



FEDERAL TAX WEEKLY

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Tax Court Nixes Micro-Captive Insurance Arrangement; Premiums Not Deductible

Avrahami, 149 TC No. 7

Although a micro-captive insurance entity was organized as an insurance company, paid claims, and met capitalization requirements, the Tax Court found that it did not operate like an insurance company, issued policies with unclear and contradictory terms, and charged unreasonable premiums. As a result, the entity's election to be taxed as a small insurance company under Code Sec. 831(b) was invalid. Premium payments were not for insurance, were not an ordinary and necessary business expenses and were not deductible under Code Sec. 162(a), the court held.

■ **Take Away.** "For several years, the IRS has devoted significant resources to examinations of captive insurance arrangements and numerous cases are the subject of Tax Court petitions. There are several cases pending in the Tax Court post-trial. In light of the *Avrahami* decision, the IRS is likely to continue devoting resources to scrutinizing and challenging captive insurance arrangements it believes are abusive," Jennifer Benda, Partner, Fox Rothschild LLP, Denver, told Wolters Kluwer.

Micro-captives

In a micro-captive arrangement, a person directly or indirectly owns an interest in an entity (the insured) conducting a trade or business. That person, or individuals related to that person (or both), also directly or indirectly own another entity (the captive). The captive may enter into a contract with the insured that offers coverage only to persons related to or affiliated with insured, or sometimes also to other entities represented by a person who promotes the micro-captive transaction. The captive may enter into a reinsurance or pooling agreement under which a portion of the risks covered under the contract are treated as pooled with risks of other entities and the captive assumes risks from other entities. Alternatively, the captive indirectly enters into the contract by reinsuring risks that the insured has initially insured with an intermediary.

In either arrangement, the insured, the captive, and the intermediary (if any) treat the contract as an insurance contract for federal income tax purposes. The insured claims a deduction for the premiums paid under Code Sec. 162. The captive excludes the premium income from its taxable income by electing under Code Sec. 831(b) to be taxed only on its investment income.

Tax Court case

In the case before the Tax Court, the taxpayers, a married couple, owned a chain of retail stores as well as several real estate companies. In 2007, the couple incorporated a captive in-

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Micro-Captive

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insurance entity in a foreign jurisdiction with the wife as its sole shareholder. The entity elected to be treated as a domestic corporation for federal tax purposes and to be taxed as a small insurance company under Code Sec. 831(b). The micro-captive sold property and casualty insurance policies to businesses owned by the taxpayers. These businesses also continued to buy insurance from third-party commercial carriers. The IRS disallowed deductions for the cost of premiums paid to the micro-captive.

■ **Comment.** According to the court, in 2009 entities owned by the couple paid the micro-captive \$730,000 in premiums for direct coverage and, in 2010, \$810,000 in premiums for direct coverage. No claims were filed against the micro-captive in 2009 or 2010. Because no claims were filed, the captive insurance company accumulated a surplus, which it transferred to the wife and to a limited liability company (LLC) that was owned by the taxpayers' three children. The LLC's primary asset was 27 acres of land. The insurance company transferred money to the LLC as mortgage and real estate loans. The LLC then issued a promissory note payable to the insurance company for the same amount.

Court's analysis

The court first found that a pure captive insurance company is one that insures only the risks of companies related to it by ownership. To be considered insurance the arrangement must involve risk-shifting; involve risk-distribution; involve insurance risk; and meet commonly accepted notions of insurance. Risk distribution, the court found, occurs when the insurer pools a large enough collection of unrelated risks.

"By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums," the court observed.

Here, the court found that the micro-captive issued seven types of direct policies. These policies covered real property as well as employees. "While we recognize that [the entity] is a micro-captive and must operate on a smaller scale...we can't find that it covered a sufficient number of risk exposures to achieve risk distribution merely through its affiliated entities," the court held.

The court also looked to the micro-captive's operations. The court found that the micro-captive "dealt with claims on an ad hoc basis." According to the court, the micro-captive "made investment choices only an unthinking insurance company would make." By the end of 2010 more than 65 percent of the micro-captive's assets were tied up in long-term, illiquid, and partially unsecured loans to related parties, the court found.

Additionally, the court found that the policies were "less than a model of clarity." The court disagreed with the taxpayers' argument that the policies were claims-made policies. The policies said otherwise, the court found. Some terms were indicative of both a claims-made policy but other terms were indicative of an occurrence policy, the court found.

Further, the court found that the premiums paid to the micro-captive were unreasonable. The taxpayers had paid some \$150,000 in premiums to third-party insurers before the formation of the micro-captive. The couple paid \$1.1 million for insurance costs in 2009 and \$1.3 million in 2010 after the formation of the micro-captive. The couple also continued to pay for their third-party insurance during this time. Accordingly, the payments were not for insurance, were not an ordinary and necessary business expenses and were not deductible under Code Sec. 162(a), the court found.

■ **Comment.** Because the micro-captive was not an insurance company its election to be treated as a domestic corporation was also not valid, the court held.

Turning to the transactions between the micro-captive and the LLC, the court found the transaction were bona fide loans. The LLC had adequate assets to satisfy the loans, plus interest, and the loans were properly papered.

■ **Comment.** The IRS argued that the court should apply the substance-over form and step-transaction doctrines to construe the transfer as a constructive dividend to the wife. The court found that the economic reality of the transaction was a bona fide loan between the parties.

Transactions of interest

In Notice 2016-66, the IRS identified instances where in an abusive structure, owners of closely-held entities create captive insurance companies and cause the creation and sale of the captive insurance policies to the closely-held entities. The policies may cover ordinary business risks or esoteric, implausible risks for exorbitant premiums while the insureds continue to maintain their far less costly commercial coverages with traditional insurers. Captive insurance policies may attempt to cover the same risks as are covered by the entities' existing commercial coverage, but the captive policies' premiums may be double or triple the premiums of the policy owners' commercial policies, the IRS explained.

Transactions that are either the same as the one described in Notice 2016-66, or are substantially similar, were designated as transactions of interest as of November 1, 2016, the IRS explained. Taxpayers who enter into the transactions on or after November 2, 2016, must disclose the transaction in accordance with the notice or be subjected to penalties.

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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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IRS Modifies Deadline For Tax-Exempt Bond Issuers To Recover Overpayment Of Arbitrage Rebate Amounts

Rev. Proc. 2017-50

New guidance from the IRS extends the deadline for issuers of tax-exempt and other tax-advantaged bonds to recover overpayment of arbitrage rebate amounts. The IRS added 60 days to the two-year deadline under Reg. §1.148-3(i)(3)(i). The IRS also provided a new two-year deadline for payments made after the date that is 60 days after the final computation date.

■ **Take Away.** Rev. Proc. 2017-50 modifies the deadline framework announced Rev. Proc. 2008-37. The IRS indicated that issuers may not have an adequate opportunity to recover payments under the prior framework and provided for the extensions in Rev. Proc. 2017-50.

Background

Generally, an issuer can recover overpayments of arbitrage rebate amounts when it can establish that such an overpayment has been made. An overpayment is the excess of a rebate payment to the U.S. over the sum of the rebate amount as of the most recent computation date and any other amounts required to be paid as of the date the recovery is requested.

Rev. Proc. 2008-37

In Rev. Proc. 2008-37, the IRS released procedures for issuers of tax-exempt bonds to

Micro-Captive

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■ **Comment.** In June, an IRS official told the Federal Bar Association's annual insurance tax conference in Washington, D.C. that the agency continues to review data it receives about micro-captives. The official said that the disclosures "are providing valuable information about how to move forward."

*References: Dec. 60,991;
TRC BUSEXP: 18,210.05.*

claim refunds of excess arbitrage rebate payments. Generally, the issuer must request a refund of an overpayment within two years after the final computation date for the issue to which the overpayment relates.

■ **Comment.** The IRS issued final regs in 2014 (TD 9701) that included imposition of the two year deadline for filing claims.

Rev. Proc. 2017-50

Now, Rev. Proc. 2017-50 extends the deadline for filing claims for recovery of overpayments. The deadline is extended to two years after (1) the date that is 60 days after the final computation date of the issue to which the payment relates; or (2)

with respect to the portion of the overpayment paid more than 60 days after the final computation date, the date that the payment was made to the U.S.

Rev. Proc. 2017-50 applies to claims that are pending or filed with the IRS on or after August 25, 2017, for recovery of overpayments of arbitrage rebate, penalty in lieu of arbitrage rebate, or yield reduction payments for an issue of bonds. For purposes of Rev. Proc. 2017-50, an issuer that has made a payment after the final computation date for the issue to which the overpayment relates, but prior to August 25, 2017, will be deemed to have made the payment on August 25, 2017, the agency explained.

*References: FED ¶146,342;
TRC SALES: 51,552.20.*

U.S. Senator, Citizens And Expatriates Lacked Standing To Challenge FATCA, IGAs And FBAR

Crawford, CA-6, August 18, 2017

The Sixth Circuit Court of Appeals has affirmed a district court's dismissal of a suit to enjoin enforcement of the *Foreign Account Tax Compliance Act* (FATCA); related inter-governmental agreements (IGAs); and foreign bank account reporting requirements (FBAR), also known as FinCEN Form 114). The diverse group of plaintiffs, including U.S. Senator Rand Paul, R-Kentucky, and several U.S. citizens and expatriates who lived abroad, lacked standing because they did not allege a present or potential legal injury.

■ **Take Away.** Unhappiness with a statute, without direct harm, is not enough to sustain a legal challenge to its enforcement, according to at least the Sixth Circuit. FATCA and FBARs have been unpopular on a number of fronts, both internationally and domestically. Repeal of FATCA requirements as directed toward U.S. citizens has been discussed as a pos-

sible addition to tax reform that will be considered later in the Fall.

Background

The plaintiffs argued that the FATCA reporting requirements violated the Equal Protection clause and the constitutional right to privacy. The plaintiffs also argued that the IGAs were an unconstitutional usurpation of congressional and presidential powers; and the penalty for willful FBAR violations was unconstitutionally excessive.

Court's analysis

The court noted that it could not hear the case unless the plaintiffs had standing. Standing requires a plaintiff to allege an actual or imminent injury that is a concrete and particularized invasion of a legally protected interest, traceable to the defendant and redressable by the

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Deed Of Easement Enough To Serve As Contemporaneous Written Acknowledgment

310 Retail, LLC, TC Memo 2017-164

A limited liability company (LLC) satisfied the substantiation requirements in Code Sec. 170(f)(8) for a charitable contribution of an easement to a landmark preservation council. Although the taxpayer had not received from the donee organization a timely letter that could have acted as a contemporaneous written acknowledgment, the Tax Court considered the deed of easement a *de facto* qualified acknowledgment.

■ **Take Away.** The IRS has held taxpayers' feet to the fire on more than

one occasion recently in insisting not only on the adequacy of proof that a charitable contribution has taken place but that the strict rules on substantiation surrounding those deductions under Code Sec. 170 have been followed irrespective of other proof. This latest Tax Court case again turns back the IRS's argument that a qualifying contemporaneous written acknowledgment of a charitable donation must take the form of a letter between donor and donee.

Background

The taxpayer, an LLC, donated a façade easement (a "conservation easement") in connection with an historic building. On audit, the IRS disallowed a \$26 million charitable deduction by the taxpayer on the grounds that a contemporaneous written acknowledgment within the meaning of Code Sec. 170(f)(8)(B) was not provided. Code Sec. 170(f)(8)(A) provides: "No deduction shall be allowed ... for any contribution of \$250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment of the contribution by the donee organization that meets the requirements of subparagraph (B)."

Although the LLC did not receive from the donee organization a timely letter of the sort that normally acts as a "contemporaneous written acknowledgment," the taxpayer claimed that it nevertheless satisfied the statutory substantiation requirements, pointing to three documents:

- two Forms 990, Return of Organization Exempt From Income Tax, filed by the donee organization six years after the gift was made (although those forms stated that no goods or services were provided in exchange for the gift, they were not issued "contemporaneously" as required under Code Sec. 170(f)(8)(B)); and
- the deed of easement that the donee organization executed contemporaneously with the gift.

Court's analysis

The Tax Court found that the deed of easement constituted a contemporaneous written acknowledgment sufficient to substantiate the taxpayer's gift because it was properly executed and recorded. The Court also found that the deed also sufficiently included what should be considered "an affirmative indication that the donee organization had supplied no goods or services to the taxpayer in exchange for its gift." The deed explicitly stated that it represented the parties' "entire agreement" and, thus,

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FATCA

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court. A generalized or hypothetical harm is not sufficient. Under this test, neither the original plaintiffs, nor two spouses and one child they proposed as additional plaintiffs, had standing.

FATCA. None of the plaintiffs were actually subject to FATCA because their foreign holdings were less than the applicable reporting thresholds. Instead, they argued that FATCA made foreign financial institutions (FFIs) reluctant to provide services to Americans, and some foreign governments imposed additional reporting requirements through the IGAs. However, these alleged injuries were traceable to the decisions of the FFIs and the foreign governments, not to FATCA itself. At best, these harms were merely second-order effects of government regulation on the market for international banking services.

■ **Comment.** The plaintiffs also claimed that FATCA caused resentment and marital discord; however, these personal feelings were not legal injuries.

IGAs. Similarly, none of the plaintiffs' alleged injuries were traceable to IGAs that the Treasury Department had entered into with foreign governments to facilitate FATCA enforcement. In particular, Sen. Paul's claim that he was denied his constitutional right to cast a Senate vote against the IGAs did not give him legisla-

tive standing. The alleged incursion upon his own political power was not a concrete injury absent any claim that his vote alone would have forestalled the IGAs. Any diminution in the Senate's lawmaking power was a generalized grievance rather than a particularized injury.

■ **Comment.** The court noted that Sen. Paul had a legislative remedy that allowed him to seek to amend or repeal FATCA.

FBAR. The FBAR reporting requirements applied to most of the plaintiffs, but they did not have standing to challenge the discretionary penalty for willful violations. No penalties had been imposed on them and, since most did not claim they intended to violate FBAR, they did not show a credible threat of any future penalties.

Although one plaintiff claimed he was not complying with FBAR, he did not show he was actually threatened with a penalty. He also did not show why he would be subject to the allegedly excessive penalty of at least \$100,000 for a willful violation, rather than the \$10,000 penalty for an ordinary violation.

Finally, the fact that one plaintiff's college account was held in her father's name rather than her own was not due to FBAR; rather, her father chose to keep the account in his name to avoid any risk of subjecting her to FBAR.

*References: 2017-2 ustc ¶150,315;
TRC INTL: 36,052.*

Estate Could Not Deduct Gift Tax Paid By Donees As Expense

Sommers Estate, 149 TC No. 8

Gift taxes on gifts made within three-years of death, paid by a decedent's nieces, were not a deductible expense by the estate, the Tax Court has found. The court also found that the estate could not apportion any estate tax to the nieces.

■ **Take Away.** Net gifts late in life can increase the transferor's estate tax, especially if the interests of the transferees and the heirs do not align. In this case, the Tax Court reviewed the applicable state law (New Jersey) apportionment statute to provide for the apportionment of federal estate tax only to transferees who receive nonprobate property included in the decedent's gross estates. Further, irrespective of

timing, the estate had a right to reimbursement from the donees.

Background

As part of his estate plan, the decedent transferred his art collection to a limited liability company (LLC). He then gifted his units in the LLC to his three nieces under a written transfer agreement in which they agreed to pay any gift taxes due. He died a few months later, before any gift tax had been paid.

The decedent and, later, his estate had both tried to rescind the gifts, but state courts in Indiana and New Jersey had found that the gifts were irrevocable. The Tax Court had previously relied on these decisions to find that collateral estoppel barred

the inclusion of the gifts in the decedent's estate (*Sommers Est., Dec. 59,409(M)*).

After the Tax Court's decision, the nieces paid the gift taxes. Since the gifts were made less than three years before the decedent's death, these gift taxes were included in the estate under the Code Sec. 2503(b) "gross up rule."

Court's analysis

The parties asked for summary judgment on three issues: First, could the estate deduct the gift tax the nieces paid? Second, could any of the estate tax be apportioned to the nieces? And third, what was the widow's marital deduction?

The first issue, the estate's deduction for the gift taxes, involved the estate's argument

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Easement

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negated the provision or receipt of any consideration not stated in that deed.

The Tax Court further found that, apart from the charitable conveyance and the covenants attending the easement, the only "consideration" mentioned in the deed of easement was a consideration of one dollar, which was boilerplate language and had no legal effect for purposes of Code Sec. 170(f)(8).

■ **Comment.** Two other relatively recent opinions bear upon the latest taxpayer victory. *RP Golf, LLC, Dec. 59,215(M), TC Memo 2012-282*, likewise found that a deed of easement had met the requirement of Code Sec. 170(f)(8), a deed which the latest Tax Court opinion states, "is similar in all material respects to the deed in *RP Golf, LLC*." The other opinion, *BC Ranch II, L.P., CA-5, August 11, 2017*, also indicated a willingness by the courts to bend the rules in favor of the taxpayer whenever possible, observing that the very purpose of the statute is not to "discourage and hinder future conservation easements."

References: Dec. 60,997(M); TRC INDIV: 51,364.45.

IRS Announces Relief For Victims Of Hurricane Harvey

The IRS has announced tax relief for victims of Hurricane Harvey that began on August 23, 2017, in parts of Texas. Taxpayers in areas designated by the Federal Emergency Management Agency (FEMA) for individual assistance. At press time, the counties of Aransas, Bee, Brazoria, Calhoun, Chambers, Fort Bend, Galveston, Goliad, Harris, Jackson, Kleberg, Liberty, Matagorda, Nueces, Refugio, San Patricio, Victoria and Wharton are eligible for relief.

New deadlines

The tax relief postpones, until January 31, 2018, various tax filing and payment deadlines that occurred starting on August 23, 2017, for affected individuals and businesses. This blanket relief until January 31, 2018, includes:

- the September 15, 2017 and January 16, 2018 deadlines for making quarterly estimated tax payments;
- the October 16, 2017 deadline for individuals on a six-month filing extension of their 2016 tax-year returns (but because tax payments related to these 2016 returns were originally due on April 18, 2017, however, those payments are not eligible for this relief); and
- the October 31 deadline for quarterly payroll and excise tax returns (for federal payroll and excise tax deposits normally due on or after August 23 and before September 7, the IRS is also waiving late-deposit penalties if the deposits are made by September 7, 2017).

The IRS also announced that it will work with any taxpayer who lives outside the disaster area but whose records necessary to meet a deadline occurring during the postponement period are located in the affected area.

■ **Comment.** "This has been a devastating storm, and the IRS will move quickly to provide tax relief to hurricane victims," IRS Commissioner John Koskinen said. "The IRS will continue to closely monitor the storm's aftermath, and we anticipate providing additional relief for other affected areas in the near future."

IR-2017-135; FED ¶46,343; TRC FILEIND: 15,204.25.

Airline Pilot's Abode Was In U.S.; Ineligible For Foreign Earned Income Exclusion

Acone, TC Memo. 2017-162

The Tax Court has found that an airline pilot's abode for purposes of the foreign earned income exclusion was the U.S. and not South Korea. The court was not persuaded that the taxpayer intended to be anything more than a transient in South Korea.

■ **Take Away.** The court acknowledged that the taxpayer made an attempt to assimilate into the local environment, such as learning Korean. The taxpayer also testified about his circle of friends and co-workers in South Korea. However, the court found this evidence was outweighed by factors indicating that he was not a bona fide resident of South Korea.

Background

The taxpayer worked as a pilot for a foreign airline. Between 2006 and 2013, the taxpayer was stationed in South Korea. While there, the taxpayer stayed in a hotel owned by the airline.

The taxpayer claimed the maximum allowable foreign earned income exclusion for each year for 2011 and 2012. The IRS disagreed with this treatment.

Court's analysis

The court first found that a taxpayer generally must meet several conditions to qualify for the foreign earned income exclusion. The first two conditions, the court explained, render the taxpayer a "qualified individual." The third condition relates to the type of income the taxpayer receives. First, the taxpayer's tax home must be in a foreign jurisdiction. Second, the taxpayer must be a U.S. citizen who is a bona fide resident of a foreign jurisdiction for an entire tax year; or be a U.S. citizen or resident who is present in a foreign country or countries during at least 330 full days of a 12-month period. Third, the taxpayer must have earned income from personal services rendered in a foreign country.

A taxpayer's abode has been defined as "one's home, habitation, residence, domicile, or place of dwelling," the court noted. "The word connotes stability, not transience," the court added.

Here, the court found that the taxpayer's housing in South Korea was a hotel, which the court characterized as the "quintessence of transience." The court noted that it is possible to permanently reside in a hotel. However, in this case, the taxpayer stayed in any available room. The taxpayer "was part of the perpetual stream of hotel 'guests' coming and going," the court found.

The court further found that the taxpayer preferred to spend time in the U.S. When the taxpayer was in the U.S., he tended to stay here longer than he stayed in South Korea when he was there, the court noted.

The court also looked to whether the taxpayer intended to be a bona fide resident of South Korea, and other factors. Here,

the taxpayer testified that he intended to work for the airline until retirement, at which time he returned to the U.S.

■ **Comment.** According to the court, the taxpayer in 2011 had 46 stays in South Korea, consisting of 91 days on duty and 22 days off duty; and had 20 stays in the U.S., consisting of 26 days on duty and 133 days off duty. In 2012, the taxpayer had 40 stays in South Korea, consisting of 108 days on duty and 27 days off duty; and had 28 stays in the U.S., consisting of 58 days on duty and 116 days off duty. The taxpayer was not present in South Korea during at least 330 full days of a 12-month period but was instead present in the U.S. for over 100 days during both years in issue, so the 330-day test was not satisfied, the court found.

References: Dec. 60,995(M); TRC EXPAT: 12,100.

Gift Tax

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that Code Sec. 2502(c) required the donor to pay gift taxes, and Reg. §20.2053-6(d) allowed the estate to deduct gift taxes that were owed at the donor's death. However, the court noted that a claim against an estate was deductible only when it exceeded any right to reimbursement. Even if the estate had paid the taxes itself, it would have been entitled to reimbursement from the nieces under their transfer agreement with the decedent. Moreover, allowing the estate to deduct the taxes would frustrate the purpose of the gross-up rule, which is intended to discourage deathbed gifts that reduce the transferor's estate.

The second issue, the apportionment of the estate tax, depended on a state (New Jersey) apportionment law that divided estate tax among the estate fiduciary and transferees interested in the gross tax estate. The estate argued that the LLC units were part of the gross tax estate because the unified nature of federal transfer taxes meant that the gifts to the nieces affected the estate tax liability.

The estate also argued that a portion of the net gift represented gift tax that was added back into the estate; thus, the nieces received a portion of the estate that allowed them to pay the gift tax. After reviewing other state apportionment statutes, the court disagreed. The LLC units were not part of the estate; thus, the nieces were not transferees of the estate and the units were not included in computing the estate tax liability.

■ **Comment.** The court noted that the apportionment statute could be overridden by directions to the contrary, but the decedent had left no such instructions.

The third issue, the amount of the widow's marital deduction, arose because under Code Sec. 2506, property that would have been distributed to the surviving spouse was not included in the marital deduction if it was used to satisfy the estate's debts. The court refused summary judgment because the marital deduction depended on the factual question of the extent to which assets otherwise exempt from claims against the estate were used.

References: Dec. 60,994; TRC ESTGIFT: 39,306.

Tax Court Determines Gain On Part Sale/Gift Of Residence To Parents

Fiscalini, TC Memo 2017-163

An individual sold his personal residence to his parents after previously being gifted part of the same residence by them, as well as having them pay off outstanding mortgages as part of the sale to avoid foreclosure. The Tax Court found that the taxpayer owed long-term capital gain on that sale, but not to the extent argued by the IRS.

■ **Take Away.** The situation in which parents help a son or daughter with buying a home, and/or addressing any subsequent issues, can take many forms. Here, the parents took title to a portion of the home representing the down payment. They stepped in again, buying back the house when mortgage refinancing left their son facing foreclosure during the 2007 economic downturn. Sorting out gifts from tax basis and the impact of buy-back arrangements, as in this case, can sometimes raise questions with the IRS.

Background

The taxpayer and his parents purchased a home. The parents contributed \$40,000

cash and the taxpayer took out a \$234,000 mortgage. A few years later, the parents gifted their share of the home to the taxpayer. Over the years, the taxpayer claimed he put \$50,000 in improvements into the home. He also had refinanced his home until, at the start of the economic downturn in 2007, he found himself facing foreclosure, unable to make the mortgage payments. His parents stepped in again as purchasers, paying the taxpayer \$975,000 for the property, paying off the \$664,000 mortgages and accepting “a gift of equity” from the son of the \$295,000 difference (less \$16,751 settlement costs).

On audit, the taxpayer and the IRS disagreed over the amount of capital gain realized based upon different conclusions over the taxpayer’s adjusted basis (\$329,000 and \$234,000, respectively) and the amount realized on the sale of the property (\$664,000 and \$975,000, respectively).

Court’s analysis

The Tax Court agreed with the taxpayer that the parent’s initial gift of the \$40,000 original share of the home was basis that carried over to the taxpayer. His basis equal to the original \$274,000 purchase price of the

home could not be increased by his claimed \$50,000 in improvements, however, since the court determined that he failed to carry his burden of proof for that amount.

The Tax Court also agreed with the taxpayer that the purchase price for determining long-term capital gain was \$664,000 and not \$975,000. The gift of the difference was not made subsequent to the sale but instead was part of it. Cash did not exchange hands for that amount; it was a transfer of property that was in part a sale and in part a gift.

After reducing the purchase price by the \$16,751 settlement costs and excluding \$250,000 of the gain under the Code Sec. 121 homesale exclusion, the court found that the taxpayer was required to recognize \$122,000 of long-term capital gain from the sale to his parents.

■ **Comment.** The facts recited in this case did not mention what became of the home after the parents buy back. Whether or not the parents then allowed their son to continue living in the house, however, likely would not have been relevant to the court’s decision.

References: Dec. 60,996(M); TRC SALES: 6,350.

TAX BRIEFS

Internal Revenue Service

The IRS will not acquiesce to the holding in *G.H. Bartell, Jr., Est.*, 147 TC No. 5, Dec. 50,669, that a sale and acquisition of business property qualified as a like-kind exchange. Taxpayers that use accommodating parties outside the scope of Rev. Proc. 2000-37, 2000-2 CB 308, have not engaged in an exchange if the taxpayer, rather than the accommodating party, acquires the benefits and burdens of ownership of the replacement property before the taxpayer transfers the relinquished property.

AOD-2017-6, FED ¶46,341; TRC SALES: 30,604

Victims of severe storms, flooding, landslides and mudslides that began on July 28, 2017, in parts of West Virginia may qualify for tax relief from the IRS. The president has declared the counties of Harrison, Marion, Marshall and Wetzel federal disaster areas. Individuals who reside or have a business in these counties may qualify for tax relief. The IRS has postponed certain deadlines for taxpayers who reside or have a business in the disaster area. Certain deadlines falling on or after July 28, 2017, and before November 30, 2017, have been postponed to November 30, 2017.

West Virginia Disaster Relief Notice (WV-2017-02), FED ¶46,340; TRC FILEIND: 15,204.25

International

A U.S. expatriate’s challenge to penalties imposed for failure to file Form 5471 was dismissed. The individual failed to state a claim for relief under the Fifth or Eighth Amendments and lacked standing to bring his equal protection claim.

Dewees, DC D.C., 2017-2 USTC ¶50,321; TRC INTLOUT: 9,454.35

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Tax Briefs

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The Tax Court properly concluded that a military contractor and his wife failed to show they were entitled to the foreign earned income exclusion. The taxpayer did not dispute that he failed the physical presence test and that Iraq and Afghanistan were not on the list of eligible waiver countries.

Thompson, CA-9, 2017-2 USTC ¶50,311;
TRC EXPAT: 12,100

Jurisdiction

An estate's tax refund action was dismissed for lack of jurisdiction. The refund claim was not timely and the estate failed to present documentation sufficient to support tolling the statute of limitations.

Estate of Kirsch, DC N.Y., 2017-2 USTC ¶50,319;
TRC IRS: 36,052.05

Tax Crimes

There was sufficient evidence to convict an individual of tax fraud. In addition, he was properly sentenced to thirty months imprisonment, two years of supervised release and restitution.

DiCosola, CA-7, 2017-2 USTC ¶50,316;
TRC IRS: 66,052

A commodities trader who was convicted of tax fraud was properly sentenced to sixty months imprisonment and restitution. The individual ran a "Ponzi" scheme and failed to report as income investor money he converted to his personal use. His sentence was not substantively or procedurally unreasonable.

Olson, CA-1, 2017-2 USTC ¶50,310;
TRC IRS: 66,052

Stock Sale

A majority shareholder who bought out the minority shareholder in order to sell the company was taxable on the sale of all the stock. The individual acquired ownership of the stock prior to selling it to the buyer in a cash and stock merger. Therefore, he owed tax on the income he derived from the sale of the shares.

Tseytin, CA-3, 2017-2 USTC ¶50,317;
TRC CCORP: 12,202.05

Deductions

The Tax Court properly determined that an individual was not entitled to deduct certain business expenses. The individual failed to demonstrate his entitlement to the deductions. The Tax Court properly imposed penalties on the individual. His underpayment of tax was due to his substantial understatement of income tax.

Besaw, CA-9, 2017-2 USTC ¶50,314;
TRC BUSEXP: 3,100

The cost of additive minerals was part of a cement corporation's total costs when computing its gross income from mining under the proportionate profits method. The additive minerals were a necessary component of finished cement and their costs were paid or incurred to produce the taxpayer's first marketable product. However, these additive minerals were not mining costs and, therefore, were not included in total mining costs as direct mining costs.

Mitsubishi Cement Corporation & Subsidiaries,
TC, CCH Dec. 60,992(M), FED ¶48,106(M);
TRC FARM: 15,154.15

Summary Judgment

Summary judgment was properly granted in an action challenging the disallowance of an individual's request for an abatement of interest. Her claims were barred by *res judicata*. The individual raised the same for the same tax year in a prior Tax Court proceeding, which was decided on the merits.

Barrett, CA-9, 2017-2 USTC ¶50,313;
TRC LITIG: 3,052

Sale of Property

An order reducing an individual's tax liabilities to judgment and directing the sale of various properties was vacated and remanded. The properties ordered sold were titled in the name of the individual's corporation, which did not have an opportunity to show it was not the individual's alter ego or nominee.

Arlin Geophysical, CA-10, 2017-2 USTC
¶50,312; TRC IRS: 45,160.05

Refund Claims

A federal district court refused to reconsider its dismissal of an individual's refund claim. While the taxpayer submitted a statement from a licensed mental health counselor, that statement was not written

by someone who qualified as a physician under Rev. Proc. 99-21, 1999-1 CB 960.

Milton, DC Wash., 2017-2 USTC ¶50,318;
TRC IRS: 36,052.05

A married couple was not entitled to an income tax refund. The taxpayers could not establish that they overpaid their taxes. Although the terms of the Tax Court stipulation were carried out, the taxpayers accrued interest and penalties because of their reporting error, which were not affected by the Tax Court stipulation. Therefore, the taxpayers were liable for that debt and the IRS properly levied their brokerage account to collect it.

Zhou, FedCl, 2017-2 USTC ¶50,309;
TRC LITIG: 9,152.15

Collection Due Process

An IRS settlement officer (SO) did not abuse his discretion by sustaining a levy to collect the outstanding tax liabilities of a separated couple. However, the taxpayers did not claim economic hardship at their Collection Due Process (CDP) hearing. Therefore, the SO properly closed the case when the taxpayers failed to submit a counteroffer by his deadline and ceased further communications with him.

Bullock, TC, CCH Dec. 60,993(M),
FED ¶48,107(M); TRC IRS: 51,056.25

Charitable Contribution Deduction

An individual, who was an avid big-game hunter, was not entitled to a charitable contribution deduction in excess of the amount allowed by the IRS. The IRS's valuation expert convincingly testified that the donated items were neither world-class trophies nor museum-quality research specimens but were mostly "remnants and scraps" such as partial skins, skulls, tails and hooves. Therefore, the specimens were clearly commodities, not collectibles, and their FMV were based on market prices for similar items, which were readily available.

Gardner, TC, CCH Dec. 60,998(M),
FED ¶48,112(M); TRC INDIV: 51,458

Tax Protestor

A tax protestor was not entitled to dismiss the government's collection action. The individual's argument that the court lacked jurisdiction over the action was without merit.

Schmidt, DC Wash., 2017-2 USTC ¶50,320;
TRC PENALTY: 3,260

IRS Officials Discuss Tax Reform, Filing Season And Strategic Goals

The IRS hosted its Nationwide Tax Forum from August 22-24 in National Harbor, Maryland, just outside of Washington, D.C. The three-day forum provided tax professionals with various informative education seminars and updates on current IRS practices and procedures and the 2017 filing season. This Practitioner's Corner focuses on specific content provided during the event as related to the IRS's role in tax reform and the Security Summit alliance formed to combat identity theft refund fraud, as well as procedural safeguards expected in 2018.

Tax reform

The IRS considers itself a key player in implementing successful tax reform/simplification. Although the IRS does not play a direct role in tax policy decisions, it is tasked with administering any tax law changes, small or large, to the tax code. Because the IRS is such an integral part of tax reform in that practical dynamic, the Service is closely monitoring congressional legislative developments related to tax reform on Capitol Hill, according to IRS Small Business Self Employed (SB/SE) Division Commissioner Mary Beth Murphy. The SB/SE Commissioner gave the keynote address.

The IRS does not advocate for any particular tax policy decisions, Murphy said, noting that the IRS's focus is on tax law administration. That said, however, the IRS does welcome tax reform that would result in simplification of the tax code and, therefore, its administration, according to Murphy. "No one would be more delighted with a simplified tax code than IRS employees," she said. "Their jobs would be made much easier if the tax code were less complicated."

Because the IRS's focus is on administering current tax law and any forthcom-

ing changes to the Code, the Service has a great interest in working with tax writers on Capitol Hill to ensure tax law changes are clear to taxpayers, Murphy said. Further, Murphy emphasized the importance of Congress providing the IRS with advance notice of legislative changes to allow the Service to update its systems and procedures accordingly. "We've asked Congress to give us as much lead time as possible on any tax changes that might be enacted," she added.

"The IRS considers itself a key player in implementing successful tax reform ... the agency is closely monitoring congressional legislative developments related to tax reform on Capitol Hill, according to SB/SE Division Commissioner Mary Beth Murphy."

2017 filing season

The 2017 tax filing seasons has largely been deemed a success by IRS officials, including IRS Commissioner John Koskinen. As of August 4, the IRS has received over 144 million individual tax returns, which is likely growing to a grand total of approximately 152 million, Murphy reported. The IRS has issued 107 million refunds this year, totaling more than \$299 billion dollars, she added. The average refund for individual taxpayers totaled close to \$2,800.

The 2017 filing season was accompanied by the challenges of implementing several provisions enacted in 2015 under the *Protecting Americans from Tax Hikes (PATH) Act*, which took effect in 2017. By enacting these changes, Congress provided the IRS with "new tools" for 2017, all of which help the IRS verify and prevent fraud, according to an IRS official with the IRS Wage and Investment Division.

EITC. One specific requirement that took effect this year under the PATH Act was the IRS's hold until February 15 of all tax returns that claimed the Earned Income Tax Credit (EITC) or the Additional Child Tax Credit (ACTC). Over \$50 billion dollars in EITC and ACTC refunds were issued after February 15. Implementing this change slowed the typical pace of refund distribution early in the filing season, but had its benefits, according to Murphy, because it aides the

IRS in fraud detection. "It gives us more time to match EITC and ACTC returns with W-2s, which we're getting earlier in the filing season, thanks to another PATH Act provision," she said. The IRS is now able to do a "better job" of identifying incorrect or fraudulent returns. "Receiving W-2s earlier has also helped us move faster to release refunds for those returns that appear suspicious, but where we can verify the taxpayer's identity."

Tying back to tax reform, Murphy noted that Congress gave the IRS "plenty of lead time" to implement the changes under the PATH Act, and such an advanced notice is also hoped for by the IRS in connection with anticipated tax reform this fall. "We used the time to work with tax practitioner groups and other organizations to get the word out," she said in referring to the heads up given in connection with the PATH Act. "The smooth operation of the filing season that just ended is proof that this preparation paid off."

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White House not expected to release separate tax reform plan

The White House is not expected to release a separate tax reform plan from that of Republican lawmakers, a senior official within the Trump administration has said. The White House will likely turn to Congressional tax writing committees for the unveiling of a tax reform proposal and legislation, according to several reports.

White House Press Secretary Sarah Huckabee Sanders told reporters on August 24 that the White House will make specific announcements related to tax reform. "I think you can expect some of that to take place in the very short order, probably next week, and following through to the fall," she said.

The White House has been working closely with top Republican lawmakers on tax reform. They include House Speaker Paul Ryan, R-Wisconsin, Senate Majority Leader Mitch McConnell, R-Kentucky, Treasury Secretary Steven Mnuchin, National Economic Council Director Gary Cohn, Senate Finance Committee Chair Orrin Hatch, R-Utah, and House Ways and Means Committee Chair Kevin Brady, R-Texas.

Governors aim for bipartisan approach to ACA changes

Gov. John Hickenlooper, D-Colorado, and Gov. John Kasich, R-Ohio, have announced they are working on a bipartisan plan for various changes to the Affordable Care Act (ACA). The governors have broadly indicated that their plan will address market stability and possibly the reach of the employer shared responsibility requirement.

"There are several important things, but the probably top one on our list would be this notion of having some sort of reinsurance to make sure the high-cost pool is not causing higher rates for all the people seeking insurance on the private markets," Hickenlooper said.

"We're getting very close. I just talked to my staff who are working on this with Gov. Hickenlooper's people, and we think we'll have some specifics here, I actually think we could have it within a week," Kasich said on August 22.

Also on August 22, Sen. Lamar Alexander, R-Tennessee, chair of the Senate Health, Education, Labor, and Pensions Committee, and Ranking Member Patty Murray, D-Washington, announced the committee will hear from state insurance commissioners and governors, respectively, at the first two bipartisan hearings in September on stabilizing premiums in the individual insurance market. "Any solution that Congress passes for a 2018 stabilization package will have to be small, bipartisan and balanced," Alexander said. "Through these and other planned public hearings, we have the critical opportunity to work together toward an agreement by the end of September to help prevent millions of patients and families from paying more for the care they need next year," Murray said.

IRS posts draft Instructions for 2017 Form 1095-A, Health Insurance Statement

The IRS has posted draft instructions for Form 1095-A, Health Insurance Statement, on its website. Form 1095-A is used to report certain information to the IRS about individuals who enroll in a qualified health plan through the ACA Marketplace. The IRS explained that the Marketplaces file Form 1095-A with the agency on or before January 31, 2018, for coverage in calendar year 2017. The Marketplaces must submit Form 1095-A to the IRS electronically.

In related ACA news, the U.S. Department of Health and Human Services (HHS) has updated its Health Insurance Marketplace county map. HHS explained that the map reflects projected issuer participation on the Health Insurance Marketplaces in 2018 based on the known issuer public announcements through August 23, 2017. Participation is expected to fluctuate, HHS explained.

TIGTA reviews IRS's additional appropriations for cybersecurity, identity theft

The IRS adequately tracked and monitored and appropriately spent the additional funding designated for cybersecurity enhancements and identity theft prevention, the Treasury Inspector General for Tax Administration (TIGTA) recently reported. Congress appropriated an additional \$290 million to the IRS in fiscal year (FY) 2016 to the IRS to make improvements in the customer service level of service, safeguard taxpayer data through enhanced cybersecurity and improve the identification and prevention of identity theft and refund fraud.

The IRS allocated approximately \$91 million of the \$290 million in additional funding to safeguard taxpayer data through cybersecurity enhancements, TIGTA reported. Of the \$91 million, approximately \$71 million was obligated in FY 2016, with the remaining approximate \$20 million being obligated in FY 2017. In addition, the IRS allocated approximately \$14 million to identity theft operations support to help protect taxpayers by combating identity theft and refund fraud through collaborative efforts with leading tax preparation firms, software developers, payroll and tax financial product processors and state tax administrators.

IRS posts updated version of Pub. 1220 for e-filing certain forms

The IRS has posted an updated version of Pub. 1220, Specifications for Electronic Filing of Forms 1097, 1098, 1099, 3921, 3922, 5498, and W-2G for Tax Year 2017. Pub. 1220 provides the specifications for filing of Forms 1097, 1098, 1099, 3921, 3922, 5498, and W-2G electronically with the IRS. Pub 1220 also provides the requirements and specifications for electronic filing under the Combined Federal/State Filing Program (CF/SF). The IRS reminded filers that, generally, boxes on paper forms correspond with fields used for the electronic file.

Practitioners' Corner

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■ **Comment.** IRS officials want taxpayers and practitioners to be aware that most PATH Act changes were made permanent. That was not the case, however, with some changes over which the IRS share with taxpayers an uncertainty regarding their renewal. These include, among others, the above-the-line deduction for qualified tuition and related expenses, the mortgage debt exclusion, and the mortgage insurance premium deduction that were only extended through 2016. For businesses, bonus depreciation will drop from its 50 percent level down to 40 percent in 2018 as part of a complete phase-out by 2020, unless Congress acts.

Security Summit and identity theft

The Security Summit is a unique partnership that began in March 2015 between the IRS and representatives of the software industry, tax preparation firms, payroll and tax financial product processors and state tax administrators. The permanent partnership held under the auspices of the Electronic Tax Administration Advisory Committee was formed to more effectively combat identity theft refund fraud.

The collaborative efforts of Security Summit partners resulted in new safeguards for the 2016 and 2017 filing seasons, which has resulted in better protection for taxpayers from identity theft, according to IRS officials. While results for the 2017 filing season are not yet available, the IRS has reported a 30 percent drop in confirmed identity theft returns, a 50 percent drop in suspicious returns, and a 46 percent drop in taxpayers reporting themselves as victims. The IRS saw a decline of self-reported identity theft cases, dropping from 698,700 in calendar year 2015 to 376,500 in 2016.

ISAC. The Security Summit created the Identity Theft Tax Refund Fraud Information Sharing and Analysis Center (ISAC)

in 2016, which launched in its preliminary stages this year. ISAC allows Summit partners to more quickly identify emerging tax fraud schemes and share that information among each other. "This will be a long term defense in the nation's tax system," an IRS official said.

Despite the improvements, "identity theft continues to be a major threat to tax administration," Murphy said. During fiscal year 2016, the IRS stopped over \$6.5 billion in fraudulent refunds on 969,000 confirmed fraudulent tax reforms. "There is still more work to be done," Murphy noted, adding that the IRS's fraud filters continue to identify a large number of false returns. "We are finding that, as the IRS improves monitoring capabilities and shuts off certain avenues of entry, identity thieves look for new ways of getting in."

The IRS is becoming increasingly concerned about the identity thieves targeting tax return preparers to steal taxpayer information. The IRS reports it is seeing scams that involve thieves obtaining remote access to return preparers' computers and software. Also, the IRS launched a pilot program in 2016, which tested the idea of adding a verification code to the W-2. This code helps confirm the accuracy of a tax return that is electronically filed, according to the IRS. The pilot was expanded in 2017 to include up to 50 million W-2s, Murphy noted, and it will be tested again during the 2018 filing season.

■ **Comment.** "I have a request for return preparers: When you see this number [the Form W-2 verification code] on a client's W-2, please fill the number in on their return. It will help protect your clients and keep them from facing refund delays, and it will help the IRS stop fraud in its tracks," Murphy said.

Some of the Security Summit initiatives implemented in 2017 include the identification of more return data elements for verification purposes and shared data elements from business returns, as well as working with state and bank partnerships to identify suspect refunds.

Also a part of the Security Summit effort in 2017, the partnership is host-

ing a 10-week education and awareness campaign called "Don't Take the Bait," which launched in July. The series, which is part of the Protect Your Clients, Protect Yourself campaign, aims to encourage tax professionals to increase their computer security and be cautious when reviewing their emails. "Tax professionals must remember that they have not just an obligation but a legal requirement under federal law to protect taxpayer information," the IRS has said.

New for the IRS during the 2018 filing season is a focus on improving "trusted customer" and reducing false positives for returns, according to the IRS official. This effort will require sharing additional return data elements and expanding W-2 verification code initiative. Also, the IRS will focus on new verification items for Forms 1120, 1120S, 1041 and Schedule K1. Several of the new Form 1120 verification data points that can be expected in 2018 include the name and social security number of executives authorized to sign the return, payment history, parent company information, additional information about deductions, and filing history - Forms 940, 941, or other business related tax forms, for example.

Looking ahead

The IRS plans to release the next iteration of its strategic plan for the future direction of the agency in June 2018, Murphy announced at the Forum. The new plan, in accordance with requirements of all federal agencies, will guide the goals and direction of the Service through 2022. The current plan, which included details, among others, to build a relationship between the IRS, state administrators, and the private sector, as well as increase taxpayer access to digital services, expires in 2017.

Although IRS Commissioner John Koskinen's five year term as commissioner ends on November 12, 2017, the expectation is that most aspects of the Service's strategic plan will not change significantly moving forward. Having adequate budget funding to accomplish the plan may remain the most speculative part of any predictions.

COMPLIANCE CALENDAR

■ September 1

Employers deposit Social Security, Medicare, and withheld income tax for August 26, 27, 28, and 29.

■ September 7

Employers deposit Social Security, Medicare, and withheld income tax for August 30, 31, and September 1.

■ September 8

Employers deposit Social Security, Medicare, and withheld income tax for September 2, 3, 4, and 5.

■ September 11

Employees who received \$20 or more in tips during August report them to their employers.

■ September 13

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

■ September 15

Corporations deposit the third installment of estimated tax for 2017.

Individuals deposit the third installment of 2017 estimated tax.

Corporations and S corporations with 6-month extensions file 2016 Forms 1120 and 1120S and pay tax due.

Partnerships with 5-month extensions file 2016 Form 1065.

Employers to whom the monthly deposit rule applies, deposit employment taxes and nonpayroll withholding for payments in August.

■ September 15

Employers deposit Social Security, Medicare, and withheld income tax for September 9, 10, 11, and 12.

MONTHLY QUIZZER

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

Q1. The Treasury Department and the IRS announced a delay, until January 1, _____, to the implementation of the so-called Documentation Regulations under the Section 385 debt-equity regulations.

- (a) 2018
- (b) 2019
- (c) 2020
- (d) 2021

Q2. The new chief of IRS Criminal Investigations (CI) announced that CI will organize a new nationally coordinated investigations unit, which will focus on employment tax enforcement, international tax enforcement and other projects. *True or False?*

Q3. The IRS released model amendments that a sponsor of a qualified defined benefit plan may use to amend its plan document to offer bifurcated benefit distribution options to participants under Code Sec. 417(e). *True or False?*

Q4. The Social Security Administration's Board of Trustees estimated that the Social Security wage base for 2018 will be _____. The Social Security Administration is expected to announce the official wage base for 2018 before year-end.

- (a) \$127,000
- (b) \$129,100
- (c) \$130,500
- (d) \$141,000

Answers:

Q1. (b), See Issue #31, page 351.

Q2. True, See Issue #32, page 361.

Q3. True, See Issue #34, page 385.

Q4. (c), See Issue #33, page 382.

TRC TEXT REFERENCE TABLE

The cross references at the end of the articles in Wolters Kluwer Federal Tax Weekly (FTW) are text references to Wolters Kluwer 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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