

# 2013 TAX YEAR-IN-REVIEW

January 3, 2014

Special Report

## HIGHLIGHTS

- Tax Reform/Extenders Await 2014
- Sweeping Repair/Capitalization Regulations
- Revised Rules On Net Investment Income Tax
- Affordable Care Act Implementation
- Supreme Court/IRS On Same-Sex Marriage
- Rules For Corporate/Partnership Transactions
- IRS Focus On Foreign Tax Compliance

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## 2013 Tax Developments Break New Ground; Build On Past

2013 was an eventful year for federal tax developments, notable from its onset by passage of the American Taxpayer Relief Act of 2012 (ATRA), which permanently extended the Bush-era tax cuts for all but higher-income taxpayers as well as numerous other important, but previously temporary, provisions. The year also saw an ample release of important guidance relating to the Affordable Care Act, the new Net Investment Income tax and Additional Medicare Tax, capitalization and repairs, the tax treatment of married same-sex couples and much more. In international taxation, the IRS won several important victories in the federal courts relating to international financial transactions used as tax shelters. The IRS also stepped up investigations of U.S. persons who may be hiding funds in undisclosed offshore accounts and continued to implement the Foreign Account Tax Compliance Act (FATCA) by releasing rules and regulations, draft forms and signing intergovernmental agreements. *With all these factors in mind, this Tax Briefing reviews the key federal tax developments from 2013.*

**IMPACT.** *2013 was bracketed by tax legislation: the year started with the successful passage of ATRA and ended with no movement on the tax extenders. There remains uncertainty over the fate of the many popular extenders, such as enhanced Code Sec. 179 expensing and bonus depreciation, not permanently extended by ATRA. The extenders may be affected by continued discussion of comprehensive tax reform. However, the momentum toward tax reform has been slowed by other issues in Congress. It is also far from clear if the White House and the GOP can reach an agreement*

*that covers both individual and business tax reform. The two sides remain divided over the question of whether tax reform should be revenue neutral or include revenue-raising measures.*

**COMMENT.** *For 16 days in October, the IRS ceased nearly all day-to-day operations, including most enforcement, collection, return and refund processing, and most computer system programming. Some online functions remained available. As a result, taxpayers and practitioners enter 2014 to find a delayed start to the filing season and, consequently, delayed refunds. However, the threat of a shutdown during the 2014 filing season has been averted with passage of the Bipartisan Budget Act of 2013, which effectively provides funding for the IRS for two years.*

## TAX LEGISLATION AND REFORM

In January 2013, President Obama signed ATRA into law, which resolved the tax side of the so-called fiscal cliff. ATRA made permanent some temporary tax incentives but only extended others through 2013. At year-end, those provisions had not been extended again.

**ATRA.** Under ATRA, the Bush-era tax cuts were made permanent for lower and moderate income taxpayers. ATRA also permanently patched the alternative minimum tax (AMT) to prevent its encroachment on middle income taxpayers, provided a maximum estate tax rate of 40 percent with a \$5 million exclusion (indexed for inflation), and made several other changes.

**IMPACT.** *Effective for 2013, higher income individuals are subject to increased taxes. Income above \$400,000 (indexed for inflation) and \$450,000 for married couples filing a joint return (also indexed for inflation) is taxed at a 39.6 percent rate. Additionally, ATRA raised the top rate for capital gains and dividends to 20 percent where a taxpayer's income exceeds the thresholds set for the 39.6 percent tax bracket. ATRA also revived the "Pease" itemized-deduction limitation and the personal exemption phaseout (PEP) for higher income taxpayers.*

**Extenders.** While ATRA extended many of the extenders, it did so only through 2013. These included the state and local sales tax deduction, higher education tuition deduction, teachers' classroom expense deduction, research tax credit, transit benefits parity, a mortgage debt forgiveness exclusion, and more. Consequently, 2014 has started with the extenders—at last count, up to 55 of them—having expired.

**IMPACT.** *The days of Congress routinely extending the extenders may be over. An eleventh-hour push by Democrats in the Senate in December to extend the extenders by unanimous consent failed. The GOP-controlled House did not even take up the extenders in 2013.*

**President Obama's proposals.** President Obama unveiled early in 2013 a proposed \$3.77 trillion fiscal year (FY) 2014 budget, his fifth since taking office, which included new revenue raisers, impacting taxpayers of all types. They included limiting contributions and accruals on tax-favored retirement benefits; reducing the value to 28 percent of certain deductions and exclusions that would otherwise reduce taxable income in the 33, 35 or 39.6 percent tax brackets; creating 20 "Promise Zones" (14 urban and six rural) to offer tax incentives for job creation; repealing the last-in, first-out (LIFO) method of accounting; and eliminating many fossil fuel tax incentives.

President Obama also renewed his call for business tax simplification in exchange for

using the "one-time revenues" to encourage job creation. The President's plan would eliminate unspecified tax preferences to achieve a 28 percent corporate tax rate (25 percent for manufacturers), allow businesses to expense up to \$1 million in investments, impose a minimum tax on foreign earnings, and provide new incentives for clean energy.

**SFC tax reform proposals.** Sen. Max Baucus, D-Mont., chair of the Senate Finance Committee (SFC), unveiled a series of tax reform proposals (including legislative language) in 2013. The proposals reflect hearings the SFC held over the past three years on tax reform. Baucus proposed a simplified depreciation system, international tax reforms, and improvements in tax administration.

"Taxpayers and practitioners enter 2014 to find a delayed filing season and ... delayed refunds."

**COMMENT.** *Baucus emphasized that the proposals should be considered as a package and not as stand-alone proposals. However, it is unclear if the Senate leadership agrees. Baucus has won some support for tax reform from his House counterpart, Ways and Means Chair Dave Camp, R-Mich., whose committee also explored tax reform in 2013.*

**COMMENT.** *President Obama has nominated Baucus to serve as U.S. ambassador to China. It is unclear if Baucus' successor as SFC chair will share his enthusiasm for tax reform.*

## NEW MEDICARE TAXES

Effective January 1, 2013, the Affordable Care Act imposed two new Medicare taxes on qualified taxpayers: a 3.8 percent net investment income (NII) tax and a 0.9 percent Additional Medicare Tax. Throughout

much of 2013 ...and despite proposed reliance regulations issued in 2012, many taxpayers and their advisors continued to have questions regarding the application of these new taxes. Finally, on November 26, 2013—a full 330 days into the first year in which the two new taxes applied, the IRS released much-anticipated final regulations.

**IMPACT.** *The final NII tax regulations are intended to clarify many issues, largely in favor of taxpayers, but also defer complete resolution of other questions to guidance promised in 2014. They arrived late enough in the year to foreclose consistent or aggressive strategies for the 2013 tax year.*

**Net Investment Income Tax.** The NII tax on taxpayers (individuals and trusts and estates) equals 3.8 percent of the lesser of: (1) net investment income for the tax year, or (2) the excess, if any of: (a) an individual's modified adjusted gross income (MAGI) for the tax year, over (b) the threshold amount.

**COMMENT.** *The threshold amount is \$250,000 in the case of a taxpayer making a joint return or a surviving spouse, \$125,000 in the case of a married taxpayer filing a separate return, and \$200,000 in any other case (these amounts are not indexed for inflation). The threshold amount for trusts and estates is the start of their 39.6 percent tax bracket, which, for 2013 was \$11,950 (\$12,150 for 2014).*

**Final regulations.** The November 2013 final regulations retained most provisions from the 2012 proposed reliance regulations, but nevertheless changed several key portions to accommodate what it conceded was legitimate criticism (TD 9644). The final regulations addressed dozens of requests for changes to the 2012 proposed regulations. Some recommendations were adopted, some were tweaked, and some were rejected by the IRS.

Some of the more significant pro-taxpayer changes in the final regulations include:

- Allowing Code Sec. 465 net disposition losses to offset other categories of investment income and treating as properly allocable deductions net operating losses allocable to investment income;
- Concluding generally that income treated as nonpassive under the Code Sec. 469 passive activity limitations also may qualify as nonpassive under Code Sec. 1411;
- Classifying income from self-rented property more favorably;
- Providing safe harbors under which some real estate professionals will avoid the NII tax;
- Acknowledging that renting out even a single item of property may qualify as a trade or business, depending on facts and circumstances; and
- Providing regrouping opportunities on passive activities that apply to Code Sec. 469 in addition to Code Sec. 1411.

**New proposed regulations.** In response to taxpayer feedback, the IRS issued new proposed reliance regulations at the same time as the final regulations. The proposed reliance regulations are intended to provide, among other things, simplified methods to compute NII vulnerable gain or loss on the sale of pass through entities (NPRM REG-130843-13). The proposed reliance regulations address areas that either were not covered in the 2012 proposed regulations, or that the IRS subsequently revised.

**Additional Medicare Tax.** Final regulations on the Additional Medicare Tax were also released by the IRS in November (TD 9645). The Additional Medicare Tax applies to employee compensation/self-employment income in any tax year beginning after December 31, 2012. The final regulations generally track proposed regulations issued in 2012, with some clarifications.

The IRS acknowledged that the Additional Medicare Tax requires new record-keeping and withholding procedures for employers. However, the agency declined to give employers additional time to correct errors, allow corrections for a certain period without penalty, or exempt de minimis errors from penalties. The IRS also

described correction of overpayments and underpayments by employers in the final regulations.

**IMPACT.** *Employers should be aware of the requirement that they withhold additional income tax from employees whose wages exceed the threshold for the tax (generally, \$200,000). Employers that did not properly withhold for 2013 compensation may expect to be assessed penalties since corrections under the regulations are generally only allowed if made within the same tax year.*

“The final NII tax regulations are intended to clarify many issues, largely in favor of taxpayers, but also defer complete resolution of other questions to guidance promised in 2014.”

## AFFORDABLE CARE ACT

When Congress passed the Affordable Care Act in 2010 it delayed the effective dates of many key provisions. Effective January 1, 2014, the individual mandate took effect; however, the Obama administration mitigated the requirements for some individuals as the deadline approached. And the Obama administration delayed the effective date of the employer mandate entirely.

**Employer mandate.** The IRS issued proposed regulations on the employer mandate in January (NPRM REG-138006-12). The proposed regulations describe an applicable large employer (ALE) for purposes of Code Sec. 4980H, the number of hours of service in a calendar month treated as full-time, how the requirement would apply to a new employer that is an applicable large employer, and more.

**IMPACT.** *Under the Affordable Care Act, an ALE with respect to a calendar year is an employer that employed an average of at least 50 full-time equivalent employees on business days during the preceding calendar year. The proposed regulations would treat 130 hours of service in a calendar month as the monthly equivalent of 30 hours of service per week.*

**Delay.** In July, the Obama administration announced that the employer mandate would not apply until 2015. The administration explained that it took this action to give employers additional time to implement reporting requirements under Code Sec. 6056. The IRS subsequently issued transition relief providing that information reporting under Code Sec. 6056 (and Code Sec. 6055 for insurers) is optional for 2014.

**Individual mandate.** The IRS issued proposed regulations on the individual shared responsibility payment requirement (individual mandate) in January (NPRM REG-148500-12). Under the proposed regulations, minimum essential coverage for purposes of the individual mandate includes (not an exhaustive list) qualified employer-sponsored coverage, Medicare, Medicaid, and coverage for veterans and children. Certain individuals are exempt from the requirement to carry minimum essential coverage, such as individuals who experience a short gap in coverage, individuals who are unlawfully present in the U.S., and individuals who are incarcerated. The Obama Administration also grandfathered for 2014 certain additional plans that were being cancelled.

**COMMENT.** *Unlike the employer mandate, the individual mandate in general is not delayed and took effect January 1, 2014. However, individuals will not report any liability for failing to carry minimum essential coverage until they file their 2014 returns in 2015.*

**Code Sec. 36B credit.** Individuals who obtain health insurance coverage through an Affordable Care Act Marketplace after 2013 may be eligible for the Code Sec. 36B

credit to offset the cost of coverage. In January, the IRS released final regulations on the Code Sec. 36B premium assistance tax credit (TD 9611). In May, the IRS issued proposed regulations to clarify the meaning of “minimum value” (MV) for purposes of claiming the Code Sec. 36B credit (NPRM REG-125398-12).

The IRS also issued proposed reliance regulations on reporting the Code Sec. 36B credit (NPRM REG-140789-12). Marketplaces will report the level of coverage, advance payments of the credit and more to the IRS.

**COMMENT.** *Marketplaces will provide qualified taxpayers with a written statement that includes this same information on or before January 31 of the year following the calendar year of coverage.*

**COMMENT.** *The Code Sec. 36B credit has been challenged in litigation. In October, a federal district court declined to dismiss a suit claiming that Congress intended for the Code Sec. 36B credit to be available only when individuals purchase health insurance through a state-established Marketplace (Halbig v. Sebelius, D-D.C., No. 13-00623).*

**Health insurance fees.** In November, the IRS issued final regulations on the application of annual fees to health insurance

providers under the Affordable Care Act. The annual fee on covered entities is effective after 2013. The IRS intends to notify each covered entity of the preliminary fee calculation by June 15 of each fee year and the final fee calculation on or before August 31. The fee must be paid by September 30 of each fee year (TD 9643).

**Branded prescription drug fee.** The IRS issued guidance on the branded prescription drug fee for the 2014 fee year in August (Notice 2013-51). The IRS explained it will mail each covered entity a paper notice of its preliminary fee calculation for the 2014 fee year by March 3, 2014. The IRS will notify each covered entity of its final fee calculation for 2014 by August 29, 2014.

**90-day waiting period.** The IRS and the U.S. Departments of Health and Human Services (HHS) and Labor (DOL) issued proposed reliance regulations in March to describe the 90-day limitation for group health insurance under the Affordable Care Act (NPRM REG-122706-12). Insured and self-insured group health plans are generally precluded from imposing a waiting period that exceeds 90-days before coverage can begin for eligible group members.

**Compensation.** The IRS issued proposed reliance regulations on the \$500,000 deduction limitation on compensation provided

by health insurance providers under the Affordable Care Act in April (NPRM REG-106796-12). The deduction limit applies to a covered health insurance provider in a tax year beginning after December 31, 2012.

**Charitable hospitals.** In April, the IRS released proposed reliance regulations on the Code Sec. 501(r)(3) requirement that charitable hospitals perform a community health needs assessment (CHNA) every three years or risk losing their tax-exempt status (NPRM REG-106499-12). The IRS issued temporary and proposed regulations in August for charitable hospital organizations on how to report excise taxes and file any excise tax return for failing to meet the CHNA requirements (TD 9629, NPRM REG-115300-13).

**Indoor tanning tax.** In June, the IRS issued final regulations on the Affordable Care Act’s indoor tanning tax when services are bundled (TD 9621). This excise tax generally took effect in 2010.

**PCORI.** The Affordable Care Act established the Patient-Centered Outcomes Research Institute (PCORI), which is funded by the Patient-Centered Outcomes Research Trust Fund. The trust fund is funded—in part—by fees paid by issuers of certain health insurance policies and sponsors of certain self-insured health plans. In July, the IRS posted frequently asked questions (FAQs) on its website about the PCORI fees that apply to specified health insurance policies with policy years ending after September 30, 2012, and before October 1, 2019.

**COMMENT.** *IRS Chief Counsel determined in 2013 that the Patient-Centered Outcomes Research Trust Fund fee is deductible under Code Sec. 162(a) (AM 2013-002).*

**Preventative services.** In July, the IRS issued final regulations on the coverage of certain preventative services under the Affordable Care Act (TD 9624). The final regulations generally provide that the requirement to offer coverage for certain preventative services without cost sharing is subject to

## TOP 10 TAX DEVELOPMENTS FOR 2013

The start of a New Year presents a time to reflect on the past 12 months and, based on that history, predict what may happen next. Here is a list of the top 10 developments from 2013 that may prove particularly important as we move forward into the New Year.

- American Taxpayer Relief Act (ATRA)
- Unaddressed Tax Extenders
- Repair and Capitalization Regulations
- NII/Additional Medicare Tax Final Regs
- Supreme Court Decision/IRS Guidance on Same-Sex Marriage
- Affordable Care Act Implementation
- Foreign Compliance Measures
- Code Sec. 501(c)(4) Organizations
- IRS Return Preparer Oversight
- Comprehensive Tax Reform Proposals

the religious employer exemption and eligible organization accommodations.

## HEALTH BENEFITS

In the area of health benefits, the IRS announced a number of important developments affecting employee benefits, individual benefits and more. Some of the projects reflected changes made by the Affordable Care Act but others were independent developments.

**Health FSA “use-or-lose” rule.** In November, the IRS announced relief from the “use-or-lose” rule for health flexible spending arrangements (health FSAs) by allowing a new up-to-\$500 carryover option for year-end balances (Notice 2013-71, TDNR JL-2202). Effective for plan years starting in 2013, employers may amend their cafeteria plan documents to provide for this new option. Any unused amount above \$500 will be forfeited.

**IMPACT.** *The move is intended to mitigate the harsh impact of the “use-or-lose” rule and to encourage greater participation in health FSAs.*

**COMMENT.** *Generally, an employer that offers FSAs can allow each year’s remaining account balance to be used for expenses incurred up until 2 ½ months into the next year (March 15 for calendar year plans). Account balances that remain unused at the end of the plan year (or beyond the 2 ½ month grace period, if applicable) are automatically forfeited.*

**COMMENT.** *Starting in 2013, the Affordable Care Act limited each employee’s salary reduction contributions to a health FSA to no more than \$2,500 each year (adjusted for inflation for plan years beginning after 2013).*

**COMMENT.** *The up-to-\$500 carryover amount will not count toward the following year’s \$2,500 inflation-adjusted salary-reduction limit.*

**IMPACT.** *Incorporation of the carryover is optional; however, employers cannot*

*offer both the grace period and the carryover at the same time.*

**Health savings accounts (HSAs).** Adjusted for inflation, the annual limitation on deductible contributions under Code Sec. 223(b)(2)(A) for an individual with self-only coverage under a high-deductible health plan (HDHP) is \$3,300 or \$6,550 for an individual with family coverage for 2014, up from \$3,250 and \$6,450, respectively, for calendar year 2013 (Rev. Proc. 2013-25).

**COMMENT.** *For calendar year 2014, an HDHP is defined as a health plan with an annual deductible that is not less than \$1,250 for self-only coverage and \$2,500 for family coverage, the same as in 2013.*

**Wellness programs.** The IRS, DOL and HHS issued final regulations in June to clarify the design of wellness programs for group health plans (both insured and self-insured) and group health insurance issuers, for plan years beginning on or after January 1, 2014 (TD 9620). The regulations describe the standards for participatory wellness programs and health contingent wellness programs.

**IMPACT.** *Wellness programs are growing in popularity. The final regulations explain that wellness programs generally must satisfy certain criteria, including the requirement that the program must be available to all similarly-situated individuals. A reasonable alternative standard (or waiver) must be available to any individual for whom it is unreasonably difficult, due to a medical condition, to satisfy the standard.*

**Mental health benefits.** The IRS, DOL and HHS issued final regulations requiring group and individual health insurance plans to provide parity in their mental health and substance use disorder (MH/SUD) benefits, with medical/surgical (M/S) benefits offered by the same plans (TD 9640, TDNR JL-2213). The final regulations implement the Mental Health Parity and Addiction Equity Act of 2008, as amended by the Affordable Care Act.

**COMMENT.** *The final regulations are intended to ensure that health plan features like copays and deductibles are not more restrictive for mental health benefits than for medical benefits.*

## INDIVIDUALS: SAME-SEX MARRIAGE

On June 26, 2013, the U.S. Supreme Court struck down Section 3 of the Defense of Marriage Act (DOMA) in a 5 to 4 decision (*E.S. Windsor, S.Ct., 2013-2 USTC ¶50,400*). The *Windsor* decision set in motion a wave of new guidance from the IRS and other federal agencies impacting married same-sex couples.

**Windsor decision.** In *Windsor*, the Supreme Court held that Section 3 of DOMA is unconstitutional as deprivation of the equal protection of persons that is protected by the Fifth Amendment. Writing for the majority, Justice Kennedy said that DOMA created two contradictory marriage regimes: married same-sex couples lived as married for purposes of state law (in states that recognized same-sex marriage) but as unmarried for purposes of federal law.

**IMPACT.** *Immediately after the decision was announced, President Obama directed all federal agencies to quickly revise their rules and regulations to reflect *Windsor*. The question arose if the IRS would take a place of celebration approach or a place of domicile approach to same-sex marriage. The IRS ultimately took a place of celebration approach (discussed below).*

**IRS guidance.** The IRS issued the first batch of guidance in August (Rev. Rul. 2013-17 and FAQs). The IRS explained that it would treat all legally married same-sex couples as married for all federal tax purposes, including income and gift and estate taxes, regardless of whether a couple resides in a jurisdiction that recognizes same-sex marriage or in a jurisdiction that does not recognize same-sex marriage. The IRS also announced that that for tax year 2013 and going forward, same-sex spouses generally must file using a married filing separately or jointly filing

status. Additionally, the IRS provided that individuals who were in a same-sex marriage may, but are not required to, file original or amended returns—for federal tax purposes for one or more prior tax years still open under the statute of limitations—choosing to be treated as married.

**IMPACT.** *As long as a couple is married in a jurisdiction that recognizes same-sex marriage, the IRS will recognize their marriage even if the couple later relocates to a jurisdiction that does not recognize same-sex marriage.*

**IMPACT.** *The IRS reiterated in its guidance on same-sex marriage that it does not treat registered domestic partners, individuals in a civil union, or similar relationships as married for federal tax purposes because these individuals are not married under the laws of any jurisdiction.*

**Employers.** Because of Section 3 of DOMA, employers that allowed an employee to add his or her same-sex spouse to their health plan needed to impute income to the employee for federal income tax purposes equal to the fair market value of health coverage provided to the same-sex spouse. However, this did not apply if the same-sex spouse qualified as a dependent. The IRS issued Notice 2013-61, describing two administrative procedures for employers to correct overpayment of employment taxes.

**COMMENT.** *In updated FAQs posted on its website in December, the IRS explained an employee should seek a refund of Social Security and Medicare taxes from his or her employer first. However, if the employer indicates an intention not to file a claim or adjust the overpaid Social Security and Medicare taxes, the employee may claim a refund of any overpayment of employee Social Security and Medicare taxes.*

**COMMENT.** *Section 2 of DOMA (which provides that states do not have to recognize same-sex marriages performed in other states) was not before the Supreme Court. At the time this Briefing was*

*prepared, 18 states and the District of Columbia recognize same-sex marriage.*

## INDIVIDUALS: INCOME/EXPENSES

During 2013, developments affecting the taxation of individual income taxation fell across a broad range of sectors. In addition to the 3.8 percent Net Investment Income tax and the 0.9 Additional Medicare Tax (discussed, above, in this Briefing), 2013 developments touched upon such diverse areas as marriage and divorce, gambling losses, charitable contributions, investment transactions, and more.

“The Windsor decision set in motion a wave of new guidance from the IRS and other federal agencies impacting married same-sex couples.”

**Equitable innocent spouse relief.** The IRS issued proposed regulations in August that would remove a two-year deadline for requesting Code Sec. 6015(f) equitable innocent spouse relief (NPRM REG-132251-11). The IRS also updated its equitable innocent spouse relief procedures in September (Rev. Proc. 2013-34). At the same time, the IRS described procedures for streamlined equitable innocent spouse relief determinations.

**IMPACT.** *In regulations issued in 2002, the IRS set a two-year deadline for requesting relief under Code Sec. 6015(f). The proposed regulations replace the two-year requirement with a requirement that a request for equitable innocent spouse relief must be filed with the IRS within the period of limitation in Code Sec. 6502 for collection of tax or the period of limitation in Code Sec.*

*6511 for a credit or refund of tax, as applicable to the specific request.*

**COMMENT.** *IRS Chief Counsel announced acquiescence in the Ninth Circuit ruling, *Wilson*, 2013-1 USTC ¶50,147 (AOD-2012-07). The IRS will no longer argue that the Tax Court should review Code Sec. 6015(f) equitable innocent spouse claims only for an abuse of discretion or that the court should limit its review to the administrative record.*

**IMPACT.** *The revised procedures reflect the elimination of the two-year deadline to request equitable innocent spouse relief. The revised procedures also give greater deference to the presence of abuse in a relationship.*

**Broker reporting.** The IRS issued final, temporary and proposed regulations on the requirement that brokers report the basis of debt instruments and options that they sell on behalf of customers (TD 9616, NPRM REG-154563-12). The IRS provided phased-in effective dates and other measures intended to relieve the burden on brokers.

**IMPACT.** *The IRS provided a January 1, 2014 start date for less complex debt instruments, options and securities future contracts. For certain complex instruments with a fixed yield and maturity date, and for more complex debt without a fixed yield and maturity date, the IRS does not require basis reporting until January 1, 2016. The final regulations generally except short-term debt from basis reporting.*

**COMMENT.** *The IRS decided to give affected entities more time to develop compliance systems, rather than provide penalty relief. The IRS previously provided penalty relief for the reporting of stock basis, which took effect in 2011.*

**Gambling losses.** In July, the Court of Appeals for the District of Columbia Circuit reversed the Tax Court and applied the IRS’s per-session rule for U.S. citizens to a nonresident alien’s gambling losses (*Park*,

*CA-D.C., 2013-2 USTC ¶50,423*). The DC Circuit found that the nonresident alien could subtract gambling losses from his wins within a gambling session to arrive at per-session wins or losses.

**Conservation easements.** In 2013, the Tax Court denied several deductions claimed for the donation of real property associated with charitable conservation easements. In *Belk, CCH Dec. 59,401, 140 TC No. 1*, the taxpayer had contributed land to a Code Sec. 501(c)(3) organization. The conservation easement agreement permitted the parties to substitute what property would be subject to the conservation easement. The Tax Court found that the conservation easement must relate to specific property or it cannot be a qualified conservation easement. The use restriction was not granted in perpetuity, the court found.

In July, the Tax Court declined to reconsider its 2012 ruling in *Carpenter, CCH Dec. 58,902(M)*, where it found that language providing for extinguishment of an easement by mutual consent does not guarantee that the conservation purpose of the donated property will continue to be protected in perpetuity (*Carpenter II, CCH Dec. 59,591(M)*).

**Casualty/theft loss.** The Tax Court found in March that a married couple was entitled to a theft loss deduction resulting from home repair fraud (*Urtis, CCH Dec. 59,470(M)*). The contractor had used a significant amount of the taxpayer's progress payments for unrelated expenses. According to the court, the taxpayers were victims of a theft under Code Sec. 165 stemming from the violation of their state home repair law.

**COMMENT.** *The Tax Court emphasized that a conviction was not necessary for the theft to qualify for purposes of Code Sec. 165.*

IRS Chief Counsel approved a casualty loss deduction under Code Sec. 165(c) for two homes that were destroyed by fire, even though the homes had been constructed

without the proper building permits (CCA 201346009). Chief Counsel concluded that there were not sufficient grounds for denying a casualty loss deduction based on public policy considerations.

**Mortgage insurance premiums.** The IRS issued final rules in November on the Code Sec. 6050H information reporting requirements for those who receive an aggregate amount of \$600 or more in mortgage insurance premiums during any calendar year (TD 9642). Effective for mortgage insurance premiums received on or after January 1, 2013 (but not before), these premiums must be reported on Form 1098, Mortgage Insurance Statement.

## INDIVIDUALS: RETIREMENT BENEFITS

In 2013, IRS developments focused on facilitating the transfer of assets between certain qualified plans and plan sponsor compliance. In addition, the IRS updated several key contribution amounts and income limits for 2014 to account for annual inflation figures.

**2014 COLA limits.** The IRS announced the 2014 cost-of-living adjustments (COLAs) for qualified plans in October (IR-2013-86). Many retirement plan contribution and benefit limits increase slightly in 2014.

**COMMENT.** *The limitation for defined contribution (DC) plans increases from \$51,000 for 2013 to \$52,000 for 2014. The annual benefit limit under a Code Sec. 415(b)(1)(A) defined benefit plan (the maximum amount a plan may pay a participant each year) increases from \$205,000 for 2013 to \$210,000 for 2014. The limits on elective deferrals for employees who participate in 401(k), 403(b), certain 457 plans, and the federal government's Thrift Savings Plan, remain \$17,500 for 2014, unchanged from 2013.*

**In-plan Roth rollovers.** The IRS issued guidance in December in question-and-answer format on in-plan Roth rollovers (Notice 2013-74) to reflect the expansion of the in-plan rollover provisions under ATRA.

Generally, a Code Sec. 401(k) plan, 403(b), or governmental 457(b) plan can permit a rollover of an amount that is ineligible for distribution at the time of the rollover.

**IMPACT.** *The following contributions (and earnings thereon) may be rolled over to a designated Roth account in the same plan, without regard to whether the amounts satisfy the conditions for distribution: elective deferrals in Code Sec. 401(k) and 403(b) plans; matching contributions and nonelective contributions, including qualified matching contributions and qualified*

## 2013 AND 2014 DOLLAR LIMITS

IRAs	2013	2014
IRA Contribution Limit	\$5,500	\$5,500
IRA Catch-Up Contributions	1,000	1,000
<b>Traditional IRA AGI Deduction Phase-out Starting at</b>		
Joint Return	95,000	96,000
Single or Head of Household	59,000	60,000
<b>401(k), 403(b), Profit-Sharing Plans, etc.</b>		
Annual Compensation - 401(a)(17)/404(l)	255,000	260,000
Elective Deferrals - 402(g)(1)	17,500	17,500
Defined Contribution Limits - 415(c)(1)(A)	51,000	52,000
Social Security Taxable Wage Base	113,700	117,000

*nonelective contributions described in Reg. §1.401(k)-6; and annual deferrals made to governmental 457(b) plans.*

**COMMENT.** *The IRS also clarified the extended deadline for a calendar year plan sponsor wanting to allow in-plan Roth rollovers for the 2013 tax year. The sponsor has until December 31, 2014 to amend the plan.*

**Safe harbor for struggling 401(k) plan sponsors.** The IRS issued final regulations allowing employers facing economic difficulties to reduce or suspend nonelective contributions to safe harbor Code Sec. 401(k) plans in November (TD 9641). The employer generally must be operating at an economic loss as described in Code Sec. 412(c)(2)(A) to qualify, the IRS explained.

“The IRS issued much-anticipated final regulations ( the so-called ‘repair’ regs) on the treatment of costs to acquire, produce or improve tangible property.”

**Reporting hard-to-value assets.** The IRS announced that for 2014 the new information reporting requirements imposed on financial institutions with respect to certain hard-to-value assets invested in an IRA are optional (2013ARD 222-5). In other words, for 2014 financial institutions may or may not report on the value of IRA assets that have no readily available fair market value, such as investments in non-publicly traded stock, ownership interests in a partnership, trust, or LLC, real estate, or option contracts.

**IMPACT.** *In December the IRS released instructions for 2014 Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., and 2014 Form 5498, IRA Contribution Information. The instructions indicate*

*that financial institutions must indicate when IRA assets have no readily available fair market value by using Code K on Form 1099-R. In addition, on the as-of-yet unreleased 2014 Form 5498, financial institutions must report the fair market value of the IRA asset in the new box 15a and indicate the type of asset in box 15b by using the appropriate category code. However, these reporting requirements are optional for 2014, to provide financial institutions reasonable time to fully implement them, the IRS announced.*

## BUSINESS DEDUCTIONS/CREDITS

The treatment of business expenditures obviously has a major impact on the determination of the business’s profits and losses. While companies seek to make a profit (especially on their financial accounting statements), they also want the tax treatment of their expenditures to reduce their taxable profits. In 2013, the IRS continued to issue important guidance on a business’ deduction of “repair” expenditures for tangible personal property.

**Final “repair” regulations.** The IRS issued much-anticipated final regulations ( the so-called “repair” regs) on the treatment of costs to acquire, produce or improve tangible property in September (TD 9636). The guidance is intended to instruct taxpayers how to determine whether to capitalize the costs under Code Sec. 263 or deduct them under Code Sec. 162. The IRS also issued new proposed regulations on dispositions of property under Code Sec. 168 (NPRM REG-110732-13).

**IMPACT.** *The final regulations retain many aspects of the temporary regulations issued in December 2011 but make some helpful and taxpayer-friendly changes. Significant changes affect:*

- materials and supplies,
- the de minimis safe harbor,
- improvements,
- routine maintenance,

- new safe harbors for small taxpayers, and
- a capitalization election.

The final regulations raised the threshold for deductible materials and supplies from \$100 to \$200; eliminated a controversial ceiling on the use of the de minimis deduction; eased the rules for writing off building systems that are replaced; and prescribed a 10-year period over which companies must perform recurring maintenance, to deduct these expenses.

**IMPACT.** *The final regulations affect any industry that uses tangible property, real or personal. The final regulations are generally effective January 1, 2014, but taxpayers may elect to apply the regulations to 2012 or 2013.*

**IMPACT.** *The new proposed regulations make significant changes to the rules for determining the asset disposed of, the use of a general asset account, and partial dispositions of assets.*

**COMMENT.** *The final regulations aim to reduce controversy by allowing companies to follow their book or financial policies. The regulations provide additional clarity and flexibility to all taxpayers, and helpful, simplified rules for smaller taxpayers.*

**LB&I directive.** The IRS Large Business & International Division (LB&I) updated its 2012 directive that generally instructed employees to discontinue audits of costs to maintain, replace or improve tangible property for the 2012 and 2013 tax years (LB&I-04-0313-001). LB&I instructed examiners and managers to cease audits and not begin any new audits for tax years beginning before January 1, 2012.

**Travel and entertainment expenses.** During 2013, the IRS issued the usual annual adjustments to various amounts relating to travel and entertainment expenses. These included the standard mileage rates, the depreciation vehicle limits, and the fair market value amounts for fringe benefit usage of company cars. Several of these rates bucked the trend and decreased slightly for 2013, owing mainly to lower gas prices.

**COMMENT.** *At the time this Briefing was prepared, the IRS has not yet finalized guidance issued in 2012 on the local lodging expenses deduction and meal and travel expense reimbursements (NPRM REG-137589-07). However, the IRS instructed that taxpayers may apply the proposed regulations to expenses paid or incurred in taxable years for which the period of limitation on credit or refund under Code Sec. 6511 has not expired.*

**Standard mileage rates.** The optional business standard mileage rate for 2014 is 56 cents-per-mile, the IRS announced in December (IR-2013-95, Notice 2013-80). This reflects a decrease from the 2013 rate of 56.5 cents-per-mile. The optional standard mileage rate for qualified medical and moving expenses will also decrease from 24 cents-per-mile for 2013 to 23.5 cents-per-mile for 2014. The 14 cents-per-mile rate for charitable miles driven is set by statute, however, and it remains unchanged for 2014.

For 2014, the depreciation component of the business standard mileage rate will be 22 cents-per mile. This represents a one-cent decrease from the depreciation component for the 2013 business standard mileage rate.

**IMPACT.** *Gas prices are one factor affecting the optional business standard mileage rates.*

**Vehicle depreciation dollar limits.** The IRS released inflation-adjustments on depreciation deductions for business-use passenger automobiles, light trucks, and vans first placed in service during calendar year 2013 (Rev. Proc. 2013-21).

**IMPACT.** *The maximum depreciation limits under Code Sec. 280F for passenger automobiles first placed in service during calendar year 2013 are \$11,160 for the first tax year (\$3,160 if bonus depreciation does not apply); \$5,100 for the second tax year; \$3,050 for the third tax year; and \$1,875 for each succeeding tax year. The maximum depreciation limits under Code Sec. 280F for trucks and vans*

*first placed in service during the 2013 calendar year are \$11,360 for the first tax year (\$3,360 if bonus depreciation does not apply); \$5,400 for the second tax year; \$3,250 for the third tax year; and \$1,975 for each succeeding tax year.*

**Fringe benefit income/FMV limits.** The IRS issued the maximum fair market value (FMV) amounts for purposes of determining which is the proper valuation rule for employees calculating fringe benefit income from employer-provided automobiles, trucks, and vans that were first made available for personal use in 2013 (Notice 2013-17). Taxpayers with employer-provided vehicles within the designated FMV amounts may apply either the vehicle cents-per-mile rule or fleet average valuation rule.

The maximum 2013 FMV amounts for purposes of applying the cents-per-mile valuation rule are \$16,000 for a passenger automobile and \$17,000 for a truck or van, including passenger automobiles such as minivans and sport utility vehicles, which are built on a truck chassis.

**COMMENT.** *For 2014, the projected amounts for purposes of applying the cents-per-mile valuation rule will be \$16,000 for a passenger automobile (same as for 2013); and \$17,300 for a truck or van, which includes minivans and SUVs built on a truck chassis (up from \$17,000 in 2013).*

**Per diem rates.** The IRS announced the simplified per diem rates that taxpayers can use to reimburse employees for expenses incurred during travel after September 30, 2013 (Notice 2013-65). The high-cost area per diem increases from \$242 to \$251 and the low-cost area per diem increases from \$163 to \$170.

**50-percent meal deduction limit.** The IRS issued final regulations in August to clarify who is subject to the 50-percent limit on meal expense deductions under Code Sec. 274 in multi-party arrangements—the employer or employee leasing company, the employee, or a third-party client (TD

9625). The final regulations generally permit the parties to determine who is subject to the 50-percent limit. If there is no agreement, the 50-percent limit applies to the party who pays the expenses under a reimbursement arrangement, the IRS explained.

**COMMENT.** *The exception is only available to one party to the reimbursement arrangement; therefore, the deduction limitation will still apply to the other party to the arrangement.*

**Code Sec. 199 deduction.** The IRS and the Tax Court issued rulings and guidance on the Code Sec. 199 domestic production activities deduction in 2013. In general, these 2013 developments broadened the scope and flexibility of the Code Sec. 199 deduction beyond exclusive use by those who would traditionally be classified as manufacturers, looking more toward the process and contractual obligations involved when applying this tax benefit.

- **Claiming the deduction.** In *ADVO, Inc., CCH Dec. 59,670*, the Tax Court added a new factor to the eight-factor test from *Grodt & McKay, CCH Dec. 38,472*, for determining which party in a contract manufacturing arrangement held the benefits and burdens of ownership and was therefore entitled to the deduction. The Tax Court in *ADVO* asked whether the taxpayer had actively and extensively participated in the management and operations of the contract manufacturer's activity.
- **Billboards.** IRS Chief Counsel determined that mobile billboards qualified for the Code Sec. 199 domestic production activities deduction (CCA 201302017). Chief Counsel determined that the mobile billboards were intended to be moved frequently and, therefore, were not inherently permanent structures.
- **Photo processing.** IRS Chief Counsel issued field attorney advice stating that a retail drug store and pharmacy chain could claim the Code Sec. 199 deduction for its photo processing activities (FAA 20133302F). Chief Counsel

pointed out that the drug store employees created the photo products from raw materials, including paper, ink and blank computer disks, using sophisticated machinery and equipment. Thus, the taxpayer transforms raw materials into finished photo products, which qualified as products “manufactured, produced, grown or extracted” in the U.S.

- **IRS directives.** The IRS issued two directives in 2013, LB&I-04-0713-006, in July and LB&I-04-1013-008, in October. The directives allow the contracting parties themselves to determine who will claim the deduction, in situations where each of the parties can demonstrate some indicia of the benefits and burdens of ownership. If the taxpayer does not follow the directive, examiners are instructed to apply regular audit procedures to determine benefits and burdens. If the directives do not apply, the taxpayer and the examiner must apply all the facts and circumstances. In such cases it is possible the IRS analysis would take into account the nine factors expounded upon in the *ADVO* decision.

**IMPACT.** *LB&I instructed examiners not to challenge the taxpayer’s ownership claim under Code Sec. 199 if the taxpayer provides all three of the following documents: a statement explaining the taxpayer’s basis for determining that it has the benefits and burdens of ownership; a certification signed by the taxpayer that it is claiming the benefits and burdens of ownership; and a certification signed by the counterparty to the contract manufacturing arrangement that it is not claiming the Code Sec. 199 deduction.*

**Home office deduction.** The IRS announced a new optional safe harbor method for individuals to determine the amount of their deductible home office expenses (IR-2013-5, Rev. Proc. 2013-13). The safe harbor is effective for tax years beginning on or after January 1, 2013.

**IMPACT.** *The maximum deduction under the safe harbor—under current regulations—is \$1,500. The allowable square footage of a home used for a qualified business purpose is 300 square feet. The IRS indicated that the \$1,500 amount, which is not indexed for inflation, may be revisited in future years.*

**COMMENT.** *The Tax Court held that a motor home used as the base for a taxpayer’s consulting business did not qualify for the home office exception (Dunford, CCH Dec. 59,609(M)). The taxpayer and his wife could not show that an identifiable area of their motor home was used exclusively for business purposes.*

**Production tax credit.** The IRS issued guidance on the production tax credit (PTC) and the investment tax credit (ITC) that may be claimed in lieu of the PTC (Notice 2013-60). The guidance clarifies Notice 2013-29 on when a taxpayer has begun construction of a qualifying facility.

**IMPACT.** *To qualify for the credit, the statute provides a safe harbor if construction of a facility began before January 1, 2014, and the taxpayer makes continuous progress toward completing the facility so that it is placed in service before January 1, 2016. Whether a taxpayer makes continuous progress is determined by the facts and circumstances.*

**Whistleblower litigation expenses.** A federal district court found that a taxpayer was engaged in a trade or business under Code Sec. 162(a) when litigating a lawsuit under the Federal Claims Act (FCA) against his former employer (*Bagley, DC-Calif., 2013-2 USTC ¶50,462*). The taxpayer’s litigation expenses in pursuing an FCA lawsuit as a qui tam relator could be deducted as ordinary and necessary expenses incurred for a trade or business.

**IMPACT.** *The decision allows the whistleblower to deduct all of his litigation expenses against his income. Treating the expenses as miscellaneous itemized deductions would have substantially increased the whistleblower’s tax liability.*

**Research expenditures.** The IRS issued proposed regulations (NPRM REG-124148-05) in September 2013 to allow taxpayers to deduct currently or amortize (over 60 months) research and experimentation expenses incurred for prototypes and other tangible property “in the experimental or laboratory sense.” The ultimate success, failure or use of the property does not affect eligibility to write off the expenses. However, costs for producing a product after uncertainty is eliminated do not qualify for the write-off.

**IMPACT.** *The regulations aim to clarify the treatment of certain expenses for prototypes and pilot models.*

**Expensing real property.** After ATRA extended Code Sec. 179 expensing of qualified real property through 2013, the IRS issued guidance on the income limitation (Notice 2013-59). Qualified real property includes leasehold improvement property, restaurant property, and retail improvement property.

**IMPACT.** *According to the IRS, taxpayers were confused about how to treat their disallowed deductions. Since the deduction for qualified real property expired at the end of 2013, the guidance explains that disallowed deductions from qualified real property must be taken as depreciation after 2013. Disallowed deductions from other Code Sec. 179 property can still be carried forward and deducted in a later year.*

## PARTNERSHIPS

The use of partnerships for doing business continues to increase exponentially, with more partners, more complex structures, and more challenges to tax compliance. This increasing complexity, the IRS has discovered, sometimes results in partners and partnerships pushing the envelope to obtain large tax benefits.

**Noncompensatory stock options.** The IRS issued final regulations in February 2013 with a characterization rule that treats the holder of a noncompensatory stock option

as a partner in certain circumstances (TD 9612, NPRM REG-106918-08). Under the final regulations, the exercise of a non-compensatory option does not trigger the recognition of gain or loss to either the issuing partnership or the option holder, unless the partnership is satisfying a debt.

**IMPACT.** *A noncompensatory option is an option issued by a partnership, other than an option issued in connection with the performance of services. The characterization rule is designed to prevent partnerships from allocating income to a partner in a low tax bracket when the option holder will get the benefit and is in a higher bracket.*

**Recourse liabilities.** The IRS issued proposed regulations (NPRM REG-13984-12) to determine a partner's share of the partnership's recourse liabilities. The regulations would apply to multiple partners liable for the same liability (overlapping risk of loss), tiered partnerships, and related partners. Generally, the partners will each include a portion of the liability in their basis.

**IMPACT.** *A partner's basis is increased for his share of partnership liabilities. Basis can affect whether the partner must recognize a gain on a partnership distribution or can recognize a loss on a distributive share of partnership losses. The proposed regs are intended to eliminate confusion stemming from a 2004 Tax Court case (IPO II, CCH Dec. 55,622), and bring clarity to the rules for allocating debt, the IRS explained.*

**Employee's undistributed partnership profits.** In a case of first impression, the Tax Court found in December that an employee who held a nonvested partnership interest was not taxable on partnership profits allocated to the interest, because the partnership did not actually distribute any amounts to the employee (*Crescent Holdings, LLC*, CCH Dec. 59,705). The court found that since the partnership interest was subject to a substantial risk of forfeiture, the employee's right to receive a distribution of profits was subject to the same risk of forfeiture and should not be recognized as income.

**IMPACT.** *The regulations under Code Sec. 83 are clear that a distribution of profits on a nonvested partnership interest is taxable as compensation under Code Sec. 61. However, the regulations do not address the treatment of undistributed profits allocated to a nonvested interest.*

**Unamortized partnership expenses.** The IRS issued proposed regulations in 2013 that would require a partnership undergoing a technical termination (a transfer of 50 percent or more of the partnership interests) to continue amortizing start-up and organizational expenses over a 15-year period (NPRM REG-126285-12). While some deductible expenses can be completely written off when a trade or business is completely disposed of, a partnership undergoing a technical termination is deemed to contribute its assets and liabilities to a new partnership and to continue its operations.

"The IRS announced in 2013 that it would no longer rule on whether a transaction qualifies for nonrecognition treatment under Code Sec. 355 as a spinoff."

**IMPACT.** *The proposed regs would provide that a technical termination is not a disposal of the partnership's trade or business, and would not allow the partners to accelerate the deduction of the expenses.*

**Historic rehabilitation tax credits.** The U.S. Supreme Court announced in May that it would not review the Third Circuit Court of Appeals' decision in *Historic Boardwalk Hall, LLC*, 2012-2 USTC ¶50,538. Reversing the Tax Court, the Third Circuit had found that the investor was not a bona fide partner of a limited liability company (LLC) and therefore was not entitled to an allocation of historic rehabilitation tax

credits (HRTCs) as a partner. The Third Circuit found that the partnership was set up merely to transfer credits to the investor and was more akin to a sale.

**IMPACT.** *Lawmakers had requested IRS guidance, expressing concern that the Third Circuit's decision would discourage investments in historic properties that are designed to claim the credit. At the end of 2013, the IRS issued guidance that provided a safe harbor to allow a partnership to allocate its HRTCs to its investment partners (Rev. Proc. 2014-12).*

## CORPORATIONS

Corporate transactions and reorganizations are an important part of the economy and the tax world. The IRS strives to facilitate business-related transactions by corporations while discouraging transactions that lack a business purpose other than reducing taxes. The IRS issued several sets of regulations in the corporate area in 2013.

**Rulings under Code Sec. 355.** The IRS announced in 2013 that it would no longer rule on whether a transaction qualifies for nonrecognition treatment under Code Sec. 355 as a spinoff (Rev. Proc. 2013-32). Instead, the IRS will only rule on significant issues under related Tax Code sections (such as nonrecognition and basis) that result from the application of Code Sec. 355. A significant issue is a legal issue (as opposed to a factual issue) that is not essentially free from doubt.

**IMPACT.** *This is a significant change by the IRS because spinoffs are common transactions. These "comfort rulings" reduced the tax risk associated with spinoffs that may not pass Code Sec. 355 rules for tax-free treatment. Smaller, family-owned businesses in particular had benefited from the assurance of a letter ruling.*

**COMMENT.** *This announcement continues an IRS trend of not ruling on standard reorganizations. Code Sec. 355*

*was one of the few remaining corporate areas where the IRS would rule on the overall transaction.*

**S corporations.** The IRS announced in August exclusive simplified methods for use by taxpayers requesting late S corporation elections, ESBT elections, QSST elections, QSub elections, and certain late corporate classification elections (Rev. Proc. 2013-30). Additionally, the IRS provided transition relief for pending letter ruling requests.

**IMPACT.** *The revenue procedure, the IRS explained, is intended to consolidate various pre-existing relief procedures into a single document.*

**Qualified stock dispositions.** The IRS issued final regulations in May under Code Sec. 336(e) allowing taxpayers to elect to treat the sale, exchange, or distribution of at least 80 percent (by vote and value) of a corporation's stock (a qualified stock disposition or QSD) as a deemed disposition of the corporation's underlying assets (TD 9619). The final regulations generally track proposed regulations issued in 2008 (NPRM REG-143544-04), with some modifications.

**COMMENT.** *Code Sec. 336(e) provides relief from potential multiple taxation of the same economic gain, which can result by taxing a transfer of appreciated corporate stock without providing a corresponding step-up in the basis of the corporation's assets.*

**Duplicated losses - regulations.** Final regulations (TD 9633) were released by the IRS to prevent duplicated losses where a taxpayer transfers property with a built-in loss to a corporation in a Code Sec. 351 transaction. However, the regulations provide a taxpayer-favorable election to prevent the duplicated loss by reducing basis in the taxpayer's stock, rather than the basis of the property transferred to the corporation.

**IMPACT.** *The election allows taxpayers to preserve a higher basis for the property transferred, which enables the corporation*

*to take more depreciation and reduce its taxes. An election may also avoid the recognition of additional income stemming from taxable dividends paid by a controlled foreign corporation to the transferor.*

**Duplicated losses -- Tax Court decision.**

The Tax Court disallowed a parent corporation's deductions for losses from the sale of a subsidiary's assets that duplicated losses the parent had already claimed from selling the same subsidiary's stock (*Duquesne Light Holdings, CCH Dec. 59,639(M)*). The claimed deductions represented the same economic loss as a second deduction, and there was no evidence that Congress intended to authorize the double deduction, the court found.

**Built-in losses.** The IRS issued proposed regulations in 2013 that would clarify that taxpayers receiving an asset with a built-in loss must reduce the basis of the asset to fair market value (NPRM REG-161948-05). The reduction would be required if the transferor's gain would not have been subject to U.S. taxes, but the transferee's loss would be subject to U.S. taxes.

**IMPACT.** *The IRS explained that the primary goal of the regulations is to prevent taxpayers from importing a net built-in loss in certain nonrecognition transactions, including a Code Sec. 332 liquidation, a Code Sec. 351 transfer of property, or a Code Sec. 368 reorganization.*

**Transfers to RICs and REITs.** The IRS adopted final regulations that provide exceptions to the built-in gain rules that apply to transfers of property by a C corporation to regulated investment companies (RICs) and real estate investment trusts (REITs) (TD 9626). The exceptions apply to tax-exempt gain, gain from Code Sec. 1031 exchanges, and gain from Code Sec. 1033 exchanges.

**IMPACT.** *Corporations could avoid corporate level taxes on appreciated property by converting to a RIC or REIT. The built-in gain rule would normally require a RIC or REIT to recognize gain at the corporate level if it sold property received*

*from a C corporation. Here, the IRS recognized that certain transactions were not abusive and should not trigger tax.*

**Mexican Land Trusts.** The IRS determined in June 2013 that a Mexican Land Trust (known as a *fideicomiso*) that holds title to residential real property is not a trust under federal tax law (Rev. Rul. 2013-14). Although a Mexican bank held legal title to the property, the bank had no duties with respect to the property, and the U.S. purchaser of the property was treated as the owner of the property for tax purposes. Instead, the relevant U.S. person was the owner of the real estate.

**IMPACT.** *Mexican law requires this arrangement for real estate owned by a U.S. citizen in certain "restricted zones" near the U.S.-Mexico border. If the arrangement had qualified as a trust, it could have been subject to reporting for U.S. taxes (and to penalties for non-reporting).*

**TAX ACCOUNTING**

A number of court decisions and IRS determinations impacted tax accounting in 2013. Some of these are expected to play out further in 2014.

**Private equity funds.** The First Circuit Court of Appeals found that a private equity fund that invested in a distressed company was not a mere investor, but in fact was in a trade or business of managing the company (*Sun Capital Partners III, LP, July 24, 2013*). As a consequence, the equity fund was potentially liable to a multiemployer pension fund for a substantial share of the vested but unfunded benefits owed by the distressed company.

**IMPACT.** *Although the issue of investor liability to the pension fund did not directly involve the Internal Revenue Code, the court examined several tax cases on the trade or business issue. If a fund is treated as conducting a trade or business under the Tax Code, this would suggest that carried interest paid to fund*

*managers is ordinary income, not capital gains, and could have other tax implications to private equity funds and others.*

**Deferred COI income.** The IRS issued final regulations in July on the acceleration of cancellation of indebtedness (COI) income that was deferred by a C corporation as allowed under Code Sec. 108(i) during the 2009 and 2010 economic downturn (TD 9622). The regulations accelerate the deferred income if a C corporation has impaired its ability to pay the tax liability. The corporation must accelerate the remaining deferred income if it changes its tax status, ceases its corporate existence where Code Sec. 381(a) does not apply, or engages in an impairment transaction (the net value acceleration rule).

The IRS also issued final regulations (TD 9623) that explain when passthrough entities that deferred cancellation of indebtedness (COI) income must accelerate the recognition of that income. A partnership that defers COI income must allocate all the income to its direct partners in accordance with their distributive shares. The partnership can determine the amount of the partner's COI income that can be deferred and that must be included in income.

**Severance pay.** The U.S. Supreme Court announced in October that it will review *In Re Quality Stores, 2012-2 USTC ¶50,551*, decided in January by the Sixth Circuit Court of Appeals. The Sixth Circuit held that an employer's severance pay to terminated employees should be treated as supplemental unemployment compensation benefits (SUB payments) and was not wages for FICA taxation purposes.

**IMPACT.** *The potential monetary impact is significant. According to the IRS, the total dollar amount at issue could reach \$1 billion.*

**COMMENT.** *The U.S. government had asked for Supreme Court review. The Court of Appeals for the Federal Circuit previously found that SUB payments were subject to FICA taxation (CSX Corp., 2008-1 USTC*

*¶50,218). The Sixth Circuit's decision created a split among the Circuits.*

**Gift card sales.** The IRS modified 2011 guidance allowing taxpayers that sell gift cards redeemable for goods or services by an unrelated entity to defer income on those sales (Rev. Proc. 2013-29). The IRS had allowed taxpayers receiving advance payments for goods to defer recognizing the income until the succeeding year, if the advance payments are not included on the taxpayer's financial statement. Instead, the payment will be recognized by the taxpayer in the current year only to the extent the gift card is redeemed by the entity during the tax year.

**IMPACT.** *The treatment of gift cards continues to evolve. The IRS's 2011 guidance worked well for transactions involving related parties, but not for unrelated parties. In expanding the treatment to unrelated parties, the IRS acknowledged that it intended to allow income deferral for all parties.*

**Safe harbor for OID.** The IRS provided in May a safe harbor method of accounting—known as the proportional method—for original issue discount (OID) on a pool of credit card receivables (Rev. Proc. 2013-26). The proportional method is a simplified method that generally produces the same results as the statutory method required under Code Sec. 1272(a)(6).

**IMPACT.** *The IRS had challenged taxpayers' methods of accounting for OID as not clearly reflecting income, but lost a 2009 Tax Court decision, Capital One Financial Corp., CCH Dec. 57,945. The safe harbor method should reduce burdens and controversy for both taxpayers and the IRS, the IRS predicted. The method is available for tax years ending on or after December 31, 2012.*

**Mixed straddles.** The IRS issued temporary and proposed regulations that would eliminate an investment strategy whereby taxpayers enter into an identified mixed straddle transaction to accelerate losses to offset

built-in capital gains (TD 9627, NPRM REG-112815-12). The regulations explain how to account for unrealized gain or loss on a position before the taxpayer establishes an identified mixed straddle.

**COMMENT.** *The temporary regulations would have been applicable to all identified mixed straddles established after August 1, 2013, regardless of when any position that is a component of the identified mixed straddle was purchased or otherwise acquired. However, the IRS postponed the effective date (TD 9627, Correcting Amendments, NPRM REG-112815-12, Correction). The rules will now apply to identified mixed straddles established after the rules are finalized.*

**Straddle positions.** The IRS issued final, temporary and proposed regulations in September to extend the definition of a position in personal property to an obligor's own debt, where payments on the debt are linked to the value of other personal property (TD 9635, NPRM REG-111753-12).

**IMPACT.** *Previously, a taxpayer's own debt had not been treated as property. The regulations allow the IRS to treat more financial instruments as part of a straddle and to require that losses on one part of the straddle be deferred until gains in the offsetting position are recognized. The 2013 regulations are now effective and are intended to discourage some investments.*

**Notional Principal Contracts.** The IRS issued final regulations in November providing that the assignment of notional principal contracts and other derivative contracts to a third party will not be taxable to the nonassigning counterparty (TD 9369). The final regulations apply to assignments or transfers of derivative contracts on or after July 22, 2011, the date of temporary regulations (TD 9538) that provided for nontaxable treatment.

**IMPACT.** *Under the prior regulations, the IRS explained that it was unclear when an assignment was taxable to the*

*nonassigning counterparty. Because the Dodd–Frank Wall Street Reform and Consumer Protection Act required the transfer of many derivative contracts, the IRS explained that it wanted to clarify when the transfer was nontaxable. The final regulations provide relief to nonassigning counterparties for the assignment of derivative contracts to third parties.*

## TAX SHELTERS

The IRS, through both guidance and litigation, continued its aggressive assault on the use of tax shelters that began in earnest over a decade ago. While the use of tax shelters has dropped dramatically over the past several years, other disguised “tax-avoidance techniques” continue to draw a following (see, in particular, the *Foreign Compliance Measures part of this Tax Briefing*).

**Valuation misstatement penalty.** Resolving a split among the Circuit Courts of Appeal, the U.S. Supreme Court unanimously held in December that the IRS may impose the 40 percent valuation misstatement penalty where two partnerships had engaged in a tax shelter transaction and lacked economic substance (*Woods, S.Ct., 2012-2 USTC ¶50,604*). Once the partnerships were deemed not to exist for tax purposes, no partner could legitimately claim a basis in

his or her partnership interest greater than zero, the court found. Where an asset’s adjusted basis is zero, the valuation misstatement is deemed a gross misstatement.

**IMPACT.** *The case resolves the applicability of gross valuation misstatement penalties in cases where the IRS or the court determines that the transaction lacks economic substance. However, questions remain whether and to what extent partner level defenses can be asserted or waived in a partnership level proceeding to avoid the penalty.*

**COMMENT.** *The Health Care and Education Reconciliation Act of 2010 provides a 40 percent penalty for underpayments attributable to a nondisclosed economic substance transaction entered into on or after March 30, 2010.*

**Material advisors.** The IRS issued proposed reliance regulations clarifying the Code Sec. 6708 penalty for failure by material advisors to provide lists of their clients to the agency with respect to reportable transactions (NPRM REG-160873-04). If a material advisor fails to provide the requisite information within 20 business days, the material advisor is liable for a penalty of \$10,000 per additional day of failure, unless the penalty is due to reasonable cause. The proposed

regulations allow the IRS to grant an extension of the 20-day period.

**IMPACT.** *A material advisor may rely on the advice of an independent tax professional to establish reasonable cause. Reliance must be reasonable and in good faith, in light of all the other facts and circumstances, and the advice must have been received before the time the list is required to be furnished to the IRS.*

**STARS transactions.** Several high profile cases in 2013 reviewed the question of whether or not the Structured Trust Advantaged Repackaged Securities (STARS) financial transaction promoted by a U.K. bank had economic substance. Federal district courts have disagreed on this issue.

- The Tax Court held that a so-called STARS transaction lacked economic substance and should be disregarded for federal tax purposes (*Bank of New York Mellon Corporation, CCH Dec. 59,445*). As a result, the taxpayer, a bank, was not entitled to claimed foreign tax credits.
- The Court of Federal Claims similarly found that the STARS transaction lacked economic substance and had no business purpose (*Salem Financial Inc., 2013-2 USTC ¶50,517*).
- In *Santander Holdings USA, Inc., 2013-2 USTC ¶50,564*, however, a district court expressly departed from the holding of recent cases and found that the transactions did have economic substance, allowing the taxpayer to claim foreign tax credits.

**COMMENT.** *If the government were to lose the Santander case on appeal, it would likely seek Supreme Court review.*

**FOCUS tax shelter.** The Fifth Circuit Court of Appeals affirmed a federal district court decision holding that a series of partnership transactions marketed under “Family Office Customized” or FOCUS program lacked economic substance and that \$18 million in claimed losses should therefore be disregarded (*Nevada Partners Fund LLC, 2013-2 USTC ¶50,398*).

## 2013 TAX DEVELOPMENTS—BY THE NUMBERS

The number of tax developments in 2013 was much greater than can be highlighted in this Tax Briefing. Developments here were selected based upon their impact on a broad cross-section of taxpayers, but this selection is not comprehensive. The following chart lists the number of 2013 tax developments reported by CCH over the past year in each of the following categories:

Tax Court Regular and Memo Decisions.....	334
District and Appellate Court Decisions .....	512
Treasury Regulations .....	91
IRS Notices, Revenue Rulings and Procedures.....	185
IRS Letter Rulings, TAMs, CCAs and E-mailed Advice.....	942
IRS Announcements and News Releases.....	162

**COMMENT.** *The IRS attacked schemes similar to the FOCUS program in Notice 2000-44, the Son of BOSS currency straddle, and Notice 2002-50, the partnership straddle tax shelter. The court concluded that the FOCUS program was not designed to make a profit, and that the investments had no business purpose and no economic substance.*

**Lease-in, lease-out transactions.** Reversing the Federal Claims Court, the Court of Appeals for the Federal Circuit disallowed deductions claimed by the taxpayer in a lease-in, lease-out (LILO) transaction (*Consolidated Edison Company of New York, 2013-1 USTC ¶50,136*). The Federal Circuit found that a purported head lease and sublease were illusory.

In a separate case, the Tax Court applied the substance-over-form doctrine to conclude that an insurance company's lease-in, lease out (LILO) and sale-in, lease out (SILO) transactions were not leases (*John Hancock Life Insurance Co., CCH Dec. 59,597*). The insurance company was not entitled to deduct depreciation, rental expenses, interest expenses, and transactional costs incurred in connection with the various transactions.

**IMPACT.** *The Tax Court found that their substance was not the same as their form. The court found that several of the transactions closely resembled financing transactions instead of leases. Although the Second, Fourth, and Federal Circuits previously ruled against parties that have taken part in LILO and SILO transactions, the Tax Court had never examined the issue before.*

## FOREIGN COMPLIANCE MEASURES

In 2013, Treasury and the IRS continued to generate guidance, forms and other necessary tools to implement the Foreign Account Tax Compliance Act of 2010 (FATCA) and to take action with other foreign tax compliance and enforcement measures. Although some FATCA requirements have

been delayed, Treasury and the IRS continue to make FATCA implementation a priority. The federal courts also addressed several significant issues in the foreign tax area.

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### FATCA

FATCA generally requires foreign financial institutions (FFIs) to report to the IRS information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. To avoid withholding under FATCA, a participating FFI generally must enter into an agreement with the IRS to identify U.S. accounts; report certain information to the IRS regarding U.S. accounts; and withhold a 30-percent tax on certain U.S.-connected payments to non-participating FFIs and account holders who are unwilling to provide the required information.

**Final reporting/withholding regulations.** The IRS issued comprehensive final regulations under FATCA in January 2013 that set January 1, 2014 as the initial compliance date for FATCA (TD 9610). The final regulations describe the requirements for FFIs, nonfinancial foreign entities, and other taxpayers to comply with FATCA's reporting and withholding requirements.

**IMPACT.** *Since the passage of FATCA, there has been growing collaboration in the international community to identify and prevent tax evasion, Treasury has reported.*

**Implementation delayed.** Treasury and the IRS subsequently revised the timelines

for implementing FATCA (Notice 2013-43). Withholding requirements scheduled to generally begin on withholdable payments made after December 31, 2013 are postponed to payments made after June 30, 2014.

**COMMENT.** *Treasury is working to implement FATCA and to address base erosion and profit shifting (BEPS). Treasury plans to issue FATCA regulations for withholding agents and participating financial institutions in early 2014.*

**Intergovernmental Agreements.** The final regulations help harmonize the U.S.'s regulatory requirements with the use of intergovernmental agreements (IGAs) to implement FATCA and to facilitate the exchange of the requisite information. The U.S. has developed two model IGAs. Under Model I, FFIs report the information required by FATCA to their respective governments, which then provide this information to the IRS. Under Model II, the foreign jurisdiction directs its FFIs to report the information required by FATCA directly to the IRS.

**COMMENT.** *The U.S. has entered into FATCA agreements with a number of foreign jurisdictions, including Switzerland, Japan (Model II), Germany, Norway, and Spain, and is engaged in negotiations with others.*

**FATCA forms.** The IRS issued a draft form and instructions for the 2014 version of Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, for reporting of income under both Chapters 3 and 4. Other draft forms released by the IRS include:

- Form W-8BEN-E, Certificate of Status of Beneficial Owner for United States Withholding and Reporting (Entities);
- Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States tax Withholding and Reporting (Individuals);
- Form W-8EXP, Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding and Reporting; and

- Form W-9, Request for Taxpayer Identification Number and Certification.

**COMMENT.** *The first FATCA reporting generally will be required for 2014, although the forms will not be due until 2015.*

**FATCA registration.** The IRS opened a new online registration system in 2013 for financial institutions required to register with the agency under FATCA (IR-2013-69). FFIs can use the online registration system to create an account to provide the required information. The IRS will establish an online FATCA account for the FI and will assign global intermediary identification numbers (GIINs) to each FI.

The IRS issued a draft FFI agreement (Notice 2013-69) that substantially incorporated the requirements of the final FATCA regulations. The IRS followed up by issuing a final FFI agreement before the end of 2013 (Rev. Proc. 2014-13). The IRS also posted final Form 8957, Foreign Account Tax Compliance Act Registration, along with instructions.

**COMMENT.** *Financial institutions (FIs) may use paper Form 8957 as an alternative to the IRS's online registration system. Registration may begin January 1, 2014. The IRS will establish an online FATCA account for the FI and will assign global intermediary identification numbers (GIINs) to each FI.*

**IMPACT.** *Entities can start to register before July 1, 2014 and obtain a GIIN. An FFI will then provide its GIIN to withholding agents to demonstrate that it is registered and approved. Otherwise, the agent will institute withholding required under FATCA effective July 1, 2014.*

### Information Sharing

The U.S., the United Kingdom and Australia announced in 2013 that they will share more tax information involving companies and trusts holding offshore assets of taxpayers under their respective jurisdictions (IR-2013-48). The countries have

been working together to analyze data that identifies individuals who own the entities and advisers who assisted in establishing the entity structure.

**COMMENT.** *This information sharing is in addition to the provision of information by governments and financial institutions under FATCA. It also helps the three countries develop a better overall understanding of complex offshore structures that may be used to evade taxes.*

### Judicial Decisions

The federal courts issued several decisions in 2013 that struck at foreign-based tax abuses. Notable cases involved the treatment of foreign dividends and the issuance of “John Doe” summonses to banks suspected of holding unreported accounts.

**CFC inclusions.** Affirming the Tax Court, the Court of Appeals for the Fifth Circuit found that amounts reported as qualified dividend income by the owners of a controlled foreign corporation (CFC) were properly characterized as ordinary income (*Rodriguez*, 2013-2 *USTC* ¶50,420). The court rejected the taxpayer’s argument that Code Sec. 951 inclusions under Subpart F should be deemed dividends. The court further observed that actual dividends require a distribution by a corporation and receipt by the shareholder. Code Sec. 951 inclusions involve no distribution, the court found.

**Repatriated dividends.** The Tax Court held that a U.S. taxpayer must reduce the dividends eligible for the Code Sec. 965 repatriation deduction by the amount of debt it was owed by its CFC to the taxpayer (*BMC Software Inc.*, *CCH Dec.* 59,643). In this case, the debt resulted from the taxpayer’s agreement with the IRS to recharacterize certain payments as loans rather than as contributions to capital.

**COMMENT.** *The law reducing dividends for an increase in related-party debt deters U.S. shareholders from loaning money to their CFCs and then bringing the*

*funds back into the U.S. as repatriated dividends. The court took a strict view, applying the letter of the law even though there was no evidence of manipulation by the taxpayer.*

**“John Doe” summonses.** A federal district court authorized the IRS to issue “John Doe” summonses to five U.S. banks that would require them to produce information on taxpayers with undisclosed foreign financial accounts in two foreign banks (*Liabilities of John Does*, *S.D.N.Y.*).

The Department of Justice reported that U.S. taxpayers participating in the IRS Offshore Voluntary Disclosure (OVD) program identified more than 450 undisclosed foreign financial accounts held at the foreign banks by U.S. account holders.

**U.K. windfall profits tax.** In a unanimous decision, the Supreme Court found that a United Kingdom windfall profits tax was a creditable excess profits tax for purposes of allowing a foreign tax credit under Code Sec. 901 (*PPL Corp. et al.*, 2013-1 *USTC* ¶50,335). In a substance-over-form analysis that resolved a split among the circuits, the Supreme Court found that the tax, in essence, was “nothing more than a tax on actual profits above a threshold.”

**IMPACT.** *The government has taken a strong stand against abusive foreign tax credit claims and attempts to recharacterize payments to foreign governments as income taxes. In this case, the Supreme Court decided there was no abuse. The decision allowed the taxpayer to claim the foreign tax credit and reduce its U.S. taxes for the windfall profits tax it paid to the U.K.*

### OECD Action Plan

The Organisation for Economic Co-operation and Development (OECD)—which includes the U.S.—released a multi-pronged Action Plan in 2013 to combat tax avoidance by multinational corporations (MNCs) that use base-erosion and

profit-shifting (BEPS) techniques. The Action Plan sets a December 2015 deadline for countries to implement its 15 proposals through unilateral, bilateral, and multilateral measures. The OECD also advanced a plan to increase international cooperation and transparency through the automatic exchange of information between jurisdictions.

**COMMENT.** *The OECD defines BEPS as tax planning strategies that exploit gaps and mismatches in tax rules to make tax profits “disappear” for tax purposes or to shift profits to low-tax locations where there is little or no real activity. Although many BEPS practices are legal, they are still harmful, the OECD cautioned.*

**IMPACT.** *Many U.S. tax reformers support a lower corporate tax rate, but only if it is accompanied by a broader base subject to U.S. taxes. These reformers believe that the OECD’s BEPS strategy may play an important part in this effort.*

## Competent Authority and Advance Pricing Agreements

The IRS issued a draft revenue procedure in 2013 that would revise and update the processes for taxpayers seeking relief from double taxation to obtain competent authority assistance through the Mutual Agreement Program (MAP) (Notice 2013-78). The revenue procedure reflects the establishment of the IRS Large Business and International Division and of separate offices under the U.S. competent authority to handle requests for different types of assistance.

**IMPACT.** *The IRS expects that these revised competent authority procedures will operate more effectively and provide a more structured process for taxpayers to request relief and interact with the agency.*

The IRS also issued a draft revenue procedure that would revise and update the procedures for taxpayers to negotiate an

advance pricing agreement (APA) with the IRS (Notice 2013-79). An APA provides the transfer prices used for transactions between related parties owned by a multinational corporation.

**IMPACT.** *The APA and MAP offices have worked closely to seek efficiencies in processing their combined workloads. The creation of a single Advance Pricing and Mutual Agreement (APMA) office will likewise increase efficiency by eliminating the handoff of APA cases from one IRS office (the APA program) to another (competent authority).*

**Taxes Paid For FTC purposes.** The IRS issued final regulations that disallow the foreign tax credit where the payments to a foreign government are attributable to a structured passive investment arrangement (TD 9634). These regulations finalized proposed regulations issued in 2011. There are six requirements for a passive arrangement. One is that substantially all of the entity’s gross income is passive investment income, and all the entity’s assets are held to produce passive income.

## Dividend Equivalents

The IRS withdrew 2012 proposed regs and issued new proposed regs to impose withholding on dividend equivalents (NPRM REG-120282-10). At the same time, it adopted final regs that postponed the application of the withholding rules until January 1, 2016 (TD 9648). The 2013 proposed regs provide a new test, based on a financial instrument’s “delta,” which is the ratio of the change in fair market value of the contract to the change in the value of the property referenced by the contract.

**IMPACT.** *A 2010 law imposes 30 percent withholding on dividend equivalents. The IRS delayed withholding after it substantially revised the test for identifying dividend equivalents. The financial services industry had also indicated that it needs additional time to establish the necessary withholding systems.*

## EXEMPT ORGANIZATIONS

Exempt organizations were much in the news during 2013 largely because of the controversy surrounding the IRS’s handling of applications for tax-exempt status from conservative organizations. This brought about some significant changes in the IRS executive ranks along with new regulations and rules.

**Code Sec. 501(c)(4) organizations.** In May, the IRS announced that some applications for tax-exempt status under Code Sec. 501(c)(4) had been inappropriately flagged for extra scrutiny. The announcement resulted in numerous Congressional hearings. Some senior IRS officials, including then Acting IRS Commissioner Steven Miller, retired, resigned or were placed on administrative leave. President Obama appointed Daniel Werfel as Acting Commissioner and directed him to conduct a top-down review of the agency’s operations, processes and practices. In June, Werfel reported that there was no sign of intentional wrongdoing by agency personnel or involvement by parties outside the agency (IR-2013-62). Werfel also announced a streamlined application process for affected organizations going forward (IR-2013-62).

**COMMENT.** *Werfel also moved to curb IRS spending after reports of excessive expenditures on conferences and training, including video parodies of 1960s television shows surfaced. Werfel told Congress that these expenses were “unfortunate vestiges from a prior era” and the agency took “bold steps” to ensure spending in the future is appropriate.*

**Proposed 501(c)(4) regulations.** In November, the IRS announced proposed regulations intended to clarify tax-exempt status under Code Sec. 501(c)(4) (IR-2013-92, NPRM REG-134417-13). The IRS explained that it intended to replace the current facts and circumstances test used to determine if an organization is engaged in political campaign activities with more definite rules. The proposed regulations would provide that the promotion of social welfare

does not include direct or indirect candidate-related political activity.

**IMPACT.** *Candidate-related political activity would generally encompass communications that expressly advocate for a clearly identified political candidate or candidates of a political party; activities closely related to candidates and elections, such as “get-out-the-vote” drives and distribution of any material prepared by or on behalf of a candidate; and any contribution that is recognized under campaign finance law as a reportable contribution.*

## GOVERNMENT SHUTDOWN

On October 1, 2014, the IRS furloughed nearly 90 percent of its employees after a lapse in appropriations. Certain core-functions remained in operation, including the processing of most tax payments. The Tax Court also closed. But federal district and circuit courts generally remained open. On October 17, President Obama signed the Continuing Appropriations Act, 2014, which reopened the federal government through mid-January. On December 26, President Obama signed the Bipartisan Budget Act of 2013, which effectively keeps the government open for two more years.

**IMPACT.** *During the shutdown, all furloughed employees were instructed not to perform any work-related activities. After funding was restored, the IRS cautioned taxpayers to expect delays as employees caught up with work. Taxpayers should also be prepared for a delayed start to the 2014 filing season, which is scheduled to open on January 31, 2014 (IR-2013-100).*

**COMMENT.** *Unrelated to the lapse in appropriations were furlough days in 2013 due to sequestration under the Budget Control Act of 2011. IRS employees were furloughed for several days under sequestration in 2013. The Bipartisan Budget Act of 2013 appears to remove the need for future furlough days.*

## TAX ADMINISTRATION

Not only did the IRS have to deal with a 16-day shutdown in October, the agency also had a number of important tax administration projects on its agenda, most notably its campaign against tax-related identity theft.

**Identity theft.** Starting in January, the IRS ramped up its efforts to curb tax-related identity theft, especially those designed to protect taxpayers filing 2012 returns (FS-2013-2, FS-2013-3). The IRS expanded the Identity Protection Personal Identification Number (IP PIN) program and increased the number of employees engaged in identity theft detection work. Additionally, the IRS began using new filters to screen returns for possible identity theft. The IRS and law enforcement agencies also launched a sweep of identity theft suspects during the 2013 filing season (IR-2013-17). In April, the IRS expanded its partnership with local law enforcement agencies to curb identity theft (IR-2013-34).

**IMPACT.** *Taxpayer identity theft typically involves a criminal using an individual’s personal information to fraudulently file a tax return and claim a refund. This type of identity theft often peaks early in the filing season because criminals want to receive fraudulent refunds early. Taxpayers may not discover that their identities have been stolen until their true returns are kicked back by the IRS.*

**Return preparers.** In January, a federal district court ruled that the IRS had overreached its authority in issuing return preparer oversight regulations (*Loving, DC-DC, 2013-1 USTC ¶50,156*). Several unenrolled preparers challenged the IRS regulations, arguing that the IRS did not have the statutory authority to require them to become Registered Tax Return Preparers (RTRPs) or obtain another IRS-recognized credential. After the decision was announced, the IRS suspended its RTRP program. The IRS appealed to the Court of Appeals for the District of Columbia Circuit, which heard oral arguments in September 2013, and a decision is expected to be announced in early 2014.

**COMMENT.** *The district court initially enjoined the IRS’s Preparer Tax Identification Number (PTIN) program but lifted the injunction after finding that the PTIN requirement had been authorized by Congress.*

**Disclosure authorizations.** The IRS announced in May that it would extend the 60-day period to 120 days for submitting Code Sec. 6103(c) taxpayer authorizations that permit disclosure of returns and return information to third-party designees (TD 9618).

**Opinion/advisory letters.** The IRS established a program on June 28, 2103 for issuing opinion and advisory letters for Code Sec. 403(b) pre-approved plans (403(b) prototype plans and volume submitter plans) (Rev. Proc. 2013-22). Under the program, the IRS will issue an opinion or advisory letter as to whether the form of the plan meets the requirements of Code Sec. 403(b). An employer may then satisfy the written plan requirement and know that its plan meets the requirements of Code Sec. 403(b) by adopting a plan that has received an opinion or advisory letter.

**Fast track settlement.** The IRS announced in November that it expanded its Fast Track Settlement (FTS) program to small businesses nationwide (IR-2013-88). Under FTS, taxpayers under examination with issues in dispute will work directly with IRS representatives from SB/SE’s Examination Division and Appeals to resolve those issues.

**Installment agreements/OICs.** The IRS issued final regulations (effective January 1, 2014) increasing the fee for an installment agreement from \$105 to \$120. The charge to restructure or reinstate a defaulted agreement increases from \$45 to \$50. The fee for a direct debit agreement authorizing monthly payments remains \$52 (\$43 for lower-income taxpayers). The IRS also raised the user fee for processing an offer-in-compromise (OIC) from \$150 to \$186 (TD 9647).

**Audits/information document requests.** All information document requests (IDRs)

issued after June 30, 2013 must be issue-focused and discussed with the taxpayer. The taxpayer and the examiner must also discuss the appropriate deadline (LB&I-04-0613-004, LB&I-04-1113-009).

**IMPACT.** *Under the new rules, IRS examiners must discuss the information to be requested in the IDR with the taxpayer before the IDR is issued, and the IRS and the taxpayer must mutually agree on a reasonable response date. If a taxpayer does not respond to the IDR by that date, the case must proceed to the graduated, three-step enforcement process. This process, assuming the taxpayer could not respond to the IDRs by the dates specified at each step, would involve first a delinquency notice, then a pre-summons letter, and finally a summons.*

**Timely filing presumption.** In June, the U.S. Court of Federal Claims found that an estate's claim for a refund of tax was not timely filed because the estate's representative did not exercise prudence by doing everything expected of him to ensure timely delivery (*Langan, FedCl, 2013-2 USTC ¶60,668*). The complaint was sent by overnight mail one day before the filing deadline but arrived four days later.

**COMMENT.** *The court found that rather than do everything that could reasonably be expected to ensure delivery, the estate's representative had waited until 11:00 p.m. to send the complaint. Waiting until such a late hour was not reasonable, the court found.*

**Whistleblowers.** The IRS announced in February that it had collected \$592 million in FY 2012 resulting from whistleblower actions, compared to \$48 million in FY 2011. The IRS also paid out \$125 million in awards to whistleblowers in FY 2012. However, whistleblower awards for FY 2013 were reduced by 7.2 percent because of sequestration under the Budget Control Act of 2011.

**COMMENT.** *Congress overhauled the whistleblower awards program in 2006 and created the IRS Whistleblower Office. The IRS has been criticized by some lawmakers for moving slowly in processing whistleblower claims. The agency may be more aggressive in its whistleblower actions under its new Commissioner.*

**2013 filing season delay.** The IRS delayed the start of the 2013 filing season (for 2012 tax returns) in response to the passage of late tax legislation (ATRA). To give its

employees more time to program processing systems for the new tax laws, the IRS moved the start date of the 2013 filing season to January 30, 2013.

**IMPACT.** *Some taxpayers were unable to file returns until later in the 2013 filing season because programming for certain schedules and forms took longer than anticipated. These included Forms 4562, Depreciation and Amortization; 5695, Residential Energy Credits; and 8582, Passive Activity Loss Limitations.*

**COMMENT.** *As discussed above, the start of the 2014 filing season is also delayed. The 2014 filing season is scheduled to open on January 31, 2014 for individuals.*

**Penalty relief.** In March, the IRS announced that taxpayers filing 2012 returns with forms that were principally delayed by passage of ATRA might be eligible for relief from the Code Sec. 6651(a)(2) failure to pay penalty (IR-2013-31, Notice 2013-24). The IRS indicated it would abate the failure to pay penalty if the taxpayer requested a filing extension, paid the estimated tax liability by the original return's due date, and paid any remaining tax by the extended due date of the return.



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