Chapter 5: Rulings and Cases

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EXPLANATION OF CONTENTS

Please Note. This chapter is a collection of selected cases, Revenue Rulings, Revenue Procedures, Treasury Regulations, Announcements, and Letter Rulings issued during the past year, through approximately July 31, 2014. 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 Treasury regulations construing such statutes

> **Note.** Proposed regulations present a tentative IRS position that 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 IRC. Regulations have the force and effect of law unless they are in conflict with the statute they explain.

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

1. Treas. Reg. §1.6662-4(d)(3)(iii).

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

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

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

Service Center Advice (SCA). 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 because 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 they receive the statutory notice or notice of final determination ("90 day letter").

1. File a petition in the Tax Court without paying the tax.
2. 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 in 1942 by Congress under Article I of the Constitution. 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 issues a notice of final determination. A notice of final determination is 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 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 treats the letter as an imperfect petition and allows 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, they 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 that allow the taxpayer to present their 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 courtroom available which contains a variety of electronic technology equipment. This courtroom can be used to conduct Court proceedings. Guidelines 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 are 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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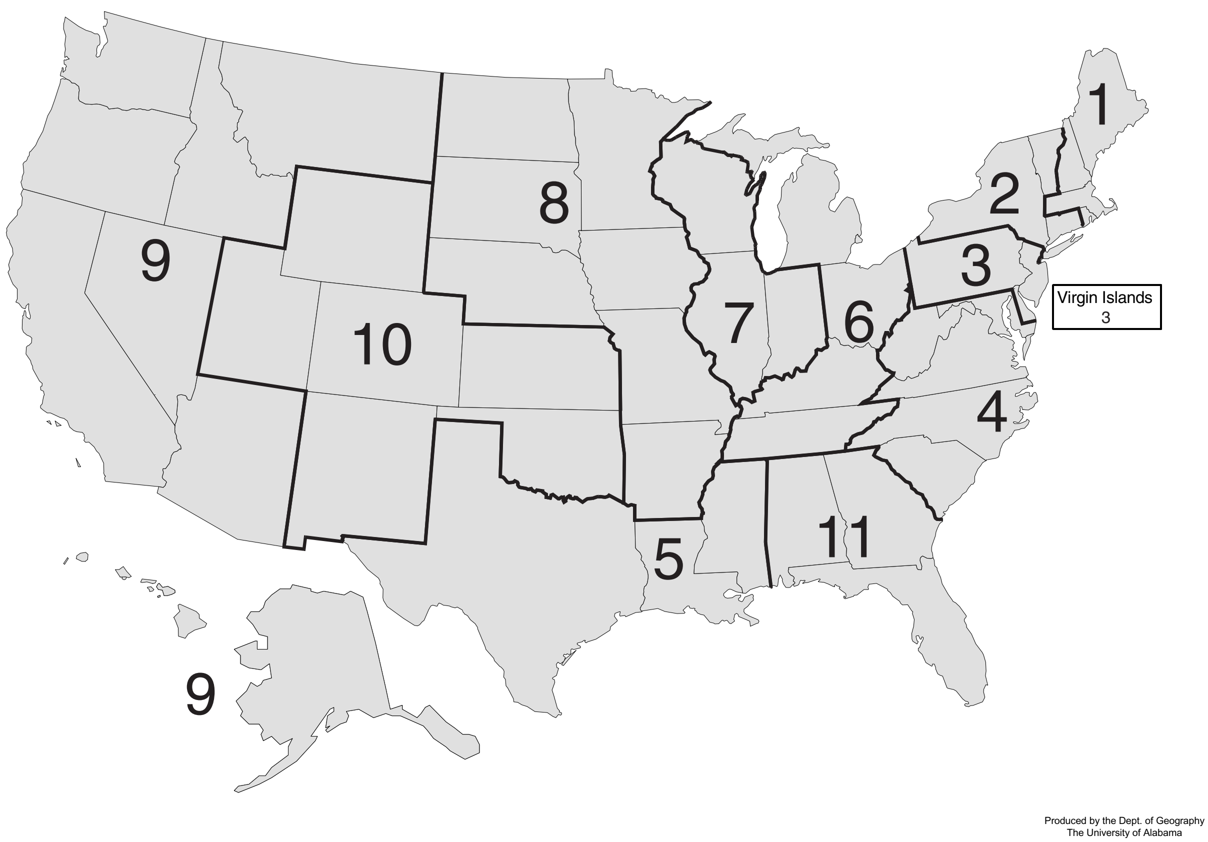
Federal Judicial Circuits and Districts



AMORTIZATION AND DEPRECIATION

Bonus Depreciation

***Michael D. and Mary M. Brown v. Comm'r,* TC Memo 2013-275 (Dec. 3, 2013)**
IRC §§167, 168, 6662, and 6663

☞ Specifically Assigned Function Determines Placed-in-Service Date

Facts. Successful insurance salesman Michael Brown caters to the wealthy. The life insurance policies he sells range from $10 million to $300 million **each.** On the larger policies, the premiums average between $10 and $15 million per year. His commission on a policy often equals the first year's premium. He has earned over $10 million on a single policy several times; one time, he earned $17 million on a single deal.

Mr. Brown's wealthy clients demand a high level of service. Relying on commercial flights or chartered flights to meet with prospective clients often resulted in lost business. In 2001, he purchased a Hawker jet that had the capability to fly nonstop for four hours without refueling. Because most of his prospective clients were either in New York City or Los Angeles, the Hawker had to stop part way between these two cities to refuel, resulting in an additional two hours of lost time for Mr. Brown.

Because of the increased bonus depreciation incentive (50% for certain property acquired and placed in service between May 6, 2003, and December 31, 2004), reduced interest rates for borrowing funds, and an exceptionally good year, Mr. Brown searched for a better airplane. One critical stipulation was that the plane had to be **delivered by the end of 2003.**

On December 16, 2003, Mr. Brown signed a contract for a Bombardier Challenger 604 with Midcoast for $22 million. Its delivery was promised to him by December 31, 2003. Mr. Brown decided he needed some modifications to the Challenger, including a conference table and a 20-inch display screen. If these additions were to be installed immediately, delivery of the Challenger would not meet the December 31 deadline. Accordingly, Mr. Brown and Midcoast agreed to a December 2003 delivery date, with work on a $500,000 modification package to start in January 2004 after the plane was returned to Midcoast Aviation Facility.

Mr. Brown accepted delivery of the Challenger on December 30 in Portland, Oregon, and promptly took "tax flights" to ensure he properly placed the aircraft into service in 2003. The first tax flight included a business lunch in Seattle, Washington, with a real-estate developer and two potential clients. The next segment of the tax flight was from Seattle to Chicago, where Mr. Brown met with his mentee Marc Pasquale for a quick tour of his new plane and a bite to eat. The plane returned to Portland late that evening. For both of these meetings, Mr. Brown had his CFO draft thank-you letters well after the meetings to substantiate deductions for the IRS. Each letter was dated December 31, 2003. The letters were sent to the developer and mentee for signature before presenting to the IRS. At trial, it was determined that neither the developer nor the mentee knew for sure when they actually received the letters for signature but they thought it was sometime between 2004 and 2006.

In January 2004, the Challenger was returned to Midcoast for the modifications. The plane was returned to Brown with the requested modifications on January 30.

On their 2003 joint tax return, Mr. and Mrs. Brown claimed almost $11.2 million of bonus depreciation on Schedule C, *Profit or Loss From Business,* for the Challenger purchase. The IRS challenged the deduction and recommended the assertion of the fraud penalty with respect to some of the proposed adjustments. The Browns were accustomed to the IRS challenging their deductions, as six notices of deficiency were issued from 2001 through 2006 spanning a number of issues, including fraudulent consulting-fee deductions. The cases were consolidated prior to trial with all issues being resolved except for the aircraft bonus depreciation and penalties.

Issues. The issues in this case are as follows.

- Whether the Browns are entitled to bonus depreciation of $11.2 million on the Challenger aircraft
- Whether the Browns are liable for the IRC §6663(a) fraud penalty
- Whether the Browns are liable for the IRC §6662(a) accuracy-related penalty

Analysis. The Challenger's "placed-in-service" date is the central issue in this case. The Browns alledge they placed it in service in 2003 when they took physical possession. The IRS contends it was placed in service in 2004 when the modifications were done and Mr. Brown had it equipped to satisfy his business needs. IRC §168(k) states that, for qualified property, the 50% bonus depreciation deduction is allowed for the taxable year in which the property is **placed in service.** Treas. Reg. §1.167(a)-11(e)(1)(1) provides that the property is first placed in service when it is in a condition or state of readiness and available for a **specifically assigned function.** The IRS argued that the modifications necessary to make the aircraft ready for Mr. Brown's use for his insurance business did not take place until 2004. After looking at several court cases dealing with similar issues, the court determined that the Challenger was not placed in service until 2004 because Mr. Brown testified that the two modifications were "needed" and "required" to be useful in his business operation.

The IRS argued that three factors supported the imposition of the fraud penalty.

- The false thank-you letters
- Mr. Brown's level of sophistication
- Mr. Brown's pattern of substantially overstating deductions

At trial, Mr. Brown testified that his practice was to have his CFO write letters on behalf of business associates only "when the IRS requests them" — that is, after a return was filed. The court noted that the letters were "a little bit over the top," but it was not clear that the contents of the letters were patently false.

To support the IRS's argument that Mr. Brown was highly sophisticated, evidence was produced that showed Mr. Brown's signature on a false letter addressed to the California Board of Equalization to avoid paying California sales tax when he bought the Hawker, along with letters from former employees drafted by the CFO to corroborate this position. The court did not find that this evidence proved specific instances of Mr. Brown's conduct related to the case at hand.

The IRS also alleged that Mr. Brown engaged in a 4-year pattern of fraud that substantially overstated deductions, which supported a finding of fraud. However, the court stated that it was not looking for evidence as to whether he committed fraud on the returns generally. Rather, the evidence had to prove he committed fraud with respect to one specific deduction. The court found it noteworthy that Mr. Brown actually took ownership of the plane in 2003 and flew to Chicago to discuss business. The court concluded that Mr. Brown actually believed that he completed all the necessary steps that would allow him to properly claim the bonus depreciation deduction for 2003.

The IRS assessed a 20% accuracy-related penalty based on the disallowed bonus depreciation deduction, which resulted in an understatement of tax of approximately $100,000. Because the IRS met the burden of proof based on the substantial understatement, the Browns had to provide evidence to show the IRS determination was incorrect. The Browns did not bring forth any evidence other than their contention that they relied on the express language of the Code. They contended that their reliance on substantial authority showed that they acted with reasonable cause and in good faith. The court, however, noted that the Browns did not produce any credible proof to demonstrate their efforts to assess their proper tax liability.

Holding. The court ruled that the bonus depreciation was not allowed for 2003. In addition, although the court did not sustain the fraud penalty, they did sustain an accuracy-related penalty.

BANKRUPTCY AND DISCHARGE OF INDEBTEDNESS

Inherited IRA

***In re Brandon Clark and Heidi Heffron-Clark,* Nos. 12-1241 and 12-1255, U.S. Court of Appeals for the 7th Circuit (Apr. 23, 2013)**

IRC §§401, 408, and 408A

☞ Appeals Court Holds that Inherited IRA is Not Exempt From Creditors' Claims in Bankruptcy

Facts. Ruth Heffron owned an individual retirement arrangement (IRA) worth approximately $450,000 when she died in 2001. Upon Ruth's death, her account passed to her daughter Heidi Heffron-Clark, who was the designated beneficiary.

Heidi and her husband Brandon Clark initiated a bankruptcy proceeding. At that time, Heidi's inherited IRA was worth approximately $300,000. The bankruptcy judge concluded that in order to qualify for a "retirement fund" exemption, an IRA must be held for the **owner's** retirement. The bankruptcy judge held that the inherited IRA was therefore not exempt, and was subject to creditor claims.

A district judge reversed this decision,[2] adopting the view that any money that represented retirement funds in the decedent's hands must be treated the same way in the successors' hands.[3] The 5th Circuit subsequently agreed with that approach,[4] observing that the Bankruptcy Code refers to "retirement funds" without providing that they must belong to the debtor.

Issue. The issue in this case is whether a nonspousal inherited IRA is exempt from creditors' claims in bankruptcy.

Analysis. Sections 522(b)(3)(C) and (d)(12) of the Bankruptcy Code exempt any "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under sections 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986." This requirement is met if an IRA is used by a person to provide for their own retirement. If a married owner of an IRA dies, the decedent's spouse inherits the account and can either keep it separate or roll it over into the spouse's own IRA. In either situation, the money remains "retirement funds" in the same way that it was before the original owner's death. The surviving spouse cannot withdraw any of the money before age 59½ without paying a penalty, and withdrawals must start no later than the year the survivor reaches age 70½.

Different rules apply to IRAs inherited by a nonspousal beneficiary (inherited IRA). Distributions from inherited IRAs must begin within a year of the original owner's death[5] and payouts must generally be completed within five years. The court noted that this makes an inherited IRA "a time-limited tax-deferral vehicle, but not a place to hold wealth for use after the new owner's retirement." The court further observed that "an inherited IRA does not have the economic attributes of a retirement vehicle, because the money cannot be held in the account until the current owner's retirement."

Holding. The 7th Circuit Court reversed the Wisconsin District Court's decision. Heidi Heffron-Clark's inherited IRA was not exempt from the bankruptcy estate. The creditors can force a distribution from a nonspousal inherited IRA.

> **Note.** In June 2014, the Supreme Court **unanimously upheld** the decision of the 7th Circuit.[6] This decision was necessitated by the conflict between the 5th and the 7th Circuits.

2. *In re Clark,* 466 B.R. 135 (W.D. Wis. 2012).
3. See *In re Nessa*, 426 B.R. 312 (BAP 8th Cir. 2010).
4. *In re Chilton,* 674 F.3d 486 (5th Cir. 2012).
5. IRC §402(c)(11)(A).
6. *Brandon Clark et ux. v. William Rameker, Trustee, et al.,* S.Ct. No. 13-299 (Jun. 12, 2014).

Bankruptcy

***Lester Lee v. Michael Walro*, No. 4:13-cv-00087; U.S. District Court for the Southern District of Indiana (Mar. 31, 2014)**
IRC §§6013 and 6402

☞ Separate Filings Rule Used to Allocate Joint Refund in Bankruptcy

Facts. Lester and Brenda Lee filed their 2011 joint federal tax return and joint Indiana (not a community property state) tax return in October 2012. The total refund for both the state and federal returns was $30,751.

Mr. Lee filed an individual petition for Chapter 7 bankruptcy in January 2012. On February 14, 2013, bankruptcy trustee Michael Walro filed a motion for Mr. Lee to turn over $15,375 (half of the total state and federal refund). Mr. Lee objected and provided calculations from his CPA, which showed that if the Lees had filed separately, Mr. Lee would have incurred a $51,744 federal tax liability and Mrs. Lee would have received a $38,774 refund. The CPA explained that the entire tax refund was due solely to Mrs. Lee's overpayment of her estimated tax liability.

The matter was argued before the Bankruptcy Court on April 4, 2013. The court applied the "minority approach" and equally divided the refund between the debtor (Mr. Lee) and the nondebtor (Mrs. Lee). On April 25, 2013, the Bankruptcy Court required Mr. Lee to turn over $14,588, referring to this amount as his pro-rata share. Mr. Lee subsequently filed a motion to appeal the decision.

Issue. The issue in this case is whether the Bankruptcy Court applied the proper legal standard for allocating ownership interests in a joint tax refund issued to Lester and Brenda Lee for purposes of determining how much of the refund should be included in Lester Lee's bankruptcy estate.

Analysis. There is a split of authority with respect to the appropriate method for allocating joint tax refunds between a debtor and a spouse who is not included in the bankruptcy for purposes of determining what funds may be included in the bankruptcy estate. The **"minority approach"** apportions the right to the refund equally, regardless of which spouse earned the income, paid withholdings, or caused any exemptions or credits to apply. A second approach, used by a majority of courts, is to utilize calculations that split joint tax refunds proportionately based upon the individuals' respective tax withholdings during the taxable year. A third approach, known as the **"separate filings rule"** (or "IRS formula") requires a determination of what each spouse's contributions and tax liabilities would have been if they filed separately and applies that proportion to the joint tax refund.

In this case, the Bankruptcy Court elected to use the minority approach. The trustee argued that, by filing joint returns, Mr. Lee would have been jointly and severally liable for any tax deficiency arising from the joint returns even if the deficiency was due solely to Mrs. Lee's income; likewise, he should have a corresponding joint interest in the refund. The trustee, however, failed to explain how joint and several liabilities equate to 50% ownership of a tax refund. According to the IRS, joint and several liability refers only to tax liability, not to tax refunds.

The trustee also argued that Indiana law treats property acquired during a marriage as joint property. However, this approach ignores the differing policies underlying domestic relations laws and bankruptcy laws. Indiana is not a community property state but rather a state that seeks to divide marital property in a manner that is just and reasonable. Based both on the application of marital dissolution laws and the nature of tax refunds, using the minority approach in bankruptcy cases could deprive one spouse of their separate property interest in the tax refund to which they would otherwise be entitled.

The separate filings rule was requested by Mr. Lee. This approach considers both income and withholdings by calculating a spouse's individual refund. This is done by subtracting a spouse's individual liability, determined using the married filing separately formula, from the spouse's contribution toward the joint liability. In this situation, the IRS formula results in the joint tax liability of $15,848 being allocated entirely to Mr. Lee. Subtracting Mr. Lee's contributions of $2,074 results in an underpayment of $13,774. Mrs. Lee, on the other hand, would be entitled to 100% of the refund of her tax overpayment.

Holding. The court reversed the Bankruptcy Court decision, holding that the separate filings rule should be applied to determine the ownership interests in the joint tax refund.

CAPITAL GAINS AND LOSSES

Sale of Lots

Cordell D. Pool et al. v. Comm'r, **TC Memo 2014-3 (Jan. 8, 2014)**
IRC §§1201, 1221, and 6651

☞ Sale of Lots Taxable as Ordinary Income

Facts. In March 2000, Concinnity, LLC, was organized in Montana by Cordell Pool, Justin Buchanan, Thomas Kallenbach, and Jay Josephs. Concinnity elected to be taxed as a partnership. The same men also formed Elk Grove Development Co. in Montana in August 2000.

On July 5, 2000, Concinnity bought 300 undeveloped acres just outside Bozeman, Montana, for $1.4 million. At the time of purchase, the land was divided into four sections (referred to as phases 1–4). This property later became the Elk Grove Planned Unit Development (Elk Grove PUD).

Concinnity and Elk Grove Development Co. entered into an agreement that gave Elk Grove Development Co. the exclusive right to purchase phases 1–3. As part of the agreement, Elk Grove Development Co. was required to complete all infrastructure improvements necessary to obtain the final plat of each phase.

Concinnity entered into an agreement with Gallatin County, Montana, in which Concinnity would pay for all improvements in phase 1. Concinnity filed an affidavit in June 2001 stating that buy-sell agreements had been entered into for 81 lots at an average fair market value of $41,000 per lot.

Concinnity's tax returns reported phase 1 was sold on May 31, 2001, and phases 2 and 3 were sold on February 21, 2003. A long-term capital gain of $500,761 was reported on Schedule D, *Capital Gains and Losses.* This gain resulted from the taxable portions of two installments it received on the phase 2 and 3 land sales. Concinnity reported the installments on its Forms 6252, *Installment Sale Income,* showing a gross profit percentage of 90.07% for the sale of phase 2 and 93.86% for the sale of phase 3.

The IRS determined that the sales should have been reported on the partnership return as ordinary income rather than capital gains. Adjustments were made on the respective partners' returns accordingly. Partners Cordell Pool, Justin and Kimberly Buchanan, and Thomas Kallenbach filed late individual tax returns for the 2005 tax year, which resulted in penalties for failure to timely file their tax returns.

Issues. The issues in this case are as follows.

- Whether the taxpayers incorrectly characterized ordinary partnership income as long-term capital gain for 2005
- Whether the taxpayers are liable for the IRC §6651(a)(1) penalty for failure to timely file their tax returns

Analysis. IRC §1201(a) provides for preferential treatment for gain realized on the sale of a capital asset. IRC §1221(a)(1) defines a capital asset as property held by the taxpayer but does not include property held by the taxpayer **primarily for sale to customers in the ordinary course of their trade or business.**

The courts use several factors for evaluating whether a taxpayer held certain properties primarily for sale to customers in the ordinary course of business, including the following.[7]

1. **Nature of Property Acquisition.** The IRS contends that Concinnity acquired Elk Grove PUD to divide and sell lots to customers for profit. The IRS cited two documents to support this position. First, Concinnity's 2000 Form 1065, *U.S. Return of Partnership Income,* identifies its principal business activity as "development" and its principal product or service as "real estate." Second, an affidavit Concinnity filed in June 2001 stated that "Concinnity has entered into buy-sell agreements for the sale of 81 lots… of Elk Grove PUD." The court recognized that the taxpayers could have decided to hold the land for investment after initially intending to develop and sell it to customers. However, the taxpayers did not produce any evidence that indicates that their intentions changed. This factor weighs in favor of the IRS.

2. **Frequency and Continuity of Sales.** Frequent and substantial sales of real property are likely to indicate sales in the ordinary course of business, while infrequent sales for significant profits are more indicative of real property held as an investment. The record does not establish whether the buy-sell agreements in the affidavit were to 81 different buyers or to Elk Grove Development alone but the records suggested that Concinnity made sales to other customers. The taxpayers had the burden of showing that their sales were not frequent and substantial. They did not carry their burden; therefore, this factor weighs in favor of the IRS.

3. **Nature and Extent of Business.** The records indicate that Concinnity obligated itself to make certain improvements to Elk Grove PUD and paid for those improvements. The taxpayers did not carry their burden of proving that Concinnity's development activities were insufficient to show that it held Elk Grove PUD primarily for sale in the ordinary course of its trade or business. Accordingly, this factor weighs in favor of the IRS.

4. **Activity of Seller About the Property.** The analysis of this factor again focuses on the 81 buy-sell agreements. The taxpayers did not carry their burden of showing that Concinnity did not spend large portions of its time actively participating in the sales of Elk Grove PUD. This factor weighs in favor of the IRS.

5. **Extent and Substantiality of the Transaction.** The taxpayers bear the burden of producing sufficient evidence demonstrating that they engaged in bona fide, arm's-length transactions. The record reflects that Elk Grove Development Co. agreed to buy the land at an inflated price. Therefore, this factor weighs in favor of the IRS.

Holding. The court concluded that the taxpayers failed to prove that the IRS's determinations are erroneous. Accordingly, the court upheld the IRS's determination that Concinnity held Elk Grove PUD primarily for sale in the ordinary course of its trade or business and improperly reported ordinary income as capital gain. In addition, because the taxpayers did not timely file their respective tax returns, they are liable for IRC §6651(a)(1) penalty.

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[7] See, e.g., *Austin v. Comm'r,* 263 F.2d 462 (9th Cir. 1959), *rev'g* TC Memo 1958-71 (Apr. 24, 1958).

CREDITS

First-Time Homebuyer Credit

***Robert D. Packard v. Comm'r,* U.S. Court of Appeals, 11th Circuit; No. 13-10586 (Mar. 27, 2014)**
IRC §36

☞ Married Couple Considered Inseparable Unit for Purposes of Homebuyer Credit

Facts. Robert and Marianna Packard got 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 residence during the three years before the purchase, but Marianna lived 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, and the Packards petitioned the Tax Court. At that proceeding, the Tax Court determined that, when considered individually, both Mr. and Mrs. Packard would be entitled to the first-time homebuyer credit. Because Mr. Packard qualified under paragraph IRC §36(c)(1) and Mrs. Packard qualified under paragraph §36(c)(6), the court determined that they are entitled to a maximum $6,500 first-time homebuyer credit.[8] The IRS appealed the decision.

Issue. The issue in this case is 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 to which this section applies." The Worker, Homeownership, and Business Assistance Act of 2009 added §36(c)(6), which allows a first-time homebuyer credit for any individual (and if married, the individual's spouse) who owned a principal residence for any five consecutive years during the 8-year period ending on the date of the purchase of a subsequent principal residence.

The court observed that Congress originally precluded a married couple from being eligible for the first-time homebuyer credit unless both spouses satisfied the requirements of §36(c)(1). **When Congress added §36(c)(6), it also precluded a married couple from being eligible unless both satisfied the requirements of that subsection.** The language of §§36(c)(1) and (6) is unambiguous and requires that a married individual be considered together with their spouse as a unit in order to qualify under either paragraph. The court stated that the fact that the Packards would have each qualified for the tax credit individually had they not been married has no bearing on the application of §36(c) to the case.

Holding. Both spouses **collectively must meet the same statutory requirements,** either as first-time homebuyers under IRC §36(c)(1) or as long-time residents under IRC §36(c)(6). Accordingly, the Tax Court decision was reversed; the Packards are not entitled to the first-time homebuyer credit.

> **Note.** For a summary of the Tax Court case, see the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Rulings and Cases.

8. *Packard v. Comm'r,* 139 TC 390 (2012).

DEDUCTIONS

Domestic Production Activities Deduction

***ADVO, Inc. et al. v. Comm'r,* 141 TC No. 9 (Oct. 24, 2013)**
IRC §§199, 168, 936, and 263A

☞ Direct Mail Advertising Distributor Not Entitled to DPAD

Facts. For the tax years ending in September 2005 and 2006 and for the short tax year ending March 2, 2007, ADVO, Inc. (ADVO), was the common parent of the consolidated group ADVO, Inc., and Subsidiaries. ADVO was acquired by Valassis Communications, Inc., on March 3, 2007, and continues to exist as its wholly owned subsidiary.

During 2005, 2006, and 2007, ADVO distributed direct mail advertising through the U.S. Postal Service. Residential recipients are the targeted potential customers for the products and services sold by ADVO's clients, the advertisers.

Some of ADVO's clients supply the advertising material for ADVO to distribute (client-supplied material). For other clients, ADVO supplies the materials for distribution (ADVO-supplied material). **ADVO contracted with third-party commercial printers to print the ADVO-supplied material.**

ADVO claimed a deduction under IRC §199 of $1.5 million for the 2006 tax year and $151,047 for the short 2007 tax year. The IRS disallowed the deduction based on its determination that **ADVO did not manufacture, produce, grow, or extract qualifying production property** under §199 for ADVO's direct advertising mailings.

Issue. The issue in this case is whether ADVO is entitled to an IRC §199 deduction for the company's direct advertising mailings.

Analysis. IRC §199, commonly referred to as the domestic production activities deduction (DPAD), allows a taxpayer to deduct a specified percentage of the lesser of:

- Its qualified production activities income (QPAI), or
- Taxable income.

The deduction is also limited to 50% of the taxpayer's W-2 wages for the tax year.[9] QPAI, for purposes of §199, means the excess, if any, of the taxpayer's domestic production gross receipts (DPGR) over the cost of goods sold and other expenses allocable to the gross receipts.[10] As applicable to ADVO, DPGR is defined in §199(c)(4)(A) as "the gross receipts of the taxpayer which are derived from… qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer… ."

ADVO asserts that its gross receipts from its printed direct mail advertising and distribution products qualify as DPGR. The IRS's position is that because ADVO contracted its actual printing to third-party printers, it did not manufacture any qualifying production property. The mail packages sold by ADVO must be determined to be qualified production property (QPP) in order for the mail packages to qualify as DPGR. The court noted that "the critical issue in this case is whether ADVO manufactured the advertising mailing packages or produced only intangible property used by printers to produce tangible personal property in the form of the advertising mail packages."

9. IRC §199(b).

10. IRC §199(c)(1).

The court observed that the intent of §199 was to encourage domestic manufacturing. It was intended that only one taxpayer could claim the deduction for the manufactured product. In the event that one taxpayer performs a qualifying production activity with another taxpayer, "then only the taxpayer that has the **benefits and burdens of ownership** of the QPP… under federal income tax principles during the period in which the qualifying activity occurs is treated as engaging in the qualifying activity."[11] The factors that the court used to determine the benefits and burdens of ownership for the purposes of this case are as follows.[12]

1. Whether legal title passes
2. How the parties treat the transaction
3. Whether an equity interest was acquired
4. Whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments
5. Whether the right of possession is vested in the purchaser and which party has control of the property or process
6. Which party pays the property taxes
7. Which party bears the risk of loss or damage to the property
8. Which party receives the profits from the operation and sale of the property
9. Whether ADVO actively and extensively participated in the management and operations of the activity

The court reviewed all the preceding factors and found that five of them weighed in favor of the IRS and four were neutral. Accordingly, the court determined that ADVO did not have the benefits and burdens of ownership. Therefore, the gross receipts from the printing activity are not DPGR.

Holding. The court held that ADVO is not entitled to the claimed §199 deduction for its 2006 tax year and its 2007 short tax year.

Uniform Capitalization Rules

***Frontier Custom Builders Inc. v. Comm'r,* TC Memo 2013-231 (Sep. 30, 2013)**
IRC §263A

☞ Custom Homebuilder Must Capitalize Production Costs

Facts. Frontier Custom Builders, Inc. (Frontier) has been a builder of custom and speculative homes since 1994. Frontier timely filed its 2005 Form 1120, *U.S. Corporation Income Tax Return.* The IRS issued a notice of deficiency for the 2005 return, making adjustments totaling $1.89 million under the uniform capitalization rules of IRC §263A.

Issues. Several issues were presented in this case. The following analysis focuses on whether the taxpayer is required to capitalize rather than deduct all direct and indirect costs of production.

Analysis. IRC §263A requires taxpayers that **produce real property** to capitalize certain direct and indirect costs of production and recover those costs in a manner appropriate to the situation.[13] The term "produce" includes "construct, build, install, manufacture, develop, or improve."[14]

11. Treas. Reg. §1.199-3(f)(1).
12. See *Grodt & McKay Realty, Inc., v. Comm'r,* 77 TC 1221 (1981); *Hutchinson v. Comm'r,* 116 TC 172 (2001); and IRC §936.
13. Treas. Reg. §1.263A-1(c).
14. IRC §263A(g)(1).

Frontier, a custom homebuilder, contends that its business model is based on sales and marketing rather than production-related services. Frontier argues that it is outside the scope of §263A because it does not employ the tradesmen who actually build the homes. The company subcontracts all those activities, which include carpentry, welding, and plumbing. Frontier claims that its actual services are more reflective of a sales and marketing company that manages the creation of a custom product rather than a construction company producing streamlined goods.

The court noted in *Von-Lusk v. Comm'r*[15] that activities, other than physical construction, must be included in the production of real property. In *Von-Lusk,* the court held that a partnership had to capitalize the costs of engineering and feasibility studies and architectural plans because those activities were development activities even though they had no immediate physical impact on the property.

Frontier's use of subcontractors for the physical activity of home construction is not sufficient for exemption from §263A. The creative design of custom homes is ancillary to the actual physical work on the land. The court noted that creative design is as much a part of a development project as digging a foundation or completing a structure's frame. Home construction cannot move forward without the design process.

Holding. The court held that Frontier is a producer of real property subject to §263A. Accordingly, it must capitalize all direct and indirect costs of production.

EMPLOYMENT TAX ISSUES

FICA Taxation of Severance Payments

***U.S. v. Quality Stores Inc. et al.,* No. 12-1408, U.S. Supreme Court (Mar. 25, 2014)**
IRC §§3101, 3121, 3401, and 3402

☞ Wages Paid to Terminated Employees Subject to FICA Taxation

Facts. Quality Stores, Inc., and its affiliates (Quality) made severance payments to employees who were involuntarily terminated as part of the company's Chapter 11 bankruptcy. The payments varied based on job seniority and length of service. At the time the payments were made, Quality withheld and paid FICA taxes. Quality later determined that the payments were not subject to FICA taxes and sought a refund on behalf of itself as well as 1,850 former employees. When the IRS did not allow the refund, Quality initiated proceedings in the Bankruptcy Court, which held that the payments were not wages taxable under FICA. The District Court and 6th Circuit affirmed the decision, concluding that severance payments are not wages subject to FICA taxation.

Issue. The issue in this case is whether severance payments made to terminated employees are taxable wages for FICA purposes.

Analysis. Under IRC §3121(a), "wages" for FICA purposes are defined broadly as "all remuneration for employment." Under IRC §3121(b), the term "employment" encompasses "any service, of whatever nature, performed… by an employee for the person employing him." Severance payments are remuneration and are made to employees only. Quality's employees were given severance payments based on job grade and management level.

IRC §3121(a)(13)(A) exempts from taxable wages any severance payments made because of retirement or disability. The payments in question are **not** payments made because of retirement or disability.

15. *Von-Lusk v. Comm'r,* 104 TC 207 (1995).

IRC §3402(o) instructs that any severance payment "shall be treated as if it were a payment of wages." Supplemental unemployment compensation benefits (SUBs), which include severance payments, are treated as if they are wages. Quality contends that the language in §3402(o) providing that SUBS should be treated "as if" they were wages is an indirect means of stating that the definition of wages does not cover severance payments.

The court disagreed that §3402(o) should be interpreted as Quality suggests. The chapter governing income tax withholding has a broad definition of the term "wages." The definitional section for income tax withholding contains a series of specific exemptions that reinforce the broad scope of its definition of wages. Severance payments are **not** specifically exempted, and they fall squarely within the broad definition of wages under §3401(a).

Holding. Severance payments made to terminated employees are taxable wages for FICA purposes.

> **Note.** For a more detailed explanation of the history and issues involved in the *Quality Stores* case, see the 2010 *University of Illinois Federal Tax Workbook,* Chapter 11: Small Business Issues. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

Domestic Partner Benefits

Ltr. Rul. 201415011 (Jan. 13, 2014)
IRC §§61, 104, 152, 501(c)(9), and 3401

☞ Guidance on Domestic Partner Benefits Clarified

Facts. Voluntary Employees' Beneficiary Association trust (Trust), was created to fund the Voluntary Employees' Benefit Association Health Reimbursement Arrangement, which is exempt from tax under IRC §501(a). The Trust is 100% funded by contributions from governmental entity employers. The plan provides health reimbursement arrangement (HRA) benefits, which are limited to qualified healthcare benefits. Beneficiaries include participants, their eligible spouses, dependents, and children pursuant to IRC §105(b). Domestic partners who qualify as dependents under IRC §152(a) are also entitled to HRA benefits. There is a qualification process, which includes attestation, investigation, and verification based on IRS guidelines.

The Trust wants to begin extending HRA benefits to nondependent domestic partners. The total amount of all impermissible benefits, including benefits to domestic partners who are not dependents, to be paid by the Trust in any plan year **will not exceed** 3% of the total benefits the Trust will pay in any plan year. When the domestic partner is not a tax-qualified dependent of the participant, the value of the domestic partner's health coverage would be included as wages to the participant. The Trust will report the income tax withholding for payments deemed wages because of the nondependent partner's coverage. The employer FICA tax, participant's portion of FICA tax, and FUTA taxes will be covered out of the participant's account. Forms W-2 will be issued to those participants who elect coverage for nondependent domestic partners.

Based on the preceding facts, the Trust requested rulings on the following issues.

1. Will the Trust's tax-exempt status be jeopardized if permissible benefits are provided to dependents of domestic partners?
2. Will the Trust's tax-exempt status be jeopardized if permissible benefits are provided to nondependents of domestic partners as long as the total of impermissible benefits is less than 3% of the total amount of benefits paid to all plan participants and beneficiaries in any plan year?
3. Is the coverage provided to a domestic partner who is a dependent under IRC §152(a) includible in gross income and is it wages for employment tax purposes?

4. Is the coverage provided to a domestic partner who is a nondependent under IRC §152 includible in gross income and is the amount of "grossed-up" wages for FICA, FUTA, and income tax withholding purposes required to be reported on a Form W-2?

5. Does the gross income of the participant and domestic partner who is a nondependent include any payment to the extent that the fair market value (FMV) of the HRA coverage provided to the domestic partner is included in the gross income of the participant pursuant to IRC §104(a)(3)?

6. Is the Trust required, as the employer, to withhold income tax and the employee portion of the FICA tax as well as the employer portions of both FICA and FUTA tax?

7. Are wages paid under IRC §3401(d)(1) considered separately from wages paid by the common law employer?

8. Can the Trust treat the HRA benefit coverage as provided on an annual basis for purposes of income tax withholding, FICA, and FUTA?

Analysis.

Rulings 1 and 2. IRC §501(c)(9) provides for an exemption from federal income tax of voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

The Trust requests a ruling that their IRC §501(c)(9) tax-exempt status will not be jeopardized if permissible benefits are provided to dependent domestic partners. Because it already provides HRA benefits to dependent domestic partners and plans to continue doing so in the future, the Trust will ensure they are qualified dependents before receiving HRA benefits.

Rulings 3 and 5. IRC §61(a)(1) and Treas. Reg. §1.61-21(a)(3) provide that gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. Treas. Reg. §1.61-21(a)(3) provides that a fringe benefit provided in connection with the performance of services is considered to have been provided as compensation for such services. Treas. Reg. §1.61-21(b)(1) provides that an employee must include in gross income the fringe benefit's FMV.

Ruling 4. Treas. Reg. §1.61-21(a)(4) provides that a taxable fringe benefit is included in the income of the person performing the services in connection with which the fringe benefit is furnished. Therefore, a fringe benefit may be taxable to a person even though that person did not actually receive the fringe benefit. Treas. Reg. §1.61-21(b)(1) provides that an employee must include in gross income the fringe benefit's FMV.

IRC §§3101 and 3111 provide for FICA tax on employees and employers. IRC §3301 imposes a FUTA tax on employers for wages, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Health benefits provided to persons other than the employee or their dependents are not excluded from FICA and FUTA wages.

If the employee portion of FICA cannot be withheld from the employee's wages, the wages must be grossed up to reflect the additional amount that results from the employer's payment of the employee's FICA. The same rationale applies to withholding that cannot be withheld from the employee's wages when required. Rev. Proc. 81-48[16] provides a formula to assist in determining the amount of grossed up wages.

16. Rev. Proc. 81-48, 1981-2 CB 623.

Ruling 6. IRC §3401(d) defines "employer" as the person for whom an individual performs any service as the employee of such person. Neither the FICA nor FUTA provisions of the Code contain a definition of employer similar to the §3401(d) definition. However, *Otte v. U.S.*[17] holds that a person who is an employer under §3401(d) is also the employer for purposes of FICA withholding under IRC §3102. It is the Trust, not the participant's employer, who administers the plan, pays the benefits, determines the coverage, and maintains records regarding eligible dependents and claims payments. The Trust, therefore, has legal control of the payment of wages and is the employer for purposes of §3401(d) with respect to these wages.

Ruling 7. Treas. Reg. §31.3402(g)-1(a)(1) provides that an employee's remuneration may consist of regular wages and supplemental wages. Supplemental wages include wage payments made without regard to an employee's payroll period but also may include payments made for a payroll period. The regulations provide that imputed income for a nondependent's health coverage is supplemental wages. Treas. Reg. §31.3402(g)-1(a)(7) provides that an employer may use optional flat rate withholding on supplemental wages if certain conditions are met. If the Trust has paid only supplemental wages and no regular wages, the Trust may not use the optional flat rate method for the imputed income for health coverage.

Ruling 8. IRS Ann. 85-113[18] provides guidelines for reporting and withholding on the value of taxable noncash fringe benefits. The employer may elect to treat taxable noncash fringe benefits as paid on a pay period, quarterly, semi-annually, annually, or on another basis, provided that the benefits are treated as paid no less frequently than annually.

Holding.

Ruling 1. The Trust's tax-exempt status is not jeopardized if permissible benefits are provided to dependents of domestic partners.

Ruling 2. The Trust's tax-exempt status is not jeopardized if permissible benefits are provided to nondependents of domestic partners as long as the total of impermissible benefits is less than 3% of the total amount of benefits paid to all plan participants and beneficiaries in any plan year, thus representing a de minimis amount.

Ruling 3. The coverage provided to a domestic partner who is a dependent under IRC §152(a) is not includible in gross income and is not wages for employment tax purposes.

Ruling 4. The coverage provided to a domestic partner who is a nondependent under §152 is includible in gross income and is grossed-up wages for FICA, FUTA, and income tax withholding purposes. The grossed-up amount determined under Rev. Proc. 81-48 is the amount includible in the participant's gross income for a nondependent domestic partner's health coverage and is the amount of the participant's wages for FICA, FUTA, and income tax withholding purposes. The grossed-up amount must be included in the participant's Form W-2.

Ruling 5. The gross income of the participant and domestic partner who is a nondependent should not include any payment to the extent that the fair market value of the HRA coverage provided to the domestic partner is included in the gross income of the participant pursuant to IRC §104(a)(3).

Ruling 6. The Trust is required, as the employer, to withhold income tax and the employee portion of the FICA tax as well as the employer portions of both FICA and FUTA tax.

Ruling 7. The wages paid under IRC §3401(d)(1) are considered separately from wages paid by the common law employer.

Ruling 8. Under IRS Ann. 85-113,[19] the Trust may treat the HRA benefit coverage provided on an annual basis for purposes of income tax withholding, FICA, and FUTA.

17. *Otte v. U.S.,* 419 U.S. 43 (1974).

18. IRS Ann. 85-113, 1985-31 IRB 31.

19. Ibid.

ESTATE AND GIFT

Late Filing Penalty

***Morton Liftin et al. v. U.S.,* No. 2013-5103; U.S. Court of Federal Claims (Jun. 10, 2014)**
IRC §§6018, 6075, and 6651

☞ Reliance on Legal Advice Is Not Reasonable Cause

Facts. Morton Liftin died on March 2, 2003. His son John was the estate's executor. John, an attorney, sought assistance from his former law partner in administering the estate. Due to the size of the estate, Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return,* was required to be filed with the IRS within nine months after the decedent's date of death. The executor requested an extension on November 26, 2003, which the IRS granted on January 16, 2004. The new deadline for filing the return was June 2, 2004.

During the preparation of Form 706 two issues arose. The principal issue was whether the decedent's widow, a citizen of Bolivia, would become a U.S. citizen. In calculating the estate value, the value of property that passes to a surviving spouse who is a U.S. citizen may be deducted. A special rule also permits the deduction if the surviving spouse becomes a citizen of the United States before the day on which the return is filed and the spouse was a resident of the United States at all times after the date of the decedent's death and before becoming a citizen of the United States. Mrs. Liftin began the process of applying for U.S. citizenship in February 2004.

The second issue involved litigation between Mrs. Liftin relating to her rights under a prenuptial agreement and the decedent's will. As of June 2, 2004, the extended due date for filing the return and paying the tax, neither of these issues were resolved. The estate made an estimated tax payment in January 2004 of $877,300, which they anticipated would be sufficient even if the estate could not claim the marital deduction.

John's former law partner advised him that a late Form 706 could be filed after the extended due date. The former partner believed that the regulations allowed for a late return in order for the estate to take advantage of the full marital deduction. As such, the Form 706 was **not filed** by the June 2, 2004 due date.

In August 2005, Mrs. Liftin became a naturalized U.S. citizen. On February 16, 2006, Mrs. Liftin and the estate settled their dispute over ancillary matters. On May 9, 2006, the Form 706 was filed, showing a tax liability of $678,572, an estimated payment of $877,300, and a refund due of $198,728. The IRS then assessed a late filing penalty of $135,714, which was 25% of the liability after adjustments.

In September 2010, the executor sought recovery of the late filing penalty in the Court of Federal Claims. **In granting summary judgment for the government,** the Court of Federal Claims divided the delay into two periods — the fourteen months up to the grant of citizenship in August 2005 and the nine months from then until the May 2006 filing. The court concluded that the delay in filing during the time before Mrs. Liftin was granted citizenship was due to reasonable cause but determined that the additional 9-month delay was not due to reasonable cause. **The 9-month delay without reasonable cause was sufficient to subject the estate to the maximum filing penalty.** The estate appealed.

Issue. The issue in this case is whether the estate is liable for the IRC §6651(a)(1) penalty for failing to timely file the estate tax return.

Analysis. IRC §6651(a)(1) imposes an addition to tax for failure to timely file a return, unless the taxpayer can establish that such failure is due to reasonable cause and not willful neglect. For each month that a federal estate tax return is late, the IRS must impose a penalty of 5% of the tax due, up to a maximum of 25%, unless it is shown that the failure to timely file is due to reasonable cause.

Nine months elapsed after Mrs. Liftin became a citizen in August 2005 before the executor filed an estate tax return in May 2006. The executor lacked reasonable cause for the filing delay during that period. Though fully able to file, the executor relied on the advice of his former law partner that he should wait to file until the other pending matters were resolved. However, the legal advice given to the executor on the timing of the estate's return did not supply reasonable cause for the post-August 2005 delay.

Holding. The estate is liable for the §6651(a)(1) failure to file penalty.

Estate Tax

U.S. v. Fred K. Whisenhunt et al., **No. 3:12-cv-00614; U.S. District Court for the Northern District of Texas (Mar. 25, 2014)**
IRC §6324

☞ Estate Beneficiary Determined to be Liable for Unpaid Taxes

Facts. Jacob Lindy Kay died on August 16, 2002. Fred K. Whisenhunt, the executor of Mr. Kay's estate, distributed the estate's assets before fully paying the federal estate tax. The IRS assessed penalties against the estate.

On July 14, 2010, the executor's legal counsel filed an interpleader action[20] to determine the proper beneficiary of $96,931 held in escrow. The government had priority by virtue of a tax lien and was awarded the money. However, the amount received by the government from the interpleader action was not sufficient to cover the estate's debt, so the government sued John F. Voelker, Fred K. Whisenhunt, and three other beneficiaries of the estate.

On May 6, 2013, the government moved for summary judgment against Mr. Voelker, who was the only remaining defendant. Mr. Voelker was the largest beneficiary of the estate, having received over $520,000. A cross-motion for summary judgment was filed by Mr. Voelker.

On Oct. 9, 2013, the two summary judgments were referred for hearing. The judge determined that Mr. Voelker is personally liable for the estate's unpaid tax obligations up to the value of the IRA distributions he received at the time of the decedent's death. However, the judge also concluded that res judicata (prevents parties from relitigating issues that were or could have been raised in a previous action) barred the government's claim. The judge recommended that the government's motion be denied, Mr. Voelker's motion be granted, and the claim against Mr. Voelker be dismissed. Both parties filed objections in March 2014.

Issue. The issue in this case is whether the beneficiary is personally liable for the estate's unpaid tax liabilities under IRC §6324(a)(2).

Analysis. The government did not attempt to relitigate the taxes due or otherwise contest what was settled in the prior proceeding. Instead, the government moved against Mr. Voelker to satisfy the estate's outstanding penalties. Even though it is connected to the interpleader action, this case was not joined together so that anything decided in that action must be accepted in this case or re-decided by this court.

Holding. The beneficiary, as the recipient of an IRA distribution, was personally liable under §6324(a)(2) for the estate's unpaid tax liabilities.

20. Interpleader is a procedure allowing a plaintiff holding property to compel two or more defendants to litigate a dispute in order to determine which defendant(s) are entitled to that property.

FOREIGN INCOME

Foreign Earned Income Exclusion

***Amad Eram v. Comm'r,* TC Memo 2014-60 (Apr. 7, 2014)**
IRC §911

☞ Taxpayer Qualifies for Foreign Earned Income Exclusion

Facts. Amad Eram was born in Iraq. After studying English in an Iraqi school, he moved to the United States in 1978 at the age of 19 with his first wife, with whom he had one child. Shortly after his move to the United States, his two brothers moved to the United States.

Mr. Eram was naturalized as a U.S. citizen in 1985. In 1989, Mr. Eram's parents moved to the United States and, together, they kept in touch with friends and family who remained in Iraq.

Mr. Eram divorced his first wife in 1986 and remarried in 1987. In 1998, he divorced his second wife, with whom he had three children. In 2000, he married his third wife. Mr. Eram and his third wife had no children together and they divorced in 2009. He had little or no contact with his children.

In 2004, Mr. Eram began working for the Defense Intelligence Agency. His work began in Virginia, and then he worked on a U.S. military base in Qatar for about 14 months. His deployment ended in early 2006. Instead of immediately returning to the United States to be with family, Mr. Eram went to Mexicali, Mexico, for a 6-month stay.

In mid-2006, he returned to the United States to work as a translator for Torres Advanced Enterprise Solutions (TAES), a defense contractor. His work for TAES required him to leave the United States for Iraq on February 26, 2008. Upon his arrival in Iraq, he was stationed on a U.S. military base within the Green Zone, a heavily secured section of Baghdad. He lived in a large employer-owned home and subsequently in a trailer on property near the employer-owned home.

Mr. Eram maintained a U.S. bank account and used its online services while abroad. He continued to own a vehicle in the United States, which was used by one of his children. He did not have an Iraqi vehicle or driver's license.

He did not maintain a home in the United States. During his time working in Iraq, he twice used his allotted vacation time to travel back to the United States to visit family. His family in the United States was precluded from visiting him in Iraq due to the nature of his work. He ended his employment on June 4, 2009, and returned to the United States to assist a son who was struggling with personal issues.

On his 2009 tax return, Mr. Eram claimed an IRC §911 foreign earned income exclusion of $38,571. The IRS disallowed the exclusion.

Issue. The issue in this case is whether Mr. Eram was a **qualified individual under §911** during the relevant period between June 2008 and June 2009 and therefore able to claim the foreign earned income exclusion.

Analysis. IRC §911 provides that a "qualified individual" is an individual whose **tax home** is in a foreign country and who is either:

- A U.S. citizen and a bona fide resident of a foreign country for an uninterrupted period that includes an entire tax year; or
- A U.S. citizen or resident who, during any consecutive 12-month period, is present in a foreign country for at least 330 days.

For the 12-month period ending on June 4, 2009, when Mr. Eram left Iraq, he was present in Iraq for at least the 330 days required to meet the test. However, the IRS argued that, although he met the 330-day requirement, Iraq was not Eram's tax home under the provisions of §911. **"Tax home" is generally defined as the vicinity of the taxpayer's principal place of employment** for purposes of IRC §162(a)(2) (relating to travel expenses while the taxpayer is away from home). The taxpayer is not treated as having a foreign tax home if the taxpayer has an abode in the United States. Although neither the Code nor the regulations define "abode" for purposes of the foreign earned income exclusion, the IRS argued that Mr. Eram maintained an abode in the United States and therefore cannot have a foreign tax home that qualified him to claim the foreign earned income exclusion. Prior case law defining "abode" looks to ties that the taxpayer maintains with the United States.

Even before the beginning of the relevant 1-year period ending June 4, 2009, Mr. Eram had divorced his first two wives, was separated from his third wife, and rarely saw any of his children. The fact that he spent six months in Mexicali after his Qatar employment ended rather than immediately returning to the United States to be with family is indicative of his weak ties to his family in the United States. He also did not maintain a home in the United States while he was abroad.

In addition, Mr. Eram has deeper ties with family in Iraq than with family in the United States. Although the IRS points out that Mr. Eram maintained a vehicle and bank account in the United States, these ties alone are not sufficient to constitute an abode in light of the much stronger Iraqi ties that exist.

Holding. Because Mr. Eram did not have sufficiently strong ties with the United States to constitute an abode, he is a qualified individual under §911 and may claim the foreign earned income exclusion.

GROSS INCOME

Compensation for Injuries

***Kathleen and George Simpson v. Comm'r,* 141 TC No. 10 (Oct. 28, 2013)**
IRC §§104 and 62

☞ Portion of Settlement is Excludable from Gross Income

Facts. Kathleen Simpson started working for Sears in 1972. In October 2000, Ms. Simpson was transferred and began managing a Sears store in Fairfield, California. Because of various problems at the Fairfield store, Ms. Simpson had to work long hours and engage in strenuous physical activities, which resulted in injuries to her shoulders, left knee, and neck. She consulted counselors and doctors for treatment and was diagnosed with clinical depression, irritable bowel syndrome, and fibromyalgia.

In June 2002, Ms. Simpson spoke to Sears' district manager and advised him of the diagnoses and requested that she be transferred to another position. Sears never transferred Ms. Simpson to another position; rather, they terminated her employment in August 2002.

After termination of her Sears' employment, Ms. Simpson retained David Anton to file a lawsuit against Sears, alleging a claim for employment discrimination on the basis of gender, age, and harassment. After Sears filed a summary judgment and adjudication motion, the state court found that Ms. Simpson could not prove that Sears had fired her for reasons other than poor job performance or that her transfer to another position would have been a reasonable accommodation.

Mr. Anton's research led him to conclude that because Sears had failed to give Ms. Simpson a California workers' compensation claim form and a notice of potential eligibility for benefits that were required under California laws, Sears violated its legal obligations under those laws. After Mr. Anton relayed his conclusions to Sears' counsel and asserted that Ms. Simpson would have been entitled to workers' compensation benefits, Ms. Simpson and Sears entered into a settlement agreement in June 2009. Sears agreed to pay $12,500 to Ms. Simpson for her lost wages and employment benefits; $98,000 for her claims for "emotional distress, physical and mental disability"; and $152,000 for attorney's fees and court costs.

Ms. Simpson never filed a workers' compensation claim, and the settlement agreement was never submitted to the California Workers' Compensation Appeals Board (WCAB) for the approval required under state law.

Ms. Simpson and her husband timely filed their 2009 joint federal income tax return, on which they reported the $12,500 payment that Sears paid for lost wages and employment benefits. They did not report anything else from the settlement but attached a letter to the return explaining the nature of the $250,000 proceeds that were reported to Ms. Simpson on Form 1099-MISC, *Miscellaneous Income.* The IRS subsequently issued a notice of deficiency to the Simpsons, which asserted that they had failed to report the $250,000 proceeds as income.

Issues. The issues in this case are as follows.

- Whether any portion of the settlement Ms. Simpson received in 2009 is excludable from her gross income under IRC §104(a)(1) or (2)
- Whether IRC §62(a)(20) allows the Simpsons to deduct attorney's fees and court costs as an above-the-line deduction

Analysis. IRC §104(a)(1) provides that gross income does not include **"amounts received under workmen's compensation acts** as compensation for personal injuries or sickness." The court observed that even when the parties intend to settle a workers' compensation claim, it does not necessarily mean that the payment is excludable under §104(a)(1). To qualify for the exclusion, a taxpayer must show that they received the benefits under a statute or regulation.[21] In order for Ms. Simpson's settlement payment to be considered "received under workmen's compensation acts," the settlement agreement must comply with the statutory requirements imposed by California's workers' compensation laws. These laws require that the parties file the signed release or agreement with the WCAB. The Simpsons acknowledged that they never submitted the settlement agreement to the WCAB for approval, and Mr. Anton apparently was not aware of these requirements. Because the settlement agreement does not meet the requirements of California's workers' compensation laws, any payments received under the agreement cannot be payments received under the state's workers' compensation act.

IRC §104(a)(2) provides that gross income does not include "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of **personal physical injuries or physical sickness."** The Simpsons claimed that 10% to 20% of the $98,000 received under the agreement is excludable under §104(a)(2) as an amount received "on account of personal physical injuries or physical sickness." The court concluded that the settlement of her claims had elements that were intended to compensate Ms. Simpson for her injuries and sickness. The records presented did not allow the court to precisely determine the extent to which the settlement was attributable to such injuries and sickness, so the court used its best judgment and found that 10% of the $98,000 settlement payment was made on account of physical injuries and sickness.

IRC §62(a)(20) allows an above-the-line deduction for attorney's fees and court costs paid in connection with an unlawful discrimination claim. The credible evidence presented to the court provided a reasonable basis for the court to conclude that the Simpsons paid $152,000 in attorney's fees and court costs, which they are entitled to deduct under §62(a)(20).

Holding. The court held that 10% of Ms. Simpson's settlement payment of $98,000, or $9,800, is excludable from gross income under §104(a)(2). In addition, the Simpsons are entitled to an above-the-line deduction for attorney's fees of $152,000.

21. *Rutter v. Comm'r,* 760 F.2d 466, 468 (2d Cir. 1985), *aff'g* TC Memo 1984-525 (1984).

Fellowship Grant and Self-Employment Tax

***Harris He Wang v. Comm'r*, TC Summ. Op. 2014-39 (Apr. 22, 2014)**

IRC §§117, 1401, 1402, and 6213

☞ Taxpayer Loses on Two Separate Issues in Consecutive Tax Years

Facts. Harris Wang was a full-time Harvard biophysics graduate student from 2005 through part of 2010. He received his doctorate in 2010. During **2009,** he received a fellowship grant from the American Society for Engineering Education (ASEE). **This grant provided him with the following benefits in 2009.**

- It paid all his tuition and related fees in connection with his Harvard graduate studies.
- It provided him with a cash stipend of $18,375 for which a 2009 Form 1099-MISC, *Miscellaneous Income,* was issued.

On his 2009 Form 1040, Mr. Wang reported $8,208 of the $18,375 stipend on line 21 as other income. He excluded the balance of $10,167 because he allegedly used that portion of the stipend to pay off student loans related to both his undergraduate and graduate studies.

Mr. Wang's father, Dr. Xing Wang, is the president of 3W Consulting Company (3W). An IRS letter dated October 29, 2010, informed 3W that its application requesting certification for investment in a **"qualifying therapeutic discovery project" (QTDP)** had been approved. Under a provision of the Affordable Care Act, 3W was awarded a grant of $244,479. The letter further stated that the grant was not taxable for federal income tax purposes.[22]

Harris Wang, the taxpayer and son of 3W's president, was paid $35,700 by 3W during 2010 to perform research in connection with the QTDP grant. The $35,700 was reported by 3W in box 3 (other income) of a 2010 Form 1099-MISC. On his 2010 Form 1040, Mr. Wang reported the $35,700 on line 21 as other income. However, he failed to pay self-employment (SE) tax on that amount.

The IRS sent a notice of deficiency to Mr. Wang, in which it determined that the entire $18,375 fellowship grant was taxable income for the 2009 tax year. The IRS also determined that the $35,700 income received from 3W was subject to SE tax for the 2010 tax year.

Issues. There are two separate issues in this case, one for 2009 and one for 2010.

- Whether the entire $18,375 cash stipend received as part of the ASEE fellowship grant is taxable income for 2009
- Whether the $35,700 of other income received from 3W is subject to SE tax for 2010

Analysis. Gross income is broadly defined in the Code to include all income from whatever source derived.[23] An exception is provided for "any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization described in IRC §170(b)(1)(A)(ii)."[24] A "qualified scholarship" means "any amount received by an individual as a scholarship or fellowship grant to the extent… such amount was used for qualified tuition and related expenses."[25]

Mr. Wang only included $8,208 of the $18,375 ASEE stipend in his gross income for 2009. He asserted that the balance was not includible in his gross income because he used it to pay educational expenses. However, **he did not introduce any receipts, bank statements, credit card records, or similar documentation to substantiate the additional educational expenses he claims to have paid.**

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22. IRC §48D(f)(3), added by a provision of the Affordable Care Act and effective for tax years beginning after Dec. 31, 2008.
23. IRC §61(a).
24. IRC §117(a).
25. IRC §117(b)(1).

Mr. Wang apparently contends that the $35,700 of income received from 3W in 2010 is not subject to SE tax using two alternative theories.

- He was a graduate student at the time he earned the money and the research he conducted was similar to that performed by graduate students pursuant to research grants.
- The money was paid from funds that were not taxable to 3W and he should enjoy the same tax advantage afforded to 3W.

The evidence showed that Mr. Wang performed medical research and lab work for 3W. There was no indication that 3W paid the funds to him for a noncompensatory reason. The court observed that Mr. Wang was engaged in the trade or business of medical research as an independent contractor of 3W and, accordingly, the entire payment that he received from 3W is subject to SE tax.

Holding. Because Mr. Wang did not produce any evidence to indicate that part of the ASEE stipend was nontaxable, the court concluded that the entire $18,375 cash stipend must be included in his 2009 gross income. The court also concluded that Mr. Wang was an independent contractor of 3W and his $35,700 compensation is subject to SE tax for the 2010 tax year.

Life Insurance Policy

***Samuel and Lillian Brach v. Comm'r,* TC Summ. Op. 2013-96 (Dec. 2, 2013)**
IRC §§61, 72, and 108

☞ Reliance on Enrolled Agent Eliminates Penalty

Facts. In 1984, Samuel Brach acquired a life insurance policy from Guardian Life Insurance Company (Guardian). This policy had both a cash value portion and a dividends portion, both of which grew steadily over the years. The policy terms allowed Mr. Brach to borrow against the policy in an amount up to the cash value of the policy. He was also allowed to terminate the policy and receive a distribution of the cash value of the policy plus accrued dividends minus outstanding debts against the policy.

In 1995, Mr. Brach borrowed against the cash value of the policy. He never made any repayments.

The Brachs' financial condition worsened and they were forced to surrender the policy in November 2010. At that time, the policy proceeds fully paid the loan, and Mr. Brach received a check for $3,786, which represented the net value of the policy.

The policy surrender resulted in a gross distribution of $65,903. Mr. Brach's investment in the contract was $32,778. Guardian issued a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* for 2010 showing a gross distribution of $65,903 and taxable income of $33,125 ($65,903 distribution − $32,778 investment).

At tax time, the Brachs gave all their information to an enrolled agent (EA) to prepare their 2010 tax return. **After evaluating all the information, the EA determined that the taxpayers were insolvent and were therefore not required to report cancellation of debt income from the surrender of the life insurance policy.**

The IRS assessed a $6,949 deficiency on the Brachs' 2010 income tax return along with IRC §§6662(a) and (d) accuracy-related penalties.

Issues. The issues in this case are as follows.

- Whether the Brachs are liable for tax on income of $33,125 received from surrender of a life insurance contract
- Whether the Brachs are liable for an accuracy-related penalty under IRC §§6662(a) and (d)

Analysis. IRC §61 provides that gross income includes all income from whatever source derived. IRC §61(a) lists specific forms of gross income, including income from life insurance contracts.

When an insurance policy is terminated and the proceeds are used to satisfy a loan against the policy, the payment of the loan is treated as if the taxpayers received the payment and then applied it against the loan.[26] In this case, after taking into account the surrender of the policy and funds distributed as a loan, Mr. Brach received net proceeds of $3,786. Guardian clearly did not forgive any part of the loan because it was paid in full. Accordingly, there was no discharge of indebtedness income.

The taxpayers believe they should not be held liable for the accuracy-related penalty. They provided their tax return preparer, who is an EA, with all their relevant information. The preparer made the determination that the taxpayers were insolvent and, as such, they were not required to include any income from the surrender of the life insurance policy on their 2010 tax return. The court noted that the Brachs relied in good faith on the EA's judgment and that they disclosed all necessary information to him. As a result, the court found that the Brachs qualified for the reasonable cause exception to the §6662 penalty.

Holding. The taxpayers should have included the distribution from the life insurance policy in their income. However, the taxpayers are not liable for the accuracy-related penalty because they relied on a qualified EA to properly prepare their tax return.

Settlement Payment

***Mohamed Kadir v. Comm'r,* TC Summ. Op. 2014-43 (May 6, 2014)**

IRC §61

☞ Court Applies Step Transaction Doctrine to Taxpayer's Settlement Payment

Facts. Mohamed Kadir, a nonnative English speaker, struggled with rising mortgage payments. He refinanced his mortgage in 2006, which involved splitting the existing mortgage into two new mortgages. He was dismayed that his mortgage payments still continued to rise. After consulting with lawyers, he sued the mortgage companies and mortgage origination company in federal court for fraud and similar violations.

The judge assisted the parties in reaching a complicated, lengthy settlement agreement. An unusual term of the settlement agreement provided that the mortgage origination company would give Mr. Kadir a check for $10,000. This, in turn, had to be used to pay down each of the two mortgages ($5,700 on the first mortgage and the remaining $4,300 on the second one). During 2010, Mr. Kadir made the payments as agreed.

Mr. Kadir received a 2010 Form 1099-MISC, *Miscellaneous Income,* for $10,000. He did not show the $10,000 on his 2010 tax return because the settlement agreement required him to use the funds to make payments against the mortgages. The IRS maintained that the $10,000 was taxable income.

Issue. The issue in this case is whether the $10,000 received by Mr. Kadir constitutes taxable income.

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26. See *McGowen v. Comm'r,* TC Memo 2009-285 (Dec. 14, 2009); *Atwood v. Comm'r,* TC Memo 1999-61 (Mar. 4, 1999); *Brown v. Comm'r,* TC Memo 2011-83 (Apr. 12, 2011), *aff'd,* 693 F.3d 765 (7th Cir. 2012); *Barr v. Comm'r,* TC Memo 2009-250 (Nov. 3, 2009).

Analysis. Generally, gross income includes income from all sources in accordance with IRC §61. However, there are exceptions, including those created by the court when the Code is not clear. One such court-created rule is the **step transaction doctrine.** Under this doctrine, two or more steps are treated as one step if the parties involved have a binding commitment to take all the steps to which the parties agreed.

The seminal case regarding the step transaction doctrine is *Minnesota Tea Co. v. Helvering,*[27] in which the Minnesota Tea Company sold all its assets and sent the proceeds to its shareholders. Although the receipt of these funds by the shareholders would normally be taxable, the shareholders agreed that they would use the proceeds to pay creditors of the Minnesota Tea Company. The Supreme Court stated that this was tantamount to the Minnesota Tea Company paying its own debts directly because the shareholders were under a binding commitment to use the funds to pay the corporation's debts. The two steps were therefore viewed as one transaction, and the receipt of the funds by the shareholders was held to be nontaxable by the court.

Mr. Kadir's settlement agreement placed him under a similar binding commitment to use the funds received to pay down the mortgages. The step transaction doctrine applies to Mr. Kadir's receipt of funds (first step) and subsequent pay down of the mortgages (second step) so that they are considered one transaction: in essence, the mortgage originator paying the mortgages down directly.

Holding. The receipt of the $10,000 by Mr. Kadir is not taxable income for 2010.

IRS PROCEDURES — MISCELLANEOUS

IRS Employee Awards

Treasury Inspector General for Tax Administration (TIGTA) Report #2014-10-007 (Mar. 21, 2014)

☞ IRS Gave Employee Awards to Those Recently Disciplined for Misconduct

IRS management has a long-standing employee incentive awards program. The goal of the program is to monetarily reward employees whose performance is consistently of high quality. In addition to cash awards, those employees can also earn compensatory leave (vacation) hours and quality step increases in their salary level.

The following chart shows details of the employee awards for fiscal years 2011 and 2012.

Fiscal Year	Number of IRS Employees	Number of Employees Who Received Awards	Percentage of Employees Receiving Awards	Amount of Cash Awards	Number of Hours Compensatory Leave
2011	104,400	70,500	67.5%	$92 million	520,000
2012	98,000	67,870	68%	86 million	490,000

The TIGTA report stated, "These awards are designed to recognize and reward IRS employees for their performance. **Oversight and control over these awards is important to ensure proper stewardship of Government funds and the effectiveness of the awards system.**"

This audit was initiated because new federal guidance issued in fiscal year 2011 requires agencies to reduce spending on awards programs beginning in fiscal year 2012. The overall objectives of this report were to evaluate the IRS's compliance with the reduced spending goals and to review the IRS's controls over awards made to employees with misconduct issues.

27. *Minnesota Tea Co. v. Helvering,* 302 U.S. 609 (1938).

In general, the IRS reduced the number and amount of employee awards in fiscal year 2012. According to the IRS, further action was taken in fiscal year 2013 to limit awards.

Between October 1, 2010 and December 31, 2012, more than 2,800 employees with recent substantiated misconduct issues resulting in disciplinary action received the following.

- $2.8 million in cash awards
- 27,000 hours of compensatory leave
- 175 quality salary step increases

More than 1,100 IRS employees with substantiated federal tax noncompliance problems received the following.

- Over $1 million in cash awards
- Over 10,000 hours of compensatory leave
- 69 quality salary step increases

With few exceptions, the IRS does not currently consider tax noncompliance or other misconduct behavior when issuing employee awards. The IRS Restructuring and Reform Act of 1998 does not specifically mention awards, but it does mandate the removal of IRS employees who are found to have willfully failed to pay all their federal tax obligations.

While not specifically prohibited, providing incentive performance awards to employees who fail to pay their federal taxes appears to create a conflict with the IRS's responsibility to ensure the integrity of tax administration. Accordingly, TIGTA recommended that the IRS implement a policy requiring its management **to consider employee misconduct issues that result in disciplinary actions, especially the nonpayment of taxes, prior to issuing performance awards.** The IRS agreed with the recommendation and will conduct a study to implement the recommendation.

Tax Return Preparers

***Sabina Loving et al. v. IRS et al.*, No. 13-5061; U.S. Court of Appeals for the District of Columbia Circuit (Feb. 11, 2013)**
IRC §§6694, 6695, 6713, and 7701

☞ IRS Not Allowed to Regulate Tax Return Preparers

Facts. In 2011, the IRS launched a new registered tax return preparer (RTRP) program, and issued new regulations requiring that certain paid tax return preparers pass an initial certification exam, pay annual fees, and complete at least 15 hours of continuing education courses each year. These regulations were likely to impact between 600,000 and 700,000 tax return preparers. The IRS asserted that regulating return preparation fell within its authority under 31 USC §330.

Three independent tax return preparers challenged the IRS's new regulations, believing that these regulations exceeded the agency's authority. They filed suit seeking declaratory and injunctive relief to prevent enforcement of the new regulations. The District Court ruled against the IRS. The IRS appealed the decision and also filed a stay motion to keep the regulations in place pending appeal.

Issue. The issue in this case is whether the IRS has the authority to regulate independent tax return preparers.

Analysis. The Appeals Court considered six factors in this case.

1. **What is the key meaning of the term "representative"?** The IRS contends that paid tax return preparers are "representatives of persons." The dictionary defines "representative" as an agent with the authority to bind others. The court determined that tax return preparers are not agents. They do not possess the legal authority to act on the taxpayer's behalf. "Representation" of a taxpayer before the IRS requires formally obtaining the taxpayer's power of attorney, something tax return preparers do not typically obtain when preparing a tax return.

2. **What is the meaning of "practice…before the Department of the Treasury."** The long-standing term "practice" before the IRS means appearing as representatives of taxpayers in adversarial tax proceedings. The new regulations expanded the definition of "practice" to cover tax return preparers. According to the IRS, the "practice" of tax return preparers includes "preparing and signing tax returns and claims for refund, and other documents for submission to the Internal Revenue Service."[28] Under 31 USC §330(a)(2), before admitting a representative to practice, the representative may be required to demonstrate good character, good reputation, the necessary qualifications, and competency to advise and assist persons in **presenting their cases.** The District Court succinctly stated that filing a tax return would never, in normal usage, be described as "presenting a case." This definition only makes sense in connection with those who assist taxpayers in the examination and appeals stages of the process.

3. **What is the history of 31 USC §330?** The original language was enacted in 1884 as part of a War Department appropriation for "horses and other property lost in the military service." When tax return preparation became a significant industry, Congress did not broaden the language to include tax return preparers.

4. **What is the broader statutory framework?** If the IRS truly believed this statute allowed for the regulation of tax return preparers, there would have been no need to enact a number of targeted provisions specific to tax return preparers, which cover precise conduct ranging from a tax return preparer's failing to sign returns to knowingly understating a taxpayer's liability.

5. **What is the nature and scope of the authority being claimed by the IRS?** The Supreme Court has stated that the courts should not lightly presume congressional intent to implicitly delegate decisions of major economic or political significance to agencies.[29] If the court were to accept the IRS's interpretation of §330, the IRS would be empowered for the first time to regulate hundreds of thousands of individuals in the multi-billion dollar tax preparation industry.

6. **What is the IRS's past approach to this statute?** Up until 2011, the IRS never interpreted the statute to give itself authority to regulate tax return preparers. During 2005 congressional hearings, both the IRS's Criminal Investigation Division chief and the National Taxpayer Advocate agreed that tax return preparers are not deemed to represent individuals before the IRS.

Holding. The IRS does not have the authority under 31 USC §330 to regulate tax return preparers.

> **Note.** In *Ridgely v. Lew,*[30] the court found that the IRS did not have the authority to regulate CPAs in regard to contingent fees for preparation of ordinary refund claims. As of the date this book was printed, the IRS has the right to appeal this decision. For more information about contingent fees, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 5: Ethical Considerations.

28. 31 CFR §10.3(f)(2).
29. See *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. at 160 (2000).
30. *Ridgely v. Lew,* No. 1:12-cv-00565 (D.C. Jul. 16, 2014).

Disclosure

***The National Organization for Marriage Inc. v. U.S.*, No. 1:13-cv-01225; U.S. District Court for the Eastern District of Virginia (Jun. 3, 2014)**
IRC §§6033, 6103, and 7431

☞ Actual Damages Awarded by IRS Disclosure

Facts. The National Organization for Marriage, Inc. (NOM) is a tax-exempt organization required to annually file a Form 990, *Return of Organization Exempt From Income Tax,* with the IRS. The Schedule B attached to Form 990 lists donors who have contributed $5,000 or more during the reporting period.

In January 2011, media member Matthew Meisel requested copies from the IRS of NOM's publicly available tax returns. After receiving the request, an IRS clerk emailed an IRS media relations specialist to verify Meisel's status as a member of the media because IRS policy expedited media requests. The IRS clerk then printed copies of NOM's 2007 and 2008 original and amended Forms 990. A unique tracking number was created in an IRS database and was imprinted as a watermark on each page of the printed copies.

The clerk sent Meisel an unredacted copy of NOM's amended 2008 Form 990. (The IRS requirement is that donor information listed in Form 990 be **redacted** before the form is sent to the requesting party.) Meisel then sent a copy of the amended 2008 Schedule B to Kevin Nix, a campaign media director for the Human Rights Campaign (HRC). Nix forwarded the Schedule B to a journalist at the Huffington Post, where it was published along with an article focusing on the fact that a political action committee associated with Mitt Romney made a $10,000 donation to NOM.

After publication of the article, the Treasury Inspector General for Tax Administration was able to digitally unredact the watermark, allowing the IRS to determine which IRS employee sent out the document. **The IRS clerk who sent out the information had no knowledge of NOM, the political opponents, or Meisel.**

NOM sought damages under IRC §7431 for unlawful inspection and disclosure of confidential tax information in violation of IRC §6103.

Issues. The issues in this case are as follows.

- Whether NOM is entitled to punitive damages
- Whether the examination of NOM's confidential tax information by the IRS clerk and others were "authorized" inspections under the statute
- Whether NOM's legal expenses for investigating the disclosure are recoverable damages
- Whether NOM's claimed damages are subject to an offset against donations received because of the publicity surrounding this case

Analysis. IRC §§6103 and 7431 provide that it is unlawful for a federal official to inspect and/or disclose a taxpayer's tax return without proper authorization. If the inspection or disclosure is willful or grossly negligent, a taxpayer may be entitled to punitive damages. In this case, NOM contends the disclosure was the result of gross negligence or willfulness. As such, NOM has the burden of proof to produce sufficient evidence that the disclosure was willful or grossly negligent. NOM provided no evidence that its unredacted tax information was willfully disclosed. This was simply a mistake on the part of one IRS employee.

The IRS clerk providing the Schedule B did not know Meisel or have any connection to the HRC when she disclosed the information. This case is similar to *Miller v. U.S.*[31] in which the 9th Circuit affirmed the District Court's conclusion that an unauthorized disclosure by an IRS agent to a newspaper reporter, who subsequently published the information, was negligent but not willful or grossly negligent. NOM also argued that the IRS procedures during this time frame were so deficient that gross negligence resulted. The court disagreed.

NOM claims entitlement to statutory and actual damages or punitive damages because its return information was unlawfully inspected. Although several IRS employees did access NOM's 2008 Schedule B from January 2011 through April 2012, NOM has not shown that these inspections were unauthorized. **The court determined that the clerk and other IRS employees inspected the return while performing their official IRS duties.** IRC §7431(c) provides that a taxpayer who establishes that their return information was disclosed in violation of §6103 has a choice between either statutory damages of $1,000 for each act of unauthorized disclosure or the sum of their actual damages plus, in the case of a willful disclosure or a disclosure that is the result of gross negligence, punitive damages. In this case, NOM claimed the following actual damages.

- $12,500 in attorneys' fees in connection with a lawsuit
- $46,086 in attorneys' fees expended during efforts to determine the source of the disclosure and prevent further dissemination of its Schedule B information

The government's position is that the damages are not recoverable because the actual damages claimed were not sustained as a result of the IRS's inadvertent disclosure but were the result of the intervening actions of third parties. To recover damages, the taxpayer must prove both proximate cause and actual cause. The court believed that the damages were both foreseeable and within the scope of risk associated with the IRS's conduct. Congress deliberately exempted from disclosure the names and addresses of an organization's donor. When such information is publicly disclosed, it could expose an organization and its donors to a multitude of harms. The independent actions of Meisel, HRC, and others cannot immunize the IRS from responsibility because it is clear that publication was likely and the harms claimed were a foreseeable consequence of publication.

The government argued that NOM should not be allowed to recover the amounts it seeks because it has fully mitigated and offset any damages. Since the date the disclosure occurred, NOM received at least $75,000 in aggregate donations from donors who had never donated to NOM before the disclosure. However, the court noted that the government did show that the disclosure rather than something else caused these additional donations.

Holding. Because NOM made no showing from which a reasonable jury could find that the disclosure of its Schedule B was the result of willfulness or gross negligence, NOM is not entitled to recover punitive damages. NOM, however, is entitled to actual damages sustained. There is no offset from claimed damages against the donations received after the disclosure.

31. *Miller v. U.S.,* 66 F.3d 220 (9th Cir. 1995).

2011 Tax Statistics

IRS Statistics of Income Bulletin (Spring 2014)

☞ Individual Income Tax Statistics for 2011 Returns

The following table shows categories of taxpayers and their tax shares for the 136.6 million[32] 2011 individual income tax returns received by the IRS. Total 2011 individual income tax increased 9.9% from a year earlier to $1.05 trillion.

2011 Individual Income Tax Rates and Shares

Category of Taxpayers	AGI Amount	Percentage of Total Income Tax Paid
Top 1%	$388,905 or greater	35.1%
Top 5%	167,728 or greater	56.5%
Top 10%	120,136 or greater	68.3%
Top 50%	34,823 or greater	97.1%
Bottom 50%	34,822 or less	2.9%

Note. Many taxpayers in the bottom 50% receive substantial nonrefundable credits, which reduces their percentage of taxes paid.

Other 2011 Individual Income Tax Statistics[33]

The alternative minimum tax (AMT) increased for 2011, rising $3.0 billion (up 11% from 2010) to $30.5 billion. The number of 2011 returns reporting AMT increased to 4.2 million (up 5.7% from 2010).

Following is a summary of the earned income credit (EIC) for 2011 returns.

- The EIC was claimed on 27.9 million returns (up 2% from 2010).
- A total of **$62.9 billion** of EIC was claimed (up 5.6% from 2010), $56.35 billion of which was refundable credits. Refundable EIC represented 89.6% of total EIC.

IRS PROCEDURES — PENALTIES

Penalties

***Gary and Linda Andersen v. Comm'r,* TC Summ. Op. 2013-100 (Dec. 9, 2013)**

IRC §§6662 and 6664

☞ Court Declines to Impose Accuracy-Related Penalty

Facts. In 2010, Gary Andersen received a fixed salary with a potential for bonuses; thus, his income could fluctuate from year to year. His wife, Linda Andersen, was employed on a part-time basis as a registered nurse and earned $28,446 in 2010. Mrs. Andersen had intended to retire by 2010, but she decided to work longer in order to increase her social security benefits.

32. This number does not include the returns filed by dependents.

33. Includes information from Fall 2013 IRS Statistics of Income Bulletin.

Mr. and Mrs. Andersen regarded their tax situation as fairly complex. They received income from multiple sources, including two S corporations that lease farmland. They were aware of the importance of keeping good tax records and maintained a system for keeping track of documents needed to prepare their returns.

Throughout her career, Mrs. Andersen received a paper copy of Form W-2, *Wage and Tax Statement.* This changed for 2010, when the payroll agent for her employer discontinued issuing paper Forms W-2 and instead made them available electronically on the Internet. **Neither Mrs. Andersen's employer nor her employer's payroll agent provided her with notice about this change, nor did she receive a paper copy of her Form W-2.**

Mr. and Mrs. Andersen retained the services of Curtis Trader, a CPA with nearly 20 years of experience, to prepare their 2010 tax return. The Andersens furnished Mr. Trader with all their tax records except for Mrs. Andersen's Form W-2. Mr. Trader had prepared the tax returns for the couple for several years and had previously spoken with Mrs. Andersen about her retirement plans. He was under the impression that she had already retired, and this impression was strengthened by the fact that the couple's tax documents included a modest distribution reported on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* Consequently, Mr. Trader did not report Mrs. Andersen's wage income on their 2010 tax return, nor did he report a credit for her tax withholding.

Mr. Trader met with the Andersens to review their 2010 tax return before it was signed and filed. During this meeting, their 2010 return was compared with their 2009 return to check for any major changes in income. The adjusted gross income fluctuated approximately $1,000 (or .67%) from one year to the next, and no other anomalies were apparent. Consequently, neither Mr. Trader nor the Andersens noticed that Mrs. Andersen's wage income was not included on the 2010 return.

In September 2010, the IRS issued a notice of deficiency for the 2010 return, determining a deficiency of $7,907, which was attributable to Mrs. Andersen's unreported wages. The IRS also assessed an accuracy-related penalty under IRC §6662(a).

As soon as they received the notice of deficiency, the Andersens telephoned Mr. Trader and faxed him the notice. Mr. Trader confirmed that Mrs. Andersen had received wages in 2010 and that these wages had not been reported on their tax return. Within one week of receiving the notice, the taxpayers paid the deficiency plus the interest. They later filed a petition with the Tax Court in which they only challenged the accuracy-related penalty.

Issue. The issue in this case is whether the taxpayers are liable for the accuracy-related penalty.

Analysis. IRC §6662(a) imposes an accuracy-related penalty of 20% of the amount of any substantial understatement of income tax. IRC §6664(c)(1) provides an exception to the accuracy-related penalty if the taxpayer establishes that there was reasonable cause for the underpayment and that the taxpayer acted in good faith.

At trial, both Mr. and Mrs. Andersen testified. The court found their testimony to be straightforward and fully credible. The Andersens appeared to be trustworthy individuals who followed the rules and took their federal tax responsibilities very seriously. They also had a 50-year history of filing timely returns, all of which the IRS accepted as filed, with the sole exception of their 2010 return.

The court noted that the Andersens' failure to notice the absence of a Form W-2 was at least partially understandable given the number of their tax documents and the fact that Mrs. Andersen never received notice that her employer's payroll agent had discontinued issuing paper Forms W-2.

The court further observed that the taxpayers demonstrated reasonable cause and good faith by hiring a CPA to prepare their returns. Mr. Trader is a highly credentialed tax professional who prepared the Andersens' return under the mistaken impression that Mrs. Andersen had retired.

Finally, the Andersens' good faith was also indicated by the fact that they contacted Mr. Trader on the same day that they received the notice of deficiency. Also, within a week of receiving the notice, they paid the deficiency and the applicable interest in full.

Holding. The court held that Mr. and Mrs. Andersen qualified for the reasonable cause and good faith exception and therefore are not liable for the §6662(a) accuracy-related penalty.

> **Note.** The judge's remarks in making his decision are interesting. Before enumerating all the factors that demonstrated that the taxpayers clearly qualified for the exception to the accuracy-related penalty, Judge Armen stated that "[T]his is an exceptionally close case. However, after weighing all the evidence, and in particular the testimony of the witnesses, we think the balance shifts in petitioners' favor."

Penalties

Yitzchok Rand and Shulamis Klugman v. Comm'r, **141 TC No. 12 (Nov. 18, 2013)**
IRC §§6662 and 6664

☞ Divided Tax Court Overturns IRS Penalty Imposed on Refundable Credits

Facts. Yitzchok Rand and Shulamis Klugman were married during 2008 and timely filed a joint federal income tax return for the year. Their 2008 adjusted gross income was $18,148, and their taxable income was zero. The total tax reported on the return was $144 of self-employment tax.

The taxpayers' total tax was reduced below zero by refundable tax credits. After taking into account the refundable credits, the taxpayers claimed an overpayment of $7,327. They received this refund in May 2009.

The IRS issued a notice of deficiency indicating that the taxpayers were not entitled to the refundable credits claimed. The taxpayers subsequently agreed with these adjustments. The notice of deficiency also determined that an accuracy-related penalty under IRC §6662 applied. The taxpayers disagreed with the penalty calculation.

Issue. The issue in this case is whether an IRC §6662(a) penalty should be imposed and its amount.

Analysis. The taxpayers agreed that they are liable for a 20% accuracy-related penalty for 2008 if there is "an underpayment of tax required to be shown on the return," as that terminology is used under IRC §6662(a). The term "underpayment" is defined under IRC §6664(a) as consisting of the following four components.

1. The tax imposed
2. The amount shown as the tax by the taxpayer on the return
3. The amounts not so shown previously assessed (or collected without assessment)
4. The amount of rebates made

The parties agree that the first component is $144 and the third and fourth components are both zero. The dispute is about the second component. The IRS contends that Treas. Reg. §1.6664-2(c) should be interpreted to require that the taxpayers' claims for the refundable credits be included in the computation. Under this interpretation, the taxpayers would be liable for an accuracy-related penalty of $1,465 (($7,471 refundable credits − $144 self-employment tax) × 20%).

The taxpayers contend that the Code excludes any credits claimed on a return from the computation of the amount of tax shown on the return. They asserted that various Code provisions allowing tax credits clearly distinguish between credits and the taxes against which credits are applied.

The taxpayers also made the alternative argument that "Even if the refundable credits at issue were to be included in the calculation of the amount of tax shown by Petitioners on their return, there is no statutory or regulatory basis for reducing the amount of tax below zero. Thus, any underpayment would be limited to the amount of the credit against Petitioners' reported self-employment tax." This position was also presented in an amicus brief filed by the Cardozo Tax Clinic. Using this approach, the amount of tax shown on the return would be $144 for purposes of the penalty computation.

The court observed that most credits are identified in the Code as a "credit against the tax imposed" and that the court had imposed penalties on disallowed credits against the tax under many provisions. The amount shown as tax was reduced by the reported credit against the tax. The court asserted that nothing in the Code suggested that such credits should have been removed from the computation.

After concluding that credits can reduce the amount shown as tax on the return, the court next addressed the taxpayers' argument that the credits cannot reduce the amount shown as tax on the return below zero. The court observed that IRC §6211(b)(4) provides that any excess of the refundable credits claimed as compared to the amount to which the taxpayer was entitled is treated as a negative tax. The court inferred from this provision that the specified refundable credits would not be considered a negative tax except for this provision. Based on the negative tax provision of §6211(b)(4), the court concluded that these credits do not yield a negative tax for purposes of defining an underpayment under §6664(a)(1)(A). Because §6662(a)(1)(A) uses the same phrase "the amount shown as the tax by the taxpayer" as §6211(a), it should be interpreted consistently with §6211. However, §6664 has no counterpart to §6211(b)(4). Accordingly, the court concluded that the taxpayers' excess refundable credits do not result in a negative tax.

The court noted that its conclusion was further supported by the rule of lenity. Under the rule of lenity, statutes that impose a penalty are construed in favor of the more lenient punishment. In this case, the words of the relevant statutes do not plainly impose a penalty on refunds resulting from the overstated credits. Because the penalty is not plainly imposed on the refundable credits, the rule of lenity confirms that §6662 does not impose a penalty on the refundable portion of the taxpayers' erroneously claimed credits.

Holding. The court, in a divided opinion, concluded that §6664(a) defines the term "underpayment" in part by reference to the amount shown as the tax by the taxpayer on their return. Therefore, the credits taken by the taxpayers on their return all reduce the amount shown as the tax on their return, but not below zero. Accordingly, the amount of Rand and Klugman's underpayment was $144, and the penalty imposed under §6664 is $29 ($144 × 20%).

Early Distribution Penalty

***Thomas and Sylvia Alexander v. Comm'r,* TC Summ. Op. 2014-18 (Feb. 26, 2014)**

IRC §§72, 408, and 6662

☞ Delay in IRA Repayment Leads to Liability for Taxable Distribution

Facts. Thomas Alexander is a licensed electrical contractor who worked for True Craft Construction (True Craft) on two large commercial developments during 2009. True Craft ran into some financial difficulties and was unable to pay $130,000 that was owed to Mr. Alexander. In lieu of the $130,000, True Craft gave Mr. Alexander a promissory note and assigned a piece of real estate to him as security for the debt. However, the property was encumbered by a past-due mortgage subject to an impending foreclosure.

To stop the foreclosure, Mr. Alexander applied for a loan from Charles Schwab, which held his SEP IRA. Because the loan could not be processed until after the foreclosure date, Mr. Alexander withdrew $36,000 from his SEP IRA on July 31, 2009. His Schwab financial adviser told him that if he replaced the money from the SEP IRA within 60 days, there would be no penalty. As the result of a delay in processing the loan, he received the loan proceeds on September 30, 2009. He mailed a check to the brokerage firm that was deposited into the SEP IRA on October 5, 2009, which was 66 days after the funds were originally withdrawn.

In January 2010, Mr. Alexander received a 2009 Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* reporting an early distribution of $36,000. **The form did not indicate a taxable amount and the Alexanders did not report a taxable transaction on their 2009 tax return.**

The IRS assessed a deficiency on the Alexanders' 2009 income tax return. It also assessed a 10% additional tax under IRC §72(t) and an accuracy-related penalty under IRC §6662(a).

Issues. The issues in this case are as follows.

- Whether the Alexanders failed to include in their income a taxable distribution from a qualified retirement plan
- Whether the Alexanders are liable for the 10% additional tax under IRC §72(t) for an early distribution from a qualified retirement plan
- Whether the Alexanders are liable for the 20% accuracy-related penalty under IRC §6662(a)

Analysis. IRC §408(d)(3) allows rollover contributions from an IRA to be excepted from inclusion in income if they are paid into an IRA or eligible retirement plan for the benefit of the individual within a 60-day period. The taxpayers argued that the 66-day period was the result of a delay in loan processing caused by the brokerage firm and this delay was beyond their control. The court noted that the Alexanders may have been attempting to compare their situation with that of the taxpayers in *Wood v. Comm'r.*[34] In *Wood,* however, there clearly was a bookkeeping error by the investment company. In this case, there was no bookkeeping error.

As an alternative argument, the taxpayers asserted that the distribution was a loan from the SEP IRA. However, under IRC §72(p), loans are only allowed from a qualified employer plan or a government plan. If Mr. Alexander's transaction was construed as a loan, it would be a prohibited transaction resulting in harsher tax consequences than those proposed by the IRS.

IRC §72(t) imposes an additional 10% tax when a person withdraws money from a qualified retirement plan unless an exception under IRC §72(t)(2) applies. In this case, Mr. Alexander had not reached age 59½, nor did he present evidence that any of the exceptions applied.

The Alexanders asserted that they should not be held liable for the accuracy-related penalty. They provided their accountant with the Form 1099-R received. The accountant advised them of the tax consequences that would result if they did not get a corrected Form 1099-R and the Alexanders contacted the brokerage firm to get the corrected form. The taxpayers' financial adviser from Charles Schwab told them that the funds were not taxable because they put the money back into the SEP IRA. After speaking to the Schwab employee, the accountant prepared the tax return without including the distribution in income.

Holding. The taxpayers should have included the distribution in income and are also subject to the 10% early distribution penalty. However, based on their testimony, the court concluded that the taxpayers had done everything in their control to determine their correct tax liability; therefore, the court rejected the IRS's determination of the accuracy-related penalty.

34. *Wood v. Comm'r,* 93 TC 114 (1989).

Erroneous Claim for Refund or Credit Penalty

Treasury Inspector General for Tax Administration (TIGTA) Report #2013-40-123 (Sep. 26, 2013)
IRC §6676

☞ IRS Enforcement of Erroneous Refund or Credit Penalty Inadequate

The Small Business and Work Opportunity Tax Act of 2007 added IRC §6676, which gives the IRS the authority to assess a 20% penalty for disallowed erroneous refund claims or credits. Taxpayers who claim excessive tax credits or refund claims may be penalized up to 20% of the erroneous amount if the credits or refund claims have **no reasonable basis.**[35] The 20% penalty is effective for any erroneous claim for refund or credit filed or submitted after May 25, 2007. The §6676 penalty cannot be assessed if the denied claim was for the earned income credit (EIC). Congress exempted the EIC from this penalty because the Code already contains specific penalties for EIC noncompliance.[36] In addition, this penalty cannot be assessed if the IRC §6662(a) accuracy-related penalty and/or the IRC §6663 fraud penalty are assessed.

TIGTA did an audit to determine whether the IRS was properly assessing the §6676 penalty. The TIGTA report noted that the IRS incorrectly interpreted the law, which significantly limited the types of erroneous tax refund or credit claims to which the penalty was intended to apply. The IRS misinterpretation pertained **in part to disallowed refundable credits,** including the following.

- Additional child tax credit
- Refundable education credit
- Adoption credit
- Other refundable credits **excluding** the EIC and credits disallowed due to identify theft

As a result, **the IRS assessed only 84 IRC §6676 penalties between May 2007 and May 2012. The total amount of these assessed penalties was $1.9 million.**

Observation. The average amount of the 84 assessed penalties during the 5-year period covered in the TIGTA report was $22,600. It is apparent that the IRS assessed the penalty only when taxpayers owed very large amounts of additional taxes due to the disallowance of an erroneous tax refund or credit claim.

In response to concerns raised by various IRS functions, the IRS Office of Chief Counsel revised its interpretation of the new penalty. This revised internal IRS guidance was issued in May 2012. Although the guidance was revised, the IRS did not develop processes and procedures to enable IRS Service Centers that disallow the majority of individual tax credits to assess the §6676 penalty. For example, in the year after the Chief Counsel revision (June 3, 2012 through May 25, 2013), there were 709,123 individual tax credits disallowed by the service centers. **The IRS could have potentially assessed §6676 penalties in excess of $1.5 billion as a result of these disallowed credits.**

35. IRC §6676(a).
36. IRC §32(k).

In a lengthy response to the TIGTA report, the IRS apparently agreed to the report's suggestions and announced it planned to take corrective action. However, in its response, t**he IRS raised several assertions protesting various conclusions reached in the TIGTA report.** Two of those IRS complaints are as follows.

- The IRS's budget is declining and implementing the report's suggestions will require transferring service center examiners from other critical priority compliance work such as identify theft and refund fraud.
- The $3.4 million estimated cost of implementing the suggestions contained in the TIGTA report will be substantially higher.

Note. It remains to be seen if the IRS is sincere in its apparent agreement to implement the TIGTA report's suggestions. The assertions and complaints contained in the IRS response indicate that the IRS does not agree factually with many of the report's conclusions. If the IRS increases its efforts to enforce the provisions of §6676, both a reduction in fraud and an increase in revenue could result.

ITEMIZED DEDUCTIONS

Mortgage Interest

Christopher DeFrancis and Jennifer Gross v. Comm'r, **TC Summ. Op. 2013-88 (Nov. 6, 2013)**
IRC §§163 and 6662

☞ Court Disallows Mortgage Interest Deduction Because Mortgage Note not Recorded

Facts. In October 2001, Christopher DeFrancis and his wife Jennifer Gross (taxpayers) purchased a house at 41 Maynard Road in Northampton, Massachusetts, for $365,000. In January 2003, they signed a document described as a "mortgage note," under which they promised to pay Joan Gross (Jennifer Gross's mother) $427,333 plus interest for a mortgage loan. They also signed another document entitled "mortgage," which provided that they "hereby mortgage grant, convey and assign to [Joan Gross] the property with an address of 41 Maynard Road." This document was not notarized or recorded.

The taxpayers paid a total of $19,230 to Joan Gross in 2009, which they treated as a payment of home mortgage interest. They also paid interest of $1,138 on a mortgage from TD Bank. They claimed a total of $20,368 as a home mortgage interest deduction on their 2009 Schedule A, *Itemized Deductions.*

The IRS examined the taxpayers' 2009 income tax return and determined that the home mortgage interest deduction claimed on the return exceeded the amount reported to the IRS on Form 1098, *Mortgage Interest Statement,* from TD Bank. The IRS disallowed the $19,230 of home mortgage interest the taxpayers paid to Joan Gross and asserted an accuracy-related penalty under IRC §6662(a).

Issues. The issues in this case are as follows.

- Whether the taxpayers are entitled to a home mortgage interest deduction
- Whether the taxpayers are liable for the IRC §6662(a) accuracy-related penalty

Analysis. Under IRC §163(h)(2)(D), taxpayers may claim a deduction for qualified residence interest. Qualified residence interest includes any interest paid or accrued during the tax year on a qualified residence for acquisition indebtedness or home equity indebtedness.

Acquisition indebtedness must be secured by the residence[37] and "recorded, where permitted, or… otherwise perfected in accordance with applicable State law."[38] The taxpayers' mortgage note at issue was not recorded with any public office nor did the taxpayers present any evidence to prove that the mortgage was otherwise perfected under Massachusetts law. Accordingly, the taxpayers did not satisfy the requirements for secured debt, and the court concluded that the amount paid to Joan Gross in 2009 was not qualified residence indebtedness.

Under IRC §6662, taxpayers may be liable for a 20% penalty on an underpayment of tax attributable to negligence, disregard of rules or regulations, or a substantial understatement of income tax. The §6662 penalty does not apply if the taxpayer demonstrates that they acted in good faith and with reasonable cause. The court noted that the taxpayers are not tax experts and that the requirement for determining the validity of the deduction was highly technical, even requiring an inquiry into state law. Accordingly, the court was satisfied that the taxpayers acted with reasonable cause and made a good faith effort to determine their proper tax liability.

Holding. The money paid to Joan Gross in 2009 was not qualified residence interest but the taxpayers were not liable for the accuracy-related penalty.

Charitable Deduction

***Margaret Payne v. Comm'r,* TC Summ. Op. 2013-64 (Aug. 13, 2013)**

IRC §§170 and 6662

☞ Court Finds that IRS Revenue Agent Fabricated Charitable Contribution Records

Facts. Margaret Payne was employed with the IRS for 28 years, 20 of which were as a **revenue agent.** At the time of trial, she had passed some parts of the CPA exam and was working at passing the remaining parts.

Ms. Payne frequently visited casinos in Atlantic City, New Jersey. She usually played the slot machines and sometimes also played card games.

Ms. Payne contended that she made cash contributions from her gambling winnings to the Living Stone Baptist Church (LSBC) in Brooklyn, New York. At the time of trial, Lemuel Mobley had been the pastor of LSBC for 12 years. The church had approximately 50 to 75 members during the years at issue, and Pastor Mobley knew all of them. He personally greeted all persons in attendance each Sunday at the conclusion of the services.

Donations to LSBC are generally made in cash. Some of the donations are placed in the collection basket without an envelope and other donations are placed in envelopes with a congregant's name written on the envelope. Designated church members count and record the contributions after each Sunday service. A report of the contributions is made each week to the pastor, including the names of the identified contributors. At the end of each year, LSBC provided a letter to each congregant upon request, which reflected the congregant's annual contributions. LSBC required congregants to personally pick up their letters and to sign and acknowledge that they had received a letter reflecting their annual contributions.

Juanita Stevenson has worked as a secretary for the IRS since 1987. Ms. Stevenson and Ms. Payne were friends and had worked together at times. Ms. Stevenson has been a member of LSBC for 49 years, where she regularly attends Sunday services and has volunteered in various capacities.

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37. IRC §163(h)(3)(B).

38. Temp. Treas. Reg. §1.163-10T(o)(1).

Ms. Payne timely filed Forms 1040 for 2008 and 2009. She reported gambling winnings of $47,808 on her 2008 return. She later agreed with the IRS that the correct amount of gambling winnings was $58,842. She also claimed a deduction for charitable contributions of $12,025 for 2008. This amount included a purported cash contribution to LSBC of $6,047, which the IRS subsequently disallowed. On her 2009 return, Ms. Payne reported gambling winnings of $13,250. She claimed a deduction for charitable contributions of $25,140 for 2009. This amount included a purported cash contribution to LSBC of $14,000, which the IRS subsequently disallowed.

During an IRS examination of Ms. Payne's 2008 and 2009 returns, an IRS agent asked Ms. Payne about the charitable contribution deductions. She provided the agent with copies of purported letters from LSBC. The letters, which were apparently prepared on LSBC's letterhead and signed by Pastor Mobley, stated that Ms. Payne had made contributions to LSBC of $6,047 and $14,000 for 2008 and 2009, respectively.

The IRS examiner contacted LSBC to determine whether Ms. Payne was actually a member and had, in fact, made contributions to the church. **Pastor Mobley told the examining agent that Ms. Payne was not a member of LSBC, that he did not know her, and that she had not made any contributions to LSBC.** He stated that the purported contribution letters were not signed by him and that the letterheads were a "cut and paste job."

After his meeting with the IRS agent, Pastor Mobley learned that Ms. Stevenson knew Ms. Payne. Ms. Payne later contacted Pastor Mobley to discuss the matter.

At some point after his discussion with Ms. Payne, Pastor Mobley wrote a letter to the IRS in which he recanted his previous statement. He stated that the amounts of money Ms. Payne allegedly contributed were actually made. **Subsequent to that, Pastor Mobley provided three contradictory explanations as to the events in question.** At one point, he asserted that the letters actually represented contributions from Ms. Stevenson. In another statement, Pastor Mobley said that he may have confused Ms. Payne with Ms. Stevenson. In another version of events, he suggested that Ms. Payne promised to make a contribution at a later time in return for the letters.

Issues. The issues in this case are as follows.

- Whether Ms. Payne is entitled to charitable contribution deductions for the 2008 and 2009 tax years
- Whether she is liable for accuracy-related penalties under IRC §6662(a)

Analysis. The court noted that the record regarding Ms. Payne's alleged charitable contributions was full of inconsistencies, contradicting testimony, fabricated documents, and untruths. The court determined that it was improbable that Ms. Payne had ever attended LSBC and even less likely that she made donations to the church in any amount. It appeared very likely that she acted in concert with Ms. Stevenson and cut and pasted stationary from LSBC.

Holding. Ms. Payne is not entitled to the claimed charitable contribution deductions for 2008 and 2009. The court also held Ms. Payne liable for accuracy-related penalties of 20% under IRC §6662.

Charitable Contributions

Larry and Diane Zavadil v. Comm'r, **TC Memo 2013-222 (Sep. 19, 2013)**

IRC §§170, 6662, and 162

☞ Taxpayers Cannot Deduct Charitable Contributions Paid by Circular Flow of Funds

Facts. Larry Zavadil organized American Business Forms, Inc. (ABF) in 1981. ABF is an S corporation that operated during the years at issue as American Solutions for Business (ASB). Mr. Zavadil was ASB's sole shareholder until June 2000, when he sold all of ASB's outstanding shares to ASB's employee stock ownership plan. In exchange for his stock shares, Mr. Zavadil received a note from ASB for $28.7 million, payable in 20 annual installments. After the sale of his shares, Mr. Zavadil served without compensation on ASB's board of directors and as its CEO.

ASB kept a ledger account on its books to keep track of Mr. Zavadil's non-ASB expenditures. During the years at issue, the non-ASB expenditures included various charitable contributions and advances to Mr. Zavadil's checking account at Glenwood State Bank, which had an account number ending in 5458 (account #5458).

Mr. Zavadil used account #5458 to pay off his ledger account at the end of each month, as was required by ASB's creditors. However, at the end of several months during the years at issue, Mr. Zavadil had insufficient funds in account #5458 to pay the checks drawn on that account. In those months, Mr. Zavadil had ASB transfer sufficient funds from ASB to account #5458, record the charge on his ASB ledger account, and then cash the check drawn on account #5458.

Mr. and Mrs. Zavadil reported adjusted gross income of $3.61 million and $3.07 million on their joint federal tax returns for 2004 and 2005, respectively. They claimed charitable contribution deductions of $576,827 and $535,731 on their Schedules A, *Itemized Deductions,* for the respective years.

Issues. There were multiple issues raised in this case but the following analysis focuses on whether the taxpayers are entitled to charitable contribution deductions in excess of the $218,355 and $202,059 that the IRS allowed for 2004 and 2005, respectively.

Analysis. The IRS did not explain in its notice of deficiency the reasons for disallowing the charitable contribution deductions. The Zavadils attempted to quantify the amounts at issue and specified that they were contesting the IRS's determinations only for those charitable contributions that the IRS disallowed on the grounds that they were the charitable contributions of ASB. The Zavadils contend that they properly deducted the charitable contributions at issue because Mr. Zavadil bore the economic burden of the charitable contributions charged to his ASB ledger account.

The IRS contends that ASB bore the economic burden of the charitable contributions at issue because Mr. Zavadil used a circular flow of funds to pay the contributions. The IRS presented evidence that Mr. Zavadil regularly issued checks from account #5458 at the end of the month to pay off his ledger balance, advanced sufficient funds at the beginning of the next month from ASB to account #5458 to cover the checks drawn on the account, and then caused ASB to cash the check from account #5458. However, the court noted Mr. Zavadil fully paid his ASB ledger balances with his own funds at certain times during the years at issue. The evidence shows that the alleged circular flow of funds did not become a regular pattern until the latter half of 2005. The court concluded that ASB did not bear the economic burden of the charitable contributions charged to Mr. Zavadil's ASB ledger account before July 2005.

The court reached a different conclusion about the charitable contributions issued from Mr. Zavadil's ASB ledger account after June 2005. From July 2005 through at least November 2005, Mr. Zavadil instructed ASB personnel to advance funds to account #5458 to cover the checks drawn on that account that were used to pay off his ASB ledger account. As a result of this circular flow of funds, ASB assumed the economic burden of the charitable contributions charged to Mr. Zavadil's ledger account after June 2005.

Holding. The Zavadils are entitled to deduct the charitable contributions at issue that were charged to Mr. Zavadil's ASB ledger account before July 2005. However, the charitable contribution deductions that were charged to his ASB ledger account after June 2005 were disallowed.

Education Expenses

***Adam and Lisa Hart v. Comm'r,* TC Memo 2013-289 (Dec. 23, 2013)**
IRC §162

☞ Lack of Established Trade or Business Precludes Deduction for MBA Tuition

Facts. Adam Hart enrolled in an MBA program at Rollins College in January 2009. At the time he enrolled in the MBA program, he was employed with Priority Healthcare Distribution as an oncology account specialist. After his employment with Priority Healthcare ended in April 2009, he held positions during 2009 at ADP Totalsource as an oncology account manager and Walgreen Company as an entry-level professional. He was also unemployed for a total of 3½ months during 2009.

When Mr. and Mrs. Hart filed their joint tax return for 2009, they claimed unreimbursed employee business expenses of $18,600 on line 21 of Schedule A, *Itemized Deductions.* Next to the line, they wrote "MBA tuition." After applying the 2% of adjusted gross income limitation for the miscellaneous itemized deduction, the net deduction for the tuition was $17,138. The IRS subsequently issued a notice of deficiency, disallowing the $17,138 unreimbursed employee business expense.

Issue. The issue in this case is whether the Harts may deduct $17,138 for unreimbursed employee business expenses for Mr. Hart's MBA tuition.

Analysis. Treas. Reg. §1.162-5 provides that a taxpayer may deduct education expenses as ordinary and necessary business expenses if the education:

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

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

Court decisions have varied on whether taxpayers may deduct education expenses related to pursuing a MBA degree, depending on the facts and circumstances of each case. The decisive factor is generally whether the taxpayer was already established in their trade or business. In Mr. Hart's situation, he held **three different jobs** during 2009. He contends he was in the business of selling cancer pharmaceuticals and the MBA classes enabled him to obtain employment in 2009. The court disagreed with his logic, stating that he **had not established** he was carrying on a trade or business.

Holding. Mr. Hart was not entitled to deduct his education expenses for 2009.

Unreimbursed Employee Travel Expenses

***Roj C. and Patricia Snellman v. Comm'r,* TC Summ. Op. 2014-10 (Feb. 3, 2014)**
IRC §§162, 262, 274, and 280F

☞ Lack of Contemporaneous Records Limits Deductions

Facts. During the first five months of 2009, Roj and Patricia Snellman lived in Indialantic, Florida, with their four young children. Mr. Snellman was unemployed until he began work in late May 2009 as a project manager for U.S. Fidelis (Fidelis) in Wentzville, Missouri. Fidelis marketed and sold extended auto warranties.

When hired, Fidelis agreed to pay Mr. Snellman an annual salary of $90,000 and informed him that his employment would end no later than December 31, 2009. A Fidelis executive told him that he would not be reimbursed for any employment-related expenses, including moving expenses.

On May 24, 2009, Mr. Snellman drove from his Florida residence to Missouri. He began work for Fidelis the next day and stayed at a hotel from May 25 to June 10, 2009. On June 11, he moved to a rented apartment in St. Charles, Missouri, and signed a lease for $525 per month. The apartment was 18 miles from Fidelis' office.

Fidelis began to experience cash flow problems, and Mr. Snellman's employment ended abruptly on November 2, 2009. He returned to his Florida residence on November 18 after collecting his last paycheck.

On the Snellmans' joint 2009 tax return, Mr. Snellman deducted the following expenses on Form 2106-EZ, *Unreimbursed Employee Business Expenses*, before taking into account the 2%-of-AGI limitation for miscellaneous itemized deductions claimed on Schedule A, *Itemized Deductions.*

Type of Expense	Deduction	Computation Details
Automobile	$ 4,060	7,381 business miles × $0.55 standard mileage rate
Meals and lodging	27,200	160 days away from Florida × $170 per diem rate

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The IRS disallowed the employee business expenses in full for the following reasons.

- Wentzville, Missouri, was Mr. Snellman's **tax home** between May 24 and November 18, 2009. Therefore, the travel and mileage expenses incurred there were nondeductible.
- Mr. Snellman did not comply with **the substantiation requirements of** IRC §274(d) and the listed property requirements of IRC §280F.
- The claimed expenses were **not ordinary and necessary** business expenses as defined by IRC §162(a)(2).

The IRS determined a deficiency of $4,396 for the Snellmans' 2009 tax return. The Snellmans petitioned the Tax Court and represented themselves before the special trial judge.

Issue. The issue in this case is whether the Schedule A unreimbursed employee business expenses are deductible.

Analysis. A taxpayer who claims a deduction must prove that the expense is allowable and must substantiate that the expense was paid or incurred.[39] When a taxpayer establishes that he paid a deductible expense but fails to establish the amount of the deduction, the court may estimate the amount allowable as a deduction.[40]

The IRS determined that Mr. Snellman's tax home for 2009 was Wentzville, Missouri, but the Snellmans contended that his tax home was Indialantic, Florida, where the family resided. IRC §162(a) provides that a taxpayer may deduct reasonable and necessary travel expenses incurred while the taxpayer is **away from home** for business purposes. IRC §162(a) further states that "the taxpayer shall not be treated as being **temporarily away from home** during any period of employment if such period exceeds 1 year." Mr. Snellman provided credible testimony that his employment with Fidelis was temporary; therefore, his tax home for 2009 was Indialantic.

IRC §274(d) imposes stringent substantiation requirements before a taxpayer may deduct expenses for travel, meals, entertainment, and the use of listed property as defined in IRC §280F(d)(4)(A), including passenger automobiles. The strict substantiation requirements for vehicle expenses must be met even when the optional standard mileage rate is used.[41] Mr. Snellman **failed to maintain a contemporaneous record** of the alleged business use of his vehicle. The mileage log offered into evidence was created after receipt of the IRS examination report. He also failed to keep any record of his hotel expenses.

39. IRC §6001 and *Hradesky v. Comm'r,* 65 TC at 89-90 (1975), *aff'd* per curiam, 540 F.2d 821 (5th Cir. 1976).

40. *Cohan v. Comm'r,* 39 F.2d 540, 543-544 (2nd Cir. 1930).

41. Treas. Reg. §1.274-5(j)(2).

Holding. Mr. Snellman's job in Missouri was a temporary assignment. However, he failed to keep the necessary records of his lodging and business auto expenses. **Based on all the evidence presented, the Tax Court allowed $8,232 of employee business expenses before application of the 2%-of-AGI limitation.**

Round trip mileage from Florida home to Missouri job site	2,210 miles × $0.55	$1,215
Apartment rent in Missouri	5.67 months × $525 per month	2,975
Meals during temporary job period	137 days × $59 per diem rate = $8,083 × 50%	4,042
Total allowed expenses		$8,232

> **Note.** IRC §274 gives the IRS the authority to disallow claimed business entertainment, travel, gift, and listed property expenses unless strict recordkeeping requirements are met. This case shows the result of failure to adhere to these rules.

LIKE-KIND EXCHANGES

Like-Kind Exchange

***Frank J. Blangiardo v. Comm'r*, TC Memo 2014-110 (Jun. 9, 2014)**

IRC §§1031 and 1041

☞ Two Divorces and Bad Legal Advice Results in Large Tax Deficiency

Facts. When Frank Blangiardo was married to his first wife, he bought property A in 1995 for $488,000. In 2000, their marriage ended in a divorce. As part of the property settlement, Mr. Blangiardo paid his first wife $500,000 to waive her ownership rights in the property.

Following the divorce, Mr. Blangiardo remarried. This second marriage ended in a 2006 divorce. Mr. Blangiardo paid his second wife $80,000 "for any and all claims" she might have against him, including any ownership rights in property A.

Mr. Blangiardo sold property A on August 15, 2008, for $2.25 million. On August 29, 2008, he bought a parcel of vacant land (property B) for $1.43 million. Regarding these two real estate transactions, Mr. Blangiardo contended the following was true.

- Property A and property B were both held for business use.
- He engaged in a legitimate IRC §1031 deferred like-kind exchange with his son, an attorney, acting as the "qualified intermediary."[42]
- His basis in Property A was **$1.068 million,** consisting of the following.
  - The 1995 purchase price of $488,000
  - The 2000 property settlement of $500,000 he paid to his first wife
  - The 2006 property settlement of $80,000 he paid to his second wife
- His deferred capital gain on the 2008 sale of property A was $1.182 million ($2.25 million sale price − $1.068 million basis).

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[42] See Treas. Reg. §1.1031(k)-1(g)(4).

In its examination of Mr. Blangiardo's 2008 tax return, the IRS proposed the following adjustments.

- The basis in property A was limited to the $488,000 purchase price of the property.
- Property A should be treated as a principal residence, and Mr. Blangiardo should be allowed the maximum IRC §121 exclusion of $250,000 on its sale.
- The sale of property A resulted in a **taxable capital gain of $1.512 million,** calculated as follows.

Sales price	$2,250,000
Less: basis	(488,000)
Less: §121 exclusion	(250,000)
Taxable gain	$1,512,000

The IRS determined a 2008 tax deficiency of $1.367 million and an IRC §6662(a) accuracy-related penalty of $273,397. Unlike most Tax Court cases, the IRS asked the court to grant a **partial summary judgment (a procedural device used to dispose of a case on an issue without trial)** on the unresolved issues.

Issues. In requesting partial summary judgment, the IRS raised the following issues.

- Whether the sale of property A and the acquisition of the vacant land constituted a valid IRC §1031 deferred exchange
- Whether Mr. Blangiardo improperly increased his basis in property A by amounts he paid to his former spouses

Analysis. If a taxpayer uses a **qualified intermediary** in a valid §1031 transaction, the transfer of relinquished property and the subsequent receipt of like-kind property are treated as an exchange.[43] Therefore, the taxpayer is not treated as if they were in actual or constructive receipt of money. A qualified intermediary must satisfy a number of requirements, one of which is that they **cannot be a "disqualified person."**[44] A disqualified person includes ancestors and **lineal descendants.**[45]

The intermediary used in Mr. Blangiardo's exchange was his son. He argued that the transaction qualified as a like-kind exchange because his son, who is an attorney, held the funds from property A in a trust account, and the real estate documents refer to the transaction as a §1031 exchange. The court did not accept this argument, noting that the regulation is explicit. A lineal descendant is a disqualified person and there is no exception based on the person's profession.

No gain or loss is recognized on the **transfer of property** from one spouse to another or to a former spouse if the transfer is **incident to a divorce.**[46] For federal income tax purposes, such transfers **are treated as gifts** from the transferor to the transferee.[47] Mr. Blangiardo acknowledged that he paid $580,000 to his former spouses in connection with his divorces but that the IRS was incorrect in treating these transactions as gifts. However, IRC §1041(b)(1) clearly provides that such transfers are gifts. IRC §1041(b)(2) provides that the basis of the property's transferee is the same as the adjusted basis of the transferor. Accordingly, Mr. Blangiardo cannot increase his basis in property A by $580,000 of settlement payments.

Holding. The disposition of property A is not a deferred exchange and the amounts paid to Mr. Blangiardo's former spouses did not increase his basis in the property.

43. Ibid.
44. Treas. Reg. §1.1031(k)-1(g)(4)(iii).
45. Treas. Reg. §1.1031(k)-1(k)(3).
46. IRC §1041(a).
47. IRC §1041(b)(1) and *Balding v. Comm'r*, 98 TC 368, 371-372 (1992).

NOT FOR PROFIT

Profit Motive

***Thomas A. Gullion v. Comm'r,* TC Summ. Op. 2013-65 (Aug. 14, 2013)**
IRC §§162, 183, and 6662

☞ Musician Engaged in Activity for Profit

Facts. Thomas Gullion began performing on the saxophone at the age of eight and played professionally since the age of 16. In 1995, he moved to Chicago and worked solely as a musician. In 2002, he moved to Wisconsin and started working as a computer programmer but continued to play the saxophone. After moving to Wisconsin, he organized a jazz festival and recorded four CDs.

In 2008, Mr. Gullion and his wife earned a total of $43,642 in wages and $70,223 from their specialized design services business that they reported on Schedule C, *Profit or Loss From Business.* For 2009, Mr. and Mrs. Gullion reported $133,245 in wages.

Mr. Gullion also reported activities related to his music on Schedules C. His gross receipts and net losses from his musical activities are reflected in the following table.

Year	Gross Receipts	Net Loss
2004	$ 1,483	$ 12,163
2005	530	11,842
2006	983	17,872
2007	1,615	20,315
2008	2,625	32,541
2009	2,931	26,003
2010	3,154	9,467
Total	$13,321	$130,203

Mr. Gullion reported a profit of $647 from his musical activities in 2011.

The IRS determined that Mr. Gullion was not engaged in the music business with the objective of making a profit for the 2008 and 2009 tax years. Accordingly, the IRS assessed deficiencies and penalties.

Issues. The issues in this case are as follows.

- Whether Mr. Gullion engaged in musical activities with the objective of making a profit within the meaning of IRC §183
- Whether he is liable for accuracy-related penalties under IRC §6662(a)

Analysis. IRC §162 allows a taxpayer to deduct ordinary and necessary expenses incurred in carrying on a trade or business. IRC §183 generally limits the amount of deductions for an activity that is not engaged in for profit to the amount of income that the activity generates. A taxpayer must be involved in an activity with continuity, regularity, and the primary purpose of making a profit in order to be engaged in a trade or business within the meaning of §162(a).[48]

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

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). The court in the case at hand decided that it was not necessary to analyze each of the nine factors. Instead, the court focused on the following factors that were most important and applicable to Mr. Gullion's situation.

1. **Taxpayer's time and effort.** The IRS claimed that Mr. Gullion worked full time as a software programmer and did not have time for a music career. The court disagreed, noting that Mr. Gullion organized a jazz festival in Wisconsin and recorded four CDs. His testimony was credible concerning the time he spent on his music career. The court recognized that a taxpayer may engage in more than one trade or business at any one time.[49]

2. **Taxpayer's success in similar activities.** Mr. Gullion earned a living from his music before moving to Wisconsin. He testified that he intended to be profitable again and, in fact, did report a small profit in 2011.

3. **History of income or losses.** The court found that "a history of losses is less persuasive in the art field than it might be in other fields," because economic success in the arts frequently takes longer to achieve than success in other fields.[50] The IRS asserted that Mr. Gullion's small profit in 2011 did not offset years of sustained losses. However, Mr. Gullion explained that the music industry had changed and that he had made adjustments and retooled his career; consequently, he was profitable in 2011.

4. **Financial status of taxpayer.** Mr. Gullion did not have substantial income or sources of capital. He earned income in the computer software industry. However, this income was not considerable, and he contended that he wanted to work full time on his music.

5. **Elements of personal pleasure or recreation.** Mr. Gullion derives pleasure from his music, but his goal is to make a profit. He views himself as a professional musician and his testimony supported his claim.

Holding. After considering all the facts and circumstances, the court held that Mr. Gullion was engaged in the trade or business of music during the years at issue. Accordingly, he was not liable for accuracy-related penalties under IRC §6662(a).

Note. For more information related to hobbies versus activities engaged in for profit, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 3, Hobby Losses.

[49] See *Gestrich v. Comm'r,* 74 TC 525, 529 (1980), *aff'd* without published opinion, 681 F.2d 805 (3d Cir. 1982).

[50] *Churchman v. Comm'r,* 68 TC 696 (1977).

Gambling Losses

***Estate of John F. Chow et al. v. Comm'r*, TC Memo 2014-49 (Mar. 24, 2014)**
IRC §§162, 183, 6651, and 6662

☞ Taxpayer is a Loser Regarding Gambling Losses

Facts. Esther Chow gambled extensively at two California casinos during 2006, 2007, and 2008 and sustained substantial losses. Mrs. Chow and her husband John deducted her substantial net slot machine gambling losses on their 2006, 2007, and 2008 joint tax returns. The taxpayers did this despite the fact that **the Tax Court had previously decided that Mrs. Chow's 2004 and 2005 gambling losses were limited to the amount of her gambling winnings.**[51]

Mrs. Chow's gambling losses were deducted on Schedule C, *Profit or Loss From Business,* for the three tax years. On each Schedule C, "gambling" was shown as the principal business or profession. The amount of the Schedule C net gambling losses are as follows.

Tax Year	Schedule C Gambling Loss
2006	($3,090,500)
2007	(2,500,686)
2008	(587,616)

The Chows filed Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, for all three tax years. However, their 2006 and 2008 returns were filed after the extension due dates.

In its exam of the 2006, 2007, and 2008 tax returns, the IRS made the following adjustments.

1. It moved Mrs. Chow's gambling winnings to line 21 (other income) of Form 1040 and included the winnings in the Chow's adjusted gross income for each year.
2. It allowed gambling losses of an equal amount on Schedule A, *Itemized Deductions,* as miscellaneous itemized deductions.

The IRS assessed tax deficiencies and penalties as shown in the following table.

Tax Year	Tax Deficiency	Failure to File Penalty	20% Accuracy-Related Penalty
2006	$480,025	$120,006 (25%)	$96,005
2007	179,440	N/A	35,888
2008	186,304	37,261 (20%)	37,261

Note. Although the Tax Court document does not indicate how the tax deficiency amounts for the three years were computed, a portion of each deficiency may have been the result of alternative minimum tax.

The IRS assessed the failure to pay penalty[52] for 2006 and 2008 and the 20% accuracy-related penalty[53] for all three tax years.

51. *Chow v. Comm'r*, TC Memo 2010-48 (Mar. 18, 2010), *aff'd* 481 Fed. Appx. 406 (9th Cir. 2012).

52. IRC §6651(a)(1).

53. IRC §6662(a).

Issues. The issues in this case are as follows.

- Whether Mrs. Chow engaged in her gambling activity for each year with an actual and honest objective of making a profit[54]
- Whether the failure to pay penalty under IRC §6651(a)(1) is applicable for the 2006 and 2008 tax years
- Whether the accuracy-related penalties under IRC §6662(a) are applicable for all three tax years

Analysis. To determine whether Mrs. Chow met the definition of a professional gambler as she claimed, she must prove that she had a bona fide profit motive. That determination is made by analyzing the nine subjective factors found in Treas. Reg. §1.183-2(b).

In its analysis of her profit objective, the court noted that Mrs. Chow continued to have sizable gambling losses in 2006, 2007, and 2008 even after suffering substantial gambling losses in 2004 and 2005. **The court also offered the following facts as evidence that she failed to carry her burden of establishing that she was engaged in her gambling activities** for the 2006–2008 tax years with an actual and honest **objective of making a profit.**

- She had no business plan for her gambling activities.
- She had no budget for her gambling activities.
- She did not maintain a separate bank account for her gambling activities.
- She did not attempt to change her gambling methods in an effort to make them profitable.
- She did not do any research in slot machine gambling in order to improve her chances of making a profit.
- She did not consult with anyone with expertise in slot machine gambling.
- She did not otherwise engage in her gambling activities in a businesslike manner.

Holding. The court held that Mrs. Chow failed to carry her burden of establishing that she engaged in her gambling activities with a profit objective. The court fully sustained the IRS examination determinations regarding tax deficiencies and penalties for all three tax years.

> **Note.** Even if the court had concluded that Mrs. Chow was a professional gambler, her allowable Schedule C gambling losses would have been limited to the amount of her gambling winnings for each year.[55] For more information about reporting gambling income, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 2: Reporting Miscellaneous Income.

54. IRC §183.

55. See, e.g., *Mayo v. Comm'r*, 136 TC 81, 90 (2011).

Hobby Loss

***Merrill C. Roberts v. Comm'r,* TC Memo 2014-74 (Apr. 29, 2014)**

IRC §§162, 183, 6651, and 6662

☞ Profit Motive for Horse Activities Established in Two out of Four Years

Facts. In 1969, Merrill Roberts bought an abandoned restaurant in Indianapolis, Indiana. He reopened the restaurant as a steakhouse, which was successful until a significant kitchen fire occurred a few months after opening.

Mr. Roberts then reopened the business as a bar in 1972. Mr. Roberts sold the establishment in 1973 and then opened a pizza parlor five miles from the former bar. The buyers defaulted and he was forced to take the "gentlemen's club," which was named Dancers, back. Dancers became a very lucrative venture, which allowed Mr. Roberts to expand by opening other nightclubs and restaurants. At one point, he owned a total of six establishments.

Mr. Roberts expanded his business activities by investing in real estate. He acquired a 50-acre parcel of land located directly across from Dancers for $250,000. For 10 years, he rented this property to a farmer. In 1997 or 1998, he bought an additional 45 acres located directly north of the 50 acres for $400,000. This property had been used to board horses and contained an operational stable.

In the mid-1990s, Mr. Roberts began easing out of the nightclub industry. He sold all his shares of the nightclub business to his three grown children.

In 1998 or 1999, the Indiana Thoroughbred Owners and Breeders Association invited Mr. Roberts to attend a free dinner and tour of Hoosier Park, the first horse racing track to be opened in Indiana. After attending the event, he asked a trainer who worked at his boarding stables to "show him the ropes" of horse racing.

He bought his first two young horses for $1,000 each in 1999. His net income was approximately $18,000 during his first year of racing. By 2001, he owned 10 racing horses and a breeding stallion. He worked every day at the horse farm and obtained his trainer's license in 2002. He consulted a blood stock agent for horse purchasing and breeding advice so he could expand the horses' bloodlines.

In June 2006, he sold the 95 acres for $2.2 million. He then purchased a 180-acre parcel of land for $1 million just 16 miles from his house and invested $500,000 to $600,000 in building improvements over the next six months.

By 2007, he had built a world-class training facility for conditioning and motivating horses that included a large training track, portable horse stalls, unique rehabilitation equipment, several specialized training areas, and small apartments for employees. On part of this 180-acre plantation, he grew hay and rented out 90 acres of land.

In 2005 through 2008, Mr. Roberts was involved in boarding, breeding, training, and racing horses. In 2007, he hired a full-time assistant trainer and collected fees for services his trainer performed for third parties. Mr. Roberts suffered an unusual number of mishaps during his first few years of horse racing, all of which created challenges for him.

Mr. Roberts used a rudimentary accounting system for all of his businesses. A database maintained by a private organization kept detailed records of each horse's history, complete with total earnings, earnings per start, and earnings per year. He also tracked the cost of boarding a horse and the amount of feed each horse required.

For 1999 through 2006, he reported income and expenses from his horse racing operation on Schedules C, *Profit or Loss From Business.* His horse farm income and expenses were reported on Forms 1120S, *U.S. Income Tax Return for an S Corporation.* In 2007, he began reporting all income and expenses from horse-related activities on the S corporation return.

The following income and expenses were reported on the 2005–2008 tax returns.

	2005	2006	2007	2008
Schedule C income	$ 64,948	$184,661		
Less: Schedule C expenses	(162,450)	(169,809)		
Net profit/loss	($ 97,502)	$ 14,852		
1120S income	$ 47,247	$ 38,013	$258,433	$ 65,563
Less: 1120S deductions	(103,165)	(83,469)	(356,684)	(357,451)
Net profit/loss	($ 55,918)	($ 45,456)	($ 98,251)	($291,888)

The IRS examined the tax returns and issued notice of deficiencies for the 2005–2008 tax years. Penalties under IRC §§6662(a) and 6651(a)(1) were also assessed.

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Issues. The issues in this case are as follows.

- Whether the taxpayer engaged in various horse-related activities during 2005–2008 with the expectation of making a profit
- Whether the taxpayer is liable for accuracy-related penalties under IRC §6662(a) for tax years 2005–2008
- Whether the taxpayer is liable for an addition to tax under IRC §6651(a)(1) for the 2007 tax year

Analysis. Courts use a 9-factor analysis in hobby loss cases in accordance with Treas. Reg. §1.183-2(b). These factors are not exclusive and no single factor is determinative. Following is a brief description of these factors as they relate to Mr. Roberts' horse activities.

1. **Manner of carrying on the activity.** Mr. Roberts conducted the horse activities in a business-like manner during 2007 and 2008, but this factor is neutral for tax years 2005 and 2006.
2. **Expertise of taxpayer or advisors.** Mr. Roberts displayed his expertise through his participation in trade associations, rising through the ranks into leadership roles at two professional racing associations. This factor weighs in Mr. Roberts' favor for all the tax years at issue.
3. **Time and effort devoted to the activity.** Mr. Roberts devoted a significant amount of time and effort in carrying on the activities beginning in 2005. This factor weighs in Mr. Roberts' favor for all the tax years at issue.
4. **Expectation that the assets used in the activity will appreciate in value.** With the transfer of his horse-related activities in 2007, this is the first year the real estate appreciation expectation weighs in favor of Mr. Roberts. For the 2005 and 2006 tax years, this factor is neutral.
5. **Success in carrying on other activities.** Mr. Roberts built a successful nightclub business. He turned a single unprofitable bar into a network of up to six different establishments. He also started a successful car dealership and an insulation company. This factor weighs in Mr. Roberts' favor.
6. **The amount of occasional profits.** Mr. Roberts had success with his first two horses and expected that success to continue. One of his horses was nominated to run in the Triple Crown Races, which showed that his horses have the potential to race at a very high level and possibly earn significant profits. This factor weighs in his favor for all the tax years at issue.
7. **Elements of personal pleasure or recreation.** Mr. Roberts transitioned out of the recreational aspect of horse racing in 2007. The factor weighs in the IRS's favor for the 2005 and 2006 tax years and in Mr. Roberts' favor for the 2007 and 2008 tax years.

8. **Financial status.** Mr. Roberts earned income from sources other than horse-related activities. The horse-related activity losses reduced his taxable income. **This factor heavily weighs in favor of the IRS.**

9. **History of income or losses.** Some of the losses incurred can be explained by a series of unfortunate events beyond Mr. Roberts' control, which included the untimely death of several racing and breeding prospects, a quarantine during racing season, and the need to hire and fire several different trainers. The startup phase and unforeseen expenses balance the history of large losses, making this factor neutral for all tax years.

Considering these nine factors, the court determined that Mr. Roberts did not engage in the horse-related activities for profit during the 2005 and 2006 tax years. However, he demonstrated a profit objective starting in 2007 when he significantly changed his operation, opened a new facility, and transitioned out of the recreational aspect of horse racing.

With respect to the IRC §6662(a) accuracy-related penalty, Mr. Roberts had a CPA whom he had employed for over 20 years. His tax returns were examined twice before and fared well both times as the result of his CPA's work. Based on Mr. Roberts' reliance on the CPA, the court determined that he had demonstrated reasonable cause and was not liable for the §6662 penalty.

With respect to the IRC §6651(a)(1) late filing penalty, Mr. Roberts contended that his former girlfriend burned some of his records in a fireplace, thus establishing reasonable cause for late filing. The court disagreed. Mr. Roberts did not present any evidence to show the records were actually destroyed or that any attempts were made to obtain the missing information.

Holding. Mr. Roberts was not engaged in his horse-related activities for profit for the 2005 and 2006 tax years but was engaged in the activities for a profit for the 2007 and 2008 tax years. He was not held liable for accuracy-related penalties but was liable for the 2007 late-filing penalty.

PASSIVE ACTIVITIES

Passive Activity Losses

***Ben and Tammy R. Bartlett v. Comm'r*, TC Memo 2013-182 (Aug. 8, 2013)**

IRC §§469 and 6662

☞ Material Participation Test Not Met Due to Lack of Records

Facts. During 2006 and 2007, Ben Bartlett operated Growin' Green, a profitable landscape and snow removal sole proprietorship in Jackson Hole, Wyoming. The net profits for this business exceeded $400,000 in 2006 and $1 million in 2007. Mr. Bartlett worked long hours at this business in both years.

In 2005, Mr. Bartlett bought 1,900 acres near Burley, Idaho, and started a rodeo bull breeding and training activity called Rainbow Ranch. The ranch was 220 miles from Mr. Bartlett's Wyoming residence.

During 2006 and 2007, three of Growin' Green's employees stayed at the ranch during the winter months, from approximately the beginning of November until the end of March. During this same time period, Mr. Bartlett reached an agreement with Cameron Tuckett, a local rancher. The agreement allowed Mr. Tuckett to graze his horses on Rainbow Ranch land in exchange for caring for the bulls from April through October after the departure of the three Growin' Green employees.

Mr. Bartlett did not keep a contemporaneous log, diary, or notes of the work he performed for Rainbow Ranch or whether his work was performed at his Wyoming residence or at the Idaho ranch. Mr. and Mrs. Bartlett's joint 2006 and 2007 tax returns reported the following Schedule F, *Profit or Loss From Farming,* net losses for Rainbow Ranch.

Tax Year	Reported Schedule F Loss	Line E Material Participation Box
2006	($105,515)	Yes box checked
2007	(134,763)	Yes box checked

An IRS examination disallowed the claimed Schedule F losses for 2006 and 2007 under the passive loss limitations of IRC §469 because Mr. Bartlett could not prove that he materially participated in the ranch activities. The IRS assessed the following additional taxes and 20% accuracy-related penalties.

Tax Year	Additional Tax	Accuracy-Related Penalty
2006	$39,510	$ 7,902
2007	51,076	10,215

Issues. The issues in this case are as follows.

- Whether the reported bull breeding activity losses are limited by the IRC §469 passive loss rules
- Whether the accuracy-related penalties under IRC §6662(a) are applicable

Analysis. A trade or business in which a taxpayer does not materially participate is a passive activity.[56] A taxpayer can satisfy the material participation test using any one of the seven tests provided in the regulations.[57]

Mr. Bartlett contends that he met three of the seven tests provided in the regulations as follows.

- He met Test 1 by performing over 500 hours of work for Rainbow Ranch in 2006 and 2007.[58]
- He met Test 3 by performing over 100 hours during 2006 and 2007, and his work for Rainbow Ranch exceeded the hours worked by any other individual.[59]

Note. To meet Test 3, Mr. Bartlett had to prove he worked more hours on Rainbow Ranch activities during both tax years than his three Growin' Green employees or Mr. Tuckett did.

- He met Test 7, the facts and circumstances test. To satisfy this test, he had to prove that his participation in Rainbow Ranch activities during both tax years was **regular, continuous, and substantial.**[60]

Mr. Bartlett testified at the Tax Court trial that he spent over 1,000 hours during both tax years on Rainbow Ranch activities. However, he failed to maintain any contemporaneous records or other documentation regarding the specific tasks he performed. The court noted that the evidence did not establish that during the years at issue Mr. Bartlett spent 500 hours on the activity, so he failed to meet the criteria of Test 1. Mr. Bartlett did not establish that he worked more than Mr. Tuckett, who worked on the ranch 40 hours per week for approximately four months. Accordingly, Mr. Bartlett failed to meet the criteria of Test 3.

56. IRC §469(c)(1).
57. Temp. Treas. Reg. §1.469-5T(a).
58. Temp. Treas. Reg. §1.469-5T(a)(1).
59. Temp. Treas. Reg. §1.469-5T(a)(3).
60. Temp. Treas. Reg. §1.469-5T(a)(7).

The evidence also failed to establish that Mr. Bartlett worked on the bull-breeding activity in a regular, continuous, and substantial manner, which is required by Test 7. The records produced at trial indicated that Mr. Bartlett was at the ranch approximately 58 days in 2006 and 35 days in 2007. These sporadic trips to the ranch combined with the intense work ethic that he demonstrated for Growin' Green do not suggest that he worked on the bull-breeding activity in a regular or continuous manner.

The court stated "While the regulations permit some flexibility regarding the evidence to prove material participation, we are not required to accept post-event 'ballpark guesstimates,' nor are we bound to accept the unverified, undocumented testimony of taxpayers."[61]

Holding. Mr. Bartlett failed to meet any of the material participation tests. Therefore, the tax deficiencies determined by the IRS for both tax years were upheld. In addition, the 20% accuracy-related penalties for both years were sustained.

Passive Activity Losses

***Charles and Delores Gragg v. U.S.,* No. 4:12-cv-03813; U.S. District Court for the Northern District of California (Mar. 31, 2014)**
IRC §§469 and 7422

☞ Estimates Do Not Satisfy Court Requirements

Facts. California residents Charles and Delores Gragg had combined gross income from their respective occupations totaling over $400,000 in 2006 and 2007. Mrs. Gragg's income was earned as a qualified real estate agent.

Additionally, they owned two real estate rental properties that incurred losses during 2006 and 2007. These losses were used to offset their other taxable income. A summary of income and expenses for the two properties follows.

	2006	2007
Arroyo Drive Residence		
Total income received	$12,000	$15,000
Less: total expenses	(25,715)	(25,217)
Net loss	($13,715)	($10,217)
Mockingbird Lane Residence		
Total income received	$ 3,600	$ 5,000
Less: total expenses	(12,438)	(15,173)
Net loss	($ 8,838)	($10,173)

The IRS examined the 2006 and 2007 returns and determined that these losses were passive activity losses. During the audit, the person who held the power of attorney for Mrs. Gragg was interviewed and provided information as to the rental property duties she performed. Mrs. Gragg supplied a signed but undated note stating that, for the Gragg's Mockingbird Lane property, in 2006 her "estimated hours were approximately 40 hours" for two months that the house was rented and "approximately 100 hours" after the tenants moved out.

She also supplied a second note for the Arroyo Drive property showing that her duties took about 200 hours in 2006 dealing with tenant eviction and 300 hours restoring the property. No documentation was provided for 2007.

61. See, e.g., *Lum v. Comm'r*, TC Memo 2012-103 (Apr. 10, 2012); and *Estate of Strangeland v. Comm'r*, TC Memo 2010-185 (Aug. 16, 2010).

The IRS examiner stated that Mrs. Gragg failed to meet the material participation test based on the documents provided. The IRS examiner determined that the Graggs' losses were passive and could only be offset against passive income and made adjustments accordingly. The taxpayers disagreed with the IRS determination and filed a claim for refund after the tax was assessed. The IRS denied their claim for refund.

Issue. The issue in this case involves whether the taxpayers are entitled to deduct the rental losses in 2006 and 2007.

Analysis. A passive activity is any trade or business in which the taxpayer does not materially participate. A rental activity is generally treated as a passive activity regardless of whether the taxpayer materially participates. There are **two main exceptions** to the general rule that rental activities are passive activities. The first exception applies to rental real estate activities in which the individual **actively participates** in the activity during the year. The Graggs did not qualify for this $25,000 special allowance because their adjusted gross income for both 2006 and 2007 exceeded the $150,000 phaseout ceiling.

The other exception provides that rental activities of a **real estate professional** are not considered passive activities. To qualify as a real estate professional, a taxpayer must satisfy both of the following requirements.[62]

- More than half of the personal services performed in trades or businesses by the taxpayer during the year are performed in real property trades or businesses in which the taxpayer **materially participates.**
- The taxpayer performs **more than 750 hours** of services during the year in real property trades or businesses in which the taxpayer **materially participates.**

The Graggs' primary contention is that Mrs. Gragg's status as a full-time real estate agent establishes that she materially participated in a qualifying real estate trade or business. Accordingly, they asserted that she need not "requalify" by demonstrating material participation in **each** of her separate real estate rental activities. The IRS did not deny that Mrs. Gragg is a real estate agent but asserted that, nonetheless, **she is required to separately establish material participation for their two rental properties for 2006 and 2007.**

The court agreed with the IRS's position. The court noted that IRC §469(c)(7)(A)(ii) requires that the analysis regarding rental activity is applied as if each interest of the taxpayer in rental real estate were a separate activity unless the taxpayer makes an election to treat the interests as one activity. The Graggs stipulated that they failed to make an election.

The IRS determined that Mrs. Gragg failed to perform more than 750 hours of service in a real property trade or business. The court noted that the records provided by Mrs. Gragg to document the number of hours spent in the activity were not reliable. These records simply estimated the approximate number of hours that she spent. Accordingly, the court concluded that the estimates did not provide reasonable records of her material participation.

Holding. The court concluded that Mrs. Gragg did not meet the standards for material participation in the rental activities. As a result, the taxpayers are not allowed to deduct the rental losses in 2006 and 2007.

62. IRC §469(c)(7).

Passive Activity Loss

***Stefan A. Tolin v. Comm'r,* TC Memo 2014-65 (Apr. 9, 2014)**

IRC §§162, 183, and 469

☞ Credible Testimony Validates Material Participation

Facts. Stefan Tolin, a Minnesota lawyer, had a practice in Minneapolis. He also spent a significant amount of time in a thoroughbred horse breeding and racing activity.

Mr. Tolin has enjoyed horse racing from the time he was an adolescent. His first racehorse purchase occurred in 1990 when he was representing a client before the Minnesota Racing Commission. He bought a mare in 1991 that eventually foaled Choosing Choice in 1993. Choosing Choice's career began in September 1995. The horse progressed until 1996 when he suffered a slab fracture in his right front leg. The injury prevented him from racing for the remainder of 1996 and all of 1997. His racing career ended in 1998, after he suffered a more serious leg injury. Choosing Choice won six of 16 races and finished third in three others, earning $77,638 during his racing career.

Mr. Tolin decided that Choosing Choice would be a great prospect for stud services. He spent countless hours promoting the stud services of Choosing Choice, including personal solicitation of those who may be interested in this service. Mr. Tolin mailed interested breeders a promotional breeding package containing pictures, race chart results, newspaper articles, copies of Choosing Choice's "nicking" analysis, and a video compilation of his notable races. The package also included a hypothetical mating cross between Choosing Choice and any of the mares they had previously discussed. He also advertised the stud services via full-page print advertisements.

During 2002 through 2004, Mr. Tolin made several trips to Louisiana to conduct horse business. He also performed some work related to this operation while in Minnesota, including paying bills, keeping books and records, registering horses, reading publications, and arranging for mortality insurance on Choosing Choice.

For the 2002 through 2004 tax years, income and expenses were shown on Schedule C, *Profit or Loss From Business,* resulting in losses in each of the three years. The IRS examined the returns and disallowed the losses for each year as passive activity losses.

Issue. The issue in this case is whether losses Mr. Tolin sustained in the operation of a thoroughbred horse breeding and racing activity were passive activity losses.

Analysis. IRC §469(a) disallows the passive activity loss of an individual taxpayer. A passive activity is generally the conduct of any trade or business in which the taxpayer does not materially participate. To meet the material participation requirement in a given year, the taxpayer must demonstrate that they participated in the activity for more than 500 hours during the tax year.

For 2002, Mr. Tolin provided a breakdown of his thoroughbred activity that totaled 798 hours. Telephone conversations with business associates and breeders totaled 311 hours and trips to Louisiana totaled 290 hours. The remaining hours were broken down into various other duties he performed.

Mr. Tolin provided credible testimony on the number of hours he spent in telephone conversations. For the time spent in Louisiana, he provided credible testimony supported by third-party witness testimony. The activities performed by Mr. Tolin clearly met the minimum requirement for 500 hours of participation. Similar testimony was provided for both 2003 and 2004.

Holding. Mr. Tolin performed more than 500 hours of qualifying work in connection with the thoroughbred activity in each of the 2002, 2003, and 2004 tax years; accordingly, he is treated as materially participating in the activity for each of these years.

Suspended Passive Losses

***Alexander and Jennifer Herwig v. Comm'r,* TC Memo 2014-95 (May 20, 2014)**

IRC §§172, 469, 1001, and 6662

☞ Appealed Foreclosure of Property Not an Entire Disposition for Suspended Loss Purposes

Facts. During 2005, Alexander and Jennifer Herwig purchased two Florida residential real estate rental properties (the Via Capri and Via Murano properties) and transferred them to an LLC, which was taxed as a partnership.

In 2008, Fifth Third Bank (FTB) foreclosed on the properties. The properties were sold at a foreclosure sale on December 19, 2008. **Mr. and Mrs. Herwig subsequently filed a counterclaim against FTB in connection with the foreclosure sale proceedings. The litigation was settled in 2011.**

Mr. Herwig received 2008 Forms 1099-A, *Acquisition or Abandonment of Secured Property,* for the properties. These Forms 1099-A showed the following amounts.

	Via Capri	Via Murano
Balance due	$574,100	$471,100
Fair market value	100,000	102,000

Mr. and Mrs. Herwig addressed the Form 1099-A cancellation-of-debt (COD) income on their returns. This was reported on their 2011 tax returns.

The 2008 partnership return for the LLC showed a long-term capital loss in the amount of $98,721 relating to the foreclosure of the properties. The partnership returns for both 2008 and 2009 also showed rental losses, ordinary business losses, and short-term capital losses. The partnership return continued to show the Via Capri and Via Murano properties on the Schedule L balance sheet for its 2008 and 2009 returns. The partnership filed a final return for 2010, showing no income or expenses.

The following nonpassive losses were reported on the joint returns of Mr. and Mrs. Herwig.

	2007	2008	2009
Nonpassive loss	$97,851	$33,608	$2,386

The IRS disallowed the nonpassive losses and recharacterized the losses as passive. The IRS contended that these passive losses carry forward and cannot be claimed in 2007, 2008, or 2009. Notices of redetermination for each of these three tax years were issued, denying nonpassive loss claims and assessing accompanying IRC §6662 accuracy-related penalties.

Issues. The issues in this case are as follows.

- Whether Mr. and Mrs. Herwig disposed of their interests in a passive activity during 2008 or 2010, thereby allowing them to deduct what otherwise are suspended passive losses arising during the years at issue
- Whether they are liable for accuracy-related penalties for the years at issue

Analysis. The relevant passive activity loss rules under IRC §469 are as follows.

- Although taxpayers are generally allowed to deduct business and investment losses under IRC §§162 and 212 respectively, IRC §469(a) disallows the deduction of passive activity losses (PALs) and credits. A PAL is defined as the excess of aggregate passive losses from all activities over aggregate passive income.
- Under §469(b), a disallowed PAL is carried forward to the following year. If the taxpayer has passive income in the following year, the PAL may be claimed against that passive income. If the taxpayer has a PAL in the following year, it is added to the prior year's PAL amount and suspended.
- IRC §469(g) indicates that suspended PALs may be treated as nonpassive (and fully deductible) if the taxpayer has disposed of the entire interest in the passive activity in a transaction with an unrelated party that results in the recognition of the gain or loss realized in the transaction. **Without a complete disposition** that meets these requirements, **the PAL amount remains suspended.**

IRC §1001 provides the tax rules associated with the disposition of property. Although a foreclosure sale usually constitutes a complete disposition under §1001, previous case law[63] indicates that **an appealed foreclosure is not considered final or complete.** Mr. and Mrs. Herwig appealed the foreclosure sale and continued to show the properties on the LLC's balance sheet each year until the final 2010 return was filed. Consequently, Mr. and Mrs. Herwig cannot use the suspended PAL amount in 2008. In court, Mr. and Mrs. Herwig provided neither an explanation of why the properties continued to be shown on the balance sheets nor any reasonable cause to dismiss the accuracy-related penalties.

Holding. The taxpayers did not dispose of their entire interests in the passive activity in either 2008 or 2010. Therefore, their suspended passive losses were not eligible to be treated as nonpassive losses for those years. In addition, Mr. and Mrs. Herwig did not provide any evidence that they had reasonable cause for the underpayments of tax for the years in issue. Consequently, they are liable for the accuracy-related penalties under IRC §6662.

> **Note.** For more information about passive activities, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities.

63. *Great Plains Gasification Assocs. v. Comm'r*, TC Memo 2006-276 (Dec. 27, 2006).

RESIDENCES

Reacquistion of Principal Residence

***Marvin E. DeBough v. Comm'r*, 142 TC No. 17 (May 19, 2014)**
IRC §§121 and 1038

☞ Trap for Taxpayer who Reaquires Principal Residence

Facts. Marvin DeBough and his wife bought a personal residence and the surrounding 80 acres in 1966 for $25,000. The entire property, located in rural Minnesota, was used for personal purposes.

After his wife's death in March 2006, Mr. DeBough sold the property on an installment basis in July 2006 for $1.4 million. Under the contract, the buyer made a $250,000 down payment to Mr. DeBough in 2006. **The remaining balance of $1.15 million was to be paid as follows.**

1. $250,000 plus interest at the rate of 5% in July 2007
2. Semi-annual payments of $25,000 each (for the years 2008 through 2013), which included interest at 5%
3. The entire remaining principal balance in July 2014

Mr. DeBough's adjusted basis in the property was $742,204, which included his deceased wife's stepped-up basis of $700,000. **He calculated a long-term capital gain on the 2006 sale of $157,796, as follows.**

Sales price	$1,400,000
Less: adjusted basis	(742,204)
Less: maximum §121 exclusion	(500,000)
Calculated 2006 capital gain	$ 157,796

The buyer made the required payment of $250,000 in 2006. Using Form 6252, *Installment Sale Income*, Mr. DeBough reported a gross profit percentage of 11.271% ($157,796 ÷ $1.4 million).

The buyer made another $250,000 payment in 2007 but only paid $5,000 in 2008. Mr. DeBough reported total taxable capital gains of $56,920 for 2006 through 2008, which are calculated as follows.

2006 reported taxable gain ($250,000 × 11.271%)	$28,178
2007 reported taxable gain ($250,000 × 11.271%)	28,178
2008 reported taxable gain ($5,000 × 11.271%)	564
Total reported taxable gains	$56,920

The buyer defaulted and Mr. DeBough reacquired the property in July 2009. His reacquisition was in full satisfaction of the outstanding indebtedness.[64] **On his 2009 tax return, he reported a $97,153 long-term capital gain due to the repossession.**

In its examination of Mr. DeBough's 2009 tax return, the IRS determined that his correct taxable gain due to reacquisition was $448,080, calculated as follows.

Total amount of 2006, 2007, and 2008 principal payments received	$505,000
Less: total of 2006, 2007, and 2008 reported taxable gains	(56,920)
IRS's determination of the correct 2009 taxable reacquisition gain	$448,080

64. IRC §1038.

The IRS determined a $58,893 tax deficiency for 2009. Mr. DeBough petitioned the Tax Court for a redetermination.

Issue. The issue in this case is whether Mr. DeBough underreported his long-term capital gain as a result of his failure to recognize gain under IRC §1038 on the reacquisition of property on which gain had been excluded under IRC §121.

Analysis. IRC §121 allows electing taxpayers to exclude gain from the sale of a home if it has been owned and used as their principal residence for periods aggregating two or more years during the 5-year period ending on the date of the sale. Married taxpayers who file a joint return can exclude up to $500,000 of the realized gain.

IRC §1038 was added by Congress in 1964 to give relief to taxpayers who were forced to recognize gain on a repossession of real property that was initially reported as an installment sale. IRC §1038 provides rules for computing recognized gain when a seller repossesses real property in satisfaction of the debt secured by the property. **Congress intended that the recognized gain should not exceed the principal payments actually received prior to the repossession less the previously reported recognized gains.**[65]

Congress contemplated the potential interaction between §§121 and 1038 by including IRC §1038(e). This section applies when the reacquired property is a former principal residence and the §121 exclusion was used to report the initial sale. **IRC §1038(e) provides an exception to the general rule**[66] **if the reacquired former principal residence is resold within one year of the reacquisition.**

Holding. Because the taxpayer did not resell the reacquired property within one year of the repossession date, the exception provided by §1038(e) does **not** apply. Therefore, the general rule of §1038 overrides the exclusion provided in §121. **The court ruled that the amount of recognized gain on the 2009 repossession is $448,080.**

Sale of Apartment

***Bentsion and Naomi Cohen v. U.S.,* No. 1:12-cv-05828; U.S. District Court for Southern District of New York (Feb. 28, 2014)**
IRC §§121, 6662, and 7422

☞ Taxpayers' Gain on Sale of Apartment is Taxable

Facts. Bentsion and Naomi Cohen owned apartment 8A at 119 West 71st Street in New York City since the 1980s. In 1990, they purchased apartment 8C for $175,000. Although the two apartments are adjacent, the Cohens never structurally modified 8A or 8C to combine or otherwise create internal access between the two units. From the time of purchase to July 2002, the Cohens leased 8C to tenants.

The Cohens' son and daughter-in-law moved into apartment 8C in November 2002. The son paid monthly rent for the apartment. The son's family stayed in 8C until August 2004, when they bought their own place. The Cohens sold 8C for $785,000 in May 2005.

Mr. Cohen prepared their joint tax returns for 2003 and 2004. The 2003 return showed rental income and expenses reported on Schedule E, *Supplemental Income and Loss,* but no rental income or expenses were reported on the 2004 tax return. Mr. Cohen hired an accountant to prepare their 2005 return. Information on apartment 8C was provided to the accountant but the sale of the apartment was not reported on the 2005 tax return.

The IRS examined the Cohens' 2005 tax return and included the sale of apartment 8C on the return, assessing additional tax of $113,879 plus interest and penalties. The Cohens paid the assessment under protest.

65. IRC §§1038(a) and (b).

66. Ibid.

Issues. The issues in this case are as follows.

- Whether the Cohens are entitled to an IRC §121 exclusion on the sale of an apartment
- Whether the Cohens are liable for the 20% accuracy-related penalty under IRC §6662(a)

Analysis. IRC §121 provides that gross income does not include up to $500,000 of gain from the sale of a principal residence. To qualify for the exclusion, the property must have been owned and used as the taxpayer's principal residence for periods aggregating two years or more during the 5-year period ending on the date of the sale or exchange.

Mr. Cohen asserted that he provided his accountant, Mr. Lipton, with information to prepare the 2005 return. Mr. Cohen stated that he clearly identified the sale of apartment 8C and that it should have been reported on the tax return that they filed. Mr. Lipton, based on facts presented by Mr. Cohen, believed that these two apartments were in fact one unit and that the $500,000 exclusion under §121 applied.

Mr. Cohen told an IRS agent that they had connected 8A and 8C by knocking down a connecting wall. When questioned about the alleged monthly rental payments that were deposited into Mrs. Cohen's account, the story changed several times but Mr. Cohen finally said they were "babysitting" fees for their grandchildren.

Mr. Lipton testified that he explained the §121 requirements for applying the $500,000 exclusion. Mr. Cohen represented that apartment 8C had been used for personal purposes but did not provide any details on the son living there or payments received from him.

After considering testimony by all parties involved, the court concluded that the Cohens failed to prove they used apartment 8C as their principal residence for two of the five years preceding the sale.

IRC §6662 provides for an accuracy-related penalty on any underpayment that is attributable to a substantial understatement of income tax. The penalty can be avoided if the taxpayers can show there was reasonable cause and they acted in good faith. The Cohens argued that they relied on their preparer's advice in deciding how to complete the 2005 return and such reliance was reasonable under the circumstances. The court looked to the 3-pronged test articulated by the Tax Court as follows.

1. The taxpayer reasonably believes that the professional upon whom the reliance is placed is a competent tax advisor who has sufficient expertise to justify reliance.
2. The taxpayer provides necessary and accurate information to the advisor.
3. The taxpayer actually relies in good faith on the advisor's judgment.

The Cohens could not prove the second or third elements of this test, so the reasonable cause exception does not apply.

Holding. The court held that the tax and penalty assessments made by the IRS were correct.

RETIREMENT

Prohibited Retirement Plan Transactions

***Terry and Sheila Ellis v. Comm'r*, TC Memo 2013-245 (Oct. 29, 2013)**
IRC §§4975, 6651, 6662, 72(t), 402, and 408

☞ Engaging in Prohibited Transaction Results in Deemed Distribution from IRA

Facts. In May 2005, Terry Ellis organized CST, a Missouri limited liability company (LLC). CST was a used vehicle dealership that conducted its operations in Harrisonville, Missouri.

In June 2005, Mr. Ellis received a distribution of $254,206 from the §401(k) account that he had accumulated with his former employer. He deposited the entire amount of the distribution in his newly opened IRA at First Trust Co. of Onaga. After opening the IRA, Mr. Ellis directed his IRA to acquire membership units in CST in exchange for a cash payment of $254,000 from the IRA to CST.

In August 2005, Mr. Ellis received another distribution from the §401(k) account that he had with his former employer. He deposited the entire distribution of $67,139 into his IRA at First Trust. Shortly thereafter, he directed his IRA to acquire additional membership units in CST in exchange for a payment of $65,500 from the IRA to CST. After this second transaction, Mr. Ellis's IRA owned 98% of CST's membership units.

Mr. Ellis was the general manager of CST and worked at the company in its used car business. CST paid Mr. Ellis $9,754 and $29,263 in compensation for his role as CST's general manager for the 2005 and 2006 tax years, respectively.

In June 2005, Mr. Ellis's legal counsel organized CDJ, LLC. Mr. Ellis owned 50% of the membership units in CDJ and his wife and three children each owned a 12.5% interest.

CDJ was formed for the purpose of acquiring investment property and issuing commercial leases on the property. In December 2005, CDJ acquired a parcel of real property in Harrisonville, Missouri. In January 2006, CST entered into an agreement to lease the Harrisonville property from CDJ. CST used this property to operate its used car business. CST made monthly rent payments to CDJ totaling $21,800 in 2006.

On Mr. and Mrs. Ellis's joint 2005 and 2006 federal tax returns, they reported the wage income from CST. However, they did not disclose that CST was owned primarily by Mr. Ellis's IRA.

The IRS issued a notice of deficiency to Mr. and Mrs. Ellis for 2005 and 2006. The notice reflected a determination of an income tax deficiency of $135,936 for 2005 or, alternatively, a deficiency of $133,067 for 2006. The determination was based on the premise that, at one of a few alternative times during 2005 and 2006, Mr. Ellis engaged in a prohibited transaction with his IRA under IRC §4975. According to the IRS, a prohibited transaction occurred at one of the following times.

- When Mr. Ellis caused his IRA to engage in the sale and exchange of membership interests in CST in 2005
- When Mr. Ellis caused CST to pay him compensation in 2005
- When Mr. Ellis caused CST to pay him compensation in 2006
- When Mr. Ellis caused CST to enter into a lease agreement with CDJ (an entity owned by Mr. and Mrs. Ellis and their children) in 2006

The IRS also asserted that Mr. Ellis's IRA ceased to be an "eligible retirement plan" under IRC §402 on the first day of the tax year in which the prohibited transaction occurred. Accordingly, the fair market value of the IRA was deemed distributed to him under IRC §408 on the first day of that tax year.

Issues. There were several issues presented in this case, but the following analysis focuses on:

- Whether Mr. Ellis participated in one or more prohibited transactions under §4975 with his IRA, and
- Whether Mr. Ellis received unreported retirement income as a result of his participation in a prohibited transaction with his IRA.

Analysis. IRC §4975 defines several **prohibited transactions** for a qualified retirement plan (including an IRA) described in IRC §408. These prohibited transactions include the following.

- Sale or exchange, or leasing of any property between a plan and a disqualified person
- Furnishing of goods, services, or facilities between a plan and a disqualified person
- An act by a disqualified person who is a fiduciary whereby that person deals with the income or assets of a plan in their own interest or for their own account
- Receipt of any consideration by any disqualified person in connection with a transaction involving the income or assets of the plan

A **disqualified person** includes a fiduciary who exercises any discretionary authority or discretionary control of the plan or exercises any authority over or control of management or disposition of plan assets.[67] The court noted that Mr. Ellis certainly exercised discretionary authority over his IRA and exercised control over the disposition of its assets. He established the IRA with the proceeds of his §401(k) account and then exerted control over his IRA by causing it to purchase CST membership units. Consequently, Mr. Ellis is a disqualified person with respect to the IRA.

The court observed that Mr. Ellis used his retirement savings as startup capital for a used car business. He operated this business and used it to pay himself compensation. He established the used car business as an investment of his IRA in an attempt to preserve the integrity of the IRA as a qualified retirement plan. The court noted that this is precisely the kind of self-serving arrangement that §4975 was enacted to prevent. Accordingly, the court sustained the IRS's determination that Mr. Ellis engaged in prohibited transactions under §4975(c) when he caused CST to pay him compensation in the 2005 tax year.

If an individual for whose benefit an IRA is established engages in a prohibited transaction under §4975, the account ceases to be an IRA as of the first day of the tax year.[68] Under these circumstances, the IRA no longer is exempt from tax and the account is deemed to have been distributed on the first day of the tax year.

Because Mr. Ellis engaged in a prohibited transaction under §4975 in 2005, the entire $321,366 converted from his §401(k) plan is deemed distributed on January 1, 2005. Therefore, that amount is includible in the gross income of Mr. and Mrs. Ellis for 2005.

> **Note.** Because the court determined that a prohibited transaction occurred in 2005, it was unnecessary to consider whether any of Mr. Ellis's later transactions were prohibited under §4975.

Holding. Mr. Ellis engaged in a prohibited transaction in 2005 and received unreported retirement income as a result of that prohibited transaction.

67. IRC §4975(e).

68. IRC §408(e)(2)(A).

Early Distributions

***Andrew Wayne Roberts v. Comm'r,* 141 TC No. 19 (Dec. 30, 2013)**
IRC §§72(t), 408, 6662, and 7703

☞ Taxpayer Not Liable for IRA Distributions Fraudulently Obtained by Wife

Facts. During 2008, Andrew Roberts worked for the U.S. Air Force while his wife, Cristie Smith, worked for Bethel Transportation. They separated for a while in 2008, permanently separated in 2009, and divorced in March 2010.

During 2008, they maintained joint checking accounts at Washington Mutual and Harborstone Federal Credit Union. Mr. Roberts exclusively used the Harborstone account, and Ms. Smith exclusively used the Washington Mutual account. Neither of them had any information about the account used by the other person.

Mr. Roberts owned IRA accounts at AIG SunAmerica Life Insurance Company and ING. In September 2008, a document was sent to SunAmerica from a fax machine at Bethel Transportation requesting that $9,000 be withdrawn from his SunAmerica IRA. The withdrawal request was signed "Andy Roberts" but was not his signature. A check was issued by SunAmerica; it was endorsed "Andy Roberts" and deposited in the Washington Mutual checking account. Again, the signature was not his. The same thing happened with Andrew's ING IRA account. Two checks totaling $27,980 were handled in the same manner in November and December 2008.

In 2009, Mr. Roberts received Forms 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* reporting distributions from SunAmerica and ING. When he received the first 1099-R, he thought that he had been a victim of theft. Later, he found out that his soon-to-be ex-wife had deposited the IRA proceeds into her account and used the proceeds for her benefit.

For each year of their marriage until 2008, Ms. Smith prepared and filed a joint federal tax return. For 2008, she filed separate returns for herself and Mr. Roberts. On Mr. Roberts' return, Ms. Smith underreported his wages by $3,000, overstated his withholding tax by $3,000, omitted interest income of $74, and omitted IRA distributions of $37,020. She also used the single filing status on Mr. Roberts' return.

Mr. Roberts' overstated $3,357 refund was electronically deposited to Ms. Smith's Washington Mutual account. He did not review his return prior to it being electronically filed, nor did Ms. Smith provide him with a copy even though he asked for one.

Issues. The issues in this case are as follows.

- Whether Mr. Roberts failed to report taxable withdrawals from his IRAs as income
- Whether Mr. Roberts is liable for the 10% additional tax under IRC §72(t) on early distributions from a qualified retirement plan
- Whether Mr. Roberts' filing status for 2008 should be married filing separately
- Whether Mr. Roberts is liable for the 20% accuracy-related penalty under IRC §6662(a)

Analysis. IRC §408(d)(1) provides that any amount paid from an IRA is included in the gross income of the payee or distributee as provided under §72. It is clearly obvious from the facts that Ms. Smith's acts were fraudulent. However, the IRS contended that Mr. Roberts must include in income the amounts withdrawn from his IRAs because he was the owner of the IRAs and the person entitled to receive distributions from them. The IRS further argued that the IRA withdrawals were deposited into the Washington Mutual account that was jointly owned by Mr. Roberts and his wife.

After comparing these facts to those in other cases decided by the courts in similar circumstances, the court found that Mr. Roberts was not a payee or distributee within the meaning of §408(d)(1) because he did not request, receive, or benefit from the IRA distributions. The court further determined that, because the distributions were not taxable income, he is not liable for the 10% early distribution penalty under §72(t).

Mr. Roberts conceded that he failed to report certain interest income and that his wage income was underreported. Additionally, he was married at the end of 2008, so his correct filing status was married filing separately. Although he did not see his tax return before Ms. Smith filed it, he did not disavow the return nor did he file an amended return for 2008. He did not take any affirmative steps to ensure the correctness of his tax liability and he cannot rely on Ms. Smith, who is not a professional tax return preparer. Because he was unable to produce any evidence that he acted with reasonable cause and in good faith with respect to the underpayments, he is liable for the IRC §6662(a) accuracy-related penalty.

Holding. Mr. Roberts was not liable for income tax on the 2008 distributions from his IRAs, nor was he liable for the §72(t) penalty for the early withdrawals. However, his filing status was incorrect and there were other inaccuracies on his tax return; therefore, he was held liable for the §6662(a) accuracy-related penalty.

Retirement Plan Distributions

***Alvan and Elisa Bobrow v. Comm'r,* TC Memo 2014-21 (Jan. 28, 2014)**

IRC §§72(t), 408, 6662, and 6664

☞ Multiple IRA Distributions Subject to Tax and Penalties

Facts. Alvan Bobrow, a New Jersey attorney specializing in tax law, and his wife Elisa maintained various accounts at Fidelity Investments during 2008 that included the following.

- Two IRAs (Alvan's IRAs)
- Fidelity Funds traditional IRA (Alvan's traditional IRA)
- Fidelity rollover IRA (Alvan's rollover IRA)
- Fidelity Funds traditional IRA (Elisa's traditional IRA)
- Joint Fidelity checking account
- Individual Fidelity checking account

During 2008, the following transactions were initiated with the Fidelity accounts.

- April 14 — Alvan requested and received two distributions totaling $65,064 from his traditional IRA.
- June 6 — Alvan requested and received a $65,064 distribution from his rollover IRA.
- June 10 — Alvan transferred $65,064 from his individual checking account to his traditional IRA.
- July 31 — Elisa requested and received $65,064 from her traditional IRA.
- August 4 — Alvan and Elisa transferred $65,064 from their joint checking account to Alvan's rollover IRA.
- September 30 — Elisa transferred $40,000 from their joint checking account to her traditional IRA.

Alvan and Elisa's 2008 income tax return as filed did not report any taxable income from the distributions they received nor did they pay any tax on early distributions. The IRS determined a deficiency in their income tax for the 2008 tax year of $51,298 and an accuracy-related penalty under IRC §6662 of $10,260.

Issues. The issues in this case are as follows.

- Whether the Bobrows received taxable income from distributions on April 14, June 6, and July 31
- Whether the Bobrows are liable for the 10% additional tax under IRC §72(t) for an early distribution from Elisa's traditional IRA
- Whether the Bobrows are liable for the accuracy-related penalty under IRC §6662(a)

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. An exception under IRC §408(d)(3)(A) applies if the entire amount is paid into either an IRA or eligible retirement plan for the benefit of the individual not later than 60 days after the distribution date.

The disputes in this case arise over the characterization of the distributions and repayments. The following table summarizes each party's characterization of alleged repayments.

Distribution	Taxpayers' Position on Repayment	The IRS Position on Repayment
April 14 — $65,064 distributions from Alvan's traditional IRA	June 10 — qualified repayment to his traditional IRA	June 10 — qualified repayment to his traditional IRA
June 6 — $65,064 distributions from his rollover IRA	August 4 — qualified repayment from joint account to Alvan's rollover IRA	Either no repayment or August 4 unqualified repayment from joint account to Alvan's rollover IRA
July 31 — $65,064 distribution from Elisa's traditional IRA	September 30 — qualified repayment from joint account to her traditional IRA	September 30 — unqualified partial repayment from joint checking account to Elisa's traditional IRA

IRC §408(d)(3)(B) limits a taxpayer from making more than one nontaxable IRA rollover in a 1-year period. At trial, the Bobrows argued that the §408(d)(3)(B) limitation is specific to each IRA maintained by a taxpayer and does not apply across all of a taxpayer's IRAs. They failed to cite any supporting case law or statutes in support of their position. The IRS cited two cases[69] in which the taxpayer withdrew funds from an IRA and deposited them into a second IRA. Within a year of the first withdrawal, the taxpayer made two separate withdrawals from the second IRA and redeposited those funds into that IRA. The court in that case held that the two later withdrawals from the second IRA were not eligible to be nontaxable rollovers because §408(d)(3)(B) limits taxpayers to one nontaxable rollover per year.

The court in the *Bobrow* case noted that the plain language of §408(d)(3)(B) limits the frequency with which a taxpayer may make a nontaxable rollover contribution. It is not specific to any single IRA maintained by a taxpayer but instead applies to all the taxpayer's IRAs. The court determined that Mr. Bobrow had already received a nontaxable distribution from his traditional IRA on April 14 when he received a subsequent distribution from his rollover IRA on June 6. IRC §408(d)(3)(B) disallows nontaxable treatment for this second distribution. As a result, the June 6 distribution from his rollover IRA is fully includible in the Bobrows' 2008 gross income.

69. *Martin v. Comm'r,* TC Memo 1992-331 (Jun. 8, 1992), *aff'd,* 987 F.2d 770 (5th Cir. 1993); and *Martin v. Comm'r,* TC Memo 1994-213 (May 12, 1994).

For the July 31 distribution from Elisa's traditional IRA and the partial repayment on September 30, the court observed that the partial repayment occurred more than 60 days after the distribution. Therefore, the distribution and partial repayment do not meet the strict requirements of §408(d)(3)(A). The Bobrows did not deny that the partial repayment was made on the 61st day after the distribution; however, they allege that the funds were not repaid within 60 days because of errors made by Fidelity. The Bobrows did not provide any documentation to support their assertion, and the court ruled in the IRS's favor.

IRC §72(t) imposes an additional 10% tax when a person receives an early distribution (generally, before age 59½) from a qualified retirement plan unless an exception under §72(t)(2) applies. Mrs. Bobrow had not attained age 59½ at the time she received the distribution on July 31, 2008. She presented no evidence to show that she qualified for any of the exceptions; accordingly, the Bobrows are also liable for the §72(t)(1) additional tax.

IRC §6662 imposes a 20% penalty on any substantial understatement of income tax. A "substantial understatement" is one that exceeds the greater of 10% of the tax required to be shown on the return for the tax year or $5,000. The understatement penalty can be reduced if the taxpayer can show one of the following.

- There was substantial authority for their treatment of an item to which the understatement is attributable.
- The taxpayer disclosed the relevant facts and there was a reasonable basis for the tax treatment.

The court determined that the Bobrows did not meet either of these conditions for a reduction in the understatement penalty. Accordingly, the court found them liable for the §6662(a) accuracy-related penalty.

Holding. The Bobrows were held liable for tax on two of three distributions from their IRAs as well as the 10% early-withdrawal penalty under §72(t) on Mrs. Bobrow's IRA distribution. The court also sustained the application of the §6662 accuracy-related penalty.

> **Note.** For a detailed discussion about the exceptions to the early-withdrawal penalty under §72(t), see the 2014 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 1: Select Rules for Retirement Plans.

Early Distribution Penalty

***Guy and Ann Dabney v. Comm'r,* TC Memo 2014-108 (Jun. 5, 2014)**
IRC §§72(t), 408, and 6662

☞ Real Property Acquisition Not Allowed in Self-Directed IRA

Facts. In 2008, Mr. Dabney rolled over funds from an IRA at Northwest Mutual into a self-directed IRA that he had with Charles Schwab & Company. Shortly thereafter, he found a piece of undeveloped land in Utah that was for sale at a price below its fair market value. After conducting Internet research, Mr. Dabney felt confident that his self-directed IRA could purchase the property. He contacted the Charles Schwab customer service line; the customer service representative informed him that Charles Schwab **did not allow alternative investments, including real property.**

Mr. Dabney also consulted with his CPA, who told him that he did not have any training in retirement accounts and was unsure whether real property could be held in the IRA. Mr. Dabney shared the Internet research he had obtained with his CPA. Mr. Dabney explained that he believed he had found a viable way to have his Charles Schwab IRA purchase the property. The CPA agreed that Mr. Dabney might be able to purchase the property and hold it in his IRA.

Mr. Dabney arranged to have funds wired directly from his IRA to the seller of the real property; the title to the property would be issued in the name of "Guy M. Dabney Charles Schwab & Co. Inc. Cust. IRA Contributory." Mr. Dabney planned to resell the property for a small gain and contribute the proceeds back into the IRA.

On February 6, 2009, Mr. Dabney signed a contract to purchase the real property. A month later, he withdrew $114,000 from his IRA by completing a distribution request provided by Charles Schwab. He checked the box indicating the withdrawal was an "early distribution, no known exception (code 1)," although he believed the withdrawal would not actually be considered an early distribution. The form did not indicate that the funds were to be used to invest in property on behalf of the Charles Schwab IRA.

Charles Schwab wired $114,000 to Chicago Title Insurance Company. Chicago Title had been directed to title the property "Guy M. Dabney Charles Schwab & Co. Inc. Cust. IRA Contributory"; however, due to a bookkeeping error, the title to the property was put in Mr. Dabney's name.

The property was ultimately sold in 2011 for $127,226 after fees and taxes. It was during 2011 that Mr. Dabney discovered the title to the property was in the wrong name. He contacted Chicago Title and received an affidavit in which the company admitted fault for the error. The $127,226 was wired directly to his Charles Schwab IRA with the notation that it was a rollover contribution.

Charles Schwab issued Mr. Dabney a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* showing an early distribution of $114,000 from his Charles Schwab IRA and that no exceptions to the early distribution penalty applied. Mr. Dabney did not recall receiving this form and thus never supplied it to his return preparer, nor did he report the income or early withdrawal penalty on his 2009 tax return. The IRS adjusted the 2009 tax return and assessed an early-withdrawal penalty and accuracy-related penalty.

Issues. The issues in this case are as follows.

- Whether the Dabneys failed to report as income a taxable distribution from a qualified retirement plan
- Whether the Dabneys are liable for the 10% additional tax under IRC §72(t) for an early distribution from a qualified retirement plan
- Whether the Dabneys are liable for the 20% accuracy-related penalty pursuant to IRC §6662(a)

Analysis. Mr. Dabney asserted that the $114,000 withdrawal from his Charles Schwab IRA was not a taxable distribution because the withdrawal was either a purchase made by the IRA or a transfer between IRA trustees. The IRS countered that the Charles Schwab IRA did not purchase the real property because Charles Schwab policies do not permit the purchase or holding of real property. Even if the title had been correctly prepared, the Charles Schwab IRA could not hold real property and would not have accepted ownership. The court agreed with the IRS's position that the $114,000 withdrawal was a taxable distribution and is includible in his gross income.

IRC §72(t) imposes an additional 10% tax when a person withdraws money from a qualified retirement plan before the taxpayer attains age 59½ unless an exception under §72(t)(2) applies. In this case, Mr. Dabney had not reached age 59½ nor did he show that any of the exceptions applied. Thus, the distribution is subject to the additional 10% tax under §72(t).

The taxpayers argued that they should not be held liable for the §6662 accuracy-related penalty. Mr. Dabney is not a sophisticated taxpayer and has no background in tax or accounting. Although he was unsuccessful, he went to great lengths to ensure the real property purchase qualified as a nontaxable event. He conducted Internet research and talked with his accountant and a Charles Schwab representative. Accordingly, the court determined that he acted in good faith.

Holding. The taxpayers should have included the distribution of $114,000 in income and they are also subject to the 10% early-distribution penalty. However, the court did not uphold the accuracy-related penalty because the taxpayers had reasonable cause for failing to report the distribution on their tax return.

Retirement Plan Distributions

***Harry Robert Haury v. Comm'r,* U.S. Court of Appeals, 8th Circuit; No. 13-1780 (May 12, 2014)**

IRC §§72(t), 166, and 408

☞ Timely IRA Contribution Qualified as Rollover

Facts. In the late 1990s, Harry Haury, a software engineer, developed workflow automation and document imaging technology, which he licensed to several related companies. By 2007, two of these companies were competing as subcontractors to obtain a substantial government contract. In 2006 and 2007, he made secured loans totaling $422,329 to the two companies to fund product development and working capital needs. Three loans in 2007 were funded using withdrawals from his IRA. Mr. Haury was less than 59½ years old in 2007; therefore, his IRA distributions were taxable as ordinary income and subject to a 10% additional tax.

Mr. Haury also made a $120,000 contribution to his IRA in April 2007. Mr. Haury's withdrawals from and contributions to his IRA in 2007 are summarized in the following table.

Date	IRA Withdrawal	IRA Contribution
February 15	$120,000	
April 9	168,000	
April 30		$120,000
May 14	100,000	
July 6	46,933	
October 25	31	
Total	$434,964	$120,000

In December 2007, the companies were "frozen out" of the government contract. Mr. Haury requested but did not receive repayment of his loans.

Mr. Haury received salaries from the two companies of $136,916 and $12,300 in 2007 and also served on the board of directors of each company. Mr. Haury and his wife held substantial ownership interests in both companies.

Mr. Haury did not file his 2007 federal income tax return. In May 2010, the IRS issued a notice of deficiency, showing more than $250,000 in unpaid taxes, penalties, and interest based on a substitute return that the IRS prepared. The bulk of the tax was due to salary income of $149,216 and IRA withdrawals of $434,964.

Mr. Haury petitioned the Tax Court for a redetermination of the deficiency. He filed a return that showed salary of $149,217, IRA withdrawals of $319,964, and a business bad debt loss of $413,156. After a trial on mostly stipulated facts, the Tax Court rejected Mr. Haury's claim that he made an offsetting $120,000 IRA rollover contribution.

The Tax Court also denied the bad debt deduction because the loans in question were nonbusiness bad debts. The court determined that Mr. Haury made bona fide loans that became totally worthless in December 2007. Using the "dominant motivation" standard,[70] the Tax Court found the worthless loans to be nonbusiness bad debts because protection of Mr. Haury's investment interests in the companies, rather than salary protection, was the dominant motivation for the loans.

Tax, interest, and penalties were redetermined based on the court's findings. Mr. Haury appealed the decision.

70. See *U.S. v. Generes,* 405 U.S. 93 (1972).

Issues. The issues in this case are as follows.

- Whether Mr. Haury should be allowed to reduce his taxable IRA distributions by $120,000 for a partial rollover contribution
- Whether Mr. Haury is entitled to a business bad debt deduction

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. This 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.[71]

At trial, Mr. Haury testified that his April 30 contribution of $120,000 resulted from repayment by the companies of a prior loan funded by his IRA account. During the original court case, the IRS contended that this $120,000 contribution was not made within the 60-day time limit based on the February 15 IRA withdrawal date. On appeal, Mr. Haury argued that the $120,000 IRA contribution was a qualifying partial rollover of the $168,000 distribution made on April 9, which was less than 60 days before the contribution.

The appeals court agreed with Mr. Haury's position. His April 30 contribution was made well within 60 days of the April 9 distribution; therefore, it was a qualifying partial rollover contribution and reduced his 2007 taxable IRA distributions by $120,000.

IRC §166(a)(1) provides that individual taxpayers may deduct from taxable ordinary income "any debt which becomes worthless within the taxable year." This does not apply to nonbusiness debts. For the bad debt characterization issue, Mr. Haury argued that the Tax Court erred because his substantial salary, lack of other sources of income, and minimal investment make this case like *Litwin v. U.S.*,[72] in which the 10th Circuit affirmed the grant of a worthless business debt deduction to a principal shareholder-CEO. The appeals court disagreed, finding that Mr. Haury's nonbusiness motivations for making loans included his considerable unquantified equity interest in the two companies and his interest in enhancing the return on his investment in the licensed technology. Therefore, the court sustained the Tax Court's determination.

Holding. Mr. Haury was allowed to consider the $120,000 IRA contribution as a rollover to offset the IRA distributions he received but denied the bad debt deduction.

S CORPORATION

Beneficial Ownership

***Ramesh and Pushparani Kumar v. Comm'r,* TC Memo 2013-184 (Aug. 13, 2013)**
IRC §1366

☞ Tax Court Rules that S Corporation Shareholder Retained Beneficial Interest in Shares

Facts. Dr. Ramesh Kumar is a physician who specializes in radiation oncology. He agreed to provide radiation oncology services with Dr. Ronald Woody III through three entities: Okeechobee Business Ventures, Inc. (OBV); Mid-Florida Radiation Oncology, P.A. (MFRO); and Port St. Lucie Ventures, Inc. (PSLV).

Dr. Kumar owned 40% of PSLV's outstanding shares of stock, and Dr. Woody owned the remaining 60% of the shares. Dr. Woody was the president and chairman of PSLV, which was an S corporation during the year at issue.

71. IRC §408(d)(3)(A).

72. *Litwin v. U.S.,* 983 F.2d 997 (10th Cir. 1993).

In late 2003 or early 2004, disputes arose among the shareholders of PSLV, OBV, and MFRO. As a result of these disputes, Dr. Kumar was shut out of PSLV's operation and management. PSLV paid wages to Dr. Woody during 2005 but made no distributions to its shareholders during that year. Dr. Kumar did not receive any wages from PSLV during 2005 or any subsequent year. Dr. Woody also prevented Dr. Kumar from taking part in PSLV's operation or management during 2005 or any subsequent year.

PSLV issued a Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.,* to Dr. Kumar for the 2005 tax year. It reported that Dr. Kumar's share of PSLV's ordinary business income was $215,920 and his share of the company's interest income was $2,344. Dr. Kumar and his wife did not report any of this income on their 2005 joint federal tax return.

Issues. The issues in this case are as follows.

- Whether Dr. Kumar has $215,920 of unreported income for the 2005 tax year from his shareholder interest in PSLV
- Whether he has $2,344 of interest income from his shareholder interest in PSLV

Analysis. Dr. Kumar argued that he is not liable for tax on the income reported to him by PSLV for 2005 because he was not the beneficial owner of his PSLV shares during that year. When the owner of record of S corporation stock holds that stock for the benefit of another, then the income, losses, deductions, and credits are passed through to the beneficial owner of the stock.[73] A taxpayer is the beneficial owner of property if the taxpayer controls that property or has the economic benefit of its ownership.[74]

Dr. Kumar contends that he was not the beneficial owner of the PSLV stock in 2005 because he was improperly excluded from the benefits of ownership. However, he did not present any case law indicating one shareholder could take beneficial ownership of stock away from another shareholder without an agreement between the two shareholders or a provision in the corporation's governing articles to that effect. To the contrary, the court noted that when one shareholder merely interferes with another shareholder's participation in the corporation, such interference does not result in a deprivation of the economic benefit of the shares.[75]

Holding. Dr. Woody's interference with Dr. Kumar's participation in PSLV did not deprive Dr. Kumar of the economic benefit of his PSLV shares. Accordingly, he must report $215,920 of income and $2,344 of interest income from PSLV for the 2005 tax year.

Reasonable Compensation

***Sean McAlary Ltd. Inc. v. Comm'r,* TC Summ. Op. 2013-62 (Aug. 12, 2013)**

IRC §§7436, 6651, 6656, 3111, 3301, 1366, and 3121

☞ Court Determines Reasonable Compensation for Sole Shareholder

Facts. Sean McAlary spent many years working in the computer technology industry. In 2002, at the age of 54, he obtained a California real estate sales license and started earning commissions selling residential real estate in southern California. In 2004, he obtained a California real estate broker's license.

In 2003, on the advice of his tax return preparer, Mr. McAlary organized his real estate activity as an S corporation. The corporate minutes dated April 1, 2004, stated that Mr. McAlary's annual base compensation would be $24,000 when the number of real estate agents and brokers (affiliates) was not more than 10.

73. Treas. Reg. §1.1361-1(e).

74. *Anderson v. Comm'r,* 164 F.2d 870 (7th Cir. 1947), *aff'g* 5 TC 443 (1945).

75. See *Hightower v. Comm'r,* TC Memo 2005-274, slip op. at 20-21.

Mr. McAlary was the S corporation's president, secretary, treasurer, sole director, and sole shareholder. He was also the only person working for the company that had a real estate broker's license. He managed all aspects of the company's operations, often working 12-hour days with few days off.

Most of the corporation's gross receipts were attributable to commissions generated by Mr. McAlary. The company reported the following results for the 2004 –2006 tax years.

Year	Gross Receipts	Net Income
2004	$376,453	$122,605
2005	405,244	161,660
2006	518,189	231,454

Mr. McAlary filed the company's 2006 Form 1120S, *U.S. Income Tax Return for an S Corporation,* on December 11, 2007. The corporation did not claim a deduction for any wages or compensation paid to Mr. McAlary, nor did it issue a Form W-2, *Wage and Tax Statement.* However, Mr. McAlary transferred a total of $240,000 from the company's account to his personal account in 2006.

Mr. McAlary and his wife filed a joint Form 1040 for the 2006 tax year on December 11, 2007. He did not report any amount for wages or salaries on the return, nor did he report any self-employment tax liability. Mr. McAlary reported the income from the S corporation on Schedule E, *Supplemental Income and Loss.*

Issues. The issues in this case are as follows.

- The amount of Mr. McAlary's compensation that is subject to employment taxes
- Whether the S corporation is liable for additions to tax under IRC §6651(a)(1) for failing to file Forms 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return,* and Forms 941, *Employer's Quarterly Federal Tax Return*
- Whether the S corporation is liable for penalties under IRC §6656 for failing to make timely deposits of FICA and FUTA taxes

Analysis. At trial, an expert witness employed by the IRS opined that $100,755 of the $240,000 Mr. McAlary received during 2006 represented reasonable compensation. The expert witness determined that $48.44 was the median hourly rate for a real estate broker in southern California. He multiplied that amount by 2,080 hours (40 hours per week × 52 weeks) to arrive at the total annual compensation amount. Mr. McAlary argued that the court should respect the agreement between him and the S corporation, which set his annual base pay at $24,000.

The court noted that an employee's reasonable compensation is dependent upon a number of factors. The court considered all the facts and circumstances, including the wage and labor statistics cited by the IRS's expert witness, general market conditions, Mr. McAlary's limited years of experience, and the company's modest operations. After reviewing these factors, the court concluded that an hourly rate of $40, or annual compensation of $83,200, represents reasonable compensation for the services that Mr. McAlary performed for the company in 2006.

The IRS determined that the company was liable for additions to tax under IRC §6651 for failing to file Forms 940 and 941 and for penalties under IRC §6656 for failing to make timely deposits of FICA and FUTA taxes. The penalties imposed under both Code sections can be avoided if the taxpayer demonstrates that the failure was due to reasonable cause and not willful neglect. Mr. McAlary testified that he provided his tax information to his tax professional and relied on him to properly compute the tax liabilities. The court noted that Mr. McAlary did not present any evidence that he investigated the tax professional's background or qualifications or otherwise confirmed that he was a competent professional. Accordingly, the court was not persuaded that the taxpayer exercised ordinary business care and prudence.

Holding. Mr. McAlary's reasonable compensation for 2006 was $83,200. The court upheld the additions to tax under §6651 and penalties under §6656 for the tax periods at issue.

STATUTE OF LIMITATIONS

Statute of Limitations
***Chad and Kelli Hessing v. Comm'r,* TC Memo 2013-179 (Aug. 5, 2013)**
IRC §§6501 and 7491

☞ Couple did not have Unreported Income From Father's Construction Business

Facts. In 2003, Chad Hessing was a 22-year old who intended to pursue a career in his father's construction business. During 2003, he worked as an employee for his father's business for a salary of $2,500 per month.

Chad and his wife Kelli had a good credit rating but the construction business's credit was fully extended. Chad's father asked them to use their good credit rating and act as purchasers of three parcels of realty so that the construction business could develop more properties.

The first parcel, purchased in March 2003, was used to construct a residence and was sold in November 2003 with a net profit to the construction business of $12,827. Chad and Kelli did not receive any money from the sale of this property. The second parcel was initially purchased in Chad and Kelli's names but was immediately transferred to one of the father's business entities. The third parcel was handled in a manner similar to the first parcel with the closing occurring at the end of December 2003.

Chad's father prepared Chad and Kelli's 2003 tax return. A Schedule C, *Profit or Loss From Business,* was prepared showing $104,300 of gross receipts and a net profit of $1,558. The return took into account the Form 1098, *Mortgage Interest Statement,* and Form 1099-MISC, *Miscellaneous Income,* issued in the taxpayer's names for the three real estate transactions for which Chad acted as an agent or conduit for his father. Because Chad had no background in business, accounting, or taxation, he presumed his father had correctly prepared their tax return.

The IRS mailed a notice of deficiency on July 28, 2010, in which it determined that the income from the sales of the three parcels was not properly reported.

Issues. The issues in this case are as follows.

- Whether the statute of limitations is still open for the 2003 tax year
- Whether the sale of three parcels of realty should be included in Chad and Kelli's 2003 income

Analysis. IRC §6501(a) provides that any tax must be assessed within three years of the filing of a return. However, under §6501(e), the IRS has six years to assess tax liabilities when a taxpayer omits from gross income an amount that exceeds 25% of the gross income stated on the return. Except for the provisions of §6501(e), the IRS would not be able to assess an income tax deficiency because the normal 3-year period had expired at the time the notice of deficiency was mailed. Accordingly, the key issue is whether the taxpayers had an omission of gross income in excess of 25% of the amount reported.

Chad and Kelli argued that they were merely acting as an agent or conduit for Chad's father. The IRS argued that Chad was in the construction business and that his income was understated. The court noted that the deeds and other documents concerning the real estate transactions bear the taxpayers' names. However, the testimony of Chad and his father contradicted the form of these transactions, and the court found this testimony to be credible. Their testimony validated that Chad simply allowed his father to use his credit reputation to facilitate the acquisition of real estate to be used in his father's construction business. On that basis, the court found that the taxpayers did not have unreported gross income.

Holding. The court held that the extended limitations period set forth in §6501(e) is not applicable because the taxpayers did not have unreported gross income. Because the period for assessment of tax for the taxpayers' 2003 return had expired, it was unnecessary for the court to consider other issues raised by the IRS.

TAX-EXEMPT STATUS

Tax-Exempt Status

***Capital Gymnastics Booster Club Inc. v. Comm'r,* TC Memo 2013-193 (Aug. 26, 2013)**
IRC §§501(c)(3) and 7428

☞ Booster Club's Fundraising Not a Tax-Exempt Purpose

Facts. In 1987, Capital Gymnastics Booster Club, Inc. (Capital Gymnastics) was organized in Virginia for the purposes of "fostering national and international sports competition, within the meaning of Section 501(c)(3)." The IRS granted Capital Gymnastics tax-exempt status in June 1988.

Capital Gymnastics had approximately 240 member families by the fiscal year ended June 30, 2003. Each athlete's family paid tuition directly to a training center that trained amateur athletes from ages 6 to 18 in gymnastics and tumbling. Tuition ranged from $200 to $330 per month for the 2003 fiscal year. Capital Gymnastics was operated to address the separate costs of competitions because these costs varied greatly among individual members.

Parents were required to pay the following fees directly to Capital Gymnastics.

- An annual dues payment of $40 to offset Capital Gymnastics' operating expenses
- An assessment of $60 to $1,400 per year per child to pay each athlete's competition costs, which included the athlete's estimated meet entry fees and the coaches' travel costs

Parents could pay their child's assessment in cash, but Capital Gymnastics gave the parents the option to voluntarily fundraise to offset the assessment amount. The fundraising options included selling wrapping paper, discount cards, cookie dough, candles, ornaments, and scrip. For the families that chose to fundraise, Capital Gymnastics awarded points proportionate to the fundraising profit that each family generated. Capital Gymnastics' financial manager periodically tallied the points for each family and reduced the family's unpaid assessment by $10 for each point that the family had earned.

Slightly more than half of the families did not participate in the fundraising. These families did not receive a benefit from the fundraising activities of the other parents. Instead, families who did not fundraise wrote checks to Capital Gymnastics for the full amount of their assessment.

For fiscal year 2003, the fundraising activities yielded a net profit of $35,326. Capital Gymnastics awarded $32,920 of the net profit to families who participated in the fundraising. Families who fundraised offset an average of 50% to 70% of their assessment for the year.

In 2005, the IRS began an examination of Capital Gymnastics' returns for its 2003 fiscal year in order to determine whether Capital Gymnastics operated in the manner stated in its application for tax-exempt status. After completing its examination, the IRS sent a letter stating it was revoking Capital Gymnastics' tax-exempt status. Capital Gymnastics appealed that determination but the IRS Office of Appeals issued a final adverse determination letter in December 2008. The letter stated that Capital Gymnastics failed to establish that its income "did not inure to the benefit of private individuals and shareholders, which is prohibited by I.R.C. section 501(c)(3)." Consequently, the IRS revoked its recognition of the organization's tax-exempt status beginning with the 2003 fiscal year.

Issue. The issue in this case is whether Capital Gymnastics satisfied the requirements of IRC §501(c)(3) and therefore qualified as exempt from tax under IRC §501(a).

Analysis. IRC §501(c)(3) confers tax-exempt status on "Corporations, and any community chest, fund or foundation**, organized and operated exclusively** for religious, charitable, scientific, testing for public safety, literary, or education purposes, or to foster national or international amateur sports competition… **no part of the net earnings of which inures to the benefit of any private shareholder or individual**…"

The IRS accepted that fundraising by a booster club is a permissible activity under §501(c)(3) and that Capital Gymnastics' mission of fostering amateur sports competition is a qualifying purpose. However, the IRS argued that almost all of the organization's fundraising proceeds were earmarked to benefit those individuals who fundraised. The IRS contended that this arrangement violates §501(c)(3) because the methodology furthers private interests rather than the organization as a whole.

The court agreed with the IRS's position and observed that this was not a situation in which the fundraising is a tiny fraction of the organization's overall function (like, for example, a once-a-year sale of candy by a school band or a church youth group's carwash). Rather, Capital Gymnastics' fundraising is the primary function of the organization. In addition, the assessments at issue were not de minimis charges but rather were serious parental obligations.

Holding. Capital Gymnastics operated in a manner that allowed substantial private inurement and promoted private interests. Therefore, the organization did not operate exclusively for an exempt purpose and did not qualify for exemption from tax under §501(a).

TAX FRAUD

Offshore Financial Accounts

***U.S. v. H. Ty Warner*, No. 1:13-cr-00731; U.S. District Court for the Northern District of Illinois (Sep. 18, 2013)**
IRC §7201

☞ Creator of Beanie Babies Convicted of Tax Evasion

Facts. H. Ty Warner, an Oak Brook, Illinois resident, willfully attempted to evade and defeat $885,300 of income tax due on his 2002 federal tax return. His actions include the following.

1. In January 1996, Warner traveled to Zurich, Switzerland, to open a secret offshore account with the Union Bank of Switzerland (UBS).
2. In December 2002, Warner closed his UBS account and transferred the $93.6 million account balance to Zurcher Kantonalbank (ZKB) located in Zurich, Switzerland.
3. In December 2002, Warner concealed his name on the ZKB account by holding it in the name of a fictitious entity named Molani Foundation.
4. In calendar year 2002, Warner earned $3.16 million of interest on his UBS account. He failed to inform his tax practitioner about this 2002 interest income.
5. On or before June 30, 2003, Warner failed to file Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts,* (FBAR) for calendar year 2002.
6. On October 15, 2003, Warner filed a false and fraudulent 2002 individual income tax return. The $3.16 million of interest income from UBS was omitted on his 2002 Schedule B, *Interest and Ordinary Dividends*. In addition, he failed to disclose his Swiss financial accounts on the Schedule B.
7. On November 5, 2007, Warner filed a 2002 Form 1040X, *Amended Individual Income Tax Return*, with the IRS and claimed a net operating loss carryback in excess of $39 million related to his 2004 tax year. However, he failed to include the $3.16 million of interest income from UBS on the 2002 amended return. The additional tax due on the unreported $3.16 million of UBS interest for 2002 was $885,300.

On October 2, 2013, Mr. Warner pled guilty to the charges mentioned above. In court, he told the judge that he failed to inform his accountants about the Swiss bank accounts. During the hearing, Mr. Warner told the judge "When I signed those returns, I knew those moneys were missing. It was not accurate. I apologize for my conduct. It's a terrible way to meet you."[76]

At the guilty plea court appearance, Mr. Warner's attorney stated that his client agreed to pay $53.5 million of civil penalties for failing to disclose the foreign accounts on the required FBAR forms.[77] The civil fine could be the largest offshore account penalty ever publicly reported.[78]

Prosecutors stated that Mr. Warner failed to report a total of $24.4 million of income earned on his Swiss bank accounts from 1999 through 2006. His omissions of this income resulted in additional income taxes during this 8-year period of approximately $5.6 million.[79]

During the guilty plea appearance, Mr. Warner's attorney stated that while Mr. Warner "accepts full responsibility for his actions," **his client tried to enter the IRS's Offshore Voluntary Disclosure Program for taxpayers who had undisclosed offshore accounts.[80]** This attempt occurred in 2009 but was rejected by the IRS.

Sentencing Hearing. On January 14, 2014, Mr. Warner was sentenced to two years of probation on the IRC §7201 charge. In addition, he was ordered to pay a $100,000 fine and perform 500 hours of community service. His philanthropy actions also swayed the judge who stated: "Society will be best served to allow him to continue his good works."[81]

Note. For more information about the offshore asset reporting requirements, see the 2013 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Advanced Individual Issues.

76. *Beanie Babies Billionaire Ty Warner Enters Emotional Guilty Plea.* Yerak, Becky and Meisner, Jason. Oct. 2, 2013. Chicago Tribune. [articles.chicagotribune.com/2013-10-02/business/chi-beanie-babies-ty-warner-guilty-20131002_1_molani-foundation-ty-warner-tax-evasion] Accessed on Jun. 14, 2014.

77. Ibid.

78. Ibid.

79. Ibid.

80. *Ty Warner Charged with Tax Evasion.* Sep. 18, 2013. Crain's Chicago Business. [www.chicagobusiness.com/article/20130918/NEWS07/130919778/ty-warner-charged-with-tax-evasion] Accessed on Jun. 14, 2014.

81. *Beanie Babies Creator Ty Warner Won't Serve Prison Time for Tax Evasion.* Shoichet, Catherine. Jan. 14, 2014. CNN. [www.cnn.com/2014/01/14/justice/ty-warner-beanie-babies-tax-evasion/index.html] Accessed on Jun. 14, 2014.