Current Federal Tax Developments

Week of November 29, 2021

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WEEK OF NOVEMBER 29, 2021
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Published in 2021 by Kaplan Financial Education.

Printed in the United States of America.

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SECTION: 1402
ADDITIONAL GUIDANCE ON DETERMINING SELF-EMPLOYMENT INCOME OF A PARTNER THAT REFERENCES THE 2011 RENKEMEYER DECISION ADDED TO FORM 1065 INSTRUCTIONS FOR 2021 IN LATEST DRAFT

Citation: "2021 Instructions for Form 1065," Draft as of November 24, 2021, 11/24/21

The 2021 draft instructions for Form 1065 have added additional information related to a determination of whether a taxpayer has self-employment income from the partnership.[1]

The new revision to the instructions provides:

> However, whether a partner (including a member of an LLC treated as a partnership for federal income tax purposes) qualifies as a limited partner for purposes of self-employment tax depends upon whether the partner meets the definition of a limited partner under section 1402(a)(13); whether a partner is a limited partner under state limited partnership law is not determinative. Relevant to this determination is whether the partner merely invested in the partnership and is not actively participating in the partnership's business operations; a partner who is performing services for a partnership in their capacity as a partner and that is, based on the facts and circumstances, acting in the manner of a self-employed person is not a limited partner for self-employment tax purposes. See *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137, 150 (2011).[2]

Advisers that have not previously studied the *Renkemeyer* decision should definitely look that one over, as well as look at the application of that decision to a less aggressive attempt to avoid self-employment tax in the *Castigliola* case.[3]

While the IRS mentions that a determination whether a partner is a limited partner under state law is not determinative, those cases deal rather with the treatment of an

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[1] "2021 Instructions for Form 1065," Draft as of November 24, 2021, https://www.irs.gov/pub/irs-dft/i1065--dft.pdf (retrieved November 26, 2021)

[2] "2021 Instructions for Form 1065," Draft as of November 24, 2021, p. 39

[3] *Castigliola, et al v. Commissioner*, TC Memo 2017-62, April 12, 2017, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/distributive-shares-not-excludable-from-self-employment-income/nn43?h=castigliola (retrieved November 26, 2021), Edward Zollars, "Law Firm Members Not Allowed to Treat Income in Excess of Reasonable Compensation Guaranteed Payments as Not Self-Employment Income", *Current Federal Tax Developoments* website, April 12, 2017, https://www.currentfederaltaxdevelopments.com/blog/2017/4/12/law-firm-members-not-allowed-to-treat-income-in-excess-of-reasonable-compensation-guaranteed-payments-as-not-self-employment-income (retrieved November 26, 2021)

LLP or LLC member. Presumably the IRS would also extend the analysis in those cases to a partner in a true limited partnership that holds both a standard general partnership interest and a limited partnership interest, especially in a case where there are no individuals who are limited partners only with interests with the same rights as those of the limited interest held by the general partner.

SECTION: 3134
IRS ISSUES PRELIMINARY GUIDANCE FOR RETROACTIVE REPEAL OF FOURTH QUARTER EMPLOYEE RETENTION CREDIT FOR EMPLOYERS THAT ARE NOT RECOVERY STARTUP BUSINESSES

Citation: "Early Termination of the Employee Retention Credit for Most Employers", IRS Website, 11/24/21

The IRS has issued guidance on a web page on the agency's site related to the early termination of the employee retention credit for employers other than a recovery startup business.[4] The IRS posting explains:

> The Infrastructure Investment and Jobs Act amends section 3134 of the Internal Revenue Code to limit the availability of the employee retention credit in the fourth quarter of 2021 to taxpayers that are recovery startup businesses, as defined in section 3134(c)(5). Therefore, taxpayers that are not recovery startup businesses are not eligible for the employee retention credit for wages paid after September 30, 2021.[5]

This termination after the quarter began creates a number of issues for taxpayers who had presumed they would qualify for this credit for the fourth quarter of 2021, especially if the employer had a more than 20% decrease in gross receipts in the third quarter of 2021 compared to the third quarter of 2019.

The IRS first gives guidance that amounts primarily to "we'll get back to you later" for employers who have already reduced their payroll tax deposits for the fourth quarter who now find their deposits made to date are inadequate for their fourth quarter liabilities:

> Some taxpayers that are no longer eligible to claim the employee retention credit for wages paid after September 30, 2021 may have already reduced their employment tax deposits in anticipation of claiming the employee retention credit for the fourth quarter of 2021.

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[4] "Early Termination of the Employee Retention Credit for Most Employers", IRS Website, November 24, 2021, https://www.irs.gov/forms-pubs/early-termination-of-the-employee-retention-credit-for-most-employers (retrieved November 26, 2021)

[5] "Early Termination of the Employee Retention Credit for Most Employers", IRS Website, November 24, 2021

> These taxpayers should monitor guidance issued by the IRS to learn if they must take any action regarding these amounts.[6]

Some employers may have already submitted Form 7200 to request advance payment of the excess of their expected employer retention credit over their payroll tax liabilities to date. If that request is for a recovery startup business, then, unless otherwise flawed, the claim would be one that is valid under the revised law. But if the employer is not a recovery startup business, then the request would not be valid.

The IRS indicates they are going to attempt to identify the Forms 7200 that should no longer be processed and those that should go forward for processing:

> Some taxpayers may have already submitted Form 7200 to request an advance payment of the employee retention credit for the fourth quarter of 2021. If the Form 7200 hasn't been processed, the IRS will use the taxpayer's indication of whether it is a recovery startup business (Form 7200, Part 1, line H) as part of its determination regarding whether the Form 7200 claiming the employee retention credit in the fourth quarter of 2021 should be accepted or rejected.[7]

For those employers who have already received an advance payment in the fourth quarter but will not be able to claim the credit, the IRS warns that such employers will still need to take these advance payments into account when preparing their fourth quarter Form 941 and will need to watch for additional IRS guidance about actions to take regarding these balances.

> If an advance payment of the employee retention credit for the fourth quarter of 2021 was already sent to a taxpayer that is no longer eligible to claim the employee retention credit for the fourth quarter of 2021 because it is not a recovery startup business, the taxpayer will still include that advance payment on the appropriate line of its employment tax return (for example, Form 941, Part 1, line 13h) for the quarter. In this case, the taxpayer may have a balance due when it files that employment tax return. Taxpayers should continue to monitor guidance issued by the IRS to learn if they should take any additional action regarding these amounts.[8]

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[6] "Early Termination of the Employee Retention Credit for Most Employers", IRS Website, November 24, 2021

[7] "Early Termination of the Employee Retention Credit for Most Employers", IRS Website, November 24, 2021

[8] "Early Termination of the Employee Retention Credit for Most Employers", IRS Website, November 24, 2021

SECTION: 3134
AT REPRESENTATION CONFERENCE, IRS REPRESENTATIVE INDICATED IRS IS WORKING ON TRAINING STAFF FOR EMPLOYEE RETENTION TAX CREDIT EXAMS

Citation: Kristen A. Parillo, "IRS Gearing Up for Audits of Employee Retention Credits," Tax Notes Today Federal, 11/23/21

In an article published in *Tax Notes Today Federal* on November 23, Julie Foerster of the IRS Small Business/Self-Employed Division was quoted as stating at the virtual New England IRS Representation Conference on November 19 that the IRS will begin training agents to audit employee retention credits (ERC) in the February-March time period, with exams to begin based on the rollout and completion of training.[9]

The article also quoted Daniel Mayo of Withum Smith+Brown PC regarding the types of employers likely to be selected for such exams:

> Daniel Mayo of Withum Smith+Brown PC said many taxpayers are wondering how the IRS will choose which businesses to audit. "Obviously, the size of the credit could be an issue, but we'll be fascinated to see over time whether the IRS starts using" North American Industry Classification System codes, he said, referring to a coding regime for classifying business activities.
>
> "We would expect, for example, restaurants and venues to be audited with less frequency than certain other industries, because [the ERC] was really designed for industries like restaurants," Mayo said.[10]

The article reports that Ms. Foerster responded to this statement by stating the agency is developing "all of that" (presumably selection criteria) right now.[11]

Certainly, the IRS's previous guidance, such as in Notice 2021-20,[12] has indicated the IRS believes that restaurants will generally qualify for the credit when subject to various restrictions, with examples not requiring the restaurant to demonstrate, for instance,

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[9] Kristen A. Parillo, "IRS Gearing Up for Audits of Employee Retention Credits," *Tax Notes Today Federal*, November 23, 2021,

2021 TNTF 225-2, (https://www.taxnotes.com/tax-notes-today-federal/audits/irs-gearing-audits-employee-retention-credits/2021/11/23/7cmlm, subscription required, accessed November 25, 2021)

[10] Kristen A. Parillo, "IRS Gearing Up for Audits of Employee Retention Credits," *Tax Notes Today Federal*, November 23, 2021

[11] Kristen A. Parillo, "IRS Gearing Up for Audits of Employee Retention Credits," *Tax Notes Today Federal*, November 23, 2021

[12] Notice 2021-20, March 1, 2021, https://www.taxnotes.com/research/federal/irs-guidance/notices/irs-issues-q%26a-guidance-on-employee-retention-credit/38wlw?h=2021-20 (retrieved November 25, 2021)

that the loss of some or all inside dining due to COVID-19 governmental restrictions led to an actual reduction of revenues or inability to serve customers (see Q&A 17 of Notice 2021-20, Examples 1 & 2). Such revenues may have been made up by an increase in drive through or take-out orders, especially for fast food restaurants. As well, the restaurant might have been able to serve all of the dine in customers that arrived at the restaurant even with the reduced number of tables—the restaurant would still be considered to have a partially suspended business.

Conversely, a retail business that was subjected to a limited number of customers per square foot in its building was required to show an inability to serve customers due to this restriction in Example 6 of Q&A 17 of Notice 2021-20.

It must be noted that there's a world of difference between an IRS representative talking about potential future IRS actions and the actual implementation of such actions, so there's no assurance that a significant program for looking into ERC claims of taxpayers in exams will actually materialize.

But it does remind advisers that we do need to consider the quality of the authorities we look to rely upon when advising clients regarding such claims. Regardless of whether the IRS actually commences examinations, advisers are still required to be able to justify any positions on returns or claims prepared by the adviser or positions we advise clients they could take on such returns or claims. We also should remember to remind clients that these returns are subject to examination, and that for the third and fourth quarter of 2021 ERC claims, the IRS has five years to raise such challenges.[13]

SECTION: 6402
TAXPAYER HAD FILED RETURN WITHIN 3 YEARS OF ORIGINAL EXTENDED DUE DATE DESPITE IRS FALSE CONCERNS ABOUT IDENTITY THEFT, THUS TAXPAYER WAS ENTITLED TO A REFUND

Citation: Willets v. Commissioner, TC Summary Opinion 2021-39, 11/22/21

In September of 2020 we discussed issues that arose in the case of *Fowler v. Commissioner*, 155 TC No. 7, when the IRS rejected an electronically filed return due to the lack of inclusion of an identity protection PIN on the return and its effect on the date a return was treated as filed for statute of limitations purposes.[14] In that case the Court ruled that the IRS had attempted to assess tax more than 3 years after the date

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[13] IRC §3134(l)

[14] Edward Zollars, "Taxpayer's Failure to Include IP PIN on Return, Triggering E-File Rejection, Did Not Delay the Beginning of the Running of the Statute of Limitations," *Current Federal Tax Developments,* September 9, 2020, https://www.currentfederaltaxdevelopments.com/blog/2020/9/9/taxpayers-failure-to-include-ip-pin-on-return-triggering-e-file-rejection-did-not-delay-the-beginning-of-the-running-of-the-statute-of-limitations (retrieved November 25, 2021) discussing the case of *Fowler v. Commissioner*, 155 TC No. 7, September 9, 2020

the taxpayer initially attempted to file the return, and thus the IRS had failed to act in time.

In this case,[15] the IRS is now asserting the taxpayer had failed to file a return within the three-year period that began on the original filing date including extensions for filing, thus the taxpayers could not obtain the refund shown on the return that they filed within that time period, but which the IRS had rejected due to a suspicion that the return may have been the result of identity theft.

The Tax Court provided the following summary of the taxpayer's initial lack of filing of a 2014 return, followed by the taxpayer's later response to an IRS notice on the issue:

> Petitioner timely filed a request for an extension of time to file his 2014 Federal income tax return, extending the due date from April 15, 2015, to October 15, 2015. Along with the extension request filing, petitioner submitted a payment of $8,000 for his 2014 tax liability. Petitioner did not file a return by the extended October 15, 2015, due date.
>
> Petitioner mailed Form 1040, U.S. Individual Income Tax Return, to respondent on April 14, 2018.[16]

Since April 14, 2018 was well within the 3 year time period from the extended due date of October 15, 2015, it would appear the taxpayer had timely requested the refund of taxes claimed on that return.

But the IRS was concerned that the return filing might be the result of identity theft, so the following next occurred:

> Respondent documented a Form 1040 for 2014 in his internal records on May 2, 2018, but rejected it as a return because of potential identity theft.
>
> Respondent notified petitioner by letter that his Form 1040 was rejected because of concerns about potential identity theft. Petitioner did not submit to respondent any documentation disputing the potential identity theft; and it is unclear whether petitioner was aware of the issue or the rejection of his Form 1040 before commencing this case.[17]

The next action in this case was taken by the IRS in July of 2019, well after the 3-year period had expired for the filing of a claim for the overpaid tax:

> On July 29, 2019, respondent's automated underreporter unit issued to petitioner a notice of deficiency (notice) with regard to his 2014 tax

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[15] *Willets v. Commissioner*, TC Summary Opinion 2021-39, November 22, 2021, https://www.taxnotes.com/tax-notes-today-federal/individual-income-taxation/rejected-return-was-timely-filed-overpayment-credit-or-refund/2021/11/23/7cmm1 (retrieved November 25, 2021)

[16] *Willets v. Commissioner*, TC Summary Opinion 2021-39, November 22, 2021

[17] *Willets v. Commissioner*, TC Summary Opinion 2021-39, November 22, 2021

> liability; the notice also indicated that petitioner had not filed a return for 2014. After receiving the notice, petitioner submitted a copy of a Form 1040 for 2014, which respondent accepted insofar as it reports adjusted gross income.[18]

The IRS position is that the original filing in 2018 was not properly filed, thus the taxpayer had not filed a proper return before the three-year statute expired in October of 2018.

The Tax Court opinion explains the provisions in the law that set the final date for filing a claim for refund of that overpaid tax:

> Pursuant to section 6402, in the event of an overpayment, a taxpayer may recoup the balance of the overpayment — less any outstanding liabilities — in the form of a credit or a refund. To receive a credit or a refund for an overpayment, section 6511(b)(1) provides that the taxpayer must file a claim within the period of limitation set forth in section 6511(a). A claim may be embedded within a tax return, in which case filing of the return and the claim are concurrent. Sec. 301.6402-3(a)(5), Proced. & Admin. Regs. Section 6511(a) specifies that the taxpayer must submit a claim by the later of: (1) three years from the time the relevant return is filed, or (2) two years from the time the tax was paid.
>
> For the purposes of section 6511(a) the three-year period of limitation begins on the filing due date, including extensions for filing, of the relevant return. If the taxpayer files a return within this three-year period, then a claim filed within the same period is timely, regardless of whether the return was timely filed. *Weisbart v. U.S. Dep't of Treasury*, 222 F.3d 93, 95 (2d Cir. 2000) ("[A] timely filed return is no longer required in order to satisfy the three-year deadline of section 6511(a).").[19]

Applying those rules to this case, the Court notes:

> The filing due date for petitioner's 2014 return was October 15, 2015. Therefore, petitioner is entitled to a credit or refund for an overpayment so long as he filed his 2014 return and claim by October 15, 2018.[20]

If that initial filing is treated as a proper filing for purposes of claiming the refund, then the taxpayer has filed on time. Conversely, if the IRS rejection of the return due to suspicion of identity theft and the taxpayer's failure to respond invalidate that first return, then the taxpayer has filed too late.

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[18] *Willets v. Commissioner*, TC Summary Opinion 2021-39, November 22, 2021

[19] *Willets v. Commissioner*, TC Summary Opinion 2021-39, November 22, 2021

[20] *Willets v. Commissioner*, TC Summary Opinion 2021-39, November 22, 2021

The Tax Court notes that the key issue is if the return was properly submitted, since the IRS did not argue that the Form 1040 that was submitted was itself insufficient to establish the claim for refund:

> To determine whether a return was properly filed, the submitted document needs to be a required return that the taxpayer has properly filed. See *Appleton v. Commissioner*, 140 T.C. 273, 284 (2013). When assessing whether a document is a return, this Court generally relies on the test articulated in *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986). Under the *Beard* test a document is a return for statute of limitations purposes if: (1) there is sufficient data to calculate a tax liability, (2) the document purports to be a return, (3) there is an honest and reasonable attempt to satisfy the requirements of the tax law, and (4) the taxpayer executed the document under penalties of perjury. Id. at 777. The Form 1040 that petitioner mailed April 14, 2018, satisfies the requirements of the Beard test and therefore constitutes a valid return. Furthermore, respondent does not challenge petitioner's assertion that the Form 1040 was a return; rather, respondent argues that the return and the embedded claim were not filed within the relevant period of limitation.[21]

The Tax Court does not accept the IRS's view that their rejection of the return due to suspected identity theft rendered the return never properly filed. Rather the Court found:

> A return is considered filed when it is "delivered, in the appropriate form, to the specific individual or individuals identified in the Code or Regulations." *Allnutt v. Commissioner*, 523 F.3d 406, 413 (4th Cir. 2008), *aff'g* T.C. Memo. 2002-311; see also sec. 7502 (implicitly equating filing with delivery). A valid return is deemed filed on the day it is delivered, regardless of whether it is accepted by the Commissioner. See *Blount v. Commissioner*, 86 T.C. 383, 387 (1986) (holding that the period of limitation begins to run when a valid return is delivered to the Commissioner, whether or not accepted). Respondent's records indicate that petitioner's Form 1040 was received by May 2, 2018. The Form 1040 petitioner mailed to respondent on April 14, 2018, is therefore deemed to have been filed on or before May 2, 2018.
>
> Petitioner's 2014 return was due October 15, 2015, meaning the three-year period of limitation expired on October 15, 2018. See sec. 6511(a). The Form 1040 petitioner mailed on April 14, 2018, was delivered, and therefore filed, by May 2, 2018. The claim embedded in the return was filed concurrently. The return and the embedded claim were thus both filed before the three-year period of limitation expired on October 15, 2018. Petitioner is entitled to receive an overpayment credit or refund of $1,553.[22]

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[21] *Willets v. Commissioner*, TC Summary Opinion 2021-39, November 22, 2021

[22] *Willets v. Commissioner*, TC Summary Opinion 2021-39, November 22, 2021

The finding here should not be surprising to the reader—as the Tax Court notes, it's been made clear previously that the IRS's refusal to accept a return that otherwise meets the criteria for a proper claim does not nullify the timing of that original filing. But it does illustrate a rather frustrating issue we often run into in tax practice—the IRS itself often operates systems that ignore such clear legal guidance, especially when implementing systems such as those put in place to combat identity theft.

It is very possible that if the taxpayer had retained representation that this issue might have been resolved much earlier, though the $1,553 balance in question also renders representation questionably cost-effective in a case like this. But the one piece of good news is that this case, combined with the earlier *Fowler* case, gives advisers some rather clear guidance to place before IRS representatives when looking to resolve these issues.

While the IRS computers almost certainly will continue to apply the wrong dates for purposes of determining the date a statute begins running, the case law is becoming very clear that IRS processing decisions related to identity theft that falsely flag a return as being suspect do not change the statute dates—as long as the IRS received the return in question, the statute begins to run.