Chapter 5: Rulings and Cases

EXPLANATION OF CONTENTS

Please Note. This chapter is a collection of selected cases, Revenue Rulings, Revenue Procedures, Treasury Regulations, Announcements, and Letter Rulings issued during the past year, through approximately August 15, 2013. They appear in a condensed version, and are not to be relied on as a substitute for the full documents. A full citation appears for each item. This is not a comprehensive coverage of all tax law changes or explanations. It reports the rulings and cases that are likely to be of interest to most tax professionals.

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

Substantial Authority

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

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

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

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

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

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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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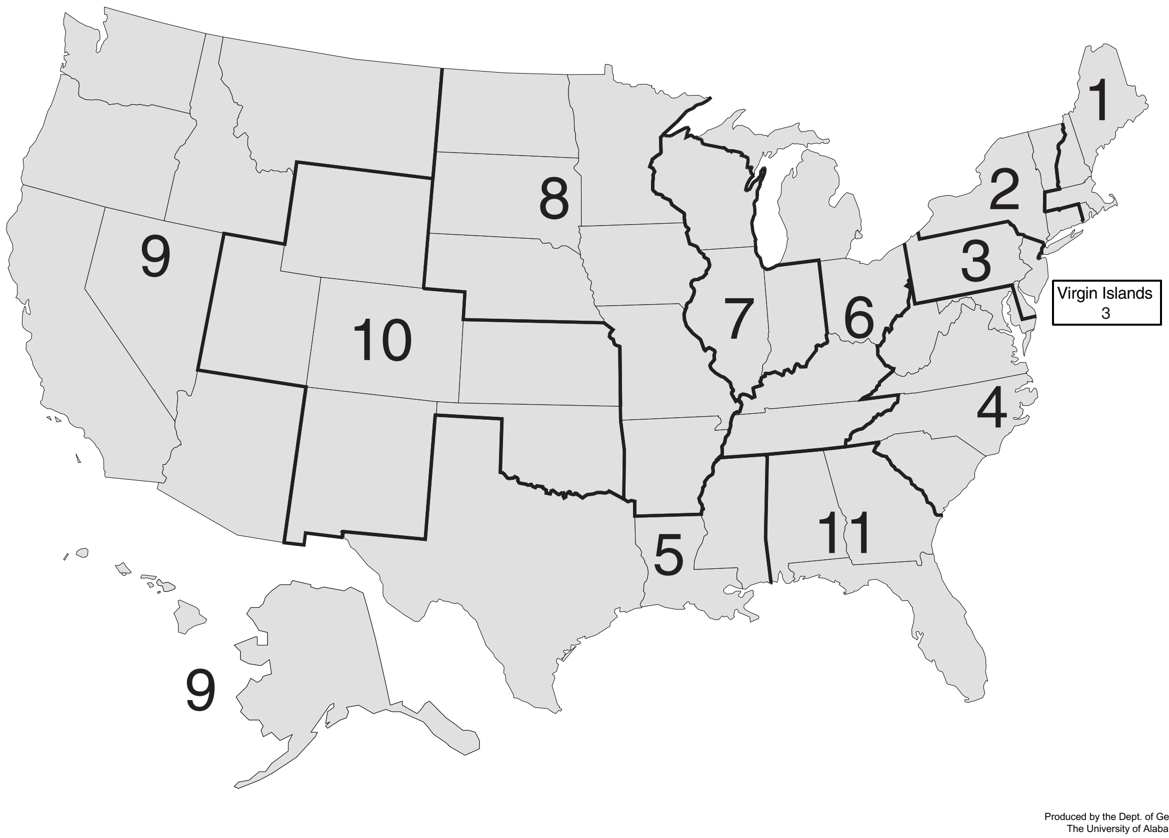
Federal Judicial Circuits and Districts



BANKRUPTCY AND DISCHARGE OF INDEBTEDNESS

Bankruptcy

***Terrance Moore, Jr., and Rhonda Moore v. Comm'r,* TC Summ. Op. 2012-116 (Nov. 29, 2012)**
IRC §§6320 and 6330

☞ Erroneous Claim Results in Lost Revenue for IRS

Facts. Terrance and Rhonda Moore filed a 2005 joint tax return. A year later the IRS issued a CP2000 notice proposing additional tax of $20,077, an IRC §6662(a) accuracy-related penalty of $4,015, and interest of $2,089, for a total of **$26,181**. In response, the Moores made two payments totaling **$6,100**. The IRS then issued a notice of deficiency showing the same amounts as proposed in the CP2000 notice.

The Moores filed a Chapter 13 bankruptcy petition on October 24, 2007. The bankruptcy petition properly listed an unsecured priority claim for the IRS of **$20,081** ($26,181 − $6,100) with respect to their 2005 income tax return. The IRS filed a proof of claim for an unsecured priority claim of $16,536 (tax of $13,977 + interest of $2,559).

The bankruptcy court confirmed the Moore's Chapter 13 bankruptcy plan on April 4, 2008. As part of the bankruptcy, the IRS received the $16,536 as originally requested. Unsecured nonpriority claim holders received $3,151. The Chapter 13 bankruptcy was then converted to a Chapter 7 bankruptcy. The Moores received a discharge under the bankruptcy code on December 3, 2009; the Chapter 7 bankruptcy case was closed on December 15, 2009.

The IRS sent a final notice of intent to levy on February 1, 2010, which listed an assessed uncollected balance on the 2005 account of $5,780. Although the Moores questioned what the uncollected balance consisted of, the IRS did not provide any explanation.

The Moores then requested a collection due process hearing, during which they explained that they had already paid the entire amount of the IRS's unsecured claim. The IRS sustained the proposed levy action in a letter dated September 17, 2010.

Issue. Whether the IRS is precluded from collecting post bankruptcy funds.

Analysis. At trial, the Moores argued that the IRS received the full amount ($16,536) of the submitted proof of claim. The IRS countered that the bankruptcy was converted from a Chapter 13 to a Chapter 7 case, and certain types of income tax liabilities and penalties are not dischargeable in a Chapter 7 bankruptcy. The IRS also argued that the fact that the proof of claim erroneously listed a lower amount of tax liability should not prevent the IRS from collecting the rest of the liability.

The Chapter 13 bankruptcy petition filed by the Moores listed the correct amount ($20,081) of their tax liability, but the IRS filed a proof of claim for a lesser amount. Had the Chapter 13 not been converted to a Chapter 7 proceeding, the IRS would not have been entitled to any more money than that shown on their proof of claim.

Holding. The IRS received exactly what they asked for. Had they requested the correct amount to begin with, they would have received it. Because the IRS did not cite any cases to support facts similar to this unique situation, the IRS is precluded from collecting the additional taxes and interest.

BUSINESS EXPENSES

Business Expenses
***James A. Cavanaugh Jr. v. Comm'r,* TC Memo 2012-324 (Nov. 26, 2012)**
IRC §162

☞ Wrongful Death Settlement Not Tax Deductible

Facts. James Cavanaugh is the CEO and sole shareholder of Dallas-based Jani-King International, Inc., a highly successful janitorial-services franchisor. He and his girlfriend, Claire Robinson, decided to spend their Thanksgiving vacation in the Caribbean. His bodyguard and another Jani-King employee traveled with them to Cavanaugh's villa in St. Maarten. Unfortunately, Robinson suffered a fatal cardiac arrest on the vacation after ingesting a large amount of cocaine.

In August 2003, Robinson's mother, Linda Robinson, sued Cavanaugh and Jani-King in Texas state court for wrongful death, along with a myriad of other charges. In September 2004, the Jani-King board of directors decided it would likely hurt their franchisor business if the case was litigated. They authorized a settlement of up to $5 million. The case was settled in August 2005 for $2.3 million, which was payable over two years. Cavanaugh initially paid $250,000 of the settlement amount but was promptly reimbursed by Jani-King. Jani-King paid the remainder of the settlement, along with the attorney fees.

Jani-King deducted the settlement amount and attorney fees on its 2005 and 2006 tax returns. In 2009, the IRS issued a notice of deficiency, in which it disallowed the settlement amount and attorney fees.

Issues. The issues in this case are as follows.

- Whether Jani-King can deduct its share of the settlement payment and legal fees
- Whether Jani-King can deduct Cavanaugh's $250,000 indemnification payment

Analysis. IRC §162 allows a deduction for ordinary and necessary business expenses. The key issue here is whether the deduction is a "business" rather than "personal" expense. In regard to legal expenses and costs, the question usually revolves around the **origin** and character of the claim underlying the legal controversy.[2]

Cavanaugh directed the court's attention to *Kopp's Co. v. U.S.,*[3] in which the son of a lumber-company president used a company car. The son was involved in an accident, in which the other car's driver was seriously injured. The injured driver sued the son, the company's president, and the company itself. The company settled and deducted its share of the settlement and legal fees. The 4th Circuit agreed with this treatment because the company was named in the suit and the company had "direct exposure to the risk of a monetary judgment."

In *U.S. v. Gilmore,*[4] a husband argued that legal fees from his divorce were ordinary and necessary business expenses because he needed to shield his business interests from his former wife's community-property claims. However, the Supreme Court held that deductibility "depends on whether or not the claim arises in connection with the taxpayer's profit-seeking activities," not on the "consequences" to the taxpayer "from a failure to defeat the claim."

2. See *U.S. v. Gilmore,* 372 U.S. 39, 49 (1963).
3. *Kopp's Co. v. U.S.,* 636 F.2d 59 (4th Cir. 1980).
4. *U.S. v. Gilmore,* 372 U.S. 39, 49 (1963).

The question here is what the origin of the claim is. Cavanaugh argued that its origin is Linda Robinson's contention that Jani-King killed Robinson by negligently allowing its employees to provide her with illegal drugs. The IRS contended that the origin was Robinson's death. The court agreed with the IRS, noting that the conduct of the Jani-King employees occurred while they were on vacation (nonprofit-seeking activities) that did not arise from or further Jani-King's business and were far from any company property.

With respect to the $250,000 payment to Cavanaugh, this payment arose from Cavanaugh's personal activities that fateful Thanksgiving holiday. Jani-King's $250,000 payment also falls under *Gilmore.* For a corporation to be able to deduct payment for another's obligation, the payment must be for a business expense. Consequently, Jani-King may not deduct the $250,000 as a business expense.

Holding. The court held that Jani-King cannot deduct the settlement costs or legal fees, nor may it deduct the $250,000 indemnification payment.

Business Expenses

Humphrey Farrington & McClain PC v. Comm'r, **TC Memo 2013-23 (Jan. 17, 2013)**

IRC §§162, 446, 481, and 6662

☞ Advanced Expenses Considered Nondeductible Loans

Facts. Humphrey Farrington & McClain (HFM), a law firm located in Independence, Missouri, conducted plaintiff-side litigation in areas including securities fraud, medical malpractice, Employee Retirement Income Security Act (ERISA) benefits, toxic-substance exposure, false advertising, consumer antitrust, and products liability. HFM initially paid advanced expenses, such as court-filing fees and court reporters, when pursuing litigation matters. HFM had four types of fee arrangements with its clients: (1) fully reimbursable, (2) net fee, (3) gross fee, and (4) class action. For all arrangements other than fully reimbursable matters, HFM advanced all expenses. If a favorable outcome occurred, clients then reimbursed HFM for the advanced expenses. For fully reimbursable matters, the clients paid an hourly fee and reimbursed the firm for all advanced expenses regardless of the case outcome.

HFM used a systematic approach in determining whether to capitalize or deduct the advanced expenses. For arrangements in the fully reimbursable category, all fees were capitalized. For arrangements in the net fee category, fees were capitalized when there was a high likelihood that reimbursement would be received. Fees were deducted in all other categories as ordinary and necessary business expenses.

The IRS issued a notice of deficiency for HFM's 2005 tax return, making an IRC §446 adjustment of $902,851 and an IRC §481 adjustment of $2.7 million. The reason stated in the notice was that the cash method of accounting was used to keep HFM's books and records for the tax year, which did not clearly reflect the income. In addition, a substantial penalty for understatement of income tax was assessed on the entire deficiency. The §446 adjustment was later changed to $403,808.

Issues. The issues in this case are as follows.

- Whether the litigation expenses HFM advanced on behalf of its contingent-fee clients in the nature of loans are deductible as ordinary and necessary business expenses
- Whether the advanced litigation expenses should be treated as loans resulting in a change in accounting method via a §481 adjustment
- Whether HFM is liable for a substantial penalty for understatement of income tax pursuant to IRC §6662(a)

Analysis. IRC §162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. HFM argued that the advanced expenses for which it claimed deductions under §162(a) were not "virtually certain" of being reimbursed and consequently, they were deductible as ordinary and necessary business expenses. The IRS countered that the advanced expenses that HFM deducted were actually loans to its clients and that HFM was only entitled to bad debt deductions for unreimbursed expenses once the relevant cases were closed.

At trial, HFM argued that advanced expenses are treated as loans only if there was an expectation of reimbursement. The IRS, on the other hand, argued that advanced expenses are not deductible if the law firm's contingent-fee arrangements provided for reimbursement upon a favorable litigation outcome. The IRS also contended that the expectation of reimbursement is irrelevant as long as the law firm has the contingent right of reimbursement. The court determined that there was a significant expectation of reimbursement for the advanced expenses that HFM deducted. Accordingly, the expenses would not be deductible even if HFM's view about the relevant legal test is correct.

With respect to the §481 adjustment, HFM argued that the IRS's treatment of advanced expenses as loans was not a change in accounting method. IRC §446(b) provides that if the taxpayer's method of accounting does not clearly reflect income, the taxpayer must use the method that, in the opinion of the IRS, does clearly reflect income. IRC §481(a) allows the IRS to impose, in the year a new method of accounting is first adopted (or imposed by the IRS), adjustments that are necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted. After reviewing the relevant court cases, the court concluded that the IRS's change in the treatment of HFM's advanced expenses was a change in the treatment of a material item used in HFM's overall plan of accounting, and thus it constituted a change in accounting method.

IRC §6662(a) and (b)(2) imposes a 20% penalty on any part of an underpayment that is attributable to a substantial understatement of income tax. At trial, HFM argued that they were not liable for the penalty because they had reasonable cause and acted in good faith with respect to the tax treatment of the advanced expenses. The court agreed that HFM's efforts to categorize advanced expenses represented a good-faith attempt to determine their deductibility.

Holding. The advanced expenses that HFM deducted should have been treated as loans. HFM was not entitled to deduct these expenses in the year paid. Instead, when a case closed, HFM was entitled to a bad debt deduction for any unreimbursed expenses. The change of accounting method pursued by the IRS was sustained. The substantial understatement penalty was reduced for the advanced payments issue and upheld on issues agreed upon prior to the trial.

Rental Expenses

***Donald and Arvilla Meinhardt v. Comm'r,* TC Memo 2013-85 (Mar. 27, 2013)**

IRC §§162, 212, 262, 274(d), 6001, and 6662

☞ IRS Disallows Farmhouse Expenses

Facts. Mr. and Mrs. Meinhardt purchased a 140-acre farm in 1976. The farm included a farmhouse and outbuildings. Mr. and Mrs. Meinhardt rented out the farmland separately from the farmhouse. They attempted to rent the farmhouse but were unable to do so.

Various individuals lived in the farmhouse from 1976 through 2007 at different times. Some exchanged services for the use of the house. Various relatives also lived in the house at times. During the years at issue in this case, the Meinhardts sometimes used the house to cook, change clothes, or stay overnight after working on the farm for the day. The taxpayers had access to the farmhouse at all times.

The Meinhardts timely filed their 2005–2007 income tax returns. The IRS issued a notice of deficiency, which disallowed all farmhouse expenses for those years.

Issue. The issue in this case is whether the taxpayers can deduct expenses associated with their farmhouse under IRC §162 for the 2005, 2006, and 2007 tax years.

Analysis. Taxpayers can deduct ordinary and necessary expenses for carrying on a trade or business under IRC §162. Although the Meinhardts reported insurance, supplies, repairs, and other expenses associated with the farmhouse, they failed to show that the farmhouse was a rental property used for the production of income under IRC §212. The taxpayers contended that the farmhouse was available for rent during the relevant time period but later testified that the house was vacant or occupied by relatives. They did not receive any rental income during the three years in question.

The Meinhardts testified that because they did not receive any offers to rent for cash, they let various individuals stay in the house rent free in exchange for providing services. However, there was no indication that the value of these services approximated the fair rental value of the property. Even if individuals lived there in exchange for working on the farmhouse, the taxpayers should have reported barter income.

The Meinhardts did recognize their unfamiliarity with tax law and used an attorney to prepare their tax returns for the relevant years. At trial, the Meinhardts testified that the attorney did a high volume of tax returns for the community, that he asked questions about the farm, and that they gave him all of the materials that they thought were relevant to the preparation of their taxes.

Holding. The court disallowed the deductions related to the farmhouse. The court concluded that the taxpayers acted in good faith and took reasonable efforts to assess their proper tax liabilities by seeking advice from a qualified tax return preparer. Accordingly, the court declined to sustain the IRC §6662 accuracy-related penalties.

Reasonable Compensation

***Aries Communications Inc. v. Comm'r*, TC Memo 2013-97 (Apr. 10, 2013)**
IRC §§162 and 6662

☞ $6.9 Million Salary Deemed Unreasonable

Facts. Aries Communications Inc. (ACI), a C corporation, and its two subsidiaries owned and operated four southern California radio stations. The corporation filed consolidated federal income tax returns from 1998 through 2008 using a fiscal year ending on August 31.

Arthur Astor was ACI's sole shareholder from its incorporation in 1983. He also was president and chief financial officer of ACI and acted as general manager for each of ACI's radio stations. Mr. Astor was a "hands-on" manager who was heavily involved in the day-to-day operations of the stations.

In **fiscal year 2003,** Mr. Astor was instrumental in negotiating the sale of one of the four stations for **$35 million**. He was personally involved in obtaining the first potential buyer's bid of $18 million. That buyer's final bid offer was $28 million. Mr. Astor then retained a broker; further negotiations between the broker, Mr. Astor, and the buyer resulted in a final sales price of $35 million.

Using a similar negotiating strategy in **fiscal year 2004,** Mr. Astor and the broker were able to sell another station for **$18 million** following an initial bid offer of $12 million.

Mr. Astor received the following **total compensation** for the 2002, 2003, 2004, and 2005 fiscal years.

Type of Pay	FY 2002	FY 2003	FY 2004	FY 2005
Salary	$136,800	$ 136,800	$ 136,800	$136,800
Commissions	123,205	68,035	62,474	56,347
Bonus	0	1,870,148	6,697,700	0
Total	$260,005	$2,074,983	$6,896,974	$193,147

The IRS examined the **2004 fiscal year corporate tax return**. The IRS examination report proposed the following.

- **Allowing only $810,000 of the $6.9 million compensation as reasonable**, resulting in a **tax deficiency of $2.7 million**
- An **accuracy-related penalty of $535,200** under IRC §6662

Issues. The issues in this case are as follows.

- Whether the compensation paid and deducted by the corporation for its fiscal year ended on August 31, 2004, is reasonable under IRC §162
- Whether the corporation is liable for the 20% accuracy-related penalty under IRC §6662 for its fiscal year ended in 2004

Analysis. IRC §162(a) provides a deduction for ordinary and necessary business expenses, including **"a reasonable allowance for salaries or other compensation for personal services actually rendered."** Compensation for prior years' services is deductible in the current year as long as the employee was actually undercompensated in prior years.[5] The court noted that "there is no doubt that Mr. Astor was the most valuable employee of ACI and the compensation paid to him, or at least a portion thereof, was for services actually rendered."

Regarding the "reasonable" requirement, the court referred to the five broad factors set forth in the *Elliotts, Inc.* court case.[6] Those factors are as follows.

1. The employee's role in the company
2. Comparison of the employee's salary with salaries paid by similar companies for similar services
3. The character and condition of the company
4. Potential conflicts of interest
5. Internal consistency

The court also considered an additional factor: whether an **independent investor** would be willing to compensate the employee as ACI compensated Mr. Astor.[7]

In addition, the court heard testimony of the expert witnesses hired by the taxpayer and the IRS.

- The **expert witness for the taxpayer** utilized an extremely complex mathematical formula to arrive at a **reasonable compensation figure of $5.14 million** ($1.76 million **less than** the reported compensation figure of $6.9 million).
- The analysis of the **expert witness for the IRS** concentrated on the second of the five factors listed above: a comparison of Mr. Astor's reported salary with salaries paid by similar companies for similar services. He concluded that **Mr. Astor's total reasonable compensation for the 2004 fiscal year was only $635,447** ($6.26 million **less than** the $6.9 million reported compensation amount).

After reviewing each of the relevant factors and considering the opinions of the expert witnesses, the court determined that reasonable compensation for Mr. Astor was $2.7 million, as follows.

Fixed salary actually paid in FY 2004 to Mr. Astor	$ 199,274
Underpayment of fixed salary for prior fiscal years	461,625
Bonus (1⁄3 of the $6 million increase in sales price of station sold in FY 2004)	2,000,000
Allowable reasonable compensation amount for FY 2004	$2,660,899

5. *R.J. Nicoll Co. v. Comm'r*, 59 TC 37, 50-51 (1972).

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

7. *Metro Leasing and Dev. Corp. v. Comm'r*, 376 F.3d 1015, 1019 (9th Cir. 2004), *aff'g* 119 TC 8 (2002).

The IRS asserted that ACI is liable for an IRC §6662 accuracy-related penalty for the 2004 fiscal year. An exception to the penalty may be allowed when the taxpayer can demonstrate reasonable cause for the underpayment and that they acted in good faith. At trial, Mr. Astor stated that he discussed the compensation with his accountants. However, he never explained what kind of information he provided to his accountants or whether he relied on the accountants' judgment. In addition, none of the accountants testified at trial. Accordingly, the court determined that ACI presented no evidence that it acted with reasonable cause and in good faith.

Holding. The court held that $2.7 million is deductible as reasonable compensation for the fiscal year ended on August 31, 2004. In addition, the court upheld the accuracy-related penalty.

> **Observation.** The amount of the disallowed compensation of $4.24 million represented a taxable dividend to Mr. Astor. This case shows the "double taxation" peril inherent in C corporations.

Reasonable Compensation

K & K Veterinary Supply, Inc. v. Comm'r, **TC Memo 2013-84 (Mar. 25, 2013)**

IRC §162

☞ Court Determines Reasonable Compensation

Facts. K & K Veterinary Supply, Inc. sells animal health products for large animals, lawn and garden products, farm hardware, pet supplies, and products for farm stores and related dealers. It sells between 17,000 and 19,000 products and has between 550 and 600 vendors.

John K. Lipsmeyer is the sole shareholder of K & K. He was also the president, co-chief executive officer, and co-chief operating officer during the years at issue in this case. His wife, Melissa Lipsmeyer, was the corporation's vice president, secretary, and assistant chief financial officer. His brother, David Lipsmeyer, was the senior vice president of sales, co-chief executive officer, and co-chief operating officer. Lipsmeyer's daughter, Jennifer Stewart, was the chief financial officer.

The company had an employee handbook and a copy was given to each employee. The handbook stated that salary would be determined by the company president. There was no written bonus policy. Bonuses were based on how well the company was doing financially, job performance, and work ethic.

K & K was a C corporation and an accrual basis taxpayer. For 2006, K & K reported gross receipts of $59.9 million and taxable income of $128,545. In 2007, K & K reported gross sales of $65.9 million and taxable income of $41,948.

K&K claimed deductions for officer and employee compensation for 2006 and 2007 in the following amounts.

	2006	2007
Officers:		
John Lipsmeyer	$981,728	$746,229
Melissa Lipsmeyer	215,000	198,000
Employees:		
David Lipsmeyer	922,853	735,029
Jennifer Stewart	287,528	287,429

The IRS sent a notice of deficiency to K&K, disallowing the following deductions claimed for salaries.

- Officer compensation paid to John and Melissa Lipsmeyer for 2006 of $363,017
- Officer compensation paid to Melissa Lipsmeyer for 2007 of $62,946
- Salaries and wages paid to David Lipsmeyer and Jennifer Stewart for 2006 of $835,788
- Salaries and wages paid to David Lipsmeyer and Jennifer Stewart for 2007 of $520,367

Issue. Although there were several issues raised in this case, the following analysis focuses on whether the amounts paid as compensation to officers and certain employees are reasonable within the meaning of IRC §162(a)(1).

Analysis. A taxpayer is entitled to a deduction for salaries and other compensation if the payments are reasonable and are payments purely for services.[8] Whether the compensation paid by a corporation to a shareholder-employee was reasonable is a question of fact. Courts have considered various factors in determining the reasonableness of compensation, including the following.

1. **Employee Qualifications.** Both John and David Lipsmeyer were employed in the animal health industry prior to forming K & K. The court found them highly qualified for their positions. Jennifer Stewart worked for the company and her college credit hours are related to her duties with the company. Melissa Lipsmeyer's prior experience was relevant to the business but did not rise to the level of qualifications needed for her positions with the company.

   The court determined that this factor favored K & K for only John and David Lipsmeyer and was neutral with respect to Jennifer Stewart and Melissa Lipsmeyer.

2. **Nature, Extent, and Scope of Employee's Work.** Except for Melissa Lipsmeyer, the court found that the employees performed duties consistent with their job titles. However, the court found Melissa Lipsmeyer's work hours and vague description of her duties were incongruous with her position title.

   The court found that this factor favored K & K for John and David Lipsmeyer and favored the IRS with respect to Melissa Lipsmeyer.

3. **Size and Complexity of the Business.** The court acknowledged that the number of products sold added to the complexity of the business. However, it found insufficient evidence to conclude that the size and complexity of the business warranted high compensation.

   The court found that this factor favored the IRS.

4. **General Economic Conditions.** The court found no evidence to conclude that the general economic conditions affected K & K's performance.

   The court found that this factor was neutral.

5. **Comparison of Salaries Paid With Gross and Net Income.** The court found that the employees' importance to K & K's growth and profits fell short of justifying the salaries they were paid.

   The court found that this factor favored the IRS.

6. **Prevailing Rates of Compensation.** The IRS used Martin Wertlieb as its expert witness. He determined the amounts of reasonable compensation based on the correlation between the benchmark companies' annual sales/revenues and fixed compensation as demonstrated by application of linear regression statistical techniques. The court agreed with the compensation amounts he found to be reasonable.

   The court found that this factor favored the IRS.

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8. Treas. Reg. §1.162-7(a).

7. **Salary Policy of the Taxpayer as to All Employees.** The evidence did not establish that K & K paid a high salary to all of its employees or the existence of a longstanding, consistently applied compensation plan.

   The court found that this factor favored the IRS.

8. **Compensation Paid in Previous Years.** K & K could not establish that any of the compensation paid was due to performance in a previous year.

   The court found that this factor was neutral.

9. **Comparison of Salaries with Distributions and Retained Earnings.** Although corporations are not required to pay a dividend, the presence of dividends is an important factor to an investor. The absence of dividends may indicate that profits are being paid as compensation. K & K paid John Lipsmeyer a dividend of $30,000 in each of the years at issue.

   The court found that this factor favored K & K.

10. **Debt Guaranty.** John and Melissa Lipsmeyer were co-guarantors on the corporation's $3.3 million debt.

    The court found that this factor favored K & K.

After giving due weight to all the factors, the court found that Mr. Wertlieb's report was persuasive and accepted his conclusions.

Holding. The court held that the following amounts represented reasonable compensation.

	2006	2007
John Lipsmeyer	$732,300	N/A
Melissa Lipsmeyer	134,400	$133,500
David Lipsmeyer	590,500	470,000
Jennifer Stewart	183,000	192,700

Reasonable Compensation

***Thousand Oaks Residential Care Home I Inc. et al. v. Comm'r,* TC Memo 2013-10 (Jan. 14, 2013)**
IRC §§162, 4972, 6651, and 6662

☞ Testimony Presented Does Not Support Reasonable Compensation Argument

Facts. Robert and Pearl Fletcher both have a medical background. Before their retirement, he was a chiropractor and she was a registered nurse.

In June of 1973, they purchased Thousand Oaks Residential Care Home (TORCH), a struggling corporation. The terms of the deal were $25,000 and the assumption of corporate debt obligations. Dr. Fletcher was the sole shareholder and he, his wife, and his brother-in-law served as the corporate board of directors. The corporation operated TORCH, which is an assisted living facility in Thousand Oaks, California. Dr. and Mrs. Fletcher received compensation totaling $512,985 and $315,699, respectively, for the years 1984 through 2002.

For the first 18 months of Dr. Fletcher's ownership, the corporation barely made enough money to pay its bills. However, the financial situation dramatically improved. From 1987 through 2003, the taxable income reported on the tax returns totaled slightly over $1.8 million dollars. For 2004 and 2005, the total loss reported was $920,988.

In July 2002, the corporation hired Grace-Ann Strick (the Fletchers' daughter) at $10 per hour. Her pay increased to $2,000 per month in October 2002 following the sale of the assisted living facility.

The corporation's **sole asset** (the assisted living facility) was sold on October 1, 2002. As part of the sale agreement, the Fletchers agreed to work at the facility until the new owner obtained her own license. The Fletchers worked there for nine months following the sale.

After the sale, the corporation was in good financial shape. The corporation's defined benefit plan covered Dr. and Mrs. Fletcher and Ms. Strick. The corporate minutes reflected that compensation to the administrators was approved for payment of back salaries that were not paid in prior years due to insufficient cash flow. Dr. Fletcher's total compensation package for 2003 through 2005 was $880,939 and Mrs. Fletcher's compensation was $820,348 for the same period.

The IRS issued notices of deficiency for the corporate returns for 2002–2005 and the Fletcher's individual returns for 2003–2005. Adjustments were recommended for unreasonable compensation paid to the Fletchers and Ms. Strick; excise tax on unfiled Forms 5330, *Return of Excise Taxes Related to Employee Benefit Plans;* and accuracy-related penalties.

Issues. The issues in this case are as follows.

- Whether the compensation paid to Robert and Pearl Fletcher was reasonable under IRC §162 for 2003, 2004, and 2005, including the pension plan contributions made on their behalf for 2003 and 2004
- Whether the compensation paid to Grace-Ann Strick was reasonable under IRC §162 for 2003, 2004, and 2005
- Whether TORCH is liable for excise tax of $44,711 and $91,128 for 2003 and 2004, respectively
- Whether TORCH is liable for the failure-to-file penalties for both 2003 and 2004 regarding unfiled excise tax returns
- Whether the Fletchers and TORCH are each liable for the accuracy-related penalties for the years at issue

Analysis. IRC §162(a)(1) provides a deduction for ordinary and necessary business expenses, including a "reasonable allowance for salaries or other compensation for personal services actually rendered." Compensation for prior years' services is deductible in the current year as long as the employee was **actually undercompensated in prior years** and the current payments are intended as compensation for past services. After analyzing the corporate annual board minutes along with the Fletchers' testimony, the court determined that the compensation paid in 2003, 2004, and 2005 was truly catch-up compensation.

The court looked at six factors in determining whether the catch-up compensation was reasonable.

1. Employee's role in the company
2. Comparison of the employee's salary with salaries paid by similar companies for similar services
3. Character and condition of the company
4. Potential conflicts of interest
5. Internal consistency
6. Whether an independent investor would be willing to compensate the employees as the Fletchers were compensated

Factors 1, 3, and 5 favored the Fletcher's position, while factors 2, 4, and 6 favored the IRS's position. The deciding factor that resulted in an "unreasonable" verdict for the Fletchers was factor 6. Taking into account the rate of return a reasonable investor would have expected, the court found that the Fletchers were overpaid by a total of $282,615; thus, the court ruled that the compensation deducted was unreasonable and nondeductible.

The compensation paid to Ms. Strick for 2003, 2004, and 2005 was also determined to be unreasonable. Ms. Strick was purportedly hired to handle third-party vendors and worker's compensations claims filed by former employees against the corporation. However, the Fletchers were not able to provide any evidence to show that their daughter actually performed those duties.

IRC §4972 imposes a 10% tax on any nondeductible contributions to qualified employer plans. Because the court determined that a portion of TORCH's contributions to the pension plan was unreasonable compensation and therefore not deductible, the 10% excise tax applies to that extent.

With respect to the IRC §6651 penalties, the Fletchers contended that they relied on the advice of their accountant when determining the correct compensation package. The accountant advised them that their compensation was reasonable; therefore, Form 5330 was not required to be filed. If the accountant had been correct about the compensation package, failure-to-file penalties would not have been recommended. The Fletchers argued that the penalties were due to **reasonable cause** and not willful neglect. The court agreed with the Fletchers' arguments regarding both the failure-to-file and accuracy-related penalties for the employment plan contributions.

The Fletchers made the same arguments with respect to the IRC §6662 accuracy-related penalty for the unreasonable compensation issue. This time the court disagreed, stating that the compensation paid to Ms. Strick was not for services actually rendered and therefore was not reasonable compensation. The accuracy-related penalty was sustained.

Holding. The court held as follows.

- The compensation paid to the Fletchers for the 2003–2005 tax years was unreasonable. They were overpaid by a total of $282,615.
- All of the compensation paid to Ms. Strick for the 2003–2005 tax years was unreasonable and nondeductible.
- TORCH is liable for excise tax with respect to the portion of its contributions to the pension plan that was determined to be unreasonable compensation.
- TORCH is not liable for the §6651 additions to tax because the failure to file excise tax returns was due to reasonable cause and not willful neglect.
- The Fletchers and TORCH are liable for the §6662(a) accuracy-related penalty with respect to the compensation paid to Ms. Strick.

Reasonable Compensation

***Glass Blocks Unlimited v. Comm'r,* TC Memo 2013-180 (Aug. 7, 2013)**

IRC §§3101, 3111, 6651, 6656, 1361, and 7436

☞ Tax Court Determines Reasonable Compensation

Facts. Frederick Blodgett was the president and sole shareholder of Glass Blocks Unlimited during 2007 and 2008. He was responsible for all operational and financial decisions of the company.

During 2007 and 2008, Glass Blocks paid day laborers $39,733 and $41,453, respectively. Glass Blocks did not file Forms 941, *Employer's Quarterly Federal Tax Return,* for any quarter in 2007 or 2008. In addition, Glass Blocks did not issue a Form W-2, *Wage and Tax Statement,* or Form 1099-MISC, *Miscellaneous Income,* to Mr. Blodgett for 2007 or 2008.

Mr. Blodgett contributed $45,000 and $10,000 in 2007 and 2008, respectively, to cover operating expenses and other costs. Glass Blocks did not give any collateral to Mr. Blodgett with respect to the transfers, and no promissory notes were issued.

During 2007 and 2008, Glass Blocks did not compensate Mr. Blodgett for the work he performed. Instead, Mr. Blodgett received distributions of $30,844 in 2007 and $31,644 in 2008.

The IRS conducted an employment tax audit for the 2007 and 2008 tax years and determined that the dividend distributions paid to Mr. Blodgett should be reclassified as wages.

Issues. The issues in this case are as follows.

- Whether distributions paid to Mr. Blodgett should be recharacterized as wages subject to federal employment tax
- Whether Glass Blocks is liable for the additions to tax under IRC §6651(a)(1) for failure to file Forms 941 for the periods at issue
- Whether Glass Blocks is liable for penalties under IRC §6656 for its failure to deposit payroll taxes

Analysis. IRC §§3101 and 3111 impose FICA taxes on employers based on wages paid to employees. Mr. Blodgett was the sole full-time worker performing substantially all of the work necessary to operate the business, including processing orders, collecting payments, arranging shipment of goods, managing inventory, and handling customer relations.

Mr. Blodgett argued that certain distributions represented repayment of loans from Glass Blocks and should not be recharacterized as wages. The IRS argued that the funds were contributions to capital and the distributions constitute wages to Mr. Blodgett.

The court looked at several factors to determine whether the transfers constituted risk capital or were actually a strict debtor-creditor relationship. There were no written agreements or promissory notes supporting Mr. Blodgett's testimony that the transfers were loans, that he required interest payments from Glass Blocks, or that a fixed repayment schedule existed.

Mr. Blodgett argued that even if the distributions should be recharacterized as wages, the wages proposed by the IRS reflect **unreasonable compensation**. Mr. Blodgett allegedly worked 20 hours per week performing "minimal and undemanding duties," for which $15,860 annually would be considered reasonable based on various salary-reporting websites for a shipping clerk, an accounts receivable clerk, an accounts payable clerk, or an S corporation officer in the wholesale durables business. The court disagreed because Mr. Blodgett's role was more substantial than any one of the positions cited. He performed **all** of those roles within the company. In addition, the "20 hours" Mr. Blodgett allegedly worked was negated by information he gave to an IRS examiner during the employment tax audit that stated he worked over 40 hours each week during 2007 and 2008. Using the $15.25 per hour rate proposed by Mr. Blodgett multiplied by 40 hours per week indicates that the numbers computed by the IRS were reasonable for a full-time employee.

Mr. Blodgett did not provide any arguments to refute the imposition of the penalties by the IRS.

Holding. The court determined that the monies paid to Mr. Blodgett were **reasonable wages**. In addition, the court upheld the penalties as originally proposed by the IRS.

Business Expenses

***Richard D. Bagley v. U.S.*, No. 2:10-cv-00483; U.S. District Court for the Central District of California (Aug. 5, 2013)**

IRC §§162, 212, and 183

☞ Whistleblower Activity Constitutes a Trade or Business

Facts. Richard Bagley earned his MBA and MS in accounting from UCLA. As an employee at TRW in California, he held a variety of positions, including Chief Financial Manager for TRW's space and technology group. His responsibilities included contract proposal pricing, indirect expense budgeting and control, and accounting. He was fully aware of the accounting schemes at TRW and how the costs flowed through the accounting system into the invoices and payment requests that TRW submitted to the government for payment.

From 1989 through 1991, he became aware of **false claims made by TRW to the government.** He signed certifications under penalties of perjury to the federal government that TRW's "indirect" expense claim for the TRW space and technology group for 1990 and 1991 represented reimbursable costs which **he believed to be incorrect.** He voiced his concerns to two individuals at TRW who he believed were operating the false claim schemes but the issues were not resolved.

In August 1993, Bagley was laid off from TRW as the result of reorganization. When he left TRW, he took documents pertaining to the false claims.

After consulting with and retaining an attorney, he filed the first lawsuit under the False Claims Act (FCA) on behalf of himself as relator and the United States on November 16, 1994. A second FCA suit was filed on June 21, 1995. From 1994 through 2003, he worked exclusively on his FCA prosecution activity and was not otherwise employed. He performed these services "in order to successfully prosecute the claims so that [he] would receive an award."

A settlement was reached in June 2003 between Northrop Grumman Corporation (Northrop) (the successor to TRW) and the government for $111.2 million. The U.S. Department of Justice awarded Bagley $27,244,000, for which he received a Form 1099-MISC with the amount shown in box 3 as "other income." Northrop wire transferred $9,407,295 to Bagley's attorneys as payment of the statutory attorneys' fee expense, for which Bagley also received a Form 1099-MISC with the amount shown in box 14 ("gross proceeds paid to an attorney"). Bagley also paid his attorneys $8,990,520 as a contingency fee.

After consulting with his attorney, Bagley filed his 2003 tax return, on which he reported $27,244,000 as ordinary income and a Schedule A deduction for attorney's fees of $9,070,520. Bagley failed to report the $8,990,520 of income from the statutory fee award.

In May 2005, Bagley filed a 2003 Form 1040X, *Amended U.S. Individual Income Tax Return,* showing the statutory attorneys' fees as part of his income. He filed a second Form 1040X in August 2007, on which he claimed a refund after moving all the lawsuit-related income to Schedule C, *Profit or Loss From Business,* and claiming deductions for the legal fees. The IRS denied the claim for refund.

Issues. The issues in this case are whether Bagley must:

- Include his income from the lawsuit as "other income" on his 2003 tax return and deduct the attorney fees on Schedule A (as he did on his first amended return), or
- Whether he can properly report the award on Schedule C and deduct his attorney fees as ordinary and necessary business expenses (as he did on his second amended return).

Analysis. IRC §162 provides a deduction for all ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. The central issue is whether Bagley's activity rose to the level of a trade or business. The court evaluated the nine factors under Treas. Reg. §1.183-2(b) in determining if a profit motive existed. Despite the government's arguments to the contrary, the court determined that the factors overwhelmingly weighed in Bagley's favor that this activity constituted a "trade or business" for purposes of §162(a).

The court then analyzed whether the litigation expenses were "ordinary and necessary expenses paid or incurred during the taxable year in carrying on" his trade or business. The court noted that Bagley was engaged in the business of prosecuting FCA lawsuits and providing services to the government in that prosecution. He paid a total of $18,477,815 to his attorneys in the course of the litigation. These legal fees were necessary for the development of the business because he had to retain a licensed attorney in order to successfully pursue an FCA lawsuit.

Holding. The court determined that Bagley was in a trade or business. Accordingly, the court allowed $18,477,815 as deductions to offset Schedule C income. He received a tax refund of $3,834,407 plus interest for the 2003 tax year.

Medical Marijuana

***Martin Olive v. Comm'r,* 139 TC No. 2 (Aug. 2, 2012)**
IRC §§280E and 6662

☞ IRC §280E Precluded Expense Deduction on Medical Marijuana Dispensary Business

Facts. Martin Olive became involved with the medical marijuana industry by volunteering at a medical marijuana dispensary in San Francisco, California, while he was pursuing his college degree. In January 2004, with the help of local friends and marijuana suppliers, he left college to open his own medical marijuana dispensary called the Vapor Room. The Vapor Room was located in a 1,250-square-foot leased space and contained couches, chairs, and tables. Patrons could use vaporizers, games, books, and art supplies while at the facility. A jewelry-store-like glass counter displayed the medical marijuana inventory. The only item for sale at the facility was marijuana. Mr. Olive required each patron to possess either a doctor's recommendation to use medical marijuana or a similar certificate issued by the city of San Francisco.

Mr. Olive obtained the marijuana from suppliers. He sold approximately 93.5% of the marijuana he purchased to patrons and gave away the remaining supply to patrons and staff.

On his 2004 and 2005 tax returns, Mr. Olive reported net Schedule C income from the Vapor Room of $64,670 and $33,778, respectively, calculated as follows:

	2004	2005
Gross receipts	$1,068,830	$3,131,605
Less: cost of goods sold	(993,377)	(2,812,478)
Gross income	$ 75,453	$ 319,127
Less: expenses	(10,783)	(285,349)
Net profit	$ 64,670	$ 33,778

The IRS examined the tax returns and proposed adjustments for gross receipts, cost of goods sold, expenses, and accuracy-related penalties.

Issues. The issues in this case are as follows.

- Whether Mr. Olive underreported gross receipts by $899,126 and $170,293 for 2004 and 2005, respectively
- Whether Mr. Olive is entitled to cost of goods sold deductions of $993,377 and $2,812,478 for 2004 and 2005, respectively
- Whether Mr. Olive can deduct claimed expenses of $10,783 and $285,349 for 2004 and 2005, respectively
- Whether Mr. Olive is liable for accuracy-related penalties for both 2004 and 2005

Analysis. During the IRS examination, Mr. Olive provided ledger books to the IRS that purported to show the Vapor Room's cash receipts and disbursements; however, there was a 79-day period that was missing from the 2004 ledger and other discrepancies. The IRS reconstructed the records to adjust for the missing period. During the trial, Mr. Olive did not provide any evidence to refute the understatement of gross receipts.

With respect to the total disallowance of cost of goods sold, Mr. Olive argued that his stand-alone ledgers are sufficient substantiation because the medical marijuana industry "shuns formal 'substantiation' in the form of receipts." The court respectfully disagreed because the ledgers did not specifically identify the marijuana vendors or reflect any marijuana that was received or given away.

The court determined that the allowable cost of goods sold deduction was 75.16% of gross receipts reduced by 6.5% to reflect the marijuana that was given away. Cost of goods sold deductions of $1,382,973 and $2,230,396 were allowed in 2004 and 2005, respectively.

The IRS argued that IRC §280E precludes Mr. Olive from deducting any of the amounts paid for business expenses. IRC §280E provides that a taxpayer may not deduct any amount for a trade or business when the trade or business consists of trafficking in controlled substances that are prohibited by federal law. Mr. Olive argued that the expenses are deductible because the Vapor Room's business did not consist of illegal trafficking in a controlled substance. The court rejected this argument, noting that it had previously held that a California medical marijuana dispensary's activity was "trafficking" within the meaning of §280E.[9]

As an alternative argument, Mr. Olive asserted that the Vapor Room also provided caregiving services in addition to dispensing medical marijuana. In fact, he alleged that the trafficked marijuana dispensing took only a small period of time compared with the caregiving services. After much discussion, the court determined that the caregiving services were not independent of the medical marijuana dispensing. Therefore, IRC §280E precludes Mr. Olive from deducting any of the Vapor Room's claimed business expenses.

Mr. Olive argued that the accuracy-related penalty should not apply because any inaccuracy underlying the understatement was accidental, not substantial, and was not negligent on his part. He also asserted that this was his first business and he had not been instructed on the proper way to keep the books and records of a business. The court determined that the accuracy-related penalty should apply to all but the disallowed expenses under §280E because the expenses of the medical marijuana dispensary had not been determined at the time Mr. Olive filed his tax returns. IRC §280E was held to prevent the deduction of expenses by a medical marijuana dispensary only after Mr. Olive filed his returns.[10]

Holding. The court upheld the recomputation of Mr. Olive's gross receipts, the recomputation of cost of goods sold, the application of IRC §280E, and the recomputation of the accuracy-related penalty based on the revised amounts.

9. *Californians Helping to Alleviate Medical Problems, Inc. v. Comm'r,* 128 TC 173 (2007).

10. Ibid.

CAPITAL GAINS AND LOSSES

Ordinary Income

Patricia and Donald Flood v. Comm'r, **TC Memo 2012-243 (Aug. 27, 2012)**
IRC §§164, 1221, 1401, and 6662

☞ Intent of Transaction Leads to Ordinary Income Treatment

Facts. Donald Flood was a day trader in the stock market during 2004 and 2005. He and his wife Patricia also operated a real-estate venture in which they purchased and sold vacant lots. From 2001 to 2008, they purchased at least 250 lots. During 2004 and 2005, they sold 2 and 40 lots, respectively. They also contributed 11 lots to the Sawyer Road Baptist Church in 2005.

The IRS issued a notice of deficiency that reflected the following.

Year	Deficiency	IRC §6662(a) Penalty
2004	$ 10,561	$ 2,112
2005	583,641	116,728

Issues. There were numerous issues raised in this case, but the analysis focuses on the following.

- Whether gains from sales of real estate lots during 2004 and 2005 were ordinary income subject to self-employment (SE) tax rather than capital gain
- Whether the Floods are entitled to a deduction for a $717,000 noncash contribution of lots donated to charity for 2005 or whether the contribution is limited to their $15,010 cost basis
- Whether the Floods are liable for accuracy-related penalties under IRC §6662 for both 2004 and 2005

Analysis. The Floods claimed capital gain treatment on the sale of their lots in the 2004 and 2005 tax years. The IRS asserted that the Floods held the property primarily for sale to customers in the ordinary course of business and, accordingly, the proceeds should be treated as ordinary income. The Floods argued that their everyday business was not the sale of real estate because Mr. Flood was a day trader. However, the tax returns as filed clearly showed the net income from the day trading was insignificant as compared with the income generated from the sale of lots. The court determined that, based on the evidence presented, the Floods' real-estate transactions were conducted in the ordinary course of a trade or business and not for investment purposes. Accordingly, ordinary income treatment as well as the imposition of SE tax is warranted.

The Floods reported a $717,000 noncash charitable contribution deduction for 2005 for the 11 lots they donated to charity. The amount of the charitable contribution deduction was based on the total value of the lots. The IRS decreased the deduction to $15,010, which was the Floods' actual cost basis, because the Floods held the lots primarily for sale to customers in the ordinary course of business. The court agreed with the IRS, noting that the 11 lots donated were purchased as part of the same real estate venture as the lots that the Floods sold in 2004 and 2005. Accordingly, the lots were held primarily for sale to customers and the amount of the noncash charitable contribution deduction is limited to their cost basis.

In addressing the imposition of the accuracy-related penalties for the 2004 and 2005 tax years, the court determined that the Floods had reasonable cause for the portion of each year's underpayment attributable to the following.

- The Floods' position that the lots they sold in 2004 and 2005 were capital assets and therefore generated capital rather than ordinary gains
- The Floods' position that the lots they donated to the church in 2005 were capital assets that gave rise to a charitable contribution deduction of $717,000

Holding. The court determined that the Floods' real estate transactions were conducted in the ordinary course of business and are therefore subject to **ordinary income tax rates.** Additionally, the basis on the lots that the Floods donated to charity is limited to the Floods' **actual cost basis.** However, the court found that the Floods had reasonable cause for the underpayment attributable to the real estate transactions and the charitable contributions; accordingly, **no penalties were imposed** under IRC §6662 with respect to these issues.

Losses

***Phillip and Lisa Sutton v. Comm'r,* TC Summ. Op. 2013-6 (Feb. 6, 2013)**
IRC §§165, 1211, 1212, 1221, and 1234

☞ Trade or Business Involvement Results in Ordinary Loss

Facts. Phillip Sutton, a California resident, began employment with Jon Gibson Co. (Gibson), a real estate development company in 2003. His duties included purchasing and developing real property for Gibson as well as managing real property that had already been developed by Gibson.

In 2005, Phillip formed Sutton Enterprises, LLC (Sutton LLC) so that he could purchase and develop real property on his own. He initially purchased a dilapidated property with the intent of fixing it up and "flipping" it. His employment with Gibson then changed slightly — he continued to be an employee while managing existing properties but became an independent contractor through Sutton LLC for purchasing and developing new properties for Gibson.

In 2006, Phillip personally bought five additional properties — two were dilapidated properties and the remaining three properties were purchased for rental or investment purposes. He renovated the dilapidated properties, listed them for sale, but did not find any buyers due to the economic downturn.

In early 2007, he obtained his real estate license to further advance his career. On February 16, 2007, he entered into an option contract to purchase property in El Dorado Hills, California, for $3.35 million. Phillip spent 20 hours per week searching for partners/investors and vetting, investigating, and developing the property. His unsuccessful efforts resulted in releasing the contract on the property and forfeiting $48,000 in March 2008. He ended his employment with Gibson in June 2008 and closed Sutton LLC the following year.

Phillip and his wife filed a Schedule C, *Profit or Loss From Business,* with their 2008 tax return that showed expenses of $40,146 (including a $16,000 loss on the abandonment of the option contract in connection with the purchase of the El Dorado Hills property). During Appeals consideration of this case, the loss was actually determined to be $48,000. **The IRS determined the loss was a capital loss,** which should have been reported on Schedule D, *Capital Gains and Losses,* rather than Schedule C.

Issue. Whether the abandonment loss incurred by the taxpayer is an ordinary loss.

Analysis. IRC §1221 defines a capital asset as any property held by the taxpayer regardless of whether it is connected with the taxpayer's trade or business. IRC §1221(a)(1) provides exceptions in which ordinary loss treatment can be afforded in certain circumstances, such as property held for sale to customers. IRC §1234(a)(1) provides that the gain or loss retains the same character that the option to purchase the property had.

At trial, the IRS argued that the El Dorado Hills property **would have been a capital asset** in Phillip's hands. Phillip purchased the option as an investment and "neither Sutton LLC nor Mr. Sutton ever held real property for sale to customers." The IRS stated that Phillip was "only in the trade or business of locating, developing, and selling real property for third parties, including Gibson." Phillip argued that he purchased the property to improve it and sell it to buyers/builders for profit and income. He had previously flipped properties and planned to do so with this one as well.

In similar cases, the courts have looked to a variety of factors, including the following.

- The taxpayer's purpose in acquiring the property and the duration of ownership
- The purpose for which the property was subsequently held
- The taxpayer's everyday business and the relationship of realty income to total income
- The frequency, continuity, and substantiality of property sales
- The extent of developing and improving the property to increase sales
- The extent to which the taxpayer used advertising, promotion, and other activities to increase sales
- The use of a business office for the sale of property
- The character and degree of supervision or control the taxpayer exercised over any representative selling the property
- The time and effort the taxpayer habitually devoted to the sales

The court noted that Phillip spent considerable time and effort on the El Dorado Hills property during the time that he held an option to purchase it. On the basis of all the facts and circumstances, **the court found that Phillip held the property primarily for sale to customers in the ordinary course of his trade or business.** Therefore, the property would have been an ordinary asset in his hands. Accordingly, he is entitled to an ordinary loss deduction on the abandonment of the option.

Holding. The court found Mr. Sutton to be in the trade or business of purchasing and developing real property and allowed an ordinary loss deduction of $48,000 in 2008 accordingly.

Insurance Company Demutualization

***Bennett and Jacquelynn Dorrance v. U.S.*, No. 2:09-cv-01284; U.S. District Court for the District of Arizona (Mar. 19, 2013)**
IRC §§1001, 1012, and 7422

☞ Court Determines Taxpayers' Basis in Shares of Demutualized Insurance Company

> **Note.** For the first time, taxpayers who receive stock in a demutualized insurance company have guidance on how to compute their basis. **This case is an important victory for taxpayers.** However, due to the U.S. district court decision in *Reuben v. U.S.*,[11] which agreed with the IRS's zero-basis position, this long-standing contentious issue remains unresolved. The IRS will continue to hold all refund claims in suspense until the *Reuben* case is overturned. Eventually, a petition may be filed with the Supreme Court requesting resolution of this issue.

Facts. In 1996, Bennett Dorrance, an heir to the Campbell Soup Company fortune, **purchased numerous life insurance policies from five mutual insurers** as part of an estate plan. All five insurers later demutualized and converted to stock companies. In 2000 and 2001, Mr. Dorrance received stock in the insurance companies in exchange for the insurance company ownership rights he had through the policies.

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11. *Timothy D. Reuben v. U.S.*, No. 2:11-cv-09448; U.S. Dist. Court for Central Dist. of CA (Jan. 15, 2013).

Mr. Dorrance sold the stock received from the demutualization in 2003. Consistent with the IRS position that the stock had a zero basis, the taxpayers treated the entire sales price of $2.249 million as a long-term capital gain on their joint 2003 tax return. **In 2007, the taxpayers filed a refund claim for their 2003 tax return, arguing that they did have a basis in the stock they sold.**

Issue. The court has to determine an equitable method to allocate the premiums paid by the taxpayers before the demutualization and apply that amount as a cost basis to calculate the taxable gain on the sale of their stock.

Analysis. Mutual rights of a policyholder in a mutual life insurance company include the right to share in company profits and to vote. Each policyholder is entitled to one vote. Prior to demutualization, mutual rights were not separable from policy ownership. A policyholder could not sell or transfer mutual rights.

The five mutual life insurance companies with which Mr. Dorrance had policies demutualized into stock companies to raise additional capital through an initial public offering (IPO), which occurred at the same time as the demutualization.

When determining how many shares of stock to give to mutual policyholders, the life insurance companies calculated:

- A **fixed component** for the loss of voting rights, and
- A **variable component** for the loss of other rights, measured by the policyholder's past and projected future contributions to the company's surplus.

For the **variable component** of the calculation, the companies estimated that **60%** represented each policyholder's **past contributions to surplus** as of the calculation date. The remaining **40%** was an estimate of **future contributions to surplus.**

When the premiums were paid, Mr. Dorrance had voting rights and the ability to participate in any distribution of the companies' surpluses, whether or not that distribution was triggered by a future demutualization. The key question is how to properly allocate cost between mutual rights and policy rights under Treas. Reg. §1.61-6(a).

Holding. The court determined that the basis in the stock sold in 2003 was equal to:

- 100% of the IPO value of the fixed shares ($3,164) received, plus
- 60% of the IPO value of the variable shares ($1.074 million) received.

The total basis of the stock was calculated by the court at $1.078 million. Therefore, the taxpayers' 2003 corrected long-term gain was $1.171 million ($2.249 million sales price − $1.078 million cost basis). The taxpayers are entitled to a 2003 refund of $161,719 ($1.078 million cost basis × 15% capital gains tax rate).

> **Note.** The court treated **past contributions to surplus** (60%) as an allowable cost basis. However, **future contributions to surplus** (40%) were omitted in calculating the allowable cost basis.

Gain Due to Foreclosure

***Drucella T. Malonzo v. Comm'r*, TC Summ. Op. 2013-47 (Jun. 10, 2013)**

IRC §1001

☞ Capital Gain Equal to Outstanding Mortgage Balance in Excess of Basis

Facts. In 2005, Drucella Malonzo purchased a residence in Sacramento, California, for $333,239, which she financed with a mortgage. She resided in the home until she moved to San Francisco in 2006.

For a portion of 2007, she rented the home. Later in 2007, the tenant vacated the home and Ms. Malonzo was unable to find another renter. At that time, the fair market value (FMV) of the residence was less than the mortgage balance. Ms. Malonzo stopped making mortgage payments and effectively abandoned the residence. However, she never took formal steps to transfer title or to provide the lender with a notice of her intention to abandon the home.

In 2008, the lender foreclosed, resold the home, and sent a 2008 Form 1099-A, *Acquisition or Abandonment of Secured Property*, to Ms. Malonzo. The 2008 Form 1099-A reported the following.

Outstanding balance of mortgage	$325,855
FMV of home (the lender's sales price)	278,315
Date of lender's acquisition or knowledge of abandonment	January 22, 2008

Ms. Malonzo did not report the Form 1099-A information on her 2008 tax return. T**he IRS examined her 2008 return and determined that she realized a long-term capital gain of $4,734, calculated as follows.**

Sale price of residence (the outstanding mortgage balance)	$325,855
Less: adjusted basis ($333,239 purchase price – $12,118 depreciation)	(321,121)
Long-term capital gain due to foreclosure	$ 4,734

Issue. Whether Ms. Malonzo realized a capital gain attributable to her abandonment of the real property and the subsequent foreclosure of the mortgage loan

Analysis. In reaching its opinion, the Tax Court relied on the following three court cases.

- Supreme Court opinion in *Crane v. Comm'r*[12]
- Supreme Court opinion in *Comm'r v. Tufts*[13]
- 5th Circuit Court opinion in *Yarbro v. Comm'r* [14]

Ms. Malonzo's case presents a similar question to that addressed in *Yarbro:* **whether her abandonment of real estate subject to a mortgage exceeding the FMV of the property is an ordinary abandonment loss or a capital gain.** The court noted that Ms. Malonzo walked away from the property with the intention of ceasing mortgage payments and **the subsequent foreclosure constituted a "sale or exchange."**[15] Therefore, the court sustained the IRS's position that Ms. Malonzo realized a long-term capital gain.

Holding. The court held that Ms. Malonzo had a $4,734 capital gain, which resulted in an income tax deficiency of $737.

> **Note.** This case illustrates how to properly report Form 1099-A information. This is a frequent IRS correspondence exam issue in cases in which the Form 1099-A information is ignored.

12. *Crane v. Comm'r*, 331 U.S. 1 (1947).
13. *Comm'r v. Tufts*, 461 U.S. 300 (1983).
14. *Yarbro v. Comm'r*, 737 F.2d 479 (5th Cir. 1984), *aff'g*. TC Memo 1982-675.
15. Treas. Reg. §1.1001-2(a)(1).

CASUALTY AND THEFT LOSSES

Casualty Losses

***Christina A. Alphonso v. Comm'r,* U.S. Court of Appeals, 2nd Circuit; No. 11-2364 (Feb. 6, 2013)**
IRC §§165 and 216

☞ Court Finds Cooperative Shareholder Has a Property Interest

Facts. Christina Alphonso was a tenant-stockholder of Castle Village Owners Corporation, a New York cooperative housing corporation, as defined in IRC §216(b). In 2005, a retaining wall collapsed below the Castle Village complex, causing significant damage. Castle Village levied an assessment of $26,390 against each stockholder.

On her 2005 tax return, Alphonso claimed a gross casualty loss of $26,390 but, after making reductions required by IRC §165, she deducted a casualty loss of $23,188. The IRS disallowed the deduction, stating that it did not qualify as a casualty loss under IRC §165(c)(3).

Alphonso petitioned the Tax Court. At that proceeding, she argued that she held "property rights in the use of the apartment and related grounds, so that her loss was the damage to the grounds which directly affected the apartments and the inability to use the related grounds." The Tax Court upheld the IRS's decision. Alphonso then appealed the decision.

Issue. Whether Alphonso had a property interest sufficient to entitle her to a casualty loss deduction for her share of costs associated with the repair of a collapsed retaining wall on the cooperative property.

Analysis. Under IRC §165, an individual is allowed to deduct "losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty." The term **"property"** is not defined in the Code. However, it is undisputed that the term "property" encompasses more than ownership in fee simple and extends to a taxpayer's leasehold interest.

IRC §216(b)(1)(B) defines a cooperative housing corporation as one in which each of the stockholders is entitled "to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation." As a general rule, losses incurred by a corporation are not normally deductible by its stockholders.[16] However, §216(a) allows tenant-stockholders to deduct their respective shares of a co-op's mortgage and real estate interest expenses.

In this case, the proprietary lease gave a defined group of persons the right to use the Castle Village grounds. All of Alphonso's rights are granted by the lease; although her right to use the grounds is not exclusive with respect to her fellow tenants, it is part of her leasehold interest. The court concluded that under New York law, Alphonso's right to use the grounds was a property interest in the grounds.

Holding. The court held that Alphonso had a property interest in the grounds, thereby satisfying the "property" element of §165(c)(3), which was sufficient to entitle her to claim a casualty loss deduction. However, the court remanded the case to the Tax Court to decide whether the loss arose from a casualty.

16. See, e.g., *Arata v. Comm'r,* 277 F.2d 576, 578 (2d Cir. 1960); *Watson v. Comm'r,* 124 F.2d 437, 439 (2d Cir. 1942).

Casualty Loss

Mark D. Ambrose et al. v. U.S.**, U.S. Court of Federal Claims; No. 11-64T (Aug. 3, 2012)**
IRC §§165 and 7422

☞ Casualty Loss Allowed After Insurance Claim Denied

Facts. Mark and Jennifer Ambrose took out a standard homeowner's insurance policy on their residence in Auburn, New York, with Farm Family Casualty Insurance Company in August 2002. A dryer fire in November 2002 resulted in the family relocating to a nearby motel while Diamond's Air Clean and Construction repaired the smoke, fire, and water damage. Unfortunately, another fire broke out on December 25, totally destroying the home. Again, Mr. Ambrose promptly made a claim with the insurance company, alleging that the second fire was caused by Diamond's negligent workmanship.

The insurance adjuster met with the Ambroses on December 27, 2002, at which time an interview was conducted and the property was inspected. A claim form was completed by the adjuster and signed by Mr. Ambrose.

A month later, the insurance company sent Mr. Ambrose a letter alleging that, at the December 27, 2002 meeting, a personal property inventory was requested by the adjuster. The letter gave the taxpayers 60 days to submit the requested information. **The Ambroses never received this letter**.

A Farm Family representative interviewed the Ambroses on two separate occasions (March 26 and April 7, 2003). The Ambrose's attorney returned the sworn proof of loss on April 23, 2003. **On June 12, 2003, Farm Family sent a letter to the Ambroses denying coverage, alleging that they intentionally and deliberately caused the fire and did not provide a timely proof of loss.** The Ambroses sued Farm Family in New York Supreme Court but lost their case. The Ambroses were also unsuccessful in a suit against Diamond.

The Ambroses then filed an amended 2007 income tax return on which they deducted a casualty loss of $167,619. After an examination by the IRS, the claim was disallowed in full. As a result, the Ambroses filed suit in January 2011.

Issue. Whether the taxpayers' failure to provide timely proof of their loss to their insurer prohibited them from claiming a casualty loss deduction for the amount of fire damage to their personal residence

Analysis. IRC §165(a) allows, as a general rule, deductions for "any loss sustained during the taxable year and not compensated for by insurance or otherwise."

During trial, the IRS argued that the Ambroses are not entitled to deduct a casualty loss for the fire that destroyed their home because they failed to file a timely insurance claim. The court looked to several cases which found that "either a taxpayer must exhaust all reasonable prospects for insurance indemnification before claiming a 'sustained loss' or that the phrase **'not compensated by'** must be equated with the phrase **'not covered by' insurance."**[17] The court looked at an extensive analysis of the relevant statutory language, the common usage terms employed, the IRS's own regulations, and the statute's legislative history to determine that the correct resolution was in the Ambrose's favor.

Holding. The court denied the government's motion to dismiss the Ambroses suit seeking a tax refund based on the casualty loss. The parties were instructed to file a joint report indicating how the case should proceed.

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17. See *Miller v. Comm'r*, 733 F.2d 402 (6 Cir. 1984), *aff'g*, 42 TC Memo 1981-431 (Aug. 13, 1981).

Theft Loss Deduction

***James and Gaetana Urtis v. Comm'r,* TC Memo 2013-66 (Mar. 5, 2013)**
IRC §§165 and 6662

☞ Deceit by Construction Company Results in Theft Loss

Facts. Riverside, Illinois residents James and Gaetana Urtis decided to increase the size of their house due to the upcoming birth of a child. They contracted with a builder to destroy a portion of their home and replace it with an addition. They agreed to pay $400,000 in installments at certain milestones in the construction progress.

Construction began in November 2005. Mr. and Mrs. Urtis and their children were unable to stay in the house during the construction period.

Once the project was underway, the contractor began demanding payments in excess of the agreed upon installments and before the installments were due. The contractor claimed that he had to make payments to suppliers and subcontractors or the construction would be delayed. Mr. and Mrs. Urtis were eager to get back into their house and made the requested payments.

To alleviate Mr. and Mrs. Urtis's concerns about the delays and the changes to the agreed payment terms, the contractor showed them parts of the construction project as it progressed. However, some of the apparent progress was actually an illusion, which the taxpayers were unable to detect because of their lack of expertise in construction.

On July 29, 2006, the contractor died. At the contractor's wake, Mr. and Mrs. Urtis found out that many of the subcontractors had not been paid and that the contractor was involved in several other projects that were undergoing financial difficulty. There was speculation that the contractor had a drug problem, which may have contributed to his financial difficulty and early death at the age of 30.

Next, the taxpayers discovered that the contractor had damaged some of their property during construction. This included the heating system, furniture, flooring, shrubbery, and patio.

Prior to construction, the contractor told the taxpayers that he was insured and had shown them proof of insurance. When the taxpayers made a claim against the insurance policy, they found out that the insurance policy did not cover "Knowing Violations Of Rights Of Another" that are caused by or at the direction of the insured with the knowledge that the act would violate the rights of another. Mr. and Mrs. Urtis also learned that the policy had lapsed shortly after the contractor signed the contract with them. However, they did settle with the insurance company for $10,000 in 2009.

During the construction period, the taxpayers paid the contractor approximately $400,000. After the contractor's death, they made significant payments to other companies to repair the damage and to complete the project.

The taxpayers claimed a theft loss deduction of $188,070 on their 2007 income tax return for the funds they paid to the contractor that he used **for purposes other than their construction project.** The IRS denied the theft loss deduction.

Issue. Whether the taxpayers are entitled to a theft loss deduction

Analysis. The IRS neither disputed the fact that the taxpayers incurred a loss nor the amount of the claimed loss. **The IRS argued that the taxpayers were not entitled to claim a theft loss deduction because the contractor did not engage in theft as defined under Illinois state law.** The court sided with Mr. and Mrs. Urtis that their loss **was** a theft loss under Illinois state law.

The IRS also argued that the deduction should have been claimed in 2006 rather than 2007 because a theft loss is deductible in the year the theft is discovered. Mr. and Mrs. Urtis discovered the loss in 2006 and, according to the IRS's contention, should have claimed the deduction in that year. The court pointed out that a theft loss deduction cannot be claimed until there is no possibility of recovery. In this case, the taxpayers had filed for reimbursement from the insurance company and believed they had a reasonable prospect of recovery in 2006 that expired in 2007.

Holding. The court held that **Mr. and Mrs. Urtis are entitled to a theft loss deduction of $188,070 for 2007.**

CREDITS

First-Time Homebuyer Credit
***Robert D. Packard v. Comm'r*, 139 TC No. 15 (Nov. 5, 2012)**
IRC §36

☞ Court Takes Reasonable Approach to First-Time Homebuyer Credit Issue

Facts. Robert and Marianna Packard were married on November 22, 2008, but continued to live in separate residences until December 1, 2009, when they purchased a house in Tarpon Springs, Florida. Robert had rented a place during the three years before the purchase and Marianna **resided in her own principal residence for approximately 5½ years.** On their 2009 jointly filed tax return, the Packards claimed a $6,500 first-time homebuyer credit.

The IRS disallowed the first-time homebuyer credit claimed by the Packards.

Issue. Whether the Packards are entitled to a first-time homebuyer credit of $6,500

Analysis. IRC §36(a) allows "an individual who is a first-time homebuyer of a principal residence in the United States" a tax credit for the year the residence is purchased. IRC §36(c)(1) defines a "first-time homebuyer" as "any individual if such individual (and if married, such individual's spouse) had no present ownership interest in a principal residence during the 3-year period ending on the date of the purchase of the principal residence. . . ."

The Worker, Homeownership, and Business Assistance Act of 2009 amended §36(c) by adding a new paragraph (6), which provides an exception for any individual (and if married, the individual's spouse) owning a principal residence for any five consecutive years during the preceding 8-year period. These individuals are also treated as first-time homebuyers.

Before the addition of paragraph (6), the first-time homebuyer credit was limited to individuals who had not owned a principal residence during the 3-year period ending on the date the residence was purchased. The issue addressed by the court is whether both husband and wife must co-own and reside together at the same residence for the 5-consecutive-year period during the 8-year period ending on the date the new residence was purchased or if one spouse can qualify for the exception under §36(c)(6) while the other spouse qualifies as a first-time homebuyer under §36(c)(1).

Holding. When considered individually, both Mr. and Mrs. Packard would be entitled to the first-time homebuyer credit. Because Mr. Packard qualifies under paragraph §36(c)(1) and Mrs. Packard qualifies under paragraph §36(c)(6), the court determined that they are entitled to a maximum $6,500 first-time homebuyer credit.

Adoption Credit

***Nancy Louise Field v. Comm'r,* TC Memo 2013-111 (Apr. 18, 2013)**

IRC §§23 and 6662

☞ Married Taxpayer Filing Separately Not Entitled to Adoption Credit

Facts. Nancy Field was married on July 16, 2008. She and her husband lived together during the last six months of 2009. On her 2009 return, Ms. Field used the married filing separately filing status and claimed an adoption credit of $10,144 under IRC §23(a), which exactly offset her reported federal tax liability.

The IRS issued a notice of deficiency, disallowing the credit. The IRS also assessed a 20% accuracy-related penalty.

Issues. The issues in this case are as follows.

- Whether Ms. Field is entitled to a tax credit for adoption expenses under IRC §23(a)
- Whether Ms. Field is liable for the accuracy-related penalty

Analysis. IRC §23(a) allows a credit against an individual's income tax for "qualified adoption expenses paid or incurred by the taxpayer." **For married taxpayers, the credit is generally allowed only if the taxpayers file a joint return for that tax year.**[18]

Ms. Field argued that the requirement to file a joint return violates her equal protection rights under the Fifth Amendment. She alleged that she adopted 15 children before her marriage and that her husband had never adopted any of those children. She contended that the effect of the joint filing requirement is to penalize her for having married in 2008.

The court noted that the joint filing requirement is very similar to a requirement under former IRC §214, which allowed married taxpayers to claim child care expenses only if they filed joint returns. The court held that requirement to be valid under the equal protection clause, and that decision was affirmed by the 5th Circuit Court of Appeals, to which an appeal of Ms. Field's case would lie.[19] The court further stated its belief that plausible administrative considerations provide a rational basis for the joint filing requirement. For example, the joint filing requirement mitigates concerns against married taxpayers claiming duplicative adoption credits for the same child on separate returns.

Holding. The court held that Ms. Field is **not entitled to a tax credit** for adoption expenses. However, the court **declined to sustain the accuracy-related penalty** because there is a genuine dispute as to the material facts about the issue.

18. IRC §23(f)(1).

19. See IRC §7482(b)(1)(A); *Black v. Comm'r,* 69 TC 505 (1977); *Cash v. Comm'r,* TC Memo 1977-405, *aff'd per curiam,* 580 F.2d 152 (5th Cir. 1978).

DEDUCTIONS

NOL Deduction

***Fred Deutsch v. Comm'r*, TC Memo 2012-318 (Nov. 15, 2012)**
IRC §§166, 172, and 6662

☞ Lack of Evidence Leads to Disallowance of NOL Deduction

Facts. Fred Deutsch, a New York resident, became involved in real estate development and management in the mid-1970s. His business expanded in the late 1980s to include real estate lending in an individual capacity as well as through his wholly owned company.

Nine alleged loans totaling over $10 million became unrecoverable in the 1990s, resulting in IRC §166 bad debt deductions. These bad debts resulted in a net operating loss (NOL) deduction in 2004, the tax year at issue in this case.

Mr. Deutsch filed tax returns with negative adjusted gross incomes for 1990–1994 and 1998–2003 totaling over $40 million. No returns were filed for 1995 or 1996. He did file a 1997 return in October 1998 showing a positive AGI.

The IRS criminal investigation division investigated the 1995–1997 tax years. Mr. Deutsch pled guilty to filing a false tax return for the 1997 tax year. As part of the criminal proceedings, he consented to the assessment and collection of tax, penalties, and interest for the 1995–1997 tax years.

Subsequent to the case resolution, Mr. Deutsch filed a 1997 Form 1040X, *Amended U.S. Individual Income Tax Return,* claiming an NOL carryforward of $8.2 million. The IRS determined that Mr. Deutsch failed to substantiate his NOL deduction and disallowed the claim accordingly.

Issues. The issues in this case are as follows.

- Whether Mr. Deutsch is entitled to a $2.8 million NOL deduction for the 2004 tax year
- Whether Mr. Deutsch is liable for an accuracy-related penalty under IRC §6662(a)

Analysis. IRC §172(a) allows an NOL for the aggregate of NOL carrybacks and carryovers to the tax year. To carry forward or carry back NOLs, the taxpayer must prove the amount of the NOL carryforward or carryback and that his gross income in other years did not offset that loss. **Mr. Deutsch contended that the NOL at issue was derived from a series of bad debt deductions that arose during the 1990s.** However, Mr. Deutsch failed to establish a prima facie case proving his entitlement to a bad debt deduction for any of his purported loans. With the exception of notes for two of the parties, the record contains no evidence to support that he ever actually made any loans to the relevant entities.

Furthermore, Mr. Deutsch could not support the alleged worthlessness of the purported debts. He testified that he never pursued legal action against any of the purported borrowers to collect the debt, nor did he present any evidence as to the worthlessness of the loans.

The accuracy-related penalty was recommended because Mr. Deutsch understated his 2004 tax liability by $367,019. Mr. Deutsch argued that he relied on his CPA in deducting the NOL at issue. However, he did not provide any evidence to show the expertise of his accountant, the information that he provided to his accountant, or his actual reliance in good faith on his accountant's advice.

Holding. The court held that Mr. Deutsch is not entitled to an NOL deduction for the year at issue. In addition, he is liable for the accuracy-related penalty.

Domestic Production Activities Deduction

ILM 201302017 (Nov. 28, 2012)

IRC §§199 and 263

☞ Traditional and Modern Billboards Are Inherently Permanent Structures

Facts. The taxpayer constructs and maintains outdoor advertising displays (billboards) and rents advertising space on the billboards to customers. Their outdoor advertising displays consist of mobile truckside billboards, traditional billboards mounted on wood structures in the ground, and modern billboards mounted on steel poles attached to a foundation. Both the traditional and modern billboards are installed on leased land with leases ranging from 30 days to 20 years. These land leases generally continue until such time as the billboard is no longer profitable. Approximately 95% of the traditional and modern billboards have remained on the same parcels of land since their initial construction. The mobile billboards, on the other hand, are moved frequently based on the particular customer's advertising needs. A **mobile** billboard moved to a new location two to four times a month depending on the advertising agreement.

The second situation involves a **traditional** billboard nailed to a wooden support frame. The lease has automatically renewed for the last 10 years (initial 30-day lease with automatic renewal clause). The company is required to remove the billboard at the lease termination.

The third situation involves a **modern** billboard mounted to a steel frame that is attached to four structural steel poles. A 3-year land lease is used with modern billboards.

Analysis. For purposes of the IRC §199 domestic production activities deduction (DPAD), qualifying production property includes tangible personal property, real property, and other specified property. Treas. Reg. §1.263A-8(c)(1) defines real property as land, unsevered natural products of land, buildings, and inherently permanent structures. To be an inherently permanent structure, the property must be attached to real property to perform its intended function for a period of time not initially known.

Conclusion. The IRS stated in this legal memorandum that the outdoor advertising display is an inherently permanent structure under IRC §263A (and therefore real property for purposes of the DPAD) when it is attached to real property and will ordinarily remain connected to the real property to perform its intended function. A mobile billboard is **not** an inherently permanent structure because it is not attached to real property and it is not intended to remain stationary indefinitely. **The traditional and modern billboards are both inherently permanent structures and therefore qualify as real property for purposes of the DPAD.**

Charitable Contribution

Ltr. Rul. 201318003 (Jan. 22, 2013)

IRC §§170, 291, 501(c)(3), and 1250

☞ Twenty Percent Reduction of Charitable Deduction Not Required

Facts. Taxpayer corporation owns improved real property located at its B plant that contains IRC §1250 depreciable real property. Most of this §1250 property has been fully depreciated. Taxpayer corporation intends to contribute some or all of the property to one or more IRC §501(c)(3) charitable organizations and claim an IRC §170 charitable contribution. The §501(c)(3) organizations will have the same basis as the taxpayer corporation pursuant to IRC §1015(a).

A request for a ruling was submitted to determine whether the charitable deduction would have to be reduced by 20% of the accumulated depreciation of the property pursuant to IRC §291(a)(1).

Analysis. IRC §291(a)(1) provides that when a corporation disposes of §1250 property, the amount that is treated as ordinary income under §1250 is equal to 20% of the excess, if any, of:

- The amount that would be treated as ordinary income if the property was IRC §1245 property, over
- The amount treated as ordinary income under §1250 (determined without regard to IRC §291(a)(1)).

Because the property basis in the hands of the §501(c)(3) tax-exempt organizations will be the same as the taxpayer corporation property basis at the time of transfer, the contribution of the property is a gift for purposes of IRC §1250(d)(1) and Treas. Reg. §1.1250-3(a)(1). The provisions of §291(a)(1) do not apply to a gift of property to the §501(c)(3) tax-exempt organizations.

Holding. Because the taxpayer corporation represented that it intends to contribute the property to one or more §501(c)(3) organizations, the contribution will meet the requirements of IRC §170. The recipient §501(c)(3) organizations will have a basis in the property equal to the taxpayer corporation's basis at the time of the transfer. **The charitable contribution deduction will not be reduced by 20% of the accumulated depreciation of the property pursuant to §291(a)(1).**

Conservation Easement

***James M. Pollard v. Comm'r,* TC Memo 2013-38 (Feb. 6, 2013)**

IRC §§170 and 6662

☞ Charitable Contribution of Conservation Easement Substantially Devalued

Facts. In 1998, James Pollard purchased a 67.51-acre parcel of farmland in Boulder County, Colorado, for $1.1 million. Two houses were located on the property, including a derelict property. He demolished the derelict house in 1999 without a demolition permit. When he applied for a permit to build a new residence, he was told that he would have to obtain approval from Boulder County because his property consisted of less than 70 acres.

Mr. Pollard hired a land-use consultant to explore alternatives. He decided to apply for a subdivision exemption to split the property into two lots. After several meetings with Boulder County officials, a modified subdivision exemption request letter was sent that raised the possibility of encumbering the property with a conservation easement.

A review of the case by the Land Use Department (LUD) staff recommended the exemption request be denied because of the property's size. The LUD's memorandum stated that if the Boulder County Board of Commissioners disregarded the LUD recommendation and chose to approve the subdivision exemption request, the exemption should be subject to several conditions. One of these conditions required the owner to dedicate a conservation easement to Boulder County for the subject property.

At the public hearing, Mr. Pollard's representative offered up an easement on a relatively small portion of the property. The commissioners rejected this proposal and stated that the exemption request would be approved only if the conservation easement encumbered the entire property.

After the commissioners visited the property, a second public hearing was held, resulting in the agreement to allow Mr. Pollard to construct a new dwelling in return for the conservation agreement. On December 13, 2001, Mr. Pollard and Boulder County entered into an agreement to make a gift of two conservation easements to Boulder County. The first gift was required to be completed by December 31, 2001, and the second was to be completed between January 2, 2003, and January 30, 2003.

Mr. Pollard hired an experienced certified general appraiser to prepare an appraisal report before and after the second conservation easement was granted. The value of the second conservation easement was $1,049,850, which he claimed on his 2003 tax return using Form 8283, *Noncash Charitable Contributions.* Due to the limitations of IRC §170(b)(1)(B), Mr. Pollard claimed carryforward contribution deductions on his 2004–2007 tax returns as well.

The IRS reduced the charitable contribution deduction and carryforwards for 2003–2007 to a total deduction of $128,000 and recommended the assertion of accuracy-related penalties for all years.

Issues. The issues in this case are as follows.

- Whether Mr. Pollard is entitled to a charitable contribution deduction for a conservation easement in excess of $128,000
- Whether Mr. Pollard is liable for the 20% accuracy-related penalty pursuant to IRC §6662(a)

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

- Is a qualified real property interest
- Is made to a qualified organization
- Is exclusively for conservation purposes

At trial, the court determined that Mr. Pollard did not convey the second conservation easement for detached and disinterested motives but rather to secure a personal benefit. Specifically, the conservation easement was granted in exchange for the requested subdivision exemption.

The IRS initially recommended the assertion of the 20% IRC §6662(a) penalty for substantial valuation misstatement. As an alternative to the §6662(a) penalty, the IRS proposed a 40% penalty under IRC §6662(h) for gross valuation misstatement. The court determined that the appraisal report submitted by Mr. Pollard complied with the requirements of Treas. Reg. §1.170-13(c), thus satisfying the reasonable cause exception; therefore, the 40% gross valuation penalty was eliminated.

With respect to the substantial valuation misstatement penalty, the court determined that Mr. Pollard did not act with reasonable cause and in good faith regarding the second conservation easement. None of the individuals Mr. Pollard relied upon in connection with the second conservation easement were tax professionals.

Holding. The court agreed with the IRS determination, finding that the second conservation easement did not constitute a charitable contribution and upheld the assertion of the 20% accuracy-related penalty.

Conservation Easement

***RP Golf LLC et al. v. Comm'r,* TC Memo 2012-282 (Oct. 3, 2012)**

IRC §170

☞ Conservation Policy Requirements Not Adhered To

Facts. RP Golf is a Missouri limited liability company. On December 29, 2003, a subsidiary of RP Golf granted a conservation easement to the Platte County Land Trust (PLT), a Missouri not-for-profit corporation. The property underlying the easement is in the city of Parkville, Platte County, Missouri and covers approximately 277 acres. The easement's purpose was to preserve and maintain open areas and spaces in light of the encroaching urban and metropolitan development.

PLT agreed to inspect and, if necessary, enforce the easement for an annual fee of approximately $15,000. The agreement between RP Golf and PLT was recorded in the Platte County Recorder's office on December 30, 2003.

RP Golf claimed a $16.4 million charitable deduction on its 2003 tax return. Attachments to the return included Form 8283, *Noncash Charitable Contributions,* and an appraiser's declaration, which stated the easement's appraised fair market value was $16.4 million. PLT's vice president signed the donee acknowledgment section of the Form 8283. In a letter dated April 10, 2008, PLT thanked RP Golf for the easement. The letter also acknowledged that no goods or services were provided in exchange for the easement.

The IRS disallowed RP Golf's charitable contribution deduction.

Issue. Whether RP Golf is entitled to a charitable contribution deduction for a conservation easement

Analysis. IRC §170 generally allows a charitable deduction for contributions made during a tax year to an IRC §501(c)(3) organization. IRC §170(f)(8)(B) provides that no deduction is allowed for a charitable contribution of $250 or more unless the contribution is substantiated with a contemporaneous written acknowledgment that includes the following information.

- Amount of cash and a description of any property other than cash contributed
- Whether the donee organization provided any goods or services for any property contributed
- Description and good faith estimate of the value of any goods or services provided

A written acknowledgment is contemporaneous if the taxpayer obtains the acknowledgment on or before the earlier of the date the return was filed or the due date (including extensions) of the return. RP Golf contended that the agreement met the requirements of IRC §170(f)(8). The IRS disagreed because the agreement lacked the statement that no goods or services were exchanged for the easement. Looking at all the relevant pieces of evidence, the court determined that the agreement did state that no goods or services were received in exchange for the contribution, thus supporting RP Golf's position.

IRC §170(f)(3)(A) provides that a taxpayer generally may not claim a charitable contribution deduction for the gift of a partial interest in any type of either real or personal property. IRC §170(f)(3)(B)(iii) provides an exception for a **"qualified conservation contribution,"** which requires a contribution exclusively for conservation purposes. IRC §170(h)(4)(A) defines "conservation purpose" to include the preservation of open space when such preservation is pursuant to a clearly delineated federal, state, or local governmental policy. The Missouri conservation policy is limited to open spaces within counties that have a population of more than 200,000 residents or in any adjoining county. During the relevant time frame, Platte County **did not have** a population that exceeded 200,000 residents, nor did any of the adjacent counties.

Holding. The court agreed with the IRS determination that **the easement was not made pursuant to a clearly delineated governmental conservation policy,** thus the charitable contribution deduction was denied.

DEPENDENCY ISSUES

Qualified Child

***Timothy R. Holmes v. Comm'r,* TC Summ. Op. 2013-32 (Apr. 22, 2013)**
IRC §§24, 32, 2(b), 151, and 152

☞ Taxpayer Cannot Claim Dependency Exemptions

Facts. Timothy Holmes was married in 2004. He and his wife separated in 2006, about a year after their daughter was born. When the separation occurred, the court gave Holmes and his wife joint custody of their daughter. The separation petition gave the mother primary custody of the daughter but granted the father "reasonable and liberal rights of visitation with the minor child as can be agreed upon between the parties." Holidays were to be split between the parents.

Holmes and his estranged wife had a son in 2007 and then they divorced in 2008. The court noted that Holmes and his former wife agreed that the terms of the previous court order remained in effect and that they would share joint custody of the son. Again, the mother was to have primary custody of the son.

Holmes used the head of household filing status on his 2009 return. He claimed two exemptions for the children, the earned income credit, and the additional child tax credit. His former wife also claimed exemptions for the children. Accordingly, the IRS challenged the deductions on Holmes's return.

Issues. The issues in this case are as follows.

- Whether Holmes is entitled to two dependency exemption deductions
- Whether he can claim the head of household filing status
- Whether he is entitled to an earned income credit of $2,690
- Whether he is entitled to an additional child tax credit of $561

Analysis. The statutory requirements for the dependency exemption, head of household filing status, earned income credit, and additional child tax credit are interrelated. The only disputed requirement, which controls each of the issues, is whether the two children resided with Holmes for more than half of the 2009 tax year.[20]

At trial, both parents testified that they had joint custody but neither had any documents to prove where the children spent the **most nights.** Holmes claimed that the children spent at least 191 nights with him. However, the mother testified that the children only lived with Holmes every other weekend from Friday night to 6:30 p.m. on the following Monday and that on opposite weeks he had the children on Monday nights. She acknowledged that the children spent the holidays with their father in 2009.

The parties agreed that **Holmes had the burden of proof.**[21] The court noted that both parties appeared credible during their testimony. However, two court orders gave primary custody to Holmes's former wife. The court found that this was sufficient to tilt the evidence against Holmes.

Holding. The court held that neither of the children had the same principal place of abode as Holmes during 2009. Accordingly, Holmes is **not** entitled to use the head of household filing status and may **not** claim dependency exemptions for the children, the earned income credit, or the additional child tax credit.

20. See IRC §152(c)(1)(B).

21. See Rule 142(a); *Welch v. Helvering,* 209 U.S. 111, 115 (1933).

DIVORCE ISSUES

Alimony

***Sharon F. Schilling v. Comm'r,* TC Memo 2012-256 (Sep. 5, 2012)**
IRC §71

☞ Payments Constitute Alimony

Facts. Sharon Schilling and her ex-husband separated in March 2003 after having five children and surviving 24 years of marriage. They entered into a separation agreement, which provided that Sharon would receive spousal support of $2,450 per month for six years. This amount was subject to reductions as their three youngest children either turned 18 or left home for college.

The divorce was finalized in October 2003. Neither the separation agreement nor the divorce decree specified that the monthly payments to Sharon would terminate upon her death.

From 2003 through 2009, Sharon Schilling received the following payments.

- April 2003–September 2003: $2,450 per month
- October 2003–September 2004: $2,325 per month
- October 2004–August 2006: $2,125 per month
- September 2006–March 2009: $1,925 per month

The reductions occurred at the times when each of the children either left for college or turned 18 years of age, as stipulated in the original separation agreement.

On her 2006 tax return, Sharon did not include any of the payments she received as alimony income. The IRS determined that $23,100 of the $24,700 she received should be reported as alimony income and recommended an adjustment accordingly.

Issue. Whether payments Sharon Schilling received from her ex-husband were includible as alimony income on her 2006 tax return.

Analysis. Payments received as alimony or separate maintenance payments must be included in taxable gross income unless the payments are designated as nontaxable child support or the payments are to continue after the death of the payee spouse.[22]

Alimony does not include amounts that the divorce or separation instruments fix as child support. **Part of a payment is fixed as child support if any amount specified in the divorce instrument will be reduced:**

- On the occurrence of a contingency relating to a child (e.g., attaining a certain age, marrying, dying, leaving school), which is specified in the divorce or separation instrument; or
- At a time that can clearly be associated with such a contingency.[23]

At trial, Sharon argued that the failure to expressly state in the separation agreement or divorce decree that the spousal support payments were to terminate on her death precludes the payments from being treated as taxable alimony. The court refuted her argument by citing the 1986 Congressional amendment to IRC §71, which provided that alimony treatment is not limited to situations in which a separation agreement or a divorce decree expressly states that the support payments are to terminate upon the death of the payee spouse.

22. See IRC §§71(a), (b)(1)(D), (c)(1).

23. IRC §71(c)(2).

Sharon also argued that on March 31, 2009, termination of all further spousal support from her ex-husband constituted a fourth reduction in support relating to the children and therefore the entire $24,700 received in 2006 represented nontaxable child support. However, the court agreed with the IRS that the March 2009 termination of all further spousal support was not a reduction clearly associated with a contingency relating to her children.

Holding. The court found that the payments made to Sharon in 2006 were taxable alimony.

Alimony Payments

Danial and Christina Martin v. Comm'r, **TC Summ. Op. 2013-31 (Apr. 17, 2013)**

IRC §§71 and 215

☞ Additional Payments do not Constitute Alimony

Facts. Danial and Ruth Martin were married from March 1975 to December 2004. The divorce decree awarded her spousal support of $1,000 per month from 2004 through 2007. In 2007, Ruth had medical problems and was unemployed. She asked Danial to increase the alimony payments so she could pay her medical and living expenses.

On the basis of Ruth's request, Danial began making monthly payments of $2,300 to her in 2007. **He did not attempt to have the spousal award changed by the court.** Danial made total payments of $27,600 to Ruth in 2007.

On his 2007 income tax return, Danial claimed a deduction of $27,600 for the alimony payments. The IRS disallowed $15,600 of that amount because it exceeded the amount of spousal support provided for in the judgment of dissolution that was filed to terminate the marriage.

Issue. The issue in this case is whether the additional payments are deductible as alimony.

Analysis. Under IRC §215(a), alimony payments are deductible. The payments must also be included in income by the recipient under IRC §71. An alimony payment is defined as any payment that satisfies the following requirements provided in IRC §71(b)(1).

- The payment is received by a spouse under a divorce or separation instrument.
- The instrument does not designate the payment as one that is not includible in gross income.
- In the case of an individual legally separated from their spouse under a divorce or separate maintenance decree, the payee spouse and the payor spouse do not live in the same household at the time payment is made.
- There is no liability to make payments for any period of time after the death of the payee spouse and there is no liability to make any payment as a substitute for such payment after the death of the payee spouse.

The court noted that amounts paid in excess of the amount required by a written instrument are not considered deductible alimony payments.[24] The increased payments were made pursuant to an oral arrangement and there was no written document that verified the arrangement.

Holding. While the court said it was admirable that Danial was willing to provide the additional payments to his former wife, **the IRS was correct in denying the additional deduction.**

24. *Van Viaanderen v. Comm'r,* 175 F.2d 389 (3d Cir. 1949), *aff'g* 10 TC 706 (1948).

Alimony

***Brendon James DeLong v. Comm'r,* TC Memo 2013-70 (Mar. 11, 2013)**
IRC §§71, 215, and 6662

☞ Court Allows Alimony Deduction For Family Support Payments

Facts. Brendon DeLong, a California resident, separated from his wife in 2006. He and Ms. DeLong had two children who lived with Ms. DeLong after the separation. While waiting for the divorce to become final, the DeLongs entered into a stipulated agreement that was incorporated into a temporary support order. The support order required Mr. DeLong to pay $3,000 as family support for January 2008.

Two months later, the Superior Court of California issued a second support order. This order required Mr. DeLong to continue making family support payments of $3,000 per month until the divorce trial was held. The court indicated that the payments were for both spousal support and child support. However, the court did not allocate the payment between the two parts. The orders did not contain any language that would terminate the family support payments on Ms. DeLong's death.

During 2008, Mr. DeLong made $24,491 of family support payments under the order. When he filed his 2008 tax return, he deducted the entire amount of the payments as alimony. The IRS subsequently issued a deficiency notice that disallowed the claimed alimony deduction.

Issue. Whether the $24,491 of family support payments are deductible as alimony

Analysis. IRC §71(b)(1) is used to define alimony or separate maintenance payments. For a cash payment to qualify as alimony or separate maintenance, the following conditions must be satisfied.

1. The payment must be received under a divorce or separation agreement.
2. The divorce or separation agreement does not designate the payment as one that is not includible in gross income and not allowable as a deduction under IRC §215.
3. For an individual legally separated from their spouse under a divorce or separate maintenance decree, 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 obligation to make the payment any time after the death of the spouse, and there is no obligation to make any payment (in cash or property) as a substitution for the payment after the death of the spouse.

A payment that satisfies these criteria is not includible in the recipient spouse's gross income and thus is **not deductible as alimony if it qualifies as child support** under §71(c).

The IRS argued that the payments made by Mr. DeLong did not qualify as alimony because they were designated as nonalimony and would continue even if Ms. DeLong died. However, the court noted that the support orders did not expressly state whether Mr. Delong's obligation for making the family support payments would terminate on Ms. Delong's death. Accordingly, the court considered whether such termination would occur by operation of California law. After analyzing the relevant California statutes, the court concluded that there is no continuing payment liability past the death of a payee spouse with respect to a family support obligation. Accordingly, Mr. Delong would have no continuing liability for the payments after Ms. DeLong's death, and the §71(b)(1)(D) requirement is met.

The court then considered whether the family support payments were designated as nonalimony. The IRS contended that the payments were designated as nonalimony because the support orders indicated that the payments were partly for child support. The court observed that the support orders made an unallocated award of spousal and child support. **Because the orders did not specify any portion of the family support payments as payable for child support, the court found that no amount of the family support payments qualified as child support.**

Holding. The court held that the family support payments constitute alimony rather than child support. Accordingly, Mr. Delong is entitled to deduct the entire amount of the family support payments for 2008.

EMPLOYMENT TAX ISSUES

Employee vs. Independent Contractor

***Juan A. Ramirez and Rebecca Ybarra-Ramirez. v. Comm'r,* TC Summ. Op. 2013-38 (May 20, 2013)**
IRC §§61, 62, and 3121

☞ Factors Point to Independent Contractor Status

Facts. Juan Ramirez was employed by Univision as an "on-air personality" and program director for KXTN radio station in San Antonio, Texas. His job duties included hosting a radio program and making off-air appearances promoting KXTN. His compensation package included a base salary plus a bonus and Univision stock options.

In 2005, KXTN ran into some financial challenges. At that time, Mr. Ramirez established direct, personal relationships with sponsors, working with them from the start of the advertising campaign to its end. Mr. Ramirez set the amount to be paid without input from either Univision or KXTN. This promotional work was not governed by his employment agreement with Univision. The charges for his services were included as a line item in Univision's monthly invoice to the sponsors.

Univision issued a Form W-2, *Wage and Tax Statement,* to Mr. Ramirez for 2007. It included both his regular wages and the $82,000 payment for talent and remote fees as compensation in box 1. On the Ramirez's 2007 Form 1040, all of the income was reported as wages on line 7. The return included a Schedule C, *Profit or Loss From Business,* on which Mr. Ramirez claimed $26,303 of expenses related to his promotional work for sponsors. A note on the Schedule C stated: "Note: W-2 gross includes freelance talent income of $82,000."

Issues. The issues in this case are as follows.

- Whether $82,000 in fees Juan Ramirez received in 2007 from Univision for off-air appearances and promotional services performed on behalf of sponsors were earned by him as an employee or as an independent contractor
- Whether expenses paid to earn the $82,000 in fees are Schedule C expenses or employee business expenses

Analysis. To determine whether an individual is an employee or independent contractor, the common law factors must be reviewed. All of the facts and circumstances are considered, and no one factor is determinative.[25] The following factors weighed in favor of classifying Mr. Ramirez as an independent contractor.

- **Degree of control.** Although Univision exercised some control over Mr. Ramirez, he was given wide latitude in programming his show. In addition, he acted outside the scope of his employment with Univision with respect to his promotional services.
- **Opportunity for profit and loss.** The amount that Mr. Ramirez earned was dependent on the satisfaction of his sponsors.
- **Right to discharge the worker**. With respect to the promotional sponsors, only his sponsors had the right to terminate their promotional relationship.
- **Integral part of the business.** Mr. Ramirez's promotional services to his sponsors were separate from the services he provided for Univision and KXTN.
- **Permanency of the relationship**. With respect to Mr. Ramirez's relationship with his sponsors, the number of sponsors varied over time and was based on the time and effort that he expended.

25. *Ewens & Miller. Inc. v. Comm'r,* 117 TC at 270 (2001).

- **The relationship the parties believed they created**. The evidence indicated that Mr. Ramirez, Univision, and the sponsors all believed that the relationship created was between Mr. Ramirez and his sponsors.
- **The provision of employee benefits**. Univision provided Mr. Ramirez with numerous employee benefits. These benefits accrued to him without regard to the number of his sponsors. The sponsors paid him a fee for his services, not employee benefits.

The court determined that the following factor was neutral.

- **Provision of facilities used**. Univision provided the facilities from which Mr. Ramirez broadcasted his program. However, he worked with sponsors and made off-air appearances at their facilities or at sites designated by them.

Holding. In this case, the evidence provided overwhelmingly pointed to the independent contractor status. The court determined that the $82,000 paid to Mr. Ramirez for talent and remote fees should have been reported as Schedule C gross receipts rather than wages. The court also ruled that the deductions on Schedule C for business expenses were properly reported.

Independent Contractor

***Mieczyslaw Kurek v. Comm'r,* TC Memo 2013-64 (Feb. 28, 2013)**

IRC §§3111, 3102, and 3402

☞ Construction Workers Classified as Employees

Facts. Mieczyslaw Kurek was the sole proprietor of KMA Construction. KMA specializes in home interior improvements such as kitchens, bathrooms, and floors. KMA also installs sheetrock, doors, windows, and engages in painting and carpentry.

In 2005, KMA had 20 to 30 projects in the Brooklyn, New York area. Although Kurek did some of the projects himself, he hired others to do most of the projects.

In 2005, KMA had 29 different workers. Some workers were used on only one job while others were used for multiple jobs. Kurek supervised the workers and set deadlines for their jobs. He paid each worker a flat fee, as negotiated for a particular job. He paid each worker weekly according to the percentage of the job the worker completed.

Kurek did not issue Forms 1099-MISC, *Miscellaneous Income,* or Forms W-2, *Wage and Tax Statement,* to any of the workers for tax year 2005. Likewise, he did not file any payroll tax returns or pay any employment taxes for 2005.

In September 2009, the IRS sent Kurek a notice of determination with respect to unpaid payroll taxes it assessed for the 2005 tax year.

Issues. The issues in this case are as follows.

- Whether the workers listed in the IRS's notice of determination should be classified as employees or independent contractors
- Whether Kurek is entitled to IRC §530 relief

Analysis. The IRS looks at seven factors in determining if a worker is an employee or an independent contractor. These factors and the court's ruling on each follow.

1. **Degree of control.** This is the crucial test used to determine the existence of an employer-employee relationship. Kurek failed to prove that he did not have control over the workers' hours. Although the workers set their own hours, Kurek set deadlines and monitored the work done. Kurek also had ultimate authority in instructing the workers about what they were to do, and he paid them weekly rather than at the end of the project. In this case, the factor weighed heavily in favor of classifying the workers as employees.

2. **Investment in facilities.** If workers furnish their own tools, this usually indicates an independent contractor status. In this case, the worker owned the small tools (usually valued at $1,000 or less), while Kurek furnished the large tools. Kurek did not provide any offices or other facilities to the workers. This factor weighed slightly in favor of classifying the workers as independent contractors.

3. **Opportunity for profit and risk of loss.** KMA paid the worker a negotiated flat fee. The worker did not have any opportunity to earn additional money if they were efficient or risk a loss if the project went over budget. This factor weighed in favor of classifying the workers as employees.

4. **Right to discharge the workers.** Employers typically have the right to terminate employees at any time. Kurek hired the workers on a project-by-project basis but could replace them at any time. This factor weighed in favor of classifying the workers as employees.

5. **Integral part of the business.** When workers are an essential part of normal business operations, this generally indicates an employee-employer relationship. Although Kurek did some projects himself, he could not have completed all of the projects without hiring other individuals. This factor weighed in favor of classifying the workers as employees.

6. **Permanency of the relationship.** A transitory work relationship may indicate independent contractor status. Kurek engaged the workers for only one project at a time, and they were free to work with other construction groups. This factor weighed slightly in favor of classifying the workers as independent contractors.

7. **Relationship the parties believed they created.** Both Kurek and one of his workers testified at trial that they believed an independent contractor relationship existed. This factor weighed in favor of classifying the workers as independent contractors.

After analyzing all of the factors, the court determined that the workers were employees for the 2005 tax year.

IRC §530 provides for relief from employment taxes even if the relationship between the principal and the worker otherwise required the payment of such taxes. IRC §530 relief is available only if the principal satisfies **all** of the following requirements.

1. The principal has not treated the worker as an employee for any period.

2. The principal consistently treated the worker as not being an employee on all tax returns for periods after 1978.

3. The principal had a reasonable basis for not treating the worker as an employee.

Kurek failed to meet the second requirement. Because he did not file Forms 1099-MISC, he failed to consistently treat the workers as independent contractors on his tax returns.

Holding. The court concluded that the workers listed in the notice of determination were Kurek's employees for the 2005 tax year and that Kurek does not qualify for §530 relief.

> **Note.** The IRS has reduced the requirements for firms to apply for the voluntary classification settlement program (VCSP). The VCSP provides partial relief from federal employment taxes for taxpayers who voluntarily reclassify their workers as employees for employment tax purposes for future tax periods. If accepted into the program, the taxpayer pays only 10% of the tax that would be due if the IRS determines the workers are employees. For more information, visit **www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Voluntary-Classification-Settlement-Program.**

ESTATE AND GIFT

Valuation

***Estate of James A. Elkins Jr. et al. v. Comm'r,* 140 TC No. 5 (Mar. 11, 2013)**
IRC §§2031 and 2703

☞ Court Allows 10% Valuation Discount for Artwork Collection

Facts. James Elkins and his wife purchased 64 works of art between 1970 and 1999. The collection consisted mainly of works of contemporary artists, including Pablo Picasso, Paul Cezanne, Jackson Pollock, and Henry Moore. These works have been primarily displayed in the family home, family office, and various other locations in both Houston and Galveston, Texas.

In July 1990, Mr. and Mrs. Elkins each created a grantor retained income trust (GRIT), which was funded by their undivided 50% interests in three of the works in the collection. Each trust was for a 10-year period and allowed the grantor the use of the transferred art interests. At the end of the 10-year period, the interests were to go to the Elkins' three children. When Mrs. Elkins died in May 1999, before the expiration of the 10-year period, her 50% undivided interests in the GRIT art passed to Mr. Elkins. Because Mr. Elkins survived the 10-year term of his GRIT, his original 50% interest passed to his three children in equal shares. Mr. Elkins retained the 50% interests in the GRIT art that he received upon Mrs. Elkins' death, which became part of his gross estate.

To allow Mr. Elkins to maintain possession of two of the works of art, a lease agreement was entered into with the amount of the rent remaining blank. The rent was not calculated until May 2006, when Deloitte LLP made a determination of the appropriate rental. This determination resulted in rent due of $841,688, which the estate sought to deduct. After examination, the parties agreed to reduce the rent to $10,000.

Under the terms of Mrs. Elkins' will, her 50% interest in the remaining 61 works of art passed outright to Mr. Elkins. Upon her death, he disclaimed a portion of those interests equal in value to the unused unified credit against estate tax (26.945% interest) so that the disclaimed portion could pass to the Elkins' children free of estate tax. He retained a 73.055% interest in each of the items.

After Mr. Elkins' death, a Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return,* was timely filed in May 2007. The return reported a federal estate tax liability of $102 million. **This estate tax return included $9.5 million for his 73.055% interest in 61 works of art and $2.7 million for his 50% interest in the three works of GRIT art.** These amounts were derived by determining Mr. Elkins' pro rata share of the fair market value (FMV) of the art, and then applying a 44.75% discount for lack of control and marketability. **The IRS challenged the valuations used, increasing them based on undiscounted FMVs of $18.4 million and $5.3 million, respectively.**

Issue. The issue in this case is to determine the total FMV of Mr. Elkins' undivided fractional interests in the 64 works of art, which is includable on the estate tax return.

Analysis. IRC §2031(a) provides: "The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated." IRC §2703(a) provides that the value of any property is determined without regard to any option, agreement, or other right to acquire or use the property at a price less than the FMV of the property.

The IRS argued that no discount from the pro rata market value of the decedent's interest in each of the 64 works of art was warranted based on two premises.

1. The restrictions on the sale in the cotenants' agreement and the art lease are restrictions that must be disregarded under IRC §2703(a)(2).
2. Because the proper market in which to determine the FMV of fractional interests in works of art is the retail market in which the entire work is commonly sold at full FMV, a fractional interest holder is not entitled to any discount.

Representatives of the estate argued that they fully supported the discounts asserted by providing evidence of facts that would be known to a hypothetical willing buyer and seller with reasonable knowledge of relevant facts, as required by Treas. Reg. §20.2031-1(b). They further argued that their expert's valuation fully takes into account the risks and impairments to value inherent in the options available to a hypothetical buyer. The court recognized that the Elkins children had strong sentimental and emotional ties to each of the works of art. Accordingly, the hypothetical seller and buyer would be faced with uncertainties regarding the hypothetical buyer's ability to monetize those interests on an undiscounted basis. As was the case in *Stone v. U.S.,*[26] some discount is appropriate to allow for such uncertainties. The court concluded that a hypothetical buyer and seller would agree to a 10% discount from pro-rata FMV; thus, a 10% discount would enable a hypothetical buyer to realize a reasonable profit on a resale of those interests to the Elkins children.

Holding. After reviewing all the information submitted by various experts, the court determined that a 10% discount is allowed in determining the value of the artwork collection for estate tax purposes.

Failure to File

***Margaret V. Stine v. U.S.,* U.S. Court of Federal Claims, No. 10-445 (Oct. 23, 2012)**
IRC §6651

☞ Temporary Health Issues Do Not Eliminate Penalties

Facts. In December 2006, Mrs. Stine gave her son $4 million. In January 2007, she gave cash gifts of $2 million to each of her two daughters. In April 2007, Mrs. Stine paid $1.83 million in federal gift taxes, largely due to the $4 million gift to her son. On March 13, 2008, her attorney sent her a letter asking her if she made any gifts in 2007 to individuals in excess of the $12,000 annual exclusion amount. This same letter also instructed her to review and execute two real estate deeds.

In early September 2008, she filed a Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return,* and the related payment for the 2007 gift taxes that should have been filed and paid by April 15, 2008. Mrs. Stine requested abatement of penalties based on her combination of acute but temporary health issues. The IRS denied her request for abatement and assessed penalty and interest totaling $471,500. Mrs. Stine appealed the decision but her appeal was denied. In late 2009, Mrs. Stine filed a request for refund but received no response from the IRS. She then filed a refund suit in July 2010.

Mrs. Stine provided information on her health events to support reasonable cause for late filing of her 2007 gift tax return. Mrs. Stine's health problems beginning in the fall of 2007 included pneumonia, recurring upper respiratory infections, knee replacement surgery, heart palpitations, a thyroid growth, and cataract surgery.

Issue. Whether Mrs. Stine's health excused her from timely filing a federal gift tax return and payment.

Analysis. IRC §6651(a)(2) allows for an addition to tax when a taxpayer fails to timely pay tax shown on a return unless it is shown that such failure is due to reasonable cause and not willful neglect. *U.S. v. Boyle,*[27] is the most prevalent case used to interpret the terms "reasonable cause" and "willful neglect." Both parties in this case relied heavily on *U.S. v. Boyle.* In addition, Mrs. Stine cited at least fourteen other cases where illness was found to have provided reasonable cause to eliminate the penalties on returns that were not timely filed.

Mrs. Stine alleged that she was incapacitated and unable to meet her obligation to timely file the gift tax return and payment by a series of adverse health events. However, the court noted that Mrs. Stine failed to provide evidence supporting **continuous** incapacity.

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26. *Stone v. U.S.*, 60 TC 540 (N.D. Cal. 2007).

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

The court also considered whether the financial transactions she accomplished during the same period show that she was **not incapacitated** at this time. During the period in question, she transferred real estate in Naples, Florida, and Annapolis, Maryland, to a revocable trust requiring her to review deeds, execute the deeds via a notary, and mail the completed documents to her tax attorney. She also executed an IRS form authorizing her tax attorneys to electronically submit payment for her 2007 federal taxes. She reviewed, signed, mailed, and paid her 2007 Connecticut income tax return and 2008 Connecticut estimated income tax payment by April 15, 2008. Mrs. Stine argued that these tasks were different than remembering and reporting two gifts of $2 million each for her two daughters that happened over one year earlier.

In *Williams v. Comm'r,*[28] the court determined that a taxpayer's serious illness must be of a duration that is commensurate with the failure to timely file a tax return. In this case, the court reasoned that if Mrs. Stine was in adequate health to respond to other reminders mentioned in the March 13, 2008 letter from her attorney, then she was in adequate health to respond to the gift tax obligation reminder as well. Even if her memory was failing, she had ready access to her broker, tax attorney, and daughters who were aware of the gifts.

Holding. Mrs. Stine was held liable for the late filing penalty for her 2007 federal gift tax return and payment.

Delinquent Estate Tax Return

***Peter Knappe et al. v. U.S.*, U.S. Court of Appeals, 9th Circuit; No. 10-56904 (Apr. 4, 2013)**
IRC §§6651 and 6075

☞ Accountant's Incorrect Advice to Executor Does Not Excuse Late Return

Facts. Ingborg Pattee died on November 30, 2005, and left a sizable estate. Her will named her longtime friend, Peter Knappe, as executor. Because he had no prior experience serving as an executor, Mr. Knappe enlisted the help of Francis Burns, a CPA who had worked as a corporate tax accountant for Mr. Knappe's company for many years. **The CPA correctly informed Mr. Knappe that the deadline to file the estate tax return was nine months from the date of death; thus, the return was due on August 30, 2006.**

Prior to the filing deadline, Mr. Knappe realized he needed a real estate appraisal and did not have time to obtain it. He asked Mr. Burns to file an extension**.** Accordingly, Mr. Burns applied for the 6-month automatic extension on August 30, 2006, using Form 4768, *Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer*) *Taxes.* **Mr. Burns incorrectly told Mr. Knappe that the estate tax return would be due in one year, or no later than August 30, 2007, even though the extension request was for only six months.**

Mr. Burns sent a copy of the extension to Mr. Knappe, but Mr. Knappe did not thoroughly review it. The IRS approved the extension request in writing on January 11, 2007. On the Form 4768, which the IRS returned to Mr. Burns, an IRS agent had handwritten "2/28/07" next to the box Mr. Burns had checked to apply for the automatic 6-month extension.

The estate tax return was filed on May 29, 2007, three months after the deadline. **The IRS assessed a 20% late-filing penalty of $196,415.** Mr. Knappe asked for an abatement of the penalty, claiming that his reliance on Mr. Burns's erroneous advice constituted a "reasonable cause" exception to the penalty.

The IRS denied the abatement request. Mr. Knappe appealed the IRS's decision, but the Appeals officer denied the appeal. Mr. Knappe then paid the penalty and sued for refund in U.S. District Court. **In May 2012, the district court sustained the imposition of the penalty but reduced it to 15%, or $147,311, based on the actual 3-month delinquency.** Mr. Knappe then appealed the district court decision to the circuit court.

Issue. The issue in this case is whether the estate is liable for the 15% penalty for filing the estate tax return three months after the extended due date.

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28. *Williams v. Comm'r,* 16 TC 893 (1951).

Analysis. The penalty can be waived if the failure to file is "due to reasonable cause and not due to willful neglect."[29] Mr. Knappe's argument for reasonable cause was his reliance on the CPA's erroneous advice. The Appeals Court cited the *Boyle* Supreme Court case in reaching its decision.[30] That case had similar facts to those in the case at hand.

The Appeals Court could find no reason why Mr. Knappe should not have understood the deadline. The court stated: "It was clear from the face of Form 4768, from the corresponding instructions, and from the governing statute that the maximum available extension of the filing deadline was six months."

Holding. The court sustained the 15% penalty.

> **Note.** The court's analysis is thorough and enlightening. It is not known whether Mr. Knappe brought suit against Mr. Burns for erroneous advice.

GROSS INCOME

Disability Benefits

***James and Mary Brady v. Comm'r,* TC Memo 2013-1 (Jan. 3, 2013)**
IRC §§86 and 6662

☞ Social Security Benefits Included As Taxable Income

Facts. In 2005, James Brady began collecting tax-free benefits from his Unum Corp. disability policy as a result of three hip surgeries and a knee replacement. As part of his contract with Unum, Mr. Brady was required to seek social security benefits if he became disabled. If he received social security benefits, this would lower the amount that Unum was required to pay him for disability benefits.

Mr. Brady was awarded social security benefits in 2008 that included benefits from the time he initially applied in 2005. He received a lump-sum payment of $76,350 (prior benefits from June 2005 through June 2008) and $10,742 in regular benefits. Pursuant to his agreement with Unum, Mr. Brady reimbursed Unum $73,042 in September 2008.

The Bradys only reported $14,050 of the social security benefits on their joint 2008 tax return, which was prepared by CPA and lawyer Ronald Krieger. They failed to report three taxable dividends (totaling $1,331) on the tax return as well.

The IRS determined that the Bradys should have reported the full amount of social security payments ($87,092) and additional dividend income of $1,331. It recommended a 20% accuracy-related penalty based on the understated income.

Issues. The issues in this case are as follows.

- Whether the Bradys are required to include all social security benefits received in 2008 in their taxable income
- Whether the Bradys are liable for the 20% accuracy-related penalty pursuant to IRC §6662(a)

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29. IRC §6651(a)(1).

30. *U.S. v. Boyle*, 469 U.S. 241, 249 n.8 (1985).

Analysis. IRC §86 provides that gross income includes up to 85% of social security benefits received during the tax year. At trial, the taxpayers argued that the social security benefits received in 2008 should be offset by the $73,042 they reimbursed to Unum. However, the law provides that **only repayments of social security benefits previously received may offset social security benefits.** Repayments of private insurance benefits cannot be used to offset social security benefits.[31] **A similar issue was addressed in *Seaver v. Comm'r,*[32]** in which the court held that when a recipient of social security benefits is **required by contract to reimburse a third party for tax-free benefits previously received, the recipient is not entitled to a deduction for the reimbursement.**

IRC §86(e) provides for an election with respect to the amount of a lump-sum payment of social security benefits in which a portion of the payment is attributable to previous years. Making the §86(e) election might have benefited the taxpayers and provided some degree of tax relief. However, although the taxpayers expressed an interest in this election, they did not provide the requisite tax returns for 2005 through 2007 nor did they refute the IRS's argument that a §86(e) election would not limit the Bradys' tax liability because of their income level in the previous years.

If a taxpayer can establish that they used reasonable cause for their return preparation or acted in good faith, the accuracy-related penalty will not be asserted. At trial, Mr. Brady testified that he forgot to give the Forms 1099-DIV to his accountant. Mr. Brady did, however, provide the accountant with all the documentation related to the amount of social security benefits received. The taxpayers relied on Mr. Krieger to accurately prepare their tax return.

Holding. Based on the same logic as found in *Seaver v. Comm'r,* the court held that the $73,042 in disputed social security benefits received must be included in the Bradys' taxable income. The taxpayers were held liable for the 20% accuracy-related penalty on the omitted dividend income but not the omitted social security benefits because they provided all the information to the accountant and relied on his advice.

> **Note.** For information about the IRC §86(e) election for lump-sum payment of social security benefits, see the 2012 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Social Security and Retirement Planning. IRS Pub. 915, *Social Security and Equivalent Railroad Retirement Benefits,* also contains a thorough explanation of this election.

Gross Income

***Raphael Dang-Quang Cung v. Comm'r,* TC Memo 2013-81 (Mar. 20, 2013)**
IRC §§61 and 6662

☞ Full Settlement Amount Determined Taxable Income

Facts. In September 2007, Raphael Cung found a "certified pre-owned" 2004 BMW convertible listed on **www.autotrader.com** for $36,864. He contacted the dealership to purchase the vehicle and was told that the $36,864 sales price was a mistake. The actual sales price was $56,000. Cung demanded that he be allowed to buy the car for the stated Internet price but the dealership refused.

Cung sued the dealership and settled for $17,000 in July 2008. The $17,000 check was issued to Cung's attorney. The attorney kept $2,000 and wrote Cung a check for $15,000. The attorney issued a Form 1099-MISC, *Miscellaneous Income,* which reported $15,000 as nonemployee compensation.

Cung did some limited research and determined that the settlement he received was nontaxable. He did not provide the Form 1099-MISC to his tax return preparer so the amount was **not** included as income on his return.

31. IRC §86(d)(2)(A).

32. *Seaver v. Comm'r,* TC Memo 2009-270 (Nov. 25, 2009).

The IRS issued a notice of deficiency, on which the $15,000 was asserted as income. The IRS also assessed an accuracy-related penalty. The IRS later increased the income by $2,000 to reflect the amount paid to the attorney.

Issues. The issues in this case are as follows.

- Whether Cung may exclude from gross income $17,000 received from a lawsuit settlement
- Whether Cung is liable for the accuracy-related penalty under IRC §6662

Analysis. Cung argued that the settlement proceeds represented lost value or a constructive reduction of the improperly asserted price of the car. In this suit, Cung sought specific performance, compensatory damages, and punitive damages. Unfortunately for him, **the settlement agreement was silent as to the allocation of the award.** Accordingly, Cung was unable to carry his burden of proof that the settlement proceeds represent "lost value." Additionally, Cung never purchased the car, so there was no sale or exchange. Because he could not carry his burden of proof, the court agreed with the IRS that the proceeds are taxable as ordinary income.

The accuracy-related penalty was assessed based on the deficiency determined by the IRS. At trial, Cung made no attempt to show that the unreported amount was due to reasonable cause. He stated that he received multiple Forms 1099 from banks and he gave them to his return preparer. **He did not remember giving the preparer the Form 1099 for the settlement, but he testified that he probably did not.**

Holding. The court held that the entire $17,000 was taxable income. Because Cung **did not establish reasonable cause,** the accuracy-related penalty was sustained.

Gross Income

***Kenneth Michael Francis and Sedef Tarlan Francis v. Comm'r,* TC Summ. Op. 2012-79 (Aug. 8, 2012)**
IRC §§451, 6662, and 6664

☞ Lump-Sum Back Pay Award Taxable in Year Received

Facts. As the result of a wrongfully denied promotion by the U.S. Air Force, California resident Kenneth Francis received $24,566 in back pay. The award was granted in 2005 but the back pay was not paid until 2008. When Mr. Francis prepared the 2008 joint federal return in February 2009, he did not include the back pay in income.

Defense Finance and Accounting Service (DFAS) sent a letter dated September 6, 2008, to Mr. Francis providing him with a Form W-2 and information stating that the taxable back pay income must be reported on his tax return. The letter was sent to his mother's Illinois address, which was listed as his "permanent home of record." Mr. Francis did not physically receive the letter until April 2009.

In April 2009, Mr. Francis began treatment for melanoma and remained in treatment for the next year. Mr. and Mrs. Francis did not file an amended return to include the back pay award after they received the DFAS letter.

The IRS determined that the back pay should have been included in income and made an adjustment accordingly. An accuracy-related penalty was also assessed.

Issues. The issues in this case are as follows.

- Whether Mr. and Mrs. Francis are required to include the back pay award in their gross income for 2008
- Whether they are liable for the 20% accuracy-related penalty pursuant to IRC §6662(a)

Analysis. IRC §61 provides that gross income includes income from whatever source derived, including compensation for services.

At trial, Mr. Francis testified that they did not receive the DFAS letter until April 2009 because the letter had been mailed to his mother's address in Illinois. He also argued that the promotion back pay received in 2008 should be included in their gross income for the years 1998 through 2002 because the promotion was attributable to the services he provided in those years. Lumping the entire amount in income in one year placed an **artificial tax burden on them.** However, similar arguments had been rejected by the court in the past.[33] The promotion back pay **cannot be reallocated to prior years** simply because doing so might provide favorable tax treatment for the taxpayers.

The taxpayers believe that they should not be held liable for the accuracy-related penalty. Although they received the back pay in 2008, they thought it was nontaxable income. They did not consult a tax professional or take any other reasonable steps to ascertain the proper tax treatment of the back pay income. They did admit that they should have filed an amended return once they received the DFAS letter but they felt that the yearlong treatment for melanoma was reasonable cause for not filing an amended return. They did not provide any explanation for not filing an amended return once the melanoma treatment ended.

Holding. The court determined that the entire amount of back pay was taxable income in 2008. The accuracy-related penalty was sustained because **reasonable cause was not established.**

Taxable Income
***Sergio Garcia v. Comm'r,* 140 TC No. 6 (Mar. 14, 2013)**
IRC §61

☞ Global Icon Faces Taxation Challenges

Facts. Sergio Garcia, a professional golfer, entered into a 7-year endorsement agreement with TaylorMade under which he would become a TaylorMade "Global Icon" from January 1, 2003, through December 31, 2009. As part of this agreement, he was required to wear and use golf products produced by TaylorMade and associated brands (Adidas and Maxfli). Various penalties were also included in the agreement for not fulfilling his obligations.

Garcia's base remuneration for 2003–2005 was $7 million. His base remuneration for years after 2005 depended on what world ranking he achieved and how well the TaylorMade products sold. **The original agreement did not specify the percentage** of the remuneration attributable to his **personal services** versus his **image rights.**

In addition, Garcia also formed two limited liability companies (LLCs): Long Drive, LLC (formed in Switzerland) and Even Par, LLC (formed in Delaware and taxed as a U.S. partnership), of which he owned 99.5% and 99.8%, respectively. Garcia sold his image rights licensed by TaylorMade to these corporations. As a result, U.S. royalty payments would not be taxed in the United States but instead would be subject to a lower rate under Swiss law.

In 2003, a dispute arose between Garcia and TaylorMade regarding the Maxfli brand of golf balls he was required to use. Garcia felt the balls were not suitable for his use and began using a competitor's brand. Two amendments were then made to the original endorsement. The **first amendment** had the following provisions.

- Reduced Garcia's base pay in 2003 from $7 million to $4 million
- Reduced base remuneration by one-seventh for each later year in which he failed to use a Maxfli ball for the entirety of the year in all golfing activities
- Changed the bonus remuneration by adding a penalty if Garcia won a major tournament during 2003 but did not use a Maxfli ball
- Division of payments would be 15% for personal services (paid to Garcia) and 85% for image rights (paid to Even Par)
- Specified that Garcia would be available for two product-testing days each year of the contract

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[33] See *Prewitt v. Comm'r,* TC Memo 1995-24 (Jan. 18, 1995).

The **second amendment** had the following provisions.

- Reduced 2004 and 2005 base remuneration from $7 million to $4.5 million and $5.5 million, respectively
- Further reduced base remuneration in 2005 to $4.75 million if Garcia failed to use a Maxfli ball in all golfing activities during that year
- Added an alternative base remuneration calculation for 2004 and 2005 should Garcia finish in the top 10 of the world golf rankings

On the Forms 1040-NR, *U.S. Nonresident Alien Income Tax Return,* that Garcia filed for 2003 and 2004, he reported a portion of the personal service payments as his U.S.-source income effectively connected with the conduct of a trade or business within the United States. None of the royalty payments made to Even Par were reported. Even Par filed partnership returns that reported only gross royalty income and matching royalty expenses, thereby leaving no taxable income. Even Par's returns stated that the royalty payments were taxable only under Swiss law.

The IRS issued notice of deficiencies to Garcia for 2003 and 2004 for $930,248 and $789,518, respectively.

Issues. The issues the court addressed in this case are as follows.

- The extent to which payments made by TaylorMade under the endorsement arrangement are compensation for personal services and the extent to which the payments are royalties for the use of Garcia's image rights
- Whether the U.S.-source royalty compensation and a portion of the U.S.-source personal service compensation are taxable to Garcia in the United States

Analysis. Prior to trial, the parties stipulated that during 2003 and 2004, 69% and 68% of Garcia's personal service income was derived from sources within the United States. With respect to the allocation of income, Garcia argued that the court should respect the allocation of 85% to royalty payments and 15% for personal service payments as found in the first amendment to the endorsement agreement. At trial, four expert reports on the allocation issue were presented. After considering all four reports as well as *Goosen v. Comm'r,*[34] the court determined that 65% of the endorsement fees is royalty compensation and 35% is personal services compensation.

The next issue is how much of Garcia's TaylorMade endorsement income is taxable to him in the United States under the Swiss Tax Treaty. During the relevant time period, Garcia was a Spanish citizen residing in Switzerland. After reviewing the application articles under the Swiss tax treaty and other pertinent information, the court determined that the income Garcia received from TaylorMade was royalty income not taxable in the United States.

In his opening brief, Garcia raised the issue that a portion of his U.S.-source personal service income might not be taxable in the United States. The court determined that by raising the issue in the manner he did, Garcia did not allow the IRS to introduce testimony and/or other evidence that could have supported the position that all U.S.-source income was taxable in the United States. **Accordingly, the court determined the issue was raised too late and did not consider it.**

Holding. The court held that the compensation paid by TaylorMade under the endorsement agreement is allocated 65% to royalties and 35% to personal services. The court further held that **none** of the royalty compensation is taxable to petitioner in the United States but that **all** of the U.S.-source personal service compensation is taxable to petitioner in the United States.

34. *Goosen v. Comm'r,* 136 TC 547 (2011).

Unreported Income

***Bruce and Sherilyn Gunkle v. Comm'r,* TC Memo 2012-305 (Nov. 1, 2012)**

IRC §§170, 501(c)(3), and 6662

☞ Vow of Poverty Does Not Eliminate Gross Income

Facts. Bruce and Sherilyn Gunkle, Texas residents, served as pastors for the City of Refuge Christian Fellowship, Inc. The City of Refuge Christian Fellowship, Inc. (City of Refuge, Inc,) was formed as a nonprofit corporation and was granted exempt status by the IRS under IRC §501(c)(3) in 1990.

In March 2004, the Gunkles each signed a **"vow of poverty"** document. The City of Refuge Christian Fellowship resolved to provide all their needs as pastors of the church. In April 2004, The City of Refuge, Inc. was **dissolved**. The IRS later notified the City of Refuge, Inc. that its §501(c)(3) status was terminated and contributions to it were no longer tax deductible.

During 2007, monies were deposited into the City of Refuge Christian Fellowship pastoral expense account, which included payments by church members and nonmembers as well as social security payments for Bruce Gunkle. All withdrawals from the account were made by either Bruce or Sherilyn. The funds were used to purchase groceries, make car and truck payments for vehicles personally owned by the Gunkles, and pay various personal expenses (mortgage payments, utility payments, vehicle expenses, and living expenses).

Sherilyn had a separate account at Randolph Brooks Federal Credit Union (RBFCU). Deposits into RBFCU came from transfers from the pastoral account, cash, and dividends earned on the account.

On their joint tax return for 2007, the Gunkles reported $36,993 as wages, which was actually Bruce Gunkle's military pension. They also reported $14,466 of social security benefits ($4,637 of which were taxable). They claimed charitable deductions totaling $13,917, of which $8,926 were contributions to City of Refuge Christian Fellowship.

The IRS examined the various bank accounts and determined that the Gunkles had unreported income of $62,457 from the pastoral account and RBFCU account. In addition, the IRS disallowed all charitable contributions and adjusted the taxable social security benefits to reflect the increased income. An IRC §6662(a) accuracy-related penalty was also assessed.

Issues. The issues in this case are as follows.

- Whether the Gunkles underreported their 2007 taxable income by $62,457
- Whether the Gunkles are entitled to charitable contribution deductions as shown on the originally filed return
- Whether the Gunkles are liable for the accuracy-related penalty

Analysis. At trial, the Gunkles argued that the deposits into the pastoral account were nontaxable gifts by various donors to the City of Refuge Christian Fellowship and that their vows of poverty insulate them from taxation on the compensation received for their church services. However, the court had previously held in other cases that deposits made into the account of a purported church were includable in the taxpayers' gross income when the taxpayers were the owners of the bank accounts, exercised complete control over the funds in the accounts, and used those funds for personal expenditures. In the Gunkles' case, the payment of their personal living expenses from funds of the City of Refuge Christian Fellowship was, by agreement in the vows of poverty, in exchange for services they performed as pastors. **Thus, the payment of their personal expenses was compensation they received.**

In addition, although the Gunkles claimed to be members of a religious order, they produced no evidence that the City of Refuge Christian Fellowship has any characteristics of a religious order. Therefore, they are not entitled to rules applicable to payment of expenses on behalf of members of a religious order. Accordingly, the court determined that the $62,457 was additional income to the Gunkles.

IRC §170 allows a deduction for contributions to qualified charitable organizations. The Gunkles gave contributions to City of Refuge Christian Fellowship, John P. Kelly Ministries, Inc, and International Christian Wealthbuilders Foundation. **The contributions to City of Refuge Christian Fellowship were determined not to be deductible because the Gunkles did not give up control over those monies.** In addition, the Gunkles did not establish that either John P. Kelly Ministries, Inc., or International Christian Wealthbuilders Foundation were qualified charitable organizations.

At trial, the Gunkles did not address the reasonable cause or good-faith defenses to refute the accuracy-related penalty.

Holding. The court determined that the Gunkles had unreported income of $62,457, disallowed all the charitable contributions, and sustained the accuracy-related penalty.

International Income

***William and Yen-Ling Rogers v. Comm'r,* TC Memo 2013-77 (Mar. 13, 2013)**
IRC §§911 and 6662

☞ Income Earned in U.S. and International Airspace is Includable in Income

Facts. Yen-Ling Rogers, a **U.S. citizen** and a bona fide resident of Hong Kong, worked as a flight attendant for United Airlines on international flights out of the Hong Kong International Airport. In addition to serving as a flight attendant, she also performed preboarding and postarrival services on every flight she worked.

For 2007, Mrs. Rogers' Form W-2 showed $41,762 of wages. On the Rogers' self-prepared joint tax return, 100% of her wages from United was excluded from income. On Form 2555-EZ, *Foreign Earned Income Exclusion,* they reported the entire $41,762 as foreign earned income. The same amount was shown as their foreign earned income exclusion.

The IRS sent a notice of deficiency to the Rogers, which stated that they could not exclude the entire amount of the United compensation that Mrs. Rogers received for flight time over international waters. An accuracy-related penalty was also assessed.

Issues. The issues in this case are as follows.

- Whether the Rogers may exclude from gross income the total wages earned from United Airlines
- Whether the Rogers are liable for an accuracy-related penalty under IRC §6662

Analysis. IRC §61(a) provides that all income from whatever source derived is includable in gross income unless a specific exclusion applies. Subject to certain limitations, a taxpayer may elect to exclude their foreign earned income from gross income. Foreign earned income is defined as "the amount received by such individual from sources within a foreign country or countries which constitute earned income attributable to services performed by such individual."[35] **As determined in the Rogers' previous Tax Court case,[36] a U.S. taxpayer is allowed the foreign earned income exclusion only with respect to wages earned while in or over foreign countries and not for wages earned in international airspace or in or over the United States.**

For the year at issue in this case, the Rogers argued that wages allocable to her nonflight time should be considered 100% foreign earned income. The IRS countered that Mrs. Rogers' wages should be allocated in proportion to her flight time because her earnings were inextricably based on her flight time services. The court noted that under an agreement between United and its flight attendants, Mrs. Rogers accrued nonflight benefits, such as sick and vacation hours, based on the period of her flight attendant service. The agreement also compensated her for additional categories, such as required training and meetings and the performance incentive program. The court concluded that there was no rational basis for allocating these forms of compensation entirely to foreign earned income.

35. IRC §911(b)(1)(A).

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

The accuracy-related penalty was assessed for 2007 based on the deficiency determined by the IRS. At trial, the Rogers stated that at the time they prepared their 2007 return, Mrs. Rogers had been unable to obtain her actual flight times. She believed that the IRS would not accept estimates. However, they did not seek competent professional advice nor did they have reasonable cause for excluding all of her income from taxation.

Holding. **The court held that only a portion of Mrs. Rogers' wages qualified as foreign earned income.** The court also ruled that the Rogers are liable for an accuracy-related penalty.

Disability Benefits

Ronald Moore and Debra Clayton-Moore v. Comm'r, **TC Memo 2012-249 (Aug. 28, 2012)**
IRC §§86 and 104

☞ Social Security Disability Benefits Include Worker's Compensation Payments

Facts. In 2009, Debra Clayton-Moore received both Ohio worker's compensation benefits as well as social security disability benefits. The information reporting document provided to Mrs. Moore by the Social Security Administration showed that she received disability benefits totaling $11,947, as follows.

Benefits paid by check	$5,844
Medicare Part B premiums	1,388
Worker's compensation offset	4,715

The Moores only reported $5,844 of the social security disability benefits on their joint 2009 tax return. The IRS determined that the full amount ($11,947) should have been reported, of which 85% was taxable income.

Issue. Whether the Moore's 2009 social security disability benefits should be increased by $6,103

Analysis. IRC §86 provides for the inclusion of social security benefits received by the taxpayer as a monthly benefit under the Social Security Act. IRC §86(d)(3) provides that if the social security benefit is reduced by a worker's compensation benefit, the social security benefit includes the portion of the worker's compensation benefit attributable to the reduction.

At trial, the taxpayers argued that including the amount of Ohio worker's compensation benefits in their taxable social security disability benefits is unfair because worker's compensation benefits are otherwise not taxable. They also argued that in their prior 2005 tax case involving social security disability benefits, the judge suggested a different result. Their 2005 tax case was resolved by a stipulated decision without an opinion of the Tax Court, which has no bearing on the case at hand.

Holding. The Tax Court held the taxpayers liable for taxes on 85% of the full amount ($11,947) of social security disability benefits received.

INNOCENT SPOUSE

Equitable Relief

Kenneth Jorgenson v. Comm'r, **TC Summ. Op. 2013-10 (Feb. 11, 2013)**
IRC §6015

☞ Facts Do not Support Innocent Spouse Relief

Facts. Kenneth and Elizabeth Jorgenson resided in a home that she owns. Their daughter and the daughter's three adult sons also resided in the home.

Mr. Jorgenson worked as a full-time employee at a civil engineering firm for 47 years until he retired in 2004. At the time he retired, he was earning $12 per hour.

On April 15, 2009, the Jorgensons met with their preparer to review and sign their 2008 joint tax return. During this meeting, Mr. Jorgenson learned that Mrs. Jorgenson had withdrawn over $200,000 from various retirement accounts, resulting in a balance due on the return of over $39,000. She believed that there had been sufficient tax withheld to cover the taxes due. To make matters worse, she spent all the monies she withdrew from the retirement accounts on their daughter's medical bills and other expenses and their grandsons' legal bills.

Mr. Jorgenson signed the joint return despite his anger that his wife did not have the money to pay the balance due. The return was then filed with the IRS. A short time later, Kenneth had second thoughts and contacted the IRS to see if he could file a separate return. The IRS told him that he could not file a separate return.

Kenneth filed Form 8857, *Request for Innocent Spouse Relief,* in February 2010, to request innocent spouse relief for the 2008 tax return. He reported monthly income and expenses of $1,760 and $2,040, respectively.

For the 2009, 2010, and 2011 tax years, he filed separate returns, reporting total pension and social security income of $60,073, $39,726, and $44,898, respectively.

The IRS denied the request for 2008 relief. Mr. Jorgenson petitioned the court, challenging the determination.

Issue. Whether Mr. Jorgenson is entitled to relief from joint and several liability under IRC §6015(f) with respect to the 2008 federal income tax liability

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

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

Following is the court's conclusion for these factors.

1. The marital status factor is **neutral** because the Jorgensons remain married and were never separated.
2. The economic hardship factor **weighs against** relief because Mr. Jorgenson currently has a substantial amount of monthly income over and above his monthly expenses.
3. The knowledge factor **weighs against** relief because Mr. Jorgenson had knowledge or reason to know that Mrs. Jorgenson would not pay the tax liability. He had the option of not filing a joint return but did so anyway.
4. The legal obligation factor **is neutral** because they were not divorced and he did not have a legal obligation to pay the outstanding tax liability pursuant to a divorce decree or agreement.
5. The significant benefit factor **weighs in favor** of relief because Mr. Jorgenson did not obtain a significant benefit from the unpaid tax liability. The funds were used to pay their daughter's medical bills and their grandsons' legal bills.
6. The compliance factor **weighs in favor** of relief because Mr. Jorgenson's tax compliance has been perfect since tax year 2009 when he began filing separate tax returns.
7. The abuse factor **is neutral** because no evidence was provided to substantiate that Mrs. Jorgenson had abused Mr. Jorgenson at any time.
8. The mental or physical health factor **is neutral** because Mr. Jorgenson was not in poor mental or physical health at the relevant times.

Holding. Based on the facts presented, the court concluded that Mr. Jorgenson did not satisfy the safe harbor requirements of Rev. Proc. 2003-61, and it would be inequitable to allow him spousal relief considering all the facts and circumstances. Accordingly, the liability for the 2008 taxes is sustained.

IRS PROCEDURES — PAYMENTS

Failure to File

Blonde Grayson Hall and Neal Hall v. Comm'r, **TC Memo 2013-93 (Apr. 4, 2013)**
IRC §§6320, 6321, 6330, and 7203

☞ Tax Court Determines that Taxpayer Did Not Sign Agreement Under Duress

Facts. Blonde Grayson Hall was an attorney. In 2002, the IRS began a criminal investigation of Ms. Hall for failing to file federal income tax returns since 1995. In 2006, Ms. Hall and her husband were convicted of willful failure to file tax returns. Pursuant to a plea agreement, they pled guilty to three counts of willful failure under IRC §7203. As part of the agreement, Ms. Hall agreed to sign Forms 4549, *Income Tax Examination Changes,* for the years 1997 through 2005 prior to her sentencing.

A part of Form 4549 states: "Consent to Assessment and Collection — I do not wish to exercise my appeal rights with the Internal Revenue Service or to contest in the United States Tax Court the findings in this report. Therefore, I give my consent to the immediate assessment and collection of any increase in tax and penalties, and accept any decrease in tax and penalties shown above, plus additional interest as provided by law."

Before accepting the guilty plea, the district court was required to determine that the guilty plea and plea agreement were voluntary. Under oath, Ms. Hall testified that she had **practiced law for approximately 24 years** and that she understood that she did not have to plead guilty but was doing so voluntarily because she thought it was in her own best interest to do so. She also testified that no one had made any threat to her to convince her to plead guilty.

In August 2006, Ms. Hall made payments for her tax deficiencies for the 1998–2001 tax years. However, she did not make any payments for the interest and penalties that had been assessed by the IRS.

The IRS issued a first notice of determination dated September 23, 2008, which stated that Ms. Hall owed $322,635 for the 1998–2001 tax years. After receiving the notice, Ms. Hall raised the issue that the agreement she signed for the years 1998 through 2001 was signed under duress, which allowed her to contest the liabilities. The IRS subsequently issued a supplemental notice of determination, which stated that Ms. Hall did not sign the Form 4549 under duress and sustained the notice of federal tax lien.

Issue. The issue in this case is whether Ms. Hall should be relieved of her agreement because it was signed under duress.

Analysis. The courts have held that **duress does not exist** when the IRS threatens to take legally authorized action if a taxpayer does not sign Form 4549.[37] Ms. Hall did not present any evidence that the IRS's efforts went beyond those allowed by law. In fact, substantial evidence was presented that showed that her decision to sign the Form 4549, as part of her plea agreement, was voluntary.

Holding. The court found Ms. Hall's **arguments either irrelevant or without merit.** Accordingly, she was not relieved of her tax obligations under the agreement.

Installment Agreement

***George Thompson v. Comm'r,* 140 TC No. 4 (Mar. 4, 2013)**
IRC §§6320, 6330, 6159, 6331, and 6672

☞ IRS Classifies Tithing and College Expenses as Conditional Expenses

Facts. George Thompson was the president of Compliance Innovations, Inc. The IRS assessed trust fund recovery penalties against Mr. Thompson with respect to employment tax liabilities owed by Compliance Innovations. He completed and filed Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals.* At the time of filing, he was married and had five children, two of whom were in college. Mr. Thompson regularly contributed 10% of his monthly income to his church.

In addition, Mr. and Mrs. Thompson had outstanding tax liabilities of $731,451 for unpaid individual taxes, penalties, and interest. He had previously filed for a partial payment installment agreement for these liabilities, and it was granted by the IRS. However, when reviewing the request for the partial pay installment agreement for the trust fund penalty, **the IRS found that the Thompsons had defaulted on the prior agreement.**

Due to the default, the IRS denied the installment request. The taxpayer then filed an appeal. The settlement officer requested that the taxpayer file a new Form 433-A for the combined liabilities.

Mr. Thompson submitted a new Form 433-A, showing monthly income of $27,633 ($331,596 annual income) and monthly expenses of $24,416. The monthly expenses included $2,110 for church tithing, $232 for church service expenses, and $2,952 for college expenses. The Thompsons requested a $3,000 per month installment payment.

The settlement officer disallowed the charitable and college expenses as not being "necessary" expenses. The settlement officer also pointed out that the taxpayers would need 24 years to repay their obligation even if no interest was accrued. Next, the IRS placed a lien on the Thompson's property.

Issue. Whether it was an abuse of discretion for the IRS settlement officer to reject the taxpayer's contention that **tithing to his church and payments for his children's college expenses should be excluded** from the monthly amount available to satisfy his unpaid tax liabilities.

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37. See *Shireman v. Comm'r,* TC Memo 2004-155 (citing *Ballard v. Comm'r,* TC Memo 1987-471, *aff'd* without published opinion, 851 F.2d 359 (5th Cir. 1988)).

Analysis. If a person fails to pay their tax liability within 10 days after notice and demand for payment, the IRS is allowed to collect the tax by levy under IRC §6331(a). Under IRC §6321, if the person neglects or refuses to pay, the IRS is allowed to place a lien on the property.

In evaluating a taxpayer's ability to pay, the IRS classifies a taxpayer's expenses into two categories: necessary expenses and conditional expenses.[38] "Necessary" expenses establish the minimum a taxpayer and family need to live. If a taxpayer requests a partial payment installment agreement, the taxpayer is only allowed necessary expenses.

In regards to the tithing, the issue involves whether the taxpayer's asserted religious obligation trumps his obligation to pay substantial amounts of delinquent penalties and taxes in a reasonable manner. Mr. Thompson introduced as evidence a biblical passage from the Old Testament to support his position (Malachi 3:8-10). The court then cited a different passage: "Render therefore to Caesar the things that are Caesar's, and to God the things that are God's" (Matthew 22:21). The judge stated that this presents a dilemma of determining which things fall into the two respective categories. **The judge noted that the court may be incapable of determining what belongs to God, but he believes he can and must decide what belongs to Caesar.** Therefore, the court used the latter approach based on existing procedures and precedents.

The taxpayer argued that it was an abuse of discretion to not allow the children's college expenses as a necessary expense. The court noted that this issue is addressed in the Internal Revenue Manual, where it states that college and education expenses are allowable if the taxpayer can pay the tax liability plus accruals within five years. Otherwise, the expenses are not allowable.[39]

Holding. The court held that proceeding with collection was not an abuse of the IRS's discretion and the proposed collection action is sustained.

IRS PROCEDURES — PENALTIES

Trust Fund Recovery Penalty

***Charles B. Erwin v. U.S. et al.,* No. 1:06-cv-00059; U.S. District Court for the Middle District of North Carolina (Feb. 5, 2013)**
IRC §§3102, 6672, and 7501

☞ Accountants Liable for Trust Fund Recovery Penalties

Facts. In 1998, William Pintner hired Buddy Light Accounting & Tax Services to manage payroll and accounts payable, calculate employee withholding tax liability, prepare Forms 941, and make federal withholding tax deposits for GC Affordable Dining (GCAD). Buddy and Barry Light (collectively, the Light brothers) performed the duties as requested and also wrote the payroll checks on behalf of GCAD, using a stamp bearing Mr. Pintner's signature.

When the arrangement originally started, GCAD had the means to fund the electronic transfers for the federal withholding taxes. Later in the summer of 1998, GCAD began experiencing financial problems. From the fourth quarter of 1998 through the third quarter of 1999, some or all of GCAD's federal withholding taxes were unpaid. The Light brothers kept GCAD personnel (Charles Erwin, Stephen Coggin, and William Pintner) informed. Despite planning efforts suggested by Buddy, the Light brothers were instructed to continue paying the employees along with certain vendors. Payments were also made to Erwin, Pintner, Coggin, and the Light brothers during the time period when GCAD owed federal withholding taxes. The Light brothers complied with these instructions.

The IRS recommended that trust fund recovery penalties be assessed against both Barry and Buddy Light.

38. *Pixley v. Comm'r,* 123 TC 269, 272 (2004); IRM 5.14.2.1.1(4) (Sep. 26, 2008).

39. IRM 5.15.1-1 Q&A (2).

Issue. Whether the **Light brothers are responsible persons** with respect to trust fund recovery penalties.

Analysis. Employers are required to withhold certain taxes from their employees' wages and pay over the withheld sums to the government. These withheld amounts are referred to as "trust fund taxes." Under IRC §6672, if an employer withholds the trust fund taxes but does not remit them to the government, personal liability can be imposed for the amount of taxes owed on the officers or employees who were responsible for collecting and remitting the payroll taxes but who willfully failed to do so.[40]

The courts look to various factors in determining who is a **"responsible person"** with respect to the trust fund recovery penalty. All of these factors point to whether the person has the **"effective power"** to pay the taxes — that is, whether the person had the actual authority or ability, in view of their status within the corporation, to pay the taxes owed. In this case, the undisputed facts demonstrate that the Light brothers are responsible persons for §6672 purposes. Even though they were not officers or directors of GCAD, they clearly had substantial control over GCAD's payroll operations. They also had the authority and responsibility to write and issue checks on behalf of GCAD. Although neither of the Light brothers signed their own names to any GCAD checks, they were granted exclusive custody of Pintner's signature stamp and were authorized to use the stamp without express limitation.

The next question the court addressed is whether the Light brothers willfully failed to pay over the trust fund taxes. The Light brothers were the first to know about the federal withholding taxes. In addition, they were aware that taxes were due and owing and still issued thousands of checks to GCAD employees; Buddy Light Accounting; various vendors and creditors; and to Pintner, Erwin, and Coggin as they requested. **The issuance of these checks indicates that they intentionally preferred other creditors over the United States, thus establishing the willfulness aspect.**

Holding. The court held that the Light brothers were jointly and severally liable to the United States for the deficiency, plus interest and all statutory additions provided by law.

Substantial Understatement Penalty

John Mayer Jr. and Kerry Mayer v. Comm'r, **TC Summ. Op. 2013-39 (May 21, 2013)**
IRC §§72(t) and 6662

☞ Hardship Withdrawal Results in Penalty

Facts. John and Kerry Mayer, Illinois residents, ran into financial trouble in October 2009. Mr. Mayer emailed the co-trustee of his employer's retirement plan requesting general information regarding **hardship withdrawals** from the plan. The information received indicated that all 401(k) hardship withdrawals are subject to income taxes as well as an **additional 10% penalty.**

Mr. Mayer requested a distribution totaling $67,257. Mr. Mayer emailed the co-trustee asking what the final check amount would be and if he would have to pay the final 10% penalty himself. The response indicated that the check amount would be $53,806 but did not address his question about the penalty. He received a check for $53,806, net of the required 20% tax withholding.

Mr. Mayer received a 2009 Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* that showed a gross distribution of $67,257 and federal income tax withholding of $13,451. The code entered in box 7 of the Form 1099-R properly indicated that the amount was an "early distribution."

40. *Newbill v. U.S.,* 441 Fed. App'x 184, 187 (4th Cir. 2011).

After consulting with their tax preparer, Mrs. Mayer indicated that she believed the hardship withdrawal was **not subject to the 10% additional tax**. Based on this discussion, Mr. Mayer again emailed the co-trustee to determine whether the Form 1099-R that was originally issued was correct. After he received an email stating that it **was** correct, he relayed this information to Mrs. Mayer.

The Mayers' 2009 return was prepared without including the additional 10% early withdrawal penalty. When Mrs. Mayer went to review the return and pick up the paperwork, she did not tell the preparer about the email they had recently received. The preparer then electronically filed the return.

The IRS determined that the Mayers were liable for both a 10% early withdrawal penalty as well as a substantial understatement penalty. Prior to trial, the Mayers agreed that they owed the additional 10% early withdrawal penalty.

Issue. The issue addressed in this case is whether the Mayers are liable for a substantial understatement penalty.

Analysis. Under IRC §6662, an accuracy-related penalty of 20% is imposed on a substantial understatement of income tax. A **substantial understatement** is one that exceeds the greater of $5,000 or 10% of the amount of tax required to be shown on the return. The Mayers' understatement exceeded both of these amounts. At trial, Mr. Mayer stated that he met with a plan co-trustee and the plan investment broker in October 2009. The investment broker allegedly told Mr. Mayer that the 10% early withdrawal penalty could be avoided if he submitted paperwork from his mortgage provider indicating that foreclosure on their home could result from their current financial situation. The investment broker testified that no such meeting ever took place. The plan co-trustee also indicated that no paperwork was ever provided by Mr. Mayer. In addition, the record clearly indicated that, on more than one occasion, the Mayers were informed that the hardship withdrawal was likely subject to the 10% early withdrawal penalty.

Holding. The court determined that the Mayers did not meet their burden of proof with respect to reasonable cause and good faith. The accuracy-related penalty for substantial understatement was sustained.

Failure-to-File Penalty

Anthony Tesoriero v. Comm'r, **TC Memo 2012-261 (Sep. 11, 2012)**
IRC §6651

☞ Reliance on Accountant Does Not Relieve Penalty

Facts. Anthony Tesoriero hired Jack M. Portney and his CPA firm to prepare his 2004 tax return. Mr. Portney's general practice was to file a Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return,* each year for Anthony and Eleanor Tesoriero. The 2004 Form 4868 showed an estimated tax liability of $69,992, which was determined solely based on the estimated taxes paid by Mr. Tesoriero. Mr. Portney did not ask the Tesorieros to provide information about their income and expenses before the extension was filed. Later, Mr. Portney learned that Eleanor Tesoriero filed a separate income tax return for 2004.

After preparing the extension, Mr. Portney placed the Form 4868 on top of an envelope with other extension requests for mailing to the IRS service center. The **usual firm practice** was to have the secretary seal the envelope, affix postage through a postage meter, and deliver the package to the mailbox. There was no evidence presented to affirm this actually happened for the 2004 tax year.

Subsequently, Mr. Tesoriero mailed his tax return on August 15, 2005. It was received at the IRS service center on August 18, 2005. Upon review of the IRS records, it was determined that no Form 4868 had been received for either Mr. Tesoriero or his former spouse. The IRS issued a notice of deficiency to Mr. Tesoriero on May 28, 2010, assessing an addition to tax for failure to timely file the 2004 return.

Issue. Whether Mr. Tesoriero is liable for the failure-to-file penalty under IRC §6651(a)(1)

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

At trial, Mr. Portney **testified at length about his office practice for mailing forms** to the IRS**.** The court determined that because the Form 4868 was not mailed via certified mail, registered mail, or an authorized private delivery service, IRC §7502 does not create a presumption of delivery.

The next defense raised by Mr. Tesoriero was reasonable cause. He contended that the advice from his accountant indicating that the return was not due until August 15, 2005, constitutes reasonable cause. The court cited several cases before observing that the **"petitioner can no more rely on Mr. Portney to file the extension than to file the return."** Furthermore, the Court of Appeals for the 2nd Circuit has held that reliance upon an adviser to file an extension request does not constitute reasonable cause.

Holding. Mr. Tesoriero was liable for the failure-to-file penalty under IRC §6651(a)(1).

ITEMIZED DEDUCTIONS

Charitable Contributions

Jolene M. Villareale v. Comm'r, **TC Memo 2013-74 (Mar. 12, 2013)**
IRC §§170 and 6001

☞ Charitable Deduction Denied Due to Lack of Written Acknowledgement

Facts. Jolene Villareale founded NDM Ferret Rescue & Sanctuary, Inc. (NDM), an IRC §501(c)(3) organization that specializes in rescuing ferrets. She was president of NDM in 2006 and responsible for managing NDM's finances, including paying bills and managing its bank accounts.

During 2006, she made 44 contributions to NDM totaling $10,022. There were a total of 27 contributions for less than $250 and 17 for $250 or more. The contributions were made by electronic transfer from Villareale's personal account to NDM's bank account.

Villareale timely filed her 2006 federal income tax return and claimed a $12,386 charitable deduction on Schedule A, *Itemized Deductions*. On May 13, 2011, the IRS issued a notice of deficiency, disallowing the 2006 charitable contribution deduction.

Issue. Whether the taxpayer is entitled to a charitable contribution deduction of $12,386 for the 2006 tax year

Analysis. Taxpayers are generally allowed to deduct charitable contributions made for the use of certain types of organizations. However, IRC §170(f)(8)(A) requires the substantiation of contributions of $250 or more by a contemporaneous written acknowledgement from the donee organization. The acknowledgement must include the following information.

- The amount of cash and a description (but not value) for any contribution of property other than cash.
- A statement as to whether any goods or services were received in consideration for the contribution.
- A description and good faith estimate of the value of any goods or services provided.

The IRS did not dispute the total cash contribution of $10,022 or that NDM was a valid IRC §501(c)(3) exempt organization. The IRS allowed all contributions for less than $250 but argued that Villareale is not entitled to deduct the contributions of $250 or more because they were not substantiated by contemporaneous written acknowledgements. **"Contemporaneous" is defined as obtained by the taxpayer on or before the earlier of the date on which the tax return is filed or the due date (including extensions) for filing the return.**

Villareale argued that the bank statements for both her and NDM were evidence that the contributions were made. **However, the bank statements do not state whether she received any goods or services in exchange for her contributions; therefore, they do not qualify as contemporaneous written acknowledgments.**

The court found it immaterial that Villareale was on both sides of the transaction and rejected her argument that sending a written acknowledgement from NDM to herself that no goods or services were received for the contribution would have been futile. The court also ignored the taxpayer's argument that she substantially complied with the law.

Holding. The court held that the taxpayer was not allowed to deduct the contributions to NDM of $250 or more.

> **Note.** Practitioners should be aware that pursuant to the IRS requirement for substantiation of charitable contributions, a contemporaneous written acknowledgement must state "no goods or services other than intangible religious benefits were provided in exchange for the contributions."

Charitable Contributions

Estate of Harvey Evenchik et al. v. Comm'r, **TC Memo 2013-34 (Feb. 4, 2013)**
IRC §170

☞ Appraising Wrong Asset Results in Loss of Charitable Contribution

Facts. Harvey Evenchik owned shares in Chateau Apartments, Inc. (Chateau). The assets of Chateau consisted of two apartment buildings located in Tucson, Arizona.

During 2004, Harvey and his wife Deanna donated slightly over 72% of the Chateau capital stock to Family Housing Resources, Inc. (FHR), a nonprofit housing corporation. They accomplished this by executing two separate documents titled "Assignment of Stock by Gift," but neither of these documents contained the date of the actual contribution. FHR sent Harvey a letter thanking him for the gift on December 16, 2004. The letter acknowledged receipt of 15,535 shares valued at $1,045,289.

The Evenchiks claimed a noncash charitable contribution on their 2004 tax return using Form 8283, *Noncash Charitable Contributions.* Along with the Form 8283, they also included two separate reports appraising the apartment complexes. The reports did not provide any information on the fair market value (FMV) of Chateau's outstanding shares or the 72% interest that Harvey held. Part of the charitable contribution deduction was claimed on their 2004 return and the remaining amount was carried forward to their 2006 return.

The IRS challenged the deduction claimed on the 2006 tax return, disallowing the charitable contribution carryforward because the Evenchiks failed to:

- Establish the name and address of the qualifying organization,
- Provide a list of the donations, and
- Show the FMV of each item on the date of contribution.

Issue. Whether the Evenchiks are entitled to a charitable deduction for stock donated to FHR.

Analysis. IRC §170 generally allows a charitable deduction for contributions made during a tax year to a §501(c)(3) organization. If a deduction is claimed of more than $5,000 for a property, IRC §170(f) requires a taxpayer to obtain a qualified appraisal for the property contribution.

The Evenchiks ran into their first hurdle with the appraisals they provided, **neither of which appraised the correct asset.** Instead of appraisals of the Chateau stock, the appraisals provided were for the underlying assets that Chateau held.

Treas. Reg. §1.170A-13(c)(3)(ii) requires a **qualified appraisal to include eleven items.** The two appraisals lacked several of these items, including the following.

- A description of the property in sufficient detail for a person who is not generally familiar with a partial interest in Chateau to ascertain that the property appraised was the property contributed
- The date or expected date of the contribution to FHR
- The terms of any agreement or understanding entered into by Evenchik or FHR relating to the use of the donated property
- A statement that the appraisal was prepared for income tax purposes
- The appraised FMV on the date of contribution

Based on the missing components, the court concluded that the Evenchiks did not strictly comply with the regulations for a qualified appraisal. However, the Evenchiks felt that even though they did not strictly comply with the regulation, they should still get a deduction because they substantially complied with it. The Evenchiks sited *Bond v. Comm'r*[41] and *Hewitt v. Comm'r,*[42] in which the taxpayers had provided most of the required information and the single defect in furnishing everything required was not significant. The court noted that a taxpayer cannot substantially comply with the qualified appraisal requirements if the appraisal submitted fails to meet the essential requirements of the governing statute.

The court also referred to *Smith v. Comm'r,*[43] in which an appraisal of an incorrect asset prevented the IRS from properly understanding and monitoring the claimed contribution. The result was that the taxpayers were not entitled to a contribution deduction for their family limited partnership interests.

Holding. Based on the same logic as found in *Smith,* the court determined that not only did the Evenchiks have the wrong asset appraised, the appraisals did not state the date of the contribution or the FMV on the date of contribution, **there was no statement that the appraisal was prepared for income tax purposes,** and it did not include the terms of any agreement regarding the use of the donated property. The court disallowed the contribution deduction accordingly.

41. *Bond v. Comm'r,* 100 TC 32 (1993).

42. *Hewitt v. Comm'r,* 109 TC 258 (1997).

43. *Smith v. Comm'r,* TC Memo 2007-368, *aff'd* 364 Fed. Appx. 317 (9th Cir. 2009).

Mortgage Interest Deduction

***Jane E. Zdunek v. Comm'r,* TC Summm. Op. 2013-13 (Feb. 20, 2013)**

IRC §§163(h)(3), 6013, and 6662

☞ **Married Filing Separately Status Limits Home Mortgage Interest Deduction**

Facts. Jane Zdunek worked for the IRS for 15 years in various capacities. She is a CPA and has prepared tax returns for compensation since 1988.

Zdunek prepared and filed her 2007 income tax return using the married filing separately (MFS) status. Her return included Schedule A, *Itemized Deductions,* on which she claimed a mortgage interest deduction of $47,477 related to a residence in Virginia and a second residence in West Virginia.

The IRS issued a notice of deficiency, disallowing the $47,477 mortgage interest deduction. In April 2011, Zdunek spoke with the Appeals Office regarding the possibility of settlement. She was informed that the mortgage interest deduction she claimed **exceeded the limitations for a MFS return.**

Issues. The issues in this case are as follows.

- Whether Zdunek may make a postpetition election to file a joint return with her husband
- Whether she is liable for the IRC §6662(a) accuracy-related penalty

Analysis. IRC §163(h)(3)(B) provides that married individuals filing separate returns may **not deduct interest on acquisition indebtedness to the extent that the acquisition indebtedness exceeds $500,000.** IRC §163(h)(3)(C) provides that a married person filing a separate return may **not deduct interest on home equity indebtedness to the extent that the indebtedness exceeds $50,000.** Additionally, married individuals filing separate returns are generally limited to claiming one residence for purposes of the mortgage interest deduction.[44]

At trial, Zdunek candidly admitted that she did not apply the MFS limitations when she claimed the $47,477 mortgage interest deduction on her 2007 return. Zdunek and the IRS then agreed that she was entitled to a mortgage interest deduction of $29,494.

Despite Zdunek's agreement with the IRS, she wanted to change her filing status from MFS to MFJ. However, IRC §6013(b)(2)(B) precludes the filing of a joint return after a taxpayer files a MFS return if the taxpayer files a timely petition with the Tax Court with respect to a notice of deficiency. The IRS issued a notice of deficiency for 2007 and Zdunek filed a petition for that tax year. Accordingly, she is now precluded from filing a joint return for 2007.

Zdunek contended that she nonetheless should be permitted to change her filing status to MFJ for 2007 because she was not informed of the MFS limitations by the IRS until after she filed her petition with the court. She framed her argument in the context of cases in which the court found that there had been surprise and substantial disadvantage to a taxpayer during a trial because of how the notice of deficiency and pleadings were drafted compared to the issues raised at trial.[45] The court acknowledged that the IRS's wording on the attachment to the notice of deficiency "may not be a model of clarity." However, the court concluded that there was no surprise or substantial disadvantage to Zdunek because she admitted at trial that she was informed of the IRS's position when she spoke to the Appeals Office at least 16 months before trial. Moreover, when she filed her petition, she was generally aware of the §163(h) indebtedness limitations because she referenced those limitations in her petition.

IRC §6662(a) imposes a 20% penalty of the amount of any underpayment attributable to negligence or disregard of rules or regulations. IRC §6664(c)(1) provides an exception to the penalty if the taxpayer established that there was reasonable cause for the underpayment and they acted in good faith. Because Zdunek maintained a CPA license and had substantial experience, knowledge, and education, the court held that she did not qualify for the reasonable cause exception.

Holding. Zdunek is only allowed a $29,494 home mortgage interest deduction and cannot change her MFS filing status for the 2007 tax year. She is also liable for the accuracy-related penalty.

44. IRC §163(h)(4)(A)(ii)(II).

45. See, e.g., *Estate of Horvath v. Comm'r,* 59 TC 551, 555 (1973).

Noncash Charitable Contributions

***Bridgett J. Bell v. Comm'r*, TC Summ. Op. 2013-20 (Mar. 4, 2013)**

IRC §§170 and 6662

☞ CPA Denied Large Noncash Contributions

Facts. Bridgett Bell, an Atlanta CPA and accounting professor, established a nonprofit corporation located in Houston in 2001. The name of the IRC §501(c)(3) corporation was Holistic Opportunities for Mental Empowerment (HOME). It provided adult literacy classes in a Houston church. During 2006, the tax year in question, Ms. Bell was the president of both HOME and its board of directors. In 2006, she made numerous trips from Atlanta to Houston to teach literacy classes at HOME and to attend to its finances.

HOME did not file a Form 990, *Return of Organization Exempt From Income Tax,* for 2006. In 2010, the IRS **revoked HOME's federal tax-exempt status for failure to file a Form 990 for three consecutive years.**

Ms. Bell's **2006 Form 1040** was filed late on October 13, 2008. It reported the following:

Adjusted gross income	$91,491
Taxable income	18,569
Total charitable contributions on Schedule A	45,746
Noncash contributions reported on Form 8283	28,898

Ms. Bell's reported noncash contributions were made entirely to HOME. They consisted of donated "land" and "building materials" of $4,236 and $24,662, respectively. Ms. Bell signed the donee acknowledgment section of the attached Form 8283, *Noncash Charitable Contributions,* on behalf of HOME in her capacity as its president. The acknowledgment was dated October 13, 2008, the date she filed her delinquent 2006 Form 1040.

An IRS examination resulted in a complete disallowance of the noncash contributions of $28,898. The IRS assessed a 2006 tax deficiency of $6,017. An accuracy-related penalty of $1,203 for substantial understatement of tax was also imposed.

Issues. The issues in this case are as follows.

- Whether the taxpayer is entitled to the noncash contribution deduction claimed on Form 8283
- Whether the taxpayer is liable for the 20% accuracy-related penalty

Analysis. If a **noncash contribution** deduction exceeds $5,000, the taxpayer **must:**[46]

- Obtain a qualified appraisal for the contributed property,
- Attach a fully completed appraisal summary (a Form 8283) to the tax return, and
- Maintain records pertaining to the claimed deduction.

Following a thorough review of various documents submitted by the taxpayer, **the Tax Court found both her testimony and documentation inadequate and not credible.** Many of the submitted receipts were illegible and undated.

Holding. The Tax Court sustained both the IRS-assessed tax deficiency and the accuracy-related penalty in full.

> **Note.** Ms. Bell was a 2-time loser at the Tax Court, as her **2004 tax return** was audited by the IRS with similar results. The court sustained the 2004 assessed tax deficiency.[47]

46. Treas. Reg. §§1.170A-13(b)(2)(ii) and 1.170A-13(c)(2).

47. *Bell v. Comm'r*, TC Summ. Op. 2011-54 (Apr. 18, 2011).

Substantiation of Deductions

***Pamela Lynn Brooks v. Comm'r,* TC Memo 2013-141 (Jun. 4, 2013)**

IRC §§151, 152, 165, 166, 4251, and 6662

☞ Former IRS Employee Unable to Substantiate Deductions

Facts. Pamela Brooks, **a former IRS tax compliance officer,** resided in California. In 1990, she received a gift of $34,000 that she used to improve a Los Angeles property owned by her mother-in-law, Beulah Bias. Ms. Brooks and her mother-in-law agreed that Ms. Brooks would be entitled to a portion of the proceeds from the sale of the property because the improvements would significantly increase the property value.

Beulah Bias died in July 1991. Ms. Brooks continued to reside at the Los Angeles property until 1993; her ex-husband stayed in the property until 2000. In 2000, Ms. Brooks learned that the Bias family was attempting to sell the Los Angeles property. She then sued the estate of Beulah Bias to protect her investment. She settled with the estate in 2003 for $17,000, after incurring $2,000 of legal fees.

Ms. Brooks also owned a property in Riverside, California, which she had purchased for $168,000. In 2004, a fire caused significant smoke damage to the property. She filed a claim with her insurance company and also applied for disaster assistance with the Federal Emergency Management Agency.

While the insurance company was investigating her claim, it found asbestos on the property. The costs to repair the smoke damage and the asbestos problem were substantial. Ms. Brooks decided not to fix the property but instead to sell it in the damaged condition. She lowered her original asking price of $335,000 to $305,000 to accommodate the prospective buyer in making the necessary repairs. She subsequently sold the property in 2004 for $305,000. She claimed a casualty loss deduction of $16,088 on her 2005 return with respect to the property.

Ms. Brooks prepared her own tax returns for the years at issue. On her 2005, 2006, and 2007 tax returns, she claimed the following items.

	2005	2006	2007
Capital loss	$ 3,000	$ 3,000	$ 3,000
Casualty loss	16,088		
Itemized deductions	27,103 [a]	9,165 [b]	31,849 [c]

[a] Includes state/local taxes of $5,044, charitable contributions of $3,500, and a casualty loss of $16,088 from the Riverside property.

[b] Includes charitable contributions of $5,200.

[c] Includes state/local taxes of $23,000, charitable contributions of $5,200, and a casualty loss of $3,129.

The IRS examined each of these returns and proposed the following adjustments.

	2005	2006	2007
Capital loss	($ 3,000)	($ 3,000)	($ 3,000)
Casualty loss	(16,088)		
Itemized deductions	(21,024)	(5,173)	(31,329)

In addition, the IRS recommended the assertion of accuracy-related penalties for all three years.

Issues. There were several issues raised in this case. The following analysis focuses on whether the taxpayer is:

- Entitled to a **capital loss** carryover deduction for 2005, 2006, and 2007;
- Entitled to **charitable contribution deductions** for 2005 and 2006;
- Entitled to a **casualty loss deduction** for 2005; and
- Liable for **accuracy-related penalties** for 2005, 2006, and 2007.

Analysis. Ms. Brooks claimed the original **capital loss** in connection with the Los Angeles property on her 2003 tax return and took carryforward deductions of $3,000 each in 2005, 2006, and 2007. The IRS disallowed the capital loss deductions in full. The IRS contended that Ms. Brooks had not shown that she had an enforceable interest in the property or that she made the improvements in the property with the intent to make a profit, as is required by IRC §165.

The court noted that Ms. Brooks had invested $34,000 in the property with the objective of realizing an economic profit. In 2000, when the Bias family attempted to sell the property, she had an economic interest in and claim against the property, which was a capital asset. **Accordingly, Ms. Brooks is entitled to a capital loss deduction under §165.**

With respect to **charitable contributions,** Ms. Brooks testified that she was a Jehovah's Witness attending religious services regularly at Kingdom Hall, where she made cash contributions during the years at issue. During 2006, she allegedly contributed $3,000 to a tsunami relief fund by giving the money to her mother who, in turn, donated the money. To substantiate her $3,000 contribution, she provided documentation showing that she received a payment from DaimlerChrysler Corporation of $15,782 on September 25, 2006, and deposited $12,782 into her bank account three days later. She contended that the $3,000 difference was the charitable contribution. **However, she could not provide a contemporaneous written acknowledgment documenting the $3,000 contribution nor could she adequately substantiate any of her other reported charitable contributions for 2005 or 2006.** Accordingly, the court agreed with the IRS determinations regarding the charitable contribution deductions.

With respect to the **casualty loss deduction** of $16,088 for the Riverside property, Ms. Brooks failed to introduce any credible evidence of the fair market value of the property immediately before the fire and an appraisal of the property immediately after the fire. The court determined that the documentation she provided was insufficient to show the loss in value and disallowed the casualty loss deduction accordingly.

The IRS contended that Ms. Brooks is liable for **accuracy-related penalties** because her underpayments of tax were attributable to negligence and disregard of rules and regulations. The court noted that Ms. Brooks was an IRS employee for many years, and her occupation involved the examination of federal income tax returns. Despite her expertise, she claimed excessive deductions and failed to maintain adequate records to substantiate her itemized deductions. Consequently, the court sustained the accuracy-related penalties.

Holding. The court held that Ms. Brooks is entitled to the capital loss deductions but that she is not entitled to the deductions for charitable contributions or for the casualty loss. In addition, the court upheld the imposition of accuracy-related penalties.

LIKE-KIND EXCHANGES

Like-Kind Exchange

William P. Adams v. Comm'r, **TC Memo 2013-7 (Jan. 10, 2013)**
IRC §§162, 212, 274(d), 280A, and 1031

☞ Facts Support Like-Kind Exchange Treatment

Facts. Williams Adams, a California semiretired electrical engineer, bought a personal residence in San Francisco in 1963 for $26,000 and resided there with his family until 1979. After Mr. Adams and his family moved to a new residence, he rented the San Francisco property until 2003. During the time he held the San Francisco property for rental, he made substantial improvements to it, including upgrading the electrical service, installing carpeting and energy efficient windows, and replacing the roof.

In 2003, Mr. Adams decided to sell the San Francisco property. After consulting with a broker, **he engaged an intermediary** to ensure that the sale met the requirements of a like-kind exchange.

With the help of a qualified intermediary, Mr. Adams sold the San Francisco property for $572,000 in June 2004 and purchased a replacement property in Eureka for $340,000 in July 2004. Mr. Adams' son Bill and his family also resided in Eureka. He worked out an arrangement for his son to do repair work on the Eureka property, which required extensive renovations. From July through September 2004, **Bill and his family spent 60 hours per week doing repairs and renovations.** They moved into the house in October 2004 and paid $1,200 per month rent until they moved in early 2008.

Starting around 1999, Mr. Adams quit filing tax returns. Instead, each year on April 15, he estimated the amount of tax he owed and sent the IRS a payment. For the 2004 tax year, he paid $5,000 to reflect the amount of tax that he estimated he owed. The IRS disagreed with this logic and issued a notice of deficiency for the 2004 tax year based on information returns provided by third parties. The IRS notice included adjustments for several items, including the following.

- Ordinary income of $572,000 received from the sale of the San Francisco house
- Penalties under IRC §§6651 and 6654

Mr. Adams petitioned the Tax Court seeking a redetermination of the deficiency. He attached a 2004 Form 1040 (dated February 12, 2008) showing joint filing status with his wife. The Form 1040 was not signed and could therefore not be processed by the IRS. The 2004 Form 1040 showed a balance due of $34,578. The return included a Schedule C, *Profit or Loss From Business,* for his electrical-safety-consulting business; rental income and expenses for three properties; and income from the San Francisco rental house disposition.

In March 2008, Mr. Adams submitted a signed 2004 Form 1040 to the IRS. This return was similar to the one attached to the Tax Court petition; however, it treated the disposition of the San Francisco house as a like-kind exchange.

Issue. There were several issues decided in this case, but the following analysis is limited to whether Mr. Adams' sale of his San Francisco house in June 2004 qualified for nonrecognition treatment as a part of an IRC §1031 like-kind exchange.

Analysis. IRC §1031(a)(1) provides that no gain or loss will be recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

Mr. Adams contended that the San Francisco property and subsequent purchase of the Eureka property qualified for §1031 treatment. The IRS, on the other hand, asserted that the purchase of the Eureka house was for personal purposes — i.e., that Mr. Adams purchased the home with the intention of letting his son and family live there at below-market rent. The court stated that the $1,200 monthly rent was a fair rental value because Bill and his family assumed substantial responsibilities for renovating, maintaining, and repairing the house. Therefore, **the court determined that Mr. Adams purchased the house for investment and the purchase and sale of properties constituted a valid §1031 exchange.**

Holding. The court determined that Mr. Adams engaged in a valid §1031 exchange but is liable for additions to tax under §6651 for failing to timely file and pay his 2004 return. He is also liable for additions to tax under §6654 for failing to make estimated tax payments.

NOT FOR PROFIT

Hobby Loss

***John Dalton Parks III v. Comm'r,* TC Summ. Op. 2012-105 (Oct. 25, 2012)**
IRC §183

☞ Coaching Activity Is For Profit Venture

Facts. John Parks began his track and field coaching career in 1984 and continued through the current time performing in various jobs. He also did some freelance writing for track and field publications. At one point, he was the editor, publisher, and owner of a cross-country running magazine called "The Harrier." In 2003, he stopped publishing in print and became involved in web-based publishing.

In 2006, he discontinued his writing and publishing and started conducting track camps and clinics. He also began focusing more time on a running club, which he ran from 2003 through 2008. He usually had 12-20 participants for which he received between $125–$200 each. In 2006, he lost the use of the track facilities he had been using and moved his efforts to substandard facilities until 2007. At that time, he became the track coach at Stayton and was able to use those facilities for his private coaching activities. Mr. Parks' efforts in both 2006 and 2007 were unprofitable due to the loss of several private coaching athletes.

Mr. Parks coached a gifted athlete, Ryan Bailey, who qualified for the Olympic trials in Oregon in 2008. He then became Bailey's professional coach and manager, earning compensation of $5,000 in 2009 and $10,000 in subsequent years.

Mr. Parks reported his coaching activities on Schedules C, *Profit or Loss From Business,* as follows.

Year	Gross Receipts	Expenses	Gain or (Loss)
2003	$11,707	$ 30,284	($18,577)
2004	11,950	29,415	(17,465)
2005	9,115	27,531	(18,416)
2006	7,744	25,125	(17,381)
2007	5,785	38,646	(32,861)
2008	7,647	44,448	(36,801)
2009	5,000	9,057	(4,057)
2010	11,270	19,243	(7,973)
2011	16,925	16,882	43
Total	$87,143	$240,631	($153,488)

The IRS examined Mr. Parks' 2006, 2007, and 2008 tax returns and determined that this activity was not engaged in for profit. This resulted in the reclassification of the expenses from his private coaching activity from a business loss reported on Schedule C to a hobby loss deduction reported on Schedule A.

Issue. Whether Mr. Parks' private track and field coaching was an activity not engaged in for profit under IRC §183.

Analysis. If a taxpayer engages in an activity without the requisite profit motive, deductions for the activity are limited under IRC §183. To determine whether the taxpayer engaged in an activity for profit, courts utilize a 9-factor analysis in accordance with Treas. Reg. §1.183-2(b).

In the court's opinion, the following five factors **weighed in Mr. Parks' favor.**

1. **Manner in which the activity is conducted.** Mr. Parks' approach to his private coaching activity was businesslike and he sought ways to improve his success, including the abandonment of his journalistic pursuits.

2. **Taxpayer's expertise.** Mr. Parks clearly displays the expertise to coach track and field.

3. **Taxpayer's time and effort.** Mr. Parks normally spent 25 to 30 hours per week on his private coaching and a lesser amount when he had high school coaching responsibilities. In addition, during 2006, 2007, and 2008, he spent 6, 32, and 36 days, respectively, traveling to track meets. Due to the substantial portion of his nonemployment time that he devoted to his private coaching activity, his personal life and marriage were negatively impacted.

4. **Taxpayer's financial status.** Mr. Parks earned an annual salary of $55,000 to $65,000 as an educator/coach. Because it was likely that the expenses incurred in his private coaching activity were a financial hardship, it reduced the amount available to pay his personal living expenses.

5. **Elements of personal pleasure.** Even though Mr. Parks may have derived personal pleasure from his involvement in teaching and coaching, he spent considerable nonemployment time on the activity.

The court found the following two factors **weighed in the IRS's favor.**

6. **Activity's history of income/losses.** Mr. Parks incurred continued losses beyond the activity's startup phase. This generally demonstrates the absence of a profit objective.

7. **Amounts of occasional profits.** Between 2003 and 2010, Mr. Parks failed to realize a profit on his coaching activity. Although he improved his gain potential, the continued losses without meaningful gain weigh in the IRS's favor.

The court found the following **two factors were neutral.**

8. **Expectation that assets will appreciate in value.** No significant assets are used in connection with Mr. Parks' activity.

9. **Taxpayer's success in similar activities.** No evidence was offered regarding Mr. Parks' success in comparable activities.

The court found five favorable, two unfavorable, and two neutral factors. With respect to the unfavorable factors, the court noted that Mr. Parks' income was increasing, losses were decreasing, and his potential for success was improving.

Holding. The court concluded that Mr. Parks did pursue his coaching activity during the subject years with a predominant profit objective. Therefore, he is entitled to deduct the excess of expenses over income from his gross income for each tax year.

Hobby Loss

***William and Julie Romanowski v. Comm'r,* TC Memo 2013-55 (Feb. 20, 2013)**

IRC §§162, 183, 212, and 6662

☞ Horse Breeding Operation Not Engaged in For Profit

Facts. William Romanowski graduated from Boston College in 1988 and then played in the National Football League for 16 years until he suffered a severe concussion. From the late 1990s until early 2004, Mr. Romanowski and his wife Julie employed a financial adviser to take care of their finances, including managing their portfolio, allocating a monthly stipend to them, and ensuring their tax returns were timely completed.

In late 2003, the Romanowskis encountered some tax issues with respect to a Colorado real estate investment. Mr. Romanowski met with a lawyer to discuss his tax issues. During this meeting, the lawyer gave him information about ClassicStar, which is a horse-breeding business. This opportunity involved leasing thoroughbreds owned by ClassicStar, which would provide boarding, care, and breeding services for the horses. The couple received an extensive package of information on the opportunity and made several trips to Kentucky to visit the ClassicStar operation. They made the decision to invest $13 million in November 2003 through a newly established entity called Romanowski Thoroughbreds, LLC. Their financial adviser opposed the investment.

For the 2003 and 2004 tax years, the Romanowskis received a summary sheet from ClassicStar, which provided the following income and expenses that they reported on their Schedule F, *Profit or Loss From Farming.*

	2003		2004	
Income		$ 0		$ 0
Expenses:				
Board and mare care expenses	$ 1,020,000		$ 0	
Breed fees	868,000		0	
Mare lease fees	9,496,200		0	
Insurance	1,708,532		0	
Interest	0		482,055	
Travel	0		5,181	
Meals & entertainment	0		1,215	
Total expenses	$13,092,732	(13,092,732)	$488,451	(488,451)
Net loss		($13,092,732)		($488,451)

These net losses offset their 2003 and 2004 income and created net operating losses (NOL), which were carried back to 1998, 1999, 2000, 2001, and 2002.

During 2003 and 2004, they spent a total of 193 and 88 hours, respectively, on this activity. Their involvement included visits to Kentucky, discussions with ClassicStar personnel, and review of the ClassicStar materials.

The IRS issued a notice of deficiency to the Romanowskis for the 1998–2004 tax years, determining deficiencies resulting from disallowance of the Schedule F expenses for 2003 and 2004 and the disallowance of related NOLs. In addition, the IRS also asserted accuracy-related penalties.

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

- Whether the Romanowskis are entitled to deductions for various horse-breeding expenses under IRC §§162 or 212
- Whether the Romanowskis are liable for the accuracy-related penalties under IRC §6662

Analysis. IRC §183(a) provides that, "In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter …."

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

1. **Manner in which the taxpayer carries on the activity.** The taxpayers did not conduct the horse activities in a business-like manner. The Romanowskis relied on ClassicStar "to an extreme degree" and did not have a discernible business plan or profit projections.

2. **Expertise of the taxpayers or their advisers.** The taxpayers entered into the business with a substantial investment relying only on a nominal amount of education, the advice of a for-profit company that was the other party to the contract, and an attorney who was not an expert in horse breeding.

3. **Expectation that assets used in the activity may appreciate in value.** The taxpayers did not provide evidence supporting an expectation that the horses would appreciate in value.

4. **Financial status of the taxpayer.** The taxpayers entered into a circular transaction which appears to have had no profit potential. Instead, it appeared that the taxpayers participated in the program solely to obtain tax benefits.

5. **Amount of occasional profits.** The taxpayers' horse activities incurred losses for two consecutive years totaling over $13 million. Participation in this program was almost entirely motivated by tax benefits.

The following factor **favors the taxpayers.**

6. **Elements of personal pleasure or recreation.** The taxpayers did not derive significant amounts of pleasure and recreation from the horse activities.

The following three factors were **determined to be neutral.**

7. **Time and effort expended by the taxpayers in carrying on the activity.** The taxpayers spent only 193 and 88 hours during 2003 and 2004, respectively, on this business activity.

8. **Success of the taxpayer in carrying on other similar or dissimilar activities.** The taxpayers had never been engaged in similar or dissimilar activities before.

9. **Taxpayer's history of income or losses with respect to the activity.** The taxpayers participated in this activity for only one breeding season.

Holding. The court held that the taxpayers' horse activities were not engaged in for profit and they could not deduct losses associated with the activities. However, the court determined that the taxpayers were not liable for the IRC §6662 accuracy-related penalty because they reasonably and in good faith relied on the advice supplied to them by an attorney and tax preparer.

Note. The Kentucky-based horse breeding business conducted by ClassicStar LLC, pled guilty in 2009 to conspiring to defraud the United States by running an illegal tax shelter.

Foreign Travel Expenses

***Sal A. Westrich v. Comm'r.* TC Summ. Op. 2013-35 (May 7, 2013)**

IRC §§183 and 6662

☞ Large Schedule C Losses for 8 Consecutive Years Dooms Taxpayer

Facts. Sal Westrich was born in France and became a U.S. Citizen in 1953. Starting in 1959, he was a professor of modern history at a Brooklyn, New York college. Instead of retiring in 2000 when he began receiving benefits from social security and his employer's retirement plan, he elected to continue to teach on a half-time basis. His alleged reason for doing so was to allow more time for his "research and writing" activity.

On Mr. Westrich's 2000 through 2008 tax returns, he included a Schedule C, *Profit or Loss From Business,* which showed that his principal business activity was "research-writer." None of the Schedules C reported any gross income, and all of the expenses represented summer travel expenses to France. The Schedule C net losses for the **2005 through 2008 tax years are as follows.**

Tax Year	Reported Schedule C Loss
2005	($62,870)
2006	(61,962)
2007	(59,564)
2008	(37,419)

The IRS examined the 2007 and 2008 tax returns and determined that **the Schedule C losses were not deductible because the taxpayer's "research and writing" activity was not engaged in for profit** under IRC §183. The IRS proposed additional tax for 2007 and 2008 of $14,914 and $9,530, respectively. In addition, a 20% accuracy-related penalty was imposed for both years.

Issues. The issues in this case are as follows.

- Whether the Schedule C net losses for the 2007 and 2008 tax years are allowable
- Whether the imposition of the 20% accuracy-related penalties is proper

Analysis. The court thoroughly analyzed the nine subjective factors shown in Treas. Reg. §1.183-2(b) to determine whether the taxpayer's "research and writing" activity was engaged in for profit. **The court concluded the following regarding the nine factors.**

- Six factors favored the position of the IRS.
- None of the factors favored the position of the taxpayer.
- Three of the factors were neutral.

The court placed significant emphasis on the following factors.

- **History of income or loss for the activity.**[48] Mr. Westrich continued to travel to France and reported substantial losses for eight consecutive years despite never reporting any Schedule C gross receipts.
- **Financial status.**[49] Substantial income from sources other than the alleged business activity, particularly if the business losses generate significant tax benefits, may indicate that the activity is not engaged in for profit. In 2007, Mr. Westrich reported $121,451 of wages, annuity income, and taxable social security benefits. In 2008, he had income of $94,485.

48. Treas. Reg. §1.183-2(b)(6); and *Golanty v. Comm'r*, 647 F.2d 170 (9th Cir. 1981), *aff'g without published opinion* 72 TC 426 (1979).

49. Treas. Reg. §1.183-2(b)(8).

Holding. The court held that the "research and writing" activity was not engaged in for profit under IRC §183 and sustained the tax deficiencies proposed by the IRS. The court also upheld the imposition of the 20% accuracy-related penalty for each tax year.

> **Note.** The use of IRC §183 to disallow reported Schedule C and Schedule F losses is a valuable tool for IRS examiners. However, IRS training manuals require the examiner to make a thorough analysis of, and conclusions for, the nine subjective factors explained in the regulations. Without this thorough analysis, disputed §183 cases are often resolved in the taxpayer's favor at the Appeals level of the IRS.

PASSIVE ACTIVITIES

Passive Activity Losses

***Joseph and Christina Veriha v. Comm'r,* 139 TC No. 3 (Aug. 8, 2012)**
IRC §469

☞ Nonpassive Treatment of Net Rental Income

Facts. Joseph Veriha owned John Veriha Trucking, Inc. (JVT). Mr. Veriha also owned 100% of JRV Leasing, LLC (JRV), and 99% of Transportation Resources, Inc. (TRI).

JVT leased its trucking equipment from TRI and JRV. The leased equipment included motorized vehicles (tractors) and storage trailers (trailers). During 2005, JVT entered into 125 separate lease agreements with TRI and 66 separate lease agreements with JRV. Both TRI's and JRV's only source of income was from the JVT leasing transactions.

During 2005, tractors and trailers owned by TRI and JRV were intermingled in the same lot. JVT paid all the expenses for both TRI and JRV tractors and trailers. All were painted the same yellow color, insured under the same blanket policy, and assigned to routes and drivers without differentiating the company owning the equipment.

During 2005, TRI generated net income that was reported on Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.* **This income was treated as passive income on Mr. Veriha's tax return. JRV, on the other hand, generated a net loss, which was reported on Mr. Veriha's Schedule C and treated as a passive loss.**

The IRS issued a notice of deficiency for $258,785, in which it recharacterized the income from TRI as nonpassive income pursuant to Treas. Reg. §1.469-2(f)(6).

Issues. Whether leasing activities should be **recharacterized as nonpassive income under the self-rental rule** of Treas. Reg. §1.469-2(f)(6).

Analysis. IRC §469(a) disallows the passive activity loss of an individual taxpayer. Under this provision, passive losses are suspended until the taxpayer either has offsetting passive income or disposes of their entire interest in the passive activity. IRC §469(d)(1) defines a passive activity loss as the amount (if any) by which the aggregate losses from all passive activities for the tax year exceed the aggregate income from all passive activities for the year.

Treas. Reg. §1.469-2(f)(6) explicity recharacterizes net rental activity income from an "item of property" as nonpassive income. Even when items of property are grouped together in an activity, the recharacterization of an item of property as nonpassive income is still applicable.

At trial, the Verihas argued that considering each tractor and trailer as an "item of property" would compel preposterous results such as a business renting tools. The business would have to recharacterize income with respect to each individual tool. The court agreed with this logic but only in situations in which each tool is governed by a separate lease agreement with a separate price.

The Verihas contended that the IRS position is contradictory to the position found in *Shaw v. Comm'r,*[50] in which net rental income from various properties, including over-the-road trailers, was reclassified as nonpassive net rental income. They also contended that "item of property" refers to an entire fleet of trucks within the trucking industry but did not cite any authority to support their position. The court found this position implausible, noting that Mr. Veriha's decision to hold the entire fleet of tractors and trailers in two separate entities is inconsistent with the idea that the entire fleet is viewed as a single "item of property." Further, the proposition is also consistent with the fact that JVT entered into separate lease agreements for each tractor and trailer it leased from TRI and JRV.

Holding. The court upheld the IRS's recharacterization of the net income from TRI and found that each tractor and trailer was a separate item of property. The court noted that the IRS had not contested the netting of gains and losses within the company, so **only the net income was recharacterized as nonpassive.**

Rental Activity Losses

***Frederick and Janice Chambers v. Comm'r,* TC Summ. Op. 2012-91 (Sep. 12, 2012)**

IRC §§469 and 6662

☞ Rental Real Estate Losses of Alleged Real Estate Professional Disallowed

Facts. During the tax years at issue (2005–2007), Frederick Chambers worked as a civilian employee for the Department of the Navy. After reducing his full-time hours for paid time off, Mr. Chambers worked 1,680 hours annually.

Mr. and Mrs. Chambers owned a single-family rental property in San Diego, California, during the years at issue. They were also responsible for the rental real estate activities of CMB Capital Investments, LLC, a Tennessee company in which Mr. Chambers owned a one-third interest.

On their 2005, 2006, and 2007 federal income tax returns, Mr. and Mrs. Chambers reported combined rental real estate losses from the San Diego property and CMB Capital of $8,901, $25,980, and $33,410, respectively. They reported adjusted gross income (AGI) of $153,955, $150,428, and $146,993 for 2005, 2006, and 2007, respectively.

In a notice of deficiency dated December 15, 2009, the IRS disallowed $8,901, $15,405, and $14,404 of the Chambers' rental real estate losses for 2005, 2006, and 2007, respectively. The IRS also recalculated their AGI as $164,856, $175,320, and $164,900 for the respective tax years.

Issues. The issues in this case are as follows.

- Whether the Chambers may deduct losses from their rental real estate activities under the passive activity loss rules of IRC §469
- Whether they are liable for accuracy-related penalties under IRC §6662(a)

Analysis. IRC §469 generally disallows passive activity losses for any tax year. Passive activities include any trade or business in which the taxpayer does not materially participate.[51]

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50. *Shaw v. Comm'r,* TC Memo 2002-35 (Feb. 6, 2002).

51. IRC §469(c)(1).

Rental activity is generally treated as per se passive regardless of whether the taxpayer materially participates in the activity.[52] However, there are two exceptions.

1. Real estate professionals under §469(c)(7)
2. Passive activity losses up to $25,000 under §469(i)

A taxpayer qualifies as a real estate professional if they satisfy **both** of the following requirements.[53]

1. More than half of the personal services performed by the taxpayer in trades or businesses during the tax year are performed in real property trades or businesses in which the taxpayer materially participates.
2. The taxpayer performs more than 750 hours of service during the tax year in real property trades or businesses in which they materially participate.

"Personal services" includes hours worked as an employee. Mr. Chambers was a Navy employee and worked at least 1,680 hours during each of the years at issue. At trial, he produced logs showing that he managed the San Diego and CMB Capital rental properties for 832 hours in 2005, 848 hours in 2006, and 936 hours in 2007. Even if all his hours qualified for purposes of §469(c)(7)(B), **the time recorded for real estate activities is less than the 1,680 hours Mr. Chambers spent working for the Navy. Accordingly, Mr. Chambers failed to meet the first prong of the real estate professional test.**

The second exception to the general rule that rental real estate activities are per se passive provides that a taxpayer who actively participates in rental real estate activities may deduct up to $25,000 per year for passive activity losses. However, the $25,000 amount is phased out entirely when the taxpayer's AGI reaches $150,000.[54] Because the Chambers' AGI for each of the years at issue exceeded $150,000, they are not entitled to deduct up to $25,000 per year of passive activity losses under §469(i).

IRC §6662(a) provides that a 20% accuracy-related penalty applies to a substantial understatement of income tax. However, no penalty is imposed if the taxpayer establishes that they acted with reasonable cause and in good faith. Circumstances that indicate reasonable cause and good faith include reliance on a tax professional's advice or an honest misunderstanding of the tax law that is reasonable in light of all the facts and circumstances.

Mr. Chambers provided credible testimony at trial that he devoted a significant amount of time to rental real estate activities. Most of these activities were corroborated by documentary evidence and recorded in logs. However, he failed to account for real estate activities that could not be documented and, as a result, did not meet the burden of proof. In addition, Mr. and Mrs. Chambers misinterpreted the real estate professional requirements of §469(c)(7) and believed that Mr. Chambers was only required to devote more than half of his 1,680 personal hours as a Navy employee to real property trades or businesses. Accordingly, **the court was convinced that the Chambers had reasonable cause to believe that Mr. Chambers qualified as a real estate professional and declined to sustain the accuracy-related penalties.**

Holding. The court held that Mr. and Mrs. Chambers were not allowed to deduct passive activity losses from their rental real estate activities but they were not liable for the accuracy-related penalties with respect to underpayments attributable to those deductions.

52. IRC §469(c)(4).

53. IRC §469(c)(7)(B).

54. IRC §469(i)(3).

Real Estate Professional

***Mohammad Hassanipour and Azar Najafi v. Comm'r,* TC Memo 2013-88 (Apr. 2, 2013)**

IRC §§162, 212, 469, and 6662

☞ Taxpayer does not Qualify as Real Estate Professional

Facts. In 2008, Mohammad Hassanipour was employed full-time as a research associate with Geron Corporation (Geron). Geron expects full-time employees to work 40 hours per week. Mr. Hassanipour prepared and signed timesheets for each week during 2008 and submitted them to Geron. The timesheets reported that he worked a total of 1,936 hours in 2008.

In 2008, the taxpayers owned 28 rental apartment units in seven buildings in Vallejo, California. Mr. Hassanipour also had a 50% interest in a single-family residence in Lake Tahoe, California. He performed various rental activity duties, including repairs, administrative tasks, communicating with tenants, researching landlord/tenant law, preparing tax returns, and other management activities. He also paid the bills and collected rents for the Lake Tahoe property.

On their 2008 joint return, Mr. and Mrs. Hassanipour reported the following.

- Combined wages of $239,037
- Net rental losses of $120,540 (fully deducted as a real estate professional)

Mr. Hassanipour prepared the joint 2008 tax return using a computer software program. **The taxpayers failed to elect to aggregate all of their rental real estate properties as a single real estate activity for 2008.**

An IRS examination determined that Mr. Hassanipour did not qualify as a real estate professional in 2008. The IRS contended that he did not spend more than half of his personal service hours for all trades or businesses in the rental activity.[55] Therefore, the IRS disallowed the reported Schedule E net rental loss in full and assessed $38,067 of additional tax. The 20% accuracy-related penalty was also imposed.

Issues. The issues in this case are as follows.

- Whether the taxpayers' net rental loss deduction is limited by IRC §469, which depends on whether Mr. Hassanipour met the definition of a real estate professional
- Whether the taxpayers are liable for the accuracy-related penalty

Analysis. At the trial, Mr. Hassanipour testified that he worked only 1,610 hours for Geron during 2008. This testimony conflicted with the 1,936 hours he reported on the timesheets he submitted to Geron.

In an attempt to prove his hours spent on rental activities, he submitted a generic (not dated 2008) calendar that was copyrighted in 2009. He alleged that the hours reported on the calendar were kept contemporaneously. According to the calendar, he spent 1,183 hours managing the 28 rental units.

Mr. Hassanipour admitted that he did not keep contemporaneous time records for the Lake Tahoe property but estimated that he spent 150 to 200 hours managing that property. He also testified that he spent over 500 additional hours in rental activity duties that were not reflected on his generic calendar. In total, he contended that he spent at least 1,833 hours in 2008 managing his rental properties. **Therefore, he alleged that he spent more time during 2008 on rental management activity than he did working for Geron.**

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55. IRC §469(c)(7)(B)(i).

The court commented that it was not required to accept a post-event "ballpark guesstimate" or the unverified, undocumented testimony of taxpayers.[56] It rejected Mr. Hassanipour's testimony because of many indications of unreliability. The court determined that the taxpayer spent more hours working for Geron during 2008 than he spent on rental activities. Therefore, the court concluded that Mr. Hassanipour did not establish that he met the real estate professional definition.

The 20% accuracy-related penalty is imposed on any underpayment of income tax that is attributable to a substantial understatement. **An understatement of income tax is substantial if it exceeds the greater of 10% of the tax required to be shown on the return, or $5,000.**[57] The accuracy-related penalty was sustained because the taxpayers could not prove that they met the "good faith or reasonable cause" exception.[58]

Holding. The court held that Mr. Hassanipour was not a real estate professional for the 2008 tax year. Accordingly, his rental activities are per se passive and may not offset the taxpayers' other income. In addition, the court sustained the accuracy-related penalty.

Passive Activity Losses

***Peter Hofinga and Margaret Wong v. Comm'r,* TC Summ. Op. 2013-43 (June 3, 2013)**

IRC §469

☞ Time Logs do not Establish that Real Estate Professional Standards were Satisfied

Facts. During 2006 and 2007, Peter Hofinga was retired and his wife, Margaret Wong (Ms. Wong), was employed full-time by the University of California Irvine. They owned eight properties at the start of 2006 and acquired another property in 2007. They had previously elected to treat all their rental properties as one activity pursuant to IRC §469(c)(7)(A). **Neither Mr. Hofinga nor Ms. Wong kept any type of contemporaneous records to show the amount of time either of them spent or the activities each of them performed with respect to any of their rental properties.**

Mr. Hofinga was more responsible for the management of the rental properties. Routinely and regularly, he performed the following tasks.

- Reviewed and paid bills
- Considered and made arrangements for repairs to be made
- Arranged for supplies to be purchased
- Reviewed rental applications
- Inspected rental properties
- Supervised and/or made arrangements for renovating and remodeling a rental property when needed

They also **employed managers** for some of the properties. These managers were responsible for collecting rent, responding to tenant inquiries or complaints, and making/supervising repairs.

On their 2006 and 2007 tax returns, the couple deducted rental property losses of $111,042 and $141,133, respectively. The IRS determined that the losses were passive activity losses and disallowed them accordingly.

Issue. Whether the taxpayers are entitled to a deduction for rental real estate losses for 2006 and 2007

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56. See *Moss v. Comm'r*, 135 TC 365, 369 (2010) and *Hoskins v. Comm'r*, TC Memo 2013-36 (2013).

57. IRC §6662(d)(10)(A).

58. IRC §6664(c)(1) and *Higbee v. Comm'r*, 116 TC 448-449 (2001).

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

The Code provides that a rental activity generally is treated as a passive activity, regardless of whether the taxpayer materially participates.[59] One of the exceptions to the general rule applies to "real estate professionals."[60] Taxpayers who qualify as real estate professionals are treated as participating in a trade or business. Their participation must be proven to be regular, continuous, and substantial to qualify for the exception. These standards are met if:[61]

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

For joint returns, the **same spouse must satisfy both requirements** to qualify for these passive loss exceptions.

Temp. Treas. Reg. §1.469-5T(f)(4) provides that taxpayers establish their active participation in a rental real estate activity by any reasonable means, including, but not limited to, " the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries." **Although the regulation specifically states that daily time logs are not required, the court has held that "post-event 'ballpark guesstimate[s]' are not acceptable."[62]**

In this case, Mr. Hofinga and Ms. Wong did not maintain contemporaneous logs of the time they devoted to the rental real estate activities, but they tried to establish their participation by other means. Ms. Wong prepared several sets of logs showing **estimates** of time spent on various activities. The logs she prepared showed hours spent by both the taxpayers. **However, for purposes of the 750-hour test, only Mr. Hofinga's hours can be taken into consideration.**

Ms. Wong then prepared a second set of logs using a generalized allocation of time spent by each of them. The court determined that the logs did not allow for a review of activity related to the rental properties on an event-by-event basis to the extent necessary to establish that the 750-hour test was satisfied.

Holding. The court held that the taxpayers were unable to establish that Mr. Hofinga satisfied the 750-hour test for either year in issue. Accordingly, the rental real estate activity is treated as a passive activity for both 2006 and 2007, thereby sustaining the IRS's disallowances of the rental property losses.

59. See IRC §469(c)(2) and (4).

60. See IRC §469(c)(7).

61. IRC §469(c)(7)(B).

62. *Bailey v. Comm'r,* TC Memo 2001-296 (Nov. 7, 2001).

RETIREMENT

IRA Deduction

***John B. and Frances H. Corcoran v. Comm'r,* TC Summ. Op. 2012-119 (Dec. 10, 2012)**
IRC §219

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☞ Active Participant Status Results in IRA Deduction Denial

Facts. John Corcoran, an insurance agent for New York Life (NYL), received a 2008 Form W-2 with a checkmark in box 13 indicating that **he was covered by NYL's retirement plan.** NYL had both a defined contribution plan (DCP) as well as a defined benefit plan (DBP). NYL automatically enrolled John in the DBP although John was **unaware** of this. Under the terms of the DBP, vesting did not occur until after five years of employment.

Under the terms of the DCP, a certain level of earned commissions were required to reach a minimum threshold. Because John knew he would not reach the required threshold, he decided not to contribute to the DCP.

In April 2009, John's employment with NYL was terminated. After his termination, he received no benefits from either the DCP or DBP.

On their 2008 joint tax return, John and Frances Corcoran claimed $6,000 each for contributions made to IRAs. The IRS disallowed John's IRA contribution deduction because he was covered under his employer's retirement plan.

Issue. Whether John's $6,000 IRA deduction for 2008 is allowable under IRC §219.

Analysis. IRC §219(b)(2)(A)(i) provides that an IRA contribution is not deductible if the taxpayer is an active participant in a qualified plan "for any part of such year." Several court cases have addressed the term "active participant" although none of these cases mirror the facts as shown in this particular case.

At trial, the IRS argued that Mr. Corcoran was an "active participant" even though he was automatically enrolled without his knowledge, did not make any contributions, and did not accrue any benefits. Mr. Corcoran did concede that he was enrolled in NYL's DBP in 2008 although he was not aware of it when he made his IRA contribution. Mr. Corcoran argued that it would be inequitable to disallow his IRA deduction considering the circumstances presented.

Holding. Although the court agreed that the result of disallowing the IRA deduction is inequitable, the court held that Mr. Corcoran was enrolled in a defined benefit plan in 2008 and therefore was not entitled to deduct his $6,000 IRA contribution.

Early Distribution Penalty

***Charles L. Hartley v. Comm'r,* TC Memo 2012-311 (Nov. 6, 2012)**
IRC §§72(t) and 414(p)

☞ Family Court Judge Order Does Not Equal QDRO

Facts. Charles Hartley, a West Virginia resident, received $52,684 in 2009 from qualified retirement plans. He reported these distributions on his 2009 tax return but did not pay the 10% additional tax pursuant to IRC §72(t).

Subsequently, the IRS assessed a deficiency of $5,268 on Hartley's 2009 tax return for the additional tax due under §72(t).

Issue. Whether Mr. Hartley is liable for the 10% additional tax under IRC §72(t) for an early distribution from a qualified retirement plan.

Analysis. IRC §72(t) imposes a 10% additional tax when a person withdraws money from a qualified retirement plan unless an exception under IRC §72(t)(2) applies. IRC §72(t)(2)(C) provides an exception for payments to alternate payees pursuant to qualified domestic relations orders (QDRO). To take advantage of this exception, the distribution **must** be made by the plan administrator to an alternate payee under a QDRO.

At trial, Mr. Hartley testified that a family court judge ordered him to have funds distributed from his qualified retirement plans in order to pay alimony to his ex-wife. **Unfortunately, Mr. Hartley never had a QDRO prepared.**

Holding. Mr. Hartley was held liable for the 10% additional tax because he did not qualify for an exception pursuant to IRC §72(t).

Retirement Plan Distributions

Ltr. Rul. 201243019 (Aug. 2, 2012)
IRC §408

☞ Rollover Requirement Waiver Not Granted

Facts. Taxpayer A fell and broke her shoulder in 2008. Around the same time period, she also began showing signs of mental impairment. Her doctor recommended that she move to an expensive assisted living institution (Institution N). In order to finance her contract with Institution N, her home was put up for sale. In addition, monies were withdrawn from her IRA on June 24, 2009, to expedite her move into Institution N. **Due to her impaired mental condition, her son executed the IRA withdrawal papers.** These funds were transferred directly to Institution N to secure a contract with the Institution. The intent was that the funds would be returned to the IRA when the home was sold. Unfortunately, the home sale occurred on September 9, 2009, which was after the 60-day rollover period had expired. The monies were then returned to a taxable account.

Taxpayer A's representative submitted a request for a waiver of the 60-day rollover requirement with respect to the IRA distribution.

Analysis. IRC §408(d)(1) provides that any amount paid or distributed from an IRA must be included in gross income by the payee or distributee in the manner provided under IRC §72. IRC §408(d)(3)(A) provides that §408(d)(1) does not apply to any amount paid or distributed from an IRA to the individual for whose benefit the IRA is maintained if the entire amount is paid into either an IRA or eligible retirement plan not later than 60 days after the distribution date.

Rev. Proc. 2003-16[63] provides the following factors to be evaluated in determining whether to grant a waiver of the 60-day rollover requirement.

- Errors committed by a financial institution
- Inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, or postal error
- The use of the amount distributed
- The time elapsed since the distribution occurred

Holding. Because the taxpayer did not present any evidence to support the factors outlined in Rev. Proc. 2003-16, the IRS declined to waive the 60-day rollover requirement.

63. Rev. Proc. 2003-16, 2003-4 IRB 359.

Prohibited Transactions

***Lawrence and Sara Peek et al. v. Comm'r,* 140 TC No. 12 (May 9, 2013)**
IRC §§408, 4975, and 6662

☞ IRA Status Lost

Facts. Lawrence Peek and Darrell Fleck, Colorado residents, each established IRAs into which they rolled over funds from other retirement accounts. In 2001, they created a new corporation, FP Company, Inc., in which each of their IRAs acquired a 50% ownership of the corporate shares.

FP Company, Inc., then purchased a fire safety company. For part of the purchase price, Peek and Fleck personally guaranteed loans totaling $200,000.

In 2003 and 2004, Peek and Fleck rolled over their FP Company stock from their traditional IRAs to Roth IRAs. In 2006, the Roth IRAs sold the FP Company stock, which resulted in substantial gains. Payments were received on five different dates in 2006 and 2007.

The IRS determined that each of their personal guaranties of the FP Company loans was an indirect extension of credit to the IRAs, which is one of several **prohibited transactions** with IRA accounts under IRC §4975. Under IRC §408(e), the accounts that held the FP Company stock ceased to be IRAs. The IRS issued notices of deficiency to both Peek and Fleck, finding them liable for taxes on the gain of the FP Company stock sale as well as accuracy-related penalties.

Issues. The issues in this case are as follows.

- Whether Peek and Fleck are liable for taxes on the gain of the sale of FP Company stock
- Whether Peek and Fleck are liable for accuracy-related penalties under IRC §6662(a) for both 2006 and 2007

Analysis. IRC §408(e)(2)(A) provides that an account **ceases to qualify as an IRA** if the individual for whose benefit the IRA is established engages in a transaction prohibited by IRC §4975. IRC §4975(c)(1)(B) prohibits any direct or indirect lending of money or other extension of credit between a retirement plan and a disqualified person. The IRS contended that the personal loan guarantees as part of the fire safety company purchase were prohibited transactions. Peek and Fleck countered that their personal guarantees were not prohibited transactions because they did not involve the "plan" (i.e., the IRAs). The loan guarantees at issue were between disqualified persons (Peek and Fleck) and an entity other than the plans (i.e., FP Company).

The court noted that this reading of the statute would rob it of its intended breadth. If the statute prohibited only a loan or loan guarantee between a disqualified person and the IRA itself, then the prohibition could be easily and abusively avoided by having the IRA create a shell subsidiary to which the disqualified person could then make a loan. The court concluded that §4975(c)(1)(B) prohibited Peek and Fleck from making loans or loan guarantees either directly to their IRAs or indirectly to their IRAs by way of the entity owned by the IRAs.

With respect to the penalties, the taxpayers argued that they relied on advice from their CPA, who originally provided them with assistance in structuring the entire plan as a promoter. However, neither of them informed their accountant of their intention to personally guarantee FP Company loans. In addition, the CPA did warn them not to engage in any transactions that the IRS would determine to be prohibited transactions.

Holding. The court held that each original account holding the FP Company stock ceased to qualify as an IRA in 2001. In 2003 and 2004, when Peek and Fleck established the Roth IRA accounts, those accounts ceased to be Roth IRAs because they engaged in prohibited transactions. **Accordingly, the gains from the sales of stock were taxable transactions.** The court sustained the assertion of the accuracy-related penalties as well.

S CORPORATION

S Corporation Basis

***Marc and Anne Barnes v. Comm'r*, U.S. Court of Appeals, D.C. Circuit; No. 12-1284 (Apr. 5, 2013)**
IRC §§1366, 1367, and 6662

☞ Insufficient Basis Prevents Deduction of S Corporation Loss

Facts. Marc and Anne Barnes were involved in numerous business activities, including restaurants, nightclubs, and an event-promotion sole proprietorship. They also owned a partial interest in Whitney Restaurants, an S corporation.

The taxpayers reported the income and losses from the various businesses on their 2003 joint income tax return. Their 2003 return included a loss of $279,289, which was reported based on the Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.,* received from Whitney Restaurants. After examining the return, the IRS allowed only $153,283 of the S corporation loss. The IRS disallowed the remaining loss of $123,006 due to **insufficient basis.**

The taxpayers challenged the IRS computation of the correct basis in the S corporation. They contended that the IRS misunderstood relevant law in computing stock basis. The dispute was whether a taxpayer's basis in an S corporation is reduced by the amount of any suspended losses **in the first year** the basis is adequate to absorb those losses, **regardless of whether the taxpayer claims a tax deduction for those losses in that year.**

On their joint 1997 tax return, Mr. and Mrs. Barnes failed to deduct an allowable S corporation suspended loss from Whitney Restaurants even though they had adequate basis to absorb the loss. **They contended that because they did not actually deduct the allowable suspended loss in 1997, there should be no basis reduction in the S corporation.** The IRS disagreed.

Another contentious issue was the correct amount of the gross receipts reported on the 2003 Schedule C of the event-promotion business. At the previous Tax Court trial,[64] the taxpayers contended that they had overstated the gross receipts figure by $30,000 due to a "bookkeeping error." The Tax Court had rejected that contention but the taxpayers did not agree with that previous finding.

The IRS had proposed an additional tax deficiency of $54,486 and imposed a 20% accuracy-related penalty of $10,897. The Tax Court upheld the IRS's positions in full and the taxpayers appealed the decision to the Circuit Court for the District of Columbia.

Issues. The issues in this case are as follows.

- Whether the allowable S corporation loss is only $153,283 as proposed by the IRS
- Whether the reported Schedule C gross receipts figure was overstated by $30,000
- Whether the 20% accuracy-related penalty proposed by the IRS is proper

Analysis. IRC §1367 specifies the effects of various losses on a shareholder's basis. This Code section states that **basis "shall be decreased for any period" by "the shareholder's pro rata share of the corporation's … items of … loss."**

IRC §1366 states that any S corporation losses for which a shareholder lacks sufficient basis "shall be **treated as incurred by the corporation in the succeeding taxable year."**

The court concluded that the taxpayers had adequate basis in the S corporation in the 1997 tax year to deduct the suspended loss that was carried over to 1997. **It could find nothing to support the taxpayers' argument that basis should not be reduced by the suspended losses that were not deducted in 1997.**

64. *Barnes v. Comm'r*, TC Memo 2012-80 (2012).

The court found it unfortunate that Mr. and Mrs. Barnes paid more tax than they owed for the 1997 tax year but added "so it goes." **They could have avoided the problem by deducting the suspended S corporation loss on their 1997 tax return or by filing an amended return prior to the expiration of the statute of limitations.** The taxpayers invoked the so-called "tax benefit rule," but that argument was dismissed as "simply inadequate."[65]

Regarding the $30,000 bookkeeping error, the Barnes provided evidence that the $30,000 was part of a $60,000 check, **but could not show that the excess $30,000 was included in total gross receipts** on the 2003 Schedule C.

Holding. The Appeals Court upheld the IRS position and the Tax Court's decision on all counts, including the imposition of the accuracy-related penalty.

SAME-SEX MARRIAGE

Defense of Marriage Act

***U.S. v. Edith S. Windsor*, No. 12-307, S.Ct. (Jun. 26, 2013)**
IRC §2056(a) (primary)

☞ Federal Law Must Recognize Same-Sex Marriages that are Valid under State Law

Facts. In 1996, as some states were beginning to consider the concept of same-sex marriage, Congress enacted the Defense of Marriage Act[66] (DOMA). Section 2 of DOMA protected states from being required to recognize same-sex marriages sanctioned in other states. Section 3 defined marriage as between one man and one woman for all federal purposes.

Edith Windsor and Thea Spyer met in New York City in 1963 and began a long-term relationship. In 1993, the city of New York gave same-sex couples the right to register as domestic partners, and Windsor and Spyer did so. In 2007, they were married in Ontario, Canada. They continued to reside in New York City.

In 2008, the New York Supreme Court ruled that the state of New York must recognize valid same-sex marriages performed in other jurisdictions, even though the state of New York did not itself grant the right to same-sex couples.[67] Because of the 2008 ruling, the state of New York recognized the Ontario marriage of Windsor and Spyer as valid in New York.

Spyer died in February 2009 and left her entire estate to Windsor. Because DOMA denies federal recognition to same-sex spouses, Windsor did not qualify for the marital exemption from the federal estate tax, which excludes from taxation "any interest in property which passes or has passed from the decedent to his surviving spouse."[68]

Windsor paid $363,053 in estate taxes and filed for a refund. The IRS denied the refund, concluding that Windsor was **not** a surviving spouse under DOMA. Windsor sued, using the argument that DOMA violates the guarantee of equal protection under the Fifth Amendment.

Both the District Court and the 2nd Circuit Court of Appeals ruled in Windsor's favor. The Bipartisan Legal Advisory Group (BLAG) of the U.S. House of Representatives appealed the decisions. The U.S. Supreme Court agreed to hear the case.

Issue. The sole issue is whether §3 of DOMA violated the Fifth Amendment guarantee of equal protection.

65. *Hillsboro National Bank v, Comm'r*, 460 U.S. 370, 377-86 (1983).

66. PL 104-199.

67. *Martinez v, County of Monroe*, 50 A.D.3d 189, 193 (4th Dept 2008).

68. IRC §2056(a).

Analysis. The state of New York recognized Windsor and Spyer as a married couple. If DOMA was determined to violate the Fifth Amendment, then the federal government must also recognize the two as being married. If the IRS recognized the couple as married, then there would be no estate tax due because of the marital exemption and Windsor would qualify for a refund of all of the estate taxes paid. If DOMA was allowed to stand, then Windsor would not qualify for a refund because, under federal law, she was not Spyer's spouse.

Holding. The Supreme Court ruled that any marriage that the state of New York defined as valid must be recognized by the IRS as a marriage under federal law. The Court found that §3 of DOMA was unconstitutional because it violated the equal liberty of persons under the Fifth Amendment.

> **Note.** Although the case dealt specifically with estate taxes, the words **marriage** and **spouse** appear numerous times in the Code and other federal laws and regulations. In its opinion, the Court noted that over 1,000 federal laws and the whole realm of federal regulations incorporate references to marital status. All of these laws are affected by this ruling.

Observations

1. In practice, same-sex married couples may or may not be recognized as married under federal law.[69] Because not all states recognize same-sex marriage, it will be possible for the couple's marriage to be:

   a. **Recognized** under federal law based on the legality of their marriage in the state in which it was **performed**, and

   b. **Not recognized** under another federal law based on the nonrecognition of their marriage in the state where they **reside**.

2. Because the federal definition of marriage under DOMA was declared unconstitutional, any valid same-sex marriages that are recognized by appropriate authorities must be federally recognized as of the **marriage date.**

3. For any years not barred by the statute of limitations, members of same-sex couples who paid social security and Medicare taxes on certain fringe benefits, income taxes, estate taxes, gift taxes, or filed gift tax returns should consider filing amended returns.

4. The federal **statute of limitations** is generally three years from the date the return was filed or two years from the date the tax was paid, whichever is later. However, the deadline for a married couple to change from filing separate returns to filing a joint return expires three years from the original due date of the returns **without** regard to extensions.[70]

   However, in *Glaze v. U.S.*,[71] which involved a couple whose **legal marital status was unknown** at the time the returns were filed, the Appellate court agreed with the lower court that the general limitation period applied instead of the shorter statutory period.

   > *. . . the limitation period set forth in Section 6013(b)(2) was not applicable to this case because decedent's administrator could not have filed a joint return within the meaning of Section 6013(b)(1) prior to the jury determination that William Currie and June Barrow were married at the time of Currie's death. . .*

   The IRS has announced that it will only follow the holding in this case if the taxpayers live in the 5th or 11th Circuits.[72]

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69. *With DOMA Victory, HRC Calls on Administration to Broadly Implement Decision.* Jun. 26, 2013. Human Rights Campaign. [www.hrc.org/blog/entry/with-doma-victory-hrc-calls-on-administration-to-broadly-implement-decision] Accessed on Jul. 7, 2013.

70. IRC §6013(b)(2)(B).

71. *Glaze v. U.S.*, 641 F.2d 339 (Apr. 2, 1981).

72. Chief Counsel Notice CC-2006-010 (Mar. 2, 2006).

5. Same-sex couples who live in states that do not recognize their legal unions as marriages may wish to file **protective claims** for federal refunds prior to expiration of the statute of limitations for any open-year returns, in the event that the courts or legislators retroactively recognize their unions.

A protective claim[73] must be filed prior to the expiration of the statute of limitations. The IRS requires that the claim describe in detail the facts and supporting reasons. The details must be sufficient for the IRS to have all the facts necessary to evaluate the claim. The statement of the facts and legal arguments must also include a written declaration that the statement is made under the penalties of perjury.

Definition of Marriage

Rev. Rul. 2013-17, IRB 2013-38 (Aug. 29, 2013)

IRC §6013

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☞ Legal Same-Sex Marriages Recognized for Federal Tax Purposes

Purpose. Rev. Rul. 2013-17 was issued by the IRS in response to the June 26, 2013 decision by the Supreme Court in *U.S. v. Windsor*.[74] The Treasury Department and **the IRS ruled that same-sex couples, legally married in jurisdictions that recognize their marriages, will be treated as married for federal tax purposes.** This ruling applies regardless of whether the couple lives in a jurisdiction that recognizes same-sex marriage or a jurisdiction that does not recognize same-sex marriage.

Analysis. Under this ruling, same-sex couples will be treated as married for **all** federal tax purposes, including income, gift, and estate taxes. **The ruling applies to all federal tax provisions in which marriage is a factor, including the following.**

- Filing status
- Claiming personal and dependency exemptions
- Taking the standard deduction
- Employee benefits
- Contributing to an IRA
- Claiming the earned income credit
- Claiming the child tax credit

Same-sex marriages legally entered into in any state, the District of Columbia, a U.S. territory, or a foreign country are covered by the ruling. **However, the ruling does not apply to registered domestic partnerships, civil unions, or similar formal relationships recognized under state law.**

Legally married same-sex couples generally **must** file their **2013 federal income tax returns** using **either** the married filing jointly or married filing separately status.

Individuals who were in same-sex marriages may, but are not required to, file original or amended returns choosing to be treated as married for federal tax purposes **for one or more prior tax years still open under the statute of limitations.** Generally, the statute of limitations for filing a refund claim is three years from the date the return was filed or two years from the date the tax was paid, whichever is later.

73. Treas. Reg. §301.6402-2(b)(1).

74. *U.S. v. Windsor,* 570 U.S. ___, 133 S. Ct. 2675 (2013).

Taxpayers who wish to file a **refund claim for income taxes** should use Form 1040X, *Amended U.S. Individual Income Tax Return*. Taxpayers who wish to file a **refund claim for gift or estate taxes** should use Form 843, *Claim for Refund and Request for Abatement.*

Additionally, employees who purchased same-sex health insurance coverage from their employers on an **after-tax basis** may treat the amounts paid for that coverage as **pre-tax and excludable from income**.

The Treasury Department and the IRS intend to issue **streamlined procedures for employers who wish to file refund claims for payroll taxes** paid on previously-taxed health insurance and fringe benefits provided to same-sex couples. In addition, the IRS intends to issue further guidance on cafeteria plans and on how qualified retirement plans and other tax-deferred arrangements should treat same-sex spouses for periods **before** the effective date of Rev. Rul. 2013-17.

Effective Date of Rev. Rul. 2013-17. The IRS began applying the terms of this ruling on September 16, 2013. However, taxpayers who wish to rely on the terms of the revenue ruling for earlier periods may do so, as long as the statute of limitations for the earlier period has not expired.

Note. The IRS website has answers to frequently asked questions about same-sex marriages,[75] registered domestic partners, and civil unions.[76] This website is a valuable resource for taxpayers and tax preparers regarding the application of Rev. Rul. 2013-17.

SELF-EMPLOYMENT INCOME

Self-Employment Tax

Lauren A. and Michael H. Howell v. Comm'r, **TC Memo 2012-303 (Nov. 1, 2012)**
IRC §§702, 1401, and 1402

☞ Self-Serving Statements Backfire

Facts. In September 1999, Lauren and Michael Howell and Harold Bruzee started Intelemed, LLC, a California medical technology company that provides hardware and software to hospitals.

Michael entered into an agreement with Intelemed on October 1, 1999, to provide management services. Under this agreement, Michael was to have exclusive control of all management and operations. Michael met with clients, set up service agreements, and handled marketing. Lauren signed Intelemed documents and discussed marketing strategies with Michael.

Intelemed filed Forms 1065, *U.S. Return of Partnership Income,* for both 2000 and 2001 because the company is treated as a partnership for federal income tax purposes. The Schedules K-1, *Partner's Share of Income, Deductions, Credits, etc.,* showed the following information.

	2000		2001	
Partner	**Ordinary Income**	**Guaranteed Payments**	**Ordinary Income**	**Guaranteed Payments**
Michael Howell	$2,595	$34,861	$ 0	$ 0
Lauren Howell	4,757	63,850	10,713	149,500
Harold Bruzee	4,262	57,214	5,826	80,000
Kevin Roberts	741	9,600	2,255	30,000

75. *Answers to Frequently Asked Questions for Individuals of the Same Sex Who Are Married Under State Law.*[www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Same-Sex-Married-Couples] Accessed on Sep. 6, 2013.

76. *Answers to Frequently Asked Questions for Registered Domestic Partners and Individuals in Civil Unions.* [www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Registered-Domestic-Partners-and-Individuals-in-Civil-Unions] Accessed on Sep. 6, 2013.

The IRS examined Intelemed's 2003–2005 tax returns. It expanded the scope of the audit to include the Howell's 2000 and 2001 tax returns, which had not been timely filed. During the time an Appeals officer was evaluating the case, the Howells **submitted delinquent tax returns** for 2000 and 2001, which showed the following.

	Taxable Income	Schedule C Net Profit	Self-Employment Income	Partnership Distributions from Intelemed
2000	$ 41,968	$25,875	$23,896	$ 68,607
2001	106,606	1,375	1,270	160,213

The IRS issued notices of deficiency for 2000 and 2001 that showed **the following proposed adjustments.**

	2000	2001
Lauren Howell guaranteed payments	$63,850	$149,500
Lauren Howell ordinary income from Intelemed	4,757	10,713
Lauren Howell self-employment income	63,850	149,500
Michael Howell self-employment income	25,875	1,679

Issue. Whether the Howells are liable for self-employment (SE) tax on payments made to Lauren by Intelemed during 2000 and 2001.

Analysis. Intelemed's 2000 and 2001 tax returns reported guaranteed payments to Lauren. For both years under consideration, Lauren signed Intelemed's tax returns. Michael provided the tax information used to prepare the returns. When the Howells filed their personal tax returns, they reported Intelemed's payments as distributive shares of partnership income classified as passive income that is **not** subject to SE tax.

At trial, the taxpayers argued that Lauren was a limited partner of Intelemed; therefore, her distributive share of Intelemed income should be excluded from her net SE earnings. Lauren testified that she did not provide any services to Intelemed during the years at issue. However, the court did not find her testimony credible in light of other evidence that showed Lauren provided marketing advice, used her credit card to purchase equipment, executed documents, and served as the company's tax matters partner.

IRC §1402(a)(13) provides that a limited partner must include guaranteed payments in SE income if the payments were received for services actually rendered to or on behalf of the partnership to the extent that the payments are remuneration for those services.

The Howells controlled Intelemed, provided the tax return information to the preparer, and signed the tax returns. By claiming the payments were not really guaranteed payments to Lauren, the Howells attempted to disavow the position taken on Intelemed's returns. At trial, the Howells argued that the payments were really partnership distributions, rather than guaranteed payments. Because the Howells provided no corroborating evidence to show the position on the Intelemed returns was incorrect, the court rejected the testimony as self-serving and unreliable.

Holding. The court found that the payments made to Lauren Howell were guaranteed payments subject to SE tax.

TAX FRAUD

Timely Tax Assessment

***City Wide Transit Inc. v. Comm'r,* U.S. Court of Appeals, 2nd Circuit; No. 12-1040 (Mar. 1, 2013)**

IRC §§6501, 6330, and 7206

☞ Fraudulent Tax Returns Allow IRS to File Assessments

Facts. Ms. Ray Fouche owned several bus companies, including City Wide Transit. By the end of 1998, the companies owed a total of over $700,000 of outstanding payroll tax liabilities that are unrelated to the current appeal.

Fouche hired Manzoor Beg to negotiate these liabilities with the IRS. She paid Beg, who falsely represented himself as a CPA, $30,000 in April 1999 and agreed to pay an additional 25% of the amount Beg was able to save City Wide in the negotiations.

Fouche also hired a payroll service to prepare quarterly payroll tax returns for the periods relevant to this appeal. Fouche wrote checks for the payroll taxes due and gave them, along with the returns, to Beg. Beg promised to give them to the revenue officer with whom he was negotiating.

Instead of filing the correct returns, Beg prepared, signed, and filed another set of returns for some of the quarters. He fraudulently added advance earned income credits (EIC) payments to the returns, which significantly reduced City Wide's tax liabilities. Then he changed the payee on the City Wide checks from the IRS to an account that he owned. He wrote checks payable to the IRS for the reduced amount shown on the fraudulent returns. These fraudulent changes reduced City Wide's payroll taxes by $371,615.

Beg's scheme was discovered by the IRS on June 10, 2002. Beg was charged and pled guilty to these charges.

In May 2004, the IRS began a civil examination of City Wide's tax returns to recover the taxes that were underassessed as a result of Beg's fraud. This resulted in the IRS assessing additional tax of $371,625. The IRS did not assess any fraud penalties against either Fouche or City Wide.

City Wide challenged the assessments as being beyond the 3-year statute of limitations. The Tax Court agreed with City Wide but noted that the IRS could trigger tolling provisions to extend the limitations period if it could show with "clear and convincing evidence that Mr. Beg had the specific intent to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes."[77] The Tax Court concluded that the IRS did not meet that standard. The IRS then appealed the decision.

Issue. Whether the IRS is prohibited from collecting because the 3-year statute had expired.

Analysis. IRC §6501(c) states that in the case of a false or fraudulent return with the intent to evade tax the IRS can assess tax at any time. In analyzing §6501(c), the court noted that limitations statutes barring the collection of taxes otherwise due and payable are construed in favor of the IRS.[78] Accordingly, the limitations period for assessing taxes is extended if the taxes were understated because of the preparer's fraud.

Holding. The appeals court concluded that Beg's scheme was to clearly evade City Wide's tax liability and that **the statute of limitation could be extended.** It did not matter that City Wide did not benefit from Beg's fraudulent practice.

77. *City Wide Transit, Inc. v. Comm'r*, TC Memo 2011-279 (Nov. 23, 2011).

78. *Bufferd v. Comm'r*, 506 U.S. 523, 527 n.6 (1993).

Preparer Fraud

U.S. v. Linda F. Townsend et al., **U.S. Court of Appeals, 7th Circuit; Nos. 12-1544, 12-1589 (Apr. 9, 2013)**

☞ Fraudulent Returns Cost Government Half a Million Dollars in Refunds

Facts. Linda Townsend and codefendant Roshunda Smith filed 174 fraudulent income tax returns, which cost the government nearly half a million dollars in refunds. The preparers pleaded guilty to conspiracy to defraud the United States and received sentences at the low end of the guideline ranges. Townsend appealed her sentence, but Smith's attorney moved to withdraw because he believed that the appeal was frivolous.

Smith and Townsend collected the names and identifying numbers of acquaintances and family members, including Townsend's two incarcerated sons. Next, using Form W-2 information from a former employer, they electronically filed tax returns, misrepresenting these individuals' income and withholdings and falsely claiming certain tax credits. The refunds were directed to Townsend's address or were electronically deposited in their own bank accounts or accounts of other participants in the scheme. In total, they applied for $1.5 million in refunds. The IRS, however, detected problems with many of the returns and only paid out $450,000.

Both Smith and Townsend pleaded guilty to a single count of conspiracy to defraud the U.S. government. The presentence report was prepared by the probation officer and resulted in an advisory sentence of 24 to 30 months imprisonment.

Smith was sentenced to 46 months imprisonment. This was partly based on the fact that she had a criminal history. She also claimed more than $1 million of fraudulent refunds.

Issue. The issue in this case is whether Townsend's sentence should be reduced.

Analysis. While Smith filed $1 million of fraudulent returns, Townsend "only" filed $500,000 worth. Townsend asserted that she worked for Smith and her only role was allowing Townsend to use her bank accounts and collecting the names of people Smith could use to file false returns. Townsend's attorney also argued that Townsend was "not a ringleader" and other people were involved in the fraud and they were not charged.

The court made several observations, which substantiate its ruling.

- Townsend not only filed false returns, but she encouraged the filing of false returns and recruited people to assist in the effort.
- Townsend involved her four adult children in the crime.
- Townsend did not argue that she was entitled to a reduction as a minor participant or explain why she was less culpable than the average violator.
- Townsend did not dispute that she was personally responsible for an intended loss of nearly $220,000 and participated in about one-third of the fraudulent returns.

Holding. The appeals court held the sentence to be correct.

Statute of Limitations

***Frank and Julie Bohannon v. Comm'r,* TC Memo 2013-122 (May 7, 2013)**
IRC §§6501 and 6663

☞ Reliance on Wife Does Not Constitute Intent to Evade

Facts. Frank Bohannon operated various businesses that included several sole proprietorships, several S corporations, and a partnership. One of his businesses provided tax return preparation services.

In the late 1980s, Mr. Bohannon began suffering from ulcerative colitis. To treat the disease, he took medications that adversely affected his acumen, attitude, and endurance. As a result, Mrs. Bohannon began handling the bookkeeping for the various businesses even though she had no bookkeeping or business experience. Although the Bohannons kept meticulous records, she incorrectly classified numerous expenditures in the books. Her errors included listing personal expenses as business deductions.

Mr. Bohannon used the yearend numbers Mrs. Bohannon provided to prepare the business tax returns and their personal tax returns. These returns improperly claimed numerous personal expenses.

An initial IRS examination turned into a criminal tax evasion investigation. The notices of deficiency issued by the IRS for the 1992 though 1995 tax years showed deficiencies totaling over $300,000, along with IRC §6663 fraud penalties.

Issues. The issues in this case are as follows.

- Whether the IRS issued a notice of deficiency within the applicable limitations period
- Whether the Bohannons are liable for deficiencies and fraud penalties

Analysis. IRC §6501(a) provides that the amount of any tax must generally be assessed within three years of filing a return. Pursuant to IRC §6501(c)(1), the period to assess tax liabilities remains open when taxpayers file false or fraudulent returns with the intent to evade tax.

The IRS contended that, as a certified tax practitioner, Mr. Bohannon **deliberately** classified personal expenditures as business expenses to reduce their tax liabilities. Mr. Bohannon credibly testified that he did not pay close attention to how Mrs. Bohannon classified these expenditures. Mr. Bohannon trusted and relied on Mrs. Bohannon's classifications. Although his reliance on her may have been imprudent, the court determined that the underpayment for expense misclassifications did not rise to the level of evading tax.

Holding. The extended limitations period set forth in IRC §6501(c)(1) is not applicable. Consequently, the IRS-recommended deficiencies are barred.