Current Federal Tax Developments

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SECTION: 61
INCENTIVES PAID FOR PARTICIPATION IN WELLNESS PROGRAM TO EMPLOYEES MUST BE TREATED AS TAXABLE WAGES

Citation: CCA 201622031, 5/27/16

Whether or not certain payments made to employees who participated in an employer's wellness program was discussed in CCA 201622031.

The memorandum was looking at programs that attempted to differentiate themselves from the program described in Revenue Ruling 2002-3. As the IRS described that ruling:

> Revenue Ruling 2002-3, 2002-3 I.R.B. 316, addresses the situation in which an employer has an arrangement under which employees may reduce their salaries and have the salary reduction amounts used to pay health insurance premiums for the employees. In addition, that employer makes payments to the employees that reimburse a portion of the amount of health insurance premiums paid by salary reduction. Revenue Ruling 2002-3 holds that the exclusions under sections 106(a) and 105(b) do not apply to amounts that the employer pays to employees to reimburse the employees for amounts paid by the employees for health insurance coverage that was excluded from gross income under section 106(a) (including salary reduction amounts pursuant to a cafeteria plan under section 125 that are applied to pay for such coverage). Accordingly, the reimbursement amounts are included in the employee's gross income under section 61, and are wages subject to employment taxes under sections 3121(a), 3306(b), and 3401(a).

The question in this case was whether payments made related to employer sponsored wellness programs could avoid the fate of the payments in Revenue Ruling 2002-3, thus not having to be included in the employee's compensation and not having to be counted for payroll tax purposes.

The first case offers various incentives as part of an employer paid wellness program. As the IRS described the situation:

> Situation 1. An employer provides all employees, regardless of enrollment in other comprehensive health coverage, with certain benefits under a wellness program at no cost to the employees. In particular, the wellness program provides health screening and other health benefits such that the program generally qualifies as an accident and health plan under section 106. In addition to those benefits, employees who participate in the program may earn cash rewards of varying amounts or benefits that do not qualify as section 213(d) medical expenses, such as gym membership fees.

As you may be able to guess, the fact that the payments don't qualify as §213(d) expenses (which are medical expenses eligible for a deduction on Schedule A) is a problem. As the IRS notes:

> Coverage by an employer-provided wellness program that provides medical care as defined under section 213(d) is generally excluded from an employee's gross income under section 106(a), and any section 213(d) medical care provided by the program is excluded from the employee's gross income under section 105(b). However, any reward, incentive or other benefit provided by the medical program that is not medical care as defined under section 213(d) is included in an employee's income, unless excludible as an employee fringe benefit under section 132.
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> Section 132(e) defines a de minimis fringe as any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable. Under § 1.132-6(c), a cash fringe benefit (other than overtime meal money and local transportation fare) is never excludable as a de minimis fringe benefit.

> A wellness program that provides employees with a de minimis fringe benefit, such as a tee-shirt, that would satisfy the requirements to be excluded under section 132(e) would provide a benefit that would be excluded from an employee's income notwithstanding the fact that the de minimis fringe benefit (the tee-shirt) is not medical care under section 213(d). However, the employer payment of gym membership fees that does not qualify as medical care as defined under section 213(d) would not be excludible from the employee's income, even if provided through a wellness plan or program, because payment or reimbursement of gym fees is a cash benefit that is not excludable as a de minimis fringe benefit. Cash rewards received from a wellness program do not qualify as the reimbursement of medical care as defined under section 213(d) or as an excludible fringe benefit under section 132, and therefore are not excludible from an employee's income.

The IRS then goes on and puts a §125 plan into the mix, describing the program as follows:

> Situation 2. An employer provides all employees, regardless of enrollment in other comprehensive health coverage, with certain benefits under a wellness program. Employees electing to participate in the wellness program pay a required employee contribution by salary reduction through a section 125 cafeteria plan. The wellness program provides health screening and other health benefits such that the program generally qualifies as an accident and health plan under section 106. In addition to those benefits, employees who participate in the program may earn cash rewards of varying amounts or benefits that do not qualify as section 213(d) medical expenses, such as gym membership fees.

It should come as no surprise that paying for the plan via a pre-tax contribution to a §125 plan does not somehow magically make the gym membership fees nontaxable compensation—rather, they again must be included as income.

Finally, the IRS throws one more set of options into the mix, keeping the §125 plan but giving the employee reimbursements of the insurance premiums:

> Situation 3. The same as Situation 2, except that one of the benefits available under the wellness program includes a reimbursement of all or a portion of the required employee contribution for the wellness plan that the employee made through salary reduction.

Of course, reimbursing the premiums seems to duplicate what the IRS didn't like in Revenue Ruling 2002-3. And, as it turns out, that is the view taken by the author of the memorandum:

> In addition, in Situation 3, that the payment to employees of reimbursements for all or a portion of the premiums paid by salary reduction is made through a wellness plan does not distinguish this arrangement from the arrangement addressed in Revenue Ruling 2002-3. Accordingly, the exclusions under sections 106(a) and 105(b) do not apply to amounts paid to employees as reimbursements of a portion of the premium for the wellness program that is excluded from gross income under section 106(a) (including salary reduction amounts pursuant to a cafeteria plan under section 125 that are applied to pay for such coverage). Accordingly, the reimbursement amounts are included in the employee's gross income under section 61 and are payments of wages subject to employment taxes under sections 3121(a), 3306(b), and 3401(a).

SECTION: 408
ASSIGNMENT OF PORTION OF DECEDENT'S IRA TO SPOUSE AS COMMUNITY PROPERTY INTEREST IN LAWSUIT SETTLEMENT CREATES TAXABLE DISTRIBUTION TO NAMED BENEFICIARY

Citation: PLR 201623001, 6/3/16

Community property law and federal tax collided and the tax result can be best called "messy" in PLR 201623001. The final result created a harsh result and tax being due from a taxpayer who had a portion of an inherited IRA that was treated as community property taken away.

The taxpayer (referred to as "Taxpayer A" in the ruling) applying for the ruling was the surviving spouse. Her deceased husband had three IRAs but named their child (referred to as "Taxpayer B" in the ruling) as the sole beneficiary of the IRA. While the ruling doesn't tell us the full details, we know the spouse filed suit against the decedent's estate for her community property interest in the assets owned by her and her deceased spouse. Thus it's possible her deceased spouse had effectively "disinherited" her by leaving all of his assets to the child.

Of course in a community property state each generally has an undivided interest in the assets acquired during marriage, though the specifics of what is and is not community property will vary due to the specific state law and the actions of the parties. Nevertheless, almost certainly a large portion of the assets held by the couple were community property. In such a case, the husband's will could only transfer ownership of his portion of the assets.

Eventually a settlement was reached with the estate and the assets were divided. As part of that division it was agreed that ½ of the IRA would be assigned to the surviving spouse and a State Court approved an order to the Custodian that it assign an amount of the IRA to the surviving spouse and treat it as a spousal rollover IRA.

The surviving spouse sought the following rulings:

- Amount 1 of the IRA of Decedent naming Taxpayer B as sole beneficiary should be classified as Taxpayer A's community property interest; then
- Taxpayer A may be treated as a payee of the inherited IRA for Taxpayer B; then
- The custodian of the inherited IRA for Taxpayer B can distribute Amount 1 to Taxpayer A in the form of a surviving spouse rollover IRA; and
- The distribution of Amount 1 from the inherited IRA for Taxpayer B to Taxpayer A will not be considered a taxable event.

The IRS declined to issue any of the above rulings.

The IRS noted that the first ruling was solely an issue of state law, and the IRS did not have any authority to issue that ruling. Rather that question was one to be decided by the State Court—but, as we'll note, it isn't a relevant issue in any event.

IRC §408(g) throws a monkey wrench into the proposed tax treatment. It simply states:

> (g) Community property laws
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> This section shall be applied without regard to any community property laws.

That one sentence manages to wreak havoc with the desired tax result in this situation. While federal law generally looks to state law with regard to property rights, in some cases (and this is one) Congress has opted to override the state property law determination and base the tax result on a different standard.

In the ruling the IRS goes on to explain the rather harsh tax results of this settlement agreement:

> Section 408(g) provides that section 408 shall be applied without regard to any community property laws, and, therefore, section 408(d)'s distribution rules must be applied without regard to any community property laws. Accordingly, because Taxpayer A was not the named beneficiary of the IRA of Decedent and because we disregard Taxpayer A's community property interest, Taxpayer A may not be treated as a payee of the inherited IRA for Taxpayer B and Taxpayer A may not rollover any amounts from the inherited IRA for Taxpayer B (and therefore any contribution of such amounts by Taxpayer A to an IRA for Taxpayer A will be subject to the contribution limits governing IRAs). Additionally, because Taxpayer B is the named beneficiary of the IRA of Decedent and because we disregard Taxpayer A's community property interest, any "assignment" of an interest in the inherited IRA for Taxpayer B to Taxpayer A would be treated as a taxable distribution to Taxpayer B. Therefore, the order of the state court cannot be accomplished under federal tax law.

What about the fact that the State Court had ordered that the amounts be treated as a Spousal IRA? The problem is that a State Court does not have the right to rewrite federal tax law, so an order signed off on by a State Court that demands a result contrary to federal law (as this one did) has no effect.

The only potential piece of good news is the fact that this ruling was issued. Hopefully someone (very possibly the Custodian that had been ordered to do the impossible) raised the objection that the Court Order simply couldn't accomplish its stated goal before the actual assignment took place. That would explain why the ruling was sought and very possibly may have saved a lot of grief for the parties in this matter and their counsel who appear to have failed to consider this issue.

In tax practice it's not unusual to find legal agreements and/or State Court orders that attempt to dictate a federal tax result that the parties involved have no right to dictate. But before feeling too smug about tax professional's superiority, tax advisers are just as likely to be blind to the impact of their actions in other areas of the law. The real lesson here is to remember that our area of expertise, as is that of most every professional, is only a portion of the overall set of issues facing our clients. We should remain very aware of the limitations of our expertise and be aware of when we are stepping outside that limited area.

SECTION: 1341
FAILURE TO CLAIM DEDUCTION OR CREDIT UNDER §1341(A) CLAIM OF RIGHT CAUSES TAXPAYER TO PAY TAX TWICE ON SAME INCOME

Citation: Udeobong v. Commissioner, TC Memo 2016-109

The taxpayer in the case of *Udeobong v. Commissioner*, TC Memo 2016-109 complained that the IRS was assessing tax on income he had previously reported. But, as the Tax Court noted, while that might be true it wasn't going to be relevant in his case.

The taxpayer in this case had received payments from Cigna before 2005 for Medicaid reimbursement payments in his Schedule C business and had paid tax on those payments. Later (but before 2010), a dispute arose with Cigna regarding whether the taxpayer was entitled to certain payments and he returned the payments to Cigna.

However, the taxpayer did not claim a deduction for the years he repaid the funds, nor did he file a claim for refund. However, he did enter into litigation with Cigna over the payments and in 2010 Cigna was required to repay the amounts he had paid back to Cigna.

The taxpayer, who reported on the cash basis of accounting, did not report the receipt of income in 2010 for these payments. His position was that he had already paid tax on the payments when they were originally received from Cigna and, thus, he would be paying a second tax on the same income if he reported them on his 2010 return.

But the Tax Court pointed out that his problem was that the repayments of the amounts, prior to 2010, gave rise under IRC §1341(a) to either a current deduction or a credit under the claim of right provisions.

He did receive cash income in 2010, but could not claim a deduction (arguably for basis in the receivable) since the claim of right provisions required that deduction or credit to be claimed in the year of repayment.

SECTION: 6663
DESPITE PREPARER BEING BARRED FROM PREPARING RETURNS, TAX COURT DOES NOT FIND UNDERSTATEMENT ON PREPARER'S OWN RETURN SUBJECT TO FRAUD PENALTY

Citation: Ericson v. Commissioner, TC Memo 2016-107, 6/1/16

The IRS argued that a pattern of fraud they claimed to see in a preparer's clients returns indicated that the preparer should be subject to the fraud penalty for understatements on his own return in the case of *Ericson v. Commissioner*, TC Memo 2016-107. However, the Tax Court was not impressed with the IRS's evidence in the case, though it did find the taxpayer liable for the general accuracy related penalty.

IRC §6663(a) outlines the fraud penalty:

> (a) Imposition of penalty
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> If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.

As the Tax Court notes in the opinion, generally the Court look for "badges of fraud" in deciding if the penalty imposed by IRC §6663(a) applies:

> Courts usually rely on certain indicia (or badges) of fraud in deciding whether a taxpayer had the requisite fraudulent intent. The badges of fraud include: (1) understated income; (2) maintaining inadequate records; (3) failing to file tax returns; (4) implausible or inconsistent explanations of behavior; [*36] (5) concealing income or assets; (6) failing to cooperate with tax authorities; (7) engaging in illegal activities; (8) dealing in cash; (9) failing to make estimated tax payments; and (10) filing false documents. See *Estate of Trompeter v. Commissioner*, 279 F.3d at 773; *Bradford v. Commissioner*, 796 F.2d 303, 307-308 (9th Cir. 1986), aff'g T.C. Memo. 1984-601; *Recklitis v. Commissioner*, 91 T.C. 874, 910 (1988); see also *Spies*, 317 U.S. at 499-500. These badges of fraud are nonexclusive. See *Niedringhaus v. Commissioner*, 99 T.C. 202, 211 (1992). The taxpayer's education and business background are also relevant to the determination of fraud. *See id*.

In this case, though, the IRS argued the individual's actions in preparing tax returns for others was the most important indicator that the understatements of tax on his return arose from a fraudulent intent to evade the tax.

Mr. Ericson was a professional tax preparer. The IRS had received complaints from other preparers regarding the quality of Mr. Ericson's returns. The agent, Mr. Van Zweden, who would eventually examine Mr. Ericson's personal returns first investigated these complaints.

> Mr. Van Zweden's examination of the client returns stemmed from complaints the IRS had received from local tax practitioners concerning returns they had become aware of that Mr. Ericson prepared. Mr. Van Zweden initially reviewed approximately 30 client returns and selected approximately 15 for examination. Mr. Van Zweden concluded after examining the 15 client returns that they tended to have at least one questionable Schedule C and oftentimes inflated employee business expenses and unallowable education credits.

In fact, the IRS had moved separately against this preparer to obtain an injunction to prevent him from preparing returns, an injunction the IRS received. As the Tax Court explained in a footnote:

> The District Court granted summary judgment on most of the Government's claims, and a permanent injunction, on the basis of considerably more extensive proof concerning Mr. Ericson's return preparer activity.

At Mr. Ericson's trial the IRS produced evidence related to two of these exams. The Tax Court, allowing the evidence over the taxpayer's objection to its relevance to his case, noted the limited use that could be made of it:

> Evidence of an individual's crimes, wrongs, or other acts is generally not admissible to prove the character of the individual to show action in conformity therewith. See Fed. R. Evid. 404(b). Such evidence is generally admissible, however, to show motive, opportunity, intent, preparation, plan, knowledge, identity, or absence of mistake or accident. See id. The Court of Appeals for the Ninth Circuit views rule 404(b) of the Federal Rules of Evidence as a "rule of inclusion", see *United States v. Ayers*, 924 F.2d 1468, 1472-1473 (9th Cir. 1991), and has held that evidence of other acts is admissible under that rule where the evidence (1) proves a material issue in the case, (2) if admitted to prove intent, is similar to the offense charged, (3) is based on sufficient evidence, and (4) is not too remote in time, see *United States v. Ramirez-Robles*, 386 F.3d 1234, [*39] 1242 (9th Cir. 2004); see also *Sherrer v. Commissioner*, T.C. Memo. 1999-122, 77 T.C.M. (CCH) 1795, 1804-1805 (1999), aff'd, 5 F. App'x 719 (9th Cir. 2001).

But the Tax Court was not impressed with the IRS's evidence in this area. The Court pointed out that despite the agent's assertion that the taxpayer was a "problem preparer" and that a standard type of fraud he committed, the IRS only produced evidence from two of the much larger number of returns the individual had prepared. As well, only one of the two returns presented the type of problems that the agent insisted were a "pattern" in his preparation.

It appears that the Court's view as that if the IRS wanted to use his pattern of preparation misconduct as evidence of fraudulent actions it should have presented more returns to show that pattern—a "pattern" can't be shown by a single example.

The Court went on to note that Mr. Ericson's own return itself did not evidence that telltale pattern of errors that the IRS claimed existed. So even if such a pattern existed, it doesn't explain the errors found on Mr. Ericson's returns. In fact, the problems on his returns arose virtually entirely from a total lack of records, a situation that could just as easily be explained by incompetence or sloppiness as opposed to a fraudulent intent to evade tax.

The Court then took a look at the standard badges of fraud analysis, but found that the IRS simply had not met its burden to show the understatements were due to fraud. The Court also refused to hold Mr. Ericson to a higher standard as a "sophisticated preparer" noting that he didn't really appear to be all that knowledgeable:

> We disagree with respondent's view that Mr. Ericson's education, his work as an accountant, and his profession as a tax preparer lead to a finding of fraud. First, the record does not persuade us that Mr. Ericson is the sophisticated tax preparer that respondent makes him out to be. Mr. Ericson had minimal education on the preparation of income tax returns before he started his return preparation business, and we do not find that his preparation of tax returns for his clients strengthened his understanding of the tax law to any significant extent. In fact, the record establishes to the contrary that Mr. Ericson is misguided in his understanding of many areas of tax law, including, for example, the requirements that taxpayers maintain records for their businesses and maintain sufficient documents to support their claims to deductions. Second, even if Mr. Ericson was sufficiently knowledgeable with respect to tax law, we are not persuaded, as discussed above, that petitioners' failure to maintain the requisite records was part of a plan to conceal, mislead, or otherwise prevent the collection of tax.

The Court came to that finding despite the fact that Mr. Ericson held a master's degree, had worked initially under the supervision of a certified public accountant (though he was not a CPA) and had been preparing returns for 20 years. While that might have given Mr. Ericson the opportunity to have become expert in tax matters, the Court found he hadn't actually gained that level of sophistication.

It is important to note that a major reason the IRS lost here is because of the higher burden the service bears in this area and, as is hinted in the footnote reference to the IRS's action against the taxpayer as a preparer, the agency's failure to actually bring sufficient evidence into this Court proceeding to carry that burden.

But the case also demonstrates that the IRS may target a preparer's clients for special scrutiny if the agency receives complaints regarding the quality of work being performed by a preparer. That can be helpful to point out to clients who always have that "neighbor" whose tax preparer allows them to claim various problematical deductions.

SECTION: 7701
ELECTION MADE BY LLC THAT HELD NO ASSETS AND CONDUCTED NO ACTIVITIES SINCE FORMATION HELD TO BE INITIAL CLASSIFICATION ELECTION

Citation: PLR 201622020, 5/27/16

Under Reg. §301.7701-3(c)(1)(iv) an LLC that makes an election to change its classification may not, without IRS approval, change its classification again within 60 months of that change of classification. However, this rule does not apply to the entity's initial classification. In that case, the organization could change its classification to an acceptable alternative at any time without IRS approval, even if that was less than 60 months after the initial classification.

In PLR 201622020 the situation involved an LLC that was formed but which sat dormant from its formation until it finally acquired assets at a later date. This LLC now wished to be taxed as an organization taxed as a corporation, but asked the IRS to allow it to treat this election as an initial election and not a change of classification that would trigger the 60 month waiting period before a change of classification could be undertaken without IRS approval.

The IRS granted the entity's request that this be treated as an initial classification by a newly formed entity that was effective on the date of formation—that is, the IRS treated the date of formation as the date in which the entity ceased to be an empty shell, despite that being well after the date the LLC had been formed under applicable law.

Note that while the LLC may change its classification from a corporation to an acceptable alternative (a disregarded entity if it has only one owner or a partnership otherwise) at any time, that does not mean that there would not a tax consequence to doing so. Rather the corporation would need to go through a deemed liquidation, with distribution of assets to the shareholders followed by the creation of the new entity—and either (or both) of those transactions could trigger taxable events.