Current Federal Tax Developments

Nichols Patrick CPE a Division of the Loscalzo Institute

October 16, 2017

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SECTION: 107
EXCLUSION FROM INCOME OF MINISTER'S HOUSING ALLOWANCE FOUND UNCONSTITUTIONAL

Citation: Gaylor, et al v. Mnuchin, et al, W.D. Wisconsin, Case No. 3:16-cv-00215, 10/6/17

Back in 2014 the Seventh Circuit Court of Appeals sidestepped the question of whether the allowance of an exclusion for a housing allowance for a minister of the gospel under IRC §107(2) was barred by the U.S. Constitution. But the method the panel used to sidestep left an obvious route for the issue to come back—and now it has returned to the Courts.

Originally in the case of *Freedom from Religion Foundation, Inc. v. Lew*, 114 AFTR 2d, ¶2014-5425 issued in November of 2014 the panel found that the organization suing to bar ministers from receiving an exclusion from income for housing allowances did not show any harm to the organization. The panel noted that the organization had not attempted to receive a similar exclusion for its employees from the IRS. So, it was the organization that voluntarily treated the payments as taxable to its employees rather than the IRS denying that treatment.

At the time I had noted that the obvious next step was for the organization to ask for such treatment and then come back to Court if the IRS did not allow the claim. The case of *Gaylor, et al v. Mnuchin, et al,* W.D. Wisconsin, Case No. 3:16-cv-00215 brings the matter back to the courts. And, in fact, the case is back before the very trial judge that, in the original case, had found that IRC §107(2) violated the U.S. Constitution. Not surprisingly, since the Seventh Circuit never actually dealt with that question (disposing of the case on a standing issue), the judge came to the same conclusion this time.

The plaintiffs in this case had filed various amended returns claiming refunds based on excluding a housing allowance from employee's income. The IRS paid out the first refund claim without explaining why, but failed to act within six months on another claim and disallowed another entirely. After the taxpayers filed suit, the IRS did disallow the claim on the one amended return they had not acted on.

Standing to sue is discussed in this opinion on two issues, one raised by the Court itself and another raised by intervening parties (ministers with various churches). The Court's worry was about the plaintiff who sued before the IRS disallowed the claim—but the Court found that the statute allows for a suit where the IRS fails to act within six months.

The intervenor's claims were more interesting—they found there was no standing because the plaintiffs had not shown a future harm is likely. The Court rejected this view, noting that while the IRS had both allowed and disallowed claims for refunds, only for the disallowed claims did they explain their rationale. The Court found that the denial, which came with a detailed explanation, was the more likely indicator of future IRS action in this area.

The Court went on to again give its conclusion that IRC §107(2) violated the establishment clause of the United State Constitution.

IRC §107, the provision in question, reads as follows:

> In the case of a minister of the gospel, gross income does not include--
>
> > (1) the rental value of a home furnished to him as part of his compensation; or
> >
> > (2) the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.

The Court, citing *Lemon v. Kurtzman*, 403 U.S. 602 (1971) found that the law had to be invalidated for violating the establishment clause if any of the following are found to be true:

- The law has no secular purpose;
- The law's primary effect advances or inhibits religion; *or*
- The law fosters an excessive entanglement with religion.

The Court then went on to note that it was applying a modified version of the test that could be summarized as determining if the government's purpose was to endorse religion and whether the statute conveys a message of endorsement, viewed from the perspective of a reasonable observer. The Court concluded that this law was intended as an endorsement of religion and served no secular purpose.

As the opinion summarizes:

> …[A]ny reasonable observer would conclude that the purpose and effect of § 107(2) is to provide financial assistance to one group of religious employees without any consideration to the secular employees who are similarly situated to ministers. Under current law, that type of provision violates the establishment clause.
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> In reaching this conclusion, I do not mean to imply that any particular minister is undeserving of the exemption or does not have a financial need for one. The important point is that many equally deserving secular employees (as well as other kinds of religious employees) could benefit from the exemption as well, but they must satisfy much more demanding requirements despite the lack of justification for the difference in treatment.

However, having gotten to this point the Court did not have an obvious answer as to what the remedy should be in this case. The opinion ends with:

> I am reluctant to make a definitive determination regarding the appropriate remedy because none of the parties developed an argument in favor of a refund, a particular injunction or both or otherwise developed an argument regarding what the court should do in the event that it concludes that § 107(2) is unconstitutional. Accordingly, I will issue declaratory relief and give the parties an opportunity to file supplemental materials regarding what additional remedies are appropriate, if any. In addition, the parties should address the question whether relief should be stayed pending a potential appeal.

So, what should an adviser working with ministers or churches do at this point? For now, there's not really anything to do. As the last sentence in the opinion notes, it is highly likely this decision will again go before the Seventh Circuit and, potentially, end up at the U.S. Supreme Court, especially if the Court of Appeals sustains the finding of the District Court.

As well, since even the judge ruling in the case couldn't determine how to proceed with "where do we go next" it is going to require waiting to see what the results are in future litigation. But certainly, advisers must counsel ministers and churches to keep a close eye on future developments in this matter.

SECTION: 170
TAX COURT REJECTS FIRST CIRCUIT'S VIEW OF LIMITS ON NEED TO SUBORDINATE MORTGAGES FOR CONSERVATION EASEMENT

Citation: Palmolive Building Investors LLC et al. v. Commissioner, 149 TC No. 18, 10/10/17

The Tax Court, in the case of *Palmolive Building Investors LLC et al. v. Commissioner*, 149 TC No. 18, refused to follow the holding of the First Circuit Court of Appeals in the case of *Kaufman v. Commissioner*. The Court continued to very strictly apply the subordination requirement in Reg. §1.170A-14(g), finding that the taxpayer in this case had not managed to satisfy the perpetuity requirement of IRC §170(h)(5).

The First Circuit and the Tax Court had disagreed on the extent to which a mortgage must be subordinated to meet the requirements of Reg. §1.170A-14(g)(2). That regulation provides:

> (2) Protection of a conservation purpose in case of donation of property subject to a mortgage.
>
> In the case of conservation contributions made after February 13, 1986, no deduction will be permitted under this section for an interest in property which is subject to a mortgage unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity.

In the case before the Tax Court, the lender had agreed to generally subordinate the debt to the claims of the charity, but the deed provided that the lender would have priority in access to any insurance proceeds on the property (assuming the donor had such insurance on the property) and to any condemnation proceeds. The Tax Court found that, despite applying the label of "subordinated" to the notes, these clauses effectively provided for just the opposite, giving the lender a priority in these situations.

In the view of the Court, the fact the mortgages had superior rights in specific situations meant the mortgages were not subordinated in accordance with Reg. §1.170A-14(g) and, therefore, the donation was not in "perpetuity" as required by IRC §170(h)(5).

The First Circuit had rejected the view that a subordination must remove any preferential treatment of the lender in unusual but possible situations, finding that such a broad reading of what is necessary to grant an easement in perpetuity meant there could be no donation of an easement, since it represents only a partial interest and it was always possible that, say, a tax lien on the property that might arise if the donor failed to pay property taxes as due could result in loss of the property without the charity receiving a prorata portion of the value.

The Tax Court rejected that view. The Court pointed out that this case, if it is appealed, would go to the Seventh Circuit Court of Appeals. The Tax Court is only bound by the decision of a Court of Appeals if the case would be appealed to that circuit under the *Golsen* rule (*Golsen v. Commissioner*, 54 TC 742). The Court also pointed out that other Circuits had agreed with the Court's generally strict interpretation of the subordination rule in the years since *Kaufman* was decided.

The Court then went after the First Circuit's logic, arguing there was a key difference in what must be done to subordinate an already existing liability at the time of the donation (the mortgage) as opposed to a possible future liability that currently did not exist. The Court also pointed out that the regulations specifically mentioned mortgages in outlining requirements to meet the perpetuity requirement, but did not mention any issues with getting taxing agencies to agree to give up rights to a priority interest that might arise in the future for delinquent taxes when the taxes were not delinquent.

SECTION: 754
SIGNATURE NO LONGER REQUIRED WHEN MAKING IRC §754 ELECTION

Citation: Proposed Reg. § 1.754-1, REG-116256-17; 82 F.R. 47408-47409, 10/12/17

Under proposed regulations on which taxpayers may rely upon immediately, elections made by partnerships under IRC §754 will no longer have to be signed by a partnership representative (REG-116256-17; 82 F.R. 47408-47409, October 12, 2017). The current regulations require that the election be signed, which has created issues with electronically filed partnership income tax returns.

In certain situations, a partnership may elect to adjust the basis of partnership property upon the occurrence of certain actions, such as a transfer of a partnership interest (as provided for in IRC §743) or upon distributions of property (as provided for in IRC §734).

The IRS describes the current regulation, which this proposed regulation would change, as follows:

> The current regulation requires that the section 754 election statement (i) set forth the name and address of the partnership making the election, (ii) be signed by any one of the partners, and (iii) contain a declaration that the partnership elects under section 754 to apply the provisions of section 734(b) and section 743(b). Accordingly, under the current regulation, a partnership that files an unsigned section 754 election statement with its partnership return (whether filed electronically or in paper) has not made a valid section 754 election.

A partnership that failed to attach a signed election to the partnership tax return had to resort to one of the relief provisions under the regulations for IRC §9100. That relief consisted of:

- Automatic relief if the error were discovered and corrected within 12 months under Reg. §301.9100-2 or

- Filing and paying for a private letter ruling request asking for relief under the provisions of Reg. §301.9100-3.

The result has been a rather significant number of private letter rulings granting late §754 election relief over the past few years. As often happens when the IRS begins to see many virtually identical rulings being issued, the IRS has decided to take steps to eliminate the need for having to deal with all the ruling requests.

In this case the IRS determined that removing the signature requirement would serve to eliminate a lot of these requests. The IRS explains the proposed change as follows:

> To ease the burden on partnerships seeking to make a valid section 754 election and to eliminate the need to seek 9100 relief, the Treasury Department and the IRS are proposing to amend the current regulation to remove the signature requirement in § 1.754-1(b)(1). The amended regulation will provide that a taxpayer making a section 754 election must file a statement with its return that: (i) sets forth the name and address of the partnership making the section 754 election, and (ii) contains a declaration that the partnership elects under section 754 to apply the provisions of section 734(b) and section 743(b).

Note that the language will now become standard for every partnership, with only the partnership identifying information changing for each taxpayer.

While the guidance was issued as a proposed regulation, the IRS has provided that taxpayers "may rely on this proposed regulation for periods preceding the proposed applicability date."

While this doesn't solve all the manners in which a taxpayer may fail to properly make an election under §754, it does make it a lot simpler to file such elections electronically.

SECTION: 6601
INTEREST DUE BACK FROM 2002 WHEN TAX EXEMPT DETERMINED IN 2013 TO BE RETROACTIVELY LOST

Citation: CreditGuard of America, Inc. v. Commissioner, 149 TC No. 17, 10/10/17

The Tax Court ruled that when an entity has its tax-exempt status retroactively revoked, interest is due on any underpaid tax for the years that the entity now has a tax liability from the date a return would have been originally due for an entity that did not have exempt status. In *CreditGuard of America, Inc. v. Commissioner,* 149 TC No. 17 the Tax Court rejected the taxpayer's view that interest should not begin to run until the date it was finally determined the entity was not tax exempt.

The issue of the retroactive loss of the organization's exempt status back to 2002 had previously been decided in a stipulated Tax Court decision entered on November 30, 2012, based on an examination the IRS had begun in 2003 but not concluded until February of 2012. The total tax determined to be due from the taxpayer was $216,547.

The IRS began accruing interest in its computation of interest due going back to March 17, 2003, the original due date for the Form 1120 now due from the entity. The IRS did not claim that the taxpayer was negligent and was not assessing any penalty for failure to pay the tax due.

The taxpayer argued that it could not have known in March of 2003 that a tax liability existed, and that in fact the matter was not determined until nearly a decade later. The opinion notes:

> Petitioner notes that it was tax exempt during 2002, that it correctly filed Form 990 for that year, and that it had no obligation to file Form 1120 until its tax exemption was revoked. It accordingly contends that the starting date for paying interest is governed by section 6601(b)(5), captioned "Last date for payment not otherwise prescribed." That section provides that, "[i]n the case of taxes payable by stamp and in all other cases in which the last date for payment is not otherwise prescribed, the last date for payment shall be deemed to be the date the liability for tax arises."

The Tax Court found both that IRC §6601(b)(5) was not applicable and, even if it had been, it would not have changed the date on which the interest computation began. The Court held:

> Section 6601(b)(5) by its terms is inapplicable here. It applies only to taxes payable by stamp and other taxes for which "the last date for payment is not otherwise prescribed." The tax involved here is the corporate income tax. The last date for payment of the corporate income tax is "otherwise prescribed," namely, by section 6072(b). For a calendar year corporate taxpayer in 2002, that date was March 17, 2003.
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> Even if section 6601(b)(5) applied, it would not help petitioner. Petitioner's corporate income tax liability for 2002 did not "arise" on February 1, 2012, when the IRS mailed the letter revoking petitioner's tax-exempt status. Nor did it arise on November 30, 2012, when this Court entered a decision determining a deficiency of $216,547 for 2002. And it did not arise on March 13, 2013, when the IRS assessed that tax.
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> Rather, by virtue of the retroactive revocation of petitioner's tax-exempt status to January 1, 2002, its corporate income tax liability arose during 2002, the calendar year for which it had become a "corporation subject to tax under subtitle A." Sec. 6012(a)(2); see Helvering v. Morgan's, Inc., 293 U.S. 121, 127 (1934) (defining taxpayers' taxable year as "the twelve months' accounting period for which they were bound to report income and pay taxes"). And petitioner's liability for payment of that tax arose on March 17, 2003, the due date of its Form 1120 for 2002. In contending that it had no tax liability for 2002 until 2012, petitioner is ignoring the fact that its tax-exempt status was revoked, not prospectively, but retroactively to January 1, 2002. Retroactive revocation is not just a slap on the wrist; it has real tax consequences.

The Court also found that computing interest back to that date was consistent with the reason interest is charged on tax underpayments, noting:

> Underpayment interest is designed to compensate the Government for the period during which the taxpayer has enjoyed use of the Government's money. "Interest, in tax cases as in others, is merely compensatory; it is not a penalty." Vick v. Phinney, 414 F.2d 444, 448 (5th

> Cir. 1969). Under this use-of-funds rationale, "a taxpayer who initially failed to satisfy his tax liability is obligated to pay interest on the taxes due from the date the tax return should have been filed, regardless of whether the failure to pay resulted from the taxpayer's miscalculation or the [G]overnment's redetermination." Brookhurst, Inc. v. United States, 931 F.2d 554, 558 (9th Cir. 1991).
>
> By executing a stipulated decision in the prior deficiency case, petitioner has agreed that it had a corporate income tax deficiency of $216,547 for 2002. It has had use and enjoyment of that $216,547 from March 17, 2003, until now. It has supplied no reason, in law or logic, why it should not have to pay interest as any other corporate taxpayer would have to do.

SECTION: 7508A
FILING DATE RELIEF PROVIDED FOR VICTIMS OF NORTHERN CALIFORNIA WILDFIRES

Citation: IRS News Release IR-2017-172, 10/13/17

The IRS has announced filing due date relief for victims of the wildfires in Northern California in IRS News Release IR-2017-172. The relief postpones tax filing deadlines beginning on October 8, 2017 to January 31, 2018 for affected individuals.

The IRS summarizes the affected filing deadlines as follows:

> This includes the Jan. 16, 2018 deadline for making quarterly estimated tax payments. For individual tax filers, it also includes 2016 income tax returns that received a tax-filing extension until Oct. 16, 2017. The IRS noted, however, that because tax payments related to these 2016 returns were originally due on April 18, 2017, those payments are not eligible for this relief.
>
> A variety of business tax deadlines are also affected, including the Oct. 31 deadline for quarterly payroll and excise tax returns. Calendar-year tax-exempt organizations whose 2016 extensions run out on Nov. 15, 2017 also qualify for the extra time.

The relief will also delay payroll tax deposit deadlines. As the release provides:

> In addition, the IRS is waiving late-deposit penalties for federal payroll and excise tax deposits normally due after Oct. 8 and before Oct. 23, if the deposits are made by Oct. 23, 2017. Details on available relief can be found on the disaster relief page on IRS.gov.

Taxpayers that have a mailing address of record in the disaster area do not need to contact the IRS, but rather are supposed to receive the relief automatically. Despite this, the notice takes into account that the system doesn't always work as expected, noting that "if an affected taxpayer receives a late filing or late payment penalty notice from the IRS that has an original or extended filing, payment or deposit due date falling within the postponement period, the taxpayer should call the number on the notice to have the penalty abated."

The IRS also will provide relief to those who do not live in the area, but whose records are located within the disaster area. The IRS provides such advice in this case:

> In addition, the IRS will work with any taxpayer who lives outside the disaster area but whose records necessary to meet a deadline occurring during the postponement period are located in the affected area. Taxpayers qualifying for relief who live outside the disaster area need to contact the IRS at 866-562-5227. This also includes firefighters and workers assisting the relief activities who are affiliated with a recognized government or philanthropic organization.

The news release also provides information to victims, reminding them that disaster related casualty losses either in the year the loss occurred or in the prior year.

SECTION: 7508A
IRS DISCUSSES EFFECT ON ASSESSMENTS OF DUE DATE RELIEF FOR DISASTERS

Citation: Chief Counsel Email Advice 201740021, 10/6/17

Special rules related to delayed dates due to Presidentially declared disaster areas suddenly became very topical in the late summer and fall of 2017. In Chief Council Email Advice 201740021 an effect of a delay in dates under what we view as the relief provision of IRC §7508A is noted.

IRC §7508A grants the IRS the authority to "stop time" for a period of up to one year for taxpayers affected by a Presidentially declared natural disaster. The main provisions, found in subsection (a), provide:

> (a) In general
>
> In the case of a taxpayer determined by the Secretary to be affected by a federally declared disaster (as defined by section 165(h)(3)(C)(i)) or a terroristic or military action (as defined in section 692(c)(2)), the Secretary may specify a period of up to 1 year that may be disregarded in determining, under the internal revenue laws, in respect of any tax liability of such taxpayer--
>
>> (1) whether any of the acts described in paragraph (1) of section 7508(a) were performed within the time prescribed therefor (determined without regard to extension under any other provision of this subtitle for periods after the date (determined by the Secretary) of such disaster or action),
>>
>> (2) the amount of any interest, penalty, additional amount, or addition to the tax for periods after such date, and
>>
>> (3) the amount of any credit or refund.

The "acts" found in §7508(a)(1) noted above are:

- Filing any return of income, estate, gift, employment, or excise tax;
- Payment of any income, estate, gift, employment, or excise tax or any installment thereof or of any other liability to the United States in respect thereof;

- Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;
- Allowance of a credit or refund of any tax;
- Filing a claim for credit or refund of any tax;
- Bringing suit upon any such claim for credit or refund;
- Assessment of any tax;
- Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;
- Collection, by the Secretary, by levy or otherwise, of the amount of any liability in respect of any tax;
- Bringing suit by the United States, or any officer on its behalf, in respect of any liability in respect of any tax; and
- Any other act required or permitted under the internal revenue laws specified by the Secretary;

Note that while the beginning of the list contains deadlines that it is generally in the taxpayer's interest to have extended, that is not true of many of the items later in the list.

Of particular interest in that list is the following item discussed in the email:

> Section 7508A would suspend the time for making assessments for the postponement time that applies to this disaster.

However the email may be overstating the issue—or, at least, under the regulations for IRC §7508A, the IRS is allowed to "pick and choose" which actions it will delay. While the law doesn't state that the IRS can "pick and choose" among the actions, Reg. §301.7508A-1(b)(1)(i) specifically allows the IRS to delay *any or all acts* that are described in the statute.

As well, the example in the regulation where there is a question of the final date to assess tax specifically mentions the IRS determining specifically that the due date for government actions would also be extended.

The examples illustrating the differences, found in Reg. §301.7508A-1(f), read as follows:

> **Example 1.** (i) Corporation X, a calendar year taxpayer, has its principal place of business in County M in State W. Pursuant to a timely filed request for extension of time to file, Corporation X's 2008 Form 1120, "U.S. Corporation Income Tax Return," is due on September 15, 2009. Also due on September 15, 2009, is Corporation X's third quarter estimated tax payment for 2009. Corporation X's 2009 third quarter Form 720, "Quarterly Federal Excise Tax Return," and third quarter Form 941, "Employer's Quarterly Federal Tax Return," are due on October 31, 2009. In addition, Corporation X has an employment tax deposit due on September 15, 2009.
>
> (ii) On September 1, 2009, a hurricane strikes County M in State W. On September 7, 2009, certain counties in State W (including County M) are determined to be disaster areas

within the meaning of section 1033(h)(3) that are eligible for assistance by the Federal government under the Stafford Act. Also on September 7, 2009, the IRS determines that County M in State W is a covered disaster area and publishes guidance announcing that the time period for affected taxpayers to file returns, pay taxes, and perform other time-sensitive acts falling on or after September 1, 2009, and on or before November 30, 2009, has been postponed to November 30, 2009, pursuant to section 7508A.

(iii) Because Corporation X's principal place of business is in County M, Corporation X is an affected taxpayer. Accordingly, Corporation X's 2008 Form 1120 will be timely if filed on or before November 30, 2009. Corporation X's 2009 third quarter estimated tax payment will be timely if made on or before November 30, 2009. In addition, pursuant to paragraph © of this section, Corporation X's 2009 third quarter Form 720 and third quarter Form 941 will be timely if filed on or before November 30, 2009. However, because deposits of taxes are excluded from the scope of paragraph (c) of this section, Corporation X's employment tax deposit is due on September 15, 2009. In addition, Corporation X's deposits relating to the third quarter Form 720 are not postponed. Absent reasonable cause, Corporation X is subject to the failure to deposit penalty under section 6656 and accrual of interest.

Example 2. The facts are the same as in Example 1, except that because of the severity of the hurricane, the IRS determines that postponement of government acts is necessary. During 2009, Corporation X's 2005 Form 1120 is being examined by the IRS. Pursuant to a timely filed request for extension of time to file, Corporation X timely filed its 2005 Form 1120 on September 15, 2006. Without application of this section, the statute of limitation on assessment for the 2005 income tax year will expire on September 15, 2009. However, pursuant to paragraph (c) of this section, assessment of tax is one of the government acts for which up to one year may be disregarded. Because September 15, 2009, falls within the period in which government acts are postponed, the statute of limitation on assessment for Corporation X's 2005 income tax will expire on November 30, 2009. Because Corporation X did not timely file an extension of time to pay, payment of its 2005 income tax was due on March 15, 2006. As such, Corporation X will be subject to the failure to pay penalty and related interest beginning on March 15, 2006. The due date for payment of Corporation X's 2005 income tax preceded the postponement period. Therefore, Corporation X is not entitled to the suspension of interest or penalties during the disaster period with respect to its 2005 income tax liability.

The initial guidance is silent on whether the IRS is going to treat this as an event extending the time for government action. However, prudence suggests that advisers presume the IRS will do so for taxpayers in affected areas.