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Inside this Issue

Proposed Regs Tighten Rules For Reporting Income/Deductions When Corporation Joins/Leaves Consolidated Group

◆ *NPRM REG-100400-14*

The IRS has issued much-anticipated proposed regs that would tighten the rules for reporting income and deductions that accrue on the day that a corporation joins or leaves a consolidated group. The regs would revised the so-called "end of the day rule" and "next day rule" to clarify the reporting period.

■ ***Take Away.*** "These regulations are significant and could affect any consolidated group in which a member joins or ceases to be a member (a change in status)," Lisa Zarlenga, partner, Steptoe & Johnson LLP, and co-chair of the firm's Tax Group, told Wolters Kluwer. "For purposes of determining whether tax items should be reported on the consolidated return or the member's separate return, the current regulations provide factors for determining what is "properly allocable" to the period after the event causing the change in status. These factors were unclear, and there was some confusion regarding the treatment of items arising on the day of the acquisition. Taxpayers thought that as long as they treated an expense consistently, the treatment should be acceptable, but the IRS has challenged this treatment. The proposed regulations take out the properly allocable language in favor of a bright-line rule that would essentially put extraordinary items arising simultaneously with the change in status on the seller's return. The regulations make the IRS position clear and should reduce controversy, but taxpayers may not be happy with the result," Zarlenga said.

■ ***Comment.*** "There has been controversy, in particular, about the treatment of certain expenses arising in connection with the transaction, including compensation-related deductions such as stock options that vest on the sale, and investment banker (success-based) fees paid as a result of the transaction," Zarlenga said. "Taxpayers read the regulations to provide flexibility and often allocated these expenses to the buyer (the party acquiring the company from the consolidated group)."

Current regs

End of the day rule. Under the current end of the day rule, a corporation that becomes or ceases to be a member of a consolidated group is treated as changing its status at the end of the day of change. Tax items that accrue during the day of change are reportable generally on the tax return for the tax year that ended because of the change in status.

S corp exception. There are two exceptions to the current rule, the S corporation exception and the next day rule. An S corporation that joins a consolidated group, terminating its S corp election, is treated as joining the group at the beginning of the day

Continued on page 122

Route to: ________ ________ ________ ________ ________

IRS Posts FAQs On Tangible Property "Repair" Regs

◆ *Tangible property regulations: FAQs, March 5, 2015*

The IRS has posted frequently asked questions (FAQs) on the final tangible property regs, also known as the "repair" regs, on its website. The FAQs discuss elections and safe harbors, as well as other simplifying provisions. The FAQs also discuss procedures for changing accounting methods to comply with the regs.

■ ***Take Away.*** The FAQs point out that some of the provisions in the final regs, such as the rules for deducting materials and supplies or the safe harbor for routine maintenance, do not change existing precedents and practices. In these cases, taxpayers who were following the prior rules will not have to change their accounting method to comply with the final regs.

Background

The repair regs are effective for tax years beginning in 2014, although taxpayers can choose to apply them for 2012 and/or 2013. In Rev. Procs. 2014-16 and 2014-54, the IRS granted automatic consent for taxpayers to change their accounting methods to comply with the repair regs. Thus, taxpayers changing their accounting methods for 2014 can inform the IRS by filing a Form 3115 with their timely-filed tax return for 2014.

Ordinarily, taxpayers must file Form 3115 to change their method of accounting, even if the IRS has granted automatic consent. In many cases, taxpayers changing an accounting method must go back to prior years and calculate a Code Sec. 481(a) adjustment. Taxpayers will generally get audit protection for prior years when they file Form 3115 with a 481 adjustment. Some accounting method changes may be made without any 481 adjustment, but taxpayers must still file Form 3115 to make the change.

Rev. Proc. 2015-20

The FAQs discuss a simplified procedure provided by the IRS for changing accounting methods. To save small businesses the trouble of calculating the 481 adjustment, taxpayers can elect to make the accounting method change in 2014 on a prospective basis, without going back. Taxpayers can also skip the filing of a Form 3115.

In the FAQs, the IRS suggested that taxpayers following Rev. Proc. 2015-20 consider including a statement on their 2014 return indicating that they are following the simplified procedures. However, this is not required. The IRS also suggested that taxpayers who do not file Form 3115 and do not intend to use the simplified procedures should also consider filing a statement as to their intentions. The IRS notes that this will help for recordkeeping and substantiation of the taxpayer's accounting method actions.

The FAQs point out that taxpayers using this procedure must follow it for all changes specified in Rev. Proc. 2015-20. Taxpayers cannot just pick some of the methods in the final regs. Taxpayers using Rev. Proc. 2015-20 and not filing Form 3115 will not receive audit protection for years prior to 2014.

Consolidated Returns

Continued from page 121

of termination. The S corp's tax year ends at the end of the preceding day.

Next day rule. Under the second exception, a transaction that clearly occurs on the same day as, but after, the event triggering the change of status is treated as occurring at the beginning of the following day.

Proposed next day rule

The IRS stated that taxpayers have interpreted the current regs, in particular the next day rule, to give them flexibility whether to report tax items on the return for the tax year ending on the day of the corporation's change in status, or on the return for the tax year beginning on the following day. This interpretation is inappropriate and may not clearly reflect income, the government said.

The proposed next day rule would provide an exception to the end of the day rule. The rule would require that "extraordinary items" that occur on the day of change, but after the event, would be taken into account on the tax return beginning the next day. For example, a sale of unwanted assets (an extraordinary item) after the event would be reported on the next day. The proposed next day rule would be mandatory.

Proposed end of the day rule

The next day rule would not apply to extraordinary items that occur simultaneously with the event causing the change in status. For example, success-based fees are an extraordinary item. However, if the fees depend on a successful closing, they arise simultaneously with the event causing the change. The proposed regs would require that the corporation report the fees under the end of the day rule, on the return that ends on the day of change.

The proposed regs also clarify that fees for services render in connection with the change of status are an extraordinary item that are reported under the end of the day rule. Other extraordinary events occurring before the event are also reported under the end of the day rule.

The proposed regs retain the S corporation exception. However, extraordinary items occurring on the day of the S corp's change of status, either before or simultaneously with the change, would be reported on the S corp's return for the period that ends on the previous day (the day preceding the termination).

References: FED ¶49,640; TRC CONSOL: 15,104.

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Reference Key

FED references are to *Standard Federal Tax Reporter*
USTC references are to *U.S. Tax Cases*
CCH Dec references are to *Tax Court Reports*
TRC references are to *Tax Research Consultant*

Supreme Court Hears Code Sec. 36B Challenge; Decision Expected In June

◆ *King v. Burwell, Oral Argument, March 4, 2015*

The controversy over the scope of the Code Sec. 36B premium assistance tax credit regs made its way to the U.S. Supreme Court on March 4. The challengers argued that the IRS erred in extending the credit to enrollees in federally facilitated Marketplaces. The government defended the regs as a valid interpretation of the *Patient Protection and Affordable Care Act* (PPACA). A decision is expected in late June.

■ ***Take Away.*** "This challenge, though highly technical, is anything but minor—it could unravel the entire infrastructure of federal health reform," Kimberly McCarthy, partner, Partridge Snow & Hahn, LLP, Providence, R.I., told CCH. "If the plaintiffs prevail, in the 37 states without their own Marketplaces, no individual will be eligible for federal tax subsidies."

■ ***Comment.*** "It is always difficult to read the Supreme Court tea leaves, although the Justices appeared to split down traditional party lines during arguments," McCarthy observed.

Background

Qualified individuals may claim the Code Sec. 36B credit to help offset the cost of health insurance. To be eligible for the credit, health insurance coverage must be obtained through the PPACA Marketplace. IRS regulations issued after passage of the PPACA provide that enrollees in state-run Marketplaces and federally facilitated Marketplaces may claim the Code Sec. 36B credit.

In *King,* the plaintiffs challenged the IRS regs as contrary to the PPACA. According to the plaintiffs, the PPACA only makes available the Code Sec. 36 credit to enrollees in state-run Marketplaces. The Fourth Circuit Court of Appeals upheld the IRS regs in July 2014. The Fourth Circuit found the language of PPACA ambiguous and deferred to the IRS's interpretation, which the court indicated was in keeping with the overall structure of the PPACA. The plaintiffs petitioned the Supreme Court to review the decision. The Supreme Court agreed to take up the case and scheduled oral argument for March 2015.

■ ***Comment.*** "The challenge revolves around eight words: 'Exchange established by a State under Section 1311,'" McCarthy noted. "The challengers take the position that these words mean what they say: only folks enrolled in state-created Marketplaces are eligible for the subsidies. Opponents say that was not Congress' intent, and since it would undermine the fundamental purposes of the law, the words must be interpreted to include people enrolled in Marketplaces established by the federal government when the state fails to do so."

Oral argument

"If Congress did not want the phrase established by the state to mean what that would normally be taken to mean, why did they use that language," Justice Samuel Alito asked. "This took a year and a half for anyone to even notice this language," Justice Elena Kagan added.

"If we read it (the PPACA) in the way you (the plaintiffs) are saying, then we are going to read the statute as intruding on the federal-state relationship because then the states are going to be coerced into establishing their own exchanges," Justice Sonia Sotomayor said.

Justice Kagan said that the courts frequently look to the entirety of a statute to ascertain meaning of certain provisions. "We look at the whole text, the particular context, the more general context, to try to make everything harmonious with everything else," Kagan said.

Justice Antonin Scalia questioned if the explanation for the challenged provision was intentional. "It prevents the federalization of the entire thing," Scalia said. Scalia also questioned the government's argument that Congress would be reluctant to pass a legislative fix. Congress adjusts, enacts a statute that takes care of the problem. "It happens all the time," Scalia said.

References: 2014-2 USTC ¶50,367; TRC HEALTH: 3,300.

IRS Provides Penalty Relief To Farmers/Fishermen With Incorrect Forms 1095-A

Farmers and fishermen who received an incorrect Form 1095-A, Health Insurance Marketplace Statement, will have until April 15, 2015, to file their 2014 tax returns and pay any tax due, the IRS has announced. Affected farmers and fishermen are eligible for penalty relief.

Background. Farmers and fishermen who choose not to make quarterly estimated tax payments generally file their returns and pay any tax due by March 1 (March 2 this year). Farmers and fishermen who fail to make timely payment of tax are liable for an addition to tax under Code Sec. 6654.

Form 1095-A. Enrollees in health insurance through the Marketplace need Form 1095-A to complete their return. In February, the U.S. Department of Health and Human Services (HHS) reported that some 800,000 enrollees in Marketplace coverage received incorrect Forms 1095-A. HHS is in the process of sending corrected Forms 1095-A to affected individuals.

Waiver. The delay in the receiving corrected Forms 1095-A may have prevented some farmers and fishermen from filing their returns by March 2, the IRS explained. The IRS will waive the Code Sec. 6654 penalty for farmers or fishermen who, due to this delay, file their returns by April 15.

IR-2015-36, Notice 2015-22, FED ¶¶46,267, 46,268; TRC FILEIND: 21,052.20.

Proposed Reliance Regs Revamp Reporting For Bingo, Keno And Slots Winnings

◆ *NPRM REG-132253-11, Notice 2015-21*

The IRS has issued proposed reliance regs to update and simplify the filing of information returns to report winnings from bingo, keno, and slot machine play. At the same time, the agency released a proposed safe harbor for individuals who engage in electronically tracked slot machine play.

■ ***Take Away.*** The current regs were issued before the widespread popularity of electronic gaming and the use of devices that electronically track wagers and winnings. The IRS explained that after 30+ years, it was time to revisit the regs.

■ ***Comment.*** The proposed regs would apply to payments of reportable gaming winnings from bingo, keno, slot machine play, and electronically tracked slot machine play made on or after the date the regs are finalized. In the interim, taxpayers may rely on the proposed regs, the IRS explained.

Background

Generally, every person engaged in a trade or business that pays reportable gambling winnings must file an information return describing the payments. Current regs provide monetary thresholds for reporting winnings from bingo, keno and slot machine play. Each payment of gambling winnings from a single bingo or keno game, or slot machine play that meets the reporting threshold is required to be reported on a Form W-2G to the same payee.

Proposed regs

The proposed regs are intended to clarify that the reporting requirement includes not only those engaged in a trade or business for profit or gain, but also organizations whose activities are not for profit or gain, such as tax-exempt organizations and governmental entities. The proposed regs also address the thresholds for when winnings from bingo, keno, and slot machine play are subject to reporting.

Reportable gambling winnings means $1,200 or more in the case of one bingo game or slot machine play, and $1,500 or more in the case of one keno game. However, the IRS explained it is open to revisiting these amounts. The IRS requested comments on the feasibility of reducing those thresholds to $600 at a future time, whether electronically tracked slot machine play should have a separate reporting threshold, and whether the amounts should be uniform for bingo, keno, and slot machine play.

■ ***Comment.*** The proposed regs retain the rule allowing the winnings from one keno game to be reduced by the amount wagered in that one game. This treatment, however, is not extended to bingo or slot machines.

Additionally, the IRS proposed new rules for determining the reporting threshold for electronically tracked slot machine play. Gambling winnings for electronically tracked slot machine play would be reported when the total amount of winnings earned from electronically tracked slot machine play during a single session netted against the total amount of wagers placed on electronically tracked slot machines during the same session is $1,200 or more; and at least one single win during the session (without regard to the amount wagered) equals or exceeds $1,200.

■ ***Comment.*** The proposed regs include many examples of when reporting would be required.

Alternative reporting method

The IRS also developed an alternative method for reporting multiple winnings from bingo, keno, and slots. A payor that makes more than one payment of reportable gambling winnings to the same payee from the same type of game during the same session may report the aggregate amount of such reportable gambling winnings on one Form W-2G. The alternative method is optional, the IRS emphasized.

Safe harbor

In Notice 2015-21, the IRS described an optional safe harbor to determine what constitutes a session of play for purposes of calculating wagering gains or losses from electronically tracked slot machine play. The optional safe harbor, the IRS explained, is intended to reduce the burden on taxpayers and the number of controversies between taxpayers and the agency.

References: FED ¶¶46,269, 49,639; TRC INDIV: 6,266.

IRS Touts Online Database For Choosing A Qualified Tax Preparer

The IRS has reminded taxpayers searching for a reputable preparer to complete their tax returns that its website features a searchable database of federal tax return preparers that lists preparers' names, addresses, credentials, and qualifications. The IRS website provides links to the websites of national organizations of tax professionals, complete with additional details about the groups, including state and local organizations or representatives. Taxpayers may also visit the IRS website to find a list of consumer tips for selecting a tax professional.

PTINs. The IRS also reminded taxpayers to make sure their return preparer signs the return and includes his or her Preparer Tax Identification Number (PTIN) on the return. All paid preparers are required to have a valid PTIN. Additionally, PTINs must be renewed each year.

■ ***Comment.*** "The tax return represents one of the biggest financial transactions of the year for many Americans, whether they are getting a refund or paying a tax bill," IRS Commissioner John Koskinen said in a statement. "Filling out tax returns accurately is critically important. Between tax law changes and tax scams circulating, it's more important than ever for people who need professional assistance to select wisely and carefully."

IR-2015-41.

IRS Lifts "Pause" In PTP Letter Ruling Requests; More Guidance In Pipeline

◆ *IRS Statement, March 9, 2015*

The IRS has lifted its nearly year-long pause in issuing private letter rulings on publicly traded partnerships (PTPs). The agency also announced that proposed regs on Code Sec. 7704(d)(1)(E) are expected to be released in the near future.

■ ***Take Away.*** PTPs have been utilized extensively in the oil and gas industry. Code Sec. 7704(d)(1)(E) refers to income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof) or the marketing of any mineral or natural resource in its roster of qualifying income.

Background

Under Code Sec. 7704(a), a PTP is treated as a corporation. However, Code Sec. 7704(c)(1) provides that Code Sec. 7704(a) does not apply to any PTP for any tax year if the partnership met the gross income requirements of Code Sec. 7704(c)(2) for the tax year and each preceding tax year beginning after December 31, 1987, during which the partnership or any predecessor was in existence. A partnership meets the gross income requirements for any tax year if 90 percent or more of the gross income of the partnership for the tax year consists of qualifying income.

In early 2014, the IRS announced that it was imposing a temporary "pause" in consideration of requests for letter rulings on PTP qualifying income. At that time, the IRS explained it was studying the scope of qualifying income.

Letter ruling requests

Private letter ruling requests resumed as of March 6, the IRS reported. During the pause, the agency developed standards to guide its ruling practice, the agency explained. The IRS cautioned that it may take time to process the ruling requests as it reaches out to taxpayers where additional information is needed.

■ ***Comment.*** "We recognize the importance of private letter rulings to industry participants, and we do not want to delay the availability of private letter rulings any longer where we are comfortable giving them," the IRS explained.

Proposed regs

The proposed regs, the IRS explained, will provide guidance on Code Sec. 7704(d)(1)(E) concerning qualifying income from the exploration, development, mining and production, processing, refining, transportation, and marketing of minerals and natural resources. Additionally, the proposed regs will address services provided by contractors to others in the oil and gas industry. The proposed regs will not address other forms of qualifying income, the IRS added.

Reference: TRC PART: 3,256.

IRS Continues Cracking Down On Taxpayer Identity Theft

The IRS and Department of Justice (DOJ) have recently reported some progress in the fight against taxpayer identity theft. The IRS initiated 1,063 identity-theft related investigations during fiscal year (FY) 2014, with IRS Criminal Investigation enforcement efforts resulting in 748 convictions.

IRS activities. The IRS initiated 1,063 identity-theft related investigations during fiscal year (FY) 2014, the agency reported. IRS Criminal Investigation enforcement efforts resulted in 748 convictions. The IRS added that it has received over 7,600 individual identity theft leads. These leads involved approximately 1.47 million returns with over $6.8 billion in refunds claimed.

■ ***Comment.*** "We are not going to prosecute our way out of this problem (identity theft), but working with our law enforcement partners and the IRS we will curb the problem," Caroline D. Ciraolo, acting assistant attorney general, Tax Division, U.S. Department of Justice, said on March 6 at the Tax Law Conference of the Federal Bar Association in Washington, D.C.

IR-2015-37.

Taxpayer Entitled To Second CDP Hearing For Civil Assessment; Restitution-Based Assessment Already Ordered

A taxpayer is entitled to a Collective Due Process (CDP) notice and hearing for both an assessment arising from a civil examination and a restitution-based assessment ordered in an earlier criminal case, the IRS Chief Counsel has determined. Even though they concern the same tax period, the restitution-based assessment and civil exam-based assessment are two separate and distinct assessments, and therefore fall within the limited circumstances under which the regulations permit more than one CDP hearing, according to Chief Counsel.

Background. Generally, Code Secs. 6320(b)(2) and 6330(b)(2) entitle a taxpayer to only one CDP hearing with respect to the same tax and tax period covered by the CDP notice. Reg. §301.6320-(1)(d)(2) provides, however, that a taxpayer is entitled to a second CDP hearing where the same type of tax and period is involved, but the amount of unpaid tax has increase because of an additional assessment of tax not including accruals of interest and penalties.

Chief Counsel's analysis. Chief Counsel observed that separate assessments are made under a restitution order and the civil examination; each is computed using a different criteria; and each may be for a different amount. A taxpayer's tax liability for the period may exceed amounts of restitution ordered, Chief Counsel noted. Therefore, having both a restitution-based assessment and assessment based on a civil examination is comparable to the exception mentioned in Reg. §301.6320-(1)(d)(2).

CCA 201510043; TRC IRS: 48,058.13.

Eighth Circuit Rejects Like-Kind Exchange Treatment For Related-Party Transactions

◆ *North Central Rental & Leasing, LLC, CA-8, March 2, 2015*

The Court of Appeals for the Eighth Circuit has affirmed a federal district court's decision that a series of transactions involving related parties did not qualify for like-kind exchange treatment under Code Sec. 1031. The Eighth Circuit concluded that the transactions were needlessly complex and used unnecessary parties.

■ ***Take Away.*** Code Sec. 1031(f)(1) denies like-kind treatment to exchanges of property between related parties if the property is sold within two years. The intent is to deny tax-free treatment to a party that has cashed out its investment in property by trading the property to a related party. Code Sec. 1031(f)(4) similarly denies like-kind treatment for a series of transactions structured to avoid the related-party rules. The appeals court agreed with the district court that the parties had essentially sold property for cash and had added extra parties to the transaction to avoid the related-party rules.

Background

Corporation B and Company N had common owners. N engaged in the rental and leasing of heavy equipment. The companies purchased new equipment from Corporation C and periodically disposed of their used equipment.

N participated in a like-kind exchange (LKE) program that allowed it to trade used equipment for new equipment and to defer taxes on the sale of the used equipment. In a typical transaction:

- N sold its low-basis, high value used equipment to an unrelated third party, which paid the proceeds to Company A, serving as a qualified intermediary (QI);
- The QI transferred the funds to B, which had unfettered use of the funds;
- B purchased new equipment from C, with six months to pay for the equipment. The court noted that this gave B a six-month interest-free loan of the sales proceeds from the exchange; and
- B transferred the new equipment to the QI, which transferred it to N.

Thus, in the immediate aftermath of the transaction, a third party owned the equipment disposed of, N held replacement property, and B held the sales proceeds. N claimed it could defer the gain from the transaction as an LKE.

Court's analysis

Congress and the IRS have approved deferred like-kind exchanges, where the seller transfers property to a QI that sells the property to a third party. The QI uses the proceeds to purchase property that is like-kind to the property disposed of, and transfers the property to the original seller. Since the seller never has control of the sales proceeds, the transaction qualifies as a like-kind exchange.

However, in this case, the transactions violated the related-party rules and were not tax-free. Noting the transactions' complexity, the appeals court found that both B and QI were unnecessary parties. B participated because it could obtain a valuable six-month interest-free loan. Because the parties engaged in hundreds of these transactions, B obtained the use of millions of dollars of cash. If B was eliminated, the QI, which received the cash initially, would have paid it to C, the equipment manufacturer. Neither B nor N would have had the use of the money.

■ ***Comment.*** The court rejected the taxpayers' argument that the case was unique because B did not have indefinite access to the funds. The court stated that it could not ignore the significant and continuous financial benefits of the transactions to B. The court also treated the related parties as one economic unit, since they were under common ownership, so the economic benefits to B were also attributed to N.

QI was an unnecessary party. B and N could have exchanged the equipment directly with each other and then sold the property to the unrelated buyer. However, this would have triggered the application

Continued on page 127

Chief Counsel Reviews AOTC Refund Where "Kiddie Tax" Applies

IRS Chief Counsel recently reiterated that a student is not entitled to the refundable portion of the American Opportunity Tax Credit (AOTC) if the taxpayer is a child with unearned income subject to the "kiddie tax."

Background. For tax years beginning after 2008 and before 2018 the AOTC is partially refundable. Forty percent of the AOTC that exceeds the total of the taxpayer's regular tax and alternative minimum tax (AMT) can be claimed as a refund.

Chief Counsel's review. Chief Counsel explained that a student is not entitled to the refundable portion of the AOTC if the student is a child described by Code Sec. 1(g). The kiddie tax applies when one of the child's parents is alive at the close of the tax year; (ii) the child does not file a joint return for the tax year, and (iii) the child is in one of these categories: the child has not attained the age of 18 by the close of the tax year; the child has not attained the age of 19 by the close of the tax year, and the child's earned income is less than one-half of the child's support for the year; or the child is a student who has not attained the age of 24 by the close of the tax year, and the child's earned income is less than one-half of the child's support for the year. The taxpayer described in the CCA fell within these parameters.

CCA 201509030; TRC INDIV: 60,158.

Wyden Releases Report On "Tax Loopholes"; Calls For Action

◆ *How Tax Pros Make the Code Less Fair and Efficient: Several New Strategies and Solutions*

Senate Finance Committee (SFC) ranking member Ron Wyden, D-Ore., has issued a report identifying six "tax avoidance strategies." Wyden called on Congress, Treasury and the IRS to take action to combat these techniques and said that reform could generate billions of dollars in revenues over the next 10 years.

■ ***Take Away.*** "Wyden wants to highlight the problems in our current tax system and build support for tax reform," Steven Rosenthal, Senior Fellow, Urban-Brookings Tax Policy Center, Washington, D.C., told Wolters Kluwer. "Financial products are a fine place to start. The tax rules operate in a complex fashion; the results are opaque; and they are only available to those who have access to banks and tax planners."

■ ***Comment.*** "Republicans and Democrats have a common reaction to the financial products area," Rosenthal said. "Their views are not particularly contentious."

Financial products

Taxpayers are using derivative contracts to lock in stock gains (or losses), while manipulating the timing of any taxes paid and minimizing the taxes paid, the report indicates. Five of the six strategies involve financial products; one involves deferred compensation. The financial product strategies include using:

- Collars to avoid paying capital gains taxes;
- Wash sales to time the recognition of capital gains;
- "Basket options" to convert short-term capital gains into long-term gains;
- Derivatives to convert ordinary income into capital gains, or capital losses into ordinary losses; and
- Derivatives to avoid the constructive ownership rules for partnership interests.

Collars, wash sales and basket options

Collars. Owners of appreciated stocks use a "collar" to lock in the gain by purchasing simultaneous options to buy and sell the stock to avoid risk and to hedge against any price fluctuation. This allows taxpayers to lock in capital gain without selling the stock. Congress enacted Code Sec. 1259 to require the recognition of gain when entering into certain derivative transactions, such as collars and to treat collars as constructive sales, but Treasury has not issued any regs, the report indicated.

Wash sales. Taxpayers with depreciated stocks can realize capital losses without changing their economic position by selling a security and immediately purchasing a substantially similar security. The report indicates that current wash sale rules deny recognizing the loss if the identical stock is purchased within 30 days of the sale, but the rules do not address similar techniques that use financial instruments like forward contracts and swaps. The report describes a technique of entering into a derivative contract for a basket of stocks that is somewhat different from the stocks sold. The report suggests that Congress update the Code Sec. 1091 wash sale rules, and that legislation or regs address similar techniques.

Basket options. Foreign banks exercise basket options held for more than a year (to achieve long-term rates), while the underlying assets in the basket or portfolio are typically held for less than a year. The IRS has characterized these transactions as an account holding securities, not an option. The law is clear that basket options are a tax shelter; the report recommends that the IRS issue a tax shelter notice imposing appropriate penalties.

Derivatives

Derivatives and other contracts on capital assets that are held to maturity generate ordinary income. However, if the contract is terminated before maturity by a sale of the underlying asset, the proceeds are capital gain (or loss). This dichotomy allows taxpayers to manipulate the timing and amount of taxes owed. A comprehensive solution would be to enact legislation that marks-to-market all derivative instruments and treats the resulting gains or losses as ordinary.

■ ***Comment.*** "Marking-to-market all derivatives and treating the income as ordinary would provide a comprehensive solution," Rosenthal said. "A global approach is the right approach. This is the most significant proposal in the report and would address the present gaming of derivatives. There would be no opportunity to defer income and change its character. The other proposals are addressing tax loopholes."

Swaps or other derivatives can be used to "mimic" ownership of an investment partnership. Taxpayers report long-term capital gains on the income. Code Sec. 1260 limits the long-term capital gain from derivatives involving partnership interests as the underlying asset. Congress enumerated instruments subject to the provisions and authorized the IRS to identify other instruments. The government has not issued final regs, so taxpayers continue to use some partnership-based derivatives to avoid ordinary income treatment.

■ ***Comment.*** "Derivatives derive their value by reference to other assets and can be used to mimic any other asset," Rosenthal said. "Where the tax rules diverge, taxpayers can game the system."

Like-Kind

Continued from page 126

of Code Sec. 1031(f)(1). The transactions were designed to avoid the related party rules and ran afoul of Code Sec. 1031(f)(4).

References: 2015-1 USTC ¶50,217; TRC SALES: 30,206.10.

Tax Briefs

Internal Revenue Service

The IRS, in its series of notices reminding taxpayers of their rights, has issued a Fact Sheet on Right No. 6 of the Taxpayer Bill of Rights, the right to finality. The list of rights are set out in detail in IRS Publication 1, Your Rights as a Taxpayer. In the right to finality, taxpayers are notified of the maximum time they have to challenge the IRS's position, as well as the maximum amount of time the IRS has to audit a specific tax year or collect a tax debt.

FS-2015-12, FED ¶46,270; TRC IRS: 33,150

Jurisdiction

A nonresident alien's petition seeking damages against the IRS for unauthorized collection was dismissed for lack of subject matter jurisdiction. However, the Claims Court had jurisdiction over the individual's refund claims for two of the tax years at issue because the individual alleged that he exhausted his administrative remedies, which the government did not deny.

G. Topsnik, FedCl, 2015-1 USTC ¶50,218; TRC IRS: 45,114

An individual's action seeking injunctive relief and damages for tax liens filed against him by IRS employees and for refund of the money seized from his bank account was dismissed for lack of subject matter jurisdiction. The individual failed to show that the government waived its sovereign immunity or consented to be sued.

Dawveed v. Starks, DC Md., 2015-1 USTC ¶50,214; TRC IRS: 45,114

Tax Crimes

The Eighth Circuit upheld a 24-month sentence imposed upon a taxpayer convicted of tax evasion. A two-level sophisticated means enhancement imposed on an individual convicted of tax evasion was supported by the evidence. Although the individual's actions were not overtly sophisticated, he conducted a repetitive and coordinated scheme to hide his assets from the IRS.

Jones, Jr., CA-8, 2015-1 USTC ¶50,220; TRC IRS: 66,462.15

Summons

An IRS summons issued to in connection with an investigation of a limited partnership's tax obligations was ordered enforced. The summoned parties were not entitled to examine an IRS agent because they could not point to specific facts or circumstances that plausibly raised an inference that the summons was issued for an improper purpose.

Clarke, DC Fla., 2015-1 USTC ¶50,219; TRC IRS: 21,300

Deductions

A self-employed real estate appraiser was denied most of the business expense deductions he claimed as Schedule C business expenses. He provided no testimony or substantiating documentation with respect to most of the deductions. He was denied most of the miscellaneous deductions he claimed on his Schedule A. The claimed itemized deductions appeared to relate to his appraisal business, and not to his employment as a census worker. Finally, he was denied any net operating loss (NOL) carryforward.

Lussy, TC, Dec. 60,242(M), FED ¶47,952(M); TRC BUSEXP: 3,200

FOIA

An individual's Freedom of Information Act (FOIA) request was dismissed because he had released his rights and claims against the IRS. The individual requested documents relating to four forfeiture actions against him. However, the individual's agreement with the IRS settling the forfeiture actions released and discharged the IRS from all duties of any kind relating to the forfeitures.

Rogers, DC Ohio, 2015-1 USTC ¶50,221; TRC IRS: 9,502

False Tax Returns

An individual was permanently enjoined from acting as a federal tax return preparer. The undisputed evidence showed that despite the IRS warnings, he continued to prepare tax returns in an improper and illegal manner. The individual's argument that he had remained honest for nearly twenty years of his practice was insignificant.

Ericson, DC Hawaii, 2015-1 USTC ¶50,222; TRC IRS: 6,200

Liens and Levies

The Tax Court properly sustained the IRS's determination to proceed with a levy to collect an individual's delinquent income taxes. The individual's claim that under the doctrine of equitable recoupment he could offset his current tax liability with the prior years' overpayments failed because the government did not bring a new proceeding arising out of the same transaction involved in an earlier proceeding.

Karagozian, CA-2, 2015-1 USTC ¶50,216; TRC IRS: 51,056.15

An IRS Appeals officer properly sustained the IRS's filing of a tax lien against an individual. The IRS properly mailed the deficiency notices to the individual's last-known address and correctly determined his tax liabilities. The IRS was entitled to send the deficiency notices to the address listed on his most recently filed tax return; the onus was on the individual to properly notify the IRS of any change of address.

Gyorgy, CA-7, 2015-1 USTC ¶50,215; TRC IRS: 27,160

Indian Tribes

The IRS has issued an updated list of Indian tribes that have settled trust management litigation cases against the United States. Notice 2013-1, I.R.B. 2013-3, 281, is modified and superseded.

Notice 2015-20, FED ¶46,271; TRC INDIV: 33,502

As Partnerships Increase In Number, So Do Calls For Examination Reform

IRS officials including Faris Fink, former commissioner, Small Business and Self-Employed Division, had announced in 2013 that the IRS would increase its scrutiny of partnerships. Now, the IRS's recently released *Winter 2015 Statistics of Income Bulletin* underscores why IRS officials are becoming increasingly concerned about partnerships. The bulletin—which highlights several trends including partnership numbers—shows that the number of partnerships grew by 3.1 percent from FY 2011 to FY 2012. Not only this, but the number of partners, the level of assets, and the total gross receipts received during this period all increased. Meanwhile, tax administrators, including IRS Commissioner John Koskinen, have expressed concern that this growth in more profitable, more complex partnerships has created a dire need for reform of the current rules for auditing partnerships. These rules were legislated before partnerships became so complex, administrators say, and now the obstacles to the IRS's efficient oversight of large partnerships leaves room for a large tax compliance gap.

■ ***Comment.*** A report issued in September 2014 by the Government Accountability Office (GAO) revealed that the IRS's field audit rate of large partnerships—defined by the GAO as having $100 million or more in assets and 100 or more direct and indirect partners—was less than one percent for FY 2012.

This Practitioners' Corner highlights the IRS's Winter 2015 statistics relating to partnership data gleaned from FY 2012. It will also provide additional context surrounding why these statistics are important.

Growth of Partnerships

The IRS's *Winter Statistics of Income Bulletin* reported that the number of partnerships filing tax returns grew 3.1 percent (from 3,285,177 to 3,388,561) between 2011 and 2012. Since 2003, the number of partnerships has grown at an average annual rate of 3.9 percent. The *Bulletin* also reported that the number of partners has grown during each of the last nine years, increasing 3.9 percent (from 24,389,807 to 25,333,616) between 2011 and 2012. Partnerships with fewer than three partners made up more than half (55.9 percent) of all partnerships, the IRS reported. Partnerships with 100 or more partners, however, accounted for almost half (47.3 percent) of all partners in 2012.

Partnership income. For 2012, partnerships passed through $1,400.8 billion in total income minus total deductions available for allocation to their partners, the *Bulletin* reported. This amount represents a 43.4-percent increase from 2011 when partnerships passed through $976.9 billion. In contrast with Tax Year 2011, when individual partners received the largest portion of passthrough income, partners classified as partnerships received the largest portion of this income for 2012. The finance and insurance sector accounted both for the largest amount reported and the biggest change in passthrough dollars, increasing $232.9 billion to $824.1 billion for 2012. The finance and insurance sector also accounted for the largest portion of the growth in total assets, reporting an increase of $802.5 billion (from $11,349.3 billion to $12,151.9 billion), followed by the real estate and rental and leasing sector with an increase of $330.9 billion (from $4,621.90 billion to $4,952.8 billion). This sector also reported the largest dollar gain in total receipts, rising $192.5 billion (from $1,188.2 billion to $1,380.7 billion), according to the IRS.

■ ***Comment.*** The IRS stated that historically, partnerships classified in the real estate and rental and leasing sector have dominated the statistics for both the number of partnerships and partners. This sector accounted for about half of all partnerships for 2012 (49.1 percent) and 2011 (48.6 percent). However, while partnerships in the real estate and rental sector made up the majority of all partnerships, they reported 22.5 percent of total assets, only 6.8 percent of total receipts, and 8.6 percent of total net income for 2012.

Need for partnership audit reform

The number of large partnerships has grown exponentially over the past decade. In its

Continued on page 131

"Tax administrators, including IRS Commissioner John Koskinen, have expressed concern that this growth in more profitable, more complex partnerships has created a dire need for reform of the current rules for auditing partnerships."

Washington Report

by the CCH Washington News Bureau

Lew defends IRS budget

Treasury Secretary Jack Lew made his case for the Treasury's fiscal year 2016 budget request in a March 4 appearance before the House Appropriations Subcommittee on Financial Services and General Government, saying that, in a system based on voluntary compliance, it is a dangerous practice to underfund enforcement for a long period of time. Underfunding the IRS is "shortsighted and damaging" to what Lew termed one of the important institutions in a democracy—the organization that is responsible for making sure that the government collects taxes from people who legally owe them and "do it in a way that provides customer service in a way that taxpayers deserve."

With respect to locking in sequestration, Lew said the current challenge is going to be for Congress to come back and do another version of what was done in the Murray/Ryan agreement, which was a two-year budget agreement intended to prevent a government shutdown in January 2013. "Sequestration was never meant to take effect," Lew responded to questioning on the sequester, which forced drastic cuts to defense and domestic spending. "It was designed to be something that would be so odious to both sides that it would make it possible to come together in the kind of balanced policies that would be a reasonable way to reduce the deficit as opposed to draconian cuts in discretionary spending."

SFC holds hearing on tax fairness

At a March 3 Senate Finance Committee (SFC) hearing on fairness in taxation, Chair Orrin Hatch, R-Utah, said that if people do not believe a tax reform proposal is fair, "it's hard to see how it could be enacted." SFC ranking member Ron Wyden, D-Ore., said in his opening statement that "tax fairness is key to what we will be working on in tax reform." Members of the SFC are currently working on tax reform discussion drafts.

Dr. Lawrence B. Lindsey, president and CEO, The Lindsey Group, made three points to the panel, telling lawmakers that rising income inequality probably cannot be successfully addressed through the tax code or through other intentional redistribution policies. The panel also heard from Deroy Murdock, a journalist and Fox News contributor, who said that he believed that the fairest tax would be one universal rate. Heather Boushey, executive director and chief economist, Washington Center for Equitable Growth, told the panel that as inequality has increased, the Tax Code has not kept pace with this change.

Steven Rattner, chair, Willett Advisors LLC, told lawmakers that a good starting point for the committee would be to revisit the Simpson-Bowles Commission, which proposed reducing the number of tax rates to three, erasing the special treatment of capital gains and dividends and eliminating most other tax deductions. "In his recent budget, President Obama proposed a few smaller changes that are worthy of the committee's consideration, including a modest increase in the tax rate on capital gains and dividends and eliminating the step up in basis on assets held at death," Rattner said.

IRS Chief Counsel describes impact of budget cuts

"The IRS is doing less with less," William Wilkins, IRS Chief Counsel, told practitioners in Washington, D.C. on March 6. However, times of crisis are often opportunities to grow, Wilkins, who spoke at the Annual Taxation Conference of the Federal Bar Association, said. Wilkins also touched on the Obama administration's proposal to streamline audits of large partnerships.

The IRS continues to operate under tight budgetary constraints, Wilkins said. The agency's budget for fiscal year (FY) 2015 is $10.9 billion, reflecting a cut of some $346 million from FY 2014 The IRS also is absorbing cuts due to sequestration, Wilkins added.

Agency-wide employment is down, including in the Office of Chief Counsel, Wilkins said. The Service has imposed a hiring freeze. "We are trying to right-size work in light of the budget constraints," Wilkins said. The Office of Chief Counsel has been affected by the hiring freeze, Wilkins reported. "Most of the immediate savings has to come from labor costs."

"We are also seeing slowdowns in information technology projects," Wilkins said. In a normal business environment, many of these projects would be greenlighted but because of the budget cuts, these projects are on hold, Wilkins reported. These projects not only cost money to implement, they also cost money to operate, Wilkins noted.

DOJ pursuing tax evasion leads, official says

The Tax Division of the U.S. Department of Justice (DOJ) is pursuing many leads about tax evasion, Caroline Ciraolo, acting assistant attorney general, said on March 6 in Washington, D.C. Ciraolo spoke at the Tax Law Conference of the Federal Bar Association.

Ciraolo highlighted recent developments to combat international tax evasion. "Our scope is global," she said. "We are pursuing leads and opening investigations." The U.S. is in talks with banks in many jurisdictions, including India, Malta and Switzerland, she added. In 2014, the U.S. entered into a deferred prosecution agreement with Bank Leumi Group. This agreement marks the first time an Israeli bank has admitted to helping U.S. taxpayers conceal income, Ciraolo noted.

Practitioners' Corner

Continued from page 129

September 2014 report, the GAO stated that the number of large partnerships has more than tripled to 10,099 from tax year 2002 to 2011. Almost two-thirds of large partnerships had more than 1,000 direct and indirect partners, had six or more tiers and/or self-reported being in the finance and insurance sector. Many of these finance and insurance partnerships are large investment funds. However, the IRS is unable to reach many of these large partnerships by audit.

> ■ ***Comment.*** The Electing Large Partnership regime, which is generally available to partnerships that had 100 or more partners in the preceding partnership tax year, was intended to make audits of large partnerships and any subsequent adjustments less burdensome on the IRS and the businesses themselves. Adjustments made at the partnership level flow through to the partners for the year in which the adjustment takes effect, rather than the audit year. Prior-year returns of partners would generally be unaffected. However, only 103 partnerships elected to file Form 1065-B, U.S. Return of Income for Electing Large Partnerships, in 2012, a decrease from 105 in 2011.

In a recent speech delivered before the New York Bar Association Section of Taxation, Koskinen stressed the need for Congressional action to facilitate audits of large partnerships and alleviate burden on partners and IRS examiners. "[Large partnership audits have] become a very challenging area for the IRS, in part because the number and complexity of partnerships has grown significantly over the last several years. A related challenge involves the application of the partnership audit rules contained in the *Tax Equity and Fiscal Responsibility Act of 1982* (TEFRA)," Koskinen said. "The procedures set up under TEFRA were designed to improve tax administration by making it possible for the IRS to conduct audits at the partnership level, instead of auditing each individual partner. But TEFRA was enacted when partnerships generally were smaller than they are today, and before they had complicated tiered structures. These days, having to follow the TEFRA procedures is more of a burden for us than a help. Many partnerships have thousands of partners. TEFRA requires us to notify each of them at the start of an audit and to push down through the partnership to each partner any resulting adjustment. This means thousands of amended K-1's and amended returns."

> ■ ***Comment.*** Currently, Code Sec. 6223(d) requires the IRS to notify all partners if after a partnership audit it issues a Final Partnership Administrative Adjustment (FPAA) to the tax matters partners. A recent IRS Advice Memorandum (AM-2015-003), however, did clarify that the IRS is not required to issue notices when it decides *not* to make adjustments to a partnership return. In addition, the IRS is not required to either link or not link any or all partners in a partnership; but if the IRS does not link partners who should receive notices, it must determine another way to issue them.

Koskinen stated that even if Congress granted the IRS the additional funding it had requested, which would enable the IRS to hire more examiners with partnership experience, legislative action would be necessary. He supported the IRS's current proposal for Congress to mandate certain streamlined audit and adjustment procedures for any partnership that either has 100 or more direct partners and/or that has at least one passthrough entity as a direct partner. "Under the streamlined procedures, only direct partners would receive audit adjustments, and any direct partner that was itself a pass-through entity would be responsible for paying the resulting tax," Koskinen suggested.

Potential developments

Several lawmakers, including President Obama, Rep. Dave Camp, R-Mich., and Sen. Carl Levin, D-Mich., have issued tax reform proposals that include changes for audits of partnership entities, but most of these have fallen flat in the debating room. Camp's proposal from early 2014 would replace the current TEFRA audit procedures with new, streamlined audit procedures conducted at the partnership level. The President has also proposed the repeal of the current partnership audit procedures. He would create new, simplified procedures for partnerships that have an aggregate of 100 or more direct partners during the tax year to which the adjustment relates and partnerships that have at least one partner that is another partnership, estate, trust, S corporation, nominee, or similar person during the tax year to which the adjustment relates.

Meanwhile, the IRS is doing what it can without Congressional help, IRS officials stated during a recent program hosted by the DC Bar. The IRS will continue to focus its limited resources more and more on auditing large partnerships, Rosemary Sereti, acting assistant deputy commissioner, IRS services and enforcement, told practitioners.

> ■ ***Comment.*** Nancy Knapp, Associate Area Counsel, IRS Large Business & International Division (LB&I), echoed Sereti's statement during a panel discussion at the March 6 Tax Law Conference of the Federal Bar Association. She stated that the IRS planned to increase audits of passthrough entities out of recognition that an estimated 191,000 of 296,000 LB&I taxpayers are passthrough entities.

> ■ ***Comment.*** Knapp also stated that the IRS has been able to improve the coordination between its examination agents and subject matter experts, which makes complex audits—including partnership audits—more efficient. However, subject matter experts can only alleviate the burden of complex audits to a certain extent, she qualified.

William Heard III, senior counsel in the Office of Associate Chief Counsel (Procedure & Administration), stated during the DC Bar program that the IRS's goal would be to close the gap between the audit rate for C corporations and the low audit rate for large partnerships. One way to accomplish this, he said, would be to conduct the audit at the partnership level and make the partnership, rather than the IRS, responsible for passing through adjustments to its partners.

Compliance Calendar

March 13
Employers deposit Social Security, Medicare, and withheld income tax for March 7, 8, 9, and 10.

March 16
Corporations file a 2014 calendar year income tax return (Form 1120) and pay any tax due.

S corporations file a 2014 calendar year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., or a substitute Schedule K1.

S corporations file Form 2553, Election by a Small Business Corporation, to elect to be treated as an S corporation beginning with calendar year 2015.

Electing large partnerships provide each partner with a copy of Schedule K1 (Form 1065B), Partner's Share of Income (Loss) From an Electing Large Partnership, or a substitute Schedule K1.

March 18
Employers deposit Social Security, Medicare, and withheld income tax for March 11, 12, and 13.

March 20
Employers deposit Social Security, Medicare, and withheld income tax for March 14, 15, 16, and 17.

March 25
Employers deposit Social Security, Medicare, and withheld income tax for March 18, 19, and 20.

TRC Text Reference Table

The cross references at the end of the articles in CCH Federal Tax Weekly (FTW) are text references to CCH Tax Research Consultant (TRC). The following is a table of TRC text references to developments reported in FTW since the last release of New Developments.

ACCTNG 21,104	67	FILEIND 18,150	79	IRS 12,350	80
ACCTNG 36,162.05	114	FILEIND 21,056.10	123	IRS 33,108.05	87
BUSEXP 6,160.20	102	HEALTH 3,000	55	IRS 45,164.05	54
BUSEXP 9,099	85	HEALTH 3,110	101	IRS 48,058.15	125
BUSEXP 33,106.40	51	HEALTH 3,250	98	IRS 51,056.25	90
BUSEXP 51,150	66	HEALTH 3,300	123	IRS 51,150	76
BUSEXP 54,158.30	39	HEALTH 3,318	50	IRS 66,304	52
BUSEXP 54,164.15	109	HEALTH 3,332	112	IRS 66,304	103
BUSEXP 54,252	99	HEALTH 9,302	99	PAYROLL 3,154	92
CCORP 12,212.10	64	HEALTH 18,108	97	PAYROLL 3,178	88
CONSOL 15,102	121	INDIV 6,266	124	PAYROLL 6,106.40	111
CONSOL 33,050	102	INDIV 33,402	52	PENALTY 3,108.05	89
CONSOL 47,000	53	INDIV 48,400	104	PENALTY 3,308	114
DEPR 3,054.05	75	INDIV 60,158	126	PENALTY 3,332	115
ESTGIFT 45,052.05	100	INDIV 63,106	78	RETIRE 66,764	90
EXCISE 13,108	113	INDIV 66,058	74	RETIRE 69,352	51
EXEMPT 12,054	80	INTL 24,102.05	65	RIC 6,056.05	54
FILEBUS 9,104	64	INTLOUT 3,302	87	SALES 12,452	75
FILEBUS 9,108	77	IRS 6,050	73	SALES 30,206.10	126
FILEIND 15,200	91	IRS 6,106	56	SALES 45,202	112
FILEIND 15,250	116	IRS 12,250	68	SALES 45,350	89

From the Helpline

The following questions have been answered recently by our "CCH Tax Research Consultant" Helpline (1-800-344-3734).

Q Where should a taxpayer report nonqualified long-term care benefits listed on a Form 1099-LTC on his/her tax return?

A Qualified long-term care benefit payments are reported on Form 8853, Archer MSAs and Long-Term Care Insurance Contracts. However, that form warns that if the contract is for nonqualified benefits, the amount must be reported on Form 1040, Line 21 (other income). *See TRC HEALTH: 12,166 for more information.*

Q May a taxpayer who actively participates in rental activity relating to a building be eligible for the energy credit under Code Sec. 48 for costs relating to installation of solar panels on the building?

A There is no limitation in Code Sec. 48 to prevent the lessor or lessee of a building from claiming a credit for purchased solar energy property (assuming the rental activity is active). Neither is there a trade or business requirement, although Code Sec. 48(a)(3)(C) requires that the property be depreciable in the hands of the purchasers. *See TRC BUSEXP: 51,102.05.*