Current Federal Tax Developments

Week of March 14, 2022

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SECTION: ERISA
DEPARTMENT OF LABOR WARNS 401(K) PLAN FIDUCIARIES REGARDING OFFERING CRYPTO INVESTMENT OPTION

Citation: "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, 3/10/22

The US Department of Labor issued a Compliance Assistance Release that contains warnings to 401(k) plans that are offering or are considering offering investments in cryptocurrencies as part of the investment options for 401(k) plan participants.[1]

The Department notes in a footnote that their concerns involve all types of digital assets, not just cryptocurrencies, despite the release only referencing cryptocurrencies:

> Although this release specifically references "cryptocurrencies," the same reasoning and principles also apply to a wide range of "digital assets" including those marketed as "tokens," "coins," "crypto assets," and any derivatives thereof.[2]

The release begins by cautioning plan fiduciaries about needing to exercise extreme care before offering such an option:

> In recent months, the Department of Labor has become aware of firms marketing investments in cryptocurrencies to 401(k) plans as potential investment options for plan participants. The Department cautions plan fiduciaries to exercise extreme care before they consider adding a cryptocurrency option to a 401(k) plan's investment menu for plan participants.[3]

The release points out the duty of plan fiduciaries to act solely in the financial interests of the plan participants:

> Under ERISA, fiduciaries must act solely in the financial interests of plan participants and adhere to an exacting standard of professional care. Courts have commonly referred to these prudence and loyalty obligations as the "highest known to the law." Fiduciaries who breach those duties are personally liable for any losses to the plan resulting from that breach. A fiduciary's consideration of whether to include an

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[1] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, March 10, 2022, https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/compliance-assistance-releases/2022-01 (retrieved March 10, 2021)

[2] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, Footnote 1, March 10, 2022

[3] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, March 10, 2022

> option for participants to invest in cryptocurrencies is subject to these exacting responsibilities.[4]

The Department goes on to warn fiduciaries that they cannot shift this responsibility to the participants regarding the prudence of this investment option:

> In a defined contribution plan, such as a 401(k) plan, the value of a participant's retirement account depends on the investment performance of the employee's and employer's contributions. When defined contribution plans offer a menu of investment options to plan participants, the responsible fiduciaries have an obligation to ensure the prudence of the options on an ongoing basis. Fiduciaries may not shift responsibility to plan participants to identify and avoid imprudent investment options, but rather must evaluate the designated investment alternatives made available to participants and take appropriate measures to ensure that they are prudent. As the Supreme Court recently explained, "even in a defined-contribution plan where participants choose their investments, plan fiduciaries are required to conduct their own independent evaluation to determine which investments may be prudently included in the plan's menu of options."[5]

Specifically, the Department states:

> The failure to remove imprudent investment options is a breach of duty.[6]

As you may surmise from that warning, the Department believes it is very likely such options are an imprudent option in most cases. The Department warns that these investments in virtual assets present significant risks and challenges to participants' retirement accounts, including significant risks of fraud, theft and loss, for the following reasons:

- **Speculative and Volatile Investments**: The Securities and Exchange Commission (SEC) staff has cautioned that investment in a cryptocurrency is highly speculative. At this stage in their development, cryptocurrencies have been subject to extreme price volatility, which may be due to the many uncertainties associated with valuing these assets, speculative conduct, the amount of fictitious trading reported, widely published incidents of theft and fraud, and other factors. Extreme volatility can have a devastating impact on participants, especially those approaching retirement and those with substantial allocations to cryptocurrency.

- **The Challenge for Plan Participants to Make Informed Investment Decisions:** Cryptocurrencies are often promoted as innovative investments that offer investors unique potential for outsized profits. These investments can all too easily attract investments from inexpert plan participants with great expectations of high returns and little appreciation of the risks the investments pose to their

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[4] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, March 10, 2022

[5] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, March 10, 2022

[6] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, March 10, 2022

retirement investments. Cryptocurrencies are very different from typical retirement plan investments, and it can be extraordinarily difficult, even for expert investors, to evaluate these assets and separate the facts from the hype. Participants are less likely to have sufficient knowledge about these investments, as compared to traditional investments, or to have the technical expertise necessary to make informed decisions about investing in them. When plan fiduciaries, charged with the duties of prudence and loyalty, choose to include a cryptocurrency option on a 401(k) plan's menu, they effectively tell the plan's participants that knowledgeable investment experts have approved the cryptocurrency option as a prudent option for plan participants. This can easily lead plan participants astray and cause losses.

- **Custodial and Recordkeeping Concerns**: Cryptocurrencies are not held like traditional plan assets in trust or custodial accounts, readily valued and available to pay benefits and plan expenses. Instead, they generally exist as lines of computer code in a digital wallet. With some cryptocurrencies, simply losing or forgetting a password can result in the loss of the asset forever. Other methods of holding cryptocurrencies can be vulnerable to hackers and theft. These are just a few examples of the custodial and recordkeeping issues that may present additional difficulties for fiduciaries of retirement plans.

- **Valuation Concerns**: The Department is concerned about the reliability and accuracy of cryptocurrency valuations. Experts have described the question of how to appropriately value cryptocurrencies as complex and challenging. Experts have fundamental disagreements about important aspects of the cryptocurrency market, noting that none of the proposed models for valuing cryptocurrencies are as sound or academically defensible as traditional discounted cash flow analysis for equities or interest and credit models for debt. Compounding these concerns, cryptocurrency market intermediaries may not adopt consistent accounting treatment and may not be subject to the same reporting and data integrity requirements with respect to pricing as other intermediaries working with more traditional investment products.

- **Evolving Regulatory Environment:** Rules and regulations governing the cryptocurrency markets may be evolving, and some market participants may be operating outside of existing regulatory frameworks or not complying with them. Fiduciaries who are considering whether to include a cryptocurrency investment option will have to include in their analysis how regulatory requirements may apply to issuance, investments, trading, or other activities and how those regulatory requirements might affect investments by participants in 401(k) plans. For example, the sale of some cryptocurrencies could constitute the unlawful sale of securities in unregistered transactions. Plan fiduciaries must take care to avoid participating in unlawful transactions, exposing themselves to liability and plan participants to the risks of inadequate disclosures and the loss of investor protections that are guaranteed under the securities laws. In addition, as the Financial Industry Regulatory Authority (FINRA) has cautioned, Bitcoin and impliedly other cryptocurrencies have "… been used in illegal activity, including drug dealing, money laundering, and other forms of illegal commerce. Abuses could impact consumers and speculators; for instance, law enforcement agencies could shut

> down or restrict the use of platforms and exchanges, limiting or shutting off the ability to use or trade bitcoins."[7]

And, just in case the above language didn't dissuade the fiduciary yet, the DOL concludes by announcing an investigative program aimed at plans that offer these options:

> Based on these and other concerns, EBSA expects to conduct an investigative program aimed at plans that offer participant investments in cryptocurrencies and related products, and to take appropriate action to protect the interests of plan participants and beneficiaries with respect to these investments. The plan fiduciaries responsible for overseeing such investment options or allowing such investments through brokerage windows should expect to be questioned about how they can square their actions with their duties of prudence and loyalty in light of the risks described above.[8]

SECTION: 162
NO DEDUCTION ALLOWED FOR TUITION PAID FOR DAUGHTER'S BOYFRIEND

Citation: Sherwin Community Painters, Inc. v. Commissioner, TC Memo 2022-19, 3/9/22

In the case of *Sherwin Community Painters, Inc. v. Commissioner*, TC Memo 2022-19 a corporation was denied a deduction for amounts paid for the boyfriend of the owners' daughter to take a course in coding.

The company in question was a commercial painting contractor whose stock was owned by Mr. and Mrs. Ward. The amounts in question were paid for a coding course at Northwestern University.

> The Wards met Mr. Kocemba in 2016 when he was dating their daughter. Mr. Kocemba expressed an interest in the course, and the Wards offered to pay the tuition if he was admitted.[9]

Although Mr. Kocemba had no coding experience before taking this course, he had worked in the construction industry. The corporation attempted to claim paying his tuition was a deductible business expense as Mr. Kocemba updated the organization's website once he completed the course:

> After completing the course in 2017, Mr. Kocemba used the skills that he had learned to update Sherwin's website over the course of several

[7] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, March 10, 2022

[8] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, March 10, 2022

[9] *Sherwin Community Painters, Inc. v. Commissioner*, TC Memo 2022-19, March 9, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/company-allowed-some-deductions%3b-owner-didn%e2%80%99t-receive-dividends/7d8b6 (retrieved March 13, 2022)

> months and spent a considerable amount of time working on the website. Sherwin did not pay him for his work. Mr. Kocemba later married the Wards' daughter. He has performed additional computer-related work for Sherwin without compensation.[10]

The Tax Court outlined the basic requirements for a deduction under IRC §162 for expenses related to a trade or business:

> Section 162(a) generally allows a deduction for the ordinary and necessary expenses paid during the taxable year in carrying on a trade [*3] or business. The term "ordinary" means that the expense is normal, usual, or customary in the taxpayer's trade or business. *Deputy v. du Pont*, 308 U.S. 488, 495 (1940). The term "necessary" means the expense is appropriate or helpful in carrying on the trade or business. *Heineman v. Commissioner*, 82 T.C. 538, 543 (1984). The expenses must proximately relate to the taxpayer's trade or business. *Larrabee v. Commissioner*, 33 T.C. 838, 843 (1960); Treas. Reg. § 1.162-1(a). The determination of whether an expense satisfies the requirements for deduction is a question of fact. *Commissioner v. Heininger*, 320 U.S. 467, 475 (1943). A taxpayer is required to substantiate the expenses underlying a deduction by keeping and producing adequate records that enable the Commissioner to determine the correct tax liability, including the amounts paid; and to demonstrate that the deduction is allowable pursuant to some statutory provision. § 6001. A taxpayer is not entitled to deduct personal, living, or family expenses. § 262.[11]

The bar on being able to claim personal, living or family expenses is a limitation on the ability to deduct business expenses that is often not well understood by taxpayers. Rather, they often believe that if they can show any sort of actual or theoretical benefit to the business, the expense should be deductible even if the personal benefits clearly are what motivated the expenditure.

In this case the Court found that IRC §262 barred this deduction. While the taxpayers argued that Mr. Kocember received the tuition in exchange for the web services he later provided, the Court found that other factors indicated this was a personal expense that was being paid through the corporation:

> While Mr. Kocemba has provided services to Sherwin free of charge that would have likely cost Sherwin more than the amount of the tuition, we nevertheless find that petitioners have not established that Sherwin is entitled to deduct the tuition. Mr. Kocemba was not an employee of Sherwin. The Wards did not have an agreement with Mr. Kocemba that he would perform any services in exchange for the tuition payment. Sherwin paid the tuition without any expectation of a return and thus did not have a business purpose for the payment. The

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[10] *Sherwin Community Painters, Inc. v. Commissioner*, TC Memo 2022-19, March 9, 2022

[11] *Sherwin Community Painters, Inc. v. Commissioner*, TC Memo 2022-19, March 9, 2022

> tuition was a personal expense, and Sherwin is not entitled to deduct it.[12]

This finding is not surprising. The only real link the company had to Mr. Kocemba was that he was dating the daughter of the owners. While he may have felt a moral obligation to provide the web site services to his benefactors' company, he was under no legal obligation to do so.

SECTION: 6011
IRS TO HIRE 10,000 EMPLOYEES, CREATE SURGE TEAM TO ADDRESS BACKLOG OF UNPROCESSED RETURNS

Citation: "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, 3/10/22

The Treasury Department and the IRS announced a program that aims to deal with the backlog of unprocessed tax returns and correspondence on March 10.[13]

The press release begins by noting the current situation:

> This year, millions of taxpayers are awaiting the processing of their tax returns and receipt of their refunds. The backlog—unprocessed returns and correspondence sent to the IRS but yet unanswered—has created one of the most challenging tax filing seasons in our nation's history.[14]

The release argues that two key factors have created this backlog. The first relates to levels of IRS staffing and funding:

> First, the agency has been chronically underfunded for more than a decade, with its budget cut by nearly 20% since 2010. Today's historically low level of funding means that the IRS isn't equipped to provide the American people the service they deserve. This is all a result of resource constraints: The IRS workforce is the same size it was in 1970, though the U.S. population has grown by 60 percent and the complexity of the economy has increased exponentially. In the first

[12] *Sherwin Community Painters, Inc. v. Commissioner*, TC Memo 2022-19, March 9, 2022

[13] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022, https://home.treasury.gov/news/press-releases/jy0648 (retrieved March 13, 2022)

[14] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

> half of 2021, fewer than 15,000 workers handled nearly 200 million calls received, which translates to one person for every 13,000 calls.[15]

The release then moves on to the issues that arose during the COVID-19 pandemic that began in March of 2020:

> Second, the pandemic created a unique set of new operational challenges for the IRS. The agency was called upon to support emergency relief for taxpayers, like distributing an unprecedented three rounds of Economic Impact Payments, totaling over $830 billion, to 85% of American households. Including individual refunds, the IRS has distributed over $1.5 trillion to Americans since the pandemic began. This was all done at a time when the IRS budget was at historic lows, and while adjusting operating protocols to ensure the IRS workforce was safe and healthy in the midst of the pandemic.
>
> These circumstances have created significant challenges. Entering a normal filing season, the IRS typically has well under one million pieces of inventory. This year, the IRS entered the filing season with a backlog that is more than 15 times as large.[16]

Hiring Program

The release goes on to describe steps the IRS is taking to add personnel to deal with the backlog.

The IRS announced a program to hire 10,000 new employees:

> The IRS today announced plans to hold job fairs across the country in March in Kansas City (March 18-19), Austin (March 24-25) and Ogden (March 31-April 1) with the aim of filling 5,000 open positions in the coming months. Working with Treasury, the Office of Personnel Management, and the National Treasury Employees Union, the IRS recently secured direct hiring authority for these employees, as well as an additional 5,000 new hires to be made over the course of the next year. Congress also helpfully provided hiring flexibilities in the House-passed omnibus to further expedite hiring in critical positions. This will allow for onboarding and training new emergency teams which will begin working on inventory within just a few weeks.[17]

A surge team of 700 employees will be reassigned to process new returns:

> The IRS is in the process of shifting approximately 700 employees at the Austin, Ogden, and Kansas City campuses to process original

[15] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

[16] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

[17] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

> returns. These efforts will address the historically high inventories of paper tax returns. At full capacity, this surge will close millions of cases each month.[18]

The release notes that the IRS had already moved 800 employees into a surge team to process amended returns and correspondence, a team that will continue in operation:

> The second surge effort builds on efforts earlier in filing season, when the IRS moved hundreds of existing employees with previous experience to address the backlog. The IRS currently has approximately 800 people on this team, which started in February.[19]

The IRS has also begun mandating overtime for certain employees and will allow others to work overtime:

> The IRS has required mandatory overtime for the over 6,000 employees processing original returns. Overtime is also available for approximately 10,000 employees processing amended returns and taxpayer correspondence. In all three submission processing centers, employees are working night shifts to work on return and correspondence processing.[20]

The IRS is also looking at using contractors to relieve the backlog:

> The IRS is quickly pursuing additional contracting options to help with original return processing, including mailroom operations, transcription, and input of paper returns into IRS systems.[21]

Taxpayer Assistance in Preparing Accurate Returns

The IRS notes that errors found in returns submitted to the agency lead to a significant amount of correspondence:

> A large share of the backlog stems from small errors by millions of taxpayers on their tax returns, which then require manual review by IRS employees before they can be processed. By helping taxpayers file accurately, the IRS can ensure that refunds are issued quickly (an error-free electronic return is processed within 21 days). Accurate individual

[18] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

[19] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

[20] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

[21] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

> filings also proactively reduce inventory by decreasing the share of returns that require time- intensive manual attention by employees.[22]

The IRS then highlights steps the agency has taken it asserts will help reduce the number of such errors:

> The IRS has sent more than 100 million letters to taxpayers to prevent delays in processing. In the letters, the IRS proactively calculates the amounts received by individual taxpayers in both third Economic Impact Payments and the advance Child Tax Credit to ensure more accurate returns.[23]

The release provides information on online help that has been made available:

> The IRS created and expanded self-service portals for taxpayers, including for online payment agreements, requesting payment transcripts, requesting Identity Protection PINs, and updating personal information. In just the last year, 9.4 million taxpayers have accessed their online accounts, allowing for important information—on benefits received, notices, and taxpayer payment history—to be easily and securely accessed.[24]

The agency next describes the in person help programs it has implemented:

> The IRS has increased the availability of in-person support for taxpayers through extra hours (including weekends) at Taxpayer Assistance Centers throughout the filing season. It also awarded $41 million of support to over 330 organizations across the United States, including Tax Counseling for the Elderly and Volunteer Income Tax Assistance organizations which provide free federal tax return preparation for the underserved.[25]

Finally, the release discusses IRS phone assistance:

> The IRS has expanded customer callbacks to 70% of its toll-free lines. Already this fiscal year, an callback option has been offered to more than three million taxpayers, saving those preparing their taxes almost one million hours of wait time. Additionally, the IRS has deployed 2,000 contractors to respond to taxpayer questions about Economic

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[22] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

[23] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

[24] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

[25] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

> Impact Payments and the advance Child Tax Credit. Since the summer of 2021, these contractors have answered over 40 million calls.[26]

Technologies the IRS is Using to Reduce the Backlog

The release concludes with a description of the ways the IRS is attempting to use technology to reduce the backlog.

The IRS has begun automating certain error correction operations that previously had to be handled by an employee:

> Last filing season, any error on a tax return required manual review by an IRS processing employee, meaning that just a few dozen such returns could be processed each hour. For this filing season, the IRS developed an automated tool that dramatically expands efficiencies and has helped the IRS close 1.5 million error resolution cases in a single week.[27]

The IRS also reminds readers of the program suspending the issuance of certain notices while the agency deals with the backlog:

> To provide relief for taxpayers, the IRS reconfigured its systems to temporarily halt sending approximately 40 form notices to taxpayers, including mailing automated collection notices that are normally issued when a taxpayer owes additional tax, and the IRS has no record of a taxpayer filing a return. This action provides important relief for taxpayers who otherwise could have received a notice for taxes already paid, but not processed due to the backlog. Importantly, this also results in less inventory since taxpayers won't contact the IRS to inquire about the notices received.[28]

Finally, the IRS notes the use of automated support options:

> he IRS developed new automated support technology to help taxpayers, including online live assistance and new voice and chat bots (in English and Spanish) to quickly answer taxpayer queries. Taxpayers' use of automated services more than doubled in the last year. The improvement of automated phone assistance and other tools has allowed the IRS to move many phone service representatives to work inventory given the exigencies of this filing season.[29]

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[26] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

[27] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

[28] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022

[29] "Treasury and IRS Announce Aggressive Plan to End Pandemic Inventory Backlog This Year," US Treasury Press Release, March 10, 2022