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# Obama Signs Highway Bill With Tax Offsets; Negotiations Continue On Omnibus And Extenders

***Fixing America's Surface Transportation (FAST) Act, (P.L. 114-94)***

President Obama signed on December 4 the *Fixing America's Surface Transportation (FAST) Act* (P.L. 114-94), a multi-year highway and transportation spending bill. The FAST Act authorizes the federal government to deny or revoke a U.S. passport to individuals with "seriously delinquent tax debt," mandates that the IRS contracts with private collection agencies to collect some tax debts, extends highway taxes, and repeals an extended due date for Form 5500, Annual Returns/Reports of Employee Benefit Plan. At the same time, lawmakers are facing a rapidly approaching deadline to pass an omnibus federal funding bill for fiscal year (FY) 2016 as well as deciding the fate of the tax extenders.

- ***Take Away.*** The breadth and impact of these measures are limited, David Kautter, Partner in Charge, Washington National Tax Office, RSM, told Wolters Kluwer. However, Kautter noted that taxpayers who are affected, particularly individuals outside the U.S. who may not be aware of the passport-related changes, need to be advised.
- ***Comment.*** As of press time, negotiations continue among the GOP, Democrats and the White House over the extenders and the omnibus spending bill. *For details of the progress of the extenders and the omnibus, see Tax Day on IntelliConnect.*

## Passports

Under the FAST Act, if the IRS certifies that an individual has a seriously delinquent tax debt, the State Department may deny, revoke or limit that individual's U.S. passport. For purposes of the FAST Act, a seriously delinquent tax debt is an unpaid federal tax liability which has been assessed, greater than $50,000 (adjusted for inflation after 2016), and for which a notice of federal tax lien has been filed (and administrative rights under Code Sec. 6320 have been exhausted or have lapsed) or a federal levy has been made. However, the term seriously delinquent tax debt does not encompass taxpayers who are making timely payments under an installment agreement, taxpayers who have requested, or have a pending, collection due process (CDP) hearing, or who have requested, or have a pending, offer in compromise. The measure is projected to raise $398 million over 10 years.

- ***Comment.*** The conference agreement added a series of procedural protections for taxpayers, Kautter noted.

The FAST Act provides for judicial review of certifications. If a federal district court or the Tax Court finds that a certification was erroneous, the court will instruct the State Department and the IRS to reverse the certification. The FAST Act also provides that the State Department may issue a passport in emergency circumstances or for humanitarian reasons as well as allowing, before revocation, a previously-issued passport to be used only for return travel to the U.S., or issuing a limited passport that only permits return travel to the U.S.

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## Tax Offsets

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- ***Comment.*** After the IRS notifies the State Department that the affected individual no longer has a seriously delinquent tax debt, the State Department will remove the certification related to that debt.

## Tax collection

The FAST Act directs the IRS to contract with one or more private collection agencies for the collection of outstanding inactive tax receivables. For purposes of the FAST Act, an inactive tax receivable is a case that the IRS has removed from its active inventory because of a lack of resources or inability to locate the taxpayer, a case where more than 1/3 of the period of the applicable limitations period has elapsed and the case has not been assigned to an IRS employee, or a case where more than 365 days have passed without interaction between the IRS and the taxpayer.

- ***Comment.*** These represent a fairly finite set of taxpayer accounts, Kautter observed. "For one reason or another, the IRS has given up on these cases," he noted.
- ***Comment.*** Both IRS Commissioner John Koskinen and National Taxpayer Advocate Nina Olson have spoken against using private collection agencies, but the estimated revenue ($2.4 billion over 10 years) made the proposal an attractive offset for the highway bill.

The FAST Act precludes the IRS from contracting out some cases. These include cases subject to a pending or active installment agreement or offer in compromise, innocent spouse cases, cases where the taxpayer is under examination, litigation, criminal investigation, or levy, cases where the taxpayer is under age 18, and cases where the taxpayer is in a combat zone. Additionally, private collection agencies cannot work cases where the taxpayer is deceased.

- ***Comment.*** Private collection agencies must operate within the parameters of federal statutes on collection, such as the *Fair Debt Collection Practices Act.*
- ***Comment.*** The measure is projected to raise $2.4 billion over 10 years.

## Special compliance program

The FAST ACT also creates a special compliance personnel program with dedicated funding. Special compliance personnel are individuals employed by the IRS to serve as revenue officers performing field collection functions or as persons operating the automated collection system. The IRS will report to Congress on the number of special compliance personnel hired and employed as well as revenue collected by these employees.

## Form 5500

The *Surface Transportation and Veterans Health Care Choice Improvement Act of 2015* provided for an automatic 3 1/2 month extension of the due date for filing Form 5500, Annual Returns/Reports of Employee Benefit Plan. The FAST Act repeals this extension, effective for returns for tax years beginning after December 31, 2015.

## Highway taxes

Under the FAST Act, the Highway Trust Fund motor fuels taxes, including the federal gasoline tax, remain unchanged through September 30, 2022. The heavy vehicle use tax is extended through September 30, 2023. Funds from the Leaking Underground Storage Tank (LUST) Trust Fund and certain motor vehicle safety penalties are transferred to the Highway Trust Fund.

## Budget

Lawmakers continue to work on a FY 2016 funding bill to keep the federal government, including the IRS, open after December 11. Both House and Senate appropriators have endorsed reductions to the IRS's budget; House appropriators have proposed some $838 million in cuts and Senate appropriators have proposed around $400 million in cuts.

## Extenders

Negotiations over the tax extenders have ebbed and flowed in recent days. According to Congressional aides, Republicans and Democrats remain divided over which extenders, if any, to make permanent and how to pay for the cost of permanent extensions. Several extenders, including the research tax credit and the state and local sales tax deduction, enjoy bipartisan support for permanent extension.

- ***Comment.*** President Obama has linked any permanent extension of business incentives to similar benefits for individuals, particularly the earned income credit (EIC).
- ***Comment.*** At press time, prospects for a permanent extension of some or all of the extenders appear to be fading in favor of another one or two year extension of the incentives.

## Return preparers

The Taxpayer Rights Act (HR 4128/Sen. 2333) would overturn *Loving, 2014-1* USTC *¶50,175 (CA-D.C.),* and authorize the IRS to regulate unenrolled preparers. The bill also would impose additional protections for taxpayers before the IRS could file an NFTL (Notice of Federal Tax Lien). Additionally, the bill would codify the IRS's Taxpayer Bill of Rights.

**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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# Chief Counsel Reaffirms Prior Guidance On Computer Costs: Some Costs Must Be Capitalized; Others Deductible

***CCA 201549024***

IRS Chief Counsel has reaffirmed the application of guidance in a 2002 private letter ruling on the accounting treatment of costs related to computer software and hardware. Chief Counsel addressed the treatment of purchased software, self-developed software, employee training, and computer hardware costs.

- ***Take Away.*** Chief Counsel stated that the principles and conclusions in LTR 200236028 continue to apply and are not changed by Rev. Proc. 2000-50 or by Reg. §1.263-4 (adopted in 2004). At the same time, Chief Counsel stated that LTR 200236028 may not be used or cited as precedent. Despite this caveat, the IRS guidance in effect provides that taxpayers may rely on the 2002 LTR, as well as guidance published in Rev. Proc. 2000-50.

## LTR 200236028

In LTR 200236028, the IRS addressed the consequences of the purchase, development and implementation of Enterprise Resource Planning (ERP) software acquired from a third party. ERP software is a database software system that integrates different business functions. Implementing the ERP software package involved costs to acquire the software; costs to install the package and to configure the software to the taxpayer's needs through options and templates; software development costs; and costs to train employees to use the new software.

In LTR 200236028, the IRS issued the following rulings:

(1) The cost of purchased ERP software must be capitalized under Code Sec. 263(a) and amortized under Code Sec. 167(f) ratably over 36 months.

(2) Employee training and related costs are deductible under Code Sec. 162.

(3) Separately stated computer hardware costs are qualified technological equipment that must be capitalized under Code Sec. 263(a) and depreciated under Code Sec. 168 over five years.

(4) If the taxpayer is solely responsible for the creation and performance of the software project, the costs of writing machine readable software are self-developed computer software that can be deducted as current expenses.

(5) The costs of option selection and implementation of templates are installation and modification costs that must be capitalized and amortized, as part of the purchase of the ERP software, over 36 months.

## Regs on intangible assets

In December 2002, the IRS issued proposed regs under Code Sec. 263(a) on costs to acquire, create or enhance intangible assets. The regs did not address ERP costs but indicated, in the preamble, that the final regs would address these costs, consistent with LTR 200236028. In January 2004, the IRS issued final regs that indicated the IRS would address these costs in separate guidance. Until then, taxpayers may rely on Rev. Proc. 2000-50. The LTR was not cited. No additional guidance has been issued.

## Chief Counsel's analysis

Chief Counsel disagreed with taxpayers' positions that LTR 200236028 no long applies following the issuing of Reg. §1.263-4 in 2004. These regs provides rules for capitalizing costs to acquire or create an intangible asset. Reg. §1.263(a)-4(c)(1)(xiv) requires the capitalization of computer software. The costs of purchased ERP software must be capitalized under the code and regs. Furthermore, the costs of option selection and templates must be capitalized as part of the purchase.

Chief Counsel also disagreed with the position that Rev. Proc. 2000-50 allows the deduction of all software costs. Sec. 6.01(2) requires amortizing acquired software over 36 months.

*Reference: TRC DEPR: 15,162.85.*

## IRS Clarifies Proposed Regs' Substantiation Option For Charitable Contributions

In response to questions, the IRS has clarified its reasons for issuing proposed regs on the "contemporaneous written acknowledgement" requirement for substantiating certain contributions to charities. In September, the IRS issued NPRM REG-138344-13 describing an optional, alternative way of substantiating donations.

***Background.*** Generally, for any contribution of $250 or more (including contributions of cash or property), taxpayers must obtain a contemporaneous written acknowledgment from the charitable organization indicating the amount of the cash and a description of any property contributed. The acknowledgment must describe whether the organization provided any goods or services in exchange for the gift and, if so, must provide a description and a good faith estimate of the value of those goods or services. One document from the organization may satisfy both the written communication requirement for monetary gifts and the contemporaneous written acknowledgment requirement for all contributions of $250 or more.

***Clarification.*** According to the IRS, there have been misunderstandings and inaccuracies about the purpose of the proposed regs, which generally provide an alternative method of substantiation through direct reporting. The IRS clarified that the proposed regs would not impose mandatory changes to current rules on how charities substantiate contributions. "Charities could continue doing things as they do now," the agency emphasized. The IRS noted that the option described in the proposed regs would not be available until final regs are issued.

*2015ARD 232-5; TRC INDIV: 51,050.*


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# Damages And Legal Expenses Paid By Corporation's Managing Shareholder To Satisfy Judgment Were Deductible Business Expenses

***LTR 201548011***

The IRS has determined that compensatory and punitive damages, plus costs and interest, paid by a taxpayer to a business partner for fraud and breach of fiduciary duty, were deductible by the taxpayer as ordinary and necessary business expenses under Code Sec. 162. The IRS further ruled that taxpayer's legal fees paid to attorneys, accounting consultants, and an expert at trial, were also deductible business expenses.

- ***Take Away.*** "LTR 201548011 underscores the importance of facts and circumstances," Daniel M. Schneider, professor emeritus, Northern Illinois University College of Law, and co-author, *Federal Taxation of Corporations & Shareholders,* told Wolters Kluwer. "Corporations trying to deduct legal expenses may need to overcome the capital nature of the expenses and shareholders trying to deduct such expenses may also face characterization of the expenses as personal expenses. Nevertheless, the taxpayer in this LTR was able to deduct damages paid in an action in fraud because the taxpayer, who was one of only a few shareholders of the corporation, also managed the corporation and had been paid for such management, and so the origin of the claim was in the taxpayer's business, not in something capital or personal. While not an expansive ruling, it nevertheless reveals that a carefully crafted scenario - establishing a business to which to attach legal expenses - remains viable," Schneider said.

## Background

The taxpayer, an individual, managed the finances of several closely-held corporations that operate a business. Taxpayer and two other parties, E and F, formed a Subchapter S corporation to purchase and operate a business. Taxpayer received a management fee based on a percentage of the company's net profits. The three shareholders shared the remaining net profits based on their ownership shares.

Shareholder E consistently received monthly checks from the taxpayer, but the checks eventually ceased. E obtained some company financial records but did not learn why the corporation was losing money. E sued the taxpayer for fraud, breach of fiduciary duty, and breach of contract. A jury found taxpayer liable and awarded damages and costs to E. When taxpayer appealed, the judgment was affirmed.

In Year 2, the taxpayer paid damages, interests and costs to E. The taxpayer paid legal fees in Years 2 and 3 for his defense in the trial court and on appeal.

## IRS analysis

To be deductible under Code Sec. 162, a business expense must be ordinary and necessary. Ordinary expenses do not have to be habitual or normal for the same taxpayer. Necessary expenses are helpful and appropriate for the business. Thus, legal fees and damages can be ordinary and necessary, regardless of their frequency or their purpose, the IRS concluded.

If litigation arises from a capital transaction, then costs and legal fees are treated as acquisition costs and capitalized under Code Sec. 263(a). Courts apply the "origin of the claim" test to distinguish business expenses from personal or capital expenses. It is necessary to consider the origin and character of the claim for which an expense, such as a settlement, was incurred, not the potential consequences to the business operation of the taxpayer.

The issue is the kind of transaction from which the litigation arose, including the nature and objectives of the lawsuit, the defenses asserted, and the purpose for which the claimed deductions were expended. In *Scallen, TC Memo. 1987-412, aff'd 89-1* USTC *¶9369*, the Tax Court concluded that settlement payments for a managing general partner's failure to properly carry out his duties were deductible business expenses. Both courts and the IRS have treated settlement payments as currently deductible if the acts giving rise to the litigation were performed in the ordinary course of the taxpayer's business.

## Conclusion

The IRS concluded that taxpayer's payments to satisfy the final judgment, including legal fees and costs, were ordinary and necessary business expenses. The claims of shareholder E clearly arose from the conduct of taxpayer's trade or business. Taxpayer's activities at issue did not result in the acquisition of a capital asset, did not defend title to an existing asset, and did not create a separate asset. The taxpayer did not receive a long-term benefit from the payments.

*Reference: TRC BUSEXP: 18,450.*

## IRS Extends Time Limits For Issuing Tribal Economic Development Bonds

The IRS has modified Notice 2012-48, regarding the allocation of volume caps for tax-exempt tribal economic development bonds. The IRS will treat the bonds as being issued within the required 180-day period (after receipt of an allocation letter), provided the total principal amounts are issued within three years. The extension applies where some of the bonds will be issued within 180 days and some will be issued after 180 days.

*Notice 2015-83, FED ¶46,466; TRC SALES: 51,056.15.*

# Return Pleading Fifth Amendment Not Frivolous

*Youssefzadeh, TC, November 6, 2015*

The Tax Court has declined to impose a frivolous return penalty on a taxpayer who omitted some information from his Form 1040 because of fears that he would incriminate himself for willfully failing to file an FBAR (Report of Foreign Bank and Financial Accounts). In granting summary judgment, the court concluded that the taxpayer demonstrated "a real and appreciable danger of self-incrimination by being compelled to answer" certain questions.

- ***Take Away.*** The IRS approach to tax protesters in Notice 2010-33 and the Internal Revenue Manual (IRM) includes imposing a frivolous return penalty on taxpayers who make a blanket assertion of the Fifth Amendment as grounds for not providing any information on their tax return. Here, the taxpayer filled out most of the Form 1040 and did not make a blanket Fifth Amendment claim. The court concluded the IRS did not have grounds for imposing the frivolous return penalty.

## Background

The taxpayer timely filed his 2011 Form 1040 and filled out most lines in a normal fashion. However, on Schedule B, Interest and Dividends, he refused to answer some questions and fill in some values, instead invoking the Fifth Amendment. He wrote that his answers to these questions might lead to or might be incriminating evidence against him.

- ***Comment.*** Question 7a on Form 1040 asks the taxpayer if he or she is required to file an FBAR.

The IRS warned that it would assess a frivolous return penalty unless the taxpayer filed a return with all required information. The taxpayer refused. The IRS assessed the penalty and notified the taxpayer of its intent to levy. The taxpayer obtained a collection due process hearing and argued that he had a valid Fifth Amendment claim and was not trying to waste the IRS's time. The IRS claimed that the return was frivolous as a matter of law, and the Appeals Officer upheld the penalty.

## Court's analysis

For a frivolous return penalty, the IRS must show three things:

(1) The document must purport to be a tax return;

(2) The return must omit enough information to prevent the IRS from judging the "substantial correctness of the self-assessment," or must clearly be substantially incorrect; and

(3) The taxpayer's position must be frivolous or designed to impede the IRS's administration of the tax code.

The parties agreed that the first factor was satisfied. The court also held that the return provided sufficient information for the IRS. Although the taxpayer blacked out the source and amount of some interest on Schedule B, the return provided all of the normal numerical information, including the total amount of interest income. The proper standard is not whether the return is completely correct but whether it is substantially correct. The court said it was.

- ***Comment.*** The court noted that the taxpayer was not "one of those tax protestors" who fills out a return with zeroes on nearly every line.

## Fifth Amendment

The third factor favored the taxpayer. The IRS argued that a return is frivolous if the taxpayer makes any Fifth Amendment claim. The court stated that the taxpayer's return had plenty of financial information and was not covered by any blanket Fifth Amendment assertions.

The Supreme Court has held that the Fifth Amendment does not excuse a complete failure to file a return (or provide any information), but a taxpayer can raise Fifth Amendment objections in a return if it called for privileged information. To claim the privilege, the taxpayer must be faced with substantial hazards of self-incrimination and must have reasonable cause to fear that an answer could lead to criminal prosecution; the information sought does not have to support conviction itself.

Here, Title 31 of the U.S. Code makes it a crime to willfully fail to file an FBAR. The questions on Form 1040 can be used to determine whether the taxpayer filed an FBAR. Therefore, the taxpayer demonstrated a real and appreciable danger of self-incrimination, and his return was not frivolous to invoke the Fifth Amendment privilege. Consequently, the court rejected the IRS's assertion of the penalty and granted the taxpayer's motion for summary judgment.

*Reference: TRC PENALTY: 3,260.15.*

# Taxpayer Not Entitled To Capital Gain Treatment On Purchase Of "Interest" In Proceeds Of Litigation Claim

*FAA 20154701F*

The IRS has determined, in field attorney advice (FAA), that a taxpayer was not entitled to claim capital gain treatment from the purchase of an "interest" in the proceeds of a litigation claim. The IRS concluded that there was no sale or disposition of property in connection with the transfer of the proceeds.

- ***Take Away.*** To have a gain or loss under Code Sec. 1222 and 1234A, there must be a sale or other disposition of property. The facts indicate there is no associated disposition of property involving the proceeds received by the taxpayer.

## Background

The taxpayer entered into a "Purchase and Sale Agreement" with another party

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# Tax Court Rules For Former Shareholders In Transferee Case

***Alterman Trust, TC Memo. 2015-231***

The Tax Court has rejected the IRS's arguments that the former shareholders of a family business were liable for unpaid taxes as transferees. The court found that the IRS failed to prove that there was a fraudulent transfer.

- ***Take Away.*** The court signaled its displeasure with "Midco" cases like the one before it. "Many taxpayers have prevailed at the trial court, but many of those taxpayers have seen their victories turned to defeat on appeal. The IRS has likewise prevailed at the trial court, and its victories have uniformly survived appeal. Rarest of all is the taxpayer victory that survives appeal."

## Background

The business operated as a freight hauler. Its primary assets were trucks, tractors, trailers, and real estate. In 2000, the owner of the business created a trust for the benefit of his three children. The trust was largely funded with stock in the family business. The owner died in 2001.

The children, now the shareholders, decided to sell the business. They reached an agreement with Company M. Through a redemption and stock sale transaction, the children sold the business to Company M. Soon after, Company M sold the business to another entity, which the children argued was contrary to their agreement. A state court agreed with the children finding that Company M had violated their agreement.

The IRS determined that the redemption and stock sale should not be respected. Instead, the transaction should instead be treated as the taxpayer liquidating and making a distribution to its shareholders.

## Court's analysis

The court first found that the IRS had to show that there was a transfer and that the taxpayers are transferees under Code Sec. 6901. The term "transferee" is nonexclusively defined and includes a donee, heir, legatee, devisee, and distributee as well as a shareholder of a dissolved corporation. A person can be a transferee, the court added, if he or she is an indirect transferee of property.

The court further found that the former shareholders lacked actual knowledge that Company M would fail to do what it promised under the share purchase agreement. Similarly, they lacked constructive knowledge. According to the court, constructive knowledge is either the "knowledge that ordinary diligence would have elicited" or a "more active avoidance of the truth." Here, the former shareholders took reasonable steps to investigate the transaction, the court found.

Additionally, the court rejected the IRS's argument that there was a circular flow of funds in the deal that served no legitimate purpose. The court found no evidence that cash in the business had been used to fund the purchase of the shares. Lastly, the court found no actual or constructive fraud under Florida's Uniform Fraudulent Transfer Act (FUFTA).

*References: Dec. 60,460(M);*
*TRC IRS: 60,050.*

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## Purchase

*Continued from page 589*

to "purchase" an interest in a contractual right to receive a percentage of a settlement covered by the agreement. The taxpayer paid a sum of money and received a series of payments in full satisfaction of his "interests" under the agreement. The taxpayer reported the difference as long-term capital gain.

The taxpayer had been looking for investment opportunities. At the advice of a consulting firm, he formed an entity to facilitate the litigation of claims by particular parties.

The parties entered into an agreement that refers to the contractual right to receive consideration and the amount to be funded. The taxpayer issued a letter that proceeds had been collected and requested a release acknowledging that the other party had fully performed its obligations under the agreement.

## IRS analysis

Code Sec. 1001 discusses gain from the sale or other disposition of property. Under Code Sec. 1221(a), a capital asset means certain property held by the taxpayer. Under Code Sec. 1222(3), long term capital gain is gain from the sale or exchange of a capital asset held more than one year. Thus, a sale or exchange is necessary for capital gain treatment. Not every gain under Code Sec. 1001 is a sale or exchange under Code Sec. 1222.

In some cases, an event that does not qualify as a sale or exchange under those terms ordinary meaning may be deemed to be a sale or exchange. For example, under Code Sec. 1234A(a), gain or loss from the cancellation, lapse or other termination of a right or obligation involving property that would be a capital asset, shall be treated as gain or loss from the sale of a capital asset.

The agreement calls only for the purchase of an interest; it does not call for the subsequent transfer of this interest. The mere receipt of that income is not realized from the disposition of taxpayer's rights, and cannot be characterized as capital gain. Furthermore, the terms of the agreement strongly suggest that the parties did not view the payments as amounts realized from the disposition of property.

Because the taxpayer did not realize gain from the disposition of property under Code Sec. 1001, its receipt of proceeds does not result in capital gain. The payments should be taxed as ordinary income, the IRS determined.

*Reference:TRC BUSEXP: 30,104.05.*

# IRS Criminal Investigations Division Issues Annual Report; Touts Conviction Rate

*IRS-CI Fiscal Year 2015 Annual Business Report*

The IRS Criminal Investigation (CI) Division achieved a conviction rate of 93.2 percent for fiscal year (FY) 2015, the agency has reported. The annual business report stated that this year CI focused on prosecuting tax-related identity theft, money laundering, public corruption, cybercrime and terrorist financing.

- ***Take Away.*** Richard Weber, Chief, IRS Criminal Investigation, explained during a December 3 conference call with reporters that despite the high conviction rate and the quality work performed by CI agents during 2015, CI operations remain hampered by the continued cuts to the IRS's budget. "We can't get around the simple truth that we're going to be left with less resources," Weber said. "We're not going to be able to do more with less. We're just going to be able to do less with less."

## Background

the IRS CI Division is tasked with investigating potential criminal violations of the Tax Code and related financial crimes. Nearly every year, the division releases an annual report highlighting the agency's successes.

## Case load and convictions

The report stated that during FY 2015, CI had initiated 3,853 cases, representing a decrease from 4,297 and 5,314 in FYs 2014 and 2013 respectively. CI obtained 2,879 total convictions and a 93.2-percent conviction rate based on the percentage of convictions compared to the total number of convictions, acquittals, and dismissals.

Summaries of notable cases involved issues such as tax fraud, return preparer fraud, tax evasion, corruption, and corporate fraud, among other things.

- ***Comment.*** The IRS indicated that CI staffing levels have declined since 2014. As of September 30, 2015, CI had 2,316 special agents on board, representing a six-percent decrease compared to the number of special agents working in CI at the end of FY 2014. Weber expressed concern with this trend, noting that tax crimes were more numerous now and that instances of identity theft continued to increase.

*Reference: TRC IRS 9,208.05.*

# TAX BRIEFS

## Internal Revenue Service

Victims of severe storms, tornadoes, straight-line winds and flooding that took place beginning on October 22, 2015 in parts of Texas may qualify for tax relief from the IRS. The president has declared the counties of Bastrop, Brazoria, Caldwell, Comal, Galveston, Guadalupe, Hardin, Harris, Hays, Hidalgo, Liberty, Navarro, Travis, Willacy and Wilson in Texas, a federal disaster area. Individuals who reside or have a business in this area may qualify for tax relief. Certain deadlines falling on or after October 22, 2015, and on or before February 29, 2016, have been postponed to February 29, 2016.

*Texas Disaster Relief Notice (HOU-2015-07), FED ¶46,468; TRC FILEIND: 15,204.25*

A table outlining the base period Treasury bill rate for the period that ended on September 30, 2015, has been released by the IRS. The base period T-bill rate for the covered period is 0.24 percent. The figures in the table are to be used to determine the amount of interest to be paid each year by a shareholder of a domestic international sales corporation (DISC). That amount is equal to the product of the shareholders' DISC-related deferred tax liability for the year and the base period T-bill rate.

*Rev. Rul. 2015-26, FED ¶46,464; TRC INTLOUT: 11,300*

The IRS has issued general requirements and conditions for the development, printing and approval of all substitute tax forms to be acceptable for filing in lieu of official IRS-produced and distributed forms. This revenue procedure will be reproduced as the next revision of IRS Publication 1167, General Rules and Specifications for Substitute Forms and Schedules.

*Rev. Proc. 2015-55, FED ¶46,465; TRC FILEBUS: 12,052.10*

The IRS has corrected certain specifications for check boxes on Form W-2 and the address to send sample substitute forms to receive approval from the Social Security Administration in a revenue procedure containing specifications for the private printing of red-ink substitutes for the 2015 revisions of Forms W-2, Wage and Tax Statement, and W-3, Transmittal of Wage and Tax Statements (Rev. Proc. 2015-51, I.R.B. 2015-42, 583).

*Announcement 2015-31, FED ¶46,467; TRC FILEBUS: 12,052.10*

The IRS has provided additional time to use allocated volume cap for issuance of TEDBs as draw-down loans if an issuer meets certain requirements. The guidance is effective for an application for allocation of TEDB volume cap that is submitted on or after December 4, 2015. In addition, an applicant that has received an allocation that has not expired before December 4, 2015, may rely on the guidance, provided that such applicant meets the applicable requirements of Notice 2012-48, as modified, on or before the expiration date of the

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## Tax Briefs

*Continued from page 591*

allocation. Notice 2012-48, I.R.B. 2012-31, 102, is modified.

*Notice 2015-83, FED ¶46,466; TRC SALES: 51,056.15*

### *Income*

An individual's photography activity was not engaged in for profit. The individual did not conduct his photography activity in a businesslike manner. He did not have a business plan, keep books and records and used his personal accounts to pay business expenses He was not entitled to flow-through losses from his S corporation and he was liable for additions to tax for one year and penalties for three years.

*Kantchev, TC, CCH Dec. 60,463(M), FED ¶48,173(M); TRC BUSEXP: 3,054*

### *Deductions*

An individual, who operated two business, was not entitled to deduct business expenses for one of his businesses because they were unsubstantiated The individual also failed to show the business purpose of the payments he made to his daughter, who served as a webmaster for one of his business websites. He was subject to substantial understatement penalties.

*Besaw, TC, CCH Dec. 60,462(M), FED ¶48,172(M); TRC BUSEXP: 3,100*

An individual, who was involved in an oil purification business, was entitled to deduct car and truck expenses in the amount determined by the court. The individual credibly testified that he visited the locations listed on contemporaneously prepared index cards and used one vehicle specifically for business travel.

*Charley, TC, CCH Dec. 60,461(M), FED ¶48,171(M); TRC BUSEXP: 24,806*

### *Liens and Levies*

A limited liability company (LLC) was not entitled to quiet title to property it purchased from a foreclosure sale because federal tax liens attached to the property had priority over the foreclosed homeowner's association lien.

*Neighborhood Improvement Projects LLC, DC Ariz., 2015-2 USTC ¶50,581; TRC IRS: 48,158.05*

### *Jurisdiction*

A *pro se* individual's complaint seeking damages for alleged unauthorized collection activities was dismissed for lack of subject matter jurisdiction. The Due Process clauses of both the Fifth and Fourteenth Amendments do not mandate the payment of money and, therefore, do not provide a cause of action under the Tucker Act.

*Zolman, FedCl, 2015-2 USTC ¶50,582; TRC LITIG: 9,056*

### *Summonses*

An IRS administrative summons issued to an individual to appear, testify and produce documents in relation to an investigation into his tax liabilities was ordered enforced. The government presented its prima facie case for summons enforcement under *Powell*. The individual failed to appear or respond to any of the allegations in the petition to enforce the summons and, therefore, failed to show cause why he should not be compelled to comply with the summons.

*A.J. Grabowski II, DC Fla., 2015-2 USTC ¶50,583; TRC IRS: 21,300*

## IRS Reminds Foreign Withholding Entities To Submit Applications By Approaching Deadline

The IRS has issued a reminder to entities seeking qualified intermediary (QI), withholding foreign partnership (WP), or withholding foreign trust status (WT) for the remaining short period of 2015 to submit their application by December 18, 2015. If a WP or WT submits its application for 2015 on or after April 1, 2014, the agreement is effective January 1 of the following calendar year. If the entity submits its application on or after April 1 and does not receive any reportable payments on or after January 1 and on or before the approval date, the WP or WT agreement will be effective the date that the entity is issued an employer identification number.

***Application guidance.*** Applicants seeking QI, WP, or WT status should submit Form 14345, Application for Qualified Intermediary, Withholding Foreign Partnership, or Withholding Foreign Trust Status, to the IRS, and should indicate on the form which status they are applying for. The IRS has provided guidance on entering into a QI withholding agreement in Rev. Proc. 2014-39. The WP and WT agreements and the application procedures are in Rev. Proc. 2014-47.

***Withholding.*** A QI agreement allows a foreign intermediary to assume the withholding and reporting obligations for income payments, such as interest and dividends, made to account holders or payees. The QI agreement reflects the requirements of the *Foreign Account Tax Compliance Act* (FATCA or Chapter 4) and the coordination rules under Chapters 3 (U.S. payments to foreign persons) and 61 and Code Sec. 3406 (backup withholding).

*Qualified Intermediaries News, www.irs.gov; TRC INTL: 33,054.25.*

## IRS Provides Debt Discharge Tax Relief For Students Of Corinthian Colleges

The IRS announced that it will not assert that taxpayers with certain discharged federal student loan debt must recognize gross income. The IRS explained that although there is no specific statutory exclusion from gross income for loans discharged under the Defense to Repayment discharge process, taxpayers with Corinthian student load debt may likely otherwise be able to exclude amounts discharged from gross income based on fraudulent misrepresentation, the insolvency exclusion, under other provisions. Rather than put them through the compliance burden of putting forth those arguments, the IRS will not assert gross income in those circumstances, nor require adjustment for any education credits or interest deductions already claimed.

*Rev. Proc. 2015-57; FED ¶46,463; TRC INDIV: 60,054.10.*

# PRACTITIONERS' CORNER

## Maintaining Confidentiality Privilege And Work Product Immunity

The recent Second Circuit Court of Appeals decision *Schaeffler, CA-2, 2015-2* USTC *¶50,555*, provided a fresh opportunity to examine under current circumstances the attorney-client privilege and work product doctrines as they apply to documents produced by non-attorney tax professionals. Both doctrines can be useful tools for accountants handling complex matters that may result in litigation, but the rules surrounding their use can be complicated. This Practitioners' Corner provides a look at each rule and how they may overlap.

### Attorney-client privilege

The attorney-client privilege is a common law rule that protects confidential communications between clients and their attorneys for the purpose of securing legal advice. The confidentiality privilege belongs to the client; its purpose is to encourage clients to have full and frank communication with their attorney. It also applies only to advice on legal matters. Prior to 1998, there was no such confidentiality privilege available to clients who obtained tax advice from their accountants. Then Congress enacted the *IRS Restructuring and Reform Act of 1998*, which added Code Sec. 7525(a)(1) to the Tax Code. Code Sec. 7525(a) provides a limited confidentiality privilege similar to the attorney-client privilege: the so-called "Tax Practitioner Privilege." The Tax Practitioner privilege applies to tax advice between a taxpayer and any federally authorized tax practitioner *to the extent the common law protection of attorney-client confidentiality would apply to the tax advice.*

- ***Comment.*** A federally authorized tax practitioner is any individual who is authorized under federal law to practice before the IRS. This includes certified public accountants (CPAs), attorneys, enrolled agents, and enrolled retirement plan agents (ERPA).

The Tax Practitioner privilege is of limited use. First, the privilege only covers "tax advice." It does not extend to communications between a taxpayer and a tax practitioner for the purpose of preparing a tax return. (Tax return preparation does not fall within the scope of the attorney-client privilege.) Second, the privilege may only be asserted in any *noncriminal* tax matter *before the IRS or in a federal court in which the United States is a party.* Third, the privilege does not extend to communications made in connection with the promotion of any tax shelter.

*"Code Sec. 7525(a) provides a limited confidentiality privilege..."*

***"Tax advice."*** The provision stating that the tax practitioner privilege covers only tax advice is particularly limiting, because the courts have interpreted the term "tax advice" narrowly to not include communications related to tax return preparation. Since much of the work accountants and other tax practitioners perform for their clients involves tax return preparation, tax practitioners should be careful to keep any communications related to tax preparation separate from communications solely intended to convey legal tax advice.

***Kovel accountant.*** In some instances, the attorney-client privilege may apply to legal tax advice provided to an attorney by a nonlawyer tax professional hired to act as the attorney's agent in that capacity. Courts generally construe this application of the privilege narrowly. Once again, courts will not extend the privilege to communications made for the purpose of tax return preparation. In addition, communications from the tax professional to the attorney must be necessary—not just helpful—for the attorney to understand the client's case and provide legal advice.

- ***Comment.*** The term "Kovel" arises from the Second Circuit Court of Appeals case, *Kovel 62-1* USTC *¶9,111*, which first established this judicial doctrine.

An attorney may try to ensure the confidentiality of communications made between himself and a tax professional by issuing a "Kovel agreement" when retaining a tax professional. To have a chance of being effective, the letter must clearly outline the scope of the tax professional's responsibilities relating to the case and specify his agency under the attorney.

Another strategy an attorney might use, should his client's case require tax preparation work, is to retain two tax professionals: one to provide legal tax advice under a Kovel agreement and a second to perform the tax return preparation work.

***Tax shelter.*** Taxpayers and tax professionals also have found it difficult to overcome the exception from privilege for communications made in "promotion of a tax shelter." For example, in *Valero Energy Corporation, CA-7, 2009-1* USTC *¶50,445,* the Seventh Circuit ordered the now-defunct Arthur Andersen accounting firm and its client to produce documents relating to the client's merger with a Canadian company that had resulted in significant tax savings. The Seventh Circuit found that the government's burden of proof to overcome privilege via the tax-shelter exception. "is relatively light. It need only show that there is some foundation in fact that a particular document falls within the tax shelter exception." The Seventh Circuit also held that the term "tax shelter," for purposes of the exception, was not limited to actively marketed tax shelters or prepackaged products. The term could refer to

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# WASHINGTON REPORT *by the Wolters Kluwer Washington News Bureau*

## Highway bill with tax offsets now law

The *Fixing America's Surface Transportation* (FAST) Act (HR 22) was signed into law by President Obama on December 4. The House had approved the multi-year highway and transportation funding bill with tax offsets by a vote of 359 to 65, and the Senate passed the bill by a vote of 83 to 16. The FAST Act instructs the IRS to contract with private collection agencies to collect some tax liabilities, imposes restrictions and limitations on passports of individuals with seriously delinquent tax debt, and extends highway taxes, among other provisions. *For more details and analysis of the FAST Act, see the lead article in this week's newsletter and coverage on IntelliConnect.*

## Senate repeals parts of ACA

On December 3, the Senate approved a budget reconciliation bill, the Restoring Americans' Healthcare Freedom Reconciliation Bill of 2015 (HR 3762), to repeal portions of the *Affordable Care Act* (PPACA). The Senate version, in the form of an amendment by Majority Leader Mitch McConnell, R-Ky., calls for stronger measures than the bill approved by the House on October 23. The White House issued a Statement of Administration Policy indicating that the President would veto the measure.

The House has voted multiple times to repeal the ACA but the Senate has never considered any of those bills. The latest measure calls for the repeal of the individual and employer mandates, as well as the medical device tax, and the excise tax on "Cadillac plans."

A reconciliation instruction is a provision in a budget resolution directing one or more committees to submit legislation changing existing law in order to bring spending, revenues or the debt ceiling into conformity with the budget resolution. Budget reconciliation requires only a simple majority (51) of votes in the Senate for passage.

## BEPS may lead to U.S. to tax reform

The uncertainty associated with the Organisation for Economic Cooperation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project could spur lawmakers to finally tackle international tax reform. Witnesses at a December 1 House Ways and Means Subcommittee on Tax Policy hearing on BEPS told the panel of the need for general corporate and international tax reform, as well as the related need to address U.S. base stripping and inversion transactions. Rep. Charles Boustany, R-La., said in his opening statement that Congress was out of time after nearly three decades of procrastinating on tax reform.

"We should reform our business tax system by reducing the corporate income tax rate and broadening the base. So lowering our statutory rate while broadening the base could help reduce erosion of the U.S. base," Deputy Assistant Treasury Secretary for International Tax Affairs Robert Stack told lawmakers. Stack added that the U.S. has a great deal at stake in the BEPS project and a strong interest in its success. "Our active participation is crucial to protecting our own tax base from erosion by multinational companies, much of which occurs as a result of exploiting tax regime differences."

On the other side of the U.S. Capitol, the Senate Finance Committee (SFC) also held a hearing on BEPS that focused on the need for international tax reform. According to SFC Chair Orrin Hatch, R-Utah, the recommendations in the OECD's BEPS reports raise a number of "serious concerns" about taxpayer confidentiality and the Treasury Department's statutory authority to implement regulations. "At the same time, the European Union has launched investigations into American multinationals that have resulted in increased uncertainty and foreign tax liabilities for our businesses abroad," Hatch said.

## TIGTA reviews IRS's help to victims of identity theft

The IRS's Identity Protection Specialized Unit (IPSU) needs to better assist victims of identity theft, according to the Treasury Inspector General for Tax Administration (TIGTA). IPSU is a dedicated unit organized specifically to help identity theft victims to get their questions answered and obtain assistance in getting their issues resolved quickly and effectively. TIGTA has previously reported that IPSU was not achieving its original purpose of providing identity theft victims with a single individual to answer questions and resolve his or her issues.

In its review, TIGTA found that the IRS no longer provides most identity theft victims with an IPSU single point of contact because of budgetary constraints. In addition, the IRS did not always issue required acknowledgment and case status letters to taxpayers or effectively conduct research to assist taxpayers who submit identity theft claim documentation without their Social Security Number.

TIGTA recommended that the IRS ensure that required acknowledgment and case status letters are timely sent to victims of identity theft, that cases submitted without a complete Social Security Number are properly researched and that a process is developed to ensure customer service representatives timely respond to taxpayers' messages. The IRS agreed with all recommendations.

## AICPA signals opposition to preparer bill

The American Institute of Certified Public Accountants (AICPA) signaled on December 4 its opposition to the pending Tax Return Preparer Competency Act of 2015 (HR 4141). According to the AICPA, "HR 4141 would allow the IRS to overregulate professional, credentialed tax return preparers and their staff without providing adequate value to taxpayers or additional protection to the public." The AICPA recommended that lawmakers authorize the IRS to develop a mandatory testing and continuing education program for unenrolled preparers.

*Continued from page 593*

"any partnership, entity, plan, or arrangement a significant purpose of which is the avoidance or evasion of income tax."

*Schaeffler, waiver, and a common legal interest.* Just because the tax practitioner privilege has limited application, however, does not mean that courts will always order production of documents. In *Schaeffler*, the Second Circuit found that one of the "Big Four" accounting firms had not waived its tax-practitioner privilege by sharing with a third-party bank consortium a memorandum prepared for its client that identified potential U.S. tax consequences of the client's financial transactions and analyzing the IRS's possible arguments in the likely event that the transactions led to litigation. The bank consortium had financed the client's initial transaction that, because of an ill-timed stock market crash, could result in significant financial loss absent jointly undertaken refinancing and restructuring transactions certain to invite IRS attention.

- ***Comment.*** The tax practitioner privilege may be waived in the same manner as the attorney-client privilege. Thus, if a taxpayer or federally authorized tax practitioner discloses to a third party the substance of a communication protected by the privilege, the privilege for that communication and any related communications is considered to be waived to the same extent and in the same manner as the privilege would be waived if the disclosure related to an attorney-client communication. However, disclosure may be acceptable in cases where the third party shares a common legal interest with the privilege holder.

The taxpayers did not waive their attorney-client privilege, the Second Circuit found in *Schaeffler*. The taxpayers shared a common legal interest with the bank consortium. The taxpayers and the consortium could only avoid joint economic disaster by cooperating in securing a particular tax treatment for the refinancing and restructuring—and securing that treatment was highly likely to involve a legal encounter with the IRS. Therefore, the consortium's common interest with the individual was of a sufficient legal character to prevent a privilege waiver by sharing the documents. Significantly, the Second Circuit held that the fact that two parties share a large financial interest did not preclude the court from finding they shared a legal interest where the legal aspects materially affect the financial interests.

## Work Product Doctrine

The "Work Product Doctrine" outlined in Federal Rule of Civil Procedure 26(b)(3) compels the federal courts to protect from discovery written materials containing an attorney's mental impressions, conclusions, opinions, or theories made in anticipation of litigation. Although it is not necessary that litigation be pending at the time that the materials are prepared, there must be more than a possibility that the IRS will challenge the taxpayer to invoke this doctrine. Work product prepared in the ordinary course of business, such as financial statements or tax returns, is not protected by the doctrine. Courts have also ruled that work product prepared for an IRS investigation or for a legal settlement was not protected.

- ***Comment.*** The work-product rule also extends to documents prepared by the party's "consultants," meaning the rule can encompass tax professionals.

Taxpayers often invoke work product doctrine alongside the attorney-client privilege. It is possible that communications that are not covered under the attorney-client privilege may nevertheless fall under the work product doctrine. For example in *Adlman, CA-2, 98-1* USTC *¶50,230*, the Second Circuit held the attorney-client privilege did not apply to the documents in question, but the work product doctrine did.

*Adlman* also clarified several standards relating to the term "in anticipation of litigation" that are favorable to tax practitioners seeking work product immunity. The Second Circuit held that a document that would otherwise be protected by work-product immunity does not lose protection merely because it is intended to assist in the making of a business decision that in turn is influenced by the likely outcome of the anticipated litigation. The Second Circuit also held that where a document was created because of anticipated litigation—and would not have been prepared in substantially similar form but for the prospect of that litigation—it is protected.

- ***Comment.*** *Adlman* involved a large firm, which had prepared a detailed 58-page memorandum for its client outlining the likely tax consequences of a major corporate merger before any audit or litigation had been initiated. The memorandum contained a detailed legal analysis of likely IRS challenges to the reorganization and the resulting tax refund claim, complete with a discussion of statutory provisions, IRS regs, legislative history, and prior judicial and IRS rulings relevant to the claim. It also proposed possible legal theories or strategies that the client corporation could use in response to an IRS-initiated lawsuit, recommended preferred methods of structuring the transaction, and made predictions about the likely outcome of litigation. The client used the firm's advice to structure its reorganization. The lower court found that this memorandum was not covered by either the attorney-client privilege or the work product doctrine. The Second Circuit disagreed with respect to the work product doctrine.

The attorney-client privilege and work-product doctrines are by and large defined by the courts, which have developed and continue to finesse the numerous legal standards for determining which communications or work products are covered. Practitioners who provide legal services for their clients should understand the challenges they may face in potential litigation against the IRS. If they have any communications with their clients or prepare any tax planning documents that could be summonsed for litigation, they should take precautions to ensure that the information contained within remains protected.


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# COMPLIANCE CALENDAR

**■ December 11**

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

**■ December 15**

Calendar-year corporations deposit the fourth installment of estimated income tax for 2015; use worksheet, Form 1120-W.

**■ December 16**

Employers deposit Social Security, Medicare, and withheld income tax for December 9, 10, and 11.

**■ December 18**

Employers deposit Social Security, Medicare, and withheld income tax for December 12, 13, 14, and 15.

**■ December 23**

Employers deposit Social Security, Medicare, and withheld income tax for December 16, 17, and 18.

# 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.*

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# FROM THE HELPLINE

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

**Q** The MACRS life for manufacturers of chemicals and allied products is 5 years. What about someone who may distribute agricultural chemicals and does some mixing of chemicals?

**A** Since such a taxpayer is not engaged in a manufacturing activity, the assets used in distributing the chemicals do not appear to fall within Asset Class 27.0 relating to chemicals and allied products. However, they may fall within Asset Class 57.0, relating to "distributive trades and services,"which encompasses retail and wholesale trades and businesses. With regard to the chemical mixing in the same distribution business, it appears the mixing activity would also fall within Asset Class 57.0. *See TRC DEPR: 3156.10.*

**Q** Can an inauguration party be funded by a 501(c)(3) organization, or should a 501(c)(4) organization be set up?

**A** 501(c)(3) charities are prohibited from participating in any way in an election for public office. *See See TRC EXEMPT: 3,000.* 501(c)(4) organizations must provide a social welfare benefit to the entire community – not just members of a particular group. 501(c)(4) organizations are permitted to lobby in relation to particular issues, but organizations that expect to have expenditures related to a particular political candidate or party should alternatively consider becoming a Code Sec. 527 organization. *See TRC EXEMPT: 9,304.*