Chapter 6: Rulings and Cases

Please note. Corrections were made to this workbook through January of 2017. 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 contains selected cases, revenue rulings, revenue procedures, Treasury regulations, announcements, and letter rulings issued during the past year, through approximately July 31, 2016. 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 is not intended to be a comprehensive coverage of all tax law changes. 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
- 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 who 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)**).

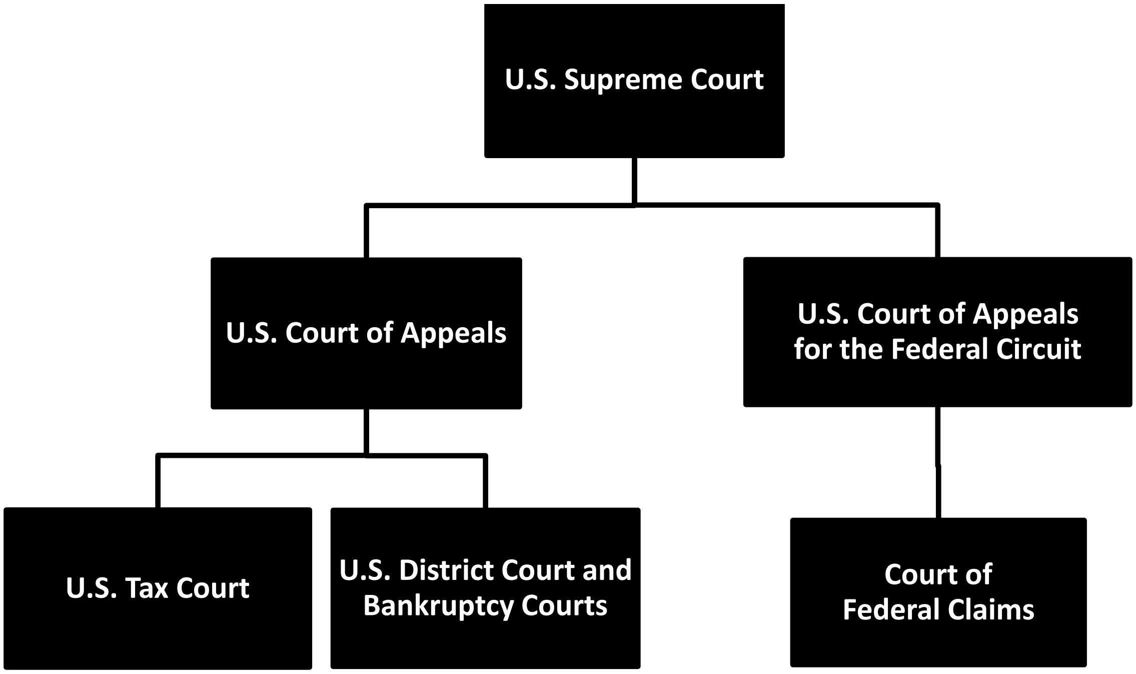
General Council Memoranda (GCM). GCMs detail the legal reasoning behind the issuance of a revenue ruling.

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

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

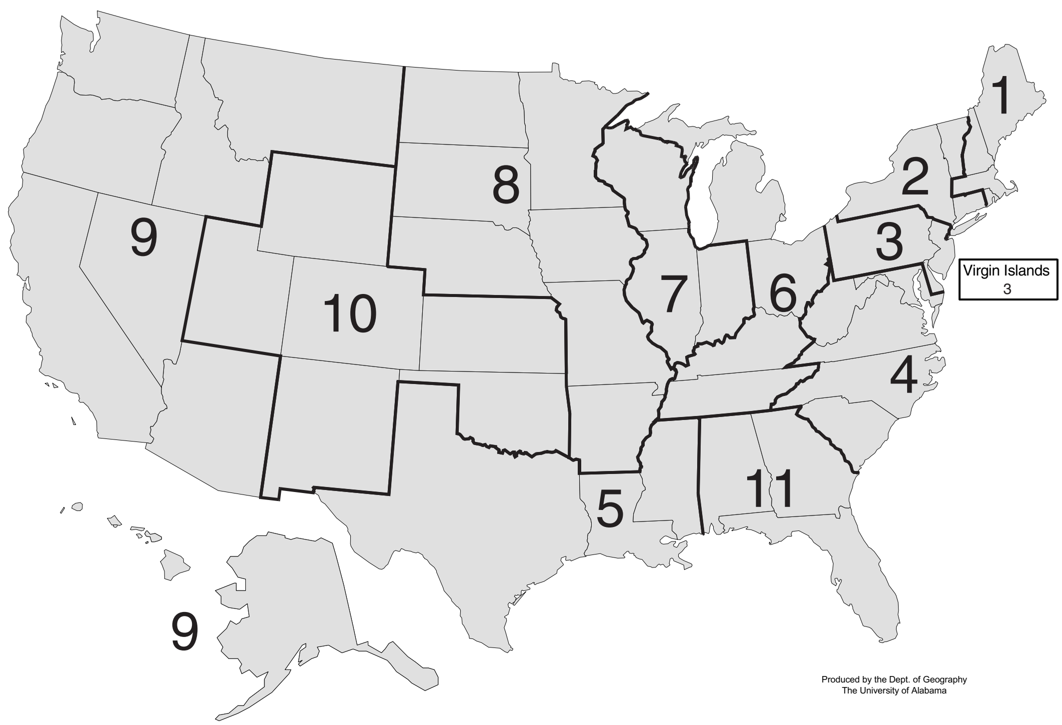
A Tax Court opinion or memorandum opinion may be appealed in a U.S. Court of Appeals. However, a taxpayer who commences their case in the U.S. Court of Federal Claims must appeal their case to the U.S. Court of Appeals for the Federal Circuit.

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

***Patricia D. Clark v. Comm'r,* TC Memo 2015-175 (Sep. 9, 2015)**
IRC §§61(a)(12), 6050P, and 6201

☞ Individual Does Not Have Cancellation of Debt Income

Facts. Patricia Clark purchased a 1996 vehicle for $13,547 in December 1999. She paid $1,000 down and financed the balance over 60 months at an annual rate of 21.5%. The contract provided information about late fees, the buyer's promise to pay, sale of a repossessed vehicle, and the seller's ability to assign all rights of the contract without recourse. After Ms. Clark signed the contract, the dealership assigned the contract to AmeriCredit.

By 2005, Ms. Clark had defaulted on the terms of the contract, and the vehicle was repossessed in March 2005. It sold at auction in June 2005 for $1,300. After the auction proceeds were applied to her account, Ms. Clark still owed $4,497 as of July 2005.

AmeriCredit attempted to collect the debt. Over the next few years, AmeriCredit assigned the debt to five separate third-party debt collectors in hopes of recouping their money. The assignment to third-party debt collectors began in May 2006 and ended in June 2011. None of the collection efforts were successful.

AmeriCredit discharged the outstanding principal balance on August 25, 2011, and issued a Form 1099-C, *Cancellation of Debt,* for $4,497. The Form 1099-C was issued to Ms. Clark but was returned to the sender because of an incorrect address.

On her 2011 tax return, Ms. Clark **did not report** any income from the discharge of indebtedness. The IRS assessed a tax deficiency of $1,472.

Issue. The issue is whether the forgiveness of Ms. Clark's loan gave rise to cancellation of indebtedness income

Analysis. IRC §61(a)(12) provides that gross income includes income from discharge of indebtedness. The regulations provide that indebtedness is discharged on the date of the occurrence of an identifiable event.[6] An **identifiable event** occurs during a calendar year if a creditor has not received a payment on a debt at any time during a testing period ending at the close of the year. The testing period is generally 36 months.

At trial, Ms. Clark argued that the debt cancellation occurred when AmeriCredit failed to receive payment on a debt over a 36-month period that ended in December 2008. Therefore, the debt should have been discharged in 2008.

The IRS argued that because AmeriCredit took collection actions during the testing period, the presumption that an identifiable event occurred in 2008 is negated. The regulations provide that the presumption that an identifiable event has occurred may be rebutted if the creditor (or third-party collection agency on behalf of the creditor) engaged in **significant, bona fide collection activity** at any time during the 12-month period ending at the close of the calendar year.[7]

The IRS established that Ms. Clark's debt was assigned at times to five separate third-party debt collectors. However, the IRS could not show what collection activities were actually undertaken.

Holding. The court **determined that absent evidence of significant, bona fide collection activity** by the five third-party debt collectors, the discharge of debt occurred in 2008. Accordingly, Ms. Clark did not have any discharge of indebtedness in 2011 and therefore had no related income.

6. Treas. Reg. §1.6050P-1(b)(2)(i)(H).

7. Treas. Reg. §1.6050P-1(b)(2)(iv).

IRA Prohibited Transaction

***Barry and Dana Kellerman v. Randy Rice et al.*, No. 4:15-cv-00347; U.S. District Court for the Eastern District of Arkansas (Sep. 14, 2015)**

IRC §§408 and 4975

☞ Prohibited Transaction Results in Loss of IRA's Exempt Status

Facts. Barry Kellerman created a self-directed IRA that was valued at $180,000 at the commencement of the bankruptcy case for him and his wife. Mr. and Mrs. Kellerman claimed the IRA as an exempt asset under 11 USC §522(d)(12).

The bankruptcy trustee contended that the IRA lost its exempt status in 2007 when Mr. Kellerman directed the IRA to engage in prohibited transactions involving disqualified persons as defined by the Internal Revenue Code. The transaction at issue involved the acquisition and development by the IRA and Panther Mountain (partnership owned 50% each by Barry and Dana Kellerman) of approximately four acres of real property. To acquire and develop the tract, the IRA and Panther Mountain executed a partnership agreement. The agreement provided that the IRA was to contribute land valued at $122,831 and cash of $40,524 and the partnership was to contribute $166,354.

The IRA purchased the 4-acre tract. On December 5, 2007, the IRA paid $40,524 to develop the property.

Shortly after the Kellermans began their bankruptcy proceeding on June 30, 2009, Panther Mountain filed its own Chapter 11 bankruptcy. Panther Mountain listed both the Kellermans and the IRA as unsecured creditors.

The bankruptcy court determined that the IRA engaged in **prohibited transactions** that caused it to lose its tax-exempt status. The court found that Panther Mountain used the IRA as a lending source for the purchase price and development of the 4-acre tract of land in violation of IRC §4975(c)(1)(B). The bankruptcy court also found that Barry Kellerman dealt with the income and assets of the IRA as a fiduciary for his own interest in violation of IRC §4975(c)(1)(E). Accordingly, the bankruptcy court concluded the Kellermans could not claim any interest in the IRA as exempt under the Bankruptcy Code.

Issue. The issue is whether the debtors' IRA can be claimed as exempt under 11 USC §522(d)(12) of the U.S. Bankruptcy Code.

Analysis. The U.S. Bankruptcy Code allows debtors to exempt retirement funds that are in an account exempt from taxation under IRC §408. An IRA is exempt from taxation unless the individual or beneficiary of the IRA engages in a transaction prohibited under IRC §4975. If this occurs, the account ceases to be an IRA as of the first day of the tax year.

IRC §4975(c)(1)(E) defines **prohibited transaction** to include an act by a disqualified person when they deal with the income or assets of a plan in their own interests or for their own account. During the bankruptcy court proceeding, the Kellermans conceded that they and Panther Mountain are disqualified persons.[8] Therefore, the remaining question is whether the IRA engaged in prohibited transactions with disqualified persons.

IRC §4975(c)(1)(E) states that a **prohibited transaction includes an act by a disqualified person who is a fiduciary when that person deals with the income or assets of a plan in their own interest or for their own account.** The District Court found that the Kellermans, who are disqualified persons, stood to benefit from the development of the 4-acre tract and adjoining land. Barry Kellerman as a fiduciary dealt with the IRA's assets for his benefit, which caused the IRA to lose its tax-exempt status.

Holding. The court concluded that the IRA lost its exempt status as of January 1, 2007, which is prior to the filing of bankruptcy. Therefore, the Kellermans cannot include the IRA as an exempt asset under 11 USC §522(d)(12).

8. See IRC §4975(e)(2).

BUSINESS EXPENSES

Uniform Capitalization Rules

***Frontier Custom Builders, Inc. v. Comm'r,* U.S. Court of Appeals, 5th Circuit; No. 14-60518 (Sep. 16, 2015)**
IRC §263A

☞ Custom Homebuilder Must Capitalize Owner's Compensation

Facts. The IRS disputed certain deductions that Frontier Custom Builders, Inc. claimed for the 2005 tax year. These deductions mostly consisted of employee salaries and bonuses, including $1.318 million paid to the company's founder, president, and CEO, Wayne Bopp. The IRS determined that most of the salaries at issue should have been capitalized, rather than deducted, under the uniform capitalization rules of IRC §263A.

Under §263A, **producers of real property** must capitalize all their production costs. Frontier is subject to these rules because it designs, builds (through contractors), and sells custom homes and improvements on real property. Capitalizable production costs include both direct and indirect costs of production.

Applying these rules, the IRS determined that most of Frontier's deducted amounts were capitalizable service costs. **Capitalizable service costs** are those service costs that "directly benefit or are incurred by reason of the performance of the [taxpayer's] production. . . activities."[9]

The IRS sent a notice of deficiency to Frontier and Frontier filed a petition with the Tax Court seeking redetermination of the alleged deficiency. The Tax Court denied Frontier's request for relief, stating that it was required to uphold the IRS's calculation method unless that method was "clearly unlawful" — a clear abuse of discretion. The Tax Court noted that Frontier failed to provide sufficient evidence that most of Mr. Bopp's time was spent on deductible services. Because Frontier failed to show "that no substantial portion of [Mr. Bopp's] time was spent on production-related activities," the Tax Court deferred to the IRS's calculation method and entered a final tax deficiency of $365,899. Frontier appealed to the 5th Circuit.

> **Note.** For more information about the Tax Court case, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Rulings and Cases. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

Issue. The issue is whether the IRS abused its discretion when it determined that compensation paid to Mr. Bopp should be capitalized under IRC §263A.

Analysis. In challenging the deficiency, Frontier argued that it is exempt from the §263A requirements because its primary business in 2005 was sales and marketing, not production-related services. In addition, Frontier contended that even if it is subject to §263A, Mr. Bopp's compensation should not be capitalized because his work involved management, overall company policy, accounting, strategic planning, and marketing, selling, or advertising.

In reviewing the evidence in the case, the Circuit Court determined that the findings of fact are not clearly erroneous and that the IRS's calculation method does not represent an abuse of discretion. Although much of Mr. Bopp's time was spent managing the company, the evidence shows that a substantial portion of his activities directly benefitted production. Some of his activities included designing homes that were later produced, creating the processes and procedures for building homes, selecting developers and reviewing subcontractors, resolving issues that arose at worksites during production, meeting with project managers about production timelines, and evaluating project managers' productivity reports.

9. Treas. Reg. §1.263A-1(e)(4)(ii)(A).

Holding. The court upheld the Tax Court's opinion that Mr. Bopp's activities support the IRS's capitalization of his compensation. Accordingly, the IRS did not abuse its discretion.

> **Note.** Mr. Bopp should have prepared a spreadsheet breaking out his different job responsibilities to determine how much of his time was spent **managing** the company and how much time was spent on **production-related services.** Mr. Bopp would then have had a much better opportunity to argue with the IRS about his capitalized salary amount versus the ordinary income portion.

Medical Marijuana

Canna Care, Inc. v. Comm'r, **TC Memo 2015-206 (Oct. 22, 2015)**
IRC §§162 and 280E

☞ IRC §280E Precludes Expense Deductions for Medical Marijuana Dispensary Business

Facts. Bryan and Lanette Davies, parents of six children, ran into financial hardship. After much prayer, Mr. Davies believed God wanted him to open a medical marijuana dispensary to solve his family's financial burdens.

Canna Care, Inc. was incorporated on July 5, 2005, under California laws. Mr. and Mrs. Davies, along with Jeff Cowen, were the officers and directors of Canna Care, Inc.

Canna Care, Inc. was located in a 2,250-square-foot space in a business park. The lobby was open to the general public and included a table with medical marijuana pamphlets, legal information, and free bibles. Once the receptionist verified the client's written physician recommendation, the client was allowed to walk down the hall to a locked sales area where marijuana was sold. Customers paid for medical marijuana or other products (e.g., books, T-shirts, and hats) and were not charged a membership fee.

Canna Care filed timely tax returns for the years at issue. The IRS disallowed various expenses claimed on the returns under IRC §280E.

Issue. The issue is whether Canna Care can deduct claimed expenses.

Analysis. IRC §162 generally allows a taxpayer to deduct ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. However, IRC §280E provides that no deduction is allowed for any amount paid or incurred during the tax year in carrying on any trade or business if the trade or business consists **of trafficking in controlled substances prohibited by federal law.**

In *Californians Helping to Alleviate Medical Problems*, *Inc. v. Comm'r* (*CHAMP),*[10] the court held that there were two separate businesses — one for caregiving services and one for a medical marijuana business — and that the taxpayer could deduct the expenses attributable to its caregiving services. The taxpayer believes the decision in *CHAMP* was incorrect because CHAMP was a single entity involved in two distinct activities that were **not** two separate businesses. The court disagreed with the taxpayer's logic.

In the case at hand, the taxpayer sold medical marijuana and other items. The parties stipulated the taxpayers were in the business of distributing medical marijuana. Based on the evidence presented, the court could not determine what percentage of the taxpayer's income was from the sale of medical marijuana and what percentage was from the sale of other items. Because of the taxpayer's stipulation, the court found that the sale of medical marijuana was the taxpayer's primary source of income and that the sale of any other items was an activity incident to its business of distributing medical marijuana.

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10. *Californians Helping to Alleviate Medical Problems*, *Inc. v. Comm'r,* 128 TC 182 (2007).

The taxpayer argued that its actions cannot be considered trafficking for purposes of §280E because its activities were not illegal under California law. This is supported by memoranda issued by the Department of Justice on October 19, 2009, and August 29, 2013, along with guidance issued by the Financial Crimes Enforcement Network on February 14, 2014. However, in *Olive v. Comm'r,*[11] the court held that the sale of medical marijuana under California law constitutes trafficking within the meaning of §280E.

Holding. The court disallowed all Canna Care's claimed expenses pursuant to IRC §280E.

Business Expenses

***H.W. Johnson Inc. v. Comm'r,* TC Memo 2016-95 (May 11, 2016)**
IRC §162

☞ Level of Involvement Justifies Significant Compensation

Facts. H.W. Johnson and his wife Margaret began a sole proprietorship concrete contracting business out of their home in 1968. In 1974, they incorporated under the name of H.W. Johnson Inc. (HWJ). Mr. Johnson handled the operations and Mrs. Johnson handled the financial and administrative matters.

Two of their sons (Bruce and Donald) began working for the business as teenagers in the 1970s. Each worked full time after they completed their education. Their level of involvement continued to increase until 1993, when they took over the daily operations. Mr. and Mrs. Johnson made gifts of the corporate stock to the boys. When Mr. Johnson retired, Bruce and Donald each had 24.5% of the shares and became co-vice presidents and members of the board of directors. Mrs. Johnson retained a 51% interest.

In 1993, HWJ had $4 million in contract revenue. The revenue figure increased steadily over the years and reached $38 million in 2004.

A reliable supply of concrete was critical to the success of this business. Bruce and Donald tried to convince Mrs. Johnson that they needed to invest in a concrete supplier to ensure a reliable supply. She felt the proposal was too risky and refused to entertain the idea. In 2003, Bruce and Donald, acting through a company called D.B.J. Enterprises, LLC (DBJ), partnered with other investors to form Arizona Materials LLC to conduct a concrete supply business. DBJ owned a 52% interest in Arizona Materials. Bruce and Donald invested additional money in Arizona Materials and guaranteed its indebtedness.

Arizona Materials was able to obtain cement even when market shortages of cement occurred. In addition, Arizona Materials gave HWJ bulk discounts for large concrete purchases. At the end of 2004, HWJ paid $500,000 to DBJ. The board meeting minutes stated that the payment was for a guaranteed supply of concrete at market prices for the year ended June 30, 2004.

Each May, HWJ held annual board meetings to determine officer compensation, director's fees, and dividends. For 2003 and 2004, Bruce and Donald received compensation as follows.

	2003	2004
Bruce	$2,013,250	$3,651,177
Donald	2,011,789	3,649,739
Total	$4,025,039	$7,300,916

11. *Olive v. Comm'r,* 139 TC 19 (2012).

HWJ had a bonus formula, under which total potential bonuses were calculated in proportion to the company's annual contract revenue and added to a "bonus pool." The bonus pool ranged from 16% to 20% depending on the level of contract revenue. The bonuses for Margaret, Donald, and Bruce varied from year to year. From 1993–1995, no bonuses were paid. From 1996–2004, the bonuses ranged from $775,000 to $3.4 million.

The IRS examined HWJ's tax returns and determined that $2.6 million and $5.6 million of officer compensation deductions for 2003 and 2004 were unreasonable; therefore, the compensation deductions were disallowed. In addition, the IRS disallowed $500,000 claimed as an administrative fee expense paid to DBJ for 2004.

Issues. The issues in this case are as follows.

- Whether the amounts that HWJ deducted for 2003 and 2004 for officer compensation paid to Bruce and Donald exceeded reasonable compensation
- Whether the company is entitled to deduct a $500,000 payment in 2004 to DBJ Enterprises, LLC

Analysis. IRC §162(a)(1) permits a taxpayer to deduct a reasonable allowance for salaries or other compensation for personal services actually rendered as an ordinary and necessary business expense. The court applies five factors to determine the reasonableness of compensation, with no one factor being determinative.

1. **Employee's role in the company** — Bruce and Donald were integral to HWJ's success during the years at issue. They were responsible for contract billing, onsite management, personnel supervision, and equipment modification to meet specific project requirements. The increase in revenue from $4 million in 1993 to over $38 million in 2004 was at least partly due to their management. **This factor weighs in the taxpayer's favor**.
2. **Comparison of compensation paid by similar companies for similar services** — The IRS conceded that HWJ's performance so exceeded that of any of the companies identified by the experts as comparable that compensation comparisons are not meaningful. HWJ's experts calculated officer's compensation as 18.4% and 20.9%, respectively, of gross revenue for 2003 and 2004 but the industry average was 2.2%. **The court concluded this factor was neutral.**
3. **Character and condition of the company** — HWJ experienced remarkable revenue, profit margin (before officer compensation), and asset growth during the years at issue. **This factor weighs in the taxpayer's favor.**
4. **Potential conflicts of interest** — If the company's earnings on equity after payment of compensation is at a level that would satisfy an independent investor, there is a strong indication that the employee is providing compensable services and that profits are not being siphoned out of the company disguised as salary. All parties agree that HWJ had pretax returns on equity of 10.2% and 9%, respectively, for 2003 and 2004. They disagree on what an expected return on equity should have been. The government provided four sources with equity figures ranging from 13.8% to 18.3%. The court found these all to be unreliable as compared to HWJ's equity figures derived from a data service that used 33 companies with sales ranging from $25 million to $50 million. This data calculated an average pretax return on equity of 10.5% and 10.9% for 2003 and 2004, respectively. The court agreed with HWJ's contention that its return on equity was in line with the industry average and therefore would have satisfied an independent investor. **This factor weighs in the taxpayer's favor.**
5. **Internal consistency of compensation arrangements** — The company consistently adhered to the officer bonus formula since its inception in 1991. **This factor weighs in the taxpayer's favor.**

Based on this analysis, the court found the officer compensation paid in 2003 and 2004 was reasonable and therefore deductible under IRC §162(a)(1).

With respect to the $500,000 payment to DBJ, HWJ argues that this payment was an ordinary and necessary business expense because it constitutes a payment to compensate DBJ for securing a guaranteed supply of concrete during 2004. The IRS countered with the following arguments.

- There was no written agreement or evidence of any oral agreement obligating the taxpayer to compensate DBJ.
- DBJ did not perform any compensable services on behalf of the taxpayer.
- The $500,000 payment was not made for services that DBJ provided but for services Bruce and Donald performed in their capacities as officers.

The court was not persuaded by the IRS arguments and determined that the $500,000 payment was an ordinary and necessary business expense because it was normal for a concrete contractor to spend money to ensure that a reliable supply of concrete existed.

Holding. The court held that compensation paid to Bruce and Donald in 2003 and 2004 was reasonable and deductible under IRC §162(a)(1). The court also held that HWJ could deduct a payment made to DBJ for securing a reliable concrete supply for the business.

CAPITAL GAINS AND LOSSES

Mark-to-Market Election

William F. Poppe v. Comm'r, **TC Memo 2015-205 (Oct. 19, 2015)**
IRC §§165, 475, 6511, 6651, and 6654

☞ Mark-to-Market Election Invalid

Facts. William Poppe worked as a high school math teacher from 2001 to 2006 in New York City. He also conducted trades through a personal trading account with Fidelity Investments to supplement his income. During the school year, he traded every day during his two free periods at school and spent four to five hours per day researching trades. He executed approximately 60 trades per month.

Mr. Poppe's accountant advised him to file an IRC §475(f) mark-to-market election in 2003. Mr. Poppe did not retain a signed copy of any election or any evidence of mailing it. **His 2003 tax return, filed July 25, 2005, contained a statement that he had made an election pursuant to IRC §475(f) but did not have a copy of Form 3115, *Application for Change in Accounting Method,* attached to it.** The return contained income from various sources, including $142,278 of business income from securities trading reported on Schedule C, *Profit or Loss From Business.* The occupation he listed on the return was "teacher."

Mr. Poppe subsequently left the teaching profession and became a full-time trader with Madison Proprietary Trading Group LLC (MPTG) in October 2006. MPTG provided him with access to a Goldman Sachs Execution and Clearing account along with office space. During 2007, he generally executed over 400 trades per month, with total securities sales of over $85 million and total purchases of over $95 million. His account at yearend showed a loss of $1,086,790.

At all relevant times, Mr. Poppe suffered from an autism spectrum disorder formerly known as Asperger's Syndrome. He was despondent in 2007 due to the losses he suffered and could not organize himself to file a timely tax return.

The IRS prepared and filed a substitute for Mr. Poppe's 2007 return on June 21, 2012. Mr. Poppe subsequently filed the 2007 return on April 15, 2013, and then filed an amended return on April 15, 2014. The return reported a loss of $1,182,487 on a Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* allegedly filed on his behalf by MPTG. He attached the Schedule K-1 to the return. The IRS checked the MPTG return for 2007 and found no Schedule K-1 for Mr. Poppe. The amended return corrected amounts of short-term and long-term capital gains and losses and included a statement that under IRC §475(f) he is entitled to the mark-to-market accounting method and plans to carry forward the losses incurred in 2007.

Issues. The issues in this case are as follows.

- Whether the taxpayer is entitled to use the mark-to-market accounting method under IRC §475(f) for the 2007 tax year
- Whether the taxpayer is liable for additions to tax under IRC §§6651(a)(1) and (2)
- Whether the taxpayer is liable for additions to tax under IRC §6654
- Whether the taxpayer is entitled to relief under IRC §6511(h)

Analysis. IRC §475(f)(1) provides that a taxpayer engaged in a trade or business as a trader in securities may elect to apply the mark-to-market method of accounting for securities held in connection with a trade or business. The mark-to-market method allows a trader in securities to recognize gain or loss on any security held in connection with the trade or business at the close of the tax year as if the security were sold for its fair market value at the end of the year. The gains or losses attributable to the securities covered by the mark-to-market election are treated as ordinary income or loss. If a taxpayer makes a valid mark-to-market election, any net loss from the business of trading in securities is an ordinary loss deductible in full. If the mark-to-market election is not made, any net loss is deductible only to the extent of any capital gains, plus $3,000.

In order to qualify as a trade or business of trading, the taxpayer's trading must be substantial and the taxpayer must seek to catch the swings in the daily market movement and profit from short-term changes. The frequency of Mr. Poppe's transactions demonstrated that he had substantial activity. In addition, at trial, Mr. Poppe testified that his intent with respect to trading in 2003 was to profit from short-term market swings. The court found that his testimony was organized and coherent and provided sufficient details on his trading strategy. Consequently, the court found his testimony persuasive on the issue of intent. The court concluded that he was a trader in securities in 2003 and was entitled to make an election under IRC §475(f) for the mark-to-market accounting method.

Next, the court considered whether Mr. Poppe actually made a proper election under §475(f) to use the mark-to-market method in 2003. The taxpayer must file a statement with the IRS making the mark-to-market election, identifying the first taxable year for which the election is effective, and describing the business the election relates to. The statement must be filed no later than the due date of the taxpayer's original federal income tax return (without regard to extensions) for the tax year immediately preceding the election year. A Form 3115 must be attached if the election entails a change in accounting method. The evidence did not conclusively show whether Mr. Poppe signed or mailed a Form 3115 in 2003. He did not submit a copy of any executed version of the form or any evidence of mailing it. In addition, Mr. Poppe filed his 2003 income tax return on July 25, 2005, failing to comply with filing deadlines. The 2003 return contained a statement that he made an election under §475(f) but did not have a Form 3115 attached to it. Therefore, he did not comply with the requirements for the election.

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. The addition is 5% for each month that the return is late, not to exceed a total of 25%. The taxpayer argued that his mental impairment constitutes reasonable cause. At trial, he offered expert testimony from a licensed psychologist. Although the psychologist who testified was highly qualified, she was not his treating healthcare provider nor was she a medical doctor. The court gave her testimony minimal weight. Even though sympathetic to the taxpayer's plight, the court did not find his mental condition prevented him from managing his business affairs. Therefore, his untimely filing was not due to reasonable cause.

IRC §6654 imposes an addition to tax for failure to make estimated tax payments when prepayments of tax, either through withholding or by making estimated quarterly payments during the year, do not equal the lesser of 90% of the tax shown for the current tax year or 100% of the tax shown for the previous tax year. The taxpayer posed the same arguments as he did for the IRC §6651(a)(1) penalty; the court used the same arguments to rule in the government's favor.

IRC §6511(h) provides for statutory tolling of the period of limitations on filing a claim for a refund or credit for overpayment of taxes when taxpayers are unable to manage their financial affairs. However, financial disability under §6511(h) has nothing to do with deadlines for filing tax returns, paying tax, or paying estimated tax. Therefore, the court found that Mr. Poppe's argument was irrelevant.

Holding. The court determined that **the taxpayer did not have a valid mark-to-market election** under IRC §475 for the 2007 tax year. Therefore, the taxpayer's securities losses are subject to capital loss treatment. The court upheld additions to tax for failure to timely file his return and pay taxes.

Partners' Income

***U.S. v. David Stewart et al.*, No. 4:10-cv-00294; U.S. District Court for the Southern District of Texas (Aug. 20, 2015)**
IRC §§6221, 6226, and 6227

☞ Partners' Income Treated As Capital Gains

Facts. In March 2003, Hydrocarbon Capital, LLC, purchased a portfolio of oil and gas properties from Mirant Corporation. Because Hydrocarbon was new to the oil and gas industry, it asked five executives of Mirant to manage the wells. These five executives, including David Stewart and Richard Plato, formed Odyssey Capital Energy I, LP.

Odyssey operated the wells or worked with other operators. It fully controlled the operations, although Hydrocarbon approved the expenses. Hydrocarbon lent Odyssey $6 million for working capital. When the assets were sold, Odyssey earned 20% interest in the sales revenue after Hydrocarbon recouped its expenses, investment, 10% return on its investment, and the loan.

Odyssey executives limited the salaries they paid themselves. They did not earn a profit from the sale if Hydrocarbon did not profit.

On April 15, 2005, Odyssey filed its 2004 federal partnership income tax return. It reported ordinary income of $20.1 million. Each partner received a Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.* The partners reported their Schedule K-1 income on their individual returns.

Two years later, Odyssey determined that the $20.1 million reported as ordinary income on the 2004 return was long-term capital gains income rather than ordinary income. On April 13, 2007, Odyssey amended its 2004 tax return and issued new Schedules K-1 to the partners.

Mr. Stewart amended his 2004 tax return on May 13, 2007, and requested a refund of $1,086,536 plus interest. The IRS requested additional documentation on August 22 and November 21. Mr. Stewart sent the requested documentation each time.

The IRS reviewed Odyssey's amended tax return in November 2007 and accepted the return. On January 16, 2008, the IRS formally approved the amended return and closed the case.

On February 1, 2008, Mr. Stewart received a refund of $1,333,068. Mr. Plato received a refund of $649,072. Two of the other partners also received refund checks. The fifth partner's refund request was denied in December 2007. That partner amended his return, and the IRS opened an investigation.

After its examination, the IRS claimed that Odyssey's 20% interest was compensation for services and the partner's earnings should be considered ordinary income. The IRS determined it erred in issuing the refunds to Mr. Stewart and Mr. Plato and demanded the return of the refunds.

Issue. The issue is whether the partners' income is ordinary income from commissions or capital gain income from an investment.

Analysis. The government argued that Odyssey managed Hydrocarbon's portfolio and the income was a commission, which is taxable as ordinary income. Further, the government argued that no tax partnership existed for the following reasons.

- The agreement disclaimed a partnership.
- Hydrocarbon contributed and controlled the money, owned the assets, and Odyssey had no money at risk.
- Odyssey was a contract employee that could not spend money or sell assets without Hydrocarbon's approval.
- Hydrocarbon and Odyssey did not have a joint name, jointly file a tax return, or maintain a single accounting ledger.

The partners contended that Odyssey's net profits interest in the portfolio of oil properties is a capital gain. They further argued that Odyssey had a tax partnership with Hydrocarbon. Hydrocarbon contributed the capital used to acquire the mineral properties but Odyssey contributed the operating expenses, technical and entrepreneurial work, and management. Odyssey exchanged its time and talent for a share of the profit. Even though Hydrocarbon had to approve the budget, Odyssey devised and implemented it, and it was billed to Odyssey.

Tax partnerships arise from the behavior of the participants and do not depend on contract language. Odyssey had an ownership interest in the entire operation. There was an equitable relationship between Odyssey and Hydrocarbon even though it was not a fee interest. Mr. Stewart and Mr. Plato risked money for that interest by accepting smaller salaries than the market value for their work. Hydrocarbon relied entirely on the expertise of Odyssey. Many partnerships have a financial partner (Hydrocarbon) and an operating partner (Odyssey). Therefore, the court determined that Odyssey and Hydrocarbon were engaged in a partnership. The partners managed the portfolio and their efforts earned significant profits for the venture when it sold. The partnership profits are long-term capital gains.

The government further argued that Odyssey did not ask for a formal adjustment, that the IRS did not approve the new return, and that the original return — with ordinary income — still controls. The partners said that Odyssey's amended return complied substantially with a request for a formal adjustment and the IRS had enough information to review and approve the return. Because Odyssey's return was accepted, the partners' amended returns, which were consistent with the amended partnership return, should be accepted. To change the partners' tax returns, the IRS would have to change the partnership return because the tax liability is determined at the partnership level. Even if the court could change the characterization of the income, the statute of limitations for the return had expired.

Holding. The court held that the partners managed property in which they owned an interest and earned a profit for their work. Their income is properly characterized as long-term capital gains.

CASUALTY AND THEFT LOSSES

Casualty Loss

***Christina Alphonso v. Comm'r,* TC Memo 2016-130 (Jul. 14, 2016)**
IRC §§165 and 216

☞ No Casualty Loss for Retaining Wall Collapse That Suffered Progressive Deterioration

Facts. Christina Alphonso was a tenant-stockholder of a New York cooperative housing corporation (co-op). The co-op owned a cooperative complex that consisted of a 7-acre tract of land on which there were five high-rise residential apartment buildings and a 2-story cottage. The grounds near the apartment complexes were supported by a retaining wall of stone masonry construction built between 1921 and 1925.

From 1985 to 2005, various engineering and architectural firms examined the retaining wall and noted structural and other deficiencies in and around the wall. Various measures were taken during that time to address some of the problems.

In May 2005, a 150-foot portion of the wall collapsed. Ms. Alphonso claimed a casualty loss of $26,390 associated with the collapse of the wall on her 2005 Form 1040. The IRS denied the deduction, arguing that the collapse was caused by gradual deterioration and not an event qualifying as a casualty under IRC §165.

Issue. The issue is whether the collapse of the retaining wall is a casualty loss under IRC §165.

Analysis. Under IRC §165, an individual can deduct nonbusiness losses if such losses arise from fire, storm, shipwreck, or other casualty. A casualty is sudden, unexpected, or unusual in nature. The progressive deterioration of property is not a casualty.[12] A collapse, even one that occurs suddenly, is not a casualty when the collapse is caused by progressive deterioration.

Ms. Alphonso argued that the collapse was caused by drainage system modifications made in 2004 and excessive rainfall occurring during January to May 2005. An expert testified on her behalf that these events and not the structural deficiencies or gradual deterioration caused the sudden collapse.

The expert who testified on behalf of the IRS argued that despite various efforts made by the co-op to repair and improve the situation, the underlying deficiencies were never corrected. The expert concluded that these deficiencies combined with deterioration over time caused the collapse.

The Tax Court examined the various engineering and architectural firms' reports issued from 1985 through 2005. It also considered the expert testimony provided by each side. The Tax Court was unimpressed by Ms. Alphonso's expert witness, noting: "We are unwilling to rely on the views of a purported expert who is at best careless and at worst not competent." Consequently, the Tax Court concluded that the collapse of the retaining wall was caused by progressive deterioration and not an unexpected event.

Holding. The Tax Court denied Ms. Alphonso's casualty loss deduction.

12. *Fay v. Helvering*, 120 F.2d 253 (2d Cir. 1941), *aff'g* 42 BTA 206 (1940).

Theft Loss Deduction

***Henry and Diane Haff v. Comm'r,* TC Memo 2015-138 (Aug. 3, 2015)**

IRC §165

☞ Court Denies Loss Deduction for Unpaid Fees

Facts. In 2005, Henry Haff began investing in GSH Development, LLC, through his single-member LLC, HJH Hinsdale. GSH was a joint venture between Mr. Haff and Grant Street Investors, LLC. GSH was formed to develop condominiums and townhomes in Hinsdale, Illinois. WexTrust Capital, LLC, owned Grant Street.

GSH was treated as a partnership for federal tax purposes, although it never filed a Form 1065, *U.S. Return of Partnership Income,* or provided a Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* to Mr. Haff.

In 2005, Mr. Haff invested $1 million in GSH. Between 2005 and 2010, he contributed an additional $337,690 to GSH.

In August 2008, the Securities and Exchange Commission filed a complaint against WexTrust's owners, alleging that WexTrust was a Ponzi scheme. A court-appointed receiver determined that it was not economically viable to continue development of the GSH project. As a result, Mr. Haff concluded that his entire investment in GSH was lost. **Mr. and Mrs. Haff claimed a bad debt deduction of $2,068,476 on their 2009 joint tax return for the lost investment.** The bad debt deduction included Mr. Haff's contributions to GSH of $1,337,690 and $730,786, which Mr. Haff alleged GSH owed him as fees for his services. However, the $730,786 was never included in Mr. and Mrs. Haff's income for tax purposes.

The IRS issued a notice of deficiency to Mr. and Mrs. Haff, which denied their bad debt deduction of $2,068,476. However, the IRS later acknowledged that Mr. and Mrs. Haff were entitled to a theft loss deduction for Mr. Haff's $1,337,690 contribution to GSH. The Haffs asserted that the additional $730,786 is deductible as a theft loss according to the safe harbor provision of Rev. Proc. 2009-20.

Issue. The issue is whether Mr. and Mrs. Haff are entitled to an additional $730,786 in deductions related to a loss from a Ponzi scheme for the 2009 tax year.

Analysis. The amount of a deductible theft loss is generally limited to the adjusted basis of the property taken.[13] Basis does not include the value of services performed until the value of the services has been subjected to tax.[14] Accordingly, Mr. and Mrs. Haff's basis does not include the $730,786 owed to Mr. Haff for his services.

The Haffs argued that the additional $730,786 is deductible under the safe harbor provided in Rev. Proc. 2009-20. However, the court observed that the safe harbor provision permits deductions only for "qualified investments." A **qualified investment** is the taxpayer's cash or property invested plus "[t]he total amount of net income with respect to the specified fraudulent arrangement that, consistent with information received from the specified fraudulent arrangement, the qualified investor **included in income for federal tax purposes** for all taxable years prior to the discovery year, including taxable years for which a refund is barred by the statute of limitations," minus the total cash or property that the taxpayer withdrew in all years.[15]

Mr. and Mrs. Haff did not include any portion of the $730,786 as income for prior years. To be included in basis, the amounts owed must have been previously included in income for tax purposes.

Holding. The court held that Mr. and Mrs. Haff are entitled to a theft loss deduction of $1,337,690 for the adjusted basis in GSH but denied the deduction for the $730,786 in service fees they claimed were owed to Mr. Haff but never paid.

13. See Treas. Regs. §§1.165-1(c), 1.165-7(b)(1), and 1.165-8(c).

14. See *Hutcheson v. Comm'r,* 17 TC 14, 19 (1951) and *Tonn v. Comm'r,* TC Memo 2001-123 (May 24, 2001), *aff'd* 40 Fed.Appx. 337 (8th Cir. 2002).

15. Rev. Proc. 2009-20, 2009-14 IRB 750 (emphasis added).

CREDITS

AMT Credits

***Nadine Vichich v. Comm'r,* 146 TC 12 (Apr. 21, 2016)**
IRC §§53, 55, and 56

☞ Wife Cannot Use Deceased Husband's AMT Credits

Facts. In 1998, William Vichich exercised employer-granted incentive stock options (ISOs). He reported the activity on his 1998 income tax return that he filed jointly with his then wife, Marla. The exercise of the ISOs resulted in an alternative minimum tax (AMT) liability of $708,181, which Mr. Vichich and Marla paid. Payment of the AMT liability generated an AMT credit carryforward.

In January 2002, Mr. Vichich and Marla got a divorce. In September 2002, Mr. Vichich married Nadine. Mr. and Mrs. (Nadine) Vichich merged their finances and filed joint tax returns for 2002 and 2003. Their 2003 federal income tax return included Form 8801, *Credit for Prior Year Minimum Tax—Individuals, Estates, and Trusts.* They claimed an AMT credit of zero and an AMT credit carryforward of $304,442.

On August 21, 2004, Mr. Vichich died. Mrs. Vichich filed her 2004 federal tax return as a surviving spouse but did not attach Form 8801 or include the AMT carryforward from 2003. Mr. Vichich's estate filed a Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, in May 2005. The estate tax return also did not include an AMT carryforward or Form 8801.

For the 2005 through 2008 tax years, Mrs. Vichich never included AMT carryforwards or Forms 8801 with her federal income tax returns. In January 2010, Mrs. Vichich filed Form 1040X, *Amended U.S. Individual Income Tax Return,* for 2007. She claimed an AMT credit of $29,172. The IRS issued her a full refund in the amount of the AMT credit. In April 2010, Mrs. Vichich filed a Form 1040X for 2008. She claimed an AMT credit of $151,928, which the IRS denied.

In October 2010, Mrs. Vichich claimed an AMT credit carryforward of $151,928 on her 2009 Form 1040. She requested a refund of $149,224, which the IRS issued. The IRS subsequently disallowed the AMT credit and issued a notice of deficiency.

Issue. The issue is whether Mrs. Vichich is entitled to use an AMT credit that arose from her deceased husband's exercise of ISOs in 1998 to offset her individual income tax liability for 2009.

Analysis. IRC §55 imposes the AMT on the amount by which the tentative minimum tax exceeds the taxpayer's regular tax. Generally, a taxpayer is not required to recognize income on the exercise of an ISO.[16] However, the difference between the exercise price and the stock's fair market value on the date of exercise is treated as an item of adjustment and is included in the taxpayer's alternative minimum taxable income (AMTI).[17] IRC §53 allows a taxpayer to claim a credit for AMT paid in prior years, adjusted for specific items. The credit is limited to the amount by which the taxpayer's regular tax liability, reduced by certain credits, exceeds the taxpayer's tentative minimum tax.

Tax attributes reported on a joint return for a year prior to a divorce must be properly allocated for subsequent years to the divorced spouses. The AMT credit was properly allocated to Mr. Vichich following his divorce from Marla.

16. IRC §421(a).

17. IRC §56(b)(3).

Although Mr. and Mrs. Vichich filed jointly, the Code does not convert two spouses into a single taxpayer. Therefore, Mr. and Mrs. Vichich remained separate taxpayers even though they merged finances and filed joint returns. Generally, credits and deductions are not transferable between taxpayers. **Under the Code and applicable case law, a spouse generally is not permitted to inherit or otherwise retain after the marriage ends a tax benefit that was originally conferred on the other spouse.**

The court drew a comparison between the AMT credit carryforward and a net operating loss (NOL) carryforward. In *Calvin v. U.S.,* the court held that the NOL provisions are personal to the taxpayer who incurred such loss and only available in other years to offset income of the same taxpayer.[18]

Only spouses who elect to file joint returns can offset one spouse's income with the other's loss deduction.[19] After a spouse dies, a taxpayer cannot file a joint return with the deceased spouse following the year of death.[20] Therefore, a deceased spouse's unused deductions must be used on the last tax return of the decedent or they are lost.

Holding. The Tax Court held that Mrs. Vichich was not entitled to carry forward an AMT credit that arose from Mr. Vichich's exercise of ISOs to offset her income tax liability.

DEDUCTIONS

Forfeited Gain

***Joseph Nacchio and Anne Esker v. U. S.,* U.S. Court of Appeals for the Federal Circuit;**
Nos. 2015-5114, 2015-5115 (Jun. 10, 2016)
IRC §§162, 165, and 1341

☞ Inside Trader Deducts Amount Forfeited on Illegally Acquired Funds

Facts. Joseph Nacchio served as the chief executive officer of Qwest Communications International, Inc., from 1997 to 2001. Part of his compensation package included options to purchase shares of Qwest stock. Mr. Nacchio exercised that option in April 2001. He then proceeded to sell 1,255,000 shares of Qwest stock. On May 16, 2001, Mr. Nacchio entered into an automatic sales plan to sell his Qwest stock. He continued selling his Qwest stock until May 29, 2001. The following day, the price of Qwest stock fell below $38 per share. Mr. Nacchio reported a net gain from the stock sales of $44.6 million on his 2001 joint tax return and paid income tax of $17.97 million on the gain.

In 2005, Mr. Nacchio was indicted on 42 counts of insider trading. In April 2007, he was found guilty on 19 of the 42 counts. The District Court sentenced Mr. Nacchio to 72 months in prison. The court also ordered him to pay a $19 million fine and to forfeit the gross income of $52 million that he derived from insider trading.

On March 17, 2008, the 10th Circuit Court reversed Mr. Nacchio's conviction and sentence.

In 2009, Mr. Nacchio amended his 2007 income tax return, claiming an $18 million credit under IRC §1341. The $18 million was the income tax that Mr. Nacchio and his wife paid on the profits from Mr. Nacchio's exercise of the options. The IRS rejected the credit, stating that §1341 may only be invoked after the right to claim a deduction is established elsewhere in the Code. The IRS asserted that because Mr. Nacchio's forfeiture was in effect a penalty, a deduction was not permitted under any Code section, including IRC §165(c)(2).

On June 24, 2010, the District Court resentenced Mr. Nacchio to 70 months in prison. The court also ordered him to pay a $19 million fine and to forfeit the net proceeds from insider trading of $44.6 million.

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18. *Calvin v. U.S.,* 354 F.2d 202 (10th Cir. 1965).
19. See Treas. Regs. §§1.172-7(c) and 1.172-3(d).
20. See IRC §§6013(c) and (d).

On January 10, 2012, Mr. Nacchio commenced an action with the Court of Federal Claims, in which he claimed a credit of $18 million under §1341. The court held that Mr. Nacchio's forfeiture was deductible under IRC §165. The court reasoned that disallowing the deduction would result in a "double sting" by requiring a taxpayer to both make restitution and pay taxes on income they did not retain. Further, the court rejected the argument that the forfeiture was not deductible under IRC §162(f). The forfeiture represented the "disgorgement of Mr. Nacchio's illicit net gain from insider trading." This was distinct from the $19 million fine, which was punitive and paid from assets unrelated to insider trading.

Issue. The issue is whether or not Mr. Nacchio is entitled to an income tax deduction for the amount he forfeited to the government.

Analysis. IRC §1341 provides special relief for taxpayers who are required to restore funds to a third party after claiming the funds in income in a prior tax year. The taxpayer must prove that they reasonably believed they had an unrestricted right to the funds when they were included in income. The taxpayer must also establish that they are entitled to a deduction (in excess of $3,000) under another Code section for the loss.

IRC §165(a) allows for a deduction of any loss sustained during the tax year and not compensated for by insurance or otherwise. IRC §165(c)(2) allows for a deduction of losses incurred in any transaction entered into for profit. The court observed that §165 is subject to a **"frustration of public policy"** doctrine. Under this doctrine, a taxpayer cannot deduct a loss if it "would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof."[21] The Supreme Court observed that a taxpayer who has violated a federal or state statute and incurred a fine or penalty is not permitted a tax deduction for its payment.[22]

Other courts of appeal concluded that forfeitures similar to Mr. Nacchio's are not deductible because they are punitive.[23] In *U.S. v. Joseph,* the court held that restitution seeks to make victims whole by reimbursing them for their losses, while forfeiture is meant to punish the defendant by transferring their ill-gotten gains to the U.S. Department of Justice.[24] Restitution and forfeiture serve distinct purposes: restitution compensates the victim, and forfeiture punishes the wrongdoer.[25]

Holding. The court held that Mr. Nacchio may not deduct his forfeiture as a loss.

DIVORCE ISSUES

Transfer Incident to Divorce

***Joseph Belot v. Comm'r,* TC Memo 2016-113 (Jun. 13, 2016)**
IRC §1041

☞ Settlement After Divorce Qualified for Nonrecognition Treatment

Facts. Joseph Belot and his wife were married on July 1, 1989. Together they opened and operated three businesses.

1. Gotta Dance, Inc. (Gotta Dance) operated dance studios. Ms. Belot was the sole shareholder.
2. Gotta Dance Boutique, LLC, (Boutique) was a retail store for dancewear and accessories. Mr. and Ms. Belot each owned 50% of Boutique.
3. Jobee Realty, LLC, (Jobee) held and leased real estate, including dance studios for Gotta Dance. Ms. Belot owned 49% and Mr. Belot owned 51% of Jobee.

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21. *Tank Truck Rentals v. Comm'r,* 356 U.S. 30, 33-36 (1958) (citing *Comm'r v. Heininger*, 320 U.S. 467, 473-74 (1943)).
22. *Tank Truck Rentals v. Comm'r,* 356 U.S. 30, 33-36 (1958).
23. See *King v. U.S.,* 152 F.3d 1200, 1202 (9th Cir. 1998).
24. *U.S. v. Joseph,* 743 F.3d 1350, 1354 (11th Cir. 2014).
25. *U.S. v. Blackman,* 746 F.3d 143 (4th Cir. 2014).

For all three businesses, Mr. Belot was primarily responsible for the financial aspects. Ms. Belot managed the dance-related aspects of the businesses including instruction, hiring, training, recruitment, and payroll.

On January 8, 2007, Mr. and Ms. Belot divorced and reached a settlement agreement. They equalized their ownership percentages in each of the three businesses. Ms. Belot transferred 50% of Gotta Dance to Mr. Belot, and Mr. Belot transferred 1% of Jobee to Ms. Belot.

On September 21, 2007, Ms. Belot filed a complaint against Mr. Belot. She claimed he mismanaged Gotta Dance and wanted to remove him as a director and employee. Furthermore, Ms. Belot wanted to compel Mr. Belot to sell his shares in Gotta Dance to either her or the corporation.

On April 11, 2008, Mr. and Ms. Belot entered into a new settlement agreement. Ms. Belot agreed to buy Mr. Belot's shares in Gotta Dance for $1.08 million, the interest in Boutique for $25,000, and the interest in Jobee for $475,000.

Issue. The issue is whether Mr. Belot's sale of his interest in the marital businesses to his ex-wife qualified for nonrecognition treatment under IRC §1041.

Analysis. IRC §1041 states that no gain or loss is recognized on transfers of property between spouses or former spouses if the transfer is incident to the divorce. A transfer of property is incident to a divorce if it is made within one year of the divorce or is related to the cessation of the marriage. A transfer of property is related to the cessation of the marriage if it is pursuant to the divorce or separation instrument and the transfer occurs not more than six years after the date of divorce. A divorce or separation instrument includes any modifications or adjustments to the decree.

Mr. and Ms. Belot made two attempts to divide their marital businesses. The first attempt was the 2007 settlement agreement, which proved unsatisfactory. The 2008 (second) settlement agreement settled a lawsuit brought by Ms. Belot. Under this agreement, Mr. Belot agreed to sell Ms. Belot all his interests in the marital businesses.

The IRS argued that the transfer under the second settlement agreement did not relate to the divorce instrument. The court disagreed, stating that the transfer was made to divide property owned by the former spouses at the time of the cessation of the marriage.

The IRS contended that the second settlement was not due to a legal or business impediment that prevented the transfer called for by the divorce decree. The court disagreed that a legal or business impediment was a necessary requirement to qualify under §1041.

The IRS pointed out that the original divorce settlement resolved all of Mr. and Ms. Belot's property issues. However, neither §1041 nor the regulations limit the nonrecognition to one, or the first, division of marital property. The IRS contended that the second agreement was essentially a sale. Again, neither §1041 nor the regulations prohibit nonrecognition due to a sale.

The IRS characterized Ms. Belot's dissatisfaction with the initial property settlement as a business dispute. However, IRC §1041 and the regulations apply to marital property that consists of business property.

Lastly, the IRS argued that because Ms. Belot filed her lawsuit in the superior court rather than family court, the lawsuit is primarily a business dispute, not a marital dispute. The court believed that the application of §1041 is not determined by the forum in which the lawsuit is filed.

Holding. The court held that **the 2008 settlement was a transfer incident to a divorce.** The settlement qualifies for nonrecognition treatment under §1041.

EMPLOYMENT TAX ISSUES

Worker Classification

***Nelly Home Care Inc. et al. v. U.S.*, No. 2:15-cv-00439;**
U.S. District Court for the Eastern District of Pennsylvania (May 10, 2016)
IRC §§3401 and 3509

☞ Factors Point to Independent Contractor Status

Facts. Helen Carney worked as a provider of homecare services for residents at the Beaumont in Bryn Mawr, Pennsylvania. She reached out to several homecare service providers and found that two of these firms treated their workers as independent contractors. She then decided to start her own company and engage the services of other providers to offer homecare services as independent contractors. She formed and managed Nelly LLC in 2004 and its successor, Nelly Home Care, Inc., (collectively referred to as "Nelly") in 2009. She had her attorney draft an independent contractor agreement.

Nelly provides nonmedical homecare services to senior citizens. A prospective customer contacts Nelly requesting homecare services, and Nelly reviews potential workers who might be available for the tasks and times requested by the client. Nelly does not provide training to potential workers nor do they supervise the workers in the performance of their duties. The workers are treated as independent contractors. Nelly did, however, purchase worker's compensation insurance for the service providers.

The IRS examined the 2004 and 2005 personal tax returns filed by Ms. Carney and her husband. As part of the audit, the IRS requested information for Nelly LLC, including documents relating to gross receipts, expenses, and copies of the independent contractor agreements. Significant adjustments were made to the Carneys' tax liability, because the IRS concluded that Ms. Carney had underreported her income by $100,000, commingled business and personal bank accounts, and charged 80% of her personal expenses through Nelly LLC. No adjustments were made to the Nelly LLC returns.

The IRS again examined the Carneys' 2008 tax return. However, this audit resulted in a "no change" determination.

In 2011, the IRS performed an employment tax examination of Nelly LLC for the 2008 and 2009 tax years and Nelly Home Care, Inc. for 2010, 2011, and 2012. After this examination, **the IRS reclassified the workers from independent contractors to employees** and determined that Nelly owed back taxes for those years. Nelly made the tax payments and filed a suit to reverse the determination.

Issue. The issue is whether the IRS erred in changing the employment status from independent contractors to employees for Nelly Home Care, Inc. and Nelly LLC.

Analysis. IRC §3509(a) states that an employer is liable for back employment taxes when it incorrectly treats an employee as "not being an employee." Section 530 of the Revenue Act of 1978 (which is uncodified) provides a safe harbor for taxpayers who owe back employment taxes after they erroneously fail to classify certain workers as employees. Section 530 "allows the taxpayer to avoid liability for certain federal employment taxes if the taxpayer had a reasonable basis for not treating such individual as an employee."[26]

Nelly provided the following arguments in support of its position that it had a reasonable basis for classifying workers as independent contractors.

- Nelly reasonably relied on past IRS audits when classifying its employees as independent contractors.
- Nelly relied on a long-standing recognized practice of a significant segment of the industry.

26. *Nu-Look Design, Inc. v. Comm'r,* 356 F.3d 290, 294 (3d Cir. 2004).

- Nelly relied on a long-standing industry practice when Ms. Carney spoke with companions from three separate agencies performing the same work before forming Nelly in 2004.
- Nelly relied on its own survey of the industry taken in 2008, which demonstrated a long-standing practice of classifying companions as independent contractors in a significant segment of the home health industry.

Although the court rejected all these arguments under the statutory safe harbor provisions of Section 530, **the court determined that Nelly is entitled to relief under the "other reasonable basis" safe harbor.** Before forming Nelly, Ms. Carney was a home health aide herself and found that many like her were treated as independent contractors. She also reached out to other companion providers, finding that at least two of them treated the workers as independent contractors. She reviewed an independent contractor agreement used by another companion company and then had her attorney draft a similar agreement.

Holding. The court determined that Nelly had a reasonable basis for classifying its workers as independent contractors and was entitled to protection under the safe harbor provisions of Section 530 of the Revenue Act of 1978.

> **Note.** This case demonstrates the importance of a complete analysis of and reliance on the safe harbor relief provided by Section 530 of the Revenue Act of 1978.

ESTATE AND GIFT

Life Insurance

***Estate of Clara M. Morrissette et al. v. Comm'r,* 146 TC No. 11 (Apr. 13, 2016)**
IRC §61

☞ Economic Benefit Regime Applies to Split-Dollar Life Insurance Arrangement

Facts. Clara Morrissette and her late husband Arthur got married in 1933. They had three sons.

In 1943, Mr. Morrissette started a moving company (Ace Van & Storage in Washington, DC). From 1954 through 2002, the Morrissette family incorporated or purchased 10 companies in addition to the original business, all of which were collectively known as Interstate Group. All companies in the group were brother-sister corporations with identical ownership.

In August 1994, Mrs. Morrissette established a revocable trust: the Clara M. Morrissette Trust (CMM Trust). She contributed all of her stock in each company in the Interstate Group to the trust.

In 2006, Mrs. Morrissette's health began to fail. Her sons petitioned the court for the appointment of a conservator. The conservator established three perpetual dynasty trusts for the benefit of the three sons and their families.

To keep the Interstate Group stock in the family upon the death of one of the brothers, each dynasty trust purchased two universal life insurance policies on the other two brothers. To fund the purchase, each dynasty trust and the CMM Trust entered into two split-dollar life insurance arrangements. The CMM Trust contributed over $9 million to each of the three dynasty trusts to pay the lump-sum premiums on the policies. Upon the death of the insured, the CMM Trust would receive a portion of the death benefit from the policy insuring the life of the deceased equal to the greater of the cash surrender value of that policy or the aggregate premium payments on that policy.

From 2006 to 2009, Mrs. Morrissette reported gifts to the dynasty trusts using the economic benefit regime set forth in Treas. Reg. §1.61-22. The reported gifts ranged from $64,249 in 2006 to $206,419 in 2009.

The IRS issued a notice of deficiency to the estate. The notice included a deficiency of $13.8 million and an IRC §6662 penalty of $2.76 million based on unreported gifts of $29.9 million used to pay for the split-dollar life insurance policies in 2006.

Issue. The issue is whether, for valuation purposes, the split-dollar life insurance arrangements are governed by the economic benefit regime set forth in Treas. Reg. §1.61-22.

Analysis. Treasury regulations provide two exclusive regimes for taxing split-dollar life insurance arrangements entered into after September 17, 2003 — the economic benefit regime and the loan regime. The determination of which regime applies depends on which party owns the life insurance policy subject to the arrangement. The regulations provide that if the only economic benefit provided to the donee under the split-dollar life insurance arrangement is current life insurance protection, then the donor is the deemed owner of the life insurance contract. In such case, the economic benefit regime applies.[27]

The key question that determines which party owns, or is deemed to own, a life insurance policy is whether the lump-sum payment of premiums made on the policies indirectly by the CMM Trust generated any additional economic benefit other than current life insurance protection to the dynasty trusts. If there is no additional economic benefit to the dynasty trusts, then the CMM Trust will be deemed the owner of the policies, and the insurance arrangements will be governed by the economic benefit regime.

To determine whether any additional economic benefit was conferred to the dynasty trusts, it is necessary to inquire whether the dynasty trusts had current access to the cash values of their respective policies. Based on the facts provided, the dynasty trusts did not have a direct or indirect right to the cash values of the policies.

Holding. The court determined that the dynasty trusts received no additional economic benefit beyond that of current life insurance protection. Therefore, the CMM Trust is the deemed owner of the life insurance contract under Treas. Reg. §1.61-22, and the economic benefit regime applies.

Gifts and Inheritance

Diane Blagaich v. Comm'r, **TC Memo 2016-2 (Jan. 4, 2016)**
IRC §§102 and 451

☞ IRS Can Challenge Whether Amounts Received by Taxpayer Were Gifts

Facts. Lewis Burns, age 72, and Diane Blagaich, age 54, were involved in a romantic relationship from November 2009 until March 2011. Both resided in a suburb of Chicago. During that time, Mr. Burns gave Ms. Blagaich a Corvette worth $70,000, a wire transfer of $200,000, and various checks totaling $73,819.

Neither Mr. Burns nor Ms. Blagaich wished to get married, so on November 29, 2010, they entered into an agreement intended to confirm their commitment to each other and to provide financial accommodations to Ms. Blagaich. The agreement provided that Mr. Burns and Ms. Blagaich would "respect each other and shall continue to spend time with each other consistent with their past practice" and that they "shall be faithful to each other and shall refrain from engaging in intimate or other romantic relations with any other individual." Additionally, the agreement required that Mr. Burns make an immediate payment of $400,000 to Ms. Blagaich.

Soon after the agreement was executed, the relationship deteriorated, and Ms. Blagaich moved out of Mr. Burns' residence on March 10, 2011. The next day, Mr. Burns sent her a notice of termination of the agreement. He believed that Ms. Blagaich was involved in an ongoing romance with another man during their relationship.

Mr. Burns filed a civil suit seeking nullification of the agreement based on fraud, the return of the Corvette and an "engagement ring," and that Ms. Blagaich "disgorge all cash and other accommodations that [Mr. Burns] provided to her, totaling in excess of $700,000."

27. Treas. Reg. §1.61-22(c)(1)(ii)(A)(2).

On April 8, 2011, Mr. Burns filed a Form 1099-MISC, *Miscellaneous Income,* for the 2010 tax year reporting $743,819 ($400,000 pursuant to the agreement + $70,000 Corvette + $73,819 various checks + $200,000 wired funds) paid to Ms. Blagaich.

In the civil action, the state court found that the Corvette, $200,000 wire transfer, and various checks were gifts to Ms. Blagaich. The Corvette was gifted because Mr. Burns did not want Ms. Blagaich to ride her Harley Davidson motorcycle. The $200,000 wire transfer was to entice Ms. Blagaich to quit her job and to travel with Mr. Burns. The various checks were issued under similar circumstances. The state court also found that Ms. Blagaich had fraudulently induced Mr. Burns to enter into the agreement and ordered her to pay $400,000 to Mr. Burns' estate (he passed away shortly after the trial).

To reflect the amount reported on the Form 1099-MISC, the IRS increased Ms. Blagaich's 2010 gross income by $743,819.

Issues. The issues in this case are as follows.

- Whether the IRS is estopped from denying that Ms. Blagaich received a gift in 2010
- Whether the doctrine of rescission applies to exclude the $400,000 payment from her 2010 gross income

Analysis. At trial, Ms. Blagaich argued that the IRS was estopped from claiming that the cash and property she received before November 29, 2010, were not gifts. **Collateral estoppel** prevents parties and their privies from relitigating issues that were already decided by a court of competent jurisdiction.[28] Ms. Blagaich must prove that the IRS is considered a party or a privy to the civil trial in order to prevent the IRS from relitigating whether the $343,819 was a gift. Ms. Blagaich claimed the IRS was a party to the civil suit because it requested and received updates, pleadings, and documents regarding the case. The court noted that Ms. Blagaich did not prove that the IRS was a party to the civil suit. The fact that the IRS kept itself apprised of the trial did not prove that the IRS was a party in the case.

Ms. Blagaich also claimed under the doctrine of rescission that she did not need to report the $400,000 in 2010. The **doctrine of rescission** states that a taxpayer does not need to report an item of gross income received under a claim of right if the recipient's right to the amount is rescinded and the parties involved are restored to the positions they would have had if no contract had been made within the year of receipt. An individual receives income under the **claim of right** whenever "earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition" are acquired.[29] Ms. Blagaich relied upon *Hope v. Comm'r,* which suggests that the rescission doctrine may apply even when repayment does not occur within the same year, but only if, before the end of the year, the recipient "recognizes his liability under an existing and fixed obligation to repay the amount received and make provisions for the repayment."[30] However, the court noted that nothing in the facts presented indicated that Ms. Blagaich recognized her liability, and she made no attempt to repay the obligation until 2013.

Holding. The court held that Ms. Blagaich could not use collateral estoppel as her defense. The court further held that the doctrine of rescission required her to include the $400,000 in her 2010 gross income.

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28. *Peck v. Comm'r,* 90 TC 162, 166 (1988), *aff'd* 904 F. 2d 525 (9th Cir. 1990).

29. *James v. U.S.,* 366 U.S. 213, 219 (1961).

30. *Hope v. Comm'r,* 55 TC 1020, 1030 (1971), *aff'd,* 471 F. 2d 738 (3rd Cir. 1973)

Gift Valuation

***Jean Steinberg v. Comm'r,* 145 TC No. 7 (Sep. 16, 2015)**

IRC §§2035 and 7520

☞ Gift Valuation Includes Promise to Pay Estate Tax

Facts. Jean Steinberg executed a will in 2002 that named her husband as the beneficiary of her residuary estate, unless he predeceased her. If Mr. Steinberg died first, their four daughters would equally share the residuary estate. Mr. Steinberg died on December 4, 2003. He left a will that established a marital trust, with Mrs. Steinberg as the trustee and beneficiary.

On December 20, 2005, Mrs. Steinberg executed a codicil to her 2002 will. Only three of her four daughters would inherit the marital trust and her residuary estate. On July 21, 2006, Mrs. Steinberg executed a new will with all four daughters again receiving equal shares of the trust and estate. Additionally, the will had the following two important provisions.

1. Any estate taxes imposed on property passing under the will would be paid out of Mrs. Steinberg's residuary estate.
2. If Mrs. Steinberg died within three years, any IRC §2035(b) estate tax would be apportioned to her daughters.

During 2006 and 2007, the daughters requested that Mrs. Steinberg terminate the marital trust and distribute the assets to them. She agreed, and they began months of negotiations. On April 17, 2007, they entered into a binding net gift agreement and Mrs. Steinberg terminated the marital trust. The following assets of the marital trust were distributed.

- $3.4 million to pay legal fees
- $10 million to Mrs. Steinberg
- The remainder to the daughters pursuant to the net gift agreement

The fair market value (FMV) of the properties transferred before any gift or estate tax liability consideration was $109.4 million. The daughters each put $10 million into an escrow account. The $40 million in the escrow account was used to pay $32.4 million of federal gift tax and the remainder was set aside for any §2035(b) estate tax liability.

Mrs. Steinberg hired Mr. Frazier, a qualified appraiser, to determine the FMV of the property rights transferred under the net gift agreement. Mr. Frazier valued the aggregate value of the net gift on the date it was made at $71.6 million. Mrs. Steinberg reported that amount on her Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return.* She paid $32.0 million in total gift tax with her return on October 15, 2008.

On July 25, 2011, the IRS sent Mrs. Steinberg a notice of deficiency for $1.8 million. The IRS disallowed the discount for the daughters' assumption of the §2035(b) estate tax liability.

Issues. The issues in this case are as follows.

- Whether a donee's promise to pay any federal or state tax liability that may arise if the donor dies within three years of the gift should be considered in determining the FMV of the gift
- If the promise should be considered, by what amount should the promise reduce the FMV of the gift

Analysis. Under IRC §2501(a), tax is due on the transfer of property by a gift. The donor is primarily responsible for paying the tax.[31] The tax is measured by the value of the property being transferred, rather than the value of enrichment the donee receives. The amount of the gift tax is based on the aggregate amount of taxable gifts donated during the year, among other factors. The amount of a gift of property is generally measured by the value of the property on the day of the gift.[32] The value of property is the price that would be set by a willing buyer and willing seller, assuming neither is compelled to buy or sell and they have reasonable knowledge of the relevant facts.

A **net gift** refers to a situation in which a donor makes a gift subject to the condition that the donee pay any resulting gift tax. The amount of the gift is reduced by that tax.

IRC §2035(b) states that a decedent's gross estate is increased by the amount of any gift tax paid within the 3-year period preceding the decedent's death. This includes gift tax attributable to a net gift.

In a previous trial between the IRS and Mrs. Steinberg,[33] the court ruled that the daughters' assumption of Mrs. Steinberg's §2035(b) liability constituted consideration in money or money's worth under IRC §2512(b). The court held in the initial trial that a willing buyer and a willing seller **in appropriate circumstances** might take the assumption of the liability into account in arriving at a sales price. In the current case, the court analyzed whether the net gift agreement was an appropriate circumstance.

An "appropriate circumstance" arises when the donee's assumption of the §2035(b) liability is a detriment to them and a benefit to the donor. A willing buyer would recognize that they would have to assume both the gift tax and the §2035(b) estate tax to obtain the properties. Likewise, the daughters had to agree to assume those liabilities to acquire the property under the net gift agreement. The donor would not be willing to transfer the properties without the liabilities being assumed. Furthermore, any recipient of the properties who assumed the liabilities would expect a reduction of the purchase price to reflect their assumption of any §2035(b) liability. The assumption of the §2035 liabilities is a detriment to the daughters because it would result in a reduction of the gift amount if Mrs. Steinberg died within three years. Mrs. Steinberg benefited because she was not liable for the gift and estate taxes that she accrued when she made the gift.

The IRS contended that the assumption of the §2035(b) liability was itself a gift because it was between family members, not conducted at arm's length, and was not in the ordinary course of business. The court disagreed, stating that nothing in the record indicated the transaction was not made at arm's length. Mrs. Steinberg and her daughters were represented by separate counsel and the gift was made after months of negotiation.

Mrs. Steinberg entered into evidence an expert valuation provided by Mr. Frazier. Mr. Frazier had 20 years of experience, performed hundreds of appraisals, was an accredited senior appraiser with the American Society of Appraisers, and had his appraisals accepted by other courts within the circuit. Mr. Frazier valued the §2035(b) liability at $5.8 million using IRS actuarial tables and IRC §7520 interest rates. The IRS did not provide an expert or any alternative valuation.

Holding. The court held that a willing buyer and willing seller would take into account the §2035(b) liability Mrs. Steinberg's daughters assumed. Furthermore, the amount of the gift would reflect a discount from the assumed liability. **The court agreed that the value of the gift was reduced by $5.8 million.**

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31. IRC §2502(c).

32. IRC §2512(a).

33. *Steinberg v. Comm'r,* 141 TC No. 8 (Sept. 30, 2013).

Gift Tax

***Sumner Redstone v. Comm'r,* TC Memo 2015-237 (Dec. 9, 2015)**

IRC §§2501, 2512, 6651, 6653(a), and 6653(b)

☞ Gift to Children Motivated by Love

Facts. Mickey and Belle Redstone had two sons, Edward and Sumner. In 1936, Mickey entered the drive-in movie theater business. He formed various corporations to hold the real estate, to operate the theaters, and to manage refreshments. To consolidate this increasingly complex structure, Mickey incorporated National Amusements, Inc. (NAI) as a holding company in 1959. Mickey, Edward, and Sumner were the directors and contributed the following amounts in exchange for 100 shares each of class A voting common stock.

Contribution	Mickey	Sumner	Edward	Total
Cash	$ 3,000	$ 0	$ 0	$ 3,000
Property	30,328	18,445	17,845	66,618
Total	$33,328	$18,445	$17,845	$69,618
Percentage	47.87%	26.50%	25.63%	100.00%

Although Mickey contributed 47.87% of the capital, he was issued only 33.33% (100 shares ÷ 300 total shares) of the company.

In 1971, Edward wanted to sell his shares of NAI. Mickey refused to give Edward his stock certificates, claiming that NAI had the right of first refusal to repurchase the shares. Mickey and his attorneys relied on the argument that a portion of Edward's shares had been held in an "oral trust" for the benefit of Edward's children since NAI's inception. Because Mickey was only awarded 33.33% of the stock after contributing nearly 48%, they argued that the extra shares Edward was awarded should be regarded as being held in trust for Edward's children. Mickey insisted that Edward acknowledge the oral trust. Negotiations became contentious and adversarial.

After Belle pleaded with Edward to reach a settlement, the parties finally reached an agreement on June 30, 1972. Edward was deemed to be the "free and clear" owner of 66.67% of his 100 shares. The remaining 33.33% had always been held by Edward for the benefit of his children. NAI would repurchase Edward's 66.67 shares, which were valued at $5 million. The purchase price would be paid in 44 quarterly installments of $125,000 each (including principal and interest), plus a final payment of all the remaining principal and interest.

On July 21, 1972, three weeks after the settlement agreement was signed, Sumner established trusts for his two children. Sumner voluntarily transferred 33.33 of his NAI shares into the trusts. The remaining 66.67 shares were reissued in Sumner's name. Neither Sumner nor his wife filed a gift tax return for the quarter ending September 30, 1972, although they did consult with their accountant. Their accountant obtained advice from his firm's national office regarding the transaction. The written advice concluded that Sumner was not required to file a gift tax return because there was no taxable gift.

In 1975, in the wake of Watergate, the IRS launched an investigation into political contributions. A Senate committee provided the IRS with lists of contributions that were to be reviewed, and Sumner's name was on this list. The IRS revenue agent assigned to this investigation limited his review to political campaign contributions and did not investigate other gift tax issues. Sumner promptly provided the agent with all requested documents, and the IRS concluded there was no necessity to solicit a gift tax return for 1972.

The Redstone family was involved in additional litigation in 2006.[34] During the deposition and trial, Sumner testified that he transferred the shares to his children willingly. While Mickey expressed reservations about Edward's shares, he never expressed those concerns regarding Sumner's shares.

As a result of the 2006 litigation, the 1972 stock transfer came to the IRS's attention. In May 2011, the IRS launched a gift tax examination for 1972. The agent assigned to Sumner's case was unaware that a previous IRS review was conducted in 1975. Sumner and his attorneys provided all requested documentation and did not complain about undergoing a second examination. On January 11, 2013, the IRS issued Sumner a notice of deficiency for the 1972 gift tax.

Various experts provided a valuation of the NAI shares Sumner transferred to his children. One expert placed the value at $75,000 per share based on the $5 million redemption price for Edward's 66.67 shares. The price for Edward's shares was negotiated at arm's length and transpired only three weeks before Sumner transferred identical shares. Therefore, the 33.33 shares Sumner transferred to his children were valued at $2.5 million ($75,000 × 33.33). Using a different calculation method, the same expert concluded the value of the shares could be $2.4 million or $3 million. A second expert set the value at $735,981.

Issues. The issues in this case are as follows.

- Whether Sumner's transfer to his children was a gift or a transfer for adequate and full monetary consideration
- Whether Sumner is liable for any additions to tax

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Analysis. In 1972, under IRC §2501(a)(1), the gift tax was imposed on the transfer of property by gift for each calendar quarter. IRC §2512(b) states that when property is transferred for less than an adequate and full consideration, then the amount by which the value of the property exceeds the value of the consideration is deemed a gift. A corollary to this provision is that a transfer of property for adequate and full consideration is not a gift for federal gift tax purposes.

A transaction between family members may be treated as a business transaction if it is conducted as an arm's-length transfer of property in settlement of a dispute. Edward's transfer to his children fits this definition because a genuine dispute existed that was litigated in court. Sumner argued that his transfer was part of an overall reconfiguration of stock ownership that brought Edward's litigation to a close. However, Sumner was under no obligation to transfer his shares to his children, and he testified to that in court. Further, Edward's settlement was signed three weeks before Sumner's transfer and therefore was not necessary to the resolution of the litigation. Additionally, there was no arm's-length negotiation and Sumner did not receive any consideration in exchange for his transfer. The transfer was motivated by Sumner's kinship with his father and children. There did not appear to be any business motivation behind the transfer.

For a closely held corporation such as NAI, an actual arm's-length sale of stock within a reasonable time around the valuation date is the best criteria of market value. Alternatively, the court may look to a variety of experts to value the stock. The court dismissed the $735,981 valuation because it did not take into consideration any macroeconomic, industry-specific, or NAI-specific conditions prevailing since 1972. The $2.5 million valuation reflected similar market conditions between when Edward's shares were valued and three weeks later when Sumner transferred his shares.

The IRS contended that Sumner was liable under §6653(b) for a fraud penalty. This was based on the belief that the oral trust that was fundamental to the original case with Edward was fiction. However, there was no evidence that Sumner used the oral trust concept to evade federal gift taxes. Throughout the course of his life, Sumner filed 34 federal gift tax returns.

34. *O'Connor v. Redstone,* 896 N.E.2d 595 (Mass. 2008).

IRC §6653(a) imposes a 5% addition to tax for underpayments due to negligence. A taxpayer may show that the failure to file a return was not negligent if they relied in good faith on advice from a tax professional. Sumner relied on the advice of competent accountants. They determined that no tax liability existed, and Sumner relied on that advice in good faith.

Holding. The Tax Court held that Sumner's transfer of NAI stock to his children constituted a gift rather than a transfer made in the ordinary course of doing business. The gift was valued at $2.5 million. The court also held that Sumner was not liable for any penalties due to fraud, negligence, or failure to file a timely gift tax return.

> **Note.** Sumner Redstone controls 80% of the voting stock in CBS and Viacom through National Amusements, Inc. He is embroiled in a legal battle over his competency and the future of his $40 billion empire.[35]

> **Note.** Although Sumner Redstone was held liable for gift tax, his brother Edward's case had a different outcome. The write up of that case follows.

Gift Tax

***Estate of Edward S. Redstone et al. v. Comm'r,* 145 TC No. 11 (Oct. 26, 2015)**

IRC §§2501, 2512, 6651, 6653(a), and 6653(b)

☞ Gift Tax Liability Not Triggered

Facts. Michael "Mickey" Redstone entered the drive-in movie theater business in 1936. Mickey and Belle Redstone had two children — Sumner and Edward. Sumner, a Harvard Law school graduate, had two children. Edward attended college and business school and also had two children. Edward and Sumner entered the family business in 1952 and 1954, respectively.

Between 1936 and 1954, Mickey amassed real estate throughout the Northeast and built several drive-in theaters. He incorporated Northeast Theatre Corporation (Northeast) in 1954. Northeast became the management company for the Redstone family business. For each drive-in theater, three separate corporations were formed: one for the real estate, one to operate the theater, and one to manage refreshments. The shares were owned by Mickey, Edward, and Sumner with Mickey owning the largest share. The business continued to grow but the complex corporate structure created challenges in obtaining financing.

They formed National Amusements, Inc. (NAI) in August 1959 as a consolidated holding company. Mickey, Edward, and Sumner each contributed their stock in the pre-existing movie companies; Mickey also contributed $3,000. One hundred shares of class A voting common stock were issued to each; the actual stock certificates were retained in NAI's corporate office. Mickey was elected president, Sumner vice president, and Edward secretary-treasurer. Sumner's job was to work with movie studios and acquire new theaters. Edward had principal responsibility for operational and back-office functions.

Conflicts developed within the Redstone family. Edward was not happy with his role in the family business and talked about leaving the business. Sumner hired a person to take over Edward's responsibilities. This upset Edward, and he left the family business in June 1971.

35. *Sumner Redstone Legal Battle Moves to a Massachusetts Court.* Steel, Emily. Jun. 7, 2016. The New York Times. [www.nytimes.com/2016/06/08/business/media/sumner-redstone-legal-battle-moves-to-a-massachusetts-court.html?_r=0] Accessed on Jul. 28, 2016.

After he left the business, Edward demanded his 100 common shares of NAI stock but did not receive them. The parties fought for six months before Edward filed two lawsuits. They settled the matter in 1972 by agreeing that NAI would purchase 66.67% of the stock for $5 million while the remaining 33.33% would be assigned to trusts for Edward's children.

Edward did not file a gift tax return with respect to the 33.33% stock transfer. After an examination, the IRS issued a notice of deficiency of $737,625 for federal gift tax along with fraud, negligence, and failure-to-file penalties.

Issue. The issue is whether Edward's transfer of stock in trust for his children was a taxable gift.

Analysis. IRC §2512(b) provides that when property is transferred for less than an adequate and full consideration, then the amount by which the value of the property exceeds the value of consideration is deemed a gift. Treas. Reg. §25.2511-1(g)(1) states that gift tax does not apply to a transfer for a full and adequate consideration or to ordinary business transactions.

A transfer of property to a family member often receives close scrutiny. However, such a transfer may be treated as a business transaction if it satisfies three elements. The transfer must have been bona fide, transacted at arm's length, and free of donative intent.

There is no indication that the Redstone family dispute was a sham designed to disguise a gratuitous transfer to Edward's children; therefore, the transfer was bona fide. The requirement that the transfer be arm's length is satisfied as long as the taxpayer acts as one would act in the settlement of differences with a stranger. Edward was definitely estranged from Mickey and Sumner in 1972; therefore, the arm's-length requirement was satisfied. The absence of donative intent is essential for a transfer to be treated as made in the ordinary course of business. There is no evidence that Edward, in making this transfer, was motivated by love and affection or other feeling that normally prompts the making of a gift.

Holding. The court held that Edward's transfer of shares in a closely held corporation to trusts for his children as part of a settlement agreement did not trigger gift tax liability. The transfer was made in the ordinary course of business and was for adequate and full consideration.

GROSS INCOME

Taxable Income

Debra and Michael Barbato v. Comm'r, **TC Memo 2016-23 (Feb. 16, 2016)**
IRC §104

☞ Damages for Emotional Distress are Taxable

Facts. In 1987, Debra Barbato began working as a letter carrier for the U.S. Postal Service (USPS). She sustained neck and back injuries in 1991 during a work-related automobile accident. In 1997, she accepted a position of modified letter carrier because of her physical limitations. In this new position, she answered telephones, helped at the service window, issued post office box keys, dealt with customer complaints, and performed other administrative duties.

After a new station manager was appointed in 2004, Ms. Barbato began experiencing turmoil at work. The new manager reassigned her to carrying mail, which caused her to experience more pain. In addition, the new manager and other supervisors retaliated against her because she requested medical accommodations and they created a hostile work environment.

Ms. Barbato filed complaints against USPS with the Equal Employment Opportunity Commission (EEOC) based on discrimination and retaliation. In 2011, she was awarded $70,000 in damages for emotional distress. The judge's decision stated that Ms. Barbato suffered from depression, anxiety, sleep problems, and post-traumatic stress disorder, and that these conditions were either caused by or exacerbated by the discriminatory actions. However, **the judge specifically found that Ms. Barbato's physical pain was not caused by USPS's discriminatory actions.**

Ms. Barbato received a Form 1099-MISC, *Miscellaneous Income,* which reported the $70,000 as "other income" for 2011. The Barbatos did not report this income on their joint return. They believed the award for emotional distress was not taxable because the emotional distress was related to her previous physical injury. After an examination of their 2011 tax return, the IRS assessed a deficiency for the $70,000 of unreported income.

Issue. The issue is whether the Barbatos can exclude the $70,000 award from their 2011 gross income.

Analysis. IRC §104(a)(2) excludes from gross income damages that a taxpayer receives for personal physical injury or physical sickness. Emotional distress is not considered a physical injury or physical sickness. Therefore, taxpayers must include damages they receive for emotional distress in their income unless the damages are paid for medical care attributable to the emotional distress.

The EEOC decision was clear that the damages were for **emotional distress** attributable to discrimination. Therefore, the $70,000 is **not excludable** from the Barbatos' gross income.

Holding. The court held that the Barbatos must include the damage award in their gross income.

Foreign Earned Income Exclusion

***Samuel Striker v. Comm'r,* TC Memo 2015-248 (Dec. 28, 2015)**
IRC §911

☞ Income Earned by Army Employee is Includable in Income

Facts. Samuel Striker, a U.S. citizen with a Ph.D. in social science, wanted to use his social science skills to assist the North Atlantic Treaty Organization (NATO) mission in Iraq or Afghanistan. He accordingly applied to the U.S. Army for a position that would allow him to participate in one of these coalition efforts. The Army accepted his application and assigned him to a NATO post in Afghanistan from October 2009 to November 2010. His second deployment was at a NATO military facility near Kabul, Afghanistan, from November 2010 to October 2011.

During both of these assignments, the Army provided Mr. Striker with standard Department of Defense fringe benefits, including health and retirement benefits. His wages were subject to federal withholding and reported on Form W-2, *Wage and Tax Statement.*

On his 2010 and 2011 tax returns, Mr. Striker claimed IRC §911 exclusions of $91,500 and $92,900, respectively. Forms 2555, *Foreign Earned Income,* were attached to his return. The IRS examined the returns and disallowed the IRC §911 foreign earned income exclusion on the grounds that Mr. Striker was an employee of the U.S. government.

Issue. The issue is whether the taxpayer may exclude wages earned while deployed to Afghanistan from gross income under IRC §911(a).

Analysis. All income from whatever source derived is includable in gross income unless a specific exclusion applies. IRC §911 provides that a taxpayer may elect to exclude their foreign earned income from gross income, subject to certain limitations. **Foreign earned income** is defined as "the amount received by such individual from sources within a foreign country or countries which constitute earned income attributable to services performed by such individual." IRC §911(b)(1)(B)(ii) excludes from foreign earned income amounts paid by the United States to an employee of the United States. Whether Mr. Striker is entitled to the foreign earned income exclusion therefore depends on whether he was employed by the United States during 2010 and 2011.

In *Gillis v. Comm'r,*[36] the taxpayer was a lieutenant colonel in the U.S. Air Force who was assigned to NATO in Germany. The taxpayer contended that he was employed by NATO. The court rejected the taxpayer's argument because he was assigned to NATO by the Air Force. NATO did not have the authority to hire or fire the taxpayer from the Air Force. Furthermore, the taxpayer was paid by the Air Force.

In Mr. Striker's case, the facts mirror *Gillis.* The taxpayer worked for the United States (Army). As an employee of the United States, Mr. Striker is not entitled to a foreign earned income exclusion.

Holding. The court held that the taxpayer cannot exclude wages earned during his deployment to Afghanistan from gross income.

Taxable Social Security Benefits

***John and Desree Thompson v. Comm'r,* TC Summm. Op. 2016-20 (May 12, 2016)**

IRC §§86, 104, and 6662

☞ Workers' Compensation Treated as Taxable Social Security Benefits

Facts. John Thompson worked for the U.S. Postal Service when he suffered an injury on the job in 2009. The injury necessitated several surgeries and Mr. Thompson was unable to work during that time. He received workers' compensation benefits for this injury from July 19, 2009, to December 23, 2013.

On February 14, 2011, Mr. Thompson applied for supplemental security income (SSI) disability benefits through the Social Security Administration (SSA). The SSA initially denied Mr. Thompson's application on the basis that he had too much income to be eligible for SSI. Three months later the SSA approved his application, effective February 2010.

Along with a notice of award, the SSA sent Mr. Thompson a pamphlet, "How Workers' Compensation and Other Disability Payments May Affect Your Social Security Benefit." The pamphlet explained that the SSA would reduce Mr. Thompson's disability checks if the total that he would receive from social security and workers' compensation payments was more than 80% of his monthly average current earnings. The SSA calculated that 80% of Mr. Thompson's average earnings was $3,458. Mr. Thompson's workers' compensation payment was $3,795. Because the workers' compensation amount was more than 80% of his average earnings, the SSA withheld Mr. Thompson's benefits.

Although he never received any SSI disability benefits in 2011, the SSA issued Mr. Thompson a Form SSA-1099, *Social Security Benefit Statement.* The form reflected $35,905 of benefits paid in 2011 for "workers' compensation offset." The Thompsons did not report any of that amount on their 2011 Form 1040, *U.S. Individual Income Tax Return.*

Issue. The issue is whether the Thompsons had taxable social security income as a result of workers' compensation benefits that Mr. Thompson received in 2011.

Analysis. Under IRC §61(a), gross income includes "all income from whatever source derived," unless specifically excluded. Generally, gross income does not include "amounts received under workers' compensation acts as compensation for personal injuries or sickness."[37] However, social security benefits **are included** in gross income if they are received by a taxpayer by reason of entitlement to a monthly benefit under the Social Security Act.[38]

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36. *Gillis v. Comm'r,* TC Memo 1986-576 (Dec. 8, 1986).

37. IRC §104(a)(1).

38. IRC §86(d)(1)(A).

A taxpayer who receives less in social security benefits because they are instead receiving workers' compensation benefits must treat the amount of workers' compensation that causes the reduction in social security benefits as if it were a social security benefit for purposes of determining gross income.[39] Therefore, taxable social security benefits include the amount of workers' compensation payments to the extent they reduce, or offset, the total social security benefits to which the recipient is entitled, **whether or not the SSA actually pays such benefits.[40]**

Holding. The court held that §86(d) is unambiguous and its application to the undisputed facts of the case are clear. The Thompsons must include in gross income $30,519 (85% of $35,905 workers' compensation shown on Form SSA-1099) of taxable social security benefits.

IRS PROCEDURES — MISCELLANEOUS

Statute of Limitations

***BASR Partnership et al. v. U.S.,* U.S. Court of Appeals, Federal Circuit; No. 2014-5037 (Jul. 29, 2015)**
IRC §§6501, 6031, 701, 6221, 6223, 6225, 6226, 6229, and 6663

☞ Third Party's Fraudulent Intent Insufficient to Extend Limitations Period

Facts. In 1999, members of the Pettinati family were selling their printing business, from which they expected to realize a large capital gain. Before the sale was finalized, Erwin Mayer, a lawyer in the Jenkens & Gilchrist law firm, contacted the Pettinati family and proposed "a tax advantaged investment opportunity." Because the Pettinatis believed that this opportunity could result in tax savings, they hired Jenkens & Gilchrist, which recommended a series of transactions that could reduce the gain reported to the IRS for the sale of the printing business. After the transactions were completed, all stock in the printing business would be owned by a family partnership, BASR. The Pettinatis would then sell the printing business by directing BASR to sell its shares to the buyer.

Three attorneys at Jenkens & Gilchrist signed a tax opinion document attesting to the legitimacy of the transactions. In addition, the Pettinatis received guidance on reporting these transactions on their 1999 tax returns in a manner that was consistent with the opinion document. The Pettinatis hired Malone & Bailey PLLC, a firm that had a long-standing relationship with the family, to prepare their tax returns. Malone & Bailey considered the legal opinions provided to the Pettinatis when preparing the BASR and Pettinati tax returns.

In 2004, the IRS received a list of Jenkens & Gilchrist clients who had used this type of tax-advantaged investment structure. The IRS issued a final partnership administrative adjustment (FPAA) to BASR in 2010 for the tax returns that reflected the sale of the printing business. The FPAA explained that BASR "lacked economic substance" because its "principal purpose… was to reduce substantially the present value of its purported partners'… aggregate federal tax liability." As a result, the IRS adjusted the tax effects of the printing business sale, which significantly increased the Pettinatis' tax liability for the 1999 tax returns.

BASR sought summary judgment in Claims Court, arguing that the adjustments and increased tax liability in the FPAA were untimely under the 3-year statute of limitations of IRC §§6229(a) and 6501(a). The government asserted that even though more than three years had passed since BASR's tax returns were filed, the limitations period remained open under IRC §§6501(c)(1) and 6229(c)(1) because the case involved "a false or fraudulent return with the intent to evade tax." The IRS conceded that the Pettinatis lacked the intent to evade tax and did not allege that Malone & Bailey, who prepared the tax returns, acted with intent to evade taxes. The IRS asserted that Mayer acted with the intent to evade tax when he conceived of and marketed the tax-advantaged investment structure.

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39. IRC §86(d)(3).

40. See *Moore v. Comm'r,* TC Memo 2012-249 (Aug. 28, 2012); *Mikalonis v. Comm'r,* TC Memo 2000-281 (Aug. 31, 2000); *Willis v. Comm'r,* TC Memo 1997-290 (Jun. 26, 1997).

In response, BASR argued that the 3-year limitations period is suspended only when the taxpayer intended to evade tax. The Claims Court agreed and granted BASR's motion for summary judgment. The government then filed a notice of appeal.

Issue. The issue is whether the 3-year statute of limitations of IRC §6501 barred the IRS from adjusting the partnership tax return filed by BASR.

Analysis. IRC §6501(c)(1) states that "in the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed… at any time." The government contended that the unlimited limitations period is triggered when **any** individual acts with the intent to evade tax and the tax return filed contains a falsity. BASR countered that §6501(c)(1) suspends the statute of limitations only when the taxpayer acts with the intent to evade tax.

The court recognized that §6501(c)(1) is silent as to which party must have the requisite fraudulent intent necessary to suspend the 3-year limitations period. Therefore, §6501(c) must be understood in context. The court noted that §6501(c)(1) is not the only Code provision that deals with the consequences of intentional tax evasion. A survey of other fraud-related Code provisions reveals that they contemplate fraud **by the taxpayer,** rather than by a person who merely contributed in a fraudulent way to filing an inaccurate tax return. IRC §7454(a) provides that "in any proceeding involving the issue whether the **petitioner** has been guilty of fraud with intent to evade tax," the IRS bears the burden of proving fraud. Thus §7454(a) indicates that Congress considered the fraudulent intent of only the taxpayer, not of a third party who assisted or advised the taxpayer.

The court further observed that the government's interpretation of §6501(c)(1) is of relatively recent vintage. In a 2001 Field Service Advisory, the IRS concluded that "[s]ection 6501(c)(1) does not by its express language require that the 'intent to evade tax' be the personal intent of Taxpayer[,] [w]e nonetheless conclude that the fraudulent intent of the return preparer is insufficient to made section 6501(c)(1) applicable."[41]

Holding. The court affirmed the Claims Court's decision that §6501 limits the IRS to the 3-year limitations period unless the taxpayer possessed the intent to evade tax.

Limitation Period for Collection

Paul W. Grauer v. Comm'r, **TC Memo 2016-52 (Mar. 22, 2016)**

IRC §§6330 and 6502

☞ Tax Debt Uncollectable Due to Expiration of Limitation Period

Facts. Illinois taxpayer Paul Grauer filed his 1998 tax return on April 6, 2000. On May 8, 2000, the IRS assessed a $57,698 tax liability against Mr. Grauer. On October 2, 2001, both parties executed a waiver extending the 10-year statute of limitations until **"May 8, 20015."** On October 3, 2001, Mr. Grauer entered into an installment agreement, which was terminated on February 20, 2006. From 2006 through 2012, the IRS issued balance due notices to Mr. Grauer.

On February 11, 2013, the IRS issued a notice of intent to levy regarding Mr. Grauer's 1998 tax liability. On March 7, 2013, Mr. Grauer filed a request for a collection due process hearing. During the course of the administrative hearing, Mr. Grauer contended that a typographical error (the waiver's May 8, 20015 expiration date) rendered the waiver invalid and that the waiver was not agreed to in connection with an installment agreement. The IRS issued a notice of determination sustaining the proposed collection action on August 19, 2013, and Mr. Grauer timely petitioned the court.

Issue. The issue is whether the IRS is permitted, pursuant to IRC §6502, to collect Mr. Grauer's 1998 tax liability.

Analysis. IRC §6502(a) provides that the period of limitation for collection may be extended by waiver if the extension is agreed to at the same time an installment agreement is entered into. Mr. Grauer contended that he did not enter into an installment agreement; therefore, the waiver is invalid and the 10-year limitation period for collection has expired.

41. FSA 200104006 (Sep. 15, 2000).

The IRS produced a waiver relating to 1998 on which the parties extended the 10-year limitation period for collection. The IRS **did not** produce an installment agreement that was entered into in connection with the waiver. The only evidence the IRS produced was an account transcript, which the IRS conceded was inaccurate and an "indecipherable and unconvincingly explained collection of numerical codes."

Holding. The court determined an installment agreement was not agreed to in connection with the waiver and the 10-year period for collection had expired.

Timely Filing

***Felix Guralnik v. Comm'r,* U.S. Tax Court; No. 4358-15 L (Aug. 24, 2015)**
IRC §§6330, 7502, and 7503

☞ Snow Day Treated as Legal Holiday

Facts. The IRS sent Felix Guralnik a notice of determination via certified mail on January 16, 2015. This notice sustained the filing of a notice of federal tax lien for Mr. Guralnik's outstanding income tax liabilities for 2003 and 2005.

To dispute the determination, Mr. Guralnik had to file a petition with the Tax Court within 30 days after the date of the letter. The 30-day window ended Sunday, February 15, 2015. Monday, February 16, 2015, was a legal holiday in the District of Columbia (Washington's Birthday). On Tuesday, February 17, 2015, federal government offices in the Washington, D.C. area and District of Columbia offices were officially closed due to a winter storm. The closures also included the Tax Court office. The Tax Court reopened on Wednesday, February 18, 2015.

Mr. Guralnik sought to challenge the notice of determination by filing a petition with the Tax Court. His petition was delivered via FedEx on Wednesday, February 18, 2015. The FedEx envelope reflected a ship date of Friday, February 13, 2015. At that time, FedEx was not among the companies designated as a private delivery service by the IRS. The IRS filed a notice to dismiss the petition because it was not timely filed.

Issue. The issue is whether Mr. Guralnik's petition seeking review of a collection determination was timely filed.

Analysis. IRC §7503 provides that when the last day prescribed under authority of the Internal Revenue laws for performing any act falls on a Saturday, Sunday, or a legal holiday, the performance of the act will be considered timely if it is performed on the next succeeding day that is not a Saturday, Sunday, or a legal holiday.

Under IRC §7502(a), a **timely mailed** petition may be treated as though it were **timely filed.** Additionally, a petition that is timely sent by a designated delivery service may be treated as though it were timely mailed. A **designated delivery service** is defined as any delivery service designated by the IRS as satisfying statutory and regulatory standards.

The IRS contends that Mr. Guralnik's petition was not timely mailed because it was sent by a delivery service that was not among those then designated by the IRS as private delivery services. Therefore, according to the IRS, timeliness is determined by the date the petition was actually delivered to the court.

The court noted that the closing of Washington, D.C. and federal government offices, including the Tax Court, means that the Tax Court's office was inaccessible on the day of the winter storm. The court found it "inconceivable that Congress would have intended, absent a specific statutory provision requiring otherwise, to bar a taxpayer who fails to anticipate on a Friday that the Government will decide to close a filing office on the first workday of the following week on account of a snowstorm."

Holding. The Tax Court held that Mr. Guralnik's petition seeking review of a collection determination was timely filed.

Offer In Compromise

***John N. Alphson v. Comm'r,* TC Memo 2016-84 (May 2, 2016)**

IRC §§6201, 6330, 6502, and 7122

☞ IRS Was Justified in Rejecting Offer in Compromise

Facts. Up until 2008, John Alphson worked in the commercial real-estate industry, owning and managing buildings as well as developing real property. In 2008, he settled an ongoing legal dispute and was to receive a $1.2 million settlement, to be paid out over three years. He received $600,000, $460,000, and $135,000 in 2008, 2009, and 2010, respectively. Mr. Alphson claimed that the terms of the settlement left him unemployed.

His 2008–2010 tax returns showed the following amounts.

Year	AGI	Tax
2008	$237,797	$ 87,704
2009	373,553	104,952
2010	123,220	13,111

Mr. Alphson never paid the income taxes he owed and subsequently filed bankruptcy in March 2010. The bankruptcy was discharged in February 2011, but his tax debt was not dischargeable. In response, Mr. Alphson submitted an offer in compromise (OIC) for $2,400 to settle his tax debt, which at that time was slightly under $200,000. The IRS rejected the OIC.

Issue. The issue is whether the IRS abused its discretion by rejecting Mr. Alphson's offer to pay $2,400 to settle his $200,000 tax liability.

Analysis. IRC §7122(d)(1) gives the IRS **wide discretion** to accept compromise offers and to prescribe guidelines to determine whether an OIC is adequate and should be accepted. Mr. Alphson's offer was based on doubt as to collectability. His petition stated that he was challenging his underlying tax liability. However, he did not raise the issue any time before or during his collection due process (CDP) hearing. Because he did not raise this argument during his hearing, the court refused to consider the issue of liability.

Next, Mr. Alphson argued the settlement officer erred in calculating his reasonable collection potential (RCP) and therefore erred in rejecting his offer. The main components of a taxpayer's RCP are his realizable net equity in his assets and his net future income. The settlement officer calculated Mr. Alphson's RCP to be over $3 million.

The settlement officer determined that Mr. Alphson had net realizable equity in assets of more than $1.5 million, which included the $1.195 million that he collected from his settlement. Both parties agreed that he received three large payments in 2008, 2009, and 2010, all of which he spent. However, the parties did not agree whether all or some of this money should be included in Mr. Alphson's RCP. The court noted that this dispute is about whether the settlement proceeds are a dissipated asset.

A dissipated asset is any asset that has been "sold, transferred, or spent on nonpriority items or debts and that is no longer available to pay the tax liability."[42] If a taxpayer can substantiate claims that they used dissipated assets for necessary living expenses, the IRS **should not** include them in the taxpayer's RCP. The Internal Revenue Manual (IRM) provides specific guidance on how to calculate and when to include dissipated assets but the parties disagree about what version of the IRM applies. Mr. Alphson requested the September 2013 version be used, but the IRS used the 2010 version that was in effect when the offer was made. The court determined that the 2010 version was the correct version. This version provides that although dissipated assets should not automatically be included in calculating RCP, if a taxpayer used assets on nonpriority items, the officer should determine what portion of the value of the assets is appropriate to include in the taxpayer's RCP.

42. *Johnson v. Comm'r,* 136 TC 475 (2011), *aff'd* 502 F.Appx 1 (D.C. Cir. 2013).

The IRS settlement officer concluded that Mr. Alphson had dissipated assets that could have paid his tax bill, but he gave Mr. Alphson another chance to refute the findings. Mr. Alphson said he used the funds to pay necessary expenses totaling $579,827, $546,641, and $135,455 in 2008, 2009, and 2010, respectively. These **necessary expenses** were allegedly for legal fees, Schedule C expenses, credit cards payments, and living expenses. However, the only documentation Mr. Alphson provided was a table summarizing the expenses. The court found that this table did not prove he actually spent these amounts or spent them on what he claims. Even though he did provide photocopies of checks, he did not organize them by expense type or purpose nor did he provide receipts to substantiate what he spent. The court concluded that the settlement officer did not abuse his discretion by determining that the legal settlement proceeds were a dissipated asset.

The court then looked to the future-income component of Mr. Alphson's RCP. The IRS calculated his future income to be nearly $2.9 million. The IRM provides that when a taxpayer has been unemployed for a long time, his current income should be used in the calculation of future income. Despite the fact that Mr. Alphson alleged he was **unemployed,** unexplained deposits of $6,355 per month to his bank account indicated otherwise. Taking a conservative approach, the court recalculated Mr. Alphson's net monthly income to be $3,000 for 60 months, or $180,000. Obviously, the $180,000 is still considerably more than the $2,400 Mr. Alphson originally offered.

The final argument made by Mr. Alphson was that the IRS can accept an offer when "special circumstances" apply. Mr. Alphson claimed he would suffer "economic hardship" if he had to pay but did not present any evidence of such hardship.

Holding. The court concluded **the IRS did not abuse its discretion** by rejecting an individual's offer to pay $2,400 to settle his $200,000 tax liability.

IRS Collection Actions

Jonathan and Cheryl Hunsaker v. U.S., **No. 14-06218, U.S. Bankruptcy Court for the District of Oregon (Jan. 13, 2016)**
11 USC §§106 and 362(k)

☞ IRS Collection Actions Caused Debtors Emotional Distress

Facts. Jonathan and Cheryl Hunsaker declared bankruptcy on November 5, 2012. The case was difficult, and the couple entered into a plan of reorganization on September 3, 2014. An automatic stay under 11 USC (Bankruptcy Code) §362(a) became effective when the petition was filed, and it remained in effect. The Hunsakers made their required plan payments. The IRS was listed as a creditor and received notice of the filing.

After the automatic stay went into effect, the IRS sent the Hunsakers four notices.

1. December 12, 2013: A notice of intent to levy and a demand for payment of $9,686
2. February 10, 2014: A notice of levy on social security benefits and a demand for payment of $9,814
3. September 1, 2014: A notice of intent to seize the Hunsakers' state tax refund or other property, demanding $10,159
4. December 8, 2014: A levy on social security benefits and a demand for payment of $10,234

The Hunsakers brought each of these notices to their attorney after they received them. The attorney assured them that any IRS collection efforts were unlawful. The attorney wrote to the IRS in December 2013 and February 2014, stating that the Hunsakers were in bankruptcy and requesting the IRS to cease its collection efforts.

Within hours of receiving each of the IRS notices, Mrs. Hunsaker suffered migraine headaches. Each spouse noted signs of tension and anxiety in the other, which increased their own stress. They were particularly concerned with the threat to Mr. Hunsaker's social security benefits. A loss of a substantial portion of their income would render the plan of reorganization unfeasible.

The Hunsakers sought a judgment against the IRS for emotional damages incurred from serial violations of the automatic stay.

Issues. The issues in this case are as follows.

- Whether the government violated an automatic stay under 11 USC §362
- If the government violated the stay, what amount of damages should be awarded

Analysis. Bankruptcy Code §362(a)(1) states that a petition for relief operates as a stay, applicable to all entities, of "the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case…" Bankruptcy Code §362(k) states that an individual injured by a willful violation of a stay can recover actual damages, including costs and attorney's fees. In appropriate circumstances, an injured individual may recover punitive damages.

The IRS admitted that the notices violated Bankruptcy Code §362 but asserted that it is immune from damages under the sovereign immunity provisions of Bankruptcy Code §106. The IRS argued that the waiver of sovereign immunity (legal doctrine that government is immune from civil suit or criminal prosecution) within §106 does not explicitly provide for a damages award based on emotional distress. However, in drafting §106, Congress explicitly excluded punitive damages but not any other type of damages. Therefore, a governmental unit is subject to liability for any type of damages otherwise authorized by the Bankruptcy Code.

In *Dawson v. Washington Mutual Bank*,[43] the Court of Appeals held that emotional distress damages are compensable under Bankruptcy Code §362(k) to an individual who meets the following criteria.

1. Suffers significant harm
2. Clearly establishes the significant harm
3. Demonstrates a connection between the significant harm and the violation of the automatic stay

The court determined that the injuries the Hunsakers suffered, especially Mrs. Hunsaker's migraines, caused significant harm and were compensable under the *Dawson* standards. It was not unreasonable that the Hunsakers were concerned that the IRS might take the threatened action, despite their attorney's assurances. The inherent tension and stress of bankruptcy were exacerbated by the violation of the stay. Their bankruptcy case was progressing well, the reorganization plan was confirmed prior to the fourth IRS notice, and the Hunsakers were making required plan payments. Mrs. Hunsaker testified that her migraines were attributable to the notices.

Holding. The court held that the IRS violated the automatic stay. Mrs. Hunsaker was awarded $3,000 for her emotional distress and Mr. Hunsaker was awarded $1,000 for his emotional distress.

[43] *Dawson v. Washington Mutual Bank,* 390 F.2d 1139, 1148 (9th Cir., 2004).

Timely Filing

***Robert Tilden v. Comm'r,* TC Memo 2015-188 (Sep. 22, 2015)**
IRC §§6212, 6213, and 7502

☞ Online Postmark Is Not Evidence of a Timely Filed Petition

Facts. On January 21, 2015, the IRS sent Robert Tilden notices of deficiency. Mr. Tilden had 90 days — until April 21, 2015 — to challenge the deficiency and penalties. Mr. Tilden sent his petition for redetermination in an envelope with a mailing label that included a postmark by Stamps.com. The postmark was dated April 21, 2015. The envelope also had a U.S. Postal Service (USPS) tracking number. Based on the tracking information, the petition entered the mail system on the 92nd day and was delivered on the 98th day. The IRS filed a motion to dismiss because the petition was not timely filed.

Issue. The issue is whether the Stamps.com postmark is an official postmark that proved Mr. Tilden mailed his petition in a timely manner.

Analysis. IRC §6212(a) authorizes the IRS to send a taxpayer a notice of deficiency by certified or registered mail. IRC §6213(a) allows the taxpayer 90 days (or 150 days if the taxpayer is outside of the United States) to file a petition for redetermination of the contested deficiency. Under IRC §7502, a petition is timely filed if it is timely mailed.

Mr. Tilden argued that under Treas. Reg. §301.7502-1(c)(1)(iii)(B), the Stamps.com postmark constituted an official postmark. The regulation states the following for postmarks made by other than the USPS.

> ***(i)*** *The postmark so made must bear a legible date on or before the last date, or the last day of the period, prescribed for filing the document or making the payment; and*
>
> ***(ii)*** *The document or payment must be received by the agency, officer, or office with which it is required to be filed not later than the time when a document or payment contained in an envelope that is properly addressed, mailed, and sent by the same class of mail would ordinarily be received if it were postmarked at the same point of origin by the U.S. Postal Service on the last date, or the last day of the period, prescribed for filing the document or making the payment.*

The IRS argued that the Stamps.com label included only the date it was purchased and not the place or date of sending or receipt.

The court looked to Treas. Reg. §301.7502-1(c)(1)(iii)(B)(3) for guidance on envelopes with a postmark made by the USPS in addition to a postmark not so made. It states that the postmark not made by the USPS is disregarded. The USPS postmark is conclusive in determining whether a document is timely mailed. Case law has determined that a USPS tracking number can serve as a functional equivalent of a USPS postmark. It provides reliable data from a neutral third-party source that is not susceptible to manipulation.[44]

Holding. The court held that the Stamps.com postmark was disregarded in favor of the USPS tracking information. Therefore, Mr. Tilden did not file his petition in a timely manner.

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44. *Boultbee v. Comm'r,* TC Memo 2011-11 (Jan. 11, 2011); *Abeles v. Comm'r,* 91 TC 1019 (Dec. 7, 1998).

IRS PROCEDURES — PENALTIES

Penalties

***Brinks Gilson & Lione A Professional Corporation v. Comm'r,* TC Memo 2016-20 (Feb. 10, 2016)**
IRC §§83, 6662, and 6664

☞ Reasonable Cause Not Established

Facts. Brinks Gilson & Lione is an intellectual property law firm organized as a corporation, with its principal offices in Chicago. It has a calendar yearend and uses the cash method of accounting.

During 2007 and 2008, the firm employed about 150 attorneys, 65 of whom were also corporate shareholders. Prior to the beginning of each calendar year, the board of directors met to settle on a compensation budget for the year. This estimate was shared with all the shareholder-attorneys. During the course of the year, each shareholder-attorney received only a percentage of their expected compensation and received an additional amount as a yearend bonus. The intent of the board was to have the yearend bonuses exhaust the corporate book income. The yearend bonuses were calculated, paid, and included as part of the shareholder's compensation. The total compensation was claimed as a deduction for employee compensation on the respective tax returns.

The IRS examined the 2006 corporate tax return and made no changes. However, the IRS examinations of the corporation's 2007 and 2008 returns resulted in a substantial amount of officer compensation being recharacterized as nondeductible dividends. After concessions by the taxpayer, the corporation's underpayments were determined to be \$1.1 million and \$1.0 million for 2007 and 2008, respectively. The IRS asserted the accuracy-related penalty for both years as well. The taxpayer agreed with the tax but disagreed with the assertion of the penalties.

Issue. The issue is whether the taxpayer is liable for accuracy-related penalties on underpayments of tax relating to amounts it deducted as officer compensation that it now agrees were nondeductible dividends.

Analysis. With respect to the IRC §6662(a) accuracy-related penalty, the taxpayer argued they had substantial authority for deducting in full the yearend bonuses paid to the shareholder-attorneys. They also argued they relied on the services of a reputable accounting firm to prepare their tax returns.

In arguing that the firm had substantial authority, the taxpayer cited *Richard Ashare, P.C. v. Comm'r.*[45] In *Ashare,* the court allowed a corporate law firm to deduct compensation paid to its sole shareholder that exceeded the firm's revenues for the year.

The IRS cited *Pediatric Surgical Associates, P.C. v. Comm'r,*[46] along with *Mulcahy, Parutisch, Salvador & Co. v. Comm'r,*[47] to support its position that certain amounts paid to shareholder-employees are nondeductible dividends. The principle applied in *Mulcahy* provides that owners with significant capital are entitled to a return on their investments. As the court observed in *Elliotts, Inc. v. Comm'r,*[48] in situations where there is no funding available for return on investments because of excessive compensation, an independent shareholder would never agree to the compensation arrangement. Therefore, the taxpayer's practice of paying out year-end bonuses to eliminate book income fails the independent-investor test.

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45. *Richard Ashare, P.C. v. Comm'r,* TC Memo 1999-282 (Aug. 24, 1999).
46. *Pediatric Surgical Associates, P.C. v. Comm'r,* TC Memo 2001-81 (Apr. 2, 2001).
47. *Mulcahy, Parutisch, Salvador & Co. v. Comm'r,* 680 F.3d 867 (7th Cir. 2012).
48. *Elliotts, Inc. v. Comm'r,* 716 F.2d 1241 (9th Cir. 1983).

The second argument the taxpayer raised against the assertion of the accuracy-related penalty was their reliance on a reputable accounting firm to prepare the returns. However, the taxpayer provided no evidence that the accounting firm advised the taxpayer regarding the deductibility of yearend bonuses. In addition, the taxpayer failed to provide the accounting firm with accurate information.

The taxpayer also argued that the "no change" letter issued by the IRS when it concluded its 2006 audit helps show the treatment of the yearend bonuses was not "too good to be true" and the reliance on the accounting firm was reasonable. However, there was no evidence that the IRS agent that examined the taxpayer's 2006 return specifically considered the deductibility of yearend bonuses paid that year. In addition, the evidence did not clearly establish that the examiner was provided with sufficient information to bring the issue to his attention.

Holding. The court held that the taxpayer failed to show it had reasonable cause for deducting the full amount of the yearend bonuses paid to its shareholder-attorneys or that it acted in good faith. Therefore, the court sustained the accuracy-related penalty.

Late-Filing Penalty

***Bradley and Nancy Reifler v. Comm'r,* TC Memo 2015-199 (Oct. 13, 2015)**
IRC §§6011 and 6651

☞ Lack of Signature Results in Invalid Tax Return

Facts. Bradley and Nancy Reifler have been married since 1988. Throughout their marriage, both have had significant experience in financial, business, and tax matters.

On their 2000 Form 1040, the taxpayers showed a filing status of married filing jointly. They followed their usual procedures for preparing and signing their tax return. Their CPA signed and dated the original return before sending it to the taxpayers on October 9, 2001. Mr. Reifler signed the original return before he put it the bin at home where he usually placed documents that required his wife's signature. The next morning, Mr. Reifler took the return back to his office and mailed it to the IRS.

The return was sent back to the taxpayers with a date stamp of October 15, 2001, along with some red ink marks. No correspondence was attached to the return. Receiving this return without correspondence did not raise any concerns because Mr. Reifler occasionally requested copies of their returns from the IRS for business reasons.

The IRS issued a delinquency notice in July 2002 for the 2000 tax return. The taxpayers discussed the issue with their CPA. They signed a second return and sent it to the IRS on August 25, 2002. Although the taxpayers felt this was merely a copy of the original return, they did not include any correspondence to explain to the IRS what had happened. The IRS processed this return as the original return with a filing date of September 2, 2002.

In April 2004, the IRS began an audit of the taxpayers' tax returns for the 2000–2005 tax years. The taxpayers agreed to extend the statute of limitations several times with respect to the 2000 tax year. The CPA sent a letter to the IRS in July 2005 informing the IRS that the taxpayers considered the original filing date of October 15, 2001, in determining the statute of limitations. The IRS issued a notice of deficiency in May 2010, shortly before the expiration of the last extension of the limitations period.

Issues. The issues in this case are as follows.

- Whether the 2000 federal income tax return, which included Mr. Reifler's signature but not Mrs. Reifler's signature, was a valid tax return
- Whether the taxpayers are liable for the IRC §6651(a)(1) penalty for failing to timely file the tax return for 2000

Analysis. Treas. Reg. §1.6012-1(a)(5) provides that the signatures of both taxpayers are required if a joint return is filed. Instructions for the 2000 Form 1040 included the same requirement and unequivocally warn that a Form 1040 is not considered a valid tax return unless signed by the taxpayers.

The taxpayers argued that the original 2000 return was a valid and timely filed joint income tax return despite the lack of Mrs. Reifler's signature. They argued that a tax return need not be perfect to be valid based on the substantial compliance doctrine. The court noted that the substantial compliance doctrine allows a taxpayer to file a return that may contain some inaccuracies and mistakes as long as a reasonable attempt to comply with tax law requirements was made. However, the substantial compliance doctrine cannot be used to justify a failure to comply with simple and clear requirements.

The taxpayers also argued that the tacit consent doctrine provides an exception to the requirement that both spouses sign a joint tax return. They contended that they are entitled to a finding that the original 2000 return is valid without Mrs. Reifler's signature because they intended to file a joint return. The IRS countered that the tacit consent doctrine is relevant only to the issue of determining whether the spouses are jointly and severally liable for the tax return that they intended to file jointly but has no bearing on the requirement that both spouses sign a joint return. After examining the case law, the court rejected the taxpayers' argument.

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. The taxpayers believe they acted with reasonable cause and without willful neglect with respect to the preparation and filing of their 2000 joint return. They believe they followed all their regular procedures in preparing and mailing the original 2000 return.

Subsequent alterations made to the original 2000 tax return indicate that they knew Mrs. Reifler's signature was missing. These alterations indicate the taxpayers understood that a tax return not signed by one of the spouses would be insufficient for some business purposes. However, the taxpayers did nothing about it until they received a delinquency notice. The court found that such conduct does not meet the standard of ordinary business care and prudence. Therefore, they are liable for the addition to tax under §6651(a)(1).

Holding. The court held that a joint income tax return that was not signed by Mrs. Reifler did not constitute a valid and timely filed return. The court found the taxpayers liable for an addition to tax for failure to timely file their return.

Late-Filing Penalty

***Maurice S. Vaughn v. U.S.,* U.S. Court of Appeals, 6th Circuit; No. 14-3858 (Dec. 15, 2015)**
IRC §6651

☞ Reliance on Agent Does Not Equate to Reasonable Cause Exception

Facts. From 1991 to 2003, Maurice "Mo" Vaughn was a major league baseball player. In May 2004, he hired Ra Shonda Kay Marshall and her company, RKM Business Services Inc., to manage his financial affairs, pay his taxes and his other bills, invest his money, and allocate funds for his immediate use.

Mr. Vaughn had two bank accounts in which he deposited all his income. Ms. Marshall, the sole signatory on both accounts, was responsible for paying all his bills, paying his taxes, and giving him a monthly budget. In 2004, 2005, and 2006, Ms. Marshall filed all his tax returns. However, she only paid the 2004 and 2005 taxes. In 2007, Ms. Marshall neither filed nor paid his taxes.

In late 2008, Mr. Vaughn terminated his arrangements with Ms. Marshall and his tax accountant and began managing his own financial affairs. After reviewing his bank statements, Mr. Vaughn found that Ms. Marshall had been embezzling from him, draining his portfolio, and failing to pay his taxes. At the time his 2007 tax return was due, he did not have enough money in his accounts to pay his tax liability. Mr. Vaughn sued Ms. Marshall and her company and has outstanding judgments against them totaling $5 million.

Mr. Vaughn attempted to recover the late-filing penalties the IRS assessed against him for his 2006 and 2007 taxes. The district court dismissed the claim for 2006 because he did not exhaust his administrative remedies. The court considered the 2007 claim and granted summary judgment to the government. Mr. Vaughn appealed.

Issue. The issue is whether the taxpayer is liable for the IRC §6651(a)(1) penalty for failure to timely file his 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. Mr. Vaughn argued that he qualifies for the reasonable cause exception because:

1. He used ordinary business prudence and care in the selection and reliance on his agents to file and pay his taxes, and
2. The agents' fraud and embezzlement left him unable to file and pay his taxes.

In *U.S. v. Boyle*,[49] the Supreme Court addressed the issue of late-filing penalties assessed against a taxpayer for his agent's failure to file and pay his taxes. The Court noted that the regulations require a taxpayer to show that he exercised ordinary business care and prudence. The Court stated that it requires no special training or effort to ascertain a deadline and make sure that it is met. Therefore, the failure to timely file a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not reasonable cause for a late filing under IRC §6651(a)(1). Based on this discussion, Mr. Vaughn's first argument is not valid.

In support of his second argument, Mr. Vaughn cited *In the Matter of American Biomaterials Corp.*[50] In that case, two corporate officers defrauded their corporation and embezzled funds. The officers' criminal actions left the corporation unable to pay its taxes, and the corporation was not held liable for penalties. The court found Mr. Vaughn's argument to be flawed because a corporation is not entitled to the reasonable cause exception if it has **lax internal controls or fails to secure competent external auditors to ensure the filing of timely tax returns and payment of taxes.**

Mr. Vaughn retained the absolute right to revoke Ms. Marshall's powers at any time and for any reason. He knew there was a deadline for taxes to be filed and paid. He failed to ensure that these responsibilities were fulfilled by Ms. Marshall.

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

ITEMIZED DEDUCTIONS

Gambling Expenses

***James Boneparte Jr. v. Comm'r,* TC Memo 2015-128 (Jul. 13, 2015)**
IRC §§61, 72(t), 162, 166, 213, 6662, and 7491

☞ Taxpayer Who Lived in Casino Not Entitled to Deduct Gambling Expenses or Losses

Facts. James Boneparte was employed full time by the Port Authority of New York and New Jersey. He generally worked from 2 p.m. to 10 p.m. during 2010.

Mr. Boneparte did not maintain a permanent residence. Instead, he kept his personal belongings in a storage locker in New Jersey. After his shift at the Port Authority was over, he usually drove approximately 125 miles to Atlantic City and checked in at a casino hotel where he stayed the night and gambled. If he had to work at the Port Authority the next day, he left Atlantic City at 10 a.m. and returned to the Port Authority to perform his job.

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

50. *In the Matter of American Biomaterials Corp.,* 954 F.2d 919 (3rd Cir. 1992).

During 2010, Mr. Boneparte gambled primarily in Atlantic City, but he also gambled at other locations in New Jersey, Nevada, California, Arizona, Maryland, Florida, and Connecticut. He did not keep a contemporaneous written log of his wins and losses from his gambling activities. Instead, he kept a running ledger in his head. Some of the casinos tracked his gambling activity, but they provided only averages over time rather than precise amounts.

While he gambled in Atlantic City, Mr. Boneparte became friends with another frequent gambler. The two discussed strategy, and the friend taught Mr. Boneparte about some aspects of gambling. They traveled together to various destinations to gamble.

Mr. Boneparte timely filed his 2010 federal income tax return. He reported income of $92,310, which included $76,779 of wages. He did not report any gambling winnings. He claimed deductions on Schedule A, *Itemized Deductions,* totaling $66,297, which included medical expenses, home mortgage interest, state and local taxes, charitable contributions, and miscellaneous deductions. He did not deduct any gambling losses.

In September 2012, the IRS informed Mr. Boneparte that his 2010 tax return had been selected for audit. The IRS requested documentation to support the claimed Schedule A deductions.

In September 2013, Mr. Boneparte mailed the IRS a Form 1040X, *Amended U.S. Individual Income Tax Return,* for 2010. Mr. Boneparte claimed the following Schedule A deductions on the amended return.

Medical travel expenses	$14,043
Taxes	8,891
Gambling losses (other miscellaneous deductions)	25,000
Total	$47,934

Mr. Boneparte also claimed that he was a professional gambler on the Schedule C, *Profit or Loss From Business,* that he included with his amended return. He reported gross income of $0 and expenses totaling $91,699.

The IRS did not accept the amended return. In November 2013, the IRS issued a notice of deficiency. The notice disallowed Mr. Boneparte's Schedule A deductions from his **original** return for medical expenses, home mortgage interest, charitable contributions, and miscellaneous deductions.

Issues. Although several issues were raised in this case, the following analysis focuses on:

- Whether Mr. Boneparte was a professional gambler during 2010, which would entitle him to deduct his gambling losses and expenses on his amended Schedule C; and
- Whether he is entitled to deductions on his amended Schedule A for $25,000 of gambling losses.

Analysis. IRC §61 defines gross income as all income from whatever source derived. This includes gambling winnings. IRC §162(a) allows deductions for ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business. If a taxpayer is engaged in the trade or business of gambling, IRC §165(d) limits their deductions for losses to the amount of their gains from such transactions. However, expenses other than wagering losses incurred in the trade or business of gambling are not subject to the §165(d) restriction.

To be a professional gambler, the taxpayer must engage in gambling with the objective of making a profit.[51] Treas. Reg. §1.183-2(b) sets forth a list of nine factors that may be considered in determining whether a profit motive exists. The court focused only on the following factors that it believed were applicable to this case.

- **Manner in which the taxpayer carries on the activity.** Mr. Boneparte did not maintain complete and accurate records of his gambling activity. He did not testify that he spent time attempting to improve his profitability by adopting new methods. This factor weighs against Mr. Boneparte.

51. IRC §§183(a), (b), and (c); *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987); Treas. Reg. §1.183-2(a).

- **Expertise of the taxpayer or their advisers.** Mr. Boneparte spent time with another frequent gambler. They talked strategy and took at least one trip together to learn the "ins and out of how to gamble." However, the court was not persuaded that he achieved any level of expertise. This factor weighs against Mr. Boneparte.
- **Taxpayer's success in carrying on other similar or dissimilar activities.** Mr. Boneparte provided no evidence of success with other business activities. This factor weighs against him.
- **Taxpayer's history of income or losses.** Mr. Boneparte had been gambling for about 11 years but did not provide any evidence regarding his history of income or losses from gambling. This factor weighs against him.
- **Taxpayer's financial status.** Mr. Boneparte earned $76,779 in wages from the Port Authority in 2010. If he is permitted to deduct his gambling-related expenses from his wage income, his taxable income would be significantly reduced. This factor weighs against him.
- **Elements of personal pleasure or recreation.** Mr. Boneparte testified that he enjoys gambling. This factor weighs against him.

After considering all the facts and circumstances and weighing the preceding factors, the court determined that Mr. Boneparte did not conduct his gambling activity in a businesslike manner and with the requisite profit motive. Therefore, he cannot deduct his gambling expenses on Schedule C.

In addition, he did not report any gambling winnings. Because gambling losses are deductible on Schedule A only to the extent of winnings, he is not entitled to deduct his purported $25,000 of losses.

Holding. The court upheld the IRS's determination that Mr. Boneparte is not entitled to deductions for gambling-related expenses or gambling losses.

Conservation Easement

***Douglas G. Carroll III and Deirdre Smith v. Comm'r,* 146 TC No. 13 (Apr. 27, 2016)**
IRC §§170, 6662, and 6664

☞ Carryforward of Charitable Deduction for Conservation Easement Disallowed

Facts. In 1985, Dr. Douglas Carroll became the sole owner of 25.8 acres on Greenspring Valley Road in Lutherville, Maryland. The property has two components (approximately 3.92 acres and 21.83 acres) that are primarily open pastureland and woodland and is part of the Green Spring Valley National Register Historic District. Dr. Carroll and his family have a 2-story residence on the 3.92 acres, and a 1,000-square-foot tenant house is located on the 21.83 acres.

In November 2005, Dr. Carroll executed a gift deed transferring his interest to himself, to his wife, and to himself as custodian for each of his three minor children under the Maryland Uniform Transfer to Minors Act, as tenants in common. In December 2005, the taxpayers executed a deed of conservation easement for no consideration on parcel 1 (3.92 acres) in favor of Maryland Environmental Trust (MET) and the Land Preservation Trust, Inc. (LPT) as joint easement holders. An appraiser visited the property in February 2006 and determined the value of the easement was $1.2 million. The MET board of directors and LPT's board of trustees both accepted the conservation easements.

The 2005 tax return filed by Dr. Carroll and his wife reported the donation of the $1.2 million conservation easement, $495,356 of which was claimed as a noncash charitable contribution on Schedule A, *Itemized Deductions.* The remainder ($704,644) was carried forward to 2006, 2007, and 2008.

The IRS disallowed the charitable contribution carryforwards for 2006 through 2008 and imposed accuracy-related penalties for all years.

Issues. The issues in this case are as follows.

- Whether the taxpayers are entitled to carryforward charitable contribution deductions for the tax years 2006, 2007, and 2008 from their 2005 contribution of a conservation easement to MET and LPT
- Whether the taxpayers are liable for accuracy-related penalties under IRC §6662(a) for the years in issue

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

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

The IRS conceded that the conservation easement was granted to qualified organizations (MET and LPT). However, the IRS argued that the conservation easement does not constitute a qualified real property interest under IRC §170(h)(1)(A) and was not contributed exclusively for conservation purposes under §170(h)(1)(C).

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Under IRC §170(h)(2)(C), the term **"qualified real property interest"** includes "a restriction (granted in perpetuity) on the use which may be made of the real property." The Carroll family's conservation easement provides that the easement is perpetual, inheritable, and assignable. The court noted that the express terms of the conservation easement satisfy the requirements of IRC §170 and the underlying regulations by providing legally enforceable restrictions that will prevent uses of the retained interest in the property that are inconsistent with the conservation purposes of the contribution.

IRC §170(h)(4)(A) provides four tests to determine if an easement establishes the existence of a **conservation purpose.** The taxpayers contend their contribution satisfies the third test; it preserves open space pursuant to a clearly delineated federal, state, or local government policy and yields a significant public benefit. The court agreed that the contribution of the conservation easement by the Carroll family was accepted by a state government agency after a thorough review process and yields a significant public benefit.

IRC §170(h)(5)(A) provides that a contribution will not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity. The issue is whether, in the event of an extinguishment of the Carrolls' conservation easement, MET and LPT would be guaranteed a proportionate share of extinguishment proceeds as required by Treas. Reg. §1.170A-14(g)(6)(ii). The terms of the conservation easement provided the grantees (MET and LPT) a proportionate share of the proceeds arising from the extinguishment. The value is to be determined by the ratio of the deduction for federal income tax purposes over the value of the subject property as a whole on the date of the gift. **This provision does not comply with the requirements of Treas. Reg. §1.170A-14(g)(6)(ii)** that the proportionate share of extinguishment proceeds be determined by the fair market value (FMV) of the easement on the date of the gift over the FMV of the whole property on that date.

The taxpayers argued that the IRS ignored the last sentence of Treas. Reg. §1.170A-14(g)(6)(ii), which provides an exception to the proportionality requirement if, under state law, the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction. The court agreed that Maryland law mandates the extinguishment proceeds in a condemnation proceeding be computed as though the easement or other right did not exist with respect to the easement donated to MET. However, the conservation easement provides both MET and LPT with coextensive rights. MET is specifically covered by the relevant Maryland code section but LPT is not mentioned. Therefore, the Carroll family's donation of the easement does **not** satisfy the state law exception in Treas. Reg. §1.170A-14(g)(6)(ii).

The IRS imposed the IRC §6662(a) accuracy-related penalties for all three years of the contribution carryforward. The penalty does not apply if the taxpayer can establish that there was reasonable cause for their position and that they acted in good faith. Reliance on professional advice may constitute reasonable cause and good faith if the reliance was reasonable. However, Dr. Carroll personally handled the conservation easement and did not consult with an attorney or other adviser; therefore, the court determined that no reasonable cause existed.

Holding. The court disallowed the taxpayers' contribution carryforwards and held that the taxpayers are liable for the accuracy-related penalties.

Rental Deductions

***Charles and Cecilia Okonkwo v. Comm'r,* TC Memo 2015-181 (Sep. 14, 2015)**

IRC §§280A, 469, and 6662

☞ Deductions Limited on House Rented to Family Member

Facts. Charles Okonkwo and his wife Cecilia resided in the Bel Air neighborhood of Los Angeles, California. In 1992, they purchased a vacant lot in Woodland Hills, California, and constructed a single-family residence there in 1997. They unsuccessfully attempted to sell the home through 2001. From 2002 through 2006, they rented the Woodland Hills home to an unrelated party for $6,000 per month. In 2007, their daughter moved into the residence and paid monthly rent of $2,000; she remained in this residence until March 2010.

The Okonkwos hired a CPA to prepare their tax returns. The CPA used estimates of certain deductions obtained during conversations with Mr. Okonkwo in preparing their 2008 tax return. The 2008 Schedule E, *Supplemental Income and Loss,* indicated that the Woodland Hills house was rental real estate. The Schedule E reported the following information.

	2008
Schedule E rental income	$ 24,000
Less: Schedule E expenses (mortgage interest, taxes, insurance, and depreciation)	(158,360)
Net rental loss	($134,360)

On Form 8582, *Passive Activity Loss Limitations,* they characterized the Schedule E loss as **passive**.

Before the CPA prepared the Okonkwos' 2009 and 2010 tax returns, he questioned them about the significant decrease in rental income for the Woodland Hills house from earlier years (2002–2006). The Okonkwos responded that the previous tenants moved out and their daughter moved in.

The Okonkwo's 2009 and 2010 Schedules C, *Profit or Loss From Business,* showed the following income and expenses. The schedules indicated that the taxpayers were in the construction business.

	2009	2010
Gross receipts	$ 24,000	$ 6,000
Less: total expenses	(108,600)	(113,820)
Net loss	($ 84,600)	($107,820)

During an IRS examination of their tax returns, the Okonkwos filed a Form 1040X, *Amended U.S. Individual Income Tax Return,* for 2008. The amended return reported the income and expenses relating to the Woodland Hills home on Schedule C instead of on Schedule E. The Okonkwos claimed a refund of $8,789 on the amended return.

The IRS disallowed the 2008 refund claim and disallowed an itemized deduction for mortgage interest on their personal residence of $19,211. As a result of the changes, the IRS determined that the Okonkwos owed income tax of $4,295 and were liable for an IRC §6662(a) penalty.

The IRS issued a notice of deficiency for 2009 and 2010, in which it disallowed Schedule C deductions and adjusted itemized deductions for mortgage interest, taxes, and retirement contributions. The IRS further determined that the Woodland Hills house was held for the production of income and the losses reported were passive under IRC §469. The notice also indicated the Okonkwos were liable for IRC §6662(a) penalties.

Issues. The issues in this case are as follows.

- Whether the taxpayers can deduct certain expenses
- Whether the taxpayers are liable for accuracy-related penalties under IRC §6662(a) for tax years 2008, 2009, and 2010

Analysis. IRC §280A provides that a dwelling unit is used as a residence if the taxpayer, or a family member, uses it for personal purposes for more than the greater of 14 days per year or 10% of the number of days it is rented at a fair rental that year. The IRS contended that the taxpayer's deductions relating to the Woodland Hills house are limited because their daughter lived there. The taxpayers contended that they are real estate developers and they rented the Woodland Hills house to their daughter because their insurance **required** that the house be occupied.

At trial, the court concluded the daughter's use of the Woodland Hills house was personal and therefore attributable to the taxpayers. Because she did not pay fair rental value, deductions are limited to the rental income received.

The court upheld the IRC §6662(a) accuracy-related penalty for 2008 because the taxpayers used estimates rather than making a reasonable attempt to comply with the law or maintain adequate books and records.

Even though the income tax understatements for both 2009 and 2010 were determined to be subject to both substantial understatement and negligence penalties, the court found that the Okonkwos reasonably relied on the CPA's advice. The CPA **knew** that their daughter resided in the house and did not pay fair rental, and the Okonkwos relied on the CPA's judgment that the expenses relating to the house were fully deductible. Therefore, the taxpayers were not liable for accuracy-related penalties for the portion of the underpayment attributable to the §280A determination. However, they were liable for §6662(a) penalties attributable to erroneously claimed itemized deductions.

Holding. The court held that the daughter's use of the Woodland Hills house is attributed to the taxpayers; therefore, the IRC §280A limitation applies to their Schedule E rental real estate losses. The court upheld the §6662(a) accuracy-related penalty for the 2008 return. For the 2009 and 2010 tax years, the court determined that the taxpayers showed reasonable cause for relying on their CPA's judgment regarding expenses on the Woodland Hills house but found that they were liable for §6662(a) penalties attributable to itemized deductions.

NOT FOR PROFIT

Hobby Loss

***Richard Steinberger and Maria Riva v. Comm'r,* TC Memo 2016-104 (May 25, 2016)**
IRC §§162, 183, 6662, and 6664

☞ Airplane Activity Not Engaged In For Profit

Facts. Richard Steinberger has practiced medicine since 1989 and has been a shareholder/employee of Wichita Urology Group, P.A. (WUG) since its formation in 2001. He is also a licensed pilot. His wife, Maria Riva, is a pediatric pulmonology physician for the University of Kansas School of Medicine.

Dr. Steinberger decided to purchase an airplane. He asked the advice of Advocate Aircraft Taxation Co. (Advocate) regarding the purchase and operation of an airplane. Advocate formed two limited liability companies for him — Air Urology, LLC (AU) and AUI. AUI was a partnership owned by Drs. Steinberger and Riva. AUI was the sole member and owner of AU. AU was taxed as a disregarded entity. In February 2006, AU purchased an airplane. It was used for both personal and business purposes by Drs. Steinberger and Riva. Dr. Steinberger was the only person who flew the airplane during 2007, 2008, and 2009.

Flight logs were used to record each of the flights during the years. AUI or WUG was listed as the operator for each of the flights. During 2007, 2008, and 2009, the following information was recorded.

	2007	2008	2009
Training/maintenance time (AUI)	23.3 hours	36.2 hours	16.3 hours
Other	10.9 hours	17.8 hours	12.7 hours
WUG	64.1 hours	43.1 hours	60.6 hours
Total flight time	98.3 hours	97.1 hours	89.6 hours

The WUG trips included Dr. Steinberger's flights to Wellington, Kansas (40 miles each way), and Anthony, Kansas (83 miles each way), once every two weeks to see patients. It would take him approximately 40–45 minutes to drive to Wellington and 35–40 minutes to fly there. It took him approximately 85–90 minutes to drive to Anthony and 45–50 minutes to fly there.

The taxpayers reported combined income on their joint returns for 2007, 2008, and 2009 from WUG and the University of Kansas of $633,345, $583,358, and $572,973, respectively. They also reported passive income from other businesses in which they held ownership interests in excess of $163,000 per year. Passive losses from AUI of $172,997, $132,212, and $26,759 were shown on Schedules E, *Supplemental Income and Loss,* for 2007, 2008, and 2009, respectively. The 2007 AUI return had an election attached to group AU and AUI for purposes of IRC §§469 and 183 and was signed by Dr. Steinberger. The 2008 and 2009 AUI returns contained an election to group AUI and WUG. Dr. Steinberger signed the 2008 election but not the 2009 election.

The IRS examined the tax returns and issued notice of deficiencies for 2007–2009, determining the airplane activity was not engaged in for profit. The IRS asserted an accuracy-related penalty for each year as well.

Issues. The issues in this case are as follows.

- Whether the taxpayers' elections to group certain activities with their airplane activity for IRC §183 purposes were valid elections for the years in issue
- Whether the airplane activity on its own was entered into for profit for 2008 and 2009
- Whether the taxpayers are liable for accuracy-related penalties for 2007, 2008, and 2009

Analysis. On a statement attached to AUI's 2007 Form 1065, *U.S. Return of Partnership Income,* the taxpayers elected to group AUI and AU for purposes of §183 for 2007. When the court examined the evidence presented, it determined that the grouping of AUI and AU as a single activity for 2007 should be allowed.

To determine whether a taxpayer is carrying on a trade or business for profit, the court examines whether the taxpayer's primary purpose in engaging in the activity is to make a profit. For 2007, AUI was not grouped with WUG for §183 purposes. Therefore, WUG's activity for 2007 was not examined to determine whether AUI and AU had a profit motive for that year. The majority of AUI's flights for 2007 were either training and maintenance flights or Dr. Steinberger's personal flights. Therefore, the court determined that AUI and AU's airplane activity was not engaged in for profit for 2007.

Next, the court examined the relationship between AUI and WUG to determine whether they constituted a single activity for 2008 and 2009. The court found the organizational and economic interrelationship was not strong enough to support a finding that they were a single activity under IRC §183.

As an alternative, the taxpayers argued that if AUI and WUG were not a single activity for §183 purposes, AUI on its own was engaged in for profit during 2008 and 2009. Again, the court found the activity was not engaged in for profit because the majority of flights were either for training and maintenance or personal in nature.

With respect to the IRC §6662(a) accuracy-related penalty, Advocate prepared AUI's returns for each year based on the airplane's flight logs and other required documentation. Advocate advised grouping AUI and AU as a single activity for 2007 and AUI and WUG as a single activity for 2008 and 2009 for §183 purposes. For the 2007 year, the taxpayers failed to show the election to group AUI and AU was based on a good-faith reliance on Advocate's professional advice; their entire argument focused on the grouping of AUI and WUG. The penalty was sustained accordingly.

The taxpayers did rely, however, in good faith on Advocate's professional advice to group AUI's and WUG's activities for 2008 and 2009. Therefore, the court found that they had reasonable cause for the grouping. Accordingly, no accuracy-related penalty was imposed for 2008 or 2009.

Holding. The court held that the taxpayers made a valid election in only one tax year to group airplane and other activities as a single activity for IRC §183 purposes. In addition, the court found that the airplane activity was not engaged in for profit, thus sustaining the IRS determination to disallow the airplane activity's flow-through losses. The accuracy-related penalty was sustained for 2007 only.

Hobby Loss

***Merrill C. Roberts v. Comm'r,* U.S. Court of Appeals, 7th Circuit; No. 15-3396 (Apr. 15, 2016)**
IRC §§162 and 183

☞ 7th Circuit Reverses Hobby Loss Determination

Facts. Mr. Roberts started out in the restaurant business in 1969 when he bought an abandoned restaurant in Indianapolis, Indiana. He opened and operated The Sherwood Inn very successfully until a large kitchen fire occurred. He opened a bar in 1972 close to the airport; this establishment was sold in 1973. He then opened a pizza parlor five miles down the road. He withdrew from the business in the mid-1990s but remained a paid consultant to the new owners.

Mr. Roberts' next venture was in real estate. He acquired a 50-acre parcel of land for $250,000 that he rented to a farmer. In 1997–1998, he bought an additional 45 acres located directly north of the 50 acres for $400,000. This property was used to board horses and contained an operational stable.

In 1998 or 1999, the Indiana Thoroughbred Owners and Breeders Association invited Mr. Roberts to attend a free dinner and tour of Hoosier Park, the first horseracing track to be opened in Indiana. This piqued his interest, and he asked a trainer to "show him the ropes" of horseracing.

In 1999, Mr. Roberts bought his first two young horses for $1,000 each. His net income was approximately $18,000 during his first year of racing. By 2001, he owned 10 racing horses and a breeding stallion. He worked every day at the horse farm and obtained his trainer's license in 2002.

In 2005, Mr. Roberts decided to build a new horse training facility to replace the current boarding stable, which badly needed repair. He then purchased a 180-acre parcel of land for $1 million and invested $500,000 to $600,000 in building improvements over the next six months. By 2007, he had built a world-class training facility for conditioning and motivating horses. The facility included a large training track, portable horse stalls, unique rehabilitation equipment, several specialized training areas, and small apartments for employees.

Mr. Roberts' horseracing activities were not profitable in 2005 and 2006. He deducted the losses on his tax returns from his other income, which he obtained mainly from consulting in the restaurant business and from renting and selling real estate.

In 2014, the Tax Court determined that Mr. Roberts improperly deducted expenses of his horse racing enterprise for 2005 and 2006 because the activity was a hobby rather than a business but became a business in 2007 and remained so in 2008.[52] Mr. Roberts appealed the Tax Court determination.

Note. For information about the 2014 case, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Rulings and Cases. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

Issue. The issue is whether the taxpayer engaged in various horse-related activities during 2005 and 2006 with the expectation of making a profit.

Analysis. Courts utilize a 9-factor analysis in hobby loss cases in accordance with Treas. Reg. §1.183-2(b). These factors overwhelmingly favor Mr. Roberts' claim that even in 2005 and 2006 his horseracing activity was a business.

1. **Manner in which the taxpayer carries on the activity** — Mr. Roberts conducted the activity in a businesslike manner.
2. **The expertise of the taxpayer or his advisors** — He prepared extensively to obtain a training license.
3. **The time and effort expended by the taxpayer in carrying on the activity** — He withdrew, to a large degree, from his previous businesses to devote the majority of his time to his horseracing activity.
4. **Expectation that assets used in activity may appreciate in value** — He expected to eventually derive a profit from the activity, including profit from the appreciation of land and buildings.
5. **The success of the taxpayer in carrying on other similar or dissimilar activities** — He grew the restaurant business over time, a pattern consistent with his attempts to repeat the process in the horseracing activity.
6. **The taxpayer's history of income or losses with respect to the activity** — A series of losses during the activity start-up may not be an indication that the activity is not engaged in for profit.
7. **The amount of occasional profits, if any, which are earned** — A substantial profit, though only occasional, is generally indicative that an activity is engaged in for profit.
8. **The financial status of the taxpayer** — Even though his adjusted gross income was $297,881 in 2005 and $1.36 million in 2006 (after selling a large piece of land), he is not an excessively wealthy individual.
9. **Elements of personal pleasure or recreation** — No social or recreational activites that Mr. Roberts engaged in were listed by the Tax Court.

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

The 7th Circuit determined that all factors are either supportive of or at least consistent with Mr. Robert's claim that his horseracing activity was a business.

Holding. The 7th Circuit reversed the Tax Court decision and held that the Tax Court erred in determining the horseracing activity was not engaged in for profit during 2005 and 2006.

> **Note.** In reversing the Tax Court decision, Circuit Judge Posner stated: "We mustn't be too hard on the Tax Court. It felt itself imprisoned by a goofy regulation… that we feel bound to set forth in its full tedious length."

PARTNERSHIPS

Partnership Income

***Nik and Shayne Lamas-Richie v. Comm'r,* TC Memo 2016-63 (Apr. 11, 2016)**

IRC §§701, 702, 704, 6662, and 6664

☞ Gossip Blogger Required to Report Partnership Income

Facts. Nik Lamas-Richie was unsatisfied with his job as a "cubicle warrior" doing credit card processing for the financial industry and decided to start a gossip blog on a website with the URL "thedirtyscottsdale.com." This website initially posted gossip about local topics in Scottsdale, Arizona, but later branched out to report regional and national gossip.

As the website generated more traffic, it attracted the attention of investors. James Grdina approached Mr. Lamas-Richie and suggested the formation of a partnership. The partnership Dirty World LLC began operations in September 2007. Mr. Grdina and Intrigue Investment Co. together owned a 59% interest in the partnership and Mr. Lamas-Richie had a 41% limited partnership interest.

The URL for the website was changed to "thedirty.com." Mr. Lamas-Richie continued in his role of website editor. In addition, he also spent time dealing with lawsuits filed by the people who were the subjects of this gossip.

Mr. Lamas-Richie entered into an employment contract with iNetwork Group LLC, a venture owned by Mr. Grdina, to compensate him for his services editing the gossip and managing the blog. For 2011, he received $74,500 of wages from iNetwork that were reported on a Form W-2, *Wage and Tax Statement.*

Mr. Lamas-Richie and his wife filed a joint tax return and reported the wages received along with income reported on Schedule C, *Profit or Loss From Business,* from Lamas Richie Productions LLC. They did not report any income or loss with respect to his 41% limited partnership interest in Dirty World.

Dirty World filed a 2011 Form 1065, *U.S. Return of Partnership Income,* which reported $61,992 of ordinary business income from operation of the website. Mr. Lamas-Richie's Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* showed ordinary income of $25,417 and no distributions to him. Mr. Lamas-Richie did not receive a copy of this Schedule K-1 and was not aware of the partnership's tax return until the IRS examined his 2011 tax return. He stated that no net profits had previously been reported for Dirty World since its formation.

Issues. The issues in this case are as follows.

- Whether Mr. Lamas-Richie's distributive share of partnership income is taxable income for 2011
- Whether the taxpayers are liable for accuracy-related penalties under IRC §6662(a) for 2011

Analysis. Treas. Reg. §1.702-1(a) provides that, after items of income and expense are determined at the partnership level, each partner is required to separately take into account their distributive share, whether or not distributed, of each class or item of partnership income, gain, loss, deduction, or credit.

Mr. Lamas-Richie conceded at trial that he held a 41% limited partnership interest in Dirty World during 2011 and he had no reason to believe the income reported on the Schedule K-1 was incorrect. Therefore, the court sustained the IRS determination that his distributive share of Dirty World's business income was taxable income to him.

IRC §6662(a) imposes a 20% penalty on the portion of any underpayment of tax attributable to a substantial understatement of income tax. An understatement of income tax is substantial if it exceeds the greater of $5,000 or 10% of the tax required to be shown on the return. The penalty does not apply to any portion of an underpayment if there was reasonable cause for such portion and the taxpayer acted in good faith.

Mr. Lamas-Richie credibly testified that he viewed himself as an employee of Dirty World, and he properly reported the wages he received from iNetwork. He had not received a Schedule K-1 at the time he and his wife filed their 2011 return. He had never received income from Dirty World in the past that he would have been required to report. The taxpayers supplied their return preparer with all their tax-related documents, and the court determined that they reasonably relied on the preparer's assurance that the return was correct as filed. Therefore, the court did not impose penalties.

Holding. The court determined that Mr. Lamas-Richie's net partnership income was taxable but declined to impose any penalties.

PASSIVE ACTIVITIES

Self-Rental

Larry and Dora Williams v. Comm'r, **U.S. Court of Appeals, 5th Circuit; No 15-60341 (Feb. 2, 2016)**
IRC §469

☞ Self-Rental Income Received by S Corporation Recharacterized as Nonpassive

Facts. Larry and Dora Williams, a married couple, owned 100% of BEK Real Estate Holdings, LLC, an S corporation. They also owned 100% of BEK Medical, Inc., a C corporation. Mr. Williams worked full time for BEK Medical and materially participated in its business activity.

For the years at issue, BEK Real Estate leased commercial real estate to BEK Medical. The net rental income was approximately $50,000 each year in 2009 and 2010. The Williamses reported this as passive income and offset it with passive losses from other S corporations, partnerships, and personally owned rental properties.

The IRS concluded that BEK Real Estate's income from the commercial lease with BEK Medical fell under the self-rental rule. Therefore, the rental income was nonpassive income. The IRS disallowed the passive losses that the Williamses claimed against this rental income. As a result, the taxpayers faced income tax deficiencies totaling $26,322 for 2009 and 2010.

Issues. The issues in this case are as follows.

- Whether the IRS erred in including S corporations in the definition of taxpayer in the regulations under IRC §469.
- Whether the self-rental rule applies to an S corporation owned by the taxpayers if the S corporation itself does not materially participate in the C corporation's business.

Analysis. Under IRC §469, passive losses may only be deducted up to the amount of passive activity income. Generally, rental income is per se passive under IRC §469(c)(2). However, Treas. Reg. §1.469-2(f)(6) recharacterizes rental income as nonpassive if the property is rented to a trade or business in which the taxpayer materially participates.

Treas. Reg. §1.469-4(a) states that taxpayer activities subject to the passive activity loss limitation rules include activities conducted through S corporations. The Williamses argued that the IRS exceeded its authority by including S corporations in the scope of the regulations because IRC §469 does not explicitly state that it applies to such activities.

The court stated that for purposes of IRC §469, an S corporation is not a taxpayer. The S corporation is a pass-through entity, and its shareholders are the taxpayers. Thus, the court found that the Code did not need to specifically include S corporations for the IRS to correctly apply IRC §469 to a taxpayer's activities that are conducted through an S corporation.

The Williamses also argued that because the S corporation did not materially participate in the C corporation's business activities, the self-rental rule did not apply. The court noted that BEK Real Estate was only a pass-through entity, which should be disregarded when applying the self-rental rule.

Holding. The court held that the IRS properly reclassified the rental income received by BEK Real Estate from BEK Medical as nonpassive income. Thus, the passive losses claimed against this income were not deductible on the income tax returns in question.

Passive Loss Rules

***Carol A. and Roy E. Stanley v. U.S.*, No. 5:14-cv-05236;**
U.S. District Court for the Western District of Arkansas (Nov. 12, 2015)
IRC §§83, 318, 416, 469, and 7422

☞ Real Estate Professional's Grouping of Activities Mostly Appropriate

Facts. In 1994, Roy Stanley began working full-time as president and general legal counsel at Lindsey Management Co., Inc. (LMC), a property management company. During 2008 or 2009, Mr. Stanley became president emeritus. In 2009 and 2010, he worked part-time at LMC and, on December 31, 2010, Mr. Stanley retired from the company.

Mr. Stanley was also president of a company that provided telecommunications services to the properties that LMC managed. In addition, Mr. and Mrs. Stanley had minority ownership interests in various business entities that owned or operated the rental properties and adjoining golf courses that LMC managed. Moreover, they directly owned two rental properties, 2% of a third rental property, and interests in 88 (in 2010) and 90 (in 2009) additional entities via a family limited partnership.

The Stanleys reported all of their income and losses from the various entities as nonpassive income on their Schedules E, *Supplemental Income and Loss.* They believed that Mr. Stanley was a real estate professional and that they had appropriately grouped their real estate and business activities.

During an audit, the IRS reclassified a significant portion of the Stanleys' losses from nonpassive to passive. As a result, the Stanleys' passive losses could not offset their nonpassive income. Consequently, the IRS assessed over $120,000 in taxes and interest for the years under audit.

Issues. The primary issues in the case are as follows.

- Whether Mr. Stanley qualified as a real estate professional
- Whether the Schedule E activities and business activities were appropriately grouped for purposes of applying the passive activity loss limitation rules
- Whether Mr. Stanley materially participated in the Schedule E activities

Analysis. To determine if Mr. Stanley was a **real estate professional** under IRC §469(c)(7), the District Court examined three factors.

1. Did Mr. Stanley have more than a 5% ownership in the real estate company? Employees of real estate companies may not use their time spent as an employee to qualify as real estate professionals unless the employee also owns more than 5% of the company. The District Court rejected all of the IRS's attempts to convince the court that Mr. Stanley's 10% ownership interest in LMC was somehow tainted and thus not sufficient to meet this test. Therefore, the court ruled that despite the fact that Mr. Stanley was an employee, his time spent on real estate activities for the company counted towards being a real estate professional.

2. Did Mr. Stanley spend over half of his time performing services as a real estate professional? The District Court noted it was undisputed that more than half of the time Mr. Stanley spent working was devoted to LMC.

3. Did Mr. Stanley perform more than 750 hours of services related to real estate businesses? The District Court noted that it was also undisputed that he worked more than 750 hours per year for LMC.

The IRS argued that the legal services performed as an employee of LMC were not directly related to real estate, and, as such, the taxpayer could not count the hours spent in that capacity towards the second or third tests. The District Court rejected that argument, noting that LMC was a real property business and, therefore, any work done as an employee of the company was done in activities related to real estate.

Based on the three factors, the District Court concluded that Mr. Stanley was a real estate professional in 2009 and 2010. Therefore, they found for the Stanleys on the first issue.

The District Court then considered if the taxpayers **appropriately aggregated the rental and nonrental activities** for passive loss purposes. The IRS argued that Treas. Reg. §1.469-9(e)(3)(i) prohibited grouping rental real estate activities with other nonrental activities. The court determined that this prohibition **only** applies to grouping for purposes of meeting the material participation test. Thus, the court ruled that the grouping for passive loss purposes was not prohibited.

The District Court then considered if the grouped activities constituted an appropriate economic unit for the measurement of passive gains or losses. The factors enumerated in Treas. Reg. §1.469-4(c) and all other relevant facts about the activities led the court to conclude that most of the activities were interwoven with the overarching rental real estate activity. Furthermore, the court concluded that the nonrental activities were insubstantial in relation to the rental activities.

The District Court listed four specific activities that did not pass the appropriate economic unit test. It also noted that the taxpayers had conceded that their "non-operational activities" should be removed from the grouping. Consequently, the court agreed with the taxpayers' grouping for the vast majority of the activities in the group.

Finally, the District Court considered the issue of whether Mr. Stanley **materially participated** in the grouped activity. The IRS argued that Treas. Reg. §1.469-9(e)(3)(ii) only allows taxpayers to count time spent in managing the taxpayer's own rental real estate interests in determining if the taxpayer meets the material participation test. The IRS further argued that Mr. Stanley's time spent at LCM should be discounted to reflect his actual ownership percentage in any given property.

The District Court resoundingly rejected the IRS's first argument, stating:

> *It would be unreasonable, in the limited scenario presented by this case of a real estate professional who works at a real estate management company and also has ownership interests in the vast majority of properties managed by the company, to delineate the time he spent on an individual property, especially where much of the work performed by Roy was done for the benefit of multiple properties or LMC generally.*

The court also rejected the second argument, finding no authority to support the proposition that the taxpayer's time is subject to any modification based on the percentage of ownership.

Holding. The court held for the Stanleys on all three issues except for the few activities that it ruled must be separated from the grouping. It found that Mr. Stanley was a real estate professional who aggregated his activities into an appropriate group that constituted a rental activity. Furthermore, it found that Mr. Stanley materially participated in the grouped rental activity.

> **Note.** The Stanleys' claim against the IRS included taxes paid, interest, and costs incurred in bringing the case to court. In its judgment, the District Court encouraged the parties to submit a stipulation as to what damages the Stanleys were entitled to as a result of the ruling.

Passive Loss Rules

Charles and Delores Gragg v. U.S., **U.S. Court of Appeals, 9th Circuit; No. 14-16053 (Aug. 4, 2016)**
IRC §§469 and 7422

☞ Real Estate Pro Did Not Materially Participate

Facts. Delores Gragg was a real estate agent who worked for a real estate brokerage during the years at issue in this case. She and her husband claimed real estate rental losses of $38,153 and $40,390 on their 2006 and 2007 income tax returns, respectively.

In 2009, the IRS audited the Graggs' 2006 and 2007 returns. The IRS requested documentation showing that the Graggs had materially participated in the rental activities. They submitted two undated notes estimating Mrs. Gragg's hours spent working at the rental properties in 2006.

The IRS denied the deductibility of the losses on the basis that the Graggs did not materially participate in the rental activities. The Graggs, however, asserted that because Mrs. Gragg was a real estate professional, it was not necessary to prove material participation in the rental activities.

Issue. The issue is whether IRC §469(c)(7) automatically renders a real estate professional's rental losses nonpassive and deductible, or whether it merely removes IRC §469(c)(2)'s per se bar on treating rental losses as passive.

Analysis. The following Code sections provide the framework for the arguments in this case.

- Under IRC §469(c)(1), any activity in which a taxpayer does not materially participate is generally passive.
- Under IRC §469(c)(2), rental activity is per se passive, regardless of whether the taxpayer materially participates.
- Under IRC §469(c)(7), the per se bar does not apply to real estate professionals.

Treas. Reg. §1.469-9(e)(1) states that taxpayers who qualify as real estate professionals can treat rental losses as nonpassive, but only if they meet material participation tests. The regulation further states that only a taxpayer's participation in rental real estate activities may be used to determine if the taxpayer materially participates in the rental activities.

Holding. The Appellate Court affirmed the District Court's ruling in favor of the IRS. In its decision, the Appellate Court stated:

> *Section 469's text, regulations, and relevant case law all point in one direction: though taxpayers who qualify as real estate professionals are not subject to §469(c)(2)'s per se rule that rental losses are passive, they still must show material participation in rental activities before deducting rental losses.*

> **Note.** Temp. Treas. Reg. §1.469-5T(a) provides seven safe harbors that may be used to meet the material participation tests. The taxpayers in this case did not provide any evidence to the courts that they qualified under one of these safe harbors.

Passive Losses

***Clarence McDonald Leland Jr. and Myna Leland v. Comm'r,* TC Memo 2015-240 (Dec. 14, 2015)**
IRC §§469 and 6662

☞ Reconstructed Records Accepted by Court

Facts. Clarence Leland is an attorney who has a practice in Jackson, Mississippi. During 2004, he purchased a 1,276-acre farm in Turkey, Texas, which is 13 hours away from his Mississippi residence. He entered into a crop-share arrangement with Clinton Pigg to crop share the 130 irrigated tillable acres. Mr. Pigg planted and harvested the crop, and Mr. Leland maintained the infrastructure of the farm.

Mr. Pigg planted cotton in 2009. He spent 29 hours during the year doing the following.

- Six hours planting 120 acres of cotton
- Three hours spraying the cotton field
- Four hours checking the farm each week
- 16 hours harvesting the cotton

In 2010, Mr. Pigg spent four hours planting and spraying 60 acres of cotton. However, the crop never developed.

Mr. Leland performed most of the farm maintenance. Occasionally, his son or a friend, Steve Coke, provided a little assistance. The farm has 6–8 miles of perimeter roads and 18–20 miles of interior roads, which must be maintained to ensure they remain passable. Most of the roads have fences running parallel that also must be maintained.

Wild hogs are an issue at the farm. They dig underneath fences to get to edible crops and have dug up and broken water lines. One year, the wild hogs devoured 250,000 pounds of peanuts that were growing on the farm. Mr. Leland hunted and trapped the wild hogs to keep the situation under control.

When Mr. Leland visits the farm, he stays in a small travel trailer that requires a fair amount of upkeep. Additionally, he keeps an old truck on the property. Each time he leaves, he disconnects the batteries on the truck and the tractors that are kept at the farm.

Mr. Leland did not keep records of the time he spent at the farm during 2009 and 2010. Consequently, the IRS limited the farm losses under IRC §469, determining deficiencies of $5,066 and $10,244 in 2009 and 2010, respectively.

In preparation for trial, Mr. Leland reconstructed the time he spent on farm-related activities using a calendar he keeps at his law practice, credit card receipts, and invoices. According to these reconstructed records, he spent 359.9 hours and 209.5 hours on farm-related activities in 2009 and 2010, respectively.

Issue. The issue is whether Mr. Leland's loss deductions for 2009 and 2010 are limited under the passive loss rules of IRC §469.

Analysis. IRC §469(a)(1) limits the deductibility of losses from certain passive activities of individual taxpayers. A **passive activity** is any activity involving the conduct of a trade or business in which the taxpayer does not **materially participate.**

Temp. Treas. Reg. §1.469-5T provides seven tests for material participation. One of these tests states that an individual will be treated as materially participating in the activity if they participate for **more than 100 hours** during the tax year, and the taxpayer's participation in the activity for that year is not less than the participation of any other individual.

The court found that Mr. Leland's reconstructed records, along with his receipts and invoices, were a reasonable means of calculating the time he spent on the farming activity during the years at issue. **The records showed that he spent well over 100 hours during 2009 and 2010 on farm-related activities.** The court was satisfied that Mr. Leland's participation was not less than the participation of any other individual, including Mr. Pigg, Mr. Coke, and his son during 2009 and 2010. Accordingly, **the court determined that Mr. Leland materially participated** in the farm activity during both 2009 and 2010.

Holding. The court held that Mr. Leland's farming activity deductions are not limited by IRC §469.

RESIDENCES

Gain on Residence

***Marvin DeBough v Comm'r,* U.S. Court of Appeals, 8th Circuit; No. 14-3036 (Aug. 28, 2015)**
IRC §§121 and 1038

☞ Taxpayer Who Reacquired Principal Residence Not Entitled to §121 Exclusion

Facts. In 1966, Marvin DeBough purchased a residence and 80 acres of land in Delano, Minnesota. In July 2006, Mr. DeBough agreed to sell the property for $1.4 million under an installment contract.

Because the property was his principal residence (and his wife's, prior to her death), Mr. DeBough excluded $500,000 of gain from the sale under IRC §121. This left taxable income of $157,796 on the sale of the property, which Mr. DeBough reported as installment sale income starting in 2006. He received a total of $505,000 from the buyers and reported a total of $56,920 as taxable installment sale income for the 2006–2008 tax years.

The buyers defaulted in 2009 and Mr. DeBough reacquired the property. He kept the $505,000 he had previously received from the buyers as liquidated damages. On his 2009 tax return, Mr. DeBough treated this transaction as a reacquisition of property in full satisfaction of debt under IRC §1038. When he calculated his realized gain on the reacquisition, he again applied the $500,000 principal residence exclusion under §121. Mr. DeBough reported $97,153 as long-term capital gains from the reacquisition of the property. He calculated this as follows.

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Taxable income as originally calculated on the 2006 sale of the property	$157,796
Less: installment sale income reported	(56,920)
Less: reacquisition costs	(3,723)
Long-term capital gain	$ 97,153

Mr. DeBough did not resell the property.

In 2012, the IRS sent a notice of deficiency regarding Mr. DeBough's 2009 tax return. The IRS determined that Mr. DeBough had underreported his long-term capital gain by applying the $500,000 §121 principal residence exclusion. Mr. DeBough filed a petition with the Tax Court seeking a redetermination of the deficiency. The Tax Court agreed with the IRS, finding that Mr. DeBough was not entitled to the §121 exclusion because he had not resold the property within one year.

> **Note.** For further information about the Tax Court case, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Rulings and Cases.

Issue. The issue is whether Mr. DeBough is entitled to claim the $500,000 principal residence exclusion when he reacquired the property in 2009.

Analysis. Under §121, married taxpayers filing a joint return may exclude up to $500,000 of gain from the sale of their principal residence. Under IRC §1038, a taxpayer may disregard gain associated with the reacquisition of property, **except to the extent** that the taxpayer received money from the sale of the property prior to the reacquisition that is more than the amount of gain on the sale that was **returned as income** in a tax year prior to the reacquisition. The IRS asserted that calculating Mr. DeBough's gain is simply a matter of subtracting the $56,920 in gain that he reported on prior tax returns from the $505,000 he received from the sale prior to reacquiring the property. Therefore, his correct taxable gain from the reacquisition was $448,080.

IRC §1038(e) provides an **exception to the general rule** for calculating gain when the reacquired property was originally sold as the taxpayer's principal residence. If a taxpayer reacquires property that was their principal residence and **resells that property within one year,** the taxpayer can continue to apply the §121 principal residence exclusion when calculating taxable gain.

The Tax Court held that the §1038(e) exception did not apply to Mr. DeBough because he did not resell the property within one year. Mr. DeBough asserted that the Code is "silent on the question" of whether the principal residence exclusion nevertheless remains available even when a reacquired principal residence is **not** resold within one year. He argued that nothing in §1038 **requires** a taxpayer to recognize gain that was previously excluded under §121.

The Appeals Court noted that Mr. DeBough reported gain of $56,920 on his 2006–2008 tax returns. This was the amount that he "returned as income" for purposes of §1038(b)(1). IRC §121 allowed him to **exclude** $500,000 of gain from the sale of his principal residence. The $500,000 principal residence exclusion cannot be considered gain that was "returned as income" on a prior tax return.

In addition, the Appeals Court noted that the fact that Congress added §1038(e) further supported the Tax Court's conclusion in this case. Mr. DeBough asserted that the principal residence exclusion is available regardless of when the reacquired property is resold. However, if he is right, then the §1038(e) exception for a principal residence that is resold within one year is completely unnecessary. IRC §1038(e) would have no operative effect if a taxpayer could claim the principal residence exclusion regardless of whether they resold the reacquired property within one year. The court declined to render part of a statute entirely superfluous.

Holding. The court **affirmed** the Tax Court's decision. Mr. DeBough is not entitled to the §121 exclusion because he did not resell the property within one year of reacquisition.

Mortgage Interest

***Bruce Voss et al. v. Comm'r,* U.S. Court of Appeals, 9th Circuit; Nos. 12-73257, 12-73261 (Aug. 7, 2015)**
IRC §163(h)(3)

☞ Court Determines that Mortgage Debt Limitations Apply on a Per-Taxpayer Basis

Facts. Bruce Voss and Charles Sophy, who are domestic partners registered with the state of California, own two homes as joint tenants. One of the homes is located in Rancho Mirage, California, and the other (which is their primary residence) is located in Beverly Hills, California. The total average balance of the mortgages on the two homes and the home equity line of credit was $2.704 million for 2006 and $2.669 million for 2007. Voss and Sophy (the taxpayers) are jointly and severally liable for the mortgages on both homes as well as the home equity line of credit.

The taxpayers filed separate federal income tax returns for the 2006 and 2007 tax years. Each claimed home mortgage interest deductions for the interest paid on the two mortgages and the home equity line of credit. Voss paid $85,962 and $76,635 for 2006 and 2007, respectively. Sophy paid $94,698 and $99,901 for 2006 and 2007, respectively.

The IRS audited the taxpayers' returns for 2006 and 2007 and assessed deficiencies. The IRS calculated each taxpayer's mortgage interest deduction by applying a limitation ratio to the total mortgage interest that each taxpayer paid in each tax year. The limitation ratio was the same for each taxpayer: $1.1 million ($1 million of home acquisition debt plus $100,000 of home equity debt) over the entire average balance for each tax year on both mortgages and the home equity line of credit.

Using the limitation ratio, the IRS disallowed $60,421 and $56,685 of Voss's claimed deductions for the 2006 and 2007 tax years. The IRS also disallowed $56,866 and $24,443 of Sophy's claimed deductions for the respective tax years.

The taxpayers filed petitions with the Tax Court. The Tax Court issued an opinion favoring the IRS.[53]

> **Note.** For further information about the Tax Court case, see the 2012 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Rulings and Cases. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

53. *Sophy et al. v. Comm'r,* 138 TC No. 8 (Mar. 5, 2012).

Issue. The issue is whether the IRC §163(h)(3) debt limit provisions apply per taxpayer or per residence when multiple unmarried taxpayers co-own a qualifying residence.

Analysis. IRC §163(h)(3)(B)(ii) provides a $1 million limitation on acquisition indebtedness for a qualified residence ($500,000 for a married individual filing a separate return). IRC §163(h)(3)(C)(ii) provides a $100,000 limit on home equity indebtedness for a qualified residence ($50,000 for a married individual filing a separate return). IRC §163(h)(4)(A)(i) defines **qualified residence** as the taxpayer's principal residence and one other residence of the taxpayer.

The parties in this case dispute whether the $1 million and $100,000 debt limits apply per taxpayer or per residence. **If the debt limits apply per taxpayer, Voss and Sophy are each entitled to a $1.1 million debt limit.** Together, the taxpayers could deduct interest payments on up to $2.2 million of acquisition and home equity debt. **If the limits apply per residence, then the $1.1 million debt limit must be divided between Voss and Sophy.**

The court noted that "discerning an answer from section 163(h) requires considerable effort on our part because the statute is silent as to how the debt limits should apply in co-owner situations." Both provisions limit "the aggregate amount treated" as acquisition or home equity debt; however, neither provision says to whom or what the limits apply. However, the court observed that both debt limit provisions contain a parenthetical that applies to one common situation of co-ownership: married individuals filing separate returns.[54] The parentheticals provide debt limits of half the amount that applies to other taxpayers "in the case of a married individual filing a separate return." The parentheticals give each spouse who files separately a debt limit of $550,000. This means that the two spouses together are entitled to a $1.1 million debt limit, which is the normal limit that also applies to single taxpayers.

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The court stated that Congress wanted to ensure that separately filing spouses do not get double the benefit that jointly filing couples get. Accordingly, in each of these provisions (and in several other Code provisions), Congress limited each separately filing spouse to half the tax benefit. **If Congress wanted to ensure that two or more unmarried taxpayers are treated as a single taxpayer for purposes of a particular deduction or credit, it can do that.** For example, IRC §36 provides an $8,000 limit on the first-time homebuyer credit. IRC §36(b)(1) provides that a $4,000 limit applies "in the case of a married taxpayer filing a separate return." However, IRC §36(b)(1)(C) has an additional provision.

> *If two or more individuals* ***who are not married*** *purchase a principal residence, the amount of the credit allowed. . . shall be allocated among such individuals in such manner as the Secretary may prescribe, except that the total amount of the credits allowed to all such individuals shall not exceed $8,000. [Emphasis added.]*

IRC §36 makes it clear that Congress knows how to treat a group of unmarried taxpayers as a single taxpayer for purposes of a specific tax benefit or burden. Congress could have done that with respect to the debt limit provisions of §163(h), but it did not. The court concluded that the parentheticals "strongly suggest that section 163(h)(3)'s debt limit provisions apply per taxpayer, not per residence."

Holding. The court reversed the Tax Court's decision by concluding that the debt limit provisions of IRC §163(h)(3) apply on a per-taxpayer basis to unmarried co-owners of a qualified residence.

> **Note.** On August 1, 2016, the IRS announced that it acquiesced in the 9th Circuit's *Voss* decision and will apply the §163(h)(2) and (3) limitations on a per-taxpayer basis.[55] Therefore, each unmarried taxpayer can deduct mortgage interest on acquisition indebtedness of up to $1 million and home equity indebtedness of up to $100,000.

54. See IRC §§163(h)(3)(B)(ii), (C)(ii).

55. AOD 2016-02, 2016-31 IRB 193.

RETIREMENT

IRA Distributions

***Cheryl Ireland v. Comm'r,* TC Summm. Op. 2015-60 (Oct. 1, 2015)**
IRC §§72(t), 408, and 61

☞ Early IRA Distribution Subject to Taxation

Facts. In 2011, Cheryl Ireland was 47 years old. She worked at a hospital that year and earned wages of $33,866. She also received a distribution of $5,294 from an IRA. The bank that maintained the IRA reported the distribution on Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* and withheld income tax of $529 from the distribution.

Ms. Ireland timely filed a Form 1040 for 2011 on which she elected the head of household filing status and claimed one dependency exemption for her daughter. She included the wages that she earned in 2011 in her gross income but did not report the IRA distribution or the related income tax withholding.

Issues. The issues in this case are as follows.

- Whether Ms. Ireland is liable for federal income tax on the unreported distribution from her IRA
- Whether she is liable for the IRC §72(t) additional tax on early distributions

Analysis. IRC §61(a) provides that gross income includes "all income from whatever source derived." Distributions from a qualified retirement plan generally are included in gross income subject to federal income taxes. IRC §408(d) provides several exceptions to the general rule that IRA distributions are included in gross income. However, no exception exists for amounts paid for medical expenses or ordinary living expenses.

Ms. Ireland maintained that her accountant informed her that it was not necessary to include the IRA distribution in her taxable income because she used the funds to pay her son's medical expenses. However, there is no Code provision that allows a taxpayer to exclude IRA distributions from taxable income if they are used to pay medical expenses.

A taxpayer who receives a distribution from a qualified retirement plan before attaining age 59½ is generally subject to a 10% additional tax on the portion of the distribution that is includable in the taxpayer's gross income.[56] IRC §72(t)(2)(B) provides an exception to the imposition of additional tax on retirement plan distributions to the extent that they do not exceed the amount allowable as a deduction under IRC §213 for amounts paid during the tax year for medical care. For purposes of this exception, the amount allowable as a deduction is determined without regard to whether the taxpayer itemized deductions for the tax year. The amount allowable as a deduction includes the amounts paid during the tax year for the medical care of the taxpayer, their spouse, or a dependent (as defined in IRC §152).

Ms. Ireland did not claim her son as a dependent for the 2011 tax year and did not demonstrate that her son met the definition of a dependent provided in §152. Therefore, she is not eligible for the exception under §72(t)(2)(B).

Holding. The court held that Ms. Ireland is liable for federal income tax on the IRA distribution and for the 10% additional tax under IRC §72(t).

56. IRC §72(t)(1) and (2).

IRA Distribution

***Raymond S. McGaugh v. Comm'r,* TC Memo 2016-28 (Feb. 24, 2016)**

IRC §§72 and 408

☞ Acting as Conduit for IRA Custodian Results in Nontaxable Event

Facts. Raymond McGaugh maintained a self-directed IRA with Merrill Lynch that held 10,000 shares of First Personal Financial Corp. (FPFC) stock. He decided to use some IRA funds to purchase an additional 7,500 shares. He asked Merrill Lynch to take care of the transaction but Merrill Lynch would not purchase the shares directly on his behalf in the summer of 2011. On October 7, 2011, Mr. McGaugh instructed Merrill Lynch to initiate a $50,000 wire transfer directly to FPFC.

FBFC issued a stock certificate in the name of "Raymond McGaugh IRA FBO Raymond McGaugh," which they claim was mailed to Merrill Lynch around November 28, 2011. Merrill Lynch alleges the stock certificate was not received until early 2012. Because Merrill Lynch believed the transaction was subject to the rollover rules and that the transfer was outside the 60-day limit for rollovers, they reported the $50,000 transaction as a taxable distribution on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*

The IRS determined the transfer from Merrill Lynch constituted a distribution from Mr. McGaugh's IRA and was includable in his gross income. In addition, the IRS considered this an early distribution because Mr. McGaugh had not reached age 59½, so it was subject to the 10% additional tax under IRC §72(t). The IRS also asserted an accuracy-related penalty.

Issue. The issue is whether a transaction involving the removal of $50,000 from Mr. McGaugh's IRA to purchase stock constituted a distribution that was not rolled over within the 60-day period allowed in IRC §408(d)(3) and is thus taxable income.

Analysis. IRC §408(d)(1) provides that any amount paid or distributed out of an individual retirement plan should be included in the distributee's gross income. Neither the Code nor the applicable regulations provide specific guidance on whether or when an amount is considered to have been paid or distributed out of an individual retirement plan through the use of the beneficiary as a conduit from the custodian to the investment.

In *Ancira v. Comm'r,*[57] the taxpayer maintained a self-directed IRA. The taxpayer requested that his IRA custodian purchase a particular company's stock for his IRA. Because the IRA custodian could not directly purchase stock that was not publicly traded, the taxpayer requested a check made payable to the issuing company. The custodian mailed the check to the taxpayer, and the taxpayer then mailed the check to the issuing company. The issuing company issued the stock certificate in the name of the IRA. The taxpayer presumed the stock certificate had been mailed to the IRA custodian as instructed, but this was not the case. The taxpayer learned of the delivery problem after receiving a notice of deficiency from the IRS. After learning of the error, the taxpayer directed the issuing company to send the stock certificate to him and he delivered it to the IRA custodian. The court held that no distribution from the IRA to the taxpayer occurred when the custodian delivered the stock to him.

The court stated that the case at hand resembles *Ancira.* The stock was not issued in Mr. McGaugh's name; rather, it was issued in the IRA's name. Even if Mr. McGaugh had physical possession of the stock certificate, he could not have realized any benefit from the certificate in the name of the IRA. Accordingly, Mr. McGaugh did not receive a distribution when Merrill Lynch made the wire transfer to FPFC. To the extent that he had control over the wired funds, he acted as a conduit for the IRA custodian. Consequently, the 60-day limitation on a rollover is not a factor.

Holding. The court held that there was no distribution from the IRA to Mr. McGaugh and therefore the transaction is not taxable income to him.

57. *Ancira v. Comm'r,* 119 TC 135 (2002).

IRA Distribution

James and Judith Thiessen v. Comm'r, **146 TC No. 7 (Mar. 29, 2016)**
IRC §§72(t), 408, 4975, and 6501

☞ Prohibited Transaction Results in Tax and Early Distribution Penalty Assessment

Facts. James Thiessen worked for Kroger Co. (grocery chain) and its subsidiary for 30 years. During 2002, Kroger told Mr. Thiessen his job would be moved to Ohio. Mr. and Mrs. Thiessen did not want to move to Ohio. Instead, they decided to acquire Ancona Job Shop (Ancona), an unincorporated business that specialized in the design, fabrication, and installation of metal products. This would allow Mr. Thiessen to continue using his skills in metal fabrication.

As the Thiessens began discussing the terms of the acquisition, they were informed by a broker that they could use the funds in their Kroger retirement accounts to acquire Ancona. Specifically, they were told they could roll their retirement funds into IRAs, the IRAs could then acquire the stock of a newly formed C corporation (Elsara Enterprises Inc.), and the C corporation could acquire Ancona. The Thiessens then turned to a CPA and attorney to assist with the IRA funding structure and with the sale contract and financing arrangement.

In early June 2003, both Mr. and Mrs. Thiessen established IRA accounts and transferred $384,856 and $47,221 from their Kroger retirement accounts. They both formally transferred these funds as tax-free rollovers, which were reported in 2003 as "rollover contributions" on Forms 5498, *IRA Contribution Information.* The IRAs then purchased 8,911 and 1,089 shares of Elsara stock from Mr. and Mrs. Thiessen's accounts, respectively, for a total purchase price of $431,500. Elsara then purchased the assets from Ancona for $601,978. The purchase was structured as follows.

Earnest money deposit	$ 60,000
Cash payment	341,765
Prorated 2003 property taxes	213
Promissory note to seller	200,000
Total purchase price	$601,978

The earnest money came from the Thiessens' personal bank account. The cash payment came from the IRAs. The promissory note stipulated that 60 monthly payments including 7% interest would be due starting September 18, 2003. **The Thiessens personally guaranteed repayment of the note.**

Starting in 2003, Elsara began filing a Form 1120, *U.S. Corporation Income Tax Return.* The Thiessens timely filed their 2003 tax return, on which they reported that they received IRA distributions totaling $432,076, which were rollovers. No mention of Elsara was made on their personal tax return.

The IRS determined that the Thiessens were liable for an income tax deficiency of $180,129 attributable primarily to unreported IRA distributions of $431,500, including computational adjustments. The amount assessed also included the 10% additional tax for early withdrawals from the IRAs imposed by IRC §72(t) because neither of the Thiessens had yet reached the age of 59½.

Issues. The issues in this case are as follows.

- Whether the IRA distributions received during 2003 were prohibited transactions
- Whether the 6-year statute of limitations period under IRC §6501(e) applies

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 account, the account ceases to be an IRA as of the first day of the tax year. IRC §4975(c)(1)(E) defines **prohibited transaction** to include an act by a disqualified person who is a fiduciary whereby the person deals with the income or assets of a plan in their own interests or for their own account.

After reviewing arguments by both the taxpayers and the IRS, the court determined that the Thiessens' guaranties of the loan were prohibited transactions. Their participation in the prohibited transactions caused the IRAs to cease to be IRAs. Accordingly, the IRA assets were deemed to be distributed to the Thiessens in a taxable transaction. The 10% additional tax also applies because neither of the Thiessens were age 59½ or older during 2003.

Under IRC §6501(a), the IRS generally must assess tax within three years after the return is filed. IRC §6501(e)(1) provides that the 3-year period may be extended to a 6-year period when the taxpayer fails to report gross income in excess of 25% of the amount of gross income reported on the return. In this case, all parties agreed the 3-year limitation period had expired. The IRS relied on the 6-year period because the Thiessens failed to report the deemed distributions from the IRAs in their gross income for 2003. Therefore, they failed to report an amount of gross income in excess of 25% of the amount of the gross income reported on their 2003 joint return.

The Thiessens argued that the 3-year limitations period applies because they disclosed on their 2003 return the rollovers from their Kroger retirement funds into IRAs. They also argued they were not required to make any further disclosure as to the rolled-over funds because case law as of the time they filed the 2003 joint return did not put them on notice that anything they did during 2003 was a prohibited transaction.

Neither the Thiessens' 2003 joint return nor any attachment to it disclosed the Thiessens' guaranties of a loan might be prohibited transactions or that they had unreported income resulting from prohibited transactions. The court concluded that a reasonable person would not discern from the 2003 joint return that the Thiessens had omitted any gross income for 2003. Therefore, the 6-year limitations period applies.

Holding. The court held that the Thiessens participated in prohibited transactions in 2003 and had unreported deemed distributions from their IRAs. The court also held that the 6-year limitations period allows the IRS to assess the income tax deficiency for 2003.

Taxable IRA Distribution

***Gary Wayne Rodrigues v. Comm'r,* TC Memo 2015-178 (Sep. 10, 2015)**
IRC §§72, 402, 408, 6320, 6321, and 6330

☞ Constructive Distributions Are Taxable Income

Facts. Gary Wayne Rodrigues served as a plan administrator for United Public Workers Mutual Aid Trust Fund (UPW plan) from 1984–2002. He was convicted of mail fraud, health care fraud, money laundering, conspiracy to commit money laundering, embezzlement, and accepting kickbacks to influence operation of the UPW plan. He was ordered to pay restitution of $378,104, a $50,000 fine, and sentenced to 64 months in prison.

Mr. Rodrigues had no liquid assets but did have a defined contribution plan from his UPW employment. In order to give him more time to find an alternate source of payment, he established an IRA at First Hawaiian Bank (FHB) and rolled his UPW pension benefits into the IRA.

In 2008, UPW brought a civil action against Mr. Rodrigues in district court and obtained a $850,000 judgment against him. To collect the judgment, UPW filed a motion to garnish gains and interest that had accrued in his IRA. FHB issued two checks in December 2009 for $428,104 and $89,344 to the district court and UPW, respectively. In addition, FHB issued a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* that reported a distribution of $517,448 to Mr. Rodrigues.

Mr. Rodrigues' 2009 tax return properly reported the IRA distribution and a $133,116 tax liability, which was not fully paid. The IRS filed a notice of federal tax lien in February 2011. In response, Mr. Rodrigues timely submitted a Form 12153, *Request for a Collection Due Process or Equivalent Hearing.* On the Form 12153, Mr. Rodrigues indicated that he was not liable for the tax owed, questioned the legality and validity of the 2008 garnishment order, and requested a telephone collection due process (CDP) hearing from prison.

In May 2011, the IRS mailed Mr. Rodrigues a letter stating that they had received his CDP hearing request. Mr. Rodrigues was offered a telephone CDP hearing but requested a correspondence hearing because he was in prison. He had no access to a computer and limited access to a typewriter while he was in prison but an IRS settlement officer denied Mr. Rodrigues' request for an extension.

The IRS finally mailed Mr. Rodrigues a "last chance letter," which gave him one last opportunity to provide additional information. He did not provide any further information. Subsequently, the IRS issued a notice of determination sustaining the lien action at issue.

Issues. The issues in this case are as follows.

- Whether distributions from the taxpayer's IRA were includable in his gross income
- Whether the IRS abused its discretion in sustaining the filing of a notice of federal tax lien

Analysis. Mr. Rodrigues did not dispute that the IRA distributions were made or disagree with the IRS's calculation of tax. Rather, he disagreed only with the legal conclusion that the IRA distributions were taxable. This case involves three separate distributions — one in 2004 and two in 2009 — all of which occurred after Mr. Rodrigues' criminal conviction. Mr. Rodrigues argued that these distributions should not be subject to tax because he personally did not receive the funds or a benefit from the funds and the withdrawals were involuntary. The IRS contended that the distributions are subject to tax regardless of actual receipt by or benefit to Mr. Rodrigues or the voluntary nature of the distribution.

The court agreed with the IRS. Mr. Rodrigues constructively received the IRA distributions when they were made to the District Court and UPW in satisfaction of his obligations. Mr. Rodrigues cannot escape taxation on the basis that the funds were disbursed to third parties.[58] The garnished funds were paid to satisfy his legal obligations and constitute gross income to him.

Next, the court reviewed whether the IRS's determination to proceed with collection violated an abuse of discretion standard. Mr. Rodrigues did not advance any argument that the IRS settlement officer's actions were an abuse of discretion. Additionally, Mr. Rodrigues did not offer any collection alternative during the CDP hearing. Accordingly, the court concluded that the actions taken by the IRS settlement officer did not abuse his discretion.

Holding. The court held that Mr. Rodrigues received taxable income from the IRA distributions that were used to satisfy his obligations. The court also held that the IRS did not abuse its discretion by sustaining a lien against him.

58. See, e.g., *Larotonda v. Comm'r,* 89 TC 287, 291 (1987); *Old Colony Trust Co. v. Comm'r,* 279 U.S. 716, 729 (1929); *Young v. Comm'r,* 113 TC 152, 157 (1999), *aff'd* 240 F.3d 369 (4th Cir. 2001).

SELF-EMPLOYMENT INCOME

Self-Employment Tax

***Thomas L. Ryther v. Comm'r,* TC Memo 2016-56 (Mar. 28, 2016)**
IRC §§1401 and 1402

☞ Taxpayer's Scrap Steel Sales Are Not Self-Employment Income

Facts. Thomas Ryther incorporated Knight Steel in April 1997. Knight Steel fabricated steel frames, mainly for general contractors.

The stock market collapsed in 2000, which greatly affected Knight Steel's business. In 2001, Knight Steel fell behind in paying employment taxes and the IRS assessed trust-fund penalties against it. Business continued to get worse and, in 2004, a Chapter 7 bankruptcy trustee took over the company to manage its liquidation.

Mr. Ryther formed a second business, Mission Steel, before Knight Steel filed bankruptcy. When Knight Steel went out of business, Mission Steel took control of Knight Steel's abandoned trailers and fabrication equipment and assumed its land leases. However, the new company never did much business. Mr. Ryther still had bills to pay, so he turned to selling scrap steel.

Knight Steel's scrap steel pile steadily grew from 1997 through 2004. During this period, Mr. Ryther was not aware that the scrap had any real value. In 2004, he saw the scrap pile in a new light. He did some research and found that the scrap did have value. In addition, scrap wholesalers were willing to come to his lot, fill their trucks, and pay him for what they took. He sold scrap steel over the next seven years once or twice per month to at least five different scrap wholesalers. His receipts from scrap sales totaled over $318,000, as shown in the following table.

Year	Scrap Sale Receipts
2004	$ 40,367
2005	26,046
2006	45,757
2007	60,584
2008	60,440
2009	55,740
2010	29,838
Total	$318,772

Mr. Ryther did not file tax returns from 2004 through 2010. In April 2012, he filed all seven returns and reported the scrap sales as miscellaneous income. The IRS subsequently determined the scrap sales were subject to self-employment (SE) tax and proposed adjustments accordingly.

Issue. The issue is whether the taxpayer is liable for SE tax on net income from sales of scrap metal.

Analysis. IRC §1401(a) imposes a tax on net earnings from self-employment, which is defined as "the gross income derived by an individual from any trade or business carried on by such individual." The IRS contended that Mr. Ryther's net profits from his sale of scrap metals are subject to SE tax as income from a trade or business. Mr. Ryther believes he was **not engaged in a trade or business.**

The court noted that both parties were correct to focus on the factual question of whether Mr. Ryther's activity was a trade or business. However, this is not an easy question to answer because the Code does not define "trade or business." The court observed that the solution is somewhat clearer if the focus is shifted to the property that Mr. Ryther sold. IRC §1402(a)(3)(C) exempts the sale of a taxpayer's own property from the definition of SE income, with two exceptions. The exception that is key to Mr. Ryther's case is property held primarily for sale to customers in the ordinary course of a trade or business. To determine whether his property was held primarily for sale to customers in the ordinary course of a trade or business or if it was held as an investment, the court looked at the following factors.

1. **Frequency and regularity of sales —** The IRS admitted that Mr. Ryther's sales were sporadic. The court therefore found that this factor favored Mr. Ryther.

2. **Substantiality of sales —** Mr. Ryther did not do anything to create the scrap; his efforts were limited solely to liquidating it. His sales were substantial but he generated large profits with little effort. The court found this factor to be neutral.

3. **Length of time the property was held —** The court noted that a short holding period generally indicates that property is held for sale primarily to customers in the ordinary course of business. Mr. Ryther held the property for seven years, which indicates he was not holding his scrap for sale in the ordinary course of business. Therefore, this factor favored Mr. Ryther.

4. **Segregation of property from business property —** Mr. Ryther had a single pile of scrap, not collections of business scrap commingled with personal scrap. The court found this factor to be neutral.

5. **Purpose of acquisition —** The court found this factor to be neutral because there were not enough facts to determine when and why Mr. Ryther acquired the scrap.

6. **Sales and advertising effort —** Mr. Ryther did not advertise the scrap or do anything else to make it more salable. However, the market for scrap has established prices and can be sold by simply arranging delivery. The court found this factor to be neutral.

7. **Time and effort spent on sales —** The amount of time Mr. Ryther spent in selling his scrap and contacting scrap wholesalers to arrange sales is unclear. Therefore, the court found this factor to be neutral.

8. **How the proceeds of the sales were used —** Mr. Ryther did not use the proceeds from scrap sales to buy more scrap but instead slowly liquidated the large pile of scrap. This factor "greatly favors" Mr. Ryther.

Based on the analysis of these factors, the court found Mr. Ryther's scrap was not property primarily held for sale to customers in the ordinary course of a trade or business.

Holding. The court concluded that Mr. Ryther was not liable for SE tax on the scrap metal sales.

Self-Employment Tax

Christine and Roger Peterson v. Comm'r, **U.S. Court of Appeals, 11th Circuit; No. 14-15773 and 14-15774 (May 24, 2016)**
IRC §§401, 404, 409A, 1401, and 1402

☞ Mary Kay Deferred Compensation Subject to Self-Employment Tax

Facts. Christine Peterson worked for Mary Kay Inc., a manufacturer and seller of cosmetics, toiletries, skin care, and related products. Mary Kay treats all sellers as independent contractors. The entry-level position is an independent beauty consultant (BC). In this position, the person is required to develop a customer base and to recruit new BCs. Once a BC recruits 24 BCs, she can become a sales director (SD). Her 24 BCs constitute a personal sales unit, and she earns commissions from all of them. The next step is becoming a national sales director (NSD). This occurs when a SD has acquired 20 offspring units and is approved for the position by a Mary Kay committee.

Mary Kay Inc. offers two post-retirement, deferred-compensation programs to its NSDs. These two programs are the Family Security program and the Great Futures program. The Family Security program is available only to an NSD who elects to participate, has an NSD agreement with Mary Kay, has reached age 65, and has completed 15 years as an NSD. The program contains a noncompetition agreement that states that the consideration an NSD received from Mary Kay is confidential and proprietary information.

The Great Futures program incentivizes an NSD to use her leadership skills in Mary Kay's emerging markets in countries outside the United States. With a minimum of five years as an NSD, retired NSDs earn commission percentages from their foreign sales units depending on their age at retirement. The percentages range from 40% for retirement at age 55 to 60% for retirement at age 65. These incentives are paid monthly for 12 years.

In 2008, both the Family Security and the Great Futures programs were amended to comply with IRC §409A.

Ms. Peterson became an independent BC with Mary Kay in the summer of 1982 in San Diego, California. She became a SD in March 1983 after acquiring 14 personal sales units. Three months later, she received a pink Cadillac from the company for a sustained high sales level for six months. She and her husband moved to Houston, Texas, where she became an NSD on July 1, 1991. The next move took them to Chicago, Illinois, for four years and then Atlanta, Georgia, for eight years. The moves to large cities were to increase her potential to develop new personal sales units, which generated commissions and continued to develop her business.

Ms. Peterson entered into the Family Security program on November 1, 1992, and the Great Futures program on July 1, 2005. She continued as a highly successful NSD for almost 19 years. The year before her retirement in 2009, she had an international network of approximately 23,000 individuals and received commissions on wholesale purchases in excess of $15 million.

Ms. Peterson retired from Mary Kay on January 1, 2009. That year, she received $408,133 under the Family Security program and $12,841 under the Great Futures program. She received a Form 1099 for the payments she received.

Despite the noncompetition agreements that she had as an NSD and under the Family Security and Great Futures programs, Christine joined another networking company. She started a new business with Isagenix, which sells health and nutritional products. Mary Kay learned about her involvement with the new company and did not allow her to go on a Greece cruise, one of three cruises she was entitled to take in her first five years of retirement. She received no other penalties from Mary Kay.

In 1991, the IRS conducted an audit of the Petersons' taxes. The Petersons hired a financial advisor who assisted with the audit. The advisor also helped them with the formation of several entities for estate planning and asset protection. On April 1, 2000, they formed Christine Peterson Defined Benefit Plan and Trust and NSD Interests, LP. Ms. Peterson attempted to assign her Mary Kay commissions to NSD Interests but Mary Kay would not allow this to happen.

For 2006, 2007, 2008, and 2009, Ms. Peterson received commissions from Mary Kay of $750,127, $799,191, $892,543, and $489,707 respectively. The Schedules C*, Profit or Loss From Business,* filed for each of these years reported "other expenses" equal to Ms. Peterson's nonemployee compensation from Mary Kay. NSD Interests in turn reported these "other expense" amounts as income and claimed deductions of $275,365; $312,266, and $173,500 for retirement contributions for 2006, 2007, and 2008.

The IRS examined the tax returns and issued notice of deficiencies for 2006–2009. The Tax Court determined that NSD interests was not entitled to deduct retirement-plan contributions for tax years 2006, 2007, and 2008 because it was not engaged in a trade or business.

Issue. The issue is whether the 2009 distributions from the two post-retirement plans are subject to self-employment (SE) tax.

Analysis. Under IRC §409A, a nonqualified deferred compensation plan is defined as any plan that provides for the deferral of compensation, with certain exceptions. The Petersons did not dispute that the 2008 amendments to the Family Program and the Great Futures Program expressly characterize payments as "deferred compensation," which means that the payments were related to Ms. Peterson's prior labor.

Ms. Peterson had signed retirement program agreements in 1992 and 2005 permitting Mary Kay to amend the agreements prospectively. Accordingly, she necessarily had consented to the 2008 amendments that expressly characterized the program payments as "deferred compensation" under a nonqualified compensation plan pursuant to IRC §409A. Therefore, the Petersons are bound by the characterization of her post-retirement program payments as deferred compensation that is subject to SE tax.

Holding. The 11th Circuit affirmed the Tax Court decision determining that deferred compensation Ms. Peterson received under a post-retirement nonqualified plan was subject to SE tax because it was derived from her former Mary Kay association.

TAX FRAUD

Fraud

***Angelina Alhadi v. Comm'r,* TC Memo 2016-74 (Apr. 21, 2016)**
IRC §§102, 1401, 1402, and 6663

☞ Caregiver Guilty of Elder Abuse and Fraud

Facts. Arthur Marsh was an optometrist in Gilroy, California. He never married nor had children. He lived in a modest 800 square-foot apartment, which he rented for $175 per month. Because his family was poor when he was a child, he lived very frugally. However, he had been a good businessman and saved over $1 million prior to his retirement in the 1980s. He invested his retirement funds wisely, and his investment steadily grew to nearly $3 million.

In 2000, Dr. Marsh fell and broke his hip. He began to use a walker and could not leave his second floor apartment without help. At the age of 91 in 2007, he could no longer drive a car or prepare his own food. He suffered from atrial fibrillation, congestive heart failure, hypertension, arthritis, incontinence, chronic back pain, hearing loss, and deteriorating vision. After Dr. Marsh suffered a stroke, his doctor diagnosed him with cognitive decline and dementia. In January 2007, Dr. Marsh was hospitalized for dehydration. His doctor would not allow him to return to his apartment unless he obtained in-home care.

Angelina Alhadi was working as a nurse assistant at the hospital where Dr. Marsh was receiving care. Even though a hospital policy banned employees from soliciting work from patients, she slipped him a note offering her services. Dr. Marsh accepted her offer, and Ms. Alhadi became his primary caregiver. He initially paid her an hourly wage from January through March. He then agreed to pay her $6,000 per month, although the usual rate for the type of services Ms. Alhadi provided was $3,750 per month. He also gave her $1,000 per month for groceries, even though it only cost about $400 per month for his food.

Ms. Alhadi began making cash deposits into her bank account. By the end of November 2007, she convinced Dr. Marsh to give her a down payment on a million-dollar home in Gilroy along with $400,000, which she spent on remodeling the house, paying off her husband's interest in their previous home, and a pool.

Dr. Marsh's niece, Sheila Person, usually talked with her uncle every Sunday night. After Ms. Alhadi entered his life, Ms. Person's success in reaching her uncle became sporadic. By the end of the summer of 2008, none of Dr. Marsh's relatives were able to get through Ms. Alhadi to personally talk to him.

By the fall of 2008, Dr. Marsh had written checks totaling $800,000 to Ms. Alhadi. In October 2008, she persuaded Dr. Marsh to write her five checks, each for $100,000. Dr. Marsh's investment company, Vanguard Group, became suspicious of the five $100,000 checks and contacted Dr. Marsh by phone to discuss them. Vanguard recorded the calls, and Ms. Alhadi's voice was heard in the background giving Dr. Marsh information to tell the Vanguard representative. Vanguard did not honor the checks; they became convinced something was seriously wrong and contacted the California Department of Health and Human Services in November 2008. The investigation clearly showed elder abuse, and Dr. Marsh was put under a temporary conservatorship.

Dr. Marsh died in February 2009 at the age of 93. The Arthur J. Marsh Trust, which Dr. Marsh had created years before as a substitute for a will, settled a suit brought against Ms. Alhadi and the trust recovered assets and $310,000 in cash.

Forms 1099 for 2007 and 2008 were filed on behalf of the trust for money Ms. Alhadi received. However, she did not take the forms with her when she had her tax returns prepared.

The IRS attempted to contact Ms. Alhadi but she refused to cooperate. The IRS then issued a notice of deficiency that asserted total unreported income of more than $1 million, along with penalties for 2007 and 2008.

Issues. The issues in this case are as follows.

- Whether Ms. Alhadi received taxable income for caregiving services
- Whether the income is subject to SE tax
- Whether she is liable for fraud penalties under IRC §6663

Analysis. The IRS introduced credit card and bank records that show Ms. Alhadi received at least $900,000 during 2007 and 2008, which was not reported on the tax returns she filed. She did not deny receiving the money; however, she contended that the amount she received should not be included in her gross income because it was either a loan or a gift from Dr. Marsh.

The court determined the money was not a loan; Dr. Marsh never once referred to the money as anything other than compensation. There were no schedules for repayments, proof of any maturity dates, set interest rates, or interest paid.

There is a strong presumption that payments an employee receives beyond their salary are compensation for services and not gifts.[59] Ms. Alhadi admitted she was paid for taking care of Dr. Marsh. Therefore, the court presumed the rest of the payments she received from Dr. Marsh were not gifts but compensation for services. The court further determined that Ms. Alhadi exercised undue influence over Dr. Marsh and that all money she received from him is taxable to her.

The IRS also asserted that Ms. Alhadi owes self-employment (SE) tax on the money she received from Dr. Marsh. SE income is income from the performance of personal services when an employer-employee relationship does not exist between the payor and the payee.[60] The agreement between Dr. Marsh and Ms. Alhadi included monthly wages of $6,000, and Dr. Marsh consistently referred to all the money he gave Ms. Alhadi as payment for her services. Therefore, the court found that she was liable for SE tax.

To prove that Ms. Alhadi committed fraud, the IRS must establish that she intentionally evaded tax that she believed was due. The IRS can meet this burden by showing that there was an underpayment and that some part of the underpayment was due to fraud. The first part of this test was easily met. Ms. Alhadi failed to report any income from Dr. Marsh; this income was substantial and resulted in a large underpayment. To prove that the underpayment was due to fraud, a number of factors were considered.

- **Understating income —** Ms. Alhadi did not disclose income totaling more than $1 million for the 2007 and 2008 tax years.
- **Concealing income or assets —** Ms. Alhadi failed to tell her tax preparer that she worked for Dr. Marsh and that she received money from him. Her return preparer advised her to file amended returns to reflect the additional income but she refused.
- **Filing false documents —** As part of her divorce proceedings, Ms. Alhadi filed false reports of her assets and income with the Superior Court of California under penalty of perjury.
- **Failing to cooperate with tax authorities —** Ms. Alhadi refused to cooperate with the IRS during the examination.
- **Giving implausible or inconsistent explanations of behavior —** Ms. Alhadi testified she only received checks from Dr. Marsh. After being confronted with evidence of cash deposits, she changed her story and acknowledged the cash came from Dr. Marsh.
- **Illegal activity** — Ms. Alhadi induced Dr. Marsh to pay her large sums of money by using undue influence. This amounts to elder abuse in violation of the California Welfare and Institutions Code.
- **Living a lavish lifestyle —** Ms. Alhadi bought a second home for $1 million in 2007. She spent a great deal of money on remodeling the house and adding a pool. She also took her family on an expensive cruise.

Based on this analysis, the court found Ms. Alhadi's 2007 and 2008 returns were fraudulent.

Holding. The court held that Ms. Alhadi underreported income from caregiving on her 2007 and 2008 tax returns and that the income was from self-employment. The returns for both years were fraudulent.

59. See *Van Dusen v. Comm'r,* 166 F.2d 647 (9th Cir. 1948), *aff'g* 8 TC 388 (1947); *Botchford v. Comm'r,* 81 F.2d 914, 916 (9th Cir. 1936), *aff'g* 29 BTA 656 (1933); *Jackson v. Comm'r,* 25 TC 1106, 1111 (1956); *Walker v. Comm'r,* 25 TC 832 (1956); *Laurie v. Comm'r,* 12 TC 86 (1949).

60. See IRC §1401 and 1402.