IN CASE YOU MISSED IT – JULY 2020
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Almost every day, federal and state courts issue opinions that affect taxpayers. And the IRS and state taxing authorities often publish guidance on a myriad of topics.

So, each month, this column will review a selection of recent court cases or guidance that tax professionals should know about when advising their clients and preparing tax returns.

For more extensive detail on any of these items, please feel free to reach out to the author.

Adkins v. U.S.
Standards for claiming a theft loss

Adkins v U.S. involved the proper timing for reporting and claiming a theft loss deduction. IRC section 165 provides that "any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss."

This general rule is limited by Treasury Regulations section 165-1(d)(3), which provides that "if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained…until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received."

In *Adkins,* the taxpayers were victims of a pump-and-dump fraudulent investment scheme. They claimed a theft loss deduction, which they then carried back to generate refunds for earlier years. Although the IRS had initially approved the theft loss deduction and related refund claims, the taxpayers were forced to file suit seeking a refund when the IRS couldn't formalize the parties' settlement before the statute of limitations on the refund requests expired.

This case had a long procedural history, having been tried, vacated, remanded, and then appealed again. In this most recent decision, the Court of Appeals for the Federal Circuit found for the taxpayers.

The basic issues in dispute were the meaning of the terms "reasonable prospect of recovery" and "ascertained with reasonable certainty." The Claims Court had held that if a reasonable prospect of recovery was "unknowable" in the year in which the theft loss was claimed, the taxpayer can never bear the burden of establishing that there was no reasonable prospect of recovery in that tax year. The Claims Court further held that for taxpayers to prove this, they must affirmatively establish that there was no reasonable probability of recovering any amount of loss under any avenue of recovery and for any possible potential recovery.

The Court of Appeals reversed this decision, however, holding that the Claims Court misconstrued the statute and regulations. The Court of Appeals noting that the law does "not require affirmative proof that a taxpayer's loss will never be recovered. The regulation is clear: a taxpayer must only demonstrate that he had no reasonable prospect of recovery at the time."

The Court further held that while taxpayers can't simply ignore meaningful avenues of potential recovery, they have no obligation to waste resources and time pursuing options with a low likelihood of success. This standard was first set out by the Supreme Court in 1927 in *United States v. S.S. White Dental Manufacturing Co.*: "[t]he Taxing Act does not require the taxpayer to be an incorrigible optimist."

Takeaway: when determining if your client is entitled to a theft loss in any given year, look at the reasonable prospects of recovery.

Kirkley v. Commissioner

Sometimes it's worth the fight to get an installment agreement

The taxpayers in *Kirkley v. Commissioner* attempted to enter into an installment agreement to satisfy their outstanding tax liabilities. The revenue officer evaluating their proposal rejected the it on the grounds that they had not sold their principal residence. The court held that this rejection was an abuse of discretion.

As opposed to the IRS's arguments to the contrary, the Internal Revenue Manual (IRM) does in fact provide discretion to revenue officers to accept an installment agreement without requiring the taxpayer to first sell all of their property. The court cited IRM 5.14.1.4(5), which states in part that the revenue officer should "explore the possibility of liquidating or borrowing against…assets" when considering an installment agreement "unless…the asset is necessary for the production of income or the health and welfare of the family."

The taxpayers' proposed installment agreement noted that they were attempting to borrow against the equity in their home to pay the proposed installments. Rather than simply accepting this fact, the IRS required them to submit copies of the loan documents and, if the loans were not obtained, to sell their residence before the installment agreement would be accepted.

The taxpayers argued that they should be allowed to enter into the agreement without first having to sell their home. They brought suit over the rejection of their proposed agreement, and the court agreed that the revenue officer had abused the discretion granted to the IRS. The court remanded the case back to Appeals for reconsideration.

Takeaway: Revenue officers often reject installment agreements and offers in compromise for numerous reasons. It's important to read the IRM closely to see if the pretext for the denial is justified.

Honigman Miller Schwartz & Cohn, LLP v. City of Detroit
Sourcing of services for income tax purposes

Honigman Miller Schwartz & Cohn, LLP v. City of Detroit addressed the issue of when the performance of services is subject to taxation in Detroit, Michigan. The city statute subjects unincorporated businesses to taxation on services that are "rendered" in the city. The law firm argued that payment for services performed by attorneys working in Detroit on behalf of clients located outside the city should be considered out-of-city revenue, focusing on where the service was delivered to the client, not where the attorney performed the service.

The city argued conversely that the relevant focus was where the work was performed, not where the client received the service. The Michigan Supreme Court held that in calculating the gross revenue attributable to services rendered in the city, the focus was properly on where the services were performed, and not where they were delivered; thus, the Court held against the taxpayer, reversing the lower court decision.

Note that this rule is different from the market-based sourcing rules adopted under Michigan Business Tax Act (MBTA), 2007 PA 36, for multi-state corporate taxes. Under this law, the location of the customer governs the taxability of the services.

Similar to Michigan, in 2015, New York switched the apportionment factor for business taxes applicable to services from place-of-performance sourcing to a market-based, customer-location sourcing methodology. Under this methodology, the sourcing analysis focuses on where the customers are located, instead of where employees perform their jobs.

This determination is done annually and can change from year to year, based on the corporation's client base. In determining whether the customer is in the state, the corporation looks to whether the benefit of the services is received in the state, and then to the delivery destination of the services.

On a tangentially related topic, the Alabama Tax Tribunal held in the taxpayer's favor, ruling that payments to an affiliate for employee services aren't included in calculating the payroll factor of the income apportionment formula actor, since they aren't payments made directly to employees. The taxpayer was correct in its use of a zero payroll factor, as it had no direct employees. (Complete Payment Recovery Services v. Department of Revenue)

Takeaway: This a reminder to practitioners to pay careful attention to the details of each state's tax laws. Not only do significant differences exist between states, but also between the tax rules that govern corporations and unincorporated entities.

Office of Chief Counsel Memorandum 202023006
Refund Period of Limitations for Overpayment Attributable to Net Operating Losses (NOL)

In Office of Chief Counsel Memorandum 202023006, the IRS addressed whether a refund claim was timely in a situation where a taxpayer used a net operating loss (NOL) carryback, which in turn generated a minimum tax credit in the carryback year that was then carried forward to a third year, resulting in an overpayment in that third year. The issue was whether the special limitations period for claiming a refund of overpayments attributable to NOL carrybacks applied to the overpayment created in that third year.

IRC section 6511(d)(2) provides a special period of limitation with respect to NOL carrybacks. It states that if a refund claim relates to an overpayment attributable to an NOL carryback, in lieu of the general three-year period of limitation, the period shall be that which ends three years after the time prescribed for filing the return for the taxable year of the NOL that results in such carryback.

Neither the code nor the regulations promulgated thereunder define the term "attributable to." Generally, case law interprets the phrase to include the entire chain of causation resulting in the overpayment. The legislative history of this IRC section also demonstrates that Congress intended the term to incorporate any overpayment caused by the NOL carryback if it triggers a chain reaction involving other tax attributes and carry forwards.

Thus, the IRS ruled that because the taxpayer's overpayment in the third year could be traced through a chain of causation to the later-year NOL carryback, the overpayment is attributable to the NOL for purposes of IRC section 6511(d)(2), and the taxpayer's refund is deemed timely under the special period of limitations.

Takeaway: when preparing a client's refund claim, remember to focus on all of the changing tax attributes that can affect other years, as those cascading changes may be deemed timely refund claims as well.

IRS Chief Counsel Advice 202019002
Payments made on rejected OIC could not be refunded

IRC section 6402(a) provides the IRS with the authority to credit the amount of any overpayment, including interest allowed thereon, against any tax liability of the taxpayer who made the overpayment. It's long settled that an overpayment is "a payment that exceeds the amount due." (See IRC section 6401 and *Jones v. Liberty Glass Co.*)

The issue raised in IRS Chief Counsel Advice (CCA) 202019002 was whether there was any "legal or statutory prohibition against issuing a refund to a taxpayer where, due to IRS's mistake, the taxpayer made payments on an OIC that had been rejected?" The Chief Counsel advised that no refund should be issued.

While IRC section 6402(a) states that the IRS "may" credit the overpayment, the CCA noted that in this scenario, the IRS is prohibited from refunding the taxpayer's OIC payments because there was no “overpayment” of the taxpayer’s tax liability. The taxpayer made payments pursuant to an OIC that were applied to his outstanding tax liability. The subsequent rejection of the OIC didn’t change the character of those payments into deposits that could be refunded; they remained payments of tax owed.

Any administrative errors made by the IRS in processing the OIC didn’t change the character of the remittances into anything other than the payment of taxes. Thus, since an outstanding tax liability remained, there was no overpayment—and the IRS couldn’t refund to the taxpayer any of his OIC remittances.

Takeaway: remind clients if they apply for an OIC that any payments they make while they’re awaiting final approval will not be refundable if the OIC is eventually rejected.

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