UPDATE FOR ACCOUNTANTS AND FINANCIAL PLANNERS

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AGENDA

- **Top 40 Federal Tax Developments of 2020 (through December 6)**
- **Reading Marital Settlement Agreements Through The Eyes of a Financial Professional**
- **Taxation of Damages**

TOP 40 FEDERAL TAX DEVELOPMENTS OF 2020 (Through December 6)

David S. De Jong

I. INDIVIDUALS

P.L. 116-136, the Coronavirus Aid, Relief and Economic Security (CARES) Act:

- Creates a credit against 2020 taxes in the form of a rebate for U.S. residents with social security numbers and not a dependent of another based on 2019 adjusted gross income (or 2018 if 2019 is unfiled) of $1,200 ($2,400 if married) plus an additional $500 per qualifying child with the maximum rebate phased out by $5 for each $100 that income exceeds $75,000 for single individuals, $112,500 for heads of household and $150,000 for married couples; the credit amount is subsequently computed on the 2020 return and the rebate is subtracted but not below zero.

In **McKenny v. United States**, 126 AFTR2d 2020-5943, the Eleventh Circuit Court of Appeals reversed a Florida Federal District Court and found a settlement payment from a CPA firm for bad tax advice to be taxable (in contrast to a payment for error in tax preparation), allowing a deduction for legal expenses and other costs only as a miscellaneous itemized deduction under pre-2018 law inasmuch as a loss related to advice on how to handle business arrangements is personal in nature.

In **Beckett v. Commissioner**, TC Summary Opinion 2020-19, the Tax Court found that, although the source of a claim for seizures at work from epilepsy was failure of an employer to make a reasonable accommodation constituting discrimination, the physical distress cited in the complaint and in the settlement agreement caused the Court to state that one-third of the settlement award was nontaxable based on the intent of the payor to pay in part for physical injury.

In **Lucero v. United States**, 126 AFTR2d 2020-6682, a New Mexico Federal District Court allowed a discharged employee to challenge the "agreed" value of privately owned stock received in a settlement for wrongful termination and accepted a significantly lower value after allowing a 38 ½ percent combined discount.

In **Connell v. Commissioner**, 126 AFTR2d 2020-5574, the Third Circuit Court of Appeals agreed with the Tax Court that cancellation of a broker's debt to his company was taxable as ordinary income and not capital gain for transferring his book of business.

In **Keefe v. Commissioner**, 126 AFTR2d 2020-5331, the Second Circuit Court of Appeals agreed with the Tax Court that a couple who took six years to renovate an historic mansion and then sold the property could not claim an ordinary loss where they spent more time trying to sell the property than rent it, the Court noting that a property never rented can still give rise to an ordinary loss under more favorable facts.

In **Campbell v. Commissioner**, TC Memo 2020-41, the Tax Court denied a charitable deduction for designer eyeglass frames purchased for $50,000 and donated after one year at an alleged value of $225,000; IRS argued successfully that there was not donative intent and that the appraisal lacked sufficient specificity.

In **Adkins v. United States**, 125 AFTR2d 2020-2290, the Federal Circuit Court of Appeals reversed a decision of the Court of Federal Claims and allowed a theft loss during the pendency of criminal charges against brokers who peddled a fraudulent investment scheme, the Court noting that every possible avenue of recovery need not be exhausted with the test being one of “reasonable prospect of recovery”; in **Littlejohn v. Commissioner**, TC Memo 2020-42, the Tax Court concluded that the failure of real estate agents to inform the taxpayers about defects was not a crime under state law and denied a deduction for a theft loss.

In **Near v. Commissioner**, TC Memo 2020-10, the Tax Court denied a pre-2018 expense deduction to an attorney who failed to submit claims for business expenses to his employer for likely payment and, in any event, could not substantiate the actual costs; in **Armstrong v. Commissioner**, TC Summary Opinion 2020-26, the Tax Court once again disallowed employee business expenses under pre-2018 law where the employee did not seek reimbursement from the employer as she thought it might not be approved.

In **Coleman v. Commissioner**, TC Memo 2020-146, the Tax Court found that a compulsive slot machine gambler netted losses despite over $350,000 of gambling winnings reported to him on 160 separate forms W-2G from three Maryland casinos and one Delaware casino; his diary of wins and losses was incomplete but he was able to show 210 withdrawals from credit cards and accounts in a single year and no accretion to wealth assisted by his expert witness who testified that, based on gambling 193 full days during the year, there was a 99 percent level of certainty that he had gambling losses of at least $151,000 for the year.

In **Richlin v. Commissioner**, TC Memo 2020-60, the Tax Court awarded an overpayment shown on a prior year tax return as well as joint estimated payments to the husband whose funds were utilized for one quarter when the payment was made after divorce and in the other cases based on a prenuptial agreement of the parties which generally made the husband responsible for all tax liabilities.

In **Notice 2020-65**, IRS provided limited guidance on the prior Presidential Memorandum permitting deferral of the employee portion of social security taxes from September-December 2020 to January-April 2021 on a ratable basis; the deferral is available only in the case of an employee grossing $4,000 or less for a biweekly pay period or equivalent and is not employer mandated.

In **Notice 2020-75**, IRS indicated that future regulations will allow flowthrough entities to deduct state and local income taxes paid at the entity level in lieu of including all or a portion of that income at the individual level where a deduction would not be allowed.

II. RETIREMENT & ESTATE PLANNING

P.L. 116-136, the Coronavirus Aid, Relief and Economic Security (CARES) Act:

- Suspends the minimum distribution rule for 2020 (and for 2019 first time required minimum distributions within the grace period ultimately extended to August 31, 2020) for defined contribution plans and IRAs, ignoring 2020 in determining any five-year period on required withdrawals (any ten-year period, in contrast, is not extended).

- Waives the 10 percent early withdrawal penalty for distributions in 2020 up to $100,000 from qualified retirement plans or IRAs with one-third taxed in each of three years beginning in 2020 and recontribution available within three years for individuals (including self-employeds) diagnosed or with a spouse or dependent diagnosed with the virus or with an inability to work due to quarantine, furlough, closing or reduced hours.
- Allows cumulative loans from employer plans from date of enactment through September 22, 2020 of up to the lesser of $100,000 or 100 percent of an individual's vested balance and delays repayment on existing loans by one year on payments due on or after the date of enactment through December 31, 2020, in each case for individuals (including self-employeds) diagnosed or with a spouse or dependent diagnosed with the virus or with an inability to work due to quarantine, furlough, closing or reduced hours.

In **Estate of Bolles v. Commissioner**, TC Memo 2020-71, the Tax Court found that 23 years of transfers between a mother and son were initially loans but became gifts in the year in which repayment could no longer be expected.

In **Letter Ruling 202029006**, IRS waived the 60-day rollover period in the case of a recent divorcee who was unaware that funds placed in her bank account by her spouse were from an IRA; in **Letter Ruling 202033008,** IRS declined to waive the 60-day rollover rule where a taxpayer's real estate agent suggested that the taxpayer pay cash for a home and put the funds back in his IRA upon sale of the current residence and did not mention the 60-day rule.

III. BUSINESS

P.L. 116-127, **The Families First Coronavirus Response Act**, creates a 100 percent tax credit against the employer portion of social security tax when employers of less than 500 employees provide paid leave from April 1, 2020 under the Act due to quarantine, seeking medical diagnosis or care for another; the cap is generally 100 percent of pay up to $511 per day for ten days but is two-thirds of pay up to a $200 payment per day for ten days for care of another but up to 60 days if the care is because of school or day care closing due to the virus (a credit against income tax is available to those self-employed).

P.L. 116-136, the Coronavirus Aid, Relief and Economic Security (CARES) Act:

- Provides a refundable employment tax credit for 50 percent of the first $10,000 of wages (including health insurance) per employee paid or incurred from March 13, 2020 for any quarter through yearend for employers fully or partially shut down by a governmental authority due to the virus or whose quarterly gross receipts declined by more than 50 percent from the comparable quarter in 2019 ceasing at the start of a quarter where the 80 percent level is attained (not available to businesses utilizing the PPP loan); for business of more than 100 employees, the credit applies only when employees were not providing services due to the virus.

- Allows a deferral of payment of the employer portion of social security taxes (one-half by self-employeds) after enactment and through 2020, one-half to December 31, 2021 and the balance to December 31, 2022 (originally not available to businesses utilizing the PPP loan).
- Relaxes the business interest limitation for 2019 and 2020 by allowing a deduction up to the amount of interest income plus 50 percent of income before depreciation and amortization and by allowing 2019 income numbers to be utilized in 2020 for calculating this limitation.

- Allows net operating losses from 2018, 2019 and 2020 to be carried back five years and to fully offset income.
- Delays the applicability of the ordinary loss limitation for individuals retroactive to 2018 with a new effective date of 2021 (2027 in the case of farmers).
- Corrects an error in the 2017 Tax Cuts and Jobs Act by restoring the treatment of leasehold improvements to commercial property by landlords or tenants as 15-year property, allowing immediate write-off through bonus depreciation.

Final Regulations under Code Section 162 allow a deduction for promotional rather than charitable expense for payments to charitable organizations bearing a direct relationship to a taxpayer's business made with a reasonable expectation of financial return commensurate with the amount of the payment.

Proposed Regulations under Section 274 clarify that the 50 percent limitation on meals applies to all food and beverage purchases (including tax, tip and delivery fees), whether meals or snacks, including de minimis and convenience of the employer (except restaurants/caterers) with the following exceptions:

- Purchases for resale
- Where taxable to the recipient
- When primarily for customers (> 50 percent)
- In connection with a nondiscriminatory employee social or recreational activity

In **NCA Argyle LP v. Commissioner**, TC Memo 2020-56, the Tax Court disagreed with IRS and found that a lump sum payment in settlement of a dispute involving a joint venture dissolved as the result of litigation gave rise to capital gain as the consideration paid was for rights in the venture, the Court also noting that the parties had negotiated such in good faith and had differing tax consequences.

In **Yapp v. Commissioner**, 126 AFTR2d 2020-5494, the Ninth Circuit Court of Appeals agreed with the Tax Court that expenses incurred in developing a product line and in soliciting pre-orders prior to the official launching of products were start-up expenses and not eligible for an immediate deduction; in **Primus v. Commissioner**, TC Summary Opinion 2020-2, the Tax Court stated that revenue is not required for a business to leave the start-up phase with nondeductibility of expenses and enter the active phase.

In **Watts v. Commissioner**, TC Memo 2020-144, the Tax Court refused to allow an individual to bring in evidence of intention of the parties in a tax allocation when the language of the document was clear.

In **Emanouil v. Commissioner**, TC Memo 2020-120, the Tax Court allowed a deduction for a developer donating three parcels of land to the town where the donation was not contingent on approval of the development; the Court also found that the income tax statement, despite some missing information, was in substantial compliance such as not to disqualify the donation.

In **Pilyavsky v. Commissioner**, TC Summary Opinion 2020-20, the Tax Court found that a database engineer fabricated about $47,000 in expenses and $10,000 in income to create a Schedule C reflecting alleged self-employment; the Court allowed $3,500 in expenses but did not adjust out the $10,000 of alleged self-employment income.

In **Lothringer v. United States**, 126 AFTR2d 2020-5663, a Texas Federal District Court determined that the owner of a corporation was, in essence, its alter ego and personally liable for corporate tax debt based, among other things, on failure to observe corporate formalities including filing income tax returns and annual reports as well as paying personal expenses out of the business.

In **Santos v. Commissioner,** TC Memo 2020-88, the Tax Court found that a taxpayer's cleaning business was akin to that of a dispatcher such that workers were independent contractors in that, when a service was sought, she would see who was available and the worker would provide her own supplies and transportation with the ability to utilize others to assist.

In **Revenue Ruling 2020-27**, IRS stated that expenses expected to be reimbursed through loan forgiveness pursuant to the PPP program should not be deducted on the 2020 tax return; in Revenue Procedure 2020-51, IRS stated that, on denial of forgiveness or a withdrawal of the forgiveness application, applicable expenses can be claimed in 2020 or in the year of denial (presumably 2021);

In **Notice 2020-43**, IRS announced its intention to require partner capital accounts to reflect basis information in 2002 rather than interrelationships among the partners with penalties to apply effective in 2021.

In **Letter Ruling 202042001**, IRS ruled that the creation of a second class of stock in the Operating Agreement of an LLC electing to be taxed as an S Corporation was inadvertent and S status was not lost if the improper language was corrected.

IV. PROCEDURE

In **CIC Services, LLC v. Internal Revenue Service,** the US Supreme Court agreed to review a ruling of the Sixth Circuit Court of Appeals at 124 AFTR2d 2019-5653, which held that the Anti-Injunction Act generally precludes lawsuits attempting to restrain tax assessments or collections (it heard oral arguments on December 1, 2020).

In **Willett v. United States**, 125 AFTR2d 2020-1037, a California Federal District Court agreed with IRS that a taxpayer did not have reasonable cause for late filing and late payment when the CPA who was engaged failed to file the returns and subsequently died, the Court noting that reliance on an agent does not constitute reasonable cause; in **Hunter Maintenance & Leasing Corporation v. United States**, 125 AFTR2d 2020-1058, an Illinois Federal District Court declined to find reasonable cause for abatement of a late filing penalty when both the outside CPA and the internal CFO died of cancer and the completed returns were found on the CFO's desk.

In **United States v. De Forrest**, 125 AFTR2d 2020-2355, a Nevada Federal District Court determined that failure to file an FBAR when required and signing a Form 1040 under penalty of perjury without declaring a foreign bank account is insufficient in and of itself to show willful failure to file FBAR reports.

In **Thompson v. Commissioner**, 155 TC No. 5, the Tax Court determined that supervisory approval is not required of discretionary penalties when a resolution is reached at the agent level inasmuch as the examination is not considered complete; a revision to **Internal Revenue Manual 20.1.1** sets forth guidance requiring supervisory approval of nonautomatic penalties prior to issuing any written communication to a taxpayer where the taxpayer is given an opportunity to consent to the assessment.

In **Porporato v. Commissioner**, TC Summary Opinion 2020-24, the Tax Court stated that, where a taxpayer's refund from an overpayment is barred due to the statute of limitations, any offset of another year is also barred.

In **Organic Cannabis Foundation LLC v. Commissioner,** 125 AFTR2d 2020-2497, the Ninth Circuit Court of Appeals agreed with the Tax Court that two petitions were filed late inasmuch as they were sent on the next to last day by "FedEx First Overnight" which at the time was not an acceptable method of delivery (although it was added two weeks later) despite being akin to other FedEx options; it would have been delivered on the last day for filing but FedEx noted that the building was inaccessible at the time of delivery due to a "safety threat" and no subsequent attempt was made until delivery one day too late at 7:30 a.m.

In **Melasky v. Commissioner**, 125 AFTR2d 2020-746, the Fifth Circuit Court of Appeals agreed with the Tax Court that IRS could apply funds from a seized bank account as it wished notwithstanding that the taxpayer had delivered a check on the account four days before the seizure; the check was not immediately presented for payment by IRS and was dishonored due to the lack of funds resulting from seizure.

In **Amanda Iris Gluck Irrevocable Trust v. Commissioner**, 154 TC No. 11, the Tax Court ruled that a taxpayer should have been allowed to raise substantive issues at a CDP hearing inasmuch as a computational adjustment was made to the return and, as such, there was not prior opportunity to raise substantive issues.

In **Dodson v. Commissioner**, TC Memo 2020-106, the Tax Court agreed that IRS did not abuse its discretion in denying an installment agreement where a couple had sufficient equity in their primary residence against which they could borrow to pay the liability in full; in **Strashny v. Commissioner**, TC Memo 2020-82, the Tax Court determined that IRS properly rejected a taxpayer's CDP appeal where they had significant investment assets that could be liquidated to pay the tax liability.

In **News Release 2020-248**, IRS expanded consideration of when a balance is temporarily uncollectible and will permit installment agreements without financial statements and substantiation and (for 2019 liabilities only) without the filing of a lien for more balances of up to $250,000 if the monthly payment proposal is sufficient; the short term ability to delay payment was increased from 120 day to 180 days.

READING MARITAL SETTLEMENT AGREEMENTS THROUGH THE EYES OF A FINANCIAL PROFESSIONAL

Kathryn E. Deckert & Eric J. Rollinger

TOPICS:

1. What is a Marital Settlement Agreement and/or Divorce Decree
2. Alimony
3. Ambiguous Definitions (i.e. Income)
4. Sales of Marital Home
5. Child Related Tax Benefits
6. Splitting Estimated Payments, Tax Refund Overpayment Applied to Next Year, PALs, Capital Loss Carry-Forwards, NOLs, and Deductions
7. Innocent Spouse Relief

WHAT IS A MARITAL SETTLEMENT AGREEMENT AND/OR DIVORCE DECREE

A <u>Marital Settlement</u> per Black's Law Dictionary is "a written agreement with details of property settlement in case there is a divorce"

A <u>Decree of Divorce</u> per Black's Law Dictionary is "the term that is given to the judgement that is issued by a court and grants a divorce."

Practice Pointer: In Maryland most Marital Settlement Agreements are incorporated but not merged into the final Decree of Divorce.

ALIMONY

Under the TCJA Alimony is now nondeductible to the payor and tax-free to the recipient for:

(1) any divorce or separation instrument executed after 12/31/2018; and

(2) any divorce or separation instrument modified after 12/31/18 that expressly provides that the new law should apply.

See P.L. 115-97 Sec. 11051(c).

ALIMONY

Meaning of "divorce or separation instrument" under IRC § 71(b)(2):

a) "a decree of divorce or separate maintenance or a written instrument incident to such a decree,
b) a written separation agreement, or
c) a decree requiring a spouse to make payments for the support or maintenance of the other spouse."

ALIMONY: MODIFICATIONS & AMENDMENTS

Q: Do divorce or separation instruments modified after 12.31.18 still qualify under old rule to allow deductions for alimony paid?

A: YES

- P.L. 115-97 Sec. 11051(c) states that "The amendments made by this section [disallowing alimony deductions] shall apply to-
  - (1) any divorce or separation instrument executed after December 31, 2018, and
  - (2) any divorce or separation instrument (as so defined) executed on or before such date and modified after such date if the modification expressly provides that the amendments made by this section apply to such modification."

ALIMONY: TO STILL QUALIFY AS DEDUCTIBLE PAYMENTS:

- Made in cash.
- Must be received by or on behalf of former spouse.
- Payments not designated as a type of payment that is not includible as gross income by the payee under IRC §71 or not deductible by the payor under IRC § 215.
- Payments not made when former couple are members of the same household (But See Benham v. CIR T.C. Memo 2000-165).
- Payments that terminate upon the death of the recipient.
- Payments not fixed as child support.
- Must be made pursuant to a divorce or separation instrument executed prior to or as of 12/31/18.

See IRC § 71(b)(2), IRC § 215, and Pub. 17, Table 18-1

ALIMONY: MSA *EXECUTED BEFORE 12.31.18* & DIVORCE DECREE *EXECUTED AFTER 12.31.18*

Q: Does a MSA executed before 12.31.18 still qualify under old rule to deduct alimony when Divorce Decree is executed after 12.31.18?

A: Hopefully Yes.

- It would seem severe for IRS to take the position that the divorce decree "trumps" the MSA and, thus, new law applies; however, a strict reading of 71(b)(2) is conceivable.
  - Example: 2018 written separation agreement calls for old law alimony payments; the parties file MFS returns for 2019 and 2020 – payor claims deductions and recipient claims alimony income; then, in 2021, they get divorced. All of a sudden, would IRS say the new law applies for 2021 and retroactively for 2019 and 2020.

AMBIGUOUS DEFINITIONS (I.E. INCOME)

MSAs often confuse the Generally Accepted Accounting Principle (GAAP) definition of "Net Income" with the tax return computations of "Net Profit," "Gross Profit," and "Income" per Return

- **Net Income** = Revenues - Costs of Doing Business (such as depreciation, interest, <u>taxes</u>, and other expenses)
  - *See* FASB ASC 6-3
  - *See* 2019 Forms 1120, 1120-S, and 1065 Sch. M-1 Line 1 for "Net income (loss) per books"
- **Net Profit** = Gross Profit + Other Income – Total Business Expenses
  - *See* 2019 Form 1040, Sch. C, Line 31
- **Gross Profit** = Gross Receipts – Returns & Allowances – COGS
  - *See* 2019 Forms 1120, 1120-S, and 1065 Page 1, Line 3; or 2019 Form 1040, Sch. C, Line 5

AMBIGUOUS DEFINITIONS (I.E. INCOME)

- **Income** per Return = Taxable Income before NOL deduction for C. Corps.
  - Taxable Income before NOL = Total Income – Total Deductions
  - *See* 2019 Form 1120 Page 1 Line 28 and Sch. M-1 Line 10
- **Income** per Return = Ordinary Business Inc. – Shareholders' Pro Rata Share Items for S. Corps.
  - Ord. Bus. Inc. = Total Income – Total Deductions
  - *See* 2019 Form 1120-S Page 1 Line 21, 2019 and Form 1120-S Sch. M-1 Line 8
- **Income** per Return = Ordinary Business Inc. – Partner's Distributive Share Items for Partnerships
  - Ord. Bus. Inc. = Total Income – Total Deductions
  - *See* 2019 Form 1065 Page 1 Line 22 and 2019 Form 1065 Sch. M-1 Line 9

AMBIGUOUS DEFINITIONS (I.E. INCOME)

"Gross Income" is defined by the IRC Sec. 61 as "all income from whatever source derived, including (but not limited to) the following items:

- Compensation for services, including fees, commissions, fringe benefits, and similar items;
- Gross income derived from business;
- Gains derived from dealings in property;
- Interest;
- Rents;
- Royalties;
- Dividends;
- Alimony and separate maintenance payments;
- Annuities;
- Income from life insurance and endowment contracts;
- Pensions;
- Income from discharge of indebtedness;
- Distributive share of partnership gross income;
- Income in respect of a decedent; and
- Income from an interest in an estate or trust." IRC § 61.

Alimony and separate maintenance payments are eliminated from the definition effective 1/1/19. *P.L. 115-97 Sec. 11051(c).*

AMBIGUOUS DEFINITIONS (I.E. INCOME)

"Actual Income" is defined by the Maryland Family Law Code as "income from any source." Md. Fam. Law Code § 12–201(b)(1).

"Actual Income" includes:

- Salaries;
- Wages;
- Commissions;
- Bonuses;
- Dividend income;
- Pension income;
- Interest income;
- Trust income;
- Annuity income;
- Social Security benefits;
- Workers' compensation benefits;
- Unemployment insurance benefits;
- Disability insurance benefits;
- For the obligor, any third party payment paid to or for a minor child as a result of the obligor's disability, retirement, or other compensable claim;
- Alimony or maintenance received; and
- Expense reimbursements or in-kind payments received by a parent in the course of: employment, self-employment, or operation of a business to the extent the reimbursements or payments reduce the parent's personal living expenses.

  \- Md. Fam. Law Code § 12–201(b)(3).

AMBIGUOUS DEFINITIONS-WHY THIS BECOMES IMPORTANT

Example:

H agrees to pay W in marital support 15% of H's income as defined by the MSA. "Income" for purposes of MSA is "all income, including wages, profits and dividends, from H's professional corporation … or any other entity for which H provides substantial medical services and any other wages, salary or other compensation for personal services"

H has the following sources of income:

- a majority ownership interest in an S Corp. that issued him a K-1 with $400K of Ordinary Business Income and $250K of Distributions;
- a minority ownership interest in a Partnership that issued him a K-1 with $1M of Ordinary Business Income, Guaranteed Payments of $350K, and Distributions of $120K; and
- $15K of Form 1099 Other Income for serving on board of directors when he did not attend any meetings.

End result:

Arguments can be made that H has "Income" as high as $2,135,000 or as low as $0 per ambiguous definition of "Income".

$0 from Wages

$0 from Profits & Div. of C Corp

$0 from Other Personal Services

$0 Total possible "Income"

$400,000 Ord. Bus. Inc. from S Corp

$250,000 Distributions from S Corp

$1,000,000 Ord. Bus. Inc. from PS

$350,000 Guar. Payments from PS

$120,000 Distributions from PS

$15,000 Other Inc. from Form 1099

$2,135,000 Total possible "Income"

SALES OF MARITAL HOME

- Hopefully, MSA will require sale of a marital home within three years of when either spouse occupied home to ensure compliance with two-out-of-five year use and ownership requirement to qualify for exclusion of gain on sale of principal residence per IRC §121(a).
- Spouse 1 treated as using property as principal residence so long as Spouse 2 is granted use of the property under a divorce or separation instrument provided that Spouse 1 or Spouse 2 uses the property as his or her principal residence (probably as a result of a use and possession order). *See* IRC §121(d)(3)(B).
- Check title to see if property is in both names, and keep property in both names, to ensure both qualify for $250,000 exclusion. IRC §121(b)(2)(A). Tres. Reg. § 1.121-2
- Tenancy by the Entirety switches to Tenants in Common at divorce

CHILD RELATED TAX BENEFITS

- **Child and Dependent Care Credit** can only be claimed by the Custodial Parent of a child
- **Earned Income Tax Credit** increased phase-out limits for qualifying children can only be claimed by the Custodial Parent
- **Head of Household Filing Status** can only be claimed by the Custodial Parent
- **Medical Expense Deduction** can only be claimed by the Parent paying the medical expenses of a qualifying child and the amount is limited to expenses exceeding certain percent of AGI
- **Child Tax Credit** can only be claimed by the Parent who can claim the child as a dependent
- The custodial parent can make a written declaration on Form 8332 to release the dependency exemption (and thereby also the Child Tax Credit) to the non-custodial parent
- **Dependency Exemption** can be claimed by the custodial parent –or- if there is a Form 8332 the non-custodial parent, but the Federal exemption is $0 for years 2018-2025

SPLITTING ESTIMATED PAYMENTS, TAX REFUND APPLIED, PALS, CAPITAL LOSS CARRY-FORWARDS, NOLS, & DEDUCTIONS

Joint Estimated Tax Payments

- Definition: Transfers made to IRS, possibly because of insufficient income withholdings, from joint funds and/or accounts
- Couples that make joint estimated tax payment(s) but nevertheless file separate returns may treat the payment(s) on account "of either husband or wife for the taxable year, or … divide between them in such manner as they may agree." Tres. Reg. § 1.6654-2(e)(5)(ii)(A)
- If no agreement can be made, the estimated tax payments for the current year must be divided in proportion to each spouse's current year's total taxes (i.e. Line 16 of 2019 Form 1040). *See* Tres. Reg. § 1.6654-2(e)(5)(ii)(B)

SPLITTING ESTIMATED PAYMENTS, TAX REFUND APPLIED, PALS, CAPITAL LOSS CARRY-FORWARDS, NOLS, & DEDUCTIONS

Tax Refund Overpayment Applied to Next Year

- Definition: Amount of tax overpaid (i.e. refund) applied to next year's estimated tax (i.e. Line 22 of 2019 Form 1040)
- In the case of a divorce and both spouses contributed to the prior year tax refund overpayment:
  - The parties can likely allocate by agreement same as estimated payments
  - If no agreement of the parties, the overpayment should be allocated in proportion to each spouses' current year total taxes (i.e. Line 16 of 2019 Form 1040). *See* IRC § 6402(a)
- Caution: if tax refund is not applied to next year then generally if must be allocated per each spouses total taxes

SPLITTING ESTIMATED PAYMENTS, TAX REFUND APPLIED, PALS, CAPITAL LOSS CARRY-FORWARDS, NOLS, & DEDUCTIONS

Passive Activity Losses (PAL)

- Definition: Losses generated from any trade or business in which the Taxpayer does not materially participate. *See* IRC §469(c)

- Suspended PALs are transferred and become part of the basis for the property

- Division of PALs upon divorce are decided upon in accordance with the property distribution section of the marital settlement agreement

SPLITTING ESTIMATED PAYMENTS, TAX REFUND APPLIED, PALS, CAPITAL LOSS CARRY-FORWARDS, NOLS, & DEDUCTIONS

Capital Loss Carryforwards

- Definition: A loss from the sale or exchange of capital assets not fully deducted in the loss year, which is carried over. *See* IRC § 1212
- The CSA in Baker held that "a capital-loss carry-forward, when generated by a capital loss from the sale of marital property, is itself marital property, which the spouses can agree to allocate as they wish at the time of a divorce." *Baker v. Baker* 221 Md. App. 399 (2015)
- Treas. Reg. § 1.1212-1(c) states "any capital loss carryover from such preceding taxable year shall be allocated to the spouses on the basis of their individual net capital loss which gave rise to such capital loss carryover."

SPLITTING ESTIMATED PAYMENTS, TAX REFUND APPLIED, PALS, CAPITAL LOSS CARRY-FORWARDS, NOLS, & DEDUCTIONS

Net Operating Losses (NOLs)

- Definition: The excess of deductions over gross income. See IRC 172(c)
- The former spouses must compute their income and deductions for the prior years separately to determine their portion of NOLs. See Treas. Reg. § 1.172-7 (d)
- The splitting of NOLs cannot be achieved through agreement
  - The former spouses should split the NOLs based on the proportions of NOLs they would have had if they filed separate returns

SPLITTING ESTIMATED PAYMENTS, TAX REFUND APPLIED, PALS, CAPITAL LOSS CARRY-FORWARDS, NOLS, & DEDUCTIONS

Deductions for Charitable Contributions

- Taxpayers may deduct up to 60 percent of their adjusted gross income (AGI) for cash contributions and 50 percent for non-cash contributions to public charities (30 percent for private foundations). See IRC § 170 (b)
- Charitable contribution carryovers from MFJ returns must be split based on the percentage of each spouse as if MFS tax returns had been filed. See Treas. Regs. § 1.170A-10 (d)(4)
- The splitting of contributions cannot be achieved through agreement. See Rev. Rul. 76-267, 1976-2 C.B. 71

INNOCENT SPOUSE RELIEF

- Joint Return must be filed. IRC §6015, *et. Seq.*
- Relief is found under IRC 6015 (b), (c) and (f)
- Must be requested within two years of final collection action, i.e. Final Notice of Intent to Levy if requesting relief under IRC Sec. 6015(b) or (c)
- From 1998-2001 IRS granted Innocent Spouse relief only 27 percent of the time

INNOCENT SPOUSE RELIEF

§6015(b)

- Only available if did not know and had no reason to know and Inequitable to hold liable

INNOCENT SPOUSE RELIEF

<u>§6015(c)</u>

- Most preferred because IRS must show requesting spouse had actual knowledge of understatement
- Must be divorced at time of request OR not members of same household for last 12 months
- No actual knowledge of the FACTS creating a deficiency unless return signed under duress (in which case alternative position is there was no joint return) or 6015(f)
- Innocent spouse status under this section permits determination of each spouse's deficiency as if separate returns were filed
- Deficiency allocated to a spouse is increased by amount of tax-avoidance transfers
- Deficiency related to child's income is allocated jointly to both parents – but not to a stepparent

INNOCENT SPOUSE RELIEF

§6015(f)

- Can be requested at anytime
- Available for both understatements and under payments
- To be eligible under (f) cannot be eligible under (b) or (c)
- Liability must be attributable to other spouse
- Must be inequitable to hold requesting spouse liable

INNOCENT SPOUSE RELIEF

§6015(f)

- Looks at Seven Equitable Factors:
  - Abuse
  - Divorce / Separation
  - Economic Hardship
  - No legal obligation
  - Subsequent years compliance
  - Poor health
  - Receipt of direct or indirect benefit

TAXATION OF DAMAGES

David S. De Jong & Mark W. Schweighofer

TAXABILITY – IN GENERAL

When an individual or business receives a settlement or award constituting damages, it may constitute ordinary income, capital gain or a return of capital.

- Our objective #1 is to be able to recognize the situations which give rise to each.

DEDUCTIBILITY OF RELATED EXPENSES – IN GENERAL

The expenses incurred in receiving a damages settlement or award may constitute an offset to the amount of damages depending on the taxability of the damages and the nature of the claim.

- Our objective #2 is to be able to determine whether the amount of gross damages can be offset by expenses.

PHYSICAL INJURY – IN GENERAL

Code section 104(a)(2) excludes compensatory damages received on account of personal physical injury or sickness whether by suit or agreement.

- Punitive damages are specifically taxable per 104(a)(2).
- Regulation 1.104(c)(1) specifically taxes workers' compensation.
- SSDI benefits have also been found taxable. <u>Pailsgaard v. Commissioner</u>, TC Memo 2018-82.

PHYSICAL INJURY – SOURCE OF THE CLAIM

If the "source of the claim" is physical injury, all damages, except punitive damages, flowing from the claim including lost wages and subsequent emotional injury, are tax free.

- Third party payments arising out of physical injury such as to a spouse for loss of consortium or to the estate in the event of death are tax-free.

EMOTIONAL INJURY

If the "source of the claim" is emotional injury, all damages are taxable except to the extent payments were made for medical care. Regulation 1.104-1(c)(1).

- It is often difficult to determine whether the source of the claim was physical or emotional as either may cause the other to worsen. A case sampling follows.

PHYSICAL VS. EMOTIONAL SOURCE OF THE CLAIM

In Moulton v. Commissioner, TC Memo 2009-38, the Tax Court determined that sleep disorder and elevated blood sugar resulted from wrongful termination, the latter being the source of the claim.

In Doyle v. Commissioner, TC Memo 2019-8, the Tax Court found that neck, shoulder and back pain as well as headaches, digestion issues and lack of concentration followed wrongful termination which was the source of the claim.

PHYSICAL VS. EMOTIONAL SOURCE OF THE CLAIM (CTD.)

However, in Letter Ruling 201950004, IRS found that payments to a mother for emotional distress arising from a child's birth defects were tax free as the source of the claim was the child's injuries.

Prior to the Wrongful Convictions Tax Relief Act of 2015, which made awards tax free in the case of wrongful conviction, courts were forced to determine whether the former "convict" had been the victim of physical injury and the purpose of the payments to him or her.

PHYSICAL VS. EMOTIONAL SOURCE OF THE CLAIM (CTD.)

In Beckett v. Commissioner, TC Summary Opinion 2020-19, the Tax Court seemed to ignore an employer's failure to make a reasonable accommodation for an employee's epilepsy as the source of the claim and found one-third of the award to be nontaxable based on the three purposes for which the employer made payment.

DISCRIMINATION AND HARASSMENT

Prior to the Small Business Job Protection Act of 1996, Section 104(a)(2) excluded damages received on account of personal injury or sickness. There were conflicting cases regarding whether payments for discrimination based on race, sex and age or disability and for sexual harassment were on account of personal injury. The word "physical" was added which made earlier cases moot. It excluded emotional issues from physical injury. It is interesting to note that the Committee Report shows the provision as a "revenue offset."

INTEREST ON DAMAGE SETTLEMENT AND AWARDS

Both prejudgment and postjudgment interest on settlements and damage awards are taxable. In Brabson v. United States, 77 AFTR2d 96-572, the Tenth Circuit Court of Appeals reversed a Colorado Federal District Court and, despite a state law making prejudgment interest as part of the damage award, found that it was taxable. The First Circuit Court of Appeals reached a similar result in Delaney v. Commissioner, 78 AFTR2d 96-6968 affirming the Tax Court.

STRUCTURED SETTLEMENTS

Structured settlements build in a time value factor but, absent a statutory interest provision under state law, the time value component in such a settlement of physical injuries allows more dollars to go untaxed. In Revenue Ruling 79-313, IRS found a payment schedule over 50 years with a 5 percent annual increase to be entirely tax free.

DAMAGES FOR LOST INCOME/PROFITS

Damages for breach of an employment agreement and for lost profits are taxable as ordinary income. Even if based on contractual rights, courts will find that wrongful termination claims give rise to ordinary income as opposed to capital gain notwithstanding the potential surrender of contract rights. See, e.g., Elliott v. Commissioner, TC Memo 1987-333.

- Examples of lost profits include termination fees, defamation, breach of covenants, breach of an agreement to buy property (even if a capital asset) interference with a licensing arrangement, and breach of duty by an insurance company to defend on a claim.

DAMAGES FOR INJURY TO CAPITAL

If the images are for injury to capital, recovery in excess of basis gives rise to capital gain. In some cases, such as when a damaged asset will be retained, recognition of gain can be avoided through a reduction in basis. A loss when there is injury to capital may be ordinary, capital or nondeductible depending on the asset's character – business, investment or personal. Where there is an injury to capital, the fact that there are lost profits in such a situation does not change the character.

INJURY TO CAPITAL - EXAMPLES

- Failure to deliver promised product
- Failure of an insurance company to settle a claim
- Injury to goodwill
- Interference with purchase of assets
- Injury to land by a strip miner
- Failure to clean up or repair
- Stock sale as the result of fraud
- Construction defects

TAX RELATED TAX ISSUES – IN THEORY

Subtle distinctions often affect tax consequences of receipt of damages. Consider the following:

- Recovery for malpractice in tax preparation is generally recovery of capital and nontaxable

- Recovery for malpractice in tax planning is generally ordinary income

TAX RELATED TAX ISSUES – IN PRACTICE

- In McKenny v. United States, 126 AFTR2d 2020-5943, the Eleventh Circuit Court of Appeals reversed a Florida Federal District Court and found a settlement payment from a CPA firm for bad tax advice to be taxable.
- However, in Consentino v. Commissioner, TC Memo 2014-186, accountants recommended a tax avoidance scheme which was reflected in a tax return. The settlement of $375,000 was a portion of the claim for $640,750 including $82,820 of cash out of pocket with the balance representing lost opportunity to use Section 1031 as a legitimate alternative. The Tax Court found that the recovery was tax free. IRS noted its nonacquiescence in Action on Decision 2016-01, alleging that the lost opportunity was speculative.

ALLOCATION OF DAMAGES

When an agreement allocates between parties, it will normally be respected when arms length and in good faith. However, in the case of damages, payment by the payor is often deductible irrespective of taxability to the recipient. Accordingly, courts will seek to determine the payor's intent in making payment. This is true both in the context of determining the extent of the exclusion for physical injury and the exclusion for restoration of capital.

SPECIFIC FACTORS IN DETERMINATION OF PAYOR'S INTENT

- Allegations contained in the Complaint
- Amendments to the Complaint
- Arguments made by each party
- Allocation in award (if settlement occurs following a decision).

See, e.g., Robinson v. Commissioner, 102 TC 116 (1994), aff'd on that issue, 76 AFTR2d 95-7786 (5^{th} Cir).

EXPENSES INCURRED IN RECOVERING BUSINESS-RELATED DAMAGES

Those who recover damages in a business context will typically be able to deduct the offsetting costs as an ordinary and necessary business expense. In a capital context, the costs of recovery will net with the amount of damages and cut the required reduction in basis or decrease the gain recognized.

EXPENSES INCURRED IN RECOVERING PERSONAL DAMAGES – IN GENERAL

To the extent a personal recovery is free of taxes, the expenses will be nondeductible, and in a capital context the expenses will also net with the recovery. However, the handling of legal fees and other costs where taxable damages are recovered has posed an historic enigma.

EXPENSES INCURRED IN RECOVERING PERSONAL TAXABLE DAMAGES – HISTORICAL CONTEXT

While taxable damages are reported on Form 1040 as "other income", reporting the offsetting expenses as miscellaneous itemized deductions because they were incurred in the production of income had multiple disadvantages in an historical context:

- 2 percent floor on deductibility
- Increase in adjusted gross income through lack of netting causing numerous phaseouts
- Expenses not deductible to offset alternative minimum tax

ATTEMPTED NETTING OF EXPENSES WITH INCOME IN RECOVERING PERSONAL TAXABLE DAMAGES

Taxpayers have historically attempted without success to net expenses with gross recoveries in the personal context. See, e.g., Bonci-Woodward v. Commissioner, TC Memo 1998-335. The US Supreme Court ruled in Commissioner v. Banks, 95 AFTR2d 2005-659 that, even when the individual received a net check from counsel, he was in constructive receipt of the amounts withheld for expenses.

AMERICAN JOBS CREATION ACT

The American Jobs Creation Act in 2004 included Code section 62(a)(20), an above-the-line deduction for legal fees and court costs incurred in connection with discrimination awards.

- Often in non-contingency cases, legal fees and costs are incurred in years prior to the resolution; they should be capitalized and deducted in the year of recovery.

TAX CUTS AND JOBS ACT – IN GENERAL

The Tax Cuts and Jobs Act in 2017 eliminated miscellaneous itemized deductions for the years 2018-2025. As a result, taxable recoveries of personal damages will net an undesirable result.

- Expect courts to revisit the netting issue in light of TCJA, perhaps on the grounds that the accretion to wealth is limited to a net amount.

TAX CUTS AND JOBS ACT – HYPOTHETICAL FACTS

Joe, in a 37 percent federal tax bracket and 9 percent state bracket, was harassed by his next-door neighbor who used social media to reveal personal information and to defame him. He was awarded $500,000 by a jury for invasion of privacy and intentional infliction of emotional distress. As the case had gone to trial, his attorney received 40 percent. Costs were an additional $30,000.

TAX CUST AND JOBS ACT – HYPOTHETICAL RESULT

Gross award	**$ 500,000**
less 40% attorney fees	(200,000)
less costs	(30,000)
less taxes on gross award	(230,000)
Net retention	**$ 40,000**

PRORATIONS IN DAMAGE SETTLEMENT AND AWARDS

- If a portion of a damage award is taxable and a portion is not, attorney fees and costs must be prorated between the taxable and tax-free portions.

- To the extent an employment related claim constitutes back wages, that portion should be reflected on a Form W-2 and the balance should be shown on Form 1099.