Chapter 6: Rulings and Cases

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EXPLANATION OF CONTENTS

Corrections were made to this workbook through January of 2013. No subsequent modifications were made.

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

Substantial Authority

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

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

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

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

The following are considered authority for purposes of determining whether there is substantial authority for the tax treatment of an item, in descending order of authority:[1]

- 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.

1. Treas. Reg. §1.6662-4(d)(3)(iii).

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.

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.**

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

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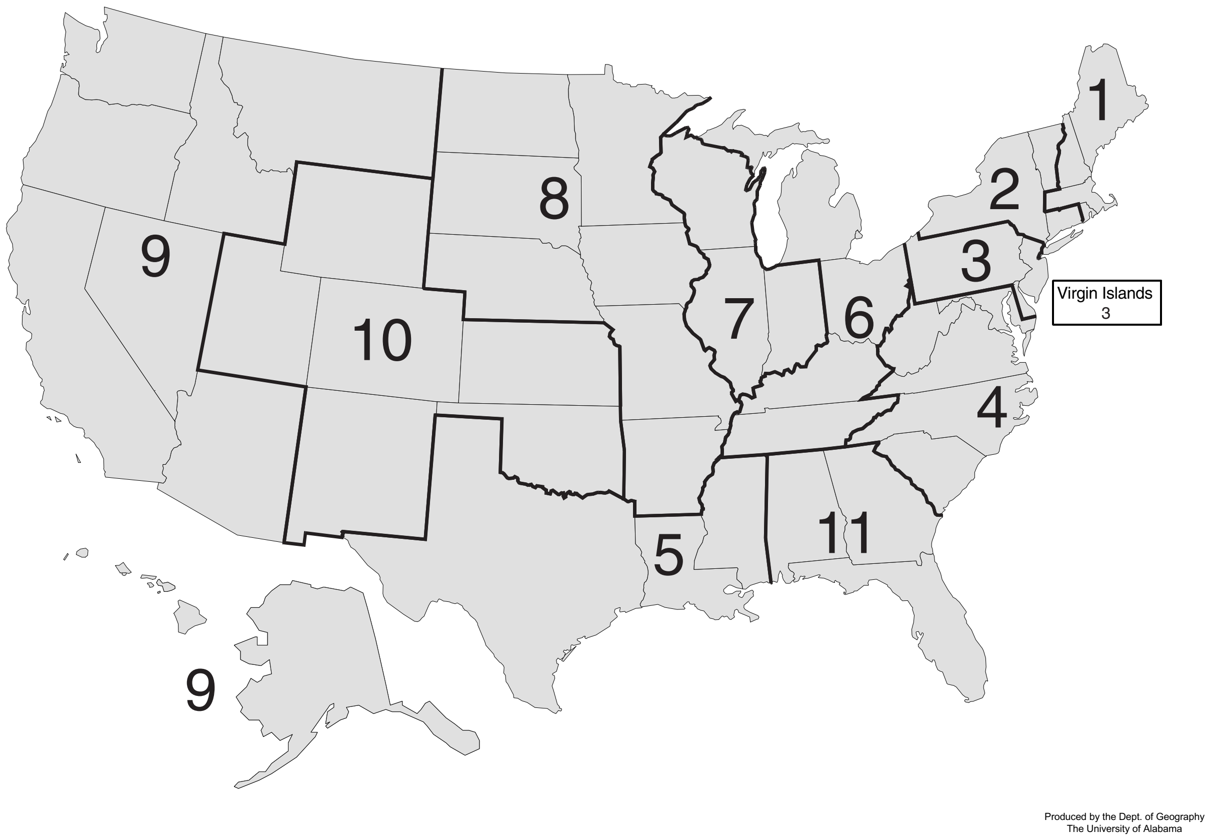
Federal Judicial Circuits and Districts



AGRICULTURAL ISSUES

Valuation of Farm Property

***Carolyn Finfrock v. U.S.*, No. 3:11-cv-03052; U.S. District Court for the Central District of Illinois (Mar. 20, 2012)**
IRC §2032A

☞ Court Holds that Federal Regulation on Special-Use Valuation is Invalid

Facts. At the time of her death in January 2008, Doris Finfrock-Ware (the decedent) owned 61.05% of the stock in Finfrock Farms, Inc. Finfrock Farms owned four parcels of real property, which were farmed by the decedent's son.

The four parcels of farmland passed indirectly to qualified heirs[2] through a change in the ownership of Finfrock Farms. The decedent's estate filed Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return,* in October 2008. The estate's adjusted value of real property, for purposes of IRC §2032A(b)(1)(B), consists of the estate's interest in the four parcels of farmland (Items 1–4), representing approximately 68% of the adjusted value of the gross estate.

The estate valued Items 1–3 by applying the usual valuation method. The estate elected to value Item 4 pursuant to IRC 2032A, because the executor of the estate, Carolyn Finfrock (Ms. Finfrock), wanted to continue operating Item 4 as a farm, whereas other members of her family opted not to continue farming Items 1–3 and sold them to unrelated third parties soon after the decedent's death. The adjusted value of the fourth parcel was $402,930, which represents approximately 15% of the adjusted value of the gross estate.

The IRS examined the estate's Form 706 and determined that the election to apply the special-use valuation of §2032A to only part of the qualifying real property did not meet the requirements of Treas. Reg. §20.2032A-8. The IRS increased the value of Item 4 on Schedule A of the Form 706 from its special-use value of $227,233 to its market value of $402,930 and assessed additional tax accordingly.

Ms. Finfrock paid the additional tax on behalf of the estate and filed a claim for refund. The IRS subsequently denied the estate's claim. Ms. Finfrock then filed a lawsuit contending that the estate should be entitled to elect the special-use valuation for Item 4 because Treas. Reg. §20.2032A-8 is invalid.

Issue. Whether Treas. Reg. §20.2032A-8 is a valid regulation.

Analysis. IRC §2032A was enacted as part of the Tax Reform Act of 1976 "to encourage the continued operation of family farms and other small family businesses by permitting real property used for the farm or business to be valued upon its present use, rather than upon its highest and best use. Thus, §2032A relieves taxpayers from having to sell an eligible family farm or business when the income from its present use is insufficient to pay the tax calculated on its highest and best use."[3]

Several conditions must be met in order to qualify for the special-use valuation. One condition is that at least 25% of the adjusted value of the gross estate consists of the adjusted value of real property that is eligible for the special-use valuation election.[4] Items 1–4 represented approximately 68% of the adjusted value of the gross estate.

Treas. Reg. §20.2032A-8(a)(2) provides that although an estate is not required to elect special-use valuation for all qualifying property, the property actually elected for the special-use valuation must constitute at least 25% of the adjusted value of the gross estate. The IRS contends that this regulation is valid and because Item 4 constituted only 15% of the adjusted value of the gross estate, the Finfrock-Ware estate was not entitled to the refund.

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2. As defined in IRC §2032A(e).

3. *Schuneman v. U.S.,* 783 F.2d 694, 697 (7th Cir. 1986).

4. IRC §2032A(b)(1)(B).

The district court previously tried another case on this issue.[5] In that case, the district court found Treas. Reg. §20.2032A-8(a)(2) invalid because it was an interpretive regulation that represented an invalid exercise of the general rulemaking power of the Code. The court held that Treas. Reg. §20.2032A-8(a)(2) added a requirement that was inconsistent with the underlying statute.

Ms. Finfrock argued that the statute is clear and unambiguous. The 25%-or-more requirement only applies to qualify an estate for the special election but it does not require that the special-use valuation be applied to property that constitutes 25% or more of the adjusted gross estate. The court agreed that the 25%-or-more requirement is a means to limit the special-use valuation to family farms and family businesses. Congress did not require the designation to be a certain percentage of the real property in the estate that meets the requirements of §2032A. The court further noted that §2032A is neither silent nor ambiguous on the issue of whether an executor can elect property for special valuation that constitutes less than 25% of the gross value of the estate's adjusted value. The statute unambiguously provides that an executor can do so.

Holding. The court held that Treas. Reg. §20.2032A-8(a)(2) is invalid. However, the case was not resolved because of additional matters concerning material participation. That will be addressed at a later time.

AMORTIZATION AND DEPRECIATION

Depreciation Lives

***AmeriSouth XXXII, Ltd. et al. v. Comm'r,* TC Memo 2012-67 (Mar. 12, 2012)**
IRC §§48, 167, 167(m), and 168

☞ Cost-Segregation Study Invites Scrutiny

Facts. AmeriSouth XXXII, Ltd. owns and operates the Garden House Apartments in Mesquite, Texas. This complex has 40 buildings located on 16 acres of land. The complex is composed of 2-story apartment buildings averaging nine apartments each. Most units have one to three bedrooms but there are a few 4-bedroom units. In addition, the complex has some common buildings, which include a storehouse for mechanical equipment, leasing office, and three pool cabanas. Some of the units have painted base molding, crown molding, chair rails, built-in framed mirrors, shelving set into the wall, and hardwood floors. Garden House also has electrical and gas lines, water pipes, and sanitary sewers. After the purchase in 2003, a $2 million renovation took place that included replacing cabinets, countertops, dishwashers, garbage disposals, vent hoods, and kitchen sinks.

Prior to filing the 2003 tax return, AmeriSouth hired MS Consultants to do a cost-segregation study. MS advised AmeriSouth that many of the items could be depreciated over a 5- or 15-year life rather than the 27.5 years normally associated with apartment buildings. This study identified $3.4 million of property qualifying for a shorter useful life. The cost-segregation study categorized the components at issue into the following twelve categories.

1. Site preparation and earthwork
2. Water-distribution system
3. Sanitary-sewer system
4. Gas line
5. Site electric
6. Special HVAC

5. *Miller v. U.S.,* 680 F.Supp. 1269, 1270 n.1 (C.D. Ill. 1988).

7. Special plumbing
8. Special electric
9. Finish carpentry
10. Millwork (cabinets, countertops, etc.)
11. Interior windows and mirrors
12. Special painting

Based on MS's advice, AmeriSouth claimed depreciation deductions of $632,674, $1,578,212, and $818,143 for 2003, 2004, and 2005, respectively, resulting in a tax deferral of almost $730,000 for 2003 through 2007.

The IRS determined that the quicker write-offs did not apply to all the component pieces and recommended adjustments of $314,996, $508,977, and $255,778 for 2003, 2004, and 2005, respectively. At trial, the IRS also raised the issue that AmeriSouth was trying to depreciate some items it did not even own.

Issue. Whether the taxpayer is entitled to depreciation deductions based on the cost-segregation study of $632,674, $1,578,212, and $818,143 for 2003, 2004, and 2005, respectively.

Analysis. Former IRC §167(m) gave the Secretary of the Treasury the authority to provide guidance on the class lives for each class of property so that taxpayers can correctly compute their depreciation deductions. Rev. Proc. 87-56 sets forth the class lives of property that are necessary to compute the depreciation allowances available under IRC §168. The taxpayer relied on two classifications within Rev. Proc. 87-56: asset class 00.3 (land improvements, depreciable over 15 years) and asset class 57.0 (distributive trades and services, depreciable over five years). AmeriSouth included its water-distribution system, sanitary-sewer system, gas lines, and site electric in the 15-year category; everything else was included in the 5-year category.

Treas. Reg. §1.48-1(e) defines "building" and "structural components." Both the IRS and AmeriSouth agree the apartments are buildings but disagree about what a structural component is.

At trial, the court looked at whether an item, either inside or outside the building, relates to the operation or maintenance of a building in order to determine if the item is a structural component. The court relied on three prominent landmarks — whether an asset is an accessory to a business, permanent, or ornamentation. After examining each of these prominent landmarks, the court discussed each category to determine the appropriate depreciable life. Overwhelmingly, the discussions favored the treatment recommended by the IRS.

Holding. Regarding the 12 categories at issue, the Tax Court found as follows.

- Categories 2, 4, 5, 7, 9, 10, 11, and 12 (structural building components) — 27.5-year property
- Category 1 — Nondepreciable, addition to cost of the land
- Category 3 — Nondepreciable, due to lack of ownership by AmeriSouth
- Category 6 (clothes dryer vents) — 5-year property
- Category 6 (stove vents) — 27.5-year property
- Category 8 (specific outlets and surveillance equipment) — 5-year property
- Category 8 (gate components and outdoor watering system outlets and timer) — 15-year property

Business Asset Price Allocations

***Peco Foods, Inc. & Subsidiaries v. Comm'r,* TC Memo 2012-18 (Jan. 17, 2012)**
IRC §§338, 1060, 1245, and 1250

☞ Post-Transaction Changes to Agreed Asset Price Allocation Not Permitted

Facts. The taxpayer, Peco Foods, is primarily engaged in the business of poultry processing. In 1995, Peco acquired the assets of an additional poultry processing plant. It did so again in another similar transaction in 1998. In each of the two transactions, Peco and the seller agreed to an allocation of the purchase price among the assets "for all purposes (including financial accounting and tax purposes)" under the terms of IRC §1060.

Peco completed a cost-segregation study in December 1999 in connection with some of the real estate assets acquired in the two transactions. Peco reclassified some of the real estate from IRC §1250 to IRC §1245 property and also subdivided real property assets into different component parts as a result of the cost-segregation study. These changes were not consistent with the original allocation of the purchase prices that Peco agreed to use with the seller in each of the acquisition transactions.

Peco filed a Form 3115, *Application for Change in Accounting Method,* with its 1998 Form 1120, *U.S. Corporation Income Tax Return,* claiming additional depreciation of $2.14 million. Peco asserted that it was entitled to this depreciation as a result of the changes to the treatment of the assets reclassified and subdivided as a result of the cost-segregation study. Peco continued to treat the assets in accordance with the changes it made for the 1999, 2000, and 2001 tax years.

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The IRS disallowed the additional depreciation deductions as a result of the changes Peco made to the treatment of assets and issued notices of deficiency for the years involved.

Issue. Whether Peco can change the treatment of assets for tax purposes after agreeing to a particular allocation of the purchase price among assets acquired in a §1060 transaction.

Analysis. Under §1060, the parties to the purchase and sale of business assets must use special allocation rules and agree in writing to the allocation of the total purchase price among the assets transferred. Moreover, §1060(a) indicates that this written agreement is binding on the parties. If Peco was allowed to change the tax treatment of assets in a manner that is different than the way it originally agreed when the assets were acquired under §1060, the assets would be treated in one manner by the buyer and another manner by the seller. Therefore, the IRS would be faced with treating the two parties to the same transaction differently, which is inconsistent and not appropriate under §1060. In addition, approving such changes would allow Peco to realize a better tax result than that which Peco originally bargained for in the acquisition transactions.

Holding. Peco's purchase price allocations as agreed to in the original asset acquisition transactions are binding for tax purposes under §1060. Post-transaction changes to these allocations are not permitted.

AT RISK

At-Risk Limitations

***Roy Zeluck v. Comm'r,* TC Memo 2012-98 (Apr. 3, 2012)**
IRC §§465, 6501, 6662, and 6664

☞ Taxpayer is Required to Report Income for a Note that is No Longer At Risk

Facts. Roy Zeluck invested $310,000 in an oil and gas partnership in 2001; $110,000 of the investment was paid by cash and the remaining $200,000 was made by a subscription note maturing December 31, 2009. Mr. Zeluck also signed an assumption agreement that made him personally liable on a partnership note up to the amount of liability on his subscription note.

Mr. Zeluck claimed partnership deductions on his 2001 and 2002 tax returns that reduced his capital account balance from $310,000 to $32,407. The partnership terminated in 2003 and distributed $32,407 to Mr. Zeluck. Mr. Zeluck did not make payments of principal on the $200,000 subscription note and failed to meet certain other requirements of the subscription agreement for interest payments.

The IRS issued a notice of deficiency which stated that Mr. Zeluck should recognize $200,000 as income in 2003. In response, Mr. Zeluck claimed that no liability existed in 2003. He also claimed that no liability existed in 2001 either and that the IRS is precluded from contesting his 2001 tax return due to the expiration of the statute of limitations under §6501.

Issues. The issues in this case are as follows.

- Whether the taxpayer is required to recognize a $200,000 gain on his 2003 tax return
- Whether the taxpayer is liable for a 20% accuracy-related penalty under IRC §6662(a)

Analysis. The courts look at various factors when determining whether a genuine indebtedness exists. These factors include the following.

1. Whether the promise to repay is evidenced by a note or other instrument
2. Whether interest was charged
3. Whether a fixed repayment schedule was established
4. Whether collateral was given to secure payment
5. Whether repayments were made
6. Whether the borrower had a reasonable prospect of repaying the debt
7. Whether the parties conducted themselves as if the debt was genuine

The court found factors 1, 2, and 4 supported the existence of genuine debt. Factors 3, 5, and 7 provide strong evidence that no genuine debt existed. Factor 6 was neutral. After considering each of the factors, the court found that the subscription note and assumption agreement were genuine debts of Mr. Zeluck at the end of 2002. The court determined that the debt became nongenuine in 2003 based on the fact that no repayments were made and no enforcement was sought after the termination and liquidation of the partnership at the beginning of 2003.

The IRS contended that Mr. Zeluck's at-risk amount in the partnership was reduced from $310,000 in 2001 to zero upon the partnership's termination in 2003. The IRS further argued that Mr. Zeluck's at-risk amount was then reduced by $200,000 in 2003 as a result of his debt becoming nongenuine. Thus, Mr. Zeluck is required to report a $200,000 gain for 2003 under IRC §465(e), which requires recapture of losses when the amount at risk is less than zero. Mr. Zeluck argued that he was still at risk for the $200,000 in 2003 as a result of the subscription note and assumption agreement. However, the court had already negated this argument. He then argued that if he was not at risk for the $200,000 in 2003, he was never at risk for the $200,000 and, therefore, IRC §465(e) does not apply. The court again rejected his arguments.

IRC §6662 imposes a 20% accuracy-related penalty if any part of an underpayment of tax required to be shown on a return is due to negligence, a disregard of rules or regulations, or a substantial understatement of income tax. After considering the facts, the court determined that Mr. Zeluck was negligent and carelessly disregarded rules in failing to properly reduce his at-risk amount after his liabilities under the subscription note and assumption agreement were discharged in 2003.

Holding. The court held that Mr. Zeluck must recognize a $200,000 gain for 2003 under §465(e) and found him liable for the accuracy-related penalty.

BAD DEBT

Nonbusiness Bad Debt

***George Saadian v. Comm'r*, TC Summ. Op. 2012-44 (May 10, 2012)**

IRC §166

☞ Timing and Failure to Pursue Collection of Bad Debt Leads to Denial of Deduction

Facts. George Saadian lent $200,000 to Nedjat Simantob, a distant relative, in January 1988. The loan was evidenced by a promissory note and stated an interest rate of 8%, payable monthly, with the principal due on or before January 2, 2000.

Mr. Simantob failed to make monthly payments as required under the note until sometime in 1990. From 1990 through 2000, Mr. Simantob made partial interest payments on the note. His last interest payment of $4,100 was made in 2003.

Mr. Saadian's attorney demanded full payment from Mr. Simantob via a letter dated April 6, 2004. The letter stated: "If this sum is not received, then we will immediately take legal action." Mr. Simantob ignored the letter and did not make any further payments. **However, no legal action was taken to force collection of the loan balance.**

Mr. Simantob died in December 2004. Mr. Saadian contacted Mr. Simantob's sons in an attempt to collect the unpaid loan from their father's estate but had no success.

Mr. Saadian deducted the $200,000 unpaid loan as a nonbusiness bad debt on his 2006 Schedule D, *Capital Gains and Losses*. He properly treated it as a short-term capital loss and used the loss to reduce his 2006 long-term capital gain of $1.33 million. The IRS disallowed the $200,000 bad debt and assessed additional tax of $30,000 (15% × $200,000).

Issue. Whether the taxpayer is entitled to the $200,000 nonbusiness bad debt deduction claimed on his 2006 tax return.

Analysis. IRC §166(d) provides that a deduction is allowed for any bad debt that becomes worthless within the taxable year. The loss from a nonbusiness bad debt must become totally worthless during the year of loss.[6] However, the note's maturity in 2000 occurred six years before the year in which the taxpayer claimed that the debt became worthless. Although Mr. Saadian pursued collection with Mr. Simantob's heirs, there was no formal claim against Mr. Simantob's estate. Therefore, the debt became worthless before 2006.

Holding. The court upheld the bad debt disallowance and the additional taxes assessed by the IRS.

BANKRUPTCY AND DISCHARGE OF INDEBTEDNESS

Bankruptcy

***Mark W. Lindros v U.S.*, No. 8:08-ap-00140, U.S. Bankruptcy Court for the Middle District of Florida (Nov. 2, 2011)**

☞ Debtor's Tax Liabilities are Dischargeable

Facts. Mark Lindros began working for the Information Management Company (IMC) in March 1994. BEA Systems (BEA) bought IMC in October 1995, and offered its employees incentive stock options (ISOs) with a 4-year vesting period.

Lindros began exercising his stock options in 1999. BEA's stock traded at a high of approximately $89 per share in 2000, while the option price was approximately $20 per share. In 2000, Lindros traded stock and reported a combined short-term and long-term capital gain of $401,380.

6. IRC §166(d)(1).

Based on the value of his existing and future ISOs, Lindros was a millionaire in 2000. He enjoyed his wealth during 2000 and the first part of 2001. In 2000, he leased a 2001 Porsche with a $10,000 down payment. In January 2001, he made a $20,000 deposit on a Ferrari and bought a house in Florida. He also spent $2,250 on flying lessons, $3,000 on elective eye surgery, $5,000 on cycling equipment, $2,000 on a kayak, $4,500 on a pool table, $6,000 on a game room, and took several nice vacations.

The value of Lindros' ISOs decreased drastically in 2001 after the crash of tech stocks and the September 11 tragedy. The BEA stock price dropped to a low of approximately $4 per share after September 11, which was substantially less than Lindros' option price of $20 per share. Lindros ultimately incurred a $651,682 loss in 2001.

Lindros also learned in 2001 that he had a significant tax liability for 2000. He was not concerned about it, however, because he was under the mistaken impression that he could carry back his 2001 capital losses to offset his 2000 capital gains.

In 2002, Lindros learned that he could not offset his tax liability for 2000 by the amount of his capital losses from the 2001 tax year. He discovered that he was limited to a $3,000 capital loss for 2001 and that he actually incurred alternative minimum tax of $47,355. At that time, he realized he would have difficulty paying his liability for 2000 because most of his fortune was gone.

In late 2002, Lindros initiated contact with the IRS to determine whether he could establish a payment arrangement. Although Lindros provided the financial information that the revenue officer requested, the IRS nevertheless levied his bank accounts and wages several times over the next two years.

The IRS collection efforts led Lindros to file bankruptcy in August 2004, and he received a Chapter 7 discharge in November 2004. Lindros thought his discharge included his 2000 tax liability and that he only owed a smaller liability for 2001, which was excepted from discharge as a priority tax. However, the IRS continued its collection efforts with respect to Lindros' liability for 2000.

Issue. Whether Lindros is entitled to a discharge from his liability for 2000.

Analysis. Chapter 7 bankruptcy relief generally entitles the debtor to a discharge from all pre-petition debts. However, 11 USC §523(a)(1)(C) excepts from discharge any tax debt for which the debtor filed a fraudulent return or that the debtor willfully attempted to evade or defeat.

Proof of the following two elements is required in order to prove that Lindros is not entitled to a discharge from the 2000 tax liability.[7]

1. Lindros engaged in evasive contact.
2. Lindros acted with a mental state consistent with willfulness.

To satisfy the first test, the government must prove that Lindros "engaged in affirmative acts to avoid the payment or collection of taxes."[8] This would include transferring property to family members or significant others for little or no consideration or using income to finance an extravagant lifestyle rather than paying delinquent taxes. Lindros did not engage in such conduct. Although he lived an expensive lifestyle between 1999 and 2001, his expenses were not extravagant considering his income at the time and his belief that the stock options were worth millions. Additionally, most of his expenses were incurred before he became aware of his 2000 tax liability. More importantly, after he learned of the tax delinquency and the value of his stocks collapsed, he tried to cut his expenses and sold some of his assets.

7. *In re Jacobs,* 490 F.3d at 913 (11th Cir. 2007); *In re Fretz,* 244 F.3d at 1327 (11th Cir. 2001).

8. *In re Jacobs,* 490 F.3d at 913 (11th Cir. 2007).

The government also failed to satisfy the second test, which requires proving that Lindros "voluntarily, consciously or knowingly, and intentionally" attempted to evade his tax liability.[9] The court noted four principal reasons that the government failed to establish that Lindros voluntarily and intentionally violated his duty. First, Lindros' testimony that he thought he would be able to offset his 2000 tax liability with capital losses from later years was credible. Second, he did not try to maintain his expensive lifestyle after he learned that he could not offset the tax liability with capital losses. Third, he initiated contact with the IRS in 2002 and attempted to work out a solution for his tax issues. Fourth, Lindros believed his 2000 tax delinquency was discharged in 2004.

Holding. The court concluded that the government failed to establish that Lindros willfully evaded the payment or collection of his taxes. Accordingly, he is entitled to a discharge from his 2000 tax liability.

Cancellation of Debt Income

David and Carla Stewart v. Comm'r, **TC Summ. Op. 2012-46 (May 21, 2012)**
IRC §§61(a)(12) and 6201

☞ Taxpayer's Discharged Debt Not Considered COD Income

Facts. David Stewart defaulted on a Maryland Bank National Association (MBNA) credit card obligation at some point between October 22, 1994 and September 6, 1996. No payments were made after the default. MBNA charged off the debt on September 12, 1996. Financial institutions often purchase defaulted debts from banks with the goal of collecting some of those debts to make a profit. On December 28, 2007, Portfolio Recovery Associates (PRA) acquired the taxpayer's defaulted MBNA debt. A couple of months after acquiring this debt, PRA began making automated collection efforts despite being aware of the fact that the limitations period for collection of the debt expired on February 15, 2001. On April 14, 2008, PRA received a letter from Mr. Stewart demanding that it cease collection activity on the debt. PRA stopped collection activity and issued a Form 1099-C, *Cancellation of Debt,* for the 2008 tax year, which reported $8,571 in cancellation of debt (COD) income for Mr. Stewart.

Mr. Stewart filed his 2008 return but did not include the amount reported on the Form 1099-C in his income. The IRS subsequently informed the taxpayer that this amount was being included in income for 2008 and issued a notice of deficiency for the corresponding additional tax. The taxpayer filed a petition in Tax Court to contest the notice of deficiency, claiming that the debt was actually discharged in an earlier year and the Form 1099-C for 2008 was incorrect.

Issues. The issues in this case are as follows.

- When the debt was actually discharged
- Whether the Form 1099-C issued for 2008 was appropriate

Analysis. A debt is deemed discharged at the time it becomes clear that the debt will never be repaid. This is determined by reviewing the facts and circumstances surrounding repayment of the debt and finding an "identifiable event" that makes the loss to the creditor certain. Treas. Reg. §1.6050P-1 provides an exclusive list of eight identifiable events under which a debt is discharged. One of these identifiable events is the expiration of a 36-month period in which no payments have been made. A rebuttable presumption arises that an identifiable event occurred in a calendar year if a 36-month nonpayment period ends at the close of that year. The debt is therefore deemed discharged in that year. However, the creditor can rebut this presumption by showing that significant, bona-fide collection action, beyond mere automated mailing or other ministerial collection activity, took place within the 12-month period at the end of that 36-month nonpayment period.

9. *In re Jacobs,* 490 F.3d at 913 (11th Cir. 2007); *In re Fretz,* 244 F.3d at 1327 (11th Cir. 2001).

Mr. Stewart made no payments after MBNA wrote off the debt on September 12, 1996. The 36-month nonpayment period therefore ended in 1999, creating a rebuttable presumption that an identifiable event occurred in 1999. Although PRA began making collection efforts a couple of months after it acquired the debt, these were only automated efforts that were insufficient to rebut the presumption.

Holding. Mr. Stewart's debt was discharged in 1999. Therefore, the Form 1099-C issued for the 2008 tax year is inappropriate. Mr. Stewart had no COD income in 2008.

Cancellation of Debt Income Received by Publicly Traded Partnerships

Rev. Proc. 2012-28, IRB 2012-27 (Jul. 2, 2012)
IRC §7704

☞ Safe Harbor for PTPs Treating COD Income as Qualified Income

Purpose. The IRS has issued guidance that provides a safe harbor under which the IRS will not challenge a determination by publicly traded partnerships (PTPs) that cancellation of debt (COD) income is qualifying income for purposes of the IRC §7704(c) exception.

Analysis. IRC §7704(b) provides that a PTP is any partnership for which interests in the partnership are traded on an established securities market or the interests are readily tradable on a secondary market. IRC §7704(a) generally requires a PTP to be treated as a corporation for tax purposes unless an exception under §7704(c) applies. Generally, if 90% or more of a PTP's income is "qualifying income," the PTP will not be taxed as a corporation. Qualifying income consists of interest, dividends, real estate rental income, gains from the sale of real property and certain other types of income, or gains from mining, natural resources, geothermal, or other activities as described in §7704(d)(1). A PTP that would be a regulated investment company under IRC §851(a) if it were incorporated does not qualify for this exception from corporate tax treatment.

This revenue procedure provides that a PTP may treat COD income as qualifying income under §7704(d) if the COD income is attributable to debt incurred in direct connection with qualifying income-generating activities of the PTP. Using any reasonable method, if the PTP can show this nexus between the income and its qualifying income-generating activities, the IRS will not challenge the treatment of the income as qualifying income by the PTP. One reasonable method is to trace the debt proceeds to the PTP's activities that generate qualifying income. A method that allocates COD income using only the ratio of qualifying gross income to total gross income is not considered a reasonable method. This revenue procedure specifically notes that the IRS may consider a request for a private letter ruling as to whether a COD allocation method is reasonable.

Effective Date. The revenue procedure is effective for COD income received by a PTP for all debts discharged on or after June 15, 2012. Moreover, PTPs may use this safe harbor for prior tax years for which the statute of limitations has not expired.

Debt Cancellation

Robert and Elizabeth Brooks v. Comm'r, **TC Memo 2012-25 (Jan. 26, 2012)**
IRC §§61(a)(12), 108, 163(d), and 212

☞ Discharged Debt Attributable to Unpaid Interest is Taxable Income

Facts. In March 1998, Dain Rauscher, Inc., (Dain) recruited Robert Brooks as a stockbroker. Dain lent Brooks more than $500,000. The original loan agreement required Brooks to repay the loan in five annual installments at the end of March in each year from 1999 through 2003. An internal Dain memorandum from March 1998, however, stated that if Brooks remained an employee, Dain would issue Brooks an annual check for the principal and interest due (net of tax withholding) prior to the loan payment due date. Brooks, in turn, would write a check to Dain for the payment of the principal and interest due. The memorandum also stated that the check from Dain "is considered income by the IRS." However, there is no evidence that the parties exchanged checks during any of the five years of the loan's term.

Both parties agreed that Dain forgave the entire loan in 2003 and included $650,342 ($506,300 of principal and $144,042 of interest) on Brooks's March 2003 pay statement. This same amount was also included on his 2003 Form W-2. Brooks included all of the wages on his 2003 tax return that he filed in May 2006. The IRS examined the return for unrelated issues that were resolved prior to trial. However, Brooks filed a Tax Court petition because he believed that he incorrectly included the $144,042 interest as income and that an adjustment should be made to reduce his taxable income accordingly.

Issue. Whether Brooks's forgiven interest is taxable income.

Analysis. IRC §61(a)(12) treats the discharge of indebtedness as income, including both loan principal and interest. There is an exception under IRC §108(e)(2) that states that a debtor does not realize discharge-of-indebtedness income to the extent payment of the liability would have given rise to a deduction.

Brooks argued that the interest that Dain forgave would have been deductible under IRC §212 because it was incurred for the production of income. The original purpose of the loan was to allow him to showcase his skills as a stockbroker. His 2003 return contains a large number of stock trades, and he asserted that he used the original funds to buy a stock portfolio. Brooks argued that this is sufficient to prove that the interest would have been deductible as an expense for the production of income.

The IRS asserted two counterarguments. First, Brooks had not taken the time and effort to trace the flow of money from the loan to his investments. Without this evidence to show what the money was actually used for, Brooks did not prove that he would have been entitled to a deduction under IRC §212. Secondly, the IRS contended that even if Brooks had shown he used the money to buy stock, he still is not entitled to a deduction because IRC §163(d)(1) limits the deduction of investment interest to a taxpayer's net investment income. Brooks's 2003 return reported net investment income of $25; therefore, he would not have been able to deduct the interest.

Holding. The court decided in favor of the IRS because Brooks failed to show that the $144,042 would have been deductible interest.

BUSINESS EXPENSES

Business Use of Home

***Luis Bulas v. Comm'r,* TC Memo 2011-201 (Aug. 17, 2011)**
IRC §§162 and 280A

☞ Former IRS Employee Does Not Understand Tax Laws

Facts. Luis Bulas, a resident of Florida, worked for seven years at the IRS, holding positions of tax technician, revenue agent, appeals auditor, and appeals officer. In 1985, he started his own accounting business in which he prepared 180–220 returns per year. He has a master's degree in accounting from Florida International University.

Mr. Bulas's residence covers 2,677 square feet. He used one of the bedrooms as his accounting business office (226.3 square feet). In addition, he allowed his clients to use a bathroom directly across the hall from the "bedroom office." Both family members and personal guests also used the bathroom on occasion. On the 2007 tax return, he claimed a deduction of $9,019 on Schedule C, *Profit or Loss From Business,* for business use of his home for the bedroom office, bathroom, and hallway that connects the bedroom and bathroom.

During 2007, Mr. Bulas's two daughters, ages 17 and 20, provided administrative assistance to his accounting business. To compensate his daughters for their services, Mr. Bulas paid their credit card bills. He did not issue either daughter a Form W-2 or a Form 1099-MISC, but he deducted $18,000 as wages paid to his daughters on Schedule C.

Upon examination, the IRS determined that neither the deduction for business use of his home or wages paid to his daughters were allowable and disallowed both deductions entirely.

Issues. The issues in this case as follows.

- Whether Mr. Bulas is entitled to Schedule C deductions related to the business use of his personal residence totaling $9,019
- Whether he is entitled to Schedule C deductions for wages paid to his daughters totaling $18,000

Analysis. IRC §280A(a) provides that deductions for a taxpayer's residence are not allowable unless an exception applies. IRC §280A(c) provides an exception that applies to a portion of the dwelling unit used **exclusively** for business on a regular basis.

At trial, the court agreed to the deduction for the expenses related solely to the "bedroom office." Although Mr. Bulas's clients sometimes used the bathroom and hallway, he admitted that his children and other personal guests also used these areas. Because the bathroom and hallway were not used exclusively by his clients, he was not entitled to a deduction for these areas.

With respect to the wages deducted for his daughters, Mr. Bulas testified that he paid his daughters for the work they performed by paying their credit card bills. He did not issue them an information reporting document (Form W-2 or 1099-MISC) nor did he withhold taxes. Mr. Bulas also failed to provide any other evidence to substantiate the amounts paid.

Holding. The court held that the taxpayer was entitled to only 8.45% of the expenses for business use of his home. This represents the portion of the residence used exclusively for business purposes (226 square feet for bedroom office ÷ 2,677 total square feet). The deduction for wages paid to his two daughters was disallowed in full.

> **Note.** See 2012 Volume C, Chapter 7: Home Office Deduction, for more information on an office in the home.

Business Expenses

Randy and Bobbi Stidham v. Comm'r, **TC Summm. Op. 2012-61 (Jun. 26, 2012)**

IRC §§162, 262, 274, and 6651

☞ No Tax Deduction for Reimbursable Expenses

Facts. Randy Stidham was employed by the American Society of Composers, Authors, and Publishers (ASCAP) during 2005. His job involved traveling to businesses throughout Kentucky and Tennessee that play music through a sound system to ensure that the businesses paid copyright fees as required by copyright law. ASCAP's reimbursement policy provided that its employees were eligible for reimbursement for various business expenses.

Mr. Stidham received an automobile allowance of $9,775, which was included on his 2005 Form W-2. He did not request any other reimbursement from ASCAP.

The following unreimbursed business expenses were claimed on Mr. and Mrs. Stidham's 2005 joint tax return, which was filed in November 2007.

- $19,887 for vehicle expenses
- $6,500 for travel expenses (including lodging)
- $3,274 for other unspecified business expenses
- $1,750 for meals and entertainment expenses
- $92 for parking fees, tolls, etc.
- $55 for tax preparation fee

The IRS disallowed the entire $31,503 of employee business expenses and the $55 tax preparation fee.

Issues. The issues in this case are as follows.

- Whether the taxpayers are entitled to deduct unreimbursed employee business expenses of $31,503
- Whether the taxpayers are entitled to deduct the tax preparation fee of $55
- Whether the taxpayers are liable for an addition to tax for the late-filed tax return

Analysis. IRC §162(a) allows a deduction for ordinary and necessary expenses that a taxpayer pays in connection with the operation of a trade or business.

At trial, Mr. Stidham provided a detailed reconstruction of his travel for the first two weeks of January 2005, which showed that he traveled approximately 2,000 miles during a 2-week period. Additionally, the taxpayers provided receipts for various travel-related expenses throughout Kentucky and Tennessee (gas, lodging, meals, etc.), which illustrated Mr. Stidham's extensive travels. Based on this documentation, the court allowed the taxpayers to deduct their claimed mileage expense but only to the extent of the $9,775 reimbursed by ASCAP. With respect to the other expenses (lodging, meals, parking fees, tolls, etc), Mr. Stidham was not reimbursed by ASCAP, although if he had submitted the proper paperwork he would likely have received reimbursement. As a result, these unreimbursed expenses are disallowed because Mr. Stidham could have been reimbursed.

The Stidhams did not provide documentation to support the $55 tax preparation fee, so the disallowance was sustained.

IRC §6651(a)(1) provides for an addition to tax of 5% of the tax required to be shown on a return for each month or fraction thereof for which there is a failure to file, not to exceed 25%. This addition is not assessed if a taxpayer shows reasonable cause for the late filing. At trial, the taxpayers neither argued nor introduced any evidence regarding reasonable cause for the late filing.

Holding. The court allowed a deduction of $9,775 for mileage and recomputed the addition to tax for failure to file based on the corrected deficiency.

CAPITAL GAINS AND LOSSES

Investor's Losses Limited

***Henricus and Pamela van der Lee v. Comm'r*, TC Memo 2011-234 (Sep. 29, 2011)**
IRC §§475, 1211, 1212, 165, 212, and 6662

☞ Husband Was an Investor Rather Than a Trader

Facts. Henricus van der Lee was employed as an investment banker by Merrill Lynch. Prior to 2002, he was prohibited from trading securities in his own account due to federal regulatory rules. After the first quarter of 2002, many of the trading restrictions were lifted.

Beginning in April 2002, Mr. van der Lee decided to start trading stocks and stock option contracts in his own accounts. He opened two brokerage accounts and made a **total of 159 closed transactions** from April 15, 2002 through December 31, 2002. Of the 76 completed sales of stock, 35 involved shares Mr. van der Lee purchased prior to 2002. In April, July, August, and September, he made between four and eight trades.

Mr. and Mrs. van der Lee failed to attach the required statement to make the mark-to-market election or a Form 3115, *Application for Change in Accounting Method,* to their 2002 joint tax return. **The tax year 2002 was the first and only year** that Mr. van der Lee **claimed he was a trader** rather than an investor in securities.

Mr. van der Lee reported his completed 2002 stock and option trading activity on Schedule C, *Profit or Loss From Business.* It showed the following.

Gross receipts from the securities trading activity	$3,710,378
Less: cost of goods sold (total basis in stocks and options sold)	(5,098,705)
Gross profit (loss)	($1,388,327)
Less: expenses (legal, office exp., travel, meals & entertainment, utilities)	(91,872)
2002 Schedule C net loss	**($1,480,199)**

The IRS determined that Mr. van der Lee "did not qualify as a trader in securities under IRC §475(f) [the mark-to-market accounting requirement] during the 2002 tax year" and that he was not eligible to elect to use the mark-to-market accounting method for his securities activity. The IRS assessed additional tax of $620,235 and an accuracy-related penalty of $7,624 for 2002.

Issues. The issues before the Tax Court were the following.

- Whether Mr. van der Lee was a trader in securities during 2002
- Whether the Schedule C loss is deductible against ordinary income
- Whether the taxpayers are liable for the accuracy-related penalty under IRC §6662(a)

Analysis. The proper taxation of gains and losses from securities transactions depends on whether the taxpayer is a dealer, trader, or an investor. Mr. van der Lee contends that he was a trader in 2002, and the IRS contends he was an investor. A trader is considered engaged in a trade or business of trading securities. Investors are not considered in the trade or business of buying and selling securities. They recognize capital gain or loss when their securities are sold. Any securities trading losses of an investor for the tax year are limited to the lower of the net loss amount or $3,000 ($1,500 in the case of a married individual filing separately).[10]

10. IRC §§165(f) and 1211(b).

In distinguishing a trader from an investor, prior court cases consider the following nonexclusive factors.

1. The taxpayer's intent
2. The nature of the income to be derived from the activity
3. The frequency, extent, and regularity of the taxpayer's securities transactions[11]

Investors derive profit from interest payments, dividends, and capital appreciation of securities. Traders buy and sell securities with reasonable frequency with the purpose of catching the swings in the daily market prices and profiting on a short-term basis.[12]

In reaching its decision, the court stressed the following factors.

- The length of time Mr. van der Lee held the stocks before selling them suggests that he was an investor rather than a trader.
- He did not trade with sufficient frequency to qualify as a trader. His overall trading activity was sporadic.
- The number of completed trades (159) does not support a conclusion that he was a trader.

Holding. The Tax Court held that Mr. van der Lee was **not a trader** in 2002. The entire Schedule C loss disallowance, including the claimed expenses of $91,872, was upheld. Instead, the taxpayers were allowed the maximum $3,000 capital loss deduction. In addition, the court sustained the accuracy-related penalty.

CLERGY

Parsonage Allowance

Comm'r v. Philip and Lynn Driscoll, **U.S. Court of Appeals, 11th Circuit; No. 11-12454 (Feb. 8, 2012)**
IRC §§107, 501(c)(3), 7701, and 61

☞ Parsonage Allowance for Second Home not Excludible from Gross Income

Facts. From 1996 to 1999, Philip and Lynn Driscoll owned a principal residence and a lake house. Mr. Driscoll was an ordained minister and he received a parsonage allowance for the acquisition, care, and maintenance of both his principal residence and his lake home. For the 1996 through 1999 tax years, Mr. and Mrs. Driscoll filed tax returns that excluded the parsonage allowance for both homes from their gross income.

The IRS issued a notice of deficiency to the Driscolls for the 1996 through 1999 tax years, denying them the exclusion from income under IRC §107(2) for the portion of the parsonage allowance allocated to the second house. The Driscolls petitioned the Tax Court for a redetermination of the deficiency.

A divided Tax Court held that the Driscolls were entitled to exclude the parsonage allowance allocated to their second house from their income, with six of the 13 judges dissenting.[13] The IRS then appealed the Tax Court ruling.

Issue. Whether the Driscolls are entitled to exclude the parsonage allowance allocated to their second house from their gross income.

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11. *Estate of Yaeger v. Comm'r*, 889 F. 2d 29 (2nd Cir. 1989).

12. Ibid.

13. *Driscoll v. Comm'r,* 135 TC 569-573 (2010).

Analysis. IRC §107 provides that the gross income of a minister of the gospel does not include "the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home…" In reaching its decision, the Tax Court majority relied on the fact that the Code cross-references the Dictionary Act[14] in determining that singular terms in the Code also include their plural forms. However, the Supreme Court explained that the Dictionary Act does not apply if "the context indicates otherwise."[15]

The Appeals Court noted that the history of §107 provides context for the term "home." The parsonage allowance income exclusion, as originally enacted in the Revenue Act of 1921,[16] applied to housing provided in kind but did not exempt cash allowances that a minister received for housing expenses. It granted an income exclusion for "the rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel…" In the Internal Revenue Code of 1954, Congress modified the parsonage allowance by changing "a dwelling house" to "a home" and added the rental allowance provision of §107(2). The court in this case stated that the consistent use of the singular in the House and Senate reports demonstrate that Congress intended for the parsonage allowance exclusion to apply to only one home.

The Appeals Court further noted that the Supreme Court stated that income exclusions should be "narrowly construed."[17] In light of this directive, the court stated that it did not believe that they should construe any ambiguity in §107(2) to favor a more expansive reading of the parsonage allowance exclusion.

Holding. The ruling of the Tax Court was reversed; thus, the Driscolls are not allowed to exclude the parsonage allowance allocated to the maintenance of a second home.

CORPORATIONS

Corporate Expenses

Mulcahy, Pauritsch, Salvador & Co. v. Comm'r, **U.S. Court of Appeals, 7th Circuit; No. 11-2105 (May 17, 2012)**
IRC §§162 and 6662

☞ "Cockeyed" Method of Distributing Profits to Owners is Disallowed

Facts. Mulcahy, Pauritsch, Salvador & Co. (MPS) is a CPA firm organized as a C corporation that has its headquarters in Orland Park, Illinois. The firm generates revenue of $5 million to $7 million per year but reported income of only $11,279 for 2001, a loss of $53,271 for 2002, and zero taxable income for 2003 after carrying forward part of the loss from 2002. MPS paid salaries totaling $323,076 in 2001 to the three founding shareholders, who owned more than 80% of the company's stock.

The IRS did not question the salary deductions for MPS, but it disallowed over $850,000 in "consulting fees" that MPS paid in each of the three years to three entities owned by the founding shareholders, which in turn passed the money on to the founding shareholders. The IRS reclassified the fees as dividends, which resulted in a corporate income tax deficiency of more than $300,000 for 2001 and similar deficiencies for each of the following two years.

The Tax Court agreed with the IRS assessment and added the 20% statutory penalty for substantial understatement of income tax.[18]

14. 1 USC §1; see IRC §7701(p)(1).

15. *U.S. v. Hayes,* 555 U.S. 415, 422 n.5, 129 S. Ct. 1079, 1085 n.5 (2009).

16. Revenue Act of 1921, PL No. 67-98, section 213(b)(11), 42 Stat. 227, 239 (1921).

17. *Comm'r v. Schleier,* 515 U.S. 323, 328, 115 S. Ct. 2159, 2163 (1995).

18. IRC §§6662(a) and (b)(2).

Issues. The issues in this case are as follows.

- Whether MPS is entitled to business expense deductions for consulting fees paid to entities owned by the founding shareholders
- Whether MPS is liable for the IRC §6662 accuracy-related penalty

Analysis. MPS argued that the consulting fees were not for services rendered to the firm by the related entities but rather payments for accounting and consulting services provided by the founding shareholders to the firm's clients and, thus, in effect additional salary. The fees were paid indirectly in order to conceal from the firm's other employees how much of the firm's income was being paid to the founding shareholders. The firm further argued that because the "consulting fees" were allocated among the founders in proportion to the number of hours that each worked, the fees could not have been dividends, because dividends are based on ownership rather than on work. The court rejected these arguments, noting that the firm did not treat the fees as labor expenses, and whatever the method of allocation of the firm's income, "… the firm owed corporate income tax on the net income hiding in those fees. A corporation cannot avoid tax by using a cockeyed method of distributing profits to its owners."

MPS's lawyers contended that the founding shareholders left funds in MPS over the years to fund working capital and thus deserved more in compensation to take that fact into account. The court responded to this argument by stating that it was remarkable that the CPA firm's lawyers appeared not to understand the difference between compensation for services and compensation for capital. The founding shareholders could have charged interest for capital they lent to the company, and the interest would have been deductible by the corporation. However, they failed to charge any interest.

In closing, the court noted their puzzlement that the firm chose to organize as a C corporation. Admittedly, there were fewer pass-through options when MPS was founded in 1979 than there are now. However, the firm chose to continue as a C corporation and sought to avoid double taxation by overstating deductions for business expenses. If MPS had reorganized as a pass-through entity, it would have achieved the same result without inviting a legal challenge. The court stated, "That an **accounting** firm should so screw up its taxes is the most remarkable feature of the case."

Holding. The court upheld the Tax Court's disallowance of the deduction for "consulting fees" paid from the firm's taxable income and the imposition of the 20% accuracy-related penalty.

S Corporation Pass-Through Losses

***Yolanda Welch et al. v. Comm'r,* TC Memo 2012-179 (Jun. 28, 2012)**

IRC §§2(b), 1366, 1367, and 6662

☞ Lack of Recordkeeping Works Against Taxpayer

Facts. In March 2001, John and Yolanda Welch started Respira, an S corporation that provides respiratory and home healthcare services and durable medical equipment. John and Yolanda were president and chief executive officer with 20% and 80% ownership, respectively.

Yolanda asserts that she borrowed in excess of $600,000 from Dr. Steven Levenson which she, in turn, loaned to Respira. However, all the funds were either paid directly from Levenson to Respira or were Respira's expenses paid using Levenson's credit card.

Yolanda executed 27 promissory notes between October 18, 2001, and November 12, 2003, for amounts owed to Dr. Levenson. The notes totaled $598,197 and were secured by receivables owed to Respira. Respira made some payments on the notes from March 2003 through May 2005.

Dr. Levenson filed suit against Yolanda and Respira in May 2007 for amounts owed to him. A settlement agreement was reached in 2008 with notes being executed by Yolanda and Respira for $600,000 and $50,000, respectively.

Respira's Forms 1120S, *U.S. Income Tax Return for an S Corporation,* for 2005 and 2006 showed losses of $50,294 and $683,059, respectively. On their separate tax returns, Yolanda and John claimed their pro-rata shares of these losses totaling $56,003 and $683,059 in 2005 and 2006, respectively. Yolanda used the married filing separately (MFS) status and John filed as head of household (HoH).

After evaluating information provided by the taxpayers about the amounts they loaned to Respira, the IRS disallowed Yolanda's losses for both 2005 and 2006, disallowed John's loss for 2006, changed John's filing status to MFS, and imposed accuracy-related penalties for both Yolanda and John.

Issues. The issues in this case are as follows.

- Whether Yolanda had sufficient basis in Respira to claim pass-through losses for 2005 and 2006
- Whether John had sufficient basis in Respira to claim a pass-through loss for 2006
- Whether John is entitled to HoH status in 2006
- Whether Yolanda and John are liable for accuracy-related penalties for 2006

Analysis. At trial, Yolanda and John argued that they met their burden of proof because they provided checks, deposit slips, bank statements, and corroborating testimony during the trial and cooperated with the IRS at every stage of the proceedings. The court disagreed. Although the taxpayers claim to have made loans to Respira that increased their basis, they were unable to show that they had any remaining basis left after taking into account the losses claimed on their tax returns since Respira's creation in 2001.

Based on the facts presented, the court determined that Yolanda and John were still married and living together in 2006; therefore, John is not entitled to the HoH filing status.

IRC §6662(a) imposes a 20% penalty on any portion of an underpayment that is attributable to negligence or intentional disregard of rules or regulations. Yolanda and John asserted that they were not liable for this penalty because they relied on a CPA who prepared all the corporate and individual returns for the years in question. They also allegedly relied on an employee who left Respira in mid-2005. The extent to which they relied on their bookkeeper and tax preparer could not be proven nor could the experience and expertise of these people be determined. Concession of the accuracy-related penalty was therefore not supported.

Holding. The court found that neither Yolanda nor John was entitled to flow-through losses from Respira, John was not entitled to HoH filing status, and both were liable for an accuracy-related penalty.

Transferee Tax Liability

Albert J. Starnes et al. v. Comm'r, **U.S. Court of Appeals, 4th Circuit; No. 11-1636 (May 31, 2012)**
IRC §§6901 and 6902

☞ No Continued Corporate Tax Liability for Selling Shareholders

Facts. Four taxpayers are former shareholders of Tarcon, a freight consolidation company that operated for decades. Tarcon's business slowed dramatically in the 1980s when the trucking industry was deregulated. By 2003, Tarcon ceased operations and a warehouse was its only asset.

The former shareholders wished to retire. They negotiated with one company who wanted to buy the warehouse. After the sale of the warehouse, with the cash proceeds in the company, they arranged to sell their shares to MidCoast, who agreed to operate Tarcon as a going concern and to satisfy the corporate tax liability that would be created due to the sale of the warehouse.

Tarcon engaged in the following transactions on November 13 and 14, 2003.

- Tarcon sold the warehouse to another company for $3.1 million. This left Tarcon with $3.1 million in cash and approximately $880,000 in tax liability that was triggered from the warehouse sale.
- With the company holding the substantial cash balance, the former shareholders sold their stock to MidCoast for $2.6 million, a purchase price that reflected an agreement by the former shareholders to contribute about half (or approximately $500,000) of the corporate tax liability, with MidCoast paying the remainder. MidCoast agreed to file the necessary returns and pay the corporate tax liability. MidCoast became the owner of the corporation with $3.1 million in cash and gave the former shareholders $2.6 million in consideration for their shares.

Prior to the sale, MidCoast provided the former shareholders with a brochure and a chart extolling the benefits of selling shares to MidCoast. The former shareholders did not completely understand this information or what MidCoast intended to do with Tarcon. However, they decided to sell their shares to MidCoast because they would have more money after the transaction (warehouse proceeds of $3.1 million − $500,000 tax liability = $2.6 million) than if they paid the entire tax liability on the warehouse transaction ($3.1 million − $880,000 tax liability = $2.22 million).

On November 24, 2003, MidCoast sold its Tarcon stock to a Bermuda company and on **December 1, 2003**, the proceeds were transferred to an account in the Cook Islands. After December 1, 2003, Tarcon never had more than $132,320 in any of its accounts. Tarcon continued to exist as a corporation long after the share sale to MidCoast, but MidCoast never paid any of the $880,000 tax liability from the warehouse sale.

The IRS was unsuccessful in obtaining payment of the tax liability from MidCoast and therefore sent each of the four former shareholders notices of transferee liability under IRC §6901(a). The Tax Court held that the former shareholders were not liable for the tax. The IRS appealed to the 4th Circuit Court of Appeals, arguing that the Tax Court erred in the application of the relevant test.

Issues. The issues in this case are as follows.

- Whether the former shareholders have transferee liability
- Whether the former shareholders are liable for tax under the common law "trust fund doctrine"

Analysis. A transferee may be liable for tax on a transfer if the transfer was fraudulent. In *Comm'r v. Stern,*[19] the Supreme Court set forth two inquiries to determine whether transferee liability exists.

- Whether there was a fraudulent transfer within the meaning of §6901 (which is determined under federal law)
- Whether the IRS, placed in the same position as a creditor under state law, could enforce the liability against the transferee (which is determined under relevant state law)

The burden of proof is on the IRS to establish these factors. Without first applying federal law to address the issue of whether a "transfer" occurred under §6901, the Tax Court looked to North Carolina law to determine if tax debt would be enforceable against the former shareholders. Under North Carolina law, the debt is enforceable if it arose from a fraudulent transfer. Applied to this case, relevant North Carolina law specifies that a fraudulent transfer occurs if:

- The transfer of shares by the former shareholders was made without receiving a reasonably equivalent value in exchange, or
- The former shareholders intended to hinder, delay, or defraud the IRS with respect to the collection of the tax.

19. *Comm'r v. Stern,* 357 U.S. 39 (1958).

The Tax Court held that because reasonably equivalent value ($2.6 million in cash) was received by the former shareholders on November 13 and 14, no fraudulent transfer existed. The IRS argued that the December 1 transfer of funds to the Cook Islands should be "collapsed" into the November transactions and considered one transaction, with Tarcon left with only $132,320 at the end of the transaction. The Tax Court held that only the November transactions should be considered because, under North Carolina law, the December 1 transaction would be included only if the former shareholders had actual or constructive knowledge of the MidCoast scheme. The former shareholders did not fully understand MidCoast's postpurchase plans for Tarcon and further reasonable inquiry would not have revealed that MidCoast was going to immediately sell the purchased shares and move funds to the Cook Islands.

The IRS argued that the former shareholders continue to be responsible for the tax debt under the common law "trust fund" theory. Under this theory, assets of a corporation are treated as a trust fund and officers and directors are deemed to be in a fiduciary position with respect to creditors. However, this doctrine only applies to situations involving the winding-up or dissolution of the corporation. The former shareholders were specifically told by MidCoast before selling their shares that MidCoast planned to continue operating Tarcon as a going concern, integrating Tarcon into their own "asset recovery" operations. The former shareholders did not know that the sale of their shares to MidCoast would leave Tarcon insolvent and Tarcon, in fact, remained in existence long after the share sale.

Holding. The Tax Court's holding in favor of the former shareholders was affirmed. The former shareholders are not liable for the tax on the sale of the warehouse.

CREDITS

Research Credit

Basim Shami et al. v. Comm'r, **TC Memo 2012-78 (Mar. 21, 2012)**
IRC §41

☞ Executives' Compensation was not Qualified Research Expense

Facts. Farouk Shami founded Farouk Systems, Inc. (FS) in 1986. FS develops, manufactures, and sells hair, skin, and nail products and is best known for its BioSilk, CHI, Color Vision, SunGlitz, and Deep Brilliance product lines.

Mr. Shami was FS's chief executive officer, president, and secretary for 2003 and 2004, and also served as chairman of the board of directors and as the sole member of FS's manufacturing and operations committee. Mr. Shami was paid wages of $8.7 million, $8.0 million, and $9.5 million for 2003, 2004, and 2005, respectively.

John McCall was FS's executive vice president and sole member of its sales and marketing committee for 2003 and 2004. He was paid wages of $5.7 million and $1.8 million for 2003 and 2004, respectively.

FS filed Form 1120S, *U.S. Income Tax Return for an S Corporation,* and claimed the research credit for each year at issue. Mr. Shami, Mr. McCall, and the other petitioners[20] (collectively, the petitioners) filed tax returns claiming their respective portions of the research credits. The IRS subsequently issued deficiency notices disallowing the claimed research credits.

Issue. Whether wages paid by FS to Mr. Shami and Mr. McCall qualify as research expenses for purposes of FS claiming the research credit under IRC §41.

20. Several cases were consolidated for purposes of the trial, briefing, and opinion.

Analysis. A taxpayer is allowed a tax credit equal to 20% of the excess of qualified research expenses (QRE) for the taxable year over the base amount.[21] QREs include wages paid or incurred for employees performing qualified services. **Qualified services** are activities associated with qualified research or with the direct supervision of research activities that constitute qualified research.[22] The term "engaging in qualified research" is defined as the actual conduct of qualified research (e.g., a scientist conducting laboratory experiments). Direct supervision of qualified research involves immediate supervision of qualified research (e.g., a research scientist who directly supervises laboratory research).[23] A taxpayer that claims a research credit must retain records that adequately substantiate eligible expenditures.

The petitioners claim that Mr. Shami and Mr. McCall spent 80% of their time performing research and development services for FS that constitute qualified services in 2003 and 2004 and that Mr. Shami spent 35% of his time performing such services in 2005. The IRS contends that the petitioners failed to adequately substantiate the wage allocations.

No documents were provided that established how much time, if any, that Mr. Shami or Mr. McCall spent performing research and development services during the years at issue. Mr. Shami, Mr. McCall, and two other FS employees testified at trial. Several witnesses contradicted Mr. Shami's testimony, and no witnesses corroborated Mr. McCall's testimony. The testimony of the other two FS employees was general, vague, conclusory, and insufficient to establish the time that Mr. Shami or Mr. McCall spent performing any specific service.

Holding. The court held that inadequate substantiation prevents any amount of the relevant wages from qualifying for the research credit.

Education Credits

Treasury Inspector General for Tax Administration (TIGTA) Report #2011-41-083 (Sep. 16, 2011)
IRC §25A

☞ $3.2 Billion in Education Credits Appear Erroneous

Analysis. A TIGTA report presents the results of its review to assess the effectiveness of IRS procedures for identifying erroneous American Opportunity Tax Credit claims from January 1 through May 28, 2010. The report revealed that 2.1 million taxpayers received $3.2 billion in education credits that appear to be erroneous. At least 1.1 million (52%) of these had their tax returns prepared by a paid tax return preparer. Following are highlights of the report.

- There were 1.7 million taxpayers who received $2.6 billion in education credits for students for whom there was no supporting documentation in IRS files that indicated they attended an educational institution.
- There were 370,924 individuals claimed as students who were not eligible because they did not attend the required amount of time and/or were postgraduate students. This resulted in an estimated $550 million in erroneous education credits.
- There were 63,713 taxpayers who erroneously received $88.4 million in education credits for students claimed as a dependent or spouse on another taxpayer's return.
- There were 250 prisoners who erroneously received $255,879 in education credits.

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21. IRC §41(a)(1).
22. IRC §41(b)(2)(B).
23. Treas. Reg. §1.41-2(c)(2).

TIGTA made a number of recommendations in its report, including that the IRS coordinate with the Department of Education to assess the potential for using its data files in tax return processing, and revising compliance programs to identify taxpayers who erroneously claim the credit.

In its response to the report, the IRS disagreed with the amount of erroneous claims identified by TIGTA. However, IRS management subsequently informed TIGTA that it found a high percentage of the claims TIGTA identified to be erroneous. As of July 2011, IRS audit results indicated that 72% of the claims reviewed were erroneous. As a result, the IRS plans to review more tax returns claiming education credits in fiscal year 2012.

DEDUCTIONS

IRC §179 Deduction

***Charles and Shanda Douglas v. Comm'r,* TC Memo 2011-214 (Aug. 31, 2011)**
IRC §§179 and 6662

☞ Flow-Through Deductions for Aircraft Disallowed

Facts. In 2007, Shanda Douglas was the sole owner and officer of Bantam, which is an over-the-road trucking business. Shanda's husband, Charles, was an employee of Bantam.

Approximately 75% of Bantam's business is classified as "critical timing" delivery services. Punctual delivery of cargo is very important because Bantam's accounts could be in jeopardy if Bantam fails to deliver on time. Charles believed that an aircraft would minimize the risk of losing customers due to late delivery by potentially replacing drivers who were unable to complete their assigned routes. Accordingly, Charles consulted his CPA regarding the tax aspects of purchasing an aircraft.

In 2006, Bantam purchased a Cessna 150 and then sold it in 2007. Later in 2007, Bantam purchased a Cessna 172 aircraft for $135,000 and reported the purchase on Form 4562, *Depreciation and Amortization.* Bantam elected to expense the aircraft under IRC §179 up to the 2007 statutory maximum of $125,000. It also deducted $10,580 for storage and upkeep of the aircraft on its 2007 Form 1120S.

Charles began taking flying lessons in 2006 using the Cessna 150 and continued the lessons in 2007 with the Cessna 172. By the end of 2007, he only held a student license. During 2007, no employees or officers of Bantam held a pilot's license that would have allowed them to use the aircraft to transport a replacement driver. The sole use of the Cessna 172 in 2007 was for Charles' flying lessons.

The IRS issued a notice of deficiency to Charles and Shanda for the 2007 taxable year, determining a deficiency in income tax of $44,625 and a penalty of $8,925.

Issues. The issues in this case are as follows.

- Whether the taxpayers are entitled to a flow-through deduction under §179 for the Cessna 172
- Whether the taxpayers are liable for an increased deficiency arising from the disallowance of expenses associated with storage and upkeep of the aircraft
- Whether the taxpayers are liable for a penalty for a substantial underpayment of income tax

Analysis. IRC §179 allows taxpayers to expense depreciable business assets in the tax year that the property is placed in service. **Placed in service** means the time that the property is in a state of readiness and availability for use in a trade or business, for the production of income, in a tax-exempt activity, or in a personal activity.[24] If the property is used partially for business purposes, a §179 deduction is allowed only if the property's business use is more than 50%.[25] The Cessna 172 was used only for Charles' flying lessons in 2007; thus, the aircraft was never used in Bantam's trade or business.

Depreciation deductions are available in certain situations under the "idle asset" rule. To qualify, the asset must be devoted to the taxpayer's business and ready for use should the occasion arise.[26] The idle asset rule does not apply to Bantam's situation. The aircraft was not idle because it was used by Charles for flying lessons. An aircraft is not considered ready for business use without a suitable pilot to fly it.

Because the Cessna 172 was not available to perform a business function in 2007, Charles and Shanda are not entitled to a flow-through deduction under §179. Likewise, the $10,580 deduction for storage and upkeep is not allowable because the aircraft was not used for business purposes.

The court noted that Charles did consult with his CPA regarding the aircraft-related deductions and relied on her advice in good faith. Accordingly, the taxpayers are not liable for the IRC §6662(a) accuracy-related penalty.

Holding. The court disallowed the flow-through §179 deduction and expenses for maintenance of the aircraft. It did not sustain the IRS's determination of an accuracy-related penalty under §6662(a).

Ordinary and Necessary Expenses

***Daniel and Marilyn Fuhrman v. Comm'r,* TC Memo 2011-236 (Sep. 29, 2011)**

IRC §§162, 212, and 6662

☞ Portion of Management Fees Paid to Affiliated Entity Is Disallowed

Facts. Daniel Fuhrman owned a trucking business. He organized the business into five wholly-owned corporations, including Top Line Express, Inc., and Top Leasing, Inc. He also was the sole member of Grasshopper Leasing, LLC.

Grasshopper owned about 30 trucks that it leased to affiliated entities, including Top Line. Top Line used the trucks in its business of hauling goods.

Top Line employed all the office personnel and truck drivers for the trucking business. Top Line had 18 to 20 employees during the years at issue, including Mr. Fuhrman.

Grasshopper had no employees. Top Line employees performed the management and administrative services for Grasshopper, but there was no written contract for these services. Additionally, Top Line did not maintain contemporaneous time records for the services its employees performed for Grasshopper. During 2004 and 2005, Top Line billed Grasshopper a monthly fee for the services it performed for Grasshopper. Grasshopper paid Top Line $101,382 and $108,000 in 2004 and 2005, respectively, for the services.

On their joint tax returns, Mr. and Mrs. Fuhrman reported Grasshopper's pass-through income on Schedules C, *Profit or Loss From Business (Sole Proprietorship).* These schedules included $103,645 and $115,168 of "other expenses" for 2004 and 2005, respectively, which primarily consisted of the purported management fees that Grasshopper paid to Top Line.

24. Treas. Reg. §1.179-4(e).

25. Treas. Reg. §1.179-1(d).

26. See *Piggly Wiggly Inc. v. Comm'r,* 84 TC 739, 745-746 (1985), *aff'd* 803 F.2d 1572 (11th Cir. 1986).

The IRS disallowed $57,052 of these "other expenses" for 2004 and $63,660 for 2005. The notice of deficiency explained that the expenses were disallowed because the Fuhrmans had not established that the expenses were paid for ordinary and necessary business expenses.

Issue. Whether the taxpayers are allowed to deduct purported management fees that Grasshopper paid to Top Line in amounts greater than that allowed by the IRS.

Analysis. IRC §162(a) allows a deduction for all ordinary and necessary expenses paid or incurred in a trade or business. The Appeals Court has held that expenses must be reasonable to be deductible as "ordinary and necessary."[27] Only the reasonable portion of an expense qualifies for a deduction under §162(a).[28] In determining whether payments between related parties, such as commonly controlled business entities, are ordinary and necessary expenses, the reasonableness concept has particular significance. In *ASAT, Inc. v. Comm'r,*[29] the court held that the taxpayer could not deduct consulting fees paid to its subsidiary because the taxpayer did not establish how the fees were determined, there was no written contract, the invoices provided little detail, and there was no evidence that the service provider's skills warranted the consulting fees.

The monthly invoices from Top Line to Grasshopper for management fees generally consist of a single line item showing a flat $9,000 "management fee" with no detail as to the services provided. There was no evidence that these amounts were determined at arm's length, which is especially relevant because Mr. Fuhrman was the sole owner of both Grasshopper and Top Line.

Over half the hours allegedly worked by Top Line employees on behalf of Grasshopper consisted of sales management, safety, and driver relations services. However, Grasshopper's business consisted of leasing trucks to other related entities. There was no business reason it would have needed to recruit, train, test, track, or dispatch truck drivers, because it employed no drivers.

Holding. The Fuhrmans are not allowed to deduct management fees greater than those the IRS allowed. Moreover, they are liable for an IRC §6662 accuracy-related penalty, because they did not demonstrate that they had reasonable cause or acted in good faith.

> **Observation.** Although not stated in the facts of this case, it appears that the taxpayers were trying to shift income from their individual returns to the corporate entity in order to optimize personal and corporate tax brackets.

27. *Comm'r v. Lincoln Elec. Co.,* 176 F.2d 815, 817 (6th Cir. 1949).

28. *U.S. v. Haskel Engg. & Supply Co.,* 380 F.2d 786, 788-789 (9th Cir. 1967).

29. *ASAT, Inc. v. Comm'r,* 108 TC 147, 174-175 (1997).

Theft Loss

***Estate of Rudolph Moragne v. Comm'r,* TC Memo 2011-299 (Dec. 27, 2011)**
IRC §§165, 6651, and 6654

☞ Wife's Activities Do Not Constitute Theft

Facts. Rudolph Moragne was a public health physician before he had two surgeries that forced him to curtail his medical practice. Dr. Moragne enlisted the help of Mary Branch, a friend and former nurse, to attend to his personal needs. Ms. Branch assisted Dr. Moragne with his financial affairs because he was depressed and disinterested in handling them himself. She wrote checks to pay Dr. Moragne's bills and mortgages.

In October 2000, Dr. Moragne married Loretta Hill. Shortly afterwards, he instructed Ms. Branch to give his checkbook to his new wife, who would have general responsibility over his financial affairs going forward. Dr. Moragne arranged for Loretta to have check writing authority and authorized her to make various payments on his behalf.

Dr. Moragne owned a residence in Chicago before he married Loretta. He sold the property in late 2004 and used some of the proceeds to purchase a residence in Olympia Fields, Illinois, for $425,000. This property was placed in Loretta's name only. She subsequently took out a $250,000 home equity line of credit on the house.

Dr. Moragne had a joint checking account with Loretta. The bank statements reflected that Loretta wrote a check to herself for $26,000 in June 2004 and another check payable to cash for $50,015 in October 2004. In addition, she wrote two checks totaling $428,000 to Dr. Moragne and herself in December 2004, which both parties endorsed.

Dr. Moragne filed a petition for dissolution of marriage in December 2005. Sometime thereafter, his counsel and guardians concluded that Loretta's activities constituted theft.

In early 2010, Dr. Moragne's guardians filed federal income tax returns for 2002 and 2004. The returns claimed theft losses of $319,569 and $384,540 for 2002 and 2004, respectively. The IRS disallowed the claimed theft losses and assessed penalties for late filing, late payment, and failure to pay estimated taxes.

Issues. The issues in this case are as follows.

- Whether Dr. Moragne is entitled to a theft loss deduction under IRC §165 for 2002 and 2004
- Whether Dr. Moragne is liable for penalties for late filing, late payment, and underpayment of estimated tax

Analysis. Under Illinois law, a theft loss requires an illegal taking done with criminal intent. However, the representative for Dr. Moragne's estate failed to establish the amount of any loss for either 2002 or 2004, nor whether Loretta's activities constituted a theft. No explanation was provided as to how Loretta used the funds or whether Dr. Moragne approved or authorized the expenditures. The fact that several of the checks were endorsed by Dr. Moragne provided evidence that he authorized Loretta to control his checkbook and expend his funds. The representative also failed to present any evidence demonstrating that all the money deposited into the bank account was Dr. Moragne's and that all the money withdrawn was spent for Loretta's benefit.

The tax returns for 2002 and 2004 were filed in January 2010. Dr. Moragne's representative provided no evidence that the failure to file the returns was due to reasonable cause. Thus, Dr. Moragne is liable for the late-filing and late-payment penalties.

Dr. Moragne also had a required estimated tax payment for 2002 and 2004 but did not make any payments. No evidence was presented to contradict the IRS's determination of a penalty and none of the statutory exceptions under IRC §6654(e) apply.

Holding. The court held that Dr. Moragne is not entitled to a theft loss deduction and is liable for penalties for late filing, late payment, and underpayment of estimated tax for 2002 and 2004.

Theft Loss

***Donald and Joyce Schroerlucke v. U.S.,* U.S. Court of Federal Claims; No. 09-772T (Sep. 21, 2011)**
IRC §§165, 1211, and 7422

☞ Taxpayers Not Entitled to Theft Loss Deduction on Sale of WorldCom Stock

Facts. Donald Schroerlucke is a former employee of WorldCom, Inc. He was the Vice President of Operations for Long Distance Discount Services, Inc., the predecessor corporation to WorldCom. Pursuant to stock option agreements with Long Distance Discount Services and WorldCom, he accumulated employee stock options between 1991 and 1998.

Mr. Schroerlucke's employment with WorldCom ended in January 1999. At that time, his stock options became fully and immediately vested. He was required to immediately exercise all of his employee stock options according to the terms of the stock option agreements. Mr. Schroerlucke had accumulated 172,492 WorldCom stock options. He exercised all of the stock options on February 12, 1999, when the market value of his WorldCom shares was $13.7 million, based on the $79.374 per share closing price on that date.

Shortly after exercising his options, Mr. Schroerlucke sold 75,374 shares of the stock at $80.67 per share, for a total of $6.1 million. He used part of the sale proceeds to pay the exercise price of $1.8 million to WorldCom and to pay withholding taxes of $4.2 million. The remaining 97,118 shares of WorldCom stock from the option exercise, which were worth $7.7 million based on the February 12, 1999 closing price, were deposited into Mr. Schroerlucke's brokerage account.

Mr. Schroerlucke began selling his remaining shares of WorldCom stock in May of 2002. His activity is summarized in the following table.

Date	Shares Sold	Sale Price	Tax Basis	Net Loss
May 1, 2002	80,000	$175,189	$4,302,499	($4,127,310)
May 24, 2002	1,242	2,093	66,796	(64,703)
September 12, 2002	47,516	6,124	2,555,469	(2,549,345)
Total	128,758 [a]	$183,406	$6,924,764	($6,741,358)

[a] The total number of shares sold by Mr. Schroerlucke is higher that the number of stock options he was awarded because of a December 1999 stock split of WorldCom stock. As a result of the stock split, Mr. Schroerlucke's holdings increased to 145,677 shares of stock.

During Mr. Schroerlucke's employment with WorldCom, he had numerous contacts with top level officials at the company, including CEO Bernard Ebbers and CFO Scott Sullivan, in which the officials "represented that WorldCom was an exceptional company and could be trusted to run its business in an ethical and honest fashion." Mr. Schroerlucke reported that he was personally and specifically discouraged by Mr. Ebbers from selling any WorldCom shares.

According to the criminal indictment of Mr. Ebbers, he and Mr. Sullivan "engaged in an illegal scheme to deceive members of the investing public, WorldCom shareholders, securities analysts, and the SEC, and others, concerning WorldCom's true operating performance and financial results," beginning in September 2000. In March 2005, Mr. Ebbers was convicted on nine counts. Mr. Sullivan pled guilty to a number of counts in his indictment in August 2005.

In April 2003, Mr. and Mrs. Schroerlucke filed their 2002 federal income tax return, on which they claimed a capital loss of $6,741,358 as a result of the sale of WorldCom stock. Pursuant to IRC §1211(b), they received the maximum annual capital loss deduction of $3,000. In April 2006, Mr. and Mrs. Schroerlucke filed a 2002 amended income tax return, changing their original capital loss claim to a theft loss claim under IRC §165. As a result, they claimed an additional tax refund of $9,959. Based on a carryback of their claimed theft loss in 2002, the Schroerluckes filed amended tax returns for 1997, 1998, and 1999, on which they claimed additional refunds of $63,018, $39,366, and $2,549,207, respectively. Their total refund claims amounted to $2,661,550. The refund claims were denied by the IRS in July 2008.

Issue. Whether the Schroerluckes are entitled to a tax refund for alleged unreimbursed theft losses with regard to Mr. Schroerlucke's WorldCom stock options.

Analysis. Treas. Reg. §1.165-8(d) defines theft as follows: "… 'theft' shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery." The specifics are left to the applicable state law. At all times relevant to this case, the Schroerluckes were residents of Georgia.

The first potentially relevant Georgia theft statute in this case involves "theft by taking," which can occur either by taking the property of another with the intent to deprive, or appropriating the property of another, which the perpetrator initially was legally holding. A theft by taking could not have occurred in the Schroerlucke's case because WorldCom did not unlawfully take or appropriate any property from Mr. Schroerlucke. Mr. Schroerlucke received the full market value of his shares at the time he exercised his options. The fact that he chose not to sell but to hold on to the shares until a later date does not transform the fallen stock prices and corresponding loss of value into a theft by taking.

The second potentially relevant Georgia theft statute involves "theft by deception." The Schroerluckes allege that WorldCom committed a theft by deception by "defraud[ing] the Plaintiffs into exercising their options, investing in the Company, and holding that investment by concealing material facts of a vast existing fraudulent scheme." However, under Georgia law, a theft by deception occurs only when there is a deceitful misrepresentation regarding an existing fact or past event. A promise of future performance cannot be the basis for a conviction.[30] The decline in the value of WorldCom stock after Mr. Schroerlucke exercised his options also cannot establish theft by deception because WorldCom did not obtain the difference in the value resulting from the decline in the stock value, which is a necessary element of theft by deception.

Holding. The court held that the plaintiffs do not qualify for a theft loss deduction for their 1997, 1998, 1999, and 2002 tax years.

Timing of Deduction

Rev. Rul. 2011-29, IRB 2011-49 (Nov. 9, 2011)
IRC §§461, 446, and 481

☞ Deduction Allowed for Bonuses Although Specific Recipients Determined After Yearend

Purpose. This revenue ruling addresses the issue of whether an employer can establish the "fact of the liability" under IRC §461 for bonuses payable to a group of employees if the employer does not know the identity of any particular bonus recipient and the amount payable to that recipient until after the end of the taxable year.

Analysis. In the scenario presented in this revenue ruling, X uses an accrual method of accounting. X pays bonuses to a group of employees pursuant to a program that defines the terms and conditions under which the bonuses are paid for a taxable year. The minimum total amount of bonuses payable under the program is determinable either through a formula that is fixed prior to the end of the taxable year or through other corporate action made before the end of the taxable year. Bonuses are paid before the 15th day of the third calendar month following the close of the taxable year.

IRC §461(a) provides that the amount of any deduction must be taken in the proper taxable year under the method of accounting that the taxpayer uses to compute taxable income. Treas. Reg. §1.461-1(a)(2)(i) provides the following 3-prong "all events test" for determining whether, under an accrual accounting method, a liability is incurred and is taken into account for federal tax purposes in the taxable year.

1. All events have occurred that establish the fact of the liability.
2. The amount of the liability can be determined with reasonable accuracy.
3. Economic performance has occurred for the liability.

30. See *Robinson v. State,* 401 S.E.2d 621, 622-23 (Ga. Ct. App. 1991) (quoting *Croy v. State,* 211 S.E.2d 183, 185 (Ga. Ct. App. 1974)).

This revenue ruling only addresses whether the first part of the test is met. Generally, all events occur to establish the fact of the liability when the event fixing the liability occurs or payment is unconditionally due.

X's liability to pay a minimum amount of bonuses to a group of employees is determined by the end of the year in which the services are rendered. This is true although the identity of the recipients and the amount awarded to each employee cannot be determined prior to the end of the taxable year. Thus, for purposes of the first part of the all events test, all the events have occurred that establish the fact of X's liability to pay the minimum amount of bonuses.

Holding. An employer can establish the **fact of the liability** for bonuses payable even though the employer does not know the identity of the specific bonus recipients and the amount payable to each until after the end of the taxable year.

Mortgage Interest Deduction

***Thomas Rose, Sr. and Cheryl Rose v. Comm'r,* TC Summ. Op. 2011-117 (Oct. 4, 2011)**

IRC §163

☞ Mortgage Interest Deduction Allowed During Construction Period

Facts. In January 2006, Thomas and Cheryl Rose entered into a contract for the purchase of beachfront property in Fort Myers Beach, Florida, for $1.575 million. There was an existing house on the property that the Roses intended to have torn down so that they could build a new house on the lot.

The Roses borrowed $1.26 million for a mortgage on the property. They closed on the purchase of the property on March 6, 2006. At that time, the demolition work had been completed and the property consisted of a vacant lot.

The Roses were required to obtain a construction permit from the Florida Department of Environmental Protection (department) in order to build a new house on the property. The department requires anyone who wants to build on beachfront property to complete a lengthy permitting process, which includes submitting detailed survey work and core drilling samples.

In July 2007, the Roses entered into a building contract with Damon Custom Structures, Inc. (DCS). The terms of the contract provided that its enforceability was contingent on the couple's ability to obtain acceptable construction financing for the project. The final price for the work that DCS agreed to perform under the contract was $1.96 million.

The department notified the Roses that their application was considered complete as of September 27, 2007. The department granted the Roses a construction permit on February 11, 2008, almost two years from the date that the couple purchased the property.

It was necessary for the Roses to secure an additional bank loan to cover construction costs before they could proceed with their plans to build a home on the property. However, the credit market was constrained because of the decline in the residential real estate market in Florida that occurred between the time that the Roses purchased the property and the date on which the construction permit was granted. Consequently, the Roses were unable to secure the financing that would allow them to proceed with the construction of the home.

In June 2009, the Roses sold the beachfront property for $750,000. Thus, they sustained a loss of $825,000 on the property 3½ years after its purchase.

The Roses filed joint federal income tax returns for 2006 and 2007 on which they deducted $87,016 and $82,201 in home mortgage interest, respectively. The IRS determined that the claimed interest deductions were not qualified residence interest. As a result, the IRS assessed deficiencies of $25,574 and $16,556 for the couple's 2006 and 2007 tax returns, respectively.

Issue. Whether the taxpayers are entitled to mortgage interest deductions for 2006 and 2007.

Analysis. A taxpayer may treat a residence that is "under construction" as a qualified residence for purposes of the mortgage interest deduction for a period of 24 months if the residence becomes a qualified residence at the time that it is ready for occupancy.[31]

The term "under construction" is not defined in the Code or regulations. Thus, the court in this case had to decide its proper interpretation. The court noted that the definitions of "under" and "construction" can be construed as broad enough to encompass the entire process of construction and not just the physical assembly of building materials.

During the period in question, the Roses purchased the property and had the existing house demolished and the lot cleared. These steps were recognized by the court as the beginning of construction. The couple also completed extensive planning and preparatory work required by the construction permitting process. Accordingly, the court stated that the property was **under construction** as a residence during 2006 and 2007.

The IRS argued that the Roses sold the property in 2009 before constructing a residence that was ready for occupancy. The IRS reasoned that the couple thus failed to satisfy the requirement that the property must become a qualified residence at the time the residence is ready for occupancy. However, the court acknowledged the well-known principle that each taxable year stands alone and is evaluated separately.[32] In order to evaluate each year on its own, it would be impossible for the taxpayers or the IRS to have known that the proposed residence would never become ready for occupancy. Whether the deductions the taxpayers claimed were appropriate should be evaluated on the basis of the facts and circumstances as they existed during the tax years at issue. The events that occurred in subsequent years that prevented the Roses from completing the construction of the residence were beyond their control.

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Holding. The court held that the Roses' planned residence was under construction during 2006 and 2007; thus, they are entitled to the claimed mortgage interest deductions for those taxable years.

Mortgage Interest Deduction
***Conrad Y. Edosada v. Comm'r,* TC Summ. Op. 2012-17 (Feb. 29, 2012)**
IRC §§163 and 6662

☞ Equitable Owner Allowed Partial Mortgage Interest Deduction

Facts. In 2005, Conrad Edosada's parents bought a California personal residence for $2.15 million with the understanding that it would be a family home. Even though the title and mortgage document were in the parents' names, it was agreed that Conrad would later be given a legal interest in the home. Conrad contributed $70,000 of his own funds towards the $570,000 down payment and agreed to be responsible for the payments on the $1.61 million mortgage loan.

Conrad moved into the home on January 10, 2007, and lived there for the rest of the year. He made all twelve mortgage payments in 2007, which included interest of **$67,003**. In December 2007, his parents deeded a small percentage (actual percentage not stated) of the home to Conrad.

On his 2007 tax return, Conrad deducted **$87,003** as home mortgage interest. This amount was exactly **$20,000 greater** than the actual amount of mortgage interest he paid in 2007. In 2010, an IRS examination resulted in a full denial of the claimed mortgage interest.

Issues. The issues in this case are as follows.

- Whether the taxpayer is entitled to a home mortgage interest deduction for 2007
- Whether the taxpayer is liable for the accuracy-related penalty

31. Temp. Treas. Reg. §1.163-10T(p)(5)(i).
32. *U.S. v. Lewis,* 340 U.S. 590 (1951); *Rose v. Comm'r,* 55 TC 28, 32 (1970).

Analysis. Qualified residence interest is any interest that is paid during the year on acquisition or home equity indebtedness.[33] However, for any year, the aggregate amount of home acquisition debt may not exceed $1 million, and the aggregate amount of home equity debt may not exceed $100,000.[34]

The indebtedness generally must be an obligation of the taxpayer. However, even if a taxpayer is not directly liable on the mortgage document, a taxpayer who is the legal or **equitable owner** of the property subject to the mortgage may nevertheless deduct the mortgage interest paid.[35]

The court determined that **Conrad had an equitable ownership interest in the home at the beginning of 2007,** the tax year in question, for the following reasons.

- He and his parents considered the residence to be the family home.
- He resided in the home for all but nine days during 2007.
- He bore a substantial risk of loss because he supplied $70,000 of his own funds towards the down payment.
- He agreed to be responsible for all of the mortgage payments.

However, the $87,003 claimed mortgage interest deduction was **excessive** for the following reasons.

- The amount claimed was $20,000 more than the interest actually paid.
- The average balance of the mortgage for 2007 was $1.7 million. A deduction is allowed only on the first $1.1 million of a home mortgage loan ($1 million of acquisition debt plus $100,000 of home equity debt).

The correct amount of allowable home mortgage interest is the pro-rata share of the interest on $1.1 million of mortgage debt. The court instructed the parties to compute the allowable interest deduction.

The court also upheld the imposition of the 20% accuracy-related penalty because **the taxpayer offered no reasonable cause** for his excessive mortgage deduction.[36]

Holding. The taxpayer may deduct only a portion of the mortgage interest he claimed on his tax return. He is also liable for an accuracy-related penalty.

Qualified Residence Interest

***Charles Sophy et al. v. Comm'r,* 138 TC No. 8 (Mar. 5, 2012)**
IRC §163

☞ Limits on Acquisition and Home Equity Debt Apply on a Per-Residence Basis

Facts. In 2000, Charles Sophy and Bruce Voss purchased a house together in Rancho Mirage, California, which was financed by a mortgage. In 2002, they purchased a second house in Beverly Hills, California, which was also financed by a mortgage. In 2003, they obtained a $300,000 home equity line of credit for the Beverly Hills house.

The total average balance in 2006 for the Beverly Hills mortgage and home equity loan and the Rancho Mirage mortgage was $2,703,568. During 2006, Sophy paid interest for the two residences of $94,698, and Voss paid $85,962. In 2007, the total average balance for the two mortgages and the home equity loan was $2,669,136. During 2007, Sophy paid interest of $99,901, and Voss paid $76,635.

33. IRC §163(h)(3)(A).

34. IRC §§163(h)(3)(B)(ii) and (C)(ii).

35. Treas. Reg. §1.163-1(b).

36. Treas. Reg. §§1.6662-3(b)(1) and 1.6664(c)(1).

On their individual federal income tax returns for 2006 and 2007, Sophy and Voss each claimed deductions for qualified residence interest. The IRS audited their returns for these years and disallowed portions of the interest deductions because the amount of the debt exceeded the qualified loan limits imposed by IRC §163. The IRS disallowed $56,866 and $24,443 of Sophy's interest deductions for 2006 and 2007, respectively. It disallowed $60,421 and $56,685 of Voss's interest deductions for 2006 and 2007, respectively.

Issue. Whether the IRS properly applied the limits under IRC §163 to reduce Sophy's and Voss's claimed qualified residence interest deductions.

Analysis. **Qualified residence interest** refers to interest paid or accrued during a tax year on acquisition debt or home equity debt with respect to a taxpayer's qualified residence.[37] However, the aggregate amount treated as acquisition debt is limited to $1 million ($500,000 if MFS).[38] Home equity debt is limited to $100,000 ($50,000 if MFS).[39]

Sophy and Voss contended that the IRC §163(h)(3) limitations are properly applied on a per-taxpayer basis for residence co-owners who are not married to each other. According to their argument, they should **each** be allowed a deduction for interest paid on up to $1.1 million of acquisition and home equity indebtedness with respect to **each** of the residences that they jointly own.

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The IRS position is that the debt limitations are properly applied on a per-residence basis, regardless of whether the co-owners are married to each other. Under this interpretation, the co-owners should collectively be limited to a deduction for interest paid on a maximum of $1.1 million of acquisition and home equity debt for each residence that they own.

The court noted that the definition of acquisition indebtedness in IRC §163(h)(3)(B)(i) uses the phrase "any indebtedness which is incurred" in conjunction with "any qualified residence of the taxpayer." The word "taxpayer" in this context is used in relation to the qualified residence, rather than to the indebtedness. Similarly, IRC §163(h)(3)(C)(i) defines home equity debt as "any indebtedness (other than acquisition indebtedness) secured by a qualified residence…" These definitions focus on the residence rather than the taxpayer. It appears that Congress used the term "any indebtedness" to refer to the total amount of indebtedness for a qualified residence. Thus, the court opined that what is being limited is the total amount of debt that may be claimed in relation to the qualified residence, rather than the debt that may be claimed in relation to an individual taxpayer.

The court found further support regarding the application of the indebtedness limitations in the parenthetical language of §163(h)(3)(B)(ii), which provides that married taxpayers who file separate returns are limited to one-half of the otherwise allowable amount of **acquisition indebtedness.** Similarly, the parenthetical language of §163(h)(3)(C)(ii) provides that married taxpayers who file separate returns are limited to one-half of the otherwise allowable amount of **home equity indebtedness.** This language appears to set out a specific allocation of the limitation amounts that married couples must use when they file separate returns. This implies that co-owners who are not married to one another may choose to allocate the limitation amounts in some other manner, such as according to ownership percentage.

Holding. The court concluded that the limitations in IRC §163(h)(3) on the amounts that may be treated as acquisition and home equity indebtedness are properly applied on a per-residence basis.

37. IRC §163(h)(3)(A).

38. IRC §163(h)(3)(B)(ii).

39. IRC §163(h)(3)(C)(ii).

Charitable Contributions

***Loren Dunlap and Nancy Dunlap, et al. v. Comm'r,* TC Memo 2012-126 (May 1, 2012)**

IRC §§170 and 6662

☞ Charitable Donation of Façade Easement Requires Proof of Value

Facts. Cobblestone Loft Condominium (CLC) is a 7-story building in the Tribeca North Historic District of New York City. The several taxpayers in this case who are challenging IRS notices of deficiency are all unit owners in CLC. Along with the ownership of their respective condominiums, each of the taxpayers has an ownership interest in the common areas of the building, including the façade.

The National Architectural Trust (NAT) is a §501(c)(3) organization that holds over 800 preservation easements in the United States, with over 500 of those in New York City. After a presentation on the donation of a façade easement, the NAT introduced a tax attorney to the CLC board, who provided the board with an opinion letter. The opinion letter indicated that a CLC façade easement donation constituted a qualified conservation contribution that could be deducted by each owner.

In December 2003, the taxpayers proceeded with the façade donations after an initial appraisal was completed by a qualified appraiser. The appraiser was referred to the CLC board by NAT. As a condition to the façade easement donations, each taxpayer was required to make cash contributions to NAT equal to 7% of each owner's appraised façade value, purportedly for monitoring fees and other costs of enforcing the easement. It was the taxpayers' understanding that these cash contributions would be deductible as charitable contributions. NAT enforced the cash contributions by indicating to unit owners that they would not receive their IRS Forms 8283, *Noncash Charitable Contributions*, required for the façade easement deductions, until the cash contributions were paid.

The IRS disallowed the amounts claimed for both the façade easements and the charitable donations and sent each taxpayer a notice of deficiency.

Issues. The issues in this case are as follows.

- Whether the taxpayers are entitled to a charitable contribution deduction for the **façade easement** donations
- Whether the taxpayers are entitled to a charitable contribution deduction for their **cash contributions**
- Whether the taxpayers are liable for **accuracy-related penalties** under IRC §6662(a) and (h)

Analysis. The taxpayers have the burden of proving a value above zero for the **façade easement**. Using two expert appraisers, the taxpayers attempted to establish a value. However, the first appraisal was flawed because it used a value for the CLC property that disregarded the actual use of the building as a condominium building rather than as an apartment building. Further, the appraisal did nothing to determine the effect of granting the façade easement on the value of the building. The second appraisal presented by the taxpayers was also flawed because it was based on comparable properties using a method that undersampled and oversampled in weak and strong real estate market years that caused skewed results. Therefore, these appraisals have no probative weight. While the granting of an easement generally has some negative effect on the overall value of a property that could serve as the value of a donation of that easement, the taxpayers failed to establish any value for the easement.

The IRS made the following arguments that the **cash contributions** are not donations because the taxpayers expected a substantial benefit.

- These contributions were made in order to receive Forms 8283 (a valuable benefit) and were not made with the necessary charitable intent.
- Because the amounts of cash donations were based on the appraised façade easement value for each taxpayer, these cash contributions were conditional gifts for which no deduction is allowed. If a subsequent appraisal had been completed with a lower value, NAT would have refunded part of the cash contributions to the taxpayers.
- The contributions were made to NAT in exchange for the monitoring and administrative services provided by NAT on a "quid pro quo" basis.

Making a cash contribution in exchange for the valuable benefit of a tax deduction is an acceptable anticipated taxpayer benefit that does not diminish the necessary charitable intent. In addition, the IRS failed to provide any evidence that, if a subsequent appraisal were completed, a lower appraised value than the one used as a basis for the cash contributions would have resulted in any refund of cash contributions to the taxpayers. The IRS failed to prove the requisite "link" between the cash contributions and the appraised façade value to establish a conditional gift. Apparently, the use of 7% of appraised value as a basis for determining the amount of the cash contribution from each taxpayer was not enough to establish a conditional gift either. Furthermore, the NAT monitoring and administrative services had an insignificant value to the taxpayers.

Holding. The court held as follows.

1. Because the taxpayers failed to prove that the façade easement had a value, they are not entitled to any deductions for the façade easement.
2. The taxpayers are entitled to charitable deductions for their cash contributions to the NAT because these contributions constituted charitable donations.
3. The taxpayers are not subject to any **accuracy-related penalties** because they reasonably and in good faith relied on a qualified appraisal by a qualified appraiser and they made a good-faith investigation of this value as required by IRC §6662(c)(2). When the taxpayers show they reasonably and in good faith rely on a qualified appraisal report in a manner satisfying the reasonable cause and good-faith requirement of §6664(c)(1), this reliance may also satisfy the good-faith investigation requirement of §6664(c)(2)(B).

Charitable Contributions

***David and Veronda Durden v. Comm'r,* TC Memo 2012-140 (May 17, 2012)**

IRC §170

☞ Incomplete Statement From Charity Results in Disallowed Deduction

Facts. Mr. and Mrs. Durden, Texas residents, claimed charitable contributions of $25,171 on their 2007 Schedule A, *Itemized Deductions.* Most of these contributions were made to Nevertheless Community Church (NCC), and all but five checks to NCC, totaling $317, were for more than $250. NCC is a §501(c)(3) organization eligible to receive tax-deductible contributions pursuant to IRC §170(c)(2).

The IRS issued a notice of deficiency disallowing the entire amount of 2007 charitable contributions. In response, the Durdens provided copies of canceled checks and a letter from NCC dated January 10, 2008, which acknowledged their contributions. The IRS rejected the letter because it lacked a statement regarding whether any goods or services were provided in consideration for the contributions. The Durdens then obtained a second letter from NCC dated June 21, 2009, which contained the same information as the January 10, 2008 letter but also included a statement that no goods or services were provided to them in exchange for their contributions.

Issue. Whether the taxpayers are entitled to deduct Schedule A charitable contributions to their church of more than $250.

Analysis. IRC §170(a)(1) allows a deduction for contributions to charitable organizations defined in IRC §170(c). IRC §170(f)(8)(A) provides: "No deduction shall be allowed… for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment of the contribution by the donee organization that meets the requirements of subparagraph (B)." For donations of money, the donee's written acknowledgement must state the amount contributed, indicate whether the donee organization provided any goods or services in consideration for the contribution, and provide a description and good faith estimate of the value of any goods or services provided by the donee organization.

As defined in IRC §170(f)(8)(C), a written acknowledgment is contemporaneous if it is obtained by the taxpayer on or before the earlier of:

1. The date the taxpayer filed the original return for the taxable year of the contribution, or
2. The due date (including extensions) for filing the original return for the year.

The IRS asserted that neither the first nor the second letter provided by NCC satisfied the requirements of §170(f)(8). The first letter failed because it did not include a statement regarding whether any goods or services were provided to the taxpayers for their contributions. The second letter, which included the statement, was not contemporaneous. The Tax Court agreed with the IRS's assertions, noting that nothing in the statutes or legislative history requires the IRS to look beyond the written acknowledgement when the acknowledgement fails to provide the information required to substantiate a charitable contribution deduction.

Holding. The court held that the Durdens failed to comply, strictly or substantially, with the clear substantiation requirements and disallowed the charitable contribution deduction at issue.

Charitable Contributions
Joseph Mohamed, Sr. and Shirley Mohamed v. Comm'r, **TC Memo 2012-152 (May 29, 2012)**
IRC §170

☞ Taxpayer-Prepared Appraisals Result in Disallowed Charitable Deductions

Facts. Joseph Mohamed is a real estate broker, certified real estate appraiser, and prominent entrepreneur. He and his wife, Shirley, established a charitable remainder unitrust (CRUT). This is a special type of trust that allows taxpayers to claim an immediate charitable deduction for a portion of the value of property contributed.

In 2003, Mohamed transferred five properties worth approximately $15.5 million to the CRUT. In 2004, another property worth $2.7 million was similarly transferred. Mohamed completed his own returns for 2003 and 2004, including Form 8283, *Noncash Charitable Contributions*. Mohamed admitted that he did not read the instructions before completing the form because the form seemed clear to him. For the required valuation of the properties, Mohamed completed his own appraisals. He did not indicate his basis in the transferred property on the form and left the declaration of appraiser section blank. He did, however, sign the donee acknowledgement area of the form for the CRUT. He attached statements to his returns for 2003 and 2004 providing the addresses of the properties and additional details. On both the 2003 and 2004 returns, Mohamed claimed substantial charitable deductions with a significant carryforward amount.

In April 2005, the IRS took issue with Mohamed's self-appraisal of the high-value properties. Mohamed in turn hired independent appraisers to complete valuations of each property transferred to the CRUT. The independent appraisals reported the value of the properties as $1.7 million higher than Mohamed's own appraisals.

The IRS challenged the taxpayer's charitable contribution deductions, arguing that the several mistakes made on the Forms 8283 for 2003 and 2004 constituted a failure to follow the requirements mandated in the relevant regulations. Mohamed contended that the regulation is invalid and that he substantially complied; therefore, his charitable contribution deductions should be allowed.

Issues. The issues in this case are as follows.

- Whether the relevant regulation that outlines the requirements for reporting this type of charitable contribution is valid
- Whether the taxpayer substantially complied with the regulatory requirements

Analysis. IRC §170(a)(1) states that "a charitable contribution shall be allowable as a deduction only if verified under regulations…" In this case, Mohamed was required to adhere to the requirements outlined in Treas. Reg. §1.170A-13 in connection with the verification of a charitable donation in excess of $5,000. A regulation cannot be invalidated unless it is arbitrary, capricious, or manifestly contrary to statute. The IRS promulgated Treas. Reg. §1.170A-13 under authority given by the Deficit Reduction Act of 1984 (DEFRA). The legislative history of DEFRA shows clear Congressional intent that contributions over $5,000 must be verified by a qualified appraiser and that the appraiser must be someone other than the taxpayer. Because this regulatory requirement is directly reflective of the statutory requirement, the regulation is not arbitrary, capricious, or manifestly contrary to the DEFRA statute.

In addition, Mohamed relied on several precedent cases on the subject of substantial compliance. However, these cases make it clear that substantial compliance requires compliance of the "essential elements" of a governing statute. A qualified appraisal by someone other than the taxpayer is an essential element for the verification of a charitable contribution in excess of $5,000.

Holding. Treas. Reg. §1.170A-13 is a valid regulation. Moreover, the taxpayer did not substantially comply with the regulation. The taxpayer is not entitled to any charitable contribution deductions for 2003 or 2004 because he failed to obtain qualified, independent appraisals.

> **Note.** In writing the Court's opinion, Judge Holmes stated: "We recognize that this result is harsh — a complete denial of charitable deductions to a couple that did not overvalue, and may well have **undervalued,** their contributions — all reported on forms that even to the Court's eyes seemed likely to mislead someone who didn't read the instructions. But the problems of misvalued property are so great that Congress was quite specific about what the charitably inclined have to do to defend their deductions, and we cannot in a single sympathetic case undermine those rules."

Charitable Contributions

Theodore Rolfs, et al. v. Comm'r, **U.S. Court of Appeals, 7th Circuit; No. 11-2078 (Feb. 8, 2012)**
IRC §170

☞ Conditions Impact the Valuation of Conditional Charitable Gift

Facts. Theodore Rolfs and his wife Julia Gallagher purchased a lakefront residence. They wanted to have the house on the property demolished so that another more suitable home could be built on the same property. They donated the house to the local fire department to be used in a training exercise, with the condition that the house be burned down. The taxpayers had an appraisal completed and arrived at the following values.

Value of land and house	$675,000
Less: value of land alone	(599,000)
Value of house alone	$ 76,000

The taxpayers claimed a $76,000 charitable contribution deduction on their 1998 tax return. The IRS disallowed the deduction, arguing that the fair market value (FMV) of the gift was zero because the condition that the house be demolished made the gift worthless. The Tax Court agreed with the IRS and the taxpayers appealed.

Issue. Whether the Tax Court was correct in disallowing the charitable contribution deduction on the basis that the benefit received by the taxpayers exceeded the value of the house donated

Analysis. The FMV of donated property must take into account conditions imposed on the donation that affect the market value of the donated property. Both parties presented competing experts who proposed differing valuation methods. The taxpayers' expert used a "before-and-after" approach, which is often used to value conservation easements. However, the IRS presented two experts who testified to the negligible value, if any, that the house would have had if separated from the land. Although there was no dispute that $76,000 of home value was destroyed in the fire, the IRS maintained that none of the $76,000 value was actually transferred to the fire department. The taxpayers decided to demolish the home and became responsible for the decrease in value when they made the demolition a condition of their gift. The fire department simply provided the mechanism to demolish the house; none of the value of the house, as a house, was donated to the fire department. The result would be different if, for example, the taxpayers left the house intact and donated it to a charity to provide housing for needy families.

The only thing the taxpayers gave to the fire department was the right to access their property to demolish their house, a service for which the taxpayers would have otherwise paid a substantial amount. Given the Tax Court's determination that there was no substantial value to the gift of the house and the cost of demolition would have been at least $10,000, the value of the gift was exceeded by the benefit the taxpayers received in return. Thus, no deduction is allowed.

Holding. Property that is donated to a charity subject to a condition that it be destroyed must be valued in light of that condition. The benefit received by the donating taxpayers exceeded the FMV of the donated house, thus no charitable contribution is allowed. The Tax Court's decision is affirmed.

> **Note.** For a more detailed discussion of the Tax Court case, see p. 255 of Chapter 7 in the 2011 *University of Illinois Federal Tax Workbook.*

Charitable Contributions

Marshall and Judith Cohan, et al. v. Comm'r, **TC Memo 2012-8 (Jan. 10, 2012)**

IRC §§170, 1001, 761, 212, 1222, and 6662

☞ Improper Documentation Leads to Disallowed Charitable Deduction

Facts. The taxpayers were members of an LLC that transferred rights of first refusal over property to The Nature Conservancy (TNC). TNC is an international charitable organization dedicated to the conservation and preservation of land and wildlife. During negotiations regarding this complex transfer, TNC agreed to indemnify the taxpayers for any tax liability incurred on the taxable component of consideration received from TNC. TNC also wanted to enhance the tax value of the transaction to the taxpayers. TNC was therefore motivated to minimize the disclosure of such consideration in the acknowledgement letter, even though all parties were aware of all the items of consideration. This would minimize the tax indemnification amount TNC was obligated to pay and entice the taxpayers to transfer the rights of first refusal to TNC. In addition, the taxpayers were similarly motivated to maximize their charitable contribution deduction amounts by reducing the disclosed consideration received from TNC. Accordingly, the acknowledgment letter from TNC to the donor taxpayers listed only some of the consideration provided to the taxpayers in the transaction.

The IRS challenged the taxpayers' charitable contribution deductions in connection with this 2001 transaction, arguing that the basic documentation requirements of a charitable donation were not met.

Issue. There are several issues in this case but the following analysis focuses on whether the taxpayers failed to meet the **documentation requirements** of a charitable contribution deduction.

Analysis. IRC §170(f)(8)(A) requires **documentation** in the form of a contemporaneous acknowledgement from the charitable organization for any charitable deduction in the amount of $250 or more. IRC §170(f)(8)(B) provides that this acknowledgement must generally include the following information.

- The amount of cash paid and a description of the property contributed, as applicable
- Whether the charitable organization provided any goods or service in return for the donated cash or property
- A description or good faith estimate of the value of the goods or services provided to the donor by the charitable organization

The taxpayers could not satisfy these requirements with an acknowledgement letter that did not fully disclose the items of consideration. Furthermore, there was motivation and a conscious decision on the part of the taxpayers and TNC to use an acknowledgement letter that left off certain items of consideration. Accordingly, the acknowledgement letter did not include an adequate description or a good faith estimate of the value of consideration.

Treas. Reg. §170A-1(h)(4)(i) indicates that a taxpayer may **rely** on a contemporaneous written acknowledgement in order to determine the fair market value of any goods or services provided to the taxpayer by the charitable organization. "However, a taxpayer may not use a charitable organization's estimate of the value of goods or services as the fair market value if the taxpayer knows, or has reason to know, that the estimate is unreasonable."[40] Because the taxpayers in this case were aware that the acknowledgement letter did not disclose certain items of consideration, reasonable reliance for the value of consideration did not exist.

The taxpayers argued that they **substantially complied** with the documentation requirements. However, substantial compliance may only be found when the taxpayer fails to follow a formality. For example, if the taxpayer meets all the documentation and disclosure requirements but fails to attach a description of the appraiser's qualifications on Form 8283, *Noncash Charitable Contributions*, substantial compliance exists. The taxpayers in this case, however, failed to disclose the proper value of total consideration received. This was necessary to properly calculate the amount of each taxpayer's charitable contribution deduction. The taxpayers and their attorneys knew that the acknowledgement letter did not disclose all items of consideration and used only the amount in the acknowledgement letter to calculate their deductions. Substantial compliance therefore did not exist.

Holding. The taxpayers did not meet the documentation requirements under IRC §170(f)(8) for the 2001 charitable contribution deductions claimed. It was appropriate for the IRS to disallow these deductions.

Charitable Deduction

***Ramona L. Mitchell v. Comm'r,* 138 TC No. 16, (Apr. 3, 2012)**
IRC §§170 and 6662

☞ No Charitable Deduction Because Subordination Requirement not Met

Facts. The Mitchells resided in Mancos, Colorado, where Mr. Mitchell operated a business. For over 20 years, Mr. Mitchell tried to purchase 456 acres of ranchland in the southern part of Mancos Valley from Clyde Sheek. Finally, in 1998, Sheek sold a 105-acre parcel to the Mitchells for $180,000. The Mitchells improved the property by installing a 2-inch water line and electrical lines. The Mitchell's son Blake and his wife built a home, shop, and guesthouse on the property in 2000.

In 2000, Mr. Mitchell sold his business and approached Sheek about purchasing the remaining 351 acres. Sheek agreed to sell the remaining 351 acres for $683,000 (cash of $83,000 and $600,000 to be paid in installments of $60,000 per year plus interest).

40. Treas. Reg. §1.170A-1 (h)(4)(i).

The 456 acres of farmland was called Lone Canyon Ranch. The Mitchells built a home there in 2001.

The Mitchells formed C. L. Mitchell Properties, LLLP in December 2002 and transferred Lone Canyon Ranch along with some other properties to the newly formed entity. Mr. Mitchell was the general partner until he became ill. At that time, Blake took over his duties. Mr. Mitchell died in 2006.

On December 31, 2003, the partnership granted a conservation easement on the south 180 acres of unimproved land to Montezuma Land Conservancy. A deed of conservation easement in gross was executed; however, the debt to Sheek was not subordinated to the conservation easement held by the Conservancy.

In 2004, the Mitchells hired William B. Love Appraisals, Inc., to appraise the conservation easement. Love issued an appraisal report showing a market value of $504,000. The partnership claimed a $504,000 charitable contribution, which flowed through to the Mitchells' individual tax return. The Mitchells attached Form 8283, *Noncash Charitable Contributions,* to their 2003 return and a copy of the Love appraisal.

In 2005, Sheek agreed to subordinate his deed of trust to the conservation easement but received no consideration for the subordination. In December 2005, Sheek signed the subordination agreement.

The IRS issued a notice of deficiency disallowing the 2003 charitable contribution deduction because the taxpayer had not met the requirements of IRC §170. In addition, the IRS stated that, if the §170 requirements had been met, the amount of charitable contribution deduction would only be $100,100.

Issues. The issues in this case are as follows.

- Whether Mrs. Mitchell is entitled to a charitable deduction for the conservation easement granted to Montezuma Land Conservancy
- If she is entitled to a deduction, what is the amount of the deduction
- Whether Mrs. Mitchell is liable for the accuracy-related penalty under IRC §6662(a) and (d) or the gross valuation misstatement penalty under IRC §6662(a) and (h)

Analysis. Although a taxpayer is generally not allowed a charitable contribution deduction for a gift of property consisting of less than an entire interest in the property, IRC §170(f)(3)(B) provides an exception for a qualified conservation contribution. A **qualified conservation contribution** is a contribution:

1. Of a qualified real property interest,
2. To a qualified organization, and
3. Which is made exclusively for conservation purposes.

The IRS agreed that the first two requirements were met. The third requirement is where the controversy arises. IRC §170(h)(5) provides that a contribution is not treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity. Furthermore, no deduction is permitted for an interest in property that is subject to a mortgage unless the mortgagee subordinates its rights in the property to the right of the donee organization to enforce the conservation purposes in perpetuity.

In this case, the IRS argued that the donated property is not protected in perpetuity because Mrs. Mitchell failed to meet the subordination requirements. Mrs. Mitchell asserted that Sheek entered into a subordination agreement in 2005. She also argued that she entered into an oral agreement with Sheek for the use of Lone Canyon Ranch; thus, she believes that the oral agreement provides the necessary protection.

At trial, the IRS argued that the conservation easement must be in place at the time of the gift. The court agreed with the IRS position.

Finally, Mrs. Mitchell contended that the Mitchells had an oral agreement with Sheek that they would not subdivide or develop Lone Canyon Ranch. She asserted that these were the same rights relinquished under the conservation easement deed of trust and thus the oral agreement protects the conservation easement purpose in perpetuity. The court disagreed, stating that the oral agreement had no effect on Sheek's ability to foreclose on the property and extinguish the conservation agreement if Mrs. Mitchell defaulted on her promissory note.

With respect to the penalty, the court found that Mrs. Mitchell had reasonable cause and acted in good faith by initially hiring an accountant and appraiser. Once she became aware of the need for a subordination agreement, she promptly obtained one.

Holding. The court held that Mrs. Mitchell did not make a qualified conservation contribution and thus is not eligible for a charitable contribution deduction. Mrs. Mitchell is not liable for penalties because she had reasonable cause and acted in good faith.

DIVIDENDS

Capital Gain Rate

***Osvaldo and Ana Rodriquez v. Comm'r,* 137 TC No. 14 (Dec. 7, 2011)**
IRC §§1, 316, 951, 956, and 957

☞ Dividend Income Does Not Qualify For Preferential Income Tax Rates

Facts. Osvaldo and Ana Rodriquez were citizens of Mexico and permanent residents of Texas. They owned 100% of the stock of Editora Paso del Norte, S.A. de C.V. (Editora). Editora was originally incorporated in 1976 in Mexico and then began operations in the United States in 2001. Initially, Editora's primary business was selling newspaper advertising and publishing newspapers. By the end of 2002, the business' focus shifted to developing, constructing, managing, and leasing commercial real estate and printing presses in both the United States and Mexico.

On their 2003 and 2004 tax returns, the taxpayers included $1.59 million and $1.48 million, respectively, as dividend income from Editora. The taxpayers treated these amounts as qualified dividend income subject to the preferential tax rates under IRC §1(h)(11)(B). The IRS determined that these amounts should have been taxed at the ordinary income rate, resulting in deficiencies of $316,950 and $295,530 for 2003 and 2004, respectively.

Issue. Whether the dividend income from Editora qualifies for preferential tax rates as qualified dividend income.

Analysis. IRC §1(h)(11) provides preferential tax rates for "qualified dividend income," which includes dividends received from a qualified foreign corporation. IRC §316(a) defines a dividend as a distribution of property made by a corporation to its shareholders. IRC §951 provides that a dividend from a controlled foreign corporation to a U.S. shareholder is included in gross income to the extent that under §959(a)(1) there is a distribution out of earnings and profits for the respective taxable year.

At trial, the taxpayers presented the following arguments.

- Because IRC §1(h)(11) does not exclude IRC §951 inclusions, it must treat them as qualified dividend income.
- The instructions for Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations,* indicate that §951 inclusions should be reported as dividends.

The court rejected both arguments. In Notice 2004-70,[41] the IRS provided guidance that §951 inclusions **do not** constitute qualified dividend income under IRC §1(h)(11). Although the 2004 Form 5471 instructions are somewhat ambiguous, the IRS guidance published before the couple filed their returns clearly states that §951 inclusions do not constitute qualified dividend income under §1(h)(11).

Holding. The court ruled that the taxpayers are not entitled to treat their §951 inclusions as qualified dividend income under §1(h)(11)(B).

DEPENDENCY ISSUES

Dependency Exemption

Gary and Sandra Scalone v. Comm'r, **TC Summ. Op. 2012-40 (May 2, 2012)**
IRC §§24 and 152

☞ Dependency Exemption for Noncustodial Parent Allowed Based on Separation Agreement

Facts. Gary Scalone and his former wife, Denise Scalone, have a daughter who lives most of the year with Denise. In their separation agreement, Denise agreed that Gary would be entitled to claim their daughter as his dependent "for calendar year 2000 and for any taxable years henceforth." She also promised that she would fill out an IRS form declaring this and attach it "to her income tax return" if Gary kept current with his child support payments.

Gary was current with his child support payments in 2006; however, Denise refused to sign the IRS form. Nonetheless, Gary claimed the child as a dependent and attached a copy of the separation agreement to the 2006 tax return that he filed jointly with his new wife.

Issue. Whether Gary is entitled to the dependency exemption for his daughter for the 2006 tax year.

Analysis. The general rule for children of divorced parents is that the custodial parent is allowed to claim the children as dependents. One of the exceptions to the general rule applies when the custodial parents signs a declaration in which they agree not to claim the child as a dependent. The noncustodial parent then attaches the declaration to their tax return for that year.[42] Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent,* is used by most people to make this declaration but a taxpayer can use any statement that conforms to the substance of that form.[43] The court noted that it is not always easy to determine whether a declaration conforms to the substance of Form 8332 because, in previous cases, courts have decided that some of the information on the form is absolutely required and some is just helpful to the IRS in processing the return.[44]

41. IRS Notice 2004-70, 2004-2 CB 724, 726.

42. IRC §152(e)(2).

43. Treas. Reg. §1.152-4(e)(3)(ii).

44. See, e.g., *Miller v. Comm'r,* 114 TC 184, 191-94 (2000), *aff'd* on another ground sub nom; *Lovejoy v. Comm'r,* 293 F.3d 1208 (10th Cir. 2002); see also *Himes v. Comm'r,* TC Memo 2010-97 ("Ms. Wyke's failure to sign . . . is the controlling factor in this case. The signature of the custodial parent releasing the claim to the dependent exemption is a statutory requirement that cannot be waived.")

In this case, Denise is the custodial parent. Both she and Gary signed the separation agreement and almost all the information on a Form 8332 is in the agreement that Gary attached to his tax return. The only items missing are his and Denise's social security numbers (SSN). It was not considered a problem that Gary's SSN was not included in the agreement because his SSN was elsewhere on the return. However, the court had to determine whether Denise's SSN was absolutely required in order for Gary to claim his daughter as a dependent. The court looked at various cases in which declarations that lack the custodial parent's SSN were accepted as substitutes for Form 8332.[45] The IRS pointed to two cases in which the substitute agreements that lacked SSNs were rejected by the courts. However, in each of those cases, other critical pieces of information were missing.[46]

Holding. The court held that Gary is entitled to a dependency exemption for his daughter for 2006.

> **Note.** For divorce decrees/agreements effective after 2008, the taxpayer cannot attach pages from the agreement instead of Form 8332. The taxpayer must use Form 8332 or a "similar statement" for the specific purpose of releasing the claim of the custodial parent without any additional conditions.

DIVORCE ISSUES

6

Alimony

***James F. Moore v. Comm'r,* TC Memo 2011-200 (Aug. 16, 2011)**
IRC §§215 and 71

☞ Mortgage Reimbursement Does Not Qualify as Alimony

Facts. In September 1996, James Moore entered into a decree that dissolved his marriage to Elaine Moore. The divorce decree required Mr. Moore to pay the mortgage, taxes, and insurance on the marital home.

Ms. Moore sold the marital home and paid off the existing mortgage of $73,780 in April 2002. Under the terms of the divorce decree, Mr. Moore was obligated to reimburse Ms. Moore for the mortgage pay-off amount.

Mr. Moore filed an appeal with the Indiana Court of Appeals regarding his reimbursement obligation. In April 2006, Mr. and Ms. Moore executed a settlement agreement under which his obligation would terminate after he paid Ms. Moore $20,000.

Mr. Moore made payments to Ms. Moore of $21,701 in 2006 and deducted these amounts as alimony on his 2006 Form 1040. The IRS later determined that these payments were not deductible as alimony.

Issue. Whether the payments of $21,701 made by Mr. Moore to his ex-wife in 2006 are deductible as alimony under IRC §215(a).

Analysis. IRC §215 permits a deduction for the payment of alimony that is includible in the gross income of the recipient under IRC §71. IRC §71(b) defines alimony as any cash payment that meets the following four criteria.

1. The payment is received by a spouse under a divorce or separation instrument.
2. The divorce or separation instrument does not designate the payment as one that is not includible in gross income and not allowable as a deduction.
3. In the case of legally separated individuals, the payee spouse and the payor spouse are not members of the same household when the payment is made.
4. There is no liability to make any payments after the death of the payee spouse.

45. See, e.g., *Boltinghouse v. Comm'r,* TC Memo 2003-134 (May 13, 2003); *Bramante v. Comm'r,* TC Memo 2002-228 (Sep. 12, 2002) ("Neither the statute nor the regulations require that the release contain the custodial parent's social security number").

46. *Nixon v. Comm'r,* TC Memo 2011-249 (Oct. 25, 2011); *Gessic v. Comm'r,* TC Memo 2010-88 (Apr. 22, 2010).

The IRS argued that the payments do not qualify as alimony because they do not terminate in the event of Ms. Moore's death. Mr. Moore contended that the payments terminate upon Ms. Moore's death by operation of Indiana law.

The divorce decree between Mr. and Ms. Moore was silent as to whether Mr. Moore's obligation to reimburse Ms. Moore terminates in the event of her death. Indiana statutory law is also silent as to whether the obligation to make maintenance payments terminates upon the death of the payee spouse. Consequently, the court independently reviewed the decree to make a determination as to the satisfaction of the §71(b) requirement.[47] The court concluded that the decree did not require the termination of payments in the event of Ms. Moore's death. Rather, Mr. Moore's obligation is terminated only by satisfaction of the mortgage or reimbursement to Ms. Moore of the mortgage payoff amount.

Holding. The court ruled that the payments in question did not satisfy the requirements of IRC §71(b)(1)(D). Consequently, Mr. Moore is not entitled to deduct the payments of $21,701 as alimony.

Alimony

***James and Joyce Chiavacci v. Comm'r,* TC Summ. Op. 2012-63 (Jul. 2, 2012)**
IRC §§71 and 6662

☞ Lump Sum Payment Does Not Qualify as Deductible Alimony

Facts. On January 3, 1994, while in the midst of divorce proceedings, James P. Chiavacci and Leigh A. Charles entered into an agreement relating to their "marital property rights, support, and other rights." Their divorce was finalized on January 10, 1994, at which time their earlier agreement along with a child support order, alimony order, and immediate withholding orders were all incorporated into the final divorce decree. Regarding the alimony order, the 1994 agreement stated "the Husband shall pay to the Wife the sum of $500.00 per month as alimony, first payment to be made on January 31, 1994, payment to cease upon death or remarriage of the Wife." Accordingly, Mr. Chiavacci paid Ms. Charles $500 per month from January 1994 through August 2007.

In April 2007, Mr. Chiavacci filed a motion with the court seeking to modify his alimony obligations due to a change in his circumstances. A settlement (2007 agreement) was reached whereby Mr. Chiavacci would make a one-time lump-sum payment of $20,000 to Ms. Charles in exchange for release of future spousal support. The settlement was finalized in September 2007, after which Mr. Chiavacci obtained a cashier's check for $20,000. On September 11, 2007, Mr Chiavacci's attorney mailed the cashier's check to Ms. Charles' attorney. On September 13, 2007, the district court entered an order amending the divorce judgment (amending order). The amending order contains the following statement: "By agreement of the parties, Spousal Support is terminated effective September 2, 2007. In all other respects, the Divorce Judgment dated January 10, 1994, as amended on August 31, 2001, remains in full force and effect."

On their 2007 tax return, Mr. and Mrs. Chiavacci claimed an alimony deduction for $24,000, (eight monthly payments of $500 each for January through August 2007 plus the $20,000 lump-sum). The IRS disallowed the deduction in its entirety.

Issues. The issues in this case are as follows.

- Whether the payments to Ms. Charles are deductible as alimony
- Whether the taxpayers are liable for the IRC §6662(a) accuracy-related penalty

47. See *Hoover v. Comm'r,* 102 F.3d 846 (6th Cir. 1996), *aff'g* TC Memo 1995-183 (Apr. 20, 1995).

Analysis. IRC §71(b) provides that **all** the following four requirements must be met in order for payments to qualify as alimony.

1. The payment is received by (or on behalf of) a spouse under a divorce or separation instrument.
2. The divorce or separation instrument does not designate the payment as a payment that is not includible in gross income under §71(b) and not allowable as a deduction under IRC §215.
3. In the case of an individual legally separated from their spouse under a decree of divorce or separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time the payment is made.
4. There is no liability to make any payment for any period after the death of the payee spouse, and there is no liability to make any payment as a substitute for such payments after the death of the payee spouse.

Both parties stipulated that they were not members of the same household in 2007, therefore satisfying requirement 3 above. The dispute arises as to whether the other three requirements were met. After reviewing all the facts in this case, the court determined that because "the 2007 agreement does not expressly state that the payment obligation terminates upon the death of the payee spouse," Mr. Chiavacci would have been liable to make a payment even after Ms. Charles' death. Therefore, his $20,000 payment does not satisfy the termination requirement of item 4. The other two requirements did not need to be addressed.

IRC §6662(a) authorizes the IRS to impose a penalty when there is evidence of a substantial understatement of income tax. The IRS met its burden of proof because the taxpayer's understatement of tax exceeded the greater of 10% of the amount of tax required to be shown on the return or $5,000. At trial, the taxpayers neither argued nor introduced any evidence indicating that they had reasonable cause and acted in good faith.

Holding. The court held that the $20,000 lump sum alimony payment was not deductible and penalties on the recomputed tax deficiency were sustained.

EMPLOYMENT TAX ISSUES

Trust Fund Taxes

***Robert A. Newbill v. U.S.,* U.S. Court of Appeals, 4th Circuit; No. 10-2326 (Jul. 29, 2011)**
IRC §§6672, 3402, and 3102

☞ Taxpayer Acted Willfully in Failing to Remit Payroll Taxes

Facts. Robert Newbill was the president, treasurer, and majority shareholder of New Construction, Inc. (NCI), a construction company which had over 300 employees and annual revenues of $40 million in 2003. As president of NCI, Newbill controlled employee compensation, had signature authority on the company's bank accounts, made day-to-day financial decisions, and negotiated and executed contracts.

Wachovia Bank supplied NCI with a $2.5 million line of credit. The terms of the line of credit provided that, in the event of NCI's default, Wachovia could terminate the line of credit, require immediate repayment of the loan, and foreclose its security interest in the bank account that NCI maintained with Wachovia.

Newbill executed a surety agreement with Atlantic Mutual Companies, in which Atlantic guaranteed NCI's performance of some of its construction contracts. If NCI was unable to meet its obligations under these contracts, the agreement required NCI to assign its interests in all the company's assets to Atlantic and allowed Atlantic to exercise joint control over NCI's activities.

In November 2003, NCI was "in difficult financial straits." Consequently, Wachovia terminated the company's line of credit and seized the balance of NCI's Wachovia bank account. Thereafter, Wachovia only released funds to NCI for pre-approved purposes.

Atlantic then assumed joint control over NCI's assets and operations under the terms of the surety agreement. In December 2003, NCI and Atlantic entered into a joint-control agreement, which provided the procedure for payment of NCI's expenses. All charges against NCI's account with Cardinal Bank required a signature from both NCI and Atlantic. Newbill was a signatory on the account.

During the period between November 26, 2003 and January 6, 2004, NCI did not pay taxes withheld from employees' wages. Newbill became aware of these unpaid taxes on December 17, 2003. Subsequently, Newbill signed checks that totaled over $100,000 to nongovernment creditors. In early 2004, NCI ceased operations and entered into bankruptcy proceedings.

The IRS subsequently assessed Newbill with a penalty under IRC §6672 for $141,093, which was the total amount of withholding taxes owed by NCI. Newbill paid part of the assessment and filed suit for a refund of $99,566, claiming that he was not a "responsible person" who willfully failed to pay withholding taxes. The district court denied Newbill's motion, granting summary judgment to the government and entering judgment against Newbill in the amount of $99,566.

Issues. The issues in this case are whether the district court erred by:

1. Holding Newbill responsible for the payment of the withholding taxes,
2. Holding that Newbill willfully failed to pay those taxes, and
3. Entering a judgment against Newbill for the disputed amount.

Analysis.

Issue 1. In determining whether an individual is a responsible party for the payment of trust fund taxes under §6672, courts look at whether the person:[48]

1. Served as an officer or director of the company,
2. Controlled the company's payroll,
3. Determined which creditors to pay and when to pay them,
4. Participated in the company's day-to-day management,
5. Had the ability to hire and fire employees, and
6. Possessed the power to write checks.

The district court established that the first five factors were present. Thus, Newbill had the authority and duty to ensure payment of NCI's payroll taxes.

Issue 2. Newbill contends that the district court erred by holding that he willfully failed to pay NCI's trust fund taxes. The appeals court disagreed, noting that Newbill signed over $100,000 worth of checks to NCI employees and creditors after December 17, 2003. Newbill could have prevented this by withholding his signature from the checks. By signing the checks to nongovernmental creditors after he had knowledge of NCI's delinquent trust fund taxes, Newbill preferred those creditors over the government. This demonstrates a willful failure to pay the taxes.

Issue 3. Newbill contends that the district court erred by entering a judgment against him for $99,566, which he had already paid. The appeals court agreed that this effectively required him to pay that portion of the penalty twice.

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48. See, e.g., *Erwin v. U.S.,* 591 F.3d 321 (4th Cir. 2010).

Holding. The appeals court affirmed the district court's holding that Newbill was a responsible person for the payment of trust fund taxes and that he willfully failed to pay those taxes. The court vacated the judgment against Newbill in the amount of $99,566, noting that the district court's judgment should be amended to provide for the dismissal of Newbill's refund suit.

Employment Status Determination

***Twin Rivers Farm Inc. v. Comm'r,* TC Memo 2012-184 (Jul. 2, 2012)**

IRC §§3121, 6011, 6651, 6656, and 7436

☞ Facts Support Employer-Employee Relationship

Facts. In October 2005, Twin Rivers Farm, Inc. (TRF) formed as an S corporation in Tennessee. During 2006, 2007, and 2008, TRF operated a horse farm, which focused on selling and leasing horses. Diana Militana was the sole owner and sole corporate officer of TRF during these years. TRF engaged two people, Adam Lopez Morales and Nallhelyo Ruiz, to work on the 114-acre property. Their duties included the following.

- Cleaning stalls, barns, barn office, restroom, and tack room
- Grooming horses
- Watering horses
- Cutting grass and performing other groundskeeping activities

The necessary equipment and supplies to perform all of these duties were provided by TRF. These included harnesses, brushes, shovels, a mower, and tractor. Morales and Ruiz also did occasional fence repair work, using materials either provided by TRF or purchased at a local store.

Morales and Ruiz received a check each week for $300 and $150, respectively. On occasion, one or both of them received an advance on their weekly check but subsequent checks were reduced to repay the advanced amount. The workers were also provided a place to live on the property.

TRF did not file any employment tax returns, make any payroll deposits, or issue Forms W-2 or 1099 during the years in question. However, TRF did purchase workers' compensation and employer's liability insurance during each of these years.

Issues. The issues in this case are the following.

- Whether the payments made to Morales and Ruiz are "wages"
- Whether TRF is liable for penalties for failing to timely file returns and failing to make employment tax deposits

Analysis. The court analyzed the following factors to determine if Morales and Ruiz meet the definition of "employee" or "independent contractor."[49]

- Degree of control — Although Mrs. Militana maintains she did not exercise control over Morales and Ruiz, the nature of the duties performed and the equipment used to perform the duties could have been controlled by Mrs. Militana if the workers were careless in doing these duties. This factor **supports the employer-employee relationship.**
- Investment in facilities — TRF provided all of the equipment Morales and Ruiz used to perform their services. This factor **supports the employer-employee relationship.**

49. See *Avis Rent A Car Sys., Inc. v. U.S.,* 503 F.2d 423, 429 (2d Cir. 1974); *Ewens & Miller, Inc. v. Comm'r,* 117 TC at 270; *Weber v. Comm'r,*103 TC 378, 387 (1994), *aff'd* per curiam, 60 F.3d 1104 (4th Cir. 1995).

- Opportunity for profit or loss — During the years at issue, Morales and Ruiz were paid $300 and $150 per week regardless of the hours they worked or their productivity. This factor **supports the employer-employee relationship.**
- Right to discharge — No evidence was provided showing the existence of any formal or informal agreement or contract that would preclude TRF from discharging the workers. This factor **supports the employer-employee relationship.**
- Part of principal's regular business — Services provided by the workers were supportive of TRF's business. This factor **supports the employer-employee relationship.**
- Permanency of relationship — Permanency of a working relationship indicates an employer-employee relationship. This factor **supports the employer-employee relationship.**
- Relationship the parties thought they created — TRF argued that the relationship created by the parties was intended to be that of a business and independent contractors. However, the facts associated with this argument indicate the opposite conclusion. Workers' compensation and employer's liability insurance were purchased by TRF. All job-related expenses were also paid by TRF. Finally, TRF provided housing for both Morales and Ruiz. This factor **supports the employer-employee relationship.**

IRC §6651(a)(1) provides an addition to tax for failure to timely file required tax returns that is equal to 5% of the tax shown on the return for each month delinquent, up to a maximum of 25%. IRC §6651 imposes a penalty for failure to make deposits of employment taxes. For both penalties, TRF submitted no credible evidence that it exercised ordinary business care and prudence in its failure to file and/or deposit employment taxes.

Holding. The court held that Morales and Ruiz were employees of TRF. Also, TRF was held liable for additions to tax for failure to timely file employment tax returns and penalties for failure to make employment tax deposits.

FICA Taxes on Tips

Rev. Rul. 2012-18, IRB 2012-26 (Jun. 20, 2012)
IRC §§3101, 3111, 3121, and 6053

☞ IRS Issues Updated Guidance Regarding FICA Taxes on Tips

Purpose. This revenue ruling updates and clarifies guidance first presented in Rev. Rul. 95-7[50] regarding FICA taxes imposed on tips and the notice and demand under IRC §3121(q).

Analysis. Under IRC §3121(a), wages for FICA tax purposes are defined as all remuneration for employment, with certain exceptions. These exceptions include tips paid in any medium other than cash[51] and cash tips received by an employee in any month in the course of employment with a particular employer in which the amount of the cash tips is less than $20.[52]

Employees who receive cash tips are required to report these tips on a monthly statement furnished to the employer by the 10th day of the following month.

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50. Rev. Rul. 95-7, 1995-1 CB 185.

51. IRC §3121(a)(12)(A).

52. IRC §3121(a)(12)(B).

Employers are required to pay social security tax on the amount of cash tips received by each employee up to the benefit base determined under IRC §3111(a)(1). Employers must pay Medicare tax on the total amount of cash tips received by the employee.[53] However, if the employee did not furnish the written statement required under IRC §6053(a) or if the statement furnished was incomplete or inaccurate, the employer is not liable for FICA taxes on the tips until the date on which notice and demand for the taxes is made to the employee by the IRS.

The revenue ruling specifies that characterization of a payment as a tip by the employer is not determinative for FICA tax purposes. An employer might incorrectly characterize a payment as a tip when the payment is actually a service charge. Rev. Rul. 59-252 provides the criteria that should be applied to determine whether a payment made in the course of employment is a tip for purposes of §3121. The revenue ruling provides that the absence of any of the following factors indicates that the payment may be a service charge rather than a tip.[54]

1. The payment must be made free from compulsion.
2. The customer must have the unrestricted right to determine the amount.
3. The payment should not be the subject of negotiation or dictated by employer policy.
4. The customer generally has the right to determine who receives the payment.

In considering the above factors, all the surrounding facts and circumstances should be considered. For example, Rev. Rul. 59-252 provides that the payment of a fixed charge imposed by a banquet hall that is distributed to the employees who render services (e.g., waiter, busser, and bartender) is a service charge rather than a tip. Accordingly, the portion of a service charge paid by a customer that is distributed to an employee is considered wages for FICA tax purposes.

Rev. Rul. 2012-18 contains 15 questions and answers that are either new or revised from the 1995 guidance.

ESTATE AND GIFT

Lottery Winnings

***Tonda L. Dickerson v. Comm'r,* TC Memo 2012-60 (Mar. 6, 2012)**

IRC §§2501, 2511, 761, and 2512

☞ Lottery Winnings Transferred to S Corporation was Taxable Gift

Facts. Tonda Dickerson is a former waitress at the Waffle House in Grand Bay, Alabama. On March 7, 1999, Edward Seward, a regular customer, gave Ms. Dickerson an envelope containing a lottery ticket. Mr. Seward did not know at the time that the ticket was one of two winning tickets for the March 6, 1999 drawing of the Florida Lotto Jackpot. The ticket was valued at $10.0 million if paid out over 30 years, with a cash payout amount of $5.1 million.

According to Ms. Dickerson, when she realized that she had a winning ticket, she knew that she would share the winnings with her family. The family had a general sharing agreement for lottery proceeds, although the agreement was never written down and there was no documentation to support its existence or its terms.

On March 8, 1999, Ms. Dickerson's father, Bobby Reece, contacted Louisa Warren, the general counsel for the Florida Lottery Commission. Ms. Warren advised Mr. Reece not to sign the lottery ticket and to form a single entity to claim the prize for the family.

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53. IRC §6053(a).

54. Rev. Rul. 59-252, 1959-2 CB 215.

Mr. Reece then contacted Dwight Reid, a lawyer that he had consulted previously. Mr. Reid prepared incorporation papers for an S corporation named 9 Mill, Inc. Ms. Dickerson and her husband owned 49% of the corporation's stock and family members shared the remaining 51%.

When Ms. Dickerson and other family members met with Florida lottery officials to claim the prize, she signed an election form on behalf of 9 Mill to receive the lottery winnings in 30 annual installments of $354,000 each. At that time, the lottery officials informed the family that there was a competing claim to the winning lottery ticket and that no payment would be made until the dispute was resolved.

Four of Ms. Dickerson's former coworkers at the Waffle House thought she was obligated to share the winnings with them because they had agreed to split lottery winnings if any of them won. The attorney for the Waffle House employees initiated a lawsuit in the Circuit Court of Mobile County, Alabama, asserting that the Waffle House claimants were entitled to 80% of the proceeds of the lottery ticket.

In February 2000, the Alabama Supreme Court concluded that while the Waffle House claimants presented sufficient evidence that an oral agreement existed, the agreement was unenforceable pursuant to Alabama's antigambling statute.

Ms. Dickerson did not file a gift tax return for the 1999 tax year until she was contacted by an attorney from the IRS. In October 2007, Ms. Dickerson filed Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return,* which reported that no taxable gift had been made. The IRS determined that she had made a gift of $2.4 million as a result of her transfer of the lottery ticket to 9 Mill. The IRS issued a notice of deficiency on July 1, 2008, determining a gift tax deficiency of $771,570.

Issues. The issues in this case are as follows.

- Whether Ms. Dickerson made a taxable gift when she contributed the lottery ticket to 9 Mill
- If she did make a gift, what was its value

Analysis. Treas. Reg. §25.2511-1(h)(1) provides that a transfer of property to a corporation for less than adequate consideration represents gifts to the other individual shareholders of the corporation. Ms. Dickerson argued that no taxable gift occurred because there was a binding and enforceable contract that required the transfer. However, the court concluded that there was no enforceable contract because the terms were too indefinite, uncertain, and incomplete. Additionally, even if the contract was otherwise enforceable, it would be rendered void pursuant to Alabama's antigambling statute.

Alternatively, Ms. Dickerson contended that she and the other family members were all members of an existing partnership, which was the true owner of the lottery ticket and its proceeds. The court determined, however, that there was not enough evidence to find that a partnership existed and that it was the owner of the winning ticket.

After deciding that a taxable gift had been made in 1999, the court had to determine the amount of the gift. The court has adopted the rule that "subsequent events are not considered in fixing fair market value, except to the extent that they were reasonably foreseeable at the date of valuation."[55] Ms. Dickerson argued that on the transfer date, a hypothetical buyer would have been aware of the claim made by the Waffle House claimants. The court agreed and determined that, after applying an appropriate discount for the 80% of the lottery ticket disputed by the Waffle House claimants, the total gift Ms. Dickerson made was $1.1 million.

Holding. The court held that Ms. Dickerson made a taxable gift to 9 Mill, and the value of the gift was $1.1 million.

[55] *Estate of Gilford v. Comm'r,* 88 TC 38, 52 (1987); see also *First Nat'l Bank of Kenosha v. U.S.,* 763 F.2d 891, 893-894 (7th Cir. 1985).

Gift Taxes

***Estate of Anne W. Morgens et al. v. Comm'r,* U.S. Court of Appeals, 9th Circuit; No. 10-73698 (May 3, 2012)**
IRC §§2035, 2056, 2207A, and 2519

☞ Gift Taxes Paid Includible in Gross Estate

Facts. Anne Morgens married Howard Morgens and remained married to him until his death in January 2000. In 1991, Mr. and Mrs. Morgens entered into the Morgens Family Living Trust Agreement, with each contributing assets to a living trust. Upon Mr. Morgens' death, one-half of the community property in the living trust attributable to Mrs. Morgens was allocated to a survivor's trust with the remainder going to a residual trust. Mrs. Morgens had the right to receive income for life from the residual trust. Upon her death, the remainder in the residual trust went to the Morgens' children and grandchildren.

In October 2000, Mr. Morgens' estate tax return was filed. The return elected QTIP treatment for property passing to the residual trust. Because the residual trust qualified for the marital deduction, its value was not taxed as part of Mr. Morgens' estate. The residual trust was then split into two separate trusts (Residual Trust A and Residual Trust B), for which Mrs. Morgens retained the right to receive income at least on an annual basis.

On December 8, 2000, Mrs. Morgens relinquished her lifetime interest in Residual Trust A, which resulted in gift tax on the deemed transfer. Mrs. Morgens filed a gift tax return showing a gross value of $6.4 million with resulting gift tax of $2.3 million paid to the IRS. She then relinquished her lifetime interest in Residual Trust B, which required a gift tax payment of $7.7 million.

Mrs. Morgens died on August 25, 2002, and her estate tax return was filed on November 24, 2003. The "gross-up rule" of IRC §2035(b) provides that a decedent's gross estate includes all gift taxes paid by the decedent within three years of her death. Mrs. Morgens' estate did not contain the gift taxes paid on Residual Trusts A and B. The IRS issued a notice of deficiency based on the failure to include the gift tax as part of her gross estate.

The Tax Court held the gift taxes paid were includible in Mrs. Morgens' estate. Her estate appealed the decision.

Issue. Whether the gift taxes paid are includible in the gross estate.

Analysis. For IRC §2035(b) to apply to gift taxes paid on §2519 deemed transfers, those taxes must be paid by the decedent. The court looked to *Brown v. U.S.,*[56] which held that when a husband gave his wife money to pay gift taxes on an insurance trust and the husband died within three years, the taxes were "paid by" the husband within the meaning of IRC §2035(b); thus, the gift taxes were includible in the husband's estate. If Mrs. Morgens had not made the deemed transfers pursuant to IRC §2519, the entire value of the trusts would have been included in her estate under IRC §2044.

Holding. The 9th Circuit, affirming the Tax Court, held that under the gross-up rule of IRC §2035(b), Mrs. Morgens' gross estate included the amount of gift tax paid on the relinquishment of her life estate interest in Residual Trusts A and B.

[56]. *Brown v. U.S.,* 329 F.3d 664 (2003).

Estate Deductions

***Estate of Emilia Olivo et al. v. Comm'r,* TC Memo 2011-163 (Jul. 11, 2011)**
IRC §2053

☞ Estate Denied $1.24 Million Deduction for Caregiving Services Rendered to Decedent

Facts. Emilia Olivo (decedent) died intestate in April 2003. She was a widow residing in Haddonfield, New Jersey, at the time of her death. She was survived by four children.

The decedent's son, Anthony Olivo, was the administrator of the estate. Mr. Olivo resided with the decedent at the time of her death and had provided care for her for many years. Mr. Olivo began providing full-time care for both his parents in September 1994, when the decedent fell and suffered a compression fracture of her lower spine that left her nearly paralyzed in both legs. At that time, Mr. Olivo's father was already experiencing severe health problems, including diabetes and congestive heart failure.

Around the time of decedent's fall in September 1994, Mr. Olivo began to find it extremely difficult to maintain his practice as an attorney. He earned very little income from his law practice from 1994 through 2003, the period when he was caring for his parents.

The decedent had numerous health problems during the last years of her life. She required assistance with dressing, bathing, and toileting. In addition to the compression fracture, the decedent's other health problems included insulin-dependent diabetes, hyperparathyroidism, hyperthyroidism, hypertension, osteoporosis, and chronic deep vein thrombosis. She also had periodic bouts with pneumonia and developed congestive heart failure and coronary artery disease. In addition to caring for the decedent's medical needs, Mr. Olivo prepared all meals and did general housekeeping.

After the decedent's death, Mr. Olivo was appointed administrator of the estate. He filed the estate's tax return in July 2004, on which he claimed a deduction of $44,200 for his services as administrator, attorney's fees of $50,000, and accountant's fees of $5,000. He also claimed a deduction of $1.24 million as a debt the estate owed to him for the care he provided to the decedent pursuant to an alleged agreement he had with her.

None of the aforementioned expenses had been paid at the time the estate return was filed. Mr. Olivo wrote a $44,200 check from the estate to himself in September 2006 in payment of the administrator's commission. From December 2004 to December 2008, Mr. Olivo wrote himself a series of checks from the estate totaling $55,400 to pay for attorney's fees and litigation expenses. The estate had not paid Mr. Olivo any of the $1.24 million claimed as a deduction for his caregiving services.

In April 2007, the IRS issued a notice of deficiency for federal estate tax. Mr. Olivo responded by filing a petition with the Tax Court.

Issues. The issues in this case are whether the estate is entitled to deduct the following.

1. The amount claimed on the estate tax return for caregiving services rendered by Mr. Olivo
2. The administrator's commission paid to Mr. Olivo
3. The accountant's and attorney's fees claimed by Mr. Olivo

Analysis. IRC §2053(a) provides that the value of a taxable estate is determined by deducting from the gross estate the claims against the estate and the administration expenses allowable by the laws of the jurisdiction under which the estate is administered. Administration expenses include attorney's fees, executor's commissions, appraiser's fees, accountant's fees, and court costs.[57]

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57. Treas. Reg. §20.2053-3.

Issue 1. Mr. Olivo contends that the estate is entitled to deduct $1.24 million to compensate him for care he provided to the decedent pursuant to an alleged agreement. He testified that the decedent offered to pay him $1,000 per week for the caregiving services. He said he became worried about the decedent's finances and suggested that she not pay him anything at the time but rather defer the payment until her death. To avoid a complicated interest calculation, the decedent agreed to pay him $400 per day, which would be deferred until her death. However, Mr. Olivo never memorialized the alleged agreement in writing. He testified that he was too distracted by the details of caring for the decedent and was not thinking like a lawyer during that time. The court found Mr. Olivo's testimony surrounding the alleged agreement to be highly questionable, stating that with his training and experience as an attorney, it was difficult to believe that he would not have reduced the agreement to writing or at least had some corroborating evidence beyond his self-serving testimony.

The estate alternatively argued that Mr. Olivo is entitled to some recovery under *quantum meruit,* which is a type of quasi-contractual recovery that allows a plaintiff to recover the reasonable value of services rendered when the plaintiff had a reasonable expectation of payment.[58] The court recognized that Mr. Olivo provided extraordinary care during decedent's last years of life but that the estate had not established that he was entitled to recover for that care under quasi-contract. Under New Jersey law, there is a presumption that services rendered to a family member living in the same household are rendered gratuitously.[59] The estate offered no evidence that would overcome the presumption.

Issue 2. Under New Jersey law, administrator's commissions are determined according to a formula in the absence of a judgment from the probate court directing otherwise. Applying the formula to the decedent's estate value of $1.7 million yields an administrator's commission of $52,223. However, the estate claimed a deduction of only $44,200. Pursuant to the regulations, the statutory amount is deductible by the estate only if the amount is actually paid or if the IRS is reasonably satisfied that such amount will be paid.[60]

Issue 3. The IRS contends that the estate is not entitled to the $55,000 deduction for attorney's and accountant's fees because it had not substantiated those fees. The record shows that Mr. Olivo did perform some legal services for the estate, including filing the estate's tax return, handling the IRS examination, and filing the estate's petition with the Tax Court. However, Mr. Olivio did not keep records of the time he spent performing legal services for the estate. Instead, he estimated the number of hours and used a billing rate of $150 per hour. Because of the lack of corroborating evidence, the Court declined to accept Mr. Olivo's estimates.

When a taxpayer establishes that a deductible expense was paid but cannot substantiate the amount, the court can estimate the amount. However, if the evidence provides no basis on which to make an estimate, the court does not allow any deduction.[61] The court allowed the attorney's fees incurred by the estate in contesting the deficiency before the court and ordered the parties to submit computations showing the correct amount to be included in the decision.

Holding. The court held as follows.

Issue 1. The estate is not entitled to deduct any amount for caregiving services rendered by Mr. Olivo.

Issue 2. The parties were ordered to use the statutory formula to calculate the administrator's commission. If the estate does not actually pay Mr. Olivo the difference between what he has already been paid and the amount permitted under the statutory formula, the estate is only allowed to deduct the amount actually paid unless the parties agree otherwise.

Issue 3. The estate is allowed to deduct only the amount of attorney's fees incurred in contesting the deficiency, which were ordered to be computed by the parties and submitted to the court.

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58. *Weichert Co. Realtors v. Ryan,* 608 A.2d 280, 285 (N.J. 1992).

59. *Waker v. Bergen,* 132 A. 669, 669-670 (N.J. 1926) (quoting *Disbrow v. Durand,* 24 A. 545, 546 (N.J. 1892)).

60. Treas. Reg. §20.2053-3(b)(1).

61. *Vanicek v. Comm'r,* 85 TC 731, 742-743 (1985).

U.S. v. Robert S. MacIntyre et al., **No. 4:10-cv-02812; U.S. District Court for the Southern District of Texas (Jun. 25, 2012)**
IRC §642

☞ Charitable Set-Aside Results in Personal Liability

Facts. J. Howard Marshall made an indirect gift to certain family members in 1995 shortly before he died. The IRS assessed gift taxes against Marshall's estate, which the estate then challenged in Tax Court. An agreement was reached setting the amount of the gift at $35.9 million to the Eleanor Pierce Stevens' Grantor Retained Income Trust. The Marshall estate never paid the tax on the gift so the unpaid gift tax shifted to the donee, Eleanor Pierce Stevens (Stevens). When Stevens died in 2007, the gift tax liability was still unpaid.

E. Pierce Marshall, Jr. (Marshall) was named the executor of Stevens' estate and Finley L. Hilliard (Hilliard) was the trustee for the Eleanor Pierce Stevens Living Trust. Both Marshall and Hilliard were aware of the unpaid gift taxes but they made distributions or paid expenses out of the respective entities, including the following.

- $29,301 for accounting services
- $7,952 for legal services
- $58,464 for 12 months of rent on an apartment Ms. Stevens occupied prior to her death

In addition, the trust returns claimed charitable deductions for the periods ending March 2008, March 2010, and March 2011 in the aggregate amount of $1.1 million for money permanently set aside pursuant to IRC §642(c). The government charged both Marshall and Hilliard for personal liability under 31 USC §3713 for distributions from the estate and trust to lower-priority creditors and failure to preserve sufficient funds to pay Stevens' gift tax liability.

Issue. Whether the estate's executor and living trust trustee are individually liable.

Analysis. Both Marshall and Hilliard argued that they did not have knowledge of the unpaid gift tax claim because of the following factors.

- Hilliard was unaware of the 2002 agreement.
- Although Hilliard was told that the IRS might assert donee liability against Stevens, he did not believe it was possible.
- Marshall believed that the agreement was not binding on Stevens because he received legal advice to that effect.

Under 31 USC §3713, the knowledge requirement does not require actual knowledge but can be proved by "notice of such facts as would put a reasonably prudent person on inquiry as to the existence of the unpaid claim of the United States." Because both men admitted that they had been told that the IRS might try to assert a claim, the knowledge requirement was met. The poor legal advice received is not a defense, because the test is not whether the claim is valid but whether "knowledge" of a potential claim exists.

The court looked at the distributions made by Marshall to the Stevens' heirs after selling her personal assets, including her car. Marshall argued that the cost of storing the personal items would violate his duty to "take care of the property of the estate… as a prudent man would take care of his own property." The court disagreed, stating that the proceeds of the car (cash) did not require storage and the other personal property was not exempt under the Texas Probate Code. Therefore, those personal items ($14,091) should have been used to pay Stevens' debt. Marshall is liable for the value of personal property he distributed.

With respect to the rent paid on Stevens's apartment ($43,848), Marshall argued that he needed to keep the apartment because of complicated schedules for family members who wished to hold a Quaker-style memorial service in her home. Although the government agreed that some amount of time might be needed to arrange a service, keeping the apartment for almost a year went well beyond the point of reasonableness. The Texas Probate Court allows a maximum of $15,000 for funeral expenses and last illness expenses. Accordingly, Marshall is personally liable for $28,848, which represents the distributions in excess of $15,000.

The accounting and legal fees paid by Hilliard out of the estate were on behalf of charitable entities other than the living trust or estate. Texas law allows accounting and legal fees to be classified as expenses of the estate if they were to preserve or manage the estate; however, in this instance, the expenses were actually a burden on the estate. Therefore, the government's claim takes priority and Hilliard is personally liable for the $37,252.

Under IRC §642(c), estates and trusts can claim income tax deductions for amounts permanently set aside to pay charitable organizations as long as the trust instrument or will sufficiently mandates the trust or estate income be set aside for that purpose. For the periods ending March 2008, March 2010, and March 2011, Marshall and Hilliard permanently set aside $1.1 million in the trust for charitable purposes, although the funds were not paid out and remained in the trust's accounts. Although this protected the charitable funds and provided a tax deduction, Marshall and Hilliard became jointly liable for $1.1 million. A charitable set aside is not considered an expense of the estate, so the men were individually liable for putting the funds beyond the reach of the government. The court also found that Marshall breached his fiduciary duty to pay the taxes due to the IRS.

Holding. The court held as follows.

- Marshall is individually liable for $42,939.
- Hilliard is individually liable for $37,252.
- Marshall and Hilliard are jointly liable for $1.1 million.

GROSS INCOME

Settlement Proceeds

***Syed and Rafiunnisa Ahmed v. Comm'r,* TC Memo 2011-295 (Dec. 22, 2011)**
IRC §§104 and 6662

☞ Proceeds From Employment Discrimination Lawsuit are Taxable

Facts. Syed Ahmed was born in India but became a U.S. citizen in 1999. He is a practicing Muslim.

In 1990, Fulton County (Georgia) hired Ahmed as a programmer in its information technology department. Ahmed was promoted to a systems analyst position in 1999.

Ahmed filed several complaints with state and federal agencies during his employment with Fulton County, alleging discrimination on the basis of his race, religion, and national origin. In a complaint he filed in July 2006 with the U.S. District Court for the Northern District of Georgia, he asked for back pay, back benefits, compensatory and punitive damages, liquidated damages, the recovery of legal expenses, and a different promotion that he was denied. In support of his claims, he alleged numerous instances of discriminatory treatment following September 11, 2001, when his coworkers and supervisors became hostile towards him because of his Muslim faith. Ahmed alleged that he was terminated from his job in retaliation for filing a complaint with the Georgia Office of Equal Employment Opportunity. He had a heart attack shortly after being terminated, and he claimed that the harassment during his employment contributed to the heart attack.

Ahmed was reinstated with back pay by Fulton County, but he alleged that the harassment continued and even accelerated after he was rehired. Among other allegations, he said that, on his first day back on the job, he was assigned to work at a building where he was exposed to chemicals that made him nauseated and dizzy and that required him to visit the emergency room that same day. Ahmed filed a workers' compensation claim for his hospitalization, but his claim was denied.

In October 2007, Ahmed signed a settlement agreement in which he agreed to dismiss his lawsuit against Fulton County in exchange for $150,000. The settlement agreement provided that he agreed to release Fulton County from any damages he may have had for "personal injuries, contractual damages, losses and damage to personal property, or any other losses or expenses of any kind (including attorneys' fees)" that arose from any actions or omissions of Fulton County. Ahmed also agreed to retire from his employment with Fulton County as a condition of the settlement agreement.

After deducting attorney's fees of $60,000, Ahmed received the remaining $90,000. The attorney's law firm issued a Form 1099-MISC to Ahmed, which stated that he received $90,000 from the settlement. Ahmed did not report this income on his tax return but did include a note at the bottom of the tax return that indicated he had received a settlement from a discrimination lawsuit.

The IRS issued a notice of deficiency, which stated that Ahmed's income should be increased by $90,000 because of the income from the settlement.

Issue. Whether proceeds from the settlement of Ahmed's employment discrimination lawsuit are excludable from gross income under IRC §104(a)(2).

Analysis. Under §104(a)(2), damages received on account of **personal physical injuries or physical sickness** may generally be excluded from gross income. When damages are received pursuant to a settlement agreement, the nature of the claim that was the basis for settlement determines whether the damages are excludable under §104(a)(2).[62] To justify exclusion from income, the petitioner must demonstrate that the settlement proceeds were in lieu of damages for physical injuries or physical sickness.[63]

Ahmed contends that the settlement was to compensate him for his physical injuries, i.e., his heart attack and the dizziness and vomiting he experienced after returning to work. Although the settlement agreement mentioned "personal injuries" among a list of other claims, it did not specifically allocate any portion of the payment to compensate Ahmed for his physical injuries. As part of the agreement, Ahmed also agreed to retire from employment with Fulton County, which suggests that part of the payment should be considered severance pay.

The complaint that Ahmed filed never connected his heart attack or other physical injuries with his claims for damages and, in fact, only mentioned "personal injuries" in boilerplate. Instead, Ahmed sought back pay, back benefits, liquidated damages, attorney's fees, and compensatory and punitive damages **for intentional discrimination.**

The court noted that it appears that one of Fulton County's primary motivations behind the settlement was to effect Ahmed's retirement. Ahmed had the burden of proof on the issue, and he failed to show that any portion of the settlement was to compensate him for physical injuries.

Holding. The court sustained the IRS's determination that the $90,000 settlement is taxable income to Ahmed. The court also sustained the accuracy-related penalty under IRC §6662 for a substantial understatement of income tax.

62. *U.S. v. Burke,* 504 U.S. 229, 237 (1992).

63. See *Green v. Comm'r,* 507 F.3d 857, 867 (5th Cir. 2007), *aff'g* TC Memo 2005-250; *Bagley v. Comm'r,* 105 TC 396, 406 (1995*), aff'd* 121 F.3d 393 (8th Cir.1997).

Qualified Tuition Plans

***Timothy and Jennifer Karlen v Comm'r,* TC Summ. Op. 2011-129 (Nov. 10, 2011)**

IRC §§529, 530, and 451

☞ Distributions Redeposited in §529 Plans Includible in Gross Income

Facts. Timothy and Jennifer Karlen maintained a §529 plan account for each of their three children. In 2008, Mr. Karlen's income decreased due to the downturn in the economy, and the couple consequently started to experience financial difficulty. In September 2008, Mr. Karlen requested distributions of $3,500 from each of his children's §529 investment accounts in order to obtain money to pay household and other living expenses. The §529 plan issued three checks to Mr. Karlen, which were dated September 9, 2008.

After receiving the three checks, Mr. Karlen decided to consult his wife about the distributions. She disagreed with his decision to withdraw the funds. As a result of their discussion, Mr. Karlen changed his mind and informed the §529 plan administrators that he no longer wanted the distributions. A representative of the §529 plan informed Mr. Karlen that the transactions could not be voided. Following the instructions of the representative, Mr. Karlen endorsed the three checks and returned them with a note requesting that the §529 plan redeposit the distributions.

The §529 plan received the three checks and redeposited each one as a new contribution into the same accounts from which they had been withdrawn. Subsequently, Mr. Karlen received a Form 1099-Q, *Payments from Qualified Education Programs (Under Sections 529 and 530),* for each of the three distributions that he received.

The Karlens did not include the distributions from the §529 plans in the income reported on their 2008 federal income tax return. Accordingly, the IRS assessed a deficiency of $1,318.

Issues. The issues in this case are:

- Whether the distributions from the §529 plan accounts are includable in gross income and, if so,
- Whether the Karlens are liable for a 10% additional tax under IRC §529(c)(6) regarding distributions not used for educational purposes.

Analysis. Distributions from a §529 plan are generally includable in the distributee's gross income in the year of distribution.[64] Under the doctrine of constructive receipt, checks generally constitute income when received, even if they are not cashed or deposited.[65]

Mr. Karlen asserted that the distributions were rolled over and therefore not taxable. However, he admitted that he requested the distributions because he needed cash and never contemplated any rollover of the distributions. The court noted that taxpayers are bound by the consequences of their actions as structured, even if hindsight reveals a more favorable tax treatment.[66] Because the distributions were not transferred to a different §529 plan for the benefit of the original beneficiary or a different beneficiary in the same family, no rollover occurred under IRC §529(c)(3)(C)(i). Thus, the distributions are includable in the Karlens' gross income.[67]

Under IRC §530(d)(4), a 10% additional tax is imposed on a distribution that was not used for educational purposes. However, the court noted that the Karlens never "used" the distributions at all; the checks were immediately returned for redeposit into the children's education investment accounts. Because of these unique circumstances, the court did not think it judicious to impose the 10% additional tax.[68]

Holding. The court ruled that the distributions from the §529 plan accounts were includable in the Karlens' gross income but did not impose the 10% additional tax.

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64. IRC §529(c)(3)(A).

65. *Walter v. U.S.,* 148 F.3d 1027, 1029-1030 (8th Cir. 1998); *Kahler v. Comm'r,* 18 TC 31, 34-35 (1952).

66. *Estate of Bean v. Comm'r,* 268 F.3d 553, 557 (8th Cir. 2001).

67. The redeposited distributions increased the basis in each account.

68. See *Larotonda v. Comm'r,* 89 TC 292 (1987).

Foreign Earned Income Exclusion

***Andrea Ready v. Comm'r*, TC Summ. Op. 2012-12 (Feb. 1, 2012)**
IRC §911

☞ International Airspace not Considered a Foreign Country

Facts. Andrea Ready was a flight attendant. She is a citizen of the United States and the United Kingdom and resides in France. She claimed the foreign earned income exclusion (FEIE) on income she earned, including income earned while in international airspace. The IRS issued a notice of deficiency and indicated to the taxpayer that the amount of 2006 and 2007 income she earned for services performed in international airspace and over international waters did not constitute foreign earned income for FEIE purposes. This income amount therefore could not be excluded from her income.

Issue. Whether Ms. Ready may exclude from her income wages attributable to services in international airspace under IRC §911.

Analysis. "Foreign country" for purposes of the FEIE under IRC §911 is defined by regulation in a geographical sense. Treas. Reg. §1.911-2(h) states that "foreign country" includes "any territory under the sovereignty of a government other than that of the United States" and "the airspace over the foreign country" and other locales.

Income not earned in a foreign country cannot be excluded from income using the FEIE and is subject to U.S. tax. In *Rogers v. Comm'r*,[69] the Tax Court held that income earned in international airspace is treated in the same manner as income earned in international waters. International waters do not fall under the definition of foreign country. International airspace does not fall under the foreign country definition either.

Holding. The taxpayer's income earned while in international airspace is taxable by the United States and cannot be excluded from income using the FEIE.

INNOCENT SPOUSE

Innocent Spouse Relief

***Sari F. Deihl v. Comm'r*, TC Memo 2012-176 (Jun. 21, 2012)**
IRC §6015

☞ Entrepreneur's Widow Entitled to Innocent Spouse Relief

Facts. Sari and Joseph Deihl were married for more than 40 years when Joseph died in February 2006. During their marriage, Mr. Deihl made the financial decisions for the family but Mrs. Deihl paid the household bills. Although the Deihls filed joint tax returns throughout their married life, Mrs. Deihl never reviewed the returns before signing them.

The Deihls were entrepreneurs. In 1982, Mr. Deihl purchased a company that manufactured tear-gas-spraying flashlights. A year later, the Deihls formed Mayor Pharmaceutical Laboratories Inc., an S corporation, to manufacture VitaMist, which was a patented multivitamin spray. They then formed KareMor International, Inc., an S corporation, to market the VitaMist products. They also held ownership in several other business entities.

For the years 1996–1999, Mrs. Deihl worked at KareMor. She earned wages of $15,000 and $44,000 for 1996 and 1997, respectively. In 1998, she earned wages of $84,613 from Creative Personnel Resources, the Diehl's employee-leasing company. Although she did not work at the Mayor corporate offices during this time frame, she did visit the offices to sign corporate documents, including checks. She also used two corporate credit cards for a variety of corporate and personal purchases.

69. *Rogers v. Comm'r*, TC Memo 2009-111 (May 20, 2009).

The 1996-1999 tax returns were filed jointly by the Deihls. The IRS examined all these returns and, after court consideration, tax deficiencies of $3.8 million and accuracy-related penalties of $765,548 were assessed. Mrs. Deihl requested innocent spouse relief, which the IRS subsequently denied.

Issue. Whether Mrs. Deihl is entitled to innocent spouse relief under IRC §6015.

Analysis. IRC §6015(a)(1) provides that a spouse may request relief from joint and several liability under IRC §6015(b) for an understatement of tax on a joint return. IRC §6015(a)(2) provides that an eligible spouse may request to limit her liability for any deficiency with respect to a joint return under IRC §6015(c). If complete relief is not available under subsection (b) or (c) of IRC §6015, a spouse may request equitable relief under IRC §6015(f).

IRC §6015(b)(1) provides relief if a taxpayer meets all of the following requirements.

1. A joint return was filed for a taxable year.
2. On the return, there is an understatement of tax attributable to erroneous items of the individual filing the joint return.
3. The other individual filing the joint return establishes that in signing the return they did not know, and had no reason to know, that there was an understatement.
4. Taking into account all the facts and circumstances, it is inequitable to hold the other individual liable for the deficiency in tax for the tax year resulting from the understatement.
5. The other individual elects the benefits of the innocent spouse provision not later than two years after the date the IRS begins collection activities with respect to the individual making the election.

The IRS agreed that Mrs. Deihl meets the requirements in 1 and 5 but disputes that requirements 2, 3, and 4 were met. With respect to requirement 2, Mrs. Deihl argued that the understatements of tax were allocable solely to Mr. Deihl because she did not assist Mr. Deihl in managing Mayor or KareMor or in making any related financial decisions. The IRS disagreed because she jointly owned and operated both Mayor and KareMor as evidenced by the fact that she signed checks, used corporate credit cards, and deposited money from both Mayor and KareMor in her personal accounts.

IRC §6015(c) provides relief but only to the extent of the actual ownership in the entities giving rise to the substantial adjustments. Mrs. Deihl argued that the deficiencies were attributable solely to Mr. Deihl because she held her interests in Mayor and KareMor purely in a nominal capacity. The court disagreed and only allowed her relief from 50% of the liabilities.

IRC §6015(f) provides an alternative means of relief for a requesting spouse who does not qualify for relief under §6015(b) or (c). Here the court looks to the seven threshold requirements under Rev. Proc. 2003-61.[70] Mrs. Deihl satisfied six out of seven requirements. She did not satisfy the other requirement which states that the income tax liability is attributable to the individual with whom the requesting spouse filed the joint return. The court found that the remaining liability is attributable to her items.

Holding. The court held that Mrs. Deihl was only entitled to relief from half of the tax liabilities under IRC §6015(c) because half of the 1996–1999 tax liabilities are allocable to Mr. Diehl.

70. Rev. Proc. 2003-61, 2003-2 CB 296.

IRS PROCEDURES — MISCELLANEOUS

Worker Classification

IRS Announcement 2011-64, 2011-41 IRB 1 (Sep. 21, 2011)
IRC §3509

☞ IRS Announces Voluntary Worker Reclassification Program

The IRS developed a new program that permits taxpayers to voluntarily reclassify workers as employees for federal employment tax purposes. The voluntary classification settlement program (VCSP) allows eligible taxpayers to reclassify their workers for federal employment tax purposes and obtain relief similar to that available under the current classification settlement program (CSP), which is available to taxpayers under IRS examination. The optional VCSP allows taxpayers to prospectively reclassify their workers as employees with limited federal employment tax liability for the past nonemployee treatment. To participate in the VCSP, the taxpayer must meet eligibility requirements, apply to participate in the program, and enter into a closing agreement with the IRS.

The VCSP is available to taxpayers who are currently treating their workers (or a group of workers) as independent contractors and want to voluntarily treat the workers as employees for future tax periods. To be eligible, the taxpayer must:

- Have consistently treated the workers as nonemployees,
- Have filed all required Forms 1099 for the workers for the previous three years,
- Not be under audit by the IRS, and
- Not be under audit concerning the classification of the workers by the Department of Labor or a state government agency.

Taxpayers who participate in the VCSP **will pay 10% of the employment tax liability** that may have been due on the compensation paid to the workers for the most recent tax year. These taxpayers will not be liable for any interest and penalties on the liability and will not be subject to an employment tax audit for the worker classification for prior years.

Eligible taxpayers must submit an application in order to participate in the program. Information about the VCSP and the application are available on the IRS website.

Examination Procedures

Field Attorney Advice (FAA) 20114701F (May 12, 2011)
IRC §7605

☞ IRS May Reexamine Closed Year's Return in Connection with Refund Claim

Facts. Taxpayer deducted a bad debt loss on its tax return for Year 1. In the course of an IRS audit of the Year 1 tax return, Taxpayer argued that the loss should have been deducted as a worthless stock loss rather than a bad debt loss. The revenue agent allowed the loss, concluding that it would either be deductible as a bad debt or worthless stock loss.

In a later year, Taxpayer filed Form 1139, *Corporation Application for a Tentative Refund,* for an NOL carryback to Year 1, which resulted in a refund claim. The audit team considering Taxpayer's claim for refund was examining Year 1 in connection with the claim. After consideration, it appeared the loss claimed for Year 1 was not allowable as either a bad debt or worthless stock loss. The IRS's disallowance was limited to the amount of the NOL carryback; it did not assess additional tax for Year 1.

Taxpayer objected to the examination of the bad debt/worthless stock issue as a reopening of a closed year under IRC §7605(b).

Analysis. IRC §7605(b) states that "[n]o taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary."

Rev. Proc. 2005-32,[71] provides that "[a] reopening of a closed case involves an examination of a taxpayer's liability that may result in an adjustment to liability unfavorable to the taxpayer for the same taxable period as the closed case. . . The Service's review, including an inspection of books of account, of a taxpayer's claim for a refund on an amended excise or income tax return, as well as the Service's review of a Form 843, *Claim for Refund and Request for Abatement,* claiming a refund for an overpayment reported on a return, is not a reopening."

A taxpayer's claim for refund requires that the IRS review the affected tax years. This is true whether the taxpayer files the claim through a Form 843, an amended tax return, or another means, such as a Form 1139. Accordingly, the IRS's examination of Year 1 in connection with Taxpayer's refund claim is not a reopening of a closed case under IRS procedures.

Even if the examination were considered a reopening of a closed case, IRC §7605(b) does not prohibit a second examination but rather prohibits **unnecessary examination or investigations.** It also requires that the taxpayer be notified in writing if an additional examination is necessary.

The IRS in this case is not subjecting the Taxpayer to onerous and unnecessarily frequent examinations and investigations. Rather, the IRS's action is in response to the Taxpayer's election to carry back an NOL and claim a refund. The IRS must determine the Taxpayer's proper tax liability in order to determine the Taxpayer's right to the claimed refund.

Holding. The reexamination of Year 1 in connection with Taxpayer's NOL carryback and claim for refund is not a violation of IRC §7605(b). Therefore, the audit team may reexamine Year 1 to determine whether Taxpayer is entitled to a claimed refund.

Statute of Limitations

***U.S. v. Home Concrete & Supply LLC et al.,* No. 11-139, U.S. Supreme Court (Apr. 25, 2012)**

IRC §6501

☞ Overstatement of Basis Does Not Extend Statute of Limitations

Facts. The IRS must ordinarily assess a deficiency against a taxpayer within three years after the return is filed.[72] However, the 3-year period is extended to six years when a taxpayer omits an amount from gross income that is in excess of 25% of the amount of gross income stated in the return.[73]

Home Concrete & Supply LLC filed its federal tax return relevant to this case in April 2000. The return overstated the basis of certain property that the taxpayers sold and, as a result, the return understated the gross income that the taxpayers received from the sale of the property by an amount that exceeded the statute's 25% threshold. The IRS asserted a deficiency outside the default 3-year limitations period but within the extended 6-year limitations period that applies to omissions of gross income in excess of 25% of the gross income reported on a return.

A district court concluded that the IRS's assessment was timely under the 6-year statute of limitations. However, the 4th Circuit 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 IRC §6501(e)(1)(A).

> **Note.** For detailed information on the 4th Circuit case, see pages 571–573 in the 2011 *University of Illinois Federal Tax Workbook.*

71. Rev. Proc. 2005-32, 2005-1 CB 1206.

72. IRC §6501(a).

73. IRC §6501(e)(1)(A).

Issue. Whether the extended limitations period applies when the taxpayer overstates the basis in property that was sold, thereby understating the gain received from the sale.

Analysis. In *Colony,*[74] the 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. The Court in *Colony* noted that "omit" limits the statute's scope to situations in which specific receipts or accruals of income are left out of the computation of gross income. To inflate the basis of property, therefore, is not to "omit" a specific item, not even of profit.

Treas. Reg. §301.6501(e)-1 was published in final form in December 2010. The regulation departs from *Colony* and states that "an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income."[75] In the government's view, this new regulation overturns *Colony's* interpretation of this statute. The government argued that the regulation embodies a reasonable, thus permissible, construction of the statute. Justice Stephen Breyer, writing for the majority in this case, did not accept this argument, noting that the statute had already been interpreted in the *Colony* case and the Court must follow that interpretation.

Holding. The Court upheld the 4th Circuit's decision that an overstatement of basis and the resulting understatement of gross income does not trigger the extended limitations period of §6501(e)(1)(A).

Limitations Period

***Robert N. and Cynthia Cadrecha v. U.S.,* No. 1:11-cv-00152; U.S. Court of Federal Claims (Apr. 2, 2012)**
IRC §§6511, 6532, and 7422

☞ Refund Suit Against the IRS Not Timely Filed

Facts. Robert and Cynthia Cadrecha owned a life insurance policy underwritten by a life insurance company that demutualized in 2003. When a life insurance company demutualizes, it converts from a policyholder-owned company to a shareholder-owned company. Each policyholder receives their respective pro-rata share of the new stock in the company. The Cadrechas received their new demutualization stock in the insurance company in 2003. Later that same year, they sold their stock.

On April 15, 2004, the taxpayers filed their 2003 tax return which reported gain on the sale of the shares, with the gain calculated using a zero cost basis. After filing their 2003 return, the Cadrechas became aware of a pending case, *Fisher v. U.S.,*[76] which was expected to address the calculation of basis amounts in demutualization shares.

On March 20, 2007, the Cadrechas' CPA filed a Form 1040X, *Amended U.S. Individual Income Tax Return,* as a protective claim for a refund pending the outcome of *Fisher*. This was filed within three years from the date the 2003 return was filed, as required under IRC §6511(a). After the 3-year limitations period expired, the IRS sent the Cadrechas a letter indicating that the IRS was unable to process their claim because the supporting information was not complete. The letter invited them to file another claim within 30 days that indicated the name of the case they were relying on plus any additional relevant information. On May 17, 2007, the CPA responded and indicated that *Fisher* was the case upon which the protective claim relied.

On June 26, 2007, the IRS sent the Cadrechas a letter indicating that the claim could not yet be resolved because the necessary research had not been completed and that they would be contacted in 45 days. On August 13, 2007, the IRS sent the taxpayers a letter indicating that the claim was still unresolved because of a heavy workload, the necessary research was not yet completed, and 45 additional days were required.

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

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

76. *Fisher v. U.S.*, 82 Fed. Cl. 780, 781-82 (2008), *aff'd* 333 F. App'x 572 (Fed. Cir. 2009).

On August 31, 2007, the IRS sent the Cadrechas a notice of disallowance, indicating that their claim was filed more than three years after the tax return due date. This notice indicated that the taxpayers could file an appeal with the Appeals Office. It indicated that the taxpayer could file in U.S. District Court or the U.S. Claims Court within two years of the letter's date. The Cadrechas' CPA sent a letter in response, indicating that he disagreed with the disallowance because the claim was filed in March 2007, within the 3-year limitations period.

On August 6, 2008, the *Fisher* case was decided. It was determined that demutualization shares **do** have a basis greater than zero.

On November 3, 2008, the CPA filed Form 843, *Claim for Refund and Request for Abatement,* in order to perfect the protective claim.

On December 11, 2009, after several written communications with the IRS that failed to provide any update or resolution on this matter, the CPA had a telephone discussion with IRS employee Ms. McDaniel. She indicated that the IRS was still waiting to process the claim because the IRS intended to appeal *Fisher.* The CPA did not specifically discuss the August 31, 2007 notice of disallowance or any timeliness issues associated with the claim with Ms. McDaniel.

In March 2011, Ms. McDaniel had another conversation with the CPA, and again indicated that the claim was being held in suspense. Ms. McDaniel was unaware of the August 31, 2007 notice of disallowance, and the CPA did not discuss it with her.

The Cadrechas filed a complaint against the IRS in the U.S. Court of Federal Claims on March 9, 2011. The IRS argued that the taxpayers' claim must be dismissed on the grounds that the federal claims court had no jurisdiction because of the following factors.

- The complaint was filed more than two years after the IRS mailed the notice of disallowance and, therefore, the federal claims court has no jurisdiction over the case under IRC §6532(a).
- The Form 843 that the CPA submitted on November 3, 2008, was filed more than three years after the date that the Cadrechas' return was filed. Therefore, the 3-year limitations period under IRC §6511(a) bars the claim and the court has no jurisdiction over it.

The taxpayers contended that the 2-year limitations period never started to run because the notice of disallowance was withdrawn by the IRS, as shown by the numerous letters received by the CPA indicating that the claim was still under consideration.

Issues. The issues are as follows.

- Whether the taxpayers filed their complaint in the federal claims court as required before the expiration of the applicable limitations period
- Whether the notice of deficiency was withdrawn, therefore preventing the limitations period from running

Analysis. Prior to filing suit for a refund in federal claims court, the taxpayer must first file a refund claim with the IRS under IRC §7422(a). After submission of this claim, the taxpayer must wait six months (or until the IRS makes a determination within that time) before a suit can be filed in the federal claims court under IRC §6532(a)(1). If the IRS issues a notice disallowing the refund, the taxpayer then has two years from the date of that notice to file a complaint under §6532(a)(1). **The Cadrechas filed their protective claim with the IRS on March 22, 2007. The IRS mailed a notice of disallowance on August 31, 2007. The Cadrechas then filed their court claim on March 9, 2011, approximately 3½ years after the August 31, 2007 mailing date of the notice.** The complaint should therefore be dismissed. The court has no jurisdiction to hear a case unless it was filed timely.

The Cadrechas argued that the letters from the IRS indicated the protective claim was still under consideration and the CPA's conversations with Ms. McDaniel indicated that the notice of disallowance was withdrawn. However, the CPA did not discuss the notice with Ms. McDaniel, who remained unaware of it during the conversations. No withdrawal could have taken place. The Cadrechas relied on case law to indicate that the IRS had withdrawn the notice, but in all the cases they cited, the taxpayer or taxpayer's agent specifically discussed the relevant issue of the statute of limitations. In the Cadrechas' case, no specific discussion of the limitations issue or time limit took place between Ms. McDaniel and the CPA.

Moreover, the correspondence from the IRS indicating the matter was under consideration and the November 3, 2008 filing of the Form 843 by the CPA had no effect on the running of the limitations period. Under IRC §6532(a)(4), any notice of consideration, reconsideration, or administrative appeal action has no effect on the running of the limitations period, which began running when the IRS issued the August 31, 2007 notice of disallowance. The Cadrechas argued that filing the Form 843 on November 3, 2008 "perfected" the earlier-filed March 20, 2007 claim. However, after the limitations period expired with respect to the original claim, that claim cannot be amended or perfected. If the November 3, 2008 filing of the Form 843 is viewed as a separate claim on its own, it was filed well after the limitations period set out in §6511 expired (three years after the filing or due date of the return or two years after the tax was paid, whichever is later).

Holding. The taxpayers did not file a claim in federal claims court before the expiration of the limitations period; therefore, the claim must be dismissed.

IRS PROCEDURES — PENALTIES

Failure to File

***Thomas Freeman v. U.S.,* No. 2:10-cv-07511; U.S. District Court for the Eastern District of Pennsylvania (Jan. 30, 2012)**
IRC §6651

☞ Attorney's Health Problems Not Reasonable Cause for Late Filing

Facts. Thomas Freeman was the executor of the estate of Robert Wooler, who died in April 2003. Freeman retained Dennis Byrne to represent the estate. Byrne held himself out as an experienced estate attorney, and he handled the administration of the estate. Byrne managed all correspondence with the IRS and assumed responsibility for ensuring that the estate's tax returns were filed and its taxes paid.

The estate tax return was due on January 25, 2004, nine months after Wooler died. Freeman spoke to Byrne about filing the return several times and relied on Byrne's assurances that he would handle the estate's tax obligations.

Freeman and Byrne initially met on a monthly basis to discuss estate matters. However, as time passed, Byrne became increasingly difficult to reach. Their discussions were limited to occasional telephone conversations that were always initiated by Freeman.

Freeman was unaware that Byrne was suffering from several physical and mental problems. These health problems led Byrne to neglect his estate duties, including the filing of the estate tax return. Freeman later learned that Byrne had embezzled money from the estate.

In 2007, the IRS sent Freeman a bill for the outstanding estate tax and related penalties and interest. Freeman confronted Byrne, who told him that the estate tax return was three years past due. In March 2007, the estate tax return was filed along with a payment of $138,179, the amount of tax due as shown on the return.

The estate appealed the penalties and interest assessed by the IRS. The appeals office abated the penalty assessed under IRC §6651(a)(2) but refused to abate any other amounts. The estate then filed a lawsuit.

Issue. This case raises multiple issues but the analysis that follows focuses on the central issue of whether the estate had reasonable cause to file the estate tax return after the deadline.

Analysis. IRC §6651(a)(1) imposes a penalty for filing a tax return after its due date unless the failure is due to reasonable cause and not willful neglect. Freeman argued that Byrne's serious mental and physical problems constitute reasonable cause for the late filing. He contended that he reasonably trusted Byrne to file the return, but Byrne failed to do so because of his ailments.

The Supreme Court rejected the same argument in *Boyle,*[77] when they held that the taxpayer's duty to file a timely tax return cannot be delegated. Consequently, reliance on an agent does not excuse an untimely filing. The Court acknowledged that a taxpayer may properly rely on the assistance of a lawyer to prepare and submit tax filings. However, a taxpayer's reliance on legal advice, which is often beyond a layperson's competence, is distinct from a taxpayer's reliance on ordinary matters such as when a tax return is due. The Court held that "the failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not 'reasonable cause' for a late filing under section 6651(a)(1)."[78]

According to the court in the case at hand, Byrne's disability is immaterial. It might explain why Byrne did not meet his obligations as the estate's attorney, but it did not excuse Freeman's failure to file for purposes of §6651(a)(1).

Holding. The court held that Freeman failed to prove that the estate had reasonable cause to file the estate tax return after the due date.

Failure to File

***Austin Danne Hardin v. Comm'r,* TC Memo 2012-162 (Jun. 11, 2012)**
IRC §§6651 and 6654

☞ Taxpayer's Mental Disorders Not Sufficient for Reasonable Cause

Facts. Austin Hardin was employed full time as an engineer with the Department of Defense. His job involved establishing reliability criteria for new military equipment and equipment testing.

During 2006, Hardin owned and managed two rental properties. He paid the monthly mortgage payments and utility bills for each property. He placed one of those properties on the market and sold it, subsequently using the proceeds to pay down a line of credit secured by his principal residence. Hardin continued to manage the other property.

Hardin filed joint tax returns with his wife, who was employed full time as a school counselor and part time as an adjunct professor at Columbus State University. Hardin was responsible for filing the returns because he was more of a "numbers person" than his wife.

Hardin was diagnosed with attention deficit hyperactivity disorder (ADHD). He also suffered from bipolar disorder, posttraumatic stress disorder, and was a 30% disabled veteran. His wife was diagnosed with mild to moderate ADHD.

Hardin failed to timely file his 2005 and 2006 income tax returns. He claimed that his late filing was due to his mental disorders and that the mental disorders constitute reasonable cause. He did not make any of his required 2006 estimated tax payments. The IRS prepared substitute returns for Hardin for these years and subsequently mailed deficiency notices to him in January 2009. After arriving at an agreement with Hardin on the amounts owed, the IRS assessed a penalty for failure to timely file and failure to pay under §6651(a)(1) and §6651(a)(2), respectively, in connection with the 2006 tax year. The IRS also assessed a §6654(a) penalty for failure to make estimated tax payments for 2006. Hardin claimed relief under §6511(h) because his mental disorders qualify him as a "financially disabled" taxpayer.

77. *U.S. v. Boyle,* 469 U.S. 248 (1985).

78. Ibid at 252.

Issues. The issues in this case are as follows.

- Whether the penalties assessed by the IRS in connection with the 2006 tax year should be upheld
- Whether the taxpayer's mental disorders are sufficient to qualify him as a "financially disabled" taxpayer under §6511(h)

Analysis. IRC §§6651(a)(1) and 6651(a)(2) provide for penalties unless the taxpayer can demonstrate that the failure was due to reasonable cause and not willful neglect. A taxpayer who exercises ordinary business care and prudence and nevertheless is unable to file a return or pay tax on time has reasonable cause. The burden of proving reasonable cause falls on the taxpayer.

Although there may be reasonable cause if a taxpayer's or family member's illness or incapacity prevents the filing of a tax return, Hardin was able to carry on consistently with his business affairs despite his mental disorders. He continued to manage his rental properties, even selling one during the 2006 tax year and paying down a line of credit with the proceeds. He was employed full time as an engineer with the Department of Defense, where he performed complex analyses of military equipment.

Hardin contended that he did not pay timely because he had a lot of debt. However, he failed to demonstrate that he exercised ordinary business care and prudence and did not establish that he would have suffered undue hardship if he had paid his tax liability. Both Hardin and his wife were employed on a full-time basis and they had proceeds from the sale of a rental property that were used to pay down a line of credit.

Hardin indicates that he is a "financially disabled" taxpayer entitled to relief. IRC §6511(h) provides for an extension of the limitations period on filing claims for refund or credit for overpayment of taxes when taxpayers are unable to manage their financial affairs. However, Hardin did not claim that he was due a refund or credit for overpayment of taxes so this argument was irrelevant.

Holding. Hardin's mental disorders do not constitute reasonable cause. He remains liable for the assessed penalties.

Failure to File
***William and Cheryl O'Bryant v. Comm'r,* TC Summ. Op. 2011-101 (Aug. 15, 2011)**
IRC §6651

☞ Wife's Brain Injury is Reasonable Cause for Late Filing

Facts. William O'Bryant practiced internal medicine in California for 18 years. After discovering that he had a proclivity for day trading, he left the medical practice and became a full-time day trader in 1998. A few months later, Mr. O'Bryant's wife suffered a severe head injury that left her partially paralyzed and with a limited memory.

Mr. and Mrs. O'Bryant at that time had two minor children and two children in college. Mr. O'Bryant ceased day trading to care for his wife and children full time. Initially, Mrs. O'Bryant was unable to perform most basic functions, and Mr. O'Bryant taught her to walk, eat, dress, etc. It took over two years for Mrs. O'Bryant to be able to independently manage her own care.

In 2001, Mr. O'Bryant began working as a medical director for a health insurance company. Shortly after he started the position, Mrs. O'Bryant developed a new condition that required additional brain surgery. During the following two years, Mr. O'Bryant's income was insufficient to cover the family's living expenses, and he incurred debt of approximately $150,000.

Mr. and Mrs. O'Bryant had prepayment credits from prior years and various estimated payments. Their 2001 and 2002 tax returns were not filed on a timely basis; accordingly, the IRS prepared substitutes for returns for those years in May 2004. In February 2006, the O'Bryants filed their 2001 and 2002 returns, which showed a small amount of tax owed.

Issue. Whether the O'Bryants are liable for IRC §6651(a)(1) additions to tax for the 2001 and 2002 tax years.

Analysis. IRC §6651(a)(1) imposes an addition to tax for any failure to timely file a federal income tax return unless the failure is due to reasonable cause and not willful neglect. Taxpayers show reasonable cause by demonstrating that they exercised ordinary business care and prudence and nonetheless were unable to file the tax return on a timely basis.

Mr. O'Bryant claimed that his late filing of the tax returns was due to reasonable cause because of his good-faith belief that prior year credits or overpayments would result in no tax due for the years at issue. Additionally, when the returns were due, he was unable to accomplish much more than caring for his wife, children, and household while continuing to earn money to support his family. During this time, Mr. O'Bryant slept little and had no time for any other activity.

To further complicate matters, during the time that Mr. O'Bryant was overwhelmed by family obligations, the O'Bryants' returns were being audited, and there were substantial differences between the parties regarding the application of credits and overpayments from prior years. **Thus, the failure to file was not due to intentional failure or reckless indifference.**

Holding. The court held that the O'Bryants are not liable for the late-filing addition to tax under §6651(a)(1) for the tax years at issue.

Early Withdrawal from IRA

***Young Kim v. Comm'r*, U.S. Court of Appeals, 7th Circuit; No. 11-3390 (May 9, 2012)**
IRC §§72(t), 6662, 408, and 6404

☞ Penalty Upheld on Early Withdrawal From IRA

Facts. Young Kim left his position as a partner in a law firm and enrolled in the London School of Economics at age 56. Kim moved funds from the law firm's retirement plan to an IRA and then withdrew approximately $240,000 from the IRA. He paid the income tax on the withdrawal but not the 10% additional tax that is due on most withdrawals before age 59½.

The IRS assessed the 10% additional tax and a penalty for substantial underpayment of taxes under IRC §6662. During a trial in Tax Court, the parties reduced the scope of the dispute because the money Kim spent on education expenses at the London School of Economics, as well as the amount spent for his daughter's education, is not subject to the 10% additional tax.[79] The Tax Court held that the portion of the withdrawal that was spent for other purposes is subject to the 10% additional tax and that he also owes the §6662 penalty for a substantially inaccurate return. Kim appealed the decision.

Issues. The issues in this case are as follows.

- Whether Kim owes the 10% additional tax for an early withdrawal from his IRA
- Whether he owes a §6662 accuracy-related penalty

Analysis. IRC §72(t)(2)(A)(v) provides that the 10% additional tax does not apply to a distribution from a pension plan made to an employee who has separated from service after age 55. However, Kim's distribution was not taken from his employer's pension plan but from an IRA. IRC §72(t)(3)(A) specifically states that the exception does not apply to distributions from an IRA. Kim argued that the distinction between a pension plan withdrawal and one from an IRA "makes no sense." The court noted that this is one of those questions that "… cannot be answered by logical analysis. The Code's lines are arbitrary."

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79. IRC §72(t)(2)(E).

IRC §6662 excuses the taxpayer from the accuracy-related penalty if the taxpayer furnished accurate information to, and then relies in good faith on, the opinion of a competent tax adviser.[80] However, Kim provided no evidence to the court showing what information he furnished to his accountant or whether the accountant competently analyzed the situation under §72(t). Kim filed a motion for a continuance with the Tax Court in order to obtain expert evidence from his accountant, but did so after the deadline for submitting such evidence had passed; thus, the Tax Court denied his motion.

Holding. The 7th Circuit affirmed the Tax Court decision that Kim was liable for a 10% additional tax on funds withdrawn from his IRA and for an accuracy-related penalty.

Levied Property

***U.S. v. Heli USA Airways, Inc.*, No. 2:09-cv-01339; U.S. District Court for the District of Nevada (Nov. 14, 2011)**
IRC §§6332, 6331, and 6321

☞ Airline Found Liable for Failure to Honor Wage Levy

Facts. Lee Rhodes was employed as a pilot by Heli USA Airways between 2008 and 2010. In January 2008, the IRS sent a notice of levy to Heli with regard to Rhodes because he had unpaid federal tax liabilities and civil penalties for the years 1999 through 2003. The levy notice was sent to the attention of Omar Palacios, the chief financial officer of Heli.

The IRS did not receive any response from Heli; accordingly, an IRS revenue officer contacted Palacios by telephone to inquire as to why Heli had not complied with the January levy on Rhodes' wages. Palacios informed the revenue officer that he had not received the January levy notice. The revenue officer stated that she had mailed the notice to him by U.S. mail and said she would send a second levy notice to him on that date by certified mail and by fax.

In April 2008, Heli still had not complied with the notices of levy. The revenue officer prepared a final demand for payment which was served on Palacios on April 8, 2008.

Palacios subsequently left Heli because he was suffering from severe anxiety and depression. After his departure, the company discovered that Palacios had neglected his responsibilities with regard to some business and legal matters.

The government filed a motion for summary judgment. As of March 2011, Rhodes' outstanding balance for tax liabilities and penalties was $49,176.

Issue. Whether Heli is liable for the outstanding tax liabilities and penalties under IRC §6332.

Analysis. IRC §6332 requires the person in possession of, or obligated with respect to, levied property to surrender it to the Treasury upon demand. Failure to do so results in personal liability under §6332(d)(1). IRC §6332(d)(2) further provides that the IRS may demand an additional 50% penalty against **anyone** who fails to surrender such property without reasonable cause.

During the relevant period, Heli paid Rhodes a total of $110,076 in wages. The IRS asserts that Heli is liable for Rhodes' unpaid taxes because it did not properly surrender the amount demanded by the IRS in the notice of levy. Heli did not assert any of the recognized defenses for failure to honor a levy.

A court must impose a 50% penalty on any person who fails or refuses to honor a levy without reasonable cause.[81] Heli argued that Palacios' breakdown in mental health was the cause of its failure to respond to the levy. The court did not agree that Palacios' conduct provides a basis for an exception to the penalty. Heli cited no authority that upheld a "reasonable cause" defense based on the conduct of a "rogue employee."

Holding. Heli is liable for the outstanding tax liability set forth in the notices of levy. The court also found Heli liable for a penalty of 50% of the recoverable amount.

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80. See *Neonatology Associates, P.A. v. Comm'r,* 115 TC 43, 98-99 (2000), *aff'd,* 299 F.3d 221, 233-35 (3d Cir. 2002); Treas. Reg. §1.6664-4(c). See also *U.S. v. Boyle,* 469 U.S. 241, 251 (1985).

81. IRC §6332(d)(2).

Accuracy-Related Penalty

***Kurt C. Olsen v. Comm'r,* TC Summm. Op. 2011-131 (Nov. 23, 2011)**

IRC §§6662 and 6664

☞ Data Entry Error Using Tax Preparation Software Constitutes Reasonable Cause

Facts. Kurt Olsen, a patent attorney for the Department of Energy, prepared the Olsens' 2007 joint return. In 2007, Mrs. Olsen received interest income from a trust established by her mother's estate. As a beneficiary of the trust, Mrs. Olsen received a Form 1041 Schedule K-1 that reported the interest income. Prior to 2007, the Olsens had never received a Schedule K-1 and were unfamiliar with the form.

Mr. Olsen used an upgraded version of tax preparation software to prepare the 2007 joint return as a precaution to ensure that the Schedule K-1 was reported properly. However, he made a data entry error that omitted the Schedule K-1 interest income from his return. The IRS determined a 2007 Form 1040 tax deficiency of $9,297 and assessed a penalty of $1,859 for substantial understatement of income tax.

Issue. Whether the taxpayer is liable for the 20% substantial understatement of tax penalty under IRC §6662.

Analysis. There is an exception to the imposition of an accuracy-related penalty if the taxpayer establishes that:

1. There was a reasonable cause for the understatement, and
2. That the taxpayer acted in good faith.[82]

Generally, the most important factor is whether the taxpayer made a good-faith effort to properly report the correct tax liability.[83] An isolated data entry error is not inconsistent with a finding of reasonable cause and good faith.

Holding. The court held that Mr. Olsen was not liable for the substantial understatement of tax penalty assessed by the IRS.

Trust Fund Penalty

***Roy Don Bunch v. Comm'r,* No. 2:10-cv-122; U.S. District Court for the Eastern District of Tennessee (Mar. 8, 2012)**

IRC §§6672, 7422, and 7501

☞ District Court Upholds "Responsible Person" Determination

Facts. Perceptions, Inc. (Perceptions), a nonprofit corporation operating in Tennessee, provides supportive living services for developmentally disabled clients. The corporation was originally formed on June 7, 2004, with three initial directors. In February 2005, articles of amendment were filed replacing the initial directors with three new directors, who included Roy Don Bunch. Bunch signed these documents as chairman of the board. From that time until the corporation's dissolution, Bunch served as president, board chairman, registered agent, CFO, and principal of Perceptions as shown on numerous documents filed on its behalf.

Bunch made start-up and bridge loans to Perceptions when funds were not sufficient to keep the operation afloat. Bunch made loans totaling $648,000 between February 2005 and August 2007. Repayments were made based on the cash flow of the operation.

[82] IRC §6664(c)(1) and Treas. Reg. §1.6664-4(a).

[83] Treas. Reg. §1.6664-4(b)(1).

Even though Bunch served as chairman of the board, he **never:**

- Received a paycheck from Perceptions,
- Hired or fired employees,
- Asked to see the books,
- Asked if taxes were paid, or
- Supervised employees.

In December 2006, Bunch became aware of a proposal to give raises to Perceptions' employees. He immediately convened a telephone conference with the other directors to discuss the proposal. He objected to the proposed raises and voiced his concerns to the other directors. As a result, no raises were given. He also became aware of the unpaid third quarter 2006 payroll taxes at about this time. He loaned money to Perceptions and the taxes were then paid.

On June 22, 2007, Bunch became actively involved in Perceptions' financial affairs. His intent was to turn Perceptions into a viable business. However, things continued to get worse; some bills were paid but no payments were made to the IRS for current or back taxes.

Part of Perceptions' funding came from the Tennessee Department of Mental Retardation Services (DMRS) in payment of client services billings. In mid-2007, DMRS starting withholding funds to Perceptions pending an investigation related to claims of lack of proper nursing supervision. After employees complained to DMRS about not receiving their regularly scheduled paychecks, DMRS agreed to release half the funds with the express condition that these funds be used solely for net payroll.

In March 2008, an IRS revenue officer informed Bunch that trust fund recovery penalties (TFRP) were being assessed against him for the second and fourth quarters of 2006 and all four quarters of 2007. On September 28, 2009, the IRS assessed TFRP against Bunch totaling $197,859. Bunch unsuccessfully appealed the determination. He then filed a Form 843, *Claim for Refund and Request for Abatement,* but it was denied. On February 9, 2010, he paid the IRS $193,952 to satisfy the TFRP.

Issue. Whether the district court erred in finding Bunch a responsible person pursuant to IRC §6672.

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.

Bunch acknowledged that he was a responsible person for the payment of taxes after June 22, 2007, when he became actively involved in Perceptions' financial affairs. However, he disputed that he was a responsible person prior to that time.

In reaching its decision, the court relied on the following facts.

- Bunch exerted significant and substantial control over the financial affairs of Perceptions.
- Bunch made start-up and bridge loans to Perceptions throughout its existence which enabled him, if he chose, to exercise almost total control over the corporation.
- Bunch was chairman of the board and a director.
- He had actual knowledge of the tax delinquencies beginning in December 2006.

Subsequent to Bunch's knowledge of the tax delinquency, Perceptions continued to pay significant amounts to other creditors, for payroll, and to repay loans to Bunch. Bunch argued that the only funds available in July and August 2007 were "encumbered" funds received from DMRS that were not available to pay the payroll taxes. The IRS concurred that if DMRS had encumbered the funds, those funds could not have been used for payment of payroll taxes. Bunch, however, failed to prove that the funds were indeed encumbered.

Holding. The court held Bunch liable for the TFRP caused from Perceptions' unpaid payroll taxes because he willfully failed to pay trust fund amounts to the IRS.

Application of Tax Payments

***Concert Staging Services, Inc. v. Comm'r,* TC Memo 2011-231 (Sep. 26, 2011)**
IRC §§6330, 6651, and 6656

☞ Installment Agreement Broadens IRS Authority for Allocating Payments

Facts. From the early 1980s until June 30, 2006, Concert Staging Services, Inc. (Concert) operated a stage production company in Little Rock, Arkansas. Michael Pinner was the sole shareholder and corporate officer. Concert filed Forms 941, *Employer's Quarterly Federal Tax Return,* for the quarters ending September 2003, December 2003, and March 2004 and Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return,* for 2003 but did not pay the balances due. Concert entered into an installment agreement on September 8, 2004.

The IRS issued a final notice of intent to levy on January 17, 2008, that showed the following unpaid amounts.

Form	Tax Period	Unpaid Amount	Penalty	Interest
941	9/30/2003	$36,024	$11,278	$16,417
941	12/31/2003	24,386	5,361	7,468
941	03/31/2004	33,731	6,930	9,277
940	12/31/2003	2,164	497	627
Total		$96,305	$24,066	$33,789

On February 15, 2008, Concert filed a Form 12153, *Request for a Collection Due Process or Equivalent Hearing,* along with a request for an installment agreement or offer in compromise. On February 18, 2008, Concert faxed Form 433-B, *Collection Information Statement for Businesses,* to the IRS without any supporting documentation for a $72,000 loan attached to the real property valued at $56,000. Subsequently, thirteen payments were made (11 from Concert's bank account totaling $27,500 and two from Pinner's account totaling $3,500), which the IRS applied to the accounts in the best interests of the IRS.

Concert made the following requests.

- The additions to tax be abated based on "reasonable cause"
- A face-to-face collection due process (CDP) hearing be held in Little Rock
- The 13 payments made on the accounts be applied only against the trust fund taxes

The settlement officer offered a face-to-face hearing in Oklahoma City but the taxpayer's counsel refused; a CDP hearing was held on April 23, 2008, via telephone.

A notice of determination concerning collection action was sent to Concert on December 31, 2008. This notice conceded that the §6656(a) penalty for the quarter that ended on September 30, 2003 was overstated and was being adjusted accordingly. However, the notice of determination rejected Concert's proposed collection alternatives because of the failure to produce supporting documentation. The notice further stated that Concert was not entitled to abatement of additional taxes and penalties because there was no reasonable cause. In response to the notice, Concert petitioned the court.

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

- Whether the taxpayer is entitled to relief from additions to tax under IRC §6651(a)(2)
- Whether the taxpayer is entitled to relief from penalties under IRC §6656(a)
- Whether Appeals abused its discretion in denying the taxpayer's request to reallocate prior payments and deposits from the nontrust-fund portion to the trust-fund portion of employment tax liabilities
- Whether Appeals abused its discretion in denying the taxpayer's request for a face-to-face CDP hearing
- Whether Appeals abused its discretion in not granting the taxpayer a 2-part hearing to discuss the payment application and collection alternatives

Analysis. IRC §6330(a)(1) provides the taxpayer with an opportunity for a CDP hearing before the Appeals Office prior to levying. IRC §6651(a)(2) allows for an addition to tax when a taxpayer fails to timely pay the tax shown on a return. IRC §6656(a) imposes a penalty on a taxpayer who fails to timely make federal tax deposits.

At trial, Pinner argued that they had reasonable cause for not timely paying the taxes because they lacked sufficient funds to both satisfy the tax liabilities and remain in business. Concert's business began suffering shortly after the September 11, 2001 attacks at the World Trade Center where they were staging a series of events. Not only did they lose staging structures and equipment but they also incurred significantly higher insurance rates.

Pinner also stated that Concert reduced both personnel and business expenses. Pinner allegedly sold his houseboat and took out a second mortgage on his Colorado ranch to provide Concert with additional funding. However, Pinner failed to provide evidence to support these claims nor did he offer evidence to support his financial status at the time the taxes were due. The court was not persuaded that Pinner "exercised ordinary business care and prudence… and was nevertheless either unable to pay the tax or would suffer an undue hardship."

The taxpayer also challenged the application of the 13 payments made to the nontrust-fund portion rather than the trust-fund portion of the liabilities. However, once Concert entered into an installment agreement, this gave the IRS the broad authority to apply payments in the best interests of the government. The Court agreed that applying the payments as Pinner requested would reduce his liability for trust fund penalties. However, because the total amount of tax liabilities owed would not change, the manner in which the payments were applied by the IRS was upheld.

In response to the abuse of discretion by the settlement officer in refusing to grant a face-to-face hearing in Little Rock, the court found that because Appeals had scheduled settlement officers to conduct face-to-face CDP hearings in Little Rock with other taxpayers before and after Pinner's CDP hearing, but apparently not on a date that Pinner was able to attend, Appeals did not abuse its discretion.

The court also determined that Appeals did not abuse its discretion in not granting the taxpayer a 2-part hearing to discuss the payment application and collection alternatives because Pinner continually refused to provide evidence to support his financial status when he was requested to do so. The settlement officer verified that the requirements of applicable law or administrative procedure for the proposed levy had been met.

Holding. The court decided all issues in favor of the IRS.

Accuracy-Related Penalty

Neal D. Crispin v. Comm'r, **TC Memo 2012-70 (Mar. 14, 2012)**
IRC §6662

☞ Sham Transaction Disregarded for Tax Purposes

Facts. Neal Crispin, a CPA, worked for Arthur Young & Company for seven years before becoming chief financial officer of Highlands Energy. After two years as CFO, he left to pursue opportunities in the structured financing and leasing industry, eventually focusing on aircraft leasing transactions. During the 1980s and 1990s, Mr. Crispin successfully managed several aircraft leasing funds. He also founded AeroCentury Corporation in the mid-1990s to acquire leased aircraft assets using leveraged financing.

In 2001, he incorporated Murus Equities, Inc., to engage in business related to a certain pool of collateralized mortgage obligations. Murus was formed as an S corporation, which Mr. Crispin wholly owned. Murus received $7.66 million of shared fees income for 2001; these shared fees flowed through to Mr. Crispin, creating a potentially substantial tax liability.

A friend of Mr. Crispin's promoted a tax-driven investment known as CARDS that could be structured to generate ordinary or capital losses for an investor. Mr. Crispin entered into a CARDS transaction late in 2001 that generated an ordinary loss equal to Murus' shared fees income in 2001. The promotional materials provided to Mr. Crispin clearly explained the tax implications of the CARDS transaction options. As a result of complex transactions, Murus' 2001 tax return claimed a $7.64 million ordinary loss on Form 4797, *Sales of Business Property,* as a "Swiss franc deposit." The Swiss franc deposit was acquired on December 28, 2001, for a cost of $9.48 million and was sold on the same day for $1.84 million. After the offsetting transactions, Mr. Crispin's Form 1040 reported $3,244 of flow-through income from Murus.

In early 2002, Mr. Crispin engaged a law firm to review and issue a tax opinion on the CARDS transaction. As part of the investigatory work, Mr. Crispin provided statements to the firm that: (1) he had a business purpose for entering into the CARDS transaction, and (2) he anticipated the CARDS transaction would be profitable, absent a tax benefit. He received the finalized tax opinion on April 29, 2002, after the 2001 returns had been filed. For the $50,000 opinion, the law firm stated that it is more likely than not that the ordinary loss created by the CARDS transaction would be allowed as a deduction.

Issues. The issues in this case are as follows.

- Whether the CARDS transaction should be disregarded for tax purposes
- Whether the taxpayer is liable for an accuracy-related penalty

Analysis. The court analyzed all facets of the CARDS transaction and concluded that it lacked economic substance. It was intended to create an ordinary loss that would substantially offset Murus' shared fees income for 2001 and it worked exactly as it was intended.

IRC §6662(h) provides a 40% penalty on that portion of an underpayment of tax that is attributable to one or more gross valuation misstatements. In previous court cases, the courts have held that the gross valuation penalty applies when an underpayment stems from deductions or credits that are disallowed because of a lack of economic substance. The reasonable and good-faith reliance on the advice of an independent competent professional as to tax treatment of an item may negate an accuracy-related penalty. Mr. Crispin argued that no accuracy-related penalty applies because he reasonably relied in good faith on the tax opinion. The court disagreed for the following reasons.

- The tax opinion relied on false representations that the taxpayer made. The most critical of these are that he had a business purpose for entering into the CARDS transaction and that he anticipated earning a profit from the CARDS transaction. Mr. Crispin entered into the transaction solely for generating a tax loss to offset Murus' shared fees income for 2001.
- The taxpayer did not actually rely on the tax opinion because the opinion was received **after** the tax returns were filed. No draft opinion was shown to be provided prior to the filing of the tax returns.

Holding. The court held that the CARDS transaction lacked economic substance, and the related loss was disallowed in full. The accuracy-related penalty was sustained in full.

LIKE-KIND EXCHANGE

Like-Kind Exchange

***Patrick and Jill Reesink v. Comm'r,* TC Memo 2012-118 (Apr. 23, 2012)**
IRC §1031

☞ Property Purchased with Investment Intent Qualifies as Like-Kind Exchange

Facts. Patrick Reesink worked for a private club in San Francisco until 2003 when he developed a blood clot in his ankle. He was declared permanently disabled by the Social Security Administration as of April 2004 and began receiving disability benefits in March 2006.

In 1986, Patrick and his brother Michael Reesink purchased a 6-unit apartment building in San Francisco. Unfortunately, the relationship between the brothers deteriorated, and in late 2002, Patrick sued his brother Michael for several causes of action with respect to their joint interests in the apartment building. The brothers settled the case in September 2004. Under the settlement agreement, the brothers agreed to sell the apartment building and divide the proceeds equally.

Patrick and Michael sold the apartment building in September 2005 for $1.4 million. Each brother's share of the gross sale proceeds was $700,000.

Patrick and his wife Jill elected to pursue an IRC §1031 like-kind exchange using the proceeds from the sale of the apartment building. Accordingly, in November 2005, they purchased a single-family home on Laurel Lane in Guerneville, California.

Patrick and Jill posted flyers throughout Guerneville advertising the Laurel Lane property for rent and posted "for rent" signs on the property. They attempted to rent the Laurel Lane property for $3,000 per month. They never lowered their monthly asking price and never found tenants for the property.

Patrick became concerned that the couple could no longer afford their financial obligations. Consequently, they decided to sell their primary residence. Patrick and Jill closed on the sale in June 2006 and moved into the Laurel Lane property at that time.

Issue. There were several issues raised in this case, but the following analysis focuses on whether Patrick and Jill's sale of rental property followed by their purchase of real estate qualifies as a like-kind exchange.

Analysis. IRC §1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged for like-kind property that is to be held for productive use in a trade or business or for investment.

The IRS argued that the couple did not hold the Laurel Lane property with the requisite investment intent at the time of the exchange. The taxpayer's investment intent must be the primary motivation for holding the exchanged property in order for the property to qualify as held for investment purposes under §1031.[84] The use of property solely as a personal residence is antithetical to its being held for investment purposes.[85]

The IRS stated that Patrick and Jill's actions surrounding the purchase of the Laurel Lane property were so unreasonable that they could not have intended to hold the Laurel Lane property for investment purposes. The IRS supported this argument by emphasizing the Reesink's "healthy balance sheet." However, the court noted that although the Reesink's decision to purchase the Laurel Lane property may not have been financially sound, it was not unreasonable for them to believe that they could supplement their lost wages with rental proceeds. Moreover, several witnesses testified at trial that the Reesinks never discussed moving to Guerneville until after the exchange had been completed and they believed they were in dire financial straits.

The Reesinks also demonstrated their intention to use the Laurel Lane property for investment purposes by placing flyers throughout Guerneville advertising the rental, showing the property to potential renters, and waiting almost eight months before moving from their previous residence.

Holding. The court concluded that the Reesinks held the Laurel Lane property with investment intent at the time of the exchange. Therefore, the sale of the apartment building followed by the purchase of the Laurel Lane property qualifies as a like-kind exchange.

NONPROFIT ORGANIZATIONS

Unrelated Business Taxable Income

Ltr. Rul. 201213034 (Jan. 5, 2012)
IRC §§501(c)(7) and 512

☞ IRS Revokes Prior Ruling on Social Club's Sale of Property

Facts. In September 2004, the IRS issued a letter ruling in response to Club's December 2003 inquiry as to whether any gain realized by Club on the sale of certain property would cause Club to lose its tax-exempt status and whether the gain would be considered unrelated business taxable income under IRC §512.

Club was incorporated in Year 1 under the nonprofit statute of the state in which it conducted its activities. Club received a determination letter from the IRS recognizing it as an organization described in IRC §501(c)(7) and tax exempt under IRC §501(a). Club's purposes, as described in its constitution, were "…to promote boating and social recreation, to encourage members to become proficient in navigation and all matters pertaining to seamanship and to advance the cause of boating in its broadest sense."

84. *Moore v. Comm'r,* TC Memo 2007-134 (May 30, 2007).

85. *Starker v. U.S.*, 602 F.2d 1341, 1350-1351 (9th Cir. 1979).

Club found it increasingly difficult to maintain its existence as its membership aged, new membership dwindled, and the costs of operation increased. For these reasons, Club members approved the sale and liquidation of Club's assets, the cessation of operations, and the dissolution of the corporation. At the time Club requested a letter ruling, it had a contract to sell its property.

Based on the information furnished by Club, the IRS issued Ltr. Rul. 2004531031 in September 2004 that stated the following.

1. Any gain Club realizes on the sale of its assets will not cause it to lose its tax-exempt status under IRC §501(c)(7).
2. Any gain Club realizes on the sale of assets will not be treated as unrelated business taxable income under §512.

Analysis. Several courts have ruled on the issue of unrelated business income tax as it applies to the sale of property by a social club. In *Tamarisk Country Club,*[86] the court ruled that the club owed tax on the amount of the proceeds from the sale of its property that exceeded the amount used to purchase new exempt property because it was not reinvested but, rather, withdrawn by members of the organization. The court applied the principle that revenue from the sale of property will be taxed, unless it is reinvested in exempt-function property.

The facts that surrounded the proposed sale of Club's assets showed that its property was used to carry out Club's exempt activities. Thus, the purpose of the sale of Club's assets was to facilitate Club's dissolution due to changed circumstances. Treas. Reg. §1.507(c)(7)-1(b) provides that the distribution of liquidated assets to a social club's members does not result in the revocation of the club's tax-exempt status. **However, because Club's property was intended to be sold and the income was not used to purchase other property to be used in the performance of Club's exempt function, the gain from the sale must be recognized as unrelated business taxable income.**[87]

Rev. Proc. 2011-4[88] provides that a letter ruling found to be in error or not in accord with the current views of the IRS may be revoked or modified. Accordingly, Ltr. Rul. 200451031 was revoked.

Holding. The IRS ruled as follows.

1. Any gain Club realizes on the sale of its assets will not cause it to lose its tax-exempt status under §501(c)(7).
2. The gain on the sale of Club's property is considered unrelated business taxable income under §512.

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86. *Tamarisk Country Club v. Comm'r,* 84 TC 756 (1985).

87. IRC §512(a)(3)(D).

88. Rev. Proc. 2011-4, 2011-1 IRB 123.

NOT FOR PROFIT

Hobby Loss

***Mark and Martha Ryberg v. Comm'r,* TC Summ. Op. 2012-24 (Mar. 12, 2012)**
IRC §§183, 274(d), 6001, and 6662

☞ Split Decison for Couple Engaged in Horse Breeding and Drag Racing Activities

Facts. Mark and Martha Ryberg resided in Minnesota and both of them were employed full time. They owned a 40-acre farm consisting of pasture, a large horse barn, and their residence. They reported losses on Schedule F, *Profit or Loss From Farming,* from their horse-breeding activity for nine consecutive years, 1998 through 2006. **The 2006 Schedule F for the activity reported the following.**

Schedule F income	$ 4,850
Schedule F expenses	(27,120)
2006 Schedule F loss	**($22,270)**

Martha Ryberg was a certified horse judge for 10 years prior to starting the horse-breeding activity in 1998. Unfortunately for the taxpayers, the following events negatively impacted the business.

- Many of their horses were infected with the West Nile virus.
- In 2001, Mark Ryberg injured his back in an auto accident on a public highway.
- In 2002, the Minnesota horse-breeding industry was in steep decline due to low demand for horses.
- In 2005, Martha was diagnosed with cancer.

In 2007, Martha terminated the horse-breeding activity in light of their continued Schedule F losses.

Mark Ryberg began his drag racing activity in 1990 when he purchased a Chevrolet Camaro. He also bought a truck and a trailer to haul his race car to drag racing events. He was able to secure a modest amount of sponsorship income from local businesses.

Mark reported losses on Schedule C, *Profit or Loss From Business,* for his drag racing activity from 1990 through 2006. **The 2006 Schedule C for the activity reported the following.**

Race winnings	$ 750
Sponsorship income	2,375
Total Schedule C income	$3,125
Less: Schedule C expenses	(9,201)
2006 Schedule C loss	**($6,076)**

In 2007, Mark ceased reporting his drag racing activity as a business due to his continuous history of Schedule C losses.

Issues. There are two issues in this case.

1. Whether the taxpayers engaged in their horse breeding and drag racing activities with the required profit objective set forth in IRC §183.
2. Whether the taxpayers are liable for the accuracy-related penalty under IRC §6662(a).

Analysis for the Horse-Breeding Activity. The fact that a taxpayer carries on an activity in a businesslike manner and maintains complete and accurate books and records may indicate a profit objective.[89] The taxpayers generally carried on their horse-breeding activity in a businesslike manner as evidenced by the following actions.

- They conducted market research before beginning the activity.
- Martha took courses in pasture renovation, feedlot permits, and manure management.
- They educated themselves on the business and economic aspects of the activity. Martha completed a law school course on horse-breeding contracts.
- Martha drafted formal breeding contracts with their clients.
- They used extensive advertising to publicize the horse-breeding services they offered.
- They kept accurate books and records on a monthly basis and maintained a separate charge account for the activity.
- They had a detailed business plan that included genetically-focused breeding of horses with high marketability.
- Detailed records were maintained regarding each horse (performance, gestation, reputation, etc.).

A profit motive may also be indicated by a change of operating methods, adoption of new techniques, or abandonment of unprofitable methods in a manner consistent with the intent of improving profitability.[90] The taxpayers made the following changes in an attempt to improve profitability.

- They cut purchased feed costs.
- They lowered veterinarian costs by vaccinating the horses themselves.
- They carefully investigated the possibility of adding boarding services.

Devoting a great deal of personal time and effort in carrying on an activity may indicate a profit objective.[91] The taxpayers did not ride their horses for pleasure. Instead, they performed all the daily physical labor associated with caring for and training the horses.

Losses sustained because of unforeseen circumstances beyond the taxpayer's control do not indicate that the activity lacked a bona-fide profit objective.[92] The Schedule F losses can be partially explained by numerous events that occurred outside their control.

Analysis for the Drag Racing Activity. Mark Ryberg did not provide a spreadsheet or any other documents relating to his 2006 expenses. He never reported a profit from the activity. The court noted that it was clear that the activity was not conducted with the required profit objective and that Mark derived personal pleasure from drag racing and participated in races as a form of recreation.

Holding. The court held that the horse-breeding activity was engaged in for profit within the meaning of IRC §183 but the drag racing activity was not. Consequently, expenses for the drag-racing activity were allowed only to the extent of the reported gross receipts. Additionally, the taxpayers did not demonstrate reasonable cause and good faith necessary to prevent the imposition of the 20% accuracy-related penalty under IRC §6662 with regard to the drag-racing activity.

89. Treas. Reg. §1.183-2(b)(1).

90. Ibid.

91. Treas. Reg. §1.183-2(b)(3).

92. Treas. Reg. §1.183-2(b).

Business Expense Deductions

Mark E. and Patti Blackwell v. Comm'r, **TC Memo 2011-188 (Aug. 8, 2011)**

IRC §183

☞ Couple's Horse Activity Was Engaged in For Profit

Facts. Mark Blackwell, a former motocross champion, had a successful career as manager and senior officer for a number of motorcycle, snowmobile, ATV, and personal watercraft companies since the late 1970s. During the 1980s while working full time, Mark completed his college degree and earned an MBA from Pepperdine University. He participated in a number of executive management programs, including a Wharton School business strategy course. Patti Blackwell has a college degree in nursing. In 1998, she earned a bachelor's degree in equine industry management at the University of Minnesota.

Contemplating the launch of a new horse breeding and training activity, Mark and Patti prepared a detailed business plan for these equine activities. The business plan contained five years of pro-forma financial statements that showed an initial 2-year loss and profits for the subsequent three years. The business plan also had a market overview and addressed advertising and promotion. The couple decided that Patti, who grew up around horses, would be in charge of the horses and Mark would be in charge of the marketing and business aspects of the activity.

They commenced their horse activity, Fresh Horses Farm (FHF) in 2000 on their ranch property where their home was located. Several horses were bought and sold, mostly with losses, from the inception of the activity through 2008. Mark spent two to five hours per week in the horse activity, and Patti worked each day with the horses and typically spent 15 to 20 hours per week in FHF activity.

FHF had its own bank account. Mark and Patti kept track of the activity's income and expenses using BarnPro, a recognized horse farm software program.

Mark and Patti were members of several recognized horse associations. In 2002 and later years, they sought and received advice from a nationally recognized horse trainer. They advertised their horses in various media and hired professional trainers to train, ride, and show their horses.

In 2003 and 2004, they purchased two horses that had nationally recognized bloodlines. In 2006, they purchased a horse that sired a number of horses owned by others that won a number of competitions and events. In 2006, they shifted their activity from reining horses to cutting horses due to greater demand in the industry. They began trying to sell yearlings to avoid the expenses of horse training. However, horse illnesses and the death of a horse proved to be major setbacks for their plans to have successful and profitable breeding mares that would produce foals with national market demand.

In 2009, because of the losses they continued to incur, Mark and Patti terminated their breeding activity. The IRS audited the couple and determined deficiencies in the amounts of $46,504 and $34,500 for 2005 and 2006, respectively, in connection with the disallowed business losses from FHF activities.

Issue. Whether the horse activity was a for-profit activity allowing the taxpayers to deduct expenses.

Analysis. IRC §183(a) and (b) provides that if an activity is not engaged in for profit, deductions cannot be claimed in excess of income from the activity. An activity is "for profit" if the taxpayer has an actual and honest profit objective. Activities carried on primarily as a hobby or sport do not qualify as for-profit activities. The taxpayer bears the burden of proving the for-profit objective behind the activity.

Treas. Reg. §1.183-2(b) provides a nonexclusive list of **nine factors** that are considered in determining whether the taxpayer is engaged in a for-profit activity. These factors and their application to this case are as follows.

1. **Manner in which the activity is carried on.** Mark and Patti carried on FHF in a reasonably businesslike manner. They kept reasonably good books and records of income and expenses. They took educational courses relating to equine care and management. They had a comprehensive business plan. The taxpayers spent six to seven years learning about this type of business before attempting to engage in it. They were not absentee or recreational horse owners. Patti worked diligently each day and did all the horse maintenance herself. Experts were consulted and hired for training, riding, and showing. Improvements to profitability were attempted by changing from reining to cutting horses and by endeavoring to sell yearlings to cut costs. They also terminated the business due to the losses realized.

2. **Expertise of the taxpayer.** Mark and Patti were well qualified to engage in FHF for profit due to Patti's education and Mark's business experience and acumen. Mark was capable of making good business decisions and marketing effectively.

3. **Time and effort expended in carrying on the activity.** The time, effort, and financial resources that Mark and Patti personally contributed to FHF are indicative of a for-profit activity, not a hobby. Of the time spent with the horses, most of it was daily hard work, not recreational.

4. **Expectation that the horses would appreciate in value.** Mark and Patti certainly had the expectation that at least some of their horses would become valuable as reining or cutting horses or as valuable breeding horses.

5. **Success in other activities.** Patti's degree in horse management indicates her high level of commitment and some likelihood of success in the profitability of the activity. Mark's business successes and ability in business development and management with other companies indicate that he was able and determined to make a profit with FHF.

6. **History of income or losses.** Although there were years in which gross income was substantial, the losses were also substantial. Those losses, however, were incurred in the early start-up years of the activity. Mark and Patti terminated FHF in 2009 when the possibility of profitability became remote.

7. **Amount of occasional profits.** Horse breeding and training is a speculative venture in which the opportunity to earn a substantial ultimate profit may be sufficient to indicate that it is a for-profit activity. FHF had the potential for profitability.

8. **Financial status.** Although the taxpayers did have substantial wealth and resources not related to FHF, the wealth of the taxpayers is not regarded as an indication that FHF was a hobby.

9. **Elements of personal pleasure.** Despite Patti's lifelong interest in horses, FHF's activities were not driven by pleasure or recreation alone. The taxpayers' efforts and investment in FHF indicate a profit motive.

Holding. FHF was an activity engaged in for profit. The expenses for 2005 and 2006 in excess of income are deductible and the resulting net losses are allowed.

PASSIVE ACTIVITIES

Rental Real Estate Activity

***Hattie M. Bonds v. Comm'r,* TC Summ. Op. 2011-122 (Oct. 17, 2011)**
IRC §§212, 469, and 6662

☞ Taxpayer Allowed to Deduct Substantiated Portion of Rental Losses

Facts. In 1988, Hattie Bonds moved to Minnesota from Kansas City, Missouri. Since that time, she resided and worked in the Minneapolis-St. Paul area. During 2006 and 2007, she worked full time as a vice principal of a Minneapolis high school, where she earned $94,082 in 2006 and $102,748 in 2007.

During the time that Ms. Bonds lived in Kansas City, she purchased a single-family house. She kept the house after she relocated to Minnesota but had not used it for personal purposes since moving. Ms. Bonds rented the Kansas City house to various tenants through 2004–2005. After that time, she advertised the house for rent but was not able to find renters.

Ms. Bonds' tax returns for 2006 and 2007 included Schedules E, *Supplemental Income and Loss,* that reported expenses and depreciation for the Kansas City house. The Schedules E reported losses of $12,929 and $12,676 for 2006 and 2007, respectively. The IRS subsequently sent Ms. Bonds a notice of deficiency that disallowed the claimed rental losses.

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Issues. The issues in this case are as follows.

1. Whether Ms. Bonds held the Kansas City house for the production of income
2. Whether the losses claimed by Ms. Bonds for the house are subject to the passive activity loss rules of IRC §469
3. Whether Ms. Bonds substantiated losses claimed for the house
4. Whether Ms. Bonds is liable for the IRC §6662(a) accuracy-related penalties

Analysis.

Issue 1. IRC §212 allows a deduction for all ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. The term "income" in this context includes not only income of the current year but also income that may be realized in a subsequent year.[93]

The record established that Ms. Bonds converted the Kansas City house from personal use to property held for the production of income when she relocated to Minnesota. Although she did not derive any rental income from the house in 2006 or 2007, the possibility of gain upon sale existed during those years.

Issue 2. IRC §469 generally disallows any passive activity losses. Rental activity is generally treated as a passive activity regardless of whether the taxpayer materially participates.[94] However, taxpayers who actively participate in a rental real estate activity may deduct a maximum loss of $25,000 per year from the activity.[95] The active participation standard is satisfied if the taxpayer significantly participates in making management decisions (such as approving new tenants, deciding on rental terms, and approving capital expenditures) or arranging for others to provide services such as repairs.[96]

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93. Treas. Reg. §1.212-1(b); see also *Bradley v. Comm'r,* TC Memo 1998-170 (May 11, 1998).
94. IRC §§469(c)(2) and (4).
95. IRC §§469(i)(1)-(2).
96. *Madler v. Comm'r,* TC Memo 1998-112 (Mar. 18, 1998).

Ms. Bonds owns the Kansas City house and makes all management decisions. Thus, she satisfied the active participation standard in 2006 and 2007 and was entitled to offset her nonpassive income for 2006 and 2007 by her substantiated rental losses, subject to the phaseout limitation for adjusted gross income in excess of $100,000.[97]

Issue 3. Ms. Bonds kept her tax records in the basement of her home in Minnesota, which was flooded on three separate occasions. Consequently, some of her records were ruined and had to be thrown out. In the absence of required records, if a taxpayer provides sufficient evidence that they have incurred a deductible expense but is unable to adequately substantiate the amount of the deduction, the court may estimate the amount of the expense and allow a deduction to that extent.[98] However, auto, travel, and meals expenses have strict substantiation requirements. The court recognized that Ms. Bonds needed to inspect the Kansas City house at various times and to address any issues that inevitably arise from property ownership. However, her trips to Kansas City also had a personal dimension because she visited her mother when she was there. In the absence of required records, the court had no discretion to allow such expenses.

The following table shows the expenses reported by Ms. Bonds and the amounts allowed by the court.

	2006		2007	
	Reported on Tax Return	**Allowed by Court**	**Reported on Tax Return**	**Allowed by Court**
Advertising	$ 168	$ 100	$ 175	$ 100
Auto/travel	2,003	0	1,746	0
Cleaning/maintenance	975	500	560	500
Insurance	700	500	710	500
Mortgage interest	3,042	3,464 [a]	3,400	3,400
Taxes	935	935	935	935
Utilities	1,460	1,000	1,475	1,000
Lodging	1,210	0	1,215	0
Meals (50%)	462	0	486	0
Depreciation	1,974	0	1,974	0
Totals	$12,929	$6,499	$12,676	$6,435

[a] The court record does not explain why the mortgage interest allowed for 2006 was greater than what was reported on Ms. Bonds' tax return.

Issue 4. Ms. Bonds not only failed to provide substantiating records for most of the expenses claimed on her Schedules E but also failed to seriously attempt to reconstruct the records using secondary evidence. Accordingly, imposition of the accuracy-related penalties was warranted.

Holding. The court held as follows.

1. Ms. Bonds held the Kansas City house for the production of income.
2. Ms. Bonds satisfied the active participation standard for rental real estate activities and is entitled to offset her nonpassive income for 2006 and 2007 by her substantiated rental losses.
3. Ms. Bonds failed to substantiate most of the expenses claimed for the Kansas City house.
4. Ms. Bonds is liable for §6662 accuracy-related penalties.

97. IRC §469(i)(3).

98. *Cohan v. Comm'r,* 39 F.2d 540, 543-544 (2d Cir. 1930).

Passive Activity Losses

Tom and Nancy Miller v. Comm'r, **TC Memo 2011-219 (Sep. 8, 2011)**

IRC §§469 and 6662

☞ Couple Allowed to Deduct Some Rental Activity Losses; Others Disallowed

Facts. Tom Miller is a partner in the San Francisco Bar Pilots Association (SFBPA), for which he pilots commercial seagoing vessels. His schedule for SFBPA requires that he work seven days and then he has seven days off. However, he is not generally required to actually work for all of his seven "on" days.

Mr. Miller also had a general contractor's license during the years at issue. He provided construction services for clients, including remodeling, replacing home siding, building decks, building fences, and replacing windows.

Tom and Nancy Miller owned six rental real estate properties during 2005 and seven during 2006. Mrs. Miller prepared the written leases for the properties, which they both reviewed and signed. Mr. and Mrs. Miller collected the rents and spent substantial time researching and bidding on various rental real estate properties during the years at issue. Mr. Miller kept contemporaneous timesheets that detailed the time he spent on both his rental real estate activities and the construction business.

Mrs. Miller prepared the couples' joint tax returns and claimed losses from their rental real estate activities of $71,464 and $143,091 for 2005 and 2006, respectively. The Millers did not make an election to treat all their interests in rental real estate as a single activity under IRC §469(c)(7)(A). The IRS issued a deficiency notice to the Millers, disallowing the Schedule E rental real estate losses for the years at issue and assessing accuracy-related penalties for those years.

Issues. The issues in this case are as follows.

- Whether the Millers' rental real estate losses for 2005 and 2006 were passive activity losses subject to the IRC §469(a) limitation
- Whether the Millers are liable for the IRC§6662(a) accuracy-related penalty

Analysis. The deduction of passive activity losses is generally suspended pursuant to IRC §469(a). A rental activity is generally treated as a per se passive activity.[99] However, if the taxpayer is a qualifying real estate professional and satisfies the material participation requirements of IRC §469(c)(1), they can avoid having the real estate activity classified as a per se passive activity. In order to qualify as a real estate professional, the taxpayer must meet the following conditions.[100]

- More than half of the taxpayer's personal services during the tax year are performed in real property trades or businesses in which the taxpayer materially participates.
- The taxpayer performs more than 750 hours of service during the tax year in real property trades or businesses in which the taxpayer materially participates.

Mr. Miller's records and testimony provided sufficient evidence to demonstrate that he met the requirements for a qualified real estate professional.

For purposes of the material participation requirement, each interest in rental real estate is treated as a separate activity unless the taxpayer makes an election to treat all interests as a single activity.[101] Mr. and Mrs. Miller did not make such an election. Thus, the material participation standards must be determined for each property.

To establish material participation, a taxpayer must satisfy one of the seven tests provided in Temp. Treas. Reg. §1.469-5T(a). The joint efforts of both spouses are considered for this purpose. **The court determined that Mr. and Mrs. Miller satisfied the material participation requirements for only two of their rental real estate activities.**

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99. IRC §469(c).

100. IRC §469(c)(7)(B).

101. IRC §469(c)(7)(A).

In determining whether the taxpayers are liable for the accuracy-related penalty, the court stated that the taxpayers acted with reasonable cause and in good faith because they prevailed on the threshold question of whether Mr. Miller qualified as a real estate professional. They also prevailed on the matter of material participation for two of their rental properties. As for the other properties, the Millers provided extensive records of their rental real estate activities, which demonstrated that they acted with reasonable cause and in good faith in claiming rental real estate losses for the years at issue.

Holding. The court held that the Millers' rental losses for the two properties in which they materially participated are not subject to the passive loss limitations. The losses with respect to the real estate activities for the Millers' other properties are disallowed. The court declined to impose the accuracy-related penalty.

RETIREMENT

Qualified Retirement Plan

Ltr. Rul. 201139011 (Jul. 7, 2011)
IRC §§402 and 408

☞ Minor Allowed to Make Tax-Free Transfer of Retirement Plan Distribution

Facts. Taxpayer was 13 years old when she became the sole beneficiary of her father's qualified retirement plan (Plan B). Although she was a minor, she was entitled to have a direct trustee-to-trustee transfer made of the entire account balance in Plan B to an individual IRA. However, her mother filed paperwork to receive a lump-sum distribution of the entire account balance in Plan B. The appropriate amount was reported on Taxpayer's 2008 tax return, and she paid the corresponding tax liability.

A financial institution was appointed conservator of Taxpayer's estate and brought suit to contest the lump-sum distribution received by Taxpayer's mother. The court ordered the mother to reimburse the amount she received in the lump-sum distribution to Taxpayer less certain allowable expenditures.

A letter ruling was requested to determine:

1. Whether Taxpayer is eligible to have a trustee-to-trustee transfer made of her father's interest in Plan B into an IRA in Taxpayer's own name, and
2. Whether Taxpayer will be required to include in gross income any portion of the amounts transferred from Plan B into an IRA set up in Taxpayer's own name.

Analysis. Taxpayer is the daughter of the decedent and the sole designated beneficiary of his account balance in Plan B. Therefore, she was entitled to have a direct trustee-to-trustee transfer of her father's account balance from Plan B to an IRA set up in her own name. If her mother, who was acting as Taxpayer's legal guardian at the time, had not made the decision to receive and misuse the lump-sum distribution of the account balance in Plan B, a tax-free transfer of the decedent's account balance could have been made to an inherited IRA for the benefit of the Taxpayer.[102]

Holding. The IRS ruled as follows.

1. Taxpayer is eligible to have a trustee-to-trustee transfer made of the court-ordered reimbursement amount and the amount of any federal and state tax refunds that result from amending Taxpayer's 2008 returns into an IRA set up and maintained in her own name.
2. Taxpayer is not required to include in gross income for federal income tax purposes any portion of the amounts transferred from Plan B into an IRA set up in her own name or the subsequent transfer pursuant to ruling 1 above.

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102. IRC §402(c)(11).

Disability Retirement Payments

***Jay and Frances Sewards v. Comm'r,* 138 TC No. 15 (Apr. 2, 2012)**
IRC §§104 and 6662

☞ Portion of Disabled Person's Retirement Benefit is Taxable

Facts. In November 2000, Jay Sewards was placed on involuntary medical disability leave from the Los Angeles County Sheriff's Department because of service-connected injuries. He was provided a continuation of his $14,093 monthly salary for one year while on disability leave. Because he had completed 34 years of employment with the Sheriff's Department and suffered a service-connected injury, Mr. Sewards was eligible for two types of retirement plans: a service retirement based on his length of service (service retirement) and a service-connected disability retirement based on his service-connected injuries (SCD retirement).

Mr. Sewards elected a service retirement benefit to take effect upon the expiration of his disability leave on October 31, 2001. Service retirement was authorized for individuals who:

- Had completed 20 years of service and attained the applicable compulsory retirement age, or
- Had attained the age of 50, completed 10 years of service, and had no break from service over 12 months.

In May 2002, Mr. Sewards applied for and was granted SCD retirement retroactive to the date that his service retirement took effect. Therefore, his SCD retirement replaced his service retirement. Individuals were eligible for SCD retirement if they were permanently incapacitated because of a disease or injury arising from their county employment. The SCD retirement provided him with one-half of his final compensation (i.e., $7,046) or his full service retirement benefit (i.e., $12,861), whichever was higher; thus, Mr. Sewards received a retirement allowance of $12,861 per month.

The Los Angeles County Employees Retirement Association (LACERA) sent Forms 1099-R to Mr. Sewards for 2001 and 2002, which reported that his service retirement payments were taxable. After his SCD retirement became effective, LACERA sent amended 2001 and 2002 Forms 1099-R to Mr. Sewards that indicated the taxable amount was not determined. The 2003, 2004, and 2005 Forms 1099-R that LACERA sent to Mr. Sewards also reported that the taxable amount was not determined. In December 2006, LACERA sent a letter to Mr. Sewards indicating that 50% of his final compensation would be reported as taxable starting in 2006. The 2006 Form 1099-R that LACERA sent to him was consistent with the letter.

Mr. Sewards and his wife did not report any portion of his SCD retirement payments as taxable on their joint 2006 federal income tax return. The IRS subsequently issued a notice of deficiency indicating that a portion of the SCD retirement benefit was taxable and that the Sewards were liable for an IRC §6662(a) accuracy-related penalty.

Issues. The issues in this case are as follows.

- Whether Mr. Sewards' retirement payments can be excluded from income
- Whether the Sewards are liable for a §6662(a) accuracy-related penalty

Analysis. IRC §104(a)(1) provides that retirement benefits are excludable from gross income if they are received under a workers' compensation act or similar statute as compensation for personal injuries or sickness. However, §104(a)(1) does not apply to the extent that the payments are determined by reference to the employee's age, length of service, or prior contributions, even if the employee's retirement is occasioned by an occupational injury or sickness.[103]

[103] Treas. Reg. §1.104-1(b).

The statute that authorized payments to Mr. Sewards is in the nature of a workers' compensation act and he did suffer an injury arising from his employment. Retirees entitled to SCD retirement benefits are guaranteed monthly installments equal to 50% of their final compensation (guaranteed amount). If their service retirement benefit exceeds the guaranteed amount, they are eligible to receive the higher amount. Because Mr. Sewards' service retirement benefit was determined by his length of service, the portion of his retirement benefit that exceeds the SCD retirement benefit is taxable.

The IRS further asserted that the Sewards are liable for a §6662(a) accuracy-related penalty for 2006. Under §6662(a), taxpayers are liable for a 20% penalty on any underpayment of tax attributable to a substantial understatement of income tax. An understatement is substantial if it exceeds the greater of $5,000 or 10% of the tax required to be reported on the return.[104] However, no penalty is imposed if there was reasonable cause for the underpayment of tax and the taxpayer acted in good faith.

LACERA sent Forms 1099-R to Mr. Sewards for 2001–2005 that did not report a taxable amount. In late 2006, LACERA sent a letter indicating it would begin reporting a portion of his SCD retirement benefits as taxable. Thus, over the course of several years, LACERA's guidance varied. The Sewards made reasonable efforts to assess their proper tax liability. Accordingly, they had reasonable cause for the underpayment and are not liable for a §6662(a) accuracy-related penalty.

Holding. The portion of Mr. Sewards' retirement benefit that exceeds the guaranteed amount of $7,046 is taxable and the Sewards are not liable for an accuracy-related penalty.

SELF-EMPLOYMENT INCOME

Self-Employment Income

***Joseph Decrescenzo v. Comm'r*, TC Memo 2012-51 (Feb. 27, 2012)**
IRC §§1401, 1402, 172, 6651, and 6654

☞ Accountant Prohibited from Using NOL Carryforward to Offset SE Income

Facts. In 2006, Joseph Decrescenzo received nonemployee compensation from his accounting business. He failed to timely file a Form 1040 for the year, so the IRS prepared a substitute for return and determined that Decrescenzo received $131,660 in self-employment (SE) income and that he owed SE tax of $15,207.

Decrescenzo filed a petition for redetermination of the deficiency. The parties agreed that he could reduce his total income by $51,065 because he had a net operating loss (NOL) carryforward from prior years. However, the parties disagreed as to whether Decrescenzo could also use the NOL carryforward to offset his SE income.

Issue. Whether Decrescenzo may offset his SE income with an NOL carryforward.

Analysis. For purposes of determining SE income, Treas. Reg. §1.1402(a)-7 states that "the deduction provided by section 172, relating to net operating losses sustained in years other than the taxable year, is excluded." There are also numerous court cases in which the taxpayer is prohibited from offsetting net earnings from self employment with an NOL carryforward or carryback.[105]

Holding. The court held that Decrescenzo is prohibited from using his NOL carryforward to reduce his net earnings from self employment.

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104. IRC §6662(d)(1)(A).

105. *Ding v. Comm'r,* TC Memo 1997-435, *aff'd,* 200 F.3d 587 (9th Cir. 1999); *Laney v. Comm'r,* TC Memo 1997-403, *aff'd* without published opinion, 168 F.3d 482 (4th Cir. 1999); *Mooney v. Comm'r,* TC Memo 1993-204, *aff'd* without published opinion, 111 F.3d 138 (9th Cir. 1997).

TAX FRAUD

Lien and Levy

***Schofield-Johnson LLC v. U.S.*, No. 09-09067, U.S. Bankruptcy Court for the Middle District of North Carolina (Sep. 22, 2011)**
IRC §§6321 and 6331

☞ Lien and Levy Allowed Against LLC as Individual's Nominee

Facts. In 1997, Sammy Johnson sued his employer for wrongful discharge and breach of contract. In March 2006, Sammy received judgment proceeds of approximately $1 million from the lawsuit. Sammy directed that the judgment proceeds be deposited into his wife Victoria's checking account. Victoria placed part of the funds in a money market account, part in an investment account, and used another portion to build a house on property in Hurdle Mills, North Carolina. She also purchased a new automobile and gave approximately $90,000 to her children.

In 2007, Sammy filed a tax return that reported a $356,660 tax liability due to his receipt of the judgment proceeds and enclosed a payment of $1,000. He did not ask Victoria to pay the remaining tax liability.

In February 2008, Victoria formed Schofield-Johnson LLC with her two sons. The company was formed for the dual purposes of protecting assets against any potential malpractice claims arising from Victoria's medical practice and developing family land. Sammy did not hold any interest in Schofield-Johnson. To fund the company, Victoria contributed her investment account (in which the judgment proceeds were deposited) and the land on which her and Sammy's home was located (which was built and furnished using the judgment proceeds).

In July 2009, the IRS filed a lien against all of Schofield-Johnson's property in order to satisfy Sammy's tax liability. The IRS also levied and attempted to seize Schofield-Johnson's investment account. Two days before the investment funds were scheduled to be released to the IRS, Schofield-Johnson filed Chapter 11 bankruptcy.

Issues. The issues in this case are as follows.

- Whether Schofield-Johnson is the nominee of Sammy Johnson
- Whether Sammy's transfer of funds to Victoria was fraudulent
- Whether the IRS can properly levy upon Schofield-Johnson's account to satisfy Sammy's tax liability

Analysis. In deciding whether the IRS may enforce a tax lien against property owned by a third-party that is a nominee or alter ego of a delinquent taxpayer, a court must first determine whether the delinquent taxpayer has any rights in the property under state law.[106] Based on the holding in *OMOA Wireless,*[107] the court must first determine whether the transfers at issue were fraudulent in order to determine whether Sammy retained any property rights in the judgment proceeds that were in the possession of Schofield-Johnson. If the transfers were fraudulent, Schofield-Johnson may be the nominee of Sammy, and the IRS can enforce its lien and levy.

North Carolina statutes provide 13 factors used to determine whether a transfer made by a debtor is fraudulent. The court found that the overwhelming majority of the factors favored the position of the IRS; therefore, the transfer from Sammy to Victoria was fraudulent under North Carolina law.

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106. *Drye v. U.S.,* 528 U.S. 49, 58 (1999); *U.S. v. Thornton,* 859 F.2d 151 (4th Cir. 1988) (unpublished table opinion).

107. *OMOA Wireless v. U.S.,* 2010 WL 3199959 (M.D.N.C. Aug 12, 2010). (Slip op.)

Even though the transfer of the judgment proceeds from Sammy to Victoria was found to be fraudulent, Schofield-Johnson can still avoid the IRS levy if it can establish that it is a "good-faith transferee for value" entitled to protection under the North Carolina statutes. The court noted that the overwhelming evidence indicated that Sammy was aware that the proceeds were taxable, that he discussed these issues with Victoria, and that they both enjoyed the benefits of the judgment proceeds. Victoria had knowledge of the facts and circumstances surrounding the source of the funds, and she knew that Sammy had a tax liability that he was trying to negotiate with the IRS. Therefore, Victoria's knowledge is properly imputed to the company, and Schofield-Johnson is not entitled to protection as a good-faith transferee for value.

Holding. The court ruled that the transfer of the judgment proceeds from Sammy to Victoria was fraudulent and that, accordingly, Schofield-Johnson is the nominee of Sammy under North Carolina law. The court further held that Schofield-Johnson is not a good-faith transferee for value and is not entitled to a defense against the claims of the IRS. Accordingly, judgment is entered in favor of the IRS.

Reaching Trust Assets for Tax Collection

***U.S. v. Jacob Evseroff, et al.,* No. 1:00-cv-06029; U.S. District Court for the Eastern District of New York (Apr. 30, 2012)**

☞ Trust Found to be Alter Ego of Taxpayer

Facts. Jacob Evseroff, an attorney in New York, invested in tax shelters between 1978 and 1982 that generated tax deductions later disallowed by the IRS. There was substantial litigation between Evseroff and the IRS for the next several years, along with IRS collection efforts regarding Evseroff's tax debt which, in January 1992, exceeded $700,000.

In January 1992, Evseroff met with another attorney to establish a trust into which he transferred his family home in Brooklyn, New York, and approximately $220,000 of funds. His sons were named as the trust beneficiaries. With respect to the transfer of the house into the trust, Evseroff received no consideration and was allowed to continue to live in the house. He continued to pay household expenses, including the mortgage and property taxes. He did not pay any rent to the trust and the trust did not assume the mortgage on the house. Evseroff's family friends and relatives served as trustees and were not active in managing trust assets. Evseroff's stated purpose for establishing the trust was to facilitate the estate planning objective of ensuring his sons received his estate and that his wife, from whom he was separated, would not receive any interest in the estate.

The IRS, in its continued effort to collect Evseroff's unpaid tax debt, claimed the transfer of assets to the trust was fraudulent and sought to reach the trust assets.

Issues. The issues in this case are as follows.

1. Whether Evseroff transferred assets to the trust through actively or constructively fraudulent conveyances
2. Whether the trust was Evseroff's alter ego or nominee

Analysis. New York state law defines a **fraudulent conveyance** as a transfer made with actual intent to defraud a present or future creditor. Actual intent is distinguished from intent that may be presumed in law and need not be proven by direct evidence but may be inferred from the circumstances surrounding the transfer. To determine whether fraudulent intent existed, several factors, including the following, are considered.

- Lack or inadequacy of consideration
- Family, friendship, or close associate relationship between the transferor and the transferee
- The transferor retained possession, use, and control of the transferred property
- A pattern or series of transactions or course of conduct after the debt was originally incurred
- The transferor's knowledge of the debt and inability to pay it

The factual findings from the trial court establish that Evseroff's transfers to the trust were **actually fraudulent.** He received no consideration for the money or house transferred to the trust and continued to retain use, possession, and control of these assets. He engaged in a pattern of actions after incurring the debt that indicated an intent to evade that debt, such as depositing his own funds to his law firm trust account and letting his sons hold his money in an effort to evade IRS collection efforts. He also purchased a home in Florida under the belief that it could not be seized by the IRS. His trustees were his friends and business associates and the named beneficiaries were his sons.

The IRS **nominee theory** focuses on whether the transferor has engaged in a sort of legal fiction by placing legal title to property in the hands of another while actually retaining all or some ownership benefits and control over the property. In determining whether a taxpayer's property is held by a nominee, the following factors are considered.

- Whether inadequate or no consideration was paid for the property transferred
- Whether it was placed in the nominee's name in anticipation of a lawsuit or other liability while the transferor remains in control of the property
- Whether there is a close relationship between the transferor and nominee
- Whether the parties failed to record the conveyance
- Whether the transferor retains possession and continues to enjoy the property's benefits

The facts establish that the trust was Evseroff's nominee with respect to the house but not the $220,000 of funds. The IRS did not sufficiently establish that Evseroff continued to exercise control over the funds beyond simply retaining them in the trust without distributing them. This alone does not establish sufficient control under a nominee theory.

The **alter ego theory** first arose under corporate law when the corporate "veil" was "pierced" if the corporate entity had no real separate existence but merely was being used as a tool for someone or something else. In New York, to pierce the corporate veil, a party must show that:

- The owner exercised such control that the entity has become a mere instrumentality of the owner, who is the real actor,
- The owner used this control to commit a fraud or other wrong, and
- The fraud or wrong results in an unjust loss or injury to the party.

Several factors suggest Evseroff dominated the trust. Trust formalities were not observed. The trust never assumed the house mortgage, and Evseroff continued to claim the mortgage interest and real estate tax deductions instead of the trust claiming these items as owner of the property. Evseroff also remained the beneficiary on the house, fire, and flood insurance. All these factors demonstrate that the trust had little substance of its own and was merely an extension of Evseroff.

Holding. The IRS may proceed to collect against all the assets in Evseroff's trust. The trust assets are subject to collection just as if they were held by Evseroff himself.

Fraud Penalty

***Mark and Cynthia May v. Comm'r,* 137 TC No. 11 (Oct. 24, 2011)**
IRC §§164, 6211, 6501, 6663, and 6664

☞ Failure to Remit Withheld Amounts Results in Underpayments

Facts. During 1994–1996 Mark May was a shareholder, president, and CEO of Maranatha Financial Group Inc., a corporation with approximately 100 employees. His gross biweekly pay was $10,000; his net pay was $6,500. Maranatha hired Paychex to process payroll and issue checks using an electronic facsimile of Mr. May's signature. From 1994 through 1996, Maranatha properly withheld all taxes from employee paychecks (including Mr. May's) but failed to remit the withholdings to the appropriate tax authorities. In addition, Mr. May filed Forms 941, *Employer's Quarterly Federal Tax Return,* for 1994–1996 in early 1997. For those tax years, Mr. May and his wife filed joint returns, on which they claimed withholding credits and deductions for payment of state and local taxes.

The U.S. District Court for the Southern District of Ohio found Mr. May guilty on two counts of federal income tax evasion and four counts of willful failure to account for and pay over payroll taxes while working for Maranatha. Evidence presented at the trial established that Mr. May used funds in the corporate account for personal expenditures.

The IRS subsequently disallowed the federal withholding and local and state tax deductions and recommended fraud penalties totaling $244,867 stemming from the overstated withholding credits in 1994, 1995, and 1996.

Issues. The issues in this case are as follows.

- Whether the court has jurisdiction to redetermine the tax underpayments involving overstated withholding credits
- Whether the taxpayers are liable for deficiencies resulting from disallowed deductions for state and local taxes
- Whether the taxpayers are liable for §6663 fraud penalties with respect to the withholding credits

Analysis. The Mays argued that the court does not have jurisdiction over any aspect of the case involving overstated withholding credits because they do not meet the statutory definition of a tax deficiency, thus resulting in an invalid notice of deficiency. In *Rice v. Comm'r,*[108] the court previously addressed this issue. *Rice* involved overstated withholding credits that resulted in an IRC §6663 fraud penalty but no deficiency. The court held that it had jurisdiction to redetermine fraud penalties, including the effect of the overstated withholding credits on the amount of the penalty.

The Mays argued that there is no underpayment of tax in the years at issue because taxes were actually withheld from Mr. May's paychecks and they were therefore entitled to withholding credits even though the withholdings were not paid to the government. In addressing this argument, the court noted that in *U.S. v. Blanchard,*[109] the defendant owned and operated his business and withheld taxes from his own paychecks but did not remit the withholdings to the government. The 6th Circuit Court of Appeals looked to whether the funds functionally left the control of the taxpayer in instances in which the taxpayer acted in both a personal and corporate capacity. The court applied the same test in this case and determined that tax underpayments existed.

The last issue for decision is whether the fraud penalty should be upheld. Because Mr. May reported tax withholdings that he knew were not remitted and was convicted for tax evasion and failure to pay over Maranatha's payroll taxes, the court found that the IRS had proven fraud by clear and convincing evidence.

Holding. The court concluded that Mr. May had tax underpayments stemming from the overstatement of withholding credits for each of the years at issue. Mr. May was also liable in part for the deficiencies resulting from the disallowed state and local income tax deductions. The fraud penalty was upheld for all claimed withholding tax credits as well as all remaining deficiencies resulting from the disallowed deductions.

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108. *Rice v. Comm'r,* TC Memo 1999-65 (Mar. 5, 1999).

109. *U.S. v. Blanchard,* 618 F.3d 562, 576 (6th Cir. 2010).

TRAVEL AND TRANSPORTATION EXPENSE

Travel Expenses

***Jac E. and Cynthia L. Baker v. Comm'r,* TC Summ. Op. 2011-95 (Jul. 19, 2011)**
IRC §§162, 262, 274, and 6662

☞ Married Couple Deemed to Have Separate Tax Homes

Facts. Jac Baker was employed as a tug master for Young Brothers, Ltd., based in Honolulu, Hawaii. Young Brothers provided inter-island cargo services throughout the Hawaiian Islands. Mr. Baker flew from the principal residence that he shared with his wife, Cynthia, in Seattle to Honolulu for work. Young Brothers did not reimburse him for the expenses of traveling between his Seattle residence and Hawaii.

Mr. Baker generally worked for one month and then had one month off. For most of his shifts, he began and ended each voyage in Honolulu. From the time Mr. Baker arrived at the Honolulu port until his 1-month shift ended, he was allowed to sleep aboard the vessel on which he worked. Young Brothers provided all of Mr. Baker's meals from the time the vessel left Honolulu.

Cynthia Baker was a flight attendant with Delta for 25 years. During the years at issue, Mrs. Baker's base station was JFK International Airport in New York City. She flew from Seattle to New York to begin each flight rotation.

Mrs. Baker kept an apartment in New York City that she shared with several others. She worked an international rotation serving European countries during the years at issue. Mrs. Baker received flight pay and a per diem allowance that began when she signed in at JFK for her rotation and ended when she returned to New York. Delta did not reimburse her for the expenses she incurred traveling between her Seattle residence to New York City.

Mr. and Mrs. Baker's 2005–2007 income tax returns were prepared by a CPA who had prepared their returns for several years. The couple claimed job expenses and other miscellaneous itemized deductions of $22,414, $17,621, and $12,134 for 2005, 2006, and 2007, respectively.

The IRS mailed a notice of deficiency to Mr. and Mrs. Baker that disallowed all of their job expenses and miscellaneous itemized deductions for 2005 and 2007 and all but $195 of the 2006 expenses and deductions. The IRS also assessed an IRC §6662(a) accuracy-related penalty for each of the years at issue.

Issues. The issues in this case are the following.

- Whether Jac and Cynthia Baker's tax home is their Seattle principal residence
- Whether they are entitled to deduct unreimbursed employee business expenses reported on Schedule A

Analysis. IRC §162(a)(2) allows a taxpayer to deduct traveling expenses if the expenses are:

- Ordinary and necessary,
- Incurred while away from home, and
- Incurred in the pursuit of a trade or business.[110]

"Home," as used in §162(a)(2) generally means the vicinity of a taxpayer's principal place of business.[111]

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110. *Comm'r v. Flowers,* 326 US 465, 470 (1946).

111. *Mitchell v. Comm'r,* 74 TC 578, 581 (1980); *Daly v. Comm'r,* 72 TC 190 (1979), *aff'd.*662 F.2d 253 (4th Cir. 1981); *Kroll v. Comm'r,* 49 TC 557, 561-562 (1968).

Mr. Baker's employer's primary office was in Honolulu, as was the home port of the vessel on which he worked most of his shifts. No evidence was presented that indicated there was a business reason for Mr. Baker's principal residence being in Washington, rather than Honolulu. His decision to commute from Seattle to Washington was a personal decision. Accordingly, Mr. Baker's tax home for the years at issue was Honolulu.

Mrs. Baker began and ended each of her flight rotations at JFK, which Delta considered to be her base station. An airline employee's principal place of business has consistently been held to be their base station.[112] Mrs. Baker chose to live in Seattle and commute to JFK. Thus, her tax home was JFK for the years at issue.

Because Mr. Baker's tax home was Honolulu, he was not "away from home" for purposes of §162(a)(2) when he was in Honolulu. Therefore, he was not entitled to deductions for the travel and incidental expenses he claimed for travel to Honolulu or incurred while he was in the Honolulu port.

In 2006 and 2007, Mr. Baker began or ended a voyage away from Honolulu on eight days. He presented evidence for meal and other expenses that he incurred while traveling away from Honolulu on those occasions. Accordingly, he is entitled to the deductions he claimed for those days.

Similarly, because Mrs. Baker's tax home was JFK, she was not entitled to a deduction for the travel expenses she incurred between Seattle and New York or the expenses she incurred while in New York City.

The meals and incidental expenses Mrs. Baker incurred while in Europe that were in excess of her per diem allowance would be deductible if they were properly substantiated.[113] However, Mrs. Baker did not keep track of the expenses she incurred in Europe. Accordingly, Mrs. Baker may use the lesser of Delta's per diem or the federal per diem allowance for the portion of her expenses that was deemed substantiated.[114]

Holding. Jac Baker's tax home was Honolulu for the years at issue. He is entitled to a deduction for meals and other expenses he incurred only for those occasions when he began or ended a voyage away from Honolulu. Cynthia Baker's tax home was New York City. Accordingly, she is not entitled to the travel expenses she incurred traveling between her principal residence in Seattle and her tax home in New York City.

The court declined to impose an accuracy-related penalty for the tax years at issue because there was reasonable cause for the underpayment and the Bakers were deemed to have acted in good faith.

Local Lodging Expense

REG-137589-07 (Apr. 25, 2012)

IRC §§162, 262, 212, and 217

☞ IRS Issues Proposed Regulations on Local Lodging Expenses

Purpose. The IRS issued proposed regulations on the deductibility of lodging expenses when the taxpayer is not traveling away from home. The regulations affect taxpayers who pay or incur expenses for local lodging. The proposed regulations provide interim guidance on the treatment of local lodging expenses pending the issuance of final regulations.

Background. Treas. Reg. §1.262-1 generally disallows deductions for local lodging expenses. The proposed regulations allow taxpayers to deduct local lodging expenses in appropriate circumstances.

112. See *Sislik v. Comm'r,* TC Memo. 1989-495 (Sep. 7, 1989) *aff'd.* per order (D.C. Cir., May 22, 1992); *Dean v. Comm'r,* TC Memo. 1976-379 (Dec. 8, 1976).

113. See Rev. Procs. 2005-10, 2005-67, and 2006-41.

114. Ibid.

Analysis. REG-137589-07 proposes to amend the regulations under §§162 and 262. The proposed regulations provide a safe harbor for local lodging expenses at business meetings, conferences, or other activities or functions. The safe harbor provides that an individual's expenses for local lodging are treated as ordinary and necessary business expenses deductible under §162 if all the following conditions are satisfied.

- The lodging is necessary for the individual to fully participate in or be available for a bona-fide business meeting, conference, training activity, or other business function.
- The lodging is for a period that does not exceed five days and does not recur more frequently than once per calendar quarter.
- If the individual is an employee, the employer requires the employee to remain at the activity or function overnight.
- The lodging is not lavish or extravagant under the circumstances and does not provide a significant element of personal pleasure, recreation, or benefit.