Current Federal Tax Developments

Week of July 20, 2020

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Contents

SECTION: FFCRA
IRS SENDING LETTERS REGARDING ISSUES WITH FORMS 7200 SUBMITTED BY SOME TAXPAYERS

Citation: IR-2020-158, 7/15/20

The IRS issued information regarding the letters taxpayers will receive when the IRS has made a math adjustment to a request for a refund filed on a Form 7200, *Advance Payment of Employer Credits Due to COVID-19*, has rejected the claim or needs verification of the business' address before processing the claim in IR-2020-158.[1]

The release indicates that taxpayers will receive:

- Letter 6312 if the IRS has either rejected the Form 7200 or made a change to the requested amount of the payment due to a computational error or
- Letter 6313 if the IRS needs a written verification that the address listed on their Form 7200 is the business' current mailing address.

The notice provides the following information related to the Letter 6312:

> The letter will explain the reason for the rejection or, if the amount is adjusted, the new payment amount will be listed on the letter.

The IRS provides the following information regarding Letter 6313:

> The IRS will not process Form 7200 or change the last known address until the taxpayer provides it (the written verification).

[1] IR-2020-158, July 15, 2020, https://www.irs.gov/newsroom/irs-is-sending-letters-to-those-experiencing-a-delay-with-advance-payment-of-employer-credits, (retrieved July 17, 2020)

SECTION: 61
SINCE LENDER DID NOT TAKE JUDICIAL ACTIONS REQUIRED FOR DEFICIENCY JUDGMENT UNDER STATE LAW, SHORT SALE DEBT TREATED AS NONRECOURSE DEBT

Citation: Duffy v. Commissioner, TC Memo 2020-108, 7/13/20

In the case of *Duffy v. Commissioner*, TC Memo 2020-108,[2] the Tax Court gave its view of what impact a state's law had on whether a debt in question was recourse or nonrecourse.

Short Sales: Recourse vs. Nonrecourse Debts

In this case the issue was key because the taxpayers had entered into a short sale of a residence that had total outstanding debt secured by the property in excess of its fair market value.

> Petitioners sold the Gearhart property in March 2011 for $800,000. JPMorgan Chase agreed to accept $750,841 of the proceeds in full satisfaction of the mortgage loan that encumbered the property. The documents which the parties stipulated regarding petitioners' sale of the Gearhart property do not include any judicial filings by JPMorgan Chase and make no reference to judicial proceedings to enforce petitioners' obligation to the bank.[3]

The $750,841 that JPMorgan Chase accepted in full payment was $626,046 less than the unpaid principal balance of that mortgage at the time.[4]

If the debt was a recourse debt, the $626,046 would represent cancellation of debt income to the taxpayers, generally taxable as ordinary income to the taxpayers unless they qualified for one of the exclusions under IRC §108.[5]

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[2] *Duffy v. Commissioner*, TC Memo 2020-108, July 13, 2020, https://www.ustaxcourt.gov/USTCInOP/OpinionViewer.aspx?ID=12283 (retrieved July 15, 2020)

[3] *Duffy v. Commissioner*, TC Memo 2020-108, p. 6

[4] *Duffy v. Commissioner*, TC Memo 2020-108, p. 11

[5] IRC §61(a)(11)

Conversely, if the debt is nonrecourse the balance of the unpaid debt ends up being included in the sales price for computing gain or loss from the disposition of the property.[6]

Anti-Deficiency Statutes

A minority of states have what are referred to as "anti-deficiency statutes" that apply to some extent to amounts borrowed and secured by a taxpayer's residence.[7] The state of Oregon, where the taxpayers resided in this case, is one such state.

While some states (Arizona and California in particular) provide absolute protection for mortgages used to acquire the property, others provide that protection only when the lender chooses to use a nonjudicial foreclosure proceeding. Such proceedings tend to be used most often in such cases, since they are much simpler than going through a formal judicial foreclosure.

But the existence of these two paths to foreclose on the property raises a key question—is a debt that is subject to such a provision treated as a recourse or non-recourse debt if the lender forecloses on the property but does not pursue a judicial foreclosure?

Advisers ran into this issue during the years following the real estate crisis. In the Nichols Patrick CPE, Inc.[8] course from that period, *Debt Related Tax Issues: Foreclosures, Short Sales and Cancellation of Debt*, we noted that the IRS had taken the position such debts were *recourse* debts:

> In Private Letter Ruling 199935002, the IRS held that when the use of a non-judicial foreclosure proceeding resulted in the lender, under the State's anti-deficiency statute, being unable to pursue a deficiency judgment, then there was a cancellation of debt event that took place at that time.
>
> The facts of that ruling provided "under State law, a mortgagee has the option of foreclosing using a judicial procedure, under which a deficiency judgment can be enforced, or a non-judicial procedure, under which a deficiency judgment is prohibited." The ruling went on to hold that "therefore, the deficiency of 22x was discharged by the non-judicial foreclosure."
>
> Under this view, the key question is whether it was within the power of the debtor to unilaterally walk away from the obligation without the risk of action on the part of the creditor. In the situation considered

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[6] Reg. §1.1001-2(a)(1); *2925 Briarpark, Ltd. v. Commissioner*, TC Memo 1997-298

[7] In Arizona this protection is even broader, protecting any property used as a residence even if used as that by someone other than the taxpayer, such as a tenant of a rental residence. See Arizona Revised Statutes §§33-729 and 33-814(G).

[8] Nichols Patrick CPE, Inc.'s courses and catalog were acquired by Kaplan, Inc. in 2016

> under the ruling, it was the unilateral decision of the creditor that removed recourse for the deficiency.
>
> Conversely, if a lender would have no option to have obtained a deficiency judgment then the debt should be treated as purely a nonrecourse obligation regardless of any terms of the note. State laws in some states (California and Arizona to name two) provide extremely strong anti-deficiency protection to purchase-money mortgages, protection that the state courts in question have held may not be escaped even if the lender decides to forego enforcing any security interest in the property.
>
> In that case, the same tax result should be obtained even if the lender uses the nonjudicial foreclosure option, since no alternative would exist under which the lender could have obtained full payment of the face value of the debt.[9]

Under this view, the existence of the right to pursue the collection of a deficiency judgment, even if not economically reasonable for the lender in the circumstances, would always render the debt recourse.

Short Sales

Quite often when a borrower attempts to sell property when prices have declined, the borrower finds that even when selling the residence for the best price available there won't be sufficient funds available from the sale to pay off the debt. In such cases, the borrower may negotiate an agreement with the lender to accept the net amount available after expenses are paid in full satisfaction of the debt. That agreement is needed so the buyer can obtain clear title to the property—otherwise there will be no sale.

Lenders are apt to agree to such arrangements since other options available to the lender are likely to result in a lower net return, as the lender would need to go through costly foreclosure proceedings, then have to market and sell the property. If the lender accepts this offer, they get a check based on the sale without incurring the additional costs.

If the debt is a recourse debt, then clearly we have a debt cancellation event under IRC §61(a)(11). But what if the debt is a nonrecourse debt? As we noted in the 2013 manual, there is a risk that this would also be viewed as a cancellation of debt since it's first a modification of the nonrecourse note, followed by a pay-off of the note:

> …[I]f the debtor simply pays less than the balance due on the note to a lender who was not the person the debtor acquired the property from and the lender releases the debtor from any additional liability, there would be a cancellation of indebtedness event. Given that, on paper, what is happening in this short sale is that the lender is

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[9] Edward Zollars and E. Lynn Nichols, *Debt Related Tax Issues: Foreclosures, Short Sales and Cancellation of Debt: New Mexico*, Nichols Patrick, CPE, Inc., July 18, 2013 edition, p. 2-10

> accepting an amount less than a full payment from the seller's funds in the sale, some advisers might worry the IRS would see this as effectively the same transaction—the lender reducing the loan via a modification, along with a sale.[10]

But the IRS eventually decided in 1995 Chief Counsel Advice Memorandum 002758 and a litigating position advanced in a case that was decided two years later that such a treatment did not reflect the economic realities of the situation:

> In 1995 Chief Counsel Advice Memorandum 002758 the IRS outlined two theories of taxation that could apply, as well as the justification for each. The IRS labeled the two options as the "two-step" approach and the "one-step" approach.
>
> **Two-Step Approach**. In the two-step approach, the short sale is viewed as two separate transactions. First the lender reduces the outstanding balance of the debt owed by the debtor. Such a loan modification transaction, discussed in Module 4, is a cancellation of indebtedness event that triggers ordinary income regardless of whether the underlying obligation is recourse or nonrecourse. The amount of the reduction would be ordinary income, but Section 108's provisions might cause the income not to be recognized by the taxpayer.
>
> The second step is the sale of the property to the third party buyer. That sale transaction treats the amount paid by the third party buyer as the sales price and computes a gain or loss based on that amount. As was noted earlier, if that property was a personal use property, IRC §262(a) would block any deduction for that loss. Thus, in some situations, there could be recognition of ordinary income based on the cancellation of debt event and the inability to deduct an offsetting loss due to IRC §262(a), even though the taxpayer's underlying net worth was unchanged or had even gone down.
>
> The memo noted that the policy argument in favor of this treatment is that "separates the tax consequences of the borrowing from the tax consequences of ownership of the property."
>
> Under this view, the borrower is in the same position with regard to the debt as a homeowner who, rather than negotiating a short sale, negotiates an equivalent debt modification but retains the home where the transaction's tax impact is explained by Rev. Ruls. 91-31 and 92-99. A taxpayer who modified the debt and then sold a year later at that same price would end up with a different tax result than one that undertook both transactions at the same time.

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[10] Edward Zollars and E. Lynn Nichols, *Debt Related Tax Issues: Foreclosures, Short Sales and Cancellation of Debt: New Mexico*, Nichols Patrick, CPE, Inc., July 18, 2013 edition, p. 3-5

> **One-Step Approach**. In the alternative the IRS looked at what was labeled a "one-step" approach to handling the transaction. The argument in this case is that the economics of the transaction taken as a whole should govern rather than paying attention to the detailed formalities. The argument goes that the holder of a property secured by a nonrecourse debt has an effective "put" option to "dispose of the property for an amount equal to the amount of the debt."
>
> Thus, in this view, the entire balance of the mortgage would be treated as the sales price for the short sale despite the fact that the third party borrower was only paying a smaller amount.
>
> The memorandum notes that if this approach is not used, a taxpayer could potentially elect whether to have a capital gain (which could be offset by capital losses or subject to a preferential tax rate) or cancellation of debt (potentially excludable under §108) by simply selecting either a deed in lieu of foreclosure (to give the property back to the lender) or a short sale (whether the property transfers to a third party with the consent of the lender). Arguably the net economic effect of those two transaction are the same, and the one-step approach would have them each taxed in the same manner.[11]

While that memorandum indicated that there was no settled law on the issue, the IRS would pursue and win the case of *2925 Briarpark, Ltd. v. Commissioner*, TC Memo 1997-298, following the "one step approach" that a short sale involving a nonrecourse debt did not lead to cancellation of debt—rather, the unpaid portion of the debt would be added to the stated sales price to determine the total proceeds from sale.

Taxpayer's Short Sale and Lender's Failure to Use Judicial Proceedings

So now back to the facts of this case—the taxpayers had entered into a short sale where the lender agreed to accept $626,046 less than the amount due on the mortgage as full payment of the debt in order to allow the short sale to go through.

The IRS took a position consistent with Private Letter Ruling 199935002, cited earlier, in this case:

> Respondent's position reflects his determination that the JPMorgan Chase loan was a recourse liability of petitioners because the lender, had it chosen to do so, could have proceeded against petitioners for the unpaid balance of the loan after application of $750,841 of the proceeds from the sale of the Gearhart property.[12]

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[11] Edward Zollars and E. Lynn Nichols, *Debt Related Tax Issues: Foreclosures, Short Sales and Cancellation of Debt: New Mexico*, Nichols Patrick, CPE, Inc., July 18, 2013 edition, pp. 3-5 – 3-6

[12] *Duffy v. Commissioner*, TC Memo 2020-108, p. 23

The IRS conceded that if this was a nonrecourse debt the taxpayer would have no income from the sale of the property, since the sale of the personal residence would still have resulted in a nondeductible loss even with the additional proceeds:

> Respondent acknowledges that, if the JPMorgan Chase loan were instead nonrecourse—in that the bank's remedies were limited to the Gearhart property—the unpaid loan would have been included in petitioners' amount realized from the sale of the property. See sec. 1.1001-2(a), Income Tax Regs. In that event, respondent accepts that the canceled loan would have reduced petitioners' nondeductible loss without resulting in cancellation of indebtedness income.[13]

That would be true even if the taxpayer had converted the property to a rental (a position subject to a separate dispute in this case) when the fair value was far less than their basis at the time of conversion, as the Court noted:

> The adjusted basis of a personal residence converted to business use is stepped down to fair market value for purposes of determining a loss on a subsequent sale of the property but not for purposes of determining gain on such sale. See *Simonsen v. Commissioner*, 150 T.C. 201, 214 (2018).[14]

The Court described Oregon law related to this issue as follows:

> Under Oregon law, when property subject to an obligation secured by a trust deed is foreclosed upon, the lender's ability to bring a deficiency action against the debtor to obtain repayment of any portion of the obligation not satisfied by the proceeds of the foreclosure sale turns on the nature of both the property and the foreclosure proceedings. See Or. Rev. Stat. sec. 86.770(2) (2011). The statute bars deficiency actions after a judicial foreclosure of a residential trust deed and after an administrative foreclosure on any type of property.[15]

The IRS took the position that since this note was not secured by a trust deed, the debt was recourse both under its terms (which provided no limit on collection of a deficiency) and under Oregon law. That is, had the lender taken judicial action, the lender could have obtained a deficiency judgement.

But the Tax Court did not agree, rather finding that, absent a showing that Chase undertook such a judicial proceeding, the debt was nonrecourse:

> If petitioners sold the Gearhart property in an administrative foreclosure, however, without the involvement of a court, the Oregon antideficiency statute limited JPMorgan Chase's remedies regardless of

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[13] *Duffy v. Commissioner*, TC Memo 2020-108, p. 23

[14] *Duffy v. Commissioner*, TC Memo 2020-108, p. 23

[15] *Duffy v. Commissioner*, TC Memo 2020-108, p. 24

> whether the trust deed securing that loan was a "[r]esidential trust deed" within the meaning of Or. Rev. Stat. sec. 86.705(5) (2011).
>
> Because the documents which the parties stipulated regarding petitioners' sale of the Gearhart property do not include any judicial filings by JPMorgan Chase and we find no reference to any judicial proceedings in the documents that were stipulated, we infer that the sale was part of an administrative rather than a judicial foreclosure. Therefore, Oregon's antideficiency statute prevented JPMorgan Chase from seeking satisfaction from petitioners' other assets of that part of its loan in excess of the proceeds it received from the sale of the Gearhart property. Petitioners' amount realized from the sale of the Gearhart property is thus determined under the general rule of section 1.1001-2(a)(1), Income Tax Regs., rather than the exception for the cancellation of recourse liabilities provided in section 1.1001-2(a)(2), Income Tax Regs. It follows that the amount of the JPMorgan Chase loan from which petitioners were discharged is included in their amount realized from their sale of the Gearhart property. Petitioners thus realized no section 61(a)(12) discharge of indebtedness income from the cancellation of the $626,046 principal amount of the JPMorgan Chase loan or $108,661 of accrued but unpaid interest.[16]

The Court effectively holds that in this situation where the lender must take a specific action to avoid the impact of an anti-deficiency statute, if the lender does not take such a position when the property is sold or foreclosed upon, the debt will be treated as nonrecourse. That is, the analysis in Private Letter Ruling 199935002 which the IRS had continued to use in this case is not accepted by the Tax Court, at least in this situation.

The holding raises questions about a majority of the anti-deficiency statutes that exist in states with such statutes. Quite often, for some or all of the loans covered by a state's anti-deficiency provision, the loss of a deficiency judgement is a trade-off the lender makes to make use of the less bothersome administrative foreclosure option.

While this worked to the taxpayer's advantage in this case, that was due to the fact that the inclusion of the unpaid balance of the loan as sales proceeds merely reduced, but did not eliminate, what was otherwise a nondeductible personal loss. The result could be less favorable if the taxpayer would qualify for relief under a provision of §108 for any cancellation of debt, and the moving of the unpaid balance of the debt to additional proceeds of the sale would not simply end up reducing what would be a nondeductible loss.

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[16] *Duffy v. Commissioner*, TC Memo 2020-108, pp. 24-25

SECTION: 108
DEBT CANCELLED BY LENDER WAS NOT QUALIFIED PRINCIPAL RESIDENCE DEBT, ENTIRE CANCELLATION AMOUNT TAXABLE

Citation: Weiderman v. Commissioner, T.C. Memo. 2020-109, 7/15/20

In the case of *Weiderman v. Commissioner*, T.C. Memo. 2020-109,[17] the taxpayer found that simply using a loan to purchase a residence isn't sufficient to make it into qualified principal residence indebtedness. The taxpayer was looking to claim an exclusion from cancellation of indebtedness income under IRC §108(a)(1)(E).

Qualified Principal Residence Indebtedness Exclusion of Cancellation of Indebtedness Income

A provision that was originally "temporarily" added as part of the economic relief packages that were enacted as a reaction to the 2008 real estate crash, the exclusion from income for cancellation of indebtedness on qualified principal residence debt has been extended multiple times, most recently as part of the 2019 end of year tax package.

The provision reads:

> (a)Exclusion from gross income
>
> (1) In general
>
> Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—
>
> …
>
> (E) the indebtedness discharged is qualified principal residence indebtedness which is discharged—
>
> (i) before January 1, 2021, or
>
> (ii) subject to an arrangement that is entered into and evidenced in writing before January 1, 2021.

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[17] *Weiderman v. Commissioner*, T.C. Memo. 2020-109, July 15, 2020, https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=12289 (retrieved July 16, 2020)

Qualified principal residence indebtedness is defined at IRC §108(h)(2) as:

> (2) Qualified principal residence indebtedness
>
> For purposes of this section, the term "qualified principal residence indebtedness" means acquisition indebtedness (within the meaning of section 163(h)(3)(B), applied by substituting "$2,000,000 ($1,000,000" for "$1,000,000 ($500,000" in clause (ii) thereof and determined without regard to the substitution described in section 163(h)(3)(F)(i)(II)) with respect to the principal residence of the taxpayer.

The cross reference to IRC §163(h)(3)(B) ties the definition to the one used for home mortgage interest that is deductible on Schedule A, but with a $2 million rather than $750,000 limit on the amount of such debt—acquisition indebtedness.

Two key tests must be met for debt to be treated as acquisition indebtedness, and thus potentially eligible for special treatment under §108(a)(1)(E)'s debt forgiveness exclusion:

- The debt is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and
- The debt is secured by such residence.

Debt Used to Acquire Residence

In this case, the Tax Court provides us with the following information regarding the debt in question:

> Following negotiations, by letter dated December 11, 2006, K-Swiss offered Mrs. Weiderman employment as vice president — marketing, directly reporting to the chief executive officer of K-Swiss, and a salary of $25,000 monthly (December 11, 2006, letter). Mrs. Weiderman was required to move to Southern California where K-Swiss was located, and as outlined in the December 11, 2006, letter K-Swiss would (among other things) grant her an interest-free loan of $500,000 to help finance the purchase of a home in that area, provide her up to 180 days of temporary housing in a furnished executive apartment, reimburse her travel expenses for three three-day trips for her and Mr. Weiderman, and pay her moving expenses from Massachusetts to California.
>
> …
>
> Meanwhile, petitioners offered to purchase a home in Agoura Hills, California (Agoura Hills property), and this purchase was consummated in February 2007. They paid $1,950,000 for the Agoura Hills property (plus settlement charges and prorated county taxes and homeowner association dues) by (1) providing a deposit or earnest money of $50,000, (2) obtaining a $1,450,000 mortgage and a $75,000 bridge loan from Wells Fargo, and (3) providing an additional deposit of $385,993, which was wired into the escrow account established for

> the purchase from petitioners' Wells Fargo checking account six days after their receipt of the $500,000 loan proceeds via wire transfer. [18]

Under the tracing rules applicable to interest, the taxpayer was allowed to trace $385,993 of the employer loan as being used to acquire the residence. But merely using the debt to acquire the residence is not enough to qualify the debt as acquisition indebtedness.

Security Requirement

The new job didn't work out and, under terms of the note, the taxpayers had to repay the note due to the loss of the position. The Court describes what happened as follows:

> On December 1, 2008, K-Swiss terminated Mrs. Weiderman's employment. Because her employment was terminated and in accordance with the February 15, 2007, promissory note, K-Swiss demanded that petitioners repay the $500,000 loan. Knowing that the only way they could pay back this loan was to sell the Agoura Hills property and thus concerned about their repayment ability, petitioners listed (with the assistance of a real estate agent) the Agoura Hills property for sale and hired Mary Lee Wegner, a Sherman Oaks, California, employment attorney, to negotiate a settlement with K-Swiss. Initially, K-Swiss offered to cancel $250,000 of the $500,000 loan in lieu of a cash severance payment. Ultimately petitioners agreed to having K-Swiss cancel $220,000 of the loan and pay them $30,000.
>
> The details of their agreement were memorialized by a separation agreement and general release executed by Mrs. Weiderman and K-Swiss in January and February 2009, respectively (2009 separation agreement), along with a promissory note secured by a deed of trust executed by petitioners on January 29, 2009, in favor of K-Swiss (January 29, 2009, promissory note). As stated in appendix A of the 2009 separation agreement, K-Swiss was obligated to pay Mrs. Weiderman $30,000 in one lump sum without payroll or other deductions on the eighth calendar day after she delivered a signed copy of the 2009 separation agreement to K-Swiss. Additionally, as stated therein, with respect to the $500,000 loan memorialized by the February 15, 2007, promissory note, K-Swiss forgave $220,000 of that debt (leaving a balance owing of $280,000) and would mark that note "Cancelled", and petitioners were obligated to sign (1) a new promissory note for $280,000 in favor of K-Swiss, replacing the February 15, 2007, promissory note and (2) a deed of trust also in favor of K-Swiss and recordable against the Agoura Hills property to secure payment of the $280,000. The January 29, 2009, promissory note reiterated K-Swiss' agreement to cancel the February 15, 2007, promissory note. It also set forth the conditions for repayment of the $280,000; to wit, that the amount would be due and payable in full

[18] *Weiderman v. Commissioner*, T.C. Memo. 2020-109, pp. 3-5

upon the sale of the Agoura Hills property or, if the net proceeds from that sale were insufficient to pay this amount, then the amount would be due on January 31, 2010.

On January 29, 2009, in accordance with appendix A of the 2009 separation agreement, petitioners signed a deed of trust in favor of K-Swiss, securing the $280,000 loan with the Agoura Hills property. Petitioners delivered the signed deed of trust to K-Swiss and K-Swiss recorded it with the Los Angeles County, California, Registrar-Recorder. On February 6, 2009, in accordance with appendix A of the 2009 separation agreement, K-Swiss wired the $30,000 into petitioners' checking account with Bank of America.3 An unnamed representative of K-Swiss wrote "CANCELLED" across the February 15, 2007, promissory note.

On May 20, 2009, the Agoura Hills property sold for $1,665,000. Shortly before the sale Mrs. Weiderman and K-Swiss agreed to amend the 2009 separation agreement to reflect an additional forgiveness of petitioners' outstanding debt this time, $35,000 of the $280,000 loan.

The details of this agreement were memorialized in a May 12, 2009, letter from K-Swiss to Mrs. Weiderman that she countersigned on May 15, 2009 (May 12, 2009, letter). As stated in the May 12, 2009, letter, Mrs. Weiderman's indebtedness to K-Swiss was reduced from $280,000 to $245,000, with repayment of the $245,000 to occur as follows: (1) $200,000 to be paid upon the sale of the Agoura Hills property and (2) the balance to be paid in two equal installments on January 31, 2010 and 2011, respectively. Additionally, as stated therein, petitioners were obligated to sign a new promissory note to reflect the $245,000 debt.

In accordance with the May 12, 2009, letter petitioners executed an "[a]mended and [r]estated" promissory note for $245,000 in favor of K-Swiss and K-Swiss was paid the $200,000 upon the sale of the Agoura Hills property. Petitioners, however, failed to make the January 31, 2010, installment payment of $22,500. After letters dated February 12 and April 6, 2010, were sent by K-Swiss to Mrs. Weiderman regarding this failure, petitioners retained Carl D. Hasting, an attorney and a certified public accountant (C.P.A.) at CDH Associates, Inc., in Westlake Village, California, as legal counsel to explore settling the outstanding $45,000 debt. In June 2010, as a result of settlement discussions, petitioners and K-Swiss executed a settlement and release agreement whereby petitioners would pay K-Swiss $15,000 and K-Swiss would forgive the remaining $30,000 of outstanding debt (June 2010 settlement agreement). At times not established by the record petitioners and K-Swiss met the terms of this agreement.[19]

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[19] *Weiderman v. Commissioner*, T.C. Memo. 2020-109, pp. 5-8

Eventually the taxpayer reported $255,000 as excludable cancellation of indebtedness income from qualified principal residence indebtedness.

The Tax Court looked at the issue of whether the debt in question was secured by a qualified principal residence. The Court noted the following definition of what constitutes a debt being secured for these purposes:

> For these purposes, secured debt is any debt that is on the security of any instrument (such as a mortgage, deed of trust, or land contract) that makes the debtor's interest in the qualified residence specific security for the payment of the debt (1) under which, in the event of default, the residence could be subjected to the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated and (2) is recorded or otherwise perfected in accordance with the applicable State law. Sec. 1.163-10T(o)(1), Temporary Income Tax Regs., 52 Fed. Reg. 48417 (Dec. 22, 1987). In California, the State in which the Agoura Hills property was situated, a mortgage or deed of trust is perfected by recordation of the document at the office of the county recorder. Cal. Civ. Code secs. 1213 and 1214 (West 1989).[20]

The Court notes that the initial loan, which was used for acquiring the residence, was not secured in accordance with this definition:

> In accordance with the December 11, 2006, letter K-Swiss granted Mrs. Weiderman a $500,000 loan to help finance the purchase of a home in Southern California, and petitioners used most of the loan proceeds to purchase the Agoura Hills property. Although the loan was memorialized by the February 15, 2007, promissory note, this note did not provide that the indebtedness was secured by the Agoura Hills property. Additionally, the February 15, 2007, promissory note was not recorded with the Los Angeles County, California, Registrar-Recorder.14 The $500,000 loan was therefore unsecured debt. Since it was unsecured debt, it was not acquisition indebtedness within the meaning of section 163(h)(3)(B)(i), and thus K-Swiss' cancellation of $220,000 of that indebtedness as memorialized by appendix A of the 2009 separation agreement was not cancellation of qualified principal residence indebtedness within the meaning of section 108.[21]

But a later loan that refinanced this loan did have such a deed of trust recorded to perfect the lien—didn't that fix the problem? Unfortunately for the taxpayer, recording that loan did not solve the problem since this new debt now failed the first test—it was not used in acquiring, constructing or substantially improving the property. As the opinion continues:

> In accordance with appendix A of the 2009 separation agreement petitioners signed the January 29, 2009, promissory note which created an indebtedness of $280,000 in favor of K-Swiss, together with a deed

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[20] *Weiderman v. Commissioner*, T.C. Memo. 2020-109, p. 25

[21] *Weiderman v. Commissioner*, T.C. Memo. 2020-109, pp. 25-26

> of trust also in favor of K-Swiss and recordable against the Agoura Hills property to secure payment of that new indebtedness. Although K-Swiss recorded the deed of trust with the Los Angeles County, California, Registrar-Recorder, the $280,000 debt was not "incurred in acquiring, constructing, or substantially improving" the Agoura Hills property. Indeed, the January 29, 2009, promissory note conditioned repayment of the $280,000 upon the sale of the Agoura Hills property. Like the indebtedness of $500,000, the indebtedness of $280,000 was therefore not acquisition indebtedness, and thus K-Swiss' cancellation of $35,000 of that indebtedness as memorialized by the May 12, 2009, letter shortly before the sale of the Agoura Hills property was not cancellation of qualified principal residence indebtedness.
>
> Finally, in accordance with the May 12, 2009, letter, petitioners executed an "[a]mended and [r]estated" promissory note for $245,000 in favor of K-Swiss. Like the February 15, 2007, promissory note, the note for $245,000 did not provide that the indebtedness was secured by the Agoura Hills property. Additionally, like the $280,000 debt, the $245,000 debt was not "incurred in acquiring, constructing, or substantially improving" the Agoura Hills property; indeed, similar to the repayment of the $280,000, repayment of ($200,000 of) the $245,000 was conditioned upon the sale of the Agoura Hills property. The indebtedness of $245,000 was therefore no different from the indebtedness of $500,000 and $280,000 — it was not acquisition indebtedness, and thus K-Swiss' cancellation of $30,000 of the outstanding indebtedness to it of $45,000 in accordance with the June 2010 settlement agreement was not cancellation of qualified principal residence indebtedness.[22]

Note that under IRC §163(h)(3)(B) a refinancing of debt that is *already* qualified principal residence debt will not cause a problem. The resulting new debt will inherit the status of the old. But in this case the debt being refinanced was not qualified debt, thus the refinancing didn't fall under the special rule found at the end of IRC §163(h)(3)(B).

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[22] *Weiderman v. Commissioner*, T.C. Memo. 2020-109, pp. 26-28

SECTION: 6031
IRS PROPOSES TO ADD DETAILED SCHEDULES K-2 AND K-3 FOR INTERNATIONAL PARTNERSHIP ITEMS

Citation: "Proposed International Changes to Form 1065, U.S. Return of Partnership Income for Tax Year 2021," IRS Website, 7/14/20

The IRS has released drafts of two new partnership tax forms for 2020 partnership returns, adding new Schedules K-2[23] (20 pages) and K-3[24] (22 pages) along with draft instructions for Schedules K-2[25] (25 pages) and K-3[26] (11 pages). The IRS announced these new forms on their website on July 14, 2020.[27]

The IRS in the announcement provides the following reason for issuing these new forms:

> The Treasury Department and the IRS are proposing updates to the partnership form for tax year 2021 (filing season 2022). The updates will provide greater clarity for partners on how to compute their U.S. income tax liability with respect to international tax matters, including how to compute deductions and credits. The redesigned form and instructions also give useful guidance to partnerships on how to provide international tax information to their partners. This proposed form would apply to a partnership required to file Form 1065, but only if the partnership has items of international tax relevance (generally foreign activities or foreign partners). The proposed changes would not affect domestic partnerships with no items of international tax relevance.

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[23] Schedule K-2, *Partners' Distributive Share Items—International* (Draft), July 8, 2020, https://www.irs.gov/pub/irs-utl/DRAFT-Sch-K-2-Form-1065.pdf (retrieved July 17, 2020)

[24] Schedule K-3, *Partner's Share of Income, Deductions, Credits, etc.—International* (Draft), July 8, 2020, https://www.irs.gov/pub/irs-utl/DRAFT-Sch-K-3-Form-1065.pdf (retrieved July 17, 2020)

[25] Partnership Instructions for Schedule K-2 (Form 1065) and Schedule K-3 (Form 1065) (Draft), July 9, 2020, https://www.irs.gov/pub/irs-utl/DRAFT-Sch-K-2-Instructions-Form-1065.pdf (retrieved July 17, 2020)

[26] Partner's Instructions for Schedule K-3 (Form 1065) (Draft)

[27] "Proposed International Changes to Form 1065, U.S. Return of Partnership Income for Tax Year 2021," IRS website, July 14, 2020, https://www.irs.gov/businesses/1065-form-changes (retrieved July 17, 2020)

The partnership instructions provide the following information regarding who will be required to file these forms:

> The partnership need not complete this schedule if the partnership does not have items of international tax relevance (typically, international activities or foreign partners).
>
> Any partnership required to file Form 1065 and that has items relevant to the determination of the U.S. tax or certain withholding tax or reporting obligations of its partners under the international provisions of the Internal Revenue Code must complete the relevant parts of Schedule K-2 and Schedule K-3. See each part and section for a more detailed description of who must file each part and section. Penalties may apply for filing Form 1065 without all required information or for furnishing Schedule K-3 to partners without all required information.[28]

Schedule K-2, *Partners' Distributive Share Items—International* (Draft), contains the following sections, each providing detail on items previously found on pre-2020 Schedule K:

- Part I - Partnership's Share of Current Year International Transaction Information
- Part II - Foreign Tax Credit Limitation
  - Section 1—Gross Income
  - Section 2—Deductions
- Part III Other Information for Preparation of Form 1116 or 1118
  - Section 1—R&E Expenses Apportionment Factors
  - Section 2—Interest Expense Apportionment Factors
  - Section 3—Foreign Taxes
- Part IV Other Foreign Transaction Information for U.S. Partners
  - Section 1—Information on Partners' Section 250 Deduction With Respect to Foreign-Derived Intangible Income (FDII)
  - Section 2—Other Tax Information
  - Section 3—Distributions From Foreign Corporations to Partnership
- Part V Information on Partners' Section 951(a)(1) and Section 951A Inclusions

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[28] Partnership Instructions for Schedule K-2 (Form 1065) and Schedule K-3 (Form 1065) (Draft), p. 1

- Part VI Information To Complete Form 8621
  - Section 1—General Information on Passive Foreign Investment Company (PFIC) or Qualified Electing Fund (QEF)
  - Section 2—Additional Information on PFIC or QEF
- Part VII Partnership's Interest in Foreign Corporation Income (Section 960)
- Part VIII Partners' Information for Base Erosion and Anti-Abuse Tax (Section 59A)
  - Section 1—Applicable Taxpayer
  - Section 2—Base Erosion Payments and Base Erosion Tax Benefits
- Part IX Foreign Partners' Character and Source of Income and Deductions
  - Section 1—Gross Income
  - Section 2—Deductions, Losses, and Net Income
  - Section 3—Allocation and Apportionment Methods for Deductions
  - Section 4—Section 871(m) Covered Partnerships

The Schedule K-3 to be provided to each partner contains the following sections:

- Part I Partner's Share of Current Year International Transaction Information
- Part II Foreign Tax Credit Limitation
  - Section 1—Gross Income
  - Section 2—Deductions
- Part III Other Information for Preparation of Form 1116 or 1118
  - Section 1—R&E Expenses Apportionment Factors
  - Section 2—Interest Expense Apportionment Factors
  - Section 3—Foreign Taxes
- Part IV Other Foreign Transaction Information for U.S. Partners
  - Section 1—Information on Partner's Section 250 Deduction With Respect to Foreign-Derived Intangible Income (FDII)
  - Section 2—Other Tax Information

- Section 3—Distributions From Foreign Corporations to Partnership

- Part V Information on Partner's Section 951(a)(1) and Section 951A Inclusions

- Part VI Information To Complete Form 8621

  - Section 1—General Information on Passive Foreign Investment Company (PFIC) or Qualified Electing Fund (QEF)

  - Section 2—Additional Information on PFIC or QEF

- Part VII Partner's Share of Partnership's Interest in Foreign Corporation Income (Section 960)

- Part VIII Partner's Information for Base Erosion and Anti-Abuse Tax (Section 59A)

  - Section 1—Applicable Taxpayer (see instructions)

  - Section 2—Base Erosion Payments and Base Erosion Tax Benefits

- Part IX Foreign Partner's Character and Source of Income and Deductions

  - Section 1—Gross Income

  - Section 2—Deductions, Losses, and Net Income

  - Section 3—Allocation and Apportionment Methods for Deductions

  - Section 4—Section 871(m) Covered Partnerships

- Part X Foreign Partner's Distributive Share of Deemed Sale Items on Transfer of Partnership Interest

The IRS is looking for comments on these new forms. As the posting on the website states:

> The IRS is seeking comments from stakeholders during a 60-day period which will begin on the date of the press release. Those interested are invited to send comments to lbi.passthrough.international.form.changes@irs.gov with the subject line: "International Form Changes."
>
> Given the sweeping nature of the changes, the Treasury Department and the IRS are also planning a series of listening events to take comments and answer questions about the form. More details about participating in these events will be posted as soon as they are finalized. Please check back for further updates

SECTION: 6109
PTIN FEES TO RESUME FOR 2021, SET AT $21 PLUS CONTRACTOR FEE OF $14.95

Citation: TD 9903, 7/17/20

The IRS has finalized regulations to set the PTIN fee at $21 plus a $14.95 third-party contractor fee as the agency begins to resume collection of this annual fee from paid tax preparers.[29] The final regulations retain the same fees as were found in the proposed regulations originally announced on April 15, 2020.

The IRS had ceased collection of the PTIN user fee following an initial loss in the US District Court for the District of Columbia in the case of *Steele v. United States*, 260 F. Supp. 3d 52 (D.D.C. 2017)[30] that found the IRS did not have the authority to charge such a fee. However, the Court of Appeals for District of Columbia found that the IRS did have the authority to charge such a fee, reversing that earlier decision of the lower court in *Montrois v. United States*, 916 F.3d 1056 (D.C. Cir. 2019).[31]

Although litigation continues over the amount of the fee the IRS may charge, the injunction against imposing the fee was lifted and the IRS has decided to begin collection of the fee again for those preparing returns in 2021.[32]

The fee is set at $21 in addition to a fee charged by the contractor.[33] The contractor fee was announced by the IRS in IR-2020-159 as $14.95.[34]

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[29] TD 9903, July 17, 2020, https://s3.amazonaws.com/public-inspection.federalregister.gov/2020-15446.pdf (retrieved July 16, 2020)

[30] TD 9903, Summary of Comments, C.

[31] TD 9903, Summary of Comments, C.

[32] TD 9903, Summary of Comments, C.

[33] Reg. §301.13(b)

[34] "IRS announces 2021 PTIN fees for tax return preparers," IR 2020-159, July 15, 2020, https://www.irs.gov/newsroom/irs-announces-2021-ptin-fees-for-tax-return-preparers (retrieved July 16, 2020)