ONPOINT PUBLICATIONS – TALKING POINTS GUIDE

TOPIC:

TAX WEEK IN REVIEW – NOVEMBER 18, 2016

TALKING POINTS FOR TAX WEEK IN REVIEW NOVEMBER 18, 2016

Slide 1. Title Page – Tax Week in Review for Week Ending 11/18/2016

Opinions, Decisions and Rulings Released This Week

Slide 2.

FRANKLIN v. COMMISSIONER - T.C. Memo. 2016-207

Issue: Did the IRS properly adjust taxpayer's liability for S-corporation dividends, S-corporation basis adjustments and omitted discharge of indebtedness income?

- Taxpayer (T) filed late for tax years 2007 and 2008. No returns were filed for 2009 or 2010. IRS determined deficiencies for all years based on:
    - S-corporation distributions of 2007 recharacterized as dividends
    - T lacked basis for S-corporation losses for 2007 and 2008
    - T's cancellation of debt income was not reported in 2008
    - Other adjustments sustained or conceded were made in the final determination for gambling winnings, unreported wages, interest income, an IRA distribution for 2010 and unreported bank deposits.

Slide 3.

Shareholder Loan Recharacterized as Dividend Income

- T was a 100% shareholder of Franklin Drywall, Inc. (FDI), an S-corporation. Per FDI's 2008 balance sheet, a Loan to Shareholder had a starting balance of $218,342 and an ending balance of zero.
- Shareholder Loan Characteristics:
    - No written note receivable or stated interest
    - Open ended
    - Classification as loan by the *advice of his accountant* and financial services firm holding corporate debt.
- With no proof of repayment from T, amount was recharacterized by IRS as a distribution for 2007.

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Shareholder Loan Recharacterized as Dividend Income

- The Tax Court disagreed with the IRS characterization.
    - Having received the funds in a prior year, the classification of dividend income would be an event for a prior year, which is not under consideration for the tax year in review.
    - As a distribution, it would not be classified as a dividend from the S corporation, unless there were accumulated earnings and profits in the retained earnings.

Comments: What did the Court consider in their determination?

1. *Section 316(a) defines a dividend as a distribution of accumulated earnings and profits (AEP) to a corporation's shareholders. As an S-corporation, unless the corporation had AEP between its inception and the effective date of its S-election (3 days), the payment would not qualify as a dividend.*
2. *Section 1368(b)(1) & (2)*
    - *Assuming there is no AEP, distributions from S-corporations are applied first to the adjusted basis in shareholder's corporate stock. Any amount in excess of the stock basis is considered a capital gain for the sale of property.*
3. *Under the circumstances, the Court found it highly unlikely that the corporation had any AEP or been involved in a reorganization or similar transaction that would have given rise to AEP.*

Slide 5:

Pass-through Losses from FDI

- FDI's 2007 Form 1120-S reported a loss of $501,448 and return was marked as "Final" for 2007. T reported only $343,939 of the loss on his 2007 return.
- IRS disallowed all but $43,152, claiming this was T's share of actual losses for 2007. This amount was also disallowed for a lack of basis.
- T claimed that he was guarantor to corporate debt in excess of $1.7M, owed to ACRO Business Finance Corp. (ACRO)
    - In 2007, ACRO seized and sold T's personal assets worth $496,000. T testified that he still owed $500,000.

Slide 6.

Pass-through Losses from FDI

- T claimed a loss of $107,298 from FDI. However, as 2007 was marked as a final return, no return was filed for 2008. T did not provide any additional record of the loss at the time of trial.
- IRS claimed lack of basis as evidenced by FDI's $513,000 of stock and APIC vs. a deficit retained earnings of $1,391,000 reported on Form 1120-S. The shareholder's basis would have been utilized for deducting losses in prior years.

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Pass-through Losses from FDI

The Tax Court decided otherwise.

- The Tax Court held that the 2007 loss under consideration was $343,939.
    - Neither T nor the IRS explained or otherwise changed the reported loss from $343,939 to $501,448 as reported on the corporate return.
    - IRS also failed to address the issue of its determination to change the loss to $43,000.
- The Court allowed the loss as T's repayment of $496,000 of debts owed by the corporation would represent an increase in debt basis for 2007.
- As no corporate return was on record for 2008, the 2008 loss of $107,298 was denied.

Comments: What did the Court consider in their determination?

1. *Section 1366(a) requires that an S-corporation shareholder take into account his pro-rata share of income, losses deductions and credits in determining his tax liability.*
2. *Section 1366(d)(1)(A) and (B) requires that losses cannot exceed the sum of his adjusted basis in stock and his adjusted basis in the S-corporation's indebtedness to him.*
3. *However, the Court noted – "No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholder." Therefore, the remaining $500,000 guaranty for ACRO debt, did not qualify as additional basis.*

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Pass-through Losses from FCS

- T claimed a loss of $187,503 from Franklin Construction Services (FCS) in 2008.
- IRS claimed T lacked sufficient basis in the corporation and denied the deduction.
- Despite claims of a family loan for $500,000 and monies invested from IRS funds, the Tax Court found no qualified evidence to support T's claims and denied the loss for 2008.

Slide 9.

2008 Discharge of Indebtedness

- The Tax Court sustained an adjustment for $67,592 of cancellation of debt income.
- T claimed to have been insolvent in 2007, but made no such claim for 2008.

The full text can be read here: T.C. Memo. 2016-207

Final Comments

1. *Section 61(a)(12) includes income from discharge from indebtedness. T's bank forgave $67,592 in 2008. However, Section 108(a)(1)(B) excludes COD income if the taxpayer is insolvent at the time COD income occurs.*
2. *Another IRS adjustment came from unexplained deposits for 2009 and 2010. Some deposits were removed from consideration as duplicative. For the record, the Court referred to Tokarski v. Commissioner (87 T.C. 74, 77) – "A bank deposit is prima facie evidence of income and respondent need not prove a likely source of that income."*

Slide 10.

THE MALULANI GROUP v. COMMISSIONER – T.C. MEMO 2016-209

Issue: Is the taxpayer entitled to non-recognition of gain under Section 1031(a) on its disposition of property?

- Taxpayer enters into a Section 1031 transaction:
    - Taxpayer (T) and related entities lease commercial real estate
    - T has fully owned subsidiary (MBL) and owns 69.67% of MIL.
    - An unrelated 3rd party that made an offer to buy property from MBL, with an allowance for a Section 1031 exchange.
    - T used a qualified intermediary, necessary to qualify for Section 1031 treatment.

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Transaction involving MIL, a related party

- Having failed to negotiate any purchase of suitable replacement property from an unrelated party, one day before the 45 day identification period expired, MBL decided to obtain its replacement property from MIL.

- Transfers were made through a qualified intermediary (QI).

    - MBL property to QI, transferred to 3rd party buyer.
    - Cash from 3rd party to QI, transferred to MIL.
    - MIL property to QI, transferred to MBL

- MBL deferred its gain of $1,888,040. MIL reported a gain of $3,127,004 for its sale of property.

Comment: MBL and Malulani Group were presented with numerous properties owned by 3rd parties. They negotiated for the purchase of an office building and apartment building, but did not close on any proposals. Though they had not previously considered any properties from Malulani Investment Limited (MIL), by February 23rd (one day before the expiration of their 45 day identification period), MBL identified 3 properties owned by MIL as possible replacement properties.

Under Section 1031(f)(1), if a transfer occurs between related parties and one of the parties sells the property received within 2 years (cashes out), any deferred

gain must be recognized. MIL did, in fact, receive cash. This section applies to direct exchanges between related parties. However, under Section 1031(f)(4), the court noted:

> *Although section 1031(f)(1) disallows nonrecognition treatment only for direct exchanges between related persons, section 1031(f)(4) provides that nonrecognition treatment does not apply to any exchange which is part of a transaction or series of transactions "structured to avoid the purposes of" section 1031(f). Therefore, section 1031(f)(4) may disallow nonrecognition treatment of deferred exchanges that only indirectly involve related persons because of the interposition of qualified intermediaries. See Ocmulgee Fields, Inc. v. Commissioner, 613 F.3d at 136.*

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The Court Decides

- The IRS denied the non-recognition of MBL's gain under Section 1031.
- MBL argued that having no preplanned arrangement of tax avoidance in an exchange with a related party, the transaction should meet the nonrecognition exception under Section 1031(f)(2)(c).
- Decision: The Tax Court rejected the premise that the lack of a tax avoidance strategy met the exception under 1031(f)(2)(c). The Court looked to the ultimate result of the transaction which resulted in MIL receiving cash for its property.

The full text can be read here: T.C. MEMO 2016-209

Comment: To support its position that the tax avoidance exception should apply, MBL pointed out that they had actively pursued third party properties to comply with Section 1031. It was only after failing to do so that they considered the properties of MIL. There was no "prearranged plan" to conduct a transaction with MIL. Using this example from legislative history:

> *" For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will*

not be entitled to nonrecognition treatment under section 1031." H.R. Rept. No. 101-247, supra at 1341, 1989 U.S.C.C.A.N. at 2811.

MBL's second argument to support its position was that they ultimately reported a higher gain than if they had sold MLB's property directly. The court noted:

> *It is true that MIL recognized more gain on the disposition of the Hawaii property than MBL realized on the disposition of the Maryland property. However, MIL was able to offset the gain recognized with NOLs, resulting in net tax savings to petitioner and MIL as an economic unit. Net tax savings achieved through use of the related party's NOLs may demonstrate the presence of a tax avoidance purpose notwithstanding a lack of basis shifting. See Teruya Bros., Ltd. & Subs. v. Commissioner, 580 F.3d at 1047; see also Teruya Bros. Ltd. & Subs. v. Commissioner, 124 T.C. at 55.*
>
> *In sum, by employing a deferred section 1031 exchange transaction to dispose of the Maryland property, petitioner and MIL, viewed in the aggregate, " have, in effect, 'cashed out' of the investment", H.R. Rept. No. 101-247, supra at 1340, 1989 U.S.C.C.A.N. at 2810, virtually tax free--in stark contrast to the substantial tax liability petitioner would have incurred as a result of a direct sale. As was the case with the transaction at issue in Teruya Bros., the transaction at issue here allowed petitioner and MIL " to cash out of a significant investment in real property under the guise of a nontaxable like-kind exchange". Teruya Bros., Ltd. & Subs. v. Commissioner, 580 F.3d at 1046; see also Ocmulgee Fields, Inc. v. Commissioner, 613 F.3d at 1365.*

In the News This Week

Slide 13:

Rev. Proc. 2016-57 – IRS Creates New Fast track Mediation Program for Appeals

The IRS is eliminating the mediation appeals process established under Rev. Proc. 2003-41 and is replacing it with a new process - SB/SE Fast Track Mediation Collection (FTMC) - specific to certain offer-in-compromise and trust fund recovery penalty disputes.

The IRS has included examples of situations that may not be appropriate for the FTMC program.

The full text can be read here: Rev. Proc. 2016-57

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Notice 2016-70 – IRS Extends Due Dates for 2016 Reporting of Health Care Information §6055 and §6056.

The IRS has extended the due date for reporting certain health information for insurers, self-insured employers, and certain other providers of minimum essential coverage under section 6055 of the Internal Revenue Code (Code) and for applicable large employers under section 6056 of the Code.

Specifically, due dates for Form 1095-B, Health Coverage and Form 1095-C, Employer-Provided Health Insurance Offer and Coverage, originally due to be issued to employees by January 31, 2017, will be due by March 2, 2017. There is no change in the due dates for submitting Forms 1094-B and 1095-B to the IRS. Both are due by February 28th (March 31st if filing electronically).

The full text can be read here: Notice 2016-70

Slide 15:

Need to change your client's IRS payment agreement? Do it online.

You can change your client's payment schedule (both for individuals and businesses) using the online process. Per the IRS:

> *This process allows a qualified taxpayer or authorized representative (Power of Attorney) the opportunity to avoid long telephone wait times or the need to visit or write to an IRS office to apply for an installment agreement. Once you complete the online process, you will receive immediate notification of whether your agreement has been approved.*
>
> To qualify: *You owe $50,000 or less in combined tax, penalties and interest, and filed all required returns. You may also qualify for a short term agreement if your balance is under $100,000.*

The can read more about the online process here: Online Payment Agreement