by **Steven Toscher**
and **Krista Hartwell**

2015 TAX LAW REVIEW

A variety of new state and federal tax laws have affected small business tax credits, charitable organizations, penalty abatement, and the status of Tax Court judges

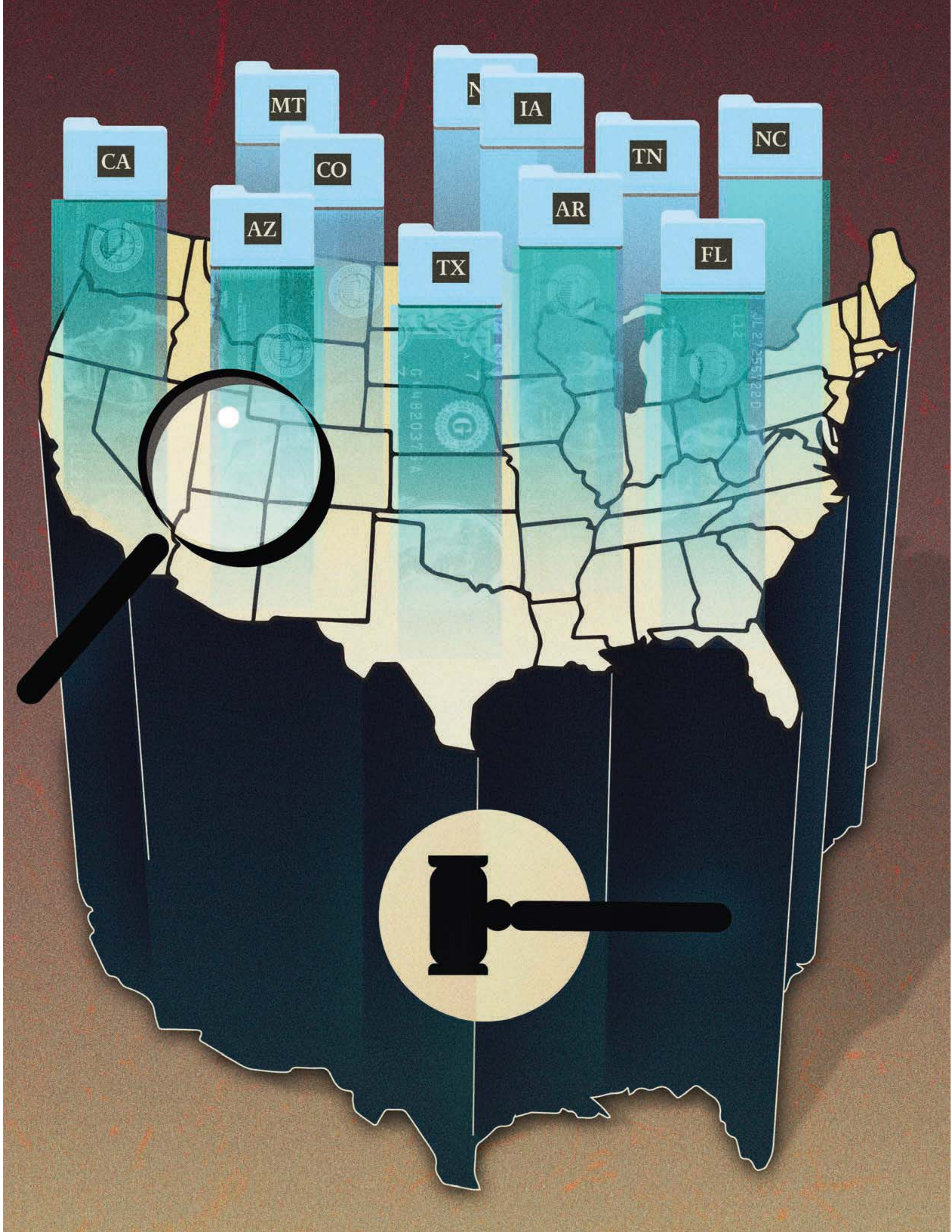
TAX REFORM is a hot button matter in today's political landscape and, while Congress has been unable to address meaningful tax reform, it has managed to pass substantial tax legislation—mostly in the context of the deficit-driven budget—which has made significant changes to the tax code. Most tax legislation in the past has been titled as such, but many of the tax initiatives enacted in 2015 are combined with other types of legislation: the Protecting Americans from Tax Hikes Act of 2015 (PATH Act),[1] the Bipartisan Budget Act,[2] the Surface Transportation and Veterans Health Care Choice Improvement Act,[3] the Fixing America's Surface Transportation Act (FAST Act),[4] and the 2016 Consolidated Appropriations Act.[5] Although new tax legislation may be less driven by good policy and tax reform than by budget realities, Congress enacted meaningful changes—including the permanent extension of important business tax incentives, a substantial overhaul of the procedures for examining and collecting taxes from large partnerships, more meaningful oversight of the IRS tax-exempt organizations division, and, for the first time, a provision that will limit a taxpayer's ability to obtain a passport and travel overseas if he or she is considered "seriously delinquent."

In 2015, President Barack Obama signed into law the PATH Act, which retroactively renewed various provisions of the tax law—the "tax extenders" provisions that have regularly expired and then extended retroactively—now making some of these provisions permanent. These provisions include the state and local sales tax deduction,[6] an above-the-line deduction for elementary and secondary school teacher expenses,[7] nontaxable IRA distributions to eligible charities,[8] and an increased deduction for qualified conservation contributions.[9] Various tax credits and other benefits were increased or adjusted: the earned income tax credit for parents of three or more children was increased[10] and the earned income tax credit marriage penalty was reduced.[11] The American Opportunity tax credit,[12] the child care tax credit[13] and excludable employer-provided mass transit and parking benefits[14] were increased.

The PATH Act also made several business tax extender provisions permanent, including the research and development credit,[15] the exclusion of all gain on qualified small business stock,[16] increased deduction for donation of wholesome food inventory, employer credit for wages paid to employees called to active duty in the military, reduction to shareholder basis for charitable contributions of S cor-

Steven Toscher is a principal of Hochman Salkin Rettig Toscher & Perez in Beverly Hills, where he specializes in civil and criminal tax litigation. Krista Hartwell is an associate at the firm and holds a masters in taxation.

KEN CORRAL


CA
MT
CO
AZ
IA
TN
NC
AR
TX
FL

porations,[17] a five-year recognition period for S corporation built-in gains tax,[18] an active financing income exception to Subpart F, Regulated Investment Company (RIC) qualified investment entity treatment, and exemption from withholding tax of RIC interest-related dividends, and short-term capital gain dividends paid to nonresident alien individuals or foreign corporations.[19] Indeed, making these provisions of the tax code permanent was one of the most important consequences of the legislation.

Commentators have observed that the most important change with the broadest tax impact is the research and development credit. This credit gives incentives to businesses to allocate spending to qualified research and development by allowing businesses to credit 20 percent of current-year qualified research and development spending that exceeds a threshold amount determined by gross receipts in earlier years.[20] The credit cannot exceed 10 percent of total spending on qualified research for the current year. For example, businesses spending $1 million on qualified research would receive a $200,000 reduction in their taxes.

In addition to making the research and development credit permanent, the PATH Act made two significant changes. First, a qualifying small business may take the credit against FICA payroll tax liability,[21] but it must make an election to apply the credit to FICA tax liability. Generally, a qualified small business for this purpose is a C corporation, S corporation, or partnership with less than $5 million of gross receipts and no gross receipts for any of the prior five tax years. In order to determine whether a business is a qualifying small business, gross receipts are computed under Section 448 of the IRC.[22] Second, an eligible small business may apply the credit against alternative minimum tax liability.[23] An eligible small business for this purpose is defined as a nonpublicly traded corporation, partnership, or sole proprietorship with average annual gross receipts for the last three tax years not exceeding $50 million.

Prior to the PATH Act, the research and development credit was available only for expenditures made before December 31, 2014. The PATH Act changes apply to expenses incurred after December 31, 2014. Accordingly, taxpayers who filed fiscal year tax returns that included a portion of the 2015 calendar year, and who had qualified research and development expenses, should consider filing amended returns to take advantage of the new, increased credit.

The PATH Act also contains several provisions relating to IRS procedures and oversight. For example, the IRS commissioner must now ensure that all IRS employees are familiar with the Taxpayer Bill of Rights.[24] Furthermore, The IRS must terminate employees who take official action for political reasons[25]—a provision that may arise from past issues involving IRS administration of tax-exempt organizations. IRS employees are prohibited from using personal e-mail for IRS business.[26] In cases of unauthorized disclosure of taxpayer information, the IRS may disclose whether it has initiated an investigation.[27] The IRS also must require employers to use an identifying number for employees other than their Social Security numbers on forms W-2.[28] Moreover, the IRS must now allow enrolled agents to use the titles EA or enrolled agent.[29]

Recent changes have also affected charitable organizations. The IRS must now formulate procedures for allowing Section 501(c) organizations receiving adverse determinations to request an administrative appeal.[30] The IRS must also create streamlined procedures for Section 501(c)(4) organizations—i.e., civic leagues and employee associations—seeking tax-exempt status.[31] Additionally, these organizations must be permitted to seek review in federal court for revocation of exempt status.[32] Gift tax will not be imposed on contributions to Sections 501(c)(4) and 501(c)(5) (labor, agricultural, or horticultural) organizations.[33]

Notably, the PATH Act contains several provisions relating to Tax Court procedures resolving various areas of dispute that have arisen in past litigation. The PATH Act clarifies that the Tax Court is independent of the executive branch and is not an executive branch agency.[34] This is in response to Congress's concern about statements made in *Kuretski v. Commissioner*.[35] In *Kuretski*, the taxpayers argued that the president's authority to remove Tax Court judges was an unconstitutional violation of separation of powers. In finding that such power is not unconstitutional, the D.C. Circuit Court stated that "the Tax Court exercises its authority as part of the Executive Branch."[36] Congress was concerned that the court's reasoning in *Kuretski* may lead the public to question the independence of the Tax Court, particularly in relation to the Department of Treasury or the IRS.

The Tax Court is now authorized to establish procedures for filing complaints regarding the conduct of Tax Court judges and special trial judges, and for the investigation and resolution of such complaints.[37] Under the PATH Act, the Tax Court is now required to conduct all proceedings under the Federal Rules of Evidence.[38] Previously, the Tax Court could conduct proceedings using the rules of evidence applied by the U.S. District Court of the District of Columbia.

In the past, the IRS has been criticized for failing to issue notices of final determination in cases in which it refused to abate interest. Without such notice, it was unclear whether the Tax Court had jurisdiction over the interest abatement issue. The PATH Act requires that when the IRS has failed to issue a notice of final determination on a claim for interest abatement, taxpayers will still be permitted to seek review in Tax Court.[39] Additionally, small Tax Court cases (S-cases) will now include review of IRS determinations not to abate interest if the failure to abate interest does not exceed $50,000.[40]

The PATH Act clarifies that spousal relief and collection due process cases may be appealed to the U.S. Court of Appeals for the circuit in which the taxpayer's legal residence is located.[41] Additionally, when a bankruptcy petition has been filed and a taxpayer is prohibited from filing a Tax Court petition, the statute of limitations in spousal relief and collection due process cases will be suspended.[42]

Bipartisan Budget Act

In addition to raising the federal debt ceiling, the Bipartisan Budget Act of 2015 includes tax provisions that dramatically change the partnership audit procedures for tax years beginning after December 31, 2017. Under the new rules, audit adjustments result in tax liability at the entity level. Qualifying small partnerships can elect out of the new rules and will be audited under the general audit rules for individuals. To be eligible for the election, the partnership must have 100 or fewer qualifying partners (individuals, estate of a deceased partner, S corporations, or C corporations).

The Bipartisan Budget Act repeals the Tax Equity and Fiscal Responsibility Act (TEFRA) partnership audit rules[43] and Electing Large Partnership (ELP) rules,[44] replacing them with new rules intended to streamline partnership audits and to allow for the first time the collection of income taxes at the partnership level rather than from the individual partners.[45] Under the TEFRA rules, the IRS was permitted to audit partnerships and determine partnership income and loss at the partnership level, but the adjustments were made at the partner level. TEFRA partnership audits required significant IRS resources because to apply the adjustments determined in the audit, the IRS had to determine the amount of tax due, assess the tax, and collect the individual allocable share of tax from each partner. The ELP rules were an attempt to simplify the procedures for larger partnerships, but few partnerships elected into the ELP rules.

Absent an election out of the new rules and into an alternative regime, partnership gain and loss will be computed at the partnership level and any "imputed underpayment" is assessed against the partnership at the highest statutory rate[46] in the year of the audit or when judicial review of the audit is completed.

Accordingly, any underpayment of tax is assessed against and collected from the partnership, and the partnership is liable for any penalties and interest arising from the audit adjustments. The imputed underpayment may be reduced in certain circumstances so as to take into account the filing of a partner's tax return that accounts for the audit adjustments, a tax-exempt partner, or regarding items of capital gain when a partner that is an individual and with respect to items of ordinary income involving a partner that is a C Corporation.[47] Materials related to reductions in imputed underpayments must be submitted within 270 days of the mailing of the notice of proposed partnership adjustment.[48]

In addition to the election available to small partnerships, all partnerships may elect out of the new rules and into an alternative regime to take the audit adjustments into account at the partner level by issuing adjusted information returns to the audit year partners. Such election must be made within 45 days after the issuance of the notice of final partnership adjustment. Once this election is made, it cannot be revoked without IRS consent.[49]

Surface Transportation and Veterans Health Care Choice Improvement Act

This act is meant to temporarily extend the Highway Trust Fund but includes several significant tax provisions designed to raise revenue. This act includes several return due date and reporting provisions, all of which are effective for tax years beginning after December 31, 2015. Calendar year partnerships and individual tax returns are both due on April 15. As a result, individuals with calendar year partnership interests generally must file their individual tax returns on extension so they have enough time to prepare their returns after receiving Schedule K-1 from the partnership. This act requires partnerships to file their returns by March 15 rather than April 15,[50] providing additional time to issue Schedule K-1 to taxpayers holding partnership interests. Return due dates for C corporations were also changed. C corporations were previously required to file their returns by March 15, but under the new return due date rules, C corporations are now required to file returns by April 15. Corporations are also now entitled to an automatic six-month (rather than three-month) extension of time to file corporate returns.[51] Additionally, the new rules change the extended due dates for several other returns:[52] partnership returns (Form 1065) can now be extended to September 15, trust returns (Form 1041) to September 30, and tax-exempt organization returns (Form 990) to November 30.

Taxpayers with a financial interest in or signature authority over foreign financial accounts with an aggregate high balance that exceeds $10,000 at any time during the calendar year must file FinCen Form 114, Foreign Bank Account Report (FBAR). Under existing law, FBARs were due by June 30 of the year following the reporting year with no extension of time available. The act makes FBARs for tax years beginning after December 31, 2015, due by April 15 of the year following the reporting year, with a single six-month extension to October 15.[53] Thus, 2016 FBARs that would otherwise be due on June 30, 2017, will be due on April 15, 2017, unless extended to October 15, 2017. This change brings into line the filing dates of the FBAR form with the dates of individual tax returns and is expected to increase compliance with what has become a very important tool for IRS international enforcement.

The Surface Transportation and Veterans Health Care Choice Improvement Act also contains two significant basis provisions. Inherited property receives a step up in basis to the fair market value at the decedent's date of death. For estate tax purposes, all of a decedent's property must be valued at its fair market value at the date of death. In some cases, beneficiaries and estates have reported different values for the same property even though the property has been valued on the same day for both purposes. While various judicial doctrines arose requiring some level of consistency,[54] this act now statutorily requires the basis of inherited property to equal the fair market value of the property reported on an estate tax return.[55] This new basis consistency rule applies to property reported on estate tax returns filed after July 31, 2015. To ensure basis is consistent, the rules also impose a new information return requirement.[56] The executor of an estate required to file an estate tax return must provide the IRS and each individual inheriting an interest in property included in the decedent's gross estate with a statement identifying the value of the interest in property as reported on the estate tax return. The same information must also be provided to certain beneficiaries. The information return and statement must be filed by the earlier of 30 days after the due date of the estate tax return or 30 days after the date the estate tax return is filed. The IRS may issue regulations on the new basis reporting rules, but has yet to do so.

This act also reversed *United States v. Home Concrete & Supply, LLC*,[57] a recent U.S. Supreme Court decision. In *Home Concrete*, the Supreme Court held that an understatement of income resulting from an overstatement of basis does not extend the three-year statute of limitations to assess tax to six years, and a treasury regulation stating that such overstatement of basis extends the three-year statute on assessment to six years was not entitled to judicial deference.

Generally, the IRS must assess tax within three years from the date a return was filed.[58] The three-year statute on assessment is extended to six years when the taxpayer has made a substantial omission from gross income.[59] A substantial omission from gross income, which extends the statute to six years, occurs when a taxpayer omits from gross income an amount in excess of 25 percent of the amount of gross income stated in the return.[60] The act reversed the Supreme Court's holding that a basis overstatement cannot result in extending the three-year statute to six years. Under the new rules, an understatement of gross income resulting from an overstatement of basis qualifies as an omission from gross income for the purposes of extending the statute of limitations. In *Home Concrete*, the Supreme Court reasoned that the treasury regulation extending the three-year statute was not entitled to judicial deference because a regulation cannot override the Supreme Court's prior interpretation of the statute of limitations in *Colony, Inc. v. Commissioner*. The new rule extending the three-year statute of limitations is located in the Internal Revenue Code[61] and is effective for returns filed after July 31, 2015, or returns filed on or before July 31, 2015, if the statute in effect prior to the amendments made by the act has not expired.

FAST Act

The FAST Act, which adds Section 7345 to the IRC, allows the IRS to limit for the first time the free travel of individuals who owe federal taxes.[62] The new section prevents "seriously delinquent" taxpayers from traveling abroad. If the IRS certifies to the State Department that a taxpayer owes more than $50,000 in assessed taxes, penalties, and interest, the State Department may revoke, deny, or limit the taxpayer's passport. The legislation is similar to many state legislative provisions, which cause taxpayers to lose certain rights—such as their driver's license—if the tax bills go unpaid. Taxpayers are entitled to judicial review by filing a suit in district court or Tax Court to determine whether the IRS's certification to the State Department was in error.[63] Taxpayers may also reverse denials, revocations, and limits on their passports by paying the liability, entering into an installment agreement or offer in compromise, or succeeding in a claim for innocent spouse relief.

2016 Consolidated Appropriations Act

Since our healthcare system has become inextricably intertwined with our tax code, in 2015 the president signed into law the 2016 Consolidated Appropriations Act, which includes several healthcare and energy provisions. A 40 percent excise tax (frequently referred to as the Cadillac tax) was scheduled to be imposed on providers or administrators of employer-sponsored health plans that exceed certain cost thresholds beginning after December 31, 2017. The Consolidated Appropriations Act delays the effective date of the Cadillac tax to tax years beginning after December 31, 2019.[64] This act also makes the Cadillac tax deductible by adding a provision to the IRC that specifies the tax code's list of nondeductible taxes in Section 275 does not apply to the Cadillac tax. Accordingly, when the Cadillac tax becomes effective for the 2020 tax year, it will be deductible.

California Tax Updates

The California legislature made some notable tax changes to individual, corporate, and sales tax. For example, the California legislature made permanent the Taxpayers' Rights Advocate provisions relating to abatement of penalties and interest.[65] The Taxpayers' Rights Advocate is now permanently authorized to abate penalties and interest attributable to Franchise Tax Board (FTB) error or unreasonable delay. An FTB error that may result in abatement of penalties and interest includes erroneous action or inaction by the board in processing documents filed or payments made by taxpayers and certain types of erroneous written advice. The Taxpayers' Rights Advocate may grant relief only if no significant aspect of the error or delay is attributed to the taxpayer and relief is not otherwise available. If the Taxpayers' Rights Advocate grants relief in excess of $500, the relief must be submitted to an FTB executive officer for concurrence. The Taxpayers' Rights Advocate may not grant relief in excess of $10,000 per tax year, adjusted for inflation beginning January 1, 2017. A refund may be paid as a result of Taxpayers' Rights Advocate penalty or interest relief only if the applicable statute of limitations for a claim for refund remains open as of the date of the basis for providing Taxpayers' Rights Advocate relief.[66]

The California legislature also enacted a refundable state earned income tax credit applicable to tax years 2015 and later.[67] The California refundable earned income tax credit is in modified conformity with the federal earned income tax credit, allowing eligible individuals an earned income tax credit and a refund of the excess credit amount over individual taxes owed. The amount of the credit is determined in accordance with Section 32 of the IRC, although the state has provided its own nonconforming phase-out percentages. The refundable amount of the credit is equal to the portion of the earned income tax credit allowed by federal law.

Beginning January 1, 2017, employers with 10 or more employees must file income tax withholding returns and pay withholding tax electronically, unless a waiver is granted. Beginning January 1, 2018, all employers must file income tax withholding returns and pay withholding tax electronically. The Employment Development Department (EDD) may grant waivers to these requirements if the employer's business is not automated, the employer shows good cause, the employer shows a current federal exemption from electronic filing, or the employer shows severe economic hardship.[68]

The expansion of the commercialization of medical marijuana has found its way into required changes in the sales and use tax law.[69] New state legislation requires the State Board of Equalization (SBE) to implement a system for reporting the movement of commercial cannabis and cannabis products throughout the distribution chain. The system must, among other things, be capable of providing at a minimum all of the following information to the SBE: 1) the amount of tax due by the designated entity, 2) the name, address, and license number of the designated entity that remitted the tax, 3) the name, address, and license number of the succeeding entity receiving the product, 4) the transaction date, and 5) any other information deemed necessary by the board for the taxation and regulation of marijuana and marijuana products. The new sales and use tax provision was included in a bill aimed at medical marijuana safety and regulation and assists in tracking medical marijuana transactions for sales tax purposes.

Nor are counterfeiters forgotten in the sales and use tax system. Existing sales and use tax law imposes a tax on retailers on their gross receipts from the sale of tangible personal property sold at retail in California, or on the storage, use, or other consumption of tangible personal property purchased from any retailer for storage, use, or other consumption. Under newly enacted legislation, a retail sale, or sale at retail, includes a sale by a convicted seller of tangible personal property with a counterfeit mark, a counterfeit label, or an illicit label on that property, or in connection with that sale, regardless of whether the sale is for resale in the regular course of business.[70] Additionally, "storage" and "use" each shall include a purchase by a convicted purchaser of tangible personal property with a counterfeit mark, a counterfeit label, or an illicit label on that property, or in connection with that purchase, regardless of whether the purchase is for resale in the regular course of business.[71] The new legislation expands retail sale, sale at retail, storage, and use to include the terms "counterfeit label" and "illicit label" where existing law only included the term "counterfeit mark."[72] Accordingly, the new law expands taxable retail sales to include more counterfeit and illicit sales.

While tax reform and simplification are the stated goals of most in Congress and state legislatures, the reality of recent tax legislation is that although meaningful tax reform has thus far proven to elude the ability of Congress, our lawmakers continue to add new tax provisions that raise revenue and make the tax system more complex. ■

---

1 Protecting Americans from Tax Hikes Act of 2015 (PATH Act), Pub. L. No. 114-113, Div. Q, 129 Stat. 2242, 3041-3129.
2 Bipartisan Budget Act of 2015, Pub. L. No. 114-74, 129 Stat. 584, 638.
3 Surface Transportation and Veterans Health Care Choice Improvement Act, Pub. L. No. 114-41, 129 Stat. 443 (2015).
4 Fixing America's Surface Transportation Act (FAST Act), Pub. L. No. 114-94, 129 Stat. 1312 (2015).
5 2016 Consolidated Appropriations Act, Pub. L. No. 114-113, 129 Stat. 2242 (2015).
6 26 U.S.C. §164(b)(5).
7 26 U.S.C. §62(a), (d).
8 26 U.S.C. §408(d)(8)(F).
9 26 U.S.C. §170(b).
10 26 U.S.C. §32(b).
11 *Id.*
12 26 U.S.C. §25A(i).
13 26 U.S.C. §24(d).
14 26 U.S.C. §132(f)(2).
15 26 U.S.C. §41(h).
16 26 U.S.C. §1202(a)(4).
17 26 U.S.C. §1367(a)(2).
18 26 U.S.C. §1347(d)(7).
19 26 U.S.C. §§871(k), 897(h).
20 26 U.S.C. §41(a)(1).
21 26 U.S.C. §41(h).
22 26 U.S.C. §41(h)(ii)(3).
23 26 U.S.C. §38(c)(4)(B)(ii).
24 26 U.S.C. §7803(a)(3).
25 Section 407 of the PATH Act amends the Internal Revenue Service Restructuring and Reform Act of 1998.
26 PATH Act §402.
27 26 U.S.C. §6103(e)(11).
28 PATH Act §402.
29 31 U.S.C. §330.
30 26 U.S.C. §7213(c).
31 26 U.S.C. §506
32 26 U.S.C. §7428(a)(1)(E).
33 26 U.S.C. §2501(a)(6).
34 26 U.S.C. §7441.
35 *See* Kuretski v. Commissioner, 755 F. 3d 929 (D.C. Cir. 2014); *see also* Senate Report 114-014, 114th Cong. (2015-16).
36 Kuretski, 755 F. 3d at 943.
37 26 U.S.C. §7466.
38 26 U.S.C. §7453.
39 26 U.S.C. §6404(h).
40 26 U.S.C. §7463(f).
41 26 U.S.C. 7482(b)(1)(F).
42 26 U.S.C. 6015(e)(6).
43 26 U.S.C. §§6221-6334.
44 26 U.S.C. §§771-77.
45 *Id.*
46 New 26 U.S.C. §6225(c), *available at* https://www.congress.gov/114/bills/hr1314/BILLS-114hr1314eah.pdf.
47 New 26 U.S.C. §6227(a), *available at* https://www.congress.gov/114/bills/hr1314/BILLS-114hr1314eah.pdf.
48 New 26 U.S.C. §6225(c), *available at* https://www.congress.gov/114/bills/hr1314/BILLS-114hr1314eah.pdf.
49 26 U.S.C. §6226.
50 26 U.S.C. §6072(b).
51 26 U.S.C. §6081(b).
52 Surface Transportation and Veterans Health Care Choice Improvement Act at §2006(b).
53 *Id.* at §2006(b)(11).
54 For a discussion of the case law duty of consistency, *see, e.g.*, Janis v. Commissioner, 461 F. 3d 1080 (9th Cir. 2006) *and* Brett Van Alen v. Commissioner, T.C. Memo 2013-235.
55 26 U.S.C. §1014(f).
56 26 U.S.C. §6035(a).
57 United States v. Home Concrete Supply, LLC, 132 S. Ct. 1836 (2012).
58 26 U.S.C. §6501(a).
59 26 U.S.C. §6501(e).
60 *Id.*
61 26 U.S.C. §6501(e)(1)(B)(ii).
62 26 U.S.C. §7345.
63 26 U.S.C. §7345(e).
64 26 U.S.C. §4980I.
65 Rev. & Tax. Code §21004(c)(1).
66 Rev. & Tax. Code §21004(c)(4).
67 Rev. & Tax. Code §17052.
68 Unemp. Ins. Code §1088(e).
69 Rev. & Tax. Code §31020.
70 Rev. & Tax. Code §6007.
71 *Id.*
72 *Id.*