Current Federal Tax Developments

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SECTION: SCAMS
IRS TO START NOTIFYING VICTIMS OF EMPLOYMENT-RELATED IDENTITY THEFT

Citation: Processes Are Not Sufficient to Assist Victims of Employment-Related Identity Theft, Reference Number: 2016-40-065, 8/10/16

In response to a report from the U.S. Treasury Inspector General for Tax Administration (Processes Are Not Sufficient to Assist Victims of Employment-Related Identity Theft, Reference Number: 2016-40-065) the IRS announced that it will begin a program to notify individuals whose social security numbers have been used in employment-related identity theft uncovered by the agency beginning January 1, 2017.

The TIGTA report looked at the state of matters related to employment related identity theft—that is, when a person uses the identity of another person to obtain employment. Given that employers today are supposed to "verify" the social security number of potential employees vs. government data bases or face penalties if it is found to have hired individuals not authorized to work in the United States, it's not surprising there is an active market in obtaining such "verifiable" identities.

While the report cites the various impacts that employment related identity theft can have on those impacted, the report doesn't link the harm to the lack of notification. For instance, it points out that those impacted might get a CP2000 notice—but, in that case, the individual clear was notified of the matter. The harm in that case is not the lack of notification but the IRS's inability to identify the problem prior to issuing a CP2000 notice.

Similarly, the failure to update the social security database is an issue—but the report didn't tell us what percentage of those not notified later received a bill to repay social security benefits, since the major negative impact would be on those receiving benefits prior to their normal retirement age. For everyone else, the only potential impact would be to increase their benefits above what they should have been—a problem for the federal treasury but not one many victims are likely to worry about.

Nevertheless, it's never good to have your information used by a third party in an unauthorized fashion even if that use doesn't result in a negative result—that data could be "recycled" later and used for more damaging identity theft since it seems reasonable to assume these individuals are receiving this information via various third parties who have a database of personal information which may be sold to the highest bidder. So the lack of notice is troubling even if the report seems to focus on the less serious (but more headline ready) harms.

The real problem will occur when the IRS discovers a return where the identification number on the return does not agree with the social security number and name found on the information returns associated with the return (such as the W-2s). In that case the IRS has been flagging the account of the person whose social security number was used to avoid a CP2000 notice and to put an identity theft warning on the account.

The TIGTA report explains this as follows:

> Our review identified that, during the period February 2011 to December 2015, the IRS identified almost 1.1 million taxpayers who were victims of employment-related identity theft. The IRS identifies these victims when it processes electronically filed (e-filed) tax returns in which the Individual Taxpayer Identification Number (ITIN)5 used to file the tax return does not match the SSN listed on third-party income documents associated with the tax return, such as a Form W-2.

The TIGTA had previously looked at this matter in 2011 and the IRS had indicated they were going to take steps to notify taxpayers whose accounts were affected—however, as this report found, that never happened aside from a small trial program the IRS started and then later shut down.

The IRS has now announced a hard and fast deadline for notifying the victims that will take place beginning January 1, 2017. Presumably the IRS will likely use a notification similar to the one they used in the 2014 test program, the text of which is provided below:

> **Letter 4491-C, Notice of Employment-Related Identity Theft**
>
> **WHY WE ARE SENDING YOU THIS LETTER**
>
> We believe your social security number (SSN) was used by another person to obtain employment. The use of your SSN in this instance hasn't affected your tax return or tax account. However, we marked your tax account to indicate that you are a victim of identity theft. This will help us to serve you more effectively and efficiently in the event you should have an identity theft-related tax issue.
>
> Federal law prevents us from providing specific details regarding the identity of the individual who used your SSN for employment purposes. Our purpose in sending this letter is to make you aware of this incident so you can take the appropriate steps to protect yourself from any potential effects of identity theft.
>
> **WHAT YOU SHOULD DO**
>
> Again, there is no impact to your tax return or tax account because of this incident. However, you should review your earnings with the Social Security Administration to ensure their records are correct. You may review earnings posted to your record on your Social Security Statement. The Statement is available online to workers age 18 and older. To get your Statement, go to www.socialsecurity.gov/mystatement and create an account.
>
> You should also monitor your credit reports and any financial accounts for further signs of misuse of your personal information. As a precaution, you may want to contact one of the three major credit bureaus to have a fraud alert placed on your account. You only need to contact one of the credit bureaus, as the one you contact is required to contact the other two.

CPAs will need to counsel clients who receive such a letter about the implications of the letter. First, the taxpayer should take the steps outlined in the letter to notify credit bureaus and confirm their earnings with social security.

Second, the adviser should explain that the real threat at this point most likely is not the party that used the identity, but rather the party form whom that data was obtained. That is, it is very likely that far more than the person's name and social security number is available for sale to the highest bidder—and the party that bought the identity for employment purposes was almost certainly not given those details since they can be resold by that party to others for more money.

An unfortunate fact of life today is that significant information (including social security numbers, addresses, employers, etc.) is available for sale—thus it is probably prudent for all individuals to assume their data is available for sale and they could be targeted.

SECTION: 25A
PURCHASE OF COMPUTER FROM LOCAL RETAILER DID NOT QUALIFY FOR AMERICAN OPPORTUNITY TAX CREDIT

Citation: Mameri v. Commissioner, T.C. Summ. Op. 2016-47, 8/25/16

In the case of *Mameri v. Commissioner*, T.C. Summ. Op. 2016-47 the Tax Court denied a taxpayer's attempt to claim an American Opportunity Tax Credit for funds expended to buy a computer for his studies.

The taxpayer's education program is described by the Court below:

> During the spring 2012 semester petitioner took courses including English 5, a critical thinking composition course. The instructor required students to build an anthology of peer-reviewed sources on

a research topic generated during class. The anthology project started the third week of the semester and was due at the end of the semester. Students could choose a topic, conduct extensive online research on the topic, and put together an anthology of the sources found. Work performed during class hours included discussion and critical thinking. Students conducted online research for the anthology outside of class hours. Petitioner spent six to seven hours per day when researching for the class.

> The Berkeley City College library had online databases available for student use, but the library had limited hours and did not have a laptop loan program. Petitioner attended both morning and evening classes and worked at Guardsmark in the afternoon.

The taxpayer traveled to Algeria in May of 2012 and purchased a computer which he took with him to Algeria, and which he used to complete his coursework. The taxpayer also produced the following:

> Petitioner also provided a signed letter from his English instructor dated May 12, 2016, stating that although the bulk of work for the English course could be performed using the Berkeley City College library's databases, the library had limited hours and no laptop loan program, so "students whose schedules didn't allow for much time on campus to use the databases during the library hours were limited to using personal computers to complete their work."

The taxpayer claimed the $1,288 cost of the computer he purchased as a portion of the expenses for which he claimed the American Opportunity Tax Credit for the year in question.

The Court pointed out the general provisions for expenses eligible to be counted in computing the credit:

> Generally, "qualified tuition and related expenses means tuition and fees required for enrollment or attendance". Sec. 1.25A-2(d)(1), Income Tax Regs. A "required" fee is one that is "required to be paid to the eligible educational institution as a condition of the student's enrollment or attendance at the institution." Id. subpara. (2)(i). Amounts paid for books, supplies, and equipment are eligible only if the fees must be paid to the institution for the student's enrollment or attendance. Id. subdiv. (ii). For example, if students are required to purchase books and reading materials for a course but can purchase them from another source such as an off-campus bookstore, they are not required to be purchased from the institution for enrollment or attendance. See id. subpara. (6), Example (2).

The purchase of the computer fell short of this requirement for a number of reasons. First, he had not acquired the computer from the educational institution, rather purchasing it from a local computer store. As the Court explained:

> There is no evidence that petitioner was required to purchase the computer directly from Berkeley City College. Instead petitioner was able to and in fact did purchase the computer from a third party. Thus the cost of the computer is not an expense that qualifies for the education credit. See id. subpara. (6), Example (2).

Even if it had been required to be purchased from the institution, there was a problem. Although clearly it was helpful to him and, arguably, he might not have completed his studies without the computer, that would not be enough.

As the Court continued:

> Petitioner asserted that, because of his visit to Algeria, he needed the computer to complete the anthology assignment. Petitioner did not indicate that Berkeley City College required him to purchase the computer. Additionally, the instructor's letter states only that students at Berkeley City College had limited options to use library computers and does not indicate that the computer was required for the class or to attend the college. Thus petitioner has not shown that purchasing the computer was a condition of enrollment or attendance as required by the regulation. See id. subparas. (1) and (2).

Thus the taxpayer was denied the credit for these expenses.

SECTION: 168
GUIDANCE GIVEN FOR TAXPAYERS IMPACTED BY RETROACTIVE REINSTATEMENT OF DEPRECIATION AND §179 RELATED TAX PROVISIONS IN PATH

Citation: Revenue Procedure 2015-48, 8/26/16

Congress' recent penchant for letting bonus depreciation expire only to be retroactively reinstated nearly a year later has created issues for many non-calendar year taxpayers. When their returns are filed assets acquired after January 1 of the year in question are not eligible for bonus depreciation. However when Congress retroactively extends the application of IRC §168(k) these returns become "erroneous" as filed since bonus depreciation must be used unless the taxpayer elected not to use bonus.

In Revenue Procedure 2016-48 the IRS gives guidance to taxpayers who find they have such "erroneous" returns already on file with the agency due to the passage late last year of the Protecting Taxpayers Against Tax Hikes Act of 2015 (PATH).

Specifically as the IRS notes in the "Purpose" section of the procedure:

> This revenue procedure provides guidance for issues related to the enactment of § 124(c)(1), § 143(a)(1), and § 143(a)(3) of the Protecting Americans From Tax Hikes Act of 2015 (PATH Act), enacted as part of the Consolidated Appropriations Act, 2016, Division Q, Pub. L. No. 114-113, 129 Stat. 2242 (December 18, 2015). Section 124(c)(1) of the PATH Act amended § 179(f) of the Internal Revenue Code (Code) by extending the application of § 179(f) from any taxable year beginning after 2009 and before 2015 to any taxable year beginning after 2009 and before 2016. Section 143(a)(1) of the PATH Act amended § 168(k)(2) of the Code by extending the placed-in-service date for property to qualify for the 50-percent additional first year depreciation deduction. Section 143(a)(3) of the PATH Act amended § 168(k)(4) of the Code by allowing corporations to elect not to claim the 50-percent additional first year depreciation deduction for certain property placed in service generally after December 31, 2014, and before January 1, 2016, and instead to increase their alternative minimum tax (AMT) credit limitation under § 53(c) of the Code.

The procedure first looks at the impact of the extension of the qualified real property provisions found at IRC §179(f). Previously any taxpayer who had unused carryover of such qualified real property deductions as of the last day of the taxpayer's taxable year beginning in 2014 had to treat that excess as placed in service on the first day of the taxpayer's first tax year beginning in 2014—that is, it couldn't be carried into a tax year beginning in 2015. Under the revised law that excess could be carried into 2015.

The procedure allows a taxpayer that had already filed a return that did not carry that excess into the 2015 tax year to choose to either amend the 2015 to do so or continue to treat that carryover as an asset placed in service in the first tax year beginning in 2014. The taxpayer must amend the return in question while the statute under §6501(a) is open and remains open for all later affected years.

The IRS provides the following mechanism for those electing to go the amended return route:

> The amended federal tax return for the taxpayer's last taxable year beginning in 2014 must include any collateral adjustments to taxable income or tax liability (for example, the amount of depreciation allowed or allowable in the last taxable year beginning in 2014 for the amount of the 2010, 2011, 2012, 2013 or 2014 disallowed § 179 deduction). Such collateral adjustments must also be made on amended federal tax returns for any affected succeeding taxable years. The amended returns for the taxpayer's last taxable year beginning in 2014 and for any affected succeeding taxable years must be filed within the time prescribed by law for filing an amended return for such taxable years.

Bonus depreciation under §168(k) had also ended generally for assets placed in service after December 31, 2014. Thus, any taxpayer filing returns with tax years ending after December 31, 2014 may have placed in service assets on which no bonus depreciation was claimed (as the law in place at the time did not allow it) but who now wish to claim bonus depreciation.

As well, some taxpayers who do not want to deal with making the change may be concerned because the law retroactively restored the provision requiring taxpayers who do not wish to use bonus depreciation to opt out of the treatment on their returns. These taxpayers did not attach an election out of bonus depreciation with their return (as it was not necessary under the law at the time) and may have concerns that the law Congress enacted would require the taxpayers to revise their returns to claim the bonus depreciation or be stuck with a permanent loss of basis for the unclaimed depreciation.

The ruling goes on to deal with these affected taxpayers, granting various options.. The IRS provides the following relief options.

If no election was made to opt out of 50% bonus depreciation, the IRS grants the taxpayer two options to claim the "lost" bonus depreciation. The first is to amend the tax return for the year in question, claiming the extra depreciation:

> An amended federal tax return for the 2014 taxable year or the 2015 short taxable year, as applicable, before the taxpayer files its federal tax return for the first taxable year succeeding the 2014 taxable year or the 2015 short taxable year, as applicable. If the taxpayer has both a 2014 taxable year and a 2015 short taxable year, and has timely filed federal tax returns for both such years, the amended federal tax returns for both the 2014 taxable year and the 2015 short taxable year must be filed before the taxpayer files its federal tax return for the first taxable year succeeding the 2015 short taxable year…

In the alternative, the IRS outlines how to catch up on that lost depreciation via filing a change of accounting method to "catch up" using §481(a) adjustment on either the first or second year following the lost depreciation:

> A *Form 3115, Application for Change in Accounting Method*, under section 6.01 of Rev. Proc. 2016-29, 2016-21 I.R.B. 880, 888, with the taxpayer's timely filed federal tax return for the first or second taxable year succeeding the 2014 taxable year or the 2015 short taxable year, as applicable, if the taxpayer owns the property as of the first day of the year of change (as defined in section 3.19 of Rev. Proc. 2015-13, 2015-5 I.R.B. 419, 429). If the taxpayer has both a 2014 taxable year and a 2015 short taxable year, and has timely filed federal tax returns for both such years, the Form 3115 must be filed with the taxpayer's timely filed federal tax return for the first or second taxable year succeeding the 2015 short taxable year if the taxpayer owns the property as of the first day of the year of change.

If the taxpayer attached an election to "opt-out" of the 50% bonus for the affected assets for the period when the bonus depreciation was not allowed but now wishes to make use of it, the IRS provides the following option:

> If, on its timely filed federal tax return for the 2014 taxable year or the 2015 short taxable year, as applicable, a taxpayer made an election within the time and in the manner described in section 2.02(3) of this revenue procedure to not deduct the 50-percent additional first year depreciation for a class of property that is qualified property, the Commissioner grants the taxpayer consent to revoke that election, provided the taxpayer files an amended federal tax return for the 2014 taxable year or the 2015 short taxable year, as applicable, in a manner that is consistent with the revocation of the election and by the later of (1) November 11, 2016, or (2) before the taxpayer files its federal tax return for the first taxable year succeeding the 2014 taxable year or the 2015 short taxable year.

A taxpayer who did not attached the election out of the 50% bonus depreciation for the affected assets will be allowed to make a "deemed election" out of the method under this procedure. The IRS outlines this option as follows:

> …[A] taxpayer that timely filed its federal tax return for the 2014 taxable year or the 2015 short taxable year, as applicable, will be treated as making the election to not deduct the 50-percent additional first year depreciation for a class of property that is qualified property if the taxpayer:
>
> > (a) On that return, did not deduct the 50-percent additional first year depreciation for that class of property but did deduct depreciation; and
> >
> > (b) Does not file an amended federal tax return or a Form 3115 within the time and in the manner provided in section 4.02 or section 4.03 of this revenue procedure, as applicable, to claim the 50-percent additional first year depreciation for the class of property.

The ruling also reminds taxpayers that such elections apply to the class of property in question:

> (3) Application. If the taxpayer makes the election under section 4.04(1) *[actual election made with original return]* or (2) *[deemed election made under this revenue procedure as described above]* of this revenue procedure for its 2014 taxable year, the election applies to both 2014 qualified property and 2015 qualified property in the same class of property for which the election is made. If the taxpayer makes the election under section 4.04(1) or (2) of this revenue procedure for its 2015 short taxable year, the election applies to 2015 qualified property in the same class of property for which the election is made.

The ruling contains similar provisions for the special treatment available to certain taxpayers who opt of bonus depreciation and increase the taxpayer's limits for bonus depreciation and the AMT credit, now dealing with "Round 5" property.

SECTION: 460
RESIDENTIAL DEVELOPER ALLOWED TO CONSIDER COMMON AREA AMENITIES IN DETERMINING COMPLETION OF INDIVIDUAL CONTRACTS OF SALE FOR RESIDENCES UNDER COMPLETED CONTRACT METHOD

Citation: Shea Homes, Inc. v. Commissioner, 142 TC No.3, 2/12/14, affd, CA9 Case Nos. Nos. 14-72161, 14-72162, 14-72163, 8/24/16

In the case of *Shea Homes, Inc. v. Commissioner*, 142 TC No.3, the question of the scope of contracts of a homebuilder when making use of the completed contract method was the key issue.

The taxpayer developed large planned residential communities which had substantial common area developments and improvements required by the localities in which the developments were located.

While most long term contracts must be accounted for using the percentage of completion method [IRC §460(a)]. However, a special exception exists for home construction contracts [IRC§460(e)(1)(A), (6)(A)]. A home construction contract is one in which 80% or more of the estimated total contract costs are expected to be attributable to dwelling units and improvements to real property directly related to such units.

Under the completed contract method, revenue from the contract is recognized when either of two "completion" tests are met [Reg. §1.460-1(f)]:

- Use and 95% Completion Test – completion takes place upon use of the property by the customer for its intended purpose and at least 95% of the total allocable costs attributable to the subject matter have been incurred by the taxpayer; *or*
- Final Completion and Acceptance Test – completion takes place upon final completion and acceptance by the customer, determined by taking into account all facts and circumstances.

The dispute arose over what consideration, if any, should be given to costs related to development wide expenses (common areas, road improvements, etc.) and their state of completion when making the determination under either of the above tests.

The IRS argued that when a customer closes on the home after the construction of their structure is completed that both tests are met, and the entire contract price for that home should be recognized by the taxpayer. In the IRS view, both tests would be met at this point—100% of the costs would be incurred and there would be both final completion and acceptance. The common area items are “secondary items” which, under Reg. §1.460-1(c)(3)(ii), are not to be considered in determining the completed status of the contract.

The taxpayer (and, it turns out, the Tax Court) disagreed with that view. The taxpayer pointed out that substantial costs were being incurred with regard to the common areas, their marketing emphasized the value of such amenities, and buyers were clearly willing to pay extra to have a home in a community with such items.

The IRS argued first that, regardless of this fact, the <u>contracts</u> did not cover the common area. The IRS points to the fact that the individual purchase and sale agreements for each home stated that it constituted the sole and entire agreement between the buyer and seller. Thus, since these contracts did not contain the details of the common areas, they simply weren’t part of the contract.

However, the Tax Court noted that the contracts made reference to documents that did contain that information. The court analyzed the laws of the states involved (Arizona, California and Colorado) and, based on the specific laws of each state (including requirements in Arizona and California regarding receipt of a developer’s public report containing such details) and determined that, despite the specific clause, courts in all of the states would have found the documents detailing the developer’s responsibilities for the common areas to be incorporated into the contract. As well, in each case the contracts contained a checklist indicating the documents were to be given to the customers and each customer actual received the documents.

The IRS next contended that the house alone was the “subject matter” referred to in the regulations. The IRS did have one issue to deal with here—because qualification under the 80% rule would be very difficult for a builder such as this taxpayer with significant costs that are not direct costs of the dwelling unit and improvements to it, Reg. §1.460-3(b)(2)(iii) allows a taxpayer to consider the “allocable share of the cost the taxpayer expects to incur for any common improvements.”

The IRS position was that the inclusion of these items was <u>solely</u> for meeting the 80% test and did not mean the items became part of the subject matter of the contract. The IRS argued this was in line with the “plain meaning” of the regulation. The Tax Court found that view wanting, holding specifically that if they were to decide upon a “plain meaning” of the subject matter, the Court would determine the subject matter would include the common improvements.

As well, the Court points to the “all facts and circumstances” clause in the second test, which it finds suggest a broad, rather than narrow, view of what constitutes the subject matter.

The IRS’s final objection is that, even if the improvements are part of the subject matter of the contract, they are nevertheless the “to be ignored” secondary items discussed in the regulations. All parties agreed that an item should be considered a “secondary item” if the contracting parties intended the item to be secondary.

The Court here finds that, in the facts in this case, the amenities were of “great importance to and a crucial aspect of SHI's, SHLP's, and Vistancia's sales effort, obtaining of governmental approval of the development, and the buyers' purchase decision, and thus the amenities are an essential element of the home purchase and sale contract.” Earlier the Court had noted that, given the expense involved with the common areas and amenities, buyers would reasonably be aware that if they were not interested in such items, they could likely obtain a comparable home for far less money in a development without such “extras” and thus they were willing to pay more.

The IRS also looked to try to use a technicality, arguing that the taxpayer had impermissibly aggregated the contracts and, regardless of whether permissible, had failed to attach the required statement with the return when contracts were aggregated. [Reg. §1.460-1(e)(4)]

The Court noted that the method used did not actually aggregate the contracts into a single mass—rather, each contract was tested with its costs and its share of the common costs for purposes of 95% test. Similarly, the mere fact that all of the contracts looked to the promised completion of work on the amenities and development as one of their conditions for final completion and acceptance would also not be combining them all—as should be clear, each buyer's contract contained portions only of interest to that buyer. So if the taxpayer had completed the amenities but, say, neglected to complete work on the one buyer's garage all other contracts may be complete, but the one would not.

While this case is generally very good news for developers of residential projects, it is important to note that the Court spent significant time on developing both the specific facts related to each project (including how each project was marketed to customers) and details of applicable state law.

Thus any taxpayer seeking to stake out a similar position would be well advised to study the details of the facts in this case and assure that their facts are similar enough to justify reliance on this case. For instance, if there was not a homeowner's association to be involved due to no common amenities and the only common costs were items required by a locality, it might be far more difficult to show that the buyers truly considered those items as anything but "secondary" items.

On appeal to the Ninth Circuit (*Shea Homes Inc. et al. v. Commissioner*, CA9, Nos. 14-72161, 14-72162, 14-72163) the IRS decided to change its argument somewhat—the agency agreed that the amenities were part of the contract, but that the Tax Court had impermissibly allowed Shea Homes to perform the 95% test against the entire cost of the development rather than simply the costs of that home and its allocable share of common area costs only.

The Ninth Circuit rejected the IRS appeal. All of the judges noted that this was an argument the IRS had not raised at Tax Court, instead basing its position entirely on the full exclusion of common area elements, the position the agency now accepts as erroneous.

The majority opinions points out that, to the extent there was error at the trial court level, that error was the IRS's (a position it seems likely the concurring judge would also accept):

> The Commissioner complains that the Tax Court focused on the house, lot and common amenities in its opinion. The Commissioner then suggests that when the Tax Court mentioned the development as a whole, it was, somehow, being inconsistent. The Commissioner overlooks the fact that his focus was on those specific aspects, and those are what he specifically pointed to when he was stating his position for purposes of the trial of this case at the Tax Court. We suspect that the Commissioner was satisfied that his position on those points would win the day and, therefore, that he need not concentrate his firepower on the overall planned community development aspect of the contracts. The resulting outcome was due to his misperception rather than a Tax Court mistake.

Two of the three judges took up the IRS's new position and rejected it out of hand, holding that the buyers had an interest on the completion of the development and not just the amenities. As the majority stated:

> The Commissioner also argues that a buyer of a house cannot himself use other homes and, therefore, the development as a whole could not be part of the subject matter of the buyer's contract. That not only begs the question but also is a non sequitur. Each person in the planned community would, indeed, have an interest in the use of other property in the development, and that would include not only the common amenities but also the use that others in the development made of their own properties. That is at least one reason for the CC&R's and the mandated homeowners' associations. It is not a question of living in another's home; it is a question of assuring that the planned lifestyle is followed to some

> degree. And until the Taxpayers' work was complete, they had an obligation to fulfill their promises regarding the development that they had induced the buyers to become a part of.

However, Judge Rawlinson, in a concurring opinion, sustains the original decision solely because the IRS had not raised the matter at trial. He notes:

> Our precedent is replete with cases precluding a party from endeavoring to assert a theory on appeal that was not presented to the trial court. See, e.g., *Stewart v. Comm'r of Internal Revenue*, 714 F.2d 977, 986 (9th Cir. 1983) ("Without question, the most appropriate times for the Commissioner to inform a taxpayer of the legal theories on which he intends to rely are first in the notice of deficiency and then in the Commissioner's answer in the Tax Court. . . .") (citation omitted); *Ecological Rights Found. v. Pac. Gas & Elec. Co.*, 713 F.3d 502, 511 (9th Cir. 2013) ("The Court will not allow a party to raise an issue for the first time on appeal merely because a party believes that he might prevail if given the opportunity to try a case again on a different theory.") (citation and alteration omitted); *Tibble v. Edison Int'l.*, 820 F.3d 1041, 1046 (9th Cir. 2016) ("We recognize a general rule against entertaining arguments on appeal that were not presented or developed before the district court. . . . [A]n issue will generally be deemed waived on appeal if the argument was not raised sufficiently for the trial court to rule on it.") (citations and internal quotation marks omitted).
>
> We need go no further than consulting this precedent to resolve the instant appeal.

He then goes on to state that the majority erred both in deciding to look at the IRS's argument and to rule on it. As well, he clearly indicates that their acceptance of the entire development as the item to be tested for 95% of the costs appears to be at odds with the regulation:

> …[T]he fact remains that a Taxpayer could readily manipulate the 95 percent completion test by deliberately incurring development costs of less than 95 percent and deferring the balance of the costs indefinitely, correspondingly deferring taxes indefinitely. I am not persuaded that this interpretation of the regulation is consistent with its plain language. For that reason, I would affirm the Tax Court's decision solely on the basis that the Commissioner failed to raise this issue sufficiently for the Tax Court to rule on it. I would reserve resolution of this important issue for a case where it was fairly joined.

At this point advisers likely should take care with the status of this issue. While the Ninth Circuit majority accepted the view that the entire development is the item to be tested, it seems very possible that view might not hold in other circuits.

As well, outside the Ninth Circuit, arguably the Tax Court could view their holding as limited to the question of the inclusion of more than just the particular costs of one house without necessarily holding that the entire development is the proper item to test for 95%.

That is, the Tax Court could take the position, stated in the Ninth Circuit opinion, that as the item was never contested there was no real decision on what would be the proper measurement level. But the one thing we know for sure is that all parties agree that in a development such as this the costs for the contract are not solely limited to costs incurred on the particular lot.

SECTION: 530
SAME LIMITATIONS ON ANNUAL ROLLOVERS OF IRAS APPLY TO COVERDELL ESAS

Citation: Program Manager Technical Advice 2016-10, 8/31/16

Following the *Bobrow v. Commissioner* (TC Memo 2014-21) decision, taxpayers discovered that, despite what the applicable IRS publication said, that once a taxpayer had completed a rollover from an IRA account the taxpayer had to wait another year to make a second rollover—even if that rollover came from a different IRA account.

But traditional IRAs aren't the only type of tax advantaged account for which rollovers are allowed—Coverdell Education Savings Accounts (the accounts originally known as Education IRAs) are also eligible for rollover treatment found at IRC §530(d)(5) that is very similar to the language found at §408(d)(3)(B) the court opined on in the *Bobrow* case. So do the same restrictions apply?

In [Program Manager Technical Advice 2016-10]() the IRS national office decided that the treatment should be the same in the case of a Coverdell Education Savings Account. The advice notes:

> There is no published guidance interpreting the § 530(d)(5) limitation on rollovers. However, *Publication 970, Tax Benefits for Education* states that only one rollover per Coverdell ESA is allowed during a 12-month period.
>
> In light of the similarity of the language of §§ 408(d)(3)(B) and 530(d)(5), we believe that, with respect to rollovers described in § 530(d)(5), only one rollover per individual per year is permitted.

The memorandum goes on to suggest potential revisions to the publication to clarify this issue. It continues:

> In the event you wish to update Publication 970, we suggest using the following language in both the What's New section and in the "Caution" box under Rollovers and Other Transfers section of Chapter 7:
>
> > "You can make only one rollover from a Coverdell ESA to another Coverdell ESA in any 12-month period regardless of the number of Coverdell ESAs you own. However, you can make unlimited transfers from one Coverdell ESA trustee directly to another Coverdell ESA trustee because such transfers are not considered to be distributions or rollovers. The once in any 12-period limitation rule does not apply to the rollover of a military death gratuity or payment from Servicemembers' Group Life Insurance (SGLI)."

The advice seems to be valid due to the very similar language found in the applicable Code sections—whatever Congress meant for IRAs in this regard seemingly should apply to ESAs.

Coverdell ESAs are unique among the education savings programs because their funds can be withdrawn for use for paying education expenses for elementary and secondary schools, rather than being limited to post-secondary education. However, the contribution is subject to a relatively low annual limit and using the funds prior to the beneficiary entering college greatly reduces the main benefit of tax free growth during the accumulation phase. Once the elementary and secondary education benefit is removed, there are few advantages (and many disadvantages) to an ESA vs. a §529 plan.

Despite these limitations, some taxpayers have established these accounts, so advisers need to remind these taxpayers that if they plan to remove the funds to roll them into another ESA they will be subjected to the same restrictions as apply to rollovers from standard IRA accounts.

SECTION: 7701
MARRIAGE DEFINITIONS FOR THE IRC REVISED IN FINAL REGULATIONS TO COMPLY WITH SUPREME COURT HOLDINGS

Citation: TD 9785, Reg. §301.7701-18, 9/2/16

Final regulations have been issued by the IRS ([TD 9785]()) revising regulations under IRC §7701 for the definitions related to marriage as they apply to the Internal Revenue Code. These regulations take into account the Supreme Court's holdings on same sex marriage found in the cases of *Obergefell v. Hodges* (135 S. Ct. 2584 (2015)) and *Windsor v. United States* (133 S. Ct. 2675 (2013)).

The final regulations generally reflect the revisions found in the proposed regulations (REG-148998-13) issued in October 2015. Rather than revised the language throughout the regulations to remove the terms "husband" and "wife" the IRS decided to issue a broad clarifying definition in Reg. §301.7701-18.

Reg. §301.7701-18(a) provides:

> (a) In general. For federal tax purposes, the terms spouse, husband, and wife mean an individual lawfully married to another individual. The term husband and wife means two individuals lawfully married to each other.

Effectively, the IRS has provided the terms "husband" and "wife" will be treated as gender neutral under the tax law.

A valid marriage is tested by looking at whether it is valid in the state, possession, or territory of the United States where the marriage was entered into, regardless of the domicile of the individuals involved. [Reg. §301.7701-18(b)(1)] If a marriage is entered into in a foreign country, it will be recognized as a marriage for federal tax purposes if the marriage would be recognized as valid by at least one state, possession, or territory of the United States, regardless of domicile. [Reg. §301.7701-18(b)(2)]

The preamble spends significant time addressing three comments regarding individuals with a "civil union", "registered domestic partner" or similar status other than marriage under a state law. The final regulations, consistent with the proposed regulations, provide that such individuals are not treated as married. Reg. §301.7701-18(c) provides:

> (c) Persons who are not lawfully married for federal tax purposes. The terms spouse, husband, and wife do not include individuals who have entered into a registered domestic partnership, civil union, or other similar formal relationship not denominated as a marriage under the law of the state, possession, or territory of the United States where such relationship was entered into, regardless of domicile. The term husband and wife does not include couples who have entered into such a formal relationship, and the term marriage does not include such formal relationships.

The comments had proposed that these individuals be treated as married for federal tax purposes. The IRS declined to do so, noting that the states in question define this as a status other than married even if the rights and responsibilities of the parties are similar or identical those who are married under the same state law. Presumably the couple in question has made a conscious decision at this point to remain "not married" rather than change their status to married, so the IRS will not require the couple to be treated as married.

The IRS also declined to limit the application of community property treatment to only those individuals who are married under state law, finding that was outside the scope of these rules. As the IRS noted in the preamble:

> These regulations provide definitions for purposes of determining marital status for federal tax law purposes. These regulations do not provide substantive rules for the treatment of married or non-married couples under federal tax law. Accordingly, because the federal tax treatment of issues that arise under community-property law involves resolution of issues under substantive tax law, which is outside the scope of these regulations, the commenter's recommendation is not adopted by these final regulations.

One planning point to note is that this means that those who obtain an alternative status other than marriage in a state that applies community property provisions to such individuals may find they have a significant federal tax advantage over those who get married in the same state if the income of the couple is predominantly community income.

That couple would have the community income divided evenly between the couple but, rather than being subjected to the married filing separate rates, would rather be able to use either the single or head of household filing statuses—either of which will produce a significantly better tax result than the married separate returns or a single married filing joint return.

The good news for advisers is that these regulations don't provide for any change from the original IRS positions announced following the Supreme Court decisions.