# Current Federal Tax Developments

Week of February 3, 2020

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ACCOUNTING
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CURRENT FEDERAL TAX DEVELOPMENTS
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# Current Federal Tax Developments

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# TAX NOTES TODAY REPORTS SPECIAL AGENT CONFIRMS CID HAS INTEREST IN USING SCHEDULE 1 VIRTUAL CURRENCY QUESTION ANSWERS IN IDENTIFYING CRIMINAL TAX EVASION CASES

## Citation: Wesley Elmore, "Cryptocurrency Checkbox Could Aid IRS in Finding Tax Criminals," Tax Notes Today Federal, 1/30/20

When the IRS first announced that a question would be added to Form 1040, Schedule 1 regarding virtual currency, observers speculated that the IRS might make use of the answer to this question to aid in tax evasion cases. A special agent in charge at the Los Angeles Criminal Investigation Division (CID) was reported to have confirmed this view when speaking at the University of Southern California Gould School of Law Tax Institute per an article published in *Tax Notes Today Federal*.[1]

Schedule 1, Form 1040 for 2019 contains the following question regarding the taxpayer's ownership, sale or exchange of virtual currencies:

> At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?

Following the question are checkboxes labeled "Yes" and "No" that the taxpayer must answer if either of the following are true per the form instructions:

- The taxpayer is otherwise required to file Schedule 1 to report income or adjustments on his/her return or
- The answer to the question is yes, even if the taxpayer is not otherwise required to file Schedule 1 with his/her return.

[1] Wesley Elmore, "Cryptocurrency Checkbox Could Aid IRS in Finding Tax Criminals," *Tax Notes Today Federal*, January 30, 2020, 2020 TNTF 20-4, https://www.taxnotes.com/tax-notes-today-federal/cryptocurrency/cryptocurrency-checkbox-could-aid-irs-finding-tax-criminals/2020/01/30/2c3y9 (retrieved January 30, 2020, subscription required)

Special Agent Ryan L. Korner is cited in the article with the following observations on the use of that information by the IRS Criminal Investigation Division:

> In the case of the new checkbox, he said, CI could be alerted to an individual who checks "no" but who is shown in a different data set to have had millions of cryptocurrency transactions last year.
>
> "We're trying to catch the egregious offenders, and that's just another line on a tax return that could potentially be a materially false statement and aid a criminal case," Korner said.[2]

Special Agent Korner described other types of cross referencing the IRS CID has used or plans to use to find tax cases, including cases regarding tax professionals that are referred to the IRS Office of Professional Responsibility.

As has been noted on our website before, the IRS has had success in court using what turned out to be false answers to the questions regarding foreign bank accounts at the bottom of Schedule B to successfully show willful failure to file the foreign bank account reporting forms, applying the higher penalty for willful failure to those taxpayers. In such cases, taxpayers have been unsuccessful in arguing that their preparer checked those boxes and that they hadn't read the return—the courts have held that taxpayers have a responsibility to read the return even if it is prepared by someone else and they personally are held responsible for the answers on the return.

It remains to be seen if the courts will apply the same standard in the criminal tax context, but it seems at a minimum the answer to this question could be seen as providing evidence of fraud for applying the fraud civil penalties. And it certainly would be far from helpful if the IRS was pursuing a criminal case, even if the courts demand more specific proof of criminal intent on the part of the taxpayer.

Despite the fact that many clients will have little or no idea what a virtual currency is, advisers need to make specific inquiry of *all* clients on this question. A default "no" answer when the IRS is aware, from data they have received from exchanges, that the taxpayer has such virtual currency could subject the client to an IRS exam or worse.

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[2] Wesley Elmore, "Cryptocurrency Checkbox Could Aid IRS in Finding Tax Criminals," *Tax Notes Today Federal*, January 30, 2020

# SECTION: 195
# TAXPAYER'S BUSINESS HAD NOT YET COMMENCED, ALL EXPENSES CAPITALIZED

## Citation: Provitola v. Commissioner, US Tax Court Bench Opinion, Nos. 12357-16 and 16168-17, 1/24/2020

The good news for the taxpayer in the case of *Provitola v. Commissioner*, US Tax Court Bench Opinion, Nos. 12357-16 and 16168-17 (2019)[3] was that the Court rejected the IRS arguments that their business related to a product to enhance television viewing was a sham. But that was more than offset by the bad news when the Court also found that the business had not yet commenced in the years in question, meaning all expenses were capitalized pursuant to IRC §195 until the year the business actually begins operations.

Mr. Provitola is an attorney who also holds a B.S. in physics. His law practice specializes in patent law and he is sole owner of the S corporation in which he practices. Around 2003 he had an idea to enhance television viewing and began developing a product. Between 2005 and 2016 he was awarded seven patents that related to this product he was developing. [4]

The couple formed Viovision Ventures, LLC with Kathleen Provitola as the sole owner of the LLC in 2007. The LLC was formed to market any product that Mr. Provilota might end up developing based on his concept. The LLC sat dormant until 2013 when it was billed for five years of services by Mr. Provitola's law firm, such services including management, product development and product design. In late 2013, the couple wrote a check for $36,000 to capitalize the LLC and the LLC wrote a check to the law firm to pay that portion of the $60,000 in fees that had been billed. A similar set of transactions took place at the end of 2014. [5]

The payments were reported as income by the law firm, which had sufficient business expenses to offset almost all of the expenses. As well, they claimed current deductions on Schedule C for the payments made by the LLC. During this time period, and right

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[3] *Provitola v. Commissioner*, US Tax Court Bench Opinion, Nos. 12357-16 and 16168-17, January 24, 2020 (released January 27, 2020), https://www.ustaxcourt.gov/InternetOrders/DocumentViewer.aspx?IndexSearchableOrdersID=313587&Todays=Y (retrieved January 28, 2020)

[4] *Provitola v. Commissioner*, pp. 3-4

[5] *Provitola v. Commissioner*, pp. 4-5

up through the day the case was heard, the LLC had not received any revenue related to the product it hoped to develop. [6]

As the Court described the activities of the LLC to date:

> As of 2015, indeed, as of the time of trial, Viovision had not attempted to sell any products and has not generated any revenue or any profit. Approximately 1,000 product units were manufactured after the years in issue, but there has been no attempt to sell them. Viovision never had any employees, never had an office apart from the Provitolas' home, and never did any advertising or marketing. Viovision has developed a website, but that website has not been made public.[7]

The IRS initially argued that the payments were not actually made in the notice of deficiency, but at trial no longer pushed that position. As well, the notice of deficiency claimed the payments were not ordinary and necessary expenses under IRC §162.[8]

But at trial the IRS advanced two different arguments:

- The LLC was a sham and not a real business, only using the expenses to offset the couple's other income and
- If it is not a sham, then the business has not yet commenced operations and, as such, all expenses would have to be capitalized as start-up expenses under IRC §195.

While the opinion rejects the IRS's first position, it does find merit in the second.

The Court found that there was more than enough evidence that the LLC was not merely a legal fiction:

> The Commissioner argued at trial that Viovision, the Provitolas' LLC, is "merely a legal fiction". However, we will respect Viovision's form because it is engaged in activities with a business purpose. Mr. Provitola is currently working on inventing and bringing to market his television viewing product through Viovision. He has developed the product and obtained several patents in the process. Although it is unclear at this time whether the product will be commercially viable, approximately 1,000 units of the product have been manufactured with the hope of eventual sale. A website has been created for that purpose, although that website is not yet public. The Provitolas treated

[6] *Provitola v. Commissioner*, pp. 5-6

[7] *Provitola v. Commissioner*, pp. 6-7

[8] *Provitola v. Commissioner*, pp. 8-9

> Viovision as a discrete entity; for example, Viovision maintains a separate bank account. Viovision is not a "sham or unreal" nor is it "a bald and mischievous fiction." Viovision exists to develop an bring to market Mr. Provitola's invention, and we will respect its existence. [9]

As well, if the LLC was a fiction, then so was the income that the law firm had reported on the S return—but the Court noted the IRS did not argue that this should be reversed:

> We note that the Commissioner's substance over form argument is inconsistent with the notice of deficiency. In the notice, the Commissioner disallowed the expenses taken by Viovision for the payment of legal and professional fees paid to APPA for lack of substantiation and because the expenses were not ordinary and necessary. Notably, the Commissioner did not make a corresponding adjustment to APPA to remove the income from the legal and professional fees. If the payments made by Viovision were mere circular payments without any substance, then the income to APPA would be disregarded along with the deduction by Viovision. This is not the position set forth in the notice of deficiency and it is not supported by the record. We will give due regard to the separate entities. [10]

However, the Court did find far more compelling the second argument the IRS made—that the expenses incurred by the LLC were start-up expenses that had to be capitalized under IRC §195.

IRC §195(a) requires a taxpayer to capitalize start-up expenditures. Such expenditures are defined by IRC §195(c)(1) as:

> (1) Start-up expenditures
>
> The term "start-up expenditure" means any amount—
>
> > (A) paid or incurred in connection with—
> >
> > > (i) investigating the creation or acquisition of an active trade or business, or
> > >
> > > (ii) creating an active trade or business, or

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[9] *Provitola v. Commissioner*, pp. 11-12

[10] *Provitola v. Commissioner*, p. 12

> > (iii) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and
>
> (B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.
>
> The term "start-up expenditure" does not include any amount with respect to which a deduction is allowable under section 163(a), 164, or 174.

IRC §195(b) provides options to recover these costs, but commencing in "the taxable year in which the active trade or business begins" through amortization and/or expensing depending on the amounts incurred. Prior to that year, the amounts are capitalized and held for possible future deduction.

The Court looked at whether the LLC was in the start-up phase of the business or if it had actually begun as an active trade or business. The Court found a case it felt was relevant in the case of *McKelvey v. Commissioner*, TC Memo 2002-63:

> In *McKelvey v. Commissioner*, T.C. Memo. 2002-63, 83 T.C.M. (CCH) 1339, the petitioner decided to start a tree farm. In preparation for his business, the Petitioner studied the commercial viability of land, forest health, entomology, and risk control issues. After buying the land for his tree farming business, the Petitioner paid for a forest management plan and planted pine trees as a pilot test for his farm. At the time of filing his tax return claiming deductions, the petitioner had not yet commercially harvested the trees. *McKelvey v. Commissioner*, T.C. Memo. 2002-63, 83 T.C.M. (CCH) 1339, 1340. This Court held that petitioner "had not actually commenced the business activity of tree farming". *McKelvey v. Commissioner*, T.C. Memo. 2002-63, 83 T.C.M. (CCH) 1339, 1341.[11]

Like the tree farm in *McKelvey*, the opinion finds that the LLC's business had also not yet commenced:

> Viovision has not yet commenced an active trade or business. Like the petitioner in *McKelvey*, Viovision has taken significant steps to prepare for the business of selling Mr. Provitola's invention. Viovision has not yet attempted to market or sell a product. It has not made any sales,

[11] *Provitola v. Commissioner*, pp.14-15

> made its website public, or attempted to market a product. As in *McKelvey* where this Court did not consider the petitioner to be engaged in a trade or business before commercially harvesting his trees, Viovision has not yet engaged in a trade or business before attempting to market and sell a product.[12]

Interestingly, this leads to a less favorable result for the years before the Court for the taxpayers than if the Court had found the entire transaction to be a sham and ignored the entire set of transactions (both the expense on the Schedule C and the income on the S corporation return), as the opinion notes:

> Because Viovision's expenses are start-up expenses, the Provitolas may not deduct those expenses under section 162. However, they may capitalize these expenses under section 165(a) in the future. Because we respect the payments made by Viovision, the payments are still income to APPA.[13]

The taxpayers have to recognize the income currently for payments to the law firm on their return, but only get the possibility of a deduction at some point in the future for the expenses.

But what about the fact that the IRS had not argued this position in the notice of deficiency and only raised the issue at trial. The Court found that this was not a major problem in this case:

> We note that this outcome is consistent with the position set forth in the Commissioner's notice of deficiency, which disallowed the expenses claimed by Viovision but did not adjust the income to APPA. To the extent the Commissioner's start-up expenditures argument is a new matter, he would bear the burden of proof. Rule 142(a)(1). That burden, however, is easily satisfied; it is clear that Viovision is still in the start-up phase and not yet an active trade or business.[14]

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[12] *Provitola v. Commissioner*, p. 15

[13] *Provitola v. Commissioner*, p. 15

[14] *Provitola v. Commissioner*, p. 15

# SECTION: 263
# NO SYNERGISTIC BENEFITS INTANGIBLE EXISTED AND THEREFORE NO ORDINARY LOSS WAS DEDUCTIBLE ON A WORTHLESS INTANGIBLE

## Citation: TAM 202004010, 1/24/20

In Technical Advice Memorandum 202004010[15] the IRS ruled that a taxpayer (Taxpayer) could not treat "post-acquisition synergies" as an intangible asset into which costs incurred by a subsidiary(Target) when Taxpayer purchased it could be capitalized and then written off as an ordinary loss under IRC §165(a) when the Taxpayer decided to dispose of Target.

The original set of transactions in which the costs in question were incurred are described as follows in the TAM:

> Taxpayer is engaged in Business. In Year 1, Taxpayer acquired the stock of Target, a manufacturer of Products, in a taxable reverse triangular merger. In announcing the acquisition of Target stock, Taxpayer and Target stated that the merger was intended to achieve cost synergies that would generate long term growth and increased efficiencies for both entities' shareholders, customers, and employees. Taxpayer paid approximately $a for Target's stock, plus assumed liabilities in the amount of $b for a basis of $c.
>
> In connection with the sale of its stock to Taxpayer, Target paid a total of $d in professional fees and administrative expenses. These included payments to several law firms, investment firms, accounting firms, other professional firms, and the Securities and Exchange Commission. Target determined that $e of these fees and expenses were paid in the process of investigating or otherwise pursuing its acquisition by Taxpayer, and therefore, were required to be capitalized as costs of facilitating the acquisition of its trade or business under § 1.263(a)-5(a). Target also determined that $f of these fees were "success-based fees" under § 1.263(a)-5(f) and utilized the safe harbor under Revenue Procedure 2011-29, 2011-18 I.R.B. 746, to allocate those success-based fees between facilitative costs, which were required to be capitalized under section 263, and non-facilitative costs, which may be deducted as business expenses under section 162. Under this safe harbor, Target allocated $g of the success-based fees to non-

[15] TAM 202004010, January 24, 2020, https://www.irs.gov/pub/irs-wd/202004010.pdf (retrieved January 27, 2020)

> facilitative costs and deducted these amounts as business expenses under section 162 on its Year 1 short-year Form 1120. In accordance with Rev. Proc. 2011-29, Target allocated the remaining success-based fees to facilitative fees and added those fees to the amounts that it had already determined must be treated as facilitative costs for a total of $h in facilitative costs incurred in its acquisition by Taxpayer.
>
> Taxpayer indicates that, in accordance with section 263, Target capitalized the $h in facilitative fees as an intangible asset on its tax books. Taxpayer stated that "since this asset was not acquired as part of the transaction, but rather created by the transaction, neither Taxpayer nor Target recorded an intangible asset for the $h in facilitative fees pursuant to Statement of Financial Accounting Standards No. 141 (2001) for separate intangibles acquired in business combinations." In addition, neither Taxpayer nor Target has amortized these fees under any section of the Code or regulations.[16]

Eventually, the Taxpayer determined it no longer wished to hold Target:

> During an earnings call on Date 1, Taxpayer's CEO stated that an evaluation of Taxpayer's Products business resulted in a meeting wherein Taxpayer's Board of Directors authorized Taxpayer's executives to advance a plan to divest Taxpayer from its Products business. Afterward, Taxpayer engaged in a sale process involving many potential buyers, and eventually selected Buyer, which Taxpayer's CEO stated would better position the Products business to achieve its full potential.
>
> On Date 2, Taxpayer entered into a stock purchase agreement with Buyer to sell Target to Buyer for $i.[17]

The TAM then goes on to describe the tax reporting by the entities involved:

> On Date 3, Taxpayer completed the sale of Target to Buyer pursuant to the agreement, resulting in an estimated capital loss of $j. On its consolidated corporate tax return for its taxable year ending on Date 4, when calculating the separate taxable income of Target under § 1.1502-12, Taxpayer claimed a section 165(a) loss deduction for Target of $h and reduced Target's separate taxable income by $h, representing the value of the administrative and professional fees capitalized under section 263(a). Taxpayer then included Target's separate taxable income in Taxpayer's consolidated taxable income

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[16] TAM 202004010, p. 3

[17] TAM 202004010, pp. 3-4

> under § 1.1502-11(a)(1). Because Taxpayer's deduction under section 165(a) reduced Target's separate taxable income, Taxpayer reduced its basis in Target stock by a corresponding amount under the investment adjustment rules of § 1.1502-32. The investment adjustment resulted in a lower basis in Target stock and, as a result, a reduced capital loss on the sale of Target.[18]

By taking this position, the parent converted a portion of the capital loss on the disposal of Target into an ordinary loss (that loss serves to reduce the basis of Target). It's likely the parent did not have sufficient capital gains to absorb that loss—and very possible the loss would expire before it could be offset against capital gains. For C corporations, capital losses are first carried back three years, then forward five years. If the loss can't be used up by the end of that fifth year, it's lost for good.[19]

IRC §263(a) governs the capitalization of various costs. For purposes of amounts capitalized as an intangible, the TAM outlines guidance found in Reg. §1.263(a)-4:

> Section 1.263(a)-4(b)(1) provides that, in general, a taxpayer must capitalize: (i) an amount paid to acquire an intangible, (ii) an amount paid to create an intangible, (iii) an amount paid to create or enhance a separate and distinct intangible asset, (iv) an amount paid to create or enhance a future benefit identified in the Federal Register or in the Internal Revenue Bulletin as an intangible for which capitalized is required under this section, or (v) an amount paid to facilitate the acquisition or creation of an intangible described in (i) through (iv) of this paragraph.
>
> Section 1.263(a)-4(b)(3)(i) provides that the term separate and distinct intangible asset means a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state, federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business.[20]

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[18] TAM 202004010, p. 4

[19] IRC §§1211(a), 1212(a)

[20] TAM 202004010, p. 4

A separate regulation (Reg. §1.263(a)-5) deals with capitalizing amounts paid to facilitate a business acquisition or reorganization. The TAM describes the application of this provision as follows:

> Section 1.263(a)-5 provides that a taxpayer must capitalize an amount paid to facilitate a business acquisition or reorganization transaction described in § 1.263(a)-5(a), which includes, among other transactions, an acquisition of an ownership interest in the taxpayer (other than an acquisition by the taxpayer of an ownership interest in the taxpayer, whether by redemption or otherwise). Section 1.263(a)-5(a)(3).
>
> Section 1.263(a)-5(g) provides for the treatment of facilitative costs capitalized under §1.263(a)-5(a). Although § 1.263(a)-5(g)(2) provides rules for the treatment of the acquirer and target corporations in taxable acquisitive transactions that involve asset acquisitions, § 1.263(a)-5(g) expressly reserves on the treatment of target's facilitative costs in a taxable stock acquisition.[21]

The TAM notes that the taxpayer agreed that the costs incurred could not qualify as a separate and distinct intangible as defined in Reg. §1.263(a)-4(b)(3)(i). Rather the taxpayer argued for the following support for its position that Target had a "post-acquisition synergies" intangible:

> Taxpayer argues that Target paid these amounts to create a separate and distinct intangible asset in the form of the synergistic benefits that Target expected to receive from its combination with Taxpayer. Taxpayer contends that these benefits arose from Target's access to Taxpayer's markets, research, quality and innovation platforms, management approaches, and supply chain productivity tools. Under this analysis, Taxpayer argues that the administrative and professional fees paid by Target in connection with Taxpayer's acquisition of its stock created a separate and distinct intangible asset that was properly capitalized by Target, but this asset became useless to Target at the termination of its relationship with the taxpayer, that is, when Taxpayer sold Target's stock to Buyer.[22]

The Taxpayer claimed that this conclusion follows the Supreme Court's decision in the case of *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79. That case dealt with costs incurred in a friendly take-over, ruling they had to be capitalized for reasons that

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[21] TAM 202004010, pp. 5-6

[22] TAM 202004010, p. 5

included the synergistic benefits expected to be received if the transaction was completed. Thus, per the TAM, the taxpayer took the following position:

> Taxpayer contends that in Target's case, these synergistic benefits comprised a separate asset that is properly recoverable at the end of the asset's useful life, consistent with the premise of *INDOPCO*. Taxpayer also argues that, by not providing regulations that specifically address the treatment of a target's capitalized facilitative costs in taxable stock acquisitions, the IRS has implicitly sanctioned alternative treatments, such as "treating such costs as creating a new asset the basis of which may or may not be amortizable." See Notice 2004-18, 2004-11 I.R.B. 605 (requesting comments on the tax treatment of capitalized facilitative costs).[23]

The TAM disagrees with this position, finding that the treatment has been addressed by the IRC §263 regulations and case law that has developed under those regulations. Under Reg. §1.263(a)-5 these costs must be capitalized.[24]

There was another key issue—had there been a "closed and completed" transaction where the resulting asset (whatever that asset might be) was worthless?. The TAM answered that question in the negative.

The TAM's prior finding that this was a corporate restructuring payment rather than an asset tied directly to benefits received in being owned by the parent is key in the analysis. The Taxpayer argued the asset was worthless due to loss of synergistic benefits, noting:

> Taxpayer argues that Target's previously capitalized fees are deductible as a loss to Target under section 165 because the asset created by the capitalization of these fees, that is, the synergistic benefits, became worthless to Target when Taxpayer sold Target's stock. Taxpayer contends that its divestiture of Target's business comprised the identifiable event that closed the transaction and fixed Target's loss. Taxpayer relies on *Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991), *motion for reh'g denied*, 950 F.2d 209 (5th Cir. 1991), which supported the use of the worthlessness test as an alternative to a finding of abandonment, to support a loss under section 165. In *Echols*, the court concluded that the petitioners could properly claim a loss under section 165 for their partnership interest based on their showing of an overt abandonment of the interest, or alternatively, based upon their showing that the partnership interest was subjectively worthless at the time of an objectively identifiable event. *Id*. at 706-07. Using this

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[23] TAM 202004010, pp. 5-6

[24] TAM 202004010, p. 6

> approach, Taxpayer contends Target's subjective determination that its asset was worthless was evidenced by Taxpayer's announcement that it planned to divest Target's business, and the identifiable event occurred, and the loss was sustained, when the Taxpayer sold Target's stock to Buyer.[25]

But the TAM had already concluded there was no "synergistic benefits" intangible, so not surprisingly, it concluded that the loss of the benefit wasn't relevant. Rather, the TAM concludes only an abandonment of Target's business by Target would have rendered these expenses available for a deduction:

> If the purpose of the expenditure has to do with the enhancement of a corporation's operations, then the useful life of the expenditures would be measured by the duration of those operations. See INDOPCO, 503 U.S. at 83-84. Under these circumstances, a taxpayer would generally not be permitted to recover these costs until the dissolution of the business enterprise or until the occurrence of another event that ends the useful life of the business. See id. In the current case, Taxpayer has not shown that Target abandoned its business or that Target's business operations were dissolved.[26]

The TAM noted that simply because the parent decided to no longer continue to hold Target did not demonstrate that Target's business was worthless:

> Taxpayer's announcement of its decision to divest may have reflected Taxpayer's financial difficulties but did not demonstrate Target's determination that its business was worthless. Assets may not be considered worthless, even when they have no liquidated value, if there is a reasonable hope and expectation that they will become valuable in the future. See *Lawson v. Commissioner*, 42 B.T.A. 1103, 1108 (1940); *Morton v. Commissioner*, 38 B.T.A. 1270, 1278 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940); Rev. Rul. 77-17, 1977-1 C.B. 44. Further, Taxpayer's sale of Target's stock to Buyer may have been a taxable event to Taxpayer but did not represent a closed or completed transaction upon which Target could claim a loss under section 165. In fact, after the sale, Target continued to exist as a corporation and continued to operate its Products business under Buyer. A deduction is not allowable under section 165 if a taxpayer intends to hold and preserve property for possible future use or to realize potential future value from the property. Rev. Rul. 2004-58, 2004-24 I.R.B 1043

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[25] TAM 202004010, p. 8

[26] TAM 202004010, p. 9

> (citing *A.J. Indus. Inc. v. United States*, 503 F.2d 660, 670 (9th Cir. 1974)).[27]

Thus, the TAM concluded that no §165(a) loss was allowed on the consolidated return and, as well, the capital loss from the disposition of Target had to be increased by that disallowed ordinary loss.[28]

# SECTION: 1341
# TAXPAYER DOES NOT QUALIFY FOR CLAIM OF RIGHT RELIEF FOR A TRANSACTION RELATED TO GRANTOR TRUST

## Citation: Heiting v. United States, US DC WD Wisconsin, Case No. 3:19-cv-00224, 1/23/20

A taxpayer was unsuccessful in attempting to recover taxes via a claim of right deduction under IRC §1341 in the case of *Heiting v. United States*, US DC WD Wisconsin, Case No. 3:19-cv-00224.[29]

The claim of right provision under the IRC is a relatively obscure provision, though one that most advisers will eventually run across in their practice. The provision is meant to provide some relief from the strict annual accounting for income taxes in certain situations where a taxpayer recognizes income that later must be repaid by the taxpayer.

The general rule for the claim of right doctrine is found at §1341(a) which provides:

> (a) General rule If—
>
> > (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
> >
> > (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years)

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[27] TAM 202004010, p. 9

[28] TAM 202004010, p. 9

[29] *Heiting v. United States*, US DC WD Wisconsin, Case No. 3:19-cv-00224, January 23, 2020, https://ecf.wiwd.uscourts.gov/doc1/20515387251 (Pacer registration required, retrieved January 25, 2020)

> > that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and
> >
> > (3) the amount of such deduction exceeds $3,000,
>
> then the tax imposed by this chapter for the taxable year shall be the lesser of the following:
>
> > (4) the tax for the taxable year computed with such deduction; or
> >
> > (5) an amount equal to—
> >
> > > (A) the tax for the taxable year computed without such deduction, minus
> > >
> > > (B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).
>
> For purposes of paragraph (5)(B), the corresponding provisions of the Internal Revenue Code of 1939 shall be chapter 1 of such code (other than subchapter E, relating to self-employment income) and subchapter E of chapter 2 of such code.

An example of the type of situation that normally triggers the claim of right is the case where a new employee receives a signing bonus that is conditioned on the employee remaining employed with the employer for a period of years. The employee includes the signing bonus in income in the year in which the bonus is received. If, in a later year, the employee leaves employment and repays a portion of the bonus, §1341(a) is triggered. The employee would have the choice of taking a deduction in the year of repayment or reducing his/her tax in the year of repayment by a credit equal to the amount of tax computed as being previously paid when this amount was included in income in the prior year.

The issue in the *Heiting* case is a bit different, involving the couple's grantor trust which had a third-party corporate trustee. The third-party trustee sold assets that were not allowed to be sold under the terms of the trust. As the opinion describes:

> The trust agreement granted the trustee broad discretion to invest, reinvest, or retain trust assets. Dkt. 11, Article II (selecting investment option C). But the trust agreement prohibited the trustee from doing anything with the stock of two companies: Bank of Montreal Quebec (BMO) and Fidelity National Information Services, Inc. Id., Article

> IX, Article X. Despite the prohibition, the trustee sold all of the trust's BMO and Fidelity stock in October 2015. The sale resulted in a taxable gain of $5,643,067.50. Proceeds from the sale remained in the trust.[30]

The trustee did not notice the problem in the year the stock was sold, but did notice the issue and take corrective action in the following year:

> In January 2016, the trustee realized that the sale of BMO and Fidelity stock was prohibited by the trust agreement. The trustee repurchased the stock with the trust's assets. The Heitings revoked the trust in February 2016.[31]

Since the trust was a grantor trust, the Heitings were treated as the owners of all assets in the trust and paid tax on the gain on sale on their 2015 return. On their 2016 return the couple claimed a deduction under the claim of right rule of §1341(a) for the repurchase of the stock. In their view, as the sale was not allowed under the trust document, the subsequent repurchase was effectively a repayment of the proceeds that led to the taxable gain.[32]

The IRS did not agree with that view and denied the deduction. The taxpayers paid the tax due and then brought suit in United States District Court to obtain a refund of the taxes paid.

IRC §1341(a) has three criteria that must be met to be able to take advantage of the provision. Two of them all parties agreed were met: the amount in question exceeded $3,000 and in 2015 the amounts in question were in the taxpayers' revocable trust and appeared to be available to the taxpayers without restriction.[33]

But the IRS argued that the taxpayers could not meet the requirement found at IRC §1341(a)(2). The government's position was that the Heitings were not actually required to return the proceeds of the stock sale. As the opinion notes:

> According to the government, once the BMO and Fidelity stock was sold, the Heitings had the unrestricted right to do what they wanted with the proceeds, because they had unrestricted rights over the assets

[30] *Heiting v. United States*, p. 2

[31] *Heiting v. United States*, p. 3

[32] *Heiting v. United States*, p. 3

[33] *Heiting v. United States*, p. 4

> in the revocable trust. Indeed, the Heitings revoked the trust in 2016.[34]

The Heitings argued that, since the trust prohibited the sale of those stocks, the trustee had to repurchase the stock—and as deemed owner under the grantor trust rules, the tax consequences fell on them. But the Court did not agree with their view:

> But the Heitings' argument is fundamentally unsound as a matter of trust law.
>
> Neither the trustee nor the Heitings were actually obligated to repurchase the BMO and Fidelity shares. Under the Wisconsin Trust Code, "[w]hile a trust is revocable, the trustee may follow a direction of the settlor that is contrary to the terms of the trust." Wis. Stat. § 701.0808(1). So the Heitings, without amending the trust, could have instructed the trustee to do anything with the proceeds of the stock sale. Under the trust agreement itself, the trustee had to follow the Heitings' directions in taking any action regarding BMO and Fidelity stock— not only in selling it, but in buying it back as well. See Dkt. 11, Article IX, Article X. And, by the terms of the trust agreement, the Heitings could have amended or revoked the trust at any time, as they did in 2016.
>
> The Heitings also contend that when they learned about the trustee's unauthorized stock sale, they had no choice in how to respond. They say that "a beneficiary of a trust cannot ignore a breach and profit from it simply because the trustee fails to remedy that breach." Dkt. 20, at 9. They cite no authority for this proposition. It's long been the law in Wisconsin that a beneficiary can consent to a trustee's action, thereby ratifying conduct that would otherwise breach the trustee's duty to the trust. See, e.g., *In re Spengler*, 596 N.W.2d 818, 825– 26, 228 Wis. 2d 250 (Ct. App. 1999); see also *Koult v. Kaufer*, 159 N.W. 806, 809, 164 Wis. 136 (1916) (if trustee improperly invests trust assets, beneficiary "may retain the property and thereby ratify the wrong"). The trustee's obligations to the Heitings simply cannot be imputed to the Heitings themselves as though the Heitings were somehow irrevocably bound to the terms of their own revocable trust. [35]

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[34] *Heiting v. United States*, p. 5

[35] *Heiting v. United States*, pp. 5-6

The case that that the taxpayers attempted to rely upon (*First National Bank of Chicago v. United States*, 551 F. Supp. 157 (N.D. Ill. 1982)) differed from the current case in a number of factors, a key one being the trust in that case was not a grantor trust:

> Moreover, First National Bank differs from this case in two key respects. First, the trust in that case was not a grantor trust; instead, the trust itself was the taxpayer, so the entity obligated to return the restricted income and the taxpayer eligible for a § 1341 credit were one and the same. Second, the stock repurchase in First National Bank was court-ordered after one of the beneficiaries sued over the unauthorized stock sale. Id. at 158. The Heitings' trustee had no comparable legal obligation, and neither did the Heitings themselves.[36]

Since there was no obligation to return the funds, the Heitings could not make use of the claim of right provisions of IRC §1341(a). As the opinion concludes:

> The unauthorized sale of the BMO and Fidelity stock may have caused the Heitings to recognize and pay tax on a substantial gain that they would have rather deferred. But § 1341 provides no remedy because they did not have to repurchase the stock. Their recourse, if any, lies against the trustee, not the IRS.[37]

## SECTION: 7502
## IRS ASKS DISTRICT COURT TO RECONSIDER RULING TAXPAYER FILED TOO LATE TO OBTAIN REFUND

### Citation: United States' Notice of Non-Opposition to Plaintiff's Motion for Reconsideration, Harrison v. Internal Revenue Service, USDC WD Wisconsin, Case: 3:19-cv-00194-wmc, 1/24/20

The IRS is asking the District Court in the case of *Harrison v. Internal Revenue Service*, USDC WD Wisconsin, Case: 3:19-cv-00194-wmc[38] to reverse its holding in favor of

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[36] *Heiting v. United States*, p. 7

[37] *Heiting v. United States*, p. 7

[38] *Harrison v. Internal Revenue Service*, USDC WD Wisconsin, Case: 3:19-cv-00194-wmc, January 9, 2020, https://ecf.wiwd.uscourts.gov/doc1/20515379693 (Retrieved January 29, 2020, Pacer registration required)

the Government, supporting the taxpayer's motion for reconsideration[39] in the IRS's own notice of non-opposition to that motion.[40] So why is the IRS asking the Court to reverse the holding in favor of the agency?

Well, it turns out that there existed controlling authority in favor of the taxpayers' position but, in the words of the plaintiff's motion for reconsideration, "all parties failed to cite the relevant authority and the Judge didn't cite the case either."

This particular case came up in a discussion on /r/taxpros on Reddit[41] where an individual with screen name of u/MeadowsofSun posted a write-up of the original opinion and user /u/probfriendhelp posted a reply detailing the IRS's reversal of course on the case.

So what was the case about? The issue involved whether a taxpayer had managed to file his late filed 2012 income tax return, for which he was claiming a refund of $7,386.48, prior to the expiration of the statute of limitations for filing the claim. The taxpayers had filed a request for an extension of time to file the return for the year in question through October 15, 2013, but had not actually filed the return until October 2016.

The taxpayers had mailed the claim on October 11, 2016, as evidenced by a postmark on the envelope. However, the IRS did not receive the late filed return until October 17, more than three years after the original extended due date. The catch was that if the actual date of filing was deemed to be October 11, the claim was filed in a timely manner and, as we discovered in the IRS notice of non-opposition, the taxpayer would

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[39] Motion for Reconsideration of a Court Order and Opinion Dated January 9, 2020 Pursuant to Federal Rule of Civil Procedure 59, *Harrison v. Internal Revenue Service*, USDC WD Wisconsin, Case: 3:19-cv-00194-wmc, January 15, 2020, https://ecf.wiwd.uscourts.gov/doc1/20515383109 (Retrieved January 29, 2020, Pacer registration and payment required)

[40] United States' Notice of Non-Opposition to Plaintiff's Motion for Reconsideration, *Harrison v. Internal Revenue Service*, USDC WD Wisconsin, Case: 3:19-cv-00194-wmc, January 24, 2020, https://ia801407.us.archive.org/15/items/harrison_v_irs_reconsider/show_temp.pdf (Retrieved January 29, 2020)

[41] https://www.reddit.com/r/taxpros/comments/evg8m4/court_ruled_that_postmark_rule_didnt_apply_to/ (Retrieved January 29, 2020)

be due the amount claimed.[42] However, if the date of filing is deemed to be October 17, then the taxpayer's claim was late and no balance would be paid.

The issue in this case was whether the rule found in IRC §7502(a) applied to a late filed return. IRC §7502(a) reads:

> (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.

The Court ruled that the postmark date is the filing date under this rule only if the postmarked date precedes the due date for filing the return, but does not apply to a return filed after the due date (including extensions).[43] With the return being filed late, they had waited too long to attempt to claim their refund and had forfeited their right to it.[44]

But it turns out that Reg. §301.7502-1(f), dealing specifically with late filed returns, comes to a very different conclusion. It reads:

> (f) Claim for credit or refund on late filed tax return
>
> (1) In general.
>
> Generally, an original income tax return may constitute a claim for credit or refund of income tax. See section 301.6402-3(a)(5). Other original tax returns can also be considered claims for credit or refund if the liability disclosed on the return is less than the amount of tax that has been paid. If section 7502 would not apply to a return (but for the

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[42] United States' Notice of Non-Opposition to Plaintiff's Motion for Reconsideration, p. 4

[43] *Harrison v. Internal Revenue Service*, original opinion, p. 6

[44] *Harrison v. Internal Revenue Service*, original opinion, p. 8

> operation of paragraph (f)(2) of this section) that is also considered a claim for credit or refund because the envelope that contains the return does not have a postmark dated on or before the due date of the return, section 7502 will apply separately to the claim for credit or refund if --
>
> > (i) The date of the postmark on the envelope is within the period that is three years (plus the period of any extension of time to file) from the day the tax is paid or considered paid (see section 6513), and the claim for credit or refund is delivered after this three-year period; and
> >
> > (ii) The conditions of section 7502 are otherwise met.
>
> (2) Filing date of late filed return.
>
> If the conditions of paragraph (f)(1) of this section are met, the late filed return will be deemed filed on the postmark date.

This clarification to the regulations under IRC §7502 was adopted by the IRS in 2001. The IRS changed its litgating position on the matter in Chief Counsel Notice CC-2001-019 that was issued in March 2001 in response to the holding of the Second Circuit Court of Appeals on this matter in the case of *Weisbart v. United States*, 222 F.3d 93 (2d. Cir. 2000). And although the IRS does not mention it, the IRS had acquiesced to the *Weisbart* decision in AOC 2000-009, issued on November 30, 2000.

As the plaintiff's motion noted, none of those sources were cited by either party in the case before the Court, and the items weren't discovered by the Judge who was handling the case. The IRS's Notice of Non-Opposition notes that the IRS Counsel had uncovered the *Weisbart* case in their research into the case, but concluded it did not control in the Seventh Circuit, where any appeal of this case would take place.[45] In fact, the Judge hearing the case noted in his opinion that the issue appeared never to have been considered by the Seventh Circuit.[46]

So how did everyone miss what now counsel on both sides agree is controlling authority on the matter? After all, it seems likely that if this regulation had been raised when the IRS first denied the refund that the matter could have been settled without any petitions being filed in court.

Unfortunately, tax law is complicated and there are a lot of ways to get diverted down the wrong road in an adviser's research into positions. It seems the advisers found IRC

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[45] United States' Notice of Non-Opposition to Plaintiff's Motion for Reconsideration, p. 3

[46] *Harrison v. Internal Revenue Service*, original opinion, p. 6

§7502(a) by itself as the answer and worked strictly from the IRC text. The advisers apparently did not find the *Weisbart* case, nor did they discover Reg. §301.7502-1(f) nor the IRS Chief Counsel Notice on point.

The IRS eventually turned to case law that looked at §7502(a) and its application to late filed returns. While they became aware of the Second Circuit's *Weisbart* decision, they noted that the Seventh Circuit itself had never looked into this issue, thus concluding it did not apply. They did not look to see if there was any IRS action related to this decision, causing them to miss both the agency's acquiescence and the Chief Counsel Notice, As with the plaintiff, it does not appear that in their research they ever looked at the underlying regulation at Reg. §301.7502-1(f).

A key reason that causes researchers to miss such important details is that we tend to latch onto the first items we find that give us an answer we like. On the advisers side, the Code, at least as they read it, seemed to support their position that the filing was timely. When first challenged on this matter, most likely when the IRS notified the taxpayers that their refund would not be paid, they likely stuck with their initial research.

And, while correct that the Internal Revenue Code is the primary source, and if the language is clear on point trumps other authority, with an exception for U.S. Constitutional issues or later adopted treaties, they appear to have failed to look to see if the regulations had spoken to this issue (which they had)—or, at least didn't appreciate the importance of Reg. §301.7502-1(f).

The reaction is somewhat natural, since it's easy to feel insulted that the IRS is claiming an error was made by the adviser, one that was going to cost the client over $7,000.

The IRS got themselves into a similar position. Clearly, the IRS employee that did the initial review to determine if the refund was going to paid came to the conclusion, likely based on case law that found its way into the later IRS briefs and the opinion, that IRC §7502(a) was ambiguous regarding whether it applied to late filed returns and that the IRS had been successful in arguing that only the actual date of receipt applied for late filed returns in some, even if not all, cases previously decided.

When the matter moved to the District Court, counsel for both sides continued down these same paths. The judge, noting that both parties were represented by counsel, most likely reasonably concluded that each party was presenting him with the materials that best bolstered their case, so he did not go out to do a bunch of independent research.

One key step that both sides should have followed in our traditional tax research flowcharts is to always check the applicable regulation(s) for any IRC section on which you plan to rely. This can be a frustrating exercise since regulations often go unmodified years after the relevant code provision has changed, and thus large parts may be outdated and other areas never discussed.

But in this case the parties would each have found that the regulation had been updated a number of times after the last change had been made to the law. You can virtually always find out when the Code provision was last changed by looking at your tax research service's code history link for any particular section. Similarly, the research services generally list the dates with links to the treasury decisions issued to modify any regulation, often at the end of the regulation. As well, many services will begin the regulation with a note regarding any laws enacted that have revised the section being analyzed in the regulation for which there has yet to be a modification in the regulation.

Understanding that this regulation appeared to be current and up to date with the IRC section itself, the researcher would have confidence that what is in Reg. §301.7502-1 represented positions that were binding on the IRS and, upon finding Reg. §301.7502-1 that appeared 100% on point, be relatively confident in a taxpayer friendly outcome.

Another step that appears to have been skipped by government counsel in their research was consulting a citator for any later actions on cases that impacted this case. Having identified *Weisbart* as having decided an identical issue, a look at the *RIA Citator 2d* would have uncovered AOD 2000-009 where the IRS acquiesced and announced the agency would no longer attempt to argue that §7502(a)'s postmark rule did not apply to late filed returns. The entry in the citator would have also referred the researcher to TD 8932 where the IRS modified Reg. §301.7502-1(f) to specifically incorporate the *Weisbart* result.

This article is not meant to be too critical of the parties in this case—in the heat of trying to get things accomplished and deal with demands on an adviser's time, following those "theoretical" rules for doing tax research can seem like a waste of time, especially when you are already committed to an answer based on your prior work. We all hate to be seen as not being "practical" in our work and, most of the time, that additional work will just confirm what we first found.

Similarly, when someone questions a result the researcher feels he/she has already resolved, we tend to get defensive and harden our position. Even if the adviser is brought in later, the client (or IRS) by now has a clear answer they prefer. It's easy to modify our approach to further research by either stopping any additional research at all or evaluating all new information we do uncover to fit the answer we've already decided to accept.

But, as this case notes, going back to basics can actually save a substantial amount of time and prevent all parties from missing the obvious.

In this case, it's likely that very soon after this case got published online and in tax news services, other tax professionals who deal in the area, both inside and outside the IRS, read the decision and had the immediate reaction that it was incorrectly decided since Reg. §301.7502-1(f) clearly resolved the matter in the opposite fashion. Such reactions were likely communicated to counsel on both sides. The taxpayer's counsel filed his motion for reconsideration five days after the decision came down, with the IRS agreeing ten days later.

The key take-away from this situation is to remind advisers about the importance of following the basic rules of tax research. We need to resist the temptation to stop our work when we first find some authority that gives us the answer we like, but rather to specifically take the time to look for other guidance, even if that guidance creates issues with what we've already found.

We also have to accept that, at some point, we all will make mistakes in conclusions we arrive at in tax research. So when our answer is questioned by another at least potentially knowledgeable party (be that the IRS or another adviser), we have to be willing to accept that we *might* be wrong or, at least, our research might be incomplete at this point.