

Current Federal Tax Developments

Week of February 17, 2020

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ACCOUNTING
CONTINUING EDUCATION

CURRENT FEDERAL TAX DEVELOPMENTS
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SECTION: SECURITY

IRS URGES TAX PROFESSIONALS TO USE MULTI-FACTOR AUTHENTICATION IN ADDITION TO PASSWORDS

Citation: “IRS urges tax professionals, taxpayers to protect tax software accounts with multi-factor authentication,” IRS News Release IR-2020-32, 2/14/20

The IRS has suggested that tax professionals should made use of multi-factor authentication to protect their systems and information in News Release IR-2020-32.¹

Multi-factor authentication (MFA) requires the user to provide multiple, independent pieces of information or items to authenticate their right to access a system or information. Such a system would involve providing two or more of the following items:

- Something you know (username/password combination);
- Something you are (fingerprint);
- Something you have (a hardware token)

Traditionally users had only been asked to provide a user name and password in order to access a system or information. The use solely of a username/password to get into a system can easily fail to provide true authentication in various situations such as:

- The user chooses a poor password (dictionary word, common password, child’s name, etc.) that a third party guesses;
- The user uses the same password for multiple accounts. In this case if one password database for a site is breached (as happened in the past to LinkedIn), attackers can attempt to use that username password combination on other sites (such as the electronic filing site for your tax software provider) to gain access due to password reuse; and
- The attacker successfully phishes the username/password from the user via an email that directs the user to a website that appears to be the regular login page when, in fact, it is simply getting that information from the user.

¹ “IRS urges tax professionals, taxpayers to protect tax software accounts with multi-factor authentication,” IRS News Release IR-2020-32, February 14, 2020, <https://www.irs.gov/newsroom/irs-urges-tax-professionals-taxpayers-to-protect-tax-software-accounts-with-multi-factor-authentication>, retrieved February 15, 2020

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The IRS news release describes the following potential attack:

The IRS reminded tax professionals to beware of phishing scams that are commonly used by thieves to gain control of their computers. Thieves may claim to be a potential client, a cloud storage provider, a tax software provider or even the IRS in their effort to trick tax professionals to download attachments or open links. These scams often have an urgent message, implying there are issues with the tax professionals' accounts that need immediate attention.

MFA has been suggested to protect against the shortcomings of passwords. The password is still required to gain entry to the system or site, but by itself it is not enough to allow the user access. Rather, at least one other authentication method (what the user is or what the user has) must be produced before the system treats the user as properly authenticated.

The IRS systems today only support a form of "what you have" MFA authentication, providing an SMS message to the user's cell phone number. While much better than not using MFA at all, the National Institute of Standards and Technology, U.S. Department of Commerce (NIST) has cautioned that such use of telephone numbers is on a "restricted" list due to risks that the message could be redirected to a device other than the one held by the intended user.²

The most likely redirection that could evade the IRS's notice (or that of other organizations, such as your tax software vendor or bank) would be SIM jacking, when a third party targets the victim. Knowing the victim's cell phone carrier and phone number, the attacker convinces an employee of the cell phone carrier to issue the attacker a replacement SIM card for the user's account (the small card inserted in a cell phone that ties that phone to the user's phone number and account).

When that new card is activated, the phone number moves to the device with that card—now one held by the unauthorized user. The attacker then receives the text and so can provide the second factor. The attacker, who would have previously arranged to phish the username/password combination, now has full access to the system and/or information meant to be protected from unauthorized access.

The good news is that this attack only works if a party is targeted, is relatively labor intensive to pull off and the user will eventually notice that his/her phone no longer works, limiting the time the attacker has to take advantage of access. But it still is a possibility that would be best to avoid if other options are available.

² NIST Special Publication 800-63B, *Digital Identity Guidelines*, June 2017, Section 5.1.3.3, <https://pages.nist.gov/800-63-3/sp800-63b.html>, retrieved February 15, 2020

But even SMS-based MFA is far better than not using any MFA protection, as was noted in a study conducted by Google and researchers from New York University and the University of California, San Diego. Even in a targeted attack, the SMS option blocked 76% of attempted account take-overs where attackers obtained the user's username/password. In the far more likely case of a bulk phishing attack, SMS blocked 96% of all attempts.³

The fact that the IRS uses the SMS routine does impact their description of MFA in the news release:

Multi-factor authentication means returning users must enter their username/password credentials plus another data point that only they know, such as a security code sent to their mobile phone. For example, thieves may steal passwords but will be unable to access the software accounts without the mobile phones to receive the security codes.⁴

In addition to SMS systems, some systems that are preferred if offered include:

- Authenticator apps: These applications are loaded on a phone and generate a six-digit code that changes every 30 seconds. The system to be logged into has the ability to generate the same code, based on a shared secret code generated when the MFA is initially turned on and the date and time when the log-in is taking place. Unlike SMS, in this case a third-party SIM jacking the phone will still not have the secret stored on the physical phone that has the authenticator app. Most of these systems use the standard originally made popular by Google Authenticator.
- Vendor specific authenticator: Some vendors provide the user with an app that is installed on the phone and which creates a prompt to respond to when access is attempted. These can be secure if properly designed.
- Hardware keys: The highest security option available today is the use of hardware keys tied to an account that must be inserted into the computer or in radio distance of a phone (for NFC or Bluetooth connection) when access is attempted. The YubiKey by Yubico is an example of such a key.

Tax advisers should make use of the most secure option they have access to for all relevant systems. The IRS news release notes:

Already, nearly two dozen tax practitioner firms have reported data thefts to the IRS this year. Use of the multi-factor authentication

³ “New research: How effective is basic account hygiene at preventing hijacking,” Google Security Blog, May 17, 2019, <https://security.googleblog.com/2019/05/new-research-how-effective-is-basic.html> (retrieved February 15, 2020)

⁴ IR-2020-32

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feature is a free and easy way to protect clients and practitioners' offices from data thefts. Tax software providers also offer free multi-factor authentication protections on their Do-It-Yourself products for taxpayers.

"The IRS, state tax agencies and the private-sector tax industry have worked together as the Security Summit to make sure the multi-factor authentication feature is available to practitioners and taxpayers alike," said Kenneth Corbin, Commissioner of the IRS Wage and Investment division. "The multi-factor authentication feature is simple to set up and easy to use. Using it may just save you from the financial pain and frustration of identity theft."⁵

The IRS also notes that MFA is being offered by more and more organizations:

Multi-factor authentication protections are now commonly offered by financial institutions, email providers and social media platforms to protect online accounts. Users should always opt for multi-factor authentication when it is offered but especially with tax software products because of the sensitive data held in the software or online accounts.

Organizations attempting to get staff (including owners) to use MFA will encounter complaints that it's "too complicated" or "gets in the way." It is clearly inconvenient, but nowhere near as inconvenient as dealing with a data breach when a partner's account gets compromised because he/she refused to figure out how to use MFA.

Now that the IRS has specifically told tax professionals they should be using MFA, a failure to implement such a requirement may expose the firm to disciplinary action and professional liability if a problem arises that regulators and/or clients note could have been prevented by the use of MFA.

SECTION: 61

IRS REMOVES FORTNITE V-BUCKS AND ROBLOX FROM DEFINITION OF VIRTUAL CURRENCIES ON THE IRS WEB SITE

Citation: "Virtual Currencies," IRS website, 2/12/20

The IRS has revised its guidance on what constitutes virtual currency on its webpage, but there was a bit of confusion that was generated with comments from IRS Chief

⁵ IR-2020-32

Counsel Michael Desmond on the day following the change. Now the IRS has issued a clarification that may help to resolve this matter, at least in most cases.

This year the IRS added a question to Schedule 1, Form 1040 and 1040-SR, that asks taxpayers for the following information regarding virtual currency transactions:

At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?

The IRS has a web page titled “Virtual Currencies” that contains information on virtual currencies, beginning with a section titled “What is a Virtual Currency?” which seemed a good place to look to see exactly what the agency wanted taxpayers to inform them about.⁶ Advisers and taxpayers turned to that page to figure out how to answer the question on Schedule 1.

Until February 12, that page had the following as part of the description of virtual currencies:

Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as “convertible” virtual currency. Bitcoin, Ether, Roblox, and V-bucks are a few examples of a convertible virtual currency.⁷

The last two items listed surprised many readers, especially the final one. For those who aren’t aware, V-bucks are the in game currency used in the popular online game *Fortnite*. The reference led to questions regarding whether the IRS really wanted parents who had purchased V-bucks for their children who play *Fortnite* to check that box yes.

On February 12, Bloomberg Tax reporter Ally Versprille reported that after she began asking the IRS about the issue, the web site language was changed, although initially the IRS did not otherwise respond to her questions.⁸ The site now has the following language in place of the portion quoted above:

Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as “convertible”

⁶ IRS Virtual Currency webpage, <https://www.irs.gov/businesses/small-businesses-self-employed/virtual-currencies>, February 12, 2020 revision, retrieved February 14, 2020

⁷ IRS Virtual Currencies webpage, version archived on January 14, 2020, <http://web.archive.org/web/20200114132858/https://www.irs.gov/businesses/small-businesses-self-employed/virtual-currencies>, retrieved February 14, 2020

⁸ Ally Versprille, <https://twitter.com/allyversprille/status/1227734823168618499>, February 12, 2020

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virtual currency. Bitcoin is one example of a convertible virtual currency.⁹

The following day, IRS Chief Counsel Michael Desmond briefly discussed the issue with reporters prior to a session. Ms. Versprille provided details of Mr. Desmond's comments in another Twitter thread. She indicated he told reporters "that 'I think it needed to be corrected' when asked why the gaming currency language was removed from the agency webpage on virtual currency."¹⁰

When pressed whether this meant that such items did not require taxpayers to check the box on Schedule 1, Mr. Desmond responded:

I asked: "So if people have gaming currency they don't need to check 'yes' on the 1040?"

He said: "I am not even looking into that...I'm not saying one way or another. I think I'd be getting ahead of myself if I said anything. Read the website. We posted a correction yesterday."¹¹

So the answer now seemed to be a definite maybe—not the most satisfying of answers regarding dealing with that question.

Finally, on Valentine's day, the IRS issued a release to the press regarding this situation that may finally clarify the issue:

The IRS recognizes that the language on our page potentially caused concern for some taxpayers. We have changed the language in order to lessen any confusion. *Transacting in virtual currencies as part of a game that do not leave the game environment (virtual currencies that are not convertible) would not require a taxpayer to indicate this on their tax return. (Emphasis added)*¹²

⁹ IRS Virtual Currencies webpage, February 12, 2020 revision, <https://www.irs.gov/businesses/small-businesses-self-employed/virtual-currencies>, retrieved February 14, 2020

¹⁰ Ally Versprille, <https://twitter.com/allyversprille/status/1228009576626302976>, February 13, 2020

¹¹ Ally Versprille, <https://twitter.com/allyversprille/status/1228014842453352449>, February 13, 2020

¹² Ally Versprille, <https://twitter.com/allyversprille/status/1228383065753432064>, February 14, 2020

So, now that the dust has settled, it appears the IRS does not want the box checked if a taxpayer merely acquires V-bucks or similar currencies in the game and uses them in the game. Similarly, a taxpayer buying such in-game currencies solely for use in the game also appears to be in the clear.

As far as taxable income goes, it should be clear that someone who buys in-game currencies to hold and then sell for cash later expecting them to appreciate, will have (and always would have had) reportable income if they are correct and the currency went up in value. But parents no longer have to be concerned that they and/or their children will need to check the box on Schedule 1 simply because they are playing *Fortnite*.

SECTION: 170 REGULATION REQUIRING COST BASIS BE IN THE APPRAISAL SUMMARY IS VALID

Citation: Oakhill Woods, LLC v. Commissioner, TC Memo 2020-24, 2/13/20

A taxpayer argued that the failure to include the basis of the property in an appraisal summary supporting its charitable deduction for a conservation easement should not prove fatal to the deduction in the case of *Oakhill Woods, LLC v. Commissioner*, TC Memo 2020-24.¹³ The letter attached to the appraisal noted:

A declaration of the taxpayer's basis in the property is not included in * * * the attached Form 8283 because of the fact that the basis of the property is not taken into consideration when computing the amount of the deduction. Furthermore, the taxpayer has a holding period in the property in excess of 12 months and the property further qualifies as "capital gain property."¹⁴

IRC §170(f)(11)(C) provides:

(C) Qualified appraisal for contributions of more than \$5,000

In the case of contributions of property for which a deduction of more than \$5,000 is claimed, the requirements of this subparagraph are met if the individual, partnership, or corporation obtains a qualified

¹³ *Oakhill Woods, LLC v. Commissioner*, TC Memo 2020-24, February 13, 2020, <https://www.ustaxcourt.gov/USTCInOP/OpinionViewer.aspx?ID=12170>, (retrieved February 14, 2020)

¹⁴ *Oakhill Woods, LLC v. Commissioner*, p. 8

appraisal of such property and attaches to the return for the taxable year in which such contribution is made such information regarding such property and such appraisal as the Secretary may require.

As the claimed deduction was nearly \$8,000,000, this provision applied to this donation. Reg. §1.170A-13(c)(2) requires that a qualified appraisal be attached to the return, and one of the requirements for an appraisal to be a qualified appraisal is that it must contain information on the cost or other basis of the property that was the subject of the appraisal.¹⁵

The IRS argued that the failure to provide the cost basis meant that there was not a properly completed appraisal summary—and that means the deduction should be disallowed.¹⁶

While the taxpayer argued that it had either strictly or substantially complied with the regulation despite not having the cost basis included, the Tax Court noted that it had rejected that position in *Belair Woods, LLC v. Commissioner*, T.C. Memo. 2018-159 which had virtually identical facts—the lack of the cost basis was a more than minor and unimportant departure from the requirements found in the regulations.¹⁷

The *Belair Woods* case was decided after the taxpayer had filed its petition in this case, so following that decision the taxpayer decided to add another argument—that the underlying regulation was invalid. As the opinion notes:

On December 12, 2018, two months after we issued our opinion in *Belair Woods*, petitioner filed a cross-motion for partial summary judgment challenging the validity of section 1.170A-13(c)(4)(ii)(D) and (E), Income Tax Regs. These provisions set forth the regulatory requirements (discussed above) that an appraisal summary “shall include” information concerning the manner in which the donor acquired the donated property, the date on which he acquired it, and the “cost or other basis of the property adjusted as required by section 1016.” *Ibid.* Petitioner contends that these provisions “are invalid under *Chevron U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837 (1984), because they do not give effect to the unambiguous language of the statute.”¹⁸

¹⁵ Reg. §1.170A-13(c)(4)(ii)(E)

¹⁶ *Oakhill Woods, LLC v. Commissioner*, pp. 11-12

¹⁷ *Oakhill Woods, LLC v. Commissioner*, p. 2

¹⁸ *Oakhill Woods, LLC v. Commissioner*, p. 22

The opinion notes that when looking at a challenge to a regulation's validity under *Chevron*, the court looks at the following two items:

- Has Congress spoken directly to the question at issue? If Congress has passed a law that unambiguously answers the question, then there is no issue for the IRS's regulation to decide. But if not, we go on to the second prong of the test.
- If there is ambiguity to be resolved, is the IRS interpretation a permissible interpretation of the statute?¹⁹

The taxpayer claimed that, in fact, the Deficit Reduction Act of 1984 (DEFRA) which had enacted IRC §170(f)(11)(C), had spoken to this issue—and it provided that the basis information was required in the return, not the appraisal summary:

The statute on which petitioner relies is a provision of DEFRA, enacted by Congress in 1984. See *supra* p. 11. The Senate Finance Committee expressed Congress' concern that “inflated valuations of donated property have been increasingly exploited by tax shelter promoters.” S. Prt. No. 98-169 (Vol. 1), *supra* at 444. The Committee believed that “stronger substantiation and overvaluation provisions should be made applicable to charitable contributions of property.” *Ibid.* DEFRA accordingly added to the Code a number of new enforcement provisions.

DEFRA section 155(a), which was not codified, directed the Secretary to advance Congress' objectives by promulgating regulations tightening the substantiation requirements for charitable deductions. It provided that, “[n]ot later than December 31, 1984, the Secretary shall prescribe regulations” requiring taxpayers claiming certain deductions to do the following:

- (A) to obtain a qualified appraisal for the property contributed,
- (B) to attach an appraisal summary to the return on which such deduction is first claimed for such contribution, and
- (C) to include on such return such additional information (including the cost basis and acquisition date of the contributed property) as the Secretary may prescribe in such regulations.²⁰

¹⁹ *Oakhill Woods, LLC v. Commissioner*, p. 23

²⁰ *Oakhill Woods, LLC v. Commissioner*, pp. 23-24

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The taxpayer argues that the IRS's requirement that the taxpayer's basis be in the appraisal summary is contrary to the clear language of Congress.

However, the Tax Court did not agree:

This argument is unpersuasive for at least three reasons. First, a taxpayer's "return" for a particular year includes all IRS forms and schedules required to be filed as part of the return. See sec. 1.6011-1, Income Tax Regs. The Form 8283, comprising the appraisal summary, was an essential component of petitioner's return for 2010. By requiring inclusion of information concerning cost basis and acquisition date on the Form 8283, the Secretary complied with Congress' mandate that such data be "include[d] on such return." DEFRA sec. 155(a)(1)(C).

Second, even if Congress were thought to have intended "appraisal summary" and "return" to be mutually exclusive terms, there is nothing in DEFRA section 155 that prohibits the Secretary from requiring that information concerning cost basis and acquisition date be included both on the appraisal summary and elsewhere on the return. Petitioner reads into DEFRA section 155(a)(1)(C) a negative pregnant that is wholly unjustified by the text.

Third, DEFRA section 155(a)(3), which petitioner fails to cite, wholly undermines its argument. That paragraph, captioned "Appraisal summary," provides that, "[f]or purposes of this subsection, the appraisal summary shall be in such form and include such information as the Secretary prescribes by regulations." (Emphasis added.) Congress thus left the Secretary with discretion to require inclusion on Form 8283 of whatever information the Secretary reasonably deemed relevant. See *Blau*, 924 F.3d at 1270 ("Though the Congress left it to the discretion of the Secretary * * * to impose additional reporting requirements, the Congress specifically identified the basis and the date of acquisition as the bare minimum that a taxpayer must provide."). The Code provision governing appraisals makes the depth of the Secretary's discretion plain. See sec. 170(f)(11)(C) (requiring that taxpayers obtain a qualified appraisal and "attach[] to the return * * * such information regarding such property and such appraisal as the Secretary may require"). For these reasons we reject petitioner's contention that the regulation violates *Chevron* step one on the theory that it contravenes "the unambiguous language of the statute."²¹

²¹ *Oakhill Woods, LLC v. Commissioner*, pp. 24=26

But since the test is a two-part test, the fact there is ambiguity would not make the regulation valid unless it represents a permissible interpretation of the statute— basically, a reasonable reading of the statute is the standard we are looking at.

Unfortunately for the taxpayer, the Tax Court found the IRS’s interpretation is a reasonable interpretation of the statute enacted by Congress:

When enacting DEFRA Congress decided that the IRS needed disclosure of information — specifically including information concerning cost basis and acquisition date of donated property — in order to combat claims of “excessive charitable deductions” by taxpayers seeking to “play ‘the audit lottery.’” S. Prt. No. 98-169 (Vol. 1), supra at 444. Congress accordingly directed the Secretary to issue regulations requiring that taxpayers claiming certain types of charitable deductions attach to their returns an appraisal summary, which “shall be in such form and include such information as the Secretary prescribes by regulations.” DEFRA sec. 155(a)(3).

The Secretary reasonably concluded that the information the IRS needed would be most accessible to its examining agents if all of the required information appeared in the same place, namely, on the appraisal summary. The Secretary [*27] therefore issued regulations requiring that information concerning cost basis and acquisition date (as well as nine other types of information) be included in the appraisal summary included with the return. See sec. 1.170A-13(c)(4)(ii), Income Tax Regs. We have no difficulty concluding that the Secretary’s requirement to this effect was “based on a permissible construction of the statute.” *Chevron*, 467 U.S. at 843.²²

Thus, the Tax Court denied the taxpayer’s challenge to the validity of the regulation.

²² *Oakhill Woods, LLC v. Commissioner*, pp. 26-27