ONPOINT PUBLICATIONS – TALKING POINTS GUIDE

TOPIC:

TAX WEEK IN REVIEW – OCTOBER 28, 2016

Slide 1. Title Page – Tax Week in Review for Week Ending 10/28/2016

Opinions, Decisions and Rulings Released This Week

Slide 2. STANLEY v. COMMISSIONER, T.C. Memo 2016-196
Issue: Were proceeds correctly categorized as nontaxable loans and were Schedule C deductions proper?

- Taxpayer (T) reported income for his insurance business on Schedule C and is also an investor in real estate. In an effort to grow his insurance business T borrowed funds from clients and friends.

- Funds were used for T's insurance business, his real estate dealings, personal expenses and loan repayments as needed. Loans received were not associated to any one business or use.

Slide 3. In determining the existence of a bona fide loan, the Court considers various factors:

- the ability of the borrower to repay;
- the existence or nonexistence of a debt instrument;
- security, interest, a fixed repayment date, and a repayment schedule;
- how the parties' records and conduct reflect the transaction;
- whether the borrower had made repayments;
- whether the lender had demanded repayment;
- the likelihood that the loan was disguised compensation for services; and
- the testimony of the purported borrower and lender.

Comment: Court reference: Welsh v. Commissioner, 204 F 3rd. 1228, 1230 (9th Cir. 2000). The factors are "non-exclusive" and provide a "general basis upon which courts may analyze a transaction."

Slide 4. What did T offer as evidence?

- Promissory notes were in writing, including name of lender, date and amount
- Interest rates were stated, including payment arrangements and due dates
- Loan periods ranges from 6 months to 2 years
- Though not consistently paid, interest was paid on some notes and 1099's were issued
- All but one loan was unsecured
- Loans were paid or renewed

Comment: Interest amounts paid in 2010 and 2011 were deducted on T's Schedule C. T could not substantiate that funds were used specifically for the insurance business, real estate or personal expenses. Subject to the tracing rules, interest paid on funds used for personal expenses are not deductible.

Slide 5.

Decision: T was allowed to exclude from income the substantiated loans, leaving only deposits not supported by an underlying loan document to be included in income. Interest deductions of $39,075 were denied due to insufficient support as to the use of the loans.*

**Treasury Regulation 1.163-8T provides "tracing rules" that allocate debt and interest depending on the type of expenditure to which the proceeds are applied.*

Comment: Section 163 generally allows a deduction for any interest paid or accrued on indebtedness in the taxable year. Section 163(h)(1) provides an exception to this general rule of deductibility for "personal interest". Treasury Regulation 1.163-8T provides "tracing rules" that allocate debt and interest depending on the type of expenditure to which the proceeds are applied. The underlying property used to secure the loan is generally irrelevant; only the loan's use is significant.

The full text can be found here: T.C. Memo 2016-196

Slide 6. JACKSON v. COMMISSIONER, T.C. Summary Opinion 2016-69

Issue: Should Pastor's income include payments of "Love Gifts?"

- Taxpayer (T) is the Pastor and a director of the Triumph Church of God. His wife is also a church director.

- T asked that he not receive a salary for his services, but would accept love offerings, gifts and loans from the church.

  Comment: Section 102(a) does say that "Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance." But read on. Section 102(c)(1) - Subsection (a) shall not exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee.

- T and his wife managed the funds for the church and signed all checks. During 2012, T made payments to himself with "Love Offering" and "Love Gift" written in the memo section of the checks.

- The church bookkeeper issued a 2012 Form 1099-MISC for the amount of $4,815.

  Comment: The bookkeeper had been employed by the church for more than 20 years. Her daughter took over her responsibilities after the year was over. T requested the 1099 be corrected, but this was never acted upon.

- The court noted that T's consideration that the receipts were nontaxable gifts was "misguided."

  Comment: T explained that he was willing to accept offerings and gifts as substitutes for a salary.

- Decision: Gifts and "Love Offerings" were compensation for services.

  Comment: From the court opinion, quoting Duberstein:
  "In Commissioner v. Duberstein, 363 U.S. at 284-285, the Supreme Court stated that the problem of distinguishing gifts from taxable income "does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases." The Supreme Court concluded that, in cases such as this one, the transferor's intention is the most critical consideration, and there must be an objective inquiry into the transferor's intent. Id. at 285-286. In other words, rather than relying on a taxpayer's subjective

Slide 6. JACKSON v. COMMISSIONER (continued)

characterization of the transfers, a court must focus on the objective facts and circumstances. Id. at 286."

The full text can be found here: [T.C. Summary Opinion 2016-69]

Slide 7. ARASHIRO v. COMMISSIONER, T.C. Summary Opinion 2016-70

Issue: Is taxpayer liable for assessments under Sections 6653(a) and 6661(a) additions to tax for 1987 and 1988 and for Section 6662(a) penalties for 1989?

- In 1987, Taxpayer (T) attended a seminar presented by Walter J. Hoyt III that promoted cattle breeding partnerships and decided to invest in two partnerships - Shorthorn Genetic Engineering 1984-A J.V partnership (Shorthorn) and the Durham Shorthorn Breeding Syndicate 1987-D J.V. partnership (Durham).
- T filed tax returns for 1987, 1988 and 1989 that included losses from each partnership. T's tax returns were prepared by a firm associated with the Hoyt organization.

Slide No. 8.

- In April, 1988, the IRS notified T that the Durham partnership's tax shelter activities had been reviewed and any deductions or credits would be denied. The IRS also cautioned T that partners could be subject to negligence and understatement additions to tax as provided by the Internal Revenue Code.

  Commentary:

  a. *Per the footnotes of the court opinion: "Most of the Hoyt partnership returns were examined pursuant to TEFRA as part of an Internal Revenue Service (IRS) initiative to combat abusive tax shelters, and the Hoyt partnerships have been the subject of numerous Tax Court opinions."*

  b. *Late 1988, IRS issues a second letter to notify of Hoyt's partnership losses and credits will be disallowed and by December 1988, T is notified that losses he claimed for 1987 from the Durham partnership have been disallowed.*

  c. *Fast forward to 1994 – Hoyt organization petitions tax court to protest IRS final partnership administrative adjustments which adjusted 1987 to 1989 returns for Shorthorn.*

ARASHIRO v. COMMISSIONER (continued)

d. Fast forward to Year 1995 – After negotiating with the IRS, T's partnership losses have been limited to the amounts of cash actually invested during 1988 and 1989. The closing agreement provides that no penalty or addition to tax will be added as to deficiencies from the adjustments for the partnership losses. Neither T nor the Appeals Officer (AO) have signed the closing agreement.

e. Fast forward to October, 2011 – The FPAA's for Shorthorn are upheld.

- Fast forward to January, 2013 – AO has assessed adjustments to tax for 1987 to 1989 for the partnership loss and credit disallowances, as well as additions to tax and accuracy-related penalties.

  Comments: Additions to tax under Sections 6653(a) and 6661(a) applied to 1987 &1988 and accuracy-related penalty under Section 6662(a) for 1989.

- T contends he should not subject to additions to tax.
  - Relied in good faith that returns were prepared properly by Hoyt organization.
  - Relied on AO's representations that his tax liabilities would be settled without penalty.

Slide No. 9 IRS and Tax Court's response?

- T had been notified that the partnership had been reviewed and losses would be disallowed.
- Reliance on professional advice by itself is not an absolute defense to negligence.
- T's actions constituted a lack of due care, particularly in light of the fact he had been notified by the IRS prior to filing.
- Though T claimed to have submitted a signed closing agreement, none is on record and T's testimony was self-serving.

- Decision: T is subject to the additions to tax and the underpayment penalties as proscribed by Sections 6653(a), 6661(a) and 6662(a).

ARASHIRO v. COMMISSIONER (continued)

Comment: Explanation of Sections 6653(a), 6661(a) and 6662(a):

a. *Sections 6653(a)(1)(A) and 6653(a)(1) impose a 5% addition to tax on an underpayment of tax if any part of the underpayment is due to negligence or disregard of rules or regulations. For 1987 section 6653(a)(1)(B) imposes another addition to tax equal to 50% of the interest due on that portion of the underpayment attributable to negligence or disregard of rules or regulations.*
b. *Section 6661(a) imposes a 25% addition to tax on any underpayment attributable to a substantial understatement of income tax.*
c. *Section 6662(a) and (b)(1) imposes a 20% accuracy-related penalty on the portion of any underpayment of tax attributable to negligence or disregard of rules or regulations.*
d. *For Sections 6661 and 6662, an understatement of income tax is "substantial" if it exceeds the greater of $5,000 or 10% of the tax required to be shown on the return.*

The full text can be found here: T.C. Summary Opinion 2016-70

In the News This Week

Slide 10. IR 2016-139: IRS Announces Tax Year 2017 Tax Benefit Increases for Inflation Adjustments

Rev. Proc. 2016-55 outlines the changes for tax year 2017. The highlights of the changes for the year are summarized below.

Tax Item	2016	2017
Standard Deduction - MFJ	$12,600	$12,700
Standard Deduction – Single\MFS	$6,300	$6,350
Standard Deduction - HOH	$9,300	$9,350
Personal Exemption	$4,050	$4,050
Effective Tax Rate of 39.6% begins for Singles on income over	$415,050	$418,400
Effective Tax Rate of 39.6% begins for MFJ on income over	$466,950	$470,700
Estate Tax – Basic Exclusion	$5,450,000	$5,490,000

See Rev. Proc. 2016-55 for full details: Rev. Proc. 2016-55

Slides 11-12. IR 2016 – 141: IRS Announces 2017 Pension Plan Limitations; 401(k) Contribution Limit Remains Unchanged at $18,000 for 2017

IR 2016-141 outlines the changes for tax year 2017. The highlights of the changes for the year are summarized below.

Description	2016	2017
Contribution limits to 401(k), 403(b), most 457 plans	$18,000	Same
Catch-up contribution limit for employees aged 50 and over who participate in 401(k), 403(b), most 457 plans	$6,000	Same
Traditional IRA Contribution Limit	$5,500	Same
IRS Catch-up contribution limit for individuals aged 50 and over	$1,000	Same
Traditional IRA Deduction Phase-outs		
Single with Employer coverage	$61,000-$71,000	$62,000-$72,000
MFJ, Contributor has ER coverage	$98,000-$118,000	$99,000-$119,000
MFJ, Non-Contrib. Covered Spouse	$184,000-$194,000	$186,000-$196,000
MFS, Contributor has ER coverage	$0-$10,000	Same
ROTH IRA Contribution Phase-outs		
Single and Head of Household	$117,000-$132,000	$118,000-$133,000
Married Filing Joint	$184,000-$194,000	$186,000-$196,000
Married Filing Separately	$0-$10,000	Same

See IR 2016-141 and Notice 2016-62 for full details.

Slide 13. IR 2016 – 142: 2017 PTIN Renewal Period Underway for Tax Professionals

IRS reminds the estimated 725,000 tax preparers that it is now time to renew your PTIN's. All current PTINs will expire December 31, 2016. The renewal fee is $50 and only takes a few minutes to renew.

Slide 14. IR 2016 – 143: Reminder: Employers Face New Jan. 31 W-2 Filing Deadline; Some Refunds Delayed Until Feb. 15

January 31st Deadline: The Protecting Americans from Tax Hikes (PATH) Act, enacted last December, includes a new requirement for employers. They are now required to file their copies of Form W-2, submitted to the Social Security Administration, by Jan. 31. The new Jan. 31 filing deadline also applies to certain Forms 1099-MISC reporting non-employee compensation such as payments to independent contractors.

Refunds Delayed until February 15th: Due to the PATH Act change, some people will get their refunds a little later. The new law requires the IRS to hold the refund for any tax return claiming either the Earned Income Tax Credit (EITC) or Additional Child Tax Credit (ACTC) until Feb. 15. By law, the IRS must hold the entire refund, not just the portion related to the EITC or ACTC.