Chapter 7: Rulings and Cases

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Please note. Corrections were made to this workbook through January of 2016. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as shortURLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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, 2015. Each appears as a condensed version and should not be relied on as a substitute for the full document. A full citation appears for each item. This chapter does not comprise a comprehensive coverage of all tax law changes or explanations. Rather, it reports the rulings and cases most likely to be of interest to tax professionals.

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 no 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 that support the treatment is substantial in relation to the weight of the authorities that support a contrary treatment.

- All the 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 the 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 that is in fact true.

NATURE OF ANALYSIS

The weight accorded to an authority depends on its relevance and persuasiveness, as well as the type of document providing the authority. For example, a case or revenue ruling that has some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts or otherwise inapplicable to the tax treatment. 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 (IRC) 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.

SUBSTANTIAL AUTHORITY HIERARCHY

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

- Applicable provisions of the IRC and other statutory provisions
- Temporary and final Treasury Regulations construing such statutes

Note. A proposed regulation presents a **tentative** IRS position that may be changed when a temporary and/or final regulation is 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

1. Treas. Reg. §1.6662-4(d)(3)(iii).

Additional information on some of the preceding items follows.

Internal Revenue Code. Except where provisions violate the U.S. Constitution, IRC provisions are binding in all courts.

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 a revenue ruling. Revenue rulings that interpret Treasury regulations are entitled to substantial deference.

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

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

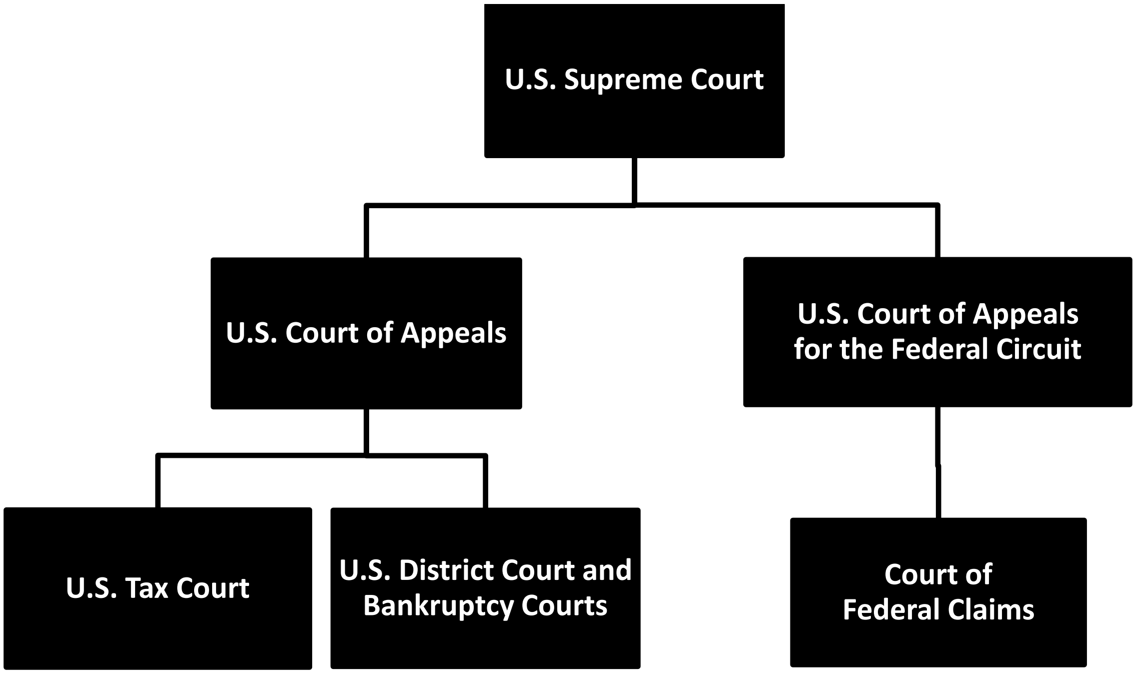
General Council Memoranda (GCM). GCMs detail the legal reasoning behind the issuance of a revenue ruling.

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

Tax Court Summary Opinions. A case decided under the small-case procedures cannot be appealed by 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 binding only on that particular case. However, reviewing the cases can still be useful; they explain the IRS's arguments, the taxpayer's arguments, and the Tax Court's reasoning.

JUDICIAL SYSTEM FOR TAX DISPUTES

Three levels of federal courts have jurisdiction to hear tax cases. The following diagram illustrates the three levels. The diagram is followed by a brief description of each court.



Note. Although tax liabilities are addressed by bankruptcy courts, they are generally addressed in a bankruptcy context under the terms of the Bankruptcy Code in a different manner than in the other courts noted in the above diagram.

CASE COMMENCEMENT

A taxpayer in a dispute with the IRS generally has two choices after they receive a statutory notice or notice of final determination (a 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, the taxpayer can file suit in a U.S. District Court or the Court of Federal Claims.

Note. U.S. District Courts also have jurisdiction to hear federal tax cases. However, these courts are generally used only for very substantial tax disputes because of the high costs and the complexities of using them to resolve tax issues. Consequently, these courts are rarely used by individual taxpayers to resolve tax disputes with the IRS.

THE U.S. TAX COURT

The U.S. Tax Court is a federal court of record that was 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 taxpayers 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, DC 20217. Although the court is physically located in Washington, the judges travel nationwide to conduct trials in various designated cities.

As of July 2015, the Tax Court is composed of 18 judges, 13 senior judges, and four special trial judges. The judges generally have expertise in tax law.

This is the only forum in which a taxpayer can contest a tax liability **without** first paying the tax. However, there is a $60 filing fee that may be paid by check or money order made out to "Clerk, United States Tax Court." 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 the following.

- Notices of deficiency
- Notices of transferee liability
- Certain types of declaratory judgments
- Readjustment and adjustment of partnership items
- Review of the failure to abate interest
- Administrative costs
- Worker classification
- Relief from joint and several liability on joint returns
- Review of certain collection actions

Furthermore, the Tax 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 versus independent contractor treatments
- Innocent spouse claim determinations
- Collection due process cases

To invoke the jurisdiction of the Tax Court, the taxpayer must file a petition in Tax Court within 90 days after the IRS notice of deficiency (or notice of final determination) is mailed.[2] **The 90-day date cannot be extended by the IRS.** Similarly, the Tax Court has no statutory authority to extend the 90-day period.[3] However, the Tax Court does have the discretion to accept a timely but nonconforming document as a petition and allow later amendments to that document that relate to the originally timely filed nonconforming petition.[4]

Observation. Taxpayers and practitioners should not rely on the Tax Court's discretion to extend the 90-day period by filing a nonconforming document that is not a valid Tax Court petition. There is no guarantee that the Tax Court will grant relief from the 90-day deadline.

Who May Practice in the U.S. Tax Court

A taxpayer may represent themselves in Tax Court, or they may be represented by a practitioner admitted to the bar of the Tax Court. Generally, an attorney who is a member of the bar of any state (or the District of Columbia) may be admitted to the bar of the U.S. Tax Court. The attorney must complete the required application for admission to practice (which must be notarized), attach the required proof of good standing in their state bar, and pay the required $35 fee.

A nonattorney may also be admitted to practice before the U.S. Tax Court. To do so, the nonattorney practitioner must pass a 4-hour examination consisting of the following four parts and pay the $75 examination fee.

- Tax Court rules of practice and procedure
- Federal taxation
- Federal rules of evidence
- Legal ethics

A score of at least 70% in each of the four parts is necessary to pass the examination. The examination is conducted at least once every two years. After passing the examination, the nonattorney practitioner must file the required application for admission.

The following resources for attorneys and nonattorneys provide information about admission to practice before the U.S. Tax Court (including the necessary forms, fee information, and mailing addresses).

- **Attorneys: uofi.tax/15b7x1** [https://www.ustaxcourt.gov/forms/Admission_Attorney_Form_30.pdf]
- **Nonattorneys: uofi.tax/15b7x2** [https://www.ustaxcourt.gov/forms/Admission_Nonattorney.pdf]

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2. IRC §6213(a).
3. *R. S. Schoenfeld v. Comm'r*, TC Memo 1993-303 (Jul. 13, 1993); *Schake v. Comm'r,* TC Memo 2002-262 (Oct. 10, 2002).
4. *R. M. Crandall v. Comm'r*, 650 F.2d 659 (5th Cir. 1981); *N. E. Carstenson v. Comm'r,* 57 TC 542 (1972).

Tax Court Decisions

The Tax Court hears several types of cases and issues several types of opinions. Specifically, the court hears both regular cases and small tax cases (referred to as S cases).

An S case is generally one that involves less than $50,000 of unpaid tax. The $50,000 threshold includes penalties but does not include interest. S cases are heard using less formal procedures and do not provide the right of appeal to a higher court. For a case to be treated as an S case, the taxpayer must choose S case status and the Tax Court must agree that the case qualifies.

> **Note.** For more information about S cases, see IRC §7463 and **uofi.tax/15b7x3** [www.ustaxcourt.gov/taxpayer_info_start.htm].

A Tax Court **summary opinion** is an opinion rendered in an S case. It may **not** be relied on as precedent.

Regular opinions are opinions from cases that are not S cases, and a regular opinion may be a memorandum opinion or a Tax Court opinion. A **Tax Court opinion** is issued if the Tax Court believes the case involves a sufficiently important or novel legal or tax issue. All other regular cases result in **memorandum opinions.** Both memorandum opinions and Tax Court opinions may be appealed and may serve as precedents.

A **bench opinion** can be issued by the Tax Court in any regular or S case. A bench opinion occurs when the judge issues the opinion orally in court during the trial. The taxpayer receives a transcript of the bench opinion a few weeks after the trial. Bench opinions may **not** be relied on as precedents.

> **Observation.** Tax Court opinions may be viewed online. A search engine for finding cases is available at **uofi.tax/15b7x4** [www.ustaxcourt.gov/UstcInOp/OpinionSearch.aspx].

> **Note.** Information about the Tax Court rules of practice and procedure are available at **uofi.tax/15b7x5** [www.ustaxcourt.gov/notice.htm].

Tax Court Appeals

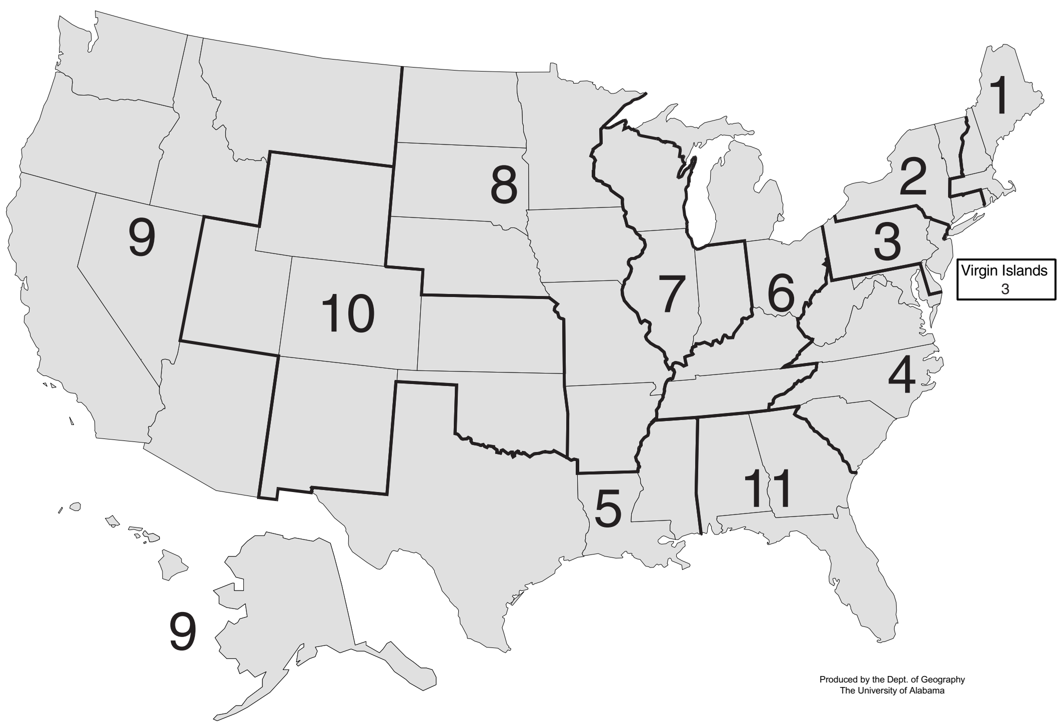
A Tax Court opinion or memorandum opinion may be appealed in a U.S. Court of Appeals. However, a taxpayer who commences their case in the U.S. Court of Federal Claims must appeal their case to the U.S. Court of Appeals for the Federal Circuit.

A final appeal can be made to the U.S. Supreme Court, but, because the Court's jurisdiction is discretionary, it hears relatively few tax cases. Many of the court transcripts from these cases can be accessed online at **uofi.tax/15b7x6** [www.uscourts.gov].

The taxpayer can file a refund suit in the Claims Court or the Federal District Court once they have paid the deficiency. In both of these courts, decisions of the Tax Court are not binding as precedents. The Claims Court is composed of a single judge. A jury trial is available only in the Federal District Court. Many federal court opinions can be accessed online at **uofi.tax/15b7x6** [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



IRS ACTIONS ON DECISION [5]

The IRS has the ability to refuse to accept a court's legal reasoning in a tax case (unless the case was resolved by the U.S. Supreme Court). Generally, the IRS may issue an Action on Decision (AOD) for a case that it did not appeal but that decided issues that were adverse to it.

An AOD is a formal memorandum that alerts IRS officials and the public about the position the IRS will take in future litigation. An AOD is issued at the discretion of the IRS, and the IRS is not bound by it. An AOD does not have the force of a regulation or revenue ruling.

An AOD may take one of the following forms, depending on the position the IRS takes regarding the litigated case.

- **Acquiescence.** The IRS accepts the holding of a court in the case and will follow it in disposing of other cases in which the same facts are controlling.
- **Acquiescence in result only.** The IRS accepts the holding of a court in the case and will follow it in disposing of other cases in which the same facts are controlling. However, the IRS has general disagreement or concern with the court's reasoning in the case.
- **Nonacquiescence.** The IRS has decided against appealing the case but does not agree with the holding of the court and will not apply the court's decision in resolving similar cases with other taxpayers.

> **Observation.** An AOD may provide a practitioner with insight on the stance the IRS will take on an issue that has been litigated. In this regard, an AOD may provide a useful source of information about taxpayers in the same or similar circumstances as those involved in the litigation.

The practitioner can view AODs online at **uofi.tax/15b7x7** [http://apps.irs.gov/app/picklist/list/actionsOnDecisions.html]. In addition, the Internal Revenue Manual provides information about when the IRS will consider issuing an AOD and the criteria used to determine when doing so is appropriate. This information can be found at **uofi.tax/15b7x8** [www.irs.gov/irm/part36/irm_36-003-001.html#d0e51].

> **Note.** Although the IRS is bound by a particular Tax Court or federal court ruling with regard to the taxpayer(s) involved in that case, it is not bound to follow that decision in subsequent cases that have the same or similar facts. In addition, the IRS is not obligated to appeal a case from Tax Court or any other court.

5. *Actions on Decision (AOD)*. [http://apps.irs.gov/app/picklist/list/actionsOnDecisions.html] Accessed on Jul. 9, 2015; IRM 36.3.1(2013).

BANKRUPTCY AND DISCHARGE OF INDEBTEDNESS

Taxable Income

Darrel W. Wyatt v. Comm'r, **TC Summ. Op. 2015-31 (Apr. 20, 2015)**
IRC §§61(a)(12), 6330, 6651, and 6654

☞ Discharge of Debt Is Taxable Income

Facts. Darrel Wyatt graduated from the University of Arkansas College of Medicine at Little Rock in 1978. He became a board-certified physician in obstetrics and gynecology.

In 2006, Dr. Wyatt moved to Putnam County, Florida. Putnam County is located in Florida's interior and is one of the state's poorer counties. Dr. Wyatt was recruited to practice at Putnam Community Medical Center in Palatka, Florida. Dr. Wyatt and the hospital entered into a recruiting agreement that required him to practice in the community for at least 48 months after beginning his private practice.

The hospital agreed to pay Dr. Wyatt a guarantee of $32,953 per month, starting on the first month the practice began and lasting for a period of 12 months. The hospital would pay Dr. Wyatt the difference between the guarantee amount and his gross cash receipts for the month. If during the month Dr. Wyatt's gross cash receipts exceeded the monthly guarantee amount, then he was required to immediately pay the hospital 100% of the excess amount.

At the end of the guarantee period, an audit of Dr. Wyatt's financial records would determine if he was liable to repay any part of the loan. If a loan repayment was required, it would be due immediately, unless Dr. Wyatt requested a deferred payment plan. Terms available included repayment over a period in excess of six months. Also included was a promissory note with interest accruing from the end of the guarantee period. If Dr. Wyatt remained in the community beyond the guarantee period, the hospital agreed to forgive and cancel one thirty-sixth of the loan repayment amount for each full calendar month Dr. Wyatt met certain requirements.

Dr. Wyatt received $260,627 net guarantee payments from the hospital under the recruiting agreement. He met the terms of the revenue guarantee–repayment forgiveness clause, so the hospital forgave and canceled the following net guarantee payments.

Year	Payment Forgiven and Canceled	Proportion of Total Forgiven and Canceled
2007	$ 43,438	6/36
2008	86,876	12/36
2009	86,875	12/36
2010	43,438	6/36
Total	$260,627	36/36

On Dr. Wyatt's 2007 through 2010 tax returns, he reported the income and expenses from his practice on a Schedule C, *Profit or Loss From Business.* He included as "other income" the amount of debt canceled by the hospital. Dr. Wyatt's 2009 return was prepared by a CPA and timely filed. The return showed tax due of $32,625 and an estimated tax penalty of $781. Dr. Wyatt did not remit any payment with the filed return.

The IRS assessed the tax, estimated tax penalty, a penalty for failure to timely pay the tax reported, and statutory interest. The IRS subsequently issued a final notice of intent to levy. In response, Dr. Wyatt filed a Form 12153, *Request for a Collection Due Process or Equivalent Hearing.* During the course of the administrative hearing, Dr. Wyatt submitted a Form 656-L, *Offer in Compromise (Doubt as to Liability).* He filed this form in an effort to satisfy his tax liabilities for 2007 through 2010 for $20,055. This amount was roughly what Dr. Wyatt calculated as his tax liability for those four years **without regard to** the amounts forgiven and canceled by the hospital. The IRS rejected the offer.

Issues. The issues in this case are as follows.

- Whether the forgiveness of a loan gave rise to income from cancellation of indebtedness
- Whether Dr. Wyatt is liable for an addition to tax for failure to pay estimated tax
- Whether Dr. Wyatt is liable for an addition to tax for failure to timely pay tax reported on a return

Analysis. Dr. Wyatt contended that the loan was a nonrecourse loan — that is, that he was not personally liable for its repayment. Consequently, Dr. Wyatt argued that he did not receive income when the loan was forgiven and canceled by the hospital. However, the court observed that Dr. Wyatt paid nothing to the hospital on his loan after the 1-year guarantee period. The hospital then forgave the balance of the loan ratably over the course of the next 36 months. This gave rise to cancellation of indebtedness income.

At trial, Dr. Wyatt testified that he lacked sufficient income to pay his 2009 tax liability, but he did not describe his financial situation. He did, however, indicate that he had resources other than his current income that he could use to satisfy his liability. The court noted that Dr. Wyatt did not demonstrate that paying his reported liability on time would have required him to risk a substantial financial loss, such that the addition to tax might be excused.

Holding. The court determined that Dr. Wyatt received cancellation of debt income through the loan forgiveness agreement. He was also liable for a penalty for failure to timely pay the tax reported on a return and a penalty for failure to make estimated tax payments.

BUSINESS EXPENSES

Business Expenses
***Vanney Associates Inc. v. Comm'r,* TC Memo 2014-184 (Sep. 11, 2014)**
IRC §162

☞ No Deduction Allowed for Bonus Check Because of Insufficient Funds

Facts. Vanney Associates Inc. is a personal service corporation that uses the cash method of accounting. Robert Vanney, a licensed architect with 39 years of experience, is the sole shareholder, chief executive officer, chief financial officer, vice president of marketing, vice president of operations, and director of human resources of Vanney Associates. Mr. Vanney's wife, Karen, is a CPA who is employed as vice president of finance for a company unrelated to Vanney Associates. However, she does prepare the payroll checks for Vanney Associates.

In 2008, Mr. Vanney received $240,000 in annual wages. At yearend, Vanney Associates's practice was to calculate the company's remaining profit and then pay it to Mr. Vanney as a bonus. On December 30, 2008, Vanney Associates paid Mr. Vanney a yearend bonus of $815,000; the net check he received after withholdings was $464,183. Mr. Vanney signed the check on behalf of Vanney Associates. He then endorsed it in his own name and made it payable to Vanney Associates. Mr. Vanney did not attempt to cash the check. He reported the payment on the books as a loan he made to Vanney Associates. Vanney Associates repaid Mr. Vanney the amount of the loan in March 2009.

Vanney Associates' reconciled bank balance was $283,033 on December 31, 2008. Therefore, **Vanney Associates did not have the funds to cover the bonus check.** The company did not get a loan to cover the check because Mr. and Mrs. Vanney did not personally need the money and did not want to incur the expenses associated with taking out a loan.

On the 2008 corporate tax return, $1.055 million was claimed as compensation for officers and $123,191 for taxes and licenses, which included $11,818 for Medicare taxes. The IRS examined the tax return and disallowed $815,000 of officer compensation and $11,818 of the deduction for taxes and licenses.

Issue. The issue in this case is whether Vanney Associates can deduct officer compensation and taxes related to a yearend bonus paid to Mr. Vanney.

Analysis. A payment by check is known as a **conditional payment**, because it is subject to the condition that the check be paid upon presentation to the drawee. The courts have previously disallowed deductions when a check was not ultimately paid because of insufficient funds.[6] Mr. Vanney cited *O'Connor v. Comm'r*,[7] in which the court held that the control of property distributed must have passed absolutely and irrevocably. The *O'Connor* court also relied on the fact that the payee had unrestricted use of the money and that the "amount was unqualifiedly his, to do with as he wished." In the case at hand, Mr. Vanney had only restricted use of the check. He could not cash the check, use it to pay a debt, or use it to make a loan to someone other than Vanney Associates. His only option was to lend it back to the company.

Holding. The court held that Vanney Associates was not entitled to deduct the portion of officer compensation relating to Mr. Vanney's yearend bonus. Vanney Associates did not have the funds to cover the check when it was presented to Mr. Vanney. Accordingly, **the check could not have been paid, and the deduction for officer compensation was not allowed.**

Business Expenses

***Bahram and Parvaneh Tarighi v. Comm'r*, TC Summ. Op. 2015-28 (Apr. 13, 2015)**
IRC §§162, 164, 195, 213, 274(d), 280F, 6651, and 6662

☞ Expenses Disallowed for Activity in Start-Up Phase

Facts. Bahram Tarighi was a civil engineer for over 25 years. He had experience as both a highway designer and a construction engineer. In 2008, while still employed, Mr. Tarighi decided to start his own business, which he named Civil Engineering Services (CES). He had business cards printed, designed stationery, and set up a website. Mr. Tarighi also purchased a computer, desk, and office supplies and set up an office in the basement of his home.

In 2008, Mr. Tarighi's employer drastically reduced his salary. Consequently, Mr. Tarighi decided that it was a good time to devote more time to developing CES. During his years in the field, he had developed many contacts. He started regularly visiting construction sites after work to distribute business cards and speak with managers and others performing construction on local highways. He also used these visits to stay abreast of what was happening in the highway construction engineering industry. Mr. Tarighi continued these regular visits during 2009, 2010, and 2011 (the years at issue in this case).

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6. See *Pike v. Comm'r*, 78 TC 822, 849 (1982), *aff'd* without published opinion, 732 F.2d 164 (9th Cir. 1984); *Steinberg v. Comm'r*, TC Memo 1995-116 (Mar. 21, 1995).

7. *O'Connor v. Comm'r*, TC Memo 1954-90 (Jun. 30, 1954).

During 2009 and the first half of 2010, Mr. Tarighi worked for Wallace Montgomery & Associates. During the second half of 2010, Mr. Tarighi worked for Progressive Engineering Services. Mr. Tarighi lost his job with Progressive in December 2010. He was then offered a job at Wallace Montgomery, but he turned it down to focus on developing CES.

Mr. and Mrs. Tarighi's 2009 and 2010 tax returns included Schedules C, *Profit or Loss From Business,* for CES. The Schedules C showed **no income,** because CES did not have any clients, was not hired to perform any services, and did not bid on any highway engineering jobs. The expenses claimed on the Schedules C totaled $46,629 and $45,618 for 2009 and 2010, respectively.

The IRS disallowed the Schedules C expenses due to lack of substantiation.

Issues. Several issues were raised in this case. However, the following analysis focuses on whether Mr. Tarighi was engaged in a trade or business.

Analysis. IRC §162(a) allows a taxpayer to deduct reasonable and necessary expenses incurred in connection with a trade or business. **To deduct expenses, the taxpayer's trade or business must be functioning as a going concern.** IRC §162(a) does not allow the deduction of startup and preopening expenses, although it may be possible to deduct them over time.[8]

Whether a taxpayer is engaged in a trade or business is determined based on the facts and circumstances of each case. The court focuses on three factors to make such a determination.

1. Whether the taxpayer undertook the activity intending to earn a profit
2. Whether the taxpayer is regularly and actively involved in the activity
3. Whether the taxpayer's activity has actually commenced

The court looked at each of these factors and found that Mr. Tarighi was not engaged in a trade or business during the years at issue. **CES did not have any income or clients and did not bid on any jobs.** If Mr. Tarighi intended to earn a profit, he would have pursued contracts and bid on jobs. The court determined that his actions were steps taken to **set up a business,** not those of an operating business. The issue of substantiation is therefore irrelevant.

Holding. The court determined that Mr. Tarighi was not entitled to claim business expense deductions for his civil engineering business. The court held that the business was in the start-up phase during the years at issue.

> **Note.** Many cases such as *Tarighi* hinge on whether a legitimate trade or business exists. IRC §162, which relates to the deductibility of ordinary and necessary expenses incurred in carrying on a trade or business, has never provided a definition of trade or business. However, the factors frequently considered in determining if the taxpayer's activity is a **trade or business** are found in cases regarding hobby losses. For recent hobby loss cases that discuss the factors used in making this determination and the Tax Court's approach to such a determination, see the "Not for Profit" section of this chapter.

8. IRC §195; *Hardy v. Comm'r,* 93 TC 684 (1989).

Business Expenses

***Arunas and Ilona Savulionis v. Comm'r,* TC Summ. Op. 2015-19 (Mar. 17, 2015)**
IRC §§162, 262, 280A, 6662, and 6664

☞ Lack of Home Office Results in Disallowed Expenses

Facts. Arunas and Ilona Savulionis are Philadelphia residents. Mr. Savulionis is a vascular ultrasound technologist and the sole proprietor of a vascular ultrasound and technology business, Arunas Savulionis Sole Proprietorship. All services were provided in an outpatient clinic in Somers Point, New Jersey, during the years at issue. The clinic billed for all services rendered and received payments accordingly. Mrs. Savulionis was the bookkeeper for the sole proprietorship during the years at issue.

Mr. Savulionis considered opening a vascular ultrasound and technology laboratory and an ultrasound technologist staffing agency in the Philadelphia area. He took some preliminary steps toward doing so in the living room of his residence. However, neither business materialized during either 2009 or 2010.

On the couple's 2009 and 2010 tax returns, they reported income on Schedules C, *Profit or Loss From Business,* of $95,556 and $88,639, respectively. All of this income was attributable to services that Mr. Savulionis provided to patients through the sole proprietorship. The IRS disallowed expenses claimed on Schedule C as follows.

Schedule C Expenses	2009	2010
Business use of home	$ 6,854	$ 7,683
Meals	6,405	6,945
Car and truck expenses	19,050	17,534

The IRS also assessed an accuracy-related penalty.

Issues. The issues in this case are as follows.

- Whether the taxpayers are entitled to the various deductions claimed on the Schedules C
- Whether the taxpayers are liable for the 20% accuracy-related penalty under IRC §6662(a)

Analysis. IRC §280A(a) provides that deductions for a taxpayer's residence are not allowable unless an exception applies. IRC §280A(c) provides an exception that applies to the portion of the dwelling unit used **exclusively for business on a regular basis.** Mr. Savulionis claimed deductions allocable to the couple's living room, which he alleges was used exclusively for business purposes. However, both entry to and exit from their house were made through a door in the living room. Access to all other rooms in the house was through the living room. In addition, the three people who lived in the house congregated in the living room to engage in family activities. The court disallowed the deductions claimed for business use of the home accordingly.

IRC §162(a) allows a deduction for ordinary and necessary travel expenses, including amounts paid for meals. This deduction is allowed if such expenses are paid or incurred while away from home in pursuit of a trade or business. As a general rule, the taxpayer's tax home is the vicinity of their principal place of business if their residence is located in a different area than the principal place of business. The meals expenses deducted on the tax returns were for meals Mr. Savulionis consumed during the days he worked at the clinic in Somers Point, New Jersey. The clinic is the only location at which he provided medical services to patients. Moreover, the only income shown on his Schedule C was generated at the clinic. Therefore, Mr. Savulionis's tax home for purposes of §162(a) was the vicinity of the clinic. No deduction for meals was allowable, because Mr. Savulionis did not incur the meals expenses while traveling away from home.

Expenses for traveling between a taxpayer's residence and regular place of business are **nondeductible personal expenses.** At court, Mr. Savulionis argued that he had a home office where he conducted business and that he also worked at the New Jersey office. Therefore, he should be entitled to deduct the cost of going between the two locations. The court had previously determined that Mr. Savulionis's residence was neither the principal place of business nor a second place of business. The expenses paid by Mr. Savulionis to travel between his residence and the clinic were therefore nondeductible personal expenses.

The court determined that the couple was not liable for the accuracy-related penalty. Clearly, they had deducted personal expenses on their tax returns for the years at issue. However, the court believed they had acted in good faith and had reasonable cause for these errors.

Holding. The court ruled that the taxpayers were not entitled to business deductions for home office expenses for a room not used exclusively for business purposes, for meal expenses that were not incurred while traveling away from home, or for travel expenses that were personal expenses. The court declined to uphold an accuracy-related penalty.

Promotional Expenses

***William and Caroline Evans v. Comm'r,* TC Memo 2014-237 (Nov. 20, 2014)**

IRC §§162, 179, and 6662

☞ Motocross Racing Sponsorship Allowed as Promotional Expense Deduction

Facts. Dave Evans Construction (DEC) is a general contractor that develops land and constructs commercial buildings and residential homes in the Boise, Idaho area. For the first half of 2006, DEC operated as a sole proprietorship. Beginning in mid-2006, the business was operated as an S corporation under the name Dave Evans Construction LLC.

Mr. and Mrs. Evans have five children, all of whom were involved in motocross racing — a popular sport in the Boise area. One of the children, Ben, possessed the talent and drive to race at a professional motocross level. Ben started racing in 1996 when he was just six years old. At age seven, he competed in a nationally televised race at the Seattle Kingdome. As a teenager, he competed on the national amateur circuit and won the Amateur Motocross National Championship 458 Pro Sport class in 2007. Winning this event qualified Ben for a license to compete on the professional circuit, which he began doing in 2007.

The Evanses were supportive of their children's interest in racing, although participating in the sport was expensive. They personally paid for their children's motorcycles and race entry fees. However, Ben's career started to take off in 2005, when he was featured in various motocross magazines. At this time, several sponsors also began supporting him.

At the same time, Mr. Evans realized his son's "star power" might enhance DEC's business. Mr. Evans consulted with his CPA, who advised him that supporting Ben's motocross racing could be a valid promotional activity for DEC. Accordingly, DEC became one of Ben's sponsors.

Many of DEC's jobs came through word of mouth, and its relationship with the Boise community played an important role in driving business. DEC's association with Ben thus helped boost DEC's goodwill and exposure in the area. DEC's connection to Ben also gave it an advantage over its competitors in securing the best local subcontractors for its projects and sometimes obtaining discounted rates.

During the years at issue, DEC purchased three capital assets for the motocross activity: a 2006 Jayco motorhome, a 26-foot Mirage trailer, and a utility trailer. Depreciation and IRC §179 expenses were claimed on these properties. The motorhome was used to transport Ben and one or two adults along with equipment. Those attending the races also slept in the motorhome.

In 2007, Honda gave Ben five motorcycles as part of a sponsorship deal. The motorhome was not large enough to carry all five motorcycles, so DEC acquired the 26-foot Mirage trailer for hauling them. The team traveled with both the motorhome and trailer, thus allowing Ben to compete in multiple classes at every race.

The taxpayers claimed deductions for expenses relating to the motocross racing activity on their 2006 and 2007 tax returns. These deductions are summarized in the following table.

Year	Taxpayer	Motocross-Related Deductions	IRC §179 Deductions
2006	Evanses (Schedule C)	$44,995	$66,783
2006	DEC (Form 1120S)	41,624	0
2007	DEC (Form 1120S)	74,579	40,303

The IRS examined the tax returns and determined deficiencies related to motocross deductions of $55,326 and $42,243 for tax years 2006 and 2007, respectively. Penalties under IRC §6662(a) were also assessed.

Issues. The issues in this case are as follows.

- Whether expenses related to Ben's motocross racing activity and deducted by DEC are ordinary and necessary business expenses
- Whether the expenses, if determined to be ordinary and necessary, are reasonable
- Whether the taxpayers are entitled to §179 deductions for the motorhome and trailers
- Whether the taxpayers are liable for IRC §6662(a) accuracy-related penalties

Analysis. IRC §162(a) allows a deduction for ordinary and necessary expenses that a taxpayer pays in connection with the operation of a trade or business. Generally, for an expenditure to be an ordinary and necessary business expense, there must be a proximate relationship between the expenditure and the taxpayer's business.[9]

At trial, the IRS argued that no proximate relationship existed between Ben's racing activity and the construction business. The IRS argued that the expenditures for the motocross racing activity were actually personal expenses; that DEC operated in Boise, whereas most of Ben's races took place outside the area; and that the taxpayers did not demonstrate that the motocross activity brought in new customers.

The taxpayers disagreed. They, along with other corporate sponsors, received tangible benefits for their advertising dollars. In addition, DEC established the nexus with new business connections, as well as connections with vendors, subcontractors, and banks—all of which resulted in an increased bottom-line profit. The court agreed with the taxpayers.

Finally, the IRS argued that the expenses incurred were not reasonable. The court compared the expenses in this case (less than 1% of DEC's gross receipts) to those in *Lang Chevrolet Co. v. Comm'r,*[10] in which an automobile dealership claimed racing expenses as a form of advertising. In *Lang,* advertising expenses constituted approximately 0.7% and 1.0% of total gross sales during the two years at issue, respectively. In this case, the court determined that expenses that constituted 0.9% and 0.7% of gross receipts for 2006 and 2007, respectively, were reasonable in light of the significant tangible and intangible benefits DEC obtained from the motocross activity.

9. *Challenge Mfg. Co. v. Comm'r,* 37 TC 650 (1962); *Henry v. Comm'r,* 36 TC 879 (1961); Treas. Reg. §1.162-1(a).

10. *Lang Chevrolet Co. v. Comm'r,* TC Memo 1967-212 (Oct. 27, 1967).

IRC §179 generally allows a taxpayer to elect to treat the cost of qualified property as a current expense in the year the property is placed in service. The IRS challenged the taxpayers' §179 deduction for the motorhome, arguing that it was used primarily for lodging. The taxpayers successfully argued that the motorhome was used for more than just lodging. It served as the primary means of transporting Ben and his motorcycles to races until the Mirage trailer was purchased. In addition, the motorhome had a rear wall that folded down at the push of a button to make a ramp to roll motorcycles into the motorhome for both transport and repairs. Accordingly, the court determined that the motorhome was not used primarily for lodging and that the taxpayers were entitled to deduct its cost under §179.

However, no documentation was provided to support the business use of the utility trailer. Therefore, no §179 expense deduction was allowed with respect to this asset.

The taxpayers prevailed on all issues in this case except the utility trailer and some conceded issues. With respect to the IRC §6662(a) accuracy-related penalty, the taxpayers argued that they acted with reasonable cause and good faith. Mr. Evans employed a CPA, whom he relied upon for correct advice. The court determined that Mr. Evans had reasonably relied in good faith on the CPA's judgment concerning the utility trailer and the conceded issues. Accordingly, they were not liable for any accuracy-related penalties.

Holding. The court held that the taxpayers were entitled to deduct motocross sponsorship expenses because the reasonable promotional expenses were ordinary and necessary for everything except the utility trailer. No penalties applied, because the business reasonably relied on professional advice in deducting the expenses.

CAPITAL GAINS AND LOSSES

Capital Gain

***Victor Fargo and Virginia King et al. v. Comm'r,* TC Memo 2015-96 (May 26, 2015)**
IRC §§163(d), 163(h)(3), 167, 1221, and 6662

☞ Property Held for Sale in Ordinary Course of Business

Facts. In 2002, Victor Fargo and Virginia King engaged in a real estate business in California. This business was conducted via several entities, including Fargo Industries Corp. (FIC), Girard Property Corp. (GPC), and GDLP.

In 1988, FIC acquired a leasehold from La Jolla Medical Building Corp. to lease a 2.2-acre parcel of land. FIC planned to develop a 72-unit apartment complex and retail space. It purchased the leasehold for $2.7 million, which was paid in installments ending in 1990. The original lease ran through 2008 but was extended through 2042 for an additional $900,000. Having this additional time allowed Mr. Fargo and Ms. King time to develop the La Jolla property.

In 1991, FIC transferred the leasehold in the La Jolla property to GDLP for a capital contribution credit. GDLP subsequently entered into various agreements with related parties for the development and management of the La Jolla property.

In the early 1990s, the real estate market dramatically declined. Consequently, development of the La Jolla property was suspended. However, GDLP obtained financing to develop the property and purchased the La Jolla property in 1997 for $1.75 million.

Through 2001, the La Jolla property was developed for residential use. The physical improvements were limited to minor repairs, which were capitalized and amortized over the course of the holding period.

In 2001, Centex Homes made an unsolicited offer to purchase the La Jolla property. In 2002, Centex Homes bought the La Jolla property from GDLP for $14.5 million plus a share of the home sales profit. The sales contract between GDLP and Centex Homes obligated GDLP to continue the development process that was already in place.

The IRS examined GDLP's 2002 tax return and determined that the partnership had realized ordinary income from the sale of property in 2002 of $7.47 million. GDLP had reported a capital gain of $628,222 on the return.

Issues. Several issues were raised in this case. However, the following analysis focuses on whether the sale of the La Jolla property generated a capital gain or ordinary income for the taxpayers.

Analysis. GDLP argued that the sale of the La Jolla property produced capital gain, because it held the property for investment purposes. The IRS contended that the sale of the property to Centex Homes produced ordinary income.

IRC §1221(a)(1) defines a **capital asset** as certain property held by the taxpayer. **Property is not a capital asset if it is held by the taxpayer primarily for sale to customers in the ordinary course of their trade or business.** To determine whether a taxpayer held property primarily for this purpose, the court analyzes several factors. In the case involving GDLP, those factors were as follows.

- **Purpose for which the property was initially acquired.** GDLP and the IRS agreed that the initial investment in the La Jolla property was made for development purposes with the intention of later selling it to customers. **This factor weighed in favor of the IRS.**
- **Purpose for which the property was subsequently held.** GDLP contended that it held the La Jolla property primarily to allow the real estate market to recover from the recession; thus, the property should be viewed as an investment. The court noted that GDLP never abandoned its development plan and incurred substantial fees relating to development expenses. **This factor weighed in favor of the IRS.**
- **Extent of improvements to the property.** The court observed that GDLP never substantially improved the La Jolla property. **This factor weighed in favor of the IRS.**
- **Extent and nature of the transactions involved.** The La Jolla property was sold to Centex Homes, an unrelated entity, at a fair price. The plan was for Mr. Fargo to develop the property and for GDLP to share in the resulting profit. Thus, GDLP and Mr. Fargo were clearly interested in the development profit. **This factor favored the IRS.**
- **Purpose for which the property was held at time of sale.** At the time Centex Homes purchased the La Jolla property, GDLP had incurred substantial development costs and taken several strategic moves to acquire financing to fund development. **This factor favored the IRS.**
- **Frequency, number, and continuity of sales.** Frequent and substantial sales of real property are more likely to indicate sales in the ordinary course of business, whereas infrequent sales for significant profits are more indicative of real property held as an investment.[11] GDLP had never sold real estate before selling the La Jolla property. **This factor favored GDLP.**
- **Extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property.** GDLP did not engage in marketing, selling, or advertising. **This factor favored GDLP.**
- **Listing of the property with brokers.** The La Jolla property was listed with GPC serving as the broker in 1993. In addition, GPC was paid a fee based on the sale price. **This factor weighed in favor of GDLP.**

Holding. The court held that the taxpayers had ordinary income from the La Jolla property sale because the property was sold in the ordinary course of the business.

11. *Phelan v. Comm'r,* TC Memo 2004-206 (Sep. 15, 2004).

Capital Gain vs. Ordinary Income

***Brian K. Brinkley v. Comm'r*, TC Memo 2014-227 (Oct. 30, 2014)**
IRC §§83, 302, 409A, 1221, 1222, 6662, and 6664

☞ Income from Merger Treated as Deferred Compensation Rather Than Sale of Stock

Facts. Brian Brinkley was one of the founders of Zave Networks Inc. (Zave) formed in 2006. As a founder, Mr. Brinkley initially owned 9.8% of Zave's common stock. After a 2008 stock sale by Zave to raise additional capital, his equity interest was diluted. At that time, he threatened to leave Zave if his stock ownership percentage ever fell below 3%.

Because Mr. Brinkley's participation was vital to the success of Zave, the company mitigated his threat by agreeing to increase his stock ownership to a minimum of 3%. Zave accomplished the increase by issuing Mr. Brinkley restricted stock grants. Nevertheless, by 2011, his equity interest in Zave had fallen to less than 1%, even though he owned 1.34 million shares of common stock.

In 2011, Google began negotiations with Zave to acquire the company as a wholly owned subsidiary (merger). Zave's board chairman explained to Mr. Brinkley that Zave was being sold to Google for $93 million and that his 1.34 million shares were valued at approximately $800,000. Mr. Brinkley objected to the $800,000 stock valuation amount. He insisted that he should receive 3% of Google's $93 million purchase price, or $2.79 million.

In response to Mr. Brinkley's objection, Zave sent him a final "letter agreement" in August 2011. The agreement contained the following terms.

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1. Zave would pay Mr. Brinkley $3.1 million of the $93 million purchase price offered by Google.
2. Mr. Brinkley would "not be entitled to the [$3.1 million], except for any amount [he] would be entitled to receive in exchange for [his] shares … in the absence of this Agreement, if [he does] not comply with the terms of the Merger Agreement."
3. Under the heading "Internal Revenue Code Compliance including IRC section 409A" (which addresses inclusion in gross income of deferred compensation under deferred compensation plans), the agreement provided that the $3.1 million "will be subject to all adjustments, tax withholdings, if any, and escrow as required in the Merger Agreement."

As a result of the merger in September 2011, Mr. Brinkley received $3.0275 million and became an employee of Google. Of the total proceeds, $360,065 was held in escrow and paid in a later year.

Mr. Brinkley received a **2011 Form W-2, *Wage and Tax Statement,* from Zave that reported the following.**

- Wages of $2,056,502
- Federal income tax withholding of $512,306

On his 2011 tax return, Mr. Brinkley reported wages of $226,073 and a long-term capital gain of $2,476,455 from the sale of his Zave stock. The capital gain was calculated as follows.

Sales price of stock	$2,540,828
Less: stock basis	(64,373)
Long-term capital gain	$2,476,455

With his 2011 return, Mr. Brinkley included Form 4852, *Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* On that form, he reported amounts different from what was shown on Form W-2. He included an attachment to Form 4852 in which he explained that $1,879,779 of "stock compensation" wages was actually part of the stock purchase — not compensation. He further explained that the payroll company had misclassified his stock sale by treating the proceeds as ordinary income, rather than long-term capital gain.

In examining Mr. Brinkley's 2011 tax return, the IRS used the amounts reported on Zave's Form W-2 to reduce the reported stock sale capital gain and to increase the reported wage income. As a result, the IRS assessed additional tax of $369,071 and an accuracy-related penalty of $48,036.

Issues. The issues in this case are as follows.

- Whether Mr. Brinkley properly reported all the income he received concerning the merger transaction
- Whether the accuracy-related penalty under IRC §6662(a) is applicable

Analysis. The IRS asserted that the $3.0275 million Mr. Brinkley received due to the merger would be properly categorized as follows.

- $787,671 proceeds from the sale of 1.34 million shares of Zave stock
- $1,879,779 deferred compensation as stated in the final letter agreement, which Mr. Brinkley signed in August 2011
- $360,065 additional deferred compensation, which was held in escrow and paid to Mr. Brinkley in a later year

Mr. Brinkley's aim was to reduce his tax liability by structuring the $3.0275 million he would receive as entirely derived from his sale of Zave stock. That goal is acceptable, but it does not allow him to ignore relevant information. Mr. Brinkley argued that Zave misclassified a large portion of his merger-based income as deferred compensation. However, the facts indicate that Zave did exactly what it intended. Zave and Google — not the taxpayer — were the negotiating parties to the merger. They agreed to the schedules that listed Mr. Brinkley as a recipient of deferred compensation.

Holding. The evidence showed that the taxpayer received full value for his Zave stock. He also received compensation for his prior and potential future employment services. Mr. Brinkley's 2011 Form W-2 accurately reported his wages. **Therefore, the additional tax and accuracy-related penalty assessed by the IRS were sustained.**

CLERGY

Parsonage Allowance

***Freedom From Religion Foundation Inc. et al. v. Jacob J. Lew et al.*, U.S. Court of Appeals, 7th Circuit; No. 14-1152 (Nov. 13, 2014)**
IRC §107

☞ Plaintiffs Do Not Have Standing to Challenge Constitutionality of Parsonage Allowance

Facts. Freedom From Religious Foundation (FFRF) is a Wisconsin-based organization of agnostics and atheists that provided a housing allowance to co-presidents Annie Gaylor and Dan Barker. IRC §107 excludes the value of employer-provided housing from the gross income of any "minister of the gospel." Neither Gaylor nor Barker was a minister, so each paid income taxes on the housing-allowance portion of their salary.

Gaylor, Barker, and FFRF brought suit in the Western District of Wisconsin, claiming that IRC §107 violates the First Amendment, because it bases a tax benefit on a religious affiliation. The Western District of Wisconsin held that the rental-allowance exemption of IRC §107(2) was unconstitutional. The government appealed this decision.

Issue. The issue in this case is whether IRC §107 is unconstitutional.

Analysis. To have standing to bring a suit, a plaintiff must show that they have suffered or are imminently threatened with:

1. A concrete and particularized "injury in fact,"
2. That is fairly traceable to the challenged action of the defendant, and
3. That is likely to be redressed by a favorable judicial decision.[12]

The requirement that the plaintiff's injury be "concrete and particularized" means that the injury must affect the plaintiff in a personal and individual way. **A general grievance about government is not considered an injury** for purposes of legal standing.[13]

The First Amendment's establishment clause is aimed primarily at protecting noneconomic interests of a spiritual nature. A plaintiff cannot establish standing based solely on being offended by the government's alleged violation of the establishment clause.[14]

Plaintiffs can demonstrate standing in establishment clause cases in a variety of ways. The plaintiffs in this case attempted to show standing by demonstrating that they had incurred a cost or been denied a benefit on account of their religion. They argued that they were denied a benefit that is conditioned on religious affiliation: specifically, an exclusion from income for their employer-provided housing allowance.

The plaintiffs' argument failed for a simple reason: They were never **denied** the parsonage exemption because they never requested it. The court noted that absent any personal denial of a benefit, the plaintiffs' claim was nothing more than a general grievance about the constitutionality of §107(2). Thus, their claim did not support standing.

Holding. The court vacated the judgment of the district court because the plaintiffs did not have standing to challenge the constitutionality of the parsonage exemption. Therefore, the court did not address the issue of the constitutionality of the parsonage exemption.

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12. *Lujan v. Defenders of Wildlife*, 504 U.S. 555 (1992).
13. Ibid.
14. See *Valley Forge Christian Coll. v. Ams. United for Separation of Church & State, Inc.*, 454 U.S. 464 (1982).

CORPORATIONS

Tax on Distributions

***Bross Trucking Inc. et al. v. Comm'r,* TC Memo 2014-107 (Jun. 5, 2014)**
IRC §§311, 331, 6651, and 6662

☞ Trucking Company Did Not Distribute Intangible Assets to Owner

Facts. Chester Bross started in the construction business in 1966. He formed Bross Construction in 1972 to do road construction projects for highway departments in Illinois, Missouri, and Arkansas. As the business grew, Mr. Bross organized additional entities to provide services and equipment for the construction projects.

Mr. Bross formed Bross Trucking Inc. in April 1982 and owned 100% of its stock. Bross Trucking hauled construction-related materials and equipment for road construction projects and hauled coal in the winter for other customers.

Bross Trucking owned very little trucking equipment. It leased most of its equipment on a yearly basis from another wholly owned Bross entity, CB Equipment. Bross Trucking paid for all the fuel and maintenance of the leased trucks. It used independent contractors to provide the hauling services.

In the late 1990s, the Missouri Division of Motor Carrier and Railroad Safety (MCRS) and the U.S. Department of Transportation (DOT) started investigating Bross Trucking. The investigations lasted several years and involved a series of complaints filed against Bross Trucking. The company received an unsatisfactory safety rating, which could have resulted in its not being able to haul for customers. Because of the complaints and the investigations, Bross Trucking was under perceived heightened regulatory scrutiny. As a result, Mr. Bross made the decision to cease Bross Trucking operations.

In July 2003, Mr. Bross and his three sons met with their attorney to discuss options for ensuring the Bross family businesses had a suitable trucking provider. The attorney suggested forming a new trucking entity, LWK Trucking. The three Bross sons owned a 98.2% interest in LWK Trucking. An unrelated third party acquired the remaining shares. Mr. Bross had no interest in the new company.

Both Bross Trucking and LWK co-existed for a short period. LWK hired several independent contractors who had previously worked for Bross Trucking and began leasing the same equipment from CB Equipment that had previously been leased to Bross. LWK employed 11 mechanics, some of whom had previously worked at Bross Trucking.

After examining Bross Trucking's 2004 corporate tax return, the IRS determined there was a deficiency of $883,800 because Bross Trucking had allegedly distributed intangible assets to Mr. Bross. According to the IRS, Mr. Bross had then made a gift of the intangible assets to his three sons, who organized LWK Trucking. The value of the intangible assets would have required filing a gift tax return and paying gift tax for 2004.

Additionally, the IRS assessed an IRC §6662 accuracy-related penalty of $176,760. The IRS also assessed substantial gift-tax deficiencies for 2004 and 2006, as well as penalties to Mr. and Mrs. Bross.

Issues. The issues in this case are as follows.

- Whether Bross Trucking distributed appreciated intangible assets to its sole shareholder, Mr. Bross
- Whether Mr. Bross gave appreciated intangible assets to his sons
- Whether the gifts should have been reported for tax year 2004
- Whether the taxpayers are liable for accuracy-related penalties under IRC §6662(a)

Analysis. IRC §311(b)(1) generally provides that if a corporation distributes appreciated assets to a shareholder, it recognizes gain as if the property were sold to the shareholder at its fair market value (FMV). Gain is recognized to the extent that the property's FMV exceeds the corporation's adjusted basis. Two specific requirements must be met before a corporation must recognize any gain.

1. The corporation must distribute property to a shareholder in a distribution controlled by IRC §§301 through 307.
2. The FMV of the property must exceed its adjusted basis in the hands of the distributing corporation.

The IRS argued that Bross Trucking distributed the company's "operations" to Mr. Bross. The IRS's opening brief suggested that Bross Trucking distributed a single intangible asset: goodwill. It included the following six separate attributes that were listed in the notice of deficiency.

1. Goodwill
2. Established revenue stream
3. Developed customer base
4. Transparency of the continuing operations between the entities
5. Established workforce, including independent contractors
6. Continuing supplier relationships

Bross Trucking did not transfer a developed customer base or a revenue stream to LWK Trucking nor did it distribute any cash assets. Bross Trucking retained all the necessary licenses and insurance to continue business. Mr. Bross retained his association with Bross Trucking and was not involved in owning or operating LWK Trucking. LWK Trucking did not benefit from any of Bross Trucking's assets or relationships.

The DOT and MCRS investigations severely impaired the viable operations of Bross Trucking. As a result, little goodwill was left in the company. The only aspect of corporate goodwill that Bross Trucking displayed was a workforce. Bross Trucking did not transfer the established workforce in place to Mr. Bross. Only about 50% of LWK Trucking's employees had formerly worked at Bross Trucking. Given this, the court was unconvinced that most of the workforce in place had been transferred.

The court noted that the impending suspension of Bross Trucking would cause customers to reevaluate whether to trust Bross Trucking and to continue to do business with it. Mr. Bross's solution was to create another business to take over the trucking needs for the family businesses. The court stated, "This is the antithesis of goodwill: Bross Trucking could not expect continued patronage because its customers did not trust it and did not want to continue doing business with it."

Holding. The court held that Bross Trucking did not distribute intangible assets to Mr. Bross and therefore Mr. Bross could not have distributed any intangible assets to his sons. Accordingly, Mr. Bross was not required to report gifts of any distributed assets for 2004 or 2006 and was not liable for §6662(a) penalties.

DEPENDENT ISSUES

Dependency Exemption

***Jean Cowan v. Comm'r*, TC Memo 2015-85 (May 4, 2015)**
IRC §§2(b), 24, 32, 151, and 152

☞ Lack of Legal Adoption Creates Many Unexpected Tax Issues

Facts. Marquis Woods was born in 1986 to a drug-addicted mother. He went to live with Jean Cowan when he was six weeks old and lived with her from that time on. In April 1991, a state court appointed Ms. Cowan his guardian until such time as the court revoked the guardianship or Marquis reached the age of majority. When he reached age 18 in 2004, the state court considered the guardianship case closed, because Marquis had reached the age of majority.

Ms. Cowan indicated that she would have adopted Marquis if she had known the legal distinction between guardianship and adoption and had been financially able to hire an attorney to pursue the adoption. In addition, she was not aware that she could have adopted Marquis after he turned 18 if he had consented to the adoption and she had been financially able to do so. Marquis continued to reside with Ms. Cowan in a mother–son relationship, despite the fact that she had never actually adopted him.

In 2006, Marquis fathered a daughter, H.A.W. During 2011, Marquis (age 25) lived with Ms. Cowan the entire year, and H.A.W. (age 5) lived with her 11 months. Ms. Cowan provided most of the support for the entire household during 2011.

On her 2011 tax return, Ms. Cowan filed as head of household and reported adjusted gross income (AGI) of $13,920. She claimed dependency exemptions for both Marquis and H.A.W. Additionally, Ms. Cowan claimed the earned income credit (EIC) and child tax credit (CTC) because she believed H.A.W. was really her grandchild and thus met the definition of a qualifying child.

The IRS determined that Ms. Cowan was not entitled to the head-of-household filing status, to exemptions for Marquis and H.A.W., to the EIC, or to the CTC. Later, the IRS conceded that Marquis was a qualifying relative and allowed the dependency exemption for him.

Issues. The issues in this case are as follows.

- Whether Ms. Cowan is entitled to a dependency exemption for H.A.W.
- Whether Ms. Cowan is entitled to the EIC or CTC for H.A.W.
- Whether Ms. Cowan is entitled to the head-of-household filing status

Analysis. IRC §151(c) allows a dependency exemption for each individual who is a dependent of the taxpayer for the tax year. An individual can qualify as a dependent if they are either a qualifying child or a qualifying relative. The IRS agreed that Marquis met the relationship test as a qualifying relative. To be a qualifying child, H.A.W. must be either:[15]

- A child of the taxpayer or a descendant of such a child; or
- A brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any such relative.

The question in this case centered on whether Marquis was Ms. Cowan's eligible foster child. Marquis was Ms. Cowan's eligible foster child until he reached age 18 and the state court terminated the guardianship relationship. Ms. Cowan argued that "the statute did not specify that the foster child ceases to be a child when they reach the age of majority." She further asserted that Marquis remained her child after he turned 18, because the Code allows for relationships created by law to persist despite the cessation of the legal circumstances that created them (relationship of affinity, i.e., marriage).

15. IRC §152(c)(2).

The court disagreed with Ms. Cowan's rationale because her relationship with Marquis was not a relationship by marriage. In addition, there was no basis for extending a principle based on marriage to a foster care relationship. Accordingly, Marquis was not an eligible foster child in 2011, because his placement ended years earlier. Because Marquis was no longer considered Ms. Cowan's child, H.A.W. was not Ms. Cowan's qualifying child as a descendant of Marquis.

To qualify for the EIC or the CTC, the taxpayer must have a qualifying child. Because H.A.W. was not a qualifying child of Ms. Cowan, Ms. Cowan was not entitled to the EIC or the CTC for the 2011 tax year.

IRC §2(b) provides that a taxpayer qualifies for head-of-household filing status if they meet all the following criteria.

- Is unmarried
- Is not a surviving spouse
- Maintains their household as the principal abode of a qualifying child or qualifying relative

H.A.W. was not Ms. Cowan's qualifying child. Moreover, she was not a qualifying relative, because she lived in the household for only 11 months. The IRS has conceded that Marquis is Ms. Cowan's qualifying relative. However, IRC §2(b)(3)(B) precludes taxpayers from claiming head-of-household filing status when their dependents are not related by blood or marriage. Therefore, Ms. Cowan could not use the head-of-household filing status on her 2011 return.

Holding. The court held that Ms. Cowan was not entitled to the head-of-household filing status or to an earned income tax credit, a child tax credit, or a dependency exemption for H.A.W.

DIVORCE ISSUES

Alimony

Joshua Henry Wish v. Comm'r, **TC Summ. Op. 2015-25 (Apr. 6, 2015)**
IRC §§71 and 215

☞ Alimony Deduction Allowed Based on Amounts Actually Paid

Facts. Joshua Wish, a California teacher, was divorced. He and his former wife had one child. During the time they were married, they decided to homeschool their child, who had learning disabilities. After the couple divorced, they agreed to continue with the homeschooling.

Homeschooling the child prevented Mr. Wish's ex-wife from working. In addition to paying child support, Mr. Wish agreed to pay alimony until she could resume working. As part of the divorce proceedings, Mr. Wish and his ex-wife agreed that in January 2009, Mr. Wish would start paying $1,200 child support per month and $3,800 alimony per month until she either went to work or remarried.

In 2009, some payments were withheld from Mr. Wish's paycheck and distributed to his ex-wife, and the remainder was paid via personal check or cash. The amount of the alimony decreased to $1,900 in September 2009 when his ex-wife returned to the workforce and discontinued homeschooling.

Mr. Wish deducted $39,900 as alimony on his 2009 tax return. The IRS disallowed $30,200 of the deduction after determining that only $9,700 was an allowable deduction. An accuracy-related penalty was also assessed.

Issues. The issues in this case are as follows.

- Whether Mr. Wish may deduct alimony amounts paid to his former wife during 2009
- Whether Mr. Wish is liable for the IRC §6662(a) accuracy-related penalty

Analysis. IRC §215(a) and (b) allows a deduction for alimony or separate maintenance payments made during the payor's taxable year that are includable in the recipient's gross income under IRC §71(a). Under IRC §71(c), if the terms of a divorce agreement reduce the amount of money received because of a **contingency relating to a child** (e.g., child attains a specific age), an amount equal to the reduction is treated as child support and does not qualify as alimony.

In court, Mr. Wish believed he was entitled to a $38,000 alimony deduction as follows.

January–August 2009 (8 × $3,800)	$30,400
September–December 2009 (4 × $1,900)	7,600
Total	$38,000

The IRS contended that the contingency in the spousal support agreement related to the child. Mr. Wish contended that the contingency related to when his ex-wife would return to work and would no longer homeschool the child. The court noted a clear and direct relationship between the amount of spousal support payments and his former wife's choice to work. There was no contingency that depended on the child. The court further observed that the amount of spousal support was reduced after the former wife went back to work but the amount of child support remained the same.

Evidence from Mr. Wish's paycheck and payments made directly to his ex-wife supported the $38,000 alimony deduction.

Holding. The court determined that Mr. Wish was entitled to most of his claimed alimony deduction except for the $900 he erroneously included in the deduction. Mr. Wish was not liable for an accuracy-related penalty, because he acted with reasonable cause and in good faith in claiming the alimony deduction.

> **Note.** Increasingly, the Tax Court is addressing cases about alimony deductions. As in the *Wish* case, the outcome of these cases frequently depend on whether payments made are properly characterized as alimony under IRC §71. Although the Tax Court looks to the divorce decree or court order in making this determination, analysis under applicable state law may be necessary to clarify terms of the divorce decree or court order.

Alimony

***Adrio M. Baur v. Comm'r,* TC Memo 2014-117 (Jun. 12, 2014)**
IRC §§71, 215, and 6662

☞ Alimony Deduction Reduced Due to Contingency Events Clause Regarding Children

Facts. Adrio Baur and his wife, Judith, were granted a divorce by the Circuit Court of their county in February 2009. They had two minor children at the time of the divorce. The divorce decree specified that Adrio was to pay **$3,750 per month** to Judith **as "unallocated maintenance and child support."** However, **a clause in the decree lowered the $3,750 monthly amount to $1,800 if the two children were "living independently or outside Judith's residence,** without any financial support from Judith."

A separate clause in the decree stated: "The sums paid by Adrio to Judith … are acknowledged to be paid incident to the judgment for dissolution of marriage and in discharge of Adrio's legal obligation to support Judith. **Said sums shall be includable in the gross income of Judith and deductible from the gross income of Adrio within the meaning and intent of Sections 71 and 215 of the [Code]."**

In 2010, Adrio made all the required payments to Judith, for a total of $45,000. On his 2010 tax return, he deducted $45,000 as alimony.

> **Note.** Adrio originally claimed an alimony deduction of $41,695 on his 2010 tax return. He stated that he made a mistake and should have claimed an alimony deduction of $45,000. This amount was corrected in the course of the proceedings.

In June 2012, the IRS issued a notice of deficiency, stating that Adrio's return contained the following discrepancies.

- The $45,000 alimony deduction should be reduced to $27,018.
- His tax was underpaid by $6,757.
- His return was subject to a 20% accuracy-related penalty under IRC §6662(a) of $1,351.

After issuing the notice of deficiency, the IRS petitioned the Circuit Court to **clarify the intent** of the divorce decree it had approved in 2009. In September 2012, the court stated: "It was the intent of the Court that all payments made from Adrio Baur to Judith Baur from February 29, 2009 to the present date … are to be includable in income to Judith Baur and deductible for income tax purposes for Adrio Baur."

Issues. The issues in this case are as follows.

- Whether the taxpayer is entitled to an alimony deduction exceeding the amount allowed by the IRS
- Whether the taxpayer is liable for the IRC §6662(a) accuracy-related penalty

Analysis. IRC §71(c)(2) provides that if any payment specified in a divorce decree is to be **reduced** under one of the following circumstances, the amount of the reduction is treated as an amount paid for child support.

1. **Upon the occurrence of a contingency related to a child** (e.g., attaining a certain age, marrying, dying, leaving school, or a similar contingency)
2. At a time that can be associated with that kind of contingency

At trial, the IRS argued that the settlement agreement made it clear that parts of the payments Adrio made to his ex-wife were for child support. He countered that the Circuit Court clarified that all the payments were for alimony. The court noted that state court orders retroactively designating divorce-related payments as alimony, rather than child support, were generally disregarded for federal income tax purposes. An exception is made when a retroactive judgment corrects a divorce decree that mistakenly fails to reflect the court's true intention.

The court observed that the Circuit Court adopted all the provisions of the settlement agreement and ordered Adrio and his ex-wife to comply with all those provisions. That agreement unambiguously provided for a reduction in the payments upon the occurrence of certain contingencies relating to the minor children.

Holding. The court concluded that it would give **no effect** to the Circuit Court's order dated September 2012. Accordingly, the court held as follows.

- The IRS determination that disallowed $27,018 of the claimed alimony deduction of $45,000 was correct.
- The taxpayer was liable for the IRC §6662(a) accuracy-related penalty.

> **Note.** This case illustrates that any contingency payments relating to children are considered nondeductible child support, rather than deductible alimony.

Alimony

***George A. Resnik Jr. v. Comm'r,* TC Summ. Op. 2015-11 (Feb. 23, 2015)**

IRC §§71 and 215

☞ Payments Fixed as Support Result in No Alimony Deduction

Facts. George and Diane Resnik were married from sometime in the 1980s through March 2007. They had three children during their marriage. The oldest child, Luke, had a lifelong neurological disorder that inhibited his speech and his language comprehension.

The divorce agreement gave primary physical custody of the couple's children and ownership of the marital residence to Ms. Resnik. It required Mr. Resnik to make 75% of the monthly payments for the mortgage on the couple's martial residence, less escrow payments for real estate taxes, assessments, and insurance. These payments were to continue until the mortgage was paid off **or** until Luke no longer lived with Ms. Resnik at the residence on a permanent basis. The divorce agreement did not designate the maintenance payments made to Wells Fargo as includable in Ms. Resnik's gross income or deductible by Mr. Resnik as alimony.

Mr. Resnik paid $14,166 to Wells Fargo in 2010 for mortgage payments. He deducted these payments as alimony on his 2010 tax return. The IRS disallowed this deduction and assessed an accuracy-related penalty.

Issues. The issues in this case are as follows.

- Whether Mr. Resnik may deduct amounts paid to Wells Fargo during 2010 as alimony
- Whether Mr. Resnik is liable for the 20% accuracy-related penalty under IRC §6662(a)

Analysis. IRC §215(a) and (b) allows the payor a deduction in an amount equal to the alimony or separate maintenance payments made during the tax year that are includable in the recipient's gross income. Under IRC §71(c)(2), if any amount specified in the divorce instrument "will be reduced" on the happening of a **contingency specified in the instrument that relates to a child of the payor spouse, then the amount that "will be reduced" is treated as child support.**

All parties agreed that Mr. Resnik's maintenance payments during 2010 met the criteria of IRC §71(b)(1) for a payment of alimony or separate maintenance. The issue was that the terms of the divorce instrument stated that the maintenance payments would be reduced to zero in the event that Luke no longer lived with Mr. Resnik's ex-wife on a permanent basis. This event was a **contingency** relating to the child of the payor spouse. Consequently, based on IRC §71(c)(2), the maintenance payments had to be treated as fixed by the divorce instrument as payable for Luke's **support.**

Mr. Resnik argued that IRC §71(c)(2) does not recharacterize any amount payable for the support of the payor spouse's children until such time as the relevant contingency has actually occurred. However, the court noted that Mr. Resnik's argument contradicted the plain language of IRC §71(c)(2). Therefore, the payments did not qualify as alimony.

Mr. Resnik conceded that if he was not entitled to an alimony deduction, then he was liable for the accuracy-related penalty.

Holding. The court held that Mr. Resnik was not entitled to a deduction for alimony or separate maintenance payments. The payments were treated as fixed by the couple's divorce instrument as payable for one of their children's support. The court also upheld the accuracy-related penalty.

Alimony

David Iglicki and Laura Stultz v. Comm'r, **TC Memo 2015-80 (Apr. 27, 2015)**
IRC §§71, 215, and 6662

☞ Terms of Judgment Disavow Alimony Deduction

Facts. David Iglicki was married to Christie Iglicki from March 1991 through April 1999. They had one child together during their marriage.

The couple's separation agreement required Mr. Iglicki to pay $735 per month in child support. If Mr. Iglicki defaulted on his child support obligation, he would become liable for $1,000 per month in spousal support. This spousal obligation would continue until:

1. Ms. Iglicki died,
2. Mr. Iglicki died, or
3. Mr. Iglicki made 36 payments.

After the divorce, Mr. Iglicki moved to Colorado. He defaulted on his child support obligation as of November 1, 2002. Ms. Iglicki filed suit in a Colorado District Court. She obtained a writ of garnishment against Mr. Iglicki's wages for the following.

- $16,500 in past-due child support, plus $6,338 in interest
- $36,000 in past-due spousal support, plus $28,156 in interest

Mr. Iglicki paid off all the child support arrears as of April 2009. In September 2009, Mr. and Ms. Iglicki agreed to increase the monthly child support from $735 to $938.

During 2010, Mr. Iglicki made $50,606 in total payments, $11,256 of which was for child support. **He claimed a deduction of $39,350 ($50,606 − $11,256) as alimony payments on his 2010 return.** Ms. Iglicki reported $13,441 of alimony income on her tax return.

The IRS disallowed the alimony deduction and asserted an accuracy-related penalty.

Issues. The issues in this case are as follows.

- Whether Mr. Iglicki and his current wife, Ms. Stultz, are entitled to an alimony deduction under IRC §215(a) for 2010
- Whether the taxpayers are liable for the 20% accuracy-related penalty under IRC §6662(a)

Analysis. IRC §215(a) allows a deduction for the alimony or separate maintenance payments made during the payor's tax year. Under IRC §71(b)(1), an alimony or separate maintenance payment is defined as any payment in cash that meets all the following requirements.

1. The payment is made under a divorce or separation instrument.
2. The instrument does not designate the payment as not includable in gross income
3. If legally separated, the spouses cannot be members of the same household when the payment is made.
4. The payments stop at the death of the payee spouse, and no substitute payee can receive the payments.

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Colorado law treats payments made to satisfy future spousal support obligations differently from payments made to satisfy support arrears. Future support obligations terminate at the death of either spouse unless otherwise agreed to. Conversely, an order enforcing spousal support arrears becomes a final money judgment, which is not affected by the death of either the payor or the payee. The payor is still responsible for the payments. Therefore, **the court determined that the spousal support payments failed to satisfy the fourth requirement.** Accordingly, Mr. Iglicki was not entitled to an alimony deduction for the payments.

Mr. Iglicki did not provide reasonable cause for deducting the alimony. As a result, the court sustained the accuracy-related penalty.

Holding. The court determined that the taxpayers were not entitled to an alimony deduction for the payments Mr. Iglicki made to his former wife, concluding that the payments did not qualify under IRC §71(b)(1)(D). The taxpayers were also liable for an accuracy-related penalty.

EMPLOYMENT TAX ISSUES

Delinquent Payroll Taxes

***Kathy L. Riggs v. Comm'r,* TC Memo 2015-98 (May 26, 2015)**
IRC §§6330 and 6672

☞ Currently Not Collectible (CNC) Status Not Appropriate

Facts. Kathy Riggs incorporated Amber Construction in 1997. This company provided services to general contractors in and around Jacksonville, Florida. From December 2003 to December 2011, Amber Construction accrued substantial unpaid federal employment taxes.

In November 2011, the IRS issued Ms. Riggs a proposed assessment regarding her personal liability for the trust fund recovery penalty. She was held to be a responsible officer for Amber Construction. The IRS also filed a lien against Ms. Riggs as the corporation's nominee in April 2012. The lien attached to an office building on Columbia Park Drive (Columbia Park property).

Ms. Riggs formed a new wholly owned corporation, Amber Rebar Inc. (Rebar), and ceased operation of Amber Construction. Rebar filed a Chapter 11 bankruptcy petition on May 15, 2012.

In a separate proceeding, the IRS established that Rebar was the successor-in-interest to Amber Construction's tax liability. In Rebar's bankruptcy proceeding, the IRS filed a proof of claim against the corporation for unpaid federal employment taxes. The IRS and Rebar entered into an **adequate protection agreement** that was converted to an order by the bankruptcy court on October 3, 2012. This agreement required Rebar to make $3,420 monthly payments to the IRS beginning on October 25, 2012. Rebar met the terms of the order for seven months. **Each check submitted indicated the payment was to be applied to Ms. Riggs's liability for the trust fund recovery penalty.**

The IRS initiated collection efforts against Ms. Riggs and issued a final notice of intent to levy on Ms. Riggs's personal assets on November 30, 2012. Subsequently, the IRS filed a notice of federal tax lien against Ms. Riggs. She then requested a collection due process hearing. The Appeals officer found that Ms. Riggs had equity in several assets. She was the sole owner of the Columbia Park property, with $92,540 of equity. She owned a boat jointly with her husband, with $45,398 of equity. She also had an interest in a residence on Oliver Creek Drive, with equity of $317,540. She owned this property with her parents until she transferred her interest in it to them via a quit-claim deed on December 30, 2012. Based on the equity Ms. Riggs had in these assets, the Appeals officer determined that she was not entitled to currently not collectible (CNC) status.

Ms. Riggs petitioned the court seeking review of the Appeals officer's determination and the IRS's allocation of the adequate protection payments.

Issues. The issues in this case are as follows.

- Whether the IRS abused its discretion in not allowing Ms. Riggs CNC status
- Whether Ms. Riggs is entitled to a different collection alternative
- Whether the payments made should have been applied to reduce Ms. Riggs's personal liability for the trust fund recovery penalty

Analysis. At trial, Ms. Riggs argued that the IRS Appeals officer erred by failing to designate her liability for the CNC status regarding the trust fund recovery penalty. CNC status — which suspends IRS collection efforts — is a collection alternative that the taxpayer may propose and that Appeals must take into consideration. Ms. Riggs claimed that she was unable to sell or use any of her assets as collateral for a loan because of the IRS liens. Because she was unable to use this equity to pay her liability, Ms. Riggs claimed that the Appeals officer's denial of CNC status was an abuse of discretion. However, the court noted that Ms. Riggs has substantial equity in the Columbia Park property and in a boat, totaling over $137,000. The court upheld the denial of CNC status accordingly.

Ms. Riggs also argued that even if she was not entitled to CNC status, she was still entitled to a different collection alternative. IRC §6330(c)(2) lists the issues a taxpayer may raise at a collection due process hearing before an Appeals officer. However, Ms. Riggs did not raise the issue of other collection alternatives, so the court could not consider them.

The last issue for decision is related to the application of the adequate protection payments that Rebar made. Ms. Riggs asserted that these payments should have been applied to reduce her personal liability for the trust fund recovery penalty. The IRS applied these payments to reduce Rebar's tax debt. It is IRS policy to apply payments in accordance with specific written directions **for those payments that are made voluntarily.** Each check mailed by Ms. Riggs indicated the payment was to be applied to the trust fund recovery penalty. However, in this case, the bankruptcy court directed the payments**.** Therefore, neither Ms. Riggs nor Rebar had the right to allocate the payments.

Holding. The court held that the **IRS did not abuse its discretion** by denying Ms. Riggs's request to designate her tax liability as currently not collectible. The court found that she had substantial equity in assets to pay a trust fund recovery penalty for unpaid federal employment taxes. The court further held that she was not entitled to other collection alternatives and that the IRS had the authority to apply the payments as it saw fit.

> **Note.** There appears to be a gradually increasing number of cases filed in Tax Court in which taxpayers claim a right to CNC status. This may be due to a statement the Tax Court made in its decision in *Lee Roy Sullivan, Jr. v. Comm'r.*[16] In *Sullivan,* the Tax Court stated that "Part 8.22.5.6.1.1(6) of the Internal Revenue Manual ("IRM"), effective March 29, 2012, characterizes CNC status as being not a collection alternative… this Court has treated CNC status as a 'collection alternative'…and we will do so here." Accordingly, the Tax Court and the IRS are apparently in disagreement on how CNC status should be viewed. After the *Sullivan* decision, there were five cases (including *Riggs)* filed in the Tax Court in which the taxpayer claimed entitlement to CNC status. However, the taxpayer in all of these cases lost on the CNC issue. Future cases must develop how the CNC status should be viewed and applied. *Sullivan,* IRM 1.2.14.1.14 (1980), and IRM 5.16.1 (revised Dec. 8, 2014) provide the IRS and Tax Court views on the applicability of CNC status.

16. *Lee Roy Sullivan, Jr. v. Comm'r,* TC Memo 2012-337 (Dec. 4, 2012).

Trust Fund Recovery Penalty

***William R. Shore v. U.S.,* No. 1:13-cv-00220; U.S. District Court for the District of Idaho (Dec. 4, 2014)**
IRC §§3102, 6672, and 7501

☞ Paying Creditors Before the Government Results in Penalty

Facts. Countryside Repair & Equipment (Countryside) was a farm equipment seller. William Shore owned real property that he leased to Countryside until late 2004, when Countryside closed. Mr. Shore was then approached by a representative for McCormick Tractors, a line of tractors sold by Countryside. The representative proposed that Mr. Shore start his own business on the property and become a McCormick dealer.

Mr. Shore eventually agreed to hire Tom Lewis, former manager of Countryside, to run his new company, called Bear River Equipment Inc. (BRE). The two verbally agreed that Mr. Lewis would run the business with the option to purchase it at any time by repaying Mr. Shore's $150,000 initial investment in the company, plus interest.

Mr. Shore hired Mr. Lewis to manage every aspect of the business. This included day-to-day operations, financial management, paying bills, purchasing product lines, and other duties required to run an equipment sales operation.

Mr. Shore played a limited role in BRE. He signed the articles of incorporation as president of BRE and owned all the shares in the company. He signed various contracts on behalf of BRE and personally guaranteed an operating line of credit obtained by BRE from Ireland Bank. Mr. Shore had regular telephone conversations with Mr. Lewis to discuss operations. Mr. Shore also made quarterly visits to check inventory and assess the business. In addition, Mr. Shore reviewed the balance sheets and annual statements provided by Mr. Lewis.

In August 2007, the IRS notified Mr. Shore of serious issues with BRE's employment taxes for 2006 and 2007. Mr. Shore subsequently discovered that Mr. Lewis had been embezzling from BRE, failing to pay creditors and BRE's taxes, and stealing BRE's assets. Mr. Shore immediately fired Mr. Lewis and took over BRE's management. A short time later, Mr. Shore terminated BRE. Before closing the company, he allowed more than $120,000 from BRE's checking account to be paid to unsecured creditors other than the United States.

The IRS assessed trust fund recovery penalties against Mr. Shore. Mr. Shore believed that he should not be held liable for BRE's unpaid payroll taxes because he was not a responsible party and did not willfully ignore tax obligations. Nonetheless, he eventually paid more than $100,000 in trust fund recovery penalties. He then filed suit to obtain a refund.

Issue. The issue in this case is whether Mr. Shore is entitled to a refund of the trust fund recovery penalties he paid related to BRE's payroll withholding taxes.

Analysis. Under IRC §6672(a), the IRS may assess a 100% penalty on responsible persons who willfully fail to collect, account for, and pay withheld federal income and social security taxes to the United States. For the United States to assess the §6672 penalty, two requirements must be met.

1. The party assessed must be a **responsible person,** who is any person required to collect, truthfully account for, and pay over the tax.
2. The party assessed must have **willfully** refused to pay the tax.[17]

The courts look to various factors in determining the application of the trust fund recovery penalty. The crucial factor is whether a party by virtue of their position in the company could have had substantial input into relevant financial decisions if they had chosen to exert their authority.[18]

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17. *U.S. v. Jones*, 33 F.3d 1137, 1139 (9th Cir. 1994).

18. *Barnett v. IRS*, 988 F.2d 1449, 1455 (5th Cir. 1995).

In this case, the undisputed facts demonstrated that Mr. Shore was a **responsible person** for purposes of §6672. He was BRE's president and as such executed contracts on BRE's behalf. He also possessed but did not utilize check-writing authority on BRE's account with Ireland Bank. He had monthly telephone conversations with Mr. Lewis to discuss the business, made unannounced visits to BRE to assess inventory, and reviewed BRE's financial statements. Mr. Shore was ultimately responsible for hiring and firing. He continued to run the operation for a short time after firing Mr. Lewis. These undisputed facts demonstrated that Mr. Shore possessed the status, duty, and authority necessary to be a responsible person under §6672.

The next question was whether Mr. Shore **willfully** failed to pay over the trust fund taxes. Mr. Shore suggested that his conduct was not willful because he did not know about BRE's unpaid tax liabilities at the time the company failed to remit payroll taxes in 2006 and 2007. However, a person may act willfully even though they did not learn about the unpaid taxes until after the corporation failed to pay them.[19] When "a responsible person learns that withholding taxes have gone unpaid in past quarters for which he was responsible, he has a duty to use all current and future unencumbered funds available to the corporation to pay those back taxes."[20] If the responsible person instead permits funds to be paid to other creditors, a finding of willfulness is appropriate.[21] **Mr. Shore learned of BRE's unpaid tax liability in August 2007. He then paid more than $120,000 to unsecured creditors.**

Mr. Shore argued that he falls within the exception carved out by the Supreme Court in *Slodov v. U.S.*[22] Under this exception, the new management of a corporation may not be liable for a §6672 penalty if they use revenue to satisfy creditors other than the United States. To qualify for the exception, the new management must assume control when a delinquency for trust fund taxes already exists and prior management has already dissipated the withheld taxes.

Although the court sympathized with Mr. Shore's predicament, it nonetheless observed that he was already a responsible person at the time the 2006 and 2007 tax liability had accrued. A responsible party is not allowed to divert after-acquired funds to pay liabilities other than those owed for unpaid payroll taxes. The issuance of checks to creditors other than the federal government indicated that Mr. Shore intentionally preferred other creditors over the United States, thus establishing the willfulness aspect.

Holding. The court held that Mr. Shore was a responsible person and that he willfully failed to pay withheld payroll taxes. Therefore, he was not entitled to a refund of the trust fund recovery penalties he paid.

Employment Status

***Darryl L. Jones and Tarri Harrold-Jones v. Comm'r,* TC Memo 2014-125 (Jun. 23, 2014)**
IRC §§172,162, and 6662

☞ Court Determines That Wife Was Independent Contractor for Husband's Law Office

Facts. Darryl Jones owns a law office. His wife, Tarri Harrold-Jones, owns and operates a company called Tarri's Business Services. During the years at issue, Mrs. Harrold-Jones leased commercial office space and business equipment to the law office and also performed services for it.

Mr. Jones often hired extra workers, and in 2003, Mrs. Harrold-Jones agreed to work on two of his largest cases. The couple was concerned that working too closely together might damage their marriage. To prevent this, they arranged their business relationship to give Mrs. Harrold-Jones as much freedom as possible. She worked from the couple's home, which was about 45 miles away from the law office. Mr. Jones told Mrs. Harrold-Jones what he wanted her to do but allowed her to accomplish the work in her own time and in her own way. **The couple agreed that Mr. Jones could discharge his wife if the arrangement proved unsatisfactory.**

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19. *Johnson v. U.S.,* 734 F.3d 352, 364 (4th Cir. 2013).

20. *Erwin v. U.S.,* 591 F.3d 313, 326 (4th Cir. 2010).

21. Ibid.

22. *Slodov v. U.S.*, 436 U.S. 238 (1978).

One of the cases Mrs. Harrold-Jones worked on involved an eccentric client. Mrs. Harrold-Jones got along well with the client, so Mr. Jones asked her to review documents with the client and keep the client calm and focused. Mrs. Harrold-Jones also performed basic legal research for the law office. She did not receive regular wages; instead, she received a percentage of the fees that Mr. Jones collected.

In 2007 and 2008, the couple filed their tax returns as married filing separately (MFS). The returns indicated that Mrs. Harrold-Jones was an independent contractor with respect to the services she provided to the law office. Mr. Jones reported her payments as contract labor on his Schedules C, *Profit or Loss From Business.* Mrs. Harrold-Jones reported the payments as gross receipts on her Schedules C. Mrs. Harrold-Jones paid self-employment (SE) tax, and Mr. Jones did not pay payroll taxes on the amounts he paid her.

In May 2011, Mr. Jones received a notice from the IRS. It informed him that the IRS had determined that Mrs. Harrold-Jones was an employee during 2007 and 2008. On the basis of the determination, the IRS sought payroll taxes from Mr. Jones, reclassified income that Mrs. Harrold-Jones reported on her Schedules C as wages, and disallowed a deduction she claimed for SE taxes.

Issues. Several issues were presented in this case. The following analysis focuses on whether the IRS properly reclassified Mrs. Harrold-Jones as an employee of the law office.

Analysis. Common law principles apply in determining whether an individual performing services for a principal is an employee or an independent contractor. In evaluating the business relationship between Mr. Jones and Mrs. Harrold-Jones, the court considered the following factors.[23]

1. **Degree of control.** Mr. Jones did not control the details of the work performed by Mrs. Harrold-Jones. Instead, he told her what he needed done and let her decide how to accomplish it. This suggests that Mrs. Harrold-Jones was an independent contractor.
2. **Investment in facilities.** Mrs. Harrold-Jones worked from her home office, and the law office did not pay any of her home office expenses. This suggests that she was an independent contractor.
3. **Opportunity for profit or loss.** Mrs. Harrold-Jones did not receive regular wages. Instead, she received payment only after the cases she worked on had settled, and these payments depended on the amounts of the settlements. Therefore, her profits were linked to her performance, which suggests that she was an independent contractor.
4. **Right to discharge.** Mr. Jones had the right to discharge Mrs. Harrold-Jones, which suggests that she was an employee.
5. **Regular business.** Mrs. Harrold-Jones performed activities that were part of the regular business of the law office. This suggests that she was an employee.
6. **Permanency of the relationship.** Mrs. Harrold-Jones worked for the law office only while the two cases that Mr. Jones assigned to her were ongoing. Once the cases had been settled, she ceased working for the law office. Although Mrs. Harrold-Jones worked on the cases for over five years, her work depended on the continuation of the cases. These facts suggest that she was an independent contractor.
7. **Relationship the parties thought they created.** The law office treated Mrs. Harrold-Jones as an independent contractor and issued to her Forms 1099-MISC, *Miscellaneous Income.* She also considered herself an independent contractor and paid SE tax during the years at issue. These points suggest that she was an independent contractor.

Holding. After weighing all the factors, the court concluded that Mrs. Harrold-Jones was an independent contractor during the years at issue.

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23. See, for example, *Weber v. Comm'r,* 103 TC 378 (1994), and *Ewens & Miller, Inc. v. Comm'r,* 117 TC 263 (2001).

ESTATE AND GIFT

Lien

***U.S. v. David Stiles et al.*, No. 2:13-cv-00138; U.S. District Court for the Western District of Pennsylvania (Dec. 2, 2014)**
IRC §§6321, 6601, 6621, 6651, 6654, and 6662

☞ Depleting Estate Leads to Personal Liability for Tax Debt

Facts. Julia Stiles died in 2002, and David Stiles was appointed executor of her estate. At the time of Ms. Stiles's death, her estate was worth approximately $2.7 million.

Between 2002 and 2005, Mr. Stiles distributed approximately $775,000 from the estate to himself. He also distributed $425,000 to each of his two sisters.

The estate tax return was not filed until June 2008. On June 9, 2008, the IRS assessed federal income taxes, interest, and penalties against the estate totaling $2.09 million.

On June 18, 2010, the IRS placed a lien on real property owned by the Stiles family in Washington, Pennsylvania, based on unpaid federal income taxes. As of March 31, 2014, the IRS had determined that the Stiles family still owed the following income tax assessments.

Tax Period	Amount
2007	$ 4,989
2008	27,072
2009	20,299
2010	85

Issue. The issue in this case is whether the Stiles family depleted the estate before paying the estate's tax liability.

Analysis. The government filed an action to reduce to judgment the tax assessments against the Stileses for depleting an estate before paying the estate's tax liabilities. The government sought to foreclose the tax lien and sell the property located in Washington, Pennsylvania.

The Stiles family responded that the actions taken by the government were "excessive and unnecessary." They argued that the payments on the tax claims had been and would continue to be forthcoming. They also argued that the estate has long been depleted through spoilage due to detrimentally relying on the advice of their counsel.

The court determined that the Stiles family failed to submit a statement refuting the facts presented by the government. In addition, the Stiles family failed to support their allegation that payments submitted to the IRS were not reflected on the record.

Personal liability may be imposed on a fiduciary who pays any part of an estate's debts before paying a claim of the government.[24] Personal liability can attach to the extent of the distribution if the government can establish three elements.

1. The fiduciary distributed assets of the estate.
2. The distribution rendered the estate insolvent.
3. The distribution took place after the fiduciary had actual or constructive knowledge of the liability for unpaid taxes.

24. 31 USC §3713(b).

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The government argued that the Stiles were personally liable for depleting an estate before paying the estate's tax liability. The estate's assets were approximately $2.7 million around the time of Julia Stiles's death. After Mr. Stiles sold real property located in Delaware and made distributions from an investment account, the estate's liabilities exceeded its assets.

Mr. Stiles admitted that he knew about the estate's federal tax liabilities. However, he contended that he relied on advice of counsel when he made distributions that led to the estate's insolvency. The court noted that relying on poor advice from an attorney is not a defense. Mr. Stiles was still liable for the decisions he made in managing the estate.

Holding. The court held that Mr. Stiles depleted Julia Stiles's estate before paying the estate's tax liability. The court entered the appropriate orders to reduce the tax assessments against the Stiles family to judgment and to foreclose against the Washington, Pennsylvania real property.

Late-Filing Penalty

***Janice C. Specht et al. v. U.S.,* No. 1:13-cv-00705; U.S. District Court for the Southern District of Ohio (Jan. 6, 2015)**
IRC §6651

☞ Warning Signs Ignored by Estate Executor

Facts. Virginia Escher passed away on December 30, 2008, at the age of 92, with an estate worth approximately $12.5 million. Her cousin, Janice Specht, was the estate's executor. Ms. Specht was a high-school-educated homemaker who had never been an executor, held stock, or been in an attorney's office.

A Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return,* was required to be filed with the IRS within nine months after Ms. Escher's death. Ms. Specht selected Ms. Escher's attorney, Mary Backsman, to assist with filing the tax return. Ms. Backsman had over 50 years of experience in estate planning, but she was battling brain cancer, which she did not disclose to Ms. Specht.

The estate's federal tax return was due on September 30, 2009, but was filed 15 months late on January 26, 2011. When the return was filed, the estate paid $3.9 million in tax and $210,602 in interest. The estate later paid $1.19 million in penalties and interest.

The undisputed facts in the case include the following.

- In **April 2008,** Ms. Specht accompanied Ms. Escher to Ms. Backsman's office to have a will prepared. During this meeting, Ms. Escher asked Ms. Specht to be the executor of the will. Ms. Specht accepted that duty.
- In **January 2009,** Ms. Backsman told Ms. Specht that the estate owed approximately $6 million in federal estate tax and that UPS stock held in the estate would need to be sold to cover the tax liability.
- On **February 9, 2009,** Ms. Specht signed an application for authority to administer estate. Ms. Specht read the application and understood that being an estate executor is a serious matter and that she had obligations and responsibilities as a fiduciary.
- On **February 9, 2009,** Ms. Specht signed a fiduciary acceptance form. This form clearly defined her duties, which included filing all tax documents as required by law.
- Prior to **September 30, 2009** (the date on which the estate return was to be filed), Ms. Specht received four notices from the Probate Court warning her that Ms. Backsman was failing to perform her duties and that the estate had missed probate deadlines. Ms. Specht asked Ms. Backsman why she had missed a deadline. Ms. Backsman responded that they had an extension and that she was handling it. However, Ms. Specht never asked to see an extension nor did she sign an extension.

- On **August 13, 2010,** Ms. Specht received notification from the Ohio Department of Taxation (ODT) that the estate's Ohio return had not been filed and was delinquent. She received another letter from ODT in September 2010 about the delinquent state return. These notices should have alerted her that she needed to ask more questions, but she did not. Finally, in September 2010, Ms. Specht called ODT regarding the delinquent estate's state returns.
- On **October 27, 2010,** Ms. Specht called UPS and learned that the company had never received a letter from Ms. Backsman requesting the estate's stock be sold.
- On **November 1, 2010,** Ms. Specht terminated Ms. Backsman and hired a new attorney.

The IRS assessed mandatory penalties against the estate, because it failed to file its return and pay its tax liabilities on a timely basis. After the penalties were assessed by the IRS, the estate pursued a malpractice action against Ms. Backsman. The action was settled on January 23, 2012.

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. Because the aggregate penalty may not exceed 25% of the tax due, it takes only five months to reach the maximum penalty.

Even though Ms. Specht lacked the sophistication to single-handedly complete and file the estate's federal tax return, she did know of the deadline for filing the estate's tax return. Ms. Specht was notified by various sources that Ms. Backsman was not doing her job, but she ignored these warning signs for quite some time. The estate was fortunate that the state of Ohio refunded the late-filing penalties for Ohio estate taxes without the estate filing a refund suit. The IRS did not follow Ohio's example.

Holding. The court held that the estate was liable for the additions to tax under IRC §6651(a)(1).

GROSS INCOME

IRA Distributions

***Elroy and Darlene Morris v. Comm'r,* TC Memo 2015-82 (Apr. 27, 2015)**

IRC §408

☞ Son Held Liable for Tax on Distributions from Father's IRA

Facts. Elroy Morris was listed as the primary and sole beneficiary on the traditional IRA owned by his father, George Morris. George died on June 4, 2011. On June 15, 2011, Elroy submitted a death claim and requested a lump-sum distribution of the IRA. He also completed a federal income tax withholding notice and election form with the death claim and checked the box to elect not to have federal income tax withheld from the distribution.

During 2011, Elroy received two distributions and the corresponding Forms 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* The first Form 1099-R reported a normal distribution of $500 and $100 of tax withheld. The second Form 1099-R reported a gross and taxable distribution of $95,484 with no tax withheld. This Form 1099-R reported a distribution code of 4 for "death."

As the personal representative of his father's estate, Elroy issued checks in July 2011 to two of his siblings totaling $37,000. This amount came from the distribution of $95,484 that Elroy received in June 2011.

Elroy sought the counsel of a local law firm in settling his father's estate. A paralegal informed him that no tax was due on the IRA distribution. She evidently meant that no federal **estate tax or state inheritance tax** was due. Elroy understood her to mean that **no taxes of any kind** were due.

Elroy and his wife (Mr. and Mrs. Morris) did not report income from either IRA distribution on their timely filed 2011 federal income tax return. The IRS issued a notice of deficiency on September 30, 2013. It stated that the IRA distributions were taxable income.

Issue. The issue in this case is whether Mr. and Mrs. Morris failed to report taxable distributions from an IRA.

Analysis. IRC §61(a) provides that "gross income means all income from whatever source derived." IRC §408(d)(1) provides that unless an exception exists, any amount paid out of a retirement plan must be included in gross income by the payee or distributee. There is no exception for distributions to a beneficiary following the death of the IRA owner.

Elroy did not argue that he was required to distribute the funds to his siblings. However, he contended that he should not be solely responsible for the tax, because he voluntarily shared the distribution with his siblings. He also argued that he received erroneous advice from the law firm that assisted him in settling the estate.

The court noted that although Elroy had acted out what he believed to be his father's wishes by sharing the IRA proceeds with his siblings, his good deed did not exclude the distributions from his income. The court rejected the argument that Elroy received erroneous advice from a lawyer. The advice might have affected an accuracy-related penalty, but it would not have changed the taxable status of the distribution.

Holding. The court held that Mr. and Mrs. Morris were required to include taxable distributions of $95,984 from an IRA in their gross income.

Gross Income

***Ruey Read v. Comm'r,* TC Memo 2015-115 (Jun. 24, 2015)**

IRC §§61, 6662, and 6664

☞ Replicating Signature Not a Valid Defense

Facts. In 1998, Ms. Ruey Read opened a checking account at USAA. Her husband, Dale Bicher, was listed as her agent, and he wrote and signed checks on the account. In January 2009, a brokerage account was opened in Ms. Read's name at optionsXpress Inc. and Mr. Bicher was authorized to buy and sell stocks on the account.

On Ms. Read and Mr. Bicher's 2009 joint tax return, they reported a $7,077 stock sale from the optionsXpress account. Ms. Read later testified that she merely signed the return and was not aware of the stock sale from the optionsXpress account.

Ms. Read and Mr. Bicher separated in July 2010. Ms. Read changed the address on both the USAA and the optionsXpress accounts in June 2011.

The IRS determined that Ms. Read and Mr. Bicher failed to report $52,089 of income from stock sales, $323 in capital gains, and $433 in taxable dividend income on their 2011 joint return. The IRS assessed a penalty of $2,506 under IRC §6662(a). The parties later agreed that Ms. Read and Mr. Bicher did **not** file a joint return for 2011.

Issues. The issues in this case are as follows.

- Whether Ms. Read failed to report $52,089 of income from stock sales
- Whether Ms. Read failed to report capital gains of $323
- Whether Ms. Read failed to report taxable dividend income of $433
- Whether Ms. Read is liable for an accuracy-related penalty under IRC §6662(a)

Analysis. IRC §61(a) defines gross income as all income from whatever source derived, including gains from dealings in property and dividends. Tax on the sale of stock is imposed on the person who owns the stock that produced the income.

Ms. Read claimed that she was a victim of identity theft, because she did not know of either account. Ms. Read alleged that Mr. Bicher had fraudulently opened both accounts in her name without her knowledge. He had supposedly traced her signature from her driver's license onto the optionsXpress application and power of attorney form. The optionsXpress account application required her signature, as well as a copy of her driver's license.

Ms. Read's signature on the power of attorney form authorizing Mr. Bicher to buy and sell stocks was consistent with her signature on her driver's license and on the optionsXpress account application. The court found it unlikely that Mr. Bicher could have traced the miniature version of her signature and created a larger replica of the signature on the account application and power of attorney forms.

The court determined that Ms. Read owned and controlled the brokerage account and the checking account. Therefore, she was responsible for reporting the income from those accounts on her tax return.

Because Ms. Read did not provide any facts to show that the penalty should not apply, the court sustained the accuracy-related penalty.

Holding. The court held that Ms. Read failed to report income from stock sales, capital gains, and dividends. The court also sustained an accuracy-related penalty.

Taxable Income

***Clarence and Susan Speer v. Comm'r*, 144 TC No. 14 (Apr. 16, 2015)**
IRC §§61 and 104

☞ Lack of Substantiation Results in Taxable Income

Facts. In 2009, Clarence Speer retired from the Los Angeles Police Department (LAPD) after many years of employment. During his career, he had been granted periods of temporary disability leave because of duty-related injuries or sicknesses. The first such temporary disability occurred in 1982, and the last occurred in 2007.

When Mr. Speer retired, he received $30,773 for 541 hours of unused vacation time and $22,740 for 800 hours of unused sick leave. These payments were included as wages on his 2009 Form W-2, *Wage and Tax Statement.* On the 2009 tax return that Mr. Speer filed jointly with his wife, the couple did not include the leave payments in income.

A statement attached to the tax return explained that the income was not included because these payments had been received under a workers' compensation act. The California Labor Code provides certain police officers a leave of absence with a salary for a period of up to one year in lieu of temporary disability, which is ordinarily payable under California's Workers' Compensation Act. The Speers and the IRS later agreed that this provision was **not relevant.**

A memorandum of understanding (MOU) between the city and the Los Angeles Police Protective League outlined the employee's rights for unused sick and vacation time. An LAPD payroll supervisor stated that of the 541 hours of vacation time for which Mr. Speer was paid, 400 hours was carried over from 2008 and 141 was earned in 2009. (Four hundred hours is the maximum that can be carried from one year to the next.) Mr. Speer earned 96 hours of sick leave a year. The 800 hours of sick leave he accumulated was the maximum an employee could accumulate.

The IRS determined that the payment for unused vacation and sick leave should have been included in income and made an adjustment accordingly.

Issue. The issue in this case is whether the Speers may exclude from their 2009 gross income a lump-sum payment that Mr. Speer received for unused vacation time and sick leave.

Analysis. IRC §61 provides that gross income includes all income from whatever source derived, including compensation for services. IRC §104(a)(1) provides that gross income does not include amounts received under workers' compensation acts as compensation for personal injuries or sickness. Treas. Reg. §1.104-1(b) provides that the exclusion applies to amounts received under a statute in the nature of a workers' compensation act. Mr. Speer received the leave payments pursuant to an MOU, **which is not a workers' compensation act.**

In their argument, the taxpayers relied heavily on *Givens v. Comm'r*.[25] In that case, a Los Angeles County deputy sheriff was injured in the course of his duties and was on disability leave for more than a year. The Los Angeles County Code had a workers' compensation system that incorporated the California Labor Code and provided additional compensation after expiration of the first year of disability. Mr. Givens received payments out of his accumulated sick leave that the court determined were excludable from gross income under §104(a)(1).

The court observed that the difference between *Givens* and this case was that Mr. Speer failed to show that the sick and vacation leave cashout provisions in the MOU were part of a comprehensive workers' compensation plan covering the taxpayer.

Holding. The court determined that the payments Mr. Speer received for unused vacation and sick leave that accrued while he was on temporary disability leave must be included in his gross income under IRC §104(a)(1). The amounts were not received under a workers' compensation act for sickness or personal injuries.

Foreign Earned Income

***William and Yen-Ling Rogers v. Comm'r,* U.S. Court of Appeals for the District of Columbia Circuit; No. 13-1241 (Apr. 17, 2015)**

IRC §§911 and 6662

☞ Income Earned in U.S. Airspace Does Not Qualify for IRC §911 Exclusion

Facts. In 2007, Yen-Ling Rogers, a U.S. citizen, lived in Hong Kong and worked as an international flight attendant for United Airlines. United Airlines paid Mrs. Rogers wages of $41,762 during 2007. Mr. and Mrs. Rogers excluded all of her United wages on their self-prepared tax return as foreign earned income under IRC §911.

The IRS examined the Rogers's return and determined that only part of Mrs. Rogers's compensation from United Airlines was eligible for the foreign earned income exclusion. The IRS also assessed an accuracy-related penalty.

The Tax Court found that Mrs. Rogers could exclude only earnings related to her time spent working **in or over** foreign countries. The court reduced the tax deficiency and upheld and recalculated the accuracy-related penalty.

The taxpayers appealed the Tax Court decision. Their main argument was that the language of §911 entitled them to **exclude all of Mrs. Rogers's flight attendant income** as foreign earned income because the income was **from sources** within a foreign country.

Issues. The issues in this case are as follows.

- Whether Mr. and Mrs. Rogers may exclude total wages earned from United Airlines from gross income
- Whether Mr. and Mrs. Rogers are liable for an accuracy-related penalty under IRC §6662
- Whether Mr. and Mrs. Rogers should be awarded costs and fees associated with this case

Analysis. All income, from whatever source derived, is includable in gross income unless a specific exclusion applies. Subject to certain limitations, a taxpayer may elect to exclude their foreign earned income from gross income. IRC §911 defines foreign earned income as earned income "from sources within a foreign country or countries."

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25. *Givens v. Comm'r,* 90 TC 1145 (1988).

Mr. and Mrs. Rogers claimed that they were entitled to exclude all of Mrs. Rogers's flight attendant income as foreign earned income, because it was "from sources within a foreign country or countries." The Tax Court had previously held that Mrs. Rogers could exclude only earnings for services actually performed **in or over** foreign countries. Mr. and Mrs. Rogers claimed to have found several court cases showing a longstanding practice by the IRS and the Tax Court of allowing the categorical exclusion of earnings from foreign-based jobs. However, the Appeals Court found that none of the cases cited were on point or controlling.

Mr. and Mrs. Rogers claimed that they should not be liable for the accuracy-related penalty. However, the court determined that their claims lacked merit. In addition, they were not entitled to costs and fees because they did not prevail in their appeal and the IRS's position was substantially justified.[26]

Holding. The Appeals Court affirmed that Mrs. Rogers could not exclude all of her wages under IRC §911 as foreign earned income. In addition, the court upheld the accuracy-related penalty and denied the claim for fees and costs. The case was remanded to the Tax Court for recomputing the tax and accuracy-related penalty.

Taxable Income

Nichelle G. Perez v. Comm'r, **144 TC No. 4 (Jan. 22, 2015)**
IRC §§61 and 104

☞ Egg Donation Results in Taxable Compensation

Facts. During 2009, Nichelle Perez decided to become an egg donor for The Donor Source. The California-based Donor Source requires that prospective donors submit to a rigorous screening process and a series of psychological and physical examinations. A select few are approved. A woman who is approved creates an online profile that includes a picture, description of family history, and personal details for prospective parents to view.

The Donor Source sets the fee for first-time egg donors based on where the donor lives. The donor fee starts at $5,500 for first-time Southern California donors and increases with each subsequent donation. Donors are also reimbursed for expenses in traveling to and from medical appointments.

Future payments are contingent on prospective parents' picking out a particular donor. Once the donor is selected, she signs two contracts: one with The Donor Source and the other with the anonymous intended parents. **These contracts provide for payment in "consideration for all of her pain, suffering, time, inconvenience, and efforts."**

Ms. Perez signed her initial contracts in February 2009 and began preparing for the egg-retrieval procedure. The preparation included a series of intrusive physical examinations, invasive internal ultrasound examinations, and painful self-administered hormonal injections.

On March 27, 2009, Ms. Perez underwent anesthesia, and doctors retrieved between 15 and 20 eggs from her. After the procedure was over, Ms. Perez felt cramped and bloated; she also had mood swings, headaches, nausea, and fatigue. She received a check for $10,000.

Ms. Perez underwent the same procedure again later in 2009. On August 31, she contracted with The Donor Source and received another $10,000 for her efforts.

The Donor Source sent Ms. Perez a Form 1099 for $20,000. Ms. Perez consulted with other egg donors online and concluded that the money was not taxable income because it compensated her **only for pain and suffering.** Consequently, she did not report the money on her 2009 tax return. The IRS disagreed and assessed a deficiency on Ms. Perez's 2009 income tax return for the $20,000 of unreported income.

Issue. The issue in this case is whether Ms. Perez may exclude the amounts paid under the service contract as damages received on account of personal physical injuries or physical sickness.

26. IRC §7430(c)(4).

Analysis. IRC §61 provides that gross income includes all income, from whatever source derived, including compensation for services. One exception to this is found in IRC §104(a)(2). It provides that **a taxpayer can exclude the amount of any damages received on account of personal physical injuries or sickness.**

The court noted that Ms. Perez had a legally recognized interest against bodily invasion. However, when she gave up that interest by consenting to the intimate invasion in exchange for payment, any amount she received must be included in her taxable income. If The Donor Source or the clinic had exceeded the scope of her consent, Ms. Perez may have had a claim for damages. In fact, the injury to Ms. Perez was within the scope of the medical procedures to which she contractually consented. Her physical pain was a byproduct of her services under a contract. Thus, the payments were not to compensate her for an unwanted invasion of her bodily integrity but for the services she rendered.

The court equated Ms. Perez's situation to that of a professional boxer, hockey player, or football player. Many of these individuals receive bruises, chipped teeth, brain injuries, and other forms of bodily damage during their careers. Although some portion of their salaries reflects the risk of pain or suffering, they agree to this risk before they begin their work. This fact makes the payments they receive taxable compensation — not excludable damages.

Holding. The court determined that Ms. Perez's compensation was not damages under IRC §104(a)(2). The amount she received for her services was taxable compensation.

Gross Income

***Parimal Shankar and Malti Trivedi v. Comm'r,* 143 TC No. 5 (Aug. 26, 2014)**

IRC §61

☞ Value of Bank Reward Points Must be Included in Gross Income

Facts. Citibank issued a 2009 Form 1099-MISC, *Miscellaneous Income,* to Parimal Shankar for $668 of "other income." Mr. Shankar and his wife did not report this on their jointly filed 2009 Form 1040, *U.S. Individual Income Tax Return.* The IRS increased the couple's gross income by $668 because Citibank reported that this was the value of 50,000 "thank-you points" Mr. Shankar had redeemed to purchase an airline ticket.

Issue. Several issues were presented in this case, but the following analysis focuses on whether the thank-you points redeemed by Mr. Shankar for an airline ticket represented taxable income.

Analysis. To show that the 2009 Form 1099-MISC was accurate, the IRS produced at trial an affidavit from Marilyn Kennedy, a custodian of records for Citibank. Documents attached to the affidavit showed that Mr. Shankar redeemed 50,000 thank-you points in February 2009 to purchase an airline ticket. Ms. Kennedy also attached a letter to the affidavit that explained that $668 was the FMV of the airline ticket.

IRC §61(a) defines **gross income** to include "all amounts from whatever source derived." The IRS contended that the omitted income was a noncash award for opening a bank account. The court proceeded on the assumption that the amount in question represented a premium for making a deposit into or maintaining a balance in a bank account. The court noted that the reward was in the nature of interest and that the receipt of interest constituted the receipt of an item of gross income. Thus, the airline ticket was gross income, and Mr. Shankar failed to show that it was worth any less than $668.

Holding. The court held that Mr. Shankar and his wife must include the value of the airline ticket received in redemption of thank-you points in their 2009 gross income.

> **Note.** In its opinion, the court stressed that it was not dealing with the taxability of frequent-flyer miles attributable to business or official travel. The IRS previously stated in Announcement 2002-18[27] that it would not assert that a taxpayer has gross income because they received or used frequent-flyer miles from business travel.

27. IRS Ann. 2002-18, 2002-1 CB 621.

Statute of Limitations

***G. Douglas and Rita M. Barkett v. Comm'r,* 143 TC No. 6 (Aug. 28, 2014)**
IRC §6501

☞ Gains from Sale Used to Determine Gross Income Omission

Facts. Douglas and Rita Barkett filed their 2006 and 2007 tax returns on September 17, 2007, and October 2, 2008, respectively. During these years, the Barketts were 80.04% partners in Barkett Family Partners (a limited partnership) and 100% shareholders of Unicorn Investments Inc. (an S corporation). On their 2006 and 2007 tax returns, the Barketts reported amounts realized from the sale of investments of more than $7 million and $4 million, respectively, and total gains from such sales of approximately $123,000 and $314,000, respectively.

On September 26, 2012, the IRS issued the Barketts a notice of deficiency for the 2006 to 2009 tax years. The Barketts claimed the notice was invalid for the 2006 and 2007 returns because it was issued after the 3-year limitations period set forth in IRC §6501(a). The IRS disagreed with the taxpayers, claiming that an omission from gross income triggered the 6-year statute of limitations under IRC §6501(e)(1).

Issue. The issue in this case is whether the statute of limitations was still open with respect to the 2006 and 2007 tax years.

Analysis. IRC §6501(a) provides that a tax must be assessed within three years of filing a return. Under IRC §6501(e)(1), if the taxpayer **omits from gross income an amount that exceeds 25% of the gross income** stated in the return, the limitations period extends to **six years.**

Both parties agree that the omitted amounts were $629,850 and $431,957 for 2006 and 2007, respectively. The disagreement came over the amounts of gross income that the Barketts stated in their returns. The Barketts argued that the gross income they stated in their returns should include the amounts **realized** from the sale of investment assets. The IRS contends that it should include only the **gain** reported on the sales (amounts realized less bases of assets sold).

In *Insulglass Corp. v. Comm'r,*[28] the court considered this issue and held that "capital gains, and not the gross proceeds are to be treated as the amount of gross income stated in the return for purposes of §6501(e)." The court decided this case based on the IRC §61(a) definition of gross income, which is "all income from whatever source derived," including "gains derived from dealings in property."

Treas. Reg. §301.6501(e)-1 explains how to determine whether gross income has been omitted from a taxpayer's return. The Supreme Court addressed the validity of this regulation in *U.S. v. Home Concrete & Supply.*[29] In this case, the Court determined that the portion of the regulation concerning omitted gross income was invalid.

The Barketts argued that this decision also invalidated the regulation's instructions concerning the calculation of gross income. Consequently, they argued, the decision invalidated the decision in *Insulglass Corp.* The court in the case at hand disagreed, noting that *Insulglass Corp.* addressed **how to calculate** gross income, which is the issue here. The Supreme Court's decision in *Home Concrete* addressed **when gross income is omitted** from the return. In addition, it explained how to calculate income under the general statutory definition of **gross income.**[30]

The general statutory definition of "gross income" requires subtracting the cost from the sales price. Under such a definition of "gross income," the calculation would take (1) total revenue from sales, $40,000, minus (2) "the cost of such sales," say, $25,000.

Holding. The court held that gross income includes gains from sales of investment assets — not the entire amounts realized from such sales. Accordingly, the extended limitations period set forth in IRC §6501(e)(1) applies because the gross income omitted from the Barketts' 2006 and 2007 returns exceeded 25% of the gross income stated in those returns.

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28. *Insulglass Corp. v. Comm'r,* 84 TC 203 (1985).
29. *U.S. v. Home Concrete & Supply, LLC,* 566 U.S. ___, ___, 132 S. Ct. 1836, 1842 (2012).
30. Ibid.

IRS PROCEDURES — MISCELLANEOUS

Summons

***U.S. v. Sanmina Corp. et al.*, No. 5:15-cv-00092; U.S. District Court for the Northern District of California (May 20, 2015)**
IRC §§165(g), 7602, and 7604

☞ Memoranda Protected by Attorney-Client Privilege and Work-Product Doctrine

Facts. Sanmina Corp. (Sanmina) filed its 2009 federal income tax return on June 15, 2010. A disclosure statement was attached to the return detailing a claim for a worthless stock deduction of $503 million for its shareholdings in Sanmina International AG. During an examination of the worthless stock deduction, the IRS issued an information document request.

Sanmina produced a valuation report drafted by its outside legal counsel at DLA Piper. The report specifically disregarded an account receivable held by Sanmina International AG totaling approximately $113 million. Sanmina claimed the $113 million account receivable lacked economic substance and was merely a bookkeeping entry. DLA Piper stated in its report that it relied on two of Sanmina's memoranda to support the conclusion that the $113 million account receivable should be disregarded. According to Sanmina, the two memoranda were prepared by Sanmina's tax department counsel and were distributed to members of Sanmina's internal tax teams and accountants providing tax advice.

The IRS summoned Sanmina to appear in its offices to produce the two memoranda. Sanmina acknowledged that the two memoranda were in its possession, but it asserted that the documents were privileged and objected to producing them. Sanmina failed to appear as summoned, and it did not produce the memoranda as demanded in the summons. The IRS petitioned the court to enforce the summons.

Issue. The issue in this case is whether the two memoranda are protected by the attorney–client privilege and work-product claims.

Analysis. The attorney–client privilege protects communications between a client and their attorney related to securing legal advice. The privilege also protects legal advice provided by the attorney that would reveal confidential communications.

The IRS contended that Sanmina did not make it clear that the memoranda were prepared for legal purposes, rather than business purposes, or that the communications related to legal advice, rather than business advice. However, the court noted that Sanmina sufficiently established that the memoranda constituted tax advice from lawyers, such that the attorney–client privilege attached.

Sanmina did not waive the privilege concerning the subject matter of the report by furnishing the DLA Piper report to the IRS. (The voluntary production of privileged information may result in a waiver of all communications on the subject.) However, Sanmina distributed the attorney memos only to its counsel and accountants, which did not constitute waiver of the attorney–client privilege. In addition, furnishing DLA Piper's report to the IRS did not constitute waiver of the privilege because the report merely mentioned the existence of the memoranda; it did not summarize or disclose the content of the memoranda.

Sanmina established that both memoranda could be withheld under the work-product doctrine. The IRS contended that it was not clear that Sanmina originally created the documents in anticipation of litigation, because no litigation or audit was pending at the time the memoranda were created. However, the court determined that the memoranda analyzed complex business and legal issues relating to the worthless stock deduction. The court observed that the size of the worthless stock deduction meant that Sanmina could reasonably have anticipated that the IRS would challenge it.

Holding. The court denied enforcement of an IRS summons because the documents were protected by the attorney–client privilege and the work–product doctrine.

Fraud Detection

***Whistleblower 21276-13W et al. v. Comm'r,* 144 TC No. 15 (Jun. 2, 2015)**

IRC §7623

☞ Whistleblower May Provide Information Prior to Submitting Application for Award

Facts. In 2009, a Florida taxpayer was arrested for assisting others in illegal activities. He agreed to cooperate with the IRS, the FBI, and other government agencies to provide information about the illegal activities. As part of his agreement, the taxpayer disclosed knowledge of a foreign entity that was organized as a general partnership and assisted U.S. taxpayers in evading federal income tax. The taxpayer and his spouse lured one of the foreign entity's senior officers to the United States, where the officer was arrested and began cooperating with government officials.

The foreign entity was indicted for conspiring to hide more than $1.2 billion from the IRS. The foreign entity pled guilty and paid approximately $74 million to the U.S. government. The taxpayer was praised for his assistance and was informed about the IRS whistleblower program.

The taxpayer and his wife both submitted Forms 211, *Application for Award for Original Information,* to the IRS Whistleblower Office. The Whistleblower Office denied the applications, because they were filed after the monies had been paid by the foreign entity. The taxpayer and his wife appealed this decision.

Issue. The issue in this case is whether the taxpayer and his wife were required to file Forms 211 with the Whistleblower Office before providing information to the IRS to qualify for an award under IRC §7623(b).

Analysis. Before IRC §7623 was amended in 2006, it authorized the IRS to pay such sums as deemed necessary for detecting underpayments of tax and detecting and bringing to trial and punishment persons guilty of violating tax laws. As a result of a review by the Treasury Inspector General for Tax Administration (TIGTA), Congress enacted the Tax Relief and Health Care Act (TRHCA) of 2006 to strengthen the Whistleblower program.

At trial, the IRS argued that the statutory provisions made clear that Congress intended the IRS Whistleblower Office to serve as the gatekeeper of whistleblower information. The IRS asserted that it could maintain the discretion granted to it by TRHCA only if whistleblower information were first provided to it.

The court disagreed with the IRS's position, noting that the TIGTA report determined that audits under the previous whistleblower award program were effective; it was the process by which awards were issued that was problematic. The court observed that if the Whistleblower Office opened an examination relating to a taxpayer, such an examination would alert the taxpayer that an informant was involved. As a result, the whistleblower could be subjected to exposure and retaliation.

The court also examined Form 211. It determined that the form does not have to be completed before a taxpayer-related examination is initiated.

Holding. The court determined that the couple was eligible for an award, even though they supplied information to other federal agencies before submitting an application to the Whistleblower Office.

Lien

U.S. v. Joseph R. Rominski et al., **No. 1:12-cv-07643; U.S. District Court for the Northern District of Illinois (Oct. 17, 2014)**

IRC §§6321, 6322, and 7403

☞ Ex-Wife was Taxpayer's Nominee

Facts. Joseph Rominski, a practicing attorney, bought property in Illinois (referred to as the Red Pine property) in 1994. The Red Pine property consisted of real estate and a single-family home.

Mr. Rominski married Lorrine Wallis in September 1996. At the time of their marriage, Ms. Wallis owned a townhouse in the same area. She retained this property the entire time they were married. However, the couple resided together at the Red Pine property from 1996 through sometime in 2002 or 2003.

In March 1997, Joseph transferred the Red Pine property to Ms. Wallis via a revocable trust; doing so allowed her to dispose of the property as she saw fit. Mr. Rominski had two purposes for transferring the house: asset protection in case of possible legal malpractice creditors and facilitation of the eventual transfer of the property to his three daughters.

In December 2001, Ms. Wallis deeded the Red Pine property to herself in her individual capacity. She intended to use it as collateral for a loan, which was to be used by Mr. Rominski to pay down his tax-related debts. Ms. Wallis was not successful in obtaining the loan, so the property was not pledged. The property was never returned to the trust, because Mr. Rominski simply forgot to do so

Mr. Rominski and Ms. Wallis divorced in 2004. Ms. Wallis moved back to her townhouse. Mr. Rominski continued to reside at the Red Pine property. He paid all expenses on the Red Pine property both during and subsequent to their marriage.

Mr. Rominski had a history of filing his tax returns late, as shown in the following table.

Tax Year	When Tax Return Was Filed	Balance Due at Filing	When Balance Was Paid
1993	November 1995	Yes	March 1996
1994	June 1996	Yes	May 1998
1995	No return filed	—	—
1996	April 2001	Yes	—

As of August 31, 2012, Mr. Rominski owed $382,655 for federal income taxes. The IRS placed a lien on the Red Pine property, although Ms. Wallis was the legal title holder.

Issue. The issue in this case is whether the government's lien attaches to the Red Pine property.

Analysis. Under IRC §6321, a lien attaches to the taxpayer's property (or rights to property) when tax is assessed and remains in place until the person satisfies the liability. The lien attaches to property owned by the delinquent taxpayer at any time during the life of the lien, including property that is acquired after the assessment date.[31]

The government contended that Ms. Wallis held title to the Red Pine property as **Mr. Rominski's** nominee; in other words, **he was the true owner.** IRC §6321 has been broadly interpreted to include not only property owned by the delinquent taxpayer but also property held by a third party if it was determined that the third party was holding the property as the taxpayer's nominee or alter ego.[32]

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31. *Glass City Bank of Jeanette v. U.S.*, 326 U.S. 265, 268 (1945).

32. *Spotts v. U.S.*, 429 F.3d 248, 251 (6th Cir. 2005) (citing *G.M. Leasing Corp. v. U.S.*, 429 U.S. 338, 350-51 (1977)).

When the property was originally transferred from Mr. Rominski to Ms. Wallis, he received no consideration for the transfer. However, the couple was married and living together on the property at the time. The transfer took place about a year after Mr. Rominski had finished paying off taxes, penalties, and interest for 1993. At that time, he still had taxes, penalties, and interest due for 1994. He had not yet filed his 1995 return, and his 1996 return was not yet due.

A key issue in this case is whether Mr. Rominski transferred the property in anticipation of a lawsuit or liability. The court noted that Mr. Rominski likely was aware at the time that he was behind on his taxes. Nonetheless, the government had not demonstrated that the property transfer was motivated by a desire to avoid a levy or other expected liability. Both Mr. Rominski and Ms. Wallis provided credible testimony that he initiated the transfer for purposes of estate planning and professional liability. Mr. Rominski said that part of his motivation was to shield the property from clients who might sue him some day for malpractice. However, that was not the type of expected liability that has tended to prove that the title holder is a mere nominee. These factors clearly indicated that a legitimate transfer **originally** took place.

After the couple's February 2004 divorce, their settlement contemplated re-transfer of the Red Pine property to Mr. Rominski, but that never happened. Following the divorce, Ms. Wallis had not benefitted from the property in any way nor had she paid any expenses relating to the property.

The court noted that the property had been Ms. Wallis's in name only **since the time of the divorce.** Accordingly, Joseph Rominski was the owner of the Red Pine property, and Lorrine Wallis held the title as his nominee.

Holding. As determined by the April 5, 2013, judgment, the government's lien properly attached to the Red Pine property.

Information Returns

Field Attorney Advice (FAA) 20151002F (Jun. 6, 2014)
IRC §§6041 and 6045

☞ No Information Reporting Requirement for Freight-Hauling Services

Facts. The company and its affiliate were multistate motor freight carriers that contracted with independent operators to haul freight on trailers owned by the company or its affiliate. The company paid the independent contractors a certain percentage of the rate it charged the shipper of the goods for payment. The company also paid specified fees for loading and unloading, reimbursements for highway and bridge tolls, and referral bonuses. The affiliate paid the independent contractor a certain percentage of the rate it charged, along with a sign-on bonus when an independent operator leased a tractor unit. In the past, the company had issued Forms 1099 to independent contractors. It stopped doing so because it believed the services met the freight exception in Treas. Reg. §1.6041-3(c).

Issues. The FAA addressed the following issues.

- Whether the company is required to file information returns pursuant to IRC §6041
- Whether the company is a broker within the meaning of IRC §6045

Analysis. IRC §6041(a) requires any person who makes certain payments to another person of $600 or more during a tax year in the course of their trade or business to file an information return with the IRS.

Treas. Reg. §1.6041-3(c) provides that payments of bills for merchandise, telegrams, telephone, **freight,** storage, and similar charges are exempt from the requirements of IRC §6041. In various private letter rulings, the IRS has consistently interpreted the word **freight** to mean a method or service for transporting goods or the cost of such transportation. The freight exception has been broadly interpreted to cover the cost of transporting goods and includes payments made to independent contractors. The FAA noted that the facts provided by the taxpayer indicated but did not conclusively prove that the payments in question were exclusively for hauling freight — not for other services or bonuses, which require the filing of information returns under §6041.

IRC §6045(a) requires every person doing business as a broker to file a return that shows the name and address of each customer. The return must also include details regarding gross proceeds and other information. The Code defines a broker as a dealer, barter exchanger, or any other person who regularly acts as a middleman with respect to property or services. Treas. Reg. §1.6045-1(a)(1) further defines a broker as any person who in the ordinary course of a trade or business stands ready to effect sales to be made by others.

The regulations defining the term **broker** focus on effecting sales made by others—not on effecting the **delivery** of personal property made by others. Furthermore, the regulations do not contain any examples of a person who acts as a middleman between a service provider and a service recipient being deemed a broker. A person who merely facilitates services is not a broker.

Holding. The company was not required to file information returns under IRC §6041 for freight-hauling payments and was not considered a broker under IRC §6045.

ITEMIZED DEDUCTIONS

Mortgage Interest

***Lourdes Puentes v. Comm'r,* TC Memo 2014-224 (Oct. 27, 2014)**

IRC §§163, and 163(h)(3)

☞ Taxpayer's Mortgage Payments Do Not Result in Equitable Ownership of Property

Facts. Benjamin Puentes bought a residence in San Francisco in 2002. He made a down payment and financed the balance of the purchase price with a mortgage loan in his name. **Mr. Puentes was the sole legal owner of the home.** He made all the required mortgage payments on the home until sometime in 2009, when he became unemployed.

Lourdes Puentes, Benjamin's sister, started living in the home in 2003 when she moved to San Francisco to attend college. She continued to reside in her brother's home through at least the end of 2010.

During 2010, Benjamin remained unemployed. That year, **Ms. Puentes made all the monthly mortgage payments, even though she had no legal obligation to do so**. She also paid the property taxes and homeowner's insurance.

The mortgage lender issued a Form 1098, *Mortgage Interest Statement*, which reported that $33,097 of loan interest was paid during 2010. Even though the Form 1098 was issued to Mr. Puentes, Ms. Puentes claimed the $33,097 mortgage interest deduction on her 2010 Schedule A, *Itemized Deductions*. The IRS issued a notice of deficiency to her, which disallowed the entire deduction. This resulted in a deficiency of $4,055 for her 2010 income tax return.

Issue. The issue in this case is whether Ms. Puentes is entitled to the mortgage interest deduction as an **equitable owner of the property** legally owned by her brother.

Analysis. Treas. Reg. §1.163-1(b) provides that interest is deductible if it is paid by a taxpayer on a mortgage of real estate of which they are the legal or equitable owner. State law determines the nature of property rights, including legal or equitable ownership, whereas federal law determines the tax consequences of those rights.

Because Mr. Puentes was the sole legal owner of the property, California law presumes him to be the full beneficial and equitable owner, as well. This presumption may be rebutted only by clear and convincing proof. The court observed that Ms. Puentes provided no evidence (let alone clear and convincing proof) that she is an equitable owner of the property.

The fact that Ms. Puentes paid the mortgage and property taxes during 2010 is not sufficient to make her an equitable owner of the home. She benefited from her brother's generosity when he made those payments during 2003–2008. Likewise, Mr. Puentes benefited from his sister's generosity when she made those payments during 2010. She made these payments not because she had an ownership interest in the property but because her brother was unemployed.

Holding. Because Ms. Puentes was neither the legal or equitable owner of the property,[33] **she was not entitled to a mortgage interest deduction for the 2010 tax year.**

> **Note.** The taxpayer's 2009 tax return was examined on the same issue. The court in the earlier case also concluded that she was not an equitable owner of the property and disallowed the mortgage interest deduction.[34]

Itemized Deductions

***Matthew and Shannon Cutler v. Comm'r,* TC Memo 2015-73 (Apr. 9, 2015)**

IRC §§62 and 164

☞ Nonresident State Taxes Cannot Be Deducted on Schedule E

Facts. Matthew Cutler was a principal in the law firm of Hagness, Dickey, & Pierce PLC (HDP). HDP was a Michigan LLC treated as a partnership for tax purposes. It had offices in Michigan, Missouri, and Virginia. Mr. Cutler worked in the Missouri office. During 2007, 2008, and 2009, HDP earned income sourced to Missouri, Michigan, Virginia, Illinois, and Oregon. Mr. Cutler did not perform services in Michigan, Virginia, Illinois, or Oregon, nor did he work for clients in those states.

Mr. Cutler received Schedules K-1, *Partner's Share of Income, Deductions, Credits, etc.,* from HDP. The schedules reported Mr. Cutler's share of ordinary business income as self-employment (SE) earnings. On Mr. and Mrs. Cutler's 2007, 2008, and 2009 tax returns, they reported this income and claimed deductions for state nonresident income taxes as unreimbursed partnership expenses on Schedules E, *Supplemental Income and Loss,* as follows.

State	2007	2008	2009
Michigan	$ 9,594	$10,822	$10,223
Virginia	2,254	4,200	4,541
Illinois	95	82	43
Oregon	0	0	25
Total state nonresident income taxes	$11,943	$15,104	$14,832

The IRS determined that the taxpayers were not entitled to deduct the state nonresident income taxes on Schedules E. Instead, they were required to claim the state nonresident income taxes as itemized deductions on Schedules A, *Itemized Deductions.* This adjustment resulted in an increase in SE tax and alternative minimum tax. The IRS assessed deficiencies of $15,234, $18,443, and $15,185 for tax years 2007, 2008, and 2009, respectively.

Issue. The issue in this case is whether the taxpayers are entitled to deduct from their gross income nonresident state taxes paid on Mr. Cutler's share of partnership income from his law firm.

Analysis. Deductions are allowed "above the line" when they are "attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee."[35]

33. See Treas. Reg. §1.163-1(b).

34. *Lourdes Puentes v. Comm'r*, TC Memo 2013-277 (Dec. 9, 2013).

35. IRC §62(a)(1).

In *Tanner v. Comm'r,*[36] the court rejected a West Virginia taxpayer's attempt to take above-the-line deductions for West Virginia income tax he paid on his share of net income earned by an accounting firm of which he was a partner. In *Strange v. Comm'r,*[37] the court disallowed above-the-line deductions for state nonresident income taxes paid on net royalty income derived from oil and gas wells.

The Cutlers argued that the facts in *Tanner* and *Strange* did not apply because the nonresident income taxes in question are entity-level taxes imposed on and immediately connected with the conduct of Mr. Cutler's trade or business. These taxes were imposed directly on HDP.

The Cutlers further argued that some of the Virginia nonresident taxes in question (unlike the state taxes in *Tanner* and *Strange*) were imposed on their gross income, rather than their net income. After reviewing the facts, the court concluded that the 2008 and 2009 Virginia taxes were not entity-level taxes that were imposed directly on HDP.

The Cutlers contended that all the nonresident taxes were constructively imposed on HDP — not them. They maintained that this was necessarily so, because Mr. Cutler performed no services in any of the states generating the nonresident income taxes. However, the court pointed out that Mr. Cutler, as an HDP principal, had the authority to manage HDP's business, including its business in Michigan, Virginia, Illinois, and Oregon. The court concluded that the Cutlers did not establish that the nonresident taxes were either expressly or constructively imposed on HDP.

The Cutlers alternatively contended that the 2008 and 2009 Virginia taxes were deductible from gross income because they were imposed on their gross income, rather than their net business income. They supported this argument by referring to Temp. Treas. Reg. §1.62-1T(d), which provides that states taxes on net income are not deductible in determining adjusted gross income (AGI).

From this, the Cutlers deduced that state taxes on gross income are deductible in determining AGI. The court noted that their argument failed. The Virginia taxes in question, according to the Virginia code, were imposed on net income, rather than gross income.

Holding. The court held that the Cutlers could not deduct state nonresident income taxes paid on Mr. Cutler's share of partnership income on their Schedules E. Instead, they were required to itemize the deductions on their Schedules A.

Mortgage Interest Deduction

***Qui Van Phan v. Comm'r,* TC Summ. Op. 2015-1 (Jan. 12, 2015)**

IRC §§163, 6662, 7463, and 7491

☞ Equitable Owner Allowed Mortgage Interest Deduction

Facts. In 2008, Qui Van Phan, a California resident, moved into a house on a 3-acre ranch to assist his mother, who was unable to care for the property. Mr. Van Phan's father left the property before 2008, and his parents got divorced in 2010. As part of the divorce settlement, his mother was required to buy out his father's interest in the property.

Mr. Van Phan's mother, father, and brother held the legal title to the property. Although Mr. Van Phan wanted to buy the property, his finances would not allow it. He entered into an oral agreement with his mother and siblings to make the mortgage payments and pay the property taxes, thereby increasing his equity in the home.

Mr. Van Phan's sister and sister-in-law refinanced the mortgage loan in 2011. In 2013, his name was added to the legal title of the property.

During 2010, Chase held a mortgage on the property. Mr. Van Phan paid monthly mortgage payments of $3,958 to Chase. On his 2010 Schedule A, *Itemized Deductions,* Mr. Van Phan claimed a $35,880 deduction for home mortgage interest.

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36. *Tanner v. Comm'r,* 45 TC 145, 147-148 (1965).

37. *Strange v. Comm'r,* 114 TC 206 (2000).

The IRS disallowed Mr. Van Phan's home mortgage interest deduction and assessed an IRC §6662 accuracy-related penalty. This resulted in additional tax of $8,970 and an accuracy-related penalty of $1,794 for 2010.

Issues. The issues in this case are as follows.

- Whether Mr. Van Phan is entitled to the mortgage interest deduction for 2010
- Whether Mr. Van Phan is liable for the 20% accuracy-related penalty under IRC §6662(a)

Analysis. IRC §163(a) allows a deduction for interest paid or accrued during the tax year on indebtedness. However, IRC §163(h)(1) provides that no deduction is allowed for personal interest. Qualified residence interest is excluded from the definition of personal interest and thus is deductible under IRC §163(a).

The indebtedness generally must be an obligation of the taxpayer — not an obligation of another. Treas. Reg. §1.163-1(b) provides that even if a taxpayer is not directly liable on a note secured by a mortgage, they may deduct the mortgage interest paid if they are the **legal or equitable owner** of the property subject to the mortgage.

Federal law determines the appropriate tax consequences of property rights. However, state law determines the nature of property rights, including legal or equitable ownership. California law applies in determining Mr. Van Phan's property rights.

Under California law, the owner of legal title to property is presumed to be the owner of full beneficial title as well. If clear and convincing evidence exists, this presumption may be rebutted.

Because Mr. Van Phan's name was not added to the property's legal title until 2013, he must provide convincing evidence that he had an equitable ownership interest in the property when he made the mortgage payments in 2010.

California law provides that an individual may overcome the presumption that the legal owner is also the equitable owner. The individual may do so by showing that an agreement or understanding between the parties exists that demonstrates an intent contrary to that reflected in the deed.

At trial, Mr. Van Phan credibly testified that his family had granted him an interest in the property. Moreover, he testified that the family would allow him to add his name to the title at any time if he paid the property expenses. His name was ultimately added to the title in 2013 when his financial status improved. The court determined that Mr. Van Phan's evidence was credible and reflected his family's agreement that he was a beneficial owner of the property.

The court has held that a taxpayer may become the equitable owner of property if they assume the burdens and benefits of ownership.[38] In determining whether the burdens and benefits of ownership have been transferred to a taxpayer, the court has often considered whether the taxpayer:[39]

1. Has a right to possess the property and to enjoy the use, rents, or profits thereof;
2. Has a duty to maintain the property;
3. Is responsible for insuring the property;
4. Bears the property's risk of loss;
5. Is obligated to pay the property's taxes, assessments, or charges;
6. Has the right to improve the property without the owner's consent; and
7. Has the right to obtain legal title at any time by paying the balance of the purchase price.

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38. See *Baird v. Comm'r,* 68 TC 115, 124 (1977).

39. *Blanche v. Comm'r,* TC Memo 2001-63, *aff'd* 33 Fed.Appx. 704 (5th Cir. 2002).

Mr. Van Phan resided at the property in 2010, which was consistent with his right to possess and enjoy use of the property. He also took a number of actions consistent with performing his duties, responsibilities, and obligations under the agreement with his family. Specifically, he made the mortgage payments before, during, and after 2010. He also made the property tax and insurance payments, paid the cable bill, maintained the property, and made improvements to the property. As a result of his actions, Mr. Van Phan was granted the right to add his name to the property's legal title.

The court found that Mr. Van Phan provided clear and convincing evidence that he was an equitable owner of the property in 2010.

Holding. The court determined that Mr. Van Phan was an equitable owner of the property in 2010 and was entitled to the mortgage interest deduction. Because no deficiency existed, the IRC §6662(a) accuracy-related penalty was not applicable.

LIKE-KIND EXCHANGES

Multi-Party Exchanges

North Central Rental & Leasing LLC et al. v. U.S., **U.S. Court of Appeals, 8th Circuit; No. 13-3411 (Mar. 2, 2015)**
IRC §1031

☞ Structured Transactions Do Not Qualify as Like-Kind Exchanges

Facts. Butler Machinery Company (Butler) sells agricultural, mining, and construction equipment for manufacturers such as Caterpillar Inc. Prior to 2002, Butler conducted a leasing business in addition to its retail sales business. In 2002, Butler formed North Central Rental & Leasing LLC (North Central) as a subsidiary to take over the leasing operations.

Two months after being formed, North Central began a like-kind-exchange (LKE) program. In the program, North Central traded its used equipment for new equipment and deferred tax recognition of gains or losses from the transactions. North Central sold its used equipment to third parties, and the third parties paid the sales proceeds to a qualified intermediary, Accruit LLC. Accruit then transferred the proceeds to Butler. At about the same time, Butler bought new Caterpillar equipment for North Central, and then it transferred the equipment to North Central via Accruit. Butler charged North Central the same amount that Butler paid for the equipment.

One of the advantages that Butler received from its use of LKE transactions was favorable financing from Caterpillar. The terms of the financing arrangement gave Butler up to six months from the invoice date to pay for the equipment.

From 2004 to 2007, 398 LKE transactions took place. However, the district court focused on one transaction that was representative of the others. It involved the exchange of Truck 1 for Truck 2, Skid Steer 1, and Skid Steer 2. North Central agreed to sell Truck 1 to a third party on or before June 30, 2004, for $756,500. North Central's adjusted tax basis in the truck was $129,373. The third party paid Accruit $756,500, and ownership of Truck 1 was transferred to the third party. On September 10, 2004, Accruit transferred the $756,500 proceeds to Butler. North Central and Butler adjusted a note between themselves to compensate Butler for the $4,566 difference between the $756,500 sales proceeds and the $761,066 that Butler paid for the replacement equipment.

After the transaction was completed, the third party owned Truck 1. North Central held replacement property (Truck 2 and Skid Steers 1 and 2) and a note reflecting the $4,566 debt to Butler. Butler had $756,500 in sales proceeds from Truck 1 and the note reflecting its $4,566 credit to North Central. North Central deferred the $627,127 gain realized from the transaction.

The IRS determined that the LKE transactions were improper and proposed adjustments accordingly.

Issue. The issue in this case is whether North Central is entitled to LKE treatment under IRC §1031.

Analysis. IRC §1031(a)(1) provides that taxpayers can defer recognizing certain gains or losses when they exchange property held for productive use in a trade or business or for investment. The property must be exchanged solely for property of like kind, which is to be held for productive use in a trade or business or for investment.

After Congress enacted the LKE provisions, sophisticated parties exploited the LKE provisions in a manner inconsistent with its purpose. Congress attempted to close this perceived loophole when it passed §1031(f) in 1989. IRC §1031(f) generally prohibits nonrecognition treatment for exchanges in which a taxpayer exchanges like-kind property with a "related person" and either party then disposes of the exchanged property within two years. In addition, Congress enacted §1031(f)(4), which prohibits nonrecognition treatment for "any exchange which is part of a transaction (or a series of transactions) structured to avoid the purposes of" §1031(f).

The court noted that the transactions in question involved an intricate interplay between at least five parties. The involvement of three of the parties — North Central, Caterpillar, and the third-party customer — was necessary for the transactions to occur. However, the involvement of Butler and Accruit **was not necessary.**

The court questioned why Butler was involved at all in the transactions. North Central argued in its briefing that Butler made the transactions administratively easier and more efficient. However, the court determined that Butler's involvement added unnecessary inefficiencies and complexities to the transactions. The real reason for Butler's involvement was that the company benefited from 6-month, interest-free loans from Caterpillar.

Despite arguments to the contrary, if Butler had not been involved in these transactions, neither Butler nor North Central would have received the interest-free loans. Accruit was also an unnecessary party to these transactions. Butler and North Central could have exchanged property directly without Accruit's involvement.

Holding. The Appeals Court determined that North Central could have achieved the same property dispositions via a much simpler means. These transactions took on their peculiar structure for no purpose except to avoid IRC §1031(f). The district court's opinion that gains from the transactions were not entitled to nonrecognition treatment under §1031 was affirmed.

NOT FOR PROFIT

Business Expenses

***Denise Celeste McMillan v. Comm'r,* TC Memo 2015-109 (Jun. 11, 2015)**
IRC §§162, 163, 183, 262, and 6662

☞ Equine Activity Not Engaged in for Profit

Facts. Denise McMillan, a California resident, timely filed her 2009 tax return, which included one Schedule C, *Profit or Loss From Business,* for her information technology (IT) work and another for her equine activity.

The Schedule C for the IT activity showed a net profit of $14,809, legal and professional expenses of $26,312, and $17,913 for 50% business use of her home. The legal expenses related to misdemeanor criminal charges from a 2005 dispute between Ms. McMillan and her neighbors and her homeowners' association over various complaints.

The Schedule C for Ms. McMillan's equine activity reported zero gross income and expenses totaling $7,486. Ms. McMillan is an international dressage rider and trainer and has been in the dressage business since the mid-1970s. During 2009, she allegedly trained horses, but a moving company lost the records that documented that activity.

Ms. McMillan owned her horse, Goldrush I, from at least 1999 through January 2008. Before 1999, Goldrush sired five foals, which generated income between $1,000 and $1,500 for each foal. From 1999 through 2009, Ms. McMillan did not breed Goldrush or any other horse. In 2007, she decided to send Goldrush to Australia for breeding. Unfortunately, Goldrush died unexpectedly in January 2008 shortly after his arrival in Australia.

Ms. McMillan had a business plan for the equine activity. She wanted to purchase a horse for $25,000–$30,000, train and show the horse, and then sell it for $100,000–$1 million. However, she was not able to find the right horse to buy.

Ms. McMillan prepared a Schedule C for her equine activity every year after 2004. The only year she reported any income was in 2004. Her 2004 through 2009 tax returns showed the following.

Year	Schedule C Equine Income	Schedule C Equine Expenses	Net Schedule C Profit/(Loss)
2004	$588	$36,453	($ 35,865)
2005	0	22,277	(22,277)
2006	0	33,128	(33,128)
2007	0	51,697	(51,697)
2008	0	4,203	(4,203)
2009	0	7,486	(7,486)
Total net losses			($154,656)

The IRS disallowed Ms. McMillan's equine activity deductions for the 2007 and 2008 tax years because she failed to show that the activity was engaged in for profit. The Tax Court sustained the IRS's disallowance.[40]

The IRS examined Ms. McMillan's 2009 tax return and disallowed legal fees of $26,312 and the loss on the Schedule C for the equine activity of $7,486. The IRS also assessed an accuracy-related penalty.

Issues. The issues in this case are as follows.

- Whether the taxpayer is entitled to deduct legal expenses of $26,312 in connection with her Schedule C for the IT activity
- Whether the taxpayer is entitled to deduct a loss of $7,486 for her Schedule C equine activity
- Whether the taxpayer is liable for an accuracy-related penalty under IRC §6662(a)

Analysis. IRC §162(a) allows a deduction for ordinary and necessary expenses that a taxpayer pays in connection with the operation of a trade or business. IRC §262(a) generally prohibits a deduction for personal, living, or family expenses.

The IRS contended that the legal and professional expenses arose from Ms. McMillan's civil case against her homeowners' association and for a criminal case in which she was a defendant. The IRS asserted that these expenses were not related to her IT business. Instead, they were personal expenses, which are not deductible.

The dispute that resulted in the legal expenses arose principally because of Ms. McMillan's claims of noise and other factors interfering with her use and enjoyment of her property. The court noted that the IRS did not challenge that Ms. McMillan claimed 50% business use of her condominium or argue that the noise and other factors did not affect her business use of the unit. The court therefore concluded that 50% of the legal fees arising from the litigation over her residence should be deductible.

40. *McMillan v. Comm'r,* TC Memo 2013-40 (Feb. 7, 2013).

The IRS disallowed the expenses from the equine activity for two reasons.

- The equine activity was not a **going concern,** so Ms. McMillan was not carrying on a trade or business.
- The equine activity was not engaged in for profit pursuant to IRC §183.

With respect to the going-concern argument, the court reviewed three factors.

1. Whether the taxpayer undertook the activity intending to earn a profit
2. Whether the taxpayer was regularly and actively involved in the activity
3. Whether the taxpayer's activity had actually commenced

The IRS determined that the equine business was not a going concern and all expenses related to the activity should be disallowed because Ms. McMillan did not do any of the following.

- Own or lease a horse in 2009
- Train any horses in 2009
- Compete in any horse shows from 1999 through 2009
- Breed any horses

The court found facts supporting all the IRS contentions except the assertion that Ms. McMillan did not train any horses in 2009. Ms. McMillan testified that she did train horses in 2009 but that her records were lost by a moving company. The IRS did not prove that Ms. McMillan did not train any horses in 2009. In addition, the IRS did not dispute that Ms. McMillan has been continuously involved with horses since the 1970s. Therefore, the equine activity had actually commenced.

IRC §183(b) limits the deductions for an activity that is not engaged in for profit to the amount of income generated by the activity. The courts use a 9-factor analysis in hobby-loss cases in accordance with Treas. Reg. §1.183-2(b). Applying that analysis, the following factors **weighed in the IRS's favor.**

1. **Expectation that assets used in activity may appreciate.** There are no assets in the equine business that would increase in value. Although Ms. McMillan did own tack, the tack would not increase in value.
2. **Success of the taxpayer in carrying on other activities.** Ms. McMillan's former accountant testified that in some earlier years, the equine activity made a profit. Nonetheless, the court determined that her recent history was evidence of failure.
3. **Taxpayer's history of income or losses with respect to the activity.** The magnitude of Ms. McMillan's expenses in the equine activity from 2004 through 2009 compared with its nonexistent profits indicates that she did not have a profit motive during 2009.
4. **Amount of occasional profits, if any, which are earned.** Ms. McMillan failed to purchase a horse or to profit from the one she did own. These facts led the court to believe that her expectation of a sale at a huge profit was unrealistic.
5. **Financial status of the taxpayer.** Ms. McMillan had regular and comfortable income from her IT activity, which indicates that the equine activity was not engaged in for profit.
6. **Elements of personal pleasure.** Ms. McMillan demonstrated an affinity for dressage. Her ownership of Goldrush allowed her to remain involved, even though she no longer competed. This helps explain her incurring substantial expenses in what was a financially losing venture.

The following factors were **neutral for both parties.**

1. **Manner in which the taxpayer carries on the activity.** The IRS failed to prove that Ms. McMillan did not carry on the equine activity in a businesslike manner. Yet Ms. McMillan did not prove that she carried on the equine activity in a businesslike manner.

2. **Expertise of the taxpayer or her advisers.** The IRS argued that Ms. McMillan provided only very general information regarding her background. Ms. McMillan is plainly very knowledgeable about dressage, but she did not persuade the court as to her level of preparation for the business aspects of the activity.

3. **Time and effort expended by the taxpayer in carrying on the activity.** The IRS stated that Ms. McMillan had substantial receipts from her IT activity in 2009, that her horse died in January 2008, and that she did not own a horse in 2009. Based on these facts, it is unlikely that Ms. McMillan spent a significant amount of time in the equine activity. However, the court noted that it could not be established that Ms. McMillan spent an insignificant amount of time in the activity.

The court found the factors overwhelmingly weighed in the IRS's favor. Consequently, all Schedule C expenses were disallowed, except for $5,690 in interest expense for transporting Goldrush to Australia in 2007. IRC §163(a) allows a deduction for all interest paid on indebtedness. IRC §163(h) disallows an interest deduction for personal interest. The interest was allowed because the IRS did not prove that the equine activity was not a trade or business in 2007.

The court did not sustain the IRC §6662(a) accuracy-related penalty. The IRS did not show the absence of reasonable cause or lack of good faith.

Holding. The court allowed Ms. McMillan to deduct half of her legal expenses for the litigation that affected the use of her condominium, for which she claimed 50% business use. The court also allowed an interest expense deduction but denied other deductions for Ms. McMillan's equine activity because it was not engaged in for profit. The court did not sustain the accuracy-related penalty.

Hobby Loss

***Henry and Christie Metz v. Comm'r,* TC Memo 2015-54 (Mar. 23, 2015)**
IRC §§162, 163, 183, 212, 469, 6662, 6664, and 7491

☞ Taxpayers' Profit Motive Established Despite More Than $14 Million in Horse Farm Losses

Facts. Henry Metz's grandfather founded Metz Baking Company in Omaha, Nebraska, in 1922. In 1973, Mr. Metz moved to Sioux City to begin working in sales for the family business. Between 1966 and 1978, the company lost $500,000 to $1 million per year. Mr. Metz became president and chief operating officer around 1983. At that time, he also played a key role in turning the business around. By 1988, the company was making $1 million to $3 million per year and was building a new facility.

Around 1989, RT Holdings, a Belgian sugar business, acquired a 70% equity stake in the bakery, and Mr. Metz and his brother maintained a 30% interest. In 1994, Specialty Foods purchased the bakery in a leveraged buyout. In 2000, Earthgrains bought the business for around $650 million.

Mr. Metz received $10 million to $12 million in 1989 when the Belgians acquired a majority interest and another $10 million to $12 million in 1994 as part of the leveraged buyout with Specialty Foods. All of these proceeds were placed in an investment account with JP Morgan. From 2004 to 2007, the JP Morgan account earned between $971,000 and $1.28 million each year in interest, dividends, and capital gains.

The funds in the JP Morgan account were used as the primary source for the Metzes' Silver Maple Farm Inc. (SMF), a horse-breeding activity formed as an S corporation. Unfortunately, 2008 was a disastrous year for the Metzes' JP Morgan account because of the stock market collapse. A margin call forced the family to sell their entire stock portfolio in 2008, resulting in a $5.48 million capital gain. Moreover, the primary funding source for SMF was gone.

The Metzes bought their first Arabian horse in 1989, but they did not start operating this activity as a business until 1991. SMF was organized as an S corporation in 1991. Christie Metz was the sole shareholder, president, and secretary. Mr. Metz served as vice president and treasurer.

SMF was run out of Sioux City until the Metzes moved in 1995 to Naples, Florida, where they purchased a farm for $550,000. Naples was the ideal setting for SMF, because it is located in a strong horse and agricultural state. Even so, the move was unsuccessful. SMF's costs kept rising, and the Metzes were not getting the necessary traffic to capture potential buyers.

From 1999 through 2009, SMF lost over $14 million. **SMF never had a profitable year between 1991 and 2009, except for 2004,** when they sold the Naples property. SMF's financial information for 1999 through 2009 is summarized in the following table.

Year	Ordinary Income (Loss)	IRC §1231 Gain (Loss)	Capital Gain (Loss)	Shareholder Contributions (Distributions)	Shareholder Loans (Repayments)
1999	($1,172,178)	$ 2,693	$ 0	$1,014,000	$ 0
2000	(1,488,829)	0	0	1,381,917	28,309
2001	(1,764,339)	0	0	1,375,805	30,590
2002	(1,694,623)	489,763	0	777,295	134,824
2003	(1,249,346)	0	0	253,117	443,614
2004	(1,286,299)	2,235,705	953,797	2,070,939	(2,131,372)
2005	(1,321,730)	0	0	1,756,157	0
2006	(1,346,646)	210,983	8,443	(2,383,802)	0
2007	(1,308,333)	193,716	0	0	1,197,228
2008	(1,194,303)	23,232	0	0	1,164,705
2009	(753,766)	32,287	0	0	625,842
Total	($14,580,392)	$3,188,379	$962,240	$6,245,428	$1,493,740

The IRS examined SMF's tax returns for 2004 through 2009 and then examined the Metzes' individual returns for the same years. In May 2010, the IRS issued a notice of deficiency.

Issues. Although several issues were raised in this case, the following analysis focuses on whether the taxpayers operated SMF to make a profit.

Analysis. The courts use a 9-factor analysis in hobby loss cases in accordance with Treas. Reg. §1.183-2(b). In this case, the following factors weighed in the taxpayer's favor.

1. The Metzes conducted the horse-breeding activities in a businesslike manner.
    - They kept records in a businesslike manner. They used QuickBooks for their bookkeeping. They also hired a CPA firm to perform work related to monthly bank reconciliations, accounts payable listings, monthly profit and loss statements, workers' compensation payments, and quarterly payroll tax returns.
    - They hired a law firm to prepare written contracts for horse and semen sales.
    - They conducted extensive advertising and promotion. They also had a very attractive website that was visually competitive with the best in the world and easily navigated. The IRS conceded that this fact might indicate a global profit motive.
    - They made changes to improve profits, including taking trips outside the United States to network at large shows to generate sales.

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2. The Metzes demonstrated expertise and attempted to improve results in an unprofitable business. Their expertise was shown through the use of professional guidance and the amount of knowledge they acquired over the years related to raising horses.
3. The Metzes devoted significant amounts of time and effort to carrying out the activities during all the years in question.
4. The Metzes had at least three potential assets (land, horses, and frozen horse fluids), which showed $6.5 million in appreciation.
5. Mr. Metz turned around the Metz Baking business from one that lost $1 million loss per year to one that was profitable enough to draw corporate suitors.
6. Two of the Metzes' horses commanded $6.5 million and $5 million, respectively, in syndication fees.
7. The Metzes did not have the finances to fund the operation after the stock market crash in 2008.

The following factors were neutral for both parties.

1. Some of the losses incurred could be explained by a series of unfortunate events beyond the Metzes' control.
2. Although the Metzes enjoyed their work, many of the tasks they performed were things very few people enjoy.

The factors clearly weighed in the taxpayers' favor. Thus, the court allowed the losses for the years under consideration.

Holding. The court held that the Metzes intended to make a profit. Thus, their pass-through losses and carryforwards were allowed.

Hobby Loss
***Cheryl R. Savello v. Comm'r,* TC Memo 2015-24 (Feb. 12, 2015)**
IRC §§162, 183, 280A, 262, 267, and 6662

☞ Facts Negate IRS Hobby Loss Determination

Facts. Cheryl Savello, a retired Nevada art teacher, owned and operated Aero-tronics Model Supply Co. (Aero-tronics). Aero-tronics was a retail sales and services business that specialized in radio-controlled planes. During the years at issue (2010 and 2011), she operated the business in a 6-room building adjacent to her Idaho residence.

Ms. Savello's father owned the business until his death in 2006. While Ms. Savello was still residing in Nevada, a retired individual oversaw the daily store operations. Until Ms. Savello's retirement, her involvement was limited primarily to signing checks. After she moved to Idaho, her involvement increased.

The store was open daily from 8 a.m. to 5 p.m. It had inventory, cash registers, display cases, offices, supplies, workspace, and a telephone.

During 2010 and 2011, Ms. Savello owned four properties in Utah, Idaho, and Nevada. One of the Nevada properties, Orange Jubilee, had one master bedroom and two smaller bedrooms. Ms. Savello rented the bedrooms individually. During 2010, the master bedroom was rented to one of Ms. Savello's daughters. A smaller bedroom was rented to her other daughter, and another bedroom was rented to an unrelated tenant. During 2011, Ms. Savello rented the master bedroom to one of her daughters.

Ms. Savello's 2010 and 2011 tax returns included Schedules C, *Profit or Loss From Business,* for Aero-tronics and Schedules E, *Supplemental Income and Loss,* for Orange Jubilee. She reported the following income and expenses on her returns.

	2010		2011	
Schedule C gross receipts		$23,096		$21,585
Schedule C cost of goods sold	$15,872		$11,316	
Schedule C expenses	12,764		12,897	
Total Schedule C expenses	$28,636	(28,636)	$24,213	(24,213)
Schedule C net profit/(loss)		**($ 5,540)**		**($ 2,628)**
Schedule E rents		$ 5,100		$ 1,500
Schedule E expenses		(27,704)		(19,719)
Schedule E net profit/(loss)		**($22,604)**		**($18,219)**

The IRS examined Ms. Savello's 2010 and 2011 tax returns and determined that Aero-tronics was not a trade or business within the meaning of IRC §162. Consequently, the IRS disallowed the Schedule C expenses for both 2010 and 2011. However, the IRS allowed Ms. Savello to deduct properly substantiated Schedule C expenses on her Schedules A to the extent of Aero-tronics' gross income for each tax year.

The IRS also determined that the rental real estate losses attributable to the Orange Jubilee property were limited by IRC §280A. It therefore disallowed all Schedule E expenses for that property (except for property tax and mortgage interest, which were allowed as itemized deductions on the Schedules A). Penalties under IRC §6662(a) were also assessed.

Issues. The issues in this case are as follows.

- Whether the taxpayer is entitled to deduct ordinary and necessary business expenses for her model airplane business
- Whether the taxpayer is entitled to deductions claimed on her Schedules E
- Whether the taxpayer is liable for accuracy-related penalties under IRC §6662(a)

Analysis. IRC §162(a) allows deductions for ordinary and necessary expenses paid in connection with the operation of a trade or business. IRC §183(b) limits the deductions for an activity that is not engaged in for profit to the amount of income generated by the activity. A taxpayer must conduct the activity with a profit motive for the activity to be considered a trade or business.

Treas. Reg. §1.183-2(b) provides a list of nine factors that may be used in deciding whether a profit motive exists. The court determined that only the following factors were applicable in this case.

1. **Manner in which the taxpayer carries on the activity.** Aero-tronics was located in a detached building and had its own utilities separate from Ms. Savello's Idaho residence. The store had inventory, cash registers, a telephone, display cases, offices, supplies, and workspace. The store was open daily from 8 a.m. to 5 p.m. Ms. Savello's daughter created a website to spur sales.
2. **Expertise of the taxpayer or advisers.** Ms. Savello had previous experience in retail sales. She also retained the volunteer who worked with her father to assist with running the business.
3. **Taxpayer's time and effort.** Ms. Savello spent time assisting with sales when she was in Idaho. Her main involvement in the business was signing checks when she was not in Idaho.

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4. **History of income or losses.** The business had been breaking even or close to even in recent years. There were no other hobby shops within a 150-mile radius of Aero-tronics.

5. **Amount of occasional profits.** Ms. Savello believed Aero-tronics may have been profitable for some of the years that her father ran the business.

6. **Taxpayer's financial status.** Ms. Savello earned a modest salary from her position as an art teacher and distributions from a pension. She did not receive substantial rental income from her rental properties.

7. **Elements of personal pleasure or recreation.** Ms. Savello was not a plane hobbyist and did not know how to build the planes.

After considering all the factors, the court concluded that Ms. Savello operated Aero-tronics with the actual and honest objective of making a profit. She derived no personal pleasure from operating Aero-tronics, and she did not have substantial income to absorb recurring losses. Consequently, Ms. Savello was entitled to deduct the substantiated Schedule C expenses on her 2010 and 2011 tax returns.

Under IRC §280A, a taxpayer generally cannot claim a deduction for expenses connected to a dwelling unit that they use as a residence. A taxpayer uses a dwelling unit as a residence if they use the dwelling unit for personal purposes for the greater of 14 days or 10% of the number of days that the unit is rented at a fair rental value.[41]

Ms. Savello testified that her primary residence for 2010 and 2011 was either Sitting Bull (one of the four properties she owned) or an apartment that she leased. With respect to the Orange Jubilee property, Ms. Savello did keep a bed at that property for her personal use. She did not stay overnight at Orange Jubilee during 2010 but did so occasionally during 2011. She started living at Orange Jubilee at the end of 2011 and planned on selling the property. Ms. Savello testified that when she moved into Orange Jubilee, she lived there alone. The court did not find her testimony about her residence during the tax years to be credible.

Ms. Savello rented bedrooms during 2010 and 2011 to one or more of her daughters at fair market value. The master bedroom rented for $600 per month, whereas the smaller bedrooms rented for $350 to $400 per month. Property managers and other third parties offered to rent Orange Jubilee for $900 to $950 per month. The rent that Ms. Savello charged her daughters did not appear to be substantially below fair market value.

However, it was unclear whether all three bedrooms were rented during 2010 and 2011 and how much rent Ms. Savello received from her daughters. Ms. Savello testified that she was lenient with her daughters if they were unable to make their rent payments. Even though it appeared the rent was set at fair market value, there was no evidence of how much the daughters actually paid.

The daughters' use of Orange Jubilee was imputed to Ms. Savello. She did not meet the burden of showing that her personal use of the rental property did not exceed 14 days or 10% of the rental days. Therefore, the §280A limitation applied to her Schedules E rental real estate expenses.

Ms. Savello had a third party prepare her tax returns. At trial, she did not call the third party to testify, she failed to provide evidence that the third party was a competent professional with sufficient expertise, and she failed to prove that she provided the third party with accurate information. Consequently, she was liable for the accuracy-related penalties for the 2010 and 2011 tax years.

Holding. The court allowed Ms. Savello to deduct the properly substantiated expenses for Aero-tronics that she reported on her Schedules C for tax years 2010 and 2011. However, the IRC §280A limitation applied to her Schedule E rental real estate expenses for Orange Jubilee. In addition, Ms. Savello was liable for the accuracy-related penalties for both 2010 and 2011.

41. IRC §280A(d)(1).

PARTNERSHIPS

Self-Employment Tax

***David H. Methvin v. Comm'r,* TC Memo 2015-81 (Apr. 27, 2015)**
IRC §§761, 1401, 1402, 7491, and 7701

☞ Net Income from Oil and Gas Ventures Subject to Self-Employment Tax

Facts. In the early 1970s, David Methvin acquired working interests in several oil and gas ventures. None of these individual interests was more than 2% or 3%. Mr. Methvin's interests were governed by a purchase and operation agreement that he entered into with Stewart Varn DBA Varn Petroleum Co. (Varn) of Wichita, Kansas. Later, the interests were transferred from Varn to Egan Resources Inc.(Egan). Egan provided a yearend accounting that showed the revenues and expenses allocated to Mr. Methvin's working interests.

During 2011, Mr. Methvin's working interests generated revenues of $10,797 and expenses of $4,037. He reported the net income ($6,760) as other income on line 21 of his Form 1040. No self-employment (SE) tax was paid on this income.

The IRS subsequently determined that the $6,760 income from his working interests was subject to SE tax.

Issue. The issue in this case is whether the taxpayer is liable for SE tax on net income from his oil and gas interests.

Analysis. IRC §1401(a) imposes a tax on the SE income of every individual. **Net earnings from self-employment** are generally defined as the gross income derived from any trade or business carried on by an individual, less allowed deductions. Net SE earnings also include a taxpayer's distributable share of income or loss from any trade or business carried on by a partnership of which they are a member.

The IRS determined that Mr. Methvin's net profits from his oil and gas working interests were subject to SE tax. The IRS asserted that the income was from a trade or business carried on by a partnership or by a joint venture taxable as a partnership or through an agent. Mr. Methvin believed that he was **not engaged in a trade or business, nor was he a partner in a partnership.** He believed his minority working interests were **investments** and that his activity in these investments did not rise to the level of a trade or business.

Mr. Methvin emphasized his lack of active involvement in the operation of the wells, his lack of expertise in the oil industry, his minimal personal involvement in the day-to-day operation of the wells, and the fact that his working interests were small minority interests. However, the court noted that the trade or business was carried out through his agents.

Cokes v. Comm'r[42] presented a very similar factual and legal situation. Mr. Methvin attempted to distinguish his case from *Cokes* in two ways.

1. The taxpayer in *Cokes* owned a 42.29% working interest in an oil and gas company.
2. The operating agreements in *Cokes* allowed the interest holders to have more rights and involvement in the venture than was true in Mr. Methvin's situation.

However, the court noted that the issue is whether the taxpayer was a member of a partnership or a joint venture treated as a partnership. The taxpayer's **lack of control does not affect that issue.** Accordingly, the court determined that the two cases were not distinguishable based on the facts presented.

42. *Cokes v. Comm'r*, 91 TC 222 (1988).

Mr. Methvin also argued that the operating agreement stated that the parties had specifically elected to be excluded from the application of subchapter K and therefore could not be considered a partnership. The court held that making this election did not change the nature of the entity.

Lastly, Mr. Methvin stated that the IRS had examined this issue for previous tax years and conceded the issue administratively. Therefore, the IRS was precluded from prevailing in this case. However, it is well established that the IRS's administrative concession of an issue for one tax year **does not** preclude the pursuit of the same issue for a different tax year.

Holding. The court concluded that the working interest owners and well operators created a joint venture for operation of the wells. Accordingly, Mr. Methvin's income from the working interests was income from a partnership of which he was a member. Therefore, the income paid to Mr. Methvin for his working interests in oil and gas ventures was subject to SE tax.

PASSIVE ACTIVITIES

Passive Losses

Larry and Dora Williams v. Comm'r, **TC Memo 2015-76 (Apr. 16, 2015)**
IRC §469

☞ Self-Rental Income Must Be Recharacterized as Nonpassive

Facts. During 2009 and 2010, Larry and Dora Williams owned 100% of BEK Real Estate Holdings LLC (BEK Real Estate), an S corporation, and 100% of BEK Medical Inc., a C corporation. Mr. Williams worked full time for BEK Medical and materially participated in its business activities for purposes of IRC §469. Neither Mr. nor Mrs. Williams materially participated in BEK Real Estate or the rental of commercial real estate to BEK Medical during 2009 or 2010.

In 2009 and 2010, BEK Real Estate leased commercial real estate to BEK Medical for use in its trade or business. BEK Real Estate had net rental income in 2009 and 2010 of $53,285 and $48,657, respectively. The Williamses reported these amounts as passive income on their Schedules E, *Supplemental Income and Loss.* They offset this income with passive losses from other S corporations, partnerships, and personally owned rental properties.

The IRS reclassified BEK Real Estate's rental income as nonpassive and disallowed the taxpayers' passive losses that were claimed in excess of their adjusted passive income for 2009 and 2010.

Issue. The issue in this case is whether the income the Williamses received from BEK Real Estate in 2009 and 2010 should be recharacterized from passive to nonpassive under Treas. Reg. §1.469-2(f)(6).

Analysis. IRC §469 generally suspends the passive activity losses of an individual taxpayer until they have offsetting passive income or dispose of their entire interest in the passive activity. A **passive activity** is any activity involving the conduct of a trade or business in which the taxpayer does not materially participate.

In certain situations, Treas. Reg. §1.469-2(f)(6) requires a taxpayer to treat income from passive activities as income from nonpassive activities. Specifically, net rental activity income from an item of property is recharacterized as nonpassive if the property is rented for use in a trade or business in which the taxpayer materially participates. This is commonly referred to as the self-rental rule.

The IRS argued that during 2009 and 2010, the Williamses received income through BEK Real Estate from property that was rented to BEK Medical, in which Mr. Williams materially participated. As a result, the Williamses satisfied the two components of Treas. Reg. §1.469-2(f)(6)(i).

1. The property was rented for use in BEK Medical's trade or business activity.
2. Mr. Williams materially participated in that activity.

The Williamses made two counterarguments.

1. They argued that IRC §469 does not apply to S corporations. Thus, defining a taxpayer's activities to include those conducted through an S corporation is contrary to the statutory instructions given by Congress when it enacted IRC §469.

2. They argued that Treas. Reg. §1.469-2(f)(6) does not apply because the lessor, BEK Real Estate, did not materially participate in the trade or business of the lessee, BEK Medical.

The court disagreed with the Williamses' first argument. In numerous cases, the court has applied the passive loss limitations of §469 to taxpayers who receive income from a pass-through entity even though pass-through entities are not specifically included in the list of taxpayers to whom §469 applies.

The court also disagreed with the Williamses' second argument. It found no authority to support the Williamses' contention that the lessor — as a distinct pass-through entity — must participate in the lessee's trade or business.

The Williamses received pass-through income in 2009 and 2010 from property rented for use in a trade or business in which Mr. Williams materially participated. Accordingly, the requirements of Treas. Reg. §1.469-2(f)(6) were met, and the rental income from BEK Real Estate was recharacterized as nonpassive income.

Holding. The court held that the income Mr. and Mrs. Williams received from renting their S corporation's property to their C corporation must be recharacterized as nonpassive income, which cannot be offset with passive losses.

Passive Losses

***Jose A. and Maria Lamas v. Comm'r,* TC Memo 2015-59 (Mar. 25, 2015)**
IRC §469

☞ Court Finds That Taxpayer Materially Participated in Family-Owned Businesses

Facts. Jose Lamas, Sr., started Aljoma Lumber Inc. (Aljoma) in 1979. Mr. Lamas named Aljoma after his three children: Alejandra Lamas, Jose Antonio Lamas, and Maria Lamas Shojaee. Aljoma, located in south Florida, manufactured, treated, and distributed lumber to wholesalers throughout Florida. The company flourished under Mr. Lamas's direction until it was sold in 2007.

Mr. Lamas helped fund three businesses for his children: Continental Trust Mortgage Corp. (Continental), Adrimar Investments Corp. (Adrimar), and Shoma Development Corp. (Shoma). Each business was structured with one of his children having 60% of the shares and the other two children each having a 20% interest.

Continental provided mortgages for many south Florida homes (some built by Shoma). Adrimar invested in a payroll service business that did work for Continental and Shoma and in other real estate projects. Aljoma sold lumber to wholesalers, who sold the lumber to contractors, who built homes for Shoma.

In 2004, Shoma formed Greens at Doral LLC, a condominium conversion project. Shoma and Greens were closely related entities. The intent was to liquidate Greens after the conversion project was completed.

Shoma had four major projects underway during 2008, which required additional cash infusions. Jose Antonio Lamas and David Flinn — a trusted business adviser of the elder Mr. Lamas — worked to find investors and purchasers for Shoma's projects, attempting to overcome Shoma's capital deficit.

During 2008, Jose Antonio worked at least 691 hours for Shoma and Greens. His work included discussing Shoma business with David Flinn, identifying potential project investors and purchasers, promoting Shoma projects to potential investors and purchasers, and working at Shoma headquarters.

In addition to his work for Shoma, Jose Antonio participated in other real estate activities in 2008. Through a company called Bella Vista Capital Partners LLC, Jose Antonio provided financing to the Bella Vista condominium conversion project. Jose Antonio worked for the Bella Vista project in 2008 for at least 294 hours.

The IRS examined the 2006 and 2008 tax returns of Jose Antonio and his wife. During the audit, Maria Lamas Shojaee's husband, Masoud Shojaee, made inconsistent statements to the IRS about the work that Jose Antonio performed for Shoma. Mr. Shojaee had originally submitted a notarized statement stating that Jose Antonio regularly and continuously worked on behalf of Shoma. After a family dispute involving Mr. Shojaee's activities, Mr. Shojaee changed his story. He stated that Mr. Lamas **did not perform any significant work for Shoma and Greens.** He also stated that Jose Antonio had no direct or indirect involvement with Shoma. Following another family dispute, Mr. Shojaee wrote a contradictory letter to the IRS stating that Jose Antonio did not materially participate in Shoma.

The IRS issued a notice of deficiency of $4.9 million to Jose Antonio and his wife for their 2006 tax return. This deficiency related to the IRS's recharacterization of the Lamases' 2008 net operating losses (NOLs) from Shoma and Greens as passive rather than nonpassive. The Lamases had claimed the losses as a tentative carryback adjustment to 2006 and received a tentative refund for that year. In the notice of deficiency, the IRS reduced the NOL allowed for 2006.

Issue. The issue in this case is whether Jose Antonio materially participated in Shoma and Greens during 2008. If he did, then the net losses from Shoma and Greens are not subject to the passive loss limitation of IRC §469.

Analysis. IRC §469 generally suspends the passive activity losses of an individual taxpayer until they have offsetting passive income or dispose of their entire interest in the passive activity. A **passive activity** is any activity in which the taxpayer does not **materially participate.**

At trial, Jose Antonio and his wife had **12 witnesses who testified or submitted stipulated testimony credibly** showing the significant effort that Jose Antonio expended in working on Shoma, Greens, Bella Vista, and another project during 2008. The IRS called four witnesses, only one of whom contradicted the Lamases' witnesses.

Generally, taxpayers materially participate if they are involved in the operations of a trade or business on a regular, continuous, and substantial basis. Temp. Treas. Reg. §1.469-5T provides seven tests to determine whether a taxpayer has materially participated, and a taxpayer only needs to satisfy one of the tests. Satisfying one of these tests provides that the taxpayer can satisfy the material participation requirement if they participate in the trade or business activity for more than 500 hours during the tax year.

The court first reviewed whether it was appropriate to aggregate the hours that Jose Antonio worked in 2008 for Shoma and Greens and treat them as a single activity. Treas. Reg. §1.469-4(c) sets forth five factors to use in determining whether activities constitute an appropriate economic unit for this purpose. After examining the evidence, the court noted that Shoma and Greens constituted an appropriate economic unit and should be grouped as a single activity. As a result, Jose Antonio's participation in Shoma qualified as work for Greens.

The court noted that the Lamases presented credible testimony to show that Jose Antonio worked at least 691 hours for Shoma and Greens during 2008. Accordingly, the court determined that Jose Antonio worked more than 500 hours in 2008 for Shoma and Greens and therefore materially participated in this activity.

Holding. The court determined that Jose Antonio Lamas materially participated in Shoma and Greens during 2008. Therefore, the passive loss limitation of IRC §469 did not apply to the losses the Lamases incurred for that year.

Passive Loss Limitations

***Richard S. Leyh and Ellen O'Neill v. Comm'r,* TC Summ. Op. 2015-27 (Apr. 13, 2015)**
IRC §§469 and 6662

☞ Revised Log Demonstrates Taxpayer Materially Participated in Rental Activity

Facts. Taxpayers Richard Leyh and Ellen O'Neill (Leyh's wife) resided in Dripping Springs, Texas. They had a rental real estate activity that consisted of 12 rental properties: 11 were single-family residences, and one was a condominium unit. Ms. O'Neill worked regularly in the rental real estate activity, but Mr. Leyh did not. Ms. O'Neill handled some of the repairs, most of the maintenance on the properties, all of the renting activities (advertising, interviewing, and vetting potential tenants), the paperwork, the bookkeeping, and the research for acquiring additional rental properties. Her onsite rental activities required her to drive 45 to 55 minutes each way.

The taxpayers deducted a $69,531 loss from the rental real estate activity on their 2010 return. This reduced their nonpassive income.

The IRS examined the 2010 tax return. The taxpayers provided a log to support their position that they were entitled to deduct the real estate losses from their nonpassive income. The log included details about the time Ms. O'Neill spent in the activity, such as dates, types of activities, and numbers of hours. The log showed **632.5 hours** in the activity. However, it **did not contain the hours** Ms. O'Neill **spent traveling from her home to the rental properties.**

After meeting with the IRS examiner, Ms. O'Neill **revised the log to include travel time to properties;** the total then came to 846 hours, but the IRS refused to accept the revised documentation. The IRS also imposed an accuracy-related penalty under IRC §6662(a).

Issues. The issues in this case are as follows.

- Whether Ms. O'Neill performed more than 750 hours of service in her rental real estate activity and was therefore entitled to deduct losses from nonpassive income under IRC §469
- Whether the taxpayers are liable for the 20% accuracy-related penalty under IRC §6662(a)

Analysis. IRC §469 generally disallows a deduction attributable to a passive activity loss that is used to reduce nonpassive income for any tax year. An exception to the general rule applies to taxpayers who qualify as real estate professionals. To qualify as a real estate professional, a taxpayer must meet two requirements.[43]

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

The IRS agreed that Ms. O'Neill met the first requirement, but it asserted that she did not satisfy the 750-hour requirement based on the original log she provided. The IRS argued that the **revised log** was insufficient to remedy the shortfall in the original log. The court determined that although the revised log contained some minor discrepancies, it showed that Ms. O'Neill clearly met the 750-hour requirement.

Holding. The court determined that the taxpayers could apply real estate rental losses against nonpassive activity income and were not liable for the 20% accuracy-related penalty under IRC §6662(a).

> **Note.** The material participation rules continue to be a litigation focal point. Since 2012, the Tax Court has heard approximately 13–15 cases annually. These cases generally involve whether the taxpayer has met one of the material participation tests or the adequacy of the taxpayer's documentation. In the first seven months of 2015, the Tax Court has heard eight such cases.

43. IRC §469(c)(7)(B).

RESIDENCES

Income-Producing Property Deductions

***Robert and Pamela Redisch v. Comm'r,* TC Memo 2015-95 (May 19, 2015)**
IRC §§165, 212, and 6662

☞ Expenses and Losses on Secondary Residence Not Allowable

Facts. Robert and Pamela Redisch enjoyed visiting Florida to spend some time away from Robert's duties as a veterinarian. In April 2003, they bought land in Hammock Dunes — a private, oceanfront community — for $125,000 with the intention of building a home on the land. The couple later returned to Hammock Dunes to meet with an architect, and they rented an oceanfront condominium. After spending time in the condo, they decided to sell the land and buy an oceanfront condo instead.

The Redisches sold their land for $200,000 in the fall of 2003. In April 2004, they bought an oceanfront condo (the Porto Mar property) for $875,000. This condo was a seasonal home; the Redisches never intended it to become their primary residence. They made some cosmetic changes to the condo and spent time there with their daughter until 2006, when she tragically passed away.

After their daughter's death, the Redisches no longer enjoyed staying in the condo because of the memories associated with their daughter. They decided to rent out the condo with the idea of eventually selling it. Mr. Redisch contacted a realtor to assist with the property rental. They wanted to rent the property under a 1-year lease that included the option to assume Mr. Redisch's golf membership. The Redisches received inquiries from two potential renters, but neither rented the property. One wanted it for only two months, and the other had a large dog — both of these were issues that conflicted with condo restrictions.

Because the Redisches were unsuccessful in renting the condo, they listed it for sale in August 2009 with a different realtor. They still hoped to rent it but felt they had to look at all their options. Other owners in the building were losing their properties to foreclosure, and the Redisches were worried about how this would affect their asking price. Their property sold in December 2010 for $725,000, and their furniture sold for $80,000.

The Redisches' 2009 and 2010 tax returns were prepared by a paid return preparer. Both returns claimed deductions relating to the Porto Mar property on Schedules E, *Supplemental Income and Loss.* The 2010 return reported the sale of the Porto Mar property as a long-term capital loss. That return was later amended to treat the sale as an ordinary loss.

The IRS examined the tax returns and assessed deficiencies of $77,793 and $89,155 for tax years 2009 and 2010, respectively. Penalties under IRC §6662(a) were also assessed.

Issues. The issues in this case are as follows.

- Whether the Porto Mar property was converted to a property held for the production of income
- Whether the taxpayers are entitled to an ordinary loss deduction on the sale of the Porto Mar property
- Whether the taxpayers are liable for accuracy-related penalties under IRC §6662(a)

Analysis. Under IRC §212, taxpayers are entitled to deduct all ordinary and necessary expenses paid or incurred during the tax year for the management, conservation, or maintenance of property held for the production of income. Whether an individual converts personal property to property held for the production of income depends on the facts and circumstances. The court often looks to **five factors** to determine the taxpayer's intent.

1. The length of time the house was occupied by the individual as their residence before it was placed on the market for sale
2. Whether the individual permanently abandoned all further personal use of the residence
3. The character of the property
4. Offers to rent
5. Offers to sell

An individual can claim a loss under IRC §165(a) on property purchased as a primary residence if the property is rented or otherwise used for income-producing purposes. The Redisches used the Porto Mar property for four years. They then allegedly signed a 1-year agreement with a realty company to rent the property but **did not provide any other evidence of such an agreement**. Mr. Redisch stated that the efforts of the realty company to rent the property were limited to featuring it in a portfolio kept in the company's office and telling prospective buyers that it was available when showing it as a model. He did not testify that other tactics were used to rent it. No evidence was provided to show efforts taken by the second listing agent for the condo's lease or sale, other than a copy of the multiple-listing service agreement.

The court determined that **no bona fide attempt was made** to rent the property. Consequently, the Redisches were not entitled to ordinary and necessary expense deductions under IRC §212. Moreover, the couple was not entitled to a loss deduction under §165 relating to the Porto Mar property, because it was not converted to a property held for the production of income.

The Redisches had a paid return preparer complete their returns. However, they provided no information about the paid return preparer or what information the preparer used to complete the returns. As a result, the IRC §6662(a) accuracy-related penalties were sustained.

Holding. The court held that the Redisches were not entitled to deduct losses under IRC §165 or expense deductions under IRC §212 for their secondary residence because they did not successfully convert it to property held for the production of income. The accuracy-related penalty was sustained.

RETIREMENT

Tax on Early Distribution

***Charles D. Trainito v. Comm'r,* TC Summ. Op. 2015-37 (Jun. 23, 2015)**
IRC §§72(t) and 108

☞ Diabetic Liable for Additional Tax on Early Distribution

Facts. Charles Trainito was diagnosed with type 2 diabetes in 2005. He managed his diabetes poorly over the years and took various medications to regulate the symptoms of the disease. In October 2010, Mr. Trainito resigned his position with the Boston Department of Environmental Health (DEH), because he was unable to perform the tasks required.

In June 2011, Mr. Trainito complained of nausea, vomiting, diarrhea, weakness, and a scratchy throat. When family members could not reach him, they contacted Emergency Medical Services (EMS). EMS personnel discovered Mr. Trainito unconscious in his home and determined that he was in a diabetic coma. Mr. Trainito spent over a month in the hospital recovering from the coma and related complications, including fevers and pneumonia. Muscle atrophy from the coma reduced Mr. Trainito's use of an arm and a leg, and he was unable to perform basic tasks, such as tying his shoelaces.

On April 22, 2011, Mr. Trainito received a distribution of $22,511 from his retirement savings account. He filed his 2011 Form 1040, *U.S. Individual Income Tax Return*, along with a Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*. On the Form 5329, Mr. Trainito claimed the distribution was exempt from the 10% additional tax on early distributions because he was permanently disabled.

During 2011, Wells Fargo canceled $3,186 of debt held by Mr. Trainito. Mr. Trainito did not report any of the debt cancellation on his 2011 income tax return. He claimed the income was exempt under IRC §108(a)(1)(B), which excludes amounts received from income if the discharge occurs when the taxpayer is insolvent.

Issues. The issues in this case are as follows.

- Whether Mr. Trainito is liable for the 10% additional tax for an early distribution from a qualified retirement plan
- Whether Mr. Trainito had cancellation-of-debt income of $3,186

Analysis. A taxpayer who receives an early distribution from a qualified retirement plan is generally subject to a 10% additional tax under IRC §72(t)(1). An exception to this general rule applies to distributions attributable to a disability.[44] An individual is considered disabled if they are "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration."[45] To be eligible for the disability exemption, Mr. Trainito had to prove he was disabled **at the time of the retirement distribution.**

Mr. Trainito provided medical records relating to the diabetic coma he experienced on June 12, 2011. He provided no medical records relating to the period before the coma, including records before April 22, 2011, the date of the retirement plan distribution. Mr. Trainito testified that he saw his primary doctor twice a month between his diagnosis in 2005 and his resignation from the DEH in October 2010. However, he did not produce any medical records from that period supporting his claim of disability, nor did his doctor testify on his behalf.

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44. IRC §72(t)(2)(A)(iii).

45. IRC §72(m)(7).

As an alternative argument, Mr. Trainito contended that he was disabled on April 22, 2011, because of depression. However, he did not produce any records documenting that he experienced depression at any time before the retirement plan distribution in 2011. His uncorroborated testimony was not enough to establish a case for disability due to depression.[46]

Gross income includes all income from whatever source derived, including income from the discharge of indebtedness.[47] However, if the taxpayer is insolvent at the time of the discharge, they can exclude the amount by which they are insolvent from gross income.[48] **Insolvency** is defined as the excess of the taxpayer's liabilities over the fair market value of their assets.[49] Mr. Trainito did not provide any documentation demonstrating insolvency as of the date that Wells Fargo discharged his indebtedness. Because Mr. Trainito did not prove he was insolvent, he must include the $3,186 of cancellation of indebtedness in his gross income.

Holding. The court held that Mr. Trainito was liable for the 10% additional tax on an early distribution from a retirement plan. He was also required to include in his gross income the $3,186 from the cancellation of his debt.

Prohibited Transaction

***Terry and Sheila Ellis v. Comm'r,* U.S. Court of Appeals, 8th Circuit; No. 14-1310 (Jun. 5, 2015)**

IRC §§72(t), 408, 4975, and 6662

☞ Payment of Wages Funded by IRA Is a Prohibited Transaction

Facts. In May 2005, CST Investments LLC (CST) was formed to sell used automobiles in Harrisonville, Missouri. CST's operating agreement listed two members: a self-directed IRA belonging to Mr. Ellis and Richard Brown, an unrelated person. The IRA provided an initial capital contribution of $319,500 for 98% ownership in CST, and Mr. Brown purchased the remaining 2% for $20.

Mr. Ellis's IRA did not exist when CST was formed. He established the IRA in June 2005 and transferred $254,206 from a 401(k) with a previous employer. An additional 401(k) rollover was deposited into the IRA in August 2005. Mr. Ellis then directed the IRA to purchase CST shares for $319,500. By the end of 2005, the IRA had a fair market value (FMV) of $321,253, which consisted of its membership interest in CST and $1,773 in cash.

As CST's general manager, Mr. Ellis had full authority to act on behalf of the company. For his services as general manager, he was paid a salary of $9,754 in 2005 and $29,263 in 2006. These amounts were reported as wages on his tax returns.

The IRS sent Mr. Ellis and his wife a notice of deficiency, which identified a 2005 income tax deficiency of $135,936, or, alternatively, a 2006 deficiency of $133,067. The notice also imposed accuracy-related penalties and a late-filing penalty for 2006. The notice explained that Mr. Ellis engaged in prohibited transactions by directing his IRA to acquire an interest in CST with the expectation that the company would employ him. These transactions resulted in the IRA losing its status as an IRA and making its entire FMV taxable income.

The Tax Court upheld the IRS's determination that Mr. Ellis engaged in a prohibited transaction. The Ellises appealed the decision.

Issue. The issue in this case is whether Mr. Ellis engaged in a prohibited transaction by having CST pay him wages in 2005.

46. See, for example, *Kowsh v. Comm'r,* TC Memo 2008-204 (Aug. 28, 2008); see also *Dwyer v. Comm'r,* 106 TC 337 (1996).

47. IRC §61(a)(12).

48. IRC §108(a)(1)(B).

49. IRC §108(d)(3).

Analysis. IRC §4975 limits the allowable transactions for certain retirement plans, including IRAs. It imposes an excise tax on prohibited transactions between a plan and a disqualified person. If a disqualified person engages in a prohibited IRA transaction, the plan loses its status as an IRA. Consequently, the IRA's FMV as of the first day of the tax year is deemed distributed and included in the disqualified person's gross income.[50]

The Tax Court determined that Mr. Ellis engaged in a prohibited transaction by allowing CST to pay him a salary in 2005. The wages came mostly from funds the company received from Mr. Ellis's IRA. By allowing this, Mr. Ellis engaged in an indirect transfer of the income and assets of the IRA for his own benefit.

In the Ellises' defense, they relied on the Plan Asset Regulation, 29 CFR §2510.3-101. Specifically, they argued that a prohibited transaction did not occur, because Mr. Ellis's salary was drawn from CST's corporate account — not from the assets or income of the IRA. However, the court noted that IRC §4975(c) prohibits both direct and indirect self-dealing of the income or assets of a plan. The Plan Asset Regulation cannot be read to nullify this general rule against self-dealing.

The Ellises also argued that the payment of wages in this particular instance was exempt under IRC §4975(d)(10). IRC §4975(d)(10) excludes from the list of prohibited transactions the receipt by a disqualified person of any reasonable compensation for services rendered in the performance of their duties with the plan. However, this exemption applies only to compensation for services rendered in the performance of plan duties. Because CST compensated Mr. Ellis in his capacity as general manager, rather than for services related to his IRA, §4975(d)(10) does not apply.

Holding. The 8th Circuit upheld a deficiency against the Ellises and imposed related penalties. The court found that Mr. Ellis engaged in a prohibited transaction when he directed a business that was owned by his IRA to pay him compensation.

Prohibited Transaction

In re: Bruce Bernard Nolte, **No. 14-36676, U.S. Bankruptcy Court for the Eastern District of Virginia (May 5, 2015)**
IRC §§408 and 4975

☞ Debtor Did Not Engage in Prohibited Transaction

Facts. In October 2005, Bruce Nolte opened an IRA with Davenport Trust Company (Davenport). This managed account gave Davenport the discretion to invest the assets held in the IRA. In 2007, Mr. Nolte requested that Davenport invest $100,000 in Cristol LLC, which gave the IRA a 5% ownership interest in Cristol. In late 2007, Mr. Nolte was appointed a member of Cristol's board of managers, effective January 15, 2008. Mr. Nolte did not receive any compensation for serving as a board member. Cristol ceased operations in 2009, and Mr. Nolte resigned from the board the same year.

In May 2014, Mr. Nolte rolled over the IRA from Davenport to Middleburg Trust Company. The IRA still held the worthless shares of Cristol.

Mr. Nolte filed a Chapter 11 voluntary petition on December 16, 2014. On December 29, 2014, he filed his required bankruptcy schedules, including a schedule of claimed exemptions. He filed an amended schedule of claimed exemptions on January 29, 2015.

On March 3, 2015, MT Technology Enterprises LLC (MT) filed an objection to the debtor's claimed exemptions. Mr. Nolte then filed a motion to dismiss, to which MT responded by filing a memorandum in opposition. At the hearing on the exemptions objection and the motion to dismiss, the court overruled MT's objection with the sole exception of whether there was a "prohibited transaction" with respect to Mr. Nolte's IRA.

50. IRC §408(e)(2).

Issue. The issue in this case is whether Mr. Nolte's claimed exemption in an IRA should be allowed.

Analysis. IRC §408(e)(2)(A) provides that when a prohibited transaction is entered into under IRC §4975 by the individual or beneficiary of an IRA, the account ceases to be an IRA as of the first day of the tax year. IRC §4975(c)(1)(E) defines a **prohibited transaction** to include an "act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in **his own interests or for his own account."**

The court stated that Mr. Nolte's purchase of a 5% interest in Cristol through his IRA was not a prohibited transaction. There was no allegation that the Cristol transaction involved an exchange of property, extension of credit, or furnishing of goods, services, or facilities between Mr. Nolte and the IRA. The court found no suggestion that Mr. Nolte used the IRA assets for his own benefit, other than as the IRA beneficiary.

In Ltr. Rul. 8009091, the IRS stated that a corporate director's purchase of 5% of the corporation's stock through the director's IRA does not by itself constitute a prohibited transaction. Accordingly, the court found that the Cristol transaction did not constitute a prohibited transaction.

Holding. The bankruptcy court allowed Mr. Nolte's claimed exemption in an IRA, because he did not engage in a prohibited transaction under IRC §4975.

Taxable Income

***Ralim S. El v. Comm'r,* 144 TC No. 9 (Mar. 12, 2015)**
IRC §§72, 72(t), 6651, and 6673

☞ Loan from Retirement Plan Is a Deemed Distribution

Facts. During 2009, Ralim El worked for the Manhattan Psychiatric Center as an assistant. He received $48,001 as wages, which was reported on a Form W-2, *Wage and Tax Statement.*

Mr. El was also a member of the Employees' Retirement System (ERS) through the Manhattan Psychiatric Center. In April 2009, he borrowed $5,993 from his ERS account. He had also received loans from his ERS retirement account in previous years. After ERS distributed the loan proceeds to Mr. El, his retirement account showed that his total contributions to his ERS retirement plan were $17,071 and his outstanding loan balance was $12,802.

At the end of 2009, ERS determined that $2,802 of Mr. El's loan proceeds were taxable for 2009 and issued a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*

Mr. El did not file a tax return for 2009.

Issues. Although several issues were raised in this case, the following analysis focuses on whether Mr. El failed to report withdrawals from his retirement account as taxable income totaling $2,802.

Analysis. A loan is not a taxable distribution from a qualified employer plan if it meets certain conditions. Under IRC §72(p)(2)(A), the exemption applies only when a loan (when added to the outstanding balance of all other loans from the plan) does not exceed the lesser of the following.

1. $50,000 reduced by the excess (if any) of:
   - **a.** The highest outstanding balance of loans from the plan during the 1-year period ending on the day before the date on which such loan was made, over
   - **b.** The outstanding balance of loans from the plan on the date on which such loan was made
2. The greater of:
   - **a.** Half of the present value of the nonforfeitable accrued benefit of the employee under the plan, or
   - **b.** $10,000

After Mr. El received the 2009 distribution from his retirement plan, his loan balance was $12,802. This was $2,802 more than the greater of half of his nonforfeitable accrued benefits (i.e., half of $17,071), or $10,000. Accordingly, Mr. El's deemed distribution for 2009 was $2,802.

Holding. The court determined that Mr. El should have included the $2,802 distribution in his 2009 income.

TAX FRAUD

Fraud

William J. Kardash Sr. et al. v. Comm'r, **TC Memo 2015-51 (Mar. 18, 2015)**
IRC §6901

☞ Shareholders Liable as Transferees for Fraudulent Transfers

Facts. Florida Engineered Construction Products Corp. (FECP) made precast concrete products that were often used in home construction. The company was owned by four individuals. Two of the individuals, Mr. Stanton and Mr. Hughes, were heavily involved in all aspects of FECP's business and controlled both the direction and management of the company. The other two individuals, Mr. Kardash and Mr. Robb (collectively, the taxpayers), were the company's engineer and sales team manager, respectively.

During the Florida housing boom in the early 2000s, FECP experienced both growth and profitability. Annual revenues peaked in 2006 at more than $100 million. However, the company failed to report any income to the IRS for the years 2005 through 2007.

Until 2001, FECP had financial audits. After the company paid off its line of credit, the financial audits were no longer performed. About this time, Mr. Hughes and Mr. Stanton began to transfer all the company's pretax profits to themselves. In addition, they made sure they received both interest and dividend payments. The interest payments were based on fictitious loans recorded on the books that were never actually made to FECP. Mr. Kardash and Mr. Robb both received dividend payments in addition to their usual salaries, but they did not receive any interest payments.

Before 2003, FECP had a bonus program, under which the four owners received hundreds of thousands of dollars of additional income. FECP suspended the bonus program, but Mr. Hughes and Mr. Stanton decided to give Mr. Kardash and Mr. Robb bonus "advances" in 2003 and 2004. Receiving these advances would allow them to maintain their high standards of living. Mr. Stanton told Mr. Kardash and Mr. Robb that these advances were loans and did not have to be reported on their tax returns. The loans would have to be repaid in the future. However, no loan agreement was signed by either party, and no interest was paid on the loans. FECP ultimately forgave these loans in 2009.

The IRS audited Mr. Kardash and Mr. Robb and recharacterized the advances as dividends includable in their income.

The IRS determined that FECP owed $120 million in taxes, penalties, and interest for the years at issue. After making collection attempts, the IRS agreed to let FECP pay $70,000 each month until the amount owed was fully paid. However, it would take FECP more than 150 years to pay the full liability. The IRS reached agreements to recoup some of the amounts owed from Mr. Hughes's estate and from Mr. Stanton. The IRS then sought to recover many of the transfers received by Mr. Kardash and Mr. Robb, as follows.

	Amounts to be recouped from...	
Year	**Mr. Kardash**	**Mr. Robb**
2003	$ 250,000	$250,000
2004	300,000	200,000
2005	1,549,990	199,890
2006	1,955,000	255,000
2007	57,500	7,500
Total	$4,112,490	$912,390

Issue. The issue in this case is whether the taxpayers are liable as transferees for payments they received.

Analysis. The IRS hired an expert to evaluate FECP's solvency. The expert used both the asset accumulation approach and the market approach to determine solvency. The **asset accumulation approach** (which the expert stated was the most appropriate) found FECP to be insolvent during all of 2005 through 2007. The **market approach** revealed insolvency from January 27, 2006, through March 23, 2007.

The taxpayers hired another expert to evaluate FECP's solvency, who calculated the value using three methods. That expert concluded that FECP was solvent prior to and on December 31, 2006. However, between January 1 and December 31, 2007, it became insolvent.

IRC §6901(a) provides the IRS with a remedy for enforcing and collecting a transferor's existing liability from the transferee of the property. The IRS can establish transferee liability if a basis exists under state law for holding the transferee liable for the transferor's debts.

The taxpayers argued that they were not liable as transferees, because the IRS failed to exhaust collection efforts against more culpable parties. They argued that the IRS's installment agreement plan with FECP eliminated their transferee liability. However, the court noted that the installment agreement plan does not preclude the taxpayers from facing transferee liability. The IRS was not required to exhaust collection efforts against FECP or against Mr. Stanton and Mr. Hughes before pursuing transferee liability.

The IRS contended that the taxpayers were liable as transferees. The transfers they received were actually and constructively fraudulent. The facts established that Mr. Hughes and Mr. Stanton organized a scheme to defraud the IRS. Even so, the IRS did not establish that the payments the taxpayers received were part of this scheme.

The court analyzed the two groups of transfers separately (2003–2004 and 2005–2007). The 2003–2004 "advance" transfers were determined to be compensation in lieu of bonuses, for which FECP never expected repayment. The taxpayers did not sign loan agreements or make interest payments. These payments were not constructively fraudulent.

Mr. Kardash and Mr. Robb argued that the transfers from 2005 through 2007 were compensation for services performed and that they gave "reasonably equivalent value" for the transfers. The IRS contended that the transfers were dividends and that Mr. Kardash and Mr. Robb did not give reasonably equivalent value for the transfers. The court stated that it would find any of the transfers during those years constructively fraudulent if FECP:

1. Was insolvent at the time of the transfer or became insolvent as a result of the transfer;
2. Was engaged in or was about to engage in a business or transaction for which its remaining assets were unreasonably small in relation to the business or transaction; or
3. Intended to incur or believed or reasonably should have believed that it would incur debts beyond its ability to pay as they became due.

Under Florida law, a company is solvent if the fair market value of its assets equals or exceeds the sum of its debts. An analysis of the experts' reports showed that FECP was insolvent once the dividends were transferred to the shareholders beginning in 2005—basically stripping the company of its assets. The court found that FECP was solvent for the years 2003 and 2004 and insolvent for the years 2005 through 2007. Accordingly, the transfers made in 2005 through 2007 were constructively fraudulent under Florida statutes.

Holding. The court held that the transfers received by Mr. Kardash and Mr. Robb in 2005 through 2007 when the company was insolvent were constructively fraudulent under Florida law. Accordingly, Mr. Kardash and Mr. Robb were liable as transferees under §6901(a) for those years.

Fraudulent Information Returns

***David Shiner v. Bernard Turnoy*, No. 1:13-cv-05867; U.S. District Court for the Northern District of Illinois (Jul. 11, 2014)**
IRC §7434

☞ Insurance Agent Liable for Willfully Filing False Form 1099

Facts. David Shiner and Bernard Turnoy were both insurance agents. They entered into an agreement under which Mr. Turnoy was to pay Mr. Shiner half of the commissions from the sale of two life insurance policies that were ultimately issued in November 2012. Mr. Turnoy said that he received $298,120 in commissions, but Mr. Shiner insisted the actual amount of commissions was significantly higher.

In December 2012, Mr. Shiner sent Mr. Turnoy a demand letter stating that he would sue if he did not receive additional documentation from Mr. Turnoy by December 17 verifying the commission amount that was to be divided. Mr. Turnoy responded on December 17 by sending a check to Mr. Shiner for $149,060, which was half of the $298,120 that Mr. Turnoy maintained he received in commissions. On the reverse side of the check, it stated "endorsement constitutes full & absolute release/hold-harmless by Shiner &/or all interested persons/parties, as per cover letter."

On the next day, Mr. Shiner filed a lawsuit charging Mr. Turnoy with breach of contract. Mr. Shiner did not negotiate or deposit the check.

Mr. Turnoy told his accountant that he had sent Mr. Shiner a check for $149,060 in December 2012. He did not inform his accountant that Mr. Shiner disputed the amount or that the check contained a restrictive endorsement. At Mr. Turnoy's direction, the accountant filed a Form 1099 for $149,060 and sent a copy to Mr. Shiner in January 2013.

Mr. Shiner then brought an action against Mr. Turnoy, charging that the Form 1099 was false because he had never accepted a payment and that Mr. Turnoy had committed tax fraud under IRC §7434 by willfully filing a false information return.

Issue. The issue in this case is whether Mr. Turnoy violated §7434 by willfully filing a false information return.

Analysis. IRC §7434 provides that a person may bring a civil action for damages against any person who willfully files a fraudulent information return for payments purportedly made to the plaintiff. Mr. Shiner argued that the Form 1099 was false, because Mr. Turnoy never actually paid him $149,060. The court noted that Mr. Shiner never cashed the check and ultimately returned it to Mr. Turnoy. However, checks are usually considered taxable income at the time of receipt, regardless of whether they are actually cashed. Under Treas. Reg. §1.451-2(a), an individual who does not accept payment may still be in "constructive receipt" of the income.

> *Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.* ***However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.*** *[Emphasis added]*

Mr. Shiner contended that the restrictive endorsement language on the back of the check qualified as "substantial limitations or restrictions." The court observed that when Mr. Turnoy included a restrictive endorsement on his check to Mr. Shiner, he transformed it from a simple payment into an offer of payment subject to a condition. Mr. Turnoy would not actually have made the payment unless Mr. Shiner had affirmatively accepted that offer by negotiating the check. Mr. Shiner could not have accepted the check without jeopardizing his legal position as to the sum he demanded from Mr. Turnoy.

That being the case, Mr. Shiner was not in constructive receipt of payment from Mr. Turnoy in 2012. Therefore, Mr. Turnoy's Form 1099 reporting that he paid Mr. Shiner was false.

Next, the court considered whether Mr. Turnoy acted willfully in filing the incorrect Form 1099. **Willful,** in this context, connotes a voluntary, intentional violation of a legal duty.[51] The court stated that it found no good-faith basis on which Mr. Turnoy could have believed that he had paid Mr. Shiner at the time he filed the Form 1099. Mr. Turnoy knew that Mr. Shiner disputed the commission amount and had threatened legal action. When Mr. Turnoy placed the restrictive endorsement language on the check, he presented Mr. Shiner with the option to reject the proffered payment or to compromise his legal position by accepting it.

Mr. Turnoy took the position that by sending a check containing a restrictive endorsement, he was both making a payment and fully satisfying a disputed debt — regardless of whether the check was accepted. The court rejected this contention and stated: "That preposterous argument is no better than an attempt to have his proverbial cake and eat it too: conditioning the check by inserting a restrictive endorsement, thus expecting to use Shiner's acceptance of the check as protection from future liability, while simultaneously insisting that the check itself constituted payment to Shiner regardless of whether it was actually accepted."

Finally, Mr. Turnoy attempted to escape liability by asserting that he filed the Form 1099 based on his accountant's advice. However, he did not disclose all the relevant information to the accountant. Relying on the advice of a tax professional can establish good faith only if the taxpayer provides all necessary and accurate information to the tax professional.[52]

Holding. The court concluded that Mr. Turnoy violated §7434 by willfully filing a false information return.

TRAVEL AND TRANSPORTATION EXPENSE

Travel Expenses

***Shalom Jacobs v. Comm'r,* TC Summ. Op. 2015-3 (Jan. 20, 2015)**
IRC §§162, 262, and 6662

☞ "Tax Turtle" Cannot Deduct Travel Expenses

Facts. Shalom Jacobs began his truck-driving career in 2002. Most of his trips involved long-haul jobs that lasted for weeks and months. He drove his own truck part of the time, but he sold the truck in late 2006.

In 2007, Mr. Jacobs worked for a travel-trailer delivery service, for which he received $7,000 of income. He **forgot** to include this $7,000 as income on his 2007 federal income tax return.

In 2009, Mr. Jacobs returned to long-haul trucking. He received gross income of $180,000 in 2009 but reported only $135,000 on his federal income tax return.

When Mr. Jacobs was not on the road, he stayed in the guestroom of his longtime friend Shimon Casper. The home that Mr. Casper shared with his wife and children in Cottage Grove, Minnesota, was an American-style kibbutz. It re-created the communal life of Israel, with everyone contributing everything they had and taking only what each needed. Mr. Jacobs claimed that he contributed around $10,000 per year to the kibbutz, but he had no evidence to substantiate this claim.

Issues. The issues in this case are as follows.

- Whether Mr. Jacobs is entitled to additional depreciation in 2009 for the truck he sold in 2006
- Whether Mr. Jacobs is entitled to per diem meal expenses for 2009
- Whether Mr. Jacobs is liable for the 20% accuracy-related penalty under IRC §6662(a)

51. *Vandenheede v. Vecchio,* 541 Fed.Appx. 577 (6th Cir. 2013).

52. *Neonatology Assocs., P.A., v. Comm'r,* 115 TC 43 (2000), *aff'd* 299 F.3d 221 (3d Cir. 2002).

Analysis. At trial, Mr. Jacobs neither testified nor gave the court any proof that he was entitled to deduct additional depreciation for tax year 2009 on the truck that he sold in 2006. Accordingly, the court ruled in favor of the IRS.

IRC §162(a)(2) allows a taxpayer to deduct reasonable and necessary travel expenses incurred while away from home in pursuit of a trade or business. IRC §262(a) denies deductions for any personal, living, or family expenses. To deduct travel expenses, Mr. Jacobs had to show that he actually was away from home. For a taxpayer who does not have a principal place of employment, tax law defines their home as the permanent residence at which they incur substantial continuing living expenses. If a taxpayer is constantly on the move, they are an itinerant, or "tax turtle."

Rev. Rul. 73-529 lists three factors to help determine if a taxpayer is an itinerant.

1. Business connection to the locale of the claimed home
2. Duplicative nature of the taxpayer's living expenses while traveling and at the claimed home
3. Personal attachments to the claimed home

The court looked at each factor and found the following.

1. Mr. Jacobs stayed at the Caspers' home for his convenience and because of his affection for the Caspers.
2. Mr. Jacobs did not provide evidence to show that he financially contributed to the Caspers' home, let alone that these expenses duplicated those he incurred when on the road.
3. Mr. Jacobs spent more time in California than in Minnesota. Also, when he stayed at the Caspers' home, he occupied the guest room. Other visitors used this room when they visited the kibbutz.

After reviewing these factors, the court found Mr. Jacobs to be an itinerant worker, whose tax home followed him on the road. Thus, he was not entitled to deduct per diem meal expenses.

A taxpayer may be able to avoid an accuracy-related penalty if they can show that they relied on the advice of a tax professional. Mr. Jacobs claimed to have relied on a qualified licensed professional tax preparer. However, he did not provide the tax preparer with all the necessary documentation to prepare his return. Moreover, the preparer he chose for 2009 was an interior designer who became a truck driver and then an unlicensed tax preparer. The preparer had a website that had not been updated in nearly 15 years and had had no tax training for at least nine years.

Holding. The court determined that Mr. Jacobs was not entitled to additional depreciation or per diem meal expenses for 2009. He was liable for the 20% accuracy-related penalty under IRC §6662(a).