Current Federal Tax Developments

Kaplan Professional Education

March 19, 2018

Section: FBAR Reporting Offshore Voluntary Disclosure Program to End on September 28, 2018 2

Citation: News Release IR-2018-52, 3/14/18 2

Section: 61 Employees Wages Included Fees Charged by International CPA Firm to Prepare U.S. and Foreign Tax Returns 3

Citation: Chief Counsel Advice 201810007, 3/9/18 3

Section: 165 Tax Court Resolves a "Kind of Conundrum Only Tax Lawyers Love" in Sale of Rental 6

Citation: Simonsen v. Commissioner, 150 TC No. 8, 3/14/18 6

Section: 965 Set of Questions and Answers Released on Reporting and Paying Section 965 Transition Tax for 2017 9

Citation: News Release IR-2018-53 and Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns (IRS website), 3/13/18 9

Summary of IRC §965 Tax 10

How to Report the Tax 10

Required IRC Transition Tax Statement 11

Making Elections Under IRC §965 12

Requirement for Additional Form 5471 Filings for non-CFCs 14

Information to Be Provided by Passthrough Entities 14

How the Tax is to Be Paid 15

Tax Return Filing Delay and Amending Already Filed Returns 15

Section: 1221 Mansion Property Was Never Actually Used in a Rental Activity, Loss Was Capital 16

Citation: Keefe v. Commissioner, TC Memo 2018-28, 3/15/18 16

©2018 Kaplan Professional Education, Inc.

Section: FBAR Reporting
Offshore Voluntary Disclosure Program to End on September 28, 2018

Citation: News Release IR-2018-52, 3/14/18

The Offshore Voluntarily Disclosure Program (OVDP) will end on September 28, 2018 the IRS announced in News Release IR-2018-52. The program offers an option for taxpayers with undisclosed foreign assets to report those assets with a reduced penalty.

The IRS has offered three OVDP programs since 2009, though the program has become less generous following the revisions in 2011 and 2014. Over that time the agency reported that 56,000 taxpayers used one of the programs and that the programs collected over $11.1 billion in back taxes, interest and penalties.

The IRS noted that the program has seen a decreasing number of applications after peaking in 2011, falling to only 600 disclosures in 2017. The news release quotes the Acting Commissioner on the matter:

> *"Taxpayers have had several years to come into compliance with U.S. tax laws under this program," said Acting IRS Commissioner David Kautter. "All along, we have been clear that we would close the program at the appropriate time, and we have reached that point. Those who still wish to come forward have time to do so."*

The news release contains an implied warning to those who have not yet come forward. The end of the program doesn't mean noncompliant taxpayers can breathe easy, emphasizing the tools the agency has available to find noncompliant individuals:

> *The IRS notes that it will continue to use tools besides voluntary disclosure to combat offshore tax avoidance, including taxpayer education, Whistleblower leads, civil examination and criminal prosecution. Since 2009, IRS Criminal Investigation has indicted 1,545 taxpayers on criminal violations related to international activities, of which 671 taxpayers were indicted on international criminal tax violations.*
>
> *"The IRS remains actively engaged in ferreting out the identities of those with undisclosed foreign accounts with the use of information resources and increased data analytics," said Don Fort, Chief, IRS Criminal Investigation. "Stopping offshore tax noncompliance remains a top priority of the IRS."*

The separate Streamlined Filing Compliance Procedures program will continue in effect. This program is aimed at taxpayers who might not have been aware of their filing obligations. Eligibility to participate in this program is conditioned on the failure not being willful.

The release reports that this program, which has had 65,000 individuals who have taken advantage of it, still may be ended at some point in the future even though the agency is not ending it at this time.

The release also describes the following options available for taxpayers with issues related to offshore assets.

> *The implementation of the Foreign Account Tax Compliance Act (FATCA) and the ongoing efforts of the IRS and the Department of Justice to ensure compliance by those with U.S. tax obligations have raised awareness of U.S. tax and information reporting obligations with respect to undisclosed foreign financial assets. Because the circumstances of taxpayers with foreign financial assets vary widely, the*

> *IRS will continue offering the following options for addressing previous failures to comply with U.S. tax and information return obligations with respect to those assets:*
>
> - *IRS-Criminal Investigation Voluntary Disclosure Program;*
> - *Streamlined Filing Compliance Procedures;*
> - *Delinquent FBAR submission procedures; and*
> - *Delinquent international information return submission procedures.*

Section: 61
Employees Wages Included Fees Charged by International CPA Firm to Prepare U.S. and Foreign Tax Returns

Citation: Chief Counsel Advice 201810007, 3/9/18

How much should an employee recognize as income when his/her employer provides the employee with tax preparation services? That was the question addressed by Chief Counsel Advice 201810007.

The employer in this case had U.S. citizens that were given work assignments in various other countries, with employees also being relocated from time to time. As is often the case in such situations, the employer decided to provide a "tax equalization" program. Under such a program, the employer agrees to compensation employees in such a fashion that their after-tax income will not fluctuate as they move from taxing regime to taxing regime.

Rather the employer will determine what the employee's after-tax income would have been if the employee had been working in the United States. The employer then increases or decreases the employee's salary as the employee moves from location to location to achieve the same after-tax income.

Since tax calculations are very fact dependent and can't really be calculated until after the tax years end for all of the taxing authorities, during the year the employer pays an amount it will believes will "equalize out" at year end—that is, after the foreign taxes are paid and the U.S. return is prepared, with the U.S. return taking into account the foreign earned income exclusion, foreign tax credit and/or foreign tax deduction as appropriate. Once the actual returns are prepared, the employer either pays additional compensation to the employee (assuming it turns out more was owed than had been contemplated) or the employee reimburses the employer (if the tax comes to less than was projected).

Of course, the tax returns that end up being prepared are generally going to be far more complicated in nature. These complications mean that the employee likely would not be able to use the same system he/she would have used to have the returns prepared as they would have had they stayed in the U.S. As well, the employer is going to want to ensure that the returns they are using to determine the equalization payments are prepared by a party that the employer believes is skilled enough to accomplish the task.

Thus, employers in these situations will generally agree to have the employee's returns prepared by an international accounting firm who, in addition to handling all the employee's returns (U.S. and other countries), will perform various calculations for the employer to compute the equalization amounts for the various employees as well as help implement the program.

Many of the employees had tax situations where, had they been working in the U.S., their returns would have been extremely simple (a Form W-2, a couple of 1099s for interest and dividends, as well as a few itemized deductions on Schedule A). Prior to being assigned outside the U.S. they may very well have used off-the-shelf consumer tax software to prepare their tax returns. Certainly, they would not have taken their returns to an international accounting firm to have it prepared, nor would such firms have been actively soliciting such clients.

The employees are clearly receiving a service (having their tax return prepared) as part of their compensation and the employer recognized that the value of that service should be taxable to the employee. But the question now becomes what amount should be treated as the value of having the return completed for the employee?

The employer reasoned that the value should be approximately what the employee would have paid to have his/her return prepared by a tax professional had the employee still resided in the U.S. The employer reasoned that the need for the returns for other countries arose only because of the action of the employer in assigning the employee to the non-U.S. location.

The international firms are not generally soliciting the sorts of U.S. returns that these employees would have been filing had they been located in the U.S., so, per the memorandum, the employer used the following methodology to compute the amount to include in the employee's income:

> *For federal employment tax purposes, Taxpayer valued the United States and state tax return preparation services provided for the benefit of its assignees at $* * * per year, and imputed this value as income and wages to its assignees. Taxpayer imputed no income or wages to its assignees in connection with the value of the employer-provided foreign tax return preparation services.*
>
> *In valuing the United States and state tax return preparation services, Taxpayer relied, in part, on:*
>
>> *(1) A * * * survey conducted by the National Society of Accountants regarding the average tax preparation fees for an itemized Form 1040 with Schedule A and a state return; and*
>>
>> *(2) A * * * Notice * * *, published by the United States Treasury Department ("Treasury Department Notice"), which estimated the average time burden and average cost of preparing a Form 1040, 1040A, or 1040EZ return.*

The amount the firm was billed by the international accounting firm included several services beyond simply preparing the individual's Form 1040 and state returns. The services the international CPA firm provided were outlined as follows in the memorandum:

> *In connection with its tax equalization policy, Taxpayer engaged CPA Firm to assist with assignees' tax matters. CPA Firm is a large, multinational accounting and consulting firm. Taxpayer's tax equalization policy provides that the following services will be performed by CPA Firm with respect to tax-equalized assignees:*
>
>> *(1) Preparation of foreign, United States, and state tax returns;*
>>
>> *(2) Computation and payment of the approximate and actual hypothetical tax and tax equalization settlements;*
>>
>> *(3) Respond to inquiries from taxing authorities, as related to the foreign assignment;*
>>
>> *(4) Global coordination of the assignment program; and*

> *(5) Provide advice and instructions to Taxpayer's payroll department regarding how to report and tax appropriately.*

The IRS agents examining the employer's payroll tax returns did not believe the employer's valuation of the services received by the employer was appropriate. The agents objected to the employer not counting any value for the preparation of non-U.S. tax returns as compensation. As well, the IRS noted that the international firm was charging amounts, even for preparation of the U.S. returns, that were far more than the employer's computed value.

The memorandum generally agreed with the agents' position on these matters. First, the memorandum found there was no basis under the law for excluding the value of the foreign returns the employee was legally obligated to file. The memorandum argues:

> *…[T]he assignees received the same or similar personal benefit from having their foreign tax returns prepared as they did from having their domestic returns prepared, and were personally obligated to file complete and accurate tax returns, there is no valid basis for excluding the value of the foreign tax preparation services from gross income while including the value of the domestic tax preparation services. Expenses paid or incurred by a taxpayer in connection with the determination, collection, or refund of a foreign tax are deductible under § 212(3) in the same manner as expenses paid or incurred in connection with the determination, collection, or refund of a domestic tax. See Sharples v. United States, 533 F.2d 550 (1976). Like the employer-provided financial consulting services described in Rev. Rul. 73-13, the receipt of the Taxpayer-provided tax preparation services (both for the domestic and foreign returns) conferred a direct and personal benefit on the assignees, and the value received must be included in the assignees' gross income under § 61.*

The IRS noted that to be a "working condition fringe" excludable from the employees' income under IRC §132, at a minimum the expense would have to have been deductible, if paid by the employee, as a business expense under IRC §162. But tax preparation is specifically only deductible for an individual under IRC §212(3). So, the employer's argument that the foreign return as a work-related fringe benefit did not allow for exclusion from the employee's income (or from FICA/Medicare taxation for the employer) was incorrect.

The memorandum also agreed with the agents' view that using the value for preparation a return that was based on a) a return that was much less complex than the employee's actual return and b) ignoring the fact that the employer was paying far more than that amount for the returns that were prepared was not appropriate.

The memorandum initially holds that, in fact, the amount the employer was paying was less than the true fair value of what the employee received. The international CPA firm had agreed to charge a discounted price for preparation of the returns based on the volume of returns the firm would be preparing. An individual looking to get his/her own returns prepared would not be able to obtain that volume discount.

The memorandum notes:

> *Neither the average tax preparation fee for an itemized Form 1040 with Schedule A and a state return according to the * * * survey conducted by the National Society of Accountants, nor the Treasury Department Notice estimating the average time burden and cost for all taxpayers filing a Form 1040, 1040A, or 1040EZ, represent an adequate measure for determining the fair market value of the tax preparation services the assignees in this case received. These assignees received sophisticated tax return preparation services from a large, multinational accounting and consulting firm*

> *with respect to both domestic and foreign tax returns. The fair market value of those services is the amount that the same or a similar large, multinational accounting and consulting firm would charge an individual employee for the same services in an arm's length transaction.*

But the memorandum does recognize one significant problem with coming with this theoretically "pure" and "correct" value for the returns:

> *Unfortunately, data regarding arm's length transactions between individual employees similar to the assignees and large, multinational accounting and consulting firms similar to the CPA Firm for the same type of tax return preparation services is not generally available. Large, multinational accounting and consulting firms like the one utilized by Taxpayer in this case, which provide premier international tax consulting services, do not typically have individual employees like the assignees in this case as tax return preparation clients. Instead, large companies, like Taxpayer, enter into contracts with multinational accounting and consulting firms, like CPA Firm, to provide tax preparation services for numerous employees stationed in various countries throughout the world.*

Given this constraint, the memorandum reluctantly concludes that the most appropriate value for the services received by the employee will be the amount the employer paid for the following services for each employee that the IRS agents had determined were services provided to the employees in this situation:

- *Preparation of basic domestic United States tax returns — 1040, 1040 NR, and first state return;*
- *Sourcing of compensation for Federal income tax purposes and the employee's foreign tax credit;*
- *Sourcing of compensation for nonresident and part-year resident state income tax purposes;*
- *Preparation of Form 1116 (Foreign Tax Credit) and Form 255 (Foreign Earned Income);*
- *Optimization of foreign earned income exclusion or foreign tax credit position;*
- *Coordination with foreign tax return preparer to confirm globally consistent approach to residency positions, treaty articles, etc.; and*
- *Notification to employees of foreign bank account reporting (FBAR) obligations if they had overseas financial accounts related to foreign assignment.*

Section: 165
Tax Court Resolves a "Kind of Conundrum Only Tax Lawyers Love" in Sale of Rental

Citation: Simonsen v. Commissioner, 150 TC No. 8, 3/14/18

In the case of *Simonsen v. Commissioner*, 150 TC No. 8, the Tax Court reaffirmed its previously stated position regarding a short sale when a nonrecourse debt is involved. As well, for the first time the Court also addressed the reportable gain/loss on a property converted to rental use that was sold for less than its original cost but more than its date of conversion fair market value.

The couple in question had purchased a townhouse in San Jose in 2005 for $695,000. They lived in that home for five years, during which the real estate crisis hit. In 2010 they relocated to Southern California and began renting the townhouse. At the time it was converted to a rental the fair value had declined to $495,000.

The only loan outstanding on the townhome was the original mortgage from Wells Fargo Bank. Under California law such a mortgage on a residence is a nonrecourse debt. That is, the bank has no recourse if the debt is not paid except to take back the property securing the debt, in this case the San Jose townhome.

In late 2011 the couple entered into a short sale to rid themselves of the debt. Wells Fargo agreed to release the lien on the property in exchange for the cash from the sale ($363,000) and agreed that the couple would not be held liable for the remaining $219,270 due on the debt. A Form 1099-S was issued by the title company for the $363,000 of sales proceeds and the bank issued a Form 1099-C showing $219,270 of debt cancellation of income.

Relying on those 1099s, the taxpayers reported a loss on the disposition of their rental based on the fair value reduced by depreciation claimed of $11,000. They reported the cancellation of debt income as being excluded from income as cancellation of qualified residence debt under IRC §108(a)(1)(E). In the end, they claimed a loss on the sale of the rental of $70,000 and no income from cancellation of indebtedness.

The IRS objected to this treatment. First, the IRS argued that, since this was a nonrecourse debt, there was only a single sale transaction (for $555,960, the outstanding balance of the mortgage when the short sale took place). At that sales price there clearly would be no loss on disposition (though the issue of whether there would be a gain is one we'll look at later).

Generally, if a taxpayer loses a property via foreclosure to a lender holding a debt for which the lender can seek recourse from the borrower, the sales price for computing gain/loss is limited to the fair value of the property foreclosed if that is insufficient to pay off the debt. But if the mortgage in question is nonrecourse, the entire debt is treated as the sales price since the lender has no option but to accept the property in full payment of the debt. [Reg. §1.1001-2, IRC §61(a)(12)] In the latter case, there would be no cancellation of debt income.

Had the mortgage been foreclosed, there clearly would have been only a sale and no cancellation of indebtedness. But this was a short sale, so would the result be the same?

The Tax Court had considered this issue previously. In the case of *2925 Briarpark, Ltd. v. Commissioner*, TC Memo 1997-298, *affd.* CA5, a partnership was attempting to have a reduction in the outstanding loan as part of a short sale treated as cancellation of indebtedness income rather than part of the sales proceeds. The Tax Court, agreeing with the IRS, found "the transaction before us is the functional equivalent of a foreclosure, reconveyance in lieu of foreclosure, abandonment, or repossession."

The court pointed out that, unlike cases where the property owner continues to hold the property after a lender agrees to reduce the principal on a nonrecourse debt (which is treated as a cancellation of debt under IRC §61(a)(12)), in a short sale both the reduction of debt and the transfer of the property to a third party are part of a single integrated transaction. In the *Briarpark* case, the bank had agreed to a contingent release of its liens upon the property, assuming the sale closed, and the bank received the agreed upon amount.

Thus, the proper treatment appears to be that a short sale of a property subject to a nonrecourse debt would be treated in the same manner as if the property had been repossessed. The entire balance of the loan, and not just the balance the lender accepted as part of the short sale, would be treated as the proceeds from the sale.

The Court found no reason to treat the Simonsens' situation differently than the treatment in *Briarpark*. As the opinion notes:

> *We think the key point here is the complete dependence of Wells Fargo's willingness to cancel the debt on the Simonsens' willingness to turn over the proceeds from the sale of their home. The Commissioner's view is consistent with the obvious realities of the transaction — that Wells Fargo had to reconvey the deed of trust for the sale to close, and that it would've been able to dictate the terms of the sale as long as it retained the deed of trust. Because Wells Fargo couldn't collect on the debt once it reconveyed the deed of trust — it was nonrecourse debt after all — the debt forgiveness occurred when the sale closed. There was but one transaction.*

But that leaves us with a problem to solve—if there is not a $70,000 loss on sale, what is the gain/loss on the sale of this rental?

Under Reg. §1.695-9(b)(2), special rules apply regarding basis when a taxpayer converts property from personal to business use. As the Court notes in the opinion:

> *The parties agree that the Simonsens converted their townhouse to a rental property in September 2010. When a taxpayer does this, his adjusted basis in the property to calculate the amount of any loss changes. See sec. 1.165-9(b)(2), Income Tax Regs.; see also Heiner v. Tindle, 276 U.S. 582, 586 (1928). There's a regulation that we have to follow here. Section 1.165-9(b)(2), Income Tax Regs., tell us to compute a loss using an adjusted basis that is the lesser of: (1) the taxpayer's existing adjusted basis or (2) the property's fair market value at the time of conversion. The parties agreed to this number — they stipulated that the fair market value of the Simonsens' home was $495,000 when they converted it to a rental property.*

The IRS and the parties assumed that this became the basis of the property, and thus the IRS argued that now there was a gain on disposition. But the Tax Court found the parties had overlooked an obvious but easy to miss point—that regulation only states it applies in computing a *loss* on disposition. The new IRS assertion was that there was a gain on the disposition of the property.

If that regulation does not apply, then the "regular" basis rules would apply. In this case that would mean we'd use the taxpayers' original cost ($695,000) reduced by depreciation allowed or allowable (they had claimed $11,000). Taking their depreciation figure as correct, that would create an adjusted basis of $684,000. The sales price would be $555,960 which would lead to a loss of $128,040. But now Reg. §1.165-9 would inject itself back into the equation since this is now a claimed loss—and thus it applies, aside from the minor problem that once we do the calculations it no longer applies.

The Court observes that "[t]his is the kind of conundrum only tax lawyers love. And it is not one we've been able to find anywhere in any case that involves a short sale of a house or any other asset for that matter."

Thus, the Court now must determine how the law should apply in this case. To do so, it looks to a similar situation that occurs when a donor gifts property when its fair value is less than the donor's basis:

> *The Code tells us that the person receiving a gift generally takes the donor's basis in the gift as his own. Sec. 1015(a). But what if such a gift has a value lower than that basis when it is given? The answer that the Code and regulations give us for gifts is that the donee uses the lower fair market value to compute a loss but the donor's basis to compute a gain. Id.; sec. 1.1015-1(a)(1), Income Tax Regs. So*

> *far, so similar to the Simonsens' situation. But what to do when a donee sells the gift at a price between these two possible bases? The regulations on gifts tell us: Section 1.1015-1(a)(2), Income Tax Regs., provides that there's no gain or loss. "The no gain or loss answer derives from a conceptual vacuum when the asset is sold for an amount less than its gain basis and more than its loss basis." Arthur B. Willis et al., Partnership Taxation 4-73, para. 4.03[2][c] (8th ed. 2017) (discussing the same odd result that must occur under section 1.165-9(b)(2), Income Tax Regs.) We know this regulation is for gifts and not converted personal residences. But we think it is logically coherent and adopt it as our holding today. We therefore conclude that the Simonsens realized neither a gain nor a loss on the short sale of their home.*

This result is not surprising and is one that this author has taken multiple times in the past, especially in cases like this one that arose in the aftermath of the real estate crisis.

But you might ask—shouldn't they have to pay tax due to having claimed depreciation? The answer is no—the depreciation affects the computation of adjusted basis, but even after reducing the beginning unadjusted basis either under the "regular rule" (so we start with cost) or using the special FMV rule of Reg. §1.165-9(b)(2) we still end up with a basis for gain that is more than the proceeds and a basis for loss that is less than the proceeds.

The Court effectively notes this, since the issue of "allowed or allowable" depreciation wasn't directly at issue here, so the court notes:

> *Adjusted basis is typically what a property owner paid for the property plus what he later spent to improve it, minus allowed or allowable depreciation. Secs. 1011(a), 1012(a), 1016. We'll ask the parties to compute appropriate allowed or allowable depreciation, but we think they'll find that it doesn't make a difference.*

Section: 965
Set of Questions and Answers Released on Reporting and Paying Section 965 Transition Tax for 2017

Citation: News Release IR-2018-53 and Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns (IRS website), 3/13/18

The IRS announced the publication of a set of questions and answers related to the tax imposed under IRC §965 under changes made by the Tax Cuts and Jobs Act in [News Release IR-2018-53](). The questions and answers are published in the form of a frequently asked question document (FAQ) on the IRS website at:

https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns

The news release notes that the IRS had previously provided some guidance on IRC §965 issues in Notices 2018-07 and 2018-13 and Revenue Procedure 2018-17. The IRS describes the purpose of these questions and answers in the news release as follows:

> *As the March 15 and April 17 deadlines approach for various filers, the IRS released information today in a question and answer format. The Frequently Asked Questions address basic information for taxpayers affected by section 965. This includes how to report section 965 income and how to report and pay the associated tax liability. The information on IRS.gov also provides details on several elections under section 965 that taxpayers can make.*

As the FAQ notes, this provision of the TCJA imposes a tax due on 2017 returns of affected taxpayers. For example, tax may due from a calendar year U.S. shareholder holding an interest in a calendar year specified foreign corporation that needs to be reported and paid with the 2017 return.

Summary of IRC §965 Tax

The FAQ gives the following quick summary of the IRC §965 tax:

> *In general, section 965 of the Code requires United States shareholders, as defined under section 951(b) of the Code, to pay a transition tax on the untaxed foreign earnings of certain specified foreign corporations as if those earnings had been repatriated to the United States. Very generally, section 965 of the Code allows taxpayers to reduce the amount of such inclusion based on deficits in earnings and profits with respect to other specified foreign corporations. The effective tax rates applicable to such income inclusions are adjusted by way of a participation deduction set out in section 965(c) of the Code. A reduced foreign tax credit applies to the inclusion under section 965(g) of the Code. Taxpayers, pursuant to section 965(h) of the Code, may elect to pay the transition tax in installments over an eight-year period. Generally, a specified foreign corporation means either a controlled foreign corporation, as defined under section 957 of the Code ("CFC"), or a foreign corporation (other than a passive foreign investment company, as defined under section 1297 of the Code, that is not also a CFC) that has a United States shareholder that is a domestic corporation.*

How to Report the Tax

One item the IRS concedes is that the agency is still working to implement reporting for this provision. The FAQ requests that individual taxpayers who are electronically filing their 2017 return wait to file the return on or after April 2, 2018. The FAQ indicates the IRS needs "time to make certain system changes to allow the returns to be accepted and processed."

The FAQ contains an appendix that outlines how taxpayers are to report the tax due on the forms due from the various taxpaying entities that may need to report the tax.

For example, the appendix provides the following guidance for Form 1040 filers:

Individual Taxpayer				
Follow these reporting instructions along with attaching the IRC 965 Transition Tax Statement				
Form	***965(a) Amount** [1]*	***965(c) Deduction** [2]*	***Foreign Tax Credit (FTC)** [3]*	***Reporting of Net Tax Liability Under Section 965** [4] **and Amounts to Be Paid in Installments Under Section 965(h) or Deferred Under Section 965(i), If Applicable***

Individual Taxpayer				
1040	Include a net section 965 amount (section 965(a) amount less section 965(c) deduction) on Page 1, Line 21, Other Income. Write SEC 965 on the dotted line to the left of Line 21.	See 965(a) amount column.	Report the relevant section 965(a) amount and the relevant section 965(c) deduction on Form 1116. If an IRC 962 election is made, report the relevant section 965(a) amount, the relevant section 965(c) deduction, the deemed paid foreign taxes with respect to the relevant section 965(a) amount, and the disallowed foreign taxes under section 965(g) on Form 1118.	Reduce on Page 2, Line 44, Tax the amount of net tax liability deferred under section 965(i), if applicable. Check box 'c' on Line 44 and write 965 to the right of the box. Include in total on Page 2, Line 73 the amount to be paid in installments for years beyond the 2017 year, if applicable. Check box 'd' on Line 73 and write TAX to the right of the box.

[1] This includes section 965(a) inclusion amounts of a United States shareholder of a deferred foreign income corporation and distributive shares and pro rata shares of section 965(a) inclusion amounts of domestic partnerships, S corporations, and other passthrough entities.
[2] This includes deductions under section 965(c) of a United States shareholder of a deferred foreign income corporation and distributive shares and pro rata shares of deductions under section 965(c) of domestic partnerships, S corporations, and other passthrough entities.
[3] See section 965(g).
[4] See section 965(h)(6) and Q&A3.

Similar tables are provided for other forms that affected taxpayers and entities must file.

Required IRC Transition Tax Statement

A taxpayer subject to this tax must attach an IRC Transition Tax Statement to the tax return. A sample statement is provided by the IRS in Appendix Q&A3 to this FAQ and as a downloadable PDF. The FAQ provides the following information about this statement:

> *A person that has income under section 965 of the Code for its 2017 taxable year is required to include with its return an IRC 965 Transition Tax Statement, signed under penalties of perjury and, in the case of an electronically filed return, in Portable Document Format (.pdf) with a filename of "965 Tax". The IRC 965 Transition Tax Statement must include the following information:*

- *The person's total amount required to be included in income under section 965(a) of the Code.*
- *The person's aggregate foreign cash position, if applicable.*
- *The person's total deduction under section 965(c) of the Code.*
- *The person's deemed paid foreign taxes with respect to the total amount required to be included in income by reason of section 965(a).*
- *The person's disallowed deemed paid foreign taxes pursuant to section 965(g).*
- *The total net tax liability under section 965 (as determined under section 965(h)(6), without regard to whether such paragraph is applicable), if applicable, which will be assessed.*
- *The amount of the net tax liability under section 965 to be paid in installments under section 965(h) of the Code, if applicable.*
- *The amount of the net tax liability under section 965, the payment of which has been deferred, under section 965(i) of the Code, if applicable.*
- *A listing of elections under section 965 of the Code or the election provided for in Notice 2018-13 that the taxpayer has made, if applicable.*

Making Elections Under IRC §965

The FAQ at Q&A 5 provides the following information about who can file the various elections under IRC §965:

> *The elections under section 965 of the Code are limited to taxpayers with a net tax liability under section 965 (in the case of section 965(h) of the Code), taxpayers that are shareholders of S corporations and that have a net tax liability under section 965 (in the case of section 965(i) of the Code), taxpayers that are REITs (in the case of section 965(m) of the Code), or taxpayers with an NOL (in the case of section 965(n) of the Code). Thus, a domestic partnership or an S corporation that is a United States shareholder of a deferred foreign income corporation may not make any of the elections under section 965 of the Code. In advance of April 2, 2018 (see Q&A11), the Treasury Department and the IRS intend to provide further guidance concerning the availability of the elections under section 965 of the Code to direct and indirect partners in domestic partnerships, shareholders in S corporations, and beneficiaries in other passthrough entities that are United States shareholders of deferred foreign income corporations.*
>
> *The election under Notice 2018-13, Section 3.02 may be made on behalf of a specified foreign corporation pursuant to the rules of §1.964-1(c)(3).*
>
> *In the case of a consolidated group (as defined in §1.1502-1(h)), in which one or more members are United States shareholders of a specified foreign corporation, the agent for the group (as defined in §1.1502-77) must make the elections on behalf of its members.*

Q&A 6 notes that elections are due on or before the due date (including extensions) of the date for filing the return to which the provision first applies (the "relevant year"). As well, if the election is made to pay the tax in installments under IRC §965(h), the first payment must be made by the due date ***not including extensions*** for filing returns for the relevant year.

The Q&A is not clear regarding whether the IRS will consider lack of a timely payment an issue that would eliminate the option to make the election or if the warning is merely to advise taxpayers penalties and interest would apply to a late payment. IRC §965(h)(5) itself does not

appear to explicitly require payment for the election to be valid, but it does grant the IRS the authority to prescribe rules for making the election.

The IRS provides the following details on how the election is to be made in Q&A 7

> *A person makes an election under section 965 of the Code or the election provided for in Notice 2018-13, Section 3.02, by attaching to a 2017 tax return a statement signed under penalties of perjury and, in the case of an electronically filed return, in Portable Document Format (.pdf), for each such election. Each such statement must include the person's name, taxpayer identification number and any other information relevant to the election, such as the net tax liability under section 965 with respect to which the installment election under section 965(h)(1) of the Code applies, the name and taxpayer identification number of the S corporation with respect to which the deferral election under section 965(i)(1) of the Code is made, the section 965(a) inclusion amount with respect to which the election under section 965(m)(1)(B) of the Code applies, the amount described in section 965(n)(2) of the Code to which the election under section 965(n)(1) of the Code applies, and the name and taxpayer identification number, if any, of the specified foreign corporation with respect to which the election under Notice 2018-13, Section 3.02, is made. Model statements are included in Appendix: Q&A7. Each election statement must have the applicable title and, in the case of an attachment in Portable Document Format (.pdf) included with an electronically filed return, the file name reflected in the following table:*

Provision Under Which Election is Made	***Title***	***File Name***
Section 965(h)(1)	Election to Pay Net Tax Liability Under Section 965 in Installments under Section 965(h)(1)	965(h)
Section 965(i)(1)	S Corporation Shareholder Election to Defer Payment of Net Tax Liability Under Section 965 Under Section 965(i)(1)	965(I)
Section 965(m)(1)(B)	Statement for Real Estate Investment Trusts Electing Deferred Inclusions Under Section 951(a)(1) By Reason of Section 965 Under Section 965(m)(1)(B)	965(m)
Section 965(n)	Election Not to Apply Net Operating Loss Deduction under section 965(n)	965(n)

Provision Under Which Election is Made	***Title***	***File Name***
Notice 2018-13, Section 3.02	Election Under Section 3.02 of Notice 2018-13 to Use Alternative Method to Compute Post-1986 Earnings and Profits	2018-13

Again, the IRS has provided example forms for the elections in Appendix Q&A7 and links to example PDFs.

Requirement for Additional Form 5471 Filings for non-CFCs

Q&8 provides that Form 5471 must be filed for each specified foreign corporation even if that corporation is not a controlled foreign corporation (CFC). The Q&A provides the following information regarding such filings:

> *In order to collect information relevant to the calculation of a United States shareholder's section 965(a) inclusion amount, a person that was a United States Shareholder of a specified foreign corporation during its 2017 taxable year, including on the last day of such year, and owned stock of the specified foreign corporation on the last day of the specified foreign corporation's year that ended during the person's year must file a Form 5471 with respect to the specified foreign corporation completed with the identifying information on page 1 of Form 5471 above Schedule A, as well as Schedule J. The exceptions to filing in the instructions to Form 5471 otherwise will continue to apply. Notice 2018-13, Section 5.02 also provides an exception to filing Form 5471 for certain United States shareholders considered to own stock by "downward attribution" from a foreign person. The IRS intends to modify the instructions to the Form 5471 as necessary.*

Information to Be Provided by Passthrough Entities

Q&A9 provides the information that will need to be provided by passthrough entities:

> *A domestic partnership, S corporation, or other passthrough entity should attach a statement to its Schedule K-1s, if applicable, that includes the following information for each deferred foreign income corporation for which such passthrough entity has a section 965(a) inclusion amount:*
>
> - *The partner's, shareholder's, or beneficiary's share of the partnership's, S corporation's, or other passthrough entity's section 965(a) inclusion amount, if applicable.*
> - *The partner's, shareholder's, or beneficiary's share of the partnership's, S corporation's, or other passthrough entity's deduction under section 965(c), if applicable.*
> - *Information necessary for a domestic corporate partner, or an individual making an election under section 962, to compute its deemed paid foreign tax credits with respect to its share of the partnership's, S corporation's, or passthrough entity's section 965(a) inclusion amount, if applicable.*

How the Tax is to Be Paid

The tax due under §965 will not simply be paid with the affected tax return. Rather Q&A10 provides the following instructions for paying the tax:

> *A taxpayer should make two separate payments as follows: one payment reflecting tax owed without regard to section 965 of the Code, and a second, separate payment reflecting tax owed resulting from section 965 of the Code (the 965 Payment).* ***Both payments must be paid by the due date of the applicable return (without extensions).***
>
> *The 965 Payment must be made either by wire transfer or by check or money order. This may be the first year's installment of tax owed in connection with a 2017 tax return by a taxpayer making the election under section 965(h) of the Code, or the full net tax liability under section 965 of the Code for a taxpayer who does not make such election and does not make an election under section 965(i) of the Code. For the 965 Payment, there is no penalty for taxpayers electing to use wire transfers as an alternative to otherwise mandated EFTPS payments. Accordingly, taxpayers that would normally be required to pay through EFTPS should submit the 965 Payment via wire transfer or they may be subject to penalties. On a wire payment of tax owed under section 965 of the Code, the taxpayer would use a 5-digit tax type code of 09650 (for more information, see https://www.irs.gov/payments/same-day-wire-federal-tax-payments). On a check or money order payment of tax owed resulting from section 965 of the Code, include an appropriate payment voucher (such as Form 1040-V or 1041-V) and along with all other required information write on the front of your payment "2017 965 Tax."*
>
> *For the payment owed without regard to section 965, normal payment procedures apply (for more information, see https://www.irs.gov/payments). This payment may be made at the same or different time from the 965 Payment, but must be made by the due date of the return or penalties and interest may apply.*

Tax Return Filing Delay and Amending Already Filed Returns

As was noted earlier, Q&A11 requests that electronically filed Forms 1040 containing 965 issues not be filed until April 2, 2018. Of course, that assumes that the adviser's tax software is able to process such returns as of that date, which likely depends on when the IRS gets the information out on the format for such electronic filings.

Q&A12 gives the following advice to taxpayers that may have already filed a return and now discover they have Section 965 issues:

> *The person should consider filing an amended return based on the information provided in these FAQs and Appendices. Failure to submit a return in this manner may result in processing difficulties and erroneous notices being issued. Failure to accurately reflect the net tax liability under section 965 of the Code in total tax could result in interest and penalties.*
>
> *In order to amend a return, a person would file the applicable form for amending the return pursuant to regular instructions and would attach:*
>
> - *amended versions of forms and schedules necessary to follow the instructions in these FAQs,*
> - *any election statements, and*
> - *the IRC 965 Transition Tax Statement included in Appendix: Q&A3.*

Section: 1221
Mansion Property Was Never Actually Used in a Rental Activity, Loss Was Capital

Citation: Keefe v. Commissioner, TC Memo 2018-28, 3/15/18

The question of whether real estate was or was not a capital asset in the hands of the taxpayer became an issue in the case of *Keefe v. Commissioner*, TC Memo 2018-28. While the issue can arise with other assets, real estate investments are generally large enough that the question of whether a gain or loss on sale is capital, §1231 or ordinary is often a very significant issue, with high stakes involved.

In this case, the taxpayer was looking at a seven-figure loss on the sale of a historic waterfront mansion they had acquired to restore and attempt to rent in Newport, Rhode Island. The restoration ended up taking much longer than anticipated and was far costlier. Although they talked with a real estate agent about renting out the property to wealthy individuals who were expected to pay $75,000 a month for the property during peak season, it was never actually rented out.

While the property was not formally listed for rent, the agent did talk with some of her clients about the potential to rent this property and one expressed interest in doing so. But the fact that the restoration was not yet complete meant the property was not actually available for rent during the vast majority of time the agent talked to her clients about doing so. Eventually the taxpayer abandoned attempts to rent out the house due to simple economic issues.

The taxpayers ran into financial difficulties in continuing the project, with the bank increasing the taxpayer's required monthly payment on the financing provided from $25,000 to $39,000 per month. The taxpayers decided to simply attempt to sell off the property, eventually agreeing to a short sale of the mansion for $6.5 million.

The preparer of the taxpayer's original 2009 return listed the loss on sale as a capital loss which limited the actual ability to offset income other than capital gains to $3,000 per year—a pittance when there is a seven-figure loss.

An estate planner the taxpayers met with apparently caused the taxpayer to question the preparer's treatment of the loss as a capital loss. Following that meeting the taxpayers hired another firm to prepare amended income tax returns. On the amended return for the year of sale, the taxpayers now treated the transaction as sale of a §1231 asset, generating a large ordinary loss and a similarly large net operating loss, which was carried back to 2004 and forward to 2010.

Though the IRS initially issued the refunds, the IRS later examined the 2009 return and took the position that, in fact, the loss was not a §1231 loss, but rather this was the sale of a capital asset.

The Tax Court, citing Second Circuit precedent, noted that for the property to be treated as property used in a trade or business the taxpayers must be engaged in "continuous, regular, and substantial activity in relation to the management of the property" as part of the rental activity.

The Court found that, in fact, there never was a rental activity. The Court notes:

> *While we have no doubt that petitioners devoted a great deal of time, effort, and expense to the renovation of Wrentham House Mansion, the record overwhelmingly confirms that Wrentham House*

> *Mansion was never held out for rent or rented after the restoration was complete. Quite simply, the rental activity with respect to Wrentham House Mansion never commenced in any meaningful or substantive way. The cases on which petitioners rely are distinguishable because in each case where a rental trade or business was found to exist, the taxpayer had already started the rental activity and had provided substantial and continuous rental-related services. See Alvary, 302 F.2d at 796; Gilford v. Commissioner, 201 F.2d at 736; Pinchot v. Commissioner, 113 F.2d at 719. In contrast, petitioners never started a rental trade or business involving Wrentham House Mansion. Richmond Television Corp. v. United States, 345 F.2d 901, 907 (4th Cir. 1965), vacated and remanded on other grounds, 382 U.S. 68 (1965); Glotov v. Commissioner, T.C. Memo. 2007-147, slip op. at 5 (holding that a taxpayer is not carrying on a trade or business until the business is functioning as a going concern and performing the activities for which it was organized).*
>
> *Because petitioners did not commence or operate a rental activity with respect to Wrentham House Mansion during the years at issue, we hold that Wrentham House Mansion was a capital asset at the time of its sale. It follows that any gain or loss was derived from the sale of a capital asset and respondent properly disallowed the NOL carryovers.*

The Court also sustained the imposition of the accuracy related penalty on the taxpayers in this case, finding they had not reasonably relied upon the advice of a professional:

> *Petitioners failed to prove that they had reasonable cause and acted in good faith within the meaning of section 6664(c)(1). Petitioners did not make a reasonable, good-faith effort to correctly assess their tax liabilities and their claimed reliance on a tax professional was both unreasonable and not credible. Petitioners' attempt to recharacterize the tax treatment of their investment in Wrentham House Mansion was opportunistic and appears to have been motivated by their financial problems and unpaid income tax liabilities. This attempted recharacterization had all the markings of being "too good to be true", yet petitioners forged ahead, knowing that they had never actually commenced a rental activity involving Wrentham House Mansion and had not done all of the things the law required to be able to rent Wrentham House Mansion. Because petitioners failed to prove that they had reasonable cause for, and acted in good faith with respect to, the positions taken on their amended income tax returns and on their only return for 2010, we sustain respondent's determination that they are liable for the section 6662 accuracy-related penalties.*

While the Court doesn't go into details regarding this matter, courts have often been less than sympathetic when a taxpayer gets conflicting advice on a position from professionals, then simply decides to believe the professional who comes up with most economically favorable answer.

The problem is that, to be able to rely on a professional, the taxpayer must make a reasonable attempt to determine which piece of advice is more credible. The burden is on the taxpayer to come up with a reason other than the tax savings for the reason they elected to believe the adviser for some reason other than getting a big refund when they followed that advice.