Chapter 14: Rulings and Cases

EXPLANATION OF CONTENTS

Please Note. This chapter is a collection of selected cases, Revenue Rulings, Revenue Procedures, Treasury Regulations, Announcements, and Letter Rulings issued during the past year, through approximately September 1, 2010. They appear in a condensed version, and are not to be relied on as a substitute for the full documents. A full citation appears for each item. This is not a comprehensive coverage of all tax law changes or explanations. It reports the rulings and cases that are likely to be of interest to most tax professionals.

Following is a discussion of the significance (weight) given to the different sources:

Substantial Authority

If there is substantial authority for a position taken on a tax return, neither the taxpayer nor the tax preparer will be subject to the penalty for underreporting income even if the IRS successfully challenges the position taken on the return. By contrast, if there is not substantial authority for a position taken on a tax return, the underreporting penalties may be imposed unless the position has been adequately disclosed and there is a reasonable basis for the position.

Evaluation of Authorities. There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.

- All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists.
- The weight of authorities is determined in light of the pertinent facts and circumstances. There may be substantial authority for more than one position with respect to the same item.
- Because the substantial authority standard is an objective one, the **taxpayer's belief** that there is substantial authority for the tax treatment of an item **is not relevant** in determining whether there is substantial authority for that treatment.

Nature of Analysis. The weight accorded an authority depends on its relevance, persuasiveness, and the type of document providing the authority. For example, a case or Revenue Ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted, such as a Private Letter Ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions. The type of document also must be considered. For example, a Revenue Ruling is accorded greater weight than a Private Letter Ruling addressing the same issue. Private rulings, technical advice memoranda, general counsel memoranda, Revenue Procedures and/or actions on decisions issued prior to the Internal Revenue Code of 1986, generally must be accorded less weight than more recent ones. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

The following are considered authority for purposes of determining whether there is substantial authority for the tax treatment of an item, in descending order of authority:

- Applicable provisions of the Internal Revenue Code (IRC) and other statutory provisions
- Temporary and final regulations construing such statutes

> **Note.** Proposed regulations present a tentative IRS position which may be changed when temporary and/or final regulations are issued.

- Revenue Rulings
- Revenue Procedures
- Tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties
- Federal court cases interpreting such statutes
- Congressional intent as reflected in committee reports
- Joint explanatory statements of managers included in congressional conference committee reports, and floor statements made prior to enactment by one of a bill's managers
- General explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book)
- Letter Rulings and technical advice memoranda issued after October 31, 1976
- Actions on decisions and general counsel memoranda issued after March 12, 1981
- IRS information or press releases, and notices, announcements, and other administrative pronouncements published by the Service in the Internal Revenue Bulletin

Internal Revenue Code. The provisions of the IRC are binding in all courts except when the provisions violate the United States Constitution.

Treasury Regulations (Income Tax Regulations). The regulations are the Treasury Department's official interpretation and explanation of the Internal Revenue Code (IRC). Regulations have the force and effect of law unless they are in conflict with the statute they explain.

Revenue Rulings. The IRS is bound by the position taken in Revenue Rulings. Revenue Rulings that interpret Treasury Regulations are entitled to substantial deference.

Letter Rulings and Technical Advice Memoranda (TAM). These are IRS rulings directed at a particular taxpayer. Private Letter Rulings are issued for a fee. The IRS is only bound to the ruling for the particular taxpayer that requested the ruling. TAM's are issued in response to a request for a legal opinion.

Chief Counsel Advice (CCA). These are IRS rulings issued to the IRS field operations by the Office of Chief Counsel. They may be directed to a particular taxpayer or to a particular issue. Included in this category are various legal memoranda (e.g., Internal Legal Memoranda **(ILM)** and Litigation Guideline Memoranda **(LGM)**).

General Council Memoranda (GCM). These detail the legal reasoning behind the issuance of a Revenue Ruling.

Service Center Advice (SCA). These SCAs are issued by the IRS in response to a question coming from an IRS Service Center. There are two types of SCAs: routine and significant. A Routine SCA is answered by district counsel and is not coordinated with the National Office. A Routine SCA is not issued to the public. A Significant SCA (SSCA), on the other hand, is only issued with the approval of the National Office. An SSCA is not legal advice and only addresses the interpretation or application of the internal revenue laws. SSCAs are made public, but any information identifying the taxpayer is deleted.

Tax Court Summary Opinions. Cases decided under the Small Case Procedures cannot be appealed by either the taxpayer or the IRS. Without the appeals process, incorrect legal interpretations by the Tax Court cannot be challenged. Therefore, the Tax Court's decision is only binding on that particular case. However, reviewing the cases can still be useful since they explain the IRS's arguments, the taxpayer's arguments, and the Tax Court's reasoning.

JUDICIAL SYSTEM FOR TAX DISPUTES

The taxpayer in a dispute with the IRS has two choices after he or she receives the statutory notice or notice of final determination ("90 day letter"):

- File a petition in the Tax Court without paying the tax.
- Pay the tax and file a claim of refund. If the IRS rejects the claim of refund, the taxpayer can file a suit in the Federal District Court or the Claims Court.

The U.S. Tax Court is a federal court of record established by Congress under Article I of the Constitution in 1942. It replaced the Board of Tax Appeals. Congress created the Tax Court to provide a judicial forum in which affected persons could dispute tax deficiencies determined by the Commissioner of Internal Revenue prior to the payment of the disputed amounts. The Tax Court is located at 400 Second Street, N.W., Washington, D.C. 20217. Although the court is physically located in Washington, the judges travel nationwide to conduct trial in various designated cities.

The Tax Court is composed of 19 judges acting as "circuit riders." This is the only forum in which a taxpayer can contest a tax liability without first paying the tax. However, jury trials are not available in this forum. More than 90% of all disputes concerning taxes are litigated in the Tax Court.

The jurisdiction of the Tax Court was greatly expanded by the Revenue Reconciliation Act of 1998 (RRA '98). The jurisdiction of the Tax Court includes the authority to hear tax disputes concerning notices of deficiency, notices of transferee liability, certain types of declaratory judgment, readjustment and adjustment of partnership items, review of the failure to abate interest, administrative costs, worker classification, relief from joint and several liability on a joint return, and review of certain collection actions. Furthermore, this court also has limited jurisdiction under IRC §7428 to hear an appeal from an organization that is threatened with the loss of its tax-exempt status. Under IRC §7478, the Tax Court can also issue a declaratory judgment for a state or local government that has failed to get a tax exemption for a bond issue.

The IRS issues a statutory notice of deficiency in tax disputes in which the Service has determined a deficiency. In cases in which a deficiency is not at issue, the IRS will issue a notice of final determination. A notice of final determination will be issued in the following types of tax disputes:

- Employee vs. Independent Contractor Treatment
- Innocent Spouse Claim Determinations
- Collection Due Process Cases

Both the statutory notice and the notice of final determination will reflect the date by which a petition must be filed with the Tax Court. **The 90-day date cannot be extended by the IRS.** If a Tax Court petition cannot be filed by the 90-day date, the taxpayer may write the Tax Court and request the correct forms to file a Tax Court petition. (The forms may also be obtained at the Tax Court website at **www.ustaxcourt.gov**). If the letter is postmarked by the 90-day date, the Tax Court will treat the letter as an imperfect petition and allow the taxpayer an additional period of time to perfect the petition and pay the filing fee. If a taxpayer cannot pay the $60 filing fee at the time the petition is filed, he or she should request a waiver of the filing fee. The Tax Court may or may not grant a waiver of the filing fee, but will generally grant an extension for the taxpayer to pay the filing fee.

Taxpayers may represent themselves in Tax Court. Taxpayers may be represented by practitioners admitted to the bar of the Tax Court. In certain tax disputes involving $50,000 or less, taxpayers may elect to have their case conducted under the Court's simplified small tax case procedure. Trials in small tax cases generally are less formal and result in a speedier disposition. However, decisions entered pursuant to small tax case procedures are not appealable and cannot be cited as precedent. The Small Claims Division has simplified petition and procedure rules which allow the taxpayer to present his or her own case. However, the IRS can remove the case to the regular docket if the case involves an important policy question.

Effective June 1, 2004, the United States Tax Court has a court room available which contains a variety of electronic technology equipment. This courtroom can be used to conduct Court proceedings. Guidelines for use can be found at **www.ustaxcourt.gov.** The courtroom is available for **parties that jointly request** that proceedings be conducted in the room and the Court grants requests by written order. Requests can be made by a written "Joint Motion to Calendar in the electronic (North) Courtroom" or can be orally requested through the judicial officer having jurisdiction. Prior to using the Court's equipment, users must be trained by the Tax Court personnel and must complete a Technology Equipment Request Form. Courtroom hours are 8:00 a.m. to 4:30 p.m. Eastern Time, Monday through Friday, excluding legal holidays in the District of Columbia.

Cases are scheduled for trial as soon as possible (on a first-in, first-out basis) after the case becomes at issue, when the parties come to a point in the pleadings which is affirmed on one side and denied on the other. When a case is scheduled, the parties are notified by the court of the date, time, and place of trial. The vast majority of Tax Court cases are settled by mutual agreement of the parties without the necessity of a trial.

However, if a trial is conducted, in due course a report is ordinarily issued by the presiding judge setting forth findings of fact and an opinion. The case is then closed in accordance with the judge's opinion by entry of a decision stating the amount of the deficiency or overpayment, if any.

The Chief Judge of the Tax Court decides which opinions will be published. The Chief Judge can also order a review by the full court of any decision within 30 days. Published decisions are reported in the *Reports of the Tax Court of the United States.* Unpublished opinions are reported as Memorandum Decisions by tax service publishers. Both the published and unpublished opinions may be found on the United States Tax Court website at **www.ustaxcourt.gov.**

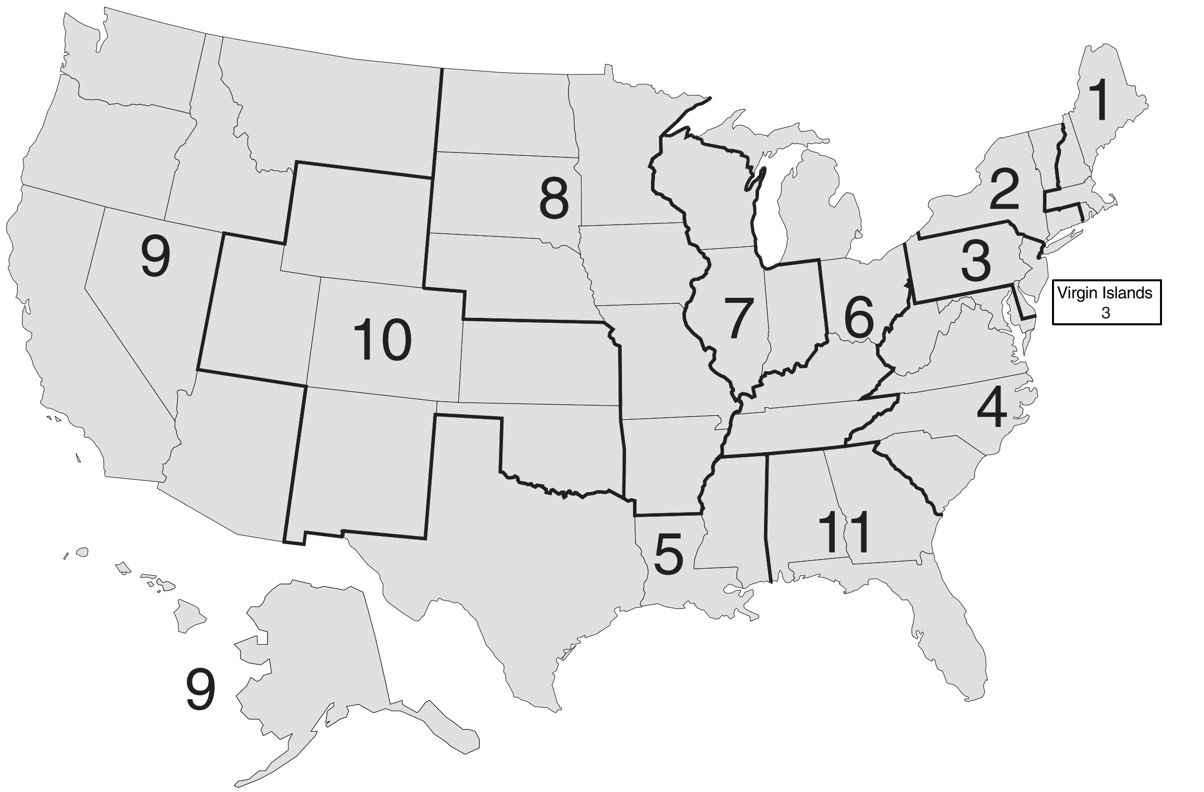
Any decision of the Tax Court can be appealed to the appropriate Circuit Court of Appeals. A final appeal can be made to the Supreme Court, but since its jurisdiction is discretionary, the court hears relatively few tax cases. Many of these court transcripts can be accessed online at **www.uscourts.gov.**

The taxpayer can choose to file a refund suit in the Claims Court or the Federal District Court once the taxpayer has paid the deficiency. In both courts, decisions of the Tax Court are not binding. The Claims Court sits as a single judge. A jury trial is available only in the Federal District Court. Many federal court opinions can be accessed online at **www.uscourts.gov.**

The 13 judicial circuits of the United States are constituted as follows:

Circuits	Hears Appeals from Federal District Courts and U.S. Tax Court Cases Originating in:
D. C.	U.S. Tax Court cases originating in D.C., Federal Administrative agencies, and Federal District Court cases for the District of Columbia
1st	Maine, Massachusetts, New Hampshire, Puerto Rico, Rhode Island
2d	Connecticut, New York, Vermont
3d	Delaware, New Jersey, Pennsylvania, Virgin Islands
4th	Maryland, North Carolina, South Carolina, Virginia, West Virginia
5th	District of the Canal Zone, Louisiana, Mississippi, Texas
6th	Kentucky, Michigan, Ohio, Tennessee
7th	Illinois, Indiana, Wisconsin
8th	Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, South Dakota
9th	Alaska, Arizona, California, Northern Hawaiian Islands, Idaho, Montana, Nevada, Oregon, Washington, Guam
10th	Colorado, Kansas, New Mexico, Oklahoma, Utah, Wyoming
11th	Alabama, Florida, Georgia
Fed.	Any federal case involving subject matter within its jurisdiction; U.S. Court of Federal Claims; U.S. Court of International Trade

Federal Judicial Circuits and Districts



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AGRICULTURAL ISSUES

Cooperative Grain Payments

Ltr. Rul. 201002009 (Oct. 1, 2009)
IRC §§199 and 1382

☞ Per-unit Retain Allocations Paid in Money, DPAD Pass-Through

Facts. Taxpayer, a farmers' cooperative, operates as a grain marketing and agricultural supply cooperative. Taxpayer purchases grain from farmer producers for delivery to its country grain elevators and, to some extent, to terminal elevators. After purchasing grain from its members, Taxpayer then markets each member's grain along with the grain of all its members with hopes of producing the best return. Grain payments are treated as purchases on Form 1120-C, *U.S. Income Tax Return for Cooperative Associations*. Taxpayer has not reported the grain payments made in cash as "per-unit retain allocation paid in money" and therefore has not reported them on line 4b of Form 1120-C, Schedule A.

This letter ruling was requested to determine:

- Whether the cash grain payments should be classified as "per-unit retain allocation paid in money," and
- Whether the IRC §199(d)(3)(C) deduction should be computed without regard to any deduction for grain payments to members and eligible nonmember patrons.

Analysis. Taxpayer's grain payments qualify as per-unit retain allocations within the meaning of IRC §1388(f) because the following conditions are satisfied:

- The payments are distributed with respect to grain marketed for patrons.
- Patrons receive the payments based on the quantity of grain delivered.
- Grain payments are determined without reference to taxpayer's net earnings.
- Grain payments are paid pursuant to a contract with the patrons establishing the necessary pre-existing agreement and obligation.
- Grain payments are paid within the payment period of IRC §1382(d).

IRC §199 and Treas. Reg. §1.199-6 provide guidance on who should include the grain payments in the IRC §199 computation. If the grain payments to members and eligible nonmember patrons are per-unit retain allocations paid in money, then they should be added back into the cooperative's §199 computation and not included in the members' and eligible nonmember patrons' §199 computations.

Holding. Grain payments made to members of a farmers' cooperative qualify as IRC §1382(b)(3) per-unit retain allocations paid in money and the §199 qualified production activities should be computed without deductions for those payments.

BANKRUPTCY AND DISCHARGE OF INDEBTEDNESS

Bankruptcy Exemption

***In re Ernest W. Willis,* No. 07-11010, U.S. Bankruptcy Court for the Southern District of Florida (Aug. 6, 2009)**
IRC §§408, 4975, and 6871

☞ Prohibited Transactions Disqualify IRA Funds from Bankruptcy Exemption

Facts. Ernest Willis filed for relief under Chapter 7 of the Bankruptcy Code on February 16, 2007. He claimed exemption for the full value of his three IRA accounts:

- A Merrill Lynch IRA valued at $1,247,000
- An AmTrust Bank IRA valued at $109,000, and
- A Fidelity Federal IRA valued at $143,000.

The trustee and creditor (movants) objected to Mr. Willis' exemptions for the IRAs. The movants' objections regarding the Merrill Lynch IRA were that Mr. Willis used funds from the IRA to purchase an assignment of mortgage and to cover a shortfall in a joint personal stock brokerage account that he owned with his wife.

Mr. Willis claimed an exemption for an AmTrust IRA that he funded from a Merrill Lynch IRA. He subsequently withdrew $108,433 on October 27, 2006 to close the AmTrust IRA and authorized AmTrust Bank to issue a check to him in that amount. He deposited the funds into a checking account with Fidelity Bank. On or about December 27, 2006, Mr. Willis issued a check to himself for $108,433 against the Fidelity Bank checking account and completed an IRA contribution form for a new AmTrust IRA account. He completed an IRA rollover form for the AmTrust IRA account number ending in 8629, indicating a contribution of $108,433.

Mr. Willis transferred $60,000 from his Merrill Lynch IRA to his Fidelity IRA. The record is unclear as to certain factual issues involving the remaining balance of funds in the Fidelity IRA. Mr. Willis and the creditor agreed that an IRA with Fidelity Bank contained funds from an AmTrust IRA ending in 0440 which Mr. Willis opened in May 1998. However, neither Mr. Willis nor the creditor were able to establish whether the funds were deposited into the Fidelity IRA that Mr. Willis claimed as exempt or to determine the source of the funds in the AmTrust IRA account ending in the number 0440.

Issue. Whether Mr. Willis is entitled to bankruptcy exemptions for the full value of the Merrill Lynch IRA, the Fidelity IRA, and the AmTrust IRA

Analysis. Retirement funds are presumed to be exempt from the bankruptcy estate when retirement funds have received an IRS favorable determination.[1] To rebut this presumption, the movants argued that Mr. Willis is a disqualified person who engaged in prohibited transactions with the Merrill Lynch IRA, which disqualified the IRA from bankruptcy estate exemption.

The creditor argued that because Mr. Willis funded the AmTrust IRA account ending in 8629 with nonexempt funds, the AmTrust IRA is disqualified from the bankruptcy estate exemption under 11 USC §522(b)(3)(C). IRA funds rolled over from a nonqualified account retain nonqualified status.[2] The funds in the AmTrust IRA account ending in 8629 can be traced to funds from the Merrill Lynch IRA after it ceased to be exempt as a result of Mr. Willis engaging in prohibited transactions.

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1. 11 USC §522(b)(4)(A).

2. *In re Swift*, 124 BR 475, 485 (Bankr. W.D. Tex. 1991) (citing 26 USC §408(d)(3)(A)(ii)); *In re Banderas*, 236 BR 837, 840 (Bankr. M.D. Fla. 1998) (citing *Baetens v. Comm'r*, 777 F.2d 1160, 1167 (6th Cir. 1985)).

The creditor further argued that the Fidelity IRA was also funded with nonexempt Merrill Lynch IRA funds, and therefore the Fidelity IRA is disqualified from the bankruptcy estate exemption. The creditor presented evidence that Mr. Willis funded the Fidelity IRA with $60,000 from the Merrill Lynch IRA after the Merrill Lynch IRA ceased to be exempt as a result of Mr. Willis engaging in prohibited transactions.

Holding. The court determined that all the funds in the Merrill Lynch IRA, all the funds in the remaining AmTrust IRA, and $60,000 in the Fidelity IRA are not exempt from the bankruptcy estate.

Bankruptcy

***In re Christine C. Parisi*, No. 8-10-70021, U.S. Bankruptcy Court for the Eastern District of New York (May 6, 2010)**
IRC §§24 and 26

☞ Court Holds Child Tax Credit is Property of Bankruptcy Estate

Facts. Christine Parisi, the single mother of a 6-year-old child, filed for Chapter 7 bankruptcy on January 4, 2010. Parisi agreed to file her 2009 tax returns and relinquish any nonexempt portion of the refund to the bankruptcy trustee. By March 2, 2010, she had received a total of $6,531 in federal and state refunds (with a total gross income of only $15,587).

After the trustee filed a motion requesting that Parisi relinquish the nonexempt portion of her refunds, she amended her bankruptcy forms to reflect the tax refunds as an asset and to request a $2,500 cash exemption of her refunds under New York law. Parisi then turned over $3,000 of her refund amounts, keeping the $2,500 cash exemption and the $1,000 child tax credit she received from her federal tax refund.

Parisi claimed the child tax credit comes from a trust fund or grant for families with dependent children and amounts to "a bailout for parents in order to improve the economic environment of families below the poverty line." She believed Congress could not have intended the credit to benefit creditors at the expense of children. Parisi argued that since she is merely the conduit of the funds, the $1,000 is not the property of the bankruptcy estate.

Issue. Whether a refund arising from a child tax credit is the property of the bankruptcy estate

Analysis. The bankruptcy estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case."[3]

The court did not find merit with Parisi's argument that she was merely the conduit for a credit for her child since the nonrefundable child tax credit is allowed to reduce the parent's tax liability. The court examined legislative intent and found no evidence that the refundable additional child tax credit was intended to be held in trust for the child.

The court declined to adopt such an interpretation, stating, "If Congress intended the child tax credit to be held in trust for the benefit of the child and exempt from the parent's creditors, it could have enacted bankruptcy legislation to this effect."

Because Parisi was entitled to the $1,000 child tax refund on her 2009 tax return and she filed her bankruptcy petition in January 2010, she had a right to receive the $1,000 at the commencement of her case. Therefore, the credit is the property of the bankruptcy estate.

Holding. The court held that the child tax credit is not part of the taxpayer's entitlement for her child and is part of the bankruptcy estate. Parisi was directed to turn over the $1,000 child tax credit to the bankruptcy trustee.

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3. 11 USC §541(a).

Capital Gains

U.S. v. Brenda and Lynwood Hall, **No. 08-17267, U.S. Court of Appeals for the 9th District (Aug. 16, 2010)**
IRC §1399

☞ Capital Gain Tax not Discharged in Bankruptcy

Facts. The taxpayers filed for Chapter 12 bankruptcy protection in 2005.[4] As part of the plan of reorganization, they moved to sell their farm for $960,000 with the approval of the Bankruptcy Court. The sale resulted in a $29,000 capital gains tax. The debtors filed an amended plan to treat the capital gains tax as an unsecured liability to be paid pro rata with other unsecured claims, with the remaining balance to be discharged. The IRS objected and argued the tax liability was a post-petition sale and was not incurred by the bankruptcy estate.

The Bankruptcy Court agreed with the IRS. On appeal, the Federal District Court for the District of Arizona reversed the Bankruptcy Court and held that taxes arising from a post-petition sale were dischargeable.[5]

Issue. Whether the capital gains tax is dischargeable in bankruptcy for a post-petition sale of assets

Analysis. Chapter 12 bankruptcy was enacted to allow financially-distressed farmers and ranchers to retain their farming operations. However, the act was drafted in a manner that allowed the IRS to veto a plan that did not include full payment of any federal income tax liability. Congress then amended the act by passing 11 USC §1222(a)(2)(A) that allowed the discharge of taxes. In this case, the court determined that the amendment applies only to "claims entitled to priority under section 507." Section 507 lists two categories that include taxes:

- Pre-petition taxes (Section 507(a)(8))
- Administrative expenses (Section 507(a)(2)) allowed under IRC §503(b)

To fall under IRC §503(b), the sale of the land had to be by the bankruptcy estate. In a Chapter 12 bankruptcy, the estate cannot incur taxes.

Holding. The court reversed the District Court and held that the tax liability is not discharged in the bankruptcy.

> **Note.** A detailed discussion on Chapter 12 bankruptcy can be found in the 2008 *University of Illinois Federal Tax Workbook*, Chapter 14, beginning on page 521. This can be found on the accompanying CD. A detailed discussion of the *Hall* case by Roger McEowen of Iowa State University can be found at **www.calt.iastate.edu/briefs/CALTLegalBrief-Bankruptcy.pdf,** beginning on page 8.

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4. *In Re Hall;* 376 B.R. 741 (Bankr. D. Ariz. 2007).

5. *Hall v. U.S.*, 2008 U.S. Dist. LEXIS 83895 (D. Ariz., Aug. 6, 2008).

BUSINESS EXPENSES

Business Expenses
Ernestine Forrest v. Comm'r, **TC Memo 2009-228 (Oct. 5, 2009)**
IRC §162

☞ Attorney Not Allowed to Deduct Business Expenses for Sporadic Activity

Facts. Ernestine Forrest was admitted to practice law in California in 1974 and in Colorado in 1986. She worked as a contract attorney performing legal services for other attorneys until 1988. From 1988 to 2000, she worked for the California Department of Corporations (the Department) as a securities regulator. Her employment with the Department was terminated in 2000. She again worked as a contract attorney in 2000 but not during 2001 and 2002.

In 2003, Ms. Forrest decided to try working again as a contract attorney. She attended the American Bar Association meeting in Seattle in February. At this meeting, she attended seminars and networked with colleagues, informing them she was available to work as a contract attorney.

Between January and March 2003, Ms. Forrest purchased various supplies, a telephone, a fax machine, and Internet services. During this time, she also filed suit to be reinstated as a securities regulator by the Department. She was reinstated by the Department and returned to work around March 25, before she had earned any 2003 income as a contract attorney.

Ms. Forrest filed her 2003 income tax return on October 15, 2006. She included a Schedule A with her return, on which she claimed $19,193 in various business and professional expenses. She did not include Schedule C, *Profit or Loss from Business,* or Form 6251, *Alternative Minimum Tax — Individuals,* with her return.

The IRS assessed a $1,882 deficiency in Forrest's 2003 federal income tax return for failure to report AMT liability. Ms. Forrest conceded the AMT adjustment but asserted that $1,761 of her Schedule A expenses should be reclassified as Schedule C business deductions.

Issue. Whether Ms. Forrest is entitled to deduct certain business expenses under IRC §162(a)

Analysis. Ms. Forrest asserted that she carried on a trade or business working as a contract attorney during 2003 and that she paid expenses in connection with this activity. The IRS's position was that she was not engaged in a trade or business because she had no clients and reported no income from the activity during 2003.

IRC §162(a) allows a deduction for ordinary and necessary expenses incurred in carrying on any trade or business. These expenses must relate to a functioning trade or business at the time the expenses were incurred. For a taxpayer to be engaged in a trade or business, the taxpayer's involvement must be regular and continuous, and the taxpayer's primary purpose for engaging in the activity must be for income or profit.[6]

Ms. Forrest stated that her activity was a continuation of a trade or business carried on in the 1980s and again in 2000. However, she did not work as a contract attorney between 1988 and 2000. She also did not work as a contract attorney in 2001 or 2002, and her 2003 activity was sporadic. Accordingly, her activity as a contract attorney was neither regular nor continuous.

Holding. Ms. Forrest failed to prove the existence of a trade or business as a contract attorney in 2003 and is not entitled to deduct business expenses under §162(a).

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6. *Comm'r v. Groetzinger,* 480 U.S. 23 (1987).

Trade or Business Involvement

***Marc and Michelle Mullarkey Vianello v. Comm'r,* TC Memo 2010-17 (Feb. 1, 2010)**
IRC §§162, 195, 166, 6662, and 6664

☞ CPA Deemed Not Engaged in Trade or Business of Farming

Facts. Marc Vianello is a CPA who, during the years at issue, operated an accounting firm in the Kansas City area. In 2001, Mr. Vianello acquired 200 acres of cropland and pasture in southwest Missouri, approximately 150 miles from his office. The farmland was held by Mr. Vianello's revocable trust. At the time of the acquisition, a tenant (pursuant to an oral lease with the prior owner) had planted the cropland in soybeans. The tenant made all the decisions for raising and marketing the crop and also mowed the pasture and maintained the fences. The tenant deducted the cost of chemicals and fertilizer from total crop sales and paid the landlord one-third of the net proceeds. Mr. Vianello never personally met the tenant during the years at issue, but the parties did agree via telephone to continue the existing lease arrangement for 2002. Accordingly, the tenant paid the expenses associated with the 2001 and 2002 soybean crops, and provided the necessary equipment and labor.

Ultimately, a disagreement between Mr. Vianello and the tenant resulted in the lease being terminated in early 2003. Mr. Vianello then had another party destroy the unharvested wheat in the spring of 2004 prior to planting Bermuda grass.

Michelle Mullarkey Vianello is also a CPA and prepared the couple's joint 2002 and 2003 income tax returns. Ms. Vianello concluded, based on what she read in IRS Pub. 225, *Farmer's Tax Guide*, and an interview with Mr. Vianello, that he materially participated in the trade or business of farming for the years at issue. Mr. and Ms. Vianello claimed Schedule F losses of $34,741 in 2002 and $134,941 in 2003.

In May 2007, the IRS issued a notice of deficiency for the Vianello's 2002 and 2003 tax returns, disallowing the farm losses for those years.

Issue. Whether Mr. Vianello was in the trade or business of farming

Analysis. Mr. Vianello argued that he was in the trade or business of farming because he was involved in major management decisions, provided and maintained fences, and discussed row crop alternatives, weed maintenance, and Bermuda grass planting with the tenant. Mr. Vianello also pointed out that his revocable trust was an eligible "person" under the farm program payment limitation rules as having satisfied the active engagement test. Mr. Vianello also claimed he bore the risk of loss under the lease because an unsuccessful harvest would mean that he would have to repay the tenant for the tenant's share of production cost.

The Tax Court determined that Mr. Vianello was not engaged in the trade or business of farming for 2002 or 2003. The court noted that the tenant paid all the expenses associated with the 2002 soybean crop and made all the cropping decisions. In addition, the court noted that the facts were unclear as to whether Mr. Vianello was responsible under the lease for reimbursing the tenant for input costs in the event of an unprofitable harvest.

Importantly, the court noted that the USDA's determination that the Vianello's revocable trust satisfied the active engagement test and was a co-producer with the tenant for farm program eligibility purposes "has no bearing on whether Vianello was engaged in such a trade or business for purposes of section 162(a)…"[7]

Holding. The court held that Mr. Vianello was not engaged in the trade or business of farming in 2002 or 2003.

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7. The Tax Court cited *A.B.C.D. Lands, Inc. v. Comm'r,* 41 TC 840 (1964) and *Hasbrouck v. Comm'r,* TC Memo 1998-249 (July 7, 1998), *aff'd without published opinion* 189 F.3d 473 (9th Cir. 1999) in support of its position.

> **Note.** The Tax Court, citing *Comm'r v. Groetzinger*,[8] noted that in order for an activity to rise to the level of a trade or business, the activity must be conducted with continuity and regularity, and the taxpayer's primary purpose for engaging in the activity must be for income or profit.

> **Observation.** While the Tax Court also declined to utilize an "arrangement" analysis consistent with the approach utilized in *Mizell*[9] in determining whether Vianello was engaged in the trade or business of farming, the court did specifically note that the Treasury regulations under §1402 "make it clear that Vianello's efforts do not constitute production or the management of the production as required to meet the material participation standard." That is a key point. The Vianello's revocable trust (in essence, the taxpayer) satisfied the active engagement test for payment limitation purposes, but Vianello was not engaged in the trade or business of farming either for deduction purposes or SE tax purposes.
>
> The court's opinion reaffirms the point that the existence of a trade or business is determined on a case-by-case basis. It is determined according to the facts and circumstances presented[11] and provides additional clarity on the point that satisfaction of the USDA's active engagement test does not necessarily mean that the taxpayer is engaged in the trade or business of farming for SE tax purposes. In spousal farming operations, *Vianello* supports the position that both spouses can be separate persons for payment eligibility purposes, but only one of them may be deemed to be in the trade or business of farming for SE tax purposes.

Licensed Sports Agent

Paul and Melody Fucaloro v. Comm'r, **TC Summ. Op. 2010-37 (Mar. 30, 2010)**
IRC §§162, 183, 274, and 6001

☞ Schedule C Loss Disallowed

Facts. Paul Fucaloro entered into two management agreements with boxers Manswell and Stiverne in March and May of 2005. Both agreements continued in effect for a 5-year period with an option for a 2-year extension.

Paul and Melody Fucaloro filed their 2005 tax return showing total wages of $175,643, taxable interest of $97, taxable refunds of state and local income taxes of $1,615, and pensions and annuities of $73,297. They claimed a business loss from Schedule C, *Profit or Loss from Business*, of $57,741. The Schedule C operation was for Mr. Fucaloro's work as a "licensed sports agent." The filed Schedule C showed no gross receipts and expenses totaling $57,741. The expenses included $15,803 for travel, $2,416 for deductible meals and entertainment, and $39,522 for other expenses.

At no time did Mr. Fucaloro have a separate bank account for any of his boxing-related activities nor did he maintain any books associated with those activities. As of the time of the trial, Mr. Fucaloro had been involved in boxing-related activities for at least 20 years and had **never** made a profit from those activities.

The IRS issued a notice to the Fucaloros indicating their loss was disallowed.

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8. *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987).

9. *Mizell v. Comm'r*, TC Memo 1995-571 (Nov. 29, 1995).

10. See *Comm'r v. Groetzinger*, 480 U.S. 23 (1987). But, with respect to USDA land diversion, conservation-type programs, the IRS has taken the position that payments received under such programs are subject to SE tax by reason of the taxpayer merely participating in the program. See CCA Ltr. Rul. 200325002 (May 29, 2003) and IRS Notice 2006-108, 2006-2 CB 1118 (specific to Conservation Reserve Program payments). However, these are low-level IRS pronouncements that do not constitute substantial authority, and the IRS has declined to issue regulations formally taking such a position.

Issue. Whether the taxpayers are entitled to a claimed business loss of $57,741 associated with Mr. Fucaloro's licensed sports activity

Analysis. The court began by reviewing the level of documentation the taxpayer had for the activities. At trial, Mr. Fucaloro provided some documentation but the majority of the receipts failed to show the business purpose of the expense. His claimed entertainment expenses did not identify the person who was being entertained or the nature of the business discussion. In fact, some of the receipts indicated the expenses were actually related to family members or his corporation, Farubrik Sports. Consequently, the court found that the taxpayers did not meet the burden of proof required under IRC §274.

The court found that the taxpayers failed to establish that during 2005 Mr. Fucaloro's boxing-related activities constituted a trade or business within the meaning of IRC §162. The court also found that the taxpayers failed to carry their burden of proof related to the recordkeeping requirements of §274(d) and the regulations thereunder associated with the expenses for transportation, hotels, meals, and entertainment.

Holding. The taxpayers were not entitled to the business loss and expense deductions from the husband's boxing activity since it was not an activity engaged in for profit and the expenses were not properly substantiated.

Employee Benefits

***Milo and Sharlyn Shellito v. Comm'r,* TC Memo 2010-41 (Mar. 3, 2010)**
IRC §§162 and 6662

☞ Farmer Cannot Deduct Employee Expenses for Wife Due to Lack of Prior Wages

Facts. Milo Shellito, a Kansas resident, started farming in 1978. Since 1982, his wife Sharlyn consistently helped him with planting and harvesting, operating equipment, feeding livestock, performing repairs and maintenance, running errands, and bookkeeping. She received no compensation for this work from 1982 to mid-2001.

In 2001, Milo followed his banker's advice and engaged a CPA to prepare his farm taxes. The CPA informed the Shellitos that they could deduct their family medical costs as a business expense if Milo hired Sharlyn as a farm employee. The CPA drafted an employment agreement, which both Shellitos signed May 29, 2001, stating that Milo would hire Sharlyn "to operate farm machinery, work and handle cattle, do repairs, run errands, and [other] farm related chores…."

The CPA also assisted the Shellitos with setting up an employee medical expense reimbursement plan. Sharlyn was listed on the plan application as Milo's only eligible employee. Sharlyn's employee benefits included unlimited reimbursement of health insurance premiums for her and her family and reimbursement of up to $15,000 of out-of-pocket medical expenses for her and her family.

Sharlyn was paid a $100 monthly salary. Her wages were paid from the Shellito's joint checking account and transferred to her individual checking account. Her employee medical reimbursement payments were handled likewise. She paid for the family's medical care and insurance premiums out of her individual checking account.

Milo gave Sharlyn a Form W-2, *Wage and Tax Statement,* for her wages in 2001 and 2002, in the amounts of $754 and $1,292, respectively. She included this income on their jointly-filed income tax returns, on which Sharlyn's occupation was listed as "HOUSE WIFE" for both years. Milo deducted both her wages and the amounts paid to her under the medical reimbursement plan on his Schedule F for both years. He claimed employee benefit program deductions of $15,593 in 2001 and $20,897 in 2002.

The IRS disallowed all Milo's employee benefit program deductions for 2001 and $20,208 of the 2002 deductions claimed and imposed an accuracy-related penalty for the substantial understatement of tax for 2002. Curiously, and without explanation, the IRS did not disallow the corresponding deductions for Sharlyn's wages, and allowed a $689 deduction in 2002 for Sharlyn's medical insurance premium.

Issues. This case raised the following issues:

- Whether Mrs. Shellito was a bona fide employee of Mr. Shellito, which would entitle him to deduct amounts he claimed for her employee benefit programs on his 2001 and 2002 Schedules F, *Profit or Loss From Farming*; and
- Whether the Shellitos are liable for the IRC §6662(a) accuracy-related penalty for 2002

Analysis. IRC §162(a)(1) allows a deduction for all ordinary and necessary expenses paid or incurred in carrying on any trade or business, including a reasonable allowance for "salaries or other compensation for personal services actually rendered." Treas. Reg. §1.162-10 extends this to include amounts paid for an employee's medical expense benefit plan.

In order to allow the deduction for Sharlyn's employee benefit plan, the court first had to determine if Sharlyn was Milo's bona fide employee. The court considers remuneration to be an essential test of the employer-employee relationship. "Absent remuneration, there is no 'plausible' employment relationship and consequently no need to undertake a common law agency analysis."[11]

Milo did not start paying Sharlyn until May 29, 2001, so Sharlyn was not considered his employee before then. However, despite the employment contract and the wage/benefit agreement the Shellitos entered into on that date, the court did not see any material change in their working arrangement. Because Sharlyn performed essentially the same jobs she had before the employment arrangement, the court found Sharlyn's compensation "illusory" and stated "Mrs. Shellito rendered her services as part of the 'shared enterprise' of marriage."

Under Kansas law, based on the "unity of marriage" concept, each spouse is liable for the other's "necessaries," which includes medical care. Sharlyn's wages were paid from the couple's joint checking account, then shifted to her individual account from which she paid the family's medical expenses. The court found that the resulting economic benefit to her was "directly offset and negated" by the fact she assumed and paid for her husband's share of the family's medical costs. Thus, they found the arrangement to be essentially the same as when the couple paid their medical expenses out of their joint account.

The court pointed to the fact that Sharlyn's occupation was listed as "HOUSE WIFE" on the return, and it believed that was an accurate characterization.

Holding. The court ruled Sharlyn was not Milo's bona fide employee and therefore Milo was not entitled to deduct amounts paid for Sharlyn's employee benefit plan expenses. It did not uphold the accuracy-related penalty because the Shellitos relied on their CPA's advice in preparing their taxes and claiming the deductions.

[11] *Graves v. Women's Profl. Rodeo Association, Inc*., 907 F.2d 71, 73 (8th Cir. 1990).

Hobby Loss

***Jo Anne M. Chandler v. Comm'r,* TC Memo 2010-92 (Apr. 29, 2010)**
IRC §§183 and 6662

☞ Taxpayer Not Allowed to Deduct Losses from Horse Activity

Facts. For each of the tax years at issue (2002–2004), Jo Anne Chandler had income between $148,000 and $167,000 from nonfarming sources. She and her husband bet on horses as a form of recreation, and reported gambling winnings of $35,000, $18,000, and $10,000 for 2002, 2003, and 2004, respectively.

Mrs. Chandler engaged in horse breeding, training, and racing of thoroughbred horses, and incurred substantial losses on her horse activities for 20 years, including the years at issue. She claimed net losses from the horse activity of $74,772 in 2002, $69,782 in 2003, and $58,702 in 2004. She continued to race the same unsuccessful horses every year even though she did not generate enough money to exceed expenses for any year. In all her years of horse activity, she never developed a horse that could win and be profitably sold.

Mrs. Chandler consulted with horse trainers and owners, but these consultations did not result in an improvement of her bottom line, and she did not make any meaningful changes to improve the profitability of her horse activity. Her expenses increased each year, and she stated that she would continue in her horse activities regardless of the level of losses.

Issues. The issues presented in this case are as follows:

- Whether the taxpayer conducted the horse activities for profit, and
- Whether the taxpayer is liable for the accuracy-related penalty

Analysis. Under the 9-factor analysis that courts utilize in hobby loss cases in accordance with Treas. Reg. §1.183-2(b), the following factors weighed in the IRS's favor:

1. The taxpayer did not conduct the horse activities in a business-like manner.
    - There was no checking account devoted exclusively to the horse activity.
    - No adequate business records were maintained for the horse activity.
    - There was no use of cost accounting methods to determine overall profitability.
    - There was no maintenance of separate records for each horse.
2. The taxpayer had no oral or written business plan and made no operational changes to improve profitability.
3. The taxpayer did not study accepted business, economic, and scientific practices related to her horse activities or consult with experts in a meaningful manner.
4. The taxpayer failed to substantiate the claimed amount of time she spent on the horse activities.
5. The taxpayer did not provide evidence supporting an expectation that her horses would appreciate in value.
6. The taxpayer did not establish that she had ever owned or operated a successful business venture.
7. The taxpayer's horse activities incurred losses for 20 consecutive years totaling over $1.5 million — well beyond the acceptable 5–10 year start-up period for horse breeding, and the losses were not unforeseeable. No profits were ever reported.
8. The taxpayer had substantial income from other sources which was reduced by approximately 40% by claiming Schedule F losses from the horse activities.
9. The taxpayer derived pleasure and recreation from the horse activities.

Holding. The court held that the taxpayer failed to conduct her horse activities for profit and could not deduct losses associated with the activities. In addition, the court determined that the taxpayer was liable for the accuracy-related penalty.

Business Expenses — Gambling

***Hoyt M. and Helen J. Orr v. Comm'r,* TC Summ. Op. 2010-55 (Apr. 26, 2010)**

IRC §§165, 162, 212, 62, 63, 67, 68, 6662, and 6664

☞ Losses in Excess of Winnings Disallowed for Professional Gambler

Facts. The taxpayers were married and filed joint income tax returns. Helen was granted early retirement on permanent disability from the railroad in 1999 when her boss noticed she was "more than a little disturbed." Helen suffered from depression, which may have resulted from a series of life events that included her husband's 1994 diagnosis with what was believed to be a terminal illness, and her elderly mother coming to live with them soon after. Helen's mother died in 2000, and she lost two brothers in the same year.

Helen was a casual gambler prior to 2004. In 2003, she won a $1.2 million casino jackpot. Bolstered by her success, she decided to become a professional gambler. Looking back, Helen realized "it was not a smart decision" to pursue gambling as a source of income. Overall, Helen lost nearly $200,000 from her gambling activities in 2004.

A former H&R Block employee, Helen prepared the couple's jointly filed 2004 return using TurboTax software. Hoyt relied on Helen to complete their tax return, even though Helen testified that her mental ability was "very, very limited" in 2004.

Because the Orrs did not have a regular tax advisor, Helen visited an IRS office, consulted with a lawyer and two accountants, and performed other research to determine how to report her gambling losses as a professional gambler. Helen received conflicting information from the IRS, with one employee expressing doubt about the deductibility of professional gambling losses and a second reporting that he had seen it done but did not know how it was accomplished. The lawyer Helen consulted was not a tax practitioner, so he referred her to an accountant, who repeated what the second IRS employee had said. Helen's professional gambling acquaintances declined to discuss their tax returns with her.

Helen decided to treat her gambling profession like any other business; therefore, she claimed her gambling income and expenses on Schedule C showing gross winnings of $909,058 as "other income," deductions for travel expenses of $10,780, and gambling losses of $1,113,766. The resulting Schedule C net loss of $215,488 reduced the Orrs' 2004 taxable income to zero.

The IRS issued a notice of deficiency for the Orrs' 2004 return, disallowing $204,708 in net gambling losses, equal to the amounts Helen bet over her winnings. The IRS also imposed an IRC §6662(a) accuracy-related penalty on the Orrs. The IRS did not dispute Helen's occupation as a professional gambler, nor did the agency question her travel expense deduction or the amount of her gambling income or losses.

In preparation for court, but after their return was already filed, Helen consulted a professional gambling website for additional information on deducting professional gambling losses. She also searched court cases and found *Groetzinger.*[12] Helen interpreted information from both the website and the *Groetzinger* case to mean that a professional gambler can deduct gambling losses in the same manner as a business owner generally may deduct losses.

Issues. This case presents multiple issues, but the relevant issues are as follows:

- Whether the Orrs may claim a deduction for Helen's professional gambling losses, and
- Whether the Orrs are liable for an accuracy-related penalty for substantial understatement of their income

12. *Comm'r v. Groetzinger*, 480 U.S. 23 (1987).

Analysis. IRC §165(d) provides that "[l]osses from wagering transactions shall be allowed only to the extent of the gains from such transactions." Although the statute does not distinguish professional gambling losses from casual gambling losses, the court has previously held that professional gamblers are denied deductions for their net gambling losses.[13]

The court dismissed the Orrs' use of the *Groetzinger* case, finding that it dealt with gambling losses in the computation of alternative minimum taxable income. The court also noted that the professional gambling website "repeatedly and consistently states that net gambling losses are not deductible, for professional as well as casual gamblers, and explains what §165(d) is and what it means."

Additionally, the court rejected the Orrs' argument that IRC §162(a) allows a deduction for all ordinary and necessary expenses paid or incurred in carrying on a trade or business, and that §162 does not mention §165(d). The court took this to mean that Helen believed §165(d) did not limit gambling losses for professional gamblers, since their losses could be presumed to be ordinary and necessary business expenses.

Citing history, judicial precedent, and the plain language of the Code, the court maintained a broad interpretation of §165(d), holding that the statute "denies a deduction for a net gambling loss even if the loss is also described as a kind of generally deductible item, such as a §162(a) business expense, a §165(a) loss from a transaction entered into for profit, or a §212 expense for the production of income."

Holding. The court held that IRC §165(d) prevents Helen Orr from deducting her net gambling losses, despite the presumption she was a professional gambler. The court did not hold the Orrs liable for the substantial understatement penalty because the couple acted in good faith and because certain factors led to the court's conclusion that there was reasonable cause for errors on the Orrs' return.

CAPITAL GAINS AND LOSSES

Stock Redemption

Ltr. Rul. 201013024 (Nov. 20, 2009)
IRC §§303 and 1001

☞ Distribution Creates Capital Gain

Facts. Taxpayer X died on Date 1. Taxpayer X's will instructed the executor to transfer his residuary estate containing all the shares of stock owned by X to a revocable trust formed by X. The executor elected to pay federal and state estate taxes in installment payments under IRC §6166. Between Year 1 and Year 2, the executor tendered some of the stock shares for redemption in order to provide liquidity with which to satisfy some of the installment payments. Some of the stock is retained by the executor since some federal and state taxes remain unpaid.

The terms of the trust are:

- Taxpayer X's child Y (Taxpayer Y) is sole income beneficiary of the trust during his lifetime.
- Trustee can distribute any portion of the trust principal based solely on Y's best interests.
- Trust terminates a certain number of years after X's death.
- If Y dies prior to the trust's termination, all remaining assets are held in trust for the grandchildren of X.
- If Taxpayer Y lives until the trust terminates, Y receives all remaining trust assets.

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13. *Valenti v. Comm'r*, TC Memo 1994-483 (Oct. 4, 1994).

Several of the trust beneficiaries sued each other over the terms of the trust. A settlement was reached whereby Taxpayer Y gave each grandchild and great-grandchild a cash payment in exchange for their remainder rights. Once the settlement agreement concluded, Taxpayer Y was the sole owner of the trust assets.

Taxpayer Y requests that the executor authorize a distribution of a portion of the stock to the trust and then that the trustee authorize a distribution of that stock to Y. Taxpayer Y agrees to be liable for a proportionate obligation to pay estate taxes relative to this transaction. The form of the proposed transaction will be a direct distribution of the stock from the executor to Y. It is likely that a substantially similar series of transactions will be undertaken in subsequent years.

Analysis. Based on the representations made, the amounts received by Taxpayer Y in the stock redemption will be treated under IRC §303 as a distribution in full payment of the stock redeemed to the extent the amount received does not exceed the sums specified in IRC §§303(a) or 303(b)(4). Pursuant to IRC §1001, gain will be realized and recognized by Y as a capital gain.

Holding. The amounts a trust beneficiary receives in redemption of a decedent's corporate stock is treated as a distribution in full payment in exchange for the redeemed stock, subject to several conditions, and the beneficiary recognizes any gain as capital gain.

CASUALTY AND THEFT LOSSES

Casualty Loss

Justin M. Rohrs v. Comm'r, **TC Summ. Op. 2009-190 (Dec. 10, 2009)**
IRC §§165 and 6662

☞ Driver Cited for DUI Allowed to Claim Casualty Loss Deduction

Facts. Justin Rohrs purchased a 2006 Ford pickup truck on August 12, 2005, for $40,210. On October 28, 2005, he attended a party at a friend's house. He expected to drink alcohol at the gathering and consequently arranged for transportation to and from his house. After returning home from the party, Rohrs decided to drive to his parents' house. On the way there, his truck slid off an embankment after he failed to negotiate a turn. Rohrs was cited and arrested for driving under the influence of alcohol (DUI) because his blood-alcohol level was .09%, and the legal threshold in California is .08%.

Rohrs' insurance claim for the accident was denied under the terms of his policy because of his DUI citation and arrest.

Rohrs filed his 2005 Form 1040 and claimed a $33,629 casualty loss deduction for the damage to his truck. In 2008, the IRS issued a notice of deficiency disallowing Rohrs' casualty loss deduction and assessing a $6,230 income tax deficiency and a $1,246 accuracy-related penalty.

Issues. The issues presented in this case are as follows:

- Whether Rohrs is entitled to a casualty loss deduction for 2005, and
- Whether he is liable for the §6662(a) accuracy-related penalty

Analysis. IRC §165 allows an individual to deduct uncompensated losses arising from casualty or theft. Negligence does not preclude a casualty loss deduction, although gross negligence may.[14] The regulations provide that an automobile may be the subject of a casualty loss if the damage is not due to the willful act or willful negligence of the taxpayer.[15]

Rohrs concedes that his actions of driving while intoxicated were negligent but does not believe that his behavior rose to the level of gross or willful negligence. The IRS disagreed; accordingly, they contend that a casualty loss deduction is barred.

"Willful negligence" and "gross negligence" are not defined in the Code or regulations. These definitions are supplied by case law. In *People v. Bennett*, the California Supreme Court defined gross negligence as "the exercise of so slight a degree of care as to raise a presumption of conscious indifference to the consequences."[16] In *People v. VonStaden*, the court held that conscious indifference could be inferred from the severity of the defendant's intoxication.[17]

The court in this case stated that Rohrs' level of intoxication and the manner in which he drove did not suggest that he was consciously indifferent to the hazards of driving while intoxicated. He arranged for transportation home from the party and thus allowed some time for his body to process the alcohol.

There is also no evidence that excess speed or alcohol directly caused Rohrs' accident. He claimed that he lost control of his truck because of windy conditions on the road. No evidence was presented at trial as to the precise cause of the accident.

Holding. Rohrs is entitled to the claimed casualty loss deduction. Accordingly, he is not liable for the §6662(a) accuracy-related penalty.

Theft Loss Deduction

Dominick J. Vincentini v. Comm'r, **TC Memo 2009-255 (Nov. 9, 2009)**
IRC §165

☞ Theft Loss Deduction for Investment in Fraud Scheme Denied

Facts. Dominick Vincentini was an investor in Anderson Ark & Associates from 1999 to 2001. Anderson Ark was an international fraud scheme that marketed various phony investment programs. Several of Anderson Ark's principals were arrested and indicted by U.S. officials in 2001. In 2004, these Anderson Ark principals were convicted of conspiracy to defraud the United States, conspiracy to commit mail and wire fraud, aiding and assisting the filing of false income tax returns, mail fraud, and various other charges. The defendants were each sentenced to prison terms of up to 20 years. In 2005, the Washington District Court entered amended judgments in which the defendants were ordered to pay restitution to investors, which included Vincentini.

In 2006, Vincentini submitted a Form 1040X, *Amended U.S. Individual Income Tax Return,* for 1999. The amended return included Form 4684, *Casualties and Thefts,* in which Vincentini claimed a $835,000 theft loss deduction related to his investment with Anderson Ark. Vincentini asserted that the theft loss occurred in 2001 or 2002 and that he could carry it back to 1999.

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14. *Heyn v. Comm'r,* 46 TC 302, 308 (1966).
15. Treas. Reg. §1.165-7(a)(3).
16. *People v. Bennett,* 819 P.2d 849 (Cal. 1991).
17. *People v. Von Staden,* 241 Cal. Rptr. 523, 527 (Ct. App. 1987).

In the first trial, the court concluded that Vincentini had suffered a theft loss of $511,500 and that the loss was discovered in 2001. His theft loss deduction was denied by the court, however, because he did not prove that he had no reasonable prospect of recovery in 2001 or 2002. The court stated that it was likely that the Anderson Ark defendants would be convicted of various charges related to the investment schemes and that, if they were convicted, it was expected that the defendants would be ordered to pay restitution to their victims.

Issue. Whether the court should reconsider its previous finding that Vincentini is not entitled to a theft loss deduction for his investment in a fraudulent investment program

Analysis. IRC §165 generally permits a taxpayer to deduct uncompensated losses resulting from theft in the year in which **the loss is discovered**. To qualify for the deduction, the taxpayer must prove all the following:

- The occurrence of a theft
- The amount of the theft loss
- The date the taxpayer discovered the theft loss

A theft loss deduction is not allowed if there is a reasonable prospect of recovery.[18]

In his motion for reconsideration, Vincentini argued that the likelihood of recovery was not 40% or greater. However, he failed to convince the court that any uniform standard had been adopted by the courts for quantifying whether a taxpayer's prospect of recovery is reasonable. **The court stated that even if they were to accept Vincentini's contention that a reasonable prospect of recovery means a chance of recovery that is 40% or better, he did not satisfy his burden of proving that his prospect for recovery was less than 40%.**

Vincentini also did not offer any convincing evidence that the Anderson Ark defendants were judgment proof, that they had insufficient assets to satisfy the restitution orders, or that it was otherwise improbable that he would receive restitution.

Holding. Vincentini's motion for reconsideration was denied.

Casualty Loss

Franklin M. and Erlinda Sykes v. Comm'r, **TC Memo 2010-84 (Apr. 21, 2010)**
IRC §§165(h), 6662, and 6664

☞ Taxpayers Denied Casualty Loss Deduction for Water Damage

Facts. In September 2004, a water pipe burst in a bathroom sink and damaged Franklin and Erlinda Sykes' California home. The Sykes received a $4,331 insurance settlement in February 2005 for the damages, based on a $6,099 repair estimate less a $1,000 deductible and a deduction for depreciation.

The Sykes claimed the insurance settlement did not cover their loss since the water damage reduced the value of their home by $45,000. They based this claim on an appraisal conducted November 1, 2004, on which the appraiser noted adjustments of $10,000 per room, $8,000 per bath, and $40 per square foot of gross living area. However, they disputed the appraiser's valuation of $715,000 and instead insisted their home was worth only $700,000 after the damage.

The Sykes included a "loss of use" computation for the portion of the house that was out of service during repairs, and claimed a casualty loss of $40,080 on their 2004 return. They later amended their return and claimed an adjusted loss of $28,877.

18. Treas. Reg. §1.165-1(d)(3).

Issues. The issues presented in this case are as follows:

- Whether the Sykes are entitled to a $28,877 casualty loss claimed on Schedule A, *Itemized Deductions,* and
- Whether they are liable for the accuracy-related penalty

Analysis. Treas. Reg. §1.165-7(a)(2) describes the method of valuation used to determine the amount of a casualty loss. The property's FMV immediately before and immediately after the casualty should generally be ascertained by competent appraisal. The IRC §165 deduction is limited to the actual loss resulting from damage to the property.

The court ruled the Sykes' assessment of their casualty loss was invalid since their appraisal did not appear to be competent. The appraiser's per-room and square-foot valuations were not explained or substantiated. The Sykes did not have any background in home valuation and did not provide evidence to prove their contention that the appraisal was off by $15,000. They did not call any witnesses or support any of their claims with documentation.

The Sykes' calculation of a "loss of use" factor has no bearing on their casualty loss deduction. Only the amount of the loss resulting from physical damage to property is deductible under IRC §165.[19]

Holding. The court held in favor of the IRS and denied the Sykes' claim for additional casualty loss deductions. The court also held the Sykes liable for the accuracy-related penalty.

CORPORATIONS

Business Restructuring

Ltr. Rul. 201001008 (Oct. 26, 2009)
IRC §§355 and 368

☞ Tax-free Transactions from Business Restructuring

Facts. The taxpayer is a closely-held corporation owned by four family shareholder groups. The taxpayer proposes to create three entities, each of which will have one class of common stock and all of which will be owned by the taxpayer. The taxpayer's assets will be transferred to the three entities. The stock of each entity will be distributed to one of three family groups. After the transactions take place, each of the four family shareholder groups will own one piece of the operation.

Issue. Whether a closely-held corporation can restructure its business in a series of tax-free transactions

Analysis. Transferring part of its assets in exchange for all the stock in one entity constituted a reorganization within the meaning of IRC §368(a)(1)(D). No gain or loss is recognized by the taxpayer upon the transfer of assets in exchange for stock. No gain or loss is recognized by the newly created entities.

Holding. A closely-held corporation can restructure its business in a series of tax-free transactions pursuant to IRC §§368(a)(1)(D) and 355(a).

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19. *Squirt Co. v. Comm'r*, 51 TC 543, 547 (1969), *aff'd* 423 F.2d 710 (9th Cir. 1970).

Property Distributions

Ltr. Rul. 201013034 (Dec. 7, 2009)
IRC §§301 and 305

☞ Special Dividends Meet Requirements of Property Distributions

Facts. Taxpayer is a real estate investment trust (REIT) with one class of outstanding common stock. For Year 1, the taxpayer makes a special fourth quarter dividend payment utilizing a combination of money and stock. Each stockholder must elect to receive cash, stock, or a combination of cash and stock (mixed option). If the stockholder does not timely elect, the taxpayer will make its own decision about how to pay the special dividend.

Issue. Whether this special dividend conforms to the requirements of Rev. Proc. 2009-15 such that it will be treated as a property distribution under IRC §301

Analysis. Neither the mixed option nor the cash option precludes the special dividends from satisfying any of the conditions of Section 3 of Rev. Proc. 2009-15. Thus, the IRS will treat any distribution of stock in the special dividend as a distribution of property to which §301 applies. The amount of the stock distribution is considered equal to the amount of money which could have otherwise been received.

Holding. Special dividends distributed by a REIT which are payable as common stock and limited amounts of cash are treated as distributions of property pursuant to §301.

Personal Service Corporations

***Kraatz & Craig Surveying Inc. v. Comm'r,* 134 TC No. 8 (Apr. 13, 2010)**
IRC §§ 448 and 11

☞ Land Surveyor Subject to Personal Service Corporation Tax as Engineer

Facts. Kraatz & Craig Surveying Inc. (Kraatz), incorporated in Tennessee, was engaged solely in the business of land surveying. Kraatz did not employee any licensed engineers, was not associated with any firm that employed licensed engineers, and did not provide any services that Tennessee law required to be performed only by licensed engineers.

The IRS issued Kraatz a notice of deficiency for 2005, claiming the company was a qualified personal service corporation because its land surveying activities constituted engineering services pursuant to Temp. Treas. Reg. §1.448-1T(e)(4)(i). This temporary regulation, published on June 16, 1987, provides that engineering includes surveying and mapping.

Issue. Whether land surveying is considered engineering and would thus subject Kraatz to the 35% flat income tax due on personal service corporations

Analysis. IRC §448(d)(2) provides that a corporation is deemed a personal service corporation if it satisfies both a function test and an ownership test. The function test requires that substantially all of the corporation's activities involve the performance of services in the fields of "health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting."

The practice of land surveying and engineering are governed by separate state statutes in Tennessee and are subject to distinct governing authorities. Kraatz argues that because land surveying in Tennessee cannot be performed by a licensed engineer unless he is also a licensed land surveyor, land surveying in Tennessee is not in the field of engineering.

When the Code is silent or ambiguous on an issue and there is a question regarding how the IRS has interpreted the Code, the court looks to outside resources to determine if the IRS correctly constructed the meaning of the statute. In this case, the court first examined the legislative history of IRC §448 to determine congressional intent regarding whether surveying is within the field of engineering.

The conference report for this legislation clearly delineates that Congress intended surveying and mapping to be treated as services performed in the field of engineering. The court also found American Society of Civil Engineers policy statements indicating a link between civil engineering and surveying. Additionally, it examined the plain meaning of the word "engineering" and found that Webster's Third New International Dictionary 413 (2002) defines "civil engineering" as "a branch of engineering concerned primarily with public works (as land surveying…)." For these reasons, the court held that the IRS constructed the temporary regulation regarding the inclusion of surveying and mapping within the field of engineering to be in accord with IRC §448.

The court determined that state licensing laws were irrelevant to this issue.

Holding. The court held that surveying is considered civil engineering, and thus deemed Kraatz a personal service corporation subject to the 35% flat income tax rate.

Reasonable Compensation

***Multi-Pak Corp. v. Comm'r*, TC Memo 2010-139 (June 22, 2010)**

IRC §§162 and 6662

☞ Court Determines Reasonable Compensation for CEO

Facts. Multi-Pak Corp. (Multi-Pak) is a California-based corporation engaged primarily in packaging nutritional and pharmaceutical products. Ralph Unthank (Ralph) incorporated the company in 1955. Ralph's son, Randal Unthank (Randal) became sole shareholder upon Ralph's death in 1972, and assumed the duties of Multi-Pak's president, CEO, and COO in 1973. Randal continued in these capacities through the years at issue, performing all managerial duties for the company and making all personnel decisions.

Multi-Pak was on the verge of bankruptcy when Randal took control. To prevent the company from going under, Randal purchased new equipment and brought in new accounts. In 2000, Multi-Pak began leasing a portion of a 35,000 square-foot adjoining building for storage. This additional space was needed to accommodate a surge in business resulting from retooling a packaging machine to double the company's production to meet customer demand.

An Unthank family partnership acquired this adjoining property in October 2001 and leased it entirely to Multi-Pak, tripling the company's space. Initially unsuitable for the company's use, Randal oversaw the redesign and renovation of the facility to meet FDA standards.

Multi-Pak's total assets; revenue; earnings before interest, taxes, depreciation, and amortization (EBITDA); net income; and total equity for 2000-2003 are shown below:

	2000	2001	2002	2003
Total assets	$2,714,100	$3,166,800	$3,320,900	$3,134,000
Revenue	5,929,500	7,947,300	9,483,800	8,770,900
EBITDA	92,200	449,600	508,500	(120,500)
Net income	24,600	246,800	140,700	(474,000)
Total equity	2,522,000	2,792,000	3,181,300	2,994,200

Multi-Pak paid Randal $2,020,000 in compensation for 2002 and $2,058,000 for 2003. These amounts were deducted as officer compensation on Multi-Pak's timely filed Forms 1120, *U.S. Corporation Income Tax Return*, for tax years 2002 and 2003, respectively. The returns were prepared by Scott Brown (Brown), a CPA, who was employed by the same firm that had prepared Multi-Pak's returns since 1965.

Brown regularly advised Multi-Pak and Randal on compensation matters, helping to determine reasonable amounts for wages and bonuses. Randal received a flat salary and a bonus based on sales and performance. Bonus amounts were calculated at the end of every month. Randal's salary and bonuses for 2000–2003 are shown below:

Year	Salary	Bonus	Total
2000	$150,000	$ 988,900	$1,138,900
2001	150,000	1,086,000	1,236,000
2002	150,000	1,870,000	2,020,000
2003	353,000	1,705,000	2,058,000

The IRS determined that Multi-Pak could deduct only $655,000 for 2002 and $660,000 for 2003 for officer compensation, because Multi-Pak did not show that a greater amount was reasonable for services. The IRS issued Multi-Pak a notice of deficiency for tax years 2001–2003, adjusting for the allowable compensation. The 2001 deficiency resulted from the recomputation of a NOL carryback from 2002 and 2003.

Issues. The issues presented in this case are as follows:

- Whether Multi-Pak paid reasonable compensation to Randal in 2002 and 2003, and
- Whether Randal is liable for the accuracy-related penalty

Analysis. IRC §162(a)(1) allows a taxpayer to deduct ordinary and necessary business expenses, including "a reasonable allowance for salaries or other compensation for personal services actually rendered." Treas. Reg. §1.162-7(a) provides that a taxpayer is entitled to a compensation deduction if the payments are reasonable in amount and paid purely for services.

The Tax Court followed the "*Elliotts'* factors" from the Court of Appeals for the 9th Circuit to determine the reasonableness of compensation in this case.[20] There are five *Elliotts'* factors, with no single factor being determinative. These factors take into consideration:

1. The employee's role in the company,
2. A comparison with other companies,
3. The character and condition of the company,
4. Any potential conflicts of interest, and
5. The internal consistency in compensation.

Applying *Elliotts'* factors to Randal's compensation, the court found the following:

1. The court found Randal's extensive hands-on management role weighed in Multi-Pak's favor.
2. After listening to expert witnesses testify for both the IRS and Multi-Pak regarding compensation comparisons, the court did not find either side to be completely convincing because neither side used comparables that were similar to Multi-Pak's size or corporate structure. The court declared this factor neutral.

20. *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241 (9th Cir. 1983), *rev'g* TC Memo 1980-282.

3. The court examined Multi-Pak's size as determined by sales, net income, and capital value; the complexities of the business; and general economic conditions. It determined that Multi-Pak was prominent in its industry and that the company's revenue increased from 2001 to 2002, but declined from 2002 to 2003. Despite the 2003 downturn in revenue and the company's lower net income after taxes, Multi-Pak's 2003 revenue was nearly 50% higher than in 2000 and its equity, revenue, and gross profit were highest in 2002 and 2003, attributable in part to the company's major retooling efforts in 2001 under Randal's leadership. Multi-Pak's business was complex and it adapted quickly to increased customer demand by doubling production and tripling its plant size — all without taking on additional debt. The court ruled that these factors weighed in Multi-Pak's favor.

4. The court examined whether Randal's relationship to the company presented a conflict of interest that would result in disguising nondeductible corporate distributions as compensation. In cases such as this when a compensated employee controls the corporation, the court employs close scrutiny of the relationship.[21]

   The court evaluates reasonable compensation from the perspective of a hypothetical investor, beginning the test of a company's annual return on equity with its net income after taxes for the year.[22] The court determined Multi-Pak's net profit after payment of compensation and provision for the payment of income taxes yielded a return on equity of 2.9% in 2002 and (15.8)% in 2003.[23] Although the court found a hypothetical investor would be satisfied with a 20% average rate of return on equity, it acknowledged there are situations in which a corporation could underperform or suffer a loss without compensation being found unreasonable.

   Randal became Multi-Pak's president in 1973 and was instrumental in keeping the company from declaring bankruptcy and returning it to financial stability. During 2002 and 2003, the company's sales were at or near all-time highs and the company had little or no debt because of Randal's leadership.

   The court deduced that an independent investor might be content with lower rates of return in exchange for Randal's "sole" contribution to the company's rising income. However, it doubted that an investor would be satisfied with a negative 15.8% return. The court found in favor of Multi-Pak for 2002 and in favor of the IRS for 2003 on this factor.

5. Finally, the court scrutinized Multi-Pak's bonus payment plan. Corporations can disguise dividends as compensation when bonuses are determined at yearend, after the corporation knows its revenue for the year.[24] Multi-Pak determined bonuses on a monthly basis, dependent on productivity and profit. *Elliotts* found such incentive payments to be valuable to the corporation as well as to the employee. The court ruled Multi-Pak's treatment of Randal's bonuses to be a "consistent business policy."

IRC §6662 imposes a 20% accuracy-related penalty on an underpayment that is due to negligence or intentional disregard of rules or regulations. A §6662(a) penalty is not imposed if the taxpayer had reasonable cause for the underpayment and acted in good faith. If a taxpayer relied in good faith on the advice of an independent, competent professional as to the tax treatment of an item, he may demonstrate that he exercised ordinary business care and prudence as to the disputed item.[25]

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21. *Elliotts*, at 1246–1247.

22. *Dexsil Corp. v. Comm'r*, 147 F.3d 96, 99 (2d Cir. 1998), *vacating* TC Memo 1995-135; *Labelgraphics, Inc. v. Comm'r*, TC Memo 1998-343, *aff'd* 221 F.3d 1091 (9th Cir. 2000).

23. See *John L. Ginger Masonry, Inc. v. Comm'r*, TC Memo 1997-251.

24. *Owensby & Kritikos, Inc. v. Comm'r*, 819 F.2d 1315 (5th Cir. 1987), *aff'g* TC Memo 1985-267; *Estate of Wallace v. Comm'r*, 95 TC 525, 556 (1990), *aff'd* 965 F.2d 1038 (11th Cir. 1992).

25. *U.S. v. Boyle*, 469 U.S. 241 (1985).

For a taxpayer to rely reasonably upon professional advice in order to negate a §6662(a) accuracy-related penalty, the taxpayer must prove that each of the following requirements were met:[26]

1. The adviser was a competent professional who had sufficient expertise to justify reliance;
2. The taxpayer provided necessary and accurate information to the adviser; and
3. The taxpayer relied in good faith on the adviser's judgment.

Randal met each of these requirements for 2003. There was nothing in the record that indicated that Mr. Brown was not a competent professional. Mr. Brown testified that Randal called him with the bonus amounts and Mr. Brown made a decision on reasonableness at the end of the year.

Holding. The court held Multi-Pak paid Randal Unthank reasonable compensation for 2002, but adjusted his allowable compensation downward to $1,284,104 for 2003 to reflect compensation that would have resulted in a more reasonable 10% return on equity. The court did not sustain the accuracy-related penalty for 2003 because Randal relied in good faith on the accountant's advice and the reliance was reasonable.

DEDUCTIONS

Illegal Deductions Claimed

William G. Halby v. Comm'r, **TC Memo 2009-204 (Sep. 14, 2009)**
IRC §§213 and 6662

☞ Tax Attorney Not Allowed Deductions for Prostitutes and Pornography

Facts. William Halby is a tax attorney residing in New York. During 2004 and 2005, he visited prostitutes in New York and purchased pornography and books and magazines on sex therapy. He recorded in a journal the dates and amounts of the costs incurred.

Halby timely filed his 2004 and 2005 Forms 1040, on which he claimed $76,314 and $49,203 of medical expense deductions on his Schedules A for those years, respectively. His returns included attachments to Schedule A which provided vague descriptions of the types of costs Halby was claiming as deductions.

The IRS issued Halby a notice of deficiency on June 21, 2007. The notice disallowed $73,934 of Halby's claimed medical expense deductions for 2004 and $47,024 of his claimed medical expense deductions for 2005. The disallowed deductions included amounts spent for books, magazines, videos, pornographic material, prostitutes, and bank and finance charges incurred in connection with loans used to pay for the expenses.

Issues. The issues in this case are as follows:

- Whether Halby is entitled to the claimed medical expense deductions in 2004 and 2005, and
- Whether Halby is liable for the IRC §6662 accuracy-related penalty for those years

Analysis. The IRS stated that Halby is not entitled to deduct amounts paid to prostitutes because such payments are illegal. He also did not provide substantiation as required by Treas. Reg. §1.213-1(h). The IRS also argued that Halby is not entitled to deduct amounts paid for books on sex therapy and pornographic material because those amounts were not pursuant to a doctor's prescription or for a specific medical condition.

Halby cited book and magazine articles about the positive health effects of sex therapy and argued that he should be allowed the deduction despite the illegality of his conduct or the lack of a doctor's prescription.

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26. *Ellwest Stereo Theatres, Inc. v. Comm'r,* TC Memo 1995-610; see also Rule 142(a)(2).

The court agreed with the IRS in its assertion that patronizing a prostitute is illegal in the state of New York. Treas. Reg. §1.213-1(e)(1)(ii) states that a taxpayer is not entitled to deduct any illegal operations or treatments. The court also stated that Halby's purchases of books and magazines on sex therapy and pornography were not for the treatment of a medical condition but were instead personal items.

Halby did not have reasonable cause or basis for claiming the deductions at issue, according to the court. Halby has been an attorney for 40 years, and he specialized in tax law. He should have known that his visits to prostitutes were illegal in New York and that case law did not support his claimed deductions.

Holding. The court held that Halby is not entitled to deductions for amounts paid for books, magazines, and prostitutes. He was also found liable for the §6662 accuracy-related penalty.

Education Expenses

***Lori A. Singleton-Clarke v. Comm'r,* TC Summ. Op. 2009-182 (Dec. 2, 2009)**

IRC §162

☞ Registered Nurse Allowed to Deduct Educational Expenses for MBA Degree

Facts. Lori Singleton-Clarke obtained a Bachelor of Science degree in nursing in 1984. She became a registered nurse (RN) and worked in various capacities for the next 24 years for hospitals and long-term care facilities. From 1993 to 2004, Singleton-Clarke held various nursing management positions of increasing responsibility. From 2004 to 2008, she worked at three different hospitals where her responsibilities were nearly identical.

In March 2005, Singleton-Clarke began taking online courses through the University of Phoenix. She graduated in April 2008, obtaining an MBA with a specialization in Health Care Management. Singleton-Clarke paid the entire cost of the MBA program herself.

Singleton-Clarke timely filed her 2005 federal income tax return. The IRS examined her return and issued a notice of deficiency, disallowing $14,787 in unreimbursed employee business expenses for education expenses.

Issue. Whether Singleton-Clarke is entitled to deduct the education expenses she paid in 2005 in connection with the MBA degree

Analysis. Treas. Reg. §1.162-5 provides that a taxpayer may deduct education expenses if the education:

- Maintains or improves skills required for the individual's job or other trade or business; or
- Meets the requirements imposed as a condition of an established employment relationship, status, or rate of compensation.

The regulations conversely state that if the education qualifies the individual for a new trade or business, then the education expenses are not deductible.[27]

In the three jobs that Singleton-Clarke held since 2004, she served as a quality control coordinator at acute care hospitals and medical centers. All three positions required an RN license or a Bachelor's in nursing, with clinical or risk management experience. She was hired for the first two jobs she held during this period before she obtained the MBA degree. She was hired by St. Mary's Hospital in September 2008, a few months after she received her MBA degree.

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27. Treas. Reg. §1.162-5(b)(3).

The court has had differing outcomes in deciding whether taxpayers may deduct education expenses related to pursuing an MBA degree, depending on the facts and circumstances of each case. The decisive factor is generally whether the taxpayer was already established in her trade or business. In Singleton-Clarke's situation, she had already worked as a quality control coordinator and had over 20 years of related work experience, during which she gained vast clinical and managerial knowledge in healthcare settings before she began the MBA program. In summary, the MBA may have improved Singleton-Clarke's skills, but she was already performing the required tasks of her trade or business before commencing the MBA program.

Holding. Singleton-Clarke's MBA degree did **not** qualify her for a new trade or business; therefore, she was entitled to deduct her education expenses for 2005.

Charitable Deductions

***Jeffrey N. & Patricia A. Wilkes v. Comm'r,* TC Summ. Op. 2010-53 (Apr. 22, 2010)**

IRC §§170 and 501(c)(3)

☞ Church Contributions Scrutinized

Facts. Jeffrey and Patricia Wilkes (Wilkes) belonged to the Westside Church of Jesus Christ in Golden, Colorado. Church of Jesus Christ followers believe that Jesus Christ is their only leader; therefore, their church has no formal leadership and no hierarchical structure. Members form independent community churches, and each church relies on the support of local members. Church of Jesus Christ doctrine prohibits local churches from accepting contributions directly from nonmembers.

In 2005, Wilkes contributed the following amounts, which they deducted as charitable contributions on their 2005 income tax return:

$ 3,450	to "Needy Saints"
6,000	to Mr. Smith for the establishment of a church in Flint, Michigan
6,500	to Mr. Small for the establishment of a church in Raleigh, North Carolina
6,000	to Mr. Saayman for the establishment of a church in South Africa
$21,950	

"Needy Saints" are private individuals, both members and nonmembers, who seek financial help from a local Church of Jesus Christ and whose requests are deemed worthy by the church elders. Wilkes gave contributions directly to seven individuals in 2005, in amounts ranging from $50 to $1,850. The largest contribution went to a woman who provided transportation to the disadvantaged; the rest of the money went to support the daily lives of the remaining Needy Saints.

Smith, Small, and Saayman were missionaries and evangelists for the Church of Jesus Christ. They used Wilkes' contributions to recruit members to new community churches, purchase and provide religious education materials, and to provide for their basic financial support. These missionaries accounted for their spending to both Wilkes and their local churches.

The IRS denied all $21,950 of Wilkes' charitable contributions for 2005 and issued a notice of deficiency to them on November 27, 2007.

Issues. Wilkes presented the Tax Court with the following issues:

- Whether the $3,450 of donations they gave to Needy Saints were deductible charitable contributions under IRC §170,
- Whether their $6,000 contribution for missionary work in South Africa on behalf of the Church of Jesus Christ was deductible under §170,
- Whether their contributions totaling $12,500 for missionary work performed with local churches in the United States were deductible under §170, and
- Whether the IRS violated their First Amendment rights by disallowing part of their charitable contributions

Analysis. IRC §170(c)(2) provides that deductible contributions must be given "for the use of…a corporation, trust, or community chest, fund, or foundation — created or organized in the United States…or under the law of the United States…organized and operated exclusively for religious [or] charitable… purposes…no part of the net earnings of which inures to the benefit of any private…individual."

The court's first order of business was to determine who "stood in receipt of" Wilkes' contributions. Because the Church of Jesus Christ did not have a hierarchical structure outside the local churches, the Church as a whole was not recognized as a qualified donee. The court ruled "[t]he mere presence of religious faith does not create an organized entity."

Since Wilkes donated money directly to the Needy Saints, the court deemed these deductions private gifts and therefore nondeductible, stating, "[a]lthough the recipients were morally obligated to use the funds in accordance with religious teachings, no organization or entity besides the individuals was the beneficiary of the gift." The court did not distinguish between the individual who used the money for transportation for the needy and the individuals who used the money for personal support.

Deductions are a matter of legislative grace, and as such, Wilkes bore the burden of proving they were entitled to claim their contributions. Wilkes did not prove Mr. Saayman created or organized the South African church in the United States or under U.S. laws; therefore, the court deemed the deduction to Mr. Saayman failed §170(c)(2).

The contributions given directly to missionaries Smith and Small to start churches in the United States posed a unique set of problems. The IRS had allowed Wilkes to deduct contributions to their local church and it did not deny that the Michigan and North Carolina churches were organized in the United States and operated exclusively for religious purposes. However, the fact that the contributions were given directly to the missionaries and not the individual churches was an issue.

Several authorities provide that contributions given to an agent of a qualified organization may be deductible.[28] An agent is one who "acts on behalf of and under the control of a principal" but "both the principal and the agent must manifest consent to the relationship." To determine if an agency exists, the court looks at (1) the relationship between the principal and the agent, and (2) the interaction of the agent with third parties on the principal's behalf.

Since Church of Jesus Christ doctrine prohibits local churches from accepting funds directly from nonmembers and the Church has no hierarchy to provide funding, local churches need agents to get started. The Michigan and North Carolina churches relied on Smith and Small, respectively, to solicit, collect, and disburse funds on their behalf and to interact with the public to recruit members. This established their agency relationship.

The fact that Smith and Small also reported regularly to their local churches, where the church elders monitored their actions and had the authority to dismiss them, convinced the court that they had established a proper agency relationship with their churches and were thus entitled to accept donations on behalf of the churches. All of these factors led the court to conclude that the contributions given directly to the missionaries were deductible.

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[28] *Skripak v. Comm'r,* 84 TC 285, 318 (1985); *Guest v. Comm'r,* 77 TC 9, 16 (1981); Rev. Rul. 57-487, 1957-2 CB 157.

The court did not accept Wilkes' argument that their constitutional rights were violated because contributions made according to the teachings of their church were not deductible. The Supreme Court found "a statute primarily having a secular effect does not violate the Establishment Clause merely because it 'happens to coincide or harmonize with the tenets of some or all religions.'"[29] Wilkes can deduct donations they give to their local church, so they are able to structure their donations to allow them to comply with the Code. Therefore, they do not bear any substantial burden that violates their right to the free exercise of their faith.

Holding. The court held the following:

1. The $3,450 donated to individuals was **not** deductible;
2. The $6,000 contributed for missionary work in South Africa was **not** deductible;
3. The $12,500 donated for missionary work performed with local churches in the United States was deductible under IRC §170; and
4. Wilkes' First Amendment rights were not violated.

Itemized Deductions — Medical

***Rhiannon G. O'Donnabhain v. Comm'r*, 134 TC No. 4 (Feb. 2, 2010)**
IRC §213

☞ Medical Deductions Allowed for Sex Reassignment Surgery

Facts. Rhiannon O'Donnabhain was born male with "unambiguous male genitalia." Although she felt uncomfortable as a male and started secretly dressing as a female as young as age 10, she lived as a man, got married, and fathered three children.

In 1997, O'Donnabhain was diagnosed with gender identity disorder (GID), a condition described in medical texts as one in which "an individual experiences persistent psychological discomfort concerning his or her anatomical gender."

One standard of treatment for males with severe and persistent GID is to administer feminizing hormones and have the patient live publicly as a female for at least a year. After this time, the patient may undergo sex reassignment surgery to reconstruct his body to anatomically resemble a woman's body.

O'Donnabhain underwent hormone treatment under a doctor's care from 1997 to 2001. In 2000, she had plastic surgery to feminize her facial features and entered public life full time as a female. In 2001, O'Donnabhain underwent sex reassignment and breast augmentation surgeries.

O'Donnabhain claimed a medical deduction of $21,741 on her 2001 tax return for the cost of these surgeries, related expenses, and transportation costs. The IRS disallowed these deductions. O'Donnabhain claims she underwent hormone treatment and sex reassignment surgery to treat GID, which was "a well recognized mental disorder in the psychiatric field that 'falls squarely within the meaning of 'disease' because it causes serious, clinically significant distress and impairment of functioning.'"

The IRS contends O'Donnabhain's medical expenses were for cosmetic enhancements to her appearance. It claims that GID is a mental disorder, but it does not rise to the level of a disease because it doesn't stem from "organic pathology within the human body." The IRS further argued that gender reassignment surgery does not treat the disease, and that O'Donnabhain was misdiagnosed with GID.

29. *Hernandez v. Comm'r*, 490 U.S. 680 (1989), quoting *McGowan v. Maryland*, 366 U.S. 420, 442 (1961).

Issues. The issues in this case include the following:

1. Whether gender identity disorder is a disease within the meaning of IRC §213(d)(1)(A) and (9)(B), and
2. Whether expenses associated with the treatment of gender identity disorder are deductible

Analysis. IRC §213(d)(1)(A) defines "medical care" as amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body. The court notes this is a two-pronged approach: "The first prong covers amounts paid for the 'diagnosis, cure, mitigation, treatment, or prevention of disease' and the second prong covers amounts paid 'for the purpose of affecting any structure or function of the body.'"

Since it was discovered that the second prong opened the medical deduction to cosmetic surgery, Congress added subsection (d)(9) to IRC §213 in 1990 to exclude what a House conference report called expenses for "elective, purely cosmetic treatment."

The legislative history of §213 and its regulations extend the term "disease" to include a mental defect. The court has long held the position that "mental disorders can be 'disease' within the meaning of [section 213(d)(1)(A)] is no longer open to question."[30]

After reviewing case law and the legislative history of §213, the court developed a framework for analyzing disputes regarding medical expense deductions in *Jacobs*.[31] In order to claim a deduction, a taxpayer must show:

1. The present existence or imminent probability of a disease, defect, or illness — mental or physical; and
2. A payment for goods or services directly or proximately related to the diagnosis, cure, mitigation, treatment, or prevention of the disease or illness.

The court devised an additional "but for" test for expenses that serve both a personal as well as medical purpose. For this test, the taxpayer must prove that the expense was for an essential treatment element and would not have been incurred for nonmedical reasons.

The court found that GID is a disease, within the meaning of §213. It based this opinion on the fact that GID is listed as a mental disorder in numerous medical textbooks and in the DSM-IV-TR, which is the primary diagnostic tool of American psychiatry. The court rejected the IRS's argument that a disease has to have an organic pathology, citing bulimia as an example of a disease with no known organic origin.

After establishing that GID is a disease, the court turned its attention to what expenses are allowable in treating the disease. It found that cross-gender hormone therapy and sex reassignment surgery are widely recognized and accepted treatments for severe GID because they relieve the distress caused by the disease, noting "[t]hus, a 'reasonable belief' in the procedures' efficacy is justified."

The court found that since O'Donnabhain's hormone therapy and surgery alleviated her suffering and actually treated her disease, it was not considered cosmetic surgery based upon the specific definition of that term in IRC §213(d)(9)(B), and was therefore allowable as a medical expense deduction.

However, the court considered O'Donnabhain's breast augmentation surgery a separate matter due to the facts and circumstances of her case. O'Donnabhain began developing breasts from the hormone treatment. Prior to the surgery, her surgeon described her appearance as "approximately B cup breasts with a very nice shape." The court found that since O'Donnabhain's breasts were "within a normal range of appearance" for her "social gender role," the additional augmentation amounted to aesthetic enhancement and was therefore nondeductible as elective cosmetic surgery.

30. *Starrett v. Comm'r*, 41 TC 877 (1964); *Hendrick v. Comm'r*, 35 TC 1223 (1961).

31. *Jacobs v. Comm'r*, 62 TC 813 (1974).

Holding. In a case of first impression, the court held:

1. O'Donnabhain's gender identity is a disease within the meaning of IRC §213(d)(1)(A) and (9)(B);
2. O'Donnabhain's hormone therapy and sex reassignment surgery were for the treatment of such disease and therefore were not disallowed as cosmetic surgery under IRC §213(d)(9)(A), but could be deducted as medical expenses under IRC §213(a); and
3. O'Donnabhain's breast augmentation surgery was cosmetic in that it improved her appearance and did not promote proper body function or treat her disease; therefore, it was disallowed as a medical deduction.

Note. As one judge observed in a footnote, the IRS was heavily vested in the outcome of this case. Its opening brief was 209 pages long, followed by a 72-page answering brief. A total of eight attorneys assisted the Chief Counsel in preparing this case.

Charitable Deductions

***Huda T. Scheidelman and Ethan W. Perry v. Comm'r,* TC Memo 2010-151 (July 14, 2010)**
IRC §§170, 6662, and 6664

☞ Taxpayer Denied Contribution Deduction for Historical Façade Easement

Facts. Huda Scheidelman purchased a home in the registered historic district of Brooklyn, New York in September 1997 for $255,000. In the fall of 2002, she received a solicitation to donate a façade conservation easement to the National Architectural Trust (NAT), an IRC §501(c)(3) organization. This donation would grant her tax benefits for agreeing to place a preservation restriction agreement on her deed to preserve the historic façade of her home.

Scheidelman consulted with John Somoza, her accountant of 10 years, regarding the easement. Somoza, a 40-year veteran tax preparer, admitted he was unfamiliar with the donation of historic façade easements but attended an NAT-sponsored seminar and further researched the tax aspects of the donation. As a result of his studies, Somoza cautioned Scheidelman that while the Code permitted a deduction for a qualified contribution, donating the façade easement would encumber the property and could make it more difficult to sell.

Scheidelman applied to NAT for the façade conservation easement in March 2003. The application stated that an "agreed upon cash donation of 10% of the easement value is required at the time the easement donation is accepted by [NAT]" since NAT's operating costs are solely funded through cash contributions from those donating façade easements. Scheidelman submitted a $1,000 deposit with her application.

In April 2004, NAT sent Scheidelman a letter stating that all of the required approvals had been obtained for the easement and that Scheidelman needed to order an appraisal. Scheidelman selected Michael Drazner, a qualified real estate appraiser and valuation expert, from the list of qualified appraisers NAT provided.

Drazner completed the appraisal in May 2004. Drazner estimated the home's market value at $1,015,000 as of the appraisal date. The Drazner report stated that the IRS "generally recognize[s]" that a façade easement donation results in a 10–15% loss in property value. Acknowledging the lack of market data regarding façade easement donations in the area, Drazner estimated the market reduction on Scheidelman's home at $115,000. He described this amount as "…approximately 11.33% of the fee simple value of $1,015,000 [based on a] range of value that the IRS has historically found to be acceptable as well as historical precedents."

After receipt of the Drazner report, NAT sent Scheidelman a letter stating they would apply a 15% discount to the requested cash donation if she closed on the easement contribution by June 30, 2004. Scheidelman sent a check for $9,275 on June 18, 2004. In turn, NAT sent Scheidelman a letter certifying that she received no goods or services in return for her gift and enclosed a Form 8283, *Noncash Charitable Contributions*, executed by the appraiser and NAT.

Scheidelman claimed a deduction for the $115,000 façade easement contribution on her 2004 return. However, her deduction was limited by IRC §170(b) and she carried over $63,083 to subsequent years. She claimed $59,959 of this carryover contribution as a deduction on her 2005 return and deducted the remaining $3,124 on her 2006 return, which she filed jointly with her husband Ethan Perry. No deduction was claimed for the cash contribution to NAT for any of these years. Somoza prepared the returns for all three years based on information he was supplied.

The IRS issued Scheidelman a notice of deficiency dated March 21, 2008, disallowing the deduction for the easement contribution for 2004 and subsequent years, stating that the return failed to establish the FMV of the charitable deduction. Additional tax of $16,873 was assessed for 2004 and $17,537 for 2005, as well as IRC §6662(a) penalties for each year. A second deficiency letter dated the same date notified Scheidelman and Perry of a deficiency of $1,015 and a §6662(a) penalty on their 2006 tax return.

Issues. The issues for decision are:

1. Whether Scheidelman is entitled to a charitable contribution deduction for her historic façade easement donation,
2. Whether a mandatory cash payment made to a donee organization is deductible as a charitable contribution, and
3. Whether §6662(a) penalties should apply

Analysis.

Issue 1. IRC §170(a)(1) allows a deduction for any charitable contribution verified under IRS regulations. Regulations require a donor claiming a noncash contribution in excess of $5,000 to obtain a qualified appraisal of the property, attach a fully completed appraisal summary (i.e., Form 8283) to the donor's tax return, and maintain records pertaining to the claimed deduction.

IRC §170(f)(11)(E), added by the American Jobs Creation Act of 2004 and effective for contributions made after June 3, 2004, provides that the term "qualified appraisal" means an appraisal that is treated as a qualified appraisal under regulations or other guidance prescribed by the Secretary. For returns filed or prepared on or before August 17, 2006, the requirements under Treas. Reg. §1.170A-13(c) related to qualified appraisal and qualified appraiser apply.

Treas. Reg. §1.170A-13(c)(3) requires that a qualified appraisal be made no earlier than 60 days before the contribution date and no later than the due date of the return for which the deduction is first claimed. The appraisal must be signed and dated by a qualified appraiser and include specified information.

The court found that the Form 8283 attached to Scheidelman's 2004 tax return "did not include the date and manner of acquisition of the property purportedly contributed or the cost or other basis of the property purportedly contributed, adjusted as provided by IRC §1016. These defects alone demonstrate that there has not been strict compliance with the regulation requirements."

Despite being confronted with conflicting testimonies at trial, the court declined to rule on the valuation of the donated easement because it held the Drazner report was not a qualified appraisal. Specifically, the court found that the Drazner report failed to outline and analyze qualitative factors leading to the after-donation appraisal and failed to explain how the property's specific attributes led to Drazner's value determination.

Scheidelman next argued that she is entitled to the façade easement contribution deduction since she substantially complied with the regulations. However, the court relied on precedent to hold that the doctrine of substantial compliance does not excuse her requirement to provide a qualified appraisal.[32]

32. *Hewitt v. Comm'r*, 109 TC 258, 264-266 (1997), *aff'd without published opinion* 166 F.3d 332 (4th Cir. 1998); *D'Arcangelo v. Comm'r*, TC Memo 1994-572.

Issue 2. A payment to a qualified organization must be a contribution or gift in order to be deductible. A payment of money or transfer of property generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return.[33]

A **quid pro quo** transaction, or one in which the taxpayer's payment is contingent on receiving a "specific benefit in return, and where the taxpayer cannot receive the benefit unless he pays the required price" fails to qualify as a charitable deduction under IRC §170.[34]

An exception to the quid pro quo rule occurs when the taxpayer donates money or property that clearly demonstrates it exceeds the value of the benefit received.[35] The court held Scheidelman did not prove that she contributed more to NAT than the value she received.

Issue 3. IRC §6664(c)(1) waives accuracy-related penalties in situations in which the taxpayer acted with reasonable cause and in good faith. The court has held reasonable cause exists when a taxpayer relies in good faith on the advice of a qualified tax adviser. The court ruled that Scheidelman relied in good faith on Somoza, who was a qualified tax professional, who in turn relied in good faith on Drazner, a qualified appraiser.

Holding. The court held as follows:

1. Scheidelman is not entitled to a charitable contribution deduction for the façade easement donation to NAT because her appraisal failed to comply with required Treasury regulations.
2. The mandatory cash payment to NAT was not deductible because Scheidelman's transaction with NAT was considered quid pro quo and there was no evidence that she contributed more than she received in value from NAT.
3. The §6662(a) penalties were waived due to Scheidelman's reasonable good faith reliance on her tax preparer.

DEPENDENCY ISSUES

Nonconforming Agreement

***Stephen S. Gessic v. Comm'r,* TC Memo 2010-88 (Apr. 22, 2010)**
IRC §§152 and 24

☞ Conditional Agreement Does Not Qualify as a Substitute Form 8332

Facts. Stephen Gessic and Dana Gessic divorced in August 1997. Attached to the judgment entry for the divorce was a separation agreement and a shared parenting plan which were signed by Mr. and Ms. Gessic.

Ms. Gessic was the custodial parent, however Mr. Gessic was granted visitation rights on the weekends, for one or two weeks during the summer, and a week near Christmas. Under the terms of the separation agreement, Mr. Gessic was required to make monthly child support payments. It was further agreed that Mr. Gessic would be allowed to claim the dependency exemptions for the two minor children if he was current on his child support payments and if Ms. Gessic had not returned to full-time work, earning over $20,000 per year. If either of these conditions were not met, he would only be entitled to claim the exemption for the younger child.

33. *U.S. v. Am. Bar Endowment,* 477 U.S. 105, 116 (1986).

34. *Graham v. Comm'r,* 822 F.2d 844, 849 (9th Cir. 1987), *aff'd sub nom Hernandez v. Comm'r,* 490 U.S. 680.

35. *U.S. v. Am. Bar Endowment,* at 117.

During the year at issue, both conditions were met. He claimed dependency exemptions and child tax credits for both minor children on his 2005 tax return. However, Ms. Gessic refused to sign Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents,* so he attached the appropriate page from the separation agreement which contained both his and Ms. Gessic's initials.

The IRS issued a notice of deficiency, disallowing the dependency exemptions and child tax credits.

Issues. The issues presented in this case are as follows:

1. Whether Mr. Gessic is entitled to two dependency exemptions for dependent children totaling $6,400 during 2005, and
2. Whether he is entitled to child tax credits of $2,000 for 2005

Analysis. IRC §151(a) allows a dependency exemption to be claimed for each individual who is a dependent of the taxpayer. In the case of divorced parents, IRC §152(e) provides special rules used to determine who is entitled to the dependency exemption for a child. IRC §152(e)(2) allows the noncustodial parent to claim a dependency exemption if the custodial parent signs a written declaration releasing the claim to exemption and the noncustodial parent attaches the declaration to the tax return. The declaration must be made either on Form 8332 or on a statement conforming to the substance of that form which includes the following:

- Name of each child,
- Name and social security number of the noncustodial parent claiming the dependency exemption,
- Social security number of the custodial parent,
- Signature of the custodial parent,
- Date of the custodial parent's signature, and
- Year(s) for which the claims were released.

A taxpayer is entitled to claim a child tax credit for each qualifying child. A taxpayer may satisfy the qualifying child requirement if the taxpayer establishes entitlement to the dependency exemption under the exception of §152(e)(2).

Mr. Gessic contends that the page from the separation agreement, which is initialed by Ms. Gessic and him, is a substitute for Form 8332. This document contained initials from both Mr. and Ms. Gessic; however, it did not include the date of such initials, the names of the minor children, or the names or social security numbers of the custodial and noncustodial parents. Moreover, since the separation agreement document is conditional, the entitlement to the exemptions may change from year to year.

The court stated that the IRS cannot be expected to police divorce decrees and separation agreements or determine taxpayer compliance with respect to such documents. **Mr. Gessic's document does not conform to the requirements for a substitute for Form 8332.**

Holding. Mr. Gessic is not entitled to dependency exemptions and child tax credits for his children because the document he and his ex-wife initialed did not conform to Form 8332.

> **Note.** See pages 48–52 in the 2009 *University of Illinois Federal Tax Workbook* for a detailed explanation of claiming the dependency exemption in divorce situations. This can be found on the accompanying CD.

DIVORCE ISSUES

Payment of Attorney's Fees in Divorce

***Michael R. Glatfelter Sr. v. Comm'r*, TC Summ. Op. 2010-2 (Jan. 11, 2010)**
IRC §§71 and 215

☞ Individual Not Entitled to Alimony Deduction for Former Wife's Legal Fees

Facts. Michael Glatfelter, a California resident, was granted a divorce in October 2003. Since that time, he has paid spousal support to his ex-wife in the amount of $200 per month. After a property settlement hearing in 2006, Michael was ordered to pay $4,000 toward his former spouse's attorney's fees. By the end of 2006, Michael had paid $3,400 of the $4,000 liability and $2,400 in alimony. On his 2006 personal income tax return, he deducted alimony payments of $5,800, the sum of the spousal support payments plus the attorney's fees.

The IRS initially disallowed the entire deduction but eventually conceded that he could deduct the $2,400 of alimony payments. The entire $3,400 paid for attorney's fees remained disallowed.

Issue. Whether the attorney fees Michael paid meet the IRS definition of deductible alimony or maintenance payments

Analysis. To be considered alimony by the IRS, payments must meet the following four conditions:[36]

1. They must be made under a divorce or separation agreement.
2. They must not be designated, by the agreement, as a payment not includible in gross income.
3. The payor and payee spouses, if legally separated, may not reside in the same household at the time payment is made.
4. The liability for the payments must cease upon the death of the payee spouse.

California law clearly separates alimony from attorney's fees and does not specify that liability for attorney's fees ends upon the remarriage or death of the ex-spouse. In addition, an appeals court has held that remarriage and death are treated "in a similar fashion" when determining continued liability of payments.

Because the 2006 court order obligating Michael to pay $4,000 toward attorney's fees did not state that his liability ended upon the remarriage or death of his ex-wife, the court relied on prior case law stating that orders to pay attorney's fees survive a remarriage of the payee spouse. The prior case dealt with remarriage, but remarriage is treated "in a similar fashion" as death. Thus, the liability for the attorney's fees does not end with death and doesn't meet the fourth condition for alimony. Because the payments are not alimony, they are not deductible.

Holding. Based upon the definition of alimony, the court upheld the denial of the $3,400 deduction.

36. IRC §71(b)(1).

Improper Alimony Deduction

***Patricia A. Kelly v. Comm'r*, TC Summ. Op. 2010-4 (Jan. 13, 2010)**
IRC §§6662 and 6664

☞ Individual's Reliance on Return Preparer Deemed Unreasonable

Facts. On January 22, 2007, Patricia and Michael Kelly signed a property settlement agreement as part of their divorce which stated that neither party would seek alimony payments. Also as part of the agreement, Patricia agreed to pay Michael $45,000 for his share of their jointly-owned house. The first of two payments was made in November 2006 in the amount of $22,500.

On Patricia's 2006 personal tax return, she deducted alimony payments of $22,500, thereby reducing her personal tax liability by $6,300. The IRS denied the alimony deduction and assessed an accuracy-related penalty of $1,260 for substantial understatement of income tax. Patricia conceded that she owed $6,300 of federal income tax but appealed the penalty on the basis that she had hired a professional tax preparer to complete her return and, therefore, was not responsible for the incorrect deduction.

Issue. Whether Patricia is liable for the accuracy-related penalty

Analysis. If an individual understates her income tax by the greater of 10% of the tax required to be shown on the return or $5,000, the IRS considers that to be substantial enough to incur an accuracy-related penalty of 20% of the underpaid tax.

Once the IRS met the burden of production as to whether the accuracy-related penalty was appropriate, it was up to Patricia to prove that she acted with reasonable cause and in good faith. Acting on the advice of a tax professional may constitute reasonable cause and good faith in certain circumstances. Patricia would be exempt from the penalty if she proved that she had provided accurate information to a competent professional and had relied upon her tax preparer's judgment to determine that the $22,500 payment was deductible. In court, Patricia admitted that she had told her tax preparer that the payment was for alimony and did not provide any additional documentation which would lead the preparer to believe otherwise.

Holding. The court determined that Patricia had not provided her tax preparer with enough information to allow him to make a decision upon which Patricia could reasonably rely and upheld the accuracy-related penalty of $1,260.

ESTATE AND GIFT TAXES

Property Valuation

***Estate of Oscar Goldberg et al. v. Comm'r,* TC Memo 2010-26 (Feb. 16, 2010)**
IRC §§2501, 2511, and 7491

☞ Properties Owned by Husband and Wife Held to be Tenancy by the Entirety

Facts. Oscar Goldberg (Oscar) lived in New York at the time of his 2004 death. His wife, Judith Goldberg (Judith), preceded him in death in 2001.

In 1968, Rachel Goldberg, Oscar's mother, quitclaimed two pieces of real estate to Oscar and his two siblings as tenants in common. The first property was located at 37–35 74th Street, Jackson Heights, New York (Property A) and the second was located at 37–40 74th Street, Jackson Heights, New York (Property B).

In 1977, Oscar transferred his share of Property A, which was then 11.66%, to "Oscar Goldberg and Judith Goldberg, as wife." He did likewise with his then 12.5% interest in Property B.

Judith did not transfer any of her interest in these two properties between then and her death. She died testate, but her will did not specifically mention either property. Her estate was split between Oscar and a trust. Oscar, as Judith's executor, transferred all Judith's interests in both properties to the trust.

Oscar did not transfer any of his interest in these properties between 1977 and his death. Oscar's Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, Schedule E, *Jointly Owned Property*, reported half interest in each of the Jackson Heights properties. His 5.83% interest in Property A was valued at $347,876 and his 6.25% interest in Property B was valued at $390,375.

The IRS determined a deficiency on the estate tax return, asserting (among other things) that the properties were owned by Oscar and Judith as tenants in the entirety. The IRS determined Oscar's ownership of Property A was 11.66%, valued at $695,752, and his ownership of Property B was 12.5%, valued at $780,750.

Oscar's estate claimed Oscar and Judith owned the properties as tenants in common.

Issue. Whether Oscar Goldberg and his wife owned both properties as tenants by the entirety or as tenants in common

Analysis. For federal estate tax purposes, property interests and rights are determined by state law. The New York Estate Powers and Trusts Law (EPTL) states "[a] disposition of real property to a husband and wife creates in them a tenancy by the entirety, unless expressly declared to be a joint tenancy or a tenancy in common."

In a tenancy by the entirety, each spouse has total possession of the property and when one spouse dies, the survivor takes the entire property. As such, an interest in property held in tenancy by the entirety cannot be divided. In a tenancy in common, each spouse owns a share in the property, so that when one spouse dies, his or her share goes to the estate.

Oscar's estate argues that Oscar and Judith owned the properties as tenants in common because that was Oscar's intention when he changed the deed to include Judith in 1977 or, alternatively, at a later date when he converted their interests to tenancies in common.

The court held the first argument failed because the 1977 deeds were ambiguous on the manner of title. The EPTL expressly establishes that unless spelled out in writing to the contrary, spouses hold title to New York property as tenants in the entirety.

As to the estate's second argument that Oscar and Judith converted their ownership to tenants in common prior to Judith's death, the court cited a New York Court of Appeals case that stated both spouses, while alive, could convert a tenancy by the entirety to a tenancy in common by the following acts:

1. Joining in a conveyance of property,
2. Obtaining a judicial decree of separation, annulment or divorce, or
3. Executing a written instrument that satisfies the requirements of New York law permitting division or partition of real property held in a tenancy by the entirety if clearly expressed in the instrument.[37]

The court did not find evidence that Oscar and Judith took any of these actions while living.

Holding. The court held that Oscar and Judith held both properties as tenants by the entirety, and thus Oscar took Judith's interest at her death. Therefore, the IRS's determination of the properties' values was upheld.

[37]. *In re Estate of Violi*, 482 N.E. 2d 29, 31 (N.Y. 1985).

EMPLOYMENT TAX ISSUES

Worker Classification

SS8 2010020002 (Oct. 26, 2009)
IRC §§3121 and 3401

☞ Direction and Control Determine Employee Status

Facts. During 2006 through 2009, a musician provided services to a church and received a Form 1099-MISC from the church for the services performed. The services included playing music on Sunday mornings from 10:30 a.m. to 11:30 a.m. and practicing two hours each week. The church's pastor provided directions to the musician each week via email.

Analysis. To determine whether the musician is an employee or independent contractor, the common law factors must be reviewed. The proper classification depends on the payer's right to direct and control the worker. Evidence of control generally falls into three categories: behavioral control, financial control, and relationship of the parties. The factors which weigh in favor of the **employee** classification in this case include the following:

- Right to control performance
- Right to direct and control the financial aspects of the worker's activities
- Relationship of the parties

The right to control performance is indicated by the church's retention of the right to change the worker's methods and to direct the worker to the extent necessary to protect the church's financial investment. For the right to direct and control the financial aspects, the worker did not invest capital or assume business risks, thus having no opportunity to realize a profit or incur a loss. Finally, the worker was not engaged in an independent enterprise. Both the church and the worker had the right to terminate the work relationship at any given time without incurring a liability.

Holding. Since the church had the right to exercise direction and control over the musician, the musician is an employee of the church and the compensation is subject to employment taxes.

> **Note.** This is an individual IRS worker classification ruling and cannot be broadly applied.

Payroll Taxes

***Douglas McVey v. U.S. et al.,* No. 08-05283 U.S. Bankruptcy Court for the District of Kansas (Feb. 23, 2010)**
IRC §§6672 and 6871

☞ Corporate President Found to be "Responsible Person" Liable for Payroll Taxes

Facts. Douglas McVey founded Practice Automation, Inc. (PAI) with Jack Weir in November 2003. PAI, an Arkansas medical office software business, operated from late 2003 through February 2006 and employed 14 people at its peak. McVey was PAI's incorporator, registered agent, and president. His responsibilities included funding the business and managing its finances, such as executing contracts on PAI's behalf, signing checks, and signing the company's employment tax returns. Weir was responsible for sales, installation, support, and training.

McVey personally contributed $330,000 to fund PAI's start-up and operations and obtained a $60,000 letter of credit from an Arkansas bank, which he guaranteed. Weir did not make any financial contributions to the company. PAI suffered cash flow issues from its inception.

McVey interviewed and hired Phyllis Copeland as PAI's controller. Copeland began preparing a spreadsheet showing unpaid debts, including payroll taxes, as early as 2004, which she testified she provided to McVey on a weekly basis. McVey claims he was unaware of PAI's unpaid payroll tax liability until August 2005. In December 2005, he disclosed the unpaid liability on a loan application for the operating line of credit he obtained for PAI.

McVey selected which creditors for Copeland to pay and acknowledged that he directed her to pay other PAI obligations, including wages, copier supplies, rent, and utilities ahead of the payroll taxes. Copeland advised McVey that a "responsible person" could be held liable for PAI's payroll taxes in the event PAI failed to remit the taxes to the IRS.

McVey filed a voluntary Chapter 13 bankruptcy petition in September 2008. He also initiated an adversary proceeding against the IRS, claiming he was not liable for the assessment of $74,857 in PAI's unpaid payroll tax obligations, because he was not PAI's "responsible person."

Issues. The issues presented in the case are as follows:

- Whether McVey is a responsible person and liable for PAI's unpaid payroll tax obligation, and
- Whether he acted willfully in failing to submit the payroll taxes to the IRS

Analysis. IRC §6672 imposes a penalty on an officer or employee of a corporate employer who willfully fails to remit payroll taxes to the IRS.

In *Taylor*,[38] the 10th Circuit Court of Appeals developed a nonexclusive list of factors as "indicia of responsibility" when determining whether a corporate officer or employee is liable for payment of payroll taxes as a responsible person. The court looks at whether the person:

1. Held a corporate office,
2. Controlled financial affairs,
3. Had authority to disburse corporate funds,
4. Owned stock, and
5. Had the ability to hire and fire employees.

In McVey's case, the court determined that he was PAI's corporate president, controlled corporate financial affairs, disbursed corporate funds, and hired employees, including the corporate controller whom he directed.

Summarizing *Taylor*, the court deemed the "crucial inquiry" to be whether the individual had "effective power" to pay the taxes. In other words, did the person have the corporate status to possess actual authority and ability to pay the taxes? In McVey's case, the court stated, "…it is apparent from the facts that McVey possessed significant power and authority over PAI's fiscal affairs and largely managed those affairs."

In assessing whether McVey acted willfully in failing to remit the payroll taxes to the IRS, the court looked at whether he displayed a "voluntary, conscious and intentional decision to prefer other creditors over the Government."[39] Noting that negligence does not give rise to the §6672 penalty, the court cited *Smith v. U.S.*, which states that the willfulness requirement is met if the responsible party displays a "reckless disregard of a known or obvious risk that trust funds may not be remitted to the government."[40]

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38. *Taylor v. IRS*, 69 F.3d 411 (10th Cir. 1995).
39. *Burden v. U.S.*, 486 F.2d 302, 304 (10 Cir. 1973).
40. *Smith v. U.S.*, 894 F.2d 1549, 1554 n, 5 (11 Cir. 1990).

The court found that McVey knew no later than August 2005 that PAI had an unpaid payroll tax liability and, in fact, disclosed this liability on his loan application in December 2005. Also, McVey was aware of his potential liability because Copeland had advised him of the responsible person provision. Yet, McVey "consciously and intentionally" directed that Copeland disburse available funds in December 2005 to creditors and vendors needed to keep the business afloat and did not remit the payroll taxes to the IRS.

Holding. The court held McVey liable for the payment of PAI's unpaid payroll taxes and subject to the penalty for willful failure to pay trust fund taxes to the IRS.

GROSS INCOME

Life Insurance Policy

***Harvey S. and Willyce Barr v. Comm'r,* TC Memo 2009-250 (Nov. 3, 2009)**
IRC §§61, 72, and 6662

☞ Surrender of Life Insurance Contract Results in Recognition of Ordinary Income

Facts. Harvey Barr has been an attorney since 1964. He specializes in complex commercial transactions and bankruptcy law. He is admitted to practice before the U.S. Tax Court, several U.S. District Courts, the U.S. Court of Appeals for the Second Circuit, and the U.S. Supreme Court.

Mr. Barr's mother, Lillian Barr (Ms. Barr) purchased a life insurance policy in 1980 to help her children pay the anticipated estate tax liability after her death. It was a whole life policy with a face amount of $200,000 and had Mr. Barr and his sister, Susan Roe, as co-owners and beneficiaries of the policy.

For the first eight or nine years of the policy, Ms. Barr gifted the amount of the premiums to Mr. Barr and Ms. Roe, who then paid the premiums directly. After that, no additional payments were made by Mr. Barr or Ms. Roe. Instead, the premiums were automatically paid from dividend accumulations and loans against the cash value of the policy.

In 2005, the current holder of the policy, New England Financial (a MetLife affiliate), sent a letter to Mr. Barr explaining the tax consequences of the policy, along with a statement of gain. The letter stated that gain must be recognized as taxable income to the extent any cash received or loan extinguished exceeds the total net investment. A second statement of gain was sent to Mr. Barr in September 2005, which listed the net investment in the policy as $225,390, the total cash value as $361,353, the total indebtedness as $354,399, and the taxable gain as $135,963.

After discussion with Ms. Barr, Mr. Barr allowed the policy to terminate because it was no longer necessary. Mr. Barr surrendered the policy in December 2005. At that time, he was the sole owner and beneficiary.

In 2005, Mr. Barr received and cashed a check from the insurance company for $11,648 and a dividend check for $304. In January 2006, he received a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, from MetLife showing a gross distribution and taxable amount of $135,963 for 2005 and a Form 1099-DIV, *Dividends and Distributions*, showing a $304 taxable dividend.

Mr. Barr timely filed a federal income tax return jointly with his wife for 2005. The gross income reported by the couple did not include either the $135,963 shown on Form 1099-R or the $304 shown on Form 1099-DIV.

Issues. The issues of this case are:

- Whether the Barrs recognize ordinary income or capital gain from the surrender of the life insurance policy, and
- Whether they are liable for the IRC §6662(a) penalty

Analysis. Upon surrender of a life insurance contract, any amount received that is not payment under an annuity is included in gross income to the extent that it, when added to amounts previously received under the contract and excluded from gross income, exceeds the investment in the contract.[41]

When the policy terminated, Mr. Barr received a net distribution of $11,648, which represented the total cash value of $361,354, plus a terminal dividend of $4,694, less $354,399 withheld to repay the outstanding policy loan balance. The satisfaction of the policy loans had the effect of paying the policy proceeds to Mr. Barr and constituted income to him at that time. Thus, Mr. Barr constructively received the cash value of $361,354 upon surrender of the policy before reduction for outstanding loans. His net investment at that time was $225,390. As a result, he is taxed under IRC §72(e) on the $135,963 reported to the IRS on Form 1099-R.

The surrender of an insurance policy is not an exchange or sale of a capital asset and therefore does not result in capital gain. Mr. Barr argued that the facts in this case are so exceptional as to require capital gain treatment. The court disagreed, stating that nothing about the policy or the manner in which it was surrendered is exceptional.

When there is a substantial understatement of income tax or negligence or disregard of rules or regulations, the accuracy-related penalty is imposed unless the taxpayer acted with reasonable cause and in good faith.[42] Mr. Barr is an experienced attorney admitted to practice before the Tax Court. He knew, or should have known, that any proceeds paid out or gain recognized to him as the owner and beneficiary of the policy would be taxable to him. Therefore, his failure to report income shown on Form 1099-R was not on account of reasonable cause and good faith.

Holding. Mr. Barr and his wife recognized $135,963 of ordinary income in 2005 from the surrender of the life insurance policy and are liable for the accuracy-related penalty.

Wrongful Death Claim

Ltr. Rul. 200940006 (Oct. 2, 2009)
IRC §104

☞ Sale of Rights to Compensatory Damage Award for Wrongful Death Excludable from Income

Facts. Taxpayer was the survivor of a victim killed in an incident for which a governmental entity was responsible. Taxpayer was one of the parties to a lawsuit filed by the estates of those killed and their survivors in which Taxpayer sought recovery for intentional infliction of severe emotional distress caused by the death of one of those killed in the incident.[43] The court granted Taxpayer a portion of an aggregate recovery awarded to the plaintiffs for compensatory damages, prejudgment interest, and punitive damages.

While the court's damage award was on appeal, Taxpayer sold the rights to a portion of the damage award to an investor in exchange for an immediate cash payment, plus a graduated rate of return. Later, an act was passed which provided compensation to all parties who had claims for wrongful death and physical injury against the governmental entity. Pursuant to the act, the prior court award of damages to the plaintiffs was voided and vacated; and procedures were established to compensate victims under the agreement.

Taxpayer filed a request for a ruling to determine whether the funds received from the wrongful death claim are excludable from gross income under IRC §104(a)(2).

Analysis. IRC §104(a)(2) specifies that the amount of any damages received, whether by suit or agreement, on account of personal physical injuries or sickness is excludable from gross income. This exclusion applies to any damages received based on a claim of emotional distress that is attributable to physical injury or sickness.[44]

41. IRC §§72(e)(5)(A) and (C); Treas. Reg. §1.72-11(d)(1).

42. IRC §6664(c)(1).

43. The relationship of the taxpayer to the victim and other details about the incident have been redacted from the text of the letter ruling.

44. H.R. Conf. Rep. No. 104-737 at 301 (1996).

Taxpayer was awarded compensatory damages, interest, and punitive damages on a claim of intentional infliction of severe emotional distress. Taxpayer exchanged the right to recover a portion of the award for an immediate cash payment, which takes the place of the court's award.

Holding. The compensatory damages awarded to Taxpayer are excludable from gross income under §104(a)(2).

Damage Award

***Daniel J. and Brenda J. Stadnyk v. Comm'r,* U.S. Court of Appeals, 6th Circuit; No. 09-1485 (Feb. 26, 2010)**
IRC §§61 and 104

☞ Mediation Agreement Award Taxable

Facts. David and Brenda Stadnyk, Kentucky residents, bought a used 1990 Geo Storm from a dealership in 1996. Just seven miles down the road, the car broke down, resulting in $479 of car repairs. Fruitless efforts to discuss the broken-down auto with the dealership resulted in the taxpayers issuing a stop-payment order with the bank for one of the payments made to the dealership. The bank, however, miscoded the stop payment as a "NSF" order and returned it to the dealership.

The dealership filed a criminal complaint against Mrs. Stadnyk for issuing and passing a worthless check. She was arrested a few weeks later in front of her husband, daughter, and family friend and taken to the Fayette County Detention Center. Here she was searched via pat-down and use of electric wand. The next morning she was released on bail. Two months later, Mrs. Stadnyk was indicted for theft by deception based on the NSF check. The charges were later dropped.

Mrs. Stadnyk did not suffer any physical injury as a result of her arrest and detention. She did, however, visit a psychologist for eight sessions, the cost of which was covered by her insurance.

In 1999, Mrs. Stadnyk filed complaints again the dealership owner as well as the bank for malicious prosecution, abuse of process, false imprisonment, defamation, and outrageous conduct. The bank agreed to pay Mrs. Stadnyk $49,000 and provide her with a letter of apology as the result of a mediation agreement. The mediation agreement contained no language indicating the purpose of the settlement. Mrs. Stadnyk was advised by her attorneys, the bank's attorneys, and the mediator that the settlement would not be taxable.

Although Mrs. Stadnyk received a Form 1099-MISC from the bank for the $49,000 payment in 2002, the taxpayers did not report the settlement on their 2002 tax return. The IRS issued a notice of deficiency assessing tax and the accuracy-related penalty. The Tax Court sustained the additional tax but conceded the penalty. The Stadnyks appealed this decision.

Issue. Whether the $49,000 settlement must be reported as gross income

Analysis. IRC §61(a) defines gross income as all income from whatever source derived. IRC §104(a)(2) excludes any damages received on account of personal physical injuries or physical sickness from income taxation.

The Stadnyks argued that the $49,000 settlement does not constitute gross income under IRC §61(a) because Mrs. Stadnyk was only made whole — not enriched — by the compensatory damages. The settlement was for something she had lost and not for an accession to wealth.

The Supreme Court has found compensatory settlement awards that are not otherwise excluded to be taxable as gross income.[45] In the instant case, the $49,000 settlement falls under the meaning of gross income unless the taxpayers can show the exclusion under IRC §104(a)(2) applies. The Supreme Court, in *Schleier,* provides two independent requirements that must be met before the exclusion applies. First, the cause of action must give rise to recovery based upon tort or tort-type rights. Second, the damages must be received on account of personal injuries or sickness. In addition, in 1996, IRC §104(a)(2) was amended such that the injury must be a **physical** personal injury.

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45. *Comm'r v. Schleier*, 515 U.S. 323, 328 (1995).

The first requirement is satisfied since Mrs. Stadnyk alleged a number of tort claims against the bank. Although the mediation agreement was silent as to the nature of the claim, the court found her complaint to be an action in tort based on Kentucky banking laws. The second requirement calls for Mrs. Stadnyk to show that she sustained damages on account of personal physical injuries or sickness. During her deposition, Mrs. Stadnyk testified that she did not suffer any physical injury as a result of her arrest and detention. However, at trial she argued that she had suffered physical injury because physical restraint and detention and the resulting deprivation of personal liberty is a physical injury. Because she unequivocally testified that she suffered no physical injuries as a result of her physical restraint, the court determined she failed to establish physical injuries or physical sickness.

As a last ditch argument, the Stadynks argued that IRC §104(a)(2) violates the Sixteenth Amendment and is unconstitutional, which was also disregarded by the court.

Holding. Affirming a Tax Court decision, the 6th Circuit held the taxpayers liable for income tax on settlement proceeds because the underlying claims were not related to a physical injury.

Unreported Bank Deposits

***Leopold and Maria Koziej v. Comm'r,* TC Summm. Op. 2010-40 (Apr. 12, 2010)**

IRC §§61, 6662, and 6664

☞ Bank Deposit Analysis Identifies Additional Taxable Income

Facts. Illinois residents Leopold and Maria Koziej operated JMB Construction during 2004 and 2005 and reported $429,866 and $641,917 as gross sales on their federal income tax returns, respectively. During both of these years, they borrowed money to cover costs associated with the business.

An IRS audit, utilizing the bank deposits method, determined unreported income of $10,355 and $37,391 for 2004 and 2005, respectively. The IRS also assessed accuracy-related penalties for both years.

Issues. The issues in this case are as follows:

- Whether gross income should be increased based on bank deposits in excess of their reported income for 2004 and 2005, and
- Whether taxpayers are liable for accuracy-related penalties pursuant to IRC §6662(a) for 2004 and 2005

Analysis. IRC §61(a) defines gross income as all income from whatever source derived. In this case, the taxpayers do not dispute that the amounts were deposited into their bank account. Rather, they disputed the taxability of these amounts. They argued that these additional deposits represented "loans" and were not taxable income.

The taxpayers testified that they received loans from friends but could not provide any corroborating evidence to verify this. They provided multiple bank statements in hopes of corroborating the "loans" from friends. The bank statements provide the date and the amount of each deposit but do not indicate the source of any of the deposited funds.

The taxpayers also claimed that they made several draws on their line of credit in 2005, identifying two separate bank deposits in their bank records. They argued that these deposits resulted from draws on their line of credit; one in the amount of $40,000 and the other in the amount of $80,000. However, these deposits were actually made more than one month before the date they obtained their credit line.

The court applied a substance-over-form analysis to review the validity of the claimed loans. There were no written documents, no repayment terms, and, in fact, no clear indication that the taxpayers intended to repay the money.

Holding. The court found the Koziejs were liable for the determined income tax deficiency on the unreported bank deposits and for accuracy-related penalties.

Attorney Fees

Ltr. Rul. 201015016 (Jan. 5, 2010)

IRC §61

☞ No Pay Obligation Results in Exclusion from Gross Income

Facts. Taxpayer, one of several plaintiffs who sued a defendant engaged in improper practices, was represented by two legal aid groups and a law firm on a pro bono basis. Taxpayer had no obligation to pay any fees or costs to any of its representatives.

Taxpayer won the lawsuit and the maximum recovery was awarded. Legislation provided that plaintiffs are entitled to recover "the costs of the action, together with reasonable attorneys' fees and costs." The legal representatives filed a motion on their own for attorneys' fees and costs. A year later, the court awarded attorneys' fees attributable to the taxpayers' claim directly to the attorneys.

Issue. Whether the attorneys' fees awarded directly to the legal representatives are includible in the taxpayer plaintiff's gross income pursuant to IRC §61

Analysis. Under normal legal service contracts, the plaintiff agrees to compensate attorneys for the services provided whether by a contingency fee or a flat fee agreement. If the court awards attorneys' fees to a plaintiff and the plaintiff uses the recovery to pay the attorneys' fees, the plaintiff's gross income must include the attorneys' fees. The rationale is that the taxpayer receives a benefit from the payment.[46] The same rationale holds true when the third party pays the creditor directly and the taxpayer never receives the payment.[47] The Supreme Court viewed the contingency-fee based agreement in the same manner in *Banks.*[48] These cases all have one common ingredient; the litigant had an obligation to pay attorney fees.

In the current situation, the taxpayer had no obligation to pay attorneys' fees to any of the legal representatives. One of the legal aid organizations and the law firm requested attorneys' fee directly.

Holding. Attorney fees awarded by the court in this case are not includable in the taxpayer's gross income under IRC §61.

Wrongful Death Recovery

Ltr. Rul. 201019005 (Feb. 2, 2010)

IRC §104

☞ Wrongful Death Settlement Excluded From Income

Facts. Several individuals were killed in an incident and the survivors of those killed entered into a joint prosecution agreement (JPA) to pursue damage claims against the entity and its responsible officials. The survivors sued for damages and won. Subsequently, a law was passed to provide fair compensation to all claimants having claims for wrongful death and physical injury. The law voided all prior court proceedings and judgments for claims. The claims were paid and the taxpayer requested a ruling on the taxability of the claim.

Analysis. IRC §104(a)(2) provides that, except in the case of amounts attributable to deductions allowed under IRC §213 (relating to medical expenses) for any prior taxable year, gross income does not include the amount of any damages received on account of personal physical injuries or physical sickness.

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46. *Kenseth v. Comm'r,* 114 TC 399 (2000), *aff'd* 259 F.3d 881 (7th Cir. 2001).

47. *Old Colony Trust Co. v. Comm'r,* 279 U.S. 716 (1929).

48. *Comm'r v. Banks,* 543 U.S. 426 (2005).

Treas. Reg. §1.104-1(c) provides that the term **damages received** means an amount received through prosecution of a legal suit or action based upon tort or tort-type rights or through a settlement agreement entered into in lieu of such prosecution. Section 1605 of the Small Business Job Protection Act of 1996 (SBJPA) limits the exclusion from gross income provided by §104(a)(2) to amounts received on account of personal **physical** injuries or **physical** sickness. In a conference report to the SBJPA, Congress expressed its intent to include wrongful death damages as excludable under §104(a)(2).

The taxpayer's action brought in court and the claim filed with the (unspecified) Department sought recovery of damages for wrongful death and intentional infliction of emotional distress attributable to a personal physical injury. These claims are based in tort under Treas. Reg. §1.104-1(c).

Under the law, any recovery of compensatory damages that Department awards are for wrongful death. This wrongful death recovery (as adjusted by the JPA) is received on account of a personal physical injury under §104 (a)(2).

Holding. Amounts received from wrongful death action resolved by legislative settlement are excludable from gross income pursuant to §104(a)(2) except for any amounts related to medical expenses deducted on a previous year's tax return.

Employee Housing Assistance Benefits

Ltr. Rul. 201001013 (Oct. 1, 2009)
IRC §61

☞ Benefits Excludable from Gross Income

Facts. The County has two programs (Program A and B), both of which offer housing to residents with low- and moderate-income levels. Program B benefits are available to low- and moderate-income level individuals living or working in the County. Program A provides similar benefits to low- and moderate-income level individuals that are enrolled in an employer-sponsored training program within the County. These benefits are nondiscriminatory and nonpreferential.

A request for a ruling was submitted seeking guidance as to whether the value of the housing benefits provided to employees of governmental functions are excludable from gross income under IRC §61.

Analysis. IRC §61 provides that gross income includes all income from whatever source derived. The IRS has consistently held that payments to individuals by governmental units for promotion of the general welfare are excludable from the recipient's gross income. This exclusion applies only to governmental payments out of a welfare fund based on the recipient's identified need and not as compensation for services. Rev. Ruls. 98-19, 76-373, and 75-271 are cited as support for the "general welfare exclusion."

Holding. The value of housing assistance benefits provided to county employees is excludable from income and the benefits are not wages subject to federal income tax withholding.

Health Benefits
Ltr. Rul. 201003007 (Oct. 13, 2009)
IRC §106

☞ Mandatory Contributions Excludable from Income

Facts. Trust was established to fund retiree health benefits for eligible retirees from Unions A and B. Trust will provide reimbursements to eligible retired employees, their spouses, and dependents for the cost of post-retirement medical expenses or health insurance premiums.

Union A and Union B negotiated mandatory contributions for their respective bargaining units, as reflected in their memorandums of understanding (MOUs) with County. Under MOUs and Plan, participation in Plan is mandatory and does not allow for elections either into or out of Plan by the employees. The MOUs and Plan also establish a mandatory pretax contribution required for each participant. Additional contributions by participants are not generally permitted. Plan also provides for mandatory contributions of a uniform percentage of accrued sick leave and vacation at the time of retirement. There are no elections on the part of individual employees associated with contributions or accrued leave.

Plan provides benefits to domestic partners. However, contributions made on behalf of domestic partners are taxable. Trust includes in gross income the value of benefits for domestic partners when the benefits are earned, not when the benefits are received. The value of coverage for a domestic partner is included during a taxable year if the individual is expected to have a domestic partner upon eligibility for benefits under Plan. Such participants are identified by reasonable actions of Trust, and amounts to include in the employee's gross income are determined under an actuarial calculation that takes into account reasonable actuarial assumptions.

Analysis. IRC §61 defines gross income as all income from whatever source derived. IRC §106(a) provides that an employee's gross income does not include employer-provided coverage under an accident or health plan. The employer may contribute to an accident or health plan by either paying the premium or contributing to a separate trust or fund which provides accident and health benefits directly or through insurance to one or more of its employees. However, if the insurance policy, trust, or fund provides other benefits in addition to accident or health, §106 applies only to the portion of the contributions allocable to accident or health benefits.

Holding. Mandatory pretax contributions to a trust established to fund retiree health benefits and mandatory contributions to the trust of accrued sick leave and vacation are excludable from the gross income of eligible retirees, their spouses, and dependents under §106.

Cancellation of Debt
***Paul N. Jensen v. Comm'r,* TC Memo 2010-77 (Apr. 15, 2010)**
IRC §61

☞ Divorce Decree Does Not Override 1099-C when Reporting CODI

Facts. Illinois resident Paul Jensen and his wife were divorced in 2004. The divorce decree states that his ex-wife "shall be solely responsible for payment of [a Citibank debt and other debts] and shall hold [Jensen] free, harmless and indemnified thereunder for these debts and for any costs incurred by [Jensen] because of these debts."

Citibank forgave $4,136 of this debt in 2005, issuing Jensen a Form 1099-C, *Cancellation of Debt*, as the borrower on the debt. He did not include the cancellation of debt income (CODI) on his return, and the IRS issued a notice of deficiency for $1,037.

Issue. Whether Jensen must include in income the CODI generated by the Citibank loan cancellation, because the divorce decree transferred sole responsibility for this debt to his ex-wife

Analysis. Rather than providing evidence that he was not the borrower on the debt, Jensen relied on his divorce decree to prove that he was no longer responsible for the debt. Despite the fact that the divorce decree stated his ex-wife had "incurred" the Citibank debt, the court was persuaded that Jensen was the original borrower. Citibank issued the Form 1099-C in his name and Jensen testified Citibank did not send him any correspondence indicating he was no longer the borrower.

Although the divorce decree gave Jensen the right of indemnification against his ex-wife under Illinois law,[49] it did not relieve his liability to Citibank.[50]

Holding. The court found Jensen liable for the tax deficiency on the Citibank CODI.

Damage Award

Ltr. Rul. 201014040 (Dec. 9, 2009)
IRC §104

☞ IRS Rules on Exclusion of Lump-Sum Payment

Facts. The taxpayer sued for physical injury and emotional distress caused by the employees and agents of the defendant. A jury found the defendant liable and awarded damages. The decision was appealed and the Appellate Court remanded the case for a new trial. A settlement was reached.

A request for a ruling was submitted seeking guidance as to whether to exclude the settlement from gross income under IRC §104(a)(2).

Analysis. Under §104(a)(2), gross income does not include the amount of any damages (other than punitive damages) received on account of personal physical injuries or physical sickness. Treas. Reg. §1.104-1(c) states that the term "damages received (whether by suit or agreement)" means an amount received through prosecution of a legal action based upon tort or tort-type rights or through a settlement agreement entered into in lieu of such prosecution.

Holding. The lump-sum payment received is excludable from gross income.

Employer-Provided Clothing

Ltr. Rul. 201005014 (Oct. 28, 2009)
IRC §132

☞ Clothing Benefits Excludable Under De Minimis Rule

Facts. Taxpayer, a political subdivision of State A, is divided into several departments. Employees in each of the departments are eligible to receive work-related articles of clothing and accessories. The employees are required to wear the clothing items while at work. In addition, the majority of these items contain Taxpayer's logo. Different categories of employees are entitled to different quantities of items. In most instances individual employees receive less than one item per year. Taxpayer requested a ruling seeking guidance as to whether the value of these articles of clothing or accessories is excludable from gross income as de minimis fringe benefits under IRC §132(a)(4).

Analysis. IRC §61(a)(1) provides that gross income includes income from whatever source derived, including, but not limited to, compensation for services including fringe benefits. IRC §132(a)(4) states that gross income does not include the value of a de minimis fringe benefit provided to an employee. IRC §132(e)(1) states the term **de minimis fringe** means any property the value of which is so small as to make accounting for it unreasonable or administratively impracticable.

49. *Diaz v. Diaz*, 403 N.E.2d 1219, 1221 (Ill. App. Ct. 1980).

50. *Gibson v. Gibson*, 219 Bankr. 195, 204-205 (Bankr. 6th Cir. 1998).

In this situation, the value of the items received by the employees is low. The departmental policies clearly provide the maximum number of items the employees may receive in a given year based on when someone is hired or when replacement items are needed. It would be burdensome for the Taxpayer to establish a system to track each individual item and require the Taxpayer to account for each item's FMV.

In this case, it is unreasonable to account for the value of the items because Taxpayer would have to incur substantial administrative costs to track the FMV of each item it provides to employees.

Holding. The value of the clothing and accessories provided by Taxpayer to employees are excludable from gross income as de minimis fringe benefits under IRC §132(a)(4).

Unreported Income

***Andrea Fabiana Orellana v. Comm'r*, TC Summm. Op. 2010-51 (Apr. 20, 2010)**
IRC §§6214, 6662, 6001, and 61

☞ IRS Revenue Officer Penalized for Not Reporting eBay Income

Facts. Andrea Fabiana Orellana, a California resident, was an IRS revenue officer and had worked for the IRS since 2001. Orellana conducted over 7,000 eBay transactions between 2000 and 2005, under a variety of eBay user IDs. She did not report any income or expenses associated with her eBay activities for any of these years.

After determining that Orellana incorrectly reported her filing status as single in 2004 and 2005 and failed to report income from eBay sales, the IRS issued her notices of deficiency and assessed accuracy-related penalties under IRC §6662 for both years.

Orellana conceded that her filing status should have been MFS for both years because she had gotten married in March of 2004 and remained married through 2005. However, she argued that her eBay transactions did not have to be reported because they did not constitute a business. She stated that she merely sold things she had around her home, such as wedding gifts, gift cards, and new and like-new clothing she bought but never wore. In essence, her eBay sales were the equivalent of an "online garage sale." She did not have receipts documenting the purchase of these items.

The IRS initiated a criminal investigation regarding the eBay transactions, but dropped the criminal case when the investigators were unable to determine Orellana's cost of goods sold. Pursuing the unreported income, a tax compliance officer (TCO) conducted a bank deposits analysis (BDA) of Orellana's 2004 and 2005 accounts. The TCO determined that unreported income was $15,320 for 2004 and $21,062 for 2005. Orellana requested an appeal. The appeals officer recalculated the BDA and revised the figures slightly downward to $14,163 for 2004 and $18,595 for 2005.

The case then went to trial, with the IRS enlisting the aid of a special enforcement program revenue agent (RA). Orellana reconstructed partial records of her eBay transactions and provided unsubstantiated explanations regarding some deposits she considered nontaxable. The RA examined Orellana's documents, as well as records of her activity for 2004 and 2005 from both eBay and PayPal, and determined Orellana had about 1,200 eBay sales in 2004 and 600 in 2005.

Armed with the PayPal records that showed specific items of gross receipts, the RA prepared another BDA. After allowing for some nontaxable deposits resulting from PayPal transfers, the RA adjusted the unreported income to $30,663 for 2004 and $11,179 for 2005.

Issues. The court considered the following issues:

1. Whether Orellana had unreported income from eBay activity in 2004 and 2005
2. Whether Orellana is entitled to claim expenses and purchase costs for her eBay transactions in excess of the amounts computed by the IRS
3. Whether Orellana is liable for accuracy-related penalties for both years under IRC §6662(a)

Analysis.

Issue 1. In examining whether Orellana had unreported income, the court noted that it didn't matter whether Orellana believed she was engaged in a business because her beliefs would not have relieved her from the responsibility of reporting gains from property sales under IRC §61(a)(3). In order to determine whether she had a gain on property, she was required to track her cost basis in the property.

In the absence of sufficient taxpayer records, the IRS is allowed to determine the taxpayer's tax liability.[51] Because Orellana presented what the court described as a "disorganized hodgepodge of eBay records" and various other incomplete and unexplained documents, the IRS was allowed to use the facts and circumstances available to reasonably reconstruct Orellana's income.

Orellana objected to the way the IRS reconstructed her income, noting that each examiner determined a different amount of unreported income. The court noted that the examiners were not comparing identical records, because new information was uncovered along the way. Also, the standards under which the records were examined varied. Under the criminal investigation, the bank records had to establish a criminal violation beyond a reasonable doubt so any ambiguous items were resolved in Orellana's favor. The civil examination standard is merely "preponderance of evidence."[52]

Issue 2. The IRS reconstructed expenses from available records, such as those for eBay user fees and bubble wrap, and identified potential business expenses such as postage fees and purchases of clothing and cosmetics similar to ones Orellana sold. However, Orellana did not provide any help to the RA to tie these potential expenses to income. The RA denied the expense of a digital camera and other postage and shipping expenses that Orellana claimed because she did not document these expenses with receipts.

The court noted that the amount of an expense can generally be estimated (unless precluded by IRC §274), but there must be a reasonable basis for the estimate or the "allowance would amount to unguided largesse."[53] Because Orellana did not provide "coherent evidence" for the court to use to determine her cost basis and expenses, the court did not allow any further deductions beyond what the IRS had already allowed.

Issue 3. IRC §§6662(a) and (b)(1) impose a 20% penalty on the portion of underpaid taxes attributable to negligence or intentional disregard of rules or regulations. The court cites the definition of negligence as "any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code" or "failure by the taxpayer to keep adequate books and records or to substantiate items properly" and defines disregard as "careless, reckless, or intentional."

Reasonable cause, such as an honest misunderstanding, can except a taxpayer from the negligence penalty.[54] However, in light of Orellana's "experience, knowledge, and education" as an IRS revenue officer, the court judged her behavior "cavalier" and **sustained** the negligence penalties for both years.

Holding. The court held Orellana had unreported income, but did not allow her any other expenses against this income beyond those determined by the IRS because she failed to support her expenses. She was held liable for the accuracy-related penalties.

51. IRC §446(b); *Petzoldt v. Comm'r*, 92 TC 661 (1989).

52. Rule 142(a).

53. *Williams v U.S.*, 245 F.2d 559 (5th Cir. 1957).

54. Treas. Reg. §1.6662-3(b)(1).

INVOLUNTARY CONVERSION

Recognition of Gain

Ltr. Rul. 200944012 (Oct. 30, 2009)
IRC §1033

☞ Taxpayer Allowed Three Years After Settlement Claim to Replace Condemned Property

Facts. Taxpayer is in the business of owning and leasing real property. Taxpayer acquired certain property and leased it to commercial tenants. A city agency later filed a condemnation action to acquire the property. The city agency deposited funds (the Deposit) with the state treasurer as "probable compensation" for the property. Taxpayer later filed an answer to the condemnation action, in which it raised certain affirmative defenses to challenge the city agency's right to take the property.

Taxpayer could have applied to withdraw the Deposit at any time under the state's eminent domain law. In doing so, however, Taxpayer would have abandoned its challenge to the city agency's right to take the property. The relevant statutes provide that withdrawal of any portion of the money deposited effects a waiver of all claims and defenses to the taking of the property except for a claim for greater compensation.

The taxpayer did not apply to withdraw the Deposit in Year 1 because it was unwilling to abandon its challenge of the city agency's action at that time. However, in Year 2, the taxpayer entered into a settlement agreement with the city agency. Accordingly, the taxpayer received its share of the deposited funds later in Year 2.

When the taxpayer filed its Year 2 Form 1065, *U.S. Return of Partnership Income,* it attached a statement electing to defer gain pursuant to IRC §1033.

Analysis. IRC §1033(a)(2)(A) provides that if property is compulsorily or involuntarily converted into money or property, the taxpayer may elect to recognize the gain (if any) only to the extent that the amount realized from the conversion exceeds the cost of replacement property similar or related in service to the converted property. The taxpayer generally has two years from the close of the taxable year in which any gain from the conversion is realized to acquire the replacement property. However, the replacement period extends until the close of the third taxable year for conversions that are condemnations of real property held for productive use of a trade or business or for investment.[55]

A taxpayer realizes gain from the involuntary conversion of property when it actually or constructively receives money or property in excess of the converted property's basis. Money or property is constructively received when it is available for the taxpayer to draw upon without substantial restriction or limitation. In this situation, the taxpayer's withdrawal of any portion of the Deposit constituted a waiver of all claims and defenses associated with the converted property except a claim for greater compensation. This waiver is a substantial limitation or restriction to the taxpayer's access to the Deposit. As a result, the taxpayer did not have actual or constructive receipt of the Deposit until Year 2, when the parties entered into a settlement agreement.

Holding. Year 2 was the first year in which any part of the gain from conversion was realized. Under §1033(g), the taxpayer has three years from the close of Year 2 to replace the condemned property with qualifying replacement property.

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55. IRC §1033(g).

IRS PROCEDURES — MISCELLANEOUS

Litigation Costs

***James T. and Tiffany A. Manning v. Comm'r,* TC Memo 2009-277 (Nov. 30, 2009)**
IRC §§7430 and 6673

☞ Taxpayers Unable to Recover Litigation Costs

Facts. James Manning operated Assent, LLC in Austin, Texas, through his wholly-owned entity, James T. Manning, LLC (a disregarded entity). Manning deducted large commission payments to the Warrior Fund, which was owned by Manning's brother, on the joint return he filed with his wife. The IRS subsequently investigated the Warrior Fund in connection with an alleged abusive tax shelter. As a result of this investigation, the IRS examined the Mannings' tax return and issued a deficiency notice which disallowed the commission deductions and assessed an accuracy-related penalty.

The primary argument that the IRS used to disallow the commission deductions was that the payments to Warrior were not deductible under IRC §162(a) because the payments were not ordinary and necessary business expenses. Using alternative theories, the IRS argued that the payments were nondeductible illegal payments and that they were not deductible because they lacked economic substance.

The Mannings admitted that $100,000 of the commission adjustments in 2003 was mistakenly deducted. At trial, the court held that the Mannings were entitled to the other deductions at issue, that they did not have $208,329 in unreported income, and that they were not liable for the accuracy-related penalty. The Mannings then filed a motion to recover litigation costs of over $250,000 from the IRS.

Issue. Whether the Mannings are entitled to recover litigation costs

Analysis. In order to recover reasonable litigation costs in any court proceeding brought by or against the United States involving the collection or determination of tax, a prevailing party must establish the following:

1. The party exhausted available administrative remedies.
2. The party substantially prevailed in the controversy.
3. The party satisfies certain net worth requirements.
4. The party did not unreasonably protract the proceedings.
5. The amount of costs is reasonable.[56]

The failure to satisfy any of the above requirements precludes an award of litigation costs.

The IRS acknowledged that the Mannings "substantially prevailed" in the proceedings; however, they argue that the Mannings should not be deemed the prevailing party because the IRS's positions were substantially justified.

If the Government establishes that its position was substantially justified, the moving party will not be treated as having prevailed.[57] The IRS's position may be incorrect yet substantially justified if the IRS had a reasonable basis in law and fact for its position.

The court found that the IRS was substantially justified in arguing that the commission deductions were not deductible, even though the Mannings were held to be entitled to the deductions. The payments were between family members and family-controlled businesses; such transactions present greater possibilities for abuse and require closer scrutiny. Further, Mr. Manning's brother was under investigation for allegedly participating in an abusive tax shelter. Because of this relationship, the IRS's position was substantially justified.

Holding. The Mannings are not allowed to recover any litigation costs.

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56. IRC §§7430(b) and (c).
57. IRC §7430(c)(4)(B).

Offer In Compromise

***Deborah Slutter v. U.S.*, No. 2:08-cv-03046; U.S. District Court for Eastern District of Pennsylvania (Feb. 22, 2010)**

IRC §§7122, 7422, 7809, and 7433

☞ Failure to Follow Proper Procedures Results in Dismissal of Suit

Facts. Deborah Slutter submitted Form 656, *Offer in Compromise,* to the IRS along with a $20,000 payment in August 2007 for tax liabilities spanning 2003, 2004, and 2005. Three months later, the IRS rejected the offer but kept the $20,000 payment. The IRS sent Ms. Slutter a notice stating that part of the $20,000 was used to satisfy her 2003 tax liability, with the remaining amount (over $9,600) characterized as an overpayment that was applied to her 2004 tax liability.

Ms. Slutter filed a complaint stating that the government's decision to retain the lump-sum offer was an "outrageous abuse of discretion and violation of its own regulations."

Issue. Whether the taxpayer properly filed suit to seek the return of the payment made with the offer in compromise.

Analysis. Title 26 of the U.S. Code, Section 7433 is subject to a requirement that all administrative remedies within the IRS be exhausted before bringing suit in the U.S. District Court. In this case, Ms. Slutter did not file an administrative claim for the return of the $20,000 before filing a complaint. If she had filed the appropriate claim, the IRS would have been compelled to return her money after rejecting her offer in compromise.

Holding. The court lacks jurisdiction because the taxpayer failed to exhaust her administrative remedies; therefore, the IRS' motion for judgment was granted.

Frivolous Arguments

IRS Notice 2010-33, IRB 2010-17

IRC §6702

☞ List of Frivolous Taxpayer Arguments Updated

Purpose. IRS Notice 2010-33 modifies and supersedes Notice 2008-14 by adding three new positions considered frivolous and subject to the $5,000 penalty. These positions are:

- Using Form 1099-OID to obtain a tax refund or payment from Treasury,
- Claims on tax returns of withheld income tax or other taxes that are obviously false, and
- Refund claims based on purported advance payments of EIC to employees.

Effective Date. Effective for submissions made and issues raised after April 7, 2010.

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Tax Collection

Treasury Inspector General for Tax Administration (TIGTA) Report #2010-40-033 (Mar. 23, 2010)

☞ Improvements Needed in IRS ASFR Program

TIGTA released its report on the evaluation of whether the IRS's Automated Substitute for Return (ASFR) Program has been successful at bringing taxpayers into compliance. Although the report did find some degree of success, use of additional tools and further analyses would allow the program to reach a greater number of taxpayers. The ASFR Program identifies taxpayers who have not filed tax returns and attempts to bring them into compliance either by securing a tax return or using substitute return procedures.

This program was evaluated for fiscal years 2006 and 2007. The ASFR Program closed more than 1.8 million cases with assessments of $16.8 billion. Approximately 50% of the FY 2005 assessments resulted in taxpayers voluntarily filing returns for tax years as far back as 1977. In addition, 49% of the FY 2005 cases showed some type of payment or other account activity. Sixty-eight percent of the ASFR inventory for FYs 2006 and 2007 was processed by IRS employees. To better utilize IRS resources and lessen the impact of the remaining inventory, program efforts were initiated in 2007 and 2008 which included the use of soft notices, resulting in a 5% response rate — 40% of which filed balance due returns, 32% filed refund returns, and 14% filed zero tax due returns. Based on the responses from this limited pilot, an existing IRS notice has been modified with some soft notice language.

The ASFR Program also utilizes system tools to process cases and provides automated assistance for case resolution. Both the Wage and Investment (W&I) and Small Business/Self-Employed (SB/SE) Divisions continue to work through system tool issues to improve performance in the ASFR Program.

TIGTA recommended the W&I and SB/SE Commissioners ensure the modified notice is evaluated in time to be implemented as originally proposed. If timely implemented, the results should be assessed to determine how they compare with the pilot results. Resource tool changes need to be made to allow the limited resources to work additional ASFR cases.

Attempted Murder

***U.S. v. Randy Nowak,* U.S. Court of Appeals, 11th Circuit; No. 09-11329 (Mar. 15, 2010)**

☞ Murder for Hire Plot

Facts. Randy Nowak decided that rather than pay his taxes, IRS employee Christine Brandt of the Lakeland IRS office should die. Nowak wanted to have Brandt killed by Outlaw bikers because she was auditing him.

Walter McGhee was Nowak's connection to the Outlaw bikers. He contacted law enforcement officials, who arranged for Nowak to meet an undercover officer posing as an Outlaw biker called "the Reaper." Walter McGhee testified to all of this at Nowak's trial. The jury found Nowak guilty as charged, sentencing him to consecutive prison sentences of 240 months and 120 months. Nowak appealed the case.

Issues. The issues in the case were all procedural and evidentiary.

Holding. After evaluating the arguments on all the issues, the appellate court upheld all of the District Court rulings.

Treasury Inspector General for Tax Administration (TIGTA) Report #2010-30-019

☞ Improvements Needed in IRS Balance Due Notice Program

TIGTA released its report on the evaluation of whether the IRS Compliance Services Collection Operations (CSCO) has effective controls over the processing of cases in the Balance Due Notice Program to ensure appropriate actions are taken to accurately and timely resolve balance due notices. A balance due account occurs when the taxpayer has an outstanding liability for taxes, penalties, and/or interest.

During the 2-week sample, 6,217 taxpayers were assisted by two campuses. A random sample of 60 cases was selected from the two campus sites for in-depth review. Fifty-seven (95%) of the 60 cases involved streamlined installment agreements. In 30% of the 57 cases (17), installment agreements were established although the taxpayer may have had the ability to fully pay and could have avoided the costs of the installment agreement, which include a user fee, penalties, and interest.

Of the 6,217 taxpayers that were assisted, approximately 1,874 taxpayers may have had the ability to pay their tax liabilities in full. In other cases, it appeared the taxpayer did not have the income to meet the terms of the installment agreements into which they entered.

The Internal Revenue Manual (IRM) instructions for streamlined installment agreements do not require contact with the taxpayer or determination of whether the ability to pay exists. The installment agreements are based entirely on information provided by the taxpayer on Form 9465, *Installment Agreement Request.*

Each case file must be documented by IRS employees to support all actions taken to resolve a taxpayer's case. Thirteen (22%) of the sampled cases were not properly documented. Based on this sample, an estimated 958 taxpayers' case files are not properly documented**.**

The IRM also requires taxpayers to be provided with final responses addressing all taxpayer issues within 30 calendar days from the date received by the IRS. In 39 (65%) of the sampled cases, this process was not followed. Interim letters acknowledging the processing delay were either late or did not occur in 26 of the 39 untimely cases. Many of these issues were unknown by IRS management because workload reviews performed by team managers do not identify these types of problems.

Recommendations by TIGTA include:

- Revising the streamlined installment agreement procedures to ensure agreements are beneficial to both the IRS and taxpayers
- Reminding employees to document and timely work case actions
- Establishing various IRS internal criteria to ensure that cases are worked in accordance with IRS policy and guidelines

Electronic Filing

Brandon R. Ballantyne v. Comm'r, **TC Memo 2010-125 (June 10, 2010)**

IRC §§6001, 6011, 6061, 6151, and 6072

☞ E-Filed Return Still Valid Despite Preparer's Fraudulent Practices

Facts. Brandon Ballantyne, a Texas resident, worked full-time with Lennon Madzima at Capital One Auto Finance from 2003 to 2004. In 2004, Madzima took an IRS seminar, bought some software, and opened Sameday Tax Services. Although Madzima left Capital One, he and Ballantyne remained friends.

Before 2004, Ballantyne used franchise tax preparation services to prepare his income tax returns. He had always personally reviewed and signed his returns before filing and had routinely received refunds. Ballantyne had Madzima prepare his 2004–2006 returns. Ballantyne gave his Forms W-2 to his friend for each of these years and Madzima electronically filed his returns. Ballantyne did not review any of these returns. Madzima gave Ballantyne refunds of about $900 in cash for 2004, 2005, and 2006. Ballantyne never questioned these refund amounts.

Ballantyne gave his 2007 Form W-2 to Madzima in February 2008, but he did not hear anything about his return despite several calls inquiring about the status of his return preparation. On April 3, 2008, Madzima e-filed Ballantyne's 2007 return. Ballantyne did not review or sign the 2007 return. He did not receive a refund from Madzima for this year.

Unbeknownst to Ballantyne, each year that Madzima had prepared his returns, Madzima had made claims for tax benefits Ballantyne was not entitled to receive, such as dependency exemptions, HoH filing status, the child tax credit and credits for earned income, education, and federal tax paid on fuels. Madzima requested Ballantyne's refund amounts be directly deposited into a California bank account that did not belong to Ballantyne.

On Ballantyne's 2007 return, Madzima filed Ballantyne as HoH with a fictitious niece and claimed the education, earned income, and additional child tax credits. The IRS deposited a little less than half the $4,774 refund that Madzima requested for Ballantyne's 2007 return into the California bank account and froze the remaining amount.

The IRS had begun investigating Madzima as early as June 2007. Ballantyne was unaware of this investigation until June 2008, when he read in a Department of Justice press release that Madzima was being sued for filing fraudulent tax returns. After trying unsuccessfully to contact Madzima to discuss his tax return, Ballantyne filed Form 3949A, *Information Referral*, to let the IRS know that Madzima might have violated federal income tax laws by filing his tax returns.

The IRS adjusted Ballantyne's 2007 tax return and determined he owed a balance due of $4,256. Ballantyne did not dispute the IRS's adjustments to his tax return, but he argued that he should not be held responsible for the balance due because he did not authorize Madzima to electronically file his 2007 return.

Issue. Whether Madzima had authority to file Ballantyne's 2007 tax return electronically

Analysis. IRC §6061(b)(1) provides for the development of procedures for the acceptance of signatures in digital or other electronic form. The Treasury Secretary is authorized to waive the signature requirement or provide for alternative methods of signing an electronic return until such procedures are in place. This allows electronically-filed returns to escape the strict signing requirements of paper-filed returns prepared by an agent of the taxpayer.

The court uses the General Rule set forth in 1 Restatement, Agency 2d, Section 26 (1958) to determine whether an agent has authority to act. In applying this rule, the court examines "written or spoken words or other conduct of the principal which, reasonably interpreted, causes the agent to believe that the principal desires him so to act on the principal's account."

Because Ballantyne gave Madzima his Forms W-2 for four consecutive years and Ballantyne acknowledges that Madzima had filed his 2004, 2005, and 2006 returns and he expected Madzima to file his 2007 return, the court held that Madzima had the authority to electronically file on Ballantyne's behalf.

The court expressed sympathy for Ballantyne in this situation, but noted that he had the duty to file a complete and accurate return and thus was not relieved from the deficiency arising from the adjusted return.

Holding. The court held the preparer had the authority to file Ballantyne's 2007 tax return electronically.

> **Note.** In 2009, a federal judge permanently barred Lennon Madzima from preparing federal tax returns for others.

Court Costs

***David and Helen Walter v. U.S.,* No. 2:09-cv-00420; U.S. District Court for the Western District of Pennsylvania (Mar. 2, 2010)**

IRC §§7460, 6511, and 7422

☞ IRS Must Pay Couple's Attorney's Fees after Winning Refund Suit

Facts. David and Helen Walter brought action against the United States in April 2009 to recover a $5,640 refund from tax year 2002 and have it applied to their underpayments for tax years 2003 through 2006. The IRS opposed this action on the basis that the statute of limitations for requesting a refund had expired for tax year 2002. The Walters requested that the statute be tolled under IRC §6511(h) on the grounds that they were financially disabled.

Prior to bringing this action, the Walters had appealed the IRS's decision that they submitted their 2002 refund request too late by filing a physician's statement explaining that physical and mental conditions prohibited them from timely filing their 2002 return. The IRS never ruled on this appeal. After making numerous inquiries into the appeal with IRS offices in Fresno and Philadelphia as well as the National Taxpayer Advocate's Office, James Carney, the Walters' attorney, determined that the IRS had lost the Walters' appeal's file.

In December 2009, the court entered judgment in the Walters' favor. In January 2010, the Walters filed a motion seeking reimbursement for $11,563 in attorney fees and $519 in court costs pursuant to IRC §6511(h).

IRC §7430(a)(2) provides that the prevailing party in a lawsuit with the United States can apply to receive reimbursement for reasonable litigation costs, including attorney fees and court costs. To be considered a prevailing party, the litigant must:

- Prevail "with respect to the most significant issue or set of issues presented,"
- Be an individual with a net worth of less than $2 million at the time the action was filed, and
- Exhaust all available administrative remedies.

However, an otherwise qualified party will **not** be treated as a prevailing party **if** the United States establishes that its position was substantially justified. The United States has the burden of proving substantial justification.

The IRS argued that its position was substantially justified because the Walters did not file their 2002 refund request within the statute of limitations. The IRS claimed the Walters were not financially disabled and that their physician's statement contained two technical deficiencies.

Issue. Whether the United States held a substantially-justified position in denying the Walters' 2009 request to apply their 2002 refund to subsequent underpayments

Analysis. To establish substantial justification, the court requires the position be "justified to a degree that could satisfy a reasonable person" or have a "reasonable basis both in law and in fact." The court did not find substantial justification in the IRS's position that the Walters' physician's statement was deficient because the statement could be — and was — easily corrected. Additionally, the court noted that the IRS did not provide medical evidence to refute the physician's statement. In fact, the IRS did not even rule on the physician's statement at the administrative level.

Holding. The court granted the Walters court costs and attorney fees, although the attorney fees were adjusted downward due to timekeeping discrepancies, disallowed hours, and limitations on hourly fees under IRC §7430(c)(1)(B)(iii).

Note. The Walters must have been confident they were going to win this case and be awarded attorney's fees and costs in order to substantially justify their spending over $12,000 in litigation expenses in an effort to recover a $5,640 refund.

Professional Misconduct

***Office of Professional Responsibility v. Tim W. Kaskey, Complaint No.;* 2009-26 (Sep. 9, 2009)**
IRC §§6011, 6012, and 6072

☞ CPA Barred from Practicing before the IRS for Failure to File Personal Tax Returns

Facts. Tim W. Kaskey was a CPA authorized to practice before the IRS. Kaskey failed to file his personal federal income tax returns for seven consecutive years, from 2001–2007, despite seeking and obtaining extensions of time to file for several of these years.

The Director of the Office of Professional Responsibility (OPR) served a complaint on Kaskey dated June 19, 2009. The complaint cited five counts of Kaskey's failure to file (including only tax years 2001–2005) and two counts of professional misconduct for failure to exercise due diligence in preparation of a corporate return and for failure to disclose and avoid penalties with multiple clients.

The complaint was mailed to Kaskey's last known mailing address on file with the IRS and was sent by both regular mail and certified mail, return receipt requested. The return receipt indicated Kaskey received the certified notice on July 1, 2009.

The complaint notified Kaskey that he was required to file and serve an answer within 30 calendar days from the date of service and that failure to file an answer could result in a default decision against him. Kaskey did not file an answer.

Issue. Whether Kaskey should be barred from practice before the IRS

Analysis. Circular 230 §10.64(d), provides that "[f]ailure to file an answer within the time prescribed (or within the time for answer as extended by the Administrative Law Judge), constitutes an admission of the allegations of the complaint and a waiver of hearing, and the Administrative Law Judge may make the decision by default without a hearing or further procedure."

Because Kaskey did not file a timely answer to the complaint he received, he waived his right to a hearing. Circular 230 §10.50(a) allows an Administrative Law Judge to censure, suspend, or disbar a practitioner from practice before the IRS as a sanction for incompetence or disreputable conduct. Circular 230 §10.51 provides that disreputable conduct includes, but is not limited to, willfully failing to file a federal tax return. Furthermore, Circular 230 §10.34(b) requires a practitioner to inform a client of any penalties reasonably likely to apply, as well as opportunities to avoid such penalties, with respect to a tax position submitted to the IRS on the client's behalf.

Holding. The Administrative Law Judge held that Kaskey engaged in disreputable conduct within the meaning of 31 CFR §10.51 and barred him from practice before the IRS until reinstated at the OPR's discretion. Before being granted reinstatement, at a minimum, Kaskey is required to file all his federal income tax returns and pay, or make arrangements to pay, all his outstanding federal tax liabilities.

IRS PROCEDURES — PENALTIES

Accuracy-Related Penalty

***Kenneth and Linda Hopson v. Comm'r,* TC Summ. Op. 2009-130 (Aug. 25, 2009)**
IRC §§6662 and 6664

☞ Reliance on Tax Return Preparation Software Does Not Excuse Understatement

Facts. In 2006, Kenneth Hopson received distributions from the Ohio Public Employees Retirement System which totaled $60,882. The amount Mr. Hopson received was a full distribution of the retirement accounts he accumulated during his employment with the State of Ohio and the City of Cleveland. He requested the distributions in order to pay off credit card debt and a home equity loan. Mr. Hopson received Forms 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, for the distributions.

Mr. Hopson prepared a joint tax return with his wife for 2006 using tax return preparation software, as he had done since the 1980s. He completed the software's interview process, which required him to enter information necessary to generate the return, but he inadvertently failed to enter the information from the Forms 1099-R. Neither he nor Mrs. Hopson reviewed the federal income tax return generated by the software program for accuracy. The return listed the couple's total income as $88,488 and their total tax as $6,515. It was timely filed with the IRS.

Issue. Whether the Hopsons are liable for the accuracy-related penalty under IRC §6662(a)

Analysis. IRC §§6662(a) and (b)(2) imposes a 20% underpayment penalty for a substantial understatement of income tax, which is defined as an understatement that exceeds the greater of 10% of the tax required to be shown on the return or $5,000. IRC §6664 provides an exception to the penalty if the taxpayer establishes reasonable cause for the understatement and that the taxpayer acted in good faith with respect to that portion.

The understatement on the Hopsons' 2006 return was $21,954, which exceeds the threshold for "substantial understatement." Mr. Hopson admitted receiving the Forms 1099-R, and he knew that they constituted income. The couple failed to review their return to ensure that all income items were included.

Holding. The court held that the Hopsons are liable for the accuracy-related penalty under §6662(a).

Failure to File Returns

***Andrew I. Walzer v. Comm'r,* TC Memo 2009-200 (Sep. 8, 2009)**
IRC §§6651, 6654, and 6072

☞ Day Trader Liable for Failure to File Penalties

Facts. Andrew Walzer began actively trading securities in 1996. He was engaged in day trading during 2001 and 2002, conducting hundreds of trades. He also ran a marking supplies business called Glo-Mark, which was a longtime family business that had recently struggled but was still profitable.

Walzer did not file federal income tax returns for 2001 and 2002, nor did he pay any federal income tax for those years. The IRS prepared substitute returns for Walzer for tax years 2001 and 2002 on November 13, 2006.

Walzer had the following income for the tax years at issue:

	2001	2002
Gross proceeds from sale of securities	$3,279,144	$3,483,750
Net short-term capital gain (loss)	137,451	(194,375)
Net long-term capital gain (loss)	(97,128)	(81,606)
Dividend income	15,869	18,578
Interest income	220	54
Gross proceeds from Glo-Mark	62,814	0

The parties to the lawsuit agreed that for the years at issue, Walzer was not in the trade or business of selling securities and was not entitled to deduct his expenses from the sale of securities on a Schedule C, *Profit or Loss From Business.*

Issue. Whether Walzer is liable for additions to tax under IRC §§6651(a)(1) and 6654 as follows:

		Additions to Tax	
Year	Deficiency	§6651(a)(1) Failure to File Penalty	§6654 Estimated Tax Penalty
2001	$1,263,403	$284,266	$50,490
2002	1,326,288	298,415	44,321

Analysis. IRC §6651(a)(1) imposes an addition to tax for failure to timely file a return, unless the taxpayer can establish that such failure is due to reasonable cause and not willful neglect. Walzer claimed his failure to timely file his returns was due to reasonable cause because he did not know he had to file returns. However, Walzer has an MBA degree from New York University and is not an unsophisticated taxpayer. In addition, his father is a retired accountant who advised him to hire an accountant to prepare his returns.

IRC §6654(a) imposes an addition to tax for any underpayment of estimated tax by an individual. Walzer did not pay any tax in 2001 or 2002, much less make any estimated tax payments.

Holding. The court held that Walzer is liable for the additions to tax pursuant to §§6651(a)(1) and 6654(a) for 2001 and 2002.

Observation. When a taxpayer fails to file a tax return, the IRS has the right to prepare a substitute return. Generally, the determination shown in the notice of deficiency is presumed correct and the taxpayer bears the burden of showing that the IRS is in error.[58] In this case the taxpayer neither claimed nor showed the determinations were in error.

58. IRC §7491(a).

Accuracy-Related Penalty

Kenneth D. and Trudi A. Woodard v. Comm'r, **TC Summ. Op. 2009-150 (Sep. 28, 2009)**
IRC §§6662, 6664, and 408

☞ CPA Did Not Exercise Ordinary Business Care in Relying on Internet Advice

Facts. Kenneth Woodard holds an undergraduate degree in accounting and earned an MBA from Harvard Business School. He was a CPA but allowed his CPA license to lapse during the period that he worked as a computer programmer.

In November 2004, Vanguard distributed $100,000 to Mr. Woodard from his contributory and rollover IRAs. He deposited this distribution to his personal checking account. In December 2004, Vanguard converted $50,000 from the contributory IRA to a Roth IRA. Vanguard reported two $50,000 distributions from the contributory IRA and one $50,000 distribution from the rollover IRA on Forms 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*

Mr. Woodard prepared a joint federal income tax return for 2004 but did not report the $150,000 in IRA distributions. Mr. Woodard's wife, Trudi, was not aware that he had taken any distributions from his IRAs.

The IRS issued a notice of deficiency resulting from the $150,000 in unreported distributions, determining a $27,606 deficiency and a $5,521 accuracy-related penalty. Mr. Woodard conceded that the IRA distributions are taxable income but challenged the IRC §6662(a) accuracy-related penalty.

Issue. Whether Mr. Woodard is liable for the accuracy-related penalty

Analysis. IRC §6662 imposes a penalty of 20% for any underpayment of tax attributable to negligence or disregard of rules or regulations or to a substantial understatement of income tax. IRC §6664 allows for a defense to this penalty if a taxpayer establishes reasonable cause for the underpayment and that he acted in good faith. The most important factor in determining whether a taxpayer acted with reasonable cause and in good faith is the extent of the taxpayer's effort to assess the proper tax liability.[59]

Mr. Woodard stated that he thought he had a self-directed IRA and intended to reinvest the $100,000 in private mortgages. He searched the Internet for information about self-directed IRAs and followed the advice he found. He argued that he should not be liable for the accuracy-related penalty because he was dealing with a complicated area of the law, that he never intended to defraud the government, that he reaped no personal benefit from the money, and that he followed Internet instructions in managing his self-directed IRA.

Good-faith reliance on advice from an independent, competent professional regarding the tax treatment of an item may meet the reasonable cause requirement.[60] A taxpayer must act with prudence and ordinary business care to claim reasonable cause.[61]

Mr. Woodard claimed to rely on information found on unspecified websites written by unidentified individuals or organizations. It is not clear from the record whether he questioned the accuracy of the information he found online. Thus, the court was not able to determine if those sources were competent to provide tax advice and could not conclude that Mr. Woodard exercised ordinary business care and prudence in selecting and relying upon this information.

Holding. The court held that Mr. Woodard was liable for the accuracy-related penalty.

59. Treas. Reg. §1.6664-4(b)(1).
60. Treas. Reg. §1.6664-4(b).
61. *Neonatology Associates, P.A. v. Comm'r,* 115 TC 43, 98 (2000), *aff'd* 299 F.3d 221 (3d Cir. 2002).

Disclosure

Rev. Rul. 2010-4, IRB 2010-4 (Jan. 4, 2010)
IRC §§6713 and 7216

☞ Disclosure of Certain Tax Return Information by Preparers Allowed

Purpose. IRC §§7216 and 6713 cover the disclosure or use of information by tax return preparers. This revenue ruling provides guidance on whether the disclosure of certain tax return information by tax return preparers subjects the preparer to penalties under IRC §§7216 and 6713.

> **Note.** For more information on §7216, see Chapter 6, Ethics, in this workbook.

Analysis. In the first scenario presented, tax return preparer A reviews income tax returns and other information of taxpayers whose income tax returns A has prepared in previous year(s), in order to determine which clients may be able to benefit from recent changes to the NOL carryback period. Following this review, preparer A contacts the affected taxpayers to tell them about the change, advise them whether amended return(s) can be filed for years affected by the change, and offer A's services in preparing and filing the amended returns.

The use of tax return information in the manner presented in the first scenario is not prohibited under §7216. The tax return preparer may use client tax return information to identify affected taxpayers, inform them of changes in tax law, advise them whether it would be appropriate to file amended income tax returns, and assist in the preparation and filing of the amended returns. These uses are for the purposes of preparing a tax return as defined in the regulations.

In the second scenario presented in the revenue ruling, tax return preparer B uses tax return information of clients to determine which clients' future income tax return filing obligations may be affected by a prospective change in the tax rules or regulations. Preparer B uses this information to contact the potentially affected taxpayers to notify them of the new rules, explain how the changes may affect them, and advise them with regard to actions they may take in response to the changes.

Treas. Reg. §301.7216-2(h)(1)(i) permits the use of tax return information by tax return preparers "for the purpose of providing other legal or accounting services to the taxpayer," in accordance with applicable legal and ethical responsibilities. Accordingly, preparer B may use tax return information to determine whether clients may be affected by regulations issued by the IRS and to contact these clients for the purpose of explaining the regulations and advising them about their response to the regulations. However, preparer B may not use the tax return information of taxpayers who have specifically informed B that they do not wish to be contacted by B or will not be using B's services in the upcoming filing season.

The last three scenarios presented in this revenue ruling concern tax return preparers who provide monthly newsletters to clients containing educational tax information, tax tips, tax law updates, and solicitations for the preparer's tax return preparation business. The tax return preparers use third-party service providers to publish, distribute, or perform all aspects of this client communication activity. The tax return preparers provide lists to the third-party service providers that contain client names, addresses, and email addresses. These preparers all have procedures in place that are designed to maintain the confidentiality of tax return information.

The third-party service provider holds itself out as providing services that are auxiliary to tax return preparation which are intended to offer additional tax information and services to the preparers' clients. Such information and additional services to clients are specifically allowed by Treas. Reg. §301.7216-2(n). The tax return preparers have procedures in place that are consistent with good business practices and designed to maintain client confidentiality. By following these procedures, the preparers conclude that the third-party service provider has sufficient data confidentiality procedures in place; therefore, the third-party service provider qualifies as both an auxiliary service provider and a tax return preparer under Treas. Reg. §301.7216-1(b)(2)(i)(B). Tax return preparers may disclose to auxiliary service providers, without obtaining taxpayer consent, tax return information to the extent necessary to obtain auxiliary services, if the service provider is located in the United States and the services provided are not substantive determinations or advice which affects the tax liability reported by the taxpayers. Thus, the third-party service provider may use the names and mailing or email addresses disclosed to it to provide newsletters, or similar communications, to the tax return preparers' clients.

Disclosure

Rev. Rul. 2010-5, IRB 2010-4 (Jan. 4, 2010)

IRC §§6713 and 7216

☞ Disclosure of Information to Professional Liability Insurance Carriers Allowed

Purpose. This revenue ruling provides guidance on whether a tax return preparer is liable for penalties under IRC §§7216 and 6713 when the preparer discloses tax return information to professional liability insurance carriers.

Analysis. Tax return preparer A expects to disclose tax return information in 2010 to insurance agents or insurance company representatives in order to obtain or maintain professional liability insurance coverage. The information would include a list of client names and descriptions of the services that A provided to those clients in previous years. Preparer A also expects to disclose tax return information required by the terms of the insurance policy to report, and to aid in the investigation of, a claim or potential claim against A. This information provided to the professional liability insurance carrier may include copies of tax returns relevant to the claim or potential claim. Preparer A also expects to disclose information required by the terms of the insurance policy for the purpose of obtaining legal representation provided by the insurance carrier related to a claim or potential claim of professional negligence, misconduct, or fraud.

The professional liability insurance policy purchased by preparer A is an auxiliary service provided in connection with the preparation of tax returns. Under Treas. Reg. §301.7216-2(d)(1), preparer A may disclose to these insurance carriers, without obtaining taxpayer consent, the information required to obtain and maintain the auxiliary services of the insurance carriers. However, disclosure by a tax return preparer of tax return information beyond what is necessary in order to obtain or maintain insurance coverage constitutes a violation of IRC §§7216 and 6713. This would result in the tax return preparer's liability for penalties under those Code sections.

A professional liability insurance carrier provides services which include investigation and management of claims or potential claims arising from the preparation of tax returns by the insured tax return preparer. Disclosure of tax return information in connection with these services is necessary to allow A to obtain the services of its professional liability insurance carrier. Thus, disclosure is permitted without taxpayer consent under Treas. Reg. §301.7216-2(d)(1), if the information is necessary to obtain those services. Disclosure of tax return information beyond what is necessary in order to obtain the auxiliary services constitutes a violation of §§7216 and 6713 and would result in the tax return preparer's liability for penalties under those sections.

The terms of a professional liability insurance policy issued in connection with the preparation of tax returns typically includes the selection and engagement of an attorney to represent the preparer during a claim investigation or litigation related to a claim. Preparer A may disclose relevant tax return information, without taxpayer consent, to the insurance carrier as an auxiliary service provider under Treas. Reg. §301.7216-2(d)(1). Information disclosed which is beyond the scope of the legal representation constitutes a violation of §§7216 and 6713 and would result in the tax return preparer's liability for penalties under those sections. After the insurance carrier selects an attorney to represent preparer A in relation to the claim, preparer A may disclose relevant tax return information to that attorney without taxpayer consent.[62]

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62. Treas. Reg. §301.7216-2(g)(1).

Failure to File

***Dennis E. Kalinoski v. Comm'r,* TC Summ. Op. 2010-30 (Mar. 15, 2010)**

IRC §6651

☞ Former Police Officer Does Not Have Reasonable Cause for Failure to File

Facts. Dennis E. Kalinoski, an Illinois resident, served as a police officer for a village in Illinois and then as a sergeant for the State of Illinois before his retirement in 1992. In addition, prior to his retirement he started a business as a gunsmith and federally-licensed firearms dealer, operating primarily through sales at gun shows and refurbishing firearms at his residence.

Up until his life started going awry in 2000, Mr. Kalinoski had always filed his tax returns timely. In 2000, his wife and daughter moved out of the house. On June 28, 2001, he was arrested for not conducting mandated buyer-identification procedures. During 2002, he became addicted to crack cocaine. During this period, Mr. Kalinoski did not file timely returns and, for some years, he did not file at all.

In March of 2003, Mr. Kalinoski purchased tax preparation software and began gathering his records in anticipation of filing his 2002 tax return. Unfortunately, he was diagnosed with a hernia that created severe back pain and kept him bedridden. He did not undergo surgery because there were women living with him who had friends who were taking illegal drugs in his home and stealing his personal property. He was scared to call the police because of fear they would find illegal drugs.

On May 3, 2003, law enforcement officials arrested Mr. Kalinoski on three firearms-related felonies. He pled guilty to one of the three charges in January 2004. While he was in jail, his family decided to clean up his house and boxed up all his papers in no particular order.

The IRS issued a notice of deficiency in October 2004 based on the substitute return they prepared, using information secured from third-party payers. The taxpayer, while free on bond from the firearms crime, timely petitioned the court contesting the deficiencies.

While incarcerated, Mr. Kalinoski appointed his brother as power of attorney. The brother delivered the disorganized records to an accountant in May 2007 in order to have the 2002 tax return prepared. In July 2007, the accountant reviewed the records and indicated the paperwork was insufficient to properly prepare a return.

After his release from a halfway house in February 2008, Mr. Kalinoski picked up his tax records and met with an IRS representative. The parties agreed as to the tax liability for 2002, which Mr. Kalinoski paid in November 2008.

Issue. Whether the taxpayer is liable for additional tax under IRC §6651 for not timely filing his 2002 tax return

Analysis. IRC §6651(a) provides for an addition to tax when a taxpayer fails to file a timely tax return. The penalty may be avoided if the taxpayer establishes that the failure was "due to reasonable cause and not due to willful neglect." Mr. Kalinoski admits he was remiss in not filing his return from April 15, 2003 until his arrest on May 3, 2003. After that time, he alleges reasonable cause for not filing because government misconduct prevented his access to financial records, despite his efforts to gather pertinent information and file his 2002 tax return.

Mr. Kalinoski argued he did not have access to his records and therefore could not timely file. However, a taxpayer can file using the most accurate estimates available even if he has no records. A taxpayer then has the opportunity to amend later, if necessary. In Mr. Kalinoski's case, it took almost two years after the due date of the return for him to request that his records be returned to him. Additionally, the information required to prepare his return was easily accessible from outside parties. He also estimated his business expenses for purposes of the settlement.

The court looked at various court cases which stated that lack of access to records due to incarceration does not give rise to reasonable cause. Mr. Kalinoski could have timely filed a return or requested an extension because he was not incarcerated at the time the return was due.

Holding. The court concluded that neither incarceration nor physical and mental health issues were reasonable causes for failing to file a tax return.

Frivolous Arguments
***William G. Precourt v. Comm'r,* TC Memo 2010-24 (Feb. 16, 2010)**
IRC §6673

☞ Repeated Frivolous Positions Result in IRC §6673 Penalty

Facts. William Precourt failed to timely file his 2006 tax return. The IRS determined a deficiency of $12,554 along with additions to tax totaling over $4,000. Acting on his own behalf, Mr. Precourt petitioned the Tax Court for a redetermination and then failed to appear in court.

Since May 2004, Mr. Precourt brought eight separate cases in Tax Court and three related cases in Federal District Court, including Collection Due Process cases. During four occasions, IRC §6673 penalties totaling $22,500 were asserted because of frivolous petitions and failure to appear in court.

Issue. Whether Mr. Precourt is liable for the maximum $25,000 penalty under IRC §6673

Analysis. Mr. Precourt began eight Tax Court cases, failed to appear for trial or hearing at five of them, and offered no support for the merits of any of them. Despite the assessment of $22,500 of §6673(a) penalties, he continued to file suits that he evidently had no intention of prosecuting.

The §6673 penalty exists to prevent abuse by taxpayers who simply want to delay the assessment of tax. This case involves a litigant who continually makes frivolous arguments despite judicial warnings.

Holding. Mr. Precourt is liable for the maximum §6673 penalty of $25,000 because he repeatedly filed petitions presenting frivolous claims.

Accuracy-Related Penalty Guidance
Rev. Proc. 2010-15, IRB 2010-7 (Jan. 27, 2010)
IRC §§6662 and 6694

☞ Adequate Disclosure Reduces Penalty Assessments

Purpose. This revenue procedure updates Rev. Proc. 2008-14 and identifies situations in which disclosures are adequate to reduce an IRC §6662(d) accuracy-related penalty or avoid an IRC §6694(a) preparer penalty.

Analysis. IRC §6662(d)(1) provides that there is a substantial understatement of income tax if the amount of the understatement exceeds the greater of 10% of the amount of tax required to be shown on the return for the taxable year, or $5,000. IRC §6694(a) imposes a penalty on a tax return preparer who prepares a return or claim for refund reflecting an understatement of liability due to an "unreasonable position" if the tax return preparer knew (or should have known) of the position.

This revenue procedure provides guidance for determining when disclosure is adequate. The taxpayer must furnish all required information and the money amounts entered on the forms must be verifiable. This revenue procedure clearly defines the different forms and line items that must be completed in order for the disclosure to be considered adequate.

Effective Date. This revenue procedure applies to any income tax return filed on a 2009 tax form for a taxable year beginning in 2009 and to any income tax return filed on a 2009 tax form in 2010 for a short taxable year beginning in 2010.

Failure to File

***Walter L. and Carol L. Selph v. Comm'r,* TC Summm. Op. 2010-20 (Mar. 1, 2010)**
IRC §§6651, 6320, and 6330

☞ Illness Meets Reasonable Cause for Not Timely Filing Tax Returns

Facts. In 2000, Walter Selph was employed by Publix Supermarket and Carol Selph was employed by the New York Times. During 2000, Mrs. Selph suffered from a variety of health problems which ultimately resulted in her filing for social security disability benefits.

The taxpayers did not timely file their tax returns for 1999, 2000, and 2001. They did file balance due returns in February 2006 for all three years. The IRS issued a Notice of Federal Tax Liens for the amounts owed, to which the taxpayers requested a collection due process hearing. The case was considered by an Appeals Settlement Officer. Despite attempts to solicit additional information from the taxpayers, none was submitted. A trial was held in February 2009 in Tampa, Florida.

Issues. This case involves the following issues:

- Whether the taxpayers are entitled to challenge their underlying tax liabilities for 1999, 2000, and 2001
- Whether they are liable for IRC §6651 additions to tax

Analysis. The IRS maintained that the taxpayers had an opportunity to dispute their underlying tax liabilities with an Appeals Settlement Office but failed to do so. Accordingly, the taxpayers should be barred from later challenging the tax assessment. The taxpayers argued they did dispute their underlying tax liabilities and therefore the issue could be raised during this court proceeding. The court agreed with the taxpayers and thus had jurisdiction to rule on the penalty issue.

The taxpayers admitted their returns were not timely filed but claimed they had reasonable cause because of numerous health issues. Although Mrs. Selph did file for short-term disability and visited psychiatrists at the time the 1999 tax return was due, she admitted that the real reason for not filing the return timely was a major project at work.

Mrs. Selph's health worsened starting in November 2000. Mr. Selph cut back on work so he could take care of their children because Mrs. Selph was unable to care for them. Therefore, the taxpayers did demonstrate reasonable cause for failure to timely file the 2000 and 2001 returns.

Holding. Penalties for failure to file and pay taxes were eliminated for the returns due in the years in which Mrs. Selph was ill (2000 and 2001). However, penalties were upheld for the return due in the year prior to her becoming ill (1999).

Accuracy-Related Penalties

***Aileen Yat Muk Lam and Shaoping Chang v. Comm'r,* TC Memo 2010-82 (Apr. 19, 2010)**
IRC §6662

☞ Reliance on TurboTax Not a Defense Against Penalties

Facts. During 2004 and 2005, Aileen Yat Muk Lam (Ms. Lam) operated a real estate business reporting income and expenses on Schedule C, *Profit or Loss from Business*. Ms. Lam prepared the couple's joint returns using TurboTax. She not only reported real estate expenses on the Schedule C but also unrelated losses. The IRS examined the returns, disallowing reported rental losses and recharacterizing trading losses from Schedule C to capital losses on Schedule D. Deficiencies of $5,069 and $4,339 were agreed to by the taxpayers for 2004 and 2005, respectively.

Issue. Whether the taxpayers are liable for IRC §6662(a) accuracy-related penalties for 2004 and 2005

Analysis. IRC §6662(a) imposes an accuracy-related penalty of 20% of any underpayment that is attributable to either substantial understatement or negligence. An exception to the IRC §6662(a) penalty exists when a taxpayer can demonstrate (1) reasonable cause for the underpayment and (2) that the taxpayer acted in good faith with respect to the underpayment. The understatement is reduced when relevant facts are adequately disclosed on the taxpayer's return. No such disclosure existed on these returns.

A substantial understatement of income existed on the 2004 return because the couple reported no tax liability on their joint return. The corrected tax liability for 2004 was $5,069, therefore resulting in a $5,069 understatement.

The amount of the taxpayer's 2005 deficiency does not justify a finding of a substantial understatement penalty under §6662. However, the IRS claims that the taxpayers were negligent in the preparation of both the 2004 and 2005 returns and that the §6662(a) penalty should be imposed for 2005 accordingly.

At trial, Ms. Lam argued that she consistently completed their tax returns using TurboTax and that she consistently confused capital gains and losses with ordinary income and expenses. Before the trial, Ms. Lam stipulated that she did not consult a tax professional or visit the IRS website for instructions on filing Schedule C.

The court determined that although the errors in tax preparation were made in good faith, they did not establish that the taxpayers behaved in a manner consistent with that of a prudent person.

Holding. The taxpayers' reliance on tax return preparation software is not a defense for errors on the return, and they are liable for accuracy-related penalties for 2004 and 2005.

LIKE-KIND EXCHANGES

Like-Kind Exchange

Rev. Proc. 2010-14, IRB 2010-12 (Mar. 5, 2010)
IRC §1031

☞ Safe Harbor for Some Like-Kind Exchanges

Purpose. This revenue procedure provides a safe harbor method of reporting gain or loss for some taxpayers who started an IRC §1031 like-kind exchange but failed to complete the exchange due to default on the transaction by a qualified intermediary (QI).

Analysis. In some instances, taxpayers initiate like-kind exchanges in good faith by transferring relinquished property to a QI but do not receive replacement property from the QI. In many of these situations, the QI enters receivership or bankruptcy preventing the completion of the transaction.

This revenue procedure applies to taxpayers who:

- Transferred relinquished property to a QI pursuant to Treas. Reg. §1.1031(k)-1(g)(4),
- Properly identified replacement property within the identification period,
- Did not complete the like-kind exchange solely because of a QI default due to a bankruptcy or receivership proceeding, and
- Did not have receipt of the proceeds from the disposition of the relinquished property or any property of the QI prior to the time the QI entered into bankruptcy or receivership.

When a QI defaults on acquiring and transferring replacement property and is subject to either a bankruptcy or receivership proceeding, the taxpayer generally cannot enforce its rights while the proceeding is pending. In this situation, the taxpayer needs to recognize gain on the transaction based on the safe harbor gross profit ratio method. Under this method, the portion of any payment attributable to the relinquished property that is recognized as gain is determined by multiplying the payment by a fraction, the numerator of which is the taxpayer's gross profit and the denominator of which is the taxpayer's contract price. Imputed interest computation may be required if warranted by the circumstances.

Example 1. Taxpayer owns investment property with a FMV of $150x and adjusted basis of $50x. On May 6, Year 1, taxpayer transfers property to QI who then transfers property to a third party in exchange for $150x. The $150x is held by QI. On June 1, taxpayer identifies Property 2 as replacement property. On June 15, QI notifies taxpayer it has filed for bankruptcy protection and cannot acquire replacement Property 2 within the exchange period. QI remains in bankruptcy proceedings until July 1, Year 2. As the result of the bankruptcy proceedings, taxpayer receives $130x on August 4, Year 2.

Taxpayer is not required to recognize gain in Year 1 because no payments attributable to the relinquished property were received. Gain of $80x will be recognized in Year 2 ($130x × ($80/$130)). Taxpayer is not entitled to an **IRC §165 loss because the payment attributable to the relinquished property exceeds the adjusted basis in the property.**

Example 2. Taxpayer owns investment property with a FMV of $160x and adjusted basis of $90x and a mortgage of $60x. On May 6, Year 1, taxpayer transfers property to QI who then transfers property to a third party in exchange for $160x. At closing, QI pays off the mortgage and holds the remaining $100x. On June 1, taxpayer identifies Property 2 as replacement property. On June 15, QI notifies taxpayer it has filed for bankruptcy protection and cannot acquire replacement Property 2 within the exchange period. QI remains in bankruptcy proceedings until September 1, Year 2. As the result of the bankruptcy proceedings, taxpayer receives a total of $70x, of which QI pays $35x in October Year 2 and $35x in February Year 3.

Taxpayer is not required to recognize gain in Year 1 because no payments attributable to the relinquished property were received. Gain of $20x will be recognized in both Years 2 and 3 ($35x × (40/70)). Taxpayer is not entitled to an **IRC §165 loss because the payment attributable to the relinquished property ($70x) plus the satisfied debt ($60x) exceeds the adjusted basis in the property ($90x).**

Example 3. The facts are the same as in **Example 2** except taxpayer's adjusted basis in investment property is $40x. Taxpayer is considered to have received $20x in Year 1 because the debt satisfaction ($60x) exceeds the adjusted basis in the property ($40x). Taxpayer recognizes gain in Year 1 of $20x ($20x × (120/120)).

Example 4. Taxpayer owns investment property with a FMV of $100x and adjusted basis of $40x. On May 6, Year 1, taxpayer transfers property to QI who then transfers property to a third party in exchange for $100x. The $100x is held by QI. On June 1, taxpayer identifies Property 2 as replacement property. On June 15, QI notifies taxpayer it has filed for bankruptcy protection and cannot acquire replacement Property 2 within the exchange period. QI remains in bankruptcy proceedings until September 1, Year 2. As the result of the bankruptcy proceedings, taxpayer receives $35x in October, Year 2. In addition, depending on the results of the QI's reorganization plan, taxpayer may receive an additional payment in February, Year 3. Taxpayer receives the $35x payment in October, Year 2 but does not receive any additional payments in Year 3.

Taxpayer is not required to recognize gain in Year 1 because no payments attributable to the relinquished property were received. Gain of $21x will be recognized in Year 2 ($35x × (60/100)). Taxpayer is entitled to an **IRC §165 loss of $5x because the payment attributable to the relinquished property ($35x) was less than the adjusted basis in the property ($40x). Taxpayer is also entitled to an IRC §165 loss deduction of $21x in Year 3 (the amount of gain that was recognized in Year 2).**

Example 5. Taxpayer owns investment property with a FMV of $150x and adjusted basis of $50x. On May 6, Year 1, taxpayer transfers property to QI who then transfers property to a third party in exchange for $150x. The $150x is held by QI. On June 1, taxpayer identifies Property 2 as replacement property. On June 15, QI notifies taxpayer it has filed for bankruptcy protection and cannot acquire replacement Property 2 within the exchange period. QI remains in bankruptcy proceedings until July 1, Year 2. As the result of the bankruptcy proceedings, taxpayer receives $130x in August, Year 3.

Taxpayer is not required to recognize gain in either Year 1 or 2 because no payments attributable to the relinquished property were received. **IRC §483 applies to the Year 3 payment because the payment was due more than 6 months after the safe harbor sale date and taxpayer received the payment more than 1 year after such date.** Gain of $75x will be recognized in Year 3 ($125x × (75/125)). Taxpayer must also include $5x of the $130x payment in Year 3 as interest income. Taxpayer is not entitled to an **IRC §165 loss because the payment attributable to the relinquished property exceeds the adjusted basis in the property.**

Effective Date. For defaulted transactions that occur on or after January 1, 2009.

PARTNERSHIPS

Abandonment Loss Deduction

***Jeffrey C. and Renee M. Milton v. Comm'r,* TC Memo 2009-246 (Oct. 28, 2009)**
IRC §§165, 6662, and 6664

☞ Abandonment Loss Deduction for Partnership Interest Disallowed

Facts. Renee Milton was the president and sole shareholder of RMI, a real estate business organized as an S corporation. In 2004, Ms. Milton's handyman told her about a business opportunity involving his son, Donald Purscelley, a welder for Kearney Mesa Welding (KM Welding). Mr. Purscelley was interested in purchasing the business from the owner of KM Welding, who was considering retirement. Mr. Purscelley did not have the funds to purchase KM Welding on his own, so his father asked Ms. Milton if she would be interested in participating in the purchase. Ms. Milton responded that she was interested in obtaining the right of first refusal to purchase the leased property on which KM Welding operated.

Ms. Milton gave Mr. Purscelley's father a check payable to the owner of KM Welding for $90,000 and told the father to purchase KM Welding. She used money that she had earned from RMI to fund the transaction. Ms. Milton's purchase check was dated February 17, 2004, and is the only document memorializing the transaction. Her name was not on the property lease and her rights were never put in writing.

Ms. Milton discussed forming a business entity with Mr. Purscelley and his father, with ownership of the business to be divided into thirds among her, Mr. Purscelley, and his father. Mr. Purscelley created an LLC for KM Welding but dissolved it in 2005 and operated KM Welding as a sole proprietorship during 2005.

In 2005, Ms. Milton became concerned that KM Welding was not paying its bills or completing projects. She was worried that her connection with KM Welding would harm her reputation and affect RMI's financial health. Ms. Milton's CPA advised her that it would be in her best interests to abandon the KM Welding partnership interest rather than risk her reputation and RMI.

RMI claimed a $100,000 abandonment loss on its 2005 Form 1120S that passed through to Ms. Milton as the sole shareholder. Although the loss was identified as an abandonment of the KM Welding partnership interest, RMI's 2005 balance sheet did not list a partnership interest as of the beginning of the year.

The IRS issued a deficiency notice to Ms. Milton and her husband, disallowing the abandonment loss and adjusting Ms. Milton's distributive share from RMI. The IRS assessed additional tax in the amount of $86,767 and a $17,353 accuracy-related penalty under IRC §6662(a).

Issues. This case involves the following issues:

- Whether Ms. Milton underreported her distributive share from RMI for 2005
- Whether she is liable for an accuracy-related penalty

Analysis. In order to claim an abandonment loss deduction, a taxpayer must prove she owned the abandoned property. Ms. Milton did not prove that RMI owned the partnership interest it purportedly abandoned in 2005. Ms. Milton did not have an asset purchase agreement or other document to substantiate the transaction; she also failed to prove that the funds involved were RMI's rather than hers individually.

Additionally, to claim an abandonment loss, the taxpayer must establish that she (1) intended to abandon the property, and (2) took affirmative action to abandon the property.[63] When the asset is an intangible property interest, such as a partnership interest, an express manifestation of abandonment is required.[64]

Ms. Milton did not provide any independent evidence to support her alleged intent to abandon the partnership interest in KM Welding. She did not offer any evidence that she would be held liable for any debts of KM Welding or that KM Welding was not completing projects or paying its bills.

Further, Ms. Milton did not take any affirmative action in 2005 to abandon the alleged partnership interest in KM Welding. She did not provide a date on which she abandoned the interest nor did she file any public document indicating that she was no longer associated with KM Welding. Additionally, there is no evidence that Ms. Milton informed her alleged partners that she was abandoning the partnership interest.

A taxpayer is liable for an accuracy-related penalty for any portion of an income tax underpayment attributable to negligence or disregard of rules and regulations unless she establishes that there is reasonable cause for the underpayment and that she acted in good faith.[65]

RMI did not maintain any books or records to substantiate the abandonment loss on its 2005 tax return. Uncorroborated self-serving testimony was the only evidence Ms. Milton presented regarding the abandonment of the alleged partnership interest. Further, Ms. Milton testified that she abandoned the KM Welding partnership interest on the advice of her CPA. However, she failed to provide even the name of her CPA or any adequate evidence that she acted in good-faith reliance on information provided by the CPA.

Holding. The court held that Ms. Milton was not entitled to an abandonment loss deduction and that she is liable for the accuracy-related penalty under §§6662(a) and (b)(1).

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63. *Citron v. Comm'r,* 97 TC 200, 208-209 (1991).

64. Ibid.

65. IRC §§6662(a) and (b)(1), 6664(c)(1).

Partnership Allocation

***Randal W. Holdner et al. v. Comm'r,* TC Memo 2010-175 (Aug. 4, 2010)**

IRC §§6662, 7701, 701, 702, and 704

☞ Father-Son Farming Operation Found to be Equal Partnership

Facts. Since 1977, William Holdner ran a farming operation with his son, Randal Holdner. By 2004, Holdner Farms had grown into a profitable cattle farming operation. Additionally, Holdner farms had two additional sources of income — rental income and logging income from jointly-owned properties.

Under their informal agreement, Randal was responsible for managing the farm and William was primarily responsible for the farm's finances and accounting. William devoted approximately 50% of his professional time to Holdner Farms. He also maintained an accounting practice, which he conducted as a partnership during the years at issue.

William prepared his and Randal's federal income tax returns for 2004–2006. They reported Holdner Farms' income and expenses from cattle sales and rental activity on Schedules F of their income tax returns and income and expenses from timber sales on Schedules D of their returns. William and Randal each reported one-half of Holdner Farms' gross income. However, William deducted most of Holdner Farms' expenses for those years on his tax returns. Their income tax returns reported the following amounts.

	2004		2005		2006	
	Randal	William	Randal	William	Randal	William
Total income	$424,107	$424,107	$342,162	$342,162	$291,255	$291,255
Total expenses	158,797	477,991	167,320	431,219	261,473	551,032
Net gain (loss)	$265,310	($ 53,884)	$174,842	($ 89,057)	$ 29,782	($259,777)

The IRS examined the Holdners' returns for 2004–2006 and determined that Holdner Farms was a partnership for federal income tax purposes and that the Holdners were equal partners who must allocate partnership income and expenses accordingly. The IRS also assessed the IRC §6662 accuracy-related penalty for each of the years at issue.

Issues. The issues for decision are:

1. Whether Holdner Farms was a partnership for federal income tax purposes
2. Whether partnership expenses must be allocated equally, in accordance with partnership income
3. Whether William is liable for the accuracy-related penalty

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Analysis.

Issue 1. IRC §7701(a)(2) defines a partnership as "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not… a trust or estate or a corporation." A partnership is created for federal income tax purposes when persons join together their property, labor, or skill for the purpose of carrying on a trade, profession, or business and there is a community of interest in the profits and losses.[66]

The court concluded that the Holdner Farms activity was a partnership for federal income tax purposes during the years at issue for several reasons. First, both William and Randal contributed capital and labor to Holdner Farms. Second, Holdner Farms has conducted a business activity for profit since 1977. Third, William and Randal shared gross income from cattle sales, timber sales, and rental income equally.

William and Randal argued that their Holdner Farms' enterprise was a joint venture between two individual proprietorships. However, there was no evidence that they maintained separate bank accounts. Additionally, even if Holdner Farms were a joint venture rather than a partnership, the joint venture would create a separate entity for federal income tax purposes.[67] As a separate domestic entity with at least two members, Holdner Farms would be treated as a partnership for federal income tax purposes unless it elected to be taxed as a corporation.[68]

Issue 2. To determine income tax liability, each partner must take into account his distributive share of partnership income, gain, loss, deduction, and credit.[69] A partner's distributive share is determined according to the partner's interest in the partnership if the partnership agreement does not state how a partner's distributive share is to be determined.[70]

Partners are presumed to have equal interests in the partnership; however, this presumption may be rebutted by establishing that the partners' interests in the partnership were other than equal.[71] William and Randal did not present sufficient evidence to rebut the presumption of equal partnership interests. All farm expenses during 2004–2006 were paid from farm revenue, which was divided equally between William and Randal. Thus, William did not bear the economic burden of the disproportionate allocation of farm expenses. Accordingly, they must allocate both income and expenses equally.

Issue 3. IRC §6662 authorizes the imposition of an accuracy-related penalty of 20% of any underpayment attributable to negligence or disregard of rules and regulations. As a practicing accountant, William knew that a disproportionate allocation of Holdner Farms' expenses would allow him to shelter his unrelated income. William did not present any credible evidence that he acted reasonably or conducted any research on the proper classification of Holdner Farms for tax purposes.

Holding. The court held that:

- Holdner Farms was a partnership for federal income tax purposes in 2004–2006.
- William and Randal were equal partners during the years at issue and Holdner Farms' income, expenses, and other partnership items must be allocated accordingly.
- William is liable for the §6662 accuracy-related penalty.

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66. *Comm'r v. Tower*, 327 U.S. 286 (1946).
67. Treas. Reg. §301.7701-1(a)(2).
68. Treas. Reg. §301.7701-3(b)(1)(i).
69. IRC §702(a).
70. IRC §704(b).
71. Treas. Reg. §1.704-1(b)(3)(i).

PASSIVE ACTIVITIES

Passive Activity Losses

Ralph and Angela Cunningham v. Comm'r, **TC Memo 2009-194 (Aug. 31, 2009)**
IRC §§469 and 6651

☞ Losses from Horse Activities Disallowed

Facts. Ralph Cunningham was a member of the dental faculty at New York University and maintained a private dental practice in Peekskill, New York during 2002. The Cunninghams were residents of New York at the time the petition was filed.

The Cunninghams' joint Form 1040 for 2002 was filed on April 21, 2006. The return included a Schedule E, *Supplemental Income and Loss,* which claimed losses from five separate horse activities located in California. The Cunninghams' joint return and the partnership returns for the horse activities were prepared by Robert Gruntz.

The Cunninghams received a notice of deficiency from the IRS, wherein the losses were disallowed as passive activities under IRC §469. On the advice of Gruntz, the Cunninghams initially refused to cooperate with the IRS. They were notified on January 14, 2009, that their trial in New York was set for June 15, 2009. When the case was called for trial, the Cunninghams produced exhibits but without any narrative facts.

Issues. This case presents the following issues:

- Whether the Cunninghams' reported losses from horse activities are limited by §469
- Whether they have reasonable cause for the late filing of their return

Analysis. Deduction of losses from passive activities is limited to income generated by such activities under §469, unless taxpayers establish that they materially participated in the activities. The Cunninghams did not show any participation in the horse activities at issue. They signed returns claiming substantial losses without determining the accuracy of the partnership returns for the horse activities.

The Cunninghams did not deny that the return was filed late. IRC §6651(a)(1) provides for penalties for failure to timely file a tax return, unless it is shown that the failure to file timely is due to reasonable cause and not due to willful neglect. The Cunninghams offered no explanation for the late filing of their return.

In a post-trial memorandum, Ralph Cunningham asserted that he was "duped by a charlatan and in essence Robert Gruntz tacitly implied that I should fabricate a log that would show 'material participation.'" The Cunninghams stated that the liability would be a financial burden for their family and threw themselves at the mercy of the court to consider reducing the liability.

Holding. The Cunninghams were found liable for a deficiency of $11,515 and a late-filing addition of $1,056 for their 2002 federal income tax return.

Passive Loss Deduction

Charles M. Akers v. Comm'r, **TC Memo 2010-85 (Apr. 21, 2010)**
IRC §§61, 68, 280A, and 469

☞ Rental Deductions Denied; Vacation Property Fails Average Rental-Use Period Test

Facts. Charles Akers owned a 3-bedroom cabin in California that he rented through Alpine Resort Rentals (Alpine), a property management company. In exchange for a 35% commission on rental income, Alpine advertised, showed, and rented the property and arranged for linen cleaning and housekeeping. Akers was responsible for maintaining the property, providing linens, paying utilities, and having the property "deep cleaned" twice per year.

In 2004, the cabin was rented three times, for a total rental period of 12 days and nine nights. The cabin was rented an average of three days per customer. Akers visited the cabin eight times in 2004, for a total of 27 days and 19 nights. Family members accompanied him on each of his visits.

Akers claimed a 2004 Schedule E loss of $20,258 for the cabin rental. The IRS disallowed all of this loss and issued Akers a notice of deficiency. Akers petitioned for a trial, claiming that his use of the cabin was "for maintenance, inspection and oversight, purchasing supplies (such as plumbing, antifreeze, smoke alarm batteries, light bulbs), management, and scheduling specialized work or repair." Akers **did not** produce substantive evidence to prove his claim.

Issues. This case presents two issues:

1. Whether Akers can claim a Schedule E, *Supplemental Income and Loss,* deduction for expenses related to the cabin in 2004, and
2. Whether the cabin is considered Akers' residence for purposes of IRC §280A

Analysis. The court found Akers bore the burden of proof to establish he was entitled to the rental deductions, because Akers did not introduce credible evidence that could shift the burden to the IRS.

Issue 1. The court found Akers did not meet the test to claim a loss of up to $25,000 from a passive rental activity because the cabin did not meet the definition of a rental activity under IRC §469(j)(8). Temp. Treas. Regs. §§1.469-1T(e)(3)(i) and (ii)(A) stipulates that an owner is not engaged in a rental activity if the average period of customer use of tangible property is seven days or less within a tax year. Akers' cabin was rented an average of only three days per customer in 2004.

The court further found that Akers could not claim that the activity was not passive under IRC §469(c)(1)(B) because he did not prove he materially participated in the cabin's rental. There are seven tests to prove material participation. The court found two pertinent in Akers' case. He failed both. Because of Alpine's involvement, he could not show that his participation constituted substantially all of the participation in the cabin's rental; and he did not prove that he spent more than 100 hours working on the cabin during 2004.

Although Akers claimed he made eight trips to the cabin in 2004 to maintain the property, he **did not** substantiate his claim with evidence. The court noted that evidence was lacking "in the form of time logs, oral testimony, and/or receipts."

Issue 2. IRC §280A(d)(1) deems a property the taxpayer's residence if the taxpayer uses the property for personal purposes the greater of 14 days or 10% of the days the property is rented at fair market value during the year. A personal-use day is counted if for any part of the day the taxpayer or his family uses the house for personal use. For this purpose, personal use does not include any day in which the property owner is substantially engaged in repair and maintenance of the property, even if other family members simultaneously are using the house for other purposes.[72]

Because Akers did not present evidence to back up his claim that he was engaged in repair or maintenance activities for more than 13 of the days he used the property, he could not prove his personal use was less than 14 days.

72. IRC §280A(d)(2).

Holding. Akers cannot claim a Schedule E deduction for the cabin expenses and is liable for the deficiency. Akers does not have to report the rental income because the cabin was rented fewer than 15 days in 2004.

Issue 1. Akers cannot claim rental expenses because the property did not meet the 7-day average customer use test for rental activity under Temp. Treas. Regs. §§1.469-1T(e)(3)(i) and (ii)(A) and he did not materially participate in the rental activity.

Issue 2. The cabin was considered Akers' residence in 2004 for purposes of IRC §280A because Akers failed to substantiate that his personal use of the property did not exceed the greater of 14 days or 10% of the days the cabin was rented at fair market value during the year. He cannot claim any expenses related to the rental activity, other than those otherwise allowed for mortgage interest and property taxes on Schedule A, *Itemized Deductions*.

Note. See Chapter 4, Tax Aspects of Home Ownership, for more information on vacation rental property.

Passive Activity Losses

***Marcel and Jennifer Ajah v. Comm'r*, TC Summ. Op. 2010-90 (July 8, 2010)**
IRC §§469, 6651, and 6662

☞ Passive Loss Denied, Accuracy-Related Penalty Excused Due to Reliance on Accountant

Facts. Dr. Marcel Ajah, a medical doctor, and Jennifer Ajah, an attorney, resided in New York. In 2005, they owned two rental properties. One was a Baltimore, Maryland, single-family residence, and the other was a Jamaica, New York, office building where Dr. Ajah's medical practice was located. Only Mrs. Ajah was involved in the rental activities.

The Ajahs' 2005 joint tax return was prepared by an accountant and filed on July 25, 2006. There is no record of an extension on file. Their return showed an adjusted gross income (AGI) of $192,070, including wages of $130,000 for Dr. Ajah and $67,500 for Mrs. Ajah, net self-employment income of $51,807 for Dr. Ajah, and $60,915 of net rental losses for both properties. The return showed a refund due of $724. No election was made to aggregate the rentals into a single rental real estate activity.

The IRS disallowed the Ajahs' rental losses and assessed a $19,797 deficiency in their 2005 federal income tax. The IRS also applied an accuracy-related penalty and a penalty for failure to timely file.

Mrs. Ajah argues that she was a real estate professional in 2005 and should be allowed to deduct all of her passive activity losses.

Issues. The issues for this case are:

- Whether IRC §469 passive activity rules preclude the Ajahs from deducting losses from their rental real estate activities, and
- Whether late filing and accuracy-related penalties apply under IRC §§6651(a)(1) and 6662(a).

Analysis. IRC §469(c)(1) defines passive activity as "any activity — (A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate." IRC §469(d)(1) defines a passive activity loss as the amount by which "(A) the aggregate losses from all passive activities for the taxable year, exceed (B) the aggregate income from all passive activities for such year." §IRC 469(a) provides that passive activity credits and losses generally are disallowed.

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The Code provides that rental real estate activity generally is treated as a passive activity, regardless of whether the taxpayer materially participates.[73] Exceptions to this passive treatment occur if the taxpayer:

1. Qualifies as a real estate professional under §469(c)(7)(B) and satisfies the material participation standards of §469(c)(1), and
2. Actively participates in the rental real estate activity. Taxpayers qualifying for this exception may claim a deduction for up to $25,000 in passive activity losses per year; however, this deduction phases out for taxpayers with an AGI of $150,000 or more.[74]

Taxpayers who qualify as real estate professionals under the first exception are treated as participating in a trade or business. Their participation must be proven to be regular, continuous, and substantial to qualify for the exception. These standards are met if:

- More than one-half of the taxpayer's personal services performed in trades or businesses during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
- The taxpayer spends more than 750 hours during the tax year materially participating in real property trades or businesses.[75]

For jointly-filed returns, the same spouse must satisfy both requirements to qualify for these passive loss exceptions.[76]

IRC §469(c)(7)(A) requires that all rental real estate activities be treated separately unless the taxpayer makes an election to treat all rental interests as a single rental real estate activity. Treas. Reg. §1.469-9(g)(3) prescribes that this election must be filed with the taxpayer's original return, specifically stating that the election is made under IRC §469(c)(7)(A).

Temp. Treas. Reg. §1.469-5T(f)(4) provides that taxpayers establish their active participation in a rental real estate activity by any reasonable means, including, but not limited to, " the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries." Although the regulation specifically states that daily time logs are not required, the court has held that "postevent 'ballpark guesstimate[s]'" are not acceptable.[77]

Ms. Ajah argues that she was a qualified real estate professional in 2005 because she was certified by the Long Island Board of Realtors, Inc., the Multiple Listing Service of Long Island, Inc., and the State of New York as a licensed real estate broker. She testified that she worked on her rental properties at least 20 hours each week in 2005, but she did not provide any evidence to back up her claim.

The court ruled that Ms. Ajah's testimony amounted to an unacceptable "ballpark guesstimate" because she did not provide any records, such as an appointment book or calendar, as evidence that she spent more than half her time on her rental activities.

In addition, because the Ajahs did not file a proper election to treat the rental properties as a single rental real estate activity, the court held that they must be treated separately. Therefore, Mrs. Ajah was required to work more than 750 hours on each rental property in 2005 to qualify for the exception. Because she testified that she worked about 20 hours a week for 52 weeks, she would have spent approximately 1,040 hours on her rental activities during the year, short of the 1,500 hours required.

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73. IRC §§469(c)(2) and (4).
74. IRC §469(i)(3)(A).
75. IRC §469(c)(7)(B).
76. IRC §469(c)(7)(B).
77. *Fowler v. Comm'r*, TC Memo 2002-223; *Goshorn v. Comm'r*, TC Memo 1993-578.

Because Mrs. Ajah failed to meet the first exception, her rental real estate activities are considered "per se passive activities." Although she could have qualified for the second exception as an active participant in a rental real estate activity and deducted up to $25,000 in passive activity losses for 2005, she is not allowed to claim this deduction because the Ajahs' $192,070 AGI exceeds the $150,000 phaseout limit.

The court next turned to the matter of penalties. Mrs. Ajah argued that the late filing penalty should not apply because "she and her husband signed an extension request and gave it to their accountant to show that they had reasonable cause for not timely filing their return." The court rejected this argument because taxpayers **cannot shift the prompt filing burden to employees or agents.**[78]

As to the accuracy-related penalty, the court determined that although the Ajahs were liable for the penalty, they met the reasonable cause exception criteria because they relied in good faith on their accountant's advice.

Holding. The court held the Ajahs could not deduct any passive losses from their rental real estate activities in 2005. The court upheld the late filing penalty but struck the accuracy-related penalty because the Ajahs reasonably relied on their accountant's assurance that their rental losses were deductible.

> **Observation.** As an interesting side note that the court did not address (other than a footnote stating other "computational" adjustments were made to the return), the Ajahs sold their Maryland residential rental property for $80,000 in 2005 but did not report the sale on their 2005 return. It would seem the court would have noted that the elimination of one rental property may have caused the number of weekly hours spent on rental activities to decrease over the course of the year.

Passive Activity Losses

***Lee E. and Kathy W. Newell v. Comm'r*, TC Memo 2010-23 (Feb. 16, 2010)**
IRC §§469 and 165

☞ California LLC Member is General Partner, Losses Allowed from Significant Participation Activity

Facts. At the time of filing, Lee and Kathy Newell resided in California. Although Lee was licensed to practice law in Florida, his primary business in California was real estate management. He spent more than 750 hours annually in real property trade or business activities in the tax years 2001–2003.

During the years at issue, Lee was the sole shareholder in California Custom Millworks, Inc. (Millworks), an S corporation engaged in the manufacture and installation of windows, doors, and other carpentry items. Lee spent between 250–350 hours each year from 2001 to 2003 actively engaged in Millworks' business.

The Newells deducted the following losses for Millworks on their joint federal tax returns:

2001	$ 458,379
2002	1,270,452
2003	798,431

Lee also owned a 33% member interest in Pasadera Country Club, LLC (Pasadera) and was its managing member. Pasadera was formed as an LLC in 1999 under California law to engage in the business of owning and operating a golf course, restaurant, and country club facility. Pasadera is classified as a partnership for federal income tax purposes. Lee spent between 400–450 hours each year actively engaged in Pasadera's business from 2001 to 2003.

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78. *U.S. v. Boyle*, 469 U.S. 241, 243 (1985).

Lee negotiated all Pasadera's construction and permanent loans and was personally liable for these loans. He and Pasadera's two other members provided funds to cover any of Pasadera's operating expense shortages.

The Newells deducted Lee's distributive shares of Pasadera's losses on their joint federal tax returns as follows:

2001	$1,882,125
2002	2,104,000
2003	2,034,394

The IRS examined the Newells' 2001–2003 income tax returns and determined that both Millworks' and Pasadera's losses arose from IRC §469 passive activities and thus "are suspended and not currently deductible" under §469(a)(1). The IRS issued a notice of deficiency disallowing the losses and the Newell's NOL carrybacks to 1996 and 1997.

The IRS argues the Newells are not allowed to deduct Lee's losses from Pasadera because he is considered to hold a nonparticipating interest in "a limited partnership as a limited partner" under the special rule in Temp. Treas. Reg. §1.469-5T(e).

Issue. Whether Lee Newell's managing member interest in Pasadera is considered a limited partnership interest as a limited partner for purposes of applying the §469 passive activity loss rules and regulations.

Analysis. Trade and business losses generally are deductible under IRC §165(c)(1). Losses from passive activities in excess of passive activity gains generally are suspended under §469, but may be carried forward.

Passive activities are defined as those in which the taxpayer does not materially participate. IRC §469(h)(1) provides that a taxpayer may establish material participation if he is involved in the operation of an activity on a regular, continuous, and substantial basis. Temp. Treas. Reg. §1.469-5T(a) provides seven tests for determining whether a taxpayer's activity meets the material participation standard.

In this case, the parties agree that only the material participation test under §1.469-5T(a)(4) applies for Lee's participation in activities for Millworks and Pasadera. To prove material participation, this test requires Lee to establish whether each activity was a significant participation activity for each year in question and to show that Lee's aggregate participation in all significant participation activities during each relevant year exceeded 500 hours.

To meet the "significant participation activity" test, an activity must be a trade or business that the taxpayer participates in for more than 100 hours per year and the taxpayer cannot establish material participation under any of the other material participation tests in the regulations.[79]

IRC §469(h)(2) states that "[e]xcept as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates." Temp. Treas. Reg. §1.469-5T(e)(3)(i) provides, in general, that:

> *. . a partnership interest shall be treated as a limited partnership interest if —*
>
> *(A) Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or*
>
> *(B) The liability of the holder of such interest for obligations of the partnership is limited under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership).*

79. Temp. Treas. Reg. §1.469-5T(c).

However, Temp. Treas. Reg. §1.469-5T(e)(3)(ii) provides an exception for a limited partner holding a general partner interest, stating:

> *[a] partnership interest of an individual shall not be treated as a limited partnership interest for the individual's taxable year if the individual is a general partner in the partnership at all times during the partnership's taxable year ending with or within the individual's taxable year (or the portion of the partnership's taxable year during which the individual (directly or indirectly) owns such limited partnership interest).*

In *Garnett*, a 2009 decision, the Tax Court held that an interest in an Iowa LLC was not an "interest in a limited partnership as a limited partner" because, unlike a limited partner, Iowa state law did not prohibit the member from participating in the partnership's business.[80] The court found that because an Iowa LLC member "more closely resembled a general partner" that the member came within the general partner exception of Temp. Treas. Reg. §1.469-5T(e)(3)(ii).

The IRS argued that because Pasadera was treated as a partnership for federal income tax purposes and that Lee was entitled to limited liability under California law, his losses were subject to the passive activity rules. The court rejected the IRS's argument, holding that for §469(h) to apply, Lee "must have held an ownership interest in a limited partnership as a limited partner." The court found he did not.

Pasadera was organized under California law, which permits members to participate in the management of an LLC, but provides that a limited partner will lose his limited liability if he participates in managing the limited partnership. Pasadera's operating agreement not only authorized managing members to participate in the company's management, it required the managing member's participation.

Because California law allows members to participate directly in an LLC's management, the court ruled California LLC members more closely resemble general partners than limited partners, despite their limited liability under California law. This is especially true in Lee's case, where as managing member he functioned as a general partner would function in a limited partnership.

Lee's engagement with Millworks was classified as a significant participation activity, as defined under Temp. Treas. Reg. §1.469-5T(c). Because Lee was considered a general partner in Pasadera, the IRS conceded that Lee's involvement with Pasadera also met the significant participation activity requirement. Because Lee's aggregate participation in all significant participation activities for each relevant year exceeded 500 hours, Lee is deemed to have been a material participant in both Millworks and Pasadera. The Newells are therefore entitled to claim Lee's losses in both Millworks and Pasadera for 2001–2003.

Holding. The court held that Newell's managing member interest in a California LLC was not considered "a limited partner interest in a limited partnership," which allowed Lee to bypass the passive activity loss rules and claim his current year losses from significant participation activities for tax years 2001–2003.

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80. *Garnett v. Comm'r*, 132 TC No. 19 (2009).

Real Estate Professional

***Gregory and Linda Bahas v. Comm'r,* TC Summ. Op. 2010-115 (Aug. 6, 2010)**
IRC §469

☞ Licensed Real Estate Agent not a Real Estate Professional

Facts. Mr. and Mrs. Bahas owned three rental properties. The three properties sustained total losses of $39,154 and $12,196 in 2006 and 2007, respectively, which they claimed on their Schedules E, *Supplemental Income and Loss*. Mrs. Bahas worked as a licensed real estate agent for a corporation during this time period and Mr. Bahas was a computer technician. Mrs. Bahas received an hourly wage and 6% of the profits from the business. Upon audit, the IRS disallowed the real estate losses under IRC §469.

Issue. Whether the Bahas are entitled to claim the losses from rental real estate property.

Analysis. The taxpayers never made a grouping election. Therefore, they did not comply with the requirements of Treas. Reg. §1.469-9(g).

The Bahas did not work more than 750 hours on their real estate rentals directly, but Mrs. Bahas maintained she met the 750-hour participation test through her work as a real estate agent. This is known as the real estate professional rule. The IRS disagreed. To meet this requirement, §469(c)(7)(D)(ii) provides:

> *Personal services performed as an employee shall not be treated as performed in real property trades or businesses. The preceding sentence shall not apply if such employee is a 5 percent owner.*

The taxpayer argued that receiving 6% of the profits deemed her to own more than 5% of the business. She used a paragraph from Pub. 925, *Passive Activity and At-Risk Rules*, to support her position.

> *Do not count personal services you performed as an employee in real property trades or businesses unless you were a 5 percent owner of your employer. You were a 5 percent owner if you owned (or are considered to have owned) more than 5 percent of your employer's outstanding stock, or capital or profits interest.*

The IRS pointed to the Code in challenging the taxpayer's real estate professional argument. IRC §469(c)(7)(D)(ii) is defined in §§416(i)(1)(B)(i) and (ii) as:

> *(i). If the employer is a corporation, any person who owns (or is considered as owning within the meaning of section 318) more than 5 percent of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation, or*
>
> *(ii). If the employer is not a corporation, any person who owns more than 5 percent of the capital or profits interest in the employer.*

Holding. As Mrs. Bahas's employment agreement did not show the transfer of any of the corporate stock to her, the court ruled she did not meet the real estate professional test and disallowed the passive loss deductions.

RESIDENCES

Installment Method for Sale of Residence

Ltr. Rul. 200931001 (Apr. 14, 2009)
IRC §453

☞ Taxpayers Allowed to Revoke Election Out of Installment Method

Facts. Taxpayers sold their principal residence. They received the proceeds from the sale over a 2-year period.

The taxpayers used a tax return preparer to prepare their tax return for the year their residence was sold. This preparer advised the taxpayers that the installment sale treatment could not be combined with the IRC §121 exclusion for income from the sale of a principal residence. As a result, the taxpayers reported all the gain, less the §121 exclusion, from the sale of their principal residence on their federal income tax return for the year the residence was sold.

The taxpayers changed tax return preparers two years after the sale of their residence. The new preparer advised the taxpayers that it was possible to exclude gain on the sale of a principal residence while reporting the remaining gain on the installment method. Consequently, the taxpayers requested approval to revoke the election out of the installment method for the year their principal residence was sold.

Analysis. IRC §453(a) provides that a taxpayer generally shall report income from an installment sale under the installment method. An installment sale is defined as a disposition of property for which at least one payment is to be received after the close of the taxable year of the disposition.[81]

A taxpayer may elect out of the installment method by reporting an amount realized equal to the selling price on a timely-filed tax return for the taxable year in which the installment sale occurs.[82] This election may be revoked only with the consent of the IRS.

Holding. Taxpayers are allowed to revoke their election out of the installment method for the sale of their principal residence.

Section 121 Exclusion

***Sung Huey Mei Hsu v. Comm'r,* TC Summ. Op. 2010-68 (June 7, 2010)**
IRC §121

☞ 50% Owner Entitled to Full §121 Exclusion on Qualified Sale of Personal Residence

Facts. Sung Huey Mei Hsu (Sung) sold her qualified personal residence in 2005. She was a 50% owner of the property. The total gain realized on the sale of the home was $529,289. Sung reported a $264,645 gain from her half of the sale on her 2005 Schedule D, *Capital Gains and Losses,* and excluded $250,000 from this gain under IRC §121 on her timely-filed 2005 income tax return.

The IRS disallowed part of the exclusion, contending that Sung was only allowed 50% of the $250,000 exclusion, or a $125,000 exclusion, because she was only a 50% owner of the residence.

Issue. Whether Sung is allowed to exclude the full $250,000 IRC §121 exclusion on the sale of her qualified principal residence, of which she was a 50% owner.

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81. IRC §453(b)(1).

82. Treas. Reg. §15A.453-1(d)(3).

Analysis. IRC §121 provides for the exclusion from gross income of up to $250,000 of gain from the sale or exchange of property if it was owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more during the 5-year period preceding the sale or exchange. Sung met the requirements for a qualified exclusion.

The court did not find any limitation in §121 that prevented partial owners from claiming the full exclusion. However, the court found that Treas. Regs. §§1.121-2(a)(2) and (4) provide an example where unmarried 50% joint owners in a principal residence are each entitled to the full $250,000 exclusion on their respective portions of the gain from the qualified sale of a residence.

Holding. Sung is allowed to exclude the full $250,000 of her portion of the gain.

RETIREMENT

Early Distribution Penalty

***Eugene and Glenda Dollander v. Comm'r,* TC Memo 2009-187 (Aug. 19, 2009)**
IRC §§72(t) and 6662(a)

☞ Hardship Withdrawal Not Exempt from Early Withdrawal Penalty

Facts. Eugene Dollander worked for the Department of Veterans Affairs (VA) from June 1985 to April 2006. In 2004, he worked at the VA Medical Center in Augusta, Georgia, as a nurse in the triage section, which deals with evaluating individuals having psychiatric emergencies.

On June 30, 2004, Dollander evaluated a person who, within an hour of the evaluation, died. Because of this incident, Dollander began to suffer mental health difficulties and was reassigned to a clerical position.

In October 2004, Dollander was diagnosed with post-traumatic stress disorder, depressive disorder, and bipolar type II. He began psychotherapy sessions and was restricted to light duty.

Dollander struggled at the VA during this period. He was accused of not adequately performing his duties. He was suspended from work without pay in February 2005. At the end of his suspension period, Dollander was taken off light duty and transferred to a job in a locked psychiatric unit in Minnesota.

While employed with the VA, Dollander established a thrift savings plan. In 2005, he requested and received an in-service financial hardship distribution of $158,310.

In April 2006, Dollander retired from the VA. His retirement was under the disability classification with the Federal Employee Retirement System. Approximately one month after he retired from the VA, Dollander began full-time work as a nurse with the State of Georgia Community Services Board.

Subsequently, the IRS assessed a deficiency in Dollander's 2005 income tax of $16,918 and an accuracy-related penalty of $3,384.

Issues. The issues in this case are as follows:

- Whether Dollander is liable for the 10% additional tax under IRC §72(t) for an early distribution from a qualified retirement plan, and
- Whether the taxpayer is liable for the IRC §6662(a) accuracy-related penalty

Analysis. IRC §72(t)(1) imposes a 10% additional tax on any distribution from a qualified retirement plan that does not satisfy one of the exceptions in §72(t)(2). The thrift savings plan is a qualified retirement plan, and Dollander's 2005 distribution of $158,310 was made before he attained age 59½. Thus, the 10% additional tax applies to the distribution unless an exception applies.

Dollander contended that he should not be subject to the 10% additional tax because he requested and received a financial hardship in-service withdrawal. However, financial hardship is not one of the exceptions listed in §72(t)(2).

Dollander further maintained that he received the distribution because he was disabled and that distributions from a qualified retirement plan attributable to the employee's disability are excepted from the 10% penalty. IRC §72(m)(7) defines an individual as being disabled for purposes of §72 as follows: "… he is unable to engage in any substantial gainful activity by reason of any medically-determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration."

In 2005, Dollander continued working at the VA earning the same salary as before his impairment was diagnosed. He then retired from the VA in 2006 and began a full-time job with another employer. Thus, Dollander was not disabled for purposes of §72(t)(2).

The accuracy-related penalty under §6662(a) does not apply to any part of an underpayment of tax if it is shown that the taxpayer acted with reasonable cause and in good faith.[83] H&R Block prepared Dollander's 2005 tax return. Dollander apparently was forthright with information given to H&R Block, including providing the receipt for the $158,310 distribution from the thrift saving plan.

Holding. Dollander was held liable for the 10% early-withdrawal penalty because he did not qualify for an exception under §72(t). Dollander was not charged with the §6662(a) penalty for the underpayment relating to the 10% additional tax because he acted in good faith and with reasonable cause.

Retirement Plan Distributions

Kenneth L. Graham v. Comm'r, **TC Summ. Op. 2009-139 (Sep. 8, 2009)**
IRC §72(t)

☞ IRA Distributions Not Substantially-Equal Periodic Payments

Facts. Kenneth Graham retired in 1999 after 35 years of employment with a telephone company. At the time of his retirement, he elected to receive a lump-sum distribution of a pension that he accumulated during his employment with the telephone company. Graham rolled these funds over into several self-directed IRAs.

Graham began receiving periodic distributions from his IRAs in 1999 at age 51. His financial advisors determined the amount of Graham's distributions from his IRAs but did not provide him with documentation detailing how the distribution amounts were calculated. Graham's advisors told him that the distributions were in accordance with one of the exceptions under IRC §72(t)(2).

In 2006, when Graham was 58, he received total distributions of $61,833 from four IRAs. The combined value of the IRAs at the close of the 2006 tax year was $284,372.

Graham reported the distributions as income on his 2006 federal income tax return but did not report any additional tax on these distributions. The IRS subsequently notified him that the distributions were subject to the 10% additional tax under §72(t). Graham argued that the distributions were part of a series of substantially-equal periodic payments and, accordingly, were not subject to the additional tax.

83. IRC §6664(c)(1).

Issue. Whether Graham is liable for the 10% additional tax on early distributions from qualified retirement plans under §72(t)(1).

Analysis. IRC §72(t)(1) imposes a 10% additional tax on early distributions from qualified retirement plans. This 10% additional tax does not apply to distributions that are part of a series of substantially-equal payments made not less frequently than annually over the life (or life expectancy) of the employee.

Payments are considered substantially-equal periodic payments if the amount of the payments is determined by one of three methods:

- The required minimum distribution method,
- The fixed amortization method, or
- The fixed annuitization method.[84]

Each of these three methods takes the taxpayer's life expectancy into consideration.

Graham had a life expectancy of 27.0 years in 2006. The amount distributed to him in that year, $61,833, exceeds one-sixth of the total value of his IRAs at the beginning of 2006. If he continued to receive distributions at that rate, his IRA balances would be depleted within seven years. Thus, the distributions could not possibly be substantially-equal periodic payments made over Graham's life expectancy.

Holding. Graham is liable for the 10% additional tax under §72(t).

401(k) Plan Enrollment

IRS Notice 2009-65, IRB 2009-39 (Sep. 28, 2009)
IRC §§401(k) and 414

☞ Sample Amendments for Adding 401(k) Automatic Enrollment Features

Purpose. This notice provides two sample plan amendments for employers and sponsors who want to add certain automatic enrollment features to their 401(k) plans.

Analysis. In the absence of an employee's affirmative election, a default provision can be applied under which the employer makes elective contributions to a 401(k) plan on the employee's behalf.[85]

Sponsors of 401(k) plans who want to add to their plan one of the sample amendments for automatic enrollment must adopt the amendment by the later of (1) the end of the plan year in which the amendment is effective, or (2) the deadline under section 1107 of the Pension Protection Act of 2006, if applicable. Proper notice must be provided to affected employees that describes the features of the plan as amended.

The adoption of either sample plan amendment (as modified, if necessary) will not result in the loss of reliance on a favorable opinion, advisory, or determination letter.

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84. See Rev. Rul. 2002-62, 2002-2 CB 710.

85. Treas. Reg. §1.401(k)-1(a)(3)(ii).

SIMPLE IRA Enrollment

IRS Notice 2009-67, IRB 2009-39 (Sep. 28, 2009)
IRC §408

☞ Sample Plan Amendment for Automatic Enrollment in SIMPLE IRA Plans

Purpose. This notice provides a sample plan amendment that prototype sponsors of SIMPLE IRA plans can use in drafting an amendment to add an automatic contribution feature to their plans. Only those plans using a designated financial institution described in IRC §408(p)(7) can use the sample amendment.

Analysis. Under an automatic contribution arrangement, in the absence of an affirmative election by an employee, a default election applies which provides that the employee is treated as having elected to have a portion of the employee's compensation contributed to a qualified retirement plan.

An employer that wants to add an automatic contribution feature to its prototype SIMPLE IRA plan using a designated financial institution must adopt an amendment provided by the prototype sponsor before the effective date of the automatic contribution arrangement. The adoption of the amendment must be evidenced by a written document that is signed and dated by the employer and designated financial institution.

Retirement Plan Contributions

Rev. Rul. 2009-31, IRB 2009-39 (Sep. 28, 2009)
IRC §§401, 402, 415, 451, and 409A

☞ Annual Contributions of Unused Paid Time Off to Retirement Plan Allowed

Purpose. This revenue ruling provides guidance on the tax consequences of an amendment to a qualified retirement plan to permit contributions of an employee's unused paid time off.

Analysis. In the first scenario presented, Company Z maintains a paid time off (PTO) plan as well as a profit-sharing plan. The company amended the plans in December 2008 to specify that the dollar amount of unused PTO as of the end of the year was forfeited and contributed to the profit-sharing plan of the employee. In the event that these contributions, in combination with prior additions, exceeded the IRC §415(c) limitations, the dollar equivalent of any remaining PTO is paid to the employee by February 28 of the following year. The amounts attributable to PTO are treated as nonelective contributions to the profit-sharing plan and includable in the employee's gross income in the taxable year in which it is contributed.

The facts presented in the first scenario do not cause the profit sharing plan of Company Z to fail to meet the requirements of IRC §401(a), if all the contributions made under the arrangement satisfy the nondiscrimination requirements of §401(a)(4). The dollar equivalent of any remaining PTO which is paid to the employee is includible in the employee's gross income in the taxable year in which it is paid.

In the second scenario presented, Company Y maintains both a profit-sharing plan and a PTO plan, under which employees may carry over to the next year a specified number of hours of unused PTO. The dollar equivalent of any unused PTO in excess of the carryover limit is paid to the employee by February 28 of the following year.

Company Y amended its 401(k) plan and its PTO plan in December 2008 to provide that a participant may elect to reduce all or part of any unused PTO that exceeds the carryover limit and have the dollar equivalent of that time off contributed by the Company to the participant's 401(k) account. Under the terms of Company Y's 401(k) plan, contributions of the dollar equivalent of PTO are treated as elective contributions. The dollar equivalent of any unused PTO that is not contributed to the 401(k) plan is paid to the participant by February 28 of the following year.

The amendment of Company Y's 401(k) plan does not cause the plan to fail to meet the requirements of §§401(a) and 401(k), if the contributions satisfy the nondiscrimination requirements and applicable limitations. Such contributions are elective and are taken into consideration for the nondiscrimination requirements and applicable limitations for the year in which they are made. Likewise, the dollar equivalent of any unused PTO that is paid to the participant is includible in the participant's gross income in the taxable year in which it is paid.

Retirement Plan Contributions

Rev. Rul. 2009-32, IRB 2009-39 (Sep. 28, 2009)
IRC §§401, 402, 415, 409A, and 451

☞ Unused Paid Time Off Can be Contributed to Plan at Termination of Employment

Purpose. This revenue ruling provides guidance on the tax consequences of various amendments to profit-sharing plans which require or permit contributions to the plan of the dollar equivalent of unused paid time off (PTO) at the termination of employment.

Analysis. Several scenarios are presented in this revenue ruling in which the dollar equivalent of unused PTO is contributed to a profit-sharing plan. In one of the scenarios, the profit-sharing plan is amended to specify that the dollar equivalent of unused PTO at the termination of a participant's employment is contributed to the company profit-sharing plan and allocated to the participant's account. The dollar equivalent of any unused PTO that is not contributed to the profit sharing plan is paid to the terminated participant within 60 days after termination. In another scenario, a 401(k) plan is amended to provide that a participant may elect to have the dollar equivalent of all or a portion of any unused PTO contributed to the participant's 401(k) account at the time the participant's employment is terminated. The dollar equivalent of any unused PTO that is not contributed to the 401(k) plan is paid to the employee after termination of employment.

In each of the scenarios, the amendments to the qualified retirement plans did not cause the plans to fail to meet the requirements of IRC §§401(a) and/or 401(k), nor to exceed the limitations of IRC §415(c). Additionally, the IRS affirmed that the dollar equivalent of unused PTO paid to the participant is includible in the participant's gross income in the year in which it is received.

Retirement Plan Distributions

***John C. Armbrust v. Comm'r,* TC Summm. Op. 2010-5, (Jan. 19, 2010)**
IRC §§72(t), 401(a), 401(k), 408(a), and 408(b)

☞ Excise Tax on Early Distribution from Retirement Plan

Facts. In 2006, John Armbrust wanted to purchase his first home but, because of his low credit rating, was unable to obtain outside financing. Instead, the taxpayer's father purchased the home with mortgage financing in his own name. About a week after closing, the taxpayer took a $50,000 lump-sum distribution from his employer's pension plan and used that money to repay his father for the down payment and closing costs on the home. The taxpayer's father then executed a quitclaim deed transferring the property to his son. The taxpayer occupied the home and made all the mortgage payments.

The pension plan distribution was reported on a Form 1099-R for 2006, showing a $50,000 gross distribution, $10,000 of withholding tax, and a code for a premature distribution. The taxpayer reported the distribution on his 2006 tax return as gross income but did not include the additional 10% tax for an early distribution. The IRS examined the return and issued a notice of deficiency for the additional tax of $5,000. The taxpayer claimed that the distribution meets one of the exceptions to the additional tax because the money was used to purchase his first home.

Issue. Whether the early distribution satisfies any of the exceptions to the additional tax under IRC §72(t)

Analysis. Congress enacted §72(t) to discourage premature withdrawals from retirement plans. IRC §4974(c) describes the types of retirement plans whose distributions are subject to the additional tax. The list includes both individual retirement arrangements (IRAs) and qualified plans described in IRC §401(a), which is the type of retirement plan at issue in this case.

IRC §72(t)(2) includes exceptions to the 10% tax. IRC §72(t)(2)(F) provides that distributions from an individual retirement plan which are qualified first-time homebuyer distributions will be excluded from the additional tax, up to a maximum distribution of $10,000. The court determined that the plain language of the statute limits the exception to distributions from IRAs, and the taxpayer's distribution was not from an IRA.

Holding. The taxpayer is not entitled to relief under §72(t)(2)(F) and is subject to the additional 10% tax on premature distributions.

Qualified Retirement Plan Distribution

Ltr. Rul. 201005057 (Nov. 10, 2009)
IRC §402

☞ Direct Rollover Not Subject to 60-Day Rollover Requirement

Facts. Taxpayer A worked for Company A, where she participated in a company-sponsored retirement plan. She then left Company A and began working at Company B. Initially, she left the retirement funds with Company A's retirement plan but later decided to roll the funds over to the Company B sponsored retirement plan. She received a check made payable to Company B, FBO Taxpayer A. She held onto the check until it was endorsed "for deposit only" by a principal of Company B and deposited it in Company B's retirement plan. A Form 1099-R was received showing code "G," indicating a direct rollover to a qualified plan. Taxpayer requests a waiver of the 60-day rollover requirement for this distribution.

Analysis. IRC §402 provides that any amount distributed from an employees' trust is taxable to the distributee in the year of distribution in the manner provided under IRC §72 unless an exception applies.

Rev. Proc. 2003-16, provides that in determining whether to grant a waiver of the 60-day rollover requirement, the IRS will consider all relevant facts and circumstances, including:

1. Errors committed by a financial institution;
2. Inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, or postal error;
3. The use of the amount distributed (for example, in the case of payment by check, whether the check was cashed); and
4. The time elapsed since the distribution occurred.

In this case, the IRS notes that Taxpayer A received a distribution in the form of a direct rollover. The distribution check was given to Taxpayer A, but made out to Company B, FBO Taxpayer A; thus, the check was not payable to Taxpayer A. Taxpayer A lacked control over the check and could not have negotiated it. The Form 1099-R received by Taxpayer A supports this conclusion by showing Code "G" in box 7, with no withholding for federal income tax.

Holding. Because the distribution from a qualified retirement plan was in the form of a direct rollover under IRC §401(a)(31), it was not subject to the 60-day rollover requirement of §402(c)(3)(A).

S CORPORATION

S Corporation Compliance

Government Accountability Office (GAO) Report #GAO-10-195 (Dec. 2009)
IRC §1371

☞ Compliance Improvement Recommendations

This study was warranted because S corporations are one of the fastest growing business entity types, accounting for nearly 4 million businesses in 2006. Unfortunately, government revenue losses for both individual income taxes and employment taxes related to S corporations are a long-standing problem. As part of this report, the GAO was asked to:

- Describe reasons for choosing the S corporation entity over other types of entities,
- Analyze S corporation noncompliance,
- Describe IRS actions to address S corporation noncompliance,
- Identify options to improve S corporation compliance, and
- Analyze shareholder noncompliance and options for improvement.

In its report, the GAO recommended that the IRS improve S corporation tax rule compliance by requiring S corporations to report basis for shareholders' ownership shares and providing additional guidance to new S corporations on calculating basis and determining compensation.

The GAO report stated that the differences in noncompliance were not statistically significant when comparing whether a paid tax return preparer was utilized to prepare Form 1120S. **The GAO estimated that 75% of S corporations that did not use a paid preparer were noncompliant while 71% of those that utilized a paid preparer were noncompliant.** The options mentioned in the report to improve the performance of S corporation return preparers included licensing, education, and penalties.

Consolidated Return

Ltr. Rul. 201002002 (Oct. 1, 2009)
IRC §§1362 and 1502

☞ S Corporation Revocation Results in Denial of Consolidated Return Filing

Facts. Parent was the common parent of a consolidated group (the "Old Group") that filed a consolidated federal income tax return on a calendar-year basis. Effective Date 1, the Parent elected to be taxed as an S corporation under IRC §1361 and made qualified Subchapter S subsidiary (QSub) elections for most, but not all of its subsidiaries effective Date 1. The Old Group terminated for federal income tax purposes at the end of the day on Date 2.

On Date 3, Parent properly revoked its S corporation election via a letter to the IRS. The revocation caused each QSub election to terminate. As a result of the termination of the QSub elections, the Parent was treated as transferring the QSubs' assets into newly formed corporations.

Because of the revocation of the S corporation election by the Parent, each of the former QSubs became members of an affiliated group with Parent as the common parent (the "New Group").

Parent requested a ruling for a waiver permitting Parent and the members of the New Group to file a consolidated federal income tax return for the short tax period.

Analysis. Parent is denied a waiver under IRC §1504(a)(3)(B), and New Group may not file a consolidated return with Parent as the common parent until the expiration of the 61st month beginning after its first taxable year in which the corporation ceased to be a member of the original affiliated group.[86]

Holding. The parent corporation may not file a consolidated return as the common parent of a new group of members for the short tax period.

Basis

***Robert Weisberg and Julie Peterson v. Comm'r,* TC Memo 2010-55 (Mar. 22, 2010)**
IRC §§1361, 1366, 6651, and 6662

☞ Mere Loan Guarantee Does Not Increase Basis in S Corporation

Facts. Robert Weisberg, an attorney, resided in Minnesota with his wife, Julie Peterson. Weisberg was a 100% shareholder in Weisberg and Associates, an S corporation, through which he practiced law.

Weisberg personally guaranteed a $200,000 line of credit from Firstar Bank in February 2000, which was issued to Weisberg Personal Injury Lawyers, P.A. — a forerunner to Weisberg and Associates. The proceeds of the loan were used to fund business expenses for the S corporation.

In March 2004, Weisberg and Associates owed $150,174 on the Firstar line of credit. That same month, Weisberg personally borrowed $250,000 from Bremer Bank and used part of the proceeds to pay off the Firstar credit line.

Weisberg received an extension of time to file his 2003 federal income tax return. The return was due by October 15, 2004, but Weisberg did not file until November 29, 2004. He claimed a loss of $199,141 from the S corporation but still had total tax due of $99,760 because of income from other sources.

The IRS disallowed the Weisberg and Associates loss, due to Weisberg's basis limitation in the S corporation, and issued a notice of deficiency in June 2007 for $100,803.

Issues. The issues for decision include:

- Whether Weisberg is entitled to deduct the $199,141 loss from Weisberg and Associates on his 2003 federal income tax return, and
- Whether Weisberg is liable for late-filing and accuracy-related penalties

Analysis. IRC §1366(d)(1) establishes that an S corporation shareholder cannot claim a loss deduction greater than the shareholder's basis in the corporation. Under certain circumstances, a shareholder can increase his S corporation basis by debt. However, the court has held that "mere shareholder guaranties of S corporation indebtedness generally fail to satisfy" these requirements.[87]

The *Spencer* court held that indirect borrowing, including a loan guaranty, did not establish debt "until and unless the shareholders pay part, or all of the obligation." Prior to the payment of the debt, liability exists but not shareholder debt. Only the guarantor's payment of the debt adds to the shareholder's basis.

Although Weisberg incurred his own personal debt to pay off the S corporation's line of credit, which the court assumed increased his basis in Weisberg and Associates by $150,174, he did not complete this transaction until March 2004. This payment did not increase his S corporation basis for 2003, the year of the deficiency.

Holding. The court disallowed the loss from Weisberg and Associates for 2003 and sustained the deficiency and related penalties.

86. IRC §1504(a)(3)(A).

87. *Spencer v. Comm'r*, 110 TC 62, 83-84 (1998).

TAX FRAUD

Fraud Penalty

***Lisa R. and Darren T. Cole et al v. Comm'r*, TC Memo 2010-31 (Feb. 22, 2010)**

IRC §§6663 and 6501

☞ Lawyers Fail to Report Proper Amount of Income

Facts. Scott and Darren Cole are attorney brothers who practiced law in Indiana through the Bentley Group. The Bentley Group was formed in 1998 and also does business under the name Cole Law Offices. Darren's wife, Lisa, worked in the law operation as a paralegal. The two brothers agreed to share profits and losses equally.

Scott and Darren advised their clients individually, and they also advised clients jointly. These joint clients were considered clients of the law practice. The brothers did not keep records, nor did they produce or maintain invoices for their services. They also failed to keep records or invoices for Lisa's paralegal services. Taxable deposits in the Bentley Group's account for 2001 totaled $1,430,802.

Scott, Darren, and Lisa withdrew in excess of $1 million from the Bentley Group's account during 2001. They then transferred the funds into numerous other accounts and provided no business explanation for doing so. No records were kept for any of the transfers from the Bentley Group's account. The 2001 withdrawals made by or on behalf of Darren or Lisa totaled $198,308, while the withdrawals made by or on behalf of Scott totaled $1,173,263.

Scott deposited legal fees in excess of $85,000 into his and his wife's personal accounts. The 2001 joint tax return he filed with his wife showed $341 of tax liability and $164 of SE tax. Their joint return did not report any wages, Schedule C income, or income from the Bentley Group or Cole Law Offices.

Likewise, Darren and Lisa failed to report amounts withdrawn from the Bentley Group account for 2001 as well as funds for legal services deposited into Lisa's personal account.

Fictitious LLCs were created for both Scott's and Darren's benefit.

The IRS conducted audits of both Darren and Scott using the specific items method and bank deposit analyses to reconstruct income. The results of the audits indicated that wages and SE income were omitted from the returns. The IRS issued deficiency notices and asserted fraud penalties against the taxpayers.

Issues. The issues in this case are as follows:

- Whether the taxpayers substantially understated their income for 2001, and
- Whether they are liable for the fraud penalty for 2001

Analysis. The court reviewed all the information provided for both parties and found the IRS properly used the specific item and bank deposit methods to reconstruct income. Neither party introduced any documentary evidence to show otherwise.

In reviewing whether the taxpayers are liable for the fraud penalty, the court found Scott and his wife, Jennifer, commingled personal and business income without hesitation, did not properly report income from the law practice on their tax return, concealed assets, gave inconsistent answers regarding his legal and tax preparation practice, and used a scheme that assigned income to an LLC to conceal the true nature of their earnings.

Similarly, Darren and Lisa both earned substantial amounts from the Bentley Group, yet reported only a nominal amount on their joint tax return. They also used a scheme that assigned income to an LLC to conceal the true nature of earnings.

Both couples were found to have fraudulently understated their 2001 tax liabilities. Because of the finding of fraud, the limitations period for assessing taxes had not expired.[88]

Holding. The two brothers and their wives are liable for fraud penalties because they fraudulently understated their 2001 income by failing to report fees received for legal and tax preparation services.

Income Tax Evasion

***U.S. v. James Ray Phipps*, U.S. Court of Appeals, 5th Circuit, No. 10831 (Jan. 25, 2010)**
IRC §§7212(a) and 7201

☞ Pyramid Scheme's Tax Evasion Promotion is not Protected Speech

Facts. James Ray Phipps operated "Life Without Debt" (LWD), an "educational" program purported to teach "members" how to eliminate debt and live within their means. Approximately 31,000 LWD followers contributed amounts ranging from $2,000 to $100,000 to Phipps' "compound-leveraging investment program." Investors were told the larger their investment, the larger their return.

Before members could receive a return on their investment, they were required to recruit two new members. Phipps collected over $4.6 million in participation income and amounts paid to him under a variety of aliases, but only 9% of LWD members collected more than their original investment.

Phipps told members he did not pay taxes on his LWD income and instructed them that they did not need to report income they received under the program. He also supplied them with anti-income-tax literature and tapes, including instructions on how to create a tax evasion defense by citing reliance on the advice of tax professionals. The IRS prepared and filed substitute tax returns for Phipps during several of the 10 years that he operated LWD and notified Phipps that he owed income tax.

A jury found Phipps guilty of mail and wire fraud, aiding and abetting, corrupt endeavoring to obstruct and impede the Internal Revenue laws, and income tax evasion. Phipps appealed to the Fifth Circuit.

Issues. Phipps' appeal raised the following two tax issues:

1. Whether his advocacy of tax evasion was protected speech under the First Amendment, and
2. Whether his "genuine belief" that LWD income did not need to be reported to the IRS excused him from the "willfulness" test for tax evasion

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88. IRC §6501(c)(1).

Analysis.

Issue 1. The appeals court found Phipps' stepped over the free speech line when he told his followers he did not pay taxes on his LWD income and neither should they. Characterizing Phipps' actions as "likely to incite or produce 'imminent lawless action,'" the court relied on several cases in which advocating for tax evasion was found to go beyond the First Amendment protection afforded to those who merely advocate tax reform.[89]

Because Phipps' tax evasion platform was not protected under the First Amendment, the appeals court ruled the jury could use it as evidence that Phipps encouraged LWD members to break the law. IRC §7212(a) imposes criminal penalties against a person who "corruptly…obstructs or impedes, or endeavors to obstruct or impede the due administration of [the Internal Revenue Code]."

In *U.S. v. Reeves,* the court found that a corrupt action is one undertaken "with the intention of securing improper benefits or advantages for one's self or others."[90] Because Phipps substantially profited from his actions, he was found to have corruptly obstructed the administration of the Code.

Issue 2. IRC §7201 provides felony fines and imprisonment for any person "who willfully attempts in any manner to evade or defeat any [income] tax … or the payment thereof…." Phipps argued that he genuinely believed that his LWD income did not need to be reported to the IRS. The court denied this argument because the IRS had notified Phipps of the income tax due on his LWD income. Because Phipps also advised participants on how to construct a "reliance defense" to avoid paying taxes, the appellate court ruled the jury could reasonably conclude that Phipps' evasion tactics were willful.

Holding. The appeals court affirmed the decision of the district court, finding Phipps guilty of obstructing and impeding Internal Revenue laws and income tax evasion, as well as mail and wire fraud.

TRAVEL AND TRANSPORTATION EXPENSE

Travel Away from Home

***James and Jeri Minick v. Comm'r*, TC Memo 2010-12 (Jan. 21, 2010)**
IRC §162(a)(2)

☞ Deductibility of Expenses for Travel Away from Home

Facts. The taxpayers, Jim and Jeri Minick, maintained a residence in Eure, North Carolina, throughout 2004. In 2004, Mr. Minick was a field engineer with Pizzagalli Construction and was paid on an hourly basis. Although Pizzagalli was located in Vermont, Mr. Minick worked on assignments at various jobsites. From January to July 2004, Mr. Minick was assigned to a jobsite in Taylors, South Carolina. From July to December of 2004, he was assigned to a jobsite in Georgia.

During 2004, Mrs. Minick spent some time at their home in Eure, some time caring for family in Virginia, and the balance of time she spent at the jobsites with her husband. The Minicks purchased a camper that they used to live in at the jobsites. In September and November of 2004, Mr. Minick stayed in motels near his jobsites.

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89. *U.S. v. Kelley*, 864 F.2d 569, 577 (7th Cir. 1989) rejected First Amendment protection of "more than mere advocacy" when defendant told clients to keep tax shelter information secret from the IRS and received commissions from sales; *U.S. v. Buttorff*, 572 F.2d 619, 624 (8th Cir. 1978) rejected First Amendment protection of activity that went "beyond mere advocacy of tax reform" in explaining to others how to avoid income tax liability.

90. *U.S. v. Reeves,* 752 F.2d 995, 1001-02 (5th Cir. 1985).

For 2004, the taxpayers filed a joint income tax return and used a post office box in Harpers Ferry, West Virginia as their home address. They claimed a deduction for unreimbursed employee business expenses which included motel charges of $2,341 and living expenses of $13,075. The living expenses were all related to the cost of keeping the camper and the cost of maintaining the home in Eure.

Issue. Whether the taxpayers were entitled to deduct expenses for travel away from home

Analysis. Under IRC §162(a)(2), taxpayers are allowed to deduct travel expenses paid or incurred while away from home for a trade or business. Travel expenses include travel fares, meals, lodging, and other incidental expenses. The taxpayer must meet three requirements in order to deduct the travel expenses. The expenses must be:

1. Ordinary and necessary,
2. Incurred while the taxpayer is away from home, and
3. Incurred in pursuit of a trade or business.

The Minicks claimed that their home was the residence in Eure and that Mr. Minick was temporarily away from home on assignments at the jobsites. The court, however, determined that they did not need to address the question of a temporary assignment if they determined that Mr. Minick had no tax home. If an individual has neither a principal place of business or place he permanently resides, then the individual is an itinerant for purposes of §162. Mr. Minick did not return to Eure at all during 2004 and neither of the taxpayers gave any indication that they intended to return to Eure for any business purpose. The court concluded that Mr. Minick had no business relationship with Eure for tax home purposes.

In addition, the court determined that the taxpayers failed to show that the expenses incurred for maintaining the home in Eure had the required business connection. Rather, it appeared that Mrs. Minick established Virginia as their "home" by getting drivers' licenses and car registrations in Virginia. Because the taxpayers could not establish the existence of any business relationship with Eure, the court found that Eure was not the taxpayers' tax home and that Mr. Minick was not "away from home" in 2004. Therefore, the court concluded that the expenses incurred for the Eure home, the motels, and the camper were all personal in nature and not deductible under §162.

Holding. Taxpayers failed to prove that Mr. Minick incurred ordinary and necessary business expenses while traveling away from home for his job and, therefore, those expenses cannot be deducted.

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