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IRS Unveils Safe Harbor For Deducting, Capitalizing Retail/Restaurant Remodel Costs

Rev. Proc. 2015-56

The IRS has announced a safe harbor method for qualified taxpayers in the restaurant business or retail trades to use to determine if costs paid or incurred to refresh or remodel a qualified building are deductible or must be capitalized. The agency also described how taxpayers may obtain automatic consent to change to the safe harbor method of accounting.

- **Take Away.** Despite the new safe harbor's obvious benefit to those that qualify, the "majority of taxpayers are left out," according to Eric Wallace, CPA, Pittsburgh, instructor/author of CCH® Tangible Property Regulations Certificate Program. "Taxpayers must have an Applicable Financial Statement (AFS), be in retail or restaurant industry (but not including auto dealers or gas stations), and have to create new General Asset Accounts (GAAs) for the percentage of the expenditures that are capitalized," Wallace added (*see page 571 in this week's newsletter for additional comments by Wallace*).

Background

Code Sec. 162 generally allows a deduction for all the ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business, including the costs of repairs and maintenance. Code Sec. 263(a) generally requires the capitalization of amounts paid to acquire, produce, or improve tangible property.

Reg. §1.162-4 allows taxpayers to deduct amounts paid for repairs and maintenance of tangible property if the amounts are not otherwise required to be capitalized. Reg. §1.263(a)-3 generally requires taxpayers to capitalize amounts paid to improve a unit of property. Improvements are defined as amounts paid that are for a betterment to a unit of property, that restore a unit of property, or that adapt a unit of property to a new or different use.

Many remodel-refresh projects are more complicated and diverse than the scenarios included in the regs, the IRS noted. Because remodel-refresh projects frequently involve work performed on building structures and a variety of building systems, the final tangible property regulations generally require taxpayers performing remodel-refresh projects to apply separate legal analyses to many different components of the building. Further, rules under Code Sec. 263A require taxpayers to apply an additional analysis to their remodel-refresh projects to determine which costs must be capitalized as the direct or allocable indirect costs of producing property used in their trade or business, the IRS explained.

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Treasury, IRS Take Additional Steps To Curb Inversions

Notice 2015-79, TDNR JL-10281, TDNR JL-10282

Treasury and the IRS have announced they intend to take additional steps to curb so-called corporate inversions. The measures are designed to "limit the ability of U.S. companies to combine with foreign entities when the new foreign parent is located in a 'third country,' limit the ability of U.S. companies to inflate the new foreign parent corporation's size and avoid the 80-percent rule, and make other regulatory changes," the government explained.

- **Take Away.** "While we intend to take additional action in the coming months, there is only so much the Treasury Department can do to prevent these tax-avoidance transactions," Treasury Secretary Jack Lew said in a conference call with reporters. House Ways and Means Committee Chair Kevin Brady, R-Texas, said in a statement, "inversions need to be addressed, but even Secretary Lew acknowledges that the only real solution to inversions is tax reform that makes American companies more competitive."
- **Comment.** Treasury and the IRS issued guidance on inversions in Notice 2014-42, which Treasury indicated was intended "to reduce some of the economic benefits of inversions." At that time, Treasury reported that more guidance would be forthcoming.

Background

In a corporate inversion, Treasury and the IRS explained that a U.S.-based multinational corporation restructures so that the U.S. parent is acquired by a foreign parent. If the former shareholders or partners of the U.S. entity hold at least 60 percent, but less than 80 percent, of the stock of the foreign parent, then certain tax consequences follow, although the foreign status of the parent is respected. If the former shareholders or partners acquire at least 80 percent of the stock of the foreign parent, the foreign parent is treated as a U.S. corporation, subject to U.S. taxes on all of its income.

Notice 2015-72

Notice 2015-72 describes the activities and transactions about which Treasury and the IRS intend to issue regs.

Tax resident. Notice 2015-72 provides that Treasury and the IRS intend "to issue regs under Code Sec. 7874 that an expanded affiliated group (EAG) cannot have substantial business activities in the relevant foreign country when compared to the EAG's total business activities unless the foreign acquiring corporation is subject to tax as a resident of the relevant foreign country."

Third country. Notice 2015-79 provides that in certain cases when the foreign parent is a tax resident of a third country, "stock of the foreign parent issued to the shareholders of the existing foreign corporation is disregarded for purposes of the ownership requirement, thereby raising the

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Safe Harbor

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Safe harbor

The safe harbor provides an approach under which qualified taxpayers may determine the portions of their remodel-refresh costs that may be deducted or must be capitalized for purposes of Code Secs. 162(a), 263(a), and 263A(b)(1). A qualified taxpayer must treat 75 percent of its qualified costs paid during the tax year as amounts deductible under Code Sec. 162(a) ("the deduction portion") and must treat the remaining 25 percent of its qualified costs paid during the tax year as costs for improvements to a qualified building under Code Sec. 263(a) and as costs for the production of property for use in the qualified taxpayer's trade or business under Code Sec. 263A ("the capital expenditure portion").

A remodel-refresh project for purposes of Rev. Proc. 2015-56 generally means a planned undertaking by a qualified taxpayer on a qualified building to alter its physical appearance and/or layout for one or more certain purposes. Remodel-refresh costs generally mean amounts paid by a qualified taxpayer for remodel, refresh, repair, maintenance, or similar activities performed on a qualified building as part of a remodel-refresh project.

Accounting method

A taxpayer must file an accounting method change to use the safe harbor for the first time. A change to the remodel-refresh safe harbor method of accounting is a change in method of accounting to which Code Secs. 446 and 481, and their regs apply. Rev. Proc. 2015-14 is modified to include the new change of accounting method in Rev. Proc. 2015-56.

References: FED ¶46,450; TRC BUSEXP: 9,092.

REFERENCE KEY

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

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District Court Rejects IRS's Theories On Qualifying As Real Estate Professional And On Grouping Activities

Stanley, DC-Ark., November 12, 2015

A property management firm executive and part owner successfully argued that the IRS incorrectly recharacterized nonpassive income as passive. The IRS lost on its arguments both to deny the taxpayer real estate professional status and to reject the taxpayer's grouping of activities in computing income and loss.

- **Take Away.** "This court analyzed more expansively than any known previous decision the relationship between the special rules for qualifying real estate professionals ('QTPs') (Code Sec. 469(c)(7) and Reg. §1.469-9) and the rules for grouping activities in Reg. §1.469-4," Michael J. Grace, JD, Whiteford Taylor & Preston, LLP, Washington, D.C., told Wolters Kluwer. (*See the Practitioners' Corner in this issue for further analysis by Grace*).

Real estate professional status

The court found that the taxpayer was a real estate professional under Code Sec. 469(c)(7) because he owned more than 5 percent of the outstanding stock of a property management company and, therefore, services he performed for the company (more than 50 percent of his personal services and more than 750 hours for the year) were treated as performed in a real property trade or business. The firm reported the taxpayer's salary of Form W-2 and income as the result of his 10-percent ownership interest on Form K-1, which he then reported on Schedule E as income from an S corp.

In determining qualifying stock ownership for this purpose, the court held that it was immaterial whether:

- The taxpayer's stock ownership bore any risk of loss;
- The taxpayer did not make a capital contribution for his shares;
- Code Sec. 83's property-for-services rule would apply for other purposes; or
- The taxpayer's stock was not readily transferable.

Generally, Reg. §1.469-9(e)(3)(ii) allows a taxpayer to credit toward material participation all "work the taxpayer performs in the management activity" as long as it is performed managing the taxpayer's own rental real estate interests. Therefore, the work in which the taxpayer was engaged for the management company could be counted as work performed in managing his own rental real estate interests.

Further, "Section 469 does not require … that all such services [within a real estate business] must be directly related to real estate," the court found. Since the company was a real property trade or business in which the taxpayer materially participated, he satisfied the requirements of Code Sec. 469(c)(7)(B)(i) and (ii) and, thus, was properly considered a real estate professional.

Aggregation

The court also found that the taxpayer appropriately aggregated the rental real estate activities. The court then rejected the IRS's contention that Reg. §1.469-9(e)(3)(i) prohibited them from grouping their single (aggregated) rental real estate activity with nonrental activities, including a company that provided telecommunications services to the rental units and golf courses adjacent to the rental properties because they constituted an appropriate economic unit and the grouped nonrental activities were all insubstantial in relation to the aggregated rental activity. All the rental real estate properties and the golf courses were under common control and were managed by the company, of which the taxpayer was a 10-percent shareholder.

The parties had agreed before trial about the hours for which the taxpayer had participated. Because he materially participated in the grouped activity, the court characterized its income and losses as nonpassive.

References: 2015-2 USTC ¶50,560; TRC REAL: 12,500.

Inversions

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ownership attributable to the shareholders of the U.S. entity, possibly above the 80 percent threshold."

Anti-stuffing rule. Notice 2015-79, Treasury and the IRS explained, is intended to clarify that the "anti-stuffing rules apply to any assets acquired with a principal purpose of avoiding the 80-percent rule, regardless of whether the assets are passive assets.

Scope of inversion gain. Notice 2015-79, Treasury and the IRS further reported, "expands the scope of inversion gain to include certain taxable deemed dividends recognized by an inverted company."

More measures. Notice 2015-79 provides that "all the built-in gain in the CFC stock must be recognized as a result of the post-inversion transfer, regardless of the amount of the CFC's deferred earnings."Notice 2015-79 also "limits the ability of companies to count passive assets that are not part of the entity's daily business functions in order to inflate the new foreign parent's size and therefore evade the 80-percent rule (this is known as using a 'cash box')." Another measure is intended "to prevent U.S. companies from reducing their size by making extraordinary dividends."

- **Comment.** Generally, Notice 2015-79 applies to acquisitions completed on or after November 19, 2015, subject to certain exceptions.

References: FED ¶¶46,451, 46,452, 46,453; TRC INTL: 30,082.05.

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IRS Announces Changes To Proposed Regs On ABLE Accounts In Interim Guidance

IR-2015-130, Notice 2015-81

The IRS has announced three changes to its proposed regs on tax-advantaged Achieving a Better Life Experience (ABLE) accounts for eligible disabled taxpayers. The changes, which are designed to alleviate the burdens on ABLE account holders and ABLE plan administrators, will appear in the final regs when they are issued, the IRS indicated. Until final regulations are issued, taxpayers can rely this guidance.

- **Take Away.** The IRS noted commenters to the proposed regs raised concerns with the requirement that a qualified ABLE program to establish safeguards to categorize distributions, collect taxpayer identification numbers (TINs) from contributors, and process disability certifications with signed physicians' diagnoses. Many states planning to administer ABLE programs indicated that these requirements would impose on them substantial administrative and cost burdens on them and requested interim guidance while they awaited the final regs.

Background

The *Stephen Beck, Jr., Achieving a Better Life Experience Act of 2014* (ABLE Act), enacted at the end of 2014, authorized states to create ABLE programs, similar to Code Sec. 529 college savings programs, to enable individuals challenged with disabilities and their families to save for and pay for disability-related expenses. Contributions up to the annual gift tax exclusion amount, currently $14,000, may be made to an ABLE account each year (subject to a cumulative limit), and distributions, including earnings, are tax-free to the designated beneficiary if used to pay qualified disability expenses.

Changes

Notice 2015-81 provides that ABLE programs will not need to include safeguards to determine which distributions are for qualified disability expenses. Neither will they be required identify distributions that will be used for housing expenses. However, designated beneficiaries will still need to categorize distributions when determining their federal income tax obligations.

ABLE programs also will not need to request the taxpayer identification numbers (TINs) of contributors to an ABLE account at the time the contribution is made, provided that the program has a system in place to reject contributions exceeding the annual limits. However, if an excess contribution is made into an ABLE account, the program will need to request the contributor's TIN.

Additionally, designated beneficiaries can open an ABLE account by certifying, under penalties of perjury, that (1) they meet the qualification standards, including their receipt of a signed physician's diagnosis (if necessary), and (2) they will retain that diagnosis and provide it to the program or the IRS on request.

References: FED ¶¶46,457, 46,458; TRC INDIV: 30,550.

Proposed Regs Clarify Rules For Requesting Innocent Spouse Relief Under Code Sec. 6015

NPRM REG-134219-08

The IRS has issued proposed regs that would revise the existing regs under Code Sec. 6015, which governs relief from joint and several liability for innocent spouses. Among the proposed changes is additional guidance on the exception under Code Sec. 6015(g)(2) to the judicial doctrine of *res judicata,* a definition of "underpayment" or "unpaid tax" for purposes of obtaining equitable relief under Code Sec. 6015(f), and more.

- **Take Away.** One of the highlights in these regs is that the IRS addresses the question of what is meaningful participation for purposes of the res judicata exception, Robert E. McKenzie, partner, Arnstein & Lehr LLP, Chicago, told Wolters Kluwer. In particular they now give a list of acts that constitute meaningful participation derived form case law and experience, he explained. "One exception [from material participation] is if the requesting spouse can show the nonrequesting spouse was abusive. The importance of the meaningful participation rules is that innocent spouse relief can be raised post-assessment, and even after an adverse Tax Court decision.

Background

Married couples who file joint returns are jointly and severally liable for any tax liabilities, including additions to tax, additional amounts, penalties, and interest, arising from that return. Code Sec. 6015, however, provides three avenues for one spouse to request relief from the responsibility for paying tax, interest, and penalties that would otherwise be jointly owed. The proposed regs would clarify, expand and add to the rules and procedural requirements governing innocent spouse relief.

Proposed changes

Res Judicata. The proposed regs provide guidance on rule under Code Sec. 6015(g)(2) that states a spouse is not eligible for relief under Code Sec. 6015 if relief was at issue in a prior proceeding or if the requesting spouse had participated meaningfully in such prior proceeding. Whether a spouse meaningfully participated in

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District Court Rules In Favor Of Taxpayer In STARS Transaction

Santander Holdings USA, Inc., DC-Mass., November 13, 2015

On a motion for summary judgment, a federal district court has found that a taxpayer had a genuine, non-tax business purpose to participate in a Structured Trust Advantaged Repackaged Securities (STARS) transaction. The taxpayer could claim foreign tax credits and interest deductions related to the transaction.

- **Take Away.** Taxpayers in similar cases have asked for Supreme Court review: *Bank of New York Mellon Corp., 2015-2* USTC *¶50,473 (CA-2)* and *Salem Financial, Inc., 2015-1* USTC *¶50,304 (CA-FC).* On November 10, another federal district court ruled in a similar case, *Wells Fargo, 2015-2* USTC *¶50,558 (see the November 19, 2015 issue of this newsletter for details).*

Background

The taxpayer undertook a STARS transaction with a bank in the U.K. The transaction required the taxpayer to transfer certain assets to a trust, which made the assets subject to taxation in the U.K. The taxpayer received distributions of the trust's income, reduced by an amount to pay the U.K. taxes and a management fee. The IRS disallowed the taxpayer's claim for foreign tax credits related to the transaction.

Court's analysis

The court first found that the step transaction and conduit doctrines hold that transactions that proceed through multiple steps or involve the interaction of a sequence of multiple entities ("conduits") or both can be examined at each step and as to each entity to see whether the step or the entity is included for a genuine business or economic non-tax reason or whether the step or entity is employed only to contrive a tax benefit that a more direct transaction would not yield. The court was not persuaded that these doctrines were applicable to the taxpayer's case. For U.S. tax purposes, there were no steps to collapse or conduits to ignore, the court found.

The court further found that U.K. tax law tends to recognize the form of a transaction, and does not generally engage in substance over form re-characterization. The court noted that the U.K. had not challenged the transaction. Further, the court found that STARS was developed by a U.K. entity that was interested in obtaining tax benefits under its own domestic law. The transaction, according to the court, was not developed because U.S. taxpayers were looking for ways "to game" the U.S. Tax Code.

Additionally, the court found that the participants in the transaction were arm's length counterparties and not related entities. The taxpayer and the U.K. had their own distinct interests. The fact that the taxpayer considered the benefits of the foreign tax credit did not mean that its motive was simply to obtain the credit, the court found.

The court concluded that the loan transaction was legitimate and the taxpayer could deduct the interest expense for the loan. The taxpayer also was entitled to claim the foreign tax credit.

References: 2015-2 USTC *¶50,564; TRC INTLOUT: 3,100.*

Innocent Spouse

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a prior proceeding requires an analysis of the facts and circumstances. The IRS has proposed adding a non-exclusive list of acts that, if they occurred, would indicated a spouse's meaningful participation in the prior proceeding.

The proposed regs also clarify that the fact that the requesting spouse did not have the ability to effectively contest the underlying deficiency in a prior proceeding is irrelevant for purposes of determining whether the requesting spouse meaningfully participated in the prior proceeding. The correct standard requires the court to ask whether the taxpayer could have raised relief under Code Sec. 6015, not whether he or she could contest the deficiency.

Code Sec. 6015(f). The proposed regulations state that for purposes of requesting equitable relief from liabilities for unpaid tax or underpayments under Code Sec. 6015(f), the terms "unpaid tax" and "underpayment" have the same meaning. The proposed regs further define "unpaid tax or underpayment on a joint Return" as the balance shown as due on the return reduced by the tax paid with the return or paid on or before the due date for payment (without considering any extension of time to pay). The regs set forth additional details on how to calculate the balance due.

Refunds. The proposed regs set forth a general rule that a requesting spouse who is entitled to relief is generally not eligible for a credit or refund of joint payments made with the nonrequesting spouse. A requesting spouse, however, may be eligible for a credit or refund of the requesting spouse's portion of the a joint overpayment from another tax year—the extent that the requesting spouse can establish his or her contribution to the overpayment.

Requesting relief. The proposed regs would revise Reg. §1.6015-1 so that a requesting spouse does not need to indicate whether he or she is requesting innocent spouse relief under Code Sec. 6015(b), (c), or (f). The regs provide that the IRS will consider in all cases whether the requesting spouse is eligible for relief under any of these subsections.

Other changes

The proposed regs would also expand the rule that penalties and interest are not separate items from which relief can be obtained in cases involving underpayments. The regs would incorporate an administratively developed rule that attribution of an erroneous item follows the attribution of the underlying item that caused the increase to adjusted gross income (AGI), and would update the rules for allocating liability between spouses under Code Sec. 6015(c). Additionally, the regs would revise the rules regarding prohibition on collection and suspension of the collection statute.

References: FED ¶49,674; TRC LITIG: 6,130.35.

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Private Foundation/Manager Liable For Excise Taxes; Amounts Paid For Radio Messages Were Taxable Expenditures

Parks, 145 T.C. No. 12

The Tax Court has found that a private foundation and its manager were liable for excise taxes on amounts they paid for radio messages to influence state legislation. The amounts paid for the messages were taxable expenditures within the definition of Code Sec. 4945(d)(1).

- **Take Away.** Under Code Sec. 4945, a private foundation is subject to an excise tax equal to 10 percent of a taxable expenditure. An excise tax of 100 percent of the expenditure is imposed if the foundation does not correct the taxable expenditure within the taxable period. Excise taxes are also imposed if a foundation manager willfully agrees to the expenditure and also if the manager fails to timely correct the expenditure.

Background

Code Sec. 4945(d)(1) provides that any amount paid by a private foundation "to carry on propaganda, or otherwise to attempt, to influence legislation" is a taxable expenditure. Code Sec. 4945(e) further defines "taxable expenditure" as any amount paid or incurred by a private foundation for an attempt to influence legislation through appeals to either the general public or any member or employee of a legislative body or other government official "other than through making available the results of nonpartisan analysis, study, or research."

- **Comment.** The regs state that an amount paid for a "direct or grass roots lobbying communication" is a taxable expenditure if the communication is made to any member or employee of a legislative body or any government official or employee who may participate in the formulation of the legislation, with the principal purpose to influence legislation. The regs further provide that a direct lobbying communication will be treated as an attempt to influence legislation only if it "refers to specific legislation" and "reflects a view on such legislation."

A tax-exempt private foundation under Code Sec. 509(a) spent $639,073 for several radio messages advocating a particular position on certain state ballot measures. Two messages referred specifically named the ballot measure in question. The others did not.

The IRS determined the amounts the foundation paid for these messages were taxable expenditures because the messages were attempts to influence legislation.

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AFRs Issued For December 2015

Rev. Rul. 2015-25

The IRS has released the short-term, mid-term, and long-term applicable interest rates for December 2015.

Applicable Federal Rates (AFR) for December 2015

Short-Term	Annual	Semiannual	Quarterly	Monthly
AFR	.56%	.56%	.56%	.56%
110% AFR	.62%	.62%	.62%	.62%
120% AFR	.67%	.67%	.67%	.67%
130% AFR	.73%	.73%	.73%	.73%
Mid-Term				
AFR	1.68%	1.67%	1.67%	1.66%
110% AFR	1.85%	1.84%	1.84%	1.83%
120% AFR	2.01%	2.00%	2.00%	1.99%
130% AFR	2.18%	2.17%	2.16%	2.16%
150% AFR	2.53%	2.51%	2.50%	2.50%
175% AFR	2.94%	2.92%	2.91%	2.90%
Long-Term				
AFR	2.61%	2.59%	2.58%	2.58%
110% AFR	2.87%	2.85%	2.84%	2.83%
120% AFR	3.13%	3.11%	3.10%	3.09%
130% AFR	3.40%	3.37%	3.36%	3.35%

Adjusted AFRs for December 2015

	Annual	Semiannual	Quarterly	Monthly
Short-term adjusted AFR	.48%	.48%	.48%	.48%
Mid-term adjusted AFR	1.38%	1.38%	1.38%	1.38%
Long-term adjusted AFR	2.61%	2.59%	2.58%	2.58%

The Code Sec. 382 adjusted federal long-term rate is 2.61%; the long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months) is 2.61%; the Code Sec. 42(b)(2) appropriate percentages for the 70% and 30% present value low-income housing credit are 7.49% and 3.21%, respectively, however, the appropriate percentage for non-federally subsidized new buildings placed in service after July 30, 2008, and before January 1, 2015, shall not be less than 9%; the Code Sec. 7520 AFR for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest is 2.0%; and the pplicable rate of interest for 2016 for purposes of Code Secs. 846 and 807 is 1.56%.

References: FED ¶46,456; TRC ACCTNG: 36,162.05.

TAX BRIEFS

Internal Revenue Service

The IRS has released the Railroad Retirement Tax Act (RRTA) tier 2 tax rates for 2016 for railroad employees, employers and employee representatives, respectively. For 2016, the tier 2 tax rate on employees is 4.9 percent of compensation and the tier 2 tax rate on employers and employee representatives is 13.1 percent of compensation.

Publication of the Tier 2 Tax Rates, FED ¶46,454; TRC PAYROLL: 9,052

The IRS has scheduled a December 18 hearing on proposed regulations relating to the administration of a multiemployer plan participant vote on an approved suspension of benefits under the Multiemployer Pension Reform Act of 2014 (P.L. 113-235) (NPRM REG-123640-15, I.R.B. 2015-37, 350; TAXDAY, 2015/09/01, I.2) beginning at 10:00 a.m. in the IRS Auditorium, Internal Revenue Service Building, 1111 Constitution Avenue, NW., Washington, D.C. 20224.

Notice of Hearing, NPRM REG-123640-15, FED ¶46,449; TRC RETIRE: 57,212.20

Jurisdiction

An married couple's petition for redetermination of a deficiency was properly dismissed because it was untimely. The taxpayers argument that their petition was timely filed under the timely-mailing is timely-filing rule was dismissed as they failed to show a timely postmark. Since the petition was not filed, or treated as filed, within the statutorily prescribed period, the Tax Court lacked jurisdiction to review the Collection Due Process hearing determination to proceed with the collection action.

Haddix, TC, Dec. 60,449(M), FED ¶48,159(M);TRC LITIG: 6,106.10

A federal district refused to reconsider its decision dismissing a married couple's refund claim for lack of subject matter jurisdiction. The claim was untimely and the limitations period could not be tolled under Code Sec. 6511(h) because the couple failed to notify the IRS that there was no person authorized to manage the husband's financial affairs during the applicable period.

Reilly, DC Calif., 2015-2 USTC ¶50,563; TRC IRS: 36,052.05

A federal district court had jurisdiction over the government's action to reduce to judgment an individual's outstanding tax liabilities and foreclose federal tax liens on the individual's property. The individual's arguments that he was a sovereign American citizen and the court lacked jurisdiction over the government's foreclosure action were dismissed as frivolous.

Campbell, Jr., DC Fla., 2015-2 USTC ¶50,562; TRC IRS: 45,158

Deductions

Two individuals were not entitled to deduct losses equal to the remaining unamortized basis in a contract. The taxpayers contended that their partnership suffered a loss because its original towing contract expired and, therefore, they were entitled to a deduction under Code Sec. 165 for the tax year at issue. However, the partnership did not suffer a loss even if the contract had expired because the LLC continued to enjoy the benefits of the towing contract even after it expired. A negligence penalty applied.

Steinberg, TC, Dec. 60,451(M), FED ¶48,161(M); TRC BUSEXP: 30,100

An individual was not entitled to deduct claimed expenses in excess of amounts already allowed because they were unsubstantiated. Since the individual, a nurse who provided in-home nursing services, failed to substantiate her claimed business expenses, a negligence penalty was imposed.

Beaubrun, TC, Dec. 60,445(M), FED ¶48,155(M); TRC BUSEXP: 3,100

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IRS Requests Information About PEOs For Certification Program

As it begins to create a certification program for professional employer organizations (PEOs), the IRS is requesting information about PEO practices. The IRS is seeking to learn about financial audit practices, verification of payroll tax obligations, working capital and net worth requirements, and covered employees.

Background. Under the *Tax Increase Prevention Act of 2014* (TIPA), the IRS must create a mechanism for voluntary certification of PEOs, for purposes of the employment tax provisions, as the employer of service providers they lease to their customers. A PEO generally must show that it satisfies requirements to be established by the IRS, including requirements with respect to tax status, background, experience, business location, and annual financial audits. The PEO also must meet bond and independent financial review requirements and comply with reporting obligations that may be imposed by the IRS. Further, the PEO must adopt the accrual method of accounting to compute its taxable income.

- **Comment.** The IRS explained that many states impose licensing, registration, and other statutory and regulatory requirements on PEOs that do business in the state. Some private assurance organizations offer PEOs "accreditation" if they satisfy certain requirements.

Request for information. The IRS has requested information about current PEO industry practices regarding audits of financial statements by certified public accountants (CPAs). This includes whether and how audits of PEOs differ in any material respects from audits of companies in other industries; and whether the CPAs conducting the audits confirm compliance with any applicable net worth or working capital requirements.

The IRS also has requested information about current PEO practices for verification of payroll tax obligations, working capital and net worth requirements, and covered employees.

IR-2015-127; TRC SALES: 39,000.

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Tax Briefs

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Summons

An accountant's petition to quash an IRS summons to produce documents and give testimony relating to an investigation into her client's tax liabilities was dismissed for lack of subject matter jurisdiction and the summons was ordered enforced. The accountant was not a party entitled to notice; therefore, the government did not waive its sovereign immunity for her to challenge the summons.

Ellis, DC Miss., 2015-2 USTC ¶50,565; TRC IRS: 21,350

An IRS summons directing an individual to appear, testify and produce documents relating to an investigation of his undisclosed offshore accounts and foreign entities was ordered enforced. The individual failed to present any evidence to support his lack of possession defense.

Malhas, DC Ill., 2015-2 USTC ¶50,559; TRC IRS: 21,300

Tax Shelters

The IRS properly ignored two limited liability companies created and utilized by a tax-shelter promoter seeking to avoid taxation, and the IRS's adjustments in a final partnership administrative adjustment (FPAA) were sustained. However, disallowance of an interest expense by the IRS was reversed. Penalties were applicable.

AD Investment 2000 Fund LLC, TC, Dec. 60,452(M), FED ¶48,162(M); TRC PART: 9,112

Innocent Spouse

An individual was not entitled to equitable innocent spouse relief because she knew or had reason to know that her husband would not pay the tax liabilities reported on their returns. The individual was aware her husband had financial difficulties due to his unprofitable farming business, she was not a victim of spousal abuse and would not suffer economic hardship if equitable relief was not granted.

Hall, TC, Dec. 60,450(M), FED ¶48,160(M); TRC INDIV: 18,056.05

Tax Court

An individual was bound by the stipulation of settled issues that he filed with the Tax Court; therefore, the court entered a decision consistent with the IRS's tax computations. The taxpayer's contention that there was no "meeting of the minds" regarding the settlement was rejected. The stipulation of settled issues was a binding contract involving mutual concessions and it finally resolved all substantive tax issues in the case. The fact that the parties did not agree to the ultimate tax consequences did not render the stipulations any less binding.

McMullen, TC, Dec. 60,447(M), FED ¶48,157(M); TRC LITIG: 6,612.05

Tax Crimes

An individual's conviction for filing false tax returns and aggravated identity theft was affirmed; however, the portion of his sentence imposing restitution was vacated and remanded for recalculation. The court's order of restitution was improper. Moreover, the error affected the individual's substantial rights because the amount he was ordered to pay far exceeded the amount the district court was authorized to impose.

Nore, CA-11, 2015-2 USTC ¶50,561; TRC IRS: 66,202

Tax-Exempt Status

A tax-exempt trust was denied abatement of the excise tax imposed on it under Code Sec. 4945 for failing to meet the technical requirements for expenditure responsibility. The trust had made grants to a foundation for a number of years that did not meet the technical requirements under Code Sec. 4945(d)(4). Therefore, the four transfers from the trust to the foundation that failed to meet these requirements were taxable expenditures. Although the trustees took corrective actions after learning of the omissions, their ignorance of the rules did alter the fact that they did not act reasonably.

Technical Advice Memorandum 201547007, FED ¶47,435; TRC EXEMPT: 24,676.10

The IRS properly denied a nonprofit corporation tax-exempt status. The corporation proposed to provide recreational activities, including gaming activities, to adults for the purpose of promoting adult sobriety and the general welfare of the citizens of the state (Montana). The form of recreation offered as therapy was also offered by for-profit entities.

GameHearts, a Montana Nonprofit Corporation, TC, Dec. 60,446(M), FED ¶48,156(M); TRC EXEMPT: 3,050

FOIA

The IRS adequately searched for documents pursuant to a Freedom of Information Act (FOIA) request pertaining to an estate and properly withheld two documents that were exempt. The IRS submitted a declaration from a senior disclosure specialist that it conducted comprehensive inquiries and searches for the requested documents and the individual failed to present evidence challenging the adequacy or sufficiency of the IRS's search.

Kohake, CA-6, 2015-2 USTC ¶50,566; TRC IRS: 9,502

Bankruptcy

A bankruptcy court properly denied a Chapter 7 debtor's challenge to the IRS's proof of claim and did not abuse its discretion in doing so without a hearing. The evidence supported the IRS's claim. Moreover, the debtor was given "notice and a hearing" because he was given notice appropriate to the circumstances and an opportunity for a hearing.

R.H. Drake, Jr., CA-2, 2015-2 USTC ¶50,567; TRC IRS: 57,062

Foundations

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Court's analysis

The Tax Court found that all but one of the private foundation's expenditures for the production and broadcast of the radio messages at issue were attempts to influence legislation and thus taxable expenditures under section 4945(d)(1) and (5). With respect to the messages that did not refer specifically to the name of the ballot measure, the court found that a communication "refers to" a ballot measure within the meaning of the regulations if it either refers to the measure by name or, without naming it, employs terms widely used in connection with the measure or describes the content or effect of the measure.

- **Comment.** The court held that one message, which had quoted facts and statistics, constituted nonpartisan analysis, study, or research, and included activity that was educational.

References: Dec. 60,448; TRC EXEMPT: 6,106.

PRACTITIONERS' CORNER

Analysis Of Relationship Between Passive Loss Rules And Qualifying Real Estate Professionals In *Stanley*

By Michael J. Grace, JD, Whiteford Taylor & Preston LLP, Washington, D.C., formerly IRS Principal Author of some of the regulations the court analyzed in Stanley. Stanley, DC Ark, 2015-2 USTC *¶50,560 is also summarized on page 563 of this issue.*

In a decision holding for Mr. and Mrs. Stanley and suggesting implications for similarly situated taxpayers, the court analyzed more expansively than any known previous decision the relationship between the special rules for qualifying real estate professionals ("QTPs") in Code Section 469(c)(7) and Reg. §1.469–9 and the rules for grouping activities in Reg. §1.469–4.

Like *Glick v. U.S.,* 96 F. Supp. 2nd 850 (S.D. Ind. 2000), *Stanley* holds that an activity of managing rental real estate may be grouped with a rental real estate activity because (i) the activities represented an appropriate economic unit and (ii) the managerial activity was insubstantial in relation to the rental real estate activity. *Stanley* helpfully expands upon *Glick* by addressing permissible activity groupings by a QTP who had elected to aggregate all rental real estate into a single rental real estate activity. *Stanley* also supplements *Glick* by shedding additional light on determining "insubstantiality" (see also *Candelaria v. U.S.,* 518 F. Supp. 2nd 852 (W.D. Tex. 2007)). Because it involved tax years predating the effective date of Code Sec. 469(c)(7), *Glick* did not address QTPs or consequences of their electing to aggregate otherwise separate interests in rental real estate.

Positive aspects

The court correctly analyzed and applied numerous aspects of the rules at issue.

- Code Sec. 469(c)(7) requires a two-step analysis: first, does the taxpayer satisfy the threshold standards for being a QTP? Second, did the QTP materially participate in rental real estate activities (""RRAs")? Other courts have truncated or confused these separate analytical steps.
- Aggregating otherwise separate interests in rental real estate must be distinguished from grouping activities.
- By rejecting the IRS's various arguments that Mr. Stanley failed to qualify as a 5-percent owner, the court implicitly confirmed the principle that an S corporation legally may bifurcate income from a shareholder's performing services between salary and a pro rata share of the corporation's income.
- The court understood the relationship between Reg. §§1.469-4 and 1.469-9.
- The court helpfully analyzed the role of participating in management under Reg. §1.469-9(e)(3)(ii).

"…[T]he court rejected the IRS's now familiar argument that participation should be sliced and diced depending on the particular capacity in which the taxpayer participates at any given time."

Grouping analysis

Until the decision's final paragraph, the court correctly and perceptively analyzed the relationship between Reg. §§1.469-9 and 1.469-4. It understood that even if the taxpayer is a QTP, Reg. §1.469–9 does not trump or override Reg. §1.469–4. Rather, for a QTP, the two sets of rules work together. A QTP may group a RRA (as identified under Reg. §1.469-9) with one or more trade or business activities to the extent the grouping satisfies applicable rules in Reg. §1.469-4.

Although the court did not reference it, Reg. §1.469-9(e)(1) further supports its conclusion that a QTP may group a RRA with other activities under Reg. §1.469-4. Reg. §1.469-9(e)(1) reads in relevant part: "Each separate rental real estate activity, or the single combined rental real estate activity if the taxpayer makes an election under [Reg. §1.469-9(g)], will be an activity of the taxpayer for all purposes of section 469…" Those "all purposes"include possibly grouping the RRAs (or single RRA) with other activities under Reg. §1.469-4.

- **Comment.** For additional guidance on grouping otherwise separate activities under Reg. §1.469-4, tax advisors might consult *Lamas v. Commissioner,* T.C. Memo 2015–-59, although that case did not involve QTPs or grouping rental real estate with trade or business activities.
- **Caution.** A real property rental activity may not be grouped with a personal property rental activity. *See* Reg. §1.469-4(d)(2). That's because a QTP may establish material participation in a RRA, but activities of renting personal property generally are *per se* passive regardless of participation.

The decision's final paragraph does not seem to follow from the court's preceding analysis. The Court correctly had determined that some of the Stanleys' trade or business activities should be grouped with its single (aggregated) RRA. It also had determined that, to answer the threshold question of whether a QTP materially participates in one or more RRAs, participation in other activities (except particular managerial activities) may not be taken

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WASHINGTON REPORT *by the Wolters Kluwer Washington News Bureau*

New House and Ways chair describes goals

New House Ways and Means Chair Kevin Brady, R-Texas, on November 18 described his vision for his committee for the rest of the 114th Congress. Regarding taxes, Brady said he will pursue modernizing what he termed "outdated U.S. international tax rules." He added that "No one has yet convinced me a dollar left overseas is better than a dollar brought home to be invested in new research, jobs and facilities." Brady was selected chair of the Ways and Means Committee after Rep. Paul Ryan, R-Wisconsin, was elected Speaker of the House.

Some of the tax extenders should be made permanent to create certainty, which in turn "boosts the local economy, and advances tax simplification by removing the asterisk from so many temporary provisions," according to Brady. He declared that an important step forward concerning the extenders is "to end this cycle of important but temporary tax provisions."

Brady said that over the coming months the Ways and Means Committee "is going to take real steps toward fixing our broken Tax Code by examining and engaging the ideas and energy of every House member who wishes to be heard. America needs a simpler, fairer, flatter tax code that's built for growth."

In related news, Joint Committee on Taxation (JCT) Vice Chairman Orrin Hatch, R-Utah, on November 19 announced that Brady was elected JCT chair for the remainder of the first session of the 114th Congress. As a result of polls conducted on November 18 among JCT members, it was also determined that Brady will serve as vice chair when the second session of the 114th Congress begins.

Senators seek to end wind production tax credit

A bipartisan group of seven senators expressed their opposition to renewal of the wind energy production tax credit on November 19. In a letter to Senate Majority Leader Mitch McConnell, R-Ky., and Senate Minority Leader Harry Reid, D-Nevada, the seven senators said that the cost of the credit outweighed its benefits. "This expensive subsidy for wind creates an incentive for investors to build unreliable and unsightly sources of electricity, and distorts the market by giving wind an unfair advantage over other, more reliable and cost-competitive forms of electricity generation," the senators wrote.

In July, the Senate Finance Committee voted 23-3 to approve legislation to extend the production tax credit as part of a package of tax extenders. In 2014, Congress extended the credit at a cost of $6.2 billion over 10 years, the senators said. An additional two-year extension is estimated to cost $9.4 billion over 10 years, they added.

Koskinen expresses optimism about FY 2016 budget

IRS Commissioner John Koskinen expressed optimism that Congress would increase the agency's budget for fiscal year (FY) 2016 after a number of years of budget cuts. "I have hope there may be an increase in funding," Koskinen said. He noted that in recent weeks and days, a number of organizations have called on Congress to increase funding for the IRS in FY 2016. Seven former commissioners wrote to lawmakers on November 9, urging Congress to boost the Service's funding On November 17, the National Society of Accountants (NSA) sent a similar letter to lawmakers. The IRS Advisory Committee (IRSAC) added its voice to the budget debate on November 18. Koskinen spoke at the International Conference on Taxpayer Rights held in Washington, D.C. on November 18.

Lawmakers are currently working on appropriations bills for FY 2016 before a stop-gap spending bill expires in mid-December. In the House, appropriators have approved an $838 million reduction in the agency's budget for FY 2016. Senate appropriators have approved legislation that would cut the IRS's budget by $470 million for FY 2016.

"Taxpayers have the right to expect a certain level of service," Koskinen said. "We need adequate funding to meet that demand," he emphasized.

TIGTA reviews trends in compliance

The IRS has increased the total dollars received and collected for the fourth straight year, despite funding cuts and fewer employees, the Treasury Inspector General for Tax Administration (TIGTA) recently reported. TIGTA's review was conducted to analyze the trends in IRS collection and examination activities.

TIGTA found that the total dollars received and collected increased to $3.1 trillion (a 6.8 percent increase) in fiscal year (FY) 2014. Enforcement revenue collected also increased from $53.3 billion in FY 2013 to $57.1 billion in FY 2014. Tax return filings remained steady while gross accounts receivable increased to $412 billion.

TIGTA reported that the IRS has faced declining funding levels in three of the last four fiscal years. The budget cuts resulted in reductions in the number of employees available to provide services to taxpayers and for enforcement activities. Overall IRS employment has declined 15 percent from 107,622 in FY 2010 to 91,018 in FY 2014. However, the IRS's responsibilities have expanded as it continued implementing tax-related portions of the *Affordable Care Act* and the *Foreign Account Tax Compliance Act,* TIGTA observed.

The number of examinations conducted in FY 2014 decreased by 11 percent from FY 2013, TIGTA reported. The decline in examinations occurred across all tax return types, including individual, corporation, S corporation, and partnership. The dollar yield per hour for most return types decreased and the no-change rates increased for most types of examinations. TIGTA made no recommendations in this report. IRS officials were provided with an opportunity to review the draft report and did not provide any comments.

Safe-Harbor Method For Retail And Restaurant Refresh-Remodeling Costs Limited In Scope, Expert Observes

By Eric Wallace, CPA, Pittsburgh, instructor/author of CCH® Tangible Property Regulations Certificate Program, and TPR Tools and Templates website.

Rev. Proc. 2015-56 creates a very detailed and complicated process for certain "qualified" taxpayers to employ a brand new "safe harbor" for determining whether expenses paid or incurred to remodel or refresh a "qualified" building are required to be capitalized or classified as refresh-remodeling (R&M):

- First of all the space that the Qualified Taxpayers performs its refresh/remodel work on cannot be more than 20 percent of the total square footage of the qualified building
- If the taxpayer is qualified and if the building work is qualified, then 75 percent of the refresh/remodel expenditures can be classified as R&M costs but 25 percent has to be capitalized.

Additional restrictions

There are further restrictions on the 25-percent part that has to be capitalized under the safe harbor:

- Those costs cannot qualify for partial asset dispositions, and
- The taxpayer has to put that 25-percent part in a new GAA.
- **Comment.** The IRS stepped on its tail in the tangible property temporary regulations that were issued in 2011 when it created the need for General Asset Accounts (GAAs) related to (PADs), pulled that requirement when they issued the final tangible property regulations (TPRs), but now has gone back to the same bad well water in creating the need for GAAs in Rev. Proc. 2015-56.
- **Comment.** Additionally, in order to use this new refresh/remodel safe harbor a qualifying taxpayer has to go through the significant trouble of amending prior year tax returns and filing new Form 3115s.

Conclusions

Due to the limited applicability and difficulty of employing Rev. Rul. 2015-56, the IRS has ruined a great opportunity to simplify the R&M-versus-capitalization issue for a significant portion of the U.S. GDP, i.e. the retail and restaurant industry. Additionally, as the taxpayer is required to have an applicable financial statement (AFS) to qualify for this safe harbor, the IRS is putting in place a procedure that simply will not work for the majority of taxpayers in these industries, i.e. the small business taxpayers.

Practitioners' Corner

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into account. See Reg. §1.469-9(e)(3)(i). Because, however, the trade or business activities were insubstantial, the grouped activity (as the court correctly observed) constituted a RRA. Because Mr. Stanley was a QTP, that RRA correctly became the activity in which the taxpayer's participation should be measured, and his participation in both the RRA and the otherwise separate trade or business activities should count. The court's appearing to state a contrary conclusion in the decision's final paragraph seems both puzzling and incorrect.

Aggregating versus grouping

It is important to distinguish "aggregating" activities from "grouping" activities. Aggregating involves only rental real estate of a QTP. A QTP may elect to aggregate into one RRA all otherwise separate interests in rental real estate. It's an "all or nothing"choice—a QTP cannot choose which interests to aggregate and which interests not to aggregate.

Grouping involves combining two or more otherwise separate activities into one activity based on particular facts and circumstances including the factors in Reg. §1.469-4(c)(2). The extent to which otherwise separate activities may be grouped depends on the particular facts.

Material participation

The court helpfully applied the rule in Reg. §1.469–9(e)(3)(ii) that participating in an activity of managing rental real estate may be treated as participation in the managed rental real estate activity. In applying this rule, the court rejected the IRS' now familiar argument that participation should be sliced and diced depending on the particular capacity in which the taxpayer participates at any given time. Reg. §1.469-5(f)(1), which the court later referenced, supports the court's conclusion: participation includes "any work done by an individual (without regard to the capacity in which the individual does the work)…".

Substantiating participation

Stanley breaks no new ground in establishing the nature of the evidence a taxpayer needs in order to prove that he or she materially participated in real property trades or businesses or RRAs. The parties apparently agreed that Mr. Stanley participated more than 750 hours in material participation real property trades or businesses and more than 500 hours in RRAs.

In advising clients seeking to deduct losses from RRAs without limitation by Code Sec. 469, tax advisors should continue to caution that based on numerous other court cases the more specific and contemporaneous the proof of participation, the better.

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COMPLIANCE CALENDAR

November 30
Employers deposit Social Security, Medicare, and withheld income tax for November 21, 22, 23, and 24.

December 2
Employers deposit Social Security, Medicare, and withheld income tax for November 25, 26, and 27.

December 4
Employers deposit Social Security, Medicare, and withheld income tax for November 28, 29, 30, and December 1.

December 9
Employers deposit Social Security, Medicare, and withheld income tax for December 2, 3, and 4.

December 10
Employees who received $20 or more in tips during November report them to their employers using Form 4070.

December 11
Employers deposit Social Security, Medicare, and withheld income tax for December 5, 6, 7, and 8.

TRC TEXT REFERENCE TABLE

The cross references at the end of the articles in Wolters Kluwer Federal Tax Weekly (FTW) are text references to 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 33,152.05	528	HEALTH 3,300	519	IRS 66,305	550
ACCTNG 36,162.05	566	HEALTH 18,000	556	IRS 66,305	554
BUSEXP 3,050	518	HEALTH 18,108	551	IRS 66,360	505
BUSEXP 6,106.15	542	INDIV 30,550	564	LITIG 6,130.35	564
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BUSEXP 12,304.05	553	INTL 30,082.05	562	PAYROLL 9,104	553
COMPEN 15,208	504	INTL 33,050	538	REAL 12,500	563
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DEPR 3,504	566	IRS 3,052	539	RETIRE 39,058.20	552
ESTGIFT 3,158	529	IRS 3,106	554	RETIRE 66,750	537
ESTGIFT 45,252.45	542	IRS 3,200	527	SALES 3,154	555
EXCISE 9,102.05	530	IRS 3,208.05	543	SALES 6,156	507
FILEBUS 9,158	540	IRS 6,106.05	526	SALES 39,000	567
FILEBUS 9,322	494	IRS 6,106.05	551	SALES 51,100	527
FILEBUS 9,458.10	531	IRS 9,400	528	SALES 51,406	552
FILEIND 15,204.05	514	IRS 21,400	549	SCORP 304.10	540

MONTHLY QUIZZER

The following questions (with answers at the bottom of the column) will help you review some of the more important developments in Wolters Kluwer Federal Tax Weekly during the past month.

Q1. The IRS announced a safe harbor method to determine if costs paid or incurred to refresh or remodel a qualified building are deductible or must be capitalized for qualified taxpayers in:

(a) Restaurant and retail trades
(b) Interstate railways
(c) Trans-Pacific shipping
(d) None of the above

Q2. Victims of identity theft and tax refund fraud may now obtain copies of fraudulent Forms 1040, 1040A, 1040EZ, 1040NR, or 1040NR-EZ filed under their names. ***True or False?***

Q3. The *my*RA retirement savings plan is similar to:

(a) Roth IRAs
(b) ESOPs
(c) TRICARE
(d) None of the above

Q4. The *Bipartisan Budget Act of 2015* repeals the rules for audits of partnerships and partners outlined in the *Tax Equity and Fiscal Responsibility Act* (TEFRA). ***True or False?***

Answers:
Q1. *(a), See Issue #48, page 561.*
Q2. *True, See Issue #47, page 550.*
Q3. *(a), See Issue #46, page 537.*
Q4. *True, See Issue #45, page 525.*