Chapter 14: Rulings and Cases

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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 August 15, 2011. 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.

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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 IRS 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.

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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. TAMs 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 trials 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.

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The IRS issues a statutory notice of deficiency in tax disputes in which the IRS 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.

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.**

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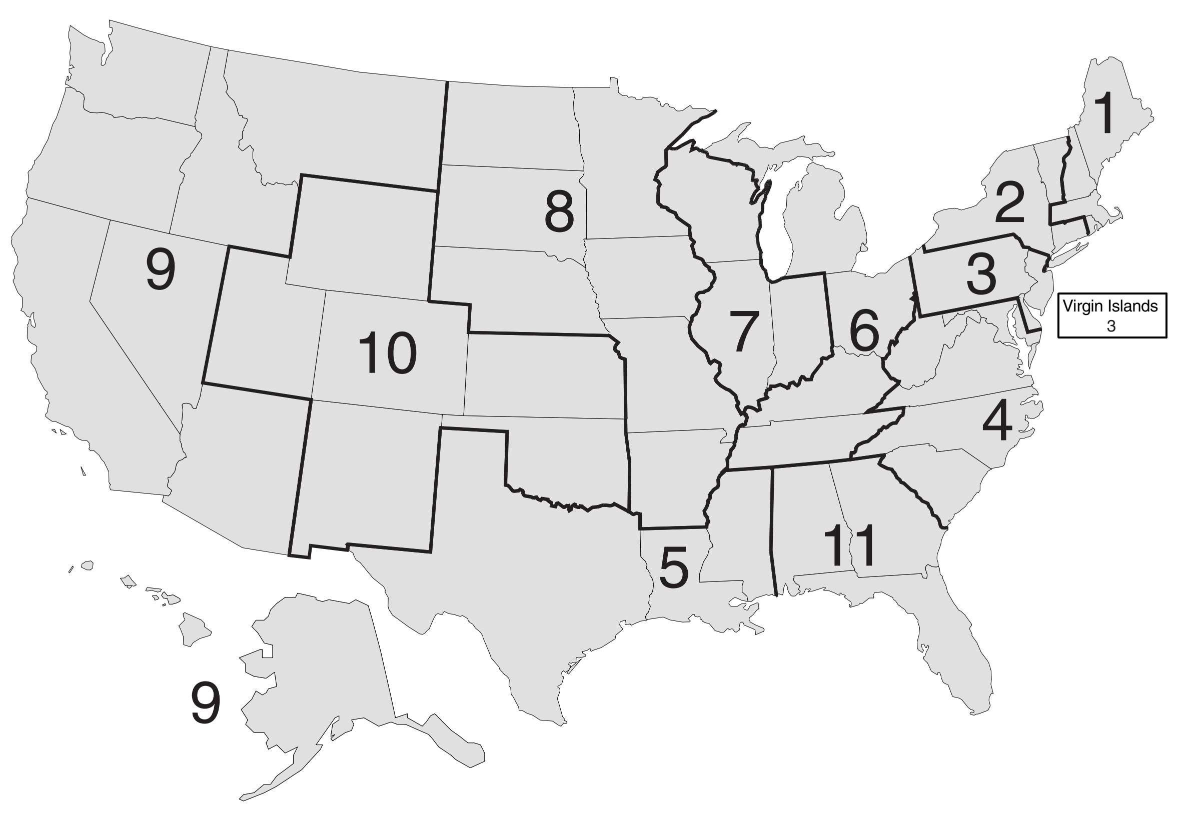
The 13 judicial circuits of the United States are constituted as follows:

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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Note. Cases pertaining to **agricultural issues** are found in Chapter 11, Agricultural Issues and Rural Investments.

AMORTIZATION AND DEPRECIATION

Condominium Units

Ltr. Rul. 201103006 (Oct. 5, 2010)
IRC §§168, 1245, and 1250

☞ Condominiums Qualify as Single Building

Facts. Taxpayer, a limited liability company, acquired a number of contiguous lots which it merged into a single lot. Taxpayer constructed a single integrated mixed-use development building. It includes residential apartments, commercial space, and a commercial parking garage with below-ground parking spaces. The building is located in a low-income community and is depreciated as nonresidential real property. All operations are accounted for using a single set of books, a single income statement and a balance sheet, and are reflected on a single federal income tax return.

Subsequently, the taxpayer decided to establish a plan of condominium ownership in which the building will be divided into five condominium units. Taxpayer requested a ruling to determine if the five condominium units can be treated as a single building for purposes of determining whether the building is residential rental property or nonresidential real property under IRC §168(e)(2).

Analysis. IRC §168(e)(2) defines residential rental property and nonresidential real property. Former Treas. Reg. §1.167(j)-3(b)(1)(ii) provided that **when two or more buildings are operated as an integrated unit, they may be treated as a single building for purposes of determining whether the building is residential rental property.** In this case, the five condominium units are located on the same single lot of real property. The operation, management, financing, and accounting for the building will not change as a result of the establishment of the plan of condominium.

Holding. A real estate developer may treat five condominium units as a single building for purposes of determining whether the integrated unit is residential or nonresidential property under IRC §168(e).

BANKRUPTCY AND DISCHARGE OF INDEBTEDNESS

Bankruptcy

Bruce Bryen v. U.S., **No. 08-00012, U.S. Bankruptcy Court for the Eastern District of Pennsylvania (Aug. 13, 2010)**
IRC §6871

☞ CPA's $19 Million Tax Debt Not Discharged in Chapter 7 Bankruptcy

Facts. Bruce Bryen (Bruce) began his career as a CPA in the 1970s. By the early 1980s, Bruce had a 50% interest in an accounting firm that he co-owned with his father, Fred Bryen (Fred). Fred formed and promoted tax shelters involving investments in "employee leasing" partnerships. Fred and Bruce recommended these investments to clients of their accounting firm.

Bruce personally invested in these employee leasing partnerships for the tax years 1980 and 1982–1988. He filed tax returns and paid the tax due reflected on each of the returns for those years.

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The IRS issued notices of deficiencies to Bruce, in which his investments in the employee leasing partnerships for the tax years 1980 and 1982–1988 were disallowed. Bruce then filed three Tax Court petitions challenging the deficiencies.

Bruce and several other investors agreed that issues concerning the employee leasing partnership investments and related tax shelters should be tried in a single test case. In 1996, the Tax Court issued its decision in the test case, reported as *Bealor v. Comm'r,*[1] concluding that the employee leasing partnership transactions were shams.

For approximately five years after the *Bealor* decision, Bruce did not receive any communication from the IRS regarding his additional tax liability. Then, in 2001, the IRS contacted Bruce and began negotiating the amount of his outstanding liability with him. In June 2002, Bruce signed three stipulations with the IRS, which stated that he owed taxes due to substantial underpayment attributable to tax-motivated transactions. The tax deficiency set forth in the stipulations was $2.8 million.

During the next few months, Bruce did not make any payments towards his tax liability. Then, in April 2003, the IRS issued a notice of assessment for each of the years at issue which totaled $13.6 million, including penalties and interest.

In January 2004, Bruce filed a petition for relief under Chapter 7 of the Bankruptcy Code. His bankruptcy schedules disclosed assets worth $364,300, including $350,000 attributed to a pension, and a $19 million general unsecured debt for taxes owed to the IRS. He reported a monthly gross income at this time of $10,417, or approximately $125,000 per year. His monthly expenses were as follows:

Description	Amount
Mortgage payment	$1,050
Rent for mother's apartment	1,256
Utilities	500
Home maintenance	300
Food	650
Clothing	500
Recreation	2,500

Bruce had not made any payments on his outstanding tax liability since 1996, when the *Bealor* case was decided. During the intervening years, he lived a lavish lifestyle with his girlfriend, Carolyn Walter, who holds a doctorate degree and is a college professor. The couple, who married in 2001, went on expensive vacations twice each year and maintained a principal residence and a vacation home. Carolyn paid all the couple's bills out of a bank account which was in her name only. Bruce gave Carolyn money to pay his share of the bills, but he did not use a checking account in order to avoid the risk of having it attached by one of his creditors.

Bruce was granted a Chapter 7 bankruptcy discharge in September 2004. It appears that he believed the tax debt had been discharged, but the IRS thought otherwise. In 2007, the IRS began collection activity with regard to the tax debt. **The IRS's position was that the tax debt had not been discharged in bankruptcy because Bruce had willfully attempted to evade or defeat his tax obligations.**[2] Bruce responded by filing a motion to reopen his bankruptcy case in order to obtain a determination of whether the tax debt was discharged. The court granted Bruce's request and he commenced an adversary proceeding.

1. *Bealor v. Comm'r,* 72 TCM (CCH) 730, 1996 WL 540109 (1996).

2. 11 USC §523(a)(1)(C).

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Issue. Whether Bruce's tax debt was discharged in bankruptcy.

Analysis. 11 USC §523(a)(1)(C) excepts from discharge any tax debt "with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax." The IRS contends that the debt Bruce owes to the IRS should be excepted from discharge because of "willful evasion."

The court in *Fegeley*[3] held that the willful evasion clause of §523(a)(1)(C) requires proof of two elements:

1. **Conduct** (i.e., the debtor must engage in conduct that constitutes an attempt to evade or defeat the tax), and
2. **Scienter** (i.e., the debtor's mental state must be that he acted willfully).

The IRS asserted that Bruce's conduct showed that he evaded the tax debt in at least two ways. The first was that he failed to make any payments on his taxes when he had the means to do so. Secondly, he dealt in cash, paid his debts through others, and lived a lavish lifestyle. Bruce earned significant income during the relevant years prior to filing the bankruptcy petition and had only modest fixed living expenses. However, he allocated a quarter of his gross monthly pay for recreation. He also paid at least $12,000 per year for vacations and maintained two homes with his wife.

As articulated in *Fegeley,* the requisite mental state for "willfulness" is that a debtor's actions are "voluntary, conscious, and intentional."[4] Bruce argued that between the issuance of the *Bealor* decision in 1996 and the actual assessment of the additional tax liabilities in April 2003, he lacked intent to evade his tax obligations because he did not know how much he owed. The court did not find his argument credible. The court was influenced by the fact that Bruce is a CPA who was a partner in a firm that handled tax matters.

The court further stated two reasons they were convinced that Bruce had the requisite intent. First, §523(a)(1) refers to evading or defeating a "tax," not an "assessed tax." The court was satisfied that Bruce was aware that he faced an enormous tax liability, even though the tax debt was not fully liquidated or assessed between 1996 and 2001. Second, between 2001 and June 2002, when he signed the IRS stipulations, Bruce knew how much he owed. However, he allowed the penalties and interest to accrue, paid nothing toward the obligation, and filed his bankruptcy case to discharge the debt within 30 days after he could do so. During this time, he continued to enjoy an extravagant lifestyle. His expenses were divided equally with his well-educated, employed spouse. The court stated that he had the money, knew he had an obligation, and chose not to pay it.

Holding. The court concluded that the IRS met its burden of establishing by a preponderance of the evidence that Bruce **willfully attempted to evade or defeat** his tax liability. Accordingly, his debt for federal income taxes is excepted from bankruptcy discharge.

3. *In re Fegeley,* 118 F.3d 979, 983 (3d Cir. 1997).
4. *In re Fegeley,* 118 F.3d 984 (3d Cir. 1997).

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BUSINESS EXPENSES

Legal Expenses

***John C. and Margaret T. Ramig v. Comm'r,* TC Memo 2011-147 (Jun. 27, 2011)**
IRC §§61, 162, and 166

☞ Taxpayers Win One Issue but Lose on Three Others

Facts. John Ramig, a licensed Oregon attorney, was also an entrepreneur. In 1995, he formed a startup company named Footwear Specialties International (doing business as Nautilus Footwear), in which he was minority owner and CEO until 2000.

When the rapid expansion of Internet businesses started, Mr. Ramig, along with other managers from Nautilus, formed shoeS4Work, Inc. He received an annual salary of $150,000 as CEO. The company had two stock classes (common and preferred). Mr. Ramig held, directly and indirectly, over 80,000 shares of common stock.

From its inception, shoeS4Work had funding issues. Despite the nearly $1.5 million it raised, at times it lacked the cash for payroll and other expenses. During 2001 and 2002, Mr. Ramig allegedly made seven loans to the company which were secured by a promissory note calling for 12% interest along with principal. The first three loans, totaling $57,000, were repaid but the last four loans, totaling $29,600, were not.

Mr. Ramig also made payments for shoeS4Work, including $11,274 worth of corporate operating expenses (postage, office supplies, and inventory), which he paid with his personal credit card; $2,500 to Puget Sound Leasing; and $2,500 to General Motors Acceptance Corporation (GMAC). These amounts were never repaid to Mr. Ramig.

ShoeS4Work ceased operations in August 2002 and liquidated most of its tangible assets to pay suppliers. The remaining assets were sold in March 2004 to SR Footwear in exchange for contingent payments in every month SR Footwear sold 5,000 or more pairs, up to a maximum of $100,000. Mr. Ramig was a minority owner of SR Footwear.

SR Footwear was run by two young executives and focused mainly on hospitality, food services, restaurants, and coffeehouse workers. Unfortunately, times were tough; SR Footwear's sales never reached the 5,000-pair threshold necessary to trigger a payment to shoeS4Work nor did they make a profit. The two young executives felt they could turn the operation around by increasing their marketing efforts and selling a lower priced private-label shoe if more capital were infused into the company. Their capital efforts failed and they left the business, with operations stopping shortly thereafter.

A shoeS4Work investor sued the company, alleging that misrepresentations were used to persuade her to invest in shoeS4Work and that the board of directors failed to supervise Mr. Ramig adequately. Mr. Ramig prevailed in the suit but incurred legal fees totaling $6,719 and $6,574 in 2004 and 2005, respectively. Mr. Ramig returned to work as an attorney in 2004.

The Ramigs also owned rental property in Arlington, Virginia through Garfield Holdings, LLC, during 2004 and 2005. The bookkeeper failed to enter rental property expenses on the 2004 return; thus, these expenses did not reduce the taxable income and tax liability reported on the 2004 tax return.

The IRS examined the 2004 and 2005 tax returns, recommending deficiencies and penalties as shown here.

Year	Tax Deficiency	IRC §6662(a) Penalties
2004	$ 953	$ 191
2005	22,114	4,443

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Issues. The issues in this case are as follows.

- Whether the Ramigs are entitled to rental expenses of $8,781 in 2004
- Whether the Ramigs are entitled to legal expenses of $6,719 and $6,754 for 2004 and 2005, respectively.
- Whether the Ramigs are entitled to a business bad-debt deduction in 2005 of $46,131.

Analysis. The Ramigs claim that $8,781 in rental property expenses is deductible. However, they did not:

- Claim the rental expenses on their originally filed return,
- Raise the issue of omitted expenses in their dealings with the IRS,
- Identify the issue of omitted expenses in their petition, or
- Move to amend their petition under Rule 41 to allow the omitted expenses to be considered.

Rental Expenses. Because the Ramigs neither raised the issue in their petition nor moved for leave to amend their petition, the court did not consider their entitlement to the rental property expense deduction. Rule 34(b)(4) states that the taxpayer must include in their petitions "Clear and concise assignments of each and every error which [they allege] to have been committed by the Commissioner in the determination of the deficiency or liability" and that "Any issue not raised in the assignments of error shall be deemed to be conceded."

Legal Fees. With respect to legal fees for both 2004 and 2005, the IRS argued that the suit was against Ramig personally and the legal fees were not related to the conduct of a trade or business. IRC §162(a) allows as a deduction ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Performing services as an employee can be a trade or business within the meaning of §162. The question is whether the legal fees arose from Ramig's business of performing services as an employee. The court found this suit and the resulting legal fees were from his performance as CEO of shoeS4Work and, therefore, are fully deductible.

Business Bad Debts. The alleged business bad debts in 2005 are composed of four unpaid promissory notes, corporate expenses paid by Mr. Ramig's personal credit card, a personal payment made to GMAC, and payments made to Puget Sound Leasing. IRC §166(a)(1) allows a deduction against ordinary income for "debt which becomes worthless within the taxable year." For individuals, this provision does not apply to any nonbusiness debt. IRC §166(d)(1)(B) treats an individual's worthless nonbusiness debts as short-term capital losses.

The 9th Circuit Court of Appeals lists 11 factors for determining whether an advance to a corporation gives rise to a bona fide debt as opposed to an equity investment.[5] Three of these factors point to characterizing the advances as debt. They are the following.

- Are the documents enforceable?
- Do the purported promissory notes have fixed maturity dates?
- Do the document labels suggest debt?

Pertaining to the advances made by Mr. Ramig to shoeS4Work, the court determined **the advances are an equity investment** because no evidence was presented to show that shoeS4Work could have borrowed money from outside lenders. Equity participants take a subordinate position to creditors regarding payment on liquidation (i.e., they get paid last). Because Mr. Ramig did not demand timely repayment of the notes, his claim is treated as subordinate to the rights of the creditors that were paid first. **Taking into consideration all facts and circumstances, the court concluded that the advances were equity investments, not loans.**

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5. *A.R. Lantz Co. v. U.S.,* 424 F.2d 1330, 1333 (9th Cir. 1970) (citing *O.H. Kruse Grain & Milling v. Comm'r,* 279 F.2d 123, 125-126 (9th Cir. 1960), *affg.* TC Memo 1959-110 (May 26, 1959).

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The credit card expenses Mr. Ramig paid on behalf of shoeS4Work were not supported by documentation showing the agreement to repay the expenses. This leads to the conclusion that the credit card expenses are equity investments and, thus, **no business bad debt is allowable.**

There was no evidence to corroborate Mr. Ramig's testimony related to the payment made to GMAC. In addition, the filed brief contradicts the testimony provided. The court concluded the Ramigs did not pay the $2,500; thus, **no deduction is allowed.**

Lastly, the payments made to Puget Sound Leasing were supposedly made as guarantor of shoeS4Work's equipment leases. Because the Ramigs did not show the payments were in discharge of an obligation as guarantor, **the deduction is not allowed.**

Substantial Understatement Penalty. IRC §6662(a) imposes a penalty equal to 20% of the part of an underpayment attributable to: (1) negligence or disregard of rules or regulations, or (2) a substantial understatement of income tax. The IRS determined the Ramigs were liable for negligence penalties. The Ramigs had an unlicensed bookkeeper prepare their 2004 and 2005 returns but signed the returns as being self-prepared. Mr. Ramig testified that he relied on his bookkeeper and made no effort to verify the accuracy of the returns. Because the Ramigs did not establish an exception from the penalty, the court upheld the penalty.

Holding. The court held the taxpayers were entitled to a deduction for legal expenses but were not entitled to expenses for claimed rental property or worthlessness of several alleged loans. The §6662(a) penalty was sustained on the corrected deficiency.

CAPITAL GAINS AND LOSSES

Day Trader's Losses Limited

Richard Kay, Jr. v. Comm'r, **TC Memo 2011-159 (Jul. 6, 2011)**
IRC §§475, 1211, 165, and 6662

☞ **Day Trader's Trading Activity not a Trade or Business**

Facts. Richard Kay holds a degree in economics and is the sole shareholder, officer, and director of a ball bearing manufacturing and distribution business (an S corporation). The wages and net income from the S corporation constitutes Kay's primary source of income.

During 2000, 2001, and 2002, Kay also engaged in trading securities and reported the income and expenses from this activity on Schedule C of his individual income tax return. On that form, he listed his principal business or profession as "day trader."

In 2000, Kay purchased and sold over $20 million in securities. He purchased and sold the same stock on the same day on only six occasions and conducted trading activity on 29% of the available trading days. On his 2000 Schedule C, Kay reported a net loss of $2,052,637, which was composed of $1,960,060 from losses on sales of stocks and $92,577 in expenses. Kay had an overall net operating loss (NOL) of $1,396,943 that was carried forward to 2001.

In 2001, the total value of the securities that Kay purchased was $2,349,320 and the value of the securities he sold was $1,576,548. **He purchased and sold the same stock on the same day on only four occasions and conducted trading activity on 7% of the available trading days.** On his 2001 Schedule C, Kay reported a net loss of $399,740, which was composed of $399,162 from losses on sales of stocks and $578 in expenses.

In 2002, the total value of the securities that Kay purchased was $1,234,428 and the value of the securities he sold was $1,852,167. **He purchased and sold the same stock on the same day on only three occasions and conducted trading activity on 8% of the available trading days.**

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On examination, the IRS determined that Kay's trading activity did not rise to the level of a trade or business and therefore disallowed ordinary losses above $3,000 for the 2001 and 2002 taxable years. They also disallowed the NOL carryover from 2000 into 2001, and assessed an accuracy-related penalty of 20% on the amount of underpaid tax.

Issue. Whether Kay's trading activity is a trade or business.

Analysis. Previous court cases have established several nonexclusive factors to be considered when determining whether a taxpayer is a securities "trader" for income tax purposes. Generally, the factors to consider are:

1. The taxpayer's intent;
2. The nature of the income derived from the activity; and
3. The frequency, extent, and regularity of the taxpayer's securities transactions.

Courts also consider the amount of time spent buying and selling securities and the holding period of the securities. **"Traders" generally hold securities for short periods of time.**

IRC §6662 imposes a 20% accuracy-related penalty on any underpayment of federal income tax attributable to a taxpayer's negligence or disregard of rules or regulations or substantial understatement of income tax. A substantial understatement of tax exists if the understatement exceeds the greater of 10% of the tax required to be shown on the return, or $5,000.

Holding. The Tax Court determined that Kay's trading activities did not rise to the level of a trade or business. The primary factor was that Kay's trading activity was infrequent and that the income from his S corporation was his primary source of income. Therefore, the losses from the sale of securities in 2001 and 2002 were limited to $3,000 each year. The NOL carryforward from 2000 to 2001 that arose from trading losses was also disallowed.

In addition, Kay did not present any evidence that he acted with reasonable cause and in good faith and therefore the accuracy-related penalty was upheld.

CASUALTY AND THEFT LOSSES

> **Note.** See Chapter 8, Small Business Issues, for a synopsis of rules associated with casualty losses.

Casualty Losses

***Christina A. Alphonso v. Comm'r,* 136 TC No. 11 (Mar. 16, 2011)**
IRC §§165 and 216

☞ Casualty Loss Denied for a Cooperative Housing Owner

Facts. Christina Alphonso owned shares in an IRC §216(b) cooperative housing corporation. She executed a proprietary lease and moved into the apartment to which her shares in the co-op were allocated. In 2005, a retaining wall that separated the apartment complex from a public road collapsed, causing significant damage to the road. The cooperative housing corporation levied an assessment against each shareholder for the damages to the road.

Ms. Alphonso paid the $26,390 assessment and claimed a casualty loss for that amount on her 2005 individual income tax return.

Issue. Whether Ms. Alphonso is entitled to a casualty loss for the amount of the damage assessment.

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Analysis. Under IRC §165, an individual is allowed to deduct "losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty." **Generally, only the owner of property damaged by a casualty is entitled to a deduction for a casualty loss sustained on that property.** However, in *Towers,*[6] it was determined that a leasehold interest in property that is damaged by a casualty is entitled to deduct a casualty loss sustained in that leasehold interest.

IRC §216(a) allows two exceptions to the general rule that a stockholder is not entitled to deduct expenses that the corporation paid or incurred. Those exceptions are for: (1) real estate taxes that the corporation paid or incurred on property that it owns; and (2) interest that the corporation paid or incurred on debt that it issued in order to acquire or construct the land or buildings that it owns. Ms. Alphonso asserted that §216(a) should be interpreted to permit not only the two deductions specifically mentioned but also a casualty loss. She also asserted that the stated purpose of §216 was to give tenant-stockholders of housing cooperatives the same tax benefits that are allowed to homeowners.

Holding. The court held that **Ms. Alphonso did not have property rights in the retaining wall (a common area) of the cooperative complex and therefore was not entitled to a casualty loss deduction under §165.**

The court also rejected Ms. Alphonso's argument that §216 should be read to include a casualty loss deduction because there was no legislative history to expand the provision beyond the two exceptions outlined in §216(a).

Casualty Losses

Robert and Doris Pang v. Comm'r, **TC Memo 2011-55 (Mar. 9, 2011)**
IRC §165(c)(3)

☞ Wrongful Death Claim Settlement Not Deductible as a Casualty Loss

Facts. In 2002, Robert Pang was involved in an accident in which he struck and killed a pedestrian with his vehicle. The decedent's estate filed a wrongful death suit. In 2004, the taxpayers paid $250,000 from their own funds to settle the lawsuit.

On their 2004 joint return, they attached Form 4684, *Casualties and Thefts*, on which they listed the $250,000 payment. After application of statutory limitations, the amount of the claimed casualty loss deduction was $217,655.

The IRS disallowed the claimed casualty loss and assessed a tax deficiency of $64,969.

Issue. Whether the $250,000 payment of a wrongful death claim qualifies as a casualty loss deduction under IRC §165(c)(3).

Analysis. IRC §165(c)(3) allows "losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft." The Tax Court has held that §165(c)(3) requires physical damage to the taxpayer's property.[7]

Holding. The court sustained the disallowance of the casualty loss. The court noted that the claimed loss was not attributable to property damage but to the monetary settlement of a wrongful death claim. **The term "losses of property" in §165(c)(3) does not include a taxpayer's payment to a third party or a decrease in the taxpayer's net worth.**

6. *Towers v. Comm'r,* 24 TC 199, 239 (1955).

7. *Kamanski v. Comm'r*, 477 F.2d 452 (9th Cir. 1973), *aff'g* TC Memo 1970-352 (Dec. 29, 1970).

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Theft Loss Deduction

***Mona Lisa Herrington v. Comm'r,* TC Memo 2011-73 (Mar. 30, 2011)**

IRC §§162, 165, 6651, and 6663

☞ Theft Loss Deduction Allowed for Funds Stolen by Abusive Boyfriend

Facts. Mona Lisa Herrington, the mother of two young children, worked two jobs to support her family in Louisiana. She owned an H&R Block franchise and also worked in a prison detention center. Her life had some challenges including a recent divorce and the death of her father. She became involved with an employee at her H&R Block office and he moved in with her.

Her personal troubles with the boyfriend included physical abuse, such as throwing her from a moving car, placing a gun against her forehead, hitting her head with a beer bottle, and throwing her from a boat into the lake.

During this relationship, the boyfriend convinced Ms. Herrington to open two sandwich shops, each of which had a video poker machine. The boyfriend had previously lost his video poker license for selling liquor to a minor. The boyfriend took charge of the finances of the "sandwich shop businesses," from which virtually all income resulted from the video poker revenue.

Ms. Herrington and her boyfriend had no agreement as to his compensation. Instead, he determined his own compensation by writing checks either to himself or to cash. He withdrew "compensation" totaling $114,000 and $96,000 in 1997 and 1998, respectively. Because she did not know when or how much money he was withdrawing, she worked out an arrangement with a friend who worked at her bank to ensure she was protected from any overdraft situations.

As a condition of her video poker license, Ms. Herrington was required to submit copies of her federal income tax returns to the Louisiana State Police along with a release allowing the police to verify the actual filing of the returns with the IRS. Another tale of woe ensued when she learned her boyfriend had not filed her tax returns for either 1997 or 1998. After an IRS criminal investigation, she pled guilty to willful failure to file tax returns for both 1997 and 1998. She ultimately filed the delinquent returns but the IRS disallowed a large amount of the Schedule C expenses, including the "compensation" paid to her boyfriend.

Issues. The issues in this case are as follows.

- Whether Ms. Herrington is entitled to deduct, as compensation or theft loss, amounts her boyfriend took from the business during 1997 and 1998
- Whether Ms. Herrington is liable for the failure to file penalty under IRC §6651
- Whether Ms. Herrington is liable for the fraud penalty under IRC §6663

Analysis. IRC §162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including "a reasonable allowance for salaries or other compensation for personal services actually rendered." The test of deductibility for compensation is whether the payments are reasonable and are payments purely for services.[8] Based on the "incredibly abusive" situation, the court determined that the boyfriend took what monies he needed without any correlation to services rendered.

IRC §165(a) allows a deduction for losses, including theft losses, incurred in a trade or business. The facts in this case support deductions for theft losses in both 1997 and 1998 because Ms. Herrington had no prospect of being reimbursed for these amounts.

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8. Treas. Reg. §1.162-7(a).

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IRC §6651(f) imposes an addition to tax for fraudulently failing to timely file her 1998 tax return. Although the taxpayer owned an H&R Block franchise and knew or should have known of the filing requirement, the IRS did not introduce clear and convincing evidence to establish fraudulent failure to file.

Because the court held that Ms. Herrington was entitled to a theft loss deduction, the underpayment on her tax returns was determined not to be the result of fraud. Consequently, no penalty is due under §6663.

Holding. The court allowed a theft loss deduction for both 1997 and 1998 for amounts taken by Ms. Herrington's boyfriend from the sandwich shop businesses. Ms. Herrington was not liable for either the fraud penalty or the addition to tax for fraudulent failure to file a return.

CORPORATIONS

Worthless Stock

Ltr. Rul. 201108001 (Nov. 19, 2010)
IRC §165

☞ Worthless Subsidiary Stock Qualifies for Ordinary Loss Deduction

Facts. Taxpayer, a savings and loan holding company, filed Chapter 11 bankruptcy after seizure of one of its subsidiaries by the Office of Thrift Supervision and its placement into the receivership of the FDIC. The subsidiary provided a broad range of banking services to customers including accepting deposits and making residential mortgage loans, consumer loans, and limited types of commercial real estate loans. The outstanding debt of the subsidiary clearly exceeds its assets; thus, it is clearly insolvent.

Analysis. IRC §165(a) allows as a deduction any loss sustained during the year and not recouped by insurance or otherwise. IRC §165(g)(1) provides that if any security which is a capital asset becomes worthless during the tax year, the resulting loss is treated as a loss from the sale or exchange of a capital asset. IRC §165(g)(3) provides an exception allowing a Parent that is a domestic corporation to claim an ordinary loss for worthless securities of an "affiliated" corporation. **To be "affiliated with the Parent," two tests must be met — ownership and gross receipts.**

Under the **ownership test,** the Parent directly owns stock in the corporation meeting the requirements of IRC §1504(a)(2) (at least 80% of the voting power and value of the corporation's stock). The **gross receipts test** requires that more than 90% of the aggregate of the corporation's gross receipts for all taxable years has been from sources other than royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stocks and securities.

In this case, the taxpayer meets the ownership test because the taxpayer directly owned all of the stock. The gross receipts test is more difficult to determine when the subsidiary earns a substantial amount of its income from interest earned on real estate loans. This test was designed to determine if the subsidiary was an operating company or an investment company. This subsidiary was clearly an operating company and not an investment or holding company; thus, it meets the gross receipts test.

Holding. All requirements for claiming a worthless securities deduction are met. Therefore, the parent holding corporation of an affiliated subsidiary, which has filed for bankruptcy, may claim an ordinary loss under IRC §165.

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2011 Workbook

CREDITS

First-Time Homebuyer Credit

***Wilfredo Emilio Rodriguez et al. v. Comm'r*, TC Memo 2011-122 (Jun. 2, 2011)**
IRC §36

☞ First-Time Homebuyer Credit Denied as Purchase from Related Party

Facts. The taxpayer, Emilio Rodriguez, suffered trauma during his 2001 birth, which rendered him mentally and physically handicapped. In 2004, Emilio received over $450,000 in net proceeds from a lawsuit related to his medical condition. In November 2004, a Florida circuit court appointed Steven W. Conner as guardian for Emilio because Emilio's parents were of "humble means" and lacked financial sophistication.

Conner was a CPA and held both bachelor's and master's accounting degrees. He had been a CPA for nearly 25 years and owned a practice with a dozen employees. He specialized in IRS audit defense and tax planning. Conner also was an experienced guardian in the state of Florida.

Emilio's parents bought a home in Middleburg, Florida in June 2001, a month after Emilio was born. They financed the purchase with a mortgage of $108,785. They lived in the home continuously from the time of purchase through the present court case.

Emilio's parents received a $200 monthly stipend from Emilio's funds starting in March 2005. In July 2006, the probate court raised this monthly allowance to $300 to pay for Emilio's medical bills and other expenses.

Early in 2009, Conner discovered the Rodriguezes had missed several mortgage payments due to financial difficulty. Conner petitioned the probate court to loan $103,000 of Emilio's funds to his parents to pay off their mortgage. The probate court authorized the loan on February 17, 2009.

Coincidently, on February 17, 2009, the Code was amended to increase the first-time homebuyer credit (FTHBC) to an $8,000 refundable credit. Conner was aware of this Code section amendment.

On May 6, 2009, Conner transferred $106,621 from Emilio's account to an escrow account at Conner's CPA firm. The amount of the transfer matched the total payoff on the Rodriguez home at the time.

The parents transferred title of their home to Conner on May 11, 2009. No money changed hands on the transfer. On May 14, 2009, Conner's firm sent a cashier's check for $106,621 to the Rodriguez family's mortgage holder to pay off the loan on their home.

On May 18, 2009, Conner sold the home in his individual capacity and repurchased it as Emilio's guardian for $106,621. He prepared and executed a warranty deed on that day, transferring the home to himself as guardian. He recorded the warranty deeds for both the May 11 and May 18 transactions on July 14, 2009.

On May 28, 2009, Conner prepared and signed a 2008 federal income tax return for Emilio, claiming an $8,000 FTHBC for the May 18, 2009 purchase.[9] **The IRS denied the credit, stating Emilio was ineligible because he purchased the house from his parents.**

Conner asserted that Emilio was eligible because Emilio bought the house from him. Conner testified that he purchased the Rodriguez home as an investment, although he acknowledged that he did not collect rent. However, he did not know the home's fair market value (FMV), and he did not have the home inspected or appraised prior to purchase.

[9] This transaction predated the requirement that first-time homebuyers must be at least age 18.

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Issue. Is Emilio eligible for the first-time homebuyer credit?

Analysis. IRC §36(c) disallows the first-time homebuyer credit to a taxpayer who purchases a home from a related person, including the taxpayer's parents.

To determine whether Emilio bought the home from his parents or from Conner, the court applied the doctrines of economic substance and step transactions to the events transferring title of the home**. The economic substance doctrine looks through legal maneuverings to the economic purpose of transactions. The step transaction doctrine views a series of transactions related to the sale of property as a whole, but finds each step of the sale — from initial negotiations to closing — to be relevant.**

The Rodriguez court was guided by a 1935 decision, which states: "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."[10]

Disregarding state law,[11] the Tax Court scrutinized the form of Conner's title transfers to determine whether Emilio bought the home from his parents.

Conner testified in court that he informed the mortgage holder he intended to use Emilio's funds to pay off the mortgage. However, Conner stated the mortgage holder was "not willing to accept payment from Emilio," so the loan never transpired.

The court did not accept Conner's testimony that the mortgage holder refused payment directly from Emilio. Citing a 1986 precedent that it is "not required to accept the self-serving testimony of the petitioner as gospel,"[12] the court found it telling that Conner did not introduce documents stating the mortgage company's refusal to accept Emilio's payment and that Conner did not call a mortgage company representative to testify regarding the refusal. The court cited the "failure to call a critical witness may give rise to a presumption that, if called, such witness' testimony would not have been favorable to the party."[13]

The court noted that Conner studied IRC §36 before initiating the transactions regarding the sale and purchase of the Rodriguez home and that Conner neither paid the Rodriguezes for the purchase of their home nor charged the Rodriguezes rent when they lived in the home while he held title. The court concluded that Conner was trying to side-step the Code by acting as an intermediary in an attempt to qualify Emilio for the FTHBC.

The fact that Conner transferred an amount from Emilio's account to his firm's escrow account that matched the Rodriguezes' mortgage payoff was further evidence to the court that the sale was "orchestrated" to maneuver around the Code. The court found Conner a mere conduit in the sale. Relying on a 1945 decision, the court noted a "sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title."[14]

Holding. The Tax Court compressed the transactions into a single event and disregarded the intermediate title transfer from the Rodriguezes to Conner. This rendered Emilio ineligible for the first-time homebuyer credit because, in effect, he bought the home from his parents.

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10. *Gregory v. Helvering,* 293 US 465 (1935).
11. *Zmuda v. Comm'r,* 79 TC 714 (1982), *aff'd*. 731 F.2d 1417 (9th Cir. 1984).
12. *Tokarski v. Comm'r,* 87 TC 74 (1986).
13. *Wichita Terminal Elevator Co. v. Comm'r,* 6 TC 1158 (1946), *aff'd*. 162 F.2d 513 (10th Cir. 1947).
14. *Comm'r v. Court Holding Co.,* 324 US 334 (1945).

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DEDUCTIONS

Domestic Production Activities Deduction

Gibson & Associates Inc. v. Comm'r, **136 TC No. 10 (Feb. 24, 2011)**
IRC §§199 and 263

☞ Construction Company Entitled to §199 Deduction for Renovation Projects

Facts. Gibson & Associates Inc., (Gibson) is an engineering and heavy highway construction company that specializes in structural rehabilitation, epoxy injection, concrete paving, bridge jacking, lead abatement, and protective coatings. It primarily erects or rehabilitates streets, bridges, airport runways, and other major components or substantial structural parts of real property in Texas, Oklahoma, Arkansas, and Kansas.

During the timeframe relevant to this case, Gibson placed its construction projects into three categories.

1. Casualty projects
2. New construction projects
3. Rehabilitation projects

Gibson's projects were further characterized as substantial renovation and repair or maintenance.

For its fiscal year that ended June 30, 2006, Gibson realized gross receipts of $25.9 million. It reported $25.8 million of its income as domestic production gross receipts (DPGR) and claimed a $63,435 deduction under IRC §199.

The IRS disallowed Gibson's §199 deduction after determining that the company had no DPGR within the meaning of §199(c)(4). The IRS later conceded that Gibson had DPGR of $13.8 million. Gibson sued in Tax Court to determine whether the remaining $11.9 million is DPGR.

Issue. Whether Gibson's DPGR receipts for the fiscal year that ended June 30, 2006, correctly include the disputed $11.9 million.

Analysis. IRC §199 allows a taxpayer to deduct a percentage (3% for 2006) of the lesser of:

- Qualified production activities income (QPAI), or
- Taxable income computed without regard to the §199 deduction.

QPAI is the taxpayer's DPGR less the sum of its cost of goods sold, plus certain expenses and other items.[15] DPGR includes a taxpayer's gross receipts from the construction of real property in the United States.[16]

The parties in this case agree that the disputed amount is DPGR to the extent that Gibson performed work on projects that erected or **substantially renovated** real property. Treas. Reg. §1.199-3(m)(5) states that "the term substantial renovation means the renovation of a major component or substantial structural part of real property that materially increases the value of the property, substantially prolongs the useful life of the property, or adapts the property to a new or different use."

A material increase in the value of real property requires that the functional value of the property increase on account of the project. The increase in value is measured by comparing the value of the real property after the project with the value of the real property before the project.[17]

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15. IRC §199(c)(1).
16. IRC §199(c)(4)(A)(ii).
17. See *Plainfield-Union Water Co. v. Comm'r,* 39 TC 337 (1962).

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A project substantially prolongs the useful life of property if it rehabilitates a critical and functional component of the property and gives the property a new life expectancy. An increase in useful life is measured by comparing the useful life of the real property after the project with the remaining useful life of the real property before the project.[18]

Property is adapted to a new or different use if the property's use after the project is not consistent with its intended use before the project. Such an adaption often corresponds to a material increase in value or to a substantial prolonging of its useful life.

The court heard the testimony of expert witnesses in its consideration of whether Gibson's work on disputed projects constituted the erection or substantial renovation of real property. The court found Gibson's experts to be more knowledgeable and reliable than the IRS's expert. Gibson's experts asserted that **the company's work on each disputed project materially increased the value of the real property and/or substantially prolonged the useful life of the real property.**

Holding. The court concluded that Gibson's projects qualify as DPGR and that its §199 deduction was correct.

Medical Expenses

IRS Ann. 2011-14, 2011-9 IRB 1 (Feb. 10, 2011)

IRC §213

☞ Lactation Equipment and Supplies are Deductible Medical Expenses

The IRS announced that breast pumps and lactation supplies are medical care under IRC §213(d) because they affect a structure or function of the body. Accordingly, if the remaining requirements of §213(a) are met, expenses paid for breast pumps and lactation supplies are deductible medical expenses. Amounts reimbursed for these expenses under flexible spending arrangements, health reimbursement arrangements, health savings accounts, or Archer medical savings accounts are not income to the taxpayer.

IRS Pub. 502, *Medical and Dental Expenses,* will be revised to reflect this announcement.

Conservation Easement

***1982 East LLC et al v. Comm'r,* TC Memo 2011-84 (Apr. 12, 2011)**

IRC §170

☞ Charitable Contribution of Historic Preservation Easement Denied

Facts. Solomon Asser is the managing member of 1982 East, LLC, (East LLC) which was formed in May 2002, primarily to purchase and operate real estate investments. In 2002, Mr. Asser was contacted by the National Architectural Trust (NAT) regarding significant income tax benefits that may be obtained through the contribution of historic preservation façade easements to NAT, a §501(c)(3) organization, with little or no practical effect on the use, value, or marketability of the property.

On November 5, 2002, East LLC acquired a certified historic structure for $8 million ($2 million cash and $6 million mortgage) with the intention of taking advantage of NAT's tax promotion. On December 30, 2004, East LLC contributed a historic preservation façade easement on the property to NAT.

An appraisal of the noncash contribution was obtained by East LLC, which concluded that the FMV of the façade easement was $6.57 million. The 2004 tax return of East LLC claimed a noncash charitable contribution deduction in the amount of $6.57 million.

[18] Ibid.

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Upon examination, the charitable contribution of the façade easement was disallowed.

Issue. Whether East LLC is entitled to a charitable contribution deduction for a façade easement.

Analysis. IRC §170 generally allows a charitable deduction for contributions made during a taxable year to a §501(c)(3) organization. A deduction is generally not allowed for a gift of property consisting of "less than an entire interest in the property"; however, IRC §170(f)(3)(B) allows an exception when less than an entire interest in property is for a "qualified conservation contribution."

A **qualified conservation contribution** is a contribution that meets **all** of the following requirements.[19]

1. Is a qualified real property interest
2. Is made to a qualified organization
3. Is exclusively for conservation purposes

IRC §170(h)(5) provides that a contribution is not treated as exclusively made for conservation purposes **unless the conservation purpose is protected in perpetuity.** The IRS asserted that the conservation purpose was not protected in perpetuity because the mortgagee on the property did not subordinate its rights to that of NAT and therefore NAT could not enforce the conservation purposes in perpetuity.

Holding. The court held that a façade easement that is a qualified conservation contribution must be protected in perpetuity. East LLC's contribution did not comply with the requirements of §170(h) and, accordingly, was not made "exclusively for conservation purposes." The deduction was disallowed.

> **Note.** See Chapter 11, Agricultural Issues and Rural Investments, for additional court cases related to conservation easement contributions.

Accrued Expenses

***Richard Mondello and Wipapan Konchom v. Comm'r,* TC Summ. Op. 2011-97 (Jul. 25, 2011)**
IRC §§6001, 162, 212, and 6662

☞ Sole Proprietor Cannot Deduct Imputed Value of His Services

Facts. Richard Mondello is the owner of a website business, which he operated during the relevant period of this case using the accrual method of accounting. In 2007, Mondello worked 1,000 hours developing the website. He charged unrelated parties between $45 and $55 per hour for performing work similar to that which he performed on his website development. Mondello's proprietorship business did not pay him for any services he performed.

On the 2007 federal tax return that Mondello filed jointly with his wife, Ms. Konchom, he deducted a $50,000 accrual for "contract labor" he performed for his own business. The IRS disallowed the deduction.

Issues. The issues presented in this case are:

- Whether Mondello is entitled to a deduction on Schedule C for an accrued payment to himself, and
- Whether he is liable for the accuracy-related penalty under IRC §6662(a).

Analysis. IRC §162 allows deductions for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. IRC §212 allows deductions for ordinary and necessary expenses paid or incurred during the taxable year for the production of income or the management or maintenance of property held for the production of income.

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19. IRC §170(h).

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The IRS cited several cases for the court's consideration on this issue. In *Maniscalco,*[20] the court said that "Whatever may be said in behalf of taking into account the value of one's own services in lieu of paid labor, such services are not considered an element of the deduction under section 162(a), just as the flow of satisfaction from services arising from one's own labor is not includible in his gross income." In *Grant,*[21] the court said that the expenditure of a taxpayer's labor does not constitute the taxpayer's payment of a deductible business expense, and the taxpayer is not allowed a deduction under §162(a). In *Rink,*[22] the court observed that "Labor performed by a taxpayer does not constitute an amount 'paid or incurred' by him, and consequently, cannot be deducted by him under section 162."

Holding. The court held that **Mondello is not entitled to a deduction for contract labor as a result of an accrual of an amount "owed" to himself for his own labor.** Additionally, the court imposed the accuracy-related penalty under §6662(a) because Mondello did not show that there was reasonable cause for, and that he acted in good faith with respect to, the underpayment.

Unreimbursed Charitable Expenses

***Jan Elizabeth Van Dusen v. Comm'r,* 136 TC No. 25 (Jun. 2, 2011)**

IRC §§170 and 280A

☞ Feline Foster Care Expenses Are Deductible

Facts. "Fix Our Ferals" (FOF) is a §501(c)(3) organization. Its mission is to trap, neuter, and release feral (wild) cats. Jan Elizabeth Van Dusen was an FOF volunteer who had a strong connection with the charitable organization. She worked closely with other FOF volunteers and frequently responded to FOF requests for volunteer services. FOF encouraged her activity and provided oversight.

During the tax year, she provided long-term care for 70 to 90 cats in her home during the cats' recovery after neutering. Most cats cared for by Ms. Van Dusen were fostered for FOF but cats from other organizations were also fostered. Ms. Van Dusen claimed that these expenses were unreimbursed volunteer expenses. These expenses included costs for veterinarian services, pet and cleaning supplies, and utilities.

To substantiate the expenses, Ms. Van Dusen's records included copies of checks, credit card statements, and billing histories obtained from vendors. Ms. Van Dusen lost some records that were more substantial. Some expenses were partially or entirely personal. The IRS disallowed Ms. Van Dusen's $12,068 deduction of expenses for unreimbursed volunteer expenses in connection with work done for FOF. She challenged the IRS decision in Tax Court.

Issue. Whether unreimbursed volunteer expenses for services rendered for a charity are deductible.

Analysis. IRC §170 allows a deduction for any charitable contribution made by the taxpayer. This includes:

- Donation of money or property directly to the organization,
- Placing money or property in trust for an organization, and
- Incurring unreimbursed expenses incident to the rendition of services to an organization.

Whether a taxpayer has actually provided services to the charitable organization depends upon:

- The strength of the taxpayer's affiliation with the organization,
- The organization's ability to request volunteer services from the taxpayer,
- The organization's supervision over the taxpayer's work, and
- The taxpayer's accountability toward the organization.

[20] *Maniscalco v. Comm'r,* TC Memo. 1978-274, *aff'd.* 632 F.2d 6 (6th Cir. 1980).

[21] *Grant v. Comm'r,* 84 TC 809, 820 (1985), *aff'd.* without published opinion 800 F.2d 260 (4th Cir. 1986).

[22] *Rink v. Comm'r,* 51 TC 746, 753 (1969).

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Expenses that are personal in nature cannot be deducted as unreimbursed charitable volunteer expenses.

Charitable contributions must satisfy the recordkeeping requirements of Treas. Reg. §1.170A-13(a) (for cash contributions) or Treas. Reg. §1.170A-13(b) (for noncash contributions). For cash contributions under Treas. Reg. §1.170A-13(a), either a canceled check, letter, or receipt from the organization or other reliable record is sufficient. Any letter, receipt, or other reliable record must indicate the organization's name and the date and amount of the contribution. Under Treas. Reg. §1.170A-13(b), the recordkeeping requirements for noncash contributions include a letter or receipt indicating the name of the organization, the date and location of the contribution, and a reasonably sufficient description of the donated property. A reliable written record suffices if it is impractical to obtain a receipt. For contributions of less than $250, the regulations are silent on whether the cash or noncash requirements apply to unreimbursed charitable volunteer expenses. Contributions of $250 or more must also satisfy additional requirements under Treas. Reg. §1.170A-13(f)(1), which requires a contemporaneous written acknowledgment from the charitable organization with additional information.

The court found that Ms. Van Dusen's strong connection with FOF, the frequent requests of her services by FOF, FOF's supervision of her, and her work in furtherance of the organization's purpose and mission allows her to deduct unreimbursed charitable volunteer expenses. However, her deduction is subject to the recordkeeping requirements established in the regulations.

For unreimbursed charitable volunteer expenses less than $250, the recordkeeping requirements of Treas. Reg. §1.170A-13(a) apply instead of those for Treas. Reg. §1.170A-13(b). Ms. Van Dusen's records did not strictly comply with these requirements. However, substantial compliance is sufficient. Her records included all information that would be provided on a canceled check.

Holding. Most expenses **under $250** are deductible based on Ms. Van Dusen's records and testimony. The deductible expenses include those for veterinary services, pet supplies, cleaning supplies, and utilities. Ms. Van Dusen's expenses for the cremation of her own pet cat, her vehicle registration fees, Costco membership, vacuum repairs, and bar association dues are personal expenses and, thus, not deductible. Ms. Van Dusen did not meet the additional recordkeeping requirements for those **expenses over $250** because she failed to obtain contemporaneous written acknowledgement. These expenses are therefore not deductible.

DIVORCE ISSUES

Alimony

***Nancy Gallagher Maes v. U.S.*, No. 6:09-cv-00042; U.S. District Court for the District of Montana (Oct. 13, 2010)**
IRC §§71, 215, and 7422

☞ Tax Refund Denied After Payments Deemed Alimony

Facts. Nancy Maes and Dr. Paul Maes were divorced in February 2001. They have four children, two of whom were minors at the time the marriage was dissolved.

An amended divorce decree was filed in October 2001. It contained the terms of the parenting plan and support agreement. The decree specified that alimony was scheduled to decrease at certain time intervals. Ms. Maes was to receive $109,000 for the first five years, $91,000 for the next three years, and $25,000 for the next two years. The scheduled reductions occurred in the same years that the two younger children turned age 20; however, nothing in the divorce decree specified that the reductions were intended to correspond with the children maturing.

The accountant's letter that outlined the property division stated that the intent was to provide each party with half the husband's income for a time. Dr. Maes was also required to pay child support in separate provisions.

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Ms. Maes argued that because both reductions in payments occurred in years that one of the children turned age 20, the Code characterizes the payments as child support. She made a motion for summary judgment, seeking a tax refund in this claim.

Issue. Whether payments Nancy Maes received from her ex-husband were child support or alimony.

Analysis. Payments received as alimony or separate maintenance payments must be included in taxable gross income.[23] Alimony does not include amounts that the divorce or separation instruments fix as child support.[24] Part of a payment is fixed as child support if any amount specified in the divorce instrument will be reduced:

- On the occurrence of a contingency relating to a child (e.g., attaining a certain age, marrying, dying, leaving school) which is specified in the divorce or separation instrument, or
- At a time which can clearly be associated with such a contingency.

If it can be demonstrated that the parties to the divorce or separation instrument did not discuss the contingency or reference the contingency in the agreement, the presumption that a payment is associated with a relevant contingency can be rebutted. In *Shepherd,*[25] the Tax Court held that a scheduled reduction in payments related to the child turning 18 only by coincidence. The alimony provision of the settlement agreement made no reference to the child turning 18.

The Maes' separation agreement does not reference an applicable childhood contingency. There was no reference in the agreement that the reductions were related to the children turning 20.

Treas. Reg. §1.71-1 states that payments to the spouse that do not designate a specific portion to be used for child support are characterized as alimony. Because Dr. and Ms. Maes did not expressly designate a portion of the alimony payment as child support, the entire payment is taxable to Ms. Maes. Nancy Maes had discretion as to how she spent the money; thus, the entire payment is taxable income.[26]

Holding. Nancy Maes' motion for summary judgment is denied.

EMPLOYMENT TAX ISSUES

FICA Taxation of Medical Residents

Mayo Foundation for Medical Education and Research et al. v. U.S., **No. 09-837, U.S. Supreme Court (Jan. 11, 2011)**
IRC §§3121, 3121(a), 7805, 3101, and 3111

☞ Wages Paid to Medical Residents are Subject to FICA

Facts. Mayo offers a residency program to doctors who have graduated from medical school and are seeking additional instruction in a chosen specialty. Such programs train doctors primarily through hands-on experience. The residents typically work 50 to 80 hours per week caring for patients. Mayo pays its residents an annual "stipend" of over $40,000 and also provides them with health insurance, malpractice insurance, and paid vacation time.

Mayo filed suit for a refund of FICA taxes it paid on medical residents' stipends, claiming that the Treasury Department's 2004 ruling on this issue was invalid.

Issue. Whether medical residents are "students" and are therefore exempt from FICA.

23. IRC §71(a).

24. IRC §71(c).

25. *Shepherd v. Comm'r,* TC Memo 2000-174 (May 25, 2000).

26. Treas. Reg. §1.71-1.

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Analysis. Under IRC §3121(b)(10), wages paid for "service performed in the employ of…a school, college, or university…if such service is performed by a student who is enrolled and regularly attending classes at the school" are excluded from FICA.

Since 1951, **the Treasury Department has construed the student exemption to exempt from taxation students who work for their schools "as incident to and for the purpose of pursuing a course of study."** In 2004, Treas. Reg. §31.3121(b)(10)-2(d)(3)(iii) was amended, which stated that "the services of a full-time employee" — which includes an employee normally scheduled to work 40 hours or more per week — "are not incident to, and for the purpose of, pursuing a course of study." Example 4 included in the regulation specifically concludes that **medical residents whose normal schedule requires the performance of services for 40 or more hours per week are not "students."**

Holding. The Supreme Court held that the regulation's conclusion regarding the exclusion of medical residents from the student exemption to FICA taxation is a reasonable interpretation of §3121(b)(10). Therefore, medical residents' wages **are** subject to FICA.

Payroll Taxes

***James H. Oppliger et al. v. U.S,* U.S. Court of Appeals, 8th Circuit; No. 10-2011 (Mar. 29, 2011)**
IRC §§6672 and 7501

☞ 100% Trust Fund Recovery Penalty Upheld

Facts. James and Gayle Oppliger formed a trucking business in 1992 (Double O) and served as the sole owners and primary officers of the company. In 1997, they formed another company (LFC) to provide payroll services for Double O and were the sole members of LFC. All Double O employees (except for Gayle) became LFC employees after the entity was established.

Mary Kerkman was hired in 1996 to perform accounting and bookkeeping services for the companies, file employment tax returns, pay payroll taxes, and provide weekly reports of the companies' financial situations. Ms. Kerkman committed suicide on April 3, 2002. Shortly thereafter, the Oppligers found that Kerkman had embezzled $10,000 from the companies.

On April 4, 2002, an IRS revenue officer went to the companies' offices and explained that **employment taxes had not been paid for LFC and Double O for 13 and 17 quarters, respectively.** The Oppligers stated that they were not aware of the unpaid liabilities.

The assets of Double O were sold on September 1, 2002. LFC paid over $2 million and $3 million to its employees and third-party creditors, respectively, between April 4, 2002, and September 1, 2002.

The IRS assessed penalties against the Oppligers for LFC and Double O in excess of $2 million. The Oppligers paid $15,015 and filed claims for refund stating that they were not liable for the unpaid taxes. Their claims were denied by the IRS and upheld by the district court. The Oppligers appealed to the U.S. 8th Circuit Court.

Issues. The issues considered in this case are:

- Whether the district court erred in finding the Oppligers were responsible persons pursuant to IRC §6672, and
- Whether the Oppligers willfully failed to pay the trust fund taxes.

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Analysis. IRC §6672 imposes a penalty on a responsible person who willfully fails to remit payroll taxes to the IRS. In determining responsible person status, the courts often consider whether the individual:

- Serves as an officer or member of the board of directors,
- Owns substantial stock in the company,
- Manages day-to-day operations,
- Possesses the authority to hire or fire employees,
- Makes decisions as to the disbursement of funds and payments to creditors,
- Controls bank accounts and disbursement of records, and
- Possesses check-signing authority.

In the Oppligers' case, the court relied on the following undisputed facts.

- The Oppligers formed the companies, held offices, and managed day-to-day business.
- The Oppligers each owned 50% of Double O, were the only shareholders and directors of Double O, and served as president and secretary of Double O.
- The Oppligers created LFC and had the authority to hire and fire employees.
- The Oppligers possessed the authority to sign tax returns, sign payroll checks, sign bank notes/security agreements, and serve as personal guarantors for both entities.

The district court determined that the Oppligers failed to pay the taxes even after the IRS revenue officer informed them of their outstanding liabilities. The Oppligers argued that the bank balances in the two companies as of April 4, 2002, totaled slightly over $8,000 and thus their potential liability should be limited to this $8,000 figure. The Oppligers, relying on *Slodov*,[27] argued that when they reassumed control of their companies, unencumbered funds did not exist to pay the taxes owed.

Holding. The court held the Oppligers liable for the payment of Double O's and LFC's unpaid payroll taxes and were subject to the penalty for willful failure to pay trust fund taxes.

EXCISE TAX

Tanning Services

Chief Counsel Advice 201128024 (Jun. 1, 2011)
IRC §5000B

☞ Tanning Services Paid by Frequent Tanners' Points not Subject to Excise Tax

The Patient Protection and Affordable Care Act (PPACA)[28] imposed a 10% excise tax on indoor tanning services furnished after July 1, 2010.[29] This created uncertainty about businesses that give frequent tanner's points toward future services based on the number of tans that customers receive. Is excise tax due on the value of tanning services awarded upon redemption of the points?

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27. *Slodov v. U.S.,* 436 US 238, 243 (1978).
28. PL 111-148.
29. IRC §5000B.

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The CCA based its determination on excise tax rules developed for other types of businesses. When a telephone company gives free or reduced rate phone services to employees, only the cash charge is assessed the telephone excise tax. The same rule applies in the airline industry. Therefore, when the customer pays for the tanning service with points, no excise tax is charged.

Occasionally, the tanning service is bundled with the sale of tanning products and other goods and services. In that case, the amount paid with points must be allocated between the tanning services and the cost of the other goods and services. There are no rules about how the allocation is made. The CCA indicates that the determination will be made upon audit based on the facts and circumstances involved.

Responsible Party for Tax Liability

***Michael J. Conway v. U.S.*, U.S. Court of Appeals, 5th Circuit; No. 10-40485 (Jul. 19, 2011)**
IRC §§6672 and 4261

☞ Personal Liability for Unpaid Business Excise Taxes

Facts. Michael Conway was the founder of an airline business. The business filed bankruptcy and owed substantial transportation excise taxes, which it was required to collect from customers and remit to the IRS.

Conway reviewed the bankruptcy schedule and was aware of pre-bankruptcy and post-bankruptcy taxes due. He continued to pay other creditors after the bankruptcy was filed. The IRS eventually sought to collect the excise taxes from Conway personally.

Conway was an officer and chairman of the business at all times. He was the largest individual stockholder and retained the greatest individual management authority. He was able to sign checks for the business and determine which bills got paid. He had the authority to hire and fire employees.

At trial, the IRS argued that Conway was a responsible party. The trial court granted the motion of the IRS and entered judgment in the amount of $8.4 million, plus interest. Conway appealed.

Issue. Whether Conway was a responsible party for purposes of collecting the excise taxes.

Analysis. Under IRC §6672(a), a person is a "responsible party" and is liable for the unpaid tax of the business if the person is required to collect, account for, and remit the tax to the IRS and willfully fails to do so. The court previously enumerated six factors to consider in determining whether someone is a responsible party. These factors are whether the person:

1. Is an officer or member of the board of directors,
2. Owns a substantial amount of stock,
3. Manages the day-to-day business,
4. Has authority to hire and fire employees,
5. Makes decisions on the disbursement of funds, and
6. Has authority to sign business checks.

Conway's role in the business meets all of the above criteria for being a responsible party.

A responsible party must act willfully in failing to pay the taxes for personal liability to arise under §6672. In this regard, it is sufficient that the person knows the taxes are due but uses business money to pay other creditors instead. Reckless disregard for the risk that the taxes may not be remitted to the IRS also constitutes willfulness. Conway knew about the amounts owed and continued paying other creditors.

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Conway argued that he had reasonable cause for his failure to pay the taxes, because he relied on the advice of counsel. However, case law indicates that in order for counsel's advice to constitute reasonable cause, the advice must negate the element of willfulness. Conway did not provide any evidence that this was the case.

Holding. Conway is a responsible party and acted willfully in failing to remit the required taxes. He is personally liable and the ruling of the trial court, which arrived at the same conclusion, was affirmed.

ESTATES AND TRUSTS

Special Needs Trust

Ltr. Rul. 201116005 (Dec. 15, 2010)
IRC §§677, 671, and 691

☞ Assignment Does Not Trigger Sale or Disposition

Facts. Taxpayer is a disabled individual eligible to receive state benefit payments. Upon his father's death, Taxpayer and siblings are entitled to receive two IRAs. Taxpayer wants to transfer his portion of the IRAs to a special needs trust. The trust terms allow flexibility by the trustee to protect Taxpayer's interest so that the trust principal will not be used if doing so will reduce, eliminate, or deny the state benefit payments that Taxpayer receives. Upon Taxpayer's death, any remaining principal and undistributed income would first go to the state as reimbursement for assistance provided during Taxpayer's lifetime and then to Taxpayer's children or siblings.

Analysis. IRC §671 provides that the grantor is treated as the owner of any portion of a trust. IRC §677(a) provides that the grantor is treated as the owner even though the income may be:

- Distributed to the grantor or the grantor's spouse,
- Held or accumulated for future distribution to the grantor or the grantor's spouse, or
- Applied to the payment of premiums on insurance policies on the life of the grantor or the grantor's spouse.

Rev. Rul. 85-13[30] concludes that a transfer of trust assets in exchange for a note is not recognized as a sale for federal income tax purposes. IRC §691 further provides guidance for what should be included in gross income when a sale, exchange, or other disposition occurs. This does not include transfers due to bequest, devise, or inheritance from the decedent.

In this case, Taxpayer's transfer of his share of the IRA is not a gift and is not considered a sale or disposition for federal income tax purposes.

Holding. The assignment of a beneficiary's share of an IRA to a special needs trust is not a deemed sale or disposition; ownership of the trust belongs to the beneficiary under IRC §§671 and 677(a).

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30. Rev. Rul. 85-13, 1985-1 CB 184.

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GROSS INCOME

Unexplained Bank Deposits

***Yury Tribin v. Comm'r,* TC Memo 2010-224 (Oct. 14, 2010)**
IRC §§1, 61, 446, and 6001

☞ Bank Deposit Analysis Reveals Additional Taxable Income

Facts. Yury Tribin worked as an independent contractor with a company that specializes in redesigning closets. She reported income on Forms 1040 for the tax years at issue in this case — 2002, 2003, and 2004.

Tribin opened her home to several of her relatives who periodically stayed with her. In 2002, Tribin's sister from Colombia, Claudia Tribin-Mora, stayed with Tribin twice. During her second visit in November 2002, Tribin-Mora advanced $5,000 to Tribin. In February or March of 2003, Tribin-Mora decided to buy a car. Tribin purchased the car and obtained the loan in her own name on her sister's behalf because Tribin-Mora did not have a valid social security number. To repay the $5,000 advance from Tribin-Mora, Tribin made payments on the car loan until her sister got a job. When Tribin-Mora obtained employment, she gave Tribin cash each month to make that month's loan payment. Tribin then wrote a check to the automobile finance company.

The IRS determined that Tribin failed to maintain or submit for examination complete accounts of her income-producing activities for 2002, 2003, and 2004. The IRS reconstructed Tribin's income by analyzing the bank deposits in her checking accounts. The IRS determined that Tribin had total bank deposits of $61,196; $111,043; and $65,564 for 2002, 2003, and 2004, respectively. After reducing these amounts by the identifiable deposits reported in income, transfers, and nontaxable deposits, unidentified deposits of $11,656, $15,619, and $16,087 remained at issue for the 2002, 2003, and 2004 tax years, respectively.

The IRS issued a notice of deficiency in November 2008, determining income tax deficiencies for the three tax years at issue.

Issue. Whether unidentified cash deposits are includable in Tribin's income for the 2002–2004 tax years.

Analysis. Taxpayers must maintain adequate records to substantiate their income and deductions. When the taxpayer fails to do so, **the IRS is authorized to use whatever method it deems appropriate to determine the existence and amount of taxpayer's income as long as it clearly reflects income.**[31]

Most of Tribin's unexplained deposits were small cash amounts for which she provided little or no evidence that they were not taxable. However, for a series of transactions between Tribin and her sister, Tribin presented sufficient evidence that the deposits related to the car loan and that they should not be included in income. Because Tribin was merely a conduit for the car loan and the cash payments, the deposits to her account with Tribin-Mora's funds do not constitute taxable income to Tribin.

At trial, Tribin presented no credible evidence concerning the remaining unidentified deposits. Tribin had a difficult time remembering the sources of the multiple small cash deposits, but nonetheless stated that it "wasn't income because this money coming… from my family." She further said that some of the deposits were gifts and others were loans but presented no documentary evidence of the gifts or loans.

Holding. The court found that the $5,000 loan from Tribin-Mora in 2002 and cash deposits totaling $2,475 in 2003 that corresponded to the car payments made by Tribin on her sister's behalf are not includable in income. The remaining unexplained bank deposits identified by the IRS are includable in Tribin's taxable income.

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31. IRC §446(b); *Mallette Bros. Constr. Co., Inc. v. U.S.,* 695 F.2d 145, 148 (5th Cir. 1983); *Gowni v. Comm'r,* TC Memo 2004-154 (Jun. 29, 2004).

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Statute of Limitations

***Home Concrete and Supply LLC et al. v. U.S.*, U.S. Court of Appeals, 4th Circuit; No. 09-2353 (Feb. 7, 2011)**
IRC §§6501, 754, and 743

☞ Overstatement of Basis Not an Omission from Gross Income and Does Not Extend Statute of Limitations

Facts. In 1999, Stephen Chandler and Robert Pierce owned all the stock of Home Oil and Coal Company, Inc. Pierce consulted with professional financial planners in contemplation of selling his interest in Home Oil. The transactions that ensued from this advice were designed to minimize the tax liability generated by selling his interest in Home Oil.

Home Concrete and Supply LLC was formed in April 1999. Its partners were Chandler, Pierce, Home Oil, and two trusts established for Pierce's children (collectively "the taxpayers").

In May 1999, each of the taxpayers initiated short sales[32] of U.S. Treasury Bonds, from which they received $7,472,405 in aggregate proceeds. A few days later, the taxpayers transferred the short sale proceeds to Home Concrete as capital contributions. By doing this, the taxpayers created outside basis equal to the amount of the contributed proceeds. Home Concrete then closed the short sales by purchasing and returning essentially identical Treasury Bonds at an aggregate purchase price of $7,359,043.

In June 1999, Home Oil transferred its business assets to Home Concrete as a capital contribution. The other taxpayers then transferred percentages of their respective partnership interests in Home Concrete to Home Oil as capital contributions to Home Oil. Home Oil sold substantially all its assets to a third-party purchaser in August 1999 for $10.6 million.

Home Concrete and the taxpayers timely filed their tax returns for the 1999 tax year. Home Concrete elected to step up its inside basis under IRC §754 to equal the taxpayers' outside bases. Accordingly, Home Concrete adjusted its inside basis to $10.5 million, which included the amount of short sale proceeds contributed by the taxpayers. Thus, Home Concrete reported a gain of only $69,125 from the sale of its assets.

Home Concrete's 1999 tax return included a §754 election form, which gave an itemized accounting of the partnership's inside basis, the amount of the basis adjustment, and the post-election basis. The return also reported the gain of $113,362 from the sale of the Treasury Bonds. The taxpayers' individual returns also reported that short sale proceeds were received.

The IRS began an investigation of the taxpayers' transactions in June 2003. As a result of the investigation, the IRS issued a final partnership administrative adjustment (FPAA) in September 2006, claiming that the transactions lacked economic substance and constituted a sham for federal income tax purposes. The FPAA decreased the taxpayers' reported outside bases in Home Concrete to zero and thus substantially increased their taxable income.

Home Concrete deposited $1.4 million with the IRS and sued in district court to recover that amount. Home Concrete alleged that the FPAA was barred by the general 3-year limitations period set forth in IRC §6501(a).

In response, the IRS contended that the FPAA was timely under the 6-year limitations period in §6501(e)(1)(A) because Home Concrete omitted gross income that exceeded 25% of the gross income reported on Home Concrete's 1999 tax return. **The taxpayers argued that the 6-year limitation period did not apply because Home Concrete's allegedly overstated basis did not constitute an omission from gross income.** Further, the taxpayers argued that even if it had been an omission, their tax returns collectively made adequate disclosure of the transactions and thus they were entitled to the safe harbor of the 3-year statute of limitations.[33]

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32. A short sale is a "sale of a security that the seller does not own or has not contracted for at the time of sale, and that the seller must borrow to make delivery." Black's Law Dictionary 1456 (9th ed. 2009). To close the short sale, "[t]he short seller is obligated . . . to buy an equivalent number of shares [or substantially identical security] in order to return the borrowed [property]. In theory, the short seller makes this covering purchase using the funds he received from selling the borrowed [property]." *Kornman & Assocs., Inc. v. U.S.,* 527 F.3d 443, 450 (5th Cir. 2008) (quoting *Zlotnick v. TIE Commc'ns,* 836 F.2d 818, 820 (3rd Cir. 1988)).

33. IRC §6501(e)(1)(B)(ii).

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The district court concluded that the FPAA was timely under the 6-year statute of limitations. Home Concrete and the taxpayers appealed.

Issue. Whether an overstated tax basis constitutes an omission from gross income for purposes of extending the limitations period for assessments.

Analysis. In *Colony,*[34] the U.S. Supreme Court held that an overstatement of basis resulting in an understatement of reported gross income does not constitute an omission from gross income for purposes of extending the general 3-year statute of limitations for tax assessments.

In 1954, the Code was amended to add the following subsections to IRC §6501(e)(1)(B):

i. *In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and*

ii. *In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.*

The appellate court in this case stated that the Supreme Court in *Colony* construed the phrase "omits from gross income" untethered from any reliance on the taxpayer's identity as a trade or business selling goods or services. Further, the court concluded that there had been no change in the pertinent language of the Code that would change the interpretation of an omission from gross income as something other than a failure to report "some income receipt or accrual."[35]

In September 2009, the IRS published a temporary regulation which became final while this case was appealed. Treas. Reg. §301.6501(e)-1 states:

. . . the term gross income, as it relates to any income other than from the sale of goods or services in a trade or business, has the same meaning as provided under section 61(a), and includes the total of the amounts received or accrued, to the extent required to be shown on the return. In the case of amounts received or accrued that relate to the disposition of property, and except as provided in paragraph (a)(1)(ii) of this section, gross income means the excess of the amount realized from the disposition of the property over the unrecovered cost or other basis of the property. Consequently, except as provided in paragraph (a)(1)(ii) of this section, an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income for purposes of section 6501(e)(1)(A)(i).[36]

Income taxes. — Paragraph (a) of this section applies to taxable years with respect to which the period for assessing tax was open on or after September 24, 2009.[37]

The IRS asked that the regulation be applied retroactively to produce the desired result in this case. The appellate court declined to do so for several reasons. First, the 1999 tax year at issue in this case is well beyond the reach of the regulation's period of applicability. Even applying the 6-year limitations period, the period for assessing tax would have expired in September 2006.

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34. *Colony, Inc. v. Comm'r,* 357 U.S. 28 (1958).

35. *Colony,* 357 U.S. at 33; see also *Bakersfield Energy Partners, L.P.,* 568 F.3d at 778.

36. Treas. Reg. §301.6501(e)-1(a)(1)(iii).

37. Treas. Reg. §301.6501(e)-1(e)(1).

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Second, the regulation interprets "omits from gross income" under §6501(e)(1)(A), and the Supreme Court declared that statute unambiguous in *Colony.* The appellate court concluded that the regulation is not entitled to controlling deference.[38]

Finally, the regulation is not a mere clarification. If applied, it would change the law governing the taxpayers' 1999 tax returns and thus subject them to liability to which they would not have been subject under pre-regulation law. Because *Colony* was established law when the taxpayers filed their 1999 returns, the appellate court refused to apply Treas. Reg. §301.6501(e)-1(e), which would establish a rule contrary to *Colony* that would subject the taxpayers to the extended limitations period 10 years after their 1999 returns were filed.

Holding. The court reversed the district court's judgment, **concluding that an overstated basis in property is not an omission from gross income that extends the limitations period in §6501(e)(1)(A).** Therefore, Home Concrete's overstated basis in the short sale proceeds did not trigger the 6-year limitation period. The general 3-year limitation period applies, which makes the FPAA untimely.

Limitations on Assessment by the IRS

***Kenneth H. and Susan W. Beard v. Comm'r*, U.S. Court of Appeals, 7th Circuit; No. 09-3741 (Jan. 26, 2011)**
IRC §6501

☞ 7th Circuit Reversed Tax Court Decision on Statute of Limitations

Facts. Kenneth Beard participated in a variant of a son-of-BOSS tax shelter. As part of the transaction, he participated in the short sale of Treasury Notes that he then transferred (along with the obligation to close the short sale) to two S corporations in which he was the majority shareholder. The S corporations closed the short sale and then Beard sold his interest in the corporations. On his 1999 individual income tax return, Beard reported his long-term capital gains from the sale of his S corporation stocks but did not reduce his bases in the stocks by the obligation to close the short sales.

In 2006, the IRS issued Beard a notice of deficiency, increasing his capital gains tax based upon a reduction in the bases of the S corporation stocks by the amount of the transferred Treasury notes. **Beard petitioned the Tax Court and sought summary judgment arguing that the notice of deficiency was untimely because it was not issued within the 3-year period for assessments.**

Issue. Whether an overstatement of basis is an omission of income under IRC §6501(e), thereby triggering a 6-year, rather than the standard 3-year, statute of limitations.

Analysis. Under §6501(e), the limitations on assessment and collection of income taxes is extended from the standard 3-year rule to six years if there is a "substantial" omission of gross income. **Substantial** is defined as an amount in excess of 25% of the gross income stated on a return.

Holding. The Tax Court accepted Beard's argument that the 3-year statute of limitation applied. However, **the 7th Circuit reversed the Tax Court decision determining that an overstatement of basis is an omission from gross income that triggers the extended 6-year period for tax assessment under §6501(e).**

[38] See *Chevron U.S.A. v. Natural Resources Defense Council, Inc.,* 467 U.S. 842-43 (1984) "If the intent of Congress is clear, that is the end of the matter; for the courts, as well as the agency, must give effect to the unambiguously expressed intent of Congress."

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Disability Benefits

***Roger and Sharon Zardo v. Comm'r,* TC Memo 2011-7 (Jan. 10, 2011)**
IRC §§104 and 105

☞ Disability Retirement Benefits Included in Gross Income

Facts. Roger Zardo was a meat cutter for Nob Hill Foods from July 1984 until June 2003. Nob Hill Foods contributed to the United Food and Commercial Workers Northern California Employers Joint Pension Plan (the UFCW Pension Plan). The UFCW Pension Plan included disability retirement benefits, which were available if certain conditions were met.

The amount of disability retirement benefits was based on the number of years the individual had worked and the benefit factor associated with each year. Zardo's employer made all plan contributions on his behalf, and the plan contributions were not included in Zardo's gross income.

Zardo incurred injuries that impaired the functioning of his back, right knee, and right shoulder. As a result of these injuries, Zardo could not work after June 3, 2003. Starting in December 2003, Zardo received a monthly disability retirement benefit of $2,197 from the UFCW Pension Plan. During 2006, Zardo received a total of $26,365 from the UFCW Pension Plan, which was reported on a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* In addition to the disability pension benefits, Zardo received workers' compensation payments and social security disability insurance benefits.

The 2006 federal income tax return of Roger and Sharon Zardo excluded from gross income all $26,365 of the UFCW Pension Plan disability retirement benefits and $13,447 of the social security disability benefits. The Zardos attached a statement to their tax return that cited IRC §104(a)(2) as the authority for excluding the UFCW Pension Plan disability retirement benefits.

The IRS adjusted the Zardos' gross income to include all of the UFCW Pension Plan disability retirement benefits and $9,886 in social security disability benefits. The social security disability benefits adjustment was based on the increase in adjusted gross income after including the UFCW Pension Plan disability retirement benefits.

Issue. Whether the $26,365 in UFCW Pension Plan disability retirement benefits must be included in the Zardos' income for 2006.

Analysis. The court considered whether the disability retirement benefits are excludable from gross income under IRC §§104(a)(1), 104(a)(2), or 105(c).

IRC §104(a)(1) excludes from gross income "amounts received under workmen's compensation acts as compensation for personal injuries or sickness." This exclusion does not apply to benefits paid under a private contractual relationship.[39] **Because Zardo received his benefits under a private collective bargaining agreement, they are not excludable under §104(a)(1).**

Under §104(a)(2), gross income excludes "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness." 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."[40] Zardo did not receive his disability retirement payments through a legal suit or a settlement but instead as a benefit of his previous employment with Nob Hill Foods. Thus, **Zardo's disability retirement benefits cannot be excluded from gross income under §104(a)(2).**

39. *Wallace v. U.S.,* 139 F.3d 1165 (7th Cir. 1998).

40. Treas. Reg. §1.104-1(c).

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IRC §105(c) provides that gross income does not include amounts that:

1. Constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, and
2. Are computed with reference to the nature of the injury without regard to the period that the employee is absent from work.

In order for payments to be treated as "computed with reference to the nature of the injury," the payments under the plan must vary according to the type and severity of the injury.[41] **If payments do not vary according to the nature of the injury or if they vary according to absence from work, they constitute compensation for lost wages and should be taxed.[42]**

Zardo's UFCW Pension Plan disability retirement benefits were calculated solely according to the number of years he worked and the benefit factor associated with each year. The benefits did not vary according to the type or severity of the injury; therefore, they are not excludable under §105(c).

Holding. The entire $26,365 of Zardo's disability retirement benefits should be included in his gross income.

Income from Cancellation of Life Insurance Policy

***Bruce A. and Carol A. Brown v. Comm'r,* TC Memo 2011-83 (Apr. 12, 2011)**
IRC §§72, 61(a)(12), and 6662

☞ Taxpayer Incorrectly Omitted Income from the Cancellation of Insurance Policy

Facts. Bruce Brown purchased a whole-life insurance policy from Northwestern Mutual Life Insurance Company on March 16, 1982. From the date of purchase through cancellation by Northwestern, a total of $44,205 in premiums was paid: $11,999 by check, $28,532 by loans on the policy, and $3,674 by dividends earned on the policy.

The policy was initially canceled by Northwestern for its cash surrender value of $31,063 (which was applied against debt) on December 29, 2004, but then it was restored in February 2005 when Brown made a minimum payment. The policy was again terminated by Northwestern on December 18, 2005, when the policy's cash surrender value was $37,365. No payment was made to Brown because the cash value was less than the debt on the policy.

Northwestern sent Mr. Brown Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* for 2005 that showed a gross distribution of $37,365 and a taxable amount of $29,093. The 1099-R described the $37,365 as "loans repaid at surrender" and described the $29,093 as "taxable amount at surrender."

According to Northwestern's calculations, the taxable amount of $29,093 was equal to the policy's cash value of $37,365 less the "net cost of the policy" of $8,272. The "net cost of the policy" was calculated as total premiums paid of $44,205 minus the $31,063 cash surrender value as of December 29, 2004, and $4,870 in nontaxable dividend payments in 2004 and 2005.

Mr. Brown prepared his own 2005 individual income tax return and did **not** report the $29,093 in taxable income shown on his Form 1099-R. He believed that the 1099-R from Northwestern was in error and that Northwestern had not forgiven his debt.

The IRS assessed income taxes on the omitted income and also assessed an accuracy-related penalty.

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41. *Beisler v. Comm'r,* 814 F.2d 1304, 1308 (9th Cir. 1987) (en banc), *aff'g.* TC Memo 1985-25 (Jan. 14, 1985); *Rosen v. U.S.,* 829 F.2d 506, 509 (4th Cir. 1987); *Hines v. Comm'r,* 72 TC 715, 720 (1979).

42. *Beisler v. Comm'r,* supra at 1308.

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Issue. Whether the termination of the life insurance contract resulted in taxable income and whether the accuracy-related penalty is appropriate.

Analysis. IRC §72(e)(5) provides that an amount received under a life insurance contract which is not received as an annuity is included in gross income to the extent it exceeds the investment in the contract. The investment in the contract is equal to the total premiums or other consideration paid less the total amount received under the contract that is excludable from gross income.

Under IRC §6662, an accuracy-related penalty of 20% is imposed on a "substantial understatement" of income tax. A **substantial understatement** is one that exceeds the greater of $5,000 or 10% of the amount of tax required to be shown on the return. Brown's understatement exceeded both of these amounts.

Holding. The court determined that Brown had constructively received $37,365 on the cancellation of the policy and the figure reported on Form 1099-R was accurate. The court also found that Brown did not provide any evidence to show that there was reasonable cause for the understatement; thus, the Browns are liable for the substantial understatement penalty.

Source and Application of Funds

Abdul M. Bangura v. Comm'r, **TC Summ. Op. 2011-23 (Mar. 8, 2011)**
IRC §§6001, 6651, and 6662

☞ IRS Uses Indirect Method to Estimate Income of Uncooperative CPA

Facts. Mr. Bangura was a CPA licensed in Maryland. In 2007, he was the sole owner of AMB CPA Services, which provided tax preparation services for approximately 100 clients. Even though he filed no extension, his 2007 Form 1040 was filed on June 13, 2008. He filed the 2007 return using the married filing separately status. It reported the following income and expenses.

Schedule C gross receipts	$28,500
Less: business supplies	(6,800)
Less: other business expenses	(2,750)
Less: business auto expenses	(14,065)
Schedule C net profit (AGI)	**$ 4,885**
Less: Schedule A itemized deductions	(51,201)
Less: personal exemption	(3,400)
Taxable income	**($49,716)**

The taxpayer failed to cooperate with the IRS revenue agent assigned to examine his delinquent 2007 tax return. Therefore, the agent used an indirect method, the source and application of funds, to determine unreported income for 2007 in the amount of $73,036. The application of funds included estimated personal living expenses of $40,599 determined by using the Bureau of Labor Statistics Consumer Expenditure Survey. The examination determined the following deficiency and penalties.

Additional tax deficiency	$33,626
Failure to file penalty (§6651(a)(1))	3,432
Accuracy-related negligence penalty (§6662(a))	6,726

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Issues. Whether Mr. Bangura:

- Underreported Schedule C gross receipts by $73,036
- Is liable for the failure to file penalty
- Is liable for the 20% accuracy-related negligence penalty

Analysis. The Internal Revenue Manual provides guidelines for using an indirect method such as the source and application of funds. The agent used this examination technique because the Schedule C business expenses of $23,615 and the Schedule A itemized deductions of $51,201 far exceeded reported Schedule C gross receipts of $28,500.

The source and application of funds method is well accepted as an appropriate method of reconstructing a taxpayer's income.[43] This income reconstruction method is based on the assumption that the amount by which a taxpayer's cash expenditures during the year exceed known sources of income represents unreported income unless the taxpayer can show that the expenditures were made from a nontaxable source of funds.

Holding. The court made some adjustments to the proposed unreported income figure of $73,036 due to computational errors made by the IRS examiner. **As a result, the court held that the correct amount of unreported income was $63,586.** In addition, the court upheld the imposition of the failure to file and the 20% accuracy-related negligence penalties.

> **Note.** See Chapter 8, Schedule C Audit Issues, in the 2010 *University of Illinois Federal Tax Workbook* for a complete description of indirect methods used to reconstruct taxpayer income. This can be found on the accompanying CD.

Gross Income
***Thomas F. and Kathryn H. Chambers v. Comm'r*, TC Memo 2011-114 (May 31, 2011)**
IRC §§61 and 7611

☞ Couple Liable for Tax on Deposits to Church Bank Account but Not for Fraud Penalties

Facts. Thomas Chambers (Chambers) founded Biblical Church in 2003 and was its sole pastor and overseer. Biblical Church, also known as Biblical Church Ministries and Biblical Church and Global Ministries, was organized as a "corporation sole" under Utah law. Chambers and his wife resided in Pennsylvania. As overseer of Biblical Church, Chambers had complete control over the corporation sole.

Chambers joined the staff of e3 Partners, a §501(c)(3) organization, as a "church planter," in which his role was to lead short-term mission trips abroad to train local pastors and evangelists. In 2005, Chambers traveled to Peru, Venezuela, and India. His trip to India continued into 2006. He also traveled to Costa Rica and South Africa in 2006. His family went with him on these mission trips, and he often had members of his own and other congregations accompany him.

Team members were responsible for raising their own money for the trips, but e3 Partners received the donations on behalf of members. The organization paid trip expenses from these donations, directing a portion of the funds to team leaders for daily team expenses. E3 Partners deposited money into the team leader's account before each trip and required each leader to document all expenses and return any unused funds to e3 Partners at the trip's end.

43. *U.S. v. Johnson,* 319 U.S. 503, 517 (1943).

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Chambers was a team leader. As such, e3 Partners deposited funds into his account numerous times. Chambers also solicited funds on his own for his mission trips. Some individuals donated money to e3 Partners on Chamber's behalf, and others wrote checks to Biblical Church. Chambers deposited Biblical Church's money into one of the church's bank accounts.

During 2005 and 2006, the Chambers had a personal checking account at M&T Bank. The church had two bank accounts — one at National Penn Bank and the other at the Bank of Lancaster County. The Chambers had sole signatory authority over the church's bank accounts.

The Chambers tried to keep the bank accounts separate to distinguish the church's funds from the missionary funds. Checks payable to Biblical Church generally were deposited in the National Penn account. Checks payable to Global Ministries generally were deposited in the Lancaster bank.

The Lancaster account was opened before the Chambers obtained a federal employer identification number (FEIN). Because the Chambers had applied for the FEIN, the bank let them open the account without one, leaving the spot where the FEIN was to go temporarily blank. Later, a 9-digit number was handwritten into this space. However, the number did not correspond to Biblical Church's FEIN. Instead, it was the social security number of an unrelated minor child.

The National Penn account, which was opened several months later, contained the correct FEIN. The Chambers closed the Lancaster account in 2006 when they discovered the FEIN error and opened a new account with the correct number at Northwest Savings Bank.

The Chambers both worked part-time in 2005 and 2006, performing janitorial services at Superior Walls of America, Ltd. Superior paid them $13 per hour for approximately 15 hours each week. Chambers intended this money to be used for mission trips and instructed Superior's controller to pay Biblical Church directly for the Chambers' work.

Chambers gave Superior a Form W-9, *Request for Taxpayer Identification Number and Certification*, claiming exemption from withholding. The Chambers later learned that they were required to report the Superior income on their personal tax return. In 2006, they filed a Schedule C to report the money they made from Superior.

In 2008, the IRS examined the Chambers' jointly filed returns for tax years 2005 and 2006, finding the Chambers owed deficiencies of $37,594 for 2005 and $18,769 for 2006, plus IRC §6663 fraud penalties of $28,196 and $14,077 for these years, respectively.

The IRS arrived at the deficiency amounts by reconstructing the Chambers' 2005 and 2006 income records, including deposits from the M&T, Lancaster, and National Penn accounts. The Northwest account was not examined.

Issues. This case presents two issues.

1. Whether the Chambers are liable for income tax on deposits into the church's bank accounts
2. Whether the Chambers are liable for fraud penalties under IRC §6663

Analysis.

Issue 1. The IRS claimed the money deposited into the church accounts was income to the Chambers because the couple exercised full control over the accounts and used the funds to pay for personal expenses. **The court has previously found that a taxpayer must include in their gross income any funds over which the taxpayer has "dominion and control."**[44] The court determined that dominion and control means the taxpayer can use an account's funds at will.[45] The court allows the IRS to reconstruct a taxpayer's gross income by examining any bank account the taxpayer controls, not just the taxpayer's personal bank account.[46]

44. *U.S. v. Goldberg,* 330 F.2d 30, 38 (3d Cir. 1964); *Davis v. U.S.,* 226 F.2d 331, 334-335 (6th Cir. 1955).

45. *Rutkin v. U.S.,* 343 U.S. 130 (1952).

46. *Price v. Comm'r,* TC Memo 2004-103 (Apr. 22, 2004); *Cohen v. Comm'r,* TC Memo 2003-42 (Feb. 24, 2003); *Woodall v. Comm'r,* TC Memo 2002-318 (Dec. 30, 2002); *Woods v. Comm'r*, TC Memo 1989-611 (Nov. 9, 1989); *aff'd.* without published opinion 929 F.2d 702 (6th Cir. 1991).

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The Chambers argued that deposits into the church's bank accounts were used to fund mission trips and church expenses. They claimed that cash withdrawals and checks made payable to them were used for church and missionary work.

The Chambers did not have receipts or records to support their claims. When a taxpayer fails to maintain adequate records, **the IRS can apply any reasonable method to determine the taxpayer's income, including indirect methods like the bank deposit analysis.**[47] This method allows the IRS to assume that all deposits are taxable income unless proven otherwise, taking into consideration any obviously nontaxable income and deductions. The burden of proving that any income is nontaxable rests with the taxpayer.[48]

The court noted some of the expenses paid with church funds appeared to be personal in nature. The Chambers claimed these expenses were the equivalent of a parsonage allowance and were therefore exempt from income tax under IRC §107. The court disallowed this claim because the church had not designated a housing allowance for the Chambers, as required by Treas. Reg. §1.107-1(b).

The court found the IRS's analysis of the church bank account deposits to be "overzealous" in attributing income to the Chambers, citing the IRS's contention that the Chambers' 2004 federal income tax refund, which was deposited into the church's account, was income to the Chambers. The court's review excluded some deposits from e3 Partners from the Chambers' income to the extent that the deposits represented nontaxable reimbursement of team leader expenses.

The court excluded a few other deposits that were noted as reimbursements or gifts to the Chambers. However, the court classified most of the income from the church's bank accounts as the Chambers' personal income.

Issue 2. The court determined that in order to impose an IRC §6663(a) penalty for tax fraud, the IRS must prove by clear and convincing evidence that the taxpayer willfully intended to conceal, mislead, or otherwise prevent tax collection.[49] The court accepts circumstantial evidence of fraud, because a taxpayer's intent is hard to prove.[50] Circumstantial evidence can include understatement of income, inadequate records, and lack of cooperation with the IRS, among other factors.

The IRS claimed the Chambers were liable for fraud because they:

- Invoked §7611 in an attempt to avoid recordkeeping,
- Organized as a corporation sole in Utah to avoid paying taxes,
- Failed to have Biblical Church recognized under IRC §501(c)(3),
- Attempted to conceal income from their janitorial services, and
- Used a false FEIN to open a bank account.

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47. *Petzoldt v. Comm'r*, 92 TC 661 (1989); *Schroeder v. Comm'r*, 40 TC 30 (1963); *Giddio v. Comm'r*, 54 TC 1530 (1970); *Estate of Mason v. Comm'r*, 64 TC 651 (1975), *aff'd.* 566 F.2d 2 (6th Cir. 1977); *Tokarski v. Comm'r*, 87 TC 74 (1986); *Clayton v. Comm'r*, 102 TC 632 (1994).

48. Rule 142(a); *Dodge v. Comm'r*, 96 TC 172, 181 (1991), *aff'd.* in part, *rev'd.* in part and remanded on other grounds 981 F.2d 350 (8th Cir. 1992); *Reaves v. Comm'r*, 31 TC 690 (1958), *aff'd.* 295 F.2d 336 (5th Cir. 1961).

49. *Parks v. Comm'r*, 94 TC 654 (1990); *Neely v. Comm'r*, 116 TC 79 (2001).

50. *Spies v. U.S.*, 317 US 492 (1943); *Niedringhaus v. Comm'r*, 99 TC 202 (1992).

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Regarding each of these claims, the court found as follows.

- The Chambers were mistaken about the §7611 exception to produce records, but their reliance on this Code section does not indicate their intent to commit fraud.
- A corporation sole is a legitimate form of incorporation for religious organizations that want to ensure that church property remains dedicated to the church, rather than passing into the hands of church leaders' heirs.[51]
- The Code automatically grants tax-exempt status to churches.[52]
- The circumstances regarding the Chambers' assignment of pay for work they performed for Superior Walls did appear to be suspect. However, because the Chambers filed a Schedule C to report this income in 2006, it weakens the suspicion of intent to commit fraud.
- The Bank of Lancaster's records show the cover sheet setting up the church's bank account was typed, but the FEIN was handwritten. Chambers testified he returned to the bank several months after opening the account to give the bank the church's FEIN, but the bank told him they already had a number in their system. Chambers did not verify the number. However, because the church's other bank accounts had the correct FEIN and because the Chambers closed the account when they discovered it had the wrong FEIN, the court found that the IRS failed to establish convincing evidence of fraud.

Holding. The court held as follows.

1. The Chambers are liable for income tax on the majority of deposits into the church's bank accounts because the Chambers exercised dominion and control over the church accounts and did not keep adequate records to show that the deposits were nontaxable.
2. The Chambers are not liable for fraud penalties under IRC §6663 because the court found that the IRS lacked clear and convincing evidence of any intent by the Chambers to commit fraud.

Unreported Wage Income

Carolyn Gay Harper v. Comm'r, **TC Summ. Op. 2011-56 (May 2, 2011)**
IRC §§61 and 6651

☞ County Payments are Considered Income

Facts. Carolyn Harper had a disabled adult son living at home during the years at issue. She received support plan payments from her county to care for her son during the 2005 and 2006 tax years. **The county wrote a letter to Harper indicating that she was being paid to assist her son with daily living. The letter indicated that the funds paid to her were payments for services.** These payments were reported on Form W-2, *Wage and Tax Statement*.

Harper did not file returns for 2005 and 2006. The IRS filed substitute returns for Harper and assessed tax for the unreported income, a penalty for failure to pay the tax shown on the returns, and the applicable penalty for failure to file a tax return. She did not pay the tax shown on the substitute returns or any penalties.

Harper argued that the care she provided her son was the same care she provided to him all his life without any payments from the county. She further argued that she was not in the business of providing care for her son and was not an employee of her son or the government. She argued that she should be excused from the failure to file penalty because she attempted to convince the county to stop reporting payments to the IRS.

The IRS maintained that the payments were income for services and were reportable and taxable.

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51. *Terrett v. Taylor,* 13 US 43 (1815); *Cnty. of San Luis Obispo v. Ashurst,* 194 Cal. Rptr. 5 (Ct. App. 1983).

52. IRC §508(c).

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Issue. Whether the amounts received by Harper in 2005 and 2006 were taxable income.

Analysis. The amounts paid to Harper by the county constituted income for payment of services and are taxable. Harper's arguments are irrelevant. The payments constitute income under IRC §61.

Holding. Harper owes the taxes as well as all penalties assessed.

INNOCENT SPOUSE

Equitable Relief

***Valarie Stephenson v. Comm'r,* TC Memo 2011-16 (Jan. 20, 2011)**
IRC §§6015 and 6013

☞ **Abused Spouse Granted Innocent Spouse Relief**

Facts. Valarie and Sean Stephenson were married in 1991, shortly before she began her junior year in high school. Ms. Stephenson dropped out three months into her junior year and moved to Sacramento to live with Mr. Stephenson, who had just graduated from high school and enlisted in the Marine Corps.

During the time the couple lived in Sacramento, Mr. Stephenson began verbally abusing Ms. Stephenson. The verbal abuse soon turned into physical abuse.

Mr. Stephenson became a highly successful stockbroker and day trader. Ms. Stephenson worked at a doctor's office and later as a personal trainer.

Mr. Stephenson managed the couple's finances throughout the marriage. He did not allow Ms. Stephenson access to the mail box or a filing cabinet that contained the checkbook and financial documents. When he needed his wife's signature on a document, he placed it in front of her and told her where to sign. If Ms. Stephenson asked what she was signing, Mr. Stephenson threatened her with violence or told her she was not smart enough to understand.

The couple's 1999 joint tax return showed taxable income of $214,711 and tax owed of $77,865. The return showed only a $915 withholding credit, and no payment was included with the return. Mr. Stephenson made regular payments to the IRS for the 1999 tax liability, beginning in August 2004 and continuing throughout 2006.

Ms. Stephenson attempted to leave her husband in 2003. When she told him of her decision, he pushed her against a wall, pointed a gun at her head, and told her that he would kill her or himself if she left him. Ms. Stephenson was so frightened that she decided to stay in the relationship.

In February 2007, Ms. Stephenson left her husband. A friend drove Ms. Stephenson to her mother's house in Phoenix. Ms. Stephenson contacted a divorce attorney in Phoenix and was told that she needed to reside in Arizona for three months before she could file for divorce. The divorce decree was finalized in June 2008.

Ms. Stephenson filed her own federal income tax return for 2006. She did not include any payment with her return because she thought the IRS would send her a bill when the due date approached. The IRS did eventually send her a bill, which she paid immediately, but the due date had already passed and her payment was late.

Ms. Stephenson called the IRS in April 2007 to inquire as to whether her payment had been received. During the phone call, Ms. Stephenson was told for the first time about the unpaid 1999 joint tax liability and that the couple had not filed a 2005 federal tax return. The IRS informed Ms. Stephenson about the possibility of innocent spouse relief for the 1999 tax liability and that she could file a separate tax return for 2005. Ms. Stephenson filed her own 2005 tax return and later timely filed her 2007, 2008, and 2009 federal income tax returns.

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In January 2008, Ms. Stephenson filed Form 8857, *Request for Innocent Spouse Relief,* requesting relief for the 1999 and 2004 tax years. **The IRS denied the request for 1999 because it was untimely.** Ms. Stephenson appealed and the Appeals Office also denied the request.

Subsequently, Ms. Stephenson filed a petition with the court challenging the determination. An IRS tax examiner considered Ms. Stephenson's claim for relief on the merits and determined that she was not entitled to relief under IRC §6015(f).

Issue. Whether Ms. Stephenson is entitled to relief from joint and several liability under §6015(f) with respect to the 1999 federal income tax liability.

Analysis. In making a determination as to whether to grant equitable relief under §6015(f), the factors set forth in Rev. Proc. 2003-61 are considered. These factors are listed below with the conclusions of the court.

1. **Marital status.** Whether the requesting spouse is separated or divorced from the nonrequesting spouse.
2. **Economic hardship.** Whether the requesting spouse would suffer economic hardship if the IRS does not grant relief from the income tax liability.
3. **Knowledge.** Regarding underpayment cases, whether the requesting spouse did not know or have reason to know that the nonrequesting spouse would not pay the income tax liability.
4. **Legal obligation.** Whether the nonrequesting spouse has a legal obligation to pay the outstanding income tax liability pursuant to a divorce decree or agreement.
5. **Significant benefit.** Whether the requesting spouse received significant benefit (beyond normal support) from the unpaid income tax liability.
6. **Compliance.** Whether the requesting spouse made a good faith effort to comply with the income tax laws in the taxable years following the taxable year(s) to which the request for relief relates.
7. **Abuse.** Whether the nonrequesting spouse abused the requesting spouse.
8. **Mental or physical health.** Whether the requesting spouse was in poor mental or physical health on the date the related tax return or Form 8857, *Request for Innocent Spouse Relief,* was signed.

Following is the court's conclusion for these factors.

Factor	Conclusion of Court
1. Marital status	Factor weighs in favor of relief because of divorce.
2. Economic hardship	Factor weighs in favor because Ms. Stephenson currently cannot afford to pay her basic living expenses.
3. Knowledge	Factor weighs in favor because Ms. Stephenson had no knowledge or reason to know that Mr. Stephenson would not pay the tax liability.
4. Legal obligation	Factor weighs in favor because Mr. Stephenson is legally obligated to pay the tax liability.
5. Significant benefit	Factor weighs in favor because Ms. Stephenson did not obtain a significant benefit from the unpaid tax liability.
6. Compliance	Factor weighs in favor because Ms. Stephenson's tax compliance has been perfect since tax year 2007.
7. Abuse	Factor weighs in favor because Ms. Stephenson suffered abuse throughout the marriage.
8. Mental or physical health	Factor is neutral since Ms. Stephenson was not in poor mental or physical health at the relevant times.

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Holding. Seven factors favor relief and one factor is neutral. The court concluded that it was inequitable to hold Ms. Stephenson liable for the 1999 joint tax liability. Accordingly, she is relieved from liability for tax year 1999.

> **Note.** National Taxpayer Advocate Nina Olson denounced the IRS for its handling of this case in remarks she made on January 22, 2011, at an American Bar Association Section of Taxation meeting. She said that there is a lack of knowledge about domestic violence among the IRS employees who handle innocent spouse relief cases. Ms. Olson said "This case has made me ashamed of the IRS."[53]

Innocent Spouse Relief

IRS News Release IR-2011-80 (Jul. 25, 2011)

IRC §6015(f)

☞ IRS Announces Elimination of 2-year Limit for Equitable Relief

Purpose. The IRS announced that it **will eliminate the 2-year time limit** that now applies to certain equitable relief requests.

> **Note.** For details about the elimination of the 2-year time limit for innocent spouse cases, see Chapter 3, IRS Update.

IRS PROCEDURES — MISCELLANEOUS

Information Reporting

IRS Notice 2010-67, IRB 2010-43 (Oct. 25, 2010)

IRC §§6045, 6045A, and 6045B

☞ Penalty Relief Provided to Brokers for Failing to Report Certain 2011 Stock Transfers

Purpose. This notice provides transitional relief from the information reporting requirement beginning in 2011 to transfers of securities by brokers and other custodians under IRC §6045A.

Analysis. The Energy Improvement and Extension Act of 2008 added IRC §§6045(g), 6045A, and 6045B to the Code. IRC §6045(g) provides that every broker required to report the gross proceeds from the sale of a covered security must also report the customer's adjusted basis in the security and whether any gain or loss on the security is long-term or short-term. This reporting is generally done on Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions.* A **covered security** includes all stock acquired beginning in 2011 **except:**

- Stock in a regulated investment company for which the average basis method is available, and
- Stock acquired in connection with a dividend reinvestment plan.

Both of the above 2011 exceptions are covered securities if acquired in 2012 or after.

53. *2011 Tax Analysts Tax Notes Today,* Doc. 2011-1548 (Jan. 25, 2011).

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In order to enable brokers to meet the §6045(g) requirements after a stock split, merger, or acquisition that affects basis, §6045B provides that an issuer of stock must report to the IRS and each stockholder or nominee a description of such action and the effect of that action on basis. This provision is effective beginning in 2011; for regulated investment companies, the requirement does not apply until 2012.

Beginning in 2011, a broker and any other person specified in Treasury Regulations that transfers custody of a covered security to a receiving broker must furnish a written statement to the receiving broker that allows the receiving broker to satisfy the basis reporting requirements of §6045(g). This statement is generally to be furnished to the receiving broker within 15 days after the transfer.

In order to allow brokers and other custodians sufficient time to make programming changes necessary to comply with the regulations, the IRS will not assess penalties for failure to furnish transfer statements under §6045A for any transfer of stock in 2011 that is not incidental to the stock's purchase or sale.[54]

> **Note.** See the "Changes to Form 1099-B" section in Chapter 7, Individual Taxpayer Topics, for more information about broker requirements for reporting the basis of securities.

Information Reporting

IRS Notice 2010-69, IRB 2010-44 (Nov. 1, 2010)
IRC §6051

☞ Interim Relief from Requirement to Report Cost of Health Insurance on W-2

Purpose. This notice provides interim relief to employers for reporting the cost of coverage under an employer-sponsored group health plan on Form W-2. Reporting the cost of such coverage will not be mandatory for Forms W-2 issued for 2011.

Analysis. The Patient Protection and Affordable Care Act of 2010, which was enacted on March 23, 2010, added IRC §6051(a)(14) to the Code. IRC §6051(a)(14) mandates that the cost of applicable employer-sponsored coverage must be reported on Form W-2, effective for taxable years beginning on or after January 1, 2011.

Pursuant to this notice, the §6051(a)(14) reporting requirement is **not** mandatory for Forms W-2 issued for 2011. Thus, employers that do not report the aggregate cost of employer-sponsored coverage on Forms W-2 issued for 2011 will not be subject to any penalties for failure to meet such requirements.

> **Note.** For more information about the requirement to report the cost of health insurance, see pages 472–473 in the 2010 *University of Illinois Federal Tax Workbook.* This can be found on the accompanying CD.

[54] See Treas. Reg. §1.6045A-1(a)(1)(ii).

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Litigation Costs

***RI Unlimited Inc. v. Comm'r,* TC Memo 2010-205 (Sep. 22, 2010)**
IRC §§7430 and 3121

☞ Litigation Costs Awarded After IRS's Position Deemed Substantially Unjustified

Facts. RI Unlimited, Inc., (RI) provides medical transcription services to medical service providers. The company hires home-based medical transcriptionists to type medical documents from dictation files. RI treated the transcriptionists as independent contractors for employment tax purposes for the tax years 2000–2003.

RI's medical transcriptionists decide how often to work, pay all relevant expenses (e.g., personal computer, Internet service, medical reference texts, and the costs of maintaining a home office), and are paid per line of completed transcription.

In 2004, the IRS conducted an employment tax examination of RI for all quarters of calendar years 2000–2003. An issue in the examination was whether RI's transcriptionists were properly characterized as independent contractors or employees. RI's counsel provided documents and information to the IRS auditor. These documents included Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding,* copies of RI's independent contractor agreement, and copies of the confidentiality agreement the transcriptionists were required to sign.

After reviewing the provided materials, the IRS examiner concluded that RI's medical transcriptionists should be treated as statutory home workers under IRC §3121(d)(3)(C). RI's counsel sent a letter to the IRS examiner in June 2005 disputing the examiner's conclusion and asserting that RI was entitled to IRC §530 relief. In August 2005, RI's counsel requested that the matter be transferred to the IRS Office of Appeals.

In February 2007, an IRS appeals officer proposed to settle the case by conceding all of the proposed tax for 2000–2002 and 75% of the proposed tax for 2003. In exchange, RI was to begin treating its medical transcriptionists as employees beginning July 1, 2007. RI rejected the settlement offer and in March 2007, the appeals officer issued a notice of determination which concluded that:

1. The transcriptionists were employees for federal employment tax purposes,
2. RI was not entitled to §530 relief, and
3. RI owed employment tax of $477,617.

In June 2007, RI filed a petition with the Tax Court, asserting that the IRS examiner erred in his determinations. In August 2008, RI's counsel wrote a letter which accompanied documents requested by the IRS in pretrial proceedings. The letter stated that even if its transcriptionists were employees for FICA tax purposes, RI was entitled to §530 relief. Enclosed were declarations of individuals with many years of experience in the industry who stated that over 25% of the firms in the medical transcription services industry treated their transcriptionists as independent contractors.

After reviewing all the materials submitted, the IRS informed RI that it would fully concede the case on the basis of §530. In July 2009, the parties stipulated that RI had no federal employment tax liability for the periods at issue and disposed of all issues in the case except RI's motion for litigation costs.

Issue. Although there were several issues raised in this case, the following analysis focuses on whether the IRS's position in this matter was substantially justified.

Analysis. IRC §7430(a) authorizes the award of reasonable litigation costs to the prevailing party in connection with any tax matter brought by or against the United States. In order for a taxpayer to be considered the prevailing party, it must be determined that the IRS's position in the court proceeding was not substantially justified. A position is substantially justified if it has a reasonable basis in both fact and law.[55]

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[55]. *Corson v. Comm'r,* 123 TC 206 (2004); *Maggie Mgmt. Co. v. Comm'r,* 108 TC 443 (1997).

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RI contends that the IRS's position was not substantially justified because its medical transcriptionists could not have been statutory home workers pursuant to §3121(d)(3)(C). RI argued that the transcriptionists had the right to delegate work to subcontractors, the transcriptionists had a substantial investment in the facilities used in connection with the work, and some of the transcriptionists did not have a continuing relationship with RI.

The IRS claimed that its position had a reasonable basis in fact and law and was, thus, substantially justified. The IRS examiner who reviewed RI's Form SS-8 and confidentiality agreement contemplated that the transcriptionists would perform their work personally and their work would be done as part of a continuing relationship between RI and the transcriptionists. An IRS appeals officer reached the same conclusion after a similar analysis of the facts and applicable law. The appeals officer also specifically concluded that the transcriptionists' investment in computers, software, and medical reference materials was not a substantial investment for purposes of §3121(d)(3). The IRS never conceded that RI's transcriptionists are independent contractors but instead conceded the case on the basis of §530 relief.

Relief from employment taxes is available under §530 if the employer demonstrates all the following.

1. It did not treat an individual as an employee for employment tax purposes for any period.
2. It filed all required federal tax returns consistent with its treatment of the individual.
3. It had a reasonable basis for not treating the individual as an employee.

One of the safe harbors an employer can use to satisfy the "reasonable basis" requirement is the long-standing recognized practice of a significant segment of the industry in which such individual was engaged. Section 530(e)(2)(B) provides that "in no event shall the significant segment requirement…be construed to require a reasonable showing of the practice of more than 25% of the industry (determined by not taking into account the taxpayer)."[56]

RI responded to the IRS's request for formal discovery on August 4, 2008. At that time, the declarations of four individuals stated that substantially more than 25% of the firms in the medical transcription services industry treated their transcriptionists as independent contractors for FICA tax purposes. The court noted that these declarations provided evidence of a long-standing recognized practice of a significant segment of the industry.

RI had the burden of establishing its entitlement to §530 relief. RI had not met this burden in July 2007, the date the IRS first took its position on this issue in the court proceeding. However, a position that was reasonable when first taken may become unreasonable in the light of changed facts and circumstances.[57] When RI submitted the declarations on August 4, 2008, it shifted the burden of proof to the IRS to establish that RI was not entitled to §530 relief. The IRS failed to produce any credible evidence to the contrary. As a result, the IRS's position that RI was not entitled to §530 relief became substantially unjustified after August 4, 2008. At that time, the IRS's position lacked a reasonable basis in fact or law and RI is entitled to reasonable litigation costs incurred after this point.

Holding. The court awarded RI reasonable litigation costs of $22,547 incurred after August 4, 2008.

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56. Small Business Job Protection Act of 1996, PL 104-188, sec. 1122, 110 Stat. 1766 (adding subsection (e) of act section 530).

57. Treas. Reg. §301.7430-5(c)(2).

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Liens

IRS News Release IR-2011-20 (Feb. 24, 2011)
IRC §§6321, 6303, and 6502

☞ IRS Announces Changes to Lien Filing Practices

Purpose. The IRS announced that it is making important changes to its lien filing practices that will lessen the negative impact on taxpayers.

Analysis. The changes to lien filing practices include the following.

- Significantly increasing the dollar threshold when liens are generally issued
- Making it easier for taxpayers to obtain lien withdrawals after paying a tax bill
- Withdrawing liens in most cases when a taxpayer enters into a direct debit installment agreement
- Creating easier access to installment agreements for more struggling small businesses
- Expanding a streamlined offer in compromise program to cover more taxpayers

IRS Commissioner Doug Shulman said, "These steps are in the best interest of both taxpayers and the tax system. People will have a better chance to stay current on their taxes and keep their financial house in order. We all benefit if that happens."

> **Note.** See Chapter 3, IRS Update, for more information regarding the IRS collection process.

Tax Preparer PTINs

IRS News Release IR-2011-74 (Jul. 12, 2011)

☞ IRS Begins Enforcing PTIN Rules

On July 12, 2011, the IRS announced that, as part of its oversight program for tax return preparers, it will send a letter to 100,000 tax return preparers who failed to follow the new preparer tax identification number (PTIN) rules for the 2011 filing season.

The letter explains that the preparer either used an outdated PTIN or used a social security number as identification on returns that were prepared in 2011. The letter identifies the requirements to register for a new PTIN or renew an old PTIN, and where to obtain assistance if necessary.

Since launching the PTIN registration program in 2010, approximately 712,000 tax preparers registered and obtained PTINs. IRS Commissioner Doug Shulman commented, "The vast majority of federal tax return preparers complied with the rules. Obviously, some preparers did not get the word, so these letters provide additional information so they can register as soon as possible. We owe it to the compliant tax preparers to make sure that everyone is on a level playing field."

The IRS is concerned that unscrupulous preparers may attempt to elude the PTIN registration program by not signing returns that they prepare. The IRS plans to caution taxpayers not to use tax return preparers who refuse to sign returns and include their PTINs on the returns. As part of its effort to identify "ghost preparers," the IRS plans to send letters to taxpayers who appear to have had assistance with their returns but lack tax preparer signatures on their 2010 tax returns. The letter will explain how taxpayers can file a complaint against preparers who fail to sign returns and how to select legitimate tax preparers.

> **Note.** For more information regarding PTIN requirements, see Chapter 12, Ethics.

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Offer-in-Compromise

***Larry E. Tucker v. Comm'r,* TC Memo 2011-67 (Mar. 22, 2011)**
IRC §§6320, 6321, 6323, 6330, and 7122

☞ IRS Collection Efforts Sustained in Court

Facts. Larry E. Tucker, a New Mexico resident, was not good about filing his tax returns on a timely basis. For four out of five years (1999–2003), he failed to timely file tax returns. Nearly a year after filing the 1999–2003 tax returns, the IRS sent him a "Final Notice — Notice of Intent to Levy and Notice of Your Right to a Hearing" under IRC §§6330(a)(1) and 6331(d)(1) for 2000, 2001, and 2002. Mr. Tucker did not timely request a hearing under IRC §6330. The IRS then sent Mr. Tucker a notice pursuant to IRC §6320(a)(1) advising him that the IRS had filed a federal tax lien against him.

In January 2003, Mr. Tucker received an advance payment on a web design project. He then put $23,700 into an E-Trade account, hoping to make profits from day trading and use these funds to resolve his IRS issues. Unfortunately, the day trading adventure failed and he ended up losing $22,645.

In July 2004, Mr. Tucker submitted a Form 656, *Offer-in-Compromise,* between the time the IRS mailed the lien notice and the time he actually received it. The lien notice showed his total liability as approximately $35,000 for the years 1999–2003. He offered to compromise his liability by paying a total of $6,000 over a 60-month period.

The IRS rejected the offer in compromise (OIC), determining that Mr. Tucker had the ability to fully pay the liability; he was then given 14 days to appeal this determination. In addition, the IRS determined that the lost E-trade funds were dissipated assets and consequently included them as well as other funds totaling $44,700 as part of the reasonable collection potential.

During the OIC evaluation process, Mr. Tucker submitted a Form 12153, *Request for a Collection Due Process or Equivalent Hearing,* in response to the lien notice. Due to the close timing of both collection activities that were underway, there was some confusion as to which IRS employee should have been considering the OIC (the original OIC examiner or the collections due process (CDP) settlement officer). The turn of events resulted in the July 2004 OIC being withdrawn by Mr. Tucker's counsel, who determined that an installment agreement would be preferable.

In July 2005, a new OIC was submitted for $36,772 ($1 more than the amount determined by the settlement officer) payable over 116 months. This offer was also rejected by the settlement officer, who stated, "It is usually not in the government's best interest to accept an offer when there is more than five years remaining on the collection statute."

In January 2006, the appeals office issued Mr. Tucker a "Notice of Determination Concerning Collection Action(s) under Section 6320 and/or 6220" to which Mr. Tucker responded by petitioning the court. The case was sent to the appeals office to conduct a supplemental CDP hearing and to reconsider the July 2005 OIC. The OIC was again rejected and the notice of federal tax lien was upheld.

Issue. Whether the appeals office abused its discretion in upholding a notice of federal tax lien against Mr. Tucker.

Analysis. The settlement officer articulated several reasons for her determination that the OIC should be rejected.

- Mr. Tucker's offer was not in the best interest of the government.
- A partial payment installment agreement (PPIA) was a better alternative to the OIC that Mr. Tucker proposed.
- There is reason to believe that Mr. Tucker's income or assets would increase in the future, such that the IRS would collect more from a PPIA than from the OIC.
- There is no law or policy that requires the IRS to accept an offer.
- The cost it takes to monitor an offer for 116 months would be similar to the cost it would take to monitor a PPIA.

Holding. The court determined that the appeals office did not abuse its discretion in upholding a notice of federal tax lien against Mr. Tucker, because there was a reasonable basis for the settlement officer's decision.

> **Note.** See Chapter 3, IRS Update, for more information regarding OICs.

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Statute of Limitations
***Martin R. Dingman v. Comm'r*, TC Memo 2011-116 (Jun. 1, 2011).**
IRC §§6091, 6330, 6331, 6501, and 6651

☞ Tax Assessment Not Within 3-Year Limitations Period

Facts. Martin Dingman failed to timely file his 1996–2000 tax returns. The IRS criminal investigation division (CID) began an investigation at some point before 2003. Dingman's attorney hand delivered 1996–2000 returns and checks in payment of tax to the CID office. The check payments were posted to Dingman's account on February 19, 2003. The IRS assessed additional tax for the 1996–2000 tax years on February 28, 2006.

Dingman contends that the assessments were done outside the 3-year limitations period. The IRS contends that the hand-delivered returns were not properly filed and, therefore, the assessments are within the 3-year limitations period.

Treas. Reg. §1.6091-2(d)(1) indicates that a hand-delivered return is properly filed when left with the district director (or authorized IRS employee) of the taxpayer's local IRS office. However, the IRS Restructuring and Reform Act of 1998 served to make this regulation obsolete due to the elimination of "district director" and other positions and a restructuring of the IRS that became effective on October 1, 2000. The IRS issued temporary updated guidance on new filing rules effective April 7, 2003. A permanent amendment to Treas. Reg. §1.6091-2 finally was promulgated September 16, 2004. Dingman's hand-delivered returns were submitted in early 2003 when the filing rules were obsolete.

Issues. The issues are as follows.

- Whether the hand-delivered returns were considered filed
- Whether Dingman was assessed within the required 3-year limitations period

Analysis. The package with the returns and checks was delivered no later than February 19, 2003 and was left with an individual with the authority to process the contents of the package. This is the date that the IRS actually deposited and credited the checks. Dingman established a prima facie case that the returns were filed no later than February 19, 2003. The IRS entered no evidence to the contrary. In addition, nothing in the Code or regulations indicates that the CID agents are not authorized to receive hand-delivered tax returns.

Holding. Dingman's returns were filed no later than February 19, 2003. The February 28, 2006 IRS assessment for additional tax was therefore outside the applicable limitations period.

IRS PROCEDURES — PAYMENTS

Income Tax Deficiencies
***William Perry v. Comm'r*, TC Memo 2010-219 (Oct. 7, 2010)**
IRC §§6213, 6651, and 6402

☞ Tax Court Allows Overpayment to Offset Prior-Year Deficiency

Facts. In August 2008, the IRS issued a notice of deficiency to William Perry, determining a $9,219 deficiency for Perry's 2002 federal income tax and additions of tax pursuant to IRC §6651. The IRS applied an overpayment of $4,416 from Perry's 2007 timely-filed return to offset part of the 2002 deficiency.

In November 2008, Perry filed a petition to contest the 2002 deficiency. He later filed a motion to enjoin the IRS from applying the 2007 overpayment to the 2002 deficiency and to order the IRS to refund the 2007 overpayment.

Issue. Whether the IRS violated restrictions on collection and assessment when it offset Perry's 2007 overpayment against his 2002 deficiency.

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Analysis. Perry asserts that IRC §6213(a) prohibits the IRS from engaging in collection activities, including offsets, during the period in which the taxpayer may petition the Tax Court (generally 90 days after the deficiency notice is mailed), or, if the taxpayer files a petition, until the Tax Court's decision becomes final. Because the offset occurred during the 90-day period in which the IRS was barred from collection activities, Perry argues that it violated §6213(a). Accordingly, Perry maintains that the court must order the IRS to refund the 2007 overpayment.

The IRS disputes that the offset violates §6213(a). An offset is not an assessment, a levy, or an in-court collection proceeding, the collection activities that are specifically barred by §6213(a). Furthermore, Treas. Reg. §301.6402-1 authorizes the IRS to offset an overpayment against any outstanding liability.

Although §6213(a) does not specifically prohibit offsets, Perry argued that the "underlying, fundamental principle" of the statute is that the IRS is prohibited from using any means of collecting a deficiency that a taxpayer may dispute in Tax Court during the 90-day period after the deficiency notice is mailed.

The Tax Court noted that §6213(a) limits the IRS's authority with respect to premature assessments, levies, and in-court collection proceedings. The parties to the case agree that the IRS did not **assess** the 2002 deficiency. An offset is also distinguishable from a **levy.** The court in *Sage* noted that "The Supreme Court has held that a levy is a means by which the Internal Revenue Service may acquire possession of a taxpayer's property…a 'set-off,' on the other hand, is the application of funds already in the government's possession against a taxpayer's outstanding tax liability."[58] Finally, an offset is not a **proceeding in court** for the collection of a deficiency but is rather an administrative "bookkeeping operation."[59]

Holding. The court held that the IRS did not violate §6213(a) and, accordingly, denied Perry's motion.

Note. In August 2007, the IRS issued Rev. Rul. 2007-51, which permitted the IRS to **offset refunds against unassessed liabilities.** The examples in the revenue ruling pertained only to corporations, and the Office of Chief Counsel advised Congress that it was only applying the ruling to corporations.[60] The *Perry* decision may indicate that the IRS has changed its mind.

IRS PROCEDURES — PENALTIES

Change in Accounting Method

***Ramesh and Pragati Bosamia v. Comm'r,* TC Memo 2010-218 (Oct. 7, 2010)**

IRC §§481 and 6501

☞ Adjustment Allowed to S Corporation's Deductions from Closed Years

Facts. Ramesh and Pragati Bosamia were the sole shareholders of India Music, Inc., and Houston-Rakhee Imports (HRI). Both these companies were S corporations.

India Music purchased most of its inventory from HRI on credit. India Music used the accrual method and thus included the yearly increase in the accounts payable to HRI in cost of goods sold. However, no payments were made from India Music to HRI in seven years. HRI used the cash method of accounting and reported no income from its sales to India Music for 1998–2004, the years at issue.

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58. *Sage v. U.S.,* 908 F.2d 18, 27 (5th Cir. 1990).

59. See *Fulgoni v. U.S.,* 23 Cl. Ct. 119, 126 (1991).

60. *Taxpayer Advocate Service 2008 Annual Report to Congress* [www.irs.gov/pub/irs-utl/08_tas_arc_legrec.pdf] Accessed on Oct. 19, 2010.

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In August 2008, the IRS issued a notice of deficiency to the Bosamias for their tax year 2004, determining that India Music was not entitled to claim cost of goods sold for 1998–2004 until the sales were included in HRI's income. At the time the notice of deficiency was issued, the IRS was barred from assessing income tax deficiencies for the Bosamia's 1998–2002 tax years because of the expiration of the 3-year statutory period for assessment under IRC §6501(a). However, the IRS made an IRC §481 adjustment of $877,581 to the Bosamia's 2004 income, which reflected India Music's total cost of goods sold claimed on their tax returns for 1998–2003. Accordingly, the IRS assessed a deficiency of $295,818 and a $59,163 accuracy-related penalty under IRC §6662(a) on the Bosamia's 2004 tax return.

Issue. Whether the IRS may make an adjustment under §481 to the Bosamia's income for 2004 that arises from closed years.

Analysis. IRC §481(a) allows adjustments to prevent duplications or omissions attributable to a change in the method of accounting initiated by the taxpayer. These adjustments may include amounts arising from taxable years for which assessment is barred by expiration of the statutory assessment period.[61]

The IRS contends that a change in method of accounting occurred in this case. The Tax Court agreed, citing Treas. Reg. §1.481-1(a)(1):

> *A change in method of accounting to which section 481 applies includes a change in the overall method of accounting for gross income or deductions, or a change in the treatment of a material item.*

Treas. Reg. §1.446-1(e)(2)(ii)(a) states:

> *A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction.*

The Tax Court previously indicated that a change to comply with the related party rules of IRC §267(a)(2) is a change in the treatment of a material item.[62] An adjustment under §267(a)(2) simply causes a delay or timing difference. However, the Bosamias argue that §267 preempts §481 and prevents a §481 adjustment attributable to closed years, citing *Tate & Lyle.*[63] The Tax Court disagreed, noting that the holding in *Tate & Lyle* does not refer to or consider §481. Thus, the case does not provide a basis for the Bosamia's argument that a §481 adjustment from a closed year is prohibited.

Holding. The court held that §481 applies and that the Bosamias are liable for the deficiency and the accuracy-related penalty.

Failure to File

***Daniel Callahan v. Comm'r,* TC Memo 2010-201 (Sep. 14, 2010)**

IRC §§1, 61, 6651, 6654, and 6673

☞ Frivolous Arguments Result in Penalties

Facts. In 2005, Daniel Callahan worked as an assistant supervisor and clinician for the Midwest College of Oriental Medicine in Racine, Wisconsin. This institution is owned by Acupuncture Center, Inc. (ACI). Callahan was paid $13,150 for his services, which was reported on a Form 1099-MISC. He has a B.S. degree in economics, a master's degree in industrial relations, a B.S. and master's degree in nutrition, and is working on a doctorate in nutrition. Although he is not an attorney, Callahan also has four years' experience as a municipal court judge in Sturtevant, Wisconsin.

Callahan did not file a tax return for 2005, nor did he pay any federal income tax or make estimated tax payments for the year. In February 2008, the IRS sent Callahan a notice of deficiency which set forth the IRS's determination of his deficiency in income taxes for 2005 and additions to tax under IRC §§6651 and 6654.

[61] *Graff Chevrolet Co. v. Campbell,* 343 F.2d 568, 572 (5th Cir. 1965); *Hamilton Indus., Inc. v. Comm'r,* 97 TC 120, 125 (1991).

[62] *Summit Sheet Metal Co. v. Comm'r,* TC Memo 1996-563 (Dec. 30, 1996).

[63] *Tate & Lyle, Inc. & Subs. v. Comm'r,* 87 F.3d 99 (3d Cir. 1996), *rev'g. and remanding* 103 TC 656 (1994).

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Issue. Whether payments received by Callahan in exchange for services are gross income subject to taxes.

Analysis. Callahan asserted that he is a citizen of the "Republic of Wisconsin" and not a citizen of the state of Wisconsin or of the United States. He therefore argued that he does not have to pay federal income taxes. This type of frivolous argument has been consistently rejected by courts.[64]

Callahan admitted that he was associated with ACI and was monetarily compensated for his services. However, he claims that the compensation he received during 2005 is not income for federal taxation purposes. Rather, he contends that his time and talent are a like-kind exchange for the money received, analogous to an exchange of property. The court disagreed and stated that the compensation he received is gross income under IRC §61(a).

The IRS contended that Callahan is liable for additions to tax for failure to file a return and failure to pay estimated income taxes under IRC §§6651(a)(1) and 6654(a), respectively. Although Callahan received a Form 1099-MISC from ACI, he did not file a tax return for 2005, nor did he offer a valid defense for his failure to file. Also, Callahan did not pay estimated taxes for 2005 but did not argue that any of the statutory exceptions to paying estimated taxes were applicable to his situation. Accordingly, the court sustained the additions to tax under §§6651(a)(1) and 6654(a).

IRC §6673(a)(1) authorizes the imposition of a penalty not to exceed $25,000 whenever the taxpayer initiates proceedings primarily for delay or if the taxpayer's position in the proceedings is frivolous or groundless. The court recognized that Callahan is a sophisticated person who holds advanced degrees and has experience as a municipal judge. He had previously made similar frivolous arguments before the court; as a result, a penalty of $1,500 was imposed under §6673(a).[65] On appeal, the 7th Circuit Court affirmed the Tax Court's decision and imposed a "presumptive" $4,000 sanction for filing a frivolous appeal. Therefore, the court in this case finds that Callahan was aware of the consequences of making frivolous arguments.

Holding. The Court sustained additions to tax under IRC §§6651(a)(1) and 6654(a) and assessed a $3,000 penalty under §6673(a).

Accuracy-Related Penalty

***Stephen G. Woodsum and Anne R. Lovett v. Comm'r,* 136 TC No. 29 (Jun. 13, 2011)**
IRC §§6662, 6664 and 6213

☞ Taxpayer Denied Relief from Accuracy-Related Penalty

Facts. Stephen Woodsum and his wife Anne Lovett hired an attorney to prepare their 2006 tax return. Mr. Woodsum was managing director of a private equity investment firm. **Over 160 information returns were provided to the attorney for inclusion on their return. However, one Form 1099 in the amount of $3.4 million was inadvertently omitted from the return. The return was 115 pages long and reported $29 million in income.**

The IRS assessed a $521,473 tax deficiency and imposed a $104,295 accuracy-related penalty on the $3.4 million in under-reported income.

Woodsum and Lovett paid the tax deficiency but challenged the imposition of the penalty because they claimed they relied on the advice of their return preparer.

Issue. Whether the taxpayers can rely on the advice of their return preparer to avoid the accuracy-related penalty.

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64. See *U.S. v. Hilgeford,* 7 F.3d 1340, 1342 (7th Cir. 1993); *U.S. v. Gerads,* 999 F.2d 1255, 1256 (8th Cir. 1993); *U.S. v. Sileven,* 985 F.2d 962 (8th Cir. 1993); *Bland-Barclay v. Comm'r,* TC Memo 2002-20 (Jan. 22, 2002); *Solomon v. Comm'r,* TC Memo 1993-509 (Nov. 3, 1993), *aff'd* without published opinion 42 F.3d 1391 (7th Cir. 1994).

65. *Callahan v. Comm'r,* TC Memo 2007-301 (Oct. 2, 2007), *aff'd* 334 Fed. Appx. 754 (7th Cir. 2009).

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Analysis. Under §6662, an accuracy-related penalty of 20% is imposed on underpayments resulting from a "substantial understatement" of income tax. A "substantial understatement" is one that exceeds the greater of $5,000 or 10% of the amount of tax required to be shown on the return. The taxpayers' understatement exceeded both of these amounts.

IRC §6664 provides that taxpayers may escape liability for the accuracy-related penalty by showing reasonable cause for the underpayment and that they acted in good faith. The couple attempted to show that they relied on the advice of their return preparer, a tax professional, to establish reasonable cause and good faith.

Holding. The court found that the omission of income from their return did not constitute "advice," but was rather a clerical error and concluded that the defense of reliance on professional advice was inapplicable. The court noted that an error by the return preparer could constitute a defense; however, the couple failed to explain the reason for the omission. The court also said that Woodsum and Lovett had a duty to review their return to make sure that all items of income were included, and they had failed to perform this duty.

The court refused to find that the omission of income was the result of reasonable cause and good faith but was instead due to lack of attention by the taxpayers.

Tax Protester

***Patricia Hyde v. Comm'r,* TC Memo 2011-104 (May 19, 2011)**
IRC §§6651, 6654, and 6673

☞ Hodgepodge of Frivolous Arguments Leads to Penalties

Facts. During 2006, Patricia Hyde worked as a consultant for Key Apparel Resources, Ltd., and Star of India Fashions, Inc., and was paid $92,500 for her services as an independent contractor. In 2006, Hyde also received a taxable distribution from an IRA, dividends, interest, and an income tax refund from the state of Arkansas. She did not dispute receiving these payments.

Hyde did not file a federal income tax return for 2006 and did not make estimated tax payments. The IRS prepared a substitute for return on her behalf. On the basis of that substitute for return, the IRS issued a notice of deficiency to Hyde on January 4, 2010. Attached to the notice was a Form 4549, *Income Tax Examination Changes,* which showed the IRS's calculation of Hyde's taxable income as $89,936.

Issues. The issues in this case include the following.

- Whether Hyde had unreported income in the amounts determined by the IRS
- Whether Hyde is liable for the 10% additional tax on early distributions from her IRA
- Whether Hyde is liable for SE tax on her earnings of nonemployee compensation
- Whether Hyde is liable for additions to tax under IRC §§6651(a)(2), 6654, and 6673

Analysis. Hyde advanced a number of claims at trial, which include the following.

- Hyde argued that the notice of deficiency is invalid because it was based on a substitute for return which she did not authorize.
- Hyde argued that the notice of deficiency is invalid because the substitute for return prepared by the IRS does not comply with the Paperwork Reduction Act of 1980.
- Hyde argued that she is not liable for federal income tax because the tax laws are incomprehensible to her.

The court called her arguments "A hodgepodge of frivolous and groundless claims that both this Court and the Eighth Circuit have consistently rejected."

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The IRS received third-party information which indicated that Hyde received a total of $104,921 in unreported income for 2006. Hyde did not produce any credible evidence to dispute the receipt of any of the income or to refute any of the additions to tax assessed against her.

Holding. The court ruled as follows.

- Hyde had unreported income in the amounts determined by the IRS.
- Hyde is liable for the 10% additional tax on an early distribution of $9,166 from an IRA.
- Hyde is liable for SE tax on the $92,500 of nonemployee compensation she received in her capacity as consultant.
- Hyde is liable for a failure to file penalty under §6651(a)(1).
- Hyde is liable for a failure to timely pay the tax due on a federal income tax return.
- Hyde is liable for an addition to tax under §6654 for underpayment of her estimated tax.
- Hyde is liable for a penalty of $3,000 under §6673 for asserting frivolous and groundless claims.

ITEMIZED DEDUCTIONS

Filing Status

***Von Argyle v. Comm'r,* U.S. Court of Appeals, 3rd Circuit, No. 10-1837 (Oct. 14, 2010)**

IRC §§7703, 6662, and 280A

☞ Separate Living Arrangement Does Not Confer Single Filing Status

Facts. In 2008, the IRS issued a notice of deficiency to Von Argyle, a CPA, for tax years 2004, 2005, and 2006, asserting deficiencies of $7,478, $3,606, and $10,607, respectively. The IRS also assessed the 20% accuracy-related penalty under IRC §6662(a) for each year. Argyle filed a petition in Tax Court contesting the notice. Argyle and the IRS entered into a stipulation as to some of the relevant facts and the case proceeded to trial on various tax issues. The Tax Court issued a decision in September 2009, concluding that Argyle had not carried his burden of proof on the factual issues and incorporating the IRS's post-trial computation of deficiencies in the amounts of $2,180, $1,384, and $10,154 for the respective tax years, plus penalties.

Argyle contested the Tax Court's decision that he was not entitled to single filing status. Argyle's wife filed for divorce in August 2004, but a divorce was not granted during the tax years at issue in this case. Argyle and his wife lived apart during these years.

Argyle also challenged the ruling that he could not deduct his legal expenses related to criminal proceedings for assault. A woman who worked for a client of Argyle filed a criminal complaint against him after he kissed her at his home. Argyle paid his defense attorney $12,500 in 2004, $25,000 in 2005, and $25,000 in 2006. Argyle deducted these fees as "legal and professional services" on his tax returns, along with an additional $10,000 in legal fees he claims he paid in 2005.

Issues. The issues in this case are as follows.

- Whether Argyle was entitled to claim single filing status
- Whether to allow his claimed deductions for legal fees

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Analysis. IRC §7703(a)(2) states that an individual legally separated from his spouse by a divorce decree or separate maintenance agreement is not considered married. The Tax Court concluded that Argyle was not entitled to single filing status due to the fact that he was neither divorced nor a party to a decree of separate maintenance, rejecting Argyle's contention that his "separate and apart" living status conferred single filing status. The appeals court agreed with the Tax Court.

Argyle maintained that his legal fees in the criminal proceeding were deductible because the woman who filed the complaint against him did so due to the fact that he had reprimanded her for employee misconduct in his client's business. He asserted that in the *Gilmore*[66] case, the court held that the test for deductibility is the origin and character of the legal claim for which the expense was incurred. The Tax Court concluded that Argyle failed to corroborate his claim that the woman engaged in misconduct. **The evidence established that the legal fees arose out of a personal relationship and were not deductible business expenses.** The appeals court agreed with the Tax Court's conclusion.

Additionally, Argyle also challenged the Tax Court's conclusion that he took other improper business expense deductions. However, he did not present evidence to demonstrate that the Tax Court erred as to their findings.

Holding. The appeals court affirmed the judgment of the Tax Court on all issues.

Mortgage Interest Deduction

Judith Ann Wheeler v. Comm'r, **TC Summ. Op. 2011-83 (Jul. 6, 2011)**
IRC §163

☞ Taxpayer Denied Mortgage Interest Deduction for Interest Paid on Boyfriend's Home Mortgage

Facts. During the period at issue in this case, Julie Ann Wheeler lived with her boyfriend, Adam Beeman, in a home owned by Beeman. Beeman purchased the home and was solely liable for the mortgage on the property. Wheeler moved in with Beeman in 2003 and agreed she would pay half of the monthly mortgage payment. Her payment went directly to Beeman and not to the mortgage lender.

In 2004, Beeman quit his job and went back to school. Wheeler agreed to assume more responsibility for payment of the mortgage and the couple's other bills. In 2006, Wheeler and Beeman had a child together. It was agreed Beeman would become a stay-at-home father and Wheeler would furnish the money to support the family.

Renovations were made to the house during the time Wheeler and Beeman lived together. During 2007, Wheeler became concerned that she had no interest in the home if she and Wheeler "split-up" or the house was sold, even though she was making the payments. At that time, Wheeler's name was added to the deed and the mortgage.

The IRS issued a notice of deficiency to Wheeler for her 2007 income tax return and denied her deduction for principal residence interest paid prior to the time that her name was added to the mortgage.

Issue. Whether Wheeler is entitled to deduct home mortgage interest **prior to** the time that she acquired title and became liable on the mortgage.

Analysis. In order to claim a deduction for home mortgage interest, the taxpayer must be obligated to pay the interest. **In Massachusetts, the conveyance of land must be in writing. There was no written document showing a transfer of ownership until Wheeler's name was entered on the property title.**

Holding. Because Wheeler's name was not on the mortgage until late in 2007, the interest was Beeman's obligation, not Wheeler's. **Any verbal understanding between Wheeler and Beeman was not legally binding under Massachusetts law until her name was entered on the deed.**

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66. *U.S. v. Gilmore,* 372 U.S. 39, 49 (1963).

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NOT FOR PROFIT

Hobby Loss
Shawn C. and David L. Blanchette v. Comm'r, **TC Summ. Op. 2011-15 (Feb. 17, 2011)**
IRC §§1, 183, 162, and 212

☞ Science Fiction Memorabilia Business Lacked Profit Motive

Facts. David and Shawn Blanchette filed a joint return for 2005, 2006, and 2007. The returns reported David's wages of $77,145, $82,925, and $86,238 for the respective years. The three returns also reported Schedule C losses from Shawn's business.

Shawn Blanchette has been an avid reader of science fiction since 1976. Her passion for science fiction grew steadily over the years, and she was a collector of science fiction memorabilia for over 20 years.

In 1992, Ms. Blanchette formed and operated a retail store in Santa Clara, California, named A Wrinkle in Time (AWIT). She worked at her store 14 hours per day, 7 days per week. Ms. Blanchette aggressively promoted AWIT with newspaper advertisements and at science fiction conventions. In 1993, she adopted a business plan to transform AWIT into a partnership that could more effectively penetrate the science fiction memorabilia market, but she never executed that plan. Despite her efforts, AWIT generated losses from 1992 to 1995.

Ms. Blanchette relocated to Sunnyvale, California in 1996. She operated AWIT as a retail store there until 2001. Ms. Blanchette also developed a website to sell her collection to online customers during this time. She continued to incur losses from 1996 through 2001.

Ms. Blanchette relocated to Las Vegas, Nevada in 2001. She sold science fiction memorabilia mostly online and at conventions from 2002 through 2005. During that time, she rented warehouse space to store her collection and she would sometimes show that collection to potential customers. Ms. Blanchette continued to incur losses from 2002 through 2005.

For 2005, 2006, and 2007, Ms. Blanchette valued her collection at $279,369, $294,166, and $299,560, respectively. She did not insure her collection.

The Blanchettes claimed losses from the collectibles activity on Schedule C, *Profit or Loss From Business,* as listed in the following table.

	2005	2006	2007
Gross receipts	$78,094	$82,428	$89,525
Cost of goods sold	(57,097)	(49,526)	(57,718)
Other income	283	0	0
Gross income	$21,280	$32,902	$31,807
Operating expenses	(47,577)	(48,683)	(59,881)
Income/loss	($26,297)	($15,781)	($28,074)

The IRS issued a notice of deficiency to the Blanchettes on January 22, 2009, disallowing their Schedule C expenses for 2005, 2006, and 2007. The IRS determined that the Schedule C expenses were not allowable as trade or business expenses because the Blanchettes did not establish that AWIT was a business venture entered into for profit.

Issue. Whether Ms. Blanchette's activity of selling science fiction memorabilia was an activity not engaged in for profit under IRC §183.

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Analysis. The courts utilize a 9-factor analysis in hobby loss cases in accordance with Treas. Reg. §1.183-2(b). In the court's opinion, the following six factors weighed in the IRS's favor.

1. **Manner in which the activity is conducted.** Ms. Blanchette did not conduct the activity in a businesslike manner. No accounting records were prepared that would indicate an intention to improve her bottom line, and inventory continued to increase without regard for the repeated losses.
2. **Expectation that assets will appreciate in value.** Ms. Blanchette did not insure her collection, indicating that she was not concerned about protecting her investment.
3. **Activity's history of income/losses.** Ms. Blanchette incurred continued losses beyond the activity's startup phase. This generally demonstrates the absence of a profit objective.
4. **Amounts of occasional profits.** Between 1992 and 2007, Ms. Blanchette failed to realize a profit on her collectibles activity.
5. **Taxpayer's financial status.** Mr. Blanchette earned a steady salary as a software engineer on which he and Ms. Blanchette subsisted. His salary enabled Ms. Blanchette to continue to pursue her longtime passion while the reported losses were used to reduce their taxable income.
6. **Elements of personal pleasure.** The small profit potential and significant satisfaction that Ms. Blanchette derived from the collectibles activity indicates that it is her quest for personal gratification rather than any bona fide profit objective that keeps her going.

The court found the following three factors were neutral.

7. **Taxpayer's expertise.** Ms. Blanchette consulted with other science fiction memorabilia collectors about her activity but failed to consult with accountants, lawyers, or business advisors.
8. **Taxpayer's time and effort.** Ms. Blanchette devoted significant personal time and effort to the collection activity; however, she also had substantial personal or recreational motivations for doing so.
9. **Taxpayer's success in similar activities.** No evidence was offered regarding Ms. Blanchette's success in comparable activities.

Holding. The court concluded that Ms. Blanchette did not pursue her collectibles activity during the subject years with a predominant profit objective. Therefore, §183 limits the allowable deductions to the amount of gross income generated from the activity.

Hobby Loss

Ronald Zenzen v. Comm'r, **TC Memo 2011-167 (Jul. 12, 2011)**

IRC §§183, 162, and 212

☞ Drag Racing Activities Not Operated for Profit

Facts. Ronald Zenzen worked full time as a mechanic. For over 40 years, he was involved in drag racing. During the 2005, 2006, and 2007 tax years, Zenzen spent $117,660 on various cars, engines, maintenance, and related expenses for drag racing. His total income over the three years, in the form of cash prizes, amounted to $2,150.

During the racing season, Zenzen and his children spent 30 hours per week preparing the cars for races in addition to the time he spent on racing activities during the weekends. Off season, he spent approximately 20 hours per week working on the cars with his children.

Zenzen did not have a business plan, nor did he keep a general ledger or a separate bank account for the drag racing activity. He never spoke with a business advisor about ways to make a profit. Zenzen only saved receipts for his expenses.

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Zenzen claimed his drag racing expenses as business expenses on Schedules C for 2005, 2006, and 2007. On audit, the IRS disallowed those expenses, contending that the drag racing operation was not a business engaged in for profit.

Issue. Whether Zenzen's drag racing operation was an activity engaged in for profit.

Analysis. Treas. Reg. §1.183-2(b) provides a list of factors to be considered in determining whether an activity is engaged in for profit. No single factor or set of factors is controlling. These factors are as follows.

1. **Manner in which the taxpayer carried on the business.** Zenzen did not keep books and records and did not maintain a budget or make forecasts. Records did not exist that would be necessary to make informed business decisions.
2. **Expertise of the taxpayer or advisors with regard to economic aspects of the operation**. While Zenzen had 40 years of drag racing experience, he has not demonstrated that he has any expertise in how to make a profit from this activity. He did not consult any advisor.
3. **Time and effort spent on the activity.** Zenzen spent much time with the activity but received significant personal enjoyment from it. Prior to characterizing the operation as a business, it was a hobby for over 30 years.
4. **Expectation that assets may appreciate in value.** Zenzen sold one car at a profit, but this is not sufficient to conclude that the entire operation was engaged in for profit. Selling this car is not attributable to Zenzen's success in drag racing.
5. **Success of taxpayer in other activities.** Zenzen has not demonstrated success in other activities. Instead, he was employed full time as a mechanic.
6. **Taxpayer's history of income or losses.** Zenzen received only $2,150 in award income but incurred $117,660 in expenses during 2005, 2006, and 2007. It appears there was no objective to realize a profit and it is highly unlikely he will recoup his losses.
7. **Amount of occasional profits.** Other than the small cash awards, Zenzen's operation produced no income.
8. **Financial status of the taxpayer.** Zenzen worked full time as a mechanic, which placed him in a financial position to operate the drag racing activity as a hobby.
9. **Elements of personal pleasure.** Zenzen enjoys the activity and the time he spends with his children on it.

Holding. Application of the factors in Treas. Reg. §1.183-2(b) indicates that the taxpayer's drag racing activity is not engaged in for profit. The IRS rightfully denied his expense deductions.

Gambling Expenses

***Randy L. Moore v. Comm'r,* TC Memo 2011-173 (Jul. 18, 2011)**

IRC §§162, 165, 183, and 6662

☞ X-Ray Technician Not a Professional Gambler

Facts. In 2006, Randy Moore was a traveling x-ray technician. He worked 40 hours per week and earned $63,619 from three different employers.

Moore started gambling in 2002 and continued through 2006, primarily playing the slot machines. He gambled frequently in 2006 but did not keep a schedule of his casino visits, nor did he keep records of his gambling transactions. Accordingly, the only documentation of Moore's gambling activities for 2006 are the Forms W-2G, *Certain Gambling Winnings,* that were issued to him by two casinos. The 12 Forms W-2G show gross gambling winnings of $25,534 for 2006.

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On his 2006 tax return, Moore attached a Schedule C on which he stated that his principal business was "pro gambling," from which he earned $25,534 of gambling income and incurred $40,989 of gambling expenses, which includes the following.

Car and truck	$ 5,340
Rent or lease	1,500
Supplies	300
Travel	1,900
Meals and entertainment	5,475
Utilities	840
Other: bad debt	25,634
Total	$40,989

The IRS issued a notice of deficiency to Moore for the 2006 tax year. The IRS later conceded that Moore can deduct $25,534 of his expenses as "wagering losses" under IRC §165(d). However, the IRS contends that Moore was not a professional gambler and that the $25,534 deduction for wagering losses should be an itemized deduction, not a business-expense deduction. They also contend that the remaining $15,455 of gambling expenses is not deductible.

Issues. The issues in this case are as follows.

- Whether Moore was a professional gambler in 2006
- Whether Moore is liable for the IRC §6662(a) accuracy-related penalty

Analysis. Moore's gambling expenses can be divided into two categories: wagering losses and nonwagering losses. Wagering losses are deductible only to the extent of wagering gains.[67] This restriction applies to professional gamblers as well as nonprofessional gamblers.[68] Gambling expenses other than wagering losses are not subject to the restriction and are deductible if the taxpayer is a professional gambler.[69]

A taxpayer must have engaged in gambling for profit in order to be a professional gambler.[70] Treas. Reg. §1.183-2(b) lists **nine factors** used to determine whether a taxpayer had a profit motive. These factors are as follows.

1. **Manner in which the taxpayer carries on the activity.** Moore did not maintain records of his gambling transactions or attempt to improve his profitability, thus indicating he did not carry on his gambling activity in a businesslike manner.
2. **The expertise of the taxpayer or his advisors.** Moore did not study gambling or consult experts in preparation for his casino visits.
3. **The time and effort expended by the taxpayer in carrying on the activity.** Moore's primary activity was working full-time as an x-ray technician. The time he devoted to gambling depended on his work schedule as an x-ray technician.
4. **Expectation that assets used in the activity may appreciate in value.** This factor is irrelevant in Moore's case.
5. **The success of the taxpayer in carrying on other similar or dissimilar activities.** Moore had no history of success with business activities that paved the way for success as a gambler.

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67. IRC §165(d).

68. *Mayo v. Comm'r,* 136 TC 81, 90 (2011).

69. IRC §162(a).

70. IRC §§183(a), (b), and (c).

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6. **The taxpayer's history of income or losses with respect to the activity.** Gambling was never a profitable activity for Moore.

7. **The amount of occasional profits, if any, which are earned.** Moore's gambling was never profitable.

8. **The financial status of the taxpayer.** Moore derived the bulk of his income from his work as an x-ray technician.

9. **Elements of personal pleasure or recreation.** Moore's gambling involved elements of personal pleasure and recreation.

An analysis of the above factors supports the conclusion that Moore did not engage in gambling for profit. Because he was not a professional gambler in 2006, he cannot deduct $15,455 of his claimed gambling expenses. Moore is entitled to a $25,534 deduction for wagering losses, but it must be classified as an itemized deduction rather than a business expense.

Holding. The court held that Moore was not a professional gambler. He is liable for a §6662(a) accuracy-related penalty for substantial understatement of income tax because he lacked reasonable cause and good faith for claiming to be a professional gambler.

PARTNERSHIPS

Special Allocations and Self-Employment Tax

***Renkemeyer, Campbell & Weaver LLP v. Comm'r,* 136 TC No. 7 (Feb. 9, 2011)**
IRC §§701, 704, 1401, 1402, and 702

☞ Special Allocation of Income Disallowed/Net Income Subject to SE Tax

Facts. A Kansas law firm was owned by four partners: three attorneys and a Kansas corporation that was owned entirely by an employee stock ownership plan (ESOP). The beneficiaries of the ESOP were the three attorney partners.

On the partnership tax return for 2004, the firm claimed the three attorney partners had profits and loss interests of 30% each, and the corporation had a 10% interest. The three partners held a one-third capital interest each, while the corporation held no capital interest. However, of the $1.6 million in gross revenue earned by the firm, over 87% was allocated to the corporation and, of the earnings allocated to the individual partners, none were reported as net earnings from self-employment.

The IRS examined the law firm's tax return for the 2004 tax year. It concluded that the partners' distributive shares of the business income should be reallocated consistent with the profit and loss sharing percentages. The IRS also determined that the attorneys' shares of the business income were subject to SE tax.

Issues. The issues in this case are as follows.

- Whether the firm can specially allocate partnership income
- Whether the firm can exclude the net income of individual partners from SE taxes

Analysis. Under Treas. Reg. §1.704-1(b)(3)(i), partners' interests in a partnership are presumed to be equal on a per capita basis unless facts and circumstances show otherwise.

The law firm claimed the special allocation of income to the corporation was based on a partnership agreement. However, they never produced an agreement for the 2004 tax year.

The firm also argued that the attorney partners were excepted from SE taxes under IRC §1402(a)(13). IRC §1402(a)(13) exempts from SE tax the net income allocated to limited partners of a partnership.

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Holding. The court determined that the firm's assertion that the missing partnership agreement provides for a special allocation was insufficient to prove the propriety of a special allocation. The court held that the proper allocation of the firm's net business income should be based on the partners' respective interests in the partnership, taking all facts and circumstances into consideration. Considering all the available facts, the income was reallocated based on the profit and loss interests of the partners.

The court rejected the firm's argument that the individual partners were exempt from SE taxes. The judge stated that the legislative history of §1402(a)(13) "does not support a holding that Congress contemplated excluding partners who performed services for a partnership in the capacity as partners…from liability for SE taxes." The court held that because nearly all the income generated by the firm was through legal services provided by the attorney partners, the individual partners were liable for SE taxes.

PASSIVE ACTIVITIES

Grouping Rental Real Estate Activities

Rev. Proc. 2011-34, IRB 2011-24 (May 26, 2011)
IRC §469

☞ **Some Taxpayers May Make Late Election to Group Real Estate Activities**

Purpose. This revenue procedure provides guidance allowing certain taxpayers to make late elections to treat all interests in rental real estate as a single rental real estate activity.

Analysis. Prior to Rev. Proc. 2011-34, a taxpayer was required to obtain permission from the IRS through a letter ruling if they wanted to make a late election under Treas. Reg. §1.469-9(g) to group passive real estate activities in order to meet the material participation test. A user fee was required to file for the letter ruling.

Unless the grouping election is made, a taxpayer's interests in real estate activities are treated as separate activities for purposes of determining whether the taxpayer materially participates in each rental real estate activity.

Specific requirements are necessary to utilize Rev. Proc. 2011-34 when making a late election. The taxpayer must indicate on a statement attached to the return that they meet all the following requirements.

1. The taxpayer failed to make the election solely because they failed to timely meet the requirements of Treas. Reg. §1.469-9(g).
2. The taxpayer filed consistently with having made an election under Treas. Reg. §1.469-9(g) on any return that would have been affected if they had timely made the election.
3. The taxpayer timely filed each return that would have been affected by the election if it had been timely made. The returns were filed within six months after the due date, excluding extensions.
4. The taxpayer has reasonable cause for the failure to meet the requirements of Treas. Reg. §1.469-9(g).

The taxpayer must complete the statement and attach it to an amended return for the most recent year. The amended return must be mailed to the IRS service center where the taxpayer files the current year tax return. The statement must identify the taxable year for the election and indicate on the top of the return, "FILED PURSUANT TO REV. PROC. 2011-34."

The taxpayer must also attach a dated and signed declaration.

The IRS will notify the taxpayer upon receipt of the completed application. If the application is accepted, the taxpayer is treated as if all real estate activities are a single activity.

Effective Date. This revenue procedure is effective for all rulings pending in the national office on June 13, 2011. The user fee on pending requests will be refunded.

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Passive Activity Losses

Todd Bailey, Jr. and Pamela Bailey v. Comm'r, **TC Summ. Op. 2011-22 (Mar. 2, 2011)**

IRC §469

☞ Taxpayer Did Not Qualify as a Real Estate Professional

Facts. During 2004, Todd Bailey worked as an emergency room doctor and had no involvement in rental real estate activities. His wife, Pamela Bailey, managed four rental properties that the couple jointly owned. The facts relating to the four rental property activities in 2004 are summarized in the following table.

Description of Property	Number of Material Participation Hours Spent by Pamela in 2004	Net Rental Income	Where Reported on 2004 Tax Return
Alisal Road Inn	324	($20,683)	Schedule C
Total for Schedule C	**324**	**($20,683)**	
Single-family home	358	($17,167)	Schedule E
Single-family home	24	345	Schedule E
Single-family home	105	0	N/A
Total for Schedule E	**487**	**($16,822)**	

In addition to the 487 hours Mrs. Bailey devoted to the three single-family homes, she spent 192 hours during 2004 researching potential acquisitions of other single-family homes. **In total, she spent 679 hours during 2004 on Schedule E rental activities.** The 679 hours does **not** include the 324 hours she spent managing the Alisal Road Inn property, which was reported on Schedule C.

The IRS examined the Bailey's 2004 joint tax return and allowed the $20,683 Schedule C loss for the Alisal Road Inn. The Inn was rented for **short-term rentals** during 2004, usually for about three days at a time. Mrs. Bailey did not employ a management company. Instead, she operated the Inn herself.

The IRS disallowed the $16,822 Schedule E rental loss under the passive activity loss rules of IRC §469. **The IRS determined that Mrs. Bailey did not qualify as a real estate professional under §469(c)(7) because she did not meet the 750-hour test for 2004.**

The taxpayers had previously made the election under §469(c)(7)(A) to treat all of their rental properties as one activity. Therefore, the 750-hour test did not apply separately to each rental property owned by the taxpayers.

Issue. Whether the taxpayers are entitled to deduct the net Schedule E rental loss of $16,822.

Analysis. A passive activity is any trade or business in which the taxpayer does not materially participate.[71] A rental activity is generally treated as a passive activity regardless of whether the taxpayer materially participates.[72]

There are **two main exceptions** to the general rule that rental activities are passive activities. The first exception applies to rental real estate activities in which the individual **actively participates** in the activity during the year.[73] The Baileys did not qualify for this $25,000 special allowance because their 2004 AGI exceeded the $150,000 phaseout ceiling.

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71. IRC §469(c)(1).

72. IRC §469(c)(2).

73. IRC §469(i)(1).

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The other exception is the one in question. Rental activities of a **real estate professional** are not considered passive activities.[74] To qualify as a real estate professional, a taxpayer must satisfy both of the following requirements.

- More than half of the personal services performed in trades or businesses by the taxpayer during the year are performed in real property trades or businesses in which the taxpayer materially participates.

Note. The IRS agreed that Mrs. Bailey satisfied this first requirement of material participation.

- The taxpayer performs **more than 750 hours** of services during the year in real property trades or businesses in which the taxpayer materially participates.[75]

The IRS determined that the Alisal Road Inn was **not** a real property trade or business for purposes of the 750-hour test. A Treasury regulation provides that an activity involving the use of tangible property is **not** a rental activity if, among other reasons, **"the average period of customer use for such property is seven days or less" during the year.**[76]

Holding. The Tax Court agreed with the IRS's position. Therefore, Mrs. Bailey spent only **679 hours** on all of her Schedule E rental real estate activities during 2004. **She was not allowed to use the 324 hours she worked at the Alisal Road Inn in meeting the 750-hour test for real estate professionals.**

As a result, she failed the 750-hour requirement and did not qualify as a real estate professional. The court sustained the IRS disallowance of the $16,822 Schedule E rental loss.

Note. This case illustrates the importance of accurate hourly recordkeeping by taxpayers who claim to meet the real estate professional exception to the general rule for passive activity losses. Mrs. Bailey did not maintain an hourly log for 2004. However, the court allowed her to reconstruct her hours based on corroborating documents.

Real Estate Rental Loss Deduction

***Yusufu Anyika and Cecelia Francis-Anyika v. Comm'r,* TC Memo 2011-69 (Mar. 24, 2011)**
IRC §§469 and 6662

☞ Taxpayer Fails to Meet Real Estate Professional Qualifications

Facts. Yusufu Anyika and Cecelia Francis-Anyika (taxpayers) filed joint returns for 2005 and 2006. Mr. Anyika is employed full-time as an engineer; this job requires him to work 1,800 hours annually. Ms. Francis-Anyika works part-time as a nurse. The taxpayers' reported wage income in 2005 was $133,117. Their reported wage income for 2006 was greater than $167,630.

Since 1990, Mr. Anyika has renovated, managed, and sold rental property. He views his rental activity as a second job and an investment.

For the 2005 and 2006 tax years, the taxpayers deducted rental real estate losses of $23,551 and $15,265, respectively. The IRS disallowed all but $5,428 of the 2005 loss and all of the 2006 loss. Notices of deficiency for the resulting unpaid tax were issued to the taxpayers.

Mr. Anyika contends that he qualified as a real estate professional under the passive activity rules. The IRS contends that he does not qualify and that the notices of deficiency were appropriate and so were penalties for substantial understatement and negligence.

74. IRC §469(c)(7)(A).

75. IRC §469(c)(7)(B).

76. Temp. Treas. Reg. §1.469-1T(e)(3)(ii)(A).

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Issues. The main issues in this case are as follows.

- Whether Mr. Anyika is a real estate professional
- Whether the taxpayers are entitled to deduct rental losses for 2005 and 2006
- Whether the assessed penalties are appropriate

Analysis. IRC §469 disallows any passive activity loss, which includes losses from real estate rentals. An exception exists for real estate professionals with material participation. The court explained to Mr. Anyika that, in order to qualify as a real estate professional, he would need to have spent more hours engaged in managing his rental properties than the 1,800 hours he worked as an employee. Mr. Anyika then asserted that he worked 1,920 hours managing the properties, in contradiction to his previous signed statement that he spent 800 hours for the year managing his properties. The court did not find the taxpayer's testimony on this point credible.

Even if a taxpayer does not qualify as a real estate professional, **the taxpayer can still deduct up to $25,000 of real estate losses per year if the taxpayer actively participates in the rental activity. Active participation** requires participation in managing the rental properties in a significant and bona fide sense. The $25,000 deduction is reduced by 50% of the taxpayer's income that exceeds $100,000. Once income reaches $150,000, the deduction is reduced to zero.

The IRS assessed penalties under IRC §6662 for 2005 and 2006, based on substantial understatement of tax and negligence. The taxpayers did not argue that they had substantial authority for their position that Mr. Anyika met the qualifications of a real estate professional or that they made adequate disclosure of their position. **He did not document the number of hours spent managing the property. A reasonable person in his position would have consulted a tax professional instead of making an assumption that the real estate professional qualifications were met.**

Holding. Mr. Anyika did not meet the qualifications of a real estate professional but did actively participate and could deduct up to $25,000 of rental losses per year. The adjustments made by the IRS reflected the limitations on the taxpayers for income in excess of $100,000 in 2005 and 2006. The penalties for substantial understatement and negligence were appropriate given taxpayer's conduct.

RESIDENCES

Qualified Residence Interest

Rev. Rul. 2010-25, IRB 2010-44 (Oct. 14, 2010)
IRC §163

☞ Taxpayers Allowed to Deduct on up to $1.1 Million of Mortgage Indebtedness Interest

Purpose. This revenue ruling provides guidance as to whether indebtedness incurred by a taxpayer to acquire, construct, or substantially improve a qualified residence can constitute home equity indebtedness to the extent it exceeds $1 million.

Analysis. There are two types of qualified residence interest under IRC §163(h)(3)(A). The first is **acquisition indebtedness** which is defined as any indebtedness incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer and that is secured by the residence.[77] Acquisition indebtedness is limited to $1 million ($500,000 for MFS taxpayers).[78] The second type is **home equity indebtedness,** which is any indebtedness, other than acquisition indebtedness, secured by a qualified residence. It is limited to the FMV of the qualified residence, reduced by the amount of acquisition indebtedness, up to a maximum of $100,000 ($50,000 for MFS taxpayers).[79]

77. IRC §163(h)(3)(B)(i).

78. IRC §163(h)(3)(B)(ii).

79. IRC §163(h)(3)(C).

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In the scenario presented in this revenue ruling, an unmarried taxpayer purchased a principal residence for its FMV of $1.5 million. The taxpayer paid $300,000 and financed the remaining $1.2 million through a loan secured by the residence.

The IRS asserts that the taxpayer may deduct interest on $1 million as acquisition indebtedness. The taxpayer may also deduct, as home equity indebtedness, interest paid during the tax year on $100,000 of the remaining indebtedness of $200,000. The $200,000 is secured by the principal residence, is not acquisition indebtedness,[80] and does not exceed the FMV of the residence reduced by the acquisition indebtedness. Therefore, $100,000 is treated as home equity indebtedness.

The revenue ruling discusses two Tax Court decisions on this issue. In *Pau,*[81] the Tax Court limited the taxpayers' deduction for qualified residence interest to the interest paid on $1 million of the $1.33 million indebtedness incurred to purchase their residence. The court stated that the taxpayers in this case failed to demonstrate that any of their debt was not incurred in acquiring, constructing, or substantially improving their residence and thus was not acquisition indebtedness. The Tax Court followed the *Pau* ruling in *Catalano.*[82]

The IRS will not follow the decisions in *Pau* and *Catalano.* The revenue ruling states that *Pau* was based on the incorrect assertion that taxpayers must demonstrate that debt treated as home equity indebtedness was not incurred in acquiring, constructing, or substantially improving their residence. However, there are no such restrictions in §163(h)(3)(C); accordingly, the IRS will determine home equity indebtedness consistent with the provisions of this revenue ruling.

RETIREMENT

Excess Contributions to Roth IRA

Robert K. and Joan L. Paschall v. Comm'r, **137 TC No. 2, (Jul. 5, 2011)**
IRC §§4973, 6651, and 408A

☞ Taxpayer Liable for Excise Tax and Penalties on Excess Contributions to Roth IRA

Facts. In 2000, Robert Paschall was introduced to Stover, a partner in the accounting firm of Grant Thornton LLP, who was promoting a "Roth restructure" transaction. Stover made a presentation to Paschall, explained how the Roth restructure worked, that it would save him taxes, and that it was "completely compliant with the tax law at that time."

The Roth restructure transaction consisted of a conversion of a traditional IRA into a Roth IRA through the use of corporate formations, transfers, and mergers in an attempt to avoid taxes and disguise excess contributions to his Roth IRA. Even though Paschall did not fully understand the Roth restructure, he executed an engagement letter with Grant Thornton specifically for the restructure and paid a fee of $120,000. Stover orchestrated and oversaw all of the steps in the Roth restructure.

On April 28, 2000, almost $1.3 million was transferred from Paschall's traditional IRA into his Roth IRA. On his 2000 income tax return (which was prepared by Stover's accounting firm), no tax was paid on the transfer, nor was a Form 5329, *Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts,* included with the return.

In September 2001, Stover left Grant Thornton for the accounting firm of Kruse Mennillo, LLP. Paschall followed Stover to his new firm where his 2002 through 2006 individual income tax returns were prepared. None of the tax returns for these years included a Form 5329.

80. By definition, any indebtedness described in §163(h)(3)(B)(i) in excess of $1 million is not acquisition indebtedness.

81. *Pau v. Comm'r,* TC Memo 1997-43 (Jan. 27, 1997).

82. *Catalano v. Comm'r,* TC Memo 2000-82 (Mar. 9, 2000).

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In 2003 or 2004, Grant Thornton LLP advised Paschall that it was turning over to the IRS the names of individuals who participated in Roth restructures.

In 2008, the IRS issued Paschall notices of deficiency for 2002 through 2006, finding him liable for a 6% excise tax for excess contributions to a Roth IRA. In addition, the IRS assessed a 25% penalty on the amount of excise tax for failure to file Form 5329 for each year.

Issues. The issues in this case are as follows.

- Whether Paschall is liable for excise taxes on excess contributions to his Roth IRA
- Whether Paschall is liable for additions to tax for failure to file Form 5329

Analysis. IRC §4973 imposes an excise tax of 6% for excess contributions to Roth IRAs, which must be reported and disclosed on Form 5329. Excess contributions are calculated on the lesser of the amount of the excess contribution or the FMV of the account at the end of the taxable year, for each year until the excess contribution plus earnings is eliminated.

IRC §6651(a)(1) provides that, in the case of a failure to timely file any return required under §6011(a), a penalty may be imposed. The penalty is 5% of the tax required to be shown on the return for each month (or fracture thereof) for which there is a failure to file, not to exceed 25% in the aggregate.

Holding. The court held that Paschall made excess contributions to a Roth IRA and was required to file Form 5329 for each year that he had an excess contribution. Because Paschall **did not file a Form 5329** with his individual income tax returns, the statute of limitations for the excise tax had not begun to run. Therefore**, all years were subject to the 6% excise tax.** In addition, the **penalty for the failure to file Form 5329** was upheld.

Annuity Payments

Ltr. Rul. 201120011 (Feb. 11, 2011)
IRC §§72 and 816

☞ Constant Percentage Increase Option Negates Substantially Equal Periodic Payments Classification

Facts. Two insurance companies plan to issue nonqualified single premium immediate annuity contracts. These contracts are available in several different options that are payable for a single life or for joint lives. An acceleration feature and cash withdrawal feature are also available if the contract owner is under age 59½. Option U allows an owner to elect at the time of issuance to have fixed annuity payments increase annually over the contract life by a constant percentage (1, 2, 3, or 4%). If Option U is elected, would the payments qualify as "substantially equal periodic payments"?

Analysis. IRC §72(q)(2)(D) provides that a distribution is not subject to the 10% tax on early distributions if it is part of a series of substantially equal periodic payments made for the life (or life expectancy) of the taxpayer. IRS Notice 89-25,[83] provides that payments are considered substantially equal periodic payments if they are made according to one of three methods.

1. The required minimum distribution (RMD) method
2. The fixed amortization method
3. The fixed annuitization method

[83] IRS Notice 89-25, 1989-1 CB 662, as modified by Rev. Rul. 2002-62.

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Rev. Rul. 2002-62 describes the RMD method as follows.

> *The annual payment for each year is determined by dividing the account balance for that year by the number from the chosen life expectancy table for that year. Under this method, the account balance, the number from the chosen life expectancy table, and the resulting annual payments are redetermined for each year. If this method is chosen, there will not be deemed to be a modification in the series of substantially equal periodic payments, even if the amount of payments changes from year to year, provided there is not a change to another method of determining the payments.*

In contrast, the annual payments under the Option U contract would automatically increase by a fixed percentage each year rather than the distribution being recomputed each year.

The insurance companies also argued that the stream of payments would not fail to be substantially equal solely based on cost-of-living adjustments. Unfortunately, the series of payments under Option U does not vary based on cost-of-living adjustments.

Holding. Payments made under a single-premium immediate annuity contract that allows for increasing annual fixed annuity payments are not substantially equal periodic payments.

Early Distributions
***Simeon and Cynthia Isaacs v. Comm'r,* TC Memo 2011-175 (Jul. 25, 2011)**
IRC §§6662, 6651, and 72(t)

☞ Podiatrist's Depression Does Not Meet Disability Exception for Early Distribution Penalty

Facts. Simeon Isaacs graduated in 1978 from Temple University with a doctorate in podiatric medicine. In 1980, Dr. Isaacs opened a podiatry business in New Orleans, Louisiana. He earned a law degree in 1991 and continued to operate his podiatry business until 1997.

In 2001, Dr. Isaacs purchased National Candy & Toy, where he worked 35 hours per week in 2003. From 2003 to 2005, Dr. Isaacs ran 24 Karat Systems, Inc., an Internet company that sold various household supplies and videotapes. He was also a partner in Greatest Hits, LLC, and Credit Consulting. Recently, Dr. Isaacs purchased a pain management clinic, where he acts as the company's registered agent, officer, president, and director.

In the six months before he left the podiatry business, Dr. Isaacs suffered from depression. He saw a psychiatrist, who told him to stop practicing podiatry because of its effect on his mental health. In 2003, Dr. Isaacs attempted suicide and was hospitalized for one week.

In 2003, Dr. Isaacs received a total of $507,294 from his qualified retirement accounts. In 2005, he received an additional $8,000 from his qualified retirement account. In each year, he received Forms 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* for the distributions. None of the Forms 1099-R indicated that the respective distribution was nontaxable.

In January 2009, the IRS mailed notices of deficiency for 2003 and 2005 to Dr. and Mrs. Isaacs, imposing the 10% additional tax under IRC §72(t) for the distributions from Dr. Isaacs' qualified retirement plans.

Issue. Whether Dr. Isaacs is liable for the 10% additional tax under §72(t) for early distributions from qualified retirement plans.

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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 statutory exceptions under §72(t)(2). Dr. Isaacs asserted that he qualifies for one of the exceptions, which provides that the 10% additional tax does not apply to a distribution "attributable to the employee's being disabled within the meaning of subsection (m)(7)."[84] IRC §72(m)(7) provides that:

> *An individual shall be considered to be disabled if 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. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary may require.*

Treas. Reg. §1.72-17A(f)(2) provides a list of examples of impairments that are considered to prevent substantial gainful activity. The only example relevant to Dr. Isaacs provides that substantial gainful activity would ordinarily be precluded in the case of "Mental diseases…requiring continued institutionalization or constant supervision of the individual."[85]

Dr. Isaacs sees a psychiatrist once every three months. However, he does not require institutionalization or constant supervision. Additionally, he engaged in substantial gainful activity during the years at issue and continues to do so through various business ventures.

Holding. The court held that there was no evidence to conclude that Dr. Isaacs was disabled within the meaning of §72(m)(7). Thus, he is liable for the 10% additional tax under §72(t) for early distributions from qualified retirement plans.

S CORPORATIONS

Reasonable Compensation

***David E. Watson PC v. U.S.*, No. 4:08-cv-00442; U.S. District Court for the Southern District of Iowa (Dec. 23, 2010)**
IRC §§3111 and 3121

☞ Unreasonable Salary Paid to S Corporation's Sole Shareholder

Facts. David Watson became a CPA in 1983 and received a master's degree in taxation from Drake University in 1993. After leaving Ernst & Young in 1992, he became a 25% shareholder in an accounting firm called Larson, Watson, Bartling & Eastman (LWBE).

In 1996, Watson incorporated David E. Watson, PC (DEWPC), in which he was the only individual who was an officer, shareholder, director, and employee during the time period relevant to this case. DEWPC has been an S corporation since its inception. DEWPC became a 25% shareholder in LWBE, replacing Watson's individual shareholder status.

By 1998, LWBE had changed its name to Larson, Watson, Bartling & Juffer (LWBJ). Watson is not a partner or employee of LWBJ but provides accounting services to LWBJ and its clients as an employee of DEWPC.

In 2002 and 2003, Watson could not practice accounting other than through LWBJ. For each of those years, he received $24,000 as a salary from DEWPC. DEWPC's income came exclusively from LWBJ distributions.

The gross revenues of LWBJ were $2.3 million for 2002 and $2.9 million for 2003. Watson's gross billings to clients were approximately $197,700 in 2002 and $200,380 in 2003. Watson received profit distributions from LWBJ through DEWPC which totaled $203,651 for 2002 and $175,470 for 2003.

Issue. Whether the salary paid to Watson in 2002 and 2003 was reasonable.

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84. IRC §72(t)(2)(A)(iii).

85. Treas. Reg. §1.72-17A(f)(2)(vi).

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Analysis. All employers are obligated to pay FICA taxes for all wages paid to employees. The term **wages** is defined as "all remuneration for employment."[86] Watson was indisputably an employee of DEWPC during the relevant time period. However, if the funds paid to Watson are properly classified as dividends, DEWPC need not pay FICA taxes on them. If, on the other hand, the funds are properly characterized as wages, DEWPC is required to pay FICA tax.

In Rev. Rul. 74-44, two shareholders of a corporation sought advice about whether they would incur liability for employment taxes in a situation similar to the one presented in this case. The shareholders performed services for the corporation but, to avoid federal employment taxes, they arranged for the corporation to pay them dividends rather than salary. The amount of the dividends was equal to the amount they would have received as reasonable compensation for services performed. The IRS stated that the dividends "were reasonable compensation for services" performed "rather than a distribution of the corporation's earnings and profits."[87] Accordingly, the dividends were properly characterized as wages that incurred liability for FICA and other federal employment taxes.[88]

In *Joseph Radtke, S.C.,*[89] the court held that certain funds designated as dividends were actually compensation for which an S corporation owed employment taxes. Radtke was the sole director, shareholder, and full-time employee of an S corporation that provided legal services. He took no salary in 1982 but instead received $18,225 in dividend payments from the corporation. The IRS recharacterized the payments as wages and assessed FICA and other employment taxes, along with penalties and interest.

In *Spicer Accounting, Inc.,* the 9th Circuit Court determined that payments designated as dividends can properly be recharacterized by the IRS as wages subject to federal employment taxes.[90] Spicer was the president, treasurer, and director of Spicer Accounting, Inc., an S corporation. He and his wife were the only shareholders in the corporation. Spicer performed substantial services for the corporation and had an arrangement whereby he would "donate his services to the corporation" and "withdraw earnings in the form of dividends."[91] The 9th Circuit affirmed the IRS's characterization of payments to Spicer as wages, emphasizing that it is the substance rather than the form of the transaction that matters. The court noted that "salary arrangements between closely-held corporations and its shareholders warrant close scrutiny."[92] The court stated that the central analysis hinges on whether the payments are remuneration for services rendered.

In the case at hand, the court was convinced that substantial portions of the distributions from LWBJ to DEWPC and in turn to Watson were actually remuneration for services performed. Watson is an exceedingly qualified accountant, with an advanced degree and approximately 20 years of experience in accounting and taxation. He worked full-time in a reputable and well-established firm, which had earnings well in excess of comparable firms. A reasonable person in Watson's role would undoubtedly expect to earn far more than a $24,000 salary. The court was convinced that Watson's salary and dividend payments were structured in a manner designed to avoid federal employment taxes.

Igor Ostrovsky is a general engineer for the IRS who has acted as an expert for the IRS in evaluating the reasonableness of taxpayer compensation on many occasions. His expert opinion at trial was that the FMV of Watson's accounting services to DEWPC and LWBJ was $91,044 per year for 2002 and 2003.

The court found the testimony of Ostrovsky to be credible and reasonable. Therefore, the court determined that the reasonable amount of Watson's remuneration for services performed was $91,044 for each of the years 2002 and 2003.

Holding. An annual salary of $91,044 for Watson is reasonable on the specific facts and circumstances of this case. Thus, the government prevails on its claim that DEWPC owes additional employment taxes, penalties, and interest on Watson's salary for 2002 and 2003. The parties were instructed to submit a joint proposed judgment with final calculations of employment taxes, interest, and penalties owed, based on the court's findings.

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86. IRC §3121(a).

87. Rev. Rul. 74-44, 1974-1 CB 287.

88. Ibid.

89. *Joseph Radtke, S.C. v. U.S.,* 712 F. Supp. 143 (E.D. Wis. 1989).

90. *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990).

91. Ibid.

92. Ibid.

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TAX FRAUD

Jeopardy Assessment and Levy

***John Larson v. U.S.*, No. 3:11-cv-03093; U.S. District Court for the Northern District of California (Jul. 11, 2011)**
IRC §§7429, 6861, and 6331

☞ IRS Obtains Jeopardy Assessment and Levy on $3 Million Refund

Facts. John Larson was convicted of tax evasion in 2008 for failure to report income in the years 1998–2001. At the time, this was the largest criminal tax case in American history. He was sentenced to 121 months of imprisonment and a fine of $6 million. He paid the fine in July 2009. Part of the reason for the large fine was that Mr. Larson had caused a "gross pecuniary loss" in excess of $100 million.

On appeal, the fine was reduced to $3 million. When the IRS learned of the impending refund, they issued a notice of jeopardy assessment against Larson and assessed more than $20 million in taxes and interest owed for the years 1998–2001. The following day, the IRS issued a notice of jeopardy levy in conjunction with the jeopardy assessment. The reason for the levy was to intercept the $3 million refund.

Issue. Whether the assessment and levy are appropriate under the circumstances.

Analysis. The IRS must show the assessment and levy are reasonable. Three conditions justify a determination that collection of tax is in jeopardy.

1. The taxpayer is or appears to be designing quickly to depart from the United States or to conceal himself.
2. The taxpayer is or appears to be designing quickly to place his property beyond the reach of the government either by removing it from the United States, by concealing it, by dissipating it, or by transferring it to other persons.
3. The taxpayer's financial solvency is or appears to be imperiled.

Even though Larson is still incarcerated, the court believes he has the ability to hide the money from the government by communicating instructions to loyal confederates with control over his assets. In Larson's tax-evasion schemes, he used foreign entities to shelter his profits. Evidence showed Larson still had relationships with foreign nationals that helped him hide funds abroad.

Holding. The court agreed with the IRS that the jeopardy assessment and levy were appropriate.

Fraud Penalty

***Energy Research and Generation Inc. v. Comm'r*, TC Memo 2011-45 (Feb. 24, 2011)**
IRC §§6501, 6653(b), 6663, and 6651

☞ Late Filed Returns Show Unreported Income and Overstated Expenses

Facts. Energy Research and Generation Inc. (ERG), a California corporation, was formed in 1967 by Glendon, Janet, and Burton Benson. Glendon and Janet are spouses; Burton is Glendon's younger brother. ERG is the only company in the world that manufactures various forms of foam metal and foam metal baffles. In the mid-1980s, Glendon and Burton squabbled over the operation and ownership of ERG. An agreement was reached after an arbitration proceeding, with ERG agreeing to purchase Glendon's stock interest for slightly over $3 million. As a result, Burton became the sole shareholder of ERG.

A CPA was hired to prepare the corporate tax returns from summary/data sheets Burton prepared. No original source documentation was provided for the tax return preparation.

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Year	Date Summary Information Provided to Tax Return Preparer	Date Return Filed
1988	July 1994	August 1, 1994
1989	August 1, 1994	August 8, 1994
1990	August 27, 1994	November 20, 1994
1991	January 26, 1995	July 16, 1995
1992	February 9, 1995	July 16, 1995
1993	September 13, 1994	September 18, 1994
1994	September 15, 1995	September 15, 1995
1995	September 4, 1996	September 16, 1996

For the years 1988 through 1995, an IRS examination determined that there were substantial deficiencies that included both understated gross receipts and overstated cost of goods sold and expenses. The revenue agent requested bank statements, reconciliations, and canceled checks for all corporate accounts for the period from December 1992 through January 1994. After several summons issuance attempts for ERG's accounts at Franklin Funds, a "new account" was found entitled ERG-Recreation Fund. Much of this account was used for the benefit of Burton and his family.

The IRS recomputed the correct tax liabilities for all years under consideration and recommended that deficiencies and fraud penalties be asserted.

Issues. The issues in this case are as follows.

- Whether the taxpayer filed fraudulent tax returns for an 8-year period
- Whether the taxpayer is liable for fraud penalties

Analysis. Fraud must be established by clear and convincing evidence. A 2-prong test must be met.

1. That ERG underpaid its taxes for each year
2. Some part of the underpayment is due to fraud

The undisputed facts show that ERG substantially underpaid its taxes for each of the years at issue, thus meeting the first test. For the eight years at issue, ERG agreed to **the disallowance of at least $8.5 million in improperly deducted expenses.** The court found several components leading to the determination of fraudulent activity, including all the following.

- Understatement of income
- Inadequate records/failure to provide the tax return preparers with accurate information
- Failure to file tax returns
- Implausible or inconsistent explanations of behavior
- Concealing assets
- Failure to cooperate with tax authorities

The IRS clearly and convincingly established that ERG filed its 1988 through 1995 tax returns intending to conceal, mislead, or otherwise prevent the collection of tax.

Holding. The court determined that the taxpayer filed fraudulent tax returns for eight years and was liable for fraud penalties for underpayments of tax and filing penalties for four tax years.

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Fraud Penalty

***Rick Fishman v. Comm'r,* TC Memo 2011-102 (May 18, 2011)**

IRC §§6663, 7454, and 7491

☞ Government Fails to Produce Clear and Convincing Evidence

Facts. Rick Fishman was an independent sales representative in Cleveland, Ohio for United Group Association (UGA) for shortly over a year before being promoted to **district sales leader.** As part of the district sales leader position, he performed not only his independent sales representative duties but also recruiting, training, managing, and motivating a team of sales representatives. When he became district sales leader, he began doing business as PACE Associates, a sole proprietorship. Mr. Fishman reported his income and expenses from the sole proprietorship on Schedule C.

In 1991, Mr. Fishman was promoted to **division sales leader.** This new team included all the previous members plus district leaders, for a total of 3–5 district leaders and 40–60 sales representatives. His new position required him to move from Ohio to Indianapolis, Indiana. He remained in this position until he left the insurance industry in 2008.

UGA paid its independent sales representatives based solely on commissions for products sold. When they sold an insurance policy, the representative would earn a sales commission equal to 20% of the policy's monthly premiums for the first 12 months that the policy was in effect. For each subsequent month that the policy remained in effect, they earned a sales commission equal to 4% of the monthly premium.

Sales leaders earned two types of commissions — sales commissions on policies they personally sold, and commissions on their subordinate agents' sales.

UGA used a commission advance system so that sales representatives would have approximately six months' anticipated but unearned commissions advanced to them to cover their personal living expenses. These "advances" were loans bearing a stated rate of interest and were required to be repaid if premium payments were discontinued within the first six months. These advances were not reported on Form 1099-MISC until they became earned.

Mr. Fishman received the entire division's weekly advances in his PACE account and would then write checks to those working under him. He maintained his own advances on personal sales and overrides in the PACE account.

Mr. Fishman paid various expenses on behalf of his district leaders. Rather than having the district leaders write him reimbursement checks, each week Mr. Fishman would deduct the amounts owed from the district leaders' commission advance checks and provided them with a copy of the balance sheet where he totaled this information. He obtained reimbursements of $54,549, $51,996, $63,159, and $59,241 for the 1994 through 1997 years, respectively.

For each of the years 1994 through 1997, Mr. Fishman prepared "summary lists" of his Schedule C business expenses which he provided to his CPA along with Forms 1099-MISC and Mrs. Fishman's Forms W-2. On the "summary lists," he did not include expenses for which he was reimbursed by the district leaders. (On the tax returns at issue, the business expenses were not deducted nor were the reimbursements reported as income.)

The IRS's criminal investigation division looked into the Fishmans' joint return and the finances of PACE from 1998 until 2003 when the investigation was terminated without criminal prosecution. Subsequently, the Fishmans' tax returns were assigned to a revenue agent for examination. The agent received a total of 16 boxes of records containing bank statements, checks, charge card statements, and telephone, shipping, and advertising bills, most of which were organized in monthly bundles.

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The revenue agent only analyzed the telephone, shipping, and advertising expenses, finding the expense amounts exceeded the amounts Mr. Fishman was reimbursed by the district leaders. The revenue agent created various spreadsheets during her examination; however, she never spoke to either the Fishmans or their CPA. The audit was completed in August 2004 with the deficiency determination being made on May 9, 2006. The notice of deficiency stated: "It is determined that you received reimbursement for business expenses claimed on your returns which were not reflected on your return. These reimbursements are taxable income to you under the provisions of Section 61 of the Internal Revenue Code. Alternatively, your other business expenses are decreased by the amount of reimbursements you received."

The notices of deficiency issued showed the following.

Year	Deficiency	§6663(a) Penalty
1994	$13,878	$10,410
1995	14,415	10,811
1996	14,692	11,019
1997	15,304	11,478

Issues. The issues in the case are as follows.

- Whether the taxpayer is liable for civil fraud penalties under IRC §6663(a)
- Whether the period of limitations on assessment for the proposed deficiencies and penalties is barred

Analysis. Fraud consists of two elements: (1) underpayment of tax, and (2) fraudulent intent. The court reviewed all the information provided by both parties and found that the IRS had not proven the Fishmans underpaid their federal income tax. In this case, the IRS determined deficiencies solely on the following 2-pronged argument.

1. Mr. Fishman paid expenses on behalf of the district leaders and deducted the expenses on his Schedule C.
2. The district leaders eventually reimbursed Mr. Fishman for these expenses and the reimbursements constituted gross income which Mr. Fishman omitted from his return.

To establish an underpayment based on this position, the IRS must produce clear and convincing evidence that the reimbursements were properly characterized as gross income. The IRS claimed Mr. Fishman conceded that he underreported gross income based on two stipulations that he made.

1. Mr. Fishman received reimbursements for expenses PACE paid on behalf of the district leaders.
2. Mr. Fishman did not report the reimbursements as gross income.

These two statements merely establish that Mr. Fishman initially paid the expenses and the district leaders reimbursed him for the expenses. They do not establish that Mr. Fishman could have deducted the reimbursed expenses as his own business expenses; thus, the government cannot represent a concession that the reimbursements were properly characterized as gross income.

Holding. The court held that the Fishmans are not liable for fraud penalties because the government did not prove that there was an underpayment of tax. Thus, the statute of limitations for making the deficiency assessments for all years under consideration is barred.

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Fraud Penalty

***F. Jeffrey Rahall v. Comm'r,* TC Memo 2011-101 (May 16, 2011)**
IRC §§662, 671, 673, 675, 6048, 6651, and 6663

☞ Lies, Lies, and More Lies

Facts. F. Jeffrey Rahall's parents accumulated millions of dollars throughout their lives, mainly through the operation and sales of several television and radio stations. Mr. Rahall's father established a number of trusts to hold his family's wealth, much of which was intended for the taxpayer (an only child) and his three children.

The "Farris E. Rahall Trust" (1964 Trust) was an irrevocable trust with Mr. Rahall's father as the settlor and his uncles and mother as trustees. Under the terms of this trust, the trust could accumulate income or distribute all income or any of the corpus as the trustees deemed necessary.

The "Farris Jeffrey Rahall 1978 Trust" (1978 Trust) was a revocable trust under which Mr. Rahall was both the trustee and beneficiary. The terms of this trust allowed Mr. Rahall to direct the trustee to pay any amount of income or trust corpus that was desired.

A third trust (Tee Holdings) was established under Cayman Islands' law in 1991 with the Cayman Overseas Trust Company as the original trustee having the absolute discretion to distribute or accumulate income for the beneficiary (Jeffrey Rahall). The corpus was to be distributed to living beneficiaries upon termination of the trust.

The Wheels Trust was established in 1995 under Channel Island law with Mr. Rahall having control of the bank accounts throughout the years in issue.

Mr. Rahall's parents' health deteriorated through 1999. In 2000, he obtained power of attorney over his parents' financial affairs. He transferred funds between his parents' accounts and his accounts. In addition, he also used a Cayman National Bank credit card to pay many of his expenses. The monies transferred and credit card charges (paid by Tee Holdings) were as follows.

Year	Monies Transferred	Credit Card Charges Paid by Tee Holdings
1999	$ 335,315	$403,551
2000	1,079,668	657,000
2001	2,303,755	164,500
2002	3,232,837	60,212
2003	2,682,117	30,217

Mr. Rahall met Brooks Rose in 1998 when he hired her as an escort. A relationship developed between the two. During the years at issue, Mr. Rahall gave Rose hundreds of thousands of dollars in addition to paying many of her expenses such as travel expenses, her children's tuition, and medical expenses. From 1999 through 2002, Mr. Rahall and Rose engaged in various purported business and charitable activities, including Angel Quest and Attitude Hair Salon.

On his 2002 tax return, Mr. Rahall deducted $392,444 in theft losses (amounts incurred by Angel Quest for travel and restaurant charges) and $246,354 for worthless stock for the Attitude Hair Salon investment. He also deducted $100,000 in 2002 as a capital loss relating to Webtank, Inc.

Amounts totaling over $184,000 were deducted as business expenses during 1999 through 2003 for personal expenses of the taxpayer and Rose. These personal expenses were paid by an S corporation, FJR Investments, Inc. The S corporation conducted no business activity during the 5-year period.

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The IRS examined the tax returns for 1999– 2003. The IRS granted Mrs. Rahall innocent spouse relief for the years in question. During the time of the audit, the IRS began the offshore voluntary compliance initiative for taxpayers who had used offshore payment cards or offshore financial arrangements to avoid U.S. income tax. The IRS sent Mr. Rahall a letter on November 24, 2003, offering him the opportunity to participate in this program as long as he provided the requested information about his foreign accounts within 150 days. However, he did not provide the requested information. During this time, Mr. Rahall denied the Wheels Trust even existed.

During the years at issue, the IRS uncovered substantial amounts of unreported income for 1999–2003 totaling in excess of $5.8 million from sources including the 1964 Trust, the 1978 Trust, Tee Holdings, Fidelity, the Wheels Trust, Rahall Realty, etc.

Issues. The issues in this case are as follows.

- Whether Rahall is liable for tax on monies he received from two domestic trusts and from two foreign trusts
- Whether Rahall is liable for tax on capital gain from a domestic trust
- Whether Rahall is liable for tax on credit card payments of his personal expenses by a foreign trust
- Whether Rahall is liable for tax on unexplained deposits made into his accounts
- Whether Rahall is entitled to deduct capital losses relating to two alleged business ventures
- Whether Rahall is entitled to a deduction for a theft loss
- Whether Rahall is liable for the failure to file or pay penalty under IRC §6651 for 2001 through 2003
- Whether Rahall is liable for the fraud penalty under IRC §6663

Analysis. Prior to trial, both parties made a number of concessions. At trial, Mr. Rahall was unable to establish he was entitled to all of the following.

- $100,000 capital loss in 2000
- $246,254 long-term capital loss in 2002, and the resulting loss carryover in 2003
- 2002 theft loss deduction

Mr. Rahall claimed Rose tricked him into providing money to Angel Quest for use in creating a calendar using photographs of models in exotic locations. The profits were then to be given to charity. No calendar was produced and the vast amount of expenses were for Mr. Rahall, Rose, her children, and occasionally others. Accordingly, the court determined that he was not entitled to a theft loss deduction.

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. His 2001 and 2002 tax returns were both filed late (July 7, 2004) without any reasonable cause for doing so.

IRC §6663(a) and (b) provides for the imposition of a fraud penalty unless the taxpayer establishes that some part of the underpayment is not attributable to fraud. The IRS relied on Mr. Rahall's pattern of underreporting his income and overstating his deductions by large amounts during all the years under consideration. He failed to maintain records to correctly compute his taxable income. He did not have records to justify many of the medical and business expenses he deducted, or to justify the capital losses he claimed. Further evidence of fraud included his failure to disclose offshore trusts used to conceal income. He also used nominees to hold assets; he titled the house he purchased for Rose under the name of Angel Heaven Mr. Rahall's explanations and excuses were implausible and unpersuasive.

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Holding. The court held Mr. Rahall liable for taxes on amounts he received from domestic and foreign trusts to the extent the distributions represent income earned by the trusts and were not from the corpus. In addition, the court denied his casualty and theft loss deductions and upheld penalties for failure to file and fraud.

> **Note.** See Chapter 7, Individual Taxpayer Topics, for detailed information on requirements for disclosing foreign financial accounts.

TRAVEL AND TRANSPORTATION EXPENSE

Travel Expenses

IRS Announcement 2011-42, 2011-32 IRB 1 (Jul. 19, 2011)
IRC §274(d)

☞ IRS Announces Discontinuance of High-Low Substantiation Method

The IRS announced that it intends to discontinue authorizing the high-low method for substantiating lodging, meal, and incidental expenses incurred in traveling away from home. In 2011, the IRS plans to publish a revenue procedure providing the general rules and procedures for substantiation of such expenses, which will omit the high-low method. In subsequent years, the IRS will publish a revenue procedure only when modifying the substantiation rules and procedures. The special transportation rate will be published in an annual notice.

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