Current Federal Tax Developments

Week of May 6, 2019

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Section: 36B
Congratulations on Your Recent Marriage. Now Repay that Entire Premium Subsidy You Used to Qualify For.

Citation: Fisher v. Commissioner, TC Memo 2019-44, 4/30/19

The tax law is not necessarily fair, and the Tax Court is not generally allowed to solve such unfairness. In the case of *Fisher v. Commissioner*, TC Memo 2019-44 the taxpayer found there was no relief available for what many people would see as an unfair result.

The case involves yet another marriage penalty in the tax law. In this case a mid-November marriage ended up forcing Christina Fisher to repay over $4,400 of advance premium tax credit (PTC) that had been used to reduce her Exchange purchased health care premiums for the year.

Under IRC §36B taxpayers who obtain their health insurance via an Exchange can qualify for a tax credit related to the cost of the insurance. The credit is a based on the income of the taxpayer's household for the year in question, as well as the number of members of that household. The credit does not apply to taxpayers whose household income exceeds 400% of the federal poverty level (FPL).

Since the purpose of the credit was to encourage people to acquire insurance and make it more affordable, the law provides for an advance payment of such credit that reduces the premium paid, so on a monthly basis the taxpayers only has to pay the amount that won't be subsidized. However, since the actual credit cannot be known until the year concludes, the advance payment is based on estimates of the taxpayer's income and household for the year.

At the end of the year, the taxpayer computes the actual credit he/she is eligible for and compares that to the total advance credit. If the taxpayer has received advanced payments in excess of the actual credit he/she is eligible for, the excess must be repaid with the tax return for the year in question.[1]

When the unmarried Christina applied for health care in December 2014, the Exchange used Christina's household income to determine that she qualified for an advance credit of $371 per month in 2015 for the purchase of the insurance coverage she was signing up for.

However, in November she married Timothy Todd Fisher. Mr. Fisher's income was substantially higher than Christina's. Their household income for the year was well in excess of 400% of the FPL, the point at which no credit is available to the individual.

While special rules do apply to the calculation for months prior to marriage when a taxpayer is married during the year,[2] those rules did not solve Christina's problem. Her assigned portion of household income for those periods was still high enough to wipe out her right to any credit for the months prior to the marriage.

The taxpayers did not claim that the amount of credit was being computed incorrectly based on their income, nor did they claim that the information reported by the Exchange on Form 1095-

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[1] IRC §36B(f)(2)

[2] Reg. §1.36B-4(b)(2)(i)

A was in error. They just complained that it was unfair to require Christina to repay an amount that she was clearly eligible for prior to getting married.

Unfortunately, tax law is often unfair and the Tax Court is not a venue in which that statutory unfairness can be addressed. As the opinion notes:

> *Although we are sympathetic to petitioners' situation, we are not a court of equity, and we cannot ignore the law to achieve what may be an equitable end. Commissioner v. McCoy, 484 U.S. 3, 7 (1987); Stovall v. Commissioner, 101 T.C. 140, 149-150 (1993); Paxman v. Commissioner, 50 T.C. 567, 576-577 (1968), aff'd, 414 F.2d 265 (10th Cir. 1969). The statute is clear; excess advance PTC payments are treated as an increase in the tax imposed. Sec. 36B(f)(2)(A). Petitioners received an advance of a PTC payment to which they ultimately were not entitled. They are liable for the $4,452 deficiency.*

Section: 61
Refund of State Tax Credit in Excess of Tax Liability is Taxable Income

Citation: Ginsburg v. Commissioner, CA FC, Case No. No. 1:17-cv-00075-RHH, 4/30/19

In March of 2015 we discussed a Tax Court case holding that various refundable New York state income tax credits represented income to the taxpayers involved in the case of *Maines v Commissioner*, 144 TC No. 8.[3] In Ginsburg v. Commissioner, CA FC, Case No. No. 1:17-cv-00075-RHH a different taxpayer decided to go a different route to obtain relief, bringing their case in the Court of Federal Claims.

Unfortunately for the taxpayer, the results turned out to be the same (the excess was taxable) and when they appealed that decision to the Court of Appeals for the Federal Circuit, they were denied relief at that level as well.

In this case, the issue involved Brownfield Redevelopment Tax Credits offered by the state of New York. As the Circuit Court opinion notes:

> *In 2005, the Ginsburgs, through Hawthorne Village, LLC ("Hawthorne"), a corporation in which the Ginsburgs indirectly hold a majority of the partnership interests, acquired property located at 220 Water Street in Brooklyn, New York ("the property"). J.A. 269.2 After the Ginsburgs applied to participate in the Brownfield Cleanup Program, NY DEC approved their application and the parties entered into a Brownfield Site Cleanup Agreement. See J.A. 186-213. "The development of [the property] started in 2005 and was completed in 2011," thereby converting what was once an old shoe factory into a residential rental building. J.A. 102; see J.A. 103. In 2011, the Ginsburgs granted an environmental easement to the State of New York. J.A. 411-17. A few months later, NY DEC issued a certificate of completion. J.A. 258-59; see J.A. 256-57.*
>
> *Hawthorne applied for a brownfield redevelopment tax credit of $6,583,835.10 for tax year 2011, see J.A. 276-79, with the Ginsburgs' share of that credit equaling $4,975,595.00, J.A. 526. In 2013, the State of New York paid the Ginsburgs a refund of $1,903,951.00 attributable to the brownfield*

[3] "State's Label of Refundable Credits as Overpayments of State Income Tax Not Binding on Federal Courts," *Current Federal Tax Developments* website, 3/13/2015, https://www.currentfederaltaxdevelopments.com/blog/nyscredits

> *redevelopment tax credit. See J.A. 353, 370. They did not report this payment as part of their income on their 2013 federal income tax return, claiming instead that this payment constituted a nontaxable refund. See J.A. 272, 370. After exercising its authority under the Internal Revenue Code to conduct an examination, see I.R.C. § 7602(a) (2012), the Internal Revenue Service ("IRS") proposed adjustments to the Ginsburgs' 2013 income taxes, by including as taxable income $1,864,618.00 of the $1,903,951.00 excess amount paid by the State of New York, J.A. 504; see J.A. 504 & n.9 (explaining that the IRS found only the $1,864,618.00 portion was taxable after accounting for "state tax withholdings" and "estimated state tax payments"). As a result of these proposed adjustments, the IRS determined the Ginsburgs owed an additional $690,628.46 in federal income tax, which the Ginsburgs paid. See J.A. 390.*

The appellate panel summarized the trial court's decision that the net refund represented taxable income as follows:

> *The Court of Federal Claims explained that "the excess [b]rownfield credit was nothing more than a cash transfer from [New York] to the [Ginsburgs]," and the payment "is, substantively, an undeniable accession to wealth over which [the Ginsburgs] have complete dominion." Id. According to the Court of Federal Claims, "New York's payment came with no strings attached," meaning "[the Ginsburgs] were free to spend, save, or transfer the excess credit in whatever way they pleased." Id.*
>
> *The Court of Federal Claims disagreed with the Ginsburgs that the brownfield redevelopment tax credit qualified for certain "exceptions or exclusions" to federal income tax liability. Id. at 5. Specifically, the Court of Federal Claims rejected the Ginsburgs' "theory that the [b]rownfield credit is a recovery of capital and thus not income" because "[the Ginsburgs] have not sold or transferred any of their capital assets" and "[n]o 'recovery' has yet occurred because [their] capital investment is still ongoing." Id. The Court of Federal Claims similarly rejected the Ginsburgs' theory of inducement stating that, "while the [b]rownfield project provided an investment incentive to [the Ginsburgs], no inducement by the [S]tate of New York occurred." Id. Instead, the Ginsburgs "freely chose to participate and take advantage of New York's state tax credit program." Id.*

The appellate panel considered the taxpayers' arguments for excluding the excess refund from income that the trial court had rejected. The taxpayers argued that the payments were simply a reimbursement of the capital costs of cleaning up and redeveloping the property. As well, they claimed there so many strings attached that they did not have true control over the amounts they received as excess tax credits.

The appellate panel did not agree with this view. First, they rejected the view that this was merely a reimbursement of costs, thus not taxable as a return of capital. The panel's opinion held:

> *…[T]he excess amount is an "undeniable accession[ ] to wealth." Glenshaw Glass, 348 U.S. at 431. After using the brownfield redevelopment tax credit to offset the Ginsburgs' state tax liability, the State of New York paid them $1,864,618.00 as the remainder of the tax credit. See J.A. 504; see also J.A. 353, 370. The Ninth Circuit's holding in Baboquivari Cattle Co. v. Commissioner is instructive. 135 F.2d 114 (9th Cir. 1943). There, a cattle rancher made improvements to ranch lands leased from the state of Arizona, including rebuilding "dirt reservoirs and earthen tanks" to prevent "erosion." Id. at 115. Pursuant to a federal statute, the United States made two payments to the rancher for "completion" of the work, with the "cost of the work to [the rancher] in each year exceed[ing] the amounts received." Id. The Ninth Circuit rejected the rancher's argument that the payments were nontaxable "capital subsidies" for "positive outlays," rather than "income subsidies." Id. The Ninth Circuit found no "justification for these . . . distinctions," concluding instead that these*

> *federal payments were taxable income, where the "beneficiary does not earn a payment merely by making an improvement" but instead "earns it in part by compliance with conditions in respect of the proper use of [the] land." Id. at 116. Similarly, the excess amount of the state tax credit (after offsetting for state tax liabilities) paid to the Ginsburgs, based on their positive outlays in redeveloping a brownfield site, is "an economic gain" made for compliance with the Brownfield Cleanup Program and is includable in gross income. Comm'r v. Banks, 543 U.S. 426, 433 (2005); see Maines v. Comm'r, 144 T.C. 123, 136 (2015) (holding that the "excess portion [of a state tax credit] that remains after first reducing state-tax liability and that may be refunded is an accession to the [taxpayers'] wealth, and must be included in their federal gross income").*

The Court rejects the "return of capital" theory, continuing:

> *Even though the brownfield redevelopment tax credit is calculated, in part, based on costs incurred by the taxpayer, such as "[s]ite preparation" and "[t]angible property" costs, see N.Y. Tax Law § 21(a)(2), (3), we do not agree that this renders the paid excess amount of the credit a nontaxable return of capital. A treatise on federal income tax explains the return of capital theory: "[w]hen the purchaser's obligations are received as part of the consideration on a sale but have no ascertainable fair market value at the time of their receipt, the seller may treat the full amount of the payments as they are received as a return of capital" and that "[o]nly those payments that are received after his entire basis has been recovered must be reported as income." 1 Mertens, Law of Fed. Income Taxation § 5:10 (2019); see 1 Bittker & Lokken, Fed. Taxation of Income, Estates and Gifts, ¶ 5.4 (2019) (explaining that gain is not realized where the "payment served only to restore the taxpayer's impaired capital").6 Here, however, the Ginsburgs neither allege that a payment was made to New York, nor explain why the payment of the excess amount of the brownfield redevelopment tax credit is a return of their basis to restore impaired capital. See generally Appellants' Br. Instead, the developer, Hawthorne, not the Ginsburgs, directly invested in the development of the brownfield site, including cleanup, see J.A. 102, and the Ginsburgs received a portion of the brownfield redevelopment tax credit that was paid by the State of New York to Hawthorne, see J.A. 526. As the Court of Federal Claims recognized, Hawthorne's "capital investment" in the property "is still ongoing." Ginsburg, 136 Fed. Cl. at 5. Under these circumstances, the Ginsburgs have failed to meet their "burden of proving that money received . . . represents a recovery of capital, rather than ordinary income." Morse, 371 F.2d at 483.*

The opinion continues to reject a "reimbursement of costs" defense in more detail:

> *The Ginsburgs aver they were induced "to cleanup and redevelop" the property and therefore the excess amount of the brownfield redevelopment tax credit is a nontaxable reduction in their cost basis, rather than taxable income. Id. at 37.7 In Freedom Newspapers, the U.S. Tax Court held that a broker's payment to a taxpayer was a nontaxable reduction in cost basis, where the broker "induce[d the taxpayer] to purchase" an additional newspaper as part of its purchase of a group of other newspapers by promising to pay the taxpayer $100,000.00 if the broker was unable to resell the additional newspaper within a year. 36 T.C.M. (CCH) at 1755; see id. at 1757-58. Similarly, in Brown, the Board of Tax Appeals held that a majority stockholder's payment to a taxpayer for the purposes of persuading the taxpayer to purchase stock in the same company was a nontaxable reduction in cost basis for the taxpayer's stock purchase because the majority stockholder induced the purchase. See 10 B.T.A. at 1054. By contrast, the State of New York here does not hold a financial interest in the Ginsburgs' purchase similar to either the broker in Freedom Newspapers or the majority stockholder in Brown. See Freedom Newspapers, 36 T.C.M. (CCH) at 1757-58; Brown, 10 B.T.A. at 1054. Nor did New York enter into negotiations with the Ginsburgs to induce them into cleaning up the brownfield site. Instead, we agree with the Court of Federal Claims that the Ginsburgs "freely chose to participate and take advantage of New York's state tax credit program." Ginsburg, 136 Fed. Cl. at*

> *5; see N.Y. Tax Law § 21. We decline to extend the common law inducement doctrine to this case given these circumstances.*

As well, the court found the Ginsburgs had complete control over these refunded amounts, noting:

> *In Baboquivari, the Ninth Circuit recognized that "[n]o part of the sums paid to the [rancher] were required to be placed by him in a particular account or fund" and "[t]he payments were not earmarked" or their use otherwise "restrict[ed]," even though "the right to have or retain the subsidy for the improvement" could be "defeated" for failure to "compl[y] with conditions in respect of the proper use of [the] land." 135 F.2d at 116 (emphasis added). Likewise, there were no restrictions on the Ginsburgs' use of the excess amount of the tax credit and the Ginsburgs were "free to use the money for any purpose [they] might see fit." Id. Even though New York could revoke the certificate of completion for, inter alia, lack of continued compliance or a discovery that the Ginsburgs made a misrepresentation of material fact, see N.Y. Envtl. Conserv. Law § 27-1419(5), the avoidance of this potential revocation is within the Ginsburgs' control and therefore does not "depend[ ] on events outside of [their] control," Hous. Indus. Inc. & Subsidiaries v. United States, 125 F.3d 1442, 1445 (Fed. Cir. 1997) (citation omitted). Moreover, although New York's law contemplates revocation of a certificate of compliance where "[t]here is good cause," N.Y. Envtl. Conserv. Law § 27-1419(5)(d), we do not believe that this alone is sufficient to hold that the Ginsburgs lacked complete dominion and control, see Indianapolis Power & Light, 493 U.S. at 210 (requiring "some guarantee" to satisfy the complete dominion and control condition, rather than an absolute guarantee). We conclude that the Ginsburgs have complete dominion and control over the payment because there is a legally — adequate guarantee that they will be allowed to keep the excess amount of the tax credit, barring actionable misconduct on their part.*

Section: 401
Determination Letter Program Reopened to Certain Existing Plans

Citation: Revenue Procedure 2019-20, 5/1/19

The IRS has opened up its plan determination letter program to a limited number of existing individually designed plans in Revenue Procedure 2019-20. The IRS had indicated in various forums that the agency would begin to reopen its determination program to cover certain existing plans. Until this procedure, the program had been limited to new individually designed plans and those that were looking for a letter at the time the plan was being terminated.

A determination letter is a ruling from the IRS that the language of the plan is in compliance with the requirements for the plan to be treated as a qualified retirement plan. While the letter does not cover issues that may arise with operation of the plan, it does assure that if the plan is operated in accordance with the plan document and other provisions of the law that it should not be at risk of losing its qualified status—in which case it would no longer be a tax exempt trust.

If a plan was found not to be qualified, employer contributions to the plan on behalf of employees would either be taxable to the employee at the time of contribution or nondeductible to the employer until includable in the income of the employer. As well, the earnings of funds inside the plan would be taxable.

This procedure allows certain existing plans to ask for a determination letter. The first class of plans that can ask for a determination letter are statutory hybrid defined benefit plans (as defined at Reg. §1.411(a)(13)-1(d)(5)).[4] Statutory hybrid defined benefit plans are those that compute accrued benefits by reference to a hypothetical account balance[5]—commonly referred to as "cash balance plans." A *Tax Notes Today* article on the revenue procedure quoted Elizabeth Thomas Dold of the Groom Law Group as noting that this procedure will be useful for sponsors of hybrid cash balance plans with a determination letter issued before the January 2017 effective date of the final cash balance plan regulations (TD 9743).[6]

The second class of existing plans that can apply for a determination letter are merged plans.[7] In this case, the ruling covers plans described in Reg §1.414(l)-1(b)(2) that were previously maintained by unrelated employers that a newly combined entity (such as the result of a merger or other acquisition) seeks to combine. Such combinations often take place following mergers and other acquisitions and the new ruling helps insure the new combined plan does not run afoul of rules that apply to modifications of the existing plans.

The procedure also provides limited sanction relief for affected plans[8], allowing for a simplified method for cleaning up such plans if the determination letter process uncovers issues with the plans as they existed before going through the determination letter process.

Section: 1361
Boilerplate Provision in LLC Operating Agreement Found to Terminate S Election

Citation: PLR 201918004, 5/3/19

Under the check the box regulations, an LLC may elect to be an S corporation. But it is important to remember that the LLC must meet all of the requirements to be treated as an S corporation during its life, which includes the single class of stock rule. PLR 201918004 details a case where an LLC was forced to ask the IRS for relief from inadvertent termination of its S status when a review of the operating agreement found that the agreement provided for the potential for a disproportionate distribution.

IRC §1362(b)(1)(D) provides that one of the conditions for S status is that the corporation does not have more than one class of stock outstanding. However, the "class of stock" is not based on state law rules for what makes for different classes of stock. Rather, Reg. §1.1362-1(l)(1)

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[4] Revenue Procedure 2019-20, Section 4

[5] IRC §411(a)(13)

[6] Kristen A. Parillo, "IRS Partially Reopens Determination Letter Program," *Tax Notes Today*, May 2, 2019,

2019 TNT 85-2, https://www.taxnotes.com/tax-notes-today/benefits-and-pensions/irs-partially-reopens-determination-letter-program/2019/05/02/29fw5 (subscription required)

[7] Revenue Procedure 2019-20, Section 5

[8] Revenue Procedure 2019-20, Sections 7 and 8

creates a federal S corporation test for what constitutes the existence of only a single class of stock:

> *(1) General rule. A corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in paragraph (l)(4) of this section (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.*

Note that the regulations look at *rights to distributions* and not at actual distributions. For this reason, if a corporation, contrary to its governing documents, issues distributions at different times that will not create a second class of stock, since the shareholder who did not receive a distribution to begin with has the *right* to receive that same distribution. Only if the shareholders have an agreement that the other shareholder no longer has a right to the make-up distribution would there be a second class of stock issue.[9]

But even if every distribution has been strictly proportional, if the agreement provides circumstances under which the equity holders will not be entitled to proportionate distributions, then there exists a second class of stock and the entity will not be eligible to make an S election.

In this case, the LLC operating agreement provided for the following:

> *Section 10 of Y's Operating Agreement provided that, "Upon dissolution of the Company…the proceeds from the liquidation of the Company's assets shall be distributed…to the Members in accordance with their respective positive Capital Account Balances; and, the balance, if any, to the Members, in accordance with their respective Percentage Interests."*

That language, which is regularly used in partnership agreements to meet the substantial economic effect provisions of Reg. §1.704-1(b)(1) and help protect any special allocations of the partnership, does not require that the distributions be on the equivalent of a "per share" basis in all situations. Regardless of whether such a disproportionate distribution has ever occurred during the life of the LLC or is likely to ever occur, the fact that the rights are not strictly proportionate terminate the S election.

The PLR concludes that the LLC's S election was terminated on the date the operating agreement containing that provision was adopted by the LLC. This forced the LLC to apply for a private letter ruling to find that the termination had been inadvertent.

The PLR notes that the standard for finding that a termination is inadvertent is as follows:

> *Section 1.1362-4(b) provides that for purposes of § 1.1362-4(a), the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the*

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[9] See Example 2, Reg. §1.1361-1(l)(4)(v)

> *termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the terminating event or circumstance took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event or circumstance, tends to establish that the termination was inadvertent.*

It is important to note that the determination that a termination was inadvertent *must be made by the Commissioner*. That is, the taxpayer can't simply take the position that the termination was inadvertent and thus ignore the termination event. Rather, to retain the S status, the entity must apply for and obtain a private letter ruling that will contain the IRS's determination. This means paying the user fee to obtain the ruling, as well as incur the professional fees involved in getting the ruling through the IRS National Office.

In this case the IRS did find that the termination was inadvertent and the taxpayer's S status was retroactively restored.