# DELAWARE TAX INSTITUTE

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# 2018 INCOME TAX DEVELOPMENTS

# NOTABLE CASES IN FEDERAL INCOME TAX

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# NOTABLE CASES IN FEDERAL INCOME TAX


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# I. DEDUCTIONS, EXCLUSIONS AND INCLUSIONS

## Compensation

### Wisconsin Central Ltd.,121 AFTR 2d ¶2018-866, U.S. Supreme Court (6/21/18)

In a 5-4 decision reversing the Seventh Circuit judgment and resolving a circuit split, the Supreme Court held that stock options granted by railroads to their employees are not "any form of money remuneration" under § 3231(e)(1) and thus are not subject to Railroad Retirement Tax.

Under the Railroad Retirement Tax Act, enacted in 1937, private railroads and their employees pay a tax on employee "compensation," defined in § 3231(e)(1) as "any form of money remuneration." Regulations issued in 1938 explained that the tax applies to "all remuneration in money, or in something which may be used in lieu of money (scrip and merchandise orders, for example)," including payments of money "related" to stock, but didn't expressly extend that treatment to stock itself.

Regs. § 31.3231(e)-1 describes "compensation" under the RRTA as having "the same meaning as the term wages" for purposes of FICA, "except as specifically limited" by the RRTA. § 3121(a) defines wages for FICA purposes as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash," except as specifically excluded.

The plan in question permitted an employee to exercise stock options by purchasing stock and holding it as an investment; purchasing stock but immediately selling a portion; or selling all the stock immediately at market price, and taking the profits.

The Service argued that such stock options qualify as a form of taxable "money remuneration" because stock can be easily converted into money. The railroads asserted that stock options aren't "money" and thus aren't compensation for RRTA purposes.

The majority opinion, delivered by Justice Gorsuch, and joined by Roberts, Kennedy, Thomas and Alito, relied on the 1933 edition of Black's Law Dictionary, which defined "money" as any currency, tokens, bank-notes, or other circulating medium in general use as the representative of value, and concluded that "stock options do not fall within that definition." The majority also noted that 1939 legislation included provisions that distinguished between "money" and "stock," e.g., the definition of "stock of the corporation" as "property other than money." In addition, the Court noted that the Federal Insurance Contributions Act (FICA), enacted by the same Congress that passed the RRTA, subjected to FICA tax "all remuneration," and not just "money remuneration," and said that this "choice to use the narrower term in the context of railroad pensions alone requires respect, not disregard."

The dissent, authored by Justice Breyer, and joined by Ginsburg, Sotomayor and Kagan, concluded that the statute was ambiguous and that IRS's interpretation of it – generally adopting the

FICA definition of "compensation" for RRTA purposes and thus including stock options – was lawful. The dissent cited the Oxford English Dictionary's contemporaneous definition of money to include "property or possessions of any kind viewed as convertible into money." This differing definition showed that "money" was ambiguous and that IRS's interpretation to resolve that ambiguity was reasonable and entitled to deference, under the *Chevron* doctrine. The dissent also found that IRS's interpretation was supported by the purpose of the RRTA, and by regs promulgated by the Railroad Retirement Board in 1938 treating "a commodity, service, or privilege" that had an "agreed upon" value as included in "any form of money remuneration."

## Cost of Goods Sold

### Transupport, Inc., 1st Cir., 121 AFTR 2d 2018-454 (2/14/18)

The First Circuit affirmed a Tax Court decision that reduced the cost of goods sold and compensation deductions taken by a wholesaler of engine parts. The taxpayer used the gross profit method to determine its cost of goods sold. Instead of calculating the cost by tracking changes in its inventory, it selected a percent profit that it claimed to make on the sale of goods and used that figure to generate its cost of goods sold. Its cost of goods sold varied without explanation from year to year, and the taxpayer kept no records indicating how it selected its gross profit percentage.

When the controlling shareholder offered the taxpayer for sale, its business broker prepared an offering memorandum, that included a summary on which the profits were substantially increased, saying, "Management has elected to use an accounting method that writes off the majority of inventory as purchased. It is conservatively estimated that actual gross profit on sales exceeds 75% on general part sales and 33% on distributor sales." One of the potential purchasers notified IRS's Whistleblower Office of potential tax fraud.

## Marijuana

### Alterman and Gibson, TC Memo 2018-83 (6/13/18)

The taxpayers were precluded from deducting any business expenses related to their legal Colorado medical marijuana dispensary business. Although the taxpayers sold other items, such as pipes and papers, the Court found this to be a unitary business of trafficking in controlled substances. so deductions related to the other items were disallowed. Under§ 280E, taxpayers may not deduct business expenses any amount where the trade consists of trafficking in controlled substances within the meaning of schedule I (which includes marijuana).

Because cost of goods sold is a reduction made in the course of computing gross income, and not a deduction, an allowance for cost of goods sold is not disallowed by § 280E. The Court permitted cost-of-goods-sold allowances to the extent they were conceded by IRS, after audit.

**Loughman, 115 T.C.M. 1472, T.C. Memo. 2018-85 (6/18/18)**

The Tax Court held that an S corporation that grew and sold medical marijuana could not deduct the wages it paid to the company's owners. The taxpayers argued that such an application of § 280E would cause the same income to be taxed twice, once as wages, and a second time as S corporation income. This resulted in the disallowed officer wages being included in the corporation's earnings, which flowed through to the taxpayers without any deduction for the wages. The taxpayers contended that this treatment was contrary to the legislative intent behind subchapter S.

## Split-Dollar Life Insurance

**De Los Santos, 116 T.C.M. 304, TC Memo 2018-155 (9/18/18)**

Life insurance policies issued on a sole shareholder-employee and his spouse-employee, incident to their participation in a purported welfare benefit plan were part of a compensatory split-dollar life insurance arrangement under Reg § 1.61-22(b)(2), causing them to recognize income. The Tax Court concluded that the plan was part of a split-dollar life insurance arrangement, and not a group term policy, because the universal life policies covered the taxpayers (a physician and his office manager), and no other employees; the coverage was based on individual selection (each had the same death benefit, even though the doctor was seven years older and earned a salary four times higher); the cash to pay the premiums was commingled with that of other entities; and the beneficiary was designated by the participant, satisfying the elements for split-dollar treatment.

## Education Expenses

**Colliver, No. 15307-16S, T.C. 2017-93, 2017 BL 462363 (12/27/17)**

A speech-language pathologist was not entitled to deduct education expenses because her master's degree qualified her for a new trade. The tasks and activities that the taxpayer was qualified to perform after earning her master's degree and certificate of clinical competency were significantly different from those she was qualified to perform before pursuing the additional education.

## Settlement Proceeds

**McKenny, 2:16-536-FtM-PAM-MRM, 2018 BL 20334, M.D. Fla., 1/2/18**

Where a CPA firm instructed a taxpayer to set up his business as an S corporation owned by an ESOP, but the CPA firm didn't properly file the documents necessary to register the company as an S corporation or properly form the ESOP, costing the taxpayers $800,000 in taxes, a district court ruled that a settlement of $800,000 that the taxpayer received from the CPA firm was nontaxable.

## II. ALIMONY, JOINT RETURNS AND DOMESTIC RELATIONS

### Alimony

**Hexum, 7th Cir., 121 AFTR 2d ¶ 2018-477, (2/22/18)**

The Seventh Circuit affirmed a Tax Court decision which rejected a husband's argument that half of the amounts that he paid to keep up the marital residence, between the time the couple signed a marriage dissolution agreement and the time the house was sold, were deductible as alimony. The key factor: his duty to make those payments would not termination with her death.

**Vanderhal, T.C. Summary Opinion 2018-41 (9/5/18)**

Payments towards taxpayer's ex-spouse's student loans qualified as alimony. The settlement agreement described these payments as "tax-free transfers," but the court agreed with the taxpayer that nothing in the agreement expressly designated the student loan payments as non-alimony payments. The division of property was not alimony, but this was a division of debt.

### Joint Returns

**Findling, receiver for Thursfield, E.D. Mich., 2018-2 U.S.T.C. ¶50,309 (6/28/18)**

The IRS could not enforce a lien against an individual's nonqualified plan because he had transferred full interest in the plan to his ex-wife as part of their divorce settlement. She had full interest in the nonqualified plan (while the taxpayer had a reversionary right after her death). A consent judgment had been entered relating to the taxpayer's breach of the prior settlement agreement and which granted the ex-wife a lien against the nonqualified plan.

### Husband-Wife LLC's

**Argosy Technologies, 115 T.C.M. 1159, T.C. Memo. 2018-35 (3/22/2018)**

The Tax Court ruled against husband/wife members of a limited liability company who appealed a determination made at a collection due process hearing regarding a levy with respect to the penalty for failure to file a partnership return. The taxpayers had argued that they weren't liable for the penalty because their entity was a single-member LLC.

## III. EXEMPT ORGANIZATIONS AND THE CHARITABLE DEDUCTION

### <u>Donor Disclosure</u>

**Americans for Prosperity Foundation, 9th Cir., 903 F.3d 1000 (9/11/18)**

Reversing the district court, the Ninth Circuit held that a California charitable registration requirement is constitutional as applied to two tax-exempt organizations, holding the state law to be substantially related to the important state interest of policing charitable fraud, and that the organizations failed to show that it impermissibly burdened their free association rights under the First Amendment.

Tax-exempt charitable organizations must report the names and contributions of donors who have contributed more than $5,000 in a year on Schedule B of Form 990. Although Form 990 must be made available to the public, that requirement does not apply to Schedule B.

California requires charitable organizations to file a copy of their IRS Form 990, including its Schedule B. The information on Schedule B information is kept confidential and is exempt from public inspection except in a judicial or administrative proceeding or in response to a search warrant.

The district court held that the Schedule B requirement is unconstitutional as applied to the plaintiffs, saying the requirement did not have a substantial relation with a sufficiently important governmental interest.

The Ninth Circuit reversed, holding that the Schedule B requirement survives the "exacting scrutiny" standard because it was substantially related to an important state interest in policing charitable fraud. The Ninth Circuit found that the district court applied an erroneous legal standard, which essentially was to require the Attorney General to show that it wasn't possible to accomplish her goals without the Schedule B. Rather, the "substantial relation" element of the exacting scrutiny test merely requires that the strength of the governmental interest reflect the seriousness of the actual burden on First Amendment rights. This element was met as the government interest of ensuring that charities operate in accordance with the law, is significant. The Court found no evidence that disclosure would limit contributors. The mere possibility that some contributors may withhold their support was insufficient to show a substantial burden on First Amendment rights.

**Citizens United and Citizen United Foundation, 2nd Cir., 882 F.3d 374 (2/15/18)**

Affirming a district court, the Second Circuit held that New York's requirement that charities disclose their donors did not violate the First Amendment, nor is it preempted by federal law.

To remain in good standing in New York, a charitable organization must submit annual disclosures, including Form 990 and all of its schedules. The filings are public, unless they are exempt from disclosure pursuant to State or Federal law, as is the case for Schedule B.

Citizens United, exempt under § 501(c)(3), and Citizen United Foundation, exempt under § 501(c)(4), registered with New York's Attorney General in 1995 and submitted disclosures annually, but omitted the parts of Schedule B that identify donors. In 2013, the Attorney General took notice of this failure, and issued a demand for compliance. The organizations have refused to do so, risking revocation of the privilege of soliciting donors in New York.

The organizations asserted that by requiring disclosure, New York created an unconstitutional prior restraint on their speech; that it gave the Attorney General the power to intimidate donors from paying for the communication of their views; that § 501(c)(4) organizations could not be classified as "charitable organizations;" and that it was beyond the state's powers to duplicate the federal government's disclosure requirements. The district court granted the State's motion to dismiss.

The Second Circuit affirmed, applying an "exacting scrutiny" standard of constitutional review – less restrictive than "strict scrutiny." The court found that, in the light most favorable to the organizations, the small chill was more than commensurate with the government's goals in preventing fraud and self-dealing in charities, because the state's law furthered those interests by making it easier to police for such fraud.

While the Court thought it plausible that some donors would find it intolerable for law enforcement officials to know where they had made donations, it found no difference than the case with any other disclosure requirement. The organizations offered nothing to suggest that their donors should more reasonably fear having their identities known to New York's Attorney General than known to IRS. The organizations alleged, but presented no evidence that the Attorney General had a vendetta against them.

The Second Circuit found the law not to be an unconstitutional prior restraint on speech. The law was neutral on its face with respect to content. The law only required the organizations to submit to the State a document they had already prepared and submitted to IRS.

The Second Circuit noted that the Due Process Clause of the Fourteenth Amendment requires that "laws which regulate persons or entities must give fair notice of conduct that is forbidden or required." A change in enforcement priorities does not trigger a notice requirement as long as that change does not alter the standard of behavior required by law. Here, the Attorney General had only stepped up enforcement.

The Second Circuit dismissed the preemption claim. The Court found that the Code does not prohibit other government entities from seeking information directly from the organization.

## Clubs

### Losantiville Country Club, 6th Cir, 122 AFTR 2d ¶2018-5332 (10/15/18)

Because a social club did not intend to profit from its nonmember events, it could not use losses from those events to offset its investment income. A club's losses, to be deductible, must be from activities intended to make a profit. The court rejected the club's attempt to show a profit motive from Regs. § 1.183-2(b), finding that § 183 does not apply to § 501(c)(7) organizations.

## Unrelated Business Income

### New Jersey Council of Teaching Hospitals, 149 T.C. No. 22, (12/20/17)

An organization of tax-exempt teaching hospitals was liable for unrelated business income tax from an agreement with two parties, one of which provided debt collection services and the other provided group purchasing programs.

The debt collection program was administered by a for-profit affiliate. The exempt organization received fees for recommending the collection agency. The taxpayer marketed and administered the group purchasing programs, and received a share of the enrollment fees. The income was not related to its educational purposes, nor was it an activity undertaken primarily for its members' convenience, nor did the revenue consist of royalties exempt from UBIT. There was no substantial relationship between the achievement of the hospital's exempt purposes and the sale of pharmaceutical supplies to members of the general public or to private patients of physicians practicing in a building owned by the hospital. Even if the taxpayer's members derived incidental benefit from the conduct of these two businesses, the taxpayer's primary purpose for engaging in these activities was to raise revenue for itself. Therefore, the business activities that gave rise to the taxpayer's fees were not carried on primarily for the convenience of its members.

## Conservation Easements

### Salt Point Timber LLC, 114 T.C.M. 633, T.C. Memo. 2017-245 (12/11/17)

The Tax Court held that a conservation easement wasn't a qualified conservation contribution because the agreement provided that if certain conditions were met, the holder of a replacement easement could be an entity other than a qualified organization, a contingency that was more than negligible.

## Amount of Deduction

### Green, 10th Circuit, 2018-1 U.S.T.C. ¶50,126 (1/12/18)

Reversing a district court, the Tenth Circuit held that § 642(c)(1), which allows trusts a deduction "without limitation" for any amount of gross income paid for a charitable purpose, does not allow a trust a charitable deduction for the excess of fair market value over adjusted basis of property contributed to a charity, where the property had been purchased by the trust with the trust's gross income. Rather, the charitable trust's deduction for its donation of real property was limited to its adjusted basis in the donated properties. The trust was not entitled to deduct the fair market value of the property because the trust never sold or exchanged the property. Therefore, it never realized the gains associated with the increase in their fair market value or paid tax on those gains.

The trustee contended that a charitable deduction under § 642(c)(1) for donated real property purchased out of gross income should be calculated based on the property's value. The IRS argued that § 642(c)(1) limits a trust's deduction to the amount of gross income it contributed to charity; gross income does not include unrealized appreciation; and a construction of the statute allowing fair market valuation would negate the requirement that the donation be traceable to gross income.

## Quid Pro Quo

### Triumph Mixed Use Investments III 115 T.C.M. 1329, T.C. Memo. 2018-65, (5/15/18)

The Tax Court determined that a real estate development company wasn't entitled to claim a charitable contribution deduction for its transfer of certain open land to a city. The Court found that the transfer was in exchange for the city's approval of its development plan, and that the city's approval constituted a substantial benefit that the taxpayer neither reported nor valued.

## Disqualified Person Liability

### Farr, 10th Cir., 736 Fed. Appx. 969 (10/1/18)

The Tax Court properly sustained the IRS's assessment of first- and second-tier excise taxes against the chief executive officer of a tax-exempt organization because she failed to credibly establish that the economic benefits she derived from using the organization's funds were traceable to any consideration she provided to it. The individual used those funds to defray personal expenses.

## IV. PARTNERSHIPS

### Tax Court Jurisdiction

**Ya Global Investments 151 T.C. No. 2, 2018 BL 291653 (8/08/18)**

A liability stemming from the duty to a foreign partner withhold income under § 1446 was a partnership liability and therefore properly before the Tax Court in a partnership-level proceeding, as were penalties relating to the partnership-item adjustments. The partnership had argued that this liability depends on a partner-level determination of whether the partnership had taxable income effectively connected with a U.S. business, and cannot be addressed until after a partnership-level proceeding is completed. The Service argued, and the court agreed, that the withholding liability fits within the definition of a partnership item under § 6231(a)(3), and more appropriately determined at the partnership level.

### TEFRA Audit Procedures

**Mellow Partners, D.C. Cir. 890 F.3d 1070, 121 AFTR 2d ¶2018-774 (5/22/18)**

A partnership formed by two single-member LLC's wasn't a "small partnership" exempt from TEFRA's audit and litigation proceedings, under former § 6221), repealed in the 2015 Budget Act, which replaced the TEFRA partnership procedures for tax years beginning after Dec. 31, 2017.

The Tax Court concluded that under Reg. §301.6231(a)(1)-1(a)(2), a partnership does not qualify for the small partnership exception if any of its partners is a "pass-thru partner" under former § 6231(a)(9), and that disregarded single-member LLC's are such pass-thru partners. The Court rejected the taxpayer's argument that a single-member LLC's tax classification under the check-the-box regs dictates whether the LLC or its owner is a partner in a partnership."The check-the-box regulations do not determine the tax consequences of a 'separate, higher-level partnership' composed of two or more disregarded entities, nor do they specify who holds a partnership interest for TEFRA purposes," said the court, rejecting the argument that the classification of the LLC's as disregarded entities meant that their individual owners, not the LLC's were the partners for TEFRA purposes.

### Partnership Proceeding

**Dynamo Holdings Limited Partnership, 115 T.C.M. 1293, T.C. Memo. 2018-61 (5/7/18)**

The Tax Court held that IRS does not bear the burden of production with respect to penalties under § 7491(c) in a partnership-level proceeding. Under § 7491(c), IRS has the burden of production in a court proceeding concerning the liability of any individual for any penalty. However, where IRS does not bear the burden of production as to penalties, the lack of supervisory approval of penalties may be raised as a defense to those penalties.

## V. CORPORATIONS

### S Corporation Basis

**Phillips, 11th Cir., 121 AFTR 2d ¶2018-756 (5/17/18)**

An S corporation shareholder couldn't increase her basis in the corporation on account of the fact that the corporation had judgments entered against it, for which she was jointly liable, with respect to loans that she had guaranteed. The mere fact of the judgments without any accompanying payment was insufficient to support a basis increase.

**Meruelo, TC Memo 2018-16 (2/5/18)**

A taxpayer who was a shareholder in an S corporation with a significant loss lacked sufficient basis in the S corporation to absorb the entire loss, rejecting the taxpayer's attempts to recharacterize inter-company transactions as loans, finding there was no actual economic outlay. At year's end, the CPA who prepared tax returns would net a subsidiary's accounts payable to its affiliates, against its accounts receivable from its affiliates. A net account payable would be reported as a "shareholder loan," and allocated on the basis of ownership interests. The CPA drafted documents to created an unsecured line of credit, with charges on the books. There was, however, no evidence of any payments of on the line of credit. The Court rejected the "incorporated pocketbook" theory. In general, for an "incorporated pocketbook" to exist, the taxpayer must show that he had a "habitual practice of having his wholly owned corporation pay money to third parties on his behalf."

### Corporate Status

**Barnhart Ranch Company, 5th Cir., 120 AFTR 2d 2017-5614 (12/20/17)**

A corporation that owned a cattle ranch's business assets and deposited the business's receipts in its bank accounts was the taxpayer. The shareholder-taxpayers unsuccessfully argued that the corporation was merely an accounting arrangement to divide income and expenses among the shareholders. "Absent extraordinary circumstances, a corporation's business is not attributable to its shareholders for tax purposes."

### Debt vs. Equity

**Povolny Group, TC Memo 2018-37 (4/2/18)**

Payments from taxpayer's corporation to his S corporation were a capital contribution that was also a constructive dividend to taxpayer – and not a loan – when the payment did not have an executed note, set an interest rate, ask for security or have a maturity date. The corporation's payments to taxpayer should be taxed as wages when the prevailing general economic conditions, and taxpayer's testimony, showed that the payments were wages and had no formalities of loans.

# VI. CAPITAL GAIN AND BASIS

## Dispositions

### McKelvey, 2nd Cir., 122 AFTR 2d ¶2018-5277, (9/26/18)

Reversing the Tax Court, the Second Circuit held the extension of the settlement dates of two variable prepaid forward contracts resulted in a taxable exchange or a constructive sale. The extension constituted an effective replacement of the original contracts. The Second Circuit also found that the amount of shares to be delivered at settlement was "substantially fixed" such that a constructive sale occurred.

The taxpayer entered into VPFC's in 2007, under which he was obligated to deliver stock worth about $200 million to investment banks on specified dates in 2008. Before the settlement dates, he paid about $12 million to the banks to extend the settlement dates until 2010. After he died, his estate settled the extended contracts by delivering shares worth about $88 million.

The Tax Court held that the 2008 extensions did not constitute sales or exchanges of property, and the open transaction treatment continued until the transactions were closed by the future delivery of stock.

The Second Circuit reversed, agreeing with the IRS that the taxpayer's obligation under each VPFC was ended when he executed the amended contracts, giving rise to short-term gain under § 1234A(1). The extensions resulted in amended contracts that replaced the original VPFC's. A material change to an original contract that fundamentally changes its substance is considered an exchange of the original contract for the amended contract under Rev Rul 90-109. Here, the extensions represented a fundamental change, given that McKelvey paid $12 million to make this change.

## Sale-Leaseback

### Exelon, 7th Cir, 2018-2 U.S.T.C. ¶50,441, (10/3/18)

The Seventh Circuit upheld a Tax Court decision denying like-kind treatment under § 1031 where the taxpayer sold its power plants and deferred tax on the gain by structuring a series of exchanges using sale-leasebacks of interests in other power plants with two unrelated tax-exempt entities. The taxpayer didn't bear the benefits and burdens of ownership in the plants, as the subleases were triple-net leases, with all costs and risks allocated to the sublessees. In effect, the taxpayer's agreements with the other parties in the exchange were not true leases, but were rather loans since the transactions didn't transfer the benefits and burdens of ownership to the power company. Because the transactions were really loans, the taxpayer exchanged its power plants for an interest in financial instruments.

## Intellectual Property

### Cooper, 9th Cir. 2018-1 U.S.T.C. ¶50,102 (12/15/17)

An inventor did not transfer "all substantial rights" to his patents to a licensing corporation that he effectively controlled, so he could not treat the royalties as capital gains. The company's officers and directors acted at the taxpayer's direction, signing checks and contracts as directed by the inventor and his lawyers. The licensing company returned valuable patent rights to the taxpayer for no consideration and then he commercialized the patents through a separate entity. Thus, while the taxpayer complied with the formal requirements of § 1235, he effectively controlled the transferee so that there was not a transfer of all substantial rights to the patents.

### Spireas, 3rd Cir., 121 AFTR 2d ¶2018-589 (3/26/18)

The Court of Appeals for the Third Circuit, affirming the Tax Court, held that amounts received by a taxpayer from a pharmaceutical company were royalties taxable as ordinary income, not as capital gains, because he retained valuable rights to the technology.

## Forfeited Deposit

### Cri-Leslie, LLC, 11th Cir., 121 AFTR 2d 2018-455 (2/15/18)

Not all real estate is a capital asset. The Eleventh Circuit affirmed that a taxpayer wasn't entitled to capital gain treatment under § 1234A for its right to retain forfeited deposits from a canceled sale of real property used in its hotel business because the realty wasn't a "capital asset," but rather was § 1231 property. Because § 1234A refers only to property that is "a capital asset in the hands of the taxpayer," and since property described in § 1231 is excluded explicitly from the definition of "capital asset" in § 1221, the treatment of § 1234A does not extend to § 1231 property.

## Short Sale

### Simonsen, 150 TC No. 8 (3/14/18)

The Tax Court held that the short sale of the taxpayers' principal residence, which had been converted into rental property, followed by the mortgagee's forgiveness of the taxpayers' debt on the residence, were part of one sale or exchange, not two separate transactions. As a result, the amount realized in that single transaction included the discharged nonrecourse debt. There was no cancellation of debt income. The amount realized was greater than the loss basis in the property under, but less than the gain basis in the property. When property is sold for an amount between those bases, there is neither a gain nor a loss on the sale.

## Applicable Asset Acquisitions

### Alta Wind I, Fed Cir., 2018-2 U.S.T.C. ¶50,357 (7/27/18)

Wind farms that were sold before their first use could include goodwill, so they were applicable asset acquisitions under § 1060, which required parties to use the residual method to allocate the purchase price among the assets.

The taxpayers bought several new wind farms, placed them in service, and then applied for the federal grants. The applications assigned almost all of the purchase price to the taxpayers' bases in grant-eligible tangible properties. The IRS contended the farms included goodwill, which requires the residual method, under which amounts allocated to tangible properties are limited to their fair market value. Any additional amounts must be allocated to intangible property.

The Claims Court agreed with the taxpayers. Since the wind farms did not operate before the sale, they could not have any goodwill or going concern value. The Appeals Court reversed, because no blanket rule precluded a new business from having goodwill and going concern value. A sale was an applicable asset acquisition if goodwill could attach to the assets. Thus, the assets did not have to include actual, accrued goodwill. The farms' power purchase agreements that obligated their main customer to buy power at an agreed-upon price were, at least in part, customer-based intangibles. The fact that the agreements imposed a contractual obligation on the customers did not mean prevent them from including goodwill.

## VII. BANKRUPTCY

**Hunsaker, 9th Cir., 122 AFTR 2d ¶2018-5187 (8/30/18)**

Reversing the district court, which had reversed the bankruptcy court, the Ninth Circuit held that sovereign immunity does not preclude an award of emotional distress damages against the U.S. for IRS's willful violation of an automatic bankruptcy stay. The IRS sent multiple collection notices to the debtors after being notified of the automatic stay. The debtors claimed these were willful violations of the automatic stay under the bankruptcy code. Disagreeing with a holding in the First Circuit, the court determined that the award of emotional distress damages is a form of monetary relief – compensatory damages – but is not punitive, and thus falls within the scope of the waiver of sovereign immunity. The Court found that in 11 USC § 106(a), Congress waived sovereign immunity for a "money recovery" under certain bankruptcy provisions, including 11 USC § 362(k), which allows an individual to recover "actual damages" for a willful violation of the automatic stay.

### Inherited IRA

**Lerbakken, 8th Cir., 2018-2 U.S.T.C. ¶50,454, (10/16/18)**

The Eighth Circuit's bankruptcy appellate panel held that an inherited IRA is not considered "retirement funds" under §522(b)(3)(C) of the Bankruptcy Code, which exempts such funds from the bankruptcy estate. The debtor received half of his wife's retirement accounts in a divorce. The court stated that the exemption for retirement accounts is limited to those who create and contribute funds. His interest in the accounts resulted from nothing more than a property settlement.

### Tax Liens

**Quinones, U.S. Bankruptcy Court, D. Puerto Rico, 2018-1 U.S.T.C. ¶50,132, (12/29/17)**

A federal bankruptcy court has jurisdiction to strip down or strip off IRS tax liens. The court has jurisdiction over core proceedings, which included the determination of the validity, extent or priority of tax liens. The government waived sovereign immunity by filing a proof of claim. Section 506 of the Bankruptcy Code allows a debtor to request liens to be stripped from the estate's property, and therefore abrogates the IRS's sovereign immunity. It is the debtor's option to "cram down" its creditors through the plan.

# VIII. EMPLOYMENT AND PAYROLL

## Disputed 1099's

### Angelopoulos v. Keystone Orthopedic, N.D. Ill., 2018-1 U.S.T.C. ¶50,139 (1/18/18)

An anesthesiologist was granted a claim for damages for a fraudulent Form 1099 filed in his name by his former business partner, the partner's medical practice and an entity he jointly owned with the partner and other physicians.

The court recognized that since a taxpayer may need to initiate costly proceedings to resolve the receipt of a fraudulently inflated 1099, it would be unjust not to compensate the taxpayer for the costs of such proceedings. Because distinguishing between a proper and a fraudulent 1099 filing could require both legal and accounting assistance, attorneys' fees and expert witness fees properly lie within the scope of expenses potentially reimbursable to a wronged taxpayer. The court used reasonableness as its touchstone in considering the individual's request for fees.

## Self-Employment Tax

### Sherman, T.C. Summary Opinion 2018-15 (4/2/18)

Payments of post-retirement nonqualified deferred compensation made to a retired Mary Kay independent contractor were subject to self-employment tax, even though the taxpayer had ceased to work for the company by the time she received them. The payments were tied to the quantity and quality of the taxpayer's labor. They were based on her age at retirement and her average commissions for the five years prior to retirement and were tied to the performance of her sales network after she retired. Further, the taxpayer was explicitly informed by the company that the payments were deferred compensation under the program agreement and were subject to self-employment tax.

## IX. RETIREMENT PLANS

### Contribution Limits

### Mazzei, (2018) 150 TC No. 7 (3/5/18)

In a reviewed opinion, the Tax Court found that the substance over form doctrine prevented the taxpayers from using a transaction involving a foreign sales corporation to exceed contribution limits to a Roth IRA.

The taxpayers used a foreign sales corporation to funnel corporate dividends into Roth IRA's, which then purchased company stock. The taxpayers were held to be the owners of such stock and liable for the excise tax on the excess contributions under § 4973. Citing *Summa Holdings*, 848 F.3d 779 (6th Cir.2017), the court held that the Roth IRAs' purchase of stock lacked substance, and the dividends were income to the taxpayers.

The taxpayers contributed $2,000 to new Roth IRA's in 1998, which paid a nominal amount for stock in an FSC. Over five years, the taxpayers routed payments totaling $533,057 from their family business, through the FSC, and into their Roth IRA's.

In form, the Court found that the taxpayers' Roth IRA's purchased FSC stock for $1 while the FSC entered into a series of contracts as part of the plan of purchase. The Roth IRA's effectively paid nothing for the FSC stock, put nothing at risk, and from an objective perspective, could not have expected any benefits. From that nominal initial investment, the taxpayers claim that their Roth IRA's earned dividends totaling $533,057 over four years.

The Court disregarded the purchase, because the form of the transactions did not reflect the underlying related party expectations and intentions. The taxpayers' transactions attempted to utilize this mismatch between substance and form to defeat the contribution limits.

Further, because the taxpayers, through passthrough entities, controlled every aspect of the transactions, the Court concluded that they, and not their Roth IRA's, were the owners of the FSC stock for Federal tax purposes at all relevant times. The dividends from the FSC were therefore properly recharacterized as dividends from the FSC to the taxpayers, followed by the taxpayers' contributions of these amounts to their respective Roth IRA's. All of these payments exceeded the applicable contribution limits and were therefore excess contributions.

### Benenson, 1st Cir., 121 AFTR 2d ¶2018-634 (4/6/18)

The First Circuit, reversing the Tax Court, upheld the taxpayers' use of a domestic international sales corporation to transfer amounts from a C corporation to Roth IRA's of the controlling shareholder's sons, with the result that each IRA exceeded $3 million over a short period.

The taxpayers' business paid DISC commissions, which passed as dividends through another family entity, to the taxpayers' Roth IRA's. The Tax Court affirmed the Service's recharacterization of the transaction under the substance-over-form doctrine, finding the transaction's only purpose was shifting "millions of dollars into Roth IRA's in violation of statutory contribution limits."

IRS argued that the taxpayers shifted value to the Roth IRA's far in excess of contribution limits, and that simply labeling the payments as DISC commissions did not immunize the payments from the application of substance-over-form principles.

The First Circuit majority sided with the taxpayers. The Court reasoned that no contribution will be accepted by a Roth IRA unless it is in cash. Once a contribution is made in cash, the cash can be invested, subject to certain limitations. Both traditional and Roth IRA's are allowed to own shares in C corporations. Taxpayers may direct IRA's to purchase shares of C corporations. Congress was aware of existing law when it passed legislation, particularly here, where Congress commanded in § 408A that, unless otherwise provided, Roth IRA's are to be treated in the same manner as traditional IRA's. Accordingly, the Court assumed that when Congress created Roth IRA's, it was aware that traditional IRA's could receive dividends from both C corporations and DISC's and was comfortable with Roth IRA's engaging in the same transactions, so long as a tax equal to the corporate income tax, either under § 246(d) or under § 995(g), was paid.

Judge Lynch dissented, finding the IRS correctly recharacterized the transaction. The majority was wrong to hold that, because Congress intended a limited tax benefit through the use of a DISC, Congress intended, without saying so, to implicitly set aside its limit on Roth IRA contributions, an entirely different tax benefit. Here, the DISC was not used for the purpose intended by Congress, but to evade the Roth IRA contribution limits. The statutory provisions adverted to by the majority did not support its conclusion. Congress did not intend the use of DISC's to circumvent well established Roth IRA contribution limits and certainly did not say so.

## QDRO

### Kirkpatrick, TC Memo 2018-20 (2/2218)

A taxpayer who, to comply with a court order in his divorce proceedings, withdrew funds from his IRA's, deposited them in his checking account from which he wrote checks to his then-wife, failed to qualify for the § 408(d)(6) exclusion from gross income for transfers of accounts incident to divorce. The divorce court ordered him to directly transfer funds to his ex-wife's IRA in a nontaxable transaction. However, the taxpayer withdrew the funds from his IRA's, deposited them in his checking account, and then wrote checks to his ex-wife and others. In addition, there was no IRA in his ex-wife's name at the time of the distribution; therefore, there was no IRA to which he could transfer. Finally, taking distributions from IRA's and then writing checks is not the appropriate form for a tax-free transfer incident to divorce under Sec. 408(d)(6). Accordingly, the spousal transfer exception did not apply and the distribution was taxable income

## X. PROCEDURE

### Execution

**Nassar, 2nd Cir., 2017-2 U.S.T.C. ¶50,393 (Oct. 20, 2017)**

The IRS was entitled to foreclose the tax liens on the condominium in which a tax debtor lived. The individual had an outstanding tax liability that was a lien on all of his property and rights to property. The district court applied a fact-specific six-factor nominee test to determine that the tax debtor was the beneficial owner of the condominium and the legal title holder was merely his nominee. Therefore, the individual's ownership interest in the condominium was subject to the tax lien. Accordingly, the government was entitled to foreclose its lien on the condominium.

### Privilege

**Marion Levine Estate, Docket 13370-13 2017 BL 498701 (10/26/17)**

The Tax Court concluded that where a taxpayer asserts a good faith and reasonable cause defense, he doesn't necessarily waive the work product privilege for documents produced in anticipation of litigation. Accordingly, IRS's subpoena served on taxpayer's attorney was limited to the period ending on the date IRS issued a notice of deficiency.

### Amended Returns

**Ramsay, 5th Cir., 2018-2 U.S.T.C. ¶50,345, (7/23/18)**

The Fifth Circuit agreed that the IRS was not required to process a second amended return filed by an individual that excluded imputed income from a former employer's purchase of a life insurance policy. The individual reported the imputed income related to a life insurance policy on his original return and indicated that he wanted his overpayment applied to his next year's tax liability. However, the taxpayer changed his reporting position by filing an amended return that removed the imputed income and included capital gains and dividend income omitted from his original return after the IRS sent him a deficiency notice. Accepting or rejecting an amended return is solely within the IRS's discretion.

### Transferee Liability

**Slone, 9th Cir., 122 AFTR 2d ¶2018-5071 (7/24/18)**

Reversing the Tax Court, the Ninth Circuit found that shareholders were liable as transferees under § 6901 for tax liabilities arising from a sale of all of their company's assets followed by a sale of all the company's stock. The stock sale operated in substance as a liquidating distribution by their company to the taxpayers in a form that was designed to avoid tax liability.

The company sold its assets for $45 million. The capital gain of $38 million caused income tax of $15.3 million. The company paid the first quarterly installment of the federal liability.

Before the sale closed, a third party expressed interest in a merger, under which it would purchase all of the company's shares for $29.8 million, then restructure the company to engage in the asset recovery business. The shareholders agreed to sell all of their shares to the third party for $35.8 million. The third party agreed to assume the company's income tax liability.

After the merger, a shareholder of the third party contributed assets with a basis of $38.1 million to the third party, which sold them for $108,731. The third party reported the $38 million gain from the asset sale and a loss of $38 million from the second sale. Claiming it had no income tax liability, the third party requested a refund for the installment paid by the original company.

The Tax Court refused to apply substance over form, and respected the transaction. The Ninth Circuit reversed, finding that the Tax Court did not address whether the shareholders had a business purpose for entering into the stock purchase transaction other than tax avoidance, and whether the stock purchase transaction had economic substance other than shielding shareholders from tax liability. On remand, the Tax Court again found that the form of the transaction had to be respected and that the shareholders weren't substantively liable for the unpaid taxes under State law.

On a second appeal, applying the state's Uniform Fraudulent Transfers Act, the Ninth Circuit held that the transaction was constructively fraudulent as to IRS because the original company did not receive a reasonably equivalent value in exchange for the transfer to the shareholders and was left unable to satisfy its tax obligation. The Ninth Circuit determined that the sale to the third party was a cash-for-cash exchange lacking independent economic substance beyond tax avoidance, and that reasonable actors in the taxpayers' position would have been on notice that the third party never intended to pay the original company's tax obligation.

The Ninth Circuit found that the financing of the stock sale demonstrated that the deal was only about tax avoidance. The third party borrowed the funds to make the purchase. After the merger, the third party could have repaid the loan over time and retained sufficient capital to sustain its purported debt collection enterprise and cover the tax obligation – had it been intended to be a legitimate business enterprise. Instead, the financing was structured so that, after the merger, the original company's significant cash holdings were immediately used to repay the loan the third party used to finance its purchase of the stock and tax liability.

**Park, N.D. Ill, 2017 BL 357951, 2017 WL 4417826 (1/4/18)**

The government's attempt to collect an FBAR penalty from a deceased taxpayer's children was dismissed. The complaint filed to state a claim under the Illinois Uniform Fraudulent Transfer Act because it failed to describe with particularity the precise circumstances of the alleged transfers, and did not contain a particularized description of the events surrounding conveyance of the decedent's or trust's assets to his children. Moreover, by the terms of the trust, the decedent's widow was the primary trustee and beneficiary of the trust during her lifetime, not the children.

Accordingly, there was no more than a possibility that the decedent's or the trust's assets were transferred to the children or that they exercised control over those assets.

**Schmidt, W.D. Washington, 2018-1 U.S.T.C. ¶50,156, (2/8/18)**

The government was not entitled to foreclose tax liens on a property that was sold by the taxpayer to a third party in exchange for a release from a prior liability. The government failed to show that the property was transferred with actual intent to hinder, delay or defraud its efforts to collect back taxes as required by the state (Washington) Uniform Fraudulent Transfer Act.

The first notice of federal tax lien was not recorded until after the property had been transferred to the buyer. In addition, the buyer was able to establish his entitlement to protection as a "purchaser" under § 6323(a). Therefore, the tax lien did not attach to the property.

**Timely Mailing**

**Pearson, 149 TC No. 20 (11/30/17)**

In a reviewed opinion with two dissenters, the Tax Court held that a Stamps.com label was a "postmark" not made by the United States Postal Service for purposes of the mailbox rule, and under the circumstances, a Tax Court petition was timely filed. The date when the Postal Service entered the taxpayer's envelope into its tracking system was not the equivalent of a postmark date and thus is irrelevant for purposes of the timely-mailing-as-timely-filing rule of § 7502.

The Stamps.com postage label does not literally "mark" the entry of mail into the postal system; the date on that label indicates the date on which the consumer purchased the postage and electronically generated the label. Earlier cases held that the date appearing on a Stamps.com postage label should be regarded as a "postmark not made by the United States Postal Service," so that because of expert testimony that the envelope was "most likely deposited" with the USPS on a timely basis, the envelope with the petition was thus received no later than when a document would ordinarily be received if it were postmarked by the USPS on the last date prescribed for filing.

**Summons**

**Pate, 8th Cir., 121 AFTR 2d ¶2018-415 (2/6/18)**

The Eighth Circuit affirmed a district court decision to enforce an IRS summons against married taxpayers on the basis of their blanket assertion of the Fifth Amendment privilege against self-incrimination. The Court found that, rather than making any specific objections in response to specific questions, the taxpayers simply refused to answer every question asked of them, including those that were "innocuous on their face."

**Hohman v. Eadie, 6th Cir., 122 AFTR 2d ¶ 2018-5014, 894 F.3d 776 (7/5/18)**

Claims by two LLC's that IRS violated the Right to Financial Privacy Act by issuing John Doe summonses for their financial information without prior court approval were dismissed. An LLC isn't treated like a partnership under federal privacy law

The IRS issued John Doe summonses, without the court approval required by § 7609(f), served the summonses on a bank to obtain financial records relating to two single-member LLC's. Under 12 *U.S.C.* § 3417, a federal agency that obtains financial records in violation of that provision can be held liable. A "person" who can maintain such an action is defined as "an individual or a partnership of five or fewer individuals." Although a single-member LLC resembles individuals or partnerships covered under the Act, it is not described in the statute, so soverien immunity was not waived.

## Summary Judgment

**Stein, 11th Cir., 121 AFTR 2d 2018-392 (1/31/18)**

Ruling en banc, the Eleventh Circuit vacated its prior decision in the case and overruled its precedent in a 1985 case to find that an affidavit which satisfies Rule 56 of the Federal Rules of Civil Procedure may create an issue of material fact and preclude summary judgment even if it is self-serving and uncorroborated.

In the prior case, *Mays v. U.S.*, 56 AFTR 2d 85-5335, the Eleventh Circuit held that a taxpayer's submissions were insufficient to create an issue for trial, because a taxpayer's claim "must be substantiated by something other than tax returns, uncorroborated oral testimony, or self-serving statements."

While an affidavit opposing summary judgment cannot be conclusory, nothing in Rule 56 prohibits an affidavit from being self-serving. Most affidavits submitted in response to a summary judgment motion are self-serving. Further, most of the Eleventh Circuit's cases correctly explain that a litigant's self-serving statements based on personal knowledge or observation can defeat summary judgment.

**To the same effect: McClendon, 5th Cir., 2018-1 U.S.T.C. ¶50,283, (6/14/18)**

## Penalties

### Palm Canyon X Investments, D.C. Cir., 121 AFTR 2d ¶ 2018-475 (2/16/18)

The D.C. Circuit found that the Tax Court properly concluded that the facts and circumstances foreclosed a reasonable-cause defense to the gross valuation misstatement penalty. The taxpayer's decision to proceed with a Son-of-BOSS transaction in the face of IRS's express warning against such schemes, in reliance only on advice provided by the tax shelter's promoters, was neither reasonable nor taken in good faith.

## Good Faith Reliance

### Larson, TC Memo 2018-30, 96 T.C.M. 73 (8/5/18)

The Tax Court held that where a taxpayer gave his tax information to his preparer, and the preparer prepared the taxpayer's return without any further interaction with the taxpayer, the taxpayer did not show reasonable cause and good faith via reliance on the advice of a tax professional for purposes of the substantial underpayment penalty.

The taxpayer gave his CPA the checks he wrote and information about the purpose of each check, but he did not generally provide receipts. He could not state definitively whether he had provided to the preparer backup receipts for the totals claimed as travel expenses on his return. He testified that he gave the preparer the items and amounts claimed for the casualty loss. The CPA asked no questions, and the taxpayer asked for no advice.

## Full-Payment Rule

### Auto Pride Collision East, E. D. Mich. 120 AFTR 2d 2017-5578 (12/21/17)

Where there is no dispute as to a taxpayer's underlying tax liability, but there is a dispute with respect to a penalty, a taxpayer who pays the tax liability but not the penalty has not met the jurisdictional requirements to have his case for abatement of the penalty heard by a district court.

### Larson, 2nd Cir., 121 AFTR 2d ¶2018-695 (4/25/18)

A tax shelter promoter's suit seeking a refund of penalties under § 6707 was dismissed because he didn't fully pay the entire amount of the assessed penalties. The Second Circuit also upheld the district court's rejection of his remaining claims seeking judicial review of IRS's penalty determination under the Administrative Procedure Act (APA) and challenging the penalties as excessive under the Eighth Amendment.

## Recovery of Attorney's Fees

### Johnson, D. Utah, 2018-1 U.S.T.C. ¶50,124, (Jan. 8, 2018)

A decedent's children, who were unsuccessfully sued by the government for estate taxes, were entitled to reasonable fees and costs. The individuals limited their fee request to the issues on which they substantially prevailed. Moreover, the government's positions on those issues were not substantially justified.

The court rejected the government's assertions that it required a written application other than the one it received. The government could not identify a "proper" method of making a written application for a special lien. Moreover, the government's legal arguments contradicted its own published guidance, misinterpreted the plain language of statutes and regulations, ignored relevant provisions of other statutes and regulations, and conflicted with the undisputed purpose of § 6166.

Further, the government's position that the trust's assets were included in the gross estate was not substantially justified. The government failed to present any factual or legal arguments that reasonably supported a conclusion that the decedent divested herself of the beneficial ownership of her trust assets during her lifetime. Finally, the government waited too long to enforce the distribution agreement and foreclose its tax lien. It was not reasonable to shift the responsibility for the IRS's own errors and lapses to the taxpayers.

# XI. PRACTICE

## Tax Promoter Penalty

### RB-1 Investments Partner, 115 T.C.M. 1323, T.C. Memo. 2018-64 (5/14/18)

Because a law firm's involvement with the taxpayer's investment in a sham tax shelter was so great, the law firm was treated as a promoter, so a taxpayer that was formed to engage in a Son of Boss tax shelter could not claim good-faith reliance on the law firm's advice for purposes of the reasonable cause exception to the valuation misstatement penalty.

## Attorney-Client Privilege

### Servin, 3rd Cir., 2018-1 U.S.T.C. ¶50,167 (2/1/18)

The IRS issued the summonses as part of its efforts to collect the lawyer's unpaid taxes, requesting names and addressees of his current clients, and a list of his settled cases. The attorney argued that compliance would violate attorney-client privilege, as well as Pennsylvania rules of professional conduct.

The Third Circuit held that the district court properly enforced the summonses. Attorney-client privilege only protects against disclosure of confidential communications. Absent unusual circumstances, the privilege does not protect against disclosing clients' identities.

## Tax Preparation Software

### Diaz v. Intuit, Inc., N.D. Cal., 2018 BL 172907 (2/15/18)

A California district court held that where hackers used TurboTax software to create fraudulent returns in the name of two innocent taxpayers, Intuit, the creator of the product, was not liable for the damages incurred by the innocent taxpayers, even though Intuit should have seen signs of suspicious behavior because of the use of a high risk domain. The court dismissed claims for negligence, and for aiding and abetting fraud.

## XII. INTERNATIONAL

### FBAR

#### Bussell, 9th Cir., 2017-2 U.S.T.C. ¶50,384 (October 25, 2017)

A $1.2 million penalty for failure to file a Report of Foreign Bank and Financial Accounts did not violate the Eighth Amendment's Excessive Fines Clause because it was not grossly disproportionate to the harm caused by the fraud and reduction of public revenues, held the Ninth Circuit in a ruling that the Supreme Court let stand, denying certiorari, 4/30/18.

### Omission of Foreign Asset Income

#### Rafizadeh, 150 T.C. No. 1, 2018 BL 8013 (1/2/18)

The extended six-year statute of limitations during which the IRS may assess for omitting foreign asset income only applies to assets for which there was a § 6038D reporting requirement when the income was omitted. The taxpayer filed a timely return, but did not report income earned on a foreign account. After obtaining this information through a summons, the IRS issued a deficiency notice, beyond the three-year limitations period. Although § 6501(e)(1)(A)(ii) extends the limitations period for the omission of gross income from assets subject to the § 6038D reporting requirements, to six years, the taxpayer did not have an obligation to report the information required by § 6038D. The returns at issue were filed before § 6038D became effective on March 10, 2010.

### Captive Insurance

#### Reserve Mechanical, 115 T.C.M. 1475, T.C. Memo. 2018-86 (06/18/2018)

The Tax Court concluded that the transactions that the taxpayer, a foreign captive insurance company, executed weren't insurance contracts for Federal income tax purposes and that the taxpayer wasn't an insurance company exempt from tax under § 501(c)(15).

Generally, payments to captive insurance subsidiaries or other similar arrangements are not deductible where there's no true risk-shifting. Cases analyzing captive insurance arrangements require an insurance risk; shifting and distributing of that risk; and insurance in its commonly accepted sense.

The Tax Court determined that the taxpayer's transactions were not insurance transactions, because the taxpayer issued a dozen policies for three insureds that covered up to $13 million. Two of the insureds, however, had insignificant operations, so substantially all risk of loss was associated with just one insured. The number of insureds and independent exposures were too few to distribute the risk that the taxpayer assumed under the policies. Further, under stop loss endorsements, the reinsurance vendor was liable only after a substantial threshold was exceeded.

## Foreign Ship Income Exclusion

### Good Fortune Shipping, D.C. Cir., 897 F.3d 256 (7/27/18)

A pre-2010 regulation provided an exemption from U.S. tax of certain foreign corporation shipping income, depending on the ownership of the corporation's stock, but it did not apply if that ownership was via bearer stock.

The D.C. Circuit held this regulation to be unreasonable and invalid by the D.C. Circuit. A shipping company argued that the categorical exclusion under Regs. § 1.883-4, was an impermissible interpretation of § 883. The court held that the IRS couldn't justify treating all bearer shares as incapable of proving ownership for meeting the "qualified shareholder test." The court also noted that the risk of abusively using bearer shares to hide ownership in the shipping industry was not a valid argument for the IRS when the regulations under § 884 provide that bearer shares can prove ownership, and therefore, proves an inconsistency.

## Credit vs. Deduction

### Trusted Media Brands, 2nd Circ., 122 AFTR 2d ¶ 2018-5123 (8/10/18)

The Second Circuit held that a taxpayer that first claimed a foreign tax credit for foreign taxes paid, then later amended its return to instead claim a deduction, could not avail itself of the 10-year limitations period in § 6511(d)(3). Thus, the taxpayer's refund suit was untimely.

Section 6511(d)(3)(A) provides that if a claim for credit or refund relates to an overpayment attributable to a tax paid to a foreign country for which credit is allowed under § 901, in lieu of the standard three-year period prescribed in § 6511(a), the period is ten years from the date prescribed for the filing of the return for the tax year in which the foreign tax was actually paid or accrued.

The Second Circuit agreed with the IRS and the district court that the special 10-year limitations period applies only to overpayments attributable to foreign taxes for which the taxpayer elects to claim a credit—and not those which the taxpayer chose to deduct despite being eligible to claim a credit.

###