CPE

Quarterly Federal Tax Update – First Quarter 2016

Federal Tax Update—First Quarter 2016

Title

Federal Tax Update—First Quarter 2016

Field of Study

Taxation

Course Description

This course provides various tax update items and other federal tax highlights.

Objectives

- Identify key recent federal tax developments that will affect various types of clients.
- Apply key recent federal tax developments that will affect individual taxpayers.
- Assess key recent federal tax developments that will affect business taxpayers.

Target Participants

CPAs in industry and public practice

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Federal Tax Update—First Quarter 2016

Highlights for Various Types of Taxpayers

- Second Quarter 2016 Interest Rates on Federal Tax Overpayments and Underpayments Go Up
- Second Circuit: Corporate Tax Overpayment Interest Rate Applies to Nonprofit Corporations
- New Law Increases Some Tax Return Failure-to-File Penalties
- IRS Announces 2016 Inflation Adjustments Mandated by PATH Act
- IRS Announces Payroll Tax Correction Procedures for Retroactive Increase in Tax-Free Employer-Provided Transportation Benefits

Highlights for Individual Taxpayers

- Passive Activity Developments
- Alimony Deduction Developments
- Update on Tax Treatment of Personal Injury Awards and Settlements
- Hobby Loss Developments
- Estate Tax Developments
- Attorney Fees Incurred by Individual Taxpayer Were Not Deductible Business Expenses

Highlights for Business Taxpayers

- IRS: Higher Audit Rates for S Corporations and Partnerships
- Tax Court: IRS Correctly Assessed Penalties against Law Firm That Mischaracterized Shareholder-Employee Bonuses
- Tax Court Affirmed: Unfavorable Recharacterization Rule Converted S Corporation's Net Rental Income into Nonpassive Income
- IRS: Impact of LLC Member's Debt Guarantee on other Members' Basis in Their Interests and At-Risk Amounts

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Key Tax Developments Affecting Various Types of Taxpayers

SECOND QUARTER 2016 INTEREST RATES ON FEDERAL TAX OVERPAYMENTS AND UNDERPAYMENTS INCREASE

The interest rates that apply to federal tax overpayments and underpayments for the second quarter of 2016 are 1 percent higher than for the first quarter (Rev. Rul. 2016-6 and IRC Sec. 6621). Before this increase, the rates had been 1 percent lower for 17 consecutive quarters. The increased rates for the second quarter are as follows:

- 4 percent for overpayments and underpayments by unincorporated taxpayers and most corporate underpayments.
- 3 percent for most corporate overpayments.
- 1.5 percent for the portion of a corporate overpayment that exceeds $10,000.
- 6 percent for large corporate underpayments (generally underpayments by C corporations in excess of $100,000).

SECOND CIRCUIT: CORPORATE TAX OVERPAYMENT INTEREST RATE APPLIES TO NONPROFIT CORPORATIONS

In a recent decision, the Second Circuit Court of Appeals concluded that a nonprofit hospital that was due a refund of overpaid FICA taxes was only entitled to the lower corporate interest rate on the tax overpayment. While the hospital was organized as a corporation (under state law and for purposes of federal tax-exempt status), it argued that it was entitled to the higher interest rate that applies to federal tax overpayments by non-corporate taxpayers. Specifically, the hospital claimed that the word "corporation" in IRC Sec. 6621(a)(1) refers only to for-profit entities. In affirming an earlier District Court decision, the Second Circuit concluded that the lower interest rates on corporate federal tax overpayments apply equally to "regular" corporations and nonprofit corporations. So the hospital was out of luck. [See *Maimonides Medical Center*, 116 AFTR 2d 2015-7091 (2nd Cir. 2015).]

Key Point: An earlier Court of Federal Claims decision reached the same conclusion for interest due on federal tax overpayments by S corporations. [See *Eaglehawk Carbon, Inc.*, 116 AFTR 2d 2015-5245 (Ct. Fed. Cl. 2015).]

NEW LAW INCREASES SOME TAX RETURN FAILURE-TO-FILE PENALTIES

On February 24, 2016, the Trade Facilitation and Trade Enforcement Act of 2015 was signed into law. The new law makes permanent the Internet Tax Freedom Act (which bans taxes on Internet access) and also includes a number of tax provisions, including stiffer penalties for failure to file certain types of federal tax returns—including income, estate, and gift tax returns. Under prior law, the minimum penalty for failure to file such returns within 60 days of the due date (including extensions) generally equaled the

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lesser of (1) $135 or (2) 100 percent of the amount of tax required to be shown on the return. The new law raises the minimum penalty to $205 or 100 percent of the amount of tax required to be shown on the return, effective for returns required to be filed after December, 31, 2015. [See IRC Sec. 6651(a), as amended.]

IRS Announces 2016 Inflation-Adjusted Amounts Mandated by PATH Act

The Protecting Americans from Tax Hikes Act of 2015 (the PATH Act) mandated inflation adjustments for certain tax items. In Rev. Proc. 2016-14, the IRS announced the following inflation-adjusted amounts for 2016 pursuant to the PATH Act's mandate.

- The maximum Section 179 deduction is $500,000 (same as for 2015).
- The threshold for the Section 179 deduction phase-out rule is $2.01 million of qualifying property additions (up from $2 million for 2015).
- The above-the-line deduction for K-12 teachers' expenses is $250 (same as for 2015).
- The maximum tax-free amount for employer-provided transit passes and vanpooling benefits is $255 (up from $250 for 2015).

IRS Announces Payroll Tax Correction Procedures for Retroactive Increase in Tax-Free Employer-Provided Transportation Benefits

For 2014, employer-provided parking allowances were tax-free up to a monthly limit of $250, and an employee could be given up to the same amount for tax-free mass transit passes or company-provided vanpooling (or both combined). However, for post-2014 years, parity between the tax-free allowances for parking and transit benefits was allowed to expire. However, the PATH Act made parity permanent for 2015 (retroactively) and later years. Specifically, for 2015, the maximum tax-free monthly allowance for transit passes and vanpooling was retroactively increased to $250 (same as the allowance for parking). Without the PATH Act, the allowance for transit benefits would have been only $130 for both 2015 and 2016. [See IRC Sec. 132(f).] In Notice 2016-6, the IRS explains how employers should handle the retroactive increase in the 2015 monthly tax-free allowance for transit passes and vanpooling (from $130 to $250). Procedures are supplied for filing Forms 941 (Employer's Quarterly Federal Tax Return) for the fourth quarter of 2015 and 2015 Forms W-2 for affected employees.

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Key Tax Developments Affecting Individual Taxpayers

Passive Activity Developments

The Section 469 passive activity loss (PAL) rules can limit a taxpayer's ability to claim current federal income tax deductions for losses thrown off by passive activities. However, when the taxpayer *materially participates* in an activity for the tax year, the taxpayer is exempt from the PAL limitations for that activity for that year. Therefore, the taxpayer can currently deduct the losses from that activity for that year unless some other tax rule prevents this outcome (such as a lack of at-risk basis).

Material Participation Tests

Temp. Reg. 1.469-5T(a) prescribes seven tests to determine if a taxpayer can meet the material participation standard with respect to a particular business activity. If one or more of these tests are passed for the tax year in question, the taxpayer meets the material participation standard for that activity for that year, which means the PAL rules are inapplicable to that activity for that year. The seven tests can be summarized as follows.

1. More-Than-500-Hours Test: This test is passed if the taxpayer participates in the activity for more than 500 hours during the year.

2. Substantially-All Test: This test is passed if the taxpayer's participation in the activity during the year constitutes substantially all the participation by all individuals (including those who are not owners of interests in the activity) during that year.

3. More-Than-100-Hours Test: This test is passed if the taxpayer participates in the activity for more than 100 hours during the year, and no other individual participates more than the taxpayer during that year.

4. Significant Participation Activity (SPA) Test: This test is passed if the activity is a SPA (as defined in Temp. Reg. 1.469-5T) in which the taxpayer participates for more than 100 hours during the year, and the taxpayer's total participation in all SPAs during the year exceeds 500 hours.

5. Prior-Year Material Participation Test: This test is passed for the year if the taxpayer materially participated in the activity for any five of the ten immediately preceding years.

6. Personal Service Activity Test: This test is passed for the year if the activity is a personal service activity, and the taxpayer materially participated in the activity for any three preceding years.

7. Facts and Circumstances Test: This test is passed if consideration of relevant facts and circumstances dictate that the taxpayer materially participated in the activity on a regular, continuous, and substantial basis. The taxpayer must participate for more than 100 hours to be eligible for this test.

Tax Court: Boat Charter Business Was Non-Passive Activity

The Tax Court recently decided that the PAL rules did not apply to a married couple's losses from a boat chartering business. The husband was an airline pilot and the wife was a nutritionist. The taxpayers provided credible testimony and reconstructed records of the time they spent on the charter activity and

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showed that they spent over 100 hours and more time than any other individuals on the activity. Therefore, they passed the more-than-100 hours test for the activity and thereby met the material participation standard for the activity. So they could deduct the boat charter losses without regard to the PAL rules. The fact that some of the charter customers were friends and acquaintances of the husband did not convert those charters into personal vacations, as the IRS claimed. (See *Larry Kline*, TC Memo 2015-144.)

Tax Court: Attorney's Farm Was Non-Passive Activity

In the facts underlying a recent Tax Court decision, the taxpayer was an attorney who owned a 1,276-acre farm in Turkey, Texas. The taxpayer leased some of the acreage to a local farmer under a crop-share arrangement. The tenant farmer planted and harvested crops on the leased acreage while the taxpayer was responsible for the entire farm's infrastructure which including maintaining the farm equipment, maintaining internal and perimeter roads and fences; clearing land; and trapping and killing wild hogs that were a serious scourge. The taxpayer did not keep contemporaneous records showing the time he spent on the farm. However, when the IRS disallowed his farm losses under the PAL rules, he was able to provide credible testimony and reconstructed records showing that he spent more than 100 hours in the farming activity and that he spent more time than any other individuals in the activity. Therefore, he passed the more-than-100 hours test for the activity and thereby met the material participation standard for the activity. So they could deduct the farm losses without regard to the PAL rules. (See *Clarence Leland, Jr.*, TC Memo 2015-240.)

Quick Summary Rental Real Estate PAL Rules

For federal income tax purposes, the general rule is that rental real estate losses are passive activity losses (PALs) by definition. That is not tax favorable, because you can generally deduct PALs only to the extent you have passive income from other sources. For example, if you have positive taxable income from other rental properties, that generally counts as passive income. Taxable gains from selling rental properties also generally count as passive income. You can use your PALs to offset passive income from these other sources, which amounts to being able to currently deduct the PALs. Unfortunately, many rental property owners have little or no passive income in most years. In that scenario, excess rental real estate PALs for the year (the amount of PALs you cannot currently deduct because you don't have enough passive income from other sources) are suspended and carried forward to future years. You can deduct the suspended PALs in future years when you finally have enough passive income or when you sell the properties that generated the PALs in the first place. Bottom line: suspended rental real estate PALs often remain suspended for a number of years. However, there are two big exceptions to the general rule that you must have some positive passive income to currently deduct rental real estate losses.

Exception for Small Landlords

This is the most well-known exception. If your client qualifies, she is allowed to currently deduct up to $25,000 of passive losses from rental real estate properties, even if she has no passive income. She must own at least 10 percent of the property generating the loss and she must "actively participate" with respect to that property [IRC Sec. 469(i)]. Note that properties owned via limited partnerships do not qualify for this exception.

Passing the active participation test is pretty easy. All the client has to do is prove that she at least exercises management control over the property in question by, for example, approving tenants and leases, authorizing maintenance and repairs, and so forth. She does not have to mow any lawns or unclog any drains to qualify for this break (however, if she does those things, it will certainly not hurt her case). (See *James Madler*, TC Memo 1998-112.)

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So far so good, but there is a big potential problem. Many real estate owners are ineligible for the small landlord exception because it is phased out between adjusted gross income (AGI) of $100,000 and $150,000. If your client's AGI is $150,000 or higher, she is completely ineligible for the small landlord exception. Now she is back under the general PAL rules, which means she can deduct passive losses only when she has some passive income or sells the properties that are throwing off losses.

Exception for Real Estate Professionals

Another exception to the general PAL rule for rental real estate losses allows qualifying individual taxpayers to currently deduct rental real estate losses even though they have little or no passive income.

To be eligible for the special exception: (1) you must spend more than 750 hours during the year delivering personal services in real estate activities in which you materially participate and (2) those hours must be more than half the time you spend delivering personal services (in other words, working) during the year. If you can clear those hurdles, you qualify as a real estate professional.

The second step is determining if you have one or more rental real estate properties in which you materially participate. If you do, those properties are exempt from the PAL rules. That means you can generally deduct losses from those properties in the current year. The three easiest-to-pass material participation tests for a rental real estate activity are the following (Temp. Reg. 1.469-5T):

1. Spend more than 500 hours on the activity during the year.
2. Spend more than 100 hours on the activity during the year and making sure no other individual spends more time than you.
3. Make sure the time you spend on the activity during the year constitutes substantially all the time spent by all individuals.

Key Point: You can elect to combine all rental real estate properties and treat the aggregated group as a single rental real estate activity for purposes of passing these material participation tests [IRC Sec. 469(c)(7)].

District Court: Real Estate Management Company Executive Could Count Hours Spent Working for Firm to Qualify for Real Estate Profession Exception

A recent U.S. District Court decision opined that, for purposes of qualifying for the real estate professional exception to the PAL rules, a real estate management company executive who owned interests in properties managed by his firm could count hours spent working for the firm on those properties as time spent on his own real estate interests. Therefore, the taxpayer was able to meet the material participation standard for his aggregated rental real estate properties, which made the aggregated losses from those properties non-passive.

Background

A real estate professional can participate in a rental real estate activity through participation in the management of rental real estate, even if the management activity is conducted through a separate taxable entity. However, in determining whether the taxpayer materially participates, management work performed by him for the entity is taken into account only to the extent it is performed in managing his own rental real estate interests. [See Reg. 1.469-9(e)(3).] Also, personal services performed as an employee do not count unless the taxpayer (employee) is a 5 percent owner of the employer, as defined by IRC Sec. 416(i)(1)(B). [See IRC Sec. 469(c)(7)(D)(ii).]

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Case Facts and the District Court's Conclusion

The taxpayers were a married couple. The husband, Roy Stanley, was a senior executive with LMC, an S corporation real estate property management firm. Stanley and his wife had ownership interests in more than 100 real estate entities.

For 2009 and 2010 (the tax years in question), the taxpayers aggregated all of their rental real estate property interests into a single activity for purposes of qualifying for the real estate professional exception, and they treated the losses as non-passive after counting time Mr. Stanley spent as an employee of LMC in managing those properties. After an audit, the IRS reclassified the rental real estate losses as passive on the grounds that Mr. Stanley was not a 5 percent owner of LMC and therefore could not count his time spent as an employee of LMC towards qualifying for the real estate professional exception. However, the District Court concluded that Mr. Stanley was a 10 percent owner of LMC.

It was undisputed that Mr. Stanley spent over half of his working hours in performing services as an employee of LMC and that he spent over 750 hours doing so. He had ownership interests in a large majority of the properties that were managed by LMC. Therefore, the District Court opined that all work performed by Mr. Stanley as an employee of LMC counted as work performed in managing his own rental real estate property interests for purposes of determining if he materially participated in his aggregated rental real estate activity. The District Court said it would be unreasonable to attempt to delineate time he spent on specific properties, especially since much of his work was done for the benefit of multiple properties. Bottom line: Mr. Stanley qualified as a real estate professional, the material participation standard was met for the taxpayer's aggregated rental real estate activity, and the losses from the aggregated activity were therefore non-passive. [See *Stanley v. U.S.*, 116 AFTR 2d 2015-6766 (District Court, Western District of Arkansas, 2015.)]

KNOWLEDGE CHECK

1. A rental real estate activity owned by an individual taxpayer

    a. Is always classified as a passive activity.
    b. Is never classified as a passive activity.
    c. Is always classified as an investment activity that generates only portfolio income and expense items under the PAL rules.
    d. Can sometimes be treated as a non-passive activity.

ALIMONY DEDUCTION DEVELOPMENTS

When a divorce or separation happens, one spouse or ex-spouse is often legally required to make payments to the other party. Payments that meet the tax-law definition of *alimony* can be deducted by the payer for federal income tax purposes and they must be reported as gross income by the recipient [IRC Secs. 71(a) and 215(a)]. More specifically, deductible alimony payments can be written off above-the-line on the payer's Form 1040, which means the payer does not have to itemize to benefit. Here is the issue: a list of specific tax-law requirements must be satisfied for payments to meet the definition of deductible alimony. Since we see litigation on this issue year after year, these tax-law requirements are apparently unknown to or poorly understood by quite a few divorce attorneys. When payments to an ex fail to meet

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the tax-law definition of alimony, they are generally treated as either child support payments or as payments to divide the marital property. Such payments represent nondeductible personal expenses for the payer and tax-free income for the recipient. This is not good news for folks who are making the payments (it *is* good news for folks who are receiving them).

The remainder of this analysis briefly summarizes the rules for tax-deductible alimony and a recent development regarding when payments can qualify as deductible alimony.

Requirements for Tax-Deductible Alimony

Whether payments qualify as tax-deductible alimony or not is determined strictly by applying the applicable language in the Internal Revenue Code and related federal income tax regulations. In general, what the divorce decree might say and what the divorcing couple might intend does not matter. The lone exception to the preceding general rule is when divorcing individuals stipulate in their divorce papers that certain amounts that would otherwise qualify as deductible alimony will not be deducted by the payer and will not be included in the payee's gross income [Temp. Reg. 1.71-1T(b), Q&A-8].

Note that it is possible (although unlikely) for payments that are not intended to be alimony to meet the tax-law definition of alimony. In such case, they are deductible by the payer and taxable income to the recipient.

Now we are ready for the specifics. For a particular payment to qualify as deductible alimony for federal income tax purposes, all the following requirements must be met for that payment [IRC Secs. 71(b) and 215].

1. Written Instrument Requirement

The payment must be made pursuant to a written divorce or separation instrument. This term includes: (1) divorce decrees, (2) separate maintenance decrees, and (3) separation instruments [IRC Sec. 71(b)(2)].

- After a decree of separate maintenance is issued by a court, the couple is considered legally separated, but the marriage is not yet considered to be legally dissolved. For tax purposes, however, this status is equivalent to being divorced.
- The purpose of a separation instrument is to settle certain marital rights in advance of obtaining a divorce decree or a separate maintenance decree.
- Other written court orders and decrees (such as temporary support orders which cover the time after a divorce petition is filed but before divorce or legal separation occurs) can also qualify as divorce or separation instruments. For example, so-called temporary alimony payments made pursuant to temporary support orders can qualify as deductible alimony if all the other tax-law requirements are met [Reg. 1.71-1(b)(6), Example 4].

Key Point: It is possible to have deductible alimony payments before a couple is divorced or legally separated. However, payments made in advance of signing a written divorce or separation instrument or before the effective date of a court order or decree cannot be deductible alimony. Such payments are considered voluntary and are therefore nondeductible. The same is true for payment of amounts in excess of what is required under a divorce or separation instrument or court order or decree.

2. Payment Must Be to or on Behalf of Spouse or Ex-Spouse

To qualify as deductible alimony, a payment must be to or on behalf of a spouse or ex-spouse. Payments to third parties, such as attorneys and mortgage lenders, are permitted if they are made on behalf of a spouse or ex-spouse and pursuant to a divorce or separation agreement or at the written request of the spouse or ex-spouse. (See Temp. Reg. 1.71-1T, Q&A-6 and -7 and *Alan Zinsmeister,* TC Memo 2000-364.)

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3. Payment Cannot Be Stated to *Not* Be Alimony

The divorce or separation instrument cannot state that the payment in question is *not* alimony or effectively stipulate that it is *not* alimony because it is *not* deductible by the payer or *not* includable in the payee's gross income. This seemingly simple requirement has spawned disputes between taxpayers and the IRS. One example is the Tax Court's 2011 *Shelton* decision where the divorce agreement said the ex-wife would receive $25,000 for her share of the ex-husband's military separation pay. Each party waived any claim for maintenance payments from the other. The Tax Court denied the ex-husband's attempt to claim an alimony deduction for the $25,000 because the divorce agreement clearly stated that neither party would receive any alimony. *(See Andrew Shelton,* TC Memo 2011-266.)

4. Ex-Spouses Cannot Live in Same Household or File Jointly

After divorce or legal separation has occurred (meaning the couple is considered divorced for federal income tax purposes), the ex-spouses cannot live in the same household or file a joint return for payments to an ex to qualify as deductible alimony.

5. Cash or Cash Equivalent Requirement

To be deductible alimony, a payment must be made in cash or cash equivalent.

6. Cannot Be Child Support

To be deductible alimony, a payment cannot be classified as fixed or deemed child support under the alimony tax rules. The rules regarding what constitutes child support—especially what constitutes deemed child support—for this purpose are complicated and represent a nasty trap for unwary taxpayers and tax professionals. These rules are beyond the scope of this analysis. For additional information, see IRS Publication 504 (*Divorced or Separated Individuals*).

7. Payee's Social Security Number Requirement

For the payer to claim an alimony deduction for a payment, the payer's return must include the payee's Social Security number (IRC Sec. 215; Temp. Reg. 1.215-1T).

8. No Payments after Recipient's Death

The obligation to make payments (other than payment of delinquent amounts) must cease if the recipient party dies. If the divorce papers are unclear about whether or not payments must continue, state law controls. If under state law, the payer must continue to make payments after the recipient's death, the payments cannot be alimony. In other words, the payment obligation must cease if the recipient party dies in order for the payment to qualify as deductible alimony. Relying on state law to support deductible alimony treatment is an act of faith that may be unwise. Therefore, divorce papers should always explicitly state whether a payment obligation (whether lump-sum or recurring) continues to exist after the death of the recipient party. Failing to meet the requirement for payments to cease if the recipient dies is probably the most common reason for lost alimony deductions. [See IRC Sec. 71(b)(1)(D).]

Key Point: In the context of planning for deductible alimony payments, it is not a problem if the *payer's* estate is required to continue making payments after the *payer's death.*

Tax Court: Alimony Deductions Allowed for Pre-Divorce Payments to Soon-to-Be-Ex Spouse

In the facts underlying a recent Tax Court decision, the taxpayer made monthly payments to his soon-to-be ex-wife pursuant to a pretrial court order but before the final divorce decree. The taxpayer deducted the payments as alimony. The wife was unemployed, and the court required the parties to "maintain

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status quo" with respect to various issues, including the wife's access to spending money. After an audit, the IRS denied the taxpayer's deductions by claiming that the payments were not alimony because they were made before the divorce became final. The unhappy taxpayer took his case to the Tax Court.

The Tax Court found that the pretrial court order qualified as a written instrument incident to decree of divorce or separate maintenance, as defined by IRC Sec. 71(b). In addition, the payments were not designated in the order as being nondeductible by the husband or not includible in the recipient wife's gross income, and they were not received while the parties were living in the same household. Since the husband's obligation to make the payments would have terminated under applicable state law if the wife died, all the requirements for treating the payments as deductible alimony were met. So he was entitled to deduct the payments. (See *Barry M. Anderson*, TC Memo 2016-47.)

KNOWLEDGE CHECK

2. For a payment to an ex-spouse to qualify as deductible alimony for federal income tax purposes,

   a. At least four out of seven specific requirements must be met.
   b. Eight specific requirements must be met.
   c. The payment must always be made directly to the ex and not to any third party.
   d. The legal obligation to make the payment must *continue* if the recipient ex-spouse dies.

UPDATE ON TAX TREATMENT OF PERSONAL INJURY AWARDS AND SETTLEMENTS

In some cases, personal injury lawsuit awards and settlements can be wholly or partially tax-free. In other cases, they can be fully taxable. Your clients may not understand this. Here is what you need to know to properly advise them.

Compensation for Physical Injury or Sickness Is Tax-Free

Payments that an individual receives as compensation for physical injury or physical sickness are federal-income-tax-free, thanks to the exclusion found in IRC Sec. 104(a)(2). The exclusion applies whether the compensation is from a court-ordered award or an out-of-court settlement and whether the money is paid in a lump sum or installments. Compensation for emotional distress that arises from physical injury or sickness is also tax-free, because the emotional distress is considered part and parcel of the physical injury or sickness [Reg. 1.104-1(c)]. However, as illustrated by a court decision covered later in this analysis, compensation for emotional distress that does not arise from physical injury or sickness is fully taxable.

Amounts received for medical expenses are also tax-free. The exception to his general rule is when the injured party claims a medical expense deduction for costs that are later reimbursed by an award or settlement. In that case, he or she must recapture any amount that is specifically allocated to medical costs up to the amount that was deducted on earlier tax returns [IRC Sec. 104(a)]. Even when there is no specific allocation, the award or settlement is automatically deemed to include a reimbursement for such expenses up to the amount of those expenses (Rev. Rul. 75-230).

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Oddly enough, the Section 104(a)(2) exclusion also covers the part of an award or settlement for physical injury or sickness that is intended to compensate the injured party for lost wages—even though the wages would have been taxable if they had been received.

On the other hand, if any part of an award or settlement is deemed to be interest for the period between the physical injury or sickness and the time the injured party is paid, the interest component is fully taxable [*Rosemary Kovacs*, 74 AFTR 2d-5001 (6th Cir. 1994)].

The IRS has privately ruled that a lump-sum payment received for an individual's sale of the right to receive future periodic payments in settlement of a personal injury claim (under a structured settlement arrangement) is considered to be income of the same character as the periodic payments. Therefore, the lump-sum amount received from such a sale is federal-income-tax-free if the Section 104(a)(2) exclusion would have applied to the payments that were sold. (See PLR 199936030.)

Example 1

Phil was seriously injured in a 2014 auto accident. He incurred $85,000 in medical expenses and $90,000 in lost wages. On his 2014 and 2015 returns, Phil deducted medical expenses totaling $60,000 (he could not deduct the full $85,000 because of the percent-of-AGI threshold for medical expense deductions). In 2016, Phil receives a $750,000 settlement that covers pain and suffering, medical expenses, lost wages, and $75,000 for interest. Only $135,000 of Phil's settlement is taxable (the $60,000 for medical expenses that were previously deducted and the $75,000 for interest). The remaining $615,000 ($750,000 - $60,000 - $75,000) is federal-income-tax-free.

Other Compensation Is Usually Taxable

Payments for legal (as opposed to physical) injuries from wrongful actions such as harassment, discrimination, wrongful termination, libel, and invasion of privacy are taxable. Related payments for interest are also taxable.

As a general rule, payments for punitive damages (amounts paid for the specific purpose of punishing the wrongdoer) are taxable even if they are paid as compensation for physical injury or sickness [IRC Sec. 104(a)(2)]. There is one exception to this general rule: federal-income-tax-free treatment applies to punitive damages paid in civil wrongful death actions when applicable state law, as in effect on September 13, 1995, only allows punitive damages in such cases [IRC Sec. 104(c)]. Interest payments related to punitive damages (whether taxable or tax-free) are taxable.

A lump-sum settlement that is for both (1) personal injuries or sickness and (2) an agreement not to reveal the circumstances that led to the injuries must be divided into two parts. The part pertaining to injuries or sickness can be excluded from gross income under IRC Sec. 104(a)(2), but the remainder is fully taxable. (See *Eugene Amos, Jr.*, TC Memo 2003-329; this is the case where NBA player Dennis Rodman famously kicked a TV cameraman during a game.)

Tax Court: Damages from Emotional Distress Claim Were Taxable

In the facts underlying a recent Tax Court decision, the taxpayer was a letter carrier for the U.S. Postal Service (USPS). She sustained injuries in a vehicular accident while on the job. Due to physical limitations caused by the injuries, the taxpayer accepted a new USPS position allowing her to work indoors.

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Years later, she was reassigned to be once again be a letter carrier, and she experienced pain due to her previous injuries. The taxpayer claimed that her manager made her work life difficult when she requested medical accommodations. This situation caused emotional distress, and the taxpayer filed a complaint against the USPS with the Equal Employment Opportunity Commission. She was awarded $70,000 for emotional distress, and she did not report any of that amount as income on her federal income tax return.

After an audit, the IRS took the position that the $70,000 was taxable. The unhappy taxpayer took her case to the Tax Court. Unfortunately for her, the Tax Court agreed that IRS was correct in finding that the $70,000 was taxable, because the award was for emotional distress—which does not fall within the IRC Section 104(a)(2) definition of personal physical injury or physical sickness. (See *Debra R. T. Barbato*, TC Memo 2016-23.)

Conclusion

The tax issues associated with personal injury awards and settlements are significant, and tax professionals can sometimes offer valuable tax-saving advice. For instance, designating a specific portion of an award or settlement as compensation for physical injury or sickness (upon the tax professional's advice) makes that portion federal-income-tax-free. Without such advance planning, taking the position that all or part of an award is tax-free may trigger a lengthy and expensive dispute with the IRS.

Knowledge Check

3. Compensation received from a lawsuit for physical injury or physical sickness is

   a. Federal-income-tax-free in all cases (except for interest and amounts that were previously deducted as medical expenses).
   b. Federal-income-tax-free only if the compensation is from a court-ordered award and not an out-of-court settlement.
   c. Federal-income-tax-free only if it is received in a lump-sum and not in installments.
   d. Subject to federal employment taxes if the taxpayer was on the job when the injury or sickness occurred.

Hobby Loss Developments

If the expenses from your client's sideline business exceed its revenues, the client probably thinks he can claim a tax deduction for the net loss. The IRS may claim your client's purported business is a hobby that never had a chance of being profitable. The IRS likes to make that argument because the rules for hobby losses are not in your client's favor. [See IRC Sec. 183 and Regs. 1.183-1 and 1.183-2.] Here is what you and clients need to know about the business-versus-hobby issue along with some recent developments that address the issue.

The Tax Issue

When an unincorporated for-profit business activity generates a net tax loss for the year (deductible expenses in excess of taxable revenue), you can deduct the loss on Form 1040 (assuming no problems

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with insufficient basis, the passive loss rules, or the at-risk rules). Use Schedule C to report a loss from a sole proprietorship business; use Schedule E for a rental business; use Schedule F for a farm or ranch. The loss is then carried to page 1 of Form 1040 where it offsets income from other sources and reduces your tax bill. If your business loss is so large that it causes you to have negative taxable income, you probably have an NOL that can be carried back to earlier tax years and/or forward to future tax years.

What happens if your activity is deemed to be a not-for-profit hobby? You must report the gross revenue on page 1 of Form 1040 (using line 21). However, your allowable expenses (other than expenses that can be deducted in any event, such as home mortgage interest and property taxes) are limited to the amount of that revenue and are treated as itemized deductions because they are not from a Section 162 business activity [IRC Sec. 183(b)]. So you basically cannot have a net tax loss from a hobby even if you lose your shirt. Worse yet, you must treat allowable hobby expenses (other than the expenses that can be deducted in any event) as miscellaneous itemized deduction items that are subject to the 2 percent-of-AGI deduction threshold (IRC Sec. 67). So you get no write-off unless you itemize. Even if you do itemize, your write-off for miscellaneous deduction items is limited to the excess of those items over 2 percent of AGI. So if you have a healthy AGI, your deduction for hobby expenses may be little or nothing. Finally, if you're a victim of AMT, miscellaneous itemized deductions for hobby expenses and property taxes allocable to hobby losses are disallowed for AMT purposes [IRC Sec. 56(b)(1)].

When all is said and done, a client can easily have a money-losing hobby that actually adds to his or her taxable income, because all the income must be reported and deductible expenses may amount to little or nothing. The client's tax bill goes up accordingly.

Now you understand why the Feds are so enthusiastic about making the hobby loss argument. But don't give up hope. The good news is yet to come.

Key Point: Hobby income is not subject to the SE tax, because a hobby is not considered a trade or business (Rev. Rul. 55-258).

Deciding If Client's Activity Is Business or Hobby

Helpfully enough, the tax law automatically assumes you have a for-profit business if the activity produces positive taxable income (revenues in excess of deductions) for at least *three out of every five years*. Losses from the other years can be deducted because they are considered to be legitimate business losses as opposed to nondeductible hobby losses. For horse racing, breeding, training, or showing activities, you're assumed to have a for-profit business if you can generate positive taxable income in *two out of every seven* years. Those who can plan ahead to pass these tests earn the right to deduct their losses from the unprofitable years.

Even if you can't pass one of these canned profitability tests, you may still be able to treat your activity as a business and rightfully deduct your losses. Basically, you must demonstrate that you have an honest intention to make a profit. Factors that can prove this intent include the following:

- Conducting the activity in a business-like manner by keeping good records and searching for profit-making strategies.
- Having or gaining expertise in the activity or hiring advisers who do.
- Spending enough time to justify the notion that the activity is a business and not just a hobby.
- Expectation of asset appreciation (this is why the IRS will almost never claim that owning rental real estate is a hobby even when tax losses are incurred for many years).
- Success in other ventures, which indicates business acumen.
- Losses caused by unusual events and plain bad luck as opposed to foreseeable ongoing losses that nobody except a hobbyist would be willing to accept.

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- Financial status: wealthy individuals can afford to absorb ongoing losses (which may indicate a hobby) while ordinary individuals are usually trying to make a buck (which indicates a business).
- Elements of personal pleasure: running a charter fishing boat is a lot more fun than draining septic tanks, so the IRS is far more likely to claim the former is a hobby if losses start showing up on your returns.

IRS: Hobby Loss Rules Irrelevant in Determining if Swap of Private Aircraft Qualified as Section 1031 Exchange

In Chief Counsel Advice (CCA) 201601011, the IRS concluded that a swap of aircraft by a partnership qualified for tax-free Section 1031 exchange treatment because the aircraft were held for productive use in a business. The aircraft were leased to a related business entity that was owned by the same individuals who owned the partnership. The aircraft were the partnership's only operating assets and did not generate an economic profit.

Case Facts

Partnership P owned several aircraft that were leased to Partnership O, which was the primary business entity of a group of related entities. Partnership O's business activities required air travel, mainly by two senior executives. For business and legal reasons, the aircraft were owned by Partnership P and then leased to Partnership O. The aircraft were Partnership P's only operating assets, but Partnership P also owned interests in other business entities in the Partnership O group of entities.

The aircraft were mainly used by two of Partnership O's senior executives for business-related travel and also for personal purposes. The aircraft served a business purpose for Partnership O by being available for business travel and by serving as a perk for the two executives. When the two executives used the aircraft for personal purposes, the required amount was included in their taxable compensation. The two executives, who indirectly owned Partnership O through other wholly-owned entities, also indirectly owned Partnership P through other wholly-owned entities.

During the tax year in question, Partnership P swapped an aircraft for a replacement aircraft in what was intended to be a tax-free Section 1031 exchange. Both the relinquished and replacement aircraft were leased under an arrangement whereby the lessee (Partnership O) provided the flight crew and other necessary services. The lease payments for the relinquished aircraft approximated a fair market rental rate, but the lease payments for the replacement aircraft were below market. In both cases, the lease payments were intended to cover the aircraft's carrying costs, but they were not intended to generate any meaningful economic profit for Partnership P.

The Tax Issue

Only property that is held for an investment or business purpose can be involved in a Section 1031 exchange. Whether property is held for an investment or business purpose is a question of fact. With regard to relinquished property (the asset given up in a Section 1031 exchange), the manner in which the relinquished property is held at the time of the exchange (as opposed when it was acquired) is the controlling factor. With regard to replacement property (the asset received in a Section 1031 exchange), the purpose for which it is held at the time of the acquisition is the controlling factor. [See *Wagensen*, 74 TC 653 (Tax Court 1980).]

After an IRS audit, the examining agent concluded that Partnership P did not hold either the relinquished aircraft or the replacement aircraft for productive use in a business and that Section 1031 exchange treatment was therefore unavailable. The agent relied on the hobby loss rules found in IRC Sec. 183 and related regulations and court decisions in determining that the aircraft were not held for business use. The agent also contended that in applying the Section 183 rules, each entity should be separately

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examined, and the profit motive of one entity should not be attributed to another entity, even if the two entities are closely related.

What the IRS Concluded

In CCA 201601011, the IRS concluded that Partnership P held both the relinquished aircraft and the replacement aircraft for productive use in a business for purposes of the Section 1031 exchange rules. For legitimate business and legal reasons, Partnership O arranged to lease the aircraft needed for its business purposes from Partnership P. While the leases did not generate a profit for Partnership P, the aircraft were still held for productive use in a business (that is, Partnership O's business).

The CCA noted that many businesses chose to hold property, especially aircraft, in separate legal entities for various legitimate legal and business reasons. If the IRS disallowed Section 1031 treatment based on the ownership-and-lease structure used by the taxpayer in this case, other businesses would be forced to structure their aircraft ownership arrangements in inefficient and potentially risky ways in order to qualify for Section 1031 treatment.

The CCA also noted that there is no authority suggesting that the Section 183 rules should be used to be used to evaluate whether property is held for productive use in a business for purposes of qualifying for Section 1031 treatment.

Warnings: On the negative side, the CCA noted that the fact that Partnership P was owned by the two executives rather than by Partnership O and that Partnership P charged below-market lease rates for the replacement aircraft could potentially bring other unfavorable tax provisions into play, such as the IRC Section 280F rules (dealing with depreciation limitations when certain types of property are used for personal purposes) or the Section 482 rules (dealing with IRS powers to reallocate income and deductions among related taxpayers). The CCA did not opine if any of these other rules were actually applicable to the case at hand. Finally, the CCA noted that the issue of whether Partnership P was a valid partnership for tax purposes and not a sham entity was not addressed. If it was a sham entity, the two executives would be treated as the owners of the aircraft, and the CCA's conclusion might be different.

Tax Court: Inherited Hobby Store Was Business, Not a Hobby

In a 2015 decision, the Tax Court opined that a hobby store inherited by an art teacher from her father was operated as a business and not as a hobby (*Cheryl R. Savello*, TC Memo 2015-24). Here is the story.

Case Facts

The taxpayer worked as an art teacher in Nevada from 2002 until she retired in 2014. She also owned Aero-tronics, a retail model airplane sales and service shop in Idaho. The shop was adjacent to a residence where the taxpayer lived part-time in 2010 and 2011 (the tax years in question). The business started in a garage and moved to a six-room building. It occupied that building in 2010 and 2011. The taxpayer inherited the business from her father when he died in 2006. After her father's death, the taxpayer took over Aero-tronics and retained a volunteer worker to oversee the daily operations of the store. The volunteer had previously helped the taxpayer's father run the store.

When she was in Idaho, the taxpayer would work in the store. After her father's death, she spent more time living in Idaho (next door to the store) and more time working at the store and attempting to build the business. When not in Idaho, her major involvement with the store was signing checks. For 2010 and 2011, the business had gross receipts of $23,000 and $22,000, respectively, and net losses of $5,500 and $2,600, respectively. The taxpayer claimed the net losses on her federal income tax returns. After an audit, the IRS denied the losses under the hobby loss rules. The unhappy taxpayer took her case to the Tax Court.

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What the Tax Court Concluded

After evaluating seven of the nine factors listed in Reg. 1.183-2(b), the Tax Court concluded that the Aero-tronics store was a business that was intended by the taxpayer to make a profit rather than a hobby activity. Therefore, her 2010 and 2011 net losses from the store were deductible as business losses.

One of the factors considered by the Tax Court was the manner in which the taxpayer carried on the activity. The taxpayer testified that Aero-tronics originated in a garage but was in a stand-alone six-room building during the tax years in question. The store had its own utilities accounts and had inventory, cash registers, a telephone, display cases, offices, supplies, and workspace. It was open every day from 8 AM to 5 PM. The taxpayer testified that her daughter was working to create a Website to spur sales. This factor indicated that the taxpayer was carrying on a business rather than a hobby.

Another factor considered by the Tax Court was the expertise of the taxpayer or the taxpayer's advisers. Although the taxpayer did not know how to build model airplanes, she had previous experience in retail sales. For additional expertise, she retained the volunteer who had worked with her father. This factor weighed in favor of treating the store as a for-profit business rather than a hobby.

A third factor was the time and effort expended by the taxpayer in carrying on the activity. The fact that a taxpayer may devote only a limited amount of time to an activity does not necessarily indicate the lack of a profit motive if the taxpayer employs other qualified persons to carry on the activity [Reg. 1.183-2(b)(3)]. The Tax Court also noted that having another job does not necessarily indicate the lack of a profit motive, because a taxpayer can engage in more than business activity (including a "regular" job) simultaneously. After her father's death, the taxpayer took over the business aspects of the Aero-tronics store, and she retained the volunteer to oversee the daily operations of the store. She would assist with sales when she was in Idaho, and she eventually moved to Idaho to spend more time working at the store and building the business. This factor weighed in favor of treating the store as a for-profit business rather than a hobby.

Another factor is the history of income or losses for the activity. The taxpayer testified that Aero-tronics may have been profitable in some of the years that her father ran the business and that it broke even or close after 2011. She stated that there had always been a market for Aero-tronics' planes and that the store had customers that came from around the State of Idaho to buy the planes. Also, there were no other hobby shops within a 150-mile radius of Aero-tronics. This factor weighed in favor of treating the store as a for-profit business rather than a hobby.

Another factor considered by the Tax Court was the taxpayer's financial status. Wealthy individuals can afford to operate a money-losing activity for years while other individuals will usually give up if they don't foresee profits. They are less able to continue with activities that are really just money-losing hobbies. [See Reg. 1.183-2(b)(8).] In this case, the taxpayer received a modest salary from her job as an art teacher and modest distributions from a pension or annuity. She did not receive substantial income from rental properties that she owned. Therefore, she was an unlikely candidate to engage in a money-losing hobby. This factor weighed in favor of treating the store as a for-profit business rather than a hobby.

Another factor is whether the taxpayer obtains elements of personal pleasure or recreation from the activity. A profit motive may be indicated when the activity lacks any appeal other than profit or the potential for profit. However, an activity will not be treated as not operated with a profit motive just because the taxpayer has purposes or motivations other than simply making a profit [Reg. 1.183-2(b)(9)]. In this case, the taxpayer testified that she was not a model airplane enthusiast and not know how to build model airplanes. So there were apparently no elements of personal pleasure or recreation here. This factor weighed in favor of treating the store as a for-profit business rather than a hobby.

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All things considered, the Tax Court concluded that the taxpayer would not have continued to run Aero-tronics if she did not have an honest expectation of profit. Therefore, the tax losses incurred in 2010 and 2011 were allowed as deductible business losses.

Knowledge Check

4. When an individual taxpayer's unincorporated for-profit business activity generates a net tax loss for the year,

    a. The taxpayer can deduct the loss to the extent of his or her investment income for the year.
    b. The taxpayer can deduct the loss as a miscellaneous itemized deduction item subject to the 2 percent-of-AGI deduction threshold.
    c. The taxpayer can deduct the loss on Form 1040 (assuming no problems with insufficient basis, the passive loss rules, or the at-risk rules).
    d. The taxpayer can deduct the loss on Schedule C if the activity is a farming or rental activity.

Estate Tax Developments

Deadline for Filing New Basis Consistency Reports Postponed Again

Executors of affected estates (generally those large enough to owe federal estate tax) must now provide the IRS and beneficiaries who inherit assets with so-called basis consistency reports using new Form 8971 (Information Regarding Beneficiaries Acquiring Property from a Decedent). This new reporting requirement is an attempt to ensure that heirs use the FMVs that are reported on the federal estate tax return (Form 706) to determine their basis in inherited assets for federal income tax purposes.

The new basis consistency reporting requirement potentially applies to property reported on Forms 706 filed after July 31, 2015. By statute, Forms 8971 (along with Schedule A of Form 8971) must be filed with the IRS by no later than 30 days after the related Form 706 is filed, or if earlier, 30 days after the due date for the Form 706 (including extensions). However, the IRS has now postponed the initial deadline for filing Forms 8971 three times. The latest postponement, to June 30, 2016, was announced in Notice 2016-27. Forms 8971 that would otherwise be due before that date are not due until then.

Key Point: Because the new basis consistency reporting rule does not apply unless the property in question increased the estate's federal estate tax liability, it can be ignored if the estate does not owe federal estate tax because the taxable estate is less than the applicable unified federal estate and gift tax exemption. Therefore, the Form 8971 filing requirement does not apply when an executor files Form 706 solely to make the aforementioned portability election to transfer a decedent's unused unified federal estate and gift tax exemption to a surviving spouse.

IRS Releases New Basis Consistency Reporting Form

The IRS has released the final version of new Form 8971 (Information Regarding Beneficiaries Acquiring Property from a Decedent) and related instructions. Form 8971 is intended to satisfy the aforementioned new basis consistency reporting requirement for estates. The basis consistency rule of IRC Secs. 6035(a)

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and 1014(f) applies when: (1) the estate is required to file an estate tax return (Form 706) after July 31, 2015, and (2) the property increases the federal estate tax liability.

New Regulations Address Estate Tax Returns Filed to Solely to Make Portability Election and New Basis Consistency Reporting Rules

The executor of an estate can make an election to transfer a married decedent's unused unified federal estate and gift tax exemption to the decedent's surviving spouse. This election is commonly called the portability election. A decedent can have an unused exemption amount in two situations:

1. The decedent's gross estate is valued at less than the exemption amount.
2. The gross estate is larger than the exemption amount, but a marital deduction, or charitable deduction, or medical expense deduction is claimed on Form 706, resulting in a taxable estate that is less than the exemption amount.

If the executor makes the portability election, the surviving spouse can add the decedent's unused exemption amount to the surviving spouse's own exemption amount and then use the increased exemption amount to shelter lifetime gifts by the surviving spouse and bequests after his or her death. Making the portability election requires the executor to file a Form 706. The Form 706 is due nine months after the decedent's date of death, but a six-month extension can be obtained. The good news: executors of estates that are not otherwise required to file Form 706 can usually use a simplified Form 706 filing procedure.

The IRS recently issued temporary and proposed regulations dealing with the basis consistency reporting rules. The regulations confirm that the requirement to file basis consistency reports (using new Form 8971) does not affect estates that file Form 706 solely to make the portability election. The new regulations apply to inherited property that is included on a Form 706 filed after July 31, 2015. [See Prop. Regs. 1.1014-10, 1.6035-1, and 1.0635-2 (found in REG-127923-15) and Temp. Reg. 1.6035-2T (found in TD 9757).

Attorney Fees Paid by Individual's LLC to Investigate Viability of Investment Opportunity Were Not Deductible Business Expense

In the facts underlying a recent Tax Court decision, the taxpayer owned a single-member LLC (treated as a sole proprietorship for tax purposes) that he used mainly to make investments in mineral rights. During the tax year in question, he claimed a business deduction for fees paid by the LLC to an attorney to evaluate the collection potential of a portfolio of distressed student loans that had been offered as an investment opportunity. The attorney advised that the package of loans was not a good deal, because the price was about $2 million and the face value of the loans was only about $3 million. The discount from face value was too small to be attractive. So the taxpayer decided not to buy.

After an audit, the IRS disallowed the deduction for the legal fees. The unhappy taxpayer took his case to the Tax Court. Unfortunately for him, the Tax Court agreed with the IRS that the legal fees did not qualify as an ordinary and necessary business expense, under IRC Sec. 162(a), because the taxpayer's proposed investment in the distressed loans did not constitute a business. While the LLC held a few personal loans made to realtors that were incidental to the taxpayer's business of buying and selling real estate, making and holding the loans did not constitute a business. So the deduction for the legal expenses was disallowed. (See *Rodney C. Niemann*, TC Memo 2016-11.)

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IRS: Higher Audit Rates for S Corporations and Partnerships

According to recently released IRS data, S corporations and partnerships were audited at higher rates than in the recent past during the government's 2015 fiscal year, while large C corporations (those with assets of $10 million and up) were audited at the lowest percentage in 10 years. As the IRS has shifted resources from corporate audits to audits of pass-through entities, audits of S corporations increased by 11.11 percent from 2014 to 2015 and partnership audits increased by 18.6 percent.

Key Point: Despite these increases, the overall audit percentages for S corporations and partnerships were still below 1 percent.

Tax Court: IRS Correctly Assessed Penalties against Law Firm That Mischaracterized Shareholder-Employee Bonuses

In a recent decision, the Tax Court opined that the IRS was correct in imposing accuracy-related penalties against a law firm that had mischaracterized dividends paid to shareholder-employees as deductible compensation for services. The Tax Court concluded that the firm lacked substantial authority for its treatment of the payments and failed to establish that it had a reasonable cause for the resulting tax underpayments or that it had acted in good faith. (See *Brinks Gilson & Lione PC*, TC Memo 2016-20.)

Tax Court Affirmed: Unfavorable Recharacterization Rule Converted S Corporation's Net Rental Income into Nonpassive Income

In a 2015 decision, the Tax Court found that the PAL self-rental recharacterization rule—which can convert otherwise passive rental income into nonpassive income—applied to net rental income earned by an S corporation that was wholly owned by the taxpayers (a joint-filing married couple). (See *Larry Williams*, TC Memo 2015-76.) The S corporation owned commercial real estate that was leased to a C corporation medical business (Medical) that was also wholly owned by the taxpayers. The husband worked full time for Medical and materially participated in its business. The taxpayers did not materially participate in the S corporation's rental real estate activity. In 2009 and 2010, the S corporation recognized net rental income of $53,285 and $48,657, respectively, from renting commercial real estate to Medical. These amounts were passed through to the taxpayers who reported them as passive income on their 2009 and 2010 federal income tax returns. The taxpayers then offset these purportedly passive income amounts with passive losses from other S corporation and partnership interests and other rental properties that they directly owned. As a general rule, rental income is passive income. So far, so good for the taxpayers.

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Unfortunately, IRS regulations include an exception that can recharacterize net rental income recognized by an individual taxpayer as nonpassive income if it is collected from a business in which the taxpayer materially participates (in other words, from a nonpassive business owned by the taxpayer). [See Reg. 1.469-2(f)(6).] This *self-rental recharacterization rule* is specifically intended to prevent taxpayers from generating positive passive income by renting property to businesses in which they materially participate and then using passive losses from other sources to offset the positive passive income from the self-rental activities. After an audit, the IRS reclassified the net rental income amounts passed through by the taxpayers' S corporation as nonpassive pursuant to the aforementioned recharacterization rule. The IRS then disallowed the taxpayers' passive losses in excess of their adjusted passive income amounts for 2009 and 2010. The unhappy taxpayers took their case to the Tax Court. Unfortunately, the Tax Court agreed with the IRS that the net rental income passed through to the taxpayers from their S corporation fell squarely within the self-rental recharacterization rule. The fact that the S corporation owned the rental property in question (as opposed to direct ownership of the property by the taxpayers) did not change the answer. Therefore, the net rental income passed through by the S corporation was treated as nonpassive income that could not be sheltered with passive losses from other sources.

Upon appeal by the taxpayers, the Fifth Circuit, affirmed the Tax Court's decision [*Larry Williams*, 117 AFTR 2d 2016-600 (5th Cir. 2016)].

KNOWLEDGE CHECK

5. An *unfavorable* PAL recharacterization rule can

   a. Convert passive losses into nonpassive losses that can be fully deducted in the current year.
   b. Convert passive losses into nonpassive losses.
   c. Convert otherwise passive net rental income into nonpassive income.
   d. Convert passive business expenses into miscellaneous itemized deduction items subject to the 2 percent-of-AGI deduction threshold.

IRS: IMPACT OF LLC MEMBER'S DEBT GUARANTEE ON OTHER MEMBERS' BASIS IN THEIR INTERESTS AND AT-RISK AMOUNTS

In the facts underlying recently released IRS Chief Counsel Advice (CCA) 201606027, a multi-member LLC that was treated as a partnership for tax purposes was in the business of buying and renovating hotels. One of the LLC members personally guaranteed some LLC nonrecourse debt that, before the guarantee, met the definition of qualified nonrecourse financing under the IRC Section 465 at-risk rules. Such debt can be included in determining the at-risk amounts of all LLC members and their basis in their LLC interests under the IRC Section 752 rules.

In the CCA, the IRS concluded that the member's guarantee was bona fide and enforceable by creditors of the LLC under applicable local law. Therefore, the guarantee caused the guaranteeing member to be personally liable for the guaranteed debt. At that point, the guaranteed amount no longer met the definition of qualified nonrecourse financing under IRC Sec. 465(b)(6)(B), and the guaranteed amount was no longer includible in determining the at-risk basis of the non-guaranteeing members or the basis of their membership interests under the Section 752 rules.

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The LLC's operating agreement provided that if the member was required to actually make a payment under the guarantee, he could call for the non-guaranteeing members to the guaranteeing member had the right under the LLC's operating agreement to call for the non-guaranteeing members to make capital contributions that would be used to reimburse the guaranteeing member. If the other members failed to make capital contributions, the guaranteeing member could treat ratable portions of the payment made under the guarantee as loans to those other members, adjust their fractional ownership interests in the LLC, or enter into a subsequent allocation agreement under which the risk of the payment made under the guarantee would be shared among all the members. However, these rights were deemed by the IRS to be insufficient to make the non-guaranteeing members personally liable for the guaranteed amount of debt for the purposes of the Section 465 and Section 752 rules.

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QUARTERLY FEDERAL TAX UPDATE – FIRST QUARTER 2016

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SOLUTIONS

Solutions to Knowledge Check Questions

1.

a. Incorrect. Rental real estate activities are *generally* treated as passive, but there are exceptions.
b. Incorrect. Rental real estate activities are *generally* treated as passive.
c. Incorrect. Rental real estate activities are considered business activities under the PAL rules. They are generally treated as passive, but they can be nonpassive in certain circumstances.
d. Correct. A small landlord or real estate professional can potentially treat rental real estate activities as nonpassive.

2.

a. Incorrect. Eight specific requirements must be met, and they must all be met in order for a payment to be tax-deductible alimony. Many divorce attorneys apparently do not understand this.
b. Correct. Eight specific requirements must be met, and they must all be met.
c. Incorrect. Payments to certain third parties, such as attorneys and mortgage lenders, can be deductible alimony if they are made on behalf of the ex-spouse pursuant to the divorce or separation agreement or at the written request of the ex-spouse.
d. Incorrect. No. The legal obligation to make the payment must *cease* if the recipient ex-spouse dies. This is probably the most common reason that payments to an ex fail to qualify as deductible alimony.

3.

a. Correct. Compensation received from a lawsuit for physical injury or physical sickness is federal-income-tax-free in all cases (except for interest and amounts that were previously deducted as medical expenses).
b. Incorrect. Compensation received from a lawsuit for physical injury or physical sickness is federal-income-tax-free in all cases (except for interest and amounts that were previously deducted as medical expenses). It does not matter if the compensation is from a court award or an out-of-court settlement.
c. Incorrect. Compensation received from a lawsuit for physical injury or physical sickness is federal-income-tax-free in all cases (except for interest and amounts that were previously deducted as medical expenses). It does not matter if the compensation is received in a lump-sum or installments.
d. Incorrect. Compensation received from a lawsuit for physical injury or physical sickness is federal-income-tax-free and federal-employment-tax-free in all cases (except for interest and amounts that were previously deducted as medical expenses, which must be included in the recipient's income for federal income tax purposes).

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4.

a. Incorrect. The loss is fully deductible regardless of investment income—assuming no problems with insufficient basis, the passive loss rules, or the at-risk rules.
b. Incorrect. The loss is fully deductible on Schedule C, E, or F—assuming no problems with insufficient basis, the passive loss rules, or the at-risk rules. The loss is not treated as an itemized deduction item.
c. Correct. The taxpayer can deduct the net loss on Form 1040, assuming no problems with insufficient basis, the passive loss rules, or the at-risk rules.
d. Incorrect. The loss is deductible (assuming no problems with insufficient basis, the passive loss rules, or the at-risk rules), but not on Schedule C. For rental losses, use Schedule E. For farming losses, use Schedule F.

5.

a. Incorrect. That would be a favorable rule.
b. Incorrect. That would be a favorable rule. The unfavorable rule we are talking about can convert otherwise passive net rental income into nonpassive income. This rule comes into play for net rental income from renting property to a business in which the taxpayer (the person who owns the rental property) materially participates
c. Correct. An *unfavorable* PAL recharacterization rule can convert otherwise passive net rental income into nonpassive income. This is the so-called self-rental recharacterization rule.
d. Incorrect. There is no such rule.

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