revenue. As part of the program, P makes a $1,000 payment to a charity described in section 170(c). P may treat the $1,000 payment as an expense of carrying on a trade or business under section 162. *This result is unchanged if, under State N's tax credit program, P expects to receive a $1,000 income tax credit on account of P's payment, and under State N law, the credit can be passed through to P's partners.*

That last sentence, adding a "clarification" to the regulation, seems to strongly imply there would be a deduction, without reduction for the benefit received, for the payment made by the partnership once the bar is cleared to show a relationship to the business and an expected benefit in excess of the contribution made.

But Don't Use the Safe Harbor

But now we hit a bump in the road. The proposed regulation provides for the following safe harbor that would solve the problem of having to determine if the payment was a trade or business expense. Proposed Reg. §1.162-15(a)(3)(i) provides:

> (i) Safe harbor for C corporations.
>
> If a C corporation makes a payment to or for the use of an entity described in section 170(c) and receives or expects to receive in return a state or local tax credit that reduces a state or local tax imposed on the C corporation, the C corporation may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of the credit received or expected to be received.

That safe harbor solves the not inconsequential problem of determining if the payment is a trade or business expense under §162 under the general rule of Reg. §1.162-15(a)(1). If a state tax credit is received for the payment it *will* be treated as a business expense. But the rule only applies to C corporations.

A second safe-harbor applies for certain passthroughs. But we quickly discover that one is not going to help us because it specifically *excludes* credits against income taxes, despite the last line in the example cited above. Proposed Reg. §1.162-15(a)(3)(ii) provides:

> (ii) Safe harbor for specified passthrough entities — (A) Definition of specified passthrough entity. For purposes of this paragraph (a)(3)(ii), an entity is a specified passthrough entity if each of the following requirements is satisfied —
>
> > (1) The entity is a business entity other than a C corporation and is regarded for all Federal income tax purposes as separate from its owners under §301.7701-3 of this chapter;
> >
> > (2) The entity operates a trade or business within the meaning of section 162;
> >
> > (3) The entity is subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity; and
> >
> > (4) In return for a payment to an entity described in section 170(c), the entity described in paragraph (a)(3)(ii)(A)(1) of this section receives or expects to receive a state or local tax credit that this entity applies or expects to apply to offset a

> state or local tax described in paragraph (a)(3)(ii)(A)(3) of this section.

> (B) Safe harbor. Except as provided in paragraph (a)(3)(ii)(C) of this section, if a specified passthrough entity makes a payment to or for the use of an entity described in section 170(c), and receives or expects to receive in return a state or local tax credit that reduces a state or local tax described in paragraph (a)(3)(ii)(A)(3) of this section, the specified passthrough entity may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of credit received or expected to be received.

> (C) Exception. The safe harbor described in this paragraph (a)(3)(ii) does not apply if the credit received or expected to be received reduces a state or local income tax.

In this case, the IRS removes the safe harbor protection for the payment if the tax in question is an income tax.

So, while the IRS gives hope with the example in Proposed Reg. §1.162-15(a)(1), the agency turns around and indicates that, unlike Example 1, Example 2's taxpayer would not be able to make use of the safe harbor.

The §162 Deduction Standard for Payments to Charities

We are back to Proposed Reg. §1.162-15(a)(1) to determine if we have a trade or business expense for the payment to the charity. The language found there is mainly drawn from current Reg. §1.170A-1(c)(5), which will reference the new Proposed Reg. $1.162-15(a)(1) if the regulations are made final.

That provision requires the payment meet two criteria to become a Proposed Reg. §1.162-15(a)(1) expenditure:

- The expenditure must bear a direct relationship to the taxpayer's trade or business and
- The expenditure is made with a reasonable expectation of financial return commensurate with the amount of the payment or transfer.[14]

Since this language is identical to the language that had already existed in the regulations, what does the case law tell us about how the courts have looked at that provision?

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[14] Proposed Reg. §1.162-15(a)(1)

Before the Tax Reform Act of 1986, advisers ran into this issue quite often. Many small businesses were organized as C corporations at the time and such entities generally had little taxable income. Officer salaries absorbed most of the funds available once all bills were paid. Corporations have a limit on charitable contribution deductions that is very low—no more than 10% of taxable income.

Thus, for a small C corporation, there was little or no taxable income, so little or no amount of allowed charitable contribution. In that environment, taxpayers and advisers looked to reclassify an item as something other than a charitable contribution.

A *Tax Adviser* article from August of 1995[15], archived at The Free Library, lists a series of citations to rulings and cases where a business link was found. In each case the two tests cited above were met.

The listed cases and rulings from that article are reproduced below:

- Bargain sales of sewing machines by a sewing machine manufacturer to churches, schools and other charitable entities, in order to encourage training in the use of sewing machines and enlarge its future market (*Singer Co.*, Ct. Cl., 1971).
- Payments by a travel agency to charitable organization clients when the payments were based on the amount, character and profitability of the business received and expected to be received (*Marquis*, 49 TC 695 (1968), acq. 1971-2 CB 3).
- Payments by a corporation to a charitable organization for cooperation and the use of its name in connection with the corporation's advertising program. Under the arrangement, the corporation paid the charity a specified amount on each unit of the corporation's product for which the purchaser mailed a label to the charity (Rev. Rul. 63-73).
- Payments made by the operator of parimutuel racetracks to local charities of profits earned on certain charity days, when the charity days were run to facilitate a favorable vote from the citizens in the area to enable the taxpayer to retain its racing license (Rev. Rul. 77-124; cf. Rev. Rul. 72-542).
- Payments by a stock brokerage business to a charitable organization equal to 6% of brokerage commissions received from the charitable organization, when the taxpayer advertised that it was making the payments to enable the charitable organization to reduce neighborhood tensions and combat community deterioration in the area in which the taxpayer's office was located. The taxpayer believed this advertised policy would promote new business and enable it to retain existing business (Rev. Rul. 72-314).

[15] Harrison, Robert E., "Payments to charities by business enterprises: Sec. 162 vs. Sec. 170.." *The Free Library,* Retrieved Sep 05 2018 from https://www.thefreelibrary.com/Payments+to+charities+by+business+enterprises%3a+Sec.+162+vs.+Sec.+170.-a017170945

- Payments by a retail business in a resort city to a governmental oil pollution control fund used for research, beautification and advertising, in order to help recover tourist business lost due to oil pollution (Rev. Rul. 73-113).

- Payments by an employer corporation to a tax-exempt union educational and cultural charitable trust, when the payments were required pursuant to a collective bargaining agreement (Rev. Rul. 74-51).

- Contributions to a tax-exempt dance company in financial difficulty, when the taxpayer derived substantial income from performing services for the dance company (Letter Ruling 9045015).

- Payments by a supermarket business of 1% of its sales to various civic organizations, churches, government entities and charities located in the communities where stores were located, pursuant to a program of advertising the donation program in newspapers and on radio and television. The charities were required to agree to the use of the charity's name in connection with the advertising (Letter Ruling 9309006).

One item of interest to note in the above list is that Rev. Rul. 77-124 was issued to distinguish the situation found in Rev. Rul. 72-542. In that ruling, the facts were as follows:

> The taxpayer is a corporation engaged in the business of operating a pari-mutuel race track. The corporation is licensed, regulated, and supervised by the Racing Commission of the state where the track is operated. The corporation is licensed to operate the track is a predetermined number of days, but elected under regulations of the Racing Commission to operate the track one additional day only for purposes of charity. Under such regulations, the corporation's election requires it to contribute all of the gross amount of that portion of gross receipts of all pari-mutuel wagers retained by it (i.e., a certain percentage of the pari-mutuel wagers less the state's tax thereon) from such charity day racing, to a charitable corporation, trust, fund or foundation. A foundation was formed by the corporation that qualifies as an organization described in section 170(c)(2) of the Internal Revenue Code of 1954. The taxpayer's portion of the pari-mutuel wagers from charity day racing was distributed to the foundation. There was no expectation of an economic return commensurate with the amount distributed.
>
> There is no written or verbal lease between the taxpayer and the foundation concerning the use of the track facilities during charity day, and the provisions of the general insurance policy issued to the taxpayer provides public liability coverage on charity day. Advertising and promotional activities for charity day are provided by the taxpayer.

The ruling first holds that the amounts received are income to the business under IRC §61.

> In the instant case, the taxpayer and not the foundation is the promoter of charity day since only the taxpayer is licensed by the state to operate a pari-mutuel race track. Under the state's regulations, the taxpayer could operate the track an additional day over the predetermined number of days allotted to it only if the taxpayer contributes its portion of the pari-mutuel wagers to a charitable organization. The taxpayer is not an agent for the foundation and is in effect assigning to the foundation earnings derived by it from the operation of the charity day racing.
>
> Accordingly, that portion of gross receipts of all pari-mutuel wagers retained by the taxpayer on charity day racing and subsequently distributed to the charitable foundation is income to the taxpayer within the meaning of section 61 of the Code.

However, the real question is what happens to the payment to the charity. In this case the IRS finds the payment does not meet the two tests cited earlier.

> If a taxpayer makes a transfer of property to a charitable organization with a reasonable expectation of an economic return to himself in his trade or business, commensurate with the amount of the transfer, no deduction under section 170 of the Code is allowable with respect to such transfer and the transfer may constitute an ordinary and necessary business expense under section 162 of the Code. See Revenue Ruling 72-314, C.B. 1972-1, 44: Conversely, if a taxpayer makes a voluntary transfer of property to a charitable organization without expectation of a commensurate economic return to him in his trade or business, the deductibility of the transfer is determined under section 170 of the Code, and no deduction under section 162 of the Code is allowable with respect to such transfer.
>
> Whether a particular transfer was made with a reasonable expectation of an economic return commensurate with the amount of the transfer is a question of fact. In the instant case, the taxpayer did not expect a commensurate economic return from the amount distributed to the foundation.
>
> Accordingly, the amount of pari-mutuel wagers retained by the taxpayer on charity day racing and distributed to the charitable foundation is not deductible as an ordinary and necessary business expense by the taxpayer under section 162(a) of the Code. However, such amount is deductible as a charitable contribution under section 170 of the Code, subject to the conditions and limitations contained in section 170 of the Code.

The preamble to the proposed regulations specifically refers to the *Marquis* case in discussing when a charitable contribution is a business expense. It's useful to refer back to that case and note just how integral the payments to charities were to her travel agency business. Her business came primarily from charitable organizations. As the Court noted in finding that her payments were business expenses and not contributions:

> Petitioner's charitable clients were numerous (some 30 in all) and bookings in connection with their organizationally sponsored trips represented a very substantial part of business (57 percent of her total billings). She had direct and continuous business dealings with them. Moreover, she contributed to the charities with which she was otherwise identified. On a recurring basis, she made payments of the type in question (including payments during the taxable years involved herein), not only in the expectation that she would continue to obtain business from the recipient, but because she could well have lost such business if she had stopped. The payments were directly keyed to the amount, character, and profitability of the business which petitioner obtained and expected to obtain from the charitable clients. Petitioner had no other feasible means of reaching these clients through normal advertising channels. Cf. *Hartless Linen Service Co*., 32 T.C. 1026, 1030 (1959). In short, petitioner's charitable clients represented a substantial, continuing, integral part of her business. They were in every sense petitioner's bread and butter.[16]

Another issue that is not clear from the regulation, is whether the determination of whether there is a sufficient benefit is made before or after taking into account the economic benefit from the tax credit.

The example might suggest it is tested before the credit, since the example comes to its conclusion based on a payment without telling us if there was or was not a credit—thus, the benefit exceeded the payment without any "subsidy" in play. The example only then tells us the result does not change if the passthrough gets a 100% credit for the expenditure.

Obviously, if the taxpayer could offset the payment with the 100% credit before checking for a business benefit, even the most minor of possible benefits would be enough to meet the test. While this is a result we might like, it doesn't seem likely the IRS is going to agree with this view. Certainly, it seems odd that they would have shut down the safe harbor option only to make it this easy to qualify—presumably the intent was to create a higher standard for income tax credit payments to charitable organizations.

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[16] *Marquis v. Commissioner*, 49 TC 695, 701 (1968)

It is possible some clarification may come when final regulations are issued regarding whether or not the tax benefit is to be considered in making the determination whether the payment qualifies as a §162 expense.

Limitation on the §162 Deduction

The last sentence of Proposed Reg. §1.162-15(a)(1) provides:

> For payments or transfers in excess of the amount deductible under section 162(a), see §1.170A-1(h).

As modified by these proposed regulations, Reg. §1.170A-1(h)(2)(i) would limit the deduction as follows:

> The charitable contribution deduction under section 170(a) for a payment a taxpayer makes partly in consideration for goods or services may not exceed the excess of -
>
> > (A) The amount of any cash paid and the fair market value of any property (other than cash) transferred by the taxpayer to an organization described in section 170(c); over
> >
> > (B) The fair market value of the goods or services received or expected to be received in return.[17]

The only change made by the proposed regulations was to add "or expected to be received" to (B) above.

Thus, a taxpayer will appear to need to quantify the goods or services expected to be received in order to determine the proper §162 business expense. The remaining amount would be a charitable contribution per the regulations.

Effective Date

The proposed regulations provide the following regarding taxpayers' abilities to apply these rules prior to the publication of final regulations:

> The proposed amendments contained in §§1.162-15(a)(1) and (2) and 1.170A-1(c)(5), regarding the application of section 162 to taxpayers that make payments or transfers to entities described in section 170(c), are proposed to apply to payments or transfers on or after December 17, 2019. However, a taxpayer may rely on these proposed regulations for payments and transfers made on or after January 1, 2018 and

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[17] Reg. §1.170A-1(h)(2)(i) as revised by REG-107431-19

> before the date regulations finalizing these proposed regulations are published in the Federal Register.[18]

Note that the key "Example 2" resides in Proposed Reg. §1.162-15(a)(2), and thus taxpayers could apply it retroactively to 2018 transactions.

With regard to the safe harbor rules, the preamble provides:

> The proposed amendment contained in §1.162-15(a)(3), regarding safe harbors for C corporations and specified passthrough entities making payments to or for the use of section 170(c) entities in exchange for state or local tax credits, is proposed to apply to payments on or after December 17, 2019. However, prior to this date, a taxpayer may continue to apply Rev. Proc. 2019-12, which applies to payments made on or after January 1, 2018.[19]

Other Challenges

Advisers assumed that, based on what was said in Revenue Procedure 2019-12 about income tax based credits not qualifying for the passthrough safe harbor and no discussion of any other special rules for passthroughs, that such payments had to be reduced by the available credit. However, the regulations and procedure did not ever say that a reduction was mandatory.

Now we have to take care not to go the other way. Certainly, the example implies that a full deduction is available, but it never explicitly says that the deduction does not have to be reduced by value received, much in the same way as would be true if an expense incurred by the taxpayer was reimbursed by a customer or client. It certainly seems out of character given what was written—but, then, the same could be said about Example 2 appearing to be out of character with the guidance given at the beginning of 2019.

So, if we want to limit ourselves solely to what the IRS has explicitly said in the regulations, what are the exposures if a taxpayer attempts to claim a full deduction on the passthrough and a tax credit individually?

- As was mentioned just before, the IRS could argue that the credit represents a "reimbursement" so that while the expense may be a §162 deduction, the tax credit benefit represents business income the shareholder would have to report to offset that deduction.
- There's a potential, though minimal, risk that the IRS could argue that an example should not be treated as binding except to the extent it clearly reflects an item

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[18] REG-107431-19, December 17, 2019, Preamble Proposed Applicability Dates

[19] REG-107431-19, December 17, 2019, Preamble Proposed Applicability Dates

found in the text of the regulation. The text of the regulation does not indicate that there is no offset. However, Courts have generally viewed examples in regulations as part of the regulation and would likely not be apt to agree to turn a blind eye to the clear statement in the example.

Advising Clients

Advisors face some interesting challenges in dealing with clients under these proposed regulations.

First there's the issue of 2018 returns. If a taxpayer made a contribution via a flow through organization in 2018 and did not claim the deduction, an analysis must be made to determine if the taxpayer can meet the standards to claim a §162 deduction. That will include outlining the benefits the taxpayer expected to receive from the payment and quantifying the expected benefits.

If it appears an additional deduction is possible, the taxpayer will need to consider the filing of an amended return. If the entity in question is a partnership (such as the one in Example 2) where the benefit was not claimed, the adviser must note if the partnership filed an election to opt out of the centralized partnership audit regime for 2018. If not, then the special rules for handling claims for such partnerships would need to be followed, effectively resulting in tax credits that would be claimed against taxes paid for the year the adjustment is transmitted to the partners.

If a taxpayer actually made a potentially qualifying contribution for 2019, then a claim for refund may be in place.

A more interesting call is planning for any 2020 contributions. For instance, with the Arizona credit, a decision might need to be made regarding whether to make the contribution in time to assure that the taxpayer could receive approval—that is, the available credits had not already been claimed. The same sort of analysis of expected benefits would need to be undertaken and tested against the two-pronged test of the regulations.

Advisers likely should recognize that the omission of income tax based credits from the safe harbor treatment for passthoughs likely occurred because the IRS is serious about taxpayers documenting compliance with the requirements in the two-pronged test.

If a client's facts are like those in the *Marquis* case, the analysis is fairly simple. But advisers will likely find that most of their clients have situations that aren't remotely comparable to *Marquis*—so the question then becomes just how far can the taxpayer stray from *Marquis* level facts and still be able to meet the two pronged test.

SECTION: 6698
SMALL PARTNERSHIP LATE FILING RELIEF IN REV. PROC. 84-35 CONTINUES TO APPLY DESPITE REPEAL OF §6231

Citation: Program Manager Technical Advice 2020-01, 1/15/20

Tax advisers who work with small partnerships have long been aware of the late filing relief provided by Revenue Procedure 84-35. But some have wondered that since the procedure refers to a provision removed from the Internal Revenue Code by the Bipartisan Budget Act of 2015 for tax years beginning on or after January 1, 2018, does it continue to apply?

In Program Manager Technical Advice 2020-01[20] the Chief Counsel's office addressed that question, determining Revenue Procedure 84-35 still is available for taxpayers to use to obtain relief from partnership late filing penalties under IRC §6698.

The Revenue Procedure provides:

> A domestic partnership composed of 10 or fewer partners and coming within the exceptions outlined in section 6231(a) (1)(B) of the Code will be considered to have met the reasonable cause test and will not be subject to the penalty imposed by section 6698 for the failure to file a complete or timely partnership return, provided that the partnership, or any of the partners, establishes, if so requested by the Internal Revenue Service, that all partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns.[21]

But §6231(a)(1)(B) does not apply to partnership tax years beginning on or after January 1, 2018. Old §6231 was part of the TEFRA partnership audit rules, the entirety of which was removed from the law in the Bipartisan Budget Act of 2015 (BBA 2015) that ushered in a new comprehensive partnership audit regime.

The PTMA notes that the relief was mandated by Congress in legislation that predated the TEFRA audit regime:

> Congress enacted section 6698 in 1978 as part of Pub. L. No. 95-600, 92 Stat. 2763. In legislative history, Congress indicated that it

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[20] Program Manager Technical Advice 2020-01, November 19, 2019, released on IRS website January 15, 2020 (retrieved January 17, 2020)

[21] Revenue Procedure 84-35, Section 3.01

> intended for the reasonable cause exception to the section 6698 penalty to apply automatically to small partnerships that meet certain criteria. The Conference Committee Report stated:
>
> > The penalty will not be imposed if the partnership can show reasonable cause for failure to file a complete or timely return. Smaller partnerships (those with 10 or fewer partners) will not be subject to the penalty under this reasonable cause test so long as each partner fully reports his share of the income, deductions and credits of the partnership.
> >
> > H.R. Rep. No. 95-1800, at 221 (1978) (Conf. Rep.).
>
> Revenue Procedure 81-11 set forth procedures, consistent with the legislative history, under which partnerships with ten or fewer partners would not be subject to the section 6698 penalty for failure to file a partnership return.[22]

Thus, the original revenue procedure providing for relief from the late filing penalties under IRC §6698 for small partnerships did not reference §6231(a)(1)(B), as it did not exist.

But noting a very similar definition of a small partnership added by Congress in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the IRS decided to use the same definition found in the then "new" TEFRA partnership rules by issuing a revised revenue procedure:

> Shortly after the issuance of Revenue Procedure 81-11, Congress enacted a definition of small partnership as part of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, Pub. L. 97-248. Section 6231(a)(1)(B), as enacted in TEFRA, provided that the term "partnership," for purposes of sections 6221 through 6232, did not include a partnership if the partnership had 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and each partner's share of each partnership item is the same as such partner's share of every other item. A husband and wife, and their estates, were treated as one partner in determining whether the partnership had 10 or fewer partners for purposes of section 6231(a)(1)(B). TEFRA did not amend section 6698 or redefine the scope of the penalty for failure to file a partnership return.
>
> To conform the relief provided in Revenue Procedure 81-11 to the definition of small partnership newly provided by section 6231(a)(1)(B), the IRS issued Revenue Procedure 84-35 to modify and

[22] Program Manager Technical Advice 2020-01, p. 2

> supersede Revenue Procedure 81-11. Revenue Procedure 84-35 cited the definition of small partnership provided by section 6231(a)(1)(B). In order to qualify for the relief provided in Revenue Procedure 84-35, the partnership must come "within the exceptions outlined in section 6231(a)(1)(B) of the Code." See Rev. Proc. 84-35, § 3.01. In citing section 6231(a)(1)(B), Revenue Procedure 84-35 was referencing law that existed at the time the revenue procedure was issued. The IRS did not express an intent that later amendments to TEFRA audit procedures would affect application of the exception to the partnership failure to file penalty.[23]

The repeal of §6231 simply restored the law prior to TEFRA. But this relief had been mandated by Congress before the passage of TEFRA and Congress did not remove that relief as part of BBA 2015.

The PMTA concludes:

> A question was raised concerning how to interpret Revenue Procedure 84-35 now that section 6231(a)(1)(B) has been repealed and will be inapplicable to any partnership for which the relief provided in Revenue Procedure 84-35 is relevant. Significantly, the reference in Revenue Procedure 84-35 to IRC section 6231(a)(1)(B) is a reference to IRC section 6231(a)(1)(B) as it was in effect when Revenue Procedure 84-35 was originally issued. Thus, it is irrelevant that there does not exist any current section 6231(a)(1)(B) that is generally effective and applicable to partnerships seeking relief under Revenue Procedure 84-35. Moreover, the legislative history of section 6698, which is the basis for the relief provided in Revenue Procedure 84-35, is still relevant, and the scope of the section 6698 penalty for failure to file a partnership return has not been affected by the repeal of the TEFRA provisions. Thus, Revenue Procedure 84-35 is not obsolete and continues to apply.
>
> Revenue Procedure 84-35 provides that in order to qualify for the relief provided in the revenue procedure, the partnership, or any of the partners, must establish, if so requested by the IRS, that all partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns. Rev. Proc. 84-35, § 3.01. Additionally, the revenue procedure states that all the relevant facts and circumstances will be taken into account in determining whether a partner has fully reported the partner's share of the income, deductions, and credits of the partnership. Rev. Proc. 84-35, § 3.04. Accordingly, the IRS may develop procedures in

[23] Program Manager Technical Advice 2020-01, pp. 3-4

accordance with Revenue Procedure 84-35 to ensure that any partnership claiming relief is in fact entitled to such relief.[24]

SECTION: 7502
PETITION TO TAX COURT FOUND TO BE TIMELY MAILED DESPITE LACK OF POSTMARK

Citation: Seely v. Commissioner, TC Memo 2020-6, 1/14/20

A topic that regularly comes up year after year in Tax Court cases is the issue of whether a document meets the requirements for protection under the timely mailed, timely filed rule found in IRC §7502(a). In the case of *Seely v. Commissioner*, TC Memo 2020-6,[25] we have one of the infrequent taxpayer victories when faced with such a challenge.

IRC §7502(a) provides:

> (a) General rule
>
> (1) Date of delivery
>
> If any return, claim, statement, or other document required to be filed, or any payment required to be made, within a prescribed period or on or before a prescribed date under authority of any provision of the internal revenue laws is, after such period or such date, delivered by United States mail to the agency, officer, or office with which such return, claim, statement, or other document is required to be filed, or to which such payment is required to be made, the date of the United States postmark stamped on the cover in which such return, claim, statement, or other document, or payment, is mailed shall be deemed to be the date of delivery or the date of payment, as the case may be.

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[24] Program Manager Technical Advice 2020-01, p. 3

[25] *Seely v. Commissioner*, TC Memo 2020-6, January 13, 2020, https://www.ustaxcourt.gov/USTCInOP/OpinionViewer.aspx?ID=12146 (retrieved January 14, 2020)

> (2) Mailing requirements
>
> This subsection shall apply only if—
>
> (A) the postmark date falls within the prescribed period or on or before the prescribed date—
>
> (i) for the filing (including any extension granted for such filing) of the return, claim, statement, or other document, or
>
> (ii) for making the payment (including any extension granted for making such payment), and
>
> (B) the return, claim, statement, or other document, or payment was, within the time prescribed in subparagraph (A), deposited in the mail in the United States in an envelope or other appropriate wrapper, postage prepaid, properly addressed to the agency, officer, or office with which the return, claim, statement, or other document is required to be filed, or to which such payment is required to be made.

Of course, the key problem with this provision is that it all depends on a few things happening—first, the postmark being applied to the envelope by the United States Postal Service (USPS), second, the postmark showing the proper date and third, that letter and postmark making it into the hands of the IRS. The case today involves a failure with the first issue—the postmark did not get applied to the envelope by the United States Postal Service.

The facts, as detailed by the Court, are as follows:

> On March 28, 2017, respondent mailed petitioners, by certified mail to their last known address, a notice of deficiency for tax years 2013, 2014, and 2015. The notice of deficiency advised petitioners that they had 90 days from the date of the notice to file a petition in the Tax Court for a redetermination of the deficiency. The notice of deficiency also stated that the last day to petition the Tax Court was June 26, 2017.
>
> Petitioners' attorney, Scott Boyce, prepared a petition seeking a redetermination of the deficiencies and mailed it to the Tax Court. The Court received the petition on July 17, 2017, 111 days after the mailing of the notice of deficiency. The envelope in which the petition was mailed was properly addressed to the Tax Court. The envelope bears U.S. postage stamps and thus appears to have been delivered by the U.S. Postal Service (USPS). However, the envelope bears no

> discernable postmark and has no other markings affixed by the USPS.[26]

The Court notes that taxpayers aren't necessarily out of luck when no postmark is visible on the envelope. Rather, the Court looks to the following for evidence of when the letter likely made it to the USPS:

> When a postmark is missing, our caselaw instructs us to deem the postmark illegible and permit the introduction of extrinsic evidence to ascertain the mailing date. See *Sylvan v. Commissioner*, 65 T.C. 548, 553-555 (1975); see also *Mason v. Commissioner*, 68 T.C. 354, 356 (1977). The burden is on the party who invokes section 7502 to present "convincing evidence" of timely mailing. Mason v. Commissioner, 68 T.C. at 356-357; see sec. 301.7502-1(c)(1)(iii)(A), Proced. & Admin. Regs. (providing that, if a USPS postmark "is not legible, the person * * * [invoking section 7502] has the burden of proving the date that the postmark was made").
>
> When confronted with illegible or missing postmarks, we have considered various types of extrinsic evidence, including testimony from the person claiming to have mailed the envelope. See *Mason v. Commissioner*, 68 T.C. at 357. We also look to evidence regarding the normal delivery time from the place of origin to our Court in Washington, D.C. See id.; *Selter v. Commissioner*, T.C. Memo. 2000-316, 2000 Tax Ct. Memo LEXIS 373, at *11; *Robinson v. Commissioner*, T.C. Memo. 2000-146, 2000 Tax Ct. Memo LEXIS 176, at *5. We may examine the envelope to see whether any markings indicate that the letter had been "misplaced, missent, or inadvertently lost or damaged". *Robinson v. Commissioner*, 2000 Tax Ct. Memo LEXIS 176, at *3 (noting the testimony of a post office employee that, in the event of misdelivery or damage, "there should be some sort of marking on * * * [the envelope] 'to let you know exactly what has happened to that letter'").
>
> The envelope that contained the petition in this case is not damaged and has no marking of any kind suggesting that it was misdirected or misplaced. The envelope, however, does not bear any postmark. Therefore, the issue turns on whether petitioners have presented convincing evidence establishing that they timely mailed their petition. We allowed both parties to present extrinsic evidence to establish the

[26] *Seely v. Commissioner*, pp. 2-3

> petition's mailing date. See *Sylvan v. Commissioner*, 65 T.C. at 553-555.[27]

The taxpayers produced a declaration from their attorney regarding when the document was mailed:

> …[P]etitioners' attorney supplied a declaration (Mr. Boyce's declaration) under penalty of perjury in which he states that "on June 22, 2017 * * * [he] deposited into the [USPS] collection receptacle located at 690 Gage Blvd, Richland, Washington 99352, the tax court petition of Michael and Nancy Seely".[28]

Since that date was before the last day for mailing the petition, if the Court accepted that statement as true then the taxpayers' petition was timely. Since the taxpayer must present *convincing* evidence, the Court looked to other evidence to either confirm or bring into doubt the assertion that the document was mailed on June 22, 2017.

The IRS objected that the letter did not arrive at the Tax Court within the normal time it would take for a letter to make it to the Court. As the Court notes:

> At the hearing respondent alleged that it takes 8 to 15 business days for the USPS to deliver a piece of mail to a Government agency located in Washington, D.C., from any location in the United States. Petitioners do not dispute this contention, and we deem it conceded. If the petition was mailed on June 26, 2017, the last day to file a petition, then the petition's delivery date would have fallen within the 15-day window. In a sworn declaration Mr. Boyce declared that he deposited the petition in the U.S. mail several days earlier, on June 22, 2017. Respondent argues that if the petition had in fact been mailed on June 22, 2017, then it would have been delivered to the Tax Court no later than July 14, 2017, which was a Friday. The petition, however, arrived on Monday, July 17, 2017. Because the petition arrived at the Court later than it should have (16 business days after the alleged mailing date rather than 15), respondent contends that Mr. Boyce's declaration is not convincing evidence.[29]

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[27] *Seely v. Commissioner*, pp. 5-6

[28] *Seely v. Commissioner*, p. 3

[29] *Seely v. Commissioner*, p. 7

But the Tax Court found the IRS's evidence wasn't persuasive that the letter wasn't mailed when claimed:

> First, we note that the petition arrived at the Court only one business day late. We also note that the Fourth of July holiday fell between the date of the alleged mailing and the delivery date. In prior cases holiday conditions at the post office (e.g., holiday closures, unusually large volumes of mail, or inefficiencies attributable to temporary staff) have been found to be a possible explanation for short delays in delivery. *Rotenberry v. Commissioner*, 847 F.2d 229 (5th Cir. 1988) (finding that holiday conditions could explain a three-day delay in ordinary delivery time for a letter mailed on December 23); see also *Mason v. Commissioner*, 68 T.C. at 357 (noting the testimony of a post office employee that, because of the Bicentennial celebrations being conducted in Washington, D.C., over the Fourth of July weekend, "it is possible that mail going * * * [to Washington, D.C.] at about that time could have been delayed"). We are thus unpersuaded by respondent's argument that Mr. Boyce's declaration is not reliable because the petition's alleged mailing date does not square with its actual delivery date.[30]

Thus, the Court found that it was more likely than not that the petition was mailed when the attorney stated it was mailed, and thus the filing was timely.

[30] *Seely v. Commissioner*, p. 8