Current Federal Tax Developments

Week of February 11, 2019

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Section: 223
Examples of Situations Where Employers Can Recover Erroneous HSA Contributions Listed in Information Letter

Citation: Information Letter 2018-0033, 2/4/19

In Information Letter 2018-33 the IRS provided some guidance on situations when an employee may recover amounts transferred by error to an employee's health savings account (HSA).

As a general rule, an individual's interest in an HSA is nonforfeitable.[1] However, the IRS in Notice 2008-59 provided for limited circumstances where an employer who funds an employee's HSA account in error can recover the funds.

The notice has a series of questions and answers that address specific situations where the funds can be recovered. But this letter reminds us that the notice was not meant to be the exclusive list of situations where funds may be recovered. The letter notes:

> *Notice 2008-59 does not specifically address other situations in which contributions to an employee's HSA are the result of the employer's or trustee's administrative or process errors, but the notice also was not intended to provide an exclusive set of circumstances in which an employer may request the return of contributed amounts. Rather if there is clear documentary evidence demonstrating that there was an administrative or process error, an employer may request that the financial institution return the amounts to the employer, with any correction putting the parties in the same position that they would have been in had the error not occurred. Employers should maintain documentation to support their assertion that a mistaken contribution occurred.*

The letter then goes on to list other situations where recovery of the funds would be appropriate:

- *An amount withheld and deposited in an employee's HSA for a pay period that is greater than the amount shown on the employee's HSA salary reduction election.*
- *An amount that an employee receives as an employer contribution that the employer did not intend to contribute but was transmitted because an incorrect spreadsheet is accessed or because employees with similar names are confused with each other.*
- *An amount that an employee receives as an HSA contribution because it is incorrectly entered by a payroll administrator (whether in-house or third-party) causing the incorrect amount to be withheld and contributed.*
- *An amount that an employee receives as a second HSA contribution because duplicate payroll files are transmitted.*
- *An amount that an employee receives as an HSA contribution because a change in employee payroll elections is not processed timely so that amounts withheld and contributed are greater than (or less than) the employee elected.*
- *An amount that an employee receives because an HSA contribution amount is calculated incorrectly, such as a case in which an employee elects a total amount for the year that is allocated by the system over an incorrect number of pay periods.*

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[1] IRC §223(d)(1)(E)

- *An amount that an employee receives as an HSA contribution because the decimal position is set incorrectly resulting in a contribution greater than intended.*

Section: 451
Taxpayers Using Impermissible Method Can Use Revenue Procedure 2018-60 to Convert Automatically to a Permitted Method

Citation: CCA 201852019, 2/1/19

Rev. Proc. 2018-60 was released by the IRS to allow taxpayers to obtain consent to change from their current method of accounting to take into account the requirements of IRC §451(b)(1)(A), added by the Tax Cuts and Jobs Act, effective for tax years beginning in 2018. But is that automatic change still available if the method the taxpayer had previously been using was one not allowed for tax purposes?

In CCA 201852019 the IRS Chief Counsel's office decided the answer was yes.

IRC §451(b)(1)(A) provides:

> *(A) In General.*
>
> *In the case of a taxpayer the taxable income of which is computed under an accrual method of accounting, the all events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in --*
>
> > *(i) an applicable financial statement of the taxpayer, or*
> >
> > *(ii) such other financial statement as the Secretary may specify for purposes of this subsection.*

The memorandum poses the following facts for analysis:

> *Taxpayer is an accrual method taxpayer with an applicable financial statement that files its tax return on a calendar year basis. Taxpayer proposes to adopt a method under Rev. Proc. 2018-60 to comply with § 451(b), as amended by section 13221 of the Tax Cuts and Jobs Act, Pub. L. No. 115-97 (December 22, 2017)(TCJA). Taxpayer's present method of accounting is an impermissible method that does not comply with either the all events test of § 451, as amended by the TCJA or with § 451, prior to being amended by the TCJA.*

The memo notes that the Revenue Procedure applies to a taxpayer who seeks to change to a method that "treats an item of gross income, or portion thereof, as meeting the all events test no later than when such item, or portion thereof, is taken into account as revenue in its AFS[2] under § 451(b)(1)(A)."

An election under this method will, by its nature, automatically also require the taxpayer to use a proper accounting method under the all events test for tax purposes even if the AFS is not reporting revenue as rapidly as the all events test. As the memorandum provides:

> *Rev. Proc. 2018-60 provides automatic consent for method changes to comply with § 451(b)(1)(A), as amended by the TCJA. The operative rule set forth in § 451(b)(1)(A) includes the requirements of the*

[2] Applicable financial statement as defined in IRC §451(b)(3)

> *all events test under § 451(b)(1)(C). Thus, to satisfy § 451(b)(1)(A), a taxpayer must also comply with the all events test as defined in § 451(b)(1)(C).*

Thus, the CCA concludes:

> *Accordingly, a taxpayer that complies with all the terms and conditions set forth in Rev. Proc. 2018-60, may obtain automatic consent of the Commissioner to change from a method that is impermissible under § 451(b)(1)(C) to a permissible method that complies with § 451(b)(1)(A), as amended by TCJA.*

Note that the taxpayer in this case will not be allowed to use its prior inappropriate tax method for cases where the AFS may still use that old method to slow recognition of revenue for tax purposes. Rather, for tax purposes the taxpayer will need to move to a correct application of the all events test in those cases.

It seems possible, based on this analysis, that this result would be available even if the taxpayer's AFS never creates a situation where a more rapid recognition would be required—thus creating an opportunity for a taxpayer to obtain automatic permission to change from an otherwise impermissible method of recognizing revenue in cases where the all events test would normally apply.

Section: 6662
Taxpayer Reasonably Relied on CPA's Advice

Citation: Doyle v. Commissioner, TC Memo. 2019-8, 2/7/19

The case of Doyle v. Commissioner, TC Memo. 2019-8 is remarkable not so much for the decision that Mr. Doyle owed additional tax, but for the Court's analysis of why he should not face penalties. The taxpayer in this case was able to prove had reasonably relied upon the advice of a tax professional.

Mr. Doyle attempted to argue that amounts he had received as a settlement received from his former employer for emotional distress could be excluded from income under IRC §104(a). IRC §104(a)(2) provides:

> *(a) In general*
>
> *Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—*
>
> > *…(2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness;…*

The Tax Court, noting that the award says it was for "emotional distress" found that this was sufficient to decide against the taxpayer's attempt to exclude his award from income. The Court noted:

> *This is enough for us to find that the $250,000 was for Doyle's emotional distress, and leads us to the next question: Is Doyle's "alleged emotional distress" a personal physical injury or physical sickness? The Code tells us it isn't. Section 104(a) specifically commands that "emotional distress shall not be treated as a physical injury or physical sickness," and caselaw tells us that emotional distress includes symptoms such as insomnia, headaches, and stomach problems that result from such distress. See Pettit*

> *v. Commissioner, T.C. Memo. 2008-87, 2008 WL 928090, at *4; see also H.R. Conf. Rept. No. 104-737, at 301 n.56 (1996), 1996-3 C.B. 741, 1041. If we stopped at the language in the settlement agreement, we would hold that the emotional-distress payments Doyle received in 2010 and 2011 are not excludable from income under section 104(a)(2). See, e.g., Hansen v. Commissioner, T.C. Memo. 2009-87, 2009 WL 1139469, at *7 (finding similar settlement-agreement language meant the payments were not excludable under section 104(a)(2)).*

The taxpayers argued that the emotional distress lead to physical symptoms—but the opinion notes the Courts have previously rejected that view:

> *But Doyle's list of ailments — e.g., nausea, vomiting, headaches, backaches — are included in the definition of emotional distress when they result from such distress, see Pettit, 2008 WL 928090, at *4; [*14] see also H.R. Conf. Rept. No. 104-737, supra at 301 n.56, 1996-3 C.B. at 1041, and he himself testified that his ailments are the consequence of the emotional distress he suffered when Wacom fired him. Doyle's own testimony therefore undermines his eligibility for excluding this part of the settlement under section 104(a)(2). And while we have ourselves noted the crumbling barrier between psychiatry and neurology, see Alhadi v. Commissioner, T.C. Memo. 2016-74, where the Code itself assumes a dualist view of the mind and body we must assume such a view as well when we apply the Code to the facts of a particular case. The Doyles may well be right ontologically, but not legally.*

The IRS argued that, in addition to the taxes and interest due, the taxpayers should also have penalties imposed under IRC §6662(a). As the Court describes this provision:

> *Section 6662(a) imposes a 20% penalty for underpayments due to "any substantial understatement of income tax," see sec. 6662(b)(2), (d), or "[n]egligence or disregard of rules or regulations," see sec. 6662(b)(1), (c). The Commissioner says the Doyles are liable for accuracy-related penalties on both grounds, and it's easy enough to see that there seems to have been a substantial understatement at least: Section 6662(d)(1)(A) says that an understatement is substantial if it is greater than $5,000 or "10 percent of the tax required to be shown on the return;" the Doyles' tax understatements in 2010 and 2011 easily exceed both those marks.*

The taxpayers argued that they should not subject to this penalties because they had reasonably relied in good faith on the advice of an experienced CPA that they provided all relevant information to. As the opinion notes:

> *The Doyles argue, however, that they shouldn't be held liable for the penalties because they had reasonable cause and acted in good faith. See sec. 6664(c)(1); sec. 1.6664-4(a)(1), Income Tax Regs. They explain that they hired Hunter — an experienced and outwardly qualified CPA — to prepare their 2010 and 2011 returns; they are not tax experts; they gave Hunter accurate and complete records; and they thought his advice was reasonable and relied on it in good faith.*

Citing the Tax Court's opinion in *Neonatology Assocs., PA v. Commissioner*, 115 TC 43 (2000), *affd* 299 F.3d 221 (3d Cir 2002), the opinion lists the following three factors to be considered when determining if the taxpayer has a valid reliance in good faith defense to penalties:

- *Was the adviser a competent professional with sufficient expertise to justify reliance;*
- *Did the taxpayer provide necessary and accurate information to the adviser; and*
- *Did the taxpayer actually, and in good faith rely on the adviser's judgment?*

The opinion first considers the qualifications of the CPA on whose advice they claimed to rely—and the Court found that the individual's resume was more than strong enough to justify reliance by the taxpayers:

> *Hunter appeared more than competent to advise the Doyles. He's an Ivy League-educated CPA with over forty years of experience preparing tax returns, and he'd done the Doyles' returns for a decade. Hunter is licensed to practice his profession in four states, teaches college accounting classes, and gave the impression that he stays current with federal tax issues. Even if the Doyles were knowledgeable about tax law — which they're not — we'd find that Hunter seemed competent enough to justify their reliance.*

The taxpayers were also found to meet the second prong of the test:

> *We also find that the Doyles provided Hunter with all the information he needed to accurately prepare their returns. Hunter credibly testified that he'd reviewed the settlement agreement and other documents about the settlement — documents that we find exist, but which the Doyles failed to introduce into evidence. He also explained, and we believe him, that Doyle's "wife provide[d] very extensive logs and records," and that he and Doyle "conversed quite a bit on all of his returns." The Doyles easily satisfy the first and second factors for their reliance defense.*

Note that the CPA in question testified for the taxpayers regarding the information he had been given. Such testimony most often is found in cases where taxpayers mount a successful reliance defense.

The third test, looking at whether their reliance was reasonable and in good faith, had one potentially fatal fact. If a taxpayer does not actually consider the advice given to see if it "makes sense" quite often the Courts find that there was not reasonable reliance. In this case the taxpayer admitted that he had essentially just looked to see how big a refund he was getting.

But in this case the Court did not ultimately find this admission to be fatal to the claim of reliance:

> *Although Doyle is a sophisticated businessman, his testimony left us with the distinct impression that he lacks tax experience or knowledge. That gives some much-needed color to his admission that he only briefly reviewed the returns Hunter prepared. "Probably like most people," Doyle testified, "you look at the bottom line and see how much you have to pay or how much you're getting back, to be quite honest." Doyle's testimony on this point was honest, and we find it reasonable given his lack of tax expertise — he had "a lot of confidence in Mr. Hunter" and "so [he] trusted" him. So we find that Doyle actually relied on Hunter's advice.*

And the Court found the nature of the issue did not make the CPA's advice itself inherently unreasonable:

> *And we find that the Doyles' reliance on Hunter's advice was reasonable and in good faith. We've recognized that the line between excludable and includable damages under section 104(a)(2) is a thin one, see Blackwood v.Commissioner, T.C. Memo. 2012-190, 2012 WL 2848677, at *6 (there is some "level of uncertainty regarding when physical manifestations of emotional distress give rise to a physical injury or physical sickness"), and even erroneous professional advice about that is good enough to prove reasonable cause, see Longoria v. Commissioner, T.C. Memo. 2009-162, 2009 WL 1905040, at *10-*12 (finding reasonable reliance even though CPA failed to consider nature of claims and terms of settlement). We've even held that advice in this area from individuals who lack "specialized knowledge in tax law" can be relied on to avoid accuracy-related penalties. See Stadnyk v.*

*Commissioner, T.C. Memo. 2008-289, 2008 WL 5330828, at *7, aff'd, 367 F. App'x 586 (6th Cir. 2010). Hunter's reporting method was odd — including settlement payments and offsetting deductions on Schedules C — but his explanation for it was innocent enough; he advised the Doyles that the emotional-distress payments were not taxable, and he credibly testified that he reported them the way he did so that the Doyles were "reporting all the information but explaining why we treated them as nontaxable." There's nothing in the record that indicates the Doyles should've been skeptical about this advice. Under these circumstances, we wouldn't expect the Doyles to second-guess their CPA's advice. See Boyle v. Commissioner, 469 U.S. 241, 251 (1985). The Doyles had reasonable cause and acted in good faith, and they are therefore not liable for the accuracy-related penalties*

Section: 7422
Suit Against TSA for Lost Tax Documents Fails Since It Was Actually a Claim for a Tax Refund

Citation: Schlieker v. US Transportation Security Administration, DC Colorado, No. 1:17-cv-01284, 2/7/19

Traveling is always a bit stressful, but it's even worse than normal if something that was in your checked baggage isn't in there when you arrive at your destination. In the case of *Schlieker v. US Transportation Security Administration*, DC Colorado, No. 1:17-cv-01284 the items that turned up missing were tax documents that Mr. Schlieker claimed cost him a $5,000 refund.

Mr. Schlieker had checked bags for a flight from Phoenix to Denver in February of 2016. His complaint indicated that he had "multiple files, folders and paperwork" that related to his tax return for 2015 in his luggage when he checked it. However, when he arrived in Denver he discovered that the paperwork was no longer in his bag. Rather, he had a notice from the TSA that his bags had been opened and inspected. He concluded the paperwork had simply not been repacked when the TSA completed its inspection of his bag.

Mr. Schlieker claimed that the lack of this paperwork cost him a $5,000 refund as he was no longer to document his right to that refund. He sought compensation from TSA for the refund he argued he was no longer able to claim.

The TSA denied his claim for compensation, which lead to the filing of a suit against the agency. But the Court agreed that it lacked jurisdiction in this case because it was fundamentally a suit for a federal tax refund. Thus, IRC provisions related to claiming refunds were triggered.

Specifically, IRC §7422(a) barred the Court from hearing the case at this point. That provision reads:

(a) No suit prior to filing claim for refund

No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.

The opinion cites the U.S Supreme Court's opinion in *United States v. Clintwood Elkhorn Mining Co.*, 553 U.S. 1, 9 (2008), noting that the Supreme Court held that the tax refund provision applies anytime the issue involves a tax refund.

> *The Supreme Court examined § 7422(a) in Clintwood Elkhorn Mining, with Chief Justice Roberts writing that "[f]ive 'any's' in one sentence and it begins to seem that Congress meant the statute to have expansive reach." 553 U.S. at 7. Clintwood concerned the Tucker Act, which provides the Court of Federal Claims with jurisdiction over certain claims for money damages against the Government. 28 U.S.C. § 1491(a)(1). The plaintiffs' argument that they could sue "directly under the Tucker Act" for refund of certain taxes on coal exports, the Court said, "does not matter. If the [plaintiffs'] claims are subject to [Internal Revenue] Code provisions, those claims are barred whatever the source of the cause of action." without an IRS administrative claim. Clintwood Elkhorn Mining, 553 U.S. at 9 (emphasis added).*

The Court notes that although the plaintiff argues he is making a claim under other provisions of federal law, at the base he is looking for a tax refund. The opinion notes:

- He was asking for damages exactly equal to the amount of his estimated lost income tax refund;
- He never claimed these documents had any value aside from their ability to be used to support his claim for an income tax refund; and
- He did not claim that the TSA failed to repack any other items, so this was solely a claim for an inability to claim a federal tax refund.

The opinion concludes:

> *Here, Plaintiff — in substance, if not in form — seeks the $5,000 tax refund. In other words, although Plaintiff cites the FTCA as the statutory basis for his claim, the amount and nature of Plaintiff's damages request indicate that Plaintiff seeks the $5,000 tax refund. Given Plaintiff's decision not to file the required IRS administrative claim, however, the Government's sovereign immunity remains in place and deprives the Court of subject matter jurisdiction.*