2015 YEAR-END TAX UPDATE

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SOME THOUGHTS FOR THE COMING YEAR ON TAXES, MONEY AND LIFE ITS OWN SELF

> *"MONEY, IT'S A GAS, GRAB THAT CASH WITH BOTH HANDS AND MAKE A STASH."*
>
> **- Pink Floyd, "Money"**

> *"WELL THE BITE KEEPS GETTING BIGGER AND THE PAYCHECK KEEPS GETTING SMALL, YOU KNOW THE IRS, THEY AIN'T GONNA REST, TIL THEY THINK THEY'VE GOT IT ALL."*
>
> **- Johnny Paycheck, "Me and the IRS"[1]**

> *"THE GOVERNMENT THAT ROBS PETER TO PAY PAUL CAN ALWAYS DEPEND UPON THE SUPPORT OF PAUL."*
>
> **- George Bernard Shaw**

> *"THE AVOIDANCE OF TAXES IS THE ONLY INTELLECTUAL PURSUIT THAT CARRIES ANY REWARD."*
>
> **- John Maynard Keynes**

> *"IF YOU EVER GET ANNOYED, LOOK AT ME, I'M SELF-EMPLOYED. I LOVE TO WORK AT NOTHING ALL DAY."*
>
> **Bachman-Turner Overdrive, "Taking Care of Business"**

1 Johnny, of course, was most famous for his 1977 classic, "Take This Job and Shove It."

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A BRIEF LOOK BACK

Where We Are Now – The View from Bucks County, Thanksgiving 2015

1. "Make America Great Again!" Sounds like a terrific idea, even for those (few?) of us who think America is already great and who are somewhat concerned about deviating from the late Yogi Berra's dictum that "if it ain't broke, don't fix it."

2. That wisdom notwithstanding, when election time rolls around, our politicians seem perfectly incapable of refraining from trying to make America great again by "improving" our tax system and, as you may have noticed, dear reader, 2016 is a presidential election year, with 2015 serving as a hilarious warm-up act to that main event.

3. With sport blossoms on plants from warm late November weather suggesting some climate change issues, and threats of terrorism from ISIS (or ISIL or Daesh, or whatever the hell these devils call themselves), one can't help but wonder why those candidates pandering for your vote trouble themselves so greatly with our tax system.

4. Now, admittedly, our tax system is not without flaws (and some pretty damned big ones, by the way), but the amount of time devoted to the issue seems wildly out of line with the degree to which Americans care about the tax system. Hell, half of us don't pay federal income taxes (usually – but not always – because our taxable incomes are too low); the 1 percent hire brilliant practitioners, who wasted seemingly good educations to become tax advisers who help the rich stay that way; and the middle class realizes that it is getting squeezed and screwed, but seems powerless to do anything about it, unlike their ancestors from Concord, Lexington and Boston who knew just what to do about oppressive taxes.

5. Perhaps the only saving grace of this "fascination with taxation" is the abundance of colorful (okay, bizarre) ideas that candidates on both sides of the aisle have proffered in order to gain your support. Without intending – or pretending – to be exhaustive (or even fair) about it, your author presents below a few of his favorite "tax hits" from the candidates:

    a. Secretary Clinton's plan would raise some folks' taxes, lower other folks' taxes and seems largely intended not to offend anyone likely to vote for her, which, I suppose, is consistent with the philosophical leanings of the "Clinton Dynasty." Besides, give her some time and her views may change.

    b. A one-handed clap for Dr. Ben Carson, who favors a 10 percent tax rate, paid for by eliminating deductions, including those for mortgage interest and charitable contributions. Dr. Carson bravely and correctly points out that there were charities before there was an income tax and that people bought homes before there were tax deductions for mortgage interest, and a 10 percent tax is akin to tithing to the church of your choice. Since interest rates for investors are likely never to go up again, why not limit the tax on Americans to 10 percent. Does the math add up? At my age and at 10 percent, who cares!

c. Carly Fiorina, who was widely pilloried as CEO of Hewlett-Packard for cutting thousands of jobs, would employ the lessons she learned in the private sector by cutting the Internal Revenue Code from approximately 70,000 pages to three! Carly, really? Three pages? What would they say? I mean, how much can you cram into three pages? Even the Lord needed seven days to create heaven and earth, and it took Moses two tablets just for your Ten Commandments.

d. But the clear winner in the race to the bottom for tax reform is Senator Ted Cruz, who has vowed to do away with the IRS. Senator Cruz's tax plan is, apparently, so simple that taxes collect themselves. Hopefully, he does not similarly plan to defend the United States by doing away with our Armed Forces. Cruz is said to have graduated from Princeton University and Harvard Law School, facts that should be relevant to those families pondering the wisdom of incurring the expense of an Ivy League education for their children.[2]

6. Having considered the tax plans of the various candidates, your author once again intends to support the "None of the Above Party." As young physicians are taught, "first do no harm."

7. I likely would support a candidate who could fix Philadelphia's major sports teams (although three cheers for the Temple Owls) but, as I occasionally tell clients, we heal the sick; we can't raise the dead!

8. When I sat down to prepare these materials, my recollection was that not all that much important happened this year in the tax arena other than the autumn thunderbolt which will importantly change partnership taxation (more on that below). Similarly, I was struck by the paucity of stupid or humorous decisions that usually populate the field and provide so much fodder for these scribblings. Somewhat to my surprise, however, upon further review, I found several rulings and decisions worthy of your attention, some of which are detailed below. As for tax humor, well your political candidates should supply tons of that going forward. Too bad that the joke is on us. So please continue, dear reader, in the hope that this outline will provide some useful tidbits for your practice and brighten your day. As always, I am honored by your time and attention.

2 In the interest of full disclosure, Republican presidential candidate Donald Trump attended the University of Pennsylvania, as did your author, and former Presidents Bush and Clinton, of course, had ties to Yale. Detect a disturbing pattern here?

THE YEAR IN REVIEW

A. Some Fun with Numbers.

1. Self-employment tax and FICA limits stay the same for 2016. The wage base remains $118,500. The FICA tax rate for employers and employees continues to be 6.2 percent. Employers and employees also pay a 1.45 percent Medicare Tax on all pay, but employees (not employers) earning more than $200,000 ($250,000 for married taxpayers) must pay an additional 0.9 percennt on wages above those amounts.

2. Similarly, Social Security benefits will not go up in 2016, again because of the lack of inflation. Try telling that to folks who pay for such frivolities as broadband Internet access, tuition for their kids, and medical insurance premiums.

3. Most dollar ceilings for retirement plans remain the same (e.g., $18,000 for §401(k) contributions). The "catch up" §401(k) limit for taxpayers 50 years or older is $6,000 for 2016, and, Lord knows, since the Great Recession, we've got lots of catching up to do.

4. Approximately 800,000 Americans who purchased insurance through HealthCare.gov received inaccurate Forms 1095-A from the Centers for Medicare and Medicaid Services. (This was not an IRS error.) As a result, some taxpayers received too much financial assistance and others too little in premium subsidies. The announcement was made about the same time CMS offered a special enrollment period this winter for the purchase of insurance under the Affordable Care Act (needed to avoid tax penalties) and must have done wonders to build confidence in ObamaCare. (See, also, B.1. below.)

5. And speaking of penalties, IRS Commissioner Koskinen reported in July that 7.5 million Americans paid a tax penalty in the 2015 filing season because they failed to have health insurance coverage. These "shared-responsibility payments" aggregated about $1.5 billion, with 40 percent of the penalties being $100 or less. (Nevertheless, approximately 85 percent of those penalized still received income tax refunds.) The average premium tax credit for 2014, on the other hand, was $3,400 per taxpayer.

6. A Treasury Inspector General's Report this May found that 1,580 IRS employees had "wilfully evaded" taxes during the 10-year period from 2004 through 2013. Some received promotions, raises and bonuses (I guess the ones who were best at it) even after they were caught, but 25 percent were fired and another 14 percent chose to resign or retire.

    a. Because IRS employs about 85,000 people, the degree of compliance by IRS personnel is actually very good.

    b. Improperly claiming dependents and the credit for first-time homebuyers were popular ploys. Undoubtedly, there were many more Americans during this time period – which included the Great Recession – who wished that their children and their houses were imaginary.

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7. IRS announced in May that data breaches had affected 114,000 taxpayers; hackers apparently accessed this data from the ever popular "Get Transcript" application on irs.gov. IRS agreed to provide free credit monitoring services for those affected. In August, to no one's great surprise, IRS "amended" the number of hacked accounts to 330,000. An additional 281,000 failed attempts at breaching accounts was also reported. (See, also, "Accounting and the Profession" below.)

    a. In recently representing a non-filer, your author considered advancing as a defense against "willfulness," the client's professed concern that if he filed tax returns, his personal data might have been stolen by hackers. In the end, however, we went with that old standby: "the Devil made me do it."

B. Accounting and the Profession

1. In February, IRS announced that those taxpayers who received incorrect Forms 1095-A (as noted, the Form needed to compute the §36B premium tax credit), could – but didn't have to – file amended 2014 tax returns.

2. Wonder how a third-of-a-million taxpayer accounts could have been hacked? The Commissioner, in appearing before a Senate Committee, testified that "we're running applications we were running when John F. Kennedy was president."

    a. The Service's goal, said Commissioner Koskinen, is for IRS to get to a level where Americans can do all their tax transactions online. Oh, yeah? I don't think so! Not for the Poor Boy – I'll just do it the old fashioned way, thank you.

    b. Nearly 145,000 foreign financial institutions are about to provide IRS with data under FATCA. Given the state of IRS's computer systems, sounds like a worldwide hackers' paradise to me.

3. The number of audits of individual tax returns performed by IRS in the first nine months of 2015 fell to 1.2 million, the lowest level in a decade, due to budget cuts. Who needs Senator Cruz's tax plan anyway? IRS expects to lose about 1,800 enforcement personnel through attrition and will reduce its spending on enforcement this year by $130 million. If you think "less is more," and are into filing false returns, the Service's budget woes are for you.

4. In Legal Advice Issued by Associate Chief Counsel 2015-004, IRS has provided useful guidance on who has the authority to sign powers of attorney for a partnership or LLC in a variety of circumstances, including in connection with TEFRA partnership level examinations. The advice covers topics such as POA's from direct and indirect partners; a discussion of circumstances in which the POA must be from someone who can act for the partnership; and POA's from non-owner LLC managers. The new partnership audit regime discussed below will render much of this guidance moot.

5. IRS has advised the payroll industry that advertising on employee copies of Form W-2 is prohibited. A substitute Form W-2 with advertising and/or coupons will be deemed an incorrect payee statement, subject to a $50 penalty.[3]

3 Darn, I wish I had thought to sell ads on Forms W-2 years ago! Think of it – the "Go Daddy W-2 Form."

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6. The IRS Office of Professional Responsibility considered in February an inquiry from a practitioner as to whether a practitioner who sends Forms 1099-C (Cancellation of Debt) to delinquent or nonpaying clients would run afoul of his obligations under Circular 230. Although OPR "punted" on the ground that it lacked sufficient information to arrive at a conclusion, the clear implication of the guidance is that a pattern of sending Forms 1099-C may well be inconsistent with the standards of Circular 230.

7. A damning report from the International Consortium of Investigative Journalists and other media sources described vividly the extent to which HSBC's Swiss private bank helped clients evade taxes in their home countries, as well as the European Union tax on bank deposits. HSBC's client roster included a number of politicians, arms dealers, rock stars and Mexican and Latin American drug cartels. American banks, of course, will not open up accounts for legitimate purveyors of medical marijuana, but welcome foreign dictators as clients.

8. The British, often known for their civility (although some may beg to differ), through Her Majesty's Revenue and Customs Office, politely asked the country's solicitors (i.e., lawyers) if they would voluntarily disclose their tax indiscretions in return for reduced penalties. Similar past programs had targeted plumbers, medical professionals, stock traders and electricians. On information, much of the perceived delinquency by U.K. solicitors involves the existence and employment of undisclosed offshore accounts.

C. Selected Real Estate Developments

1. A Law 360.com article this past winter posited that shareholder activists were increasingly pressing boards of directors of companies with REIT-eligible assets to take advantage of a seeming broadening by IRS of the definition of real property by spinning off those assets into REITs. Regulations proposed last year concluded that assets such as billboards and data centers could constitute real property for REIT purposes.

2. In September, however, IRS Notice 2015-59 and Rev. Proc. 2015-43 announced a new non-rule policy with respect to "PropCo/OpCo" spinoffs under § 355. In a typical PropCo/OpCo transaction, a subsidiary of operating company (PropCo) would purchase real property from its parent (OpCo), lease it back to OpCo, and elect REIT status. If the real estate owned by either PropCo or OpCo is the basis for a REIT election, IRS will not rule on these spinoffs absent "unique and compelling" circumstances. As one might expect, given the consequences of a failed § 355 transaction, these IRS announcements have had a chilling effect on this kind of planning. Proposed legislation is in the works to prevent or restrict this planning.

3. In CCA 201537022, a taxpayer in the business of buying raw land, subdividing it and selling the improved parcels to home builders purchased a parcel of property and assisted the local municipality in creating two districts to provide necessary public improvements. The taxpayer paid expenses and advanced funds needed to create the districts and to develop the parcel, and the districts issued bond anticipation notes to the taxpayer.

    a. The taxpayer treated its advances as additional costs in developing its parcel, accounting for the advances as capitalized costs allocable to the lots under the "alternative cost method" of Rev. Proc 92-29. That Revenue Procedure allows a developer to allocate to lots sold a proportionate share of common improvement costs (including estimated future construction costs) without regard to whether economic performance had occurred under § 461. Corrections to the amounts that have been claimed are made in subsequent years.

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   b. The Chief Counsel Advice agreed with the taxpayer's treatment of its advances to the districts as increasing its basis in the lots, and held that amounts received from the districts in payment of the bond anticipation notes are to be treated as a reduction in taxpayer's estimated common improvement costs (i.e., a reduced allocation to the basis of the lots sold in the year of repayment and subsequent years). Payments from the district after all the lots are sold must be reported as ordinary income, and no portion of the district payments can be treated as tax-exempt interest under §103.

4. CCA 201505038 holds that where a lessor elects to treat its lessee as qualifying for the § 47 rehabilitation credit, the lessee must include ratably in income 100 percent of the credit amount. A drafting error in former § 48(d)(5)(A) suggested that only 50 percent of the credit amount needed to be so treated.

5. In *Redisch v. Commissioner*, the Tax Court denied taxpayers a loss from the sale of their Florida condominium, finding that taxpayers' purported conversion of the condo from personal to rental use was not serious and their attempts to rent the property lackluster. The case is a useful primer on what it takes to succeed in converting a residence from personal use to income producing property.

6. In *Stine, LLC*, a District Court in Louisiana held that the taxpayer had carried its burden of proving that two retail stores it built were first placed in service (for depreciation purposes) in 2008, even though as of the last day of that year, the stores were not open for business and the certificates of occupancy that the taxpayer had received were limited to allowing the taxpayer to receive equipment, shelving and merchandise and did not allow customers to enter the buildings.

   a. The Court found that there is no "open for business" requirement in the § 167 Regulations. Reg. § 1.167(a)-11(e)(1)(i) provides in part that property is first placed in service when it is in a condition or state of readiness and availability for a specially assigned function.

   b. One suspects that another court might have reached a different conclusion than the court in this very favorable case.

D. Exempt Organizations

1. In *Game Hearts v. Commissioner*, the Tax Court held that an organization that promotes playing low stakes or free tabletop games, such as card games and role-playing games, in an alcohol-free environment, in lieu of patronizing casinos or bars, did not qualify for tax exemption. The taxpayer argued that it promotes the general welfare by encouraging community-minded sobriety, but the court concluded that the organization's services are also provided by for-profit entities and that its activities are available to anyone at least 18 years old and sober, not to a limited charitable class.

   a. Your author believes that tax-exemption should have been denied on the ground that the organization's activities were terminally boring.

2. In PLR 201544025, IRS ruled that a weekly flea market operated by the alumni association of a college was not substantially related to its exempt purpose of providing civic and financial support to the college, and that the fees received from participating market vendors were not rents excluded from UBTI.

   a. At least the flea market beats alcohol-free, low stakes tabletop games.

3. In a more serious vein, a California Appellate Court ruled in September that its state's Blue Cross and Blue Shield health care plans must pay the same gross premium tax as that imposed on other commercial insurance companies, since the Blues earn the bulk of their revenue from insurance products. The taxpayers argued that they were health care services providers, rather than insurers, for regulatory purposes.

    a. This is one of a series of legal attacks on Blues organizations throughout the United States.

    b. Blue Cross and Blue Shield organizations are unusual tax creatures. Prior to the Tax Reform Act of 1986, they were federally tax exempt; now, they are taxed generally as stock property and casualty companies. In Pennsylvania, Blue Cross and Blue Shield organizations are nonprofits.

E. Partnership Items

1. In a major and surprising change, the 2015 Bipartisan Budget Act replaces the existing TEFRA procedures with a new and materially different regime for the auditing of partnership (including LLC) returns. The new regime is intended to overcome difficulties that the IRS has in auditing large partnerships. A detailed discussion of the new rules is beyond the scope of these materials, but key aspects of the audit procedures are described below. The new rules are effective for years beginning on or after January 1, 2018, but their impact will be felt sooner as practitioners will have to consider what new, different or additional provisions should be included in partnership agreements.

    a. Under the new provisions, the default rule calls for IRS to assess and collect taxes (as well as interest and penalties) resulting from audit adjustments at the **partnership**, rather than the partner, level. In other words, **the partnership will have to pay the tax**. Partnerships are given an election, instead, to pass the liability to those persons who were partners during the year to which the audit adjustment relates. Note, however, that under this elective approach, it is the partnership – not IRS – that must determine how to flow the adjustments through to the partners and then report the adjustments to the partners and IRS.

    b. Partnerships with 100 or fewer partners during the year can opt out entirely from the new procedures on a year-by-year basis by filing the opt-out election with their tax returns. If a partnership elects out, IRS will issue a separate audit report to each partner, who can then independently decide whether or not to challenge the report under the deficiency procedures which otherwise apply to individuals. Importantly, however, partnerships with 100 or fewer partners **cannot** elect out if any of their partners are other partnerships or LLC's or trusts.

    c. Under the default rule, IRS will, as a general matter, determine the partnership level tax by netting all adjustments and taxing the result at the highest individual or corporate tax rate in effect for the year. Partnerships are given the opportunity to show IRS why the tax should be lower, e.g., if the adjustment is a capital gain item or if one or more of the partners are exempt organizations, but it may be burdensome on partnerships (especially tiered entities) to obtain the partner-level information that might lower the tax. If the audit **increases** a partnership loss, it appears that the benefit of that adjustment goes to those persons who are partners in the year the adjustment is made, not to those who were partners in the year to which the adjustment relates. That result can perhaps be avoided by filing an amended return for the audited year.

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d. As noted, partnerships can avoid the imposition of the tax at the partnership level by electing an alternative procedure under § 6226. Under that election, the partnership will issue adjusted Schedules K-1 to those persons who were partners during the year to which the audit adjustments relate, and the partners must then take the adjustments into account on their tax returns for the year in which they receive the adjusted K-1's. This will not be nearly as easy as it sounds. Recall that the partnership – not IRS – must flow through the adjustments to the partners. If the partnership has numerous partners, or if many partners have since left and others have been admitted, it may be too difficult, or time consuming, or expensive, for the partnership to prepare all of the amended K-1's. In addition, the interest rate on deficiencies under the elective procedure is 2 percent higher than the normal rates.

e. Partnerships must designate a "partnership representative" who has the sole authority to act for the partnership under the new audit regime. The representative need not be a partner. The partnership representative has much greater authority than the existing "tax matters partner," since the partnership and all partners are bound by the actions of the representative.

f. The new audit regime has many unanswered questions, and extensive guidance will be required. Moreover, investors and their advisers considering the acquisition of an interest in an existing partnership may wish to seek "protection" against historic tax liabilities should the partnership follow the default approach. Will lenders insist that partnerships elect the alternate procedure? Undoubtedly, we will be discussing these rules for many years to come.

2. The Highway Trust Fund extension law passed this July changes the return due dates of partnerships and C corps effective for returns for years beginning on or after January 1, 2016. The filing date for partnerships will be accelerated by one month, so returns for a calendar year partnership will be due on March 15 of the following year, just as is the case with S corporations. A six-month (i.e., to September 15) extension, rather than the current five months, will be allowed. The return due date for C corporations will be extended to the 15th day of the fourth month of the following year, rather than the current 15th day of the third month. The automatic extension period becomes five, rather than six, months.

    a. The maximum extension period for returns of several other entities – including trusts and exempt organizations – will be changed. FINCEN Form 114 (the former FBAR) will become due on April 15 (rather than June 30), but a six-month extension period will be allowed.

3. Final regulations under § 706(d), dealing generally with the determination of a partner's distributive share of gain or loss when an interest varies during the year, were adopted in July. Proposed regulations dealing with the determination of a partner's share of cash basis items were issued at the same time.

4. CCA 201525010 holds that the § 752 regulations do **not** determine whether a debt is recourse or nonrecourse for purposes of determining whether on foreclosure of property, a partnership has debt cancellation income or gain from the sale of property for purposes of § 1001 and Sections 61(a)(12) and 61(a)(3). According to IRS, the § 752 regulations are limited to determining the partners' basis in the partnership; a factual analysis of the loan documents is required per the CCA to make the § 1001 analysis. (Of course, the result may be the same in either event.)

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F. Some Procedural Matters

1. In September, IRS announced that it was closing the program allowing taxpayers and IRS Appeals to request binding arbitration on unresolved issues. Why shutter the program? In its 14-year history, a grand total of two cases were settled through arbitration. Should have been gone a long time ago.

2. In Notice 2015-72, IRS set forth a proposed Revenue Procedure updating its procedures for administrative appeals of docketed cases contained in Rev. Proc. 87-24. By and large, the new procedures are intended, generally, to ensure review by Appeals. Nevertheless, the new procedures detail several instances in which counsel will not refer a docketed case for settlement consideration by Appeals, including where the case has been designated for litigation by counsel, where it involves an important issue common to other cases in litigation, and the ever popular issuance of the Notice of Deficiency by Appeals.

3. CCA 201516065 holds that persons engaged in a trade or business in U.S. Territories who receive more than $10,000 cash in a transaction (or related transactions) must file Form 8300 with IRS, because they are subject to the general jurisdiction of the IRS. See § 6050I.

4. Some of you may know that there are a number of special provisions in the Code dealing with international shipping activities. In particular, § 1352 permits corporations to elect to be taxed under a tonnage tax regime, rather than the regular U.S. corporate income tax. Under the alternative regime, § 1359 permits an operator who sells a qualifying vessel to elect non-recognition of gain if a qualifying replacement vehicle is acquired during the replacement period. The replacement period ends three years after the close of the first year in which gain is realized, or such later date as IRS may designate on application by the taxpayer at the time and in the manner as IRS prescribes in regulations. § 1359(b). (One doesn't find replacement vessels as readily as, say, Ford Fiestas.) No regulations have ever been issued.

    a. In CCA 201537021, IRS concluded that it **must** consider a vessel operator's application under § 1359(b). The absence of regulations is not an acceptable basis for refusing to apply the substantive provisions of a Code section. The CCA gives no guidance as to the form or contents of such an application.

5. Bloomberg News reported this July that the Obama administration "quietly" afforded a victory to inverted U.S. companies when the Department of Homeland Security endorsed a legal memo from Ingersoll-Rand, PLC that concluded that U.S. trade agreements with other countries had the effect of invalidating a 2002 law that banned U.S. companies that had inverted from eligibility for government contracts. I-R had changed its address in 2001 from New Jersey to Bermuda – a most understandable switch – and then again in 2009 to Ireland.

6. CCA 201513003 disallowed a deduction for amounts paid to the United States in lieu of proceedings that would result in criminal or civil forfeiture for fraud, even though the payment was earmarked for restitution to the fraud victims. Section 162(f) denies a deduction for fines or similar penalties paid for violation of a law. Although § 1.162-21(b)(2) provides that compensatory damages paid to a government do not constitute a fine or penalty, the facts in this case – which included a deferred prosecution agreement that provided for the payment – led chief counsel to conclude that the payment was specifically made in lieu of forfeitures for criminal or civil fraud.

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7. Proposed regulations removing the requirement to attach a copy of a § 83(b) election to a taxpayer's return were issued this summer. Though applicable as of January 1, 2016, IRS said taxpayers could rely on this change for property transferred in 2015. The requirement to attach a copy of the election to the tax return had prevented taxpayers from filing electronically, according to IRS.

8. The "Fixing America's Surface Transportation (FAST) Act," signed into law on December 4, requires IRS to notify the State Department of taxpayers with "seriously delinquent tax debt," and requires the State Department to revoke the passports of those taxpayers until the debt is resolved. A seriously delinquent tax debt is one that exceeds $50,000 and for which a notice of lien has been filed. Although this provision was enacted too late for a thorough discussion in these materials, a few observations are in order. First, U. S. taxpayers living abroad could find themselves without a U.S. passport, which could be like being up that proverbial creek without a paddle for some, but which other taxpayers might celebrate. Second, although our politicians might restrict immigration to the United States of persons from certain locations or with certain beliefs, we can be comforted by the knowledge that our own tax delinquents will remain here. "You can check out any time you want, but you can never leave."

G. Selected Income Inclusion Matters

1. In a case of first impression, the Tax Court held in *Perez v. Commissioner* that $20,000 in payments to the taxpayer from her consensual performance as an egg donor for use by infertile couples was taxable compensation. Although the court accepted Ms. Perez's "utterly sincere and credible" testimony as to the pain and suffering she incurred in the medical procedures needed to harvest the eggs, and the contracts she signed designated the payments as consideration for pain and suffering (and not for the sale of body parts), the court concluded that the exclusion from income of § 104(a)(2) for "damages" for personal physical injury does not apply where the taxpayer knew in advance that physical injury or sickness would occur but nevertheless consented to the procedure. To conclude otherwise, said the court, might prompt athletes such as boxers or hockey players, and workers in mines or on farms, to argue that at least part of their compensation was nontaxable.

2. In *Speer v. Commissioner*, the Tax Court ruled that $53,000 in unused vacation and sick leave accrued by a Los Angeles policeman while on temporary disability leave could not be excluded from income as amounts received through a workers' compensation act. The L.A. Workers' Compensation Act does not cover payments issued after the disability period ends.

3. Dr. Darrel Wyatt, a physician recruited to the underserved medical community of Putnam County, Fla., by a local hospital, entered into a Recruiting Agreement with the hospital that guaranteed him for a year a loan of $33,000 per month, less the amount of the gross receipts from his practice for each such month. If, after the 12 months, he continued his practice in the area, the loan would be forgiven at a rate of 1/36 per month. The good doctor in fact continued his practice in the area, and some $260,000 paid under the Agreement was forgiven over the next 36 months. When Wyatt, who included the cancelled amounts in income, was unable to pay his taxes in 2009, he argued that the hospital advances constituted a nonrecourse loan that he was not liable to repay and, therefore, that he didn't have income when the loan was forgiven. The Tax Court had no trouble in concluding that the forgiveness gave rise to income. Stick to medicine, Doc: Tax law is not for you.

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4. IRS has announced that the value of free identity theft protection services provided to victims of data breaches is not includible in income. Given the Service's own experience with data breaches (described earlier in this document), the result seems eminently fair in the absence of any guidance on this subject. The exclusion does not apply to cash offered in lieu of identity protection services, or to proceeds received under an identity theft insurance policy.

H. Corporate Developments

1. In *Williams v. Commissioner*, the Tax Court held that the passive activity loss rules of § 469 and, in particular, the self-rental rules that treat otherwise passive income as nonpassive, apply to S corporations, even though § 469 does not by its terms specify that it applies to S corporations. In this case, the taxpayer and his wife were the sole shareholders of an S corporation that leased real estate to a C corporation that they also owned and in the business of which Mr. Williams materially participated. The court sustained IRS' treatment of the rental income as nonpassive under the self-rental rule, while upholding the validity of § 1.469-4(a), which defines a taxpayer's activities to include those conducted through an S corp.

2. In LAFA 20153001F, a merger of a consolidated group using the LIFO method into a QSub, followed by a QSub election for the members of the group, triggered a LIFO recapture amount. Although §1363(d)(1) does not, on its face, apply to QSubs, regulations to § 1363 support the conclusion that LIFO recapture applies to QSub elections as well as to S corp. elections. In a rather complicated factual and legal analysis, the advice also concludes that the LIFO recapture income had to be reported on a single transaction return separate from the group's consolidated income.

3. In *Eaglehawk Carbon, Inc. v. U.S.*, the Court of Federal Claims held that the (lower) interest rates on overpayments in excess of $10,000 by C corporations (as compared to those applicable to noncorporate taxpayers) applied to refunds of coal sales excise taxes by the taxpayer, an S corporation. In other words, S corporations are "corporations" for purposes of the interest rules of § 6621. The court relied on the definition of a corporation in § 7701(a), as well as being "consistent with common sense." (As if common sense ever had much to do with tax law.)

I. Some Other Good Stuff That You Might Have Missed.

1. The IRS has announced that it will deny tax refunds and credits of taxes withheld from non-U.S. persons unless the taxes were properly deposited in the U.S. Treasury by a withholding agent.

2. The like-kind exchange rules of § 1031 can apply to exchanges of intangible personal property, provided the exchanged intangibles are of like kind. Section 1.1031(a) -2(c)(1) states that whether intangibles are of like kind depends on the nature or character of the rights involved (e.g., a copyright or patent) and the nature or character of the underlying property to which the intangible property relates. In a factually complicated private letter ruling, IRS applied those principles to conclude that the exchange of certain manufacturing and distribution rights with respect to a specified group of products, for other manufacturing and distribution rights with respect to the same group of products qualified for nonrecognition under § 1031. PLR 201531009.

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3. Amounts paid to protect against patent infringement are ordinary and necessary business expenses and need not be capitalized, according to PLR 201536066.

4. In *Voss v. IRS* and *Sophy v. IRS*, the Ninth Circuit, in a 2-1 decision, reversed the Tax Court and held that a unmarried couple who jointly own two homes are not subject to the mortgage interest deduction limits for married couples filing separately; rather, said the court, each co-owner can take the full deduction on interest on up to $1.1 million of mortgage debt. We previously commented on the Tax Court decision in this matter, a case of first impression; the Tax Court had concluded that the $1.1 million limit applied per residence and not per taxpayer. The Appeals Court disagreed.

5. In a somewhat harsh, but, apparently, technically correct reading of the law, CCA 201518013 holds that the amendment of an executive's retention agreement in the year his right to a deferred compensation bonus vested, but before the risk of forfeiture (i.e., the vesting date) lapsed that year, was **ineffective** to avoid income inclusion for that year under § 409A. The retention agreement provided for a bonus if the executive remained employed by his employer for three years. Once it vested, the bonus would be paid over the next two years, but the agreement provided that the employer could, in its discretion, pay the entire amount on the first anniversary of the vesting date, a clear violation of § 409A. During the third year of the agreement, but before the vesting date, the employer attempted to correct the § 409A defect, but the Service ruled that a defect "at any time" during a taxable year in which the risk of the forfeiture lapses results in current taxability, citing § 409A(a)(1)(A)(i) and proposed regulation § 1.409A-4, even though the correction was made before the right to the bonus vested.

6. In an interesting dispute **not** involving the IRS, *Davidson v. Henkel Corporation*, a District Court ruled in favor of a retiree, rather than his employer, regarding FICA taxes. John Davidson, while an executive at Henkel Corporation, was a participant in a supplemental executive retirement plan. At the time of Davidson's retirement in 2003, his employer should have withheld FICA taxes on the present value of his plan benefits but mistakenly failed to do so. Eight years later, a compliance review of the plan by the company's consultants revealed the error, and the company informed Davidson that he would now be subject to the FICA taxes on his retirement benefits on a "pay as you go" basis, which Henkel would subtract from Davidson's payments. Davidson sued Henkel claiming ERISA prohibited such a benefit "reduction." The court agreed with Davidson that Henkel had failed to withhold FICA when it should have and could not withhold it now.

7. While love may be stronger than death so, apparently, are the wrath of a divorced wife and the power of family court judges. Thus, in *Yale – New Haven Hospital v. Claire M. Nicholls*, the Second Circuit held that two domestic relations orders, which were entered by the court on the day **after** a plan participant's death, but made retroactive to the date of an earlier settlement agreement, were "qualified domestic relations orders" under § 401(a)(13). A dissent would have held the plan benefits to have vested in the second wife on the date the participant died. The lawyering in the domestic relations dispute could not be considered exemplary, because the settlement agreement that contemplated the issuance of QDRO's was signed in 2008, but no QDRO's had been prepared at the time of the decedent's death in 2012.

8. In *USA v. Chabot*, the Third Circuit rejected a Fifth Amendment claim by the taxpayers in refusing to turn over records in an undisclosed foreign bank account, ruling that the exception to the Fifth Amendment privilege for records required to be maintained by law applied to the bank account. Other Appeals Courts that have considered this issue have arrived at the same conclusion. The Supreme Court denied *certiorari* in the case.

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9. We usually associate transfer pricing cases with high tech or pharmaceutical companies, but a report prepared by a whistleblower and sent to IRS this summer alleges that the Vanguard Group undercharged its affiliated mutual funds for investment advisory services and, if arm's length prices had been charged, Vanguard would owe $34.6 billion in taxes for the years 2007-2014. Vanguard responded that the case, brought by one of its former lawyers, was meritless. Undoubtedly we'll hear more about this matter in years to come.

10. IRS this summer issued proposed regulations intended to curb perceived abuses of the controlled foreign corporation rules through the use of partnerships. The Service believes that some shareholders caused their CFC's to lend funds to foreign partnerships of which they were partners and then had the partnership make distributions of those funds. The regulations treat the distributed amounts as an obligation of the shareholder qualifying as U.S. property for purposes of § 956. Taxpayers have long sought to avoid or mitigate the CFC rules through the use of partnerships.

11. In *Kott v. Commissioner*, the Tax Court held that a taxpayer who withdrew funds from his § 401(k) plan because he was delinquent in paying his mortgage was liable for the 10 percent penalty of § 72(t) on early plan withdrawals. The taxpayer was not age 59-1/2; had he been so, the 10 percent penalty tax would not have applied. The court rejected taxpayer's argument that the provision in the § 401(k) regulations allowing for hardship distributions should have exempted him from the additional tax.

12. We previously reported on the estate and gift tax litigation between IRS and the Estate of William Davidson, a very wealthy entrepreneur who, among things, owned the Detroit Pistons. IRS asserted a liability on the part of the estate of a staggering $2.7 billion, but the case was settled for approximately $457 million. Now, Davidson's estate has sued Deloitte Tax LLP for fraud, claiming that Deloitte's "flawed and defective" tax plan (which, in part, involved self-cancelling installment notes) was highly risky and unreliable and that the firm failed to adequately disclose the tax risks involved.

13. The IRS's apparent war on marijuana continues, even as the rest of the country considers embracing recreational use. Thus, the Tax Court in *Beck v. Commissioner* disallowed deductions relating to medical marijuana dispensaries, and the Ninth Circuit sustained a similar ruling in *Martin Olive v. C.I.R.*

    a. At least one recently docketed Tax Court case has raised the constitutionality of the Code section disallowing such deductions.

    b. But in better news, IRS has now abated penalties against the Allgreens LLC dispensary in Denver for failing to pay estimated taxes through the electronic transfer system. Unsurprisingly, the taxpayer could not get a bank to allow it to open a bank account with which to transfer the funds. The taxpayer had to pay in cash, and perhaps, brownies. "Baking America great again," so to speak.

14. Our update would not be complete without checking in on some of the usual scoundrels and rogues who populate the tax world.

    a. Ex-Staten Island Representative Michael Grimm, who pled guilty to one count of aiding the preparation of a false return relating to under-reported income from his restaurant, was sentenced to eight months imprisonment. The presiding judge acknowledged that going to jail for such tax crimes in New York was unheard of, but she found that the oaths taken by Grimm as a former Marine, FBI agent and lawmaker, as well as his taking tip money from his undocumented workers, counted against him.

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b. By contrast, billionaire H. Ty Warner, the creator of Beanie Babies, did not go to jail for evading $5.6 million in taxes through the use of an undisclosed Swiss bank account. He did pay a $53.6 million penalty but unlike Grimm, Warner pled guilty to one count of the more serious crime of tax evasion. The government only asked the judge to sentence him to a year and a day. Warner was put on probation for two years and ordered to perform community service. I guess going to jail for tax crimes in Illinois is even more unheard of.

c. The Justice Department sued to enjoin Lawrence Preston Siegel, a former lawyer and accountant turned rabbi, from promoting tax fraud schemes sold, particularly, to self-employed dentists in California. In Rabbi Siegel's world, purchases of jewelry and handbags from Tiffany's are deductible business expenses. Another scoundrel stealing in the name of the Lord.

d. Charles and Mary Bangle of Somers Point, owners of the famous Manco & Manco Pizza restaurants at the Jersey shore, have now pled guilty to a variety of tax crimes.

e. R. David Cohen, an attorney in Andover, Mass., was charged with money laundering and other crimes for inventing fictitious Puerto Rico residents who filed bogus returns. Attorney Cohen deposited the resulting IRS refunds in a variety of bank accounts and then sought to launder the funds through his IOLTA accounts.

15. Finally, as I always tell you, remember to practice "safe tax."

And so, my friends, as we look forward to celebrating with our loved ones during this season of miracles, may our enemies go to Hell, may our country remain great, and always remember that "the best things in life aren't things."

And from our house to yours, we wish each of you season's greetings and a healthy and prosperous new year.

Dennis Cohen