

## Massachusetts Society of CPA's Year End Tax Update - S Corps

### **Overstatement of Basis Was Not Omission of Gross Income; Six-Year Assessment Limitation Period Did Not Apply**

The IRS could not use an extended six-year limitations period to assess a deficiency where a partnership allegedly overstated its basis on disposition of an asset, thereby lowering the amount of gross income reported in its return. Overstatement of basis is not an omission of gross income for purposes of Code Sec. 6501(e)(1)(A); therefore, the Notice of Final Partnership Administrative Adjustment (FPAA) was untimely because it was not issued within the three-year limitations period. The interpretation of former Code Sec. 275(c) in *Colony, Inc.*, S Ct, 58-2 ustr ¶9593, controls the interpretation of the substantially identical language in Code Sec. 6501(e)(1)(A). Thus, a federal district court's decision that the FPAA was not time-barred was reversed and remanded.

The IRS's argument that the holding in *Colony, Inc.*, should be limited to the taxpayers in the trade or business of selling goods or services was rejected. Further, the IRS's request to retroactively apply Reg. §301.6501(e)-1(e) as a clarification of the rule established by *Colony, Inc.* was denied because the limitations period had expired before the regulation applied. The regulation, which purports to establish a rule contrary to *Colony*, would change the law governing the taxpayers' tax returns and, thereby, subject them to a liability they would not have been subject to under pre-regulation law.

*Home Concrete & Supply, LLC*, DC NC, 103 AFTR 2d ¶2009-361

### **Overstated Basis Was Omission from Gross Income**

An administrative adjustment made to a partnership return was not barred by a three-year statute of limitations because the return claimed an overstated basis, which is interpreted by the IRS as an "omission from gross income" subject to a six-year statute of limitations. The IRS accused the taxpayers of overstating their basis in certain capital assets by means of a tax shelter, and thus understating income from those assets' sale.

The trial court relied on *Colony, Inc.*, S Ct, 58-2 USTC ¶9593, a Supreme Court opinion that reviewed the precursor statute of limitations and held that overstatement of basis was not an omission from gross income subject to the extended six-year limitation period of Code Secs. 6501(e)(1)(A) and 6229(c)(2), but rather was an understatement of income subject to the three-year limitation period of Code Secs. 6501(a) and [6229\(a\)](#). Therefore, it ruled for the taxpayers, finding the modern statute, Code Sec. 6501(e)(1)(A), to be unambiguous and consistent with the earlier holding.

The government appealed, and the appeal was held in abeyance while a similar case pending before another appellate panel, *Salman Ranch Ltd.*, 2009-2 USTC ¶50,528, was decided. That panel's holding was favorable to the position urged in the present case by the taxpayers. The IRS then issued temporary regulations, and then final regulations in T.D. 9511, setting forth the Service's interpretation of the statute of limitations and the statute's interaction with *Colony*.

The position of the IRS, as set forth in the preamble to T.D. 9511, was that the holding that a basis overstatement was not an omission from gross income only applied in the context of income from sale of goods or services by a trade or business. The appellate court in the present case held that these regulations constituted intervening authority, were a reasonable interpretation of the relevant statute, and could be applied retroactively. Therefore, the court deferred to the position of the regulations and held that the extended period of limitations of Code Secs. 6501(e)(1)(A) and 6229(c)(2) applied to the taxpayers' case

*Grapevine Imports, Ltd.*, CA Fed Cir, 107 AFTR 2d 2011-1288

## **Six-Year Assessment Limitation Period Did Not Apply; Overstatement of Basis Was Not Omission of Gross Income**

In a case that was reviewed by the court, the Tax Court reaffirmed its determination that an omission from income does not include an overstatement of basis. Thus, an LLC was successful in challenging a notice of final partnership administrative adjustment (FPPA) that was issued by the IRS because the notice was issued after the general three-year period of limitations for assessing tax had expired. The IRS could not use the extended six-year limitations period to assess a deficiency where the LLC overstated its basis in an asset, thereby lowering the amount of gross income reported in its return, because basis overstatement is not an omission from gross income for purposes of Code Sec. 6501(e)(1)(A). In so holding, the Court followed the Supreme Court's decision in *Colony, Inc.*, S Ct, 58-2 USTC ¶9593

*Carpenter Family Investments, LLC*, 136 TC —, No. 17, Dec. 58,606

## **Six-Year Limitation Period Applied Because Overstated Basis Was Omission from Income; New Regulations Entitled to *Chevron* Deference**

A Final Partnership Administrative Adjustment (FPAA) issued by the IRS more than three years after the partnership filed its return was not untimely because the six-year limitations period for the assessment of taxes attributable to partnership items applied. The return claimed an overstated basis in property as a result of the partnership's participation in a Son-of-Boss transaction, which was an "omission from gross income," subject to the extended six-year statute of limitations under Code Sec. 6501(e)(1)(A). The regulations issued were entitled to *Chevron* deference because their interpretation of "omits from gross income" was a reasonable interpretation of congressional intent.

Contrary to the partnership's argument *Colony, Inc.*, S Ct, 58-2 ustc ¶9593 did not apply to basis overstatements outside the trade or business context and, therefore, the IRS's regulatory interpretation of Code Sec. 6501(e)(1)(A) was reasonable. Further, the regulations were applicable to the partnership since the case was pending before the court at the time the regulations became effective. Moreover, the preregulation state of the law was neither settled nor clear. The new regulations were not a post-hoc rationalization because the IRS intended to apply the new regulations to the pending cases that prompted

them. Finally, since *Colony, Inc.* never applied to Code Sec. 6501(e)(1)(A) and Code Sec. 6229(c)(2), there was no settled law to change.

*Intermountain Insurance Service of Vail, LLC*, CA-D.C., 107 AFTR 2d 2011-2613

## **IRS Should Increase Examinations of Tax Returns with Losses from Rental Real Estate Activity, TIGTA Says**

The IRS should increase its examinations of individual tax returns that report losses from rental real estate activity, according to a new audit report released by the Treasury Inspector General for Tax Administration (TIGTA). TIGTA's report, "Actions Are Needed in the Identification, Selection, and Examination of Individual Tax Returns with Rental Real Estate Activity, Reference Number: 2011-30-005" was conducted because a Government Accountability Office report in August 2008 stated that at least 53 percent of individual taxpayers with rental real estate activity for tax year 2001 misreported their rental real estate activity, resulting in an estimated \$12.4 billion of net misreported income.

The objectives of TIGTA's review were to evaluate the IRS's coverage of individual tax returns with rental real estate activity and to recommend changes to aid in the identification, selection, and examination of tax returns with rental real estate activity. TIGTA found that during fiscal years 2008 and 2009, the IRS's rental real estate compliance initiative program (CIP) examined a small percentage of the 318,339 examinations conducted by revenue agents and tax compliance officers. TIGTA projected that, if the IRS increased the percentage of rental real estate CIP tax returns it examined, it could increase the potential tax assessments by \$27.3 million over a five-year period.

"Given the magnitude of underreporting in our voluntary system of tax compliance, even small improvements in the IRS's examination of tax returns with rental real estate activity could increase taxpayer compliance and generate substantial additional revenue to the Federal Government, helping reduce the Tax Gap," said Treasury Inspector General for Tax Administration J. Russell George. IRS management agreed with all of TIGTA's recommendations.

TIGTA Report: Actions Are Needed in the Identification, Selection, and Examination of Individual Tax Returns With Rental Real Estate Activity (Reference Number: 2011-30-005)

## **Election for 50-Percent Bonus Depreciation Tracks Congress's Intent, Treasury Official Says**

The IRS's decision to provide a limited exception to elect 50-percent bonus depreciation, instead of 100-percent bonus depreciation, follows Congress's intent, a Treasury Department official said on March 31. The official spoke at a BNA Tax Management luncheon hosted by Buchanan, Ingersoll & Rooney, PC in Washington, D.C.

## **Bonus Depreciation**

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Relief Act ) (P.L. 111-312) extends 50-percent bonus depreciation for two years to apply to qualifying property acquired after December 31, 2007, and placed in service before January 1, 2013 (or before January 1, 2014, in the case of property with a longer production period and certain noncommercial aircraft). The bonus depreciation allowance rate is increased from 50 percent to 100 percent for qualified property acquired after September 8, 2010, and before January 1, 2012, and placed in service before January 1, 2012 (or before January 1, 2013, for longer period production property and certain noncommercial aircraft). The IRS issued bonus depreciation guidance on March 29, 2011 (Rev. Proc. 2011-26, I.R.B. 2011-16, March 29, 2011).

## **Election**

When Congress enacted the 2010 Tax Relief Act, it did not expressly provide for taxpayers to elect to deduct 50-percent bonus depreciation, instead of 100-percent bonus depreciation, for qualified property. The Joint Committee on Taxation recently noted in its General Explanation of Tax Legislation Enacted in the 111th Congress (JCS-2-11) that Congress intended to allow taxpayers to elect 50 percent, instead of 100 percent, bonus depreciation for qualified property, the official said.

"Rev. Proc. 2011-26 provides a limited exception to elect out of 100-percent bonus depreciation and take 50-percent bonus depreciation," the official explained. He added that Congress could revisit the issue in a technical corrections bill.

## **Property**

Questions also have arisen whether retail improvement property and restaurant property qualify for bonus depreciation, the official reported. Rev. Proc. 2011-26 allows taxpayers to take bonus depreciation for retail improvement property that is also leasehold improvement property. Similarly, taxpayers may take bonus depreciation for restaurant property that is also leasehold improvement property, the official said.

## **Bill Text Released Relating to S Corporation Modernization**

Congress has released the text of HR 1478, the "S Corporation Modernization Act of 2011." The Act would make several major changes to the Internal Revenue Code provisions related to S corporations as follows:

The five-year holding period enacted by the Small Business Jobs Act of 2010 for assets with built-in gains would be made permanent.

The qualifying beneficiaries of an electing small business trust (ESBT) would be expanded to include nonresident aliens.

Currently, an individual retirement account (IRA) is allowed to be a shareholder in an S corporation as long as the S corporation is a bank or savings institution holding company and the IRA was a shareholder in the bank or holding company prior to its conversion to an S corporation. The act would allow IRAs to hold stock in all S corporations.

The passive investment income as a termination event would be eliminated so that an S corporation that has excess passive investment income for three consecutive years would not lose its S status.

The excess passive investment tax threshold would be raised from 25 percent to 60 percent of the S corporation's gross receipts.

Under current law an ESBT is not allowed to claim a deduction for certain charitable contributions attributed to an S corporation within the trust, while individual shareholders of the S corporation outside the trust are allowed such deduction. The act would conform the rule applicable to ESBTs to the rule for individual shareholders of an S corporation.

The rule providing that a shareholder's basis in the stock of an S corporation making a charitable contribution of property is reduced by the shareholder's pro rata share of the adjusted basis of the contributed property (rather than the fair market value of the contributed property) is made permanent.

HR 1478 was referred to the House Ways and Means Committee on April 12, 2011.

## **QSub Election and Liquidation of Subsidiary Did Not Increase S Corporation Shareholders' Stock Bases**

Upon an S Corporation's election to treat its wholly owned subsidiary as a qualified subchapter S subsidiary (QSub) and the resulting deemed liquidation of the subsidiary, the shareholders of the S corporation did not increase their stock basis by the amount of the S corporation's built-in gain in the stock of the subsidiary. A QSub election and the resulting deemed liquidation of the subsidiary under Code Sec. 332 did not give rise to an item of income under Code Sec. 1366(a)(1)(A), and, therefore, the electing S corporation's shareholders did not increase their stock bases under Code Sec. 1367(a)(1)(A).

## **IRS Updates Optional Standard Mileage Rates**

The IRS has updated the optional standard mileage rates for computing the deductible costs of operating an automobile for business, medical or moving expense purposes and for determining the reimbursed amount of these expenses that is deemed substantiated. This modification results from recent increases in the price of fuel.

The revised standard mileage rates are 55.5 cents per mile for business use of an automobile and 23.5 cents for use of an automobile as a medical or moving expense. The mileage rate for use of an automobile as a charitable contribution is fixed by statute and remains 14 cents. The revised standard mileage rates apply to deductible transportation expenses paid or incurred for business, medical, or moving expense purposes on or after July 1, 2011, and to mileage allowances that are paid both (1) to an

employee on or after July 1, 2011, and (2) for transportation expenses an employee pays or incurs on or after July 1, 2011.

Announcement 2011-40

## **Final Regulations Issued on Deduction of Start-up and Organizational Expenses**

The IRS has released final regulations on the deduction of the start-up expenses incurred in the year a taxpayer begins an active trade or business, or of the organizational expenses of a corporation or partnership in the year in which it begins business. The regulations affect taxpayers that pay or incur these expenses and provide guidance on how to elect to deduct the expenses in accordance with the new rules. Under Code Sec. 195(b), a taxpayer may deduct start-up expenses in the amount of the lesser of the actual expenses or \$5,000, reduced by the amount by which the expenses exceed \$50,000. Under Code Sec. 248(a) or 709(b), a corporation or partnership, respectively, may deduct organizational expenses in the same amount. In any case, the taxpayer may then amortize the remaining expenses over 180 months. The final regulations reflect the proposed and temporary regulations issued in 2008 (T.D. 9411; NPRM REG-164965-04), except that the final regulations provide that a taxpayer wishing to capitalize start-up and organizational costs must affirmatively elect to do so. Otherwise, the taxpayer is deemed to have elected to amortize the start-up or organizational costs. These regulations are effective on August 17, 2011, and generally apply to expenses paid or incurred on or after August 16, 2011.

T.D. 9542

## **Dividend Distributions to Undercompensated Shareholder Properly Recharacterized as Wages Subject to Employment Taxes**

The IRS properly recharacterized "dividends" distributed from a professional S corporation to its sole shareholder and employee as wages subject to employment taxes; therefore, the IRS's assessments of additional unpaid employment taxes, interest and penalties on those wages were presumptively valid and the corporation's refund claim was denied. The payments were compensation for services performed by the shareholder, rather than a distribution of the corporation's earnings and profits. The corporation's self-proclaimed intent to pay the individual a nominal salary did not limit the government's ability to recharacterize the dividend payments as wages. The individual was an exceedingly qualified and experienced accountant working in a reputable and well-established firm, and the nominal salary paid to him was unreasonably low in comparison to what a reasonable person in his role would have expected to earn.

*Watson, P.C.* DC Iowa 12/23/10) 107 AFTR 2d ¶2011-305