Chapter 7: Rulings and Cases

Please note. Corrections were made to this workbook through January of 2018. 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 contains selected cases, revenue rulings, revenue procedures, Treasury regulations, announcements, and letter rulings issued during the past year, through approximately July 31, 2017. 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.

About the Authors

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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.

1. Treas. Reg. §1.6662-4(d)(3)(iii).

- 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

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)**).

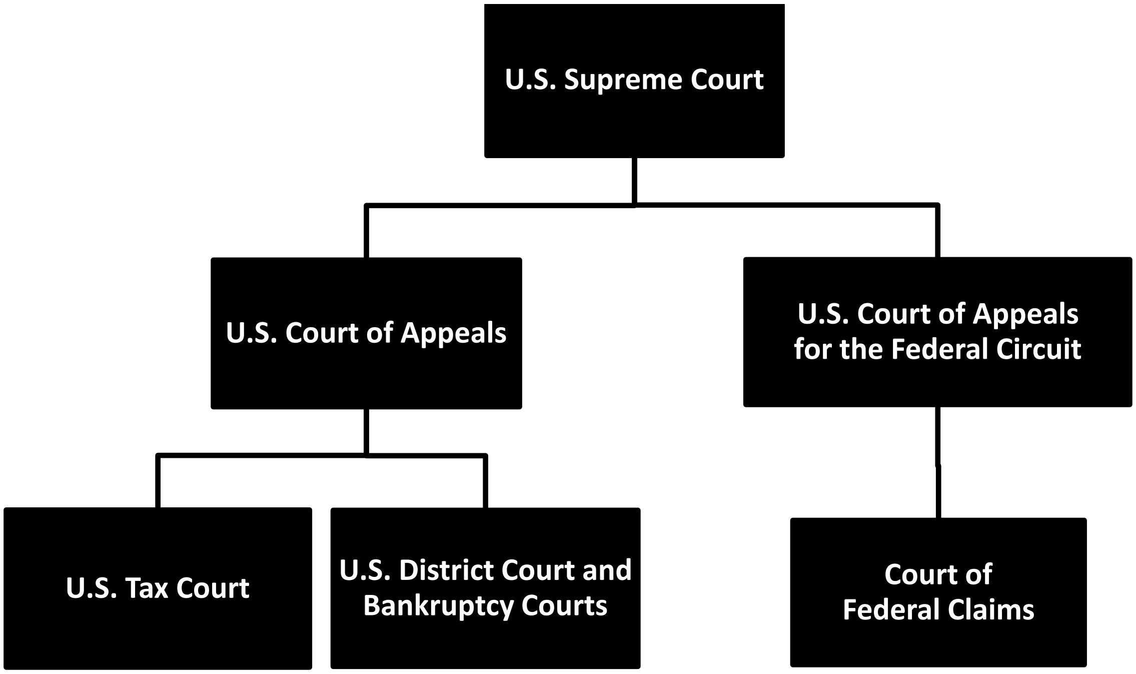
General Council Memoranda (GCM). GCMs detail the legal reasoning behind the issuance of a revenue ruling.

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

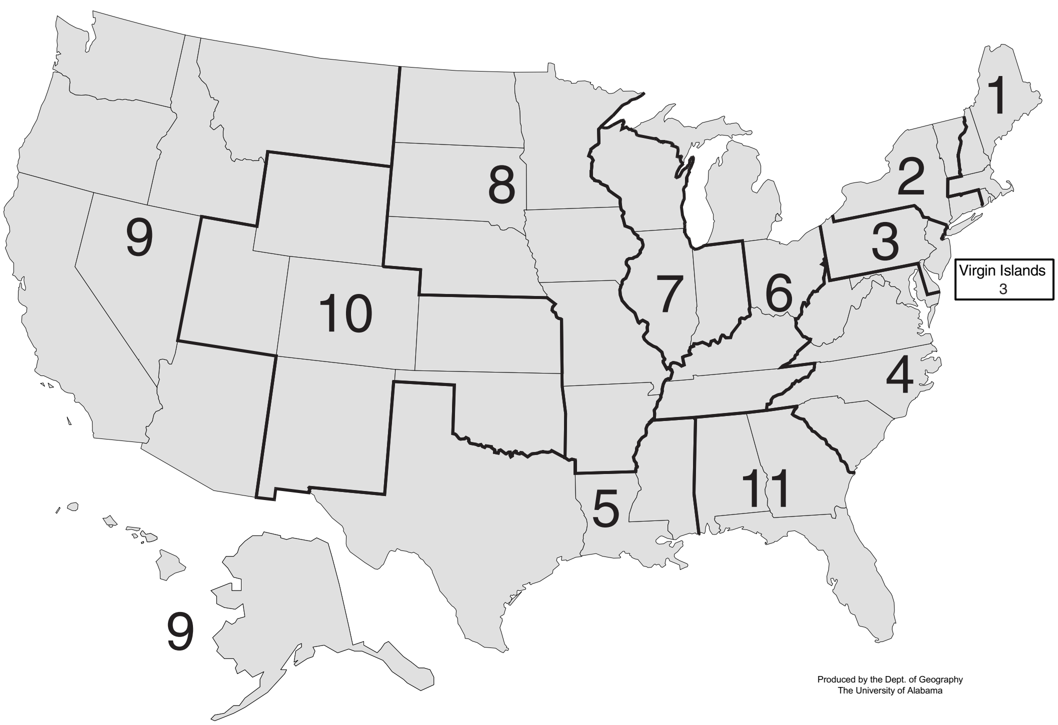
A Tax Court opinion or memorandum opinion may be appealed in a U.S. Court of Appeals. However, a taxpayer who commences their case in the U.S. Court of Federal Claims must appeal their case to the U.S. Court of Appeals for the Federal Circuit.

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).

AGRICULTURAL ISSUES

Conservation Easement

***Mark Rutkoske, Sr. et al. v. Comm'r,* 149 TC No. 6 (Aug. 7, 2017)**
IRC §§170, 702, 703, and 2032A

☞ Charitable Contribution Limited for Taxpayers Who Are Not Qualified Farmers

Facts. Mark and Felix Rutkoske are brothers and the only members in Browning Creek, LLC. The brothers owned seven parcels of land, totaling 1,455 acres in 2009. The Browning Creek Farm was one of these properties, consisting of 355 acres. This property was owned by Browning Creek, LLC. During 2009, the brothers each spent at least 2,500 hours performing physical labor and management services in growing and harvesting corn, barley, wheat, and soybeans on all of their properties.

On June 5, 2009, Browning Creek conveyed an easement to Eastern Shore Land Conservancy, Inc. After conveying the interest, Browning Creek sold its interest in the property to Quiet Acre Farm, Inc. for $2 million. Browning Creek reported a capital gain of $1.8 million from the sale of the property, which consisted of $1.3 million from the sale of the conservation easement and $489,983 from the sale of its remaining property interest. As 50% members, the capital gains were passed through to each of the brothers.

For 2009, Mark Rutkoske reported wage income of $16,800, interest income of $453, and pass-through losses of $177,524. For 2009, Felix Rutkoske and his wife reported wage income of $28,745, interest income of $586, and pass-through losses of $177,526.

The brothers also each claimed their share of the pass-through gain and the noncash charitable contribution on their 2009 Forms 1040, *U.S. Individual Income Tax Return.* The IRS determined deficiencies because the brothers were not qualified farmers under IRC §170(b)(1)(E)(v). Therefore, the brothers were not entitled to a 100% deduction for the value of the conservation easement.

Issue. The issue in this case is whether Mark and Felix Rutkoske were qualified farmers at the time they conveyed a conservation easement.

Analysis. Generally, a qualified conservation contribution deduction is limited to 50% of the donor's contribution base. The **contribution base** is defined as the taxpayer's adjusted gross income without regard to any net operating loss carryback for the tax year, less the value of any other charitable contributions for the year.[6] However, qualified farmers or ranchers may deduct up to 100% of their contribution base. The individual must be a qualified farmer or rancher for the tax year in which the contribution is made. A **qualified farmer or rancher** is an individual whose gross income from the trade or business of farming is greater than 50% of the individual's gross income for the year.[7] The following activities qualify as income from the trade or business of farming.[8]

1. Cultivating the soil or raising or harvesting any agricultural commodity on a farm
2. Handling, drying, packing, grading, or storing on a farm any agricultural commodity in its unmanufactured state but only if the owner, tenant, or operator of the farm regularly produces more than half of the commodity
3. Planting, cultivating, caring for, or cutting of trees or the preparation of trees for market

6. IRC §170(b)(1)(E)(i).
7. IRC §170(b)(1)(E)(v).
8. IRC §2032A(e)(5).

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The Code does not include the sale of land and the sale of rights to develop land (i.e., the conservation easement bargain sale) as activities that qualify as income from the trade or business of farming. Therefore, the Rutkoske brothers did not generate more than 50% of their income from the trade or business of farming.

The court acknowledged that the Rutkoske brothers are farmers; however, they are not "qualified" farmers. Even though they used most of the proceeds from the sale of the property and easement rights to continue farming operations, that does not constitute a qualified purpose. The statute refers to the measurement of income, not spending. The Code narrowly defines qualified activities and the court's duty is not to expand the scope.

Furthermore, under IRC §702(b), the income from the sale is sourced to Browning Creek, LLC. Browning Creek was in the business of leasing real estate, not farming. As such, the character from the sale flows through to the Rutkoske brothers and does not constitute income from the trade or business of farming.

Holding. The court held that the Rutkoske brothers were not qualified farmers for the purpose of §170(b). Therefore, they were limited to a charitable contribution deduction of 50% of their respective contribution bases for the conveyed conservation easement.

Farming Syndicate

AOD 2017-1 (Feb. 13, 2017) addressing *Burnett Ranches, Ltd v. U.S.*, 753 F.3rd 143;
U.S. Court of Appeals, Fifth Circuit (May 22, 2014)
IRC §§461(j)(1)(B) and (j)(2)(A)[9]

☞ IRS Issues Nonacquiescence that Limited Partnership Not a Farming Syndicate

Facts. Burnett Ranches Ltd. (the Partnership) was a limited partnership engaged in the business of farming. In 2005, Burnett Ranches, Inc., a subchapter S corporation, owned an 85.52% limited partnership interest in the Partnership. It owned a 99% interest in 2006 and 2007. Anne Burnett Windfohr Marion (Ms. Marion) was the sole owner of Burnett Ranches, Inc. during 2005–2007.

For 2005, 2006, and 2007, the Partnership filed tax returns using the cash basis of accounting. Subsequently, the IRS determined that the Partnership could not file these income tax returns using the cash method of accounting because it was a "farming syndicate" and therefore had to employ the accrual method of tax accounting. The IRS asserted that several million dollars of tax were owed as a result.

Issue. The issue in this action on decision (AOD) is whether a limited partnership is excluded from the definition of a farming syndicate under IRC §§461(j)(1)(B) and (j)(2)(A) because the sole shareholder of a limited partner S corporation actively participated in the farming business.

Analysis. Pursuant to (current) IRC §461(j)(1)(B), a farming syndicate includes a partnership engaged in the trade or business of farming if more than 35% of the losses during any period are allocable to limited partners. However, for this purpose, a "limited partner" does not include any individual who has actively participated (for a period of not less than five years) in the management of any trade or business of farming. This management includes **any interest** in a partnership or other enterprise that is attributable to such active participation.[10] The substance of the IRS's argument was that Ms. Marion's holding of her **interest** in the Partnership through her S corporation prevented it from qualifying for the active participation exception, which the IRS argued only applies to individuals. The IRS's position was that "an interest" must be narrowly construed as synonymous with legal title or direct ownership.

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9. PL 113-295 (2014) moved IRC §464(c) to §461(k). The amendment contained a typographical error that incorrectly referenced §461(k) as §461(j). Code section references used in the analysis of this case are to current IRC §461(j).

10. IRC §461(j)(2)(A).

However, the court disagreed, stating that the active participation exception in (current) §461(j)(2)(A) does not apply solely to individuals. Instead, in the court's view, the statutory language indicates that the exception applies to **any interest** in a partnership that is attributable to an individual's active participation in the management of a farming business for more than five years. Moreover, the court believed that this interpretation maintains consistency with the purpose of the farming syndicate rules as intended by Congress.

Holding. The Fifth Circuit Court of Appeals upheld the district court's previous ruling that the Partnership was not a farming syndicate and could therefore use the cash basis of accounting. However, the IRS did not acquiesce to the opinion and therefore will follow it only with respect to cases within the Fifth Circuit.

AMORTIZATION AND DEPRECIATION

Placed-in-Service Date

AOD 2017-02 (Apr. 10, 2017) addressing *Stine, LLC v. U.S.*, No. 13-03224, U.S. District Court for the Western District of Louisiana (Jan. 27, 2015)
IRC §§167 and 1400N

☞ IRS Issues Nonacquiescence Regarding Placed-In-Service Date for Depreciation Purposes

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Facts. The taxpayer operated retail stores, selling building materials and supplies to consumers and contractors. In 2007, the taxpayer started building two new retail stores in the Gulf Opportunity Zone (GO Zone). By December 31, 2008, both buildings had a 30-day certificate of occupancy issued by the state fire marshal. This allowed employees to receive equipment, shelving, racks, and merchandise and to install or stock those items. However, the buildings could not operate as retail stores nor were customers allowed to enter the buildings under the certificates of occupancy then in place.

Issue. The issue in this action on decision (AOD) is whether nonresidential buildings were placed in service by the December 31, 2008 deadline permitted for claiming GO Zone additional first-year depreciation on them.

Analysis. The date that property is placed in service, for IRC §167 depreciation purposes, depends on the property's assigned function and when the property is in a condition or state of readiness and availability to perform that function.[11]

An additional allowance of 50% of the adjusted property basis[12] is provided for GO Zone nonresidential real property that was placed in service by the taxpayer on or before December 31, 2008.[13]

The taxpayer argued that because the buildings were placed in service in 2008, the additional depreciation allowance claimed for this GO Zone property was correct. The District Court, ruling in favor of the taxpayer, stated that the buildings were placed in service when they were "substantially complete meaning in a condition of readiness and availability to perform the function for which [they were] built — in this instance to house and secure racks, shelving and merchandise."

11. Treas. Regs. §§1.167(a)-11(e)(1)(i) and 1.46-3(d)(1)(ii).

12. IRC §1400N(d)(1)(A).

13. IRC §1400N(d)(2)(A)(v).

It is the IRS's position that the District Court ruling was incorrect for two reasons. First, the court mistakenly described the buildings' function as housing and securing racks, shelving, and merchandise when their function should have been described in the context of the taxpayer's business. The taxpayer intended to use the buildings as retail stores, not to hold machinery and equipment. Second, the court ignored the regulatory requirement that property is placed in service when it is ready and available for regular operation and income-producing use.[14] In the context of electric power utilities, the IRS outlined the following five factors that, when fulfilled, would indicate that the facilities were ready and available for regular operation.[15]

1. Approval of all required licenses and permits
2. Passage of control of the facility to the taxpayer
3. Completion of critical tests
4. Commencement of daily or regular operations
5. With respect to electric power plants, synchronization of the plant facility into a power grid

The IRS indicated in this AOD that, in determining the date property is placed in service, these factors can also be applied in this business context.

Holding. The IRS's position is nonacquiescence with *Stine, LLC v. U.S.* The IRS will continue to litigate this issue, taking the position that a retail store is placed in service for depreciation purposes when the building is ready and available to operate as a retail store.

BUSINESS EXPENSES

Legal Fees

***Ellen M. Sas and Roger Jones v. Comm'r,* TC Summ. Op. 2017-2 (Jan. 30, 2017)**
IRC §§62, 67, and 162

☞ Legal Fees Improperly Deducted as Business Expense

Facts. In 2008, Ellen Sas was hired as the president and chief executive officer of Seattle Bank. In July 2010, Seattle Bank gave Ms. Sas a "Change of Control" bonus of $612,000. Ms. Sas and her husband, Roger Jones, reported the bonus on their 2010 Form 1040, *U.S. Individual Income Tax Return.*

In September 2010, Seattle Bank terminated Ms. Sas's employment. In November 2010, the bank filed a complaint against Ms. Sas, alleging breach of fiduciary duty. At that time, the bank attempted to recover the bonus. Ms. Sas filed her answer and counterclaims, including a claim of employment discrimination, in January 2011.

In May 2011, both parties signed a settlement agreement and mutual releases. Neither party paid the other anything, and they dismissed all claims against each other. However, Ms. Sas and Mr. Jones paid $25,000 and $55,798 in legal expenses connected with the lawsuit during 2010 and 2011, respectively.

Ms. Sas and Mr. Jones filed a Schedule C, *Profit or Loss From Business,* for an accounting and consulting business with their 2010 Form 1040 with Mr. Jones shown as the sole proprietor. In 2011, they filed a Schedule E, *Supplemental Income and Loss,* but reported no income on Schedule C.

14. Treas. Reg. §1.46-3(d)(1)(ii).

15. Rev. Rul. 76-428, 1976-2 CB 47; Rev. Rul. 76-256, 1976-2 CB 46.

Ms. Sas and Mr. Jones reported the legal expenses of $25,000 and $55,798 as negative "other income" on their 2010 and 2011 tax returns, respectively. The IRS disallowed the legal expenses as negative other income but allowed them as miscellaneous itemized expenses subject to the 2% of adjusted gross income (AGI) threshold. As a result, the deductible amounts were reduced to $4,525 for 2010 and $50,579 for 2011.

Issue. The issue in this case is whether the legal expenses should have been claimed as miscellaneous itemized expenses subject to the 2% of AGI threshold.

Analysis. Ms. Sas and Mr. Jones offered two separate theories for deducting their legal expenses without limitation. The first theory they asserted is that the legal fees were deductible under IRC §62(a)(20) in connection with a claim involving unlawful discrimination. This Code section does not apply to deductions **in excess** of the amount the taxpayer includes in gross income resulting from a settlement or judgment for the tax year. Ms. Sas argued that her bonus was included in their gross income when it was received, and she was able to retain the bonus because of her counterclaims. The IRS asserted that Ms. Sas received the bonus because of her work at Seattle Bank, not from any settlement. The court agreed with the IRS, noting that Ms. Sas did not receive a settlement from the bank. Therefore, the entire amount of the legal fees was in excess of the amount includable in gross income because of the settlement. Accordingly, Ms. Sas and Mr. Jones cannot deduct any of the legal fees under §62(a)(20).

Under the second theory offered by Ms. Sas and Mr. Jones, they could deduct the legal expenses as ordinary and necessary business expenses under §162 for their accounting and consulting business. They did not contend that the legal expenses were directly related to their business. Rather, they argued that the legal expenses were necessary to defend Ms. Sas from a lawsuit that would damage her professional reputation. If Ms. Sas's professional reputation was damaged, this would also damage the reputation of the accounting business. The court agreed that the lawsuit could have damaged Ms. Sas's professional reputation and her accounting business. However, the court noted that it must look to the origin of the claim, not the potential consequences of a win or loss. The court determined that the legal fees were related to Ms. Sas's employment at the bank and not to her accounting business. Therefore, the legal costs are not business expenses and are not deductible under §162.

Holding. The court held that Ms. Sas and Mr. Jones could not deduct their legal fees under either §§62(a)(20) or 162. The expenses are properly deducted as miscellaneous itemized deductions subject to the 2% of AGI limitation. As a result of this adjustment, Ms. Sas and Mr. Jones's 2011 alternative minimum tax increased by $12,888 for the 2011 tax year.

Start-up Expenses

***Julie Tizard v. Comm'r,* TC Summ. Op. 2016-42 (Aug. 15, 2016)**
IRC §§162, 195, and 212

☞ Pilot's Aviation Expenses are Disallowed as Start-Up Expenses

Facts. Julie Tizard is a veteran of the U.S. Air Force (USAF) and an accomplished pilot. She spent almost 12 years in the USAF. During this time, she was recognized as an air training command master instructor and won numerous commendations and awards.

In 1990, Ms. Tizard left active military duty and accepted a position as a full-time commercial airline pilot with United Airlines. Under Federal Aviation Administration rules, Ms. Tizard must retire as a commercial airline pilot at age 65. To prepare for that time, Ms. Tizard researched ways that she could earn income after her retirement. After considering the matter, she decided to purchase an aircraft and start an aviation business in Arizona.

Ms. Tizard decided that a Slingsby T-67C "Firefly" military training aircraft would allow her to provide various types of aviation services. She found the type of aircraft she was looking for at an aircraft museum in Florida. She negotiated the purchase of the Firefly with Guy Derby, a member of the museum's board of directors and a real estate developer. On October 6, 2010, she purchased the Firefly for $52,000 and paid $2,200 for additional equipment.

During the time that she was negotiating the Firefly purchase with Mr. Derby, he told her that he might be interested in hiring her to provide aerial land survey services in Phoenix for his real estate activities. Ms. Tizard asserted that she had a "verbal agreement" with Mr. Derby but admitted that he never actually hired her to provide aviation services.

On November 15, 2010, the Firefly was delivered to Ms. Tizard in Glendale, Arizona. That same day, she took an acquaintance who she considered a potential client for an "incentive orientation flight." Soon afterwards, the acquaintance moved to California, and Ms. Tizard never developed a business relationship with her. Ms. Tizard piloted the Firefly on one other occasion in November for approximately an hour and once in December for approximately 1.5 hours.

In October 2010, Ms. Tizard drafted a business plan. She estimated her total fixed monthly expenses at approximately $580 and that she would break even if she provided 2.5 hours of services at $250 per flight hour per month. Her goal was to provide 15 hours of aviation services per month.

Ms. Tizard filed a Form 1040 for 2010, on which she reported wages from United of $154,218. Her tax return included a Schedule C, *Profit or Loss From Business,* which reported no gross receipts and total expenses of $13,295.

Issue. The issue in this case is whether Ms. Tizard is entitled to a deduction for a $13,295 loss she sustained in 2010 in connection with an aviation activity.

Analysis. The IRS contended that Ms. Tizard is not entitled to a deduction for the $13,295 of expenses she incurred in 2010 because she was not "carrying on" a trade or business. The IRS claimed that the expenses are, at best, nondeductible startup expenditures.

Under IRC §162(a), a deduction is generally allowed for ordinary and necessary expenses incurred in connection with carrying on a trade or business. To qualify for a deduction under IRC §§162 or 212, expenses must be connected to a trade or business or other income-producing activity that is a going concern. Even if a taxpayer is committed to developing a business and invests considerable time and money in preparing to conduct business, the activity does not constitute a trade or business for purposes of §162(a) until it is actually functioning and performing the activities for which it was organized.[16] Until the time business operations actually commence, "expenses related to that activity are not 'ordinary and necessary' expenses currently deductible under section 162 (nor are they deductible under section 212) but rather are 'start-up' or 'pre-opening' expenses."[17] Under IRC §195(a), no current deduction is allowed for startup or preopening expenses.

Holding. The court concluded that Ms. Tizard was not carrying on an aviation-related trade or business in 2010. Therefore, her deduction for the loss that she claimed for her aviation activity on her 2010 tax return was disallowed.

16. *Richmond Television Corp. v. U.S.,* 345 F.2d 901, 907 (4th Cir. 1965), vacated and remanded on other grounds, 382 U.S. 68 (1965); see also *Glotov v. Comm'r,* TC Memo 2007-147 (Jun. 13, 2007).

17. *Woody v. Comm'r,* TC Memo 2009-93 (Apr. 30, 2009).

Education Expense Deduction

***Tao Long v. Comm'r,* TC Summm. Op. 2016-88 (Dec. 20, 2016)**
IRC §§56, 62, 162, 183, and 6662

☞ Business Deductions Denied but Education Expenses Allowed

Facts. Tao Long holds a bachelor of science degree from the California Institute of Technology, as well as a master of science degree in electrical engineering from the University of Illinois, Urbana-Champaign. From 2007 through 2009, he studied for and passed the required exams to obtain his Chartered Financial Analyst (CFA) designation. In 2012, he passed the required exams to obtain the Chartered Alternative Investment Analyst (CAIA) designation.

From March 2005 to May 2011, Long was employed with Broadcom, a microchip manufacturer, where he began employment as a design engineer. He subsequently obtained several promotions in the product marketing department, in which he engaged in product development and financial analysis until he resigned in May 2011.

In May 2010, while employed with Broadcom, Long enrolled in the MBA program at the University of Pennsylvania's Wharton School. Before he was admitted, Wharton required an acknowledgement from Long's employer that he would have adequate time to complete the program. Long's manager and supervisor at Broadcom responded favorably and reduced his workload to allow him more study time. Broadcom had a tuition reimbursement program, but under its terms, an employee is required to repay the reimbursement in full if the employee terminates their employment within one year of receiving reimbursement. Long did not request reimbursement under the Broadcom tuition reimbursement program.

While employed with Broadcom, Long also obtained his real estate broker's license, which allowed him to engage in various real estate transactions, including loan brokerage activities. After obtaining his real estate license, he signed contracts with four clients to represent them in transactions, using template forms from his realtor association. However, Long did not generate any income from real estate activity, never represented any clients in a real estate transaction, never made any written offers on a client's behalf, and never offered any properties for sale. He had no business plan, books, business bank account, or business credit card. Expenses were charged to his personal credit card or bank account. He maintained a handwritten log and calendar to track appointments and mileage.

In December 2009, Long signed an agreement with Info Loan to broker loans. He also developed a "mortgage shuttle" concept to save the cost of applying for a mortgage by "batching" mortgage applications, and formed Magick Investment Club, but none of these endeavors ever generated any income.

Upon his resignation from Broadcom in May 2011, he began a full-time summer internship with the investment division of Barclays Capital, where he worked from June through August of 2011. In January 2012, he started work at Connective Capital Management, LLC, and subsequently graduated from the Wharton School in April 2012. The Connective Capital Management job posting indicated a preference for a candidate with an MBA from a top university.

Long filed his self-prepared 2010 and 2011 tax returns, claiming expense deductions for his real estate activity and also for the Wharton tuition, fees, books, and related costs.

Issues. The issues in this case are as follows.

- Whether Long was engaged in a real estate trade or business, which would entitle him to the real estate activity deductions claimed
- Whether he may deduct educational expenses for his MBA
- Whether he is liable for accuracy-related penalties under IRC §6662(a)

Analysis. In order to be deductible, business expenses must be ordinary and necessary. In addition, the taxpayer must demonstrate that the underlying activity was engaged in with an actual and genuine profit motive. All facts and circumstances are considered in determining whether a profit motive existed. Greater weight is placed upon objective facts than the taxpayer's subjective statements. Among the facts and circumstances considered, nine nonexclusive factors are set forth in Treas. Reg. §1.183-2(b).

Looking at the nine factors, five indicated no profit motive, one indicated a profit, and three were neutral.

After analyzing these factors, the court concluded that the real estate activity **was not engaged** in for profit. Therefore, the deductions attributable to Long's real estate activity are limited to the gross income derived from the activity. Because Long did not derive any gross income from the activity during 2010 and 2011, he is not entitled to any of the claimed deductions.

Generally, a taxpayer's education expenses are deductible as ordinary and necessary business expenses if the education maintains or improves skills required in the taxpayer's employment or other trade or business. Services as an employee may be considered a taxpayer's trade or business. However, Treas. Reg. §1.162-5(b)(2) and (3) disallows a deduction for education expenses that are incurred to meet the minimum educational requirement for qualification in a taxpayer's trade or business or incurred to qualify the taxpayer for a new trade or business.

Under these rules, if the education qualifies a taxpayer to perform tasks and activities significantly different from those they could do before the education, the taxpayer has qualified for a new trade or business. However, education that refines existing skills does not qualify the taxpayer for a new trade or business. A taxpayer changing employers or jobs is considered to be in the same trade or business if they are still in the same general field and they are still using the same skills.

The IRS argued that Long's MBA education qualified him for a new trade or business because it enabled him to obtain a new position at Connective Capital. However, Long remained in the same trade or business when he accepted the Connective Capital position. He was already qualified in financial analysis before enrolling in the MBA program because he studied and obtained his CFA and CAIA designations. His Magick Club investment endeavor indicates he was developing financial investment skills. He also acquired investment and management skills through his full-time employment, including employment at Broadcom and Barclays Capital.

Moreover, Broadcom's cooperation in Long's enrollment in Wharton is indicative that the MBA program developed his current skills in his current trade or business. The Connective Capital posting indicated an MBA from a top university was only a preference, and Long had other qualifications listed in the posting, including investment experience.

When an employee was eligible under an employer program to obtain reimbursement and the taxpayer fails to do so, the taxpayer may not claim the expenses as an unreimbursed employee expense unless the taxpayer provides a valid reason for not seeking reimbursement. Long's decision to forgo seeking Broadcom's reimbursement for tuition while in their employ was reasonable, because he would have been obligated to repay the reimbursement when he resigned from his position.

For these reasons, the court concluded that Long **can deduct the costs** of his Wharton MBA as unreimbursed employee expenses.

IRC §6662(a) imposes a penalty of 20% of the portion of tax underpayment attributable to negligence. If the taxpayer provides evidence that the penalty should not be imposed because they acted with reasonable cause and in good faith, the penalty will not be imposed. The court noted that Long is highly educated and sophisticated in finance and management and has the ability to research complex issues.

He did not establish that he relied on professional advice but, instead, he completed his own returns. Therefore, he is liable for the penalty.

Holding. Long's real estate activity was not engaged in for profit and he is therefore not entitled to any of the deductions claimed. However, he may claim his qualifying education costs as unreimbursed employee expenses. Long is also liable for an accuracy-related penalty under IRC §6662.

Survey Costs

***CGG Americas Inc. v. Comm'r,* 147 TC No. 2 (Jul. 21, 2016)**
IRC §167

☞ Survey Expenses to Search for Oil and Gas Reserves are Deductible

Facts. During 2006 and 2007, CGG Americas Inc. (CGGA) conducted marine surveys of the outer continental shelf in the Gulf of Mexico using geophysical techniques to search for oil or gas. The raw data from these surveys was then processed to create maps of geological formations in the earth's subsurface. CGGA licensed the raw survey data and the information that resulted from processing the raw data to its customers for a fee. These customers were companies engaged in oil and gas exploration and development.

The IRS issued notices to CGGA, determining income tax deficiencies of $419,233 for the 2006 tax year and $2.8 million for the 2007 tax year. The IRS claimed that the company could not deduct survey expenses under IRC §167(h). This Code section permits the ratable deduction over a 24-month period of "any geological and geophysical expenses paid or incurred in connection with the exploration for, or development of, oil or gas within the United States..."

Issue. The issue in this case is whether the expenses CGGA incurred to conduct marine surveys and to process data from the surveys are deductible under §167(h).

Analysis. The IRS's disallowance of the §167(h) deductions for CGGA's marine survey costs was based on two arguments. The first argument was that the phrase "geological and geophysical expenses" in §167(h) is restricted to expenses incurred by owners of mineral interests. The court rejected this argument, noting that court opinions, administrative rulings, and legislative materials do not support such a restrictive interpretation.

The IRS's second argument was that CGGA's survey expenses were not "incurred in connection with the exploration for, or development of, oil or gas" within the meaning of §167(h). The IRS contended that the exploration to which the survey costs relate was the activity of CGGA's customers, rather than CGGA. The court also rejected this argument, noting that the surveying performed by CGGA was an integral part of the process of finding oil and gas deposits. If CGGA had not performed the surveys, then its customers would have had to do the surveys themselves.

Holding. The court held that the marine survey costs incurred by CGGA were deductible under §167(h).

CAPITAL GAINS AND LOSSES

Capital Losses

***Thomas Edwin and Mary Watts et al. v. Comm'r,* TC Memo 2017-114 (Jun. 14, 2017)**
IRC §§165, 741, 752, 6226, and 6662

☞ IRS Correctly Recharacterizes Loss from Ordinary to Capital

Facts. Thomas Edwin and Ronnie Watts (Watts brothers) founded Edwin Watts Golf Shops (EW) in 1968, which started as a small pro shop at a Florida golf club. EW grew into a highly successful business with 40 locations and a strong brand name. Much of the real estate in which the retail locations were operating was owned by the Watts brothers. By 2003, the business had nearly $200 million in annual sales, employed hundreds of people, and was attracting buyers.

The Watts sold EW to Wellspring (WS), a private equity firm. The sale appealed to the Watts brothers because it would allow EW to continue paying rent on the Watts-owned real estate to the brothers and keep the brothers actively involved in daily operations. The Watts brothers sold EW for $93 million, and under the terms of the agreement with WS, WS received an 80.5% "preferred" interest, while the Watts brothers retained a 19.5% "common" interest.

There were several rules in the terms of the agreement, drafted under Delaware law, which provided WS's interest with preferential treatment. These terms included the ability to appoint three of five board members, receive guaranteed payments, and receive preferential liquidation rights. Among these preferential rights were "drag-along" rights, under which WS could force the Watts brothers, as common interest holders, to sell their interests to any purchaser WS chose in a later sale of EW by WS.

In 2006, WS began seeking viable buyers, and the decision was made to sell to either Sun Capital (Sun) or Dick's Sporting Goods (Dick's). While WS had the power to sell to either buyer, it consulted the Watts brothers because of their intricate knowledge of the business. Even though Dick's offered $120 million, which was about $35 million more than Sun's bid, the Watts urged WS to sell to Sun because an agreement with Dick's would have threatened the stream of real estate rental income on the Watts-owned retail outlets. In addition, an agreement with Sun would preserve the Watts brand name and employment of many longtime employees. WS agreed to sell to Sun.

In 2007, Sun paid $87 million to WS for EW. Approximately $43.8 million was directed to Regions Bank to pay off the debts of the business, and the remaining amount was paid to WS. The Watts brothers, as common interest holders, received none of the cash.

The Watts brothers informed their longtime accountant, Harry Gates, about the sale, indicating that they received no cash in exchange for the disposition of their partnership interests. The Watts brothers provided Mr. Gates with all relevant documents. Mr. Gates determined that it was appropriate to treat the Watts' disposal of their common interests as an abandonment of the interests, triggering an ordinary loss. This is the manner in which the transaction was reported on the Watts' brothers 2007 tax returns.

The IRS sent notices of deficiency for 2007, indicating that the ordinary loss should be characterized as a capital loss instead. An accuracy-related penalty was also imposed.

Issues. The issues in the case are the following.

- Whether the Watts' 2007 loss is ordinary or capital
- Whether the Watts are liable for the accuracy-related penalty

Analysis. To support their argument for ordinary loss treatment, the Watts argued that they agreed to surrender to WS any sale proceeds due to them in order to provide WS with incentive to sell to Sun instead of Dick's. The Tax Court referred to this argument as the "incentive theory." The Watts argued that relinquishment of this purported incentive payment led to an amortizable expense. The Watts did not present an argument for their original tax return position that the transaction triggered an ordinary loss through abandonment.

The Watts argued that the agreement consisted of a latent ambiguity, and the Tax Court should interpret it with the incentive theory in mind and reconstruct the agreement accordingly.

> **Note.** A contract may have a **latent ambiguity** if the contract is clear when read, but an ambiguity in the contract becomes apparent when knowledge is obtained about outside factors or circumstances to which the contract relates.

Because the sale agreement between the Watts brothers and WS provided WS with preferential interests, including the "drag-along" rights and provided no rights to the Watts brothers to receive anything in the subsequent sale to Sun, the Watts's incentive theory argument failed. They had no rights in anything to give up to WS in exchange for WS's agreement to sell to Sun instead of Dick's. WS had the power to sell to any party without any involvement from the Watts brothers.

Under Delaware law, it is possible for a contract to have a latent ambiguity. However, a contract must be deemed ambiguous on its face before a court will conclude it contains a latent ambiguity and allow outside evidence to aid or supplement the contract's terms. The purchase and sale contract between WS and Sun was clear on its face and there were no ambiguous terms. The Watts provided no support for any unclear language or reasonable alternative interpretation of any relevant terms. Therefore, no latent ambiguity was found.

The notice of deficiency issued by the IRS is presumed correct and the taxpayer has the burden of proving it incorrect. The Watts did not meet their burden of proof in connection with the argument that the transaction resulted in an amortizable expense.

A partnership interest may be abandoned, but only under narrow circumstances. Under IRC §752(b), a partner relinquishing their partnership interest is deemed to receive a cash distribution. IRC §731(a) requires such distributions to be treated as payments from the sale or exchange of a partnership interest. Abandonment may arise only if the partner was not personally liable for partnership recourse debts, or was limited in liability and otherwise not exposed to any economic risk of loss for the partnership's nonrecourse liabilities. The IRS was correct in determining that the Watts' brothers transaction did not fall within these narrow circumstances that would give rise to an abandonment. The Watts offered no evidence to the contrary.

The Watts argued that no penalty should be imposed against them because their initial return position was taken with reasonable cause and in good faith. Specifically, the Watts relied on their longtime accountant's opinion in originally characterizing the loss as ordinary. **The court noted that it was reasonable and prudent for the Watts to rely on Mr. Gates's advice.** Therefore, they are not liable for the accuracy-related penalty.

Holding. The court held that the IRS's recharacterization of the loss from ordinary to capital was correct. However, the Watts are not liable for the accuracy-related penalty.

Capital Gains

***Gregory and Melanie Boree v. Comm'r,* TC Memo 2014-85 (May 12, 2014)**
IRC §§1221 and 6662

☞ Income From Sale of Real Estate is Ordinary Income

Facts. Greg Boree and Daniel Dukes formed Glen Forest, LLC, in September 2002. They purchased 1,982 acres of land for approximately $3.2 million.

Almost immediately after closing the transaction, Glen Forest sold 280 acres of the property to eight purchasers. During December 2002, they sold one 10-acre lot. They sold approximately 15 lots during 2003.

During 2003, Glen Forest began building an unpaved road and submitted to the county board of commissioners (board) a conceptual map of West Glen Estates. West Glen Estates was a planned residential development with over 100 lots. Glen Forest applied for, and received, exemptions allowing it to sell lots without completing interior roads or submitting plats to the board. Glen Forest also executed a declaration of covenants, conditions, and restrictions of West Glen Estates. The declaration identified Glen Forest as "developer."

During 2004, Glen Forest sold approximately 26 lots. During 2005, it sold an additional 17 lots.

In March 2005, Mr. and Mrs. Boree purchased Mr. Dukes' interest in Glen Forest and became the sole owners of Glen Forest. Throughout 2005, Mr. Boree spent significant time opposing a board decision requiring paved roads in subdivisions.

During 2006, Glen Forest sold four more lots. In April 2006, Adrian Developments (Adrian) and Glen Forest entered into an agreement under which Adrian obtained an option to purchase most of the remaining Glen Forest property. In February 2007, Glen Forest sold 1,067 acres of Glen Forest property to Adrian for approximately $9.6 million.

On the Borees' 2005–2007 Schedules C, *Profit or Loss From Business,* Mr. Boree listed his profession as "land investor." For 2005 and 2006, the Borees reported income from Glen Forest's lot sales as ordinary income. They also deducted expenses relating to the properties, claiming cumulative net losses of over $200,000. The Borees' 2007 Form 1040, *U.S. Individual Income Tax Return,* reported Mr. Boree's occupation was "real estate professional." On the 2007 return, they reported a long-term capital gain of $8.6 million relating to the Adrian transaction.

In September 2011, the IRS sent the Borees a notice of deficiency for 2007. The IRS determined that the Adrian transaction did not qualify for capital gain treatment.

Issues. The issues in this case are the following.

- Whether the Borees' sale of real property in 2007 should be classified as ordinary income or capital gain
- Whether the Borees were subject to an accuracy-related penalty for the understatement of taxes in 2007

Analysis. IRC §1221(a)(1) excludes inventory and "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" from the term "capital asset." To determine whether an asset is a capital asset, the court analyzes relevant facts and circumstances. Relevant factors include "the number, extent, continuity and substantiality of the sales… [and] the extent of subdividing, developing, and advertising."[18]

Prior to selling the property to Adrian, the Borees were involved in real estate development activities. They consistently treated Glen Forest as a real estate business and held it out as such to buyers of Glen Forest property, the board, and on their 2005, 2006, and 2007 tax returns.

The Borees conducted the following activities, showing **frequent and substantial activities** in the **ordinary course of business.**

- Subdivided the Glen Forest property
- Built a road
- Spent significant time and money on zoning activities
- Sold approximately 60 lots comprising approximately 600 acres

After reviewing the evidence, the court determined that the income from the Adrian transaction was ordinary rather than capital.

Under IRC §6662, an accuracy-related penalty may be imposed for a substantial understatement of tax. An understatement is substantial if it exceeds 10% of the tax required to be shown on the tax return. The Borees were unable to establish reasonable cause for the underpayment or that the return was prepared in good faith.

Holding. The court held that the Borees' sale of real property was ordinary income.The court also held that the Borees were liable for an accuracy-related penalty on the $1.78 million understatement of income tax.

18. *U.S. v. Winthrop,* 417 F.2d 905 (5th Cir. 1969).

Capital Assets

***CRI Leslie, LLC et al. v. Comm'r*, 147 TC No. 8 (Sep. 7, 2016)**

IRC §§162, 167, 1221, 1231, and 1234A

☞ Forfeited Deposits Relating to Sale of IRC §1231 Asset Denied Long-Term Gain Treatment

Facts. CRI Leslie, LLC (CRI) purchased a hotel property in 2005 for $13.8 million. It entered into an agreement to sell the property in 2006 for $39.2 million. CRI obtained deposits from the purchaser totaling $9.7 million before the purchaser defaulted on the agreement. Under the agreement's terms, CRI was entitled to keep the deposits.

CRI filed its 2008 return, claiming hotel operating expenses and depreciation. It also treated the forfeited deposits as a **net long-term capital gain**. The IRS disagreed with this characterization of the retained forfeited deposits and sought to treat the $9.7 million in forfeited deposits as ordinary income.

CRI and the IRS agreed that the hotel property is not a "capital asset" under IRC §1221(a)(2). This Code section defines a capital asset as property held by the taxpayer, not including property used in the taxpayer's trade or business that is subject to a depreciation allowance or real property used in the taxpayer's trade or business. CRI and the IRS further agreed that the hotel property, during the time CRI held it, was an IRC §1231 asset used in CRI's trade or business.

IRC §1234A treats gains or losses from terminations of certain contractual rights as gains or losses from the sale of a capital asset. CRI contended that Congress did not intend for §1234A to apply only to payments connected with contract terminations relating to capital assets but also to payments from terminations relating to §1231 assets.

Issue. The issue is whether the term "capital asset" used in IRC §1234A extends to IRC §1231 property.

Analysis. CRI argued that the term "capital asset" in IRC §1234A extends to IRC §1231 property because Congress clearly intended for such an extension of the term. According to CRI, Congress enacted §1234A to ensure that taxpayers received the same tax characterization of gain or loss regardless of whether the property is sold or the contract to which the property is subject is terminated. Accordingly, CRI argued, it is inconsistent to treat the forfeited deposits as ordinary income, when a completed sale of the property would have resulted in a long-term capital gain. CRI contended that there is an inherent ambiguity in §1234A and this congressional intent should be considered.

The IRS argued that the plain, unambiguous wording of §1234A is clear. Because the hotel was not a capital asset in the hands of CRI, long-term capital gain characterization is inapplicable to the forfeited deposits under §1234A. The IRS noted that, by the time §1234A was enacted by Congress, the distinction between capital assets and §1231 assets was clearly established in the Code.

After noting this was a case of first impression and there is sparse IRS guidance and case law regarding §1234A, the court agreed with the IRS's argument that the plain meaning of the statute should prevail.

Holding. The court held that §1234A only applies to capital assets as defined in IRC §1221(a). The term "capital asset" in §1234A does not extend to IRC §1231 assets. Therefore, the forfeited deposits are ordinary income as determined by the IRS.

7

Stock Transactions

***Estate of Andrew McKelvey et al. v. Comm'r*, 148 TC No. 13 (Apr. 19, 2017)**

IRC §§1001 and 1259

☞ Extension of Stock Settlement Date Is Not a Sale

Facts. Andrew McKelvey was the founder and CEO of Monster Worldwide, Inc. (Monster), known for the website, Monster.com. In 2007, Mr. McKelvey entered into a variable prepaid forward contract (VPFC) with Bank of America. Bank of America made a $50.9 million prepaid cash payment to Mr. McKelvey in exchange for up to 1.8 million shares of Monster common stock. Mr. McKelvey was to deliver the stock over the course of 10 separate settlement dates in September 2008. The actual number of shares or the cash equivalent required on the delivery dates would vary according to the stock market closing price of Monster stock on the settlement day.

In 2007, Mr. McKelvey also entered into a VPFC with Morgan Stanley. Mr. McKelvey received a cash prepayment of $142.6 million on September 27, 2007. In exchange, he agreed to deliver to Morgan Stanley up to 4.8 million Monster shares in September 2008.

Mr. McKelvey treated those exchanges as open transactions under Rev. Rul. 2003-7[19] and did not report any capital gain or loss for 2007.

In 2008, Mr. McKelvey paid Bank of America and Morgan Stanley to extend the settlement dates to 2010. He did not report any gain or loss from the execution of the extension. Mr. McKelvey died in 2008 after the extension request.

In 2014, the IRS determined that the extensions constituted a sale or exchange of property under IRC §1001 and that Mr. McKelvey should have reported capital gains from the transactions for 2008.

Issue. The issue in this case is whether the modifications Mr. McKelvey made in 2008 to the VPFCs resulted in taxable exchanges.

Analysis. A VPFC is a type of forward contract that requires a forward buyer, usually a bank, to pay a forward price to the forward seller on the date of the contract execution, rather than on the day of maturity. In exchange for the cash prepayment, the forward seller is obligated to provide one of the following to the seller.

1. Shares of stock that were pledged as collateral when the contract was initiated
2. Identical shares of the stock that were not pledged as collateral
3. Equivalent cash amount

The actual numbers of shares or cash equivalent to be delivered by the forward seller is determined based on a formula. The formula takes into account changes in the market price of the underlying stock over the duration of the contract.

The IRS recognizes that VPFCs are open transactions when executed and do not result in the recognition of a gain or loss until the future delivery.[20] The taxpayer does not know the amount of stock or cash equivalent necessary to complete the transaction until the settlement date.

The IRS argued that the extensions of the VPFCs were taxable exchanges under §1001. It argued that the extensions to the original VPFCs resulted in a constructive sale of the Monster stock under IRC §1259. The estate contended that the extensions merely postponed the settlement and averaging dates of the contracts, did not trigger any tax consequences for Mr. McKelvey, and the open transaction treatment provided by Rev. Rul. 2003-7 should continue until the contracts are settled by delivery of the stock.

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19. Rev. Rul. 2003-7, 2003-1 CB 363.

20. Ibid.

IRC §1001(c) provides that the entire gain or loss on the sale or exchange of property must be recognized. Under Treas. Reg. §1.1001-1(a), in order for the extensions to trigger recognition of gain or loss, the following two conditions must be satisfied.

1. The original VPFCs must constitute **property** to Mr. McKelvey at the time of the extension.
2. The property must be exchanged for other property differing materially either in kind or in extent.

The estate argued that the VPFCs were not property to Mr. McKelvey when the extensions were executed. Therefore, there was no property to be disposed of for a gain or loss under §1001. The court found that at the time Mr. McKelvey extended the settlement dates, he only had **obligations** to deliver the shares or cash equivalent, not actual property. Because he only had obligations rather than property, §1001 is inapplicable.

IRC §1259 states that a taxpayer must recognize gain in a constructive sale of an appreciated financial position as if the position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. A taxpayer is treated as making a constructive sale of an appreciated financial position if the taxpayer enters into a future or forward contract to deliver the same or substantially identical property.[21] According to the court, Mr. McKelvey's extension did not constitute a constructive sale under §1259 because the original VPFCs are the only contracts subject to evaluation.

Holding. The court held that the extensions of the settlement date were not sales or exchanges of property under §1001 and therefore did not result in taxable exchanges.

CASUALTY AND THEFT LOSSES

Casualty Loss

***Howard and Tandi Coates v. Comm'r,* TC Memo 2016-197 (Oct. 31, 2016)**
IRC §§165, 165(h), and 6662

☞ Taxpayers' Casualty-Loss Deduction Reduced Following Tornado Damage

Facts. Howard and Tandi Coates owned a large tract of land in Oklahoma. The 700-acre tract was divided into three adjacent areas. Property A consisted of 80 acres that contained the Coateses' personal residence. Property B consisted of 440 acres of undeveloped woodlands. The third area consisted of 180 other acres.

On January 11, 2010, the Coateses had an appraisal completed on 120 acres that included the 80 acres from property A. The appraisal valued the property at $676,900.

On May 10, 2010, a tornado cut through the ranch, causing significant damage. The houses and barns on property A were damaged, fences were torn down, and trees were knocked down. The tornado demolished 80-90% of the oak trees on property B. Without the trees, property B became covered in dense, impassable scrub that was no longer suitable for the wild turkeys, deer, and wild boar that previously lived in the woodlands.

The Coateses had insurance on property A that covered the house and barns, but the insurance did not cover damage to the land or fences. The insurance company evaluated the damage to the house and barns and estimated the cost to repair them would be between $24,000 and $28,000.

21. IRC §1259(c)(1)(C).

The Coateses believed the insurance company undervalued the cost to repair so they hired a loss-recovery advocacy service, Crossroads Insurance Recovery Advocates, LLC, to reevaluate the cost. The Coateses paid Crossroads $20,000 for the evaluation. Crossroads estimated the cost to repair the house and barns at $189,248. The Coateses forwarded Crossroads' estimate to their insurance company, and the insurance company subsequently reimbursed the Coateses $168,268 for the house and barns. The Coateses reported $148,268 ($168,268 insurance payout − $20,000 paid to Crossroads) on their 2010 Form 1040, *U.S. Individual Income Tax Return.*

The Coateses did not insure property B and did not receive any damage payments for it.

The Coateses attached a Form 4684, *Casualties and Thefts,* to their 2010 tax return. It showed a total casualty loss of $127,731, calculated as follows.

	Property A	Property B	Total
1. Adjusted basis	$500,000	$247,000	
Fair market value (FMV) before casualty	$660,000	$528,000	
Less: FMV after casualty	(450,000)	(440,000)	
2. Decrease in value	$210,000	$ 88,000	
Lesser of 1. adjusted basis and 2. decrease in value	$210,000	$ 88,000	
Less: insurance reimbursement	(148,268)	0	
Loss before statutory limits	$ 61,732	$ 88,000	$149,732
Less statutory limits:			
$100 deduction			(100)
10% of adjusted gross income (AGI)			(21,901)
Casualty loss after statutory limits			$127,731

In 2013, the Coateses had property B appraised. The appraisal concluded that the best use of property B was as hunting ground. If the land was fully remediated and restored to its pre-tornado condition, the FMV would be $506,000. The appraisal estimated it would cost $149,700 to return the property to its pre-tornado condition.

The IRS issued the Coateses a notice of deficiency for the 2010 tax year. It disallowed the Coateses' casualty-loss deduction of $127,731. Additionally, the IRS determined an income tax deficiency of $32,335 and an accuracy-related penalty of $6,467.

Issues. The issues in this case are as follows.

- How much, if any, of a casualty-loss deduction the Coateses are allowed in 2010
- Whether the Coateses are liable for an IRC §6662 accuracy-related penalty

Analysis. IRC §165 allows a deduction for a loss sustained during the year and not compensated by insurance.

The Code and regulations list the steps a taxpayer must take to determine the amount of a casualty loss.

- Identify the lesser of the adjusted basis in the property or the decline in value of the property[22]
- Reduce amount of loss by any compensation received[23]
- Adjust for $100 floor and 10% of AGI[24]

22. IRC §165(a); Treas. Reg. §1.165-7(b)(1).

23. Ibid.

24. IRC §§165(h)(1) and (2)(A).

The court attempted to determine the decline in value by looking at the actual costs the Coateses incurred to repair their property. However, the court record did not provide the total amount the Coateses spent. They spent the entire amount of the insurance reimbursement in addition to an undisclosed amount to repair fences and other damage. The court could not establish actual cost; therefore, it determined the decline in value by calculating the value of property A before the tornado and subtracting the value after the tornado.

Generally, the values before and after a casualty are ascertained by an appraisal, but it is permissible for the court to rely on the landowner's opinion of those values. The court found Mr. Coates credible and knowledgeable about the values of his property. Mr. Coates had worked for 30 years on the ranch and had substantial experience working with timberland, farmland, and pastureland. He also bought and sold various properties in the area, some of which had damage from fires or were overgrown. In these situations, Mr. Coates had to restore the land to workable farmland or grazing land before reselling it. Because the court found Mr. Coates to be credible, it found his $660,000 valuation of the 80 acres of property A was reasonable despite its inconsistency with an official appraisal. Therefore, the court agreed with Mr. Coates that the value of property A before the tornado was $660,000 and the value after the tornado was $450,000, for a decline in value of $210,000.

The Coateses reported an adjusted basis in property A of $500,000. In a post-trial brief, the IRS did not challenge this value. The $500,000 adjusted basis exceeded the $210,000 loss to the property. The allowable casualty loss is the lesser of the adjusted basis or the actual loss; therefore, the court held that the Coateses' casualty loss was at least $210,000.

The $210,000 must be reduced by any compensation received. The Coateses received an insurance payment of $168,268 for property A and they paid $20,000 for an estimate of the damage to property A. On their 2010 tax return, the Coateses offset the insurance payment with the $20,000 appraisal. The court agreed this treatment was appropriate. As such, the court agreed with the Coateses' calculation of the total casualty loss before statutory limitations of $61,732 (as shown previously).

Next, the court looked at the decline in value for property B. Before the tornado, the Coateses used the property recreationally for hunting. After the tornado, the Coateses attempted to convert the land into grazing land. On their 2010 tax return, the Coateses reported the FMV before the tornado was $528,000. This value was based on similar property sales in the area. After the tornado, Mr. Coates estimated that the FMV was $440,000. The decline in value of $88,000 was equal to $200 per acre to clear the land for grazing multiplied by 440 acres. Mr. Coates testified that $200 was a conservative estimate and a more realistic estimate would be closer to $500 per acre.

In 2013, the Coateses had an appraisal of property B completed. The appraisal stated that the best use of the land would be as hunting land and it would cost $149,700 to restore the land to that purpose. If the land was restored to hunting land, its estimated value would be $506,000.

The court determined the decline in value from the casualty loss on property B by comparing the value before and after the tornado. The court again found Mr. Coates to be credible with his estimate of value and determined the pre-tornado value was $528,000. The court also agreed with Mr. Coates' $440,000 valuation of the property after the tornado because of his expertise in the area. The best use of the land post-tornado was held to be as grazing land. If the best use of land is a use other than its current purpose, the value equals its value after it is converted to its new use less the cost of converting it to the new use.

To determine the after-tornado value, the court viewed the following relevant facts.

- The value of property B after the tornado is equal to its value as grazing land minus the cost of converting the property to grazing land.
- The value of property B as grazing land is less than $528,000.
- The cost of converting the land is $88,000 or more.

Based on an analysis of those facts, the court determined that the value of the property after the tornado is $440,000 ($528,000 – $88,000) or less. Because the Coateses did not argue for a lower value, the court did not consider a lower value.

The adjusted basis of property B is equal to the basis of the property plus or minus any adjustments. Basis is determined depending on the method by which the property was acquired (e.g., purchase, gift, or combined gift and purchase when the buyer paid less than the value of the property).

It is unclear how the Coateses acquired property B. Mr. Coates testified that he purchased the property from his mother. However, he did not say how much he paid or when the transaction occurred. The IRS claimed that the property was a gift. The Coateses tried to establish basis in the property by submitting to the court various deeds showing property transfers. However, none of the deeds showed the purchase price for the property transfers. Furthermore, the Coateses did not provide evidence of any positive adjustments to the property through improvements. The court held that the Coateses did not prove their adjusted basis in property B and thus they were not entitled to a casualty-loss deduction.

The IRS contends that the Coateses were liable for a §6662(a) accuracy-related penalty. The 20% penalty may be imposed on an underpayment of tax related to negligence or disregard of the rules or regulations. The court reasoned that because of Mr. Coates' expertise and extensive research on the matters in this case, he acted with reasonable cause and in good faith. Therefore, the court held that the Coateses were not liable for the accuracy-related penalty.

Holding. The court held that the Coateses were entitled to a casualty-loss deduction on property A but denied the Coateses a casualty-loss deduction on property B. The Coateses were not negligent and therefore the court held they were not responsible for an accuracy-related penalty.

CLERGY

Clergy Income

***Joseph and Sylvia Jackson v. Comm'r,* TC Summm. Op. 2016-69 (Oct. 24, 2016)**

IRC §§61 and 102

☞ Pastor's "Love Offerings" Were Taxable Income

Facts. In 2012, Joseph Jackson was the pastor, director, and registered agent for Triumph Church of God. His wife Sylvia Jackson was also a church director. Mr. Jackson informed the church's board of directors that he did not want a salary but would accept "love offerings," gifts, or loans from the church.

Mr. and Mrs. Jackson managed the church's bank account. During the year, they jointly signed all of the church's checks. In 2012, several of these checks were payable to Mr. Jackson, with "love offering" or "love gift" on the memo line.

Kathy Simmons was the church's long-time bookkeeper. In 2012, she issued Mr. Jackson a Form 1099-MISC, *Miscellaneous Income,* which reported $4,815 of nonemployee compensation.

The Jacksons filed a joint income tax return for 2012. They did not report the $4,815 of nonemployee compensation. The Jacksons claimed that Ms. Simmons incorrectly issued the Form 1099-MISC and that all the income was nontaxable love offerings, gifts, or loans. They requested Ms. Simmons either retract the Form 1099-MISC or issue a corrected form. She did not do so.

Issue. The issue is whether the "love offerings" Pastor Jackson received are taxable nonemployee compensation.

Analysis. Gross income generally includes all income from whatever source derived unless an exception exists.[25] IRC §102 provides an exception for amounts acquired by gift. Determining whether a payment is a gift is a factual question. The transferor's intent is the most important consideration when determining if a payment is a gift.[26]

The record shows that the payments to Mr. Jackson were in exchange for his service as a pastor. Mr. Jackson expressed to the board that he was willing to take love offerings as a substitute for a salary. In addition, Ms. Simmons considered the payments to be compensation.

The Jacksons failed to provide any supporting testimony or facts to support their claim that the payments were anything other than taxable compensation. Additionally, the court looked at the frequency of the payments and the fact that the payments appeared to be made on behalf of the entire congregation as further evidence that the payments were taxable compensation.

Holding. The Tax Court held that the income Mr. Jackson received from his church was taxable compensation.

CREDITS

Earned Income Credit

***Kevin Skaggs v. Comm'r,* 148 TC No. 15 (Apr. 26, 2017)**
IRC §32

☞ Inmate's Income from Correctional Hospital Not Earned Income

Facts. Kevin Skaggs was sentenced to 310 months in prison after being convicted of several felonies. He is in the custody of the Kansas Department of Corrections and his earliest release date is May 30, 2029.

From mid-2012 to mid-2016, Mr. Skaggs resided in the Larned State Hospital. This hospital treats mentally ill inmates while holding them in custody. Mr. Skaggs's movement to the hospital was recorded in Kansas Department of Corrections (KDOC) records as an "inter-facility movement" from Larned Correctional Mental Health Facility to Larned State Hospital. During 2015, Mr. Skaggs earned income from part-time work as a custodian for the hospital.

Mr. Skaggs filed a 2015 return reporting $2,921 in income, $62 of taxes withheld by his employer, and an earned income credit (EIC) of $224. The taxes withheld and the EIC claim resulted in a $286 refund shown on the return. The IRS issued Mr. Skaggs a notice of deficiency, denying the EIC claim. Mr. Skaggs's refund was also withheld.

Mr. Skaggs filed a Tax Court petition, challenging the denial of his EIC claim. He claimed that during his time at the hospital he ceased being an inmate and became a patient, and the hospital was not a penal institution. He noted that the Larned State Hospital was not included in a Kansas statutory list of correctional institutions. To support his claim, Mr. Skaggs indicated that he was not treated like an inmate during his hospital stay and was subject to fewer restrictions. He was able to wear his own clothes rather than clothing issued by the KDOC and had greater freedom to communicate with the outside world. Mr. Skaggs further indicated that his wages were not subject to the same mandatory deductions or restrictions as those imposed on a KDOC inmate's wages.

Issue. The issue in this case is whether Mr. Skaggs was entitled to the EIC.

25. IRC §61(a).

26. *Comm'r v. Duberstein,* 363 U.S. 278 (1960).

Analysis. IRC §32(c)(2)(B)(iv) states that income earned while a taxpayer is an inmate in a penal institution is not included in income for purposes of the EIC. Neither the Code nor regulations define "inmate" or "penal institution." When defining a statutory term, the ordinary, everyday meaning is generally used. Black's Law Dictionary defines inmate as a "person confined in a prison, hospital, or similar institution." This is similar to the definition provided in the Merriam-Webster Collegiate Dictionary, which defines inmate as "a person confined (as in a prison or hospital)."

Black's Law Dictionary refers the reader to the definition of "prison" when defining "penal institution." "Prison" is defined therein as a "state or federal facility of confinement for convicted criminals—esp. felons." The Merriam-Webster Collegiate Dictionary has no reference to "penal institution" but defines "prison" as "a place of confinement esp. for lawbreakers."

The KDOC's records characterized Mr. Skaggs's transfer to the hospital as an "inter-facility transfer," not a release. The distinction in treatment and restrictions Mr. Skaggs cites to differentiate his status from that of an inmate is not convincing because inmates are frequently treated differently due to any number of factors.

Even though not included in the Kansas statutory list of correctional institutions, the Kansas State security hospital is housed in the Larned State Hospital. According to the statute, the security hospital was established for the purpose of holding in custody, examining, treating and caring for those with mental illness who are transferred for care or treatment from a correctional institution.

Further, an inmate's sentence is not tolled during their time in the security hospital, and they can only be treated there as an inmate. An inmate can only be released from the security hospital once their sentence is over. If treatment is over before the inmate's sentence ends, the inmate must return to prison.

Holding. The court held that Mr. Skaggs was still an inmate while at the hospital. The IRS properly denied his EIC claim.

DEDUCTIONS

Employee Business Expenses

***Mario J. Collodi, Jr. and Elizabeth L. Collodi v. Comm'r,* TC Summ. Op. 2016-57 (Sep. 19, 2016)**
IRC §§162, 262, 6662, and 7491

☞ Taxpayers Denied Deduction for Business Expense While at Tax Home

Facts. During 2011, Ensign United States Drilling California employed Mario Collodi, Jr. as a motor hand. Mr. Collodi resided in northern California with his wife, Elizabeth, and their children. He worked at various wells in southern California. While working in southern California, Mr. Collodi stayed in a hotel that was 15 miles from one worksite and 40 miles from the other worksites.

The Collodis hired Barbara Kirby-Rosamond to prepare their 2011 Form 1040, *U.S. Individual Income Tax Return.* Mr. Collodi recorded his mileage and overnight travel on a calendar, which he summarized for Ms. Kirby-Rosamond. Ms. Kirby-Rosamond returned the calendar to the Collodis after preparing the return.

On their 2011 return, the Collodis claimed the following expenses as miscellaneous itemized deductions subject to the 2% of adjusted gross income limitation.

- Mileage from southern California to the Collodis' residence in northern California
- Mileage for daily round trips between the hotel and Mr. Collodi's worksites
- Meals and incidentals for every day Mr. Collodi was in southern California

The Collodis claimed $15,856 in mileage expenses and $13,561 in overnight travel expenses on their 2011 Form 2106, *Employee Business Expenses.*

During an examination of the Collodis' 2011 return, the examining agent requested documents substantiating the Collodis' itemized deductions. The Collodis were unable to produce the calendar or any support for the mileage or overnight expenses.

Issues. The issues in this case are the following.

- Whether the Collodis are entitled to unreimbursed employee business expense deductions for 2011
- Whether the Collodis are liable for an IRC §6662(a) accuracy-related penalty

Analysis. The Collodis believe they are entitled to the deductions for overnight travel and vehicle use because the uncertainty of Mr. Collodi's job made it impractical for them to move to southern California. The IRS claims that Mr. Collodi was not working away from home under IRC §162(a) and is therefore not entitled to the deductions. Furthermore, the Collodis failed to substantiate their expenses.

IRC §162(a) allows a deduction of ordinary and necessary traveling expenses (including meals and lodging) incurred during the year in carrying on a trade or business if:

- The expense is incurred away from home, and
- The expense is incurred in the pursuit of a trade or business.

A taxpayer's home for purposes of §162(a) generally refers to the area of the taxpayer's principal place of employment, regardless of whether that is near the taxpayer's residence.[27] A taxpayer whose place of business changes but their residence does not change is considered to move their tax home to the location of the new principal place of business. An exception exists if the employment away from the taxpayer's permanent residence is **temporary.**[28] IRC §162(a) provides that a taxpayer is not treated as being temporarily away from home if the period of employment exceeds one year.

Mr. Collodi was employed in southern California from 2010 through October 2012. He was not temporarily away from home and, therefore, his tax home was southern California. Mr. Collodi is not eligible to deduct his expenses for meals, incidentals, and automobile trips between his hotel and worksite because he was not away from his home. His mileage expenses for trips between southern and northern California were also not deductible because they were motivated by personal reasons rather than business.

A taxpayer is liable for a 20% penalty for any portion of an underpayment of tax attributable to a substantial understatement of income tax. An understatement is substantial if it exceeds the greater of 10% of the tax required to be shown on the return or $5,000. The penalty is not imposed if the taxpayer proves they acted with reasonable cause and good faith. Reliance on the advice of a tax preparer may establish reasonable cause and good faith.

Mr. and Mrs. Collodi were not experienced in tax preparation and therefore sought the expertise of Ms. Kirby-Rosamond. She prepared the Collodis' tax returns for over a decade. The court believed Mr. Collodi's testimony that he maintained a contemporaneous calendar documenting his overnight travel and mileage, that he brought that to Ms. Kirby-Rosamond, and that she used that information to prepare their tax returns. Therefore, the court concluded that the Collodis relied on their return preparer in good faith. Accordingly, the court held that the Collodis were not responsible for an accuracy-related penalty regarding underpayments attributable to overnight travel and mileage expenses.

Holding. The court held that Mr. Collodi was not entitled to unreimbursed employee business expense deductions because he was not away from home under §162(a)(2). However, the court held that he was not liable for the accuracy-related penalty under §6662(a).

27. *Daly v. Comm'r,* 72 TC 190, 195 (Apr. 24, 1979).

28. *Peurifoy v. Comm'r,* 358 U.S. 59 (Nov. 10, 1958).

Employee Business Expenses

Richard Liljeberg et al. v. Comm'r, **148 TC No. 6 (Mar. 16, 2017)**

IRC §§67, 162, 213, and 871

☞ Tax Court Adheres to Precedent for Employee Expenses of Nonresident Aliens

Facts. Richard Liljeberg, Anna Zolotareva, and Enda Conway were three nonresident alien students who participated in the U.S. Department of State's Summer Work Travel Program (SWTP). The SWTP is a work and cultural exchange program. All three taxpayers came to the United States during the summer months under a "J" visa to participate in the SWTP. The maximum duration of participation under the SWTP was four months, and each participant was required to maintain their foreign home while participating. Each of the taxpayers worked in the United States at jobs that were seasonal or temporary in nature. The Tax Court heard each of the three taxpayer's cases in a consolidated case because the issues in each are identical. All three taxpayers claimed unreimbursed employee expenses that were disallowed by the IRS. The details for each taxpayer follow.

- **Richard Liljeberg.** Mr. Liljeberg, a citizen and resident of Finland, was a student at a Helsinki university. He lived with his mother before coming to the United States to participate in the SWTP but returned home to Finland to his own rented home. He had a driver's license and car in Finland, received mail at his Finland residence, was registered to vote in Finland, and had a bank account there. Mr. Liljeberg worked for a Finnish employer before coming to the United States but did not return to that employer upon returning to Finland.

  Mr. Liljeberg worked as a lifeguard in Wisconsin under the SWTP. He deducted $1,700 in unreimbursed employee expenses on his nonresident tax return for 2012. This amount was composed of airfare, SWTP costs, visa expenses, and insurance costs. The IRS disallowed the deduction and issued a notice of deficiency for $54.

- **Anna Zolotareva.** Ms. Zolotareva, a citizen and resident of Russia, was a student at a Russian university. She lived with her parents before coming to the United States in 2012 to participate in the SWTP. Ms. Zolotareva returned to her parents' home after her SWTP participation. Throughout 2012, she held a Russian driver's license and was registered to vote in Russia, but she did not work in Russia at any time during 2012.

  Ms. Zolotareva worked as a housekeeper at a resort in Washington and returned to Russia after her employment. She filed a nonresident tax return for 2012 claiming $2,610 of unreimbursed employee expenses, including program fees, travel costs, visa fees, and medical insurance. The IRS disallowed the deduction and issued a notice of deficiency for $161.

- **Enda Conway.** A resident and citizen of Ireland, Mr. Conway was a student at University College in Dublin. While in the United States to participate in the SWTP in 2012, he worked as a server at a New York restaurant. During his time in the United States, Mr. Conway continued to pay his phone bill and gym membership in Ireland, retained his Irish driver's license, and maintained his ownership of a car in Ireland. He also continued to receive mail and own a bank account in Ireland. However, he did not work in Ireland at any time during 2012.

  Mr. Conway filed a 2012 nonresident tax return and claimed unreimbursed employee expenses of $3,157. This amount included travel, SWTP fees, medical insurance, and meals and entertainment expenses. The IRS disallowed the claim, and issued a notice of deficiency indicating that Mr. Conway owed $401 of tax.

Issue. The issue in this case is whether the unreimbursed employee expenses claimed by each of the three taxpayers are deductible.

Analysis. For nonresident aliens, deductions are allowed only if they are effectively connected with the conduct of a trade or business in the United States under IRC §873(a). In order for expenses to be deductible under IRC §162(a)(2), the expense must be:

- Ordinary and necessary,
- Incurred while the taxpayer was "away from home," and
- Incurred in the pursuit of a trade or business.

Home is defined as the vicinity of the taxpayer's principal place of employment, not the taxpayer's place of residence. This definition serves to mitigate the burden on a taxpayer who, because of employment demands, must maintain two places of abode and incur duplicate expenses. Expenses associated with a residence obtained for personal reasons that is located far from one's principal place of employment are not deductible. However, a taxpayer away from home on a temporary, rather than permanent, basis may claim that they are away from their permanent home and can deduct the expenses incurred while on a temporary or indefinite job assignment. Whether the job assignment is temporary is a question of fact.

The three taxpayers argued that they remained residents and citizens of their respective countries during 2012 while they were in the United States to work at temporary jobs. They maintain that because their work was temporary, they did not need to be engaged in employment prior to accepting the temporary work at a second location.

The IRS argued that each taxpayer's principal place of business was the U.S. location of their respective summer jobs. These locations were their "tax homes" during 2012, not their foreign home countries. Moreover, pursuing education is not a trade or business. Because none of these taxpayers were away from home in the pursuit of a trade or business, the expenses they claimed are not deductible. The taxpayer needs a business justification in order to continue maintaining their first home.

The Tax Court agreed with the IRS, citing *Hantzis v. Comm'r.*[29] *Hantzis* involved a law student who lived in Boston with her husband during the school year. She could not deduct her expenses incurred during her time at a summer job in New York because maintaining her Boston home did not have any business justification. If no business need dictates the location of the original home, then taking temporary employment elsewhere does not create the need for a second place of abode for business reasons to justify the deduction of expenses. A taxpayer who accepts temporary work away from their usual home, without a business connection to their original home, is not "away from home" for purposes of deducting expenses under IRC §162(a)(2). The taxpayer's tax home becomes the second, temporary location.

Maintaining health insurance was a requirement of the SWTP. However, health insurance is primarily a personal concern rather than a business expense. As such, the cost of health insurance was allowed to the extent that the expenses exceeded 10% of the taxpayer's adjusted gross income under IRC §213.

Holding. The court held that the three taxpayers may claim a deduction for the cost of health insurance as a medical expense on Schedule A, but the other expenses claimed may not be deducted because the taxpayers were not away from home for purposes of IRC §162(a)(2).

29. *Hantzis v. Comm'r*, 638 F.2d 248 (1st Cir. 1981).

Charitable Contributions

***RERI Holdings I, LLC v. Comm'r,* 149 TC No. 1 (Jul. 3, 2017)**

IRC §§170, 170A, 6226, 6231, 6662, 6664, and 7520

☞ Tax Court Denies $33 Million Deduction for a $3 Million Donation

Facts. Red Sea Tech I, Inc. (Red Sea) agreed to purchase property from Intergate.LA, LLC (Intergate) in July 2001. Red Sea and Intergate entered into a purchase and sale agreement for the property, which consisted of land and a website hosting facility that was leased to AT&T. The lease had a 15.5-year initial term, renewable for 5-year periods at increased rental rates. AT&T was obligated to pay annual rent on Intergate's Hawthorne property of $3.888 million in the initial lease term, and the rent could have increased to as much as $5.646 million annually based on the renewal terms. On February 4, 2002, Red Sea assigned its purchase rights to the property to RS Hawthorne, LLC (Hawthorne), an entity that Red Sea controlled as sole member (indirectly through another controlled entity).

On February 7, 2002, Hawthorne purchased the land and website hosting facility, subject to the AT&T lease, for $42.35 million. It financed the purchase through a loan from BB&T Bank for $43.67 million. On the same day, Red Sea assigned its controlling sole member interest to RJS Realty Corp. (RJS), but Red Sea reserved an estate for years (referred to by the parties as a "term of years" or TOYS) with an expiration date of December 31, 2020. The corresponding remainder interest (referred to by the parties as a successor member interest, or SMI) was the interest received by RJS. The TOYS interest bound Red Sea to comply with specified conditions, the breach of which would require Red Sea to forfeit its TOYS interest to RJS. The consequence of a breach of any of these conditions was strictly limited to such forfeiture. RJS was not entitled to sue Red Sea for any breach of conditions. The conditions required Red Sea to comply with the AT&T lease and BB&T Bank loan terms and ensure its other controlled entities, including Hawthorne, complied with the lease and bank loan terms. Moreover, neither Red Sea nor the controlled entities could sell or encumber the property.

RERI Holdings I, LLC (RERI) purchased the SMI from RJS for $2.95 million on March 25, 2002. RERI assigned the SMI to the University of Michigan on August 27, 2003. No similar conditions existed with this transfer, but a breach of any of the conditions in the Red Sea-RJS agreement would have caused the TOYS and SMI interests to merge. In connection with the SMI transfer to the University of Michigan, RERI claimed a charitable contribution deduction of $33.02 million for 2003.

The IRS asserted that RERI was not entitled to any deduction because the transaction was a tax sham, or in the alternative, the deduction should have been limited to the $1.94 million that the University of Michigan realized as proceeds when it subsequently sold the SMI. In addition, the IRS imposed a substantial valuation misstatement penalty, or in the alternative, a gross misstatement penalty.

RERI based its deduction on an appraisal of the SMI. This appraisal assigned a $55 million value to the ownership interest in the entire underlying property and multiplied this by an actuarial factor purportedly provided by IRC §7520 to arrive at the value of the SMI donated. In addition, RERI's 2003 return included Form 8283, *Noncash Charitable Contributions*, but the space in which to indicate the basis in the donated property was left blank.

Issues. The issues in the case are as follows.

- Whether RERI is entitled to a $33.02 million tax deduction for a charitable contribution made to the University of Michigan
- Whether RERI is liable for either of the imposed penalties if not entitled to the charitable deduction

Analysis. The Tax Court reviewed several appraisals and methodologies offered by four appraisers (two that offered appraisal evidence for RERI, and two for the IRS).

The Tax Court looked to the substantiation requirements for charitable donations of property worth more than $5,000. Under Treas. Reg. §§1.170A-13(c)(2)(i)(A), (B), and (C), the donor must not only obtain a qualified appraisal of the contributed property but must also attach a fully completed appraisal summary (Form 8283) to their return. The appraisal summary must provide, among other items, the donor's cost basis in the donated property. The Tax Court discussed the legislative history behind these strict substantiation requirements. These requirements were established because Congress wanted the IRS to be alerted before an audit to cases of inflated property valuations serving as the basis for charitable deductions. Congress wanted to deter taxpayers from "playing the audit lottery" when using valuations as a basis for such deductions.

The Tax Court noted that strict compliance was required with these regulations, and failure to comply by not providing a basis amount on Form 8283 served to undermine the purpose of the regulations. RERI's failure to state its basis precluded a determination of substantial compliance with the regulations.

However, even though a deduction was not allowable, the Tax Court still needed to establish a value for the SMI to know whether the substantial valuation misstatement penalty was applicable. There is a penalty for a "substantial" misstatement of value or basis of property and an alternate penalty for a "gross" misstatement. Under IRC §6662(a), the penalty is 20% of the portion of underpayment of tax attributable to a substantial valuation misstatement. This penalty applies if the value or basis is overstated by 200% or more of the correct value.[30] A gross misstatement penalty of 40% applies if a value or basis overstatement exists that is 400% or more of the correct value.[31] Under IRC §6662(e)(2), neither penalty applies unless the understatement of tax attributable to either a substantial or gross misstatement is more than $5,000.

Generally, the value of a charitable contribution is the FMV of the donated property on the date the contribution was made. The Tax Court noted that, typically, a "willing buyer-willing seller" standard is used to measure the FMV of property. This test, however, is not normally used for the valuation of life estates, terms of years, remainders, and similar partial property interests. Instead, each partial interest is valued separately using present value calculations that are completed using prescribed tables and interest rates under IRC §7520.

Treas. Reg. §1.7520-3, however, limits the application of this method. The standard factors can be used to value remainder interests, such as the SMI, only if the agreements governing the property provide adequate protection to the rights of the holder in a manner consistent with the law of trusts. The IRC §7520 method cannot be used to value a restricted remainder interest. A restricted interest exists if the interest is subject to a contingency, power, or other restriction. A restricted interest is instead valued by finding its FMV based on a facts-and-circumstances test.[32]

The Tax Court found that because RJS, the SMI holder, could not sue the TOYS interest holder (Red Sea) if it breached any of the conditions and instead was limited to obtaining the TOYS through forfeiture, the SMI was a restricted remainder interest. Accordingly, its FMV must be determined using the facts-and-circumstances test.

Under this test, the Tax Court used projected cash flows, their expected growth rates, and an applicable discount rate. Based on this analysis, the court determined that the FMV for the SMI on the date of donation to the University of Michigan was $3.46 million.

The Tax Court determined that because the SMI's donated FMV was $3.46 million and RERI claimed a charitable deduction on its 2003 return of $33.02 million, this represents a 954% overstatement in value. This is well in excess of the required 400% threshold needed for the gross misstatement penalty to apply.

In addition, the only evidence RERI has to establish a reasonable cause and good faith defense to the penalty is their reliance on appraisal values about 18 months before the donation was made. This is not sufficient evidence to establish the defense.

Holding. The court held that RERI failed to adequately substantiate its charitable contribution deduction amount and, therefore, no deduction is allowable. The court also held that RERI is liable for the gross misstatement penalty.

30. IRC §6662(e)(1).

31. IRC §6662(h)(2).

32. Treas. Reg. §1.7520-3(b)(1)(iii).

Charitable Contributions

***Phyllis McGrady and Christopher Antoniacci v. Comm'r*, TC Memo 2016-233 (Dec. 22, 2016)**

IRC §§170, 501(c)(3), 6662, and 6664

☞ Couple Entitled to Reduced Charitable Contribution Deduction for Conservation Easement

Facts. Phyllis McGrady and her husband Christopher Antoniacci (taxpayers) owned two parcels of land in Buck County, Pennsylvania: a 25-acre homestead property (parcel B) and a 20-acre parcel of undeveloped land (parcel A). When the taxpayers purchased parcel B, the sellers granted them an informal, unrecorded easement to use a gravel road as a back entrance to the taxpayers' property. The taxpayers had the option of purchasing from Edward and Sarah Rorer an adjacent additional tract of 137 acres of undeveloped land consisting of woodlands and land cleared for farming (Rorer tract).

Heritage Conservancy (Heritage) was a nonprofit organization focused on environmental conservation in Buck County and the surrounding area. In 2005, Heritage identified the Rorer tract and the McGrady/Antoniacci tract as the most significant undeveloped tracts remaining in the area. In December 2005, the taxpayers contacted Heritage to identify a plan for conserving the Rorer tract, which the couple had the option to purchase. The taxpayers hired a civil engineer who sketched out several plans for dividing the tract into residential units. After lengthy negotiations, the parties agreed to the following plan.

- The taxpayers conveyed to Heritage a fee simple interest in parcel A as a charitable contribution. In February 2007, the deed was recorded in Heritage's name. Heritage delivered to the township a conservation easement over parcel A for $100,000.
- In 2007, the taxpayers conveyed to the township a conservation easement over parcel B as a charitable contribution. The taxpayers were permitted to make improvements to their residence and the existing outbuildings within a 2-acre residential envelope.
- The Rorers sold a conservation easement over the Rorer tract to the township for $5.615 million. Heritage purchased the Rorer tract from the Rorers, subject to the conservation easement, for $6.085 million.
- The taxpayers donated cash and common stock totaling $275,000 to Heritage, $268,000 of which was donated during 2007.

To enable the deal to close, the taxpayers purchased from Heritage a 37-acre parcel of land (buy-back parcel) carved out from parcel A and the Rorer tract for $485,000. The land could not be developed because it was fully covered by conservation easements.

As part of the development proposal to create 10 new residences on the Rorer tract, the taxpayers were granted a formal, recorded easement to the access road leading to the back entrance to their property. They did not pay for the easement, nor were they required to contribute to the construction of the road or the cost of annual maintenance and upkeep on the road.

The couple reported a noncash charitable contribution of $4.7 million on their 2007 federal income tax return. The contribution consisted of two separate gifts.

- $2.35 million for the qualified conservation easement on parcel B to the township
- $2.35 million for the donation of parcel A to Heritage

The taxpayers included all the appropriate forms and the required appraisals with their tax return. They claimed $987,830 of the charitable deduction on their 2007 returns and carried the remaining deduction forward.

The IRS denied the deductions in full. It claimed the taxpayers lacked donative intent, they failed to satisfy various reporting requirements, they overvalued the donated property, and they received benefits in exchange for their gifts. The IRS also assessed accuracy-related penalties.

Issues. The issues in the case are the following.

- Whether the taxpayers are entitled to charitable contribution deductions for the conservation easement
- Whether the taxpayers are subject to accuracy-related penalties

Analysis. In a quid pro quo exchange, the taxpayer receives property or services from the charity equal to the amount donated. In these scenarios, there is no contribution or gift. The taxpayers in this case conveyed a fee simple interest as an outright gift. They could not change their minds and reacquire the property. The transaction was not contingent upon any benefit from Heritage. Additionally, the gift of the easement to the township had no strings attached. The taxpayers did not receive any benefit from the donation.

The IRS asserted that the taxpayers steered negotiations in a manner that benefited them. The taxpayers negotiated for 18 months with the Rorers, the township, Heritage, and the developer. There was no evidence that the couple had enough power to sway the negotiations in their favor.

The IRS insisted that the taxpayers received the benefit of privacy from the buy-back parcel. The buy-back parcel protected the taxpayers on all sides of their residence from further development. However, they were already protected because of the placement of previous easements. The taxpayers purchased the buy-back parcel in order to close the deal and likely paid more than the land was worth. The court held that the taxpayers were mere incidental beneficiaries and did not lack donative intent.

To determine the fair market value (FMV) of the properties donated, the court typically considers three approaches: the market approach, the income approach, and the asset-based approach. The three experts engaged in the case all agreed that the market approach provided the appropriate methodology, and the court concurred. The market approach values a property by comparing it to similar properties sold near the valuation date. The parties agreed that the FMV of parcel A must be determined according to its highest and best use. In January 2007, the highest and best use was residential development. The taxpayers employed two experts who asserted that the appropriate comparable sales were multi-lot properties at a per-lot price. The expert witness for the IRS claimed that the appropriate comparable sales were raw land on a per-acre price. The court agreed that a per-lot valuation was more accurate.

The most likely buyer for parcel A would be a residential developer. Therefore, the court looked at how a residential developer would price the land to determine FMV. The court believed a developer would make an offer based on a per-lot basis. A developer would also make an appropriate downward adjustment for the risk that the expected number of buildable lots might not be approved. After testimony from three expert witnesses, the court determined that a 25% downward adjustment was appropriate.

The court evaluated the comparable properties the experts used to establish FMV and made some adjustments. Substituting these adjustments into the matrix of one of the experts, the court determined an appropriate per-lot value of $243,544. Parcel A was divided into 9 lots, therefore the FMV was $2,191,896 ($243,544 × 9 lots).

To determine the FMV of parcel B, the courts relied on Treas. Reg. §1.170A-14(h)(3)(i). The FMV of an easement is equal to the difference between the FMV of the property it encumbers **before** granting the easement and the FMV of the encumbered property **after** granting the easement. The court determined that the highest and best use of parcel B was residential development based on the large offers numerous developers made for the Rorer tract. Parcel B was approved for a 10-lot development; nine lots would be new residences and the tenth was the taxpayers' existing homestead. After reviewing comparable homes and based on expert testimony, the court found $900,000 to be a reasonable estimate for the taxpayers' homestead. Using the previously established FMV per lot of $243,544, the court concluded the **before** value of parcel B was $3,091,896 (($243,544 × 9 lots) + $900,000).

After the imposition of the easement, parcel B was divided into a 2-acre residential compound and 23 surrounding acres which were fully conserved and ineligible for any development. An expert witness provided five comparable properties that each were subject to an easement and contained an original stone house and outbuildings. Based on those comparable properties, the court found $1.6 million to be the value of parcel B **after** the imposition of the easement. By comparing the before and after FMVs, the court calculated the FMV of the easement at $1,491,896 ($3,091,896 − $1,600,000).

However, the court agreed with the IRS's claim that the taxpayers received a tangible benefit from the recorded easement affording them secondary access to their property. The taxpayers contended that they previously had this access through an informal arrangement with the Rorers. Because the previous easement was informal and unrecorded, the taxpayers had no rights to the road from the new owners. The total cost to build the road was $318,090. Dividing the total amount by the 11 residences that benefited from the road, the court determined that the taxpayers received a $29,000 benefit.

The court believed that the taxpayers relied in good faith on the appraisals of a qualified individual with significant experience in the real estate market for the area. They also relied on the advice of a tax return preparer who competently represented them for years. As such, the court held that the taxpayers were not liable for any accuracy-related penalty.

Holding. The court held that the taxpayers had the required donative intent to claim a charitable contribution deduction of $3,654,792 ($2,191,896 parcel A + $1,491,896 parcel B easement − $29,000 road easement). It denied the IRS assertion that the couple donated real property in a quid pro quo exchange. Because the taxpayers relied in good faith on an appraiser and tax preparer, the court held they were not liable for any penalties.

Charitable Contributions
***Ten Twenty Six Investors v. Comm'r,* TC Memo 2017-115 (Jun. 15, 2017)**
IRC §170

☞ Limited Partnership Not Entitled to a Charitable Contribution for Gifted Easement

Facts. Ten Twenty Six Investors (TTS) is a New York state limited partnership. Throughout 2004, TTS owned a New York City warehouse built in 1928 that was designed by Cass Gilbert, the same architect who designed the Woolworth Building and the U.S. Supreme Court building. On December 21, 2004, TTS executed an easement deed, entitled "Conservation Deed of Easement," that granted a façade easement on the warehouse to the National Architectural Trust (NAT). NAT accepted the deed on December 30, 2004. However, NAT did not record the deed until December 14, 2006.

TTS's 2004 partnership return claimed a noncash charitable deduction under IRC §170 of approximately $11.4 million in connection with the easement granted to NAT. This was in accordance with an appraisal obtained by TTS.

The IRS issued a final partnership administrative adjustment for 2004, disallowing the noncash charitable contribution. The IRS also imposed a 40% gross valuation misstatement penalty or, alternatively, the 20% accuracy-related penalty. TTS's tax matters partner filed a petition due to the disallowance of the noncash contribution.

Issue. The issue is whether the noncash contribution of an easement is deductible by TTS.

Analysis. A qualified conservation contribution under IRC §170(h)(2) must be granted in perpetuity. IRC §170(h)(5)(A) mandates an additional separate perpetuity requirement.

In order to be tax deductible, the donation of an easement must be a qualified conservation easement. Under the perpetuity requirements, this requires the rights given to the donee to be legally enforceable by the donee and any successors in interest to the donee. The Tax Court reviewed New York property law and concluded this requirement was not met by the deed of easement granted by TTS. The Tax Court noted that because the deed was not recorded in 2004, there was no way for these perpetuity requirements to have been met in 2004, which precluded any 2004 deduction.

State law controls the issue of property interests, while federal tax law controls federal tax ramifications. The IRS argued that the easement was a conservation easement under New York law. It points to the New York statute, NYECL sec. 49-0305(4), that states a conservation easement in New York has no legal effect until recorded. The IRS argued that the warehouse was not subject to any legally enforceable restrictions during 2004 because the easement was not recorded until December 2006; therefore, no 2004 deduction is allowed.

TTS argued that the easement granted was not a conservation easement because its definition under New York law requires creation under title 49 of the New York statute. The deed did not reference that title, as required by the statute. TTS argued that there was no intent to create an easement under this title. Moreover, it argued that delivery of the easement deed to NAT resulted in the creation of a restrictive covenant under New York real property law. This created a sufficient legally enforceable restriction without recordation. This type of transaction was possible before enactment of New York's title 49 conservation easement statute, and that statute has no effect on the creation of restrictive covenants.

The Tax Court relied on three nearly identical cases as precedent, in which a deed of easement was delivered to the NAT, which failed to record that deed until a year later. These deeds were nearly identical in all respects to that given by TTS to NAT. In all three cases, the Tax Court (and in one of the cases, the U.S. District Court for the Southern District of New York) found that a deed of easement was effective only upon recording. Moreover, the Tax Court noted that under New York statutory law, a deed to create a conservation easement must be recorded to be effective.

Holding. The court held that TTS was not entitled to a deduction in 2004 for its conservation easement grant.

Moving Expenses

***Christopher and Sandra Anderson v. Comm'r*, TC Summ. Op. 2017-17 (Mar. 16, 2017)**

IRC §217

☞ Taxpayers Denied Moving Expenses

Facts. Christopher Anderson was laid off from his job in December 2011. Mr. and Mrs. Anderson decided to move from Pennsylvania to California, where Mr. Anderson had a network of professional contacts. They arrived in the general location of Mr. Anderson's new principal place of work on March 7, 2012.

On June 7, 2012, Mr. Anderson signed a 1-year employment contract with David M. Lewis Co., LLC. The agreement commenced on July 16, 2012. After Mr. Anderson signed the contract, he assisted with preparing marketing materials highlighting his experience and background and participated in employment-related training programs. The Andersons took a 10-day vacation in June before Mr. Anderson started working because he was ineligible for paid leave during his first year.

Mr. Anderson started work consulting with clients on July 16, 2012. He received his first paycheck on July 27, 2012.

Mr. and Mrs. Anderson took a deduction for over $17,000 of moving expenses on their 2012 return. The IRS issued a notice of deficiency, determining a deficiency of $6,095 for the 2012 tax year.

Issue. The issue is whether Mr. Anderson was a full-time employee at his new place of employment for at least 39 weeks during the year after he arrived in the general location of his new place of work.

Analysis. IRC §217 allows deductions for moving expenses paid or incurred during the tax year in connection with the commencement of work by a taxpayer as an employee at a new principal place of work. Moving expenses are generally defined as reasonable expenses of moving household goods and personal effects from the former residence to the new residence and related travel. A condition of claiming the deduction is that the taxpayer must be employed full-time in the general location of the new employment for at least 39 weeks during the 12-month period immediately following the move. The Andersons moved to California on March 7, 2012, so Mr. Anderson must have worked full-time for 39 weeks starting on that date to deduct moving expenses.

Mr. Anderson claimed that he became a full-time employee on June 7, 2012, when he signed his employment agreement. The Andersons asserted that he was no longer able to seek alternative employment opportunities from that day forward. Additionally, Mr. Anderson was treated as a full-time employee when he assisted with marketing material and engaged in training activities. The court observed that, generally, employment is considered to commence when the employer is under an obligation to pay the employee. The firm was not obligated to pay Mr. Anderson for the marketing work or training. These were routine preliminary administrative tasks required when starting a new job.

The IRS claimed that Mr. Anderson became a full-time employee on July 16, 2012. This was the date specified in his contract and the day he began consulting with clients. The employment agreement did not contain a provision barring Mr. Anderson from seeking other employment opportunities before July 16.

Holding. The Tax Court held that Mr. Anderson was not entitled to deduct moving expenses because he did not work at least 39 weeks in the 12-month period following the move.

> **Caution**. Before deducting moving expenses, it is important to verify that the 39-week test is met.

Claim of Right

Michael and Sharon Nordloh v. Comm'r, **TC Summ. Op. 2017-37 (May 30, 2017)**
IRC §§62, 86, 461, and 6662

☞ Claim of Right and Cash Method Result in Income Inclusion and Disallowed Deduction

Facts. Michael Nordloh had medical problems that left him unable to work after back surgery. Doctors declared him disabled, and he applied to the Social Security Administration (SSA) for disability (SSD) benefits. The SSA denied his claim and Mr. Nordloh hired an attorney to appeal the SSA's decision.

While awaiting the outcome of his appeal, Mr. Nordloh began receiving disability payments under an employer-provided MetLife long-term disability (LTD) policy. Under the terms of this policy, the MetLife payments would be offset by any SSD payments Mr. Nordloh received, and he was required to repay to MetLife any overpayment triggered by the receipt of SSD benefits. Mr. Nordloh reported and paid income tax on the MetLife disability payments he received.

In August 2009, Mr. Nordloh's SSA disability claim was allowed. The attorney who handled the SSA appeal advised Mr. Nordloh that he would receive a retroactive SSD payment and that he should not spend the funds because of his repayment obligation to MetLife. In December 2010, Mr. Nordloh received a lump-sum payment of $87,004. He followed his attorney's advice and deposited the SSD funds in his bank account. This payment was reported on a Form SSA-1099, *Social Security Benefit Statement,* which stated that the $87,004 was composed of retroactive payments for 2007 through 2010.

Mr. Nordloh repaid $83,233 to MetLife by issuing a check from his account in January 2011 to satisfy his repayment obligation under the policy. Unsure of how to report the receipt of SSD payments and the MetLife repayment on their 2010 joint return, Mr. and Mrs. Nordloh retained a tax preparer. They claimed the $83,233 MetLife repayment made in 2011 as a deduction in computing adjusted gross income (AGI) on their 2010 return. The resulting AGI amount, reduced by the MetLife repayment, was used to calculate the taxable amount of SSD.

In 2012, the Nordlohs received a Notice CP-2000, *Notice of Underreported Income,* proposing a $7,822 increase in tax and imposing a $1,564 penalty for their 2010 return. The Nordlohs hired a different tax preparer to respond and prepared amended 2010 and 2011 returns. The amended returns showed an increased tax liability for 2010 and increased refund for 2011. The additional 2010 tax liability exceeded the 2011 refund amount by $5,169, which the Nordlohs paid to the IRS to satisfy their tax liability.

The IRS, however, disagreed with this approach. It sent the Nordlohs a notice of deficiency indicating that further adjustments were made to their 2010 return and the couple owed an additional tax liability of $27,378. This tax liability was attributable to the disallowance of the deduction of the 2011 MetLife repayment on the 2010 return. The disallowance of the deduction increased income by $83,233 for 2010. It also increased the taxable amount of SSD payments received in 2010 by $54,127 (for a total increase in income of $137,360). The notice of deficiency also imposed an IRC §6662 accuracy-related penalty.

The Nordlohs claimed that the MetLife repayment should be deductible in 2010 and that the 2010 SSD benefits are excludable from income because they were contractually obligated to repay those funds to MetLife and did not have sufficient control over them.

Issues. The issues in the case are as follows.

- Whether the $83,233 repayment to MetLife is deductible in 2010, although the repayment was made in 2011
- Whether the $87,004 of SSD benefits received during 2010 is excludable from income
- Whether the Nordlohs are liable for an accuracy-related penalty

Analysis. The Nordlohs are **cash method taxpayers**. Under the cash method of accounting, they may deduct an expenditure for the tax year in which the expenditure is actually made.[33] Therefore, any deduction for the MetLife repayment must be claimed in 2011, because the repayment was made in January 2011.

The $87,004 of SSD benefits is not includable in income under the claim of right rule if Mr. Nordloh received these funds only as a conduit, he was required to pay those funds to someone else, and he did not have control over the funds or the right to keep them. However, if Mr. Nordloh received funds without restriction or limitation on their use, that income is taxable even though a repayment obligation exists.

Even though Mr. Nordloh had a repayment obligation to MetLife, he did not receive the funds as a conduit. Instead, he received these funds without limitations or restrictions on the use of those funds. His attorney's advice to deposit the funds in an account and preserve them for repayment instead of spending the money is indicative of the control Mr. Nordloh had over the money. Mr. Nordloh exercised full control over the funds and intermingled them with his own bank account funds.

The court determined that the Nordlohs demonstrated adequate reasonable cause and good faith with respect to their underpayment. The Nordlohs retained two different tax preparers to assist them in ascertaining the correct tax liability and they reasonably relied on the advice of these preparers. Therefore, the court found the couple was not liable for an accuracy-related penalty.

33. Treas. Reg. §1.446-1(c)(1)(i).

Holding. The court held that because the Nordlohs are cash method taxpayers, the MetLife repayment, made in 2011, is not deductible on their 2010 return. Moreover, Mr. Nordloh had a claim of right to the SSD benefits, without restriction or limitation on their use, and he had control over those funds. Therefore, the SSD benefits are not excludable from 2010 income. The Nordlohs are consequently liable for the tax shown on the IRS deficiency notice. However, they are not liable for the accuracy-related penalty.

> **Note.** If Mr. Nordloh had actually issued the check in 2010, the outcome would have been different. It is important for a tax professional to get all documentation and confirm the facts with their clients.

Education Expenses

***Megan and John Creigh v. Comm'r,* TC Summ. Op. 2017-26 (Apr. 27, 2017)**
IRC §§162 and 6662

☞ Software Developer's Executive MBA Course Costs Not Deductible

Facts. Megan Creigh earned a Bachelor of Science degree in computer science and a Master of Science degree in computer engineering. She worked for a corporation as a systems software engineer, and subsequently worked for another corporation from 1993 to 1997 as head of information technology. As head of information technology, Mrs. Creigh developed and managed a computerized information system, created an information technology strategy, and managed information technology operations. From 1997 to 2007, Mrs. Creigh worked for another company as a project manager and consultant. She used her software engineering skills to manage teams of other consultants and professionals in designing and implementing software systems. This job required substantial travel.

In 2007, Mrs. Creigh left work to raise her child. In 2010, she wanted to return to work as a consultant but did not want to return to her previous employer because the extensive traveling conflicted with raising a young child. During 2010, Mrs. Creigh attempted to connect with businesses that needed her consulting expertise. During 2011 and 2012, she applied for jobs involving the design and implementation of business processes and software systems. Mrs. Creigh believed that if she obtained a job interview, she would have the opportunity to discuss her independent consulting business with the employer. In an effort to obtain independent consulting work, she also applied for contract work, connected with former colleagues, and attended networking events. These efforts proved unfruitful and she was unable to obtain any job or consulting work in 2011 or 2012.

Through her networking efforts, Mrs. Creigh learned that many managers of the companies she sought as customers enrolled in executive MBA (EMBA) programs. She believed enrolling in an EMBA program would give her exposure to managers to market her consulting services. Mrs. Creigh enrolled in the EMBA program at UCLA in September 2011. She regularly traveled approximately 70 miles from her home to UCLA to attend classes and events. Mrs. Creigh took several classes, such as marketing, accounting, international business strategy, finance, human resources, and economic forecasting. She graduated in June 2013.

The Creighs filed a joint return for 2012 that included a Schedule C, *Profit or Loss From Business,* for Mrs. Creigh's consulting business. The Schedule C showed no income but claimed $59,282 for tuition, fees, and expenses for the EMBA program, $4,973 for vehicle and travel expenses for the trips between home and UCLA, and $449 for supplies. This amounted to a Schedule C loss of $64,704.

The IRS disallowed the education and travel costs and issued a notice of deficiency for an additional federal tax liability of $17,992. It also imposed an accuracy-related penalty of $3,598. Mrs. Creigh contended that she was engaged in a trade or business and the expenses were deductible.

Issues. The issues are as follows.

- Whether the education and travel expenses are deductible
- Whether the Creighs are liable for the accuracy-related penalty

Analysis. Under IRC §162, a taxpayer must be engaged in a trade or business in order for education costs to be deductible. A taxpayer may be deemed to be engaged in a trade or business if they were previously employed or engaged in a trade or business, and while no longer so engaged, seek to continue pursuing their line of work while undertaking a degree program related to that line of work.

Accordingly, under Treas. Reg. §§1.162-5(a)(1) and (2), education expenses are deductible if the education maintains or improves skills required by the taxpayer in their employment or trade or business or if the education meets express employer requirements. However, education costs are not deductible if incurred to meet the minimum requirements of the taxpayer's trade or business or if those expenses are attributable to a study program leading to the taxpayer's qualification in a new trade or business.

Whether Mrs. Creigh was engaged in a trade or business during 2012 is irrelevant because the EMBA course of study served to qualify her for a new trade or business. The costs were therefore not deductible. The EMBA courses qualified Mrs. Creigh for tasks and work significantly different from her previous employment as a computer consultant. The EMBA courses involved subject areas very different from those necessary for her computer engineering or software development work. Her testimony indicated that the business courses were not helpful to her project management work in her field.

Relevant travel, meals, and lodging costs attributable to education are deductible under IRC §162 only if the underlying education costs are also deductible. Therefore, the travel expenses claimed on the Creighs' 2012 return are not deductible.

The Creighs failed to provide sufficient evidence that they relied on their accountant's advice. They were unable to prove that they acted with reasonable cause and in good faith. Therefore, they are liable for the accuracy-related penalty.

Holding. The court held that the tuition, fees, travel, and related expenses were not deductible. The court also held that the Creighs did not act with reasonable cause or good faith and were liable for the accuracy-related penalty.

Medical Costs

Victoria Malev v. Comm'r, **U.S. Tax Court, Docket No. 1282-16S (Mar. 1, 2017)**
IRC §213

☞ Taxpayer Allowed Medical Deduction for Alternative Medical Treatments

Facts. Victoria Malev suffered from at least one spinal disease. She received only partial and temporary pain relief from chiropractic therapy. Ms. Malev's doctor suggested surgery but advised that it would not completely solve her problems and might worsen her condition. In 2016 (which is after the year at issue), her doctor recommended integrative medical care. Duke University defines integrative medicine as an approach to care that puts the patient at the center and addresses the full range of physical, emotional, mental, social, spiritual, and environmental influences that affect a person's health. Integrative medical care employs a personalized strategy that considers the patient's unique conditions, needs, and circumstances. It uses an array of scientific disciplines to heal illness and disease and help people regain and maintain optimum health.

Ms. Malev paid expenses in connection with integrative medical care during 2012 and deducted such expenses on her 2012 tax return.

Issue. The issue in this case is whether Ms. Malev can deduct as medical expenses amounts paid for treatments not routinely or universally recognized.

Analysis. Treas. Reg. §1.213-1(e) identifies expenses a taxpayer pays for "healing services" as deductible medical expenses. Nothing in IRC §213 or the underlying regulation requires that the treatments be furnished by an individual licensed to practice medicine in any particular discipline, that the services or treatments be provided in person rather than remotely, that the treatment be successful, or that the treatment be universally accepted as effective.[34]

Ms. Malev sincerely believed that her treatments alleviated her pain. The court noted that if the 2016 recommendation from Ms. Malev's doctor had been given before 2012, this would be an easy case. The doctor's diagnosis included a recommendation that Ms. Malev pursue "integrated medical treatment." However, the diagnosis came later and seemed to undermine Ms. Malev's claim that the treatments she had received had "cured" her. In these circumstances, the court observed that it must take into account the role an individual's state of mind plays in the treatment of disease.

The court looked at the fact that Ms. Malev believed the treatments were effective. The court also recognized that expenses paid for alternative medical treatments can be deducted as a medical expense.

Holding. The court held that Ms. Malev could deduct the cost of alternative medical treatments as medical expenses on her 2012 return.

Gambling Losses

***Peter Phuong Pham and Bach Nguyen v. Comm'r,* TC Summ. Op. 2016-73 (Nov. 8, 2016)**
IRC §§61, 162, 165, and 6001

☞ Professional Gamblers Denied Deduction for Gambling Losses

Facts. Peter Phuong Pham and his wife, Bach Nguyen, were each employed by Hustler Casino as house players during 2013. Casinos hire players to ensure there are enough players to start and maintain card games and to entice additional players to the games. In this role, Hustler Casino paid Mr. Pham and Ms. Nguyen an hourly salary.

Hustler Casino required Mr. Pham and Ms. Nguyen to use their own money to bet on the poker games. They were also responsible for table fees. Table fees include a regular fee of $5 per hand and a collection for a "bad beat jackpot" of $1 per hand. Under unspecified circumstances, the casino would declare a player "won the jackpot." At that time, the casino would distribute the bad beat jackpot funds to the winner of that jackpot.

Mr. Pham and Ms. Nguyen estimated that they each played six hours per day, 21 days a month, for seven months in 2013. They attempted to track their winnings and losses for gambling but they stopped because it was "bad for their psyche."

In 2013, Mr. Pham and Ms. Nguyen received $16,800 in gambling winnings from Hustler Casino as house players. They also received $6,600 in gambling winnings from Commerce Casino, where they played recreationally.

Mr. Pham and Ms. Nguyen's wages from Hustler Casino totaled $15,402 in 2013. On their jointly filed 2013 tax return, they reported the wages and the $6,600 in winnings from Commerce Casino but failed to report the $16,800 from the Form W-2G, *Certain Gambling Winnings,* issued by Hustler Casino.

The IRS issued Mr. Pham and Ms. Nguyen a notice of deficiency for failing to report the gambling income. Mr. Pham and Ms. Nguyen replied that they did not report the gambling income because their gambling losses exceeded their winnings. They estimated that they each lost $1,000 per month for the seven months they worked at the casino as house players. They also claimed they paid an estimated $7,056 into the bad beat jackpot and that their gambling losses totaled $21,056. Mr. Pham and Ms. Nguyen did not provide any receipts or records to support their loss claims.

Issue. The issue is whether and to what extent Mr. Pham and Ms. Nguyen incurred deductible gambling losses.

34. *Tso v. Comm'r,* TC Memo 1980-339 (Sep. 18, 1980).

Analysis. Gross income includes all income from whatever source derived, including gambling.[35] "Professional gamblers" are engaged in the trade or business of gambling and may deduct their gambling losses up to the amount of their gambling income to arrive at adjusted gross income. Nonprofessional gamblers may deduct gambling losses to the extent of their gambling income as an itemized deduction. The court held that Mr. Pham and Ms. Nguyen were engaged in the business of gambling and were required to substantiate their gambling losses.

The court stated that Mr. Pham and Ms. Nguyen's claim that it was too difficult to maintain records is without merit. In certain circumstances, courts may estimate amounts when a taxpayer fails to keep adequate records. However, Mr. Pham and Ms. Nguyen kept no records and had no evidence of their losses. Therefore, the court was unable to estimate an amount for gambling losses, and Mr. Pham and Ms. Nguyen were not entitled to any gambling deductions.

Holding. The court held that Mr. Pham and Ms. Nguyen could not deduct their gambling losses because they **failed to maintain adequate records of their losses** or provide any basis from which the court could make an estimate of their expenses.

Conservation Easement

Partita Partners LLC et al. v. U.S., **No. 1:15-cv-02561; U.S. District Court for the Southern District of New York (Oct. 25, 2016)**
IRC §§170 and 6226

☞ Deduction for Historic Preservation Easement Disallowed

Facts. In April 2003, Partita Partners LLC purchased a 4-story walk-up building on Lexington Avenue in New York City for $4.05 million. The building has been designated as part of the Upper East Side Historic District since 1981. As such, it is subject to regulation by the New York City Landmarks Preservation Commission.

In 2007, E. William Judson, a managing member of Partita, met with a representative of the Trust for Architectural Easements (TAE). They discussed the donation of an easement in the building's façade to the TAE. In June 2008, Mr. Judson signed an easement donation agreement along with other documents.

In October 2008, Mr. Judson signed a deed of easement. This document stated that 2,700 square feet of development rights associated with the property would be reserved for the future expansion of the property. The deed of easement specified that Partita could undertake additional construction on the property, subject to TAE's approval. According to Mr. Judson's deposition, these development rights were to add two or three floors on the roof and to potentially extend the ground floor of the building.

On its federal tax return for 2008, Partita claimed a charitable deduction of $4.186 million for its donation of the easement to TAE. The IRS subsequently disallowed Partita's claimed deduction and assessed accuracy-related penalties.

Issue. The issue is whether Partita's tax deduction satisfied statutory requirements.

Analysis. IRC §170(h)(4)(B) allows a taxpayer to take a deduction for the donation of the façade of a building located in a registered historic district. Such a donation must:

- Include a restriction that preserves the entire exterior of the building (including the front, sides, rear, and height of the building); and
- Prohibit any change in the exterior of the building that is inconsistent with the historical character of the exterior.[36]

35. IRC §61.

36. IRC §170(h)(4)(B)(i).

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Partita claimed that the restriction allowed construction above the roof or new construction that does not extend vertically beyond the building's highest point. However, the court noted the restriction includes an unqualified restriction that preserves the entire exterior of the building. The Code section describes the exterior as "including the front, sides, rear, and height of the building." Partita argued the use of the word "including" limits the exterior solely to those features. However, IRC §7701(c) provides "[t]he terms 'includes' and 'including' when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the term defined."

Partita argued that the deduction should be allowed if rooftop construction does not exceed the height of the current bulkhead on the roof. The court disagreed, noting that IRC §170(h)(4)(B) requires a restriction that "preserves the entire exterior of the building."

Holding. The court held that because the deed of easement did not contain a restriction that preserved the entire exterior of the building, Partita is not eligible for the claimed deduction under IRC §170(h)(4)(B).

Charitable Contribution

RP Golf et al. v. Comm'r, **U.S. Court of Appeals, 8th Circuit; No. 16-3277 (Jun. 26, 2017)**
IRC §170

☞ Taxpayers Denied Charitable Contribution for Donation of an Easement

Facts. In 1997 and 1998, RP Golf acquired land in Platte County, Missouri, to develop two private golf clubs. In order to purchase the land, RP Golf obtained loans from two banks.

In December 2003, RP Golf granted a permanent conservation easement to PLT, a Missouri not-for-profit organization. On April 14, 2004, the banks signed subordinations of their mortgages to PLT's right to enforce the easement. The subordinations were effective December 31, 2003.

RP Golf filed its 2003 partnership return, on which it claimed a $16.4 million tax deduction for the easement. The IRS disallowed the deduction, claiming it did not meet the requirements for a "qualified conservation contribution." RP Golf challenged the IRS in Tax Court. The court ruled that the easement was not protected in perpetuity and was therefore not a qualified conservation contribution. RP Golf appealed the decision.

Issue. The issue in the case is whether RP Golf was entitled to a charitable contribution deduction for the easement.

Analysis. IRC 170(b)(1)(E) defines a qualified conservation contribution as a contribution of a real property interest to a qualified organization exclusively for conservation purposes. The conservation purpose must be **protected in perpetuity.**[37] However, the Code does not define "protected in perpetuity" or how to accomplish the mandate.

Treas. Reg. §1.170A-14(g)(2) states that a deduction is not allowed for an interest in property that is subject to a mortgage unless the mortgagee subordinates its rights to the rights of the charitable organization to enforce the conservation purposes of the gift in perpetuity. Both the Ninth and Tenth Circuits have held that the regulation requires that a mortgage must be subordinated at the time of the gift.

RP Golf argued to the Tax Court that it secured oral agreements from the two banks prior to conveying the property to PLT. However, the court found insufficient testimony or documentation of the alleged oral agreements.

Holding. The court affirmed that RP Golf was not entitled to a charitable contribution for the conservation easement because the bank mortgages on the property were not subordinated when the easement was conveyed.

37. IRC §170(h)(5)(A).

DIVORCE

Dependency Exemption and Child Credit

***Brandi McCutcheon-Cox v. Comm'r,* TC Summ. Op. 2017-20 (Mar. 30, 2017)**
IRC §§24, 151, and 152

☞ Federal Law Controls Dependency Exemption Claims

Facts. Brandi McCutcheon-Cox married Thomas Cox in 1995, and they had three children together. In 2007, the couple filed for divorce. Under the divorce decree, Mr. Cox was entitled to tax exemptions for the three children until Ms. McCutcheon-Cox earned $20,000 or more of income for the year, after which the ex-spouses would annually alternate the exemptions.

During 2012, the three children lived with Ms. McCutcheon-Cox for more than half the year. Ms. McCutcheon-Cox filed her 2012 return, on which she reported income of $17,732 and claimed dependency exemptions for the three children and additional child tax credits. Mr. Cox filed a 2012 return and also claimed dependency exemptions for the three children. The IRS accepted Mr. Cox's return as filed but sent Ms. McCutcheon-Cox a notice of deficiency. The IRS disallowed the three dependency exemptions and made adjustments to Ms. McCutcheon-Cox's child tax credits.

Issues. The issues are whether Ms. McCutcheon-Cox is allowed to claim the dependency exemptions for her three children and whether she is entitled to additional child tax credits on her 2012 return.

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Analysis. IRC §152(c)(1) allows a dependency exemption for a qualifying child. A **qualifying child** is defined as one who has not filed a joint return for the year and meets specified relationship, principal place of abode, age, and support tests. The IRS agreed that Ms. McCutcheon-Cox satisfies the requirements of §152(c) with respect to her children. However, the IRS argued that the 2007 divorce decree does not allow her to claim the dependency exemptions because her 2012 income was less than $20,000.

In situations of legal separation or divorce, IRC §152(e)(1) provides the relevant rule for determining which parent is entitled to claim dependency exemptions. Generally, the parent having custody of the child for the greater portion of the year may claim the exemption. An exception to this rule exists if, among other factors, the custodial parent signs a written declaration releasing their claim to the exemption and the noncustodial parent attaches that written declaration to their return for the year. Either a Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent,* or a court order or decree **issued before July 3, 2008**, that satisfies certain requirements may serve as the written declaration. One such requirement for a court order or decree to qualify is that the release of the claim to the dependency exemption must be **unconditional.** The 2007 divorce decree does not contain an unconditional waiver because it specifically includes the $20,000 income condition. In addition, Ms. McCutcheon-Cox did not complete and furnish a Form 8332 to Mr. Cox.

Holding. The court held that without a Form 8332 or a qualifying divorce decree as a written declaration, Ms. McCutcheon-Cox is entitled to the dependency exemptions as the custodial parent under IRC §152. She is also entitled to the additional child tax credits she claimed on her 2012 return.

Joint and Several Tax Liability

***Mae Izzedin Asad and Sam Akel v. Comm'r,* TC Memo 2017-80 (May 15, 2017)**
IRC §§6013, 6015, 6662, and 6664

☞ IRS Not Bound by Couple's Divorce Agreement

Facts. Mae Asad and Sam Akel are divorced. Each owned rental properties during 2008 and 2009. While married, they filed 2008 and 2009 joint tax returns that reflected rental losses from each of the rental properties they owned.

The IRS issued a notice of deficiency in 2013 to both spouses for the 2008 and 2009 tax years. The deficiency for 2008 was $14,478, and the 2009 deficiency was $10,933. An accuracy-related penalty for each year was also included. After their divorce, each spouse separately sought relief from joint and several liability. A portion of each deficiency was attributable to their respective rental property losses claimed in 2008 and 2009. The IRS denied each spouse's request for relief.

Shortly before trial, the IRS agreed to apportion the liability for the 2008 and 2009 deficiencies based on the respective loss amounts attributable to each spouse's rental property in proportion to the total loss claimed collectively by both spouses in each year. This apportionment left Ms. Asad liable for the larger share of the tax liability in each of the years, because the losses claimed for her property were larger. The IRS determined that, for 2008 and 2009, she was liable for 72% and 59%, respectively, of the deficiency amounts allocable to each year.

However, in Tax Court, both spouses indicated they were willing to agree to a 50/50 split in the tax liability in accordance with their 2013 divorce agreement.

Issue. The issue is whether the 2008 and 2009 rental losses should be allocated in proportion to the total losses or a 50/50 split.

Analysis. The divorce agreement establishes Ms. Asad and Mr. Akel's rights against one another under state law but is not binding on the IRS. The IRS is not a party to a divorce agreement. Accordingly, a divorce agreement does not control their spousal liabilities to the IRS. Unless a separate agreement is reached with the IRS, each spouse who is a party to a divorce agreement is still jointly and severally liable to the IRS for any tax deficiency.

Ms. Asad and Mr. Akel did not petition the court to review the IRS's notice of deficiency. As such, the court could not make a determination on the penalties.

Holding. The court held that Ms. Asad and Mr. Akel are liable for 2008 and 2009 deficiencies in proportion to the total loss claimed. Because neither spouse addressed the accuracy-related penalty in their complaint, the court was without jurisdiction to address this penalty.

Alimony

***Mark A. Quintal v. Comm'r,* TC Summ. Op. 2017-3 (Feb. 2, 2017)**
IRC §§71 and 215

☞ Payments Pursuant to Divorce Are Not Alimony

Facts. Mark Quintal and Ms. Gramlich-Quintal were married in 1992. They had three children together and divorced in 2010. A separation agreement executed in 2009 stated that Ms. Gramlich-Quintal would have sole physical custody of the three children. Mr. Quintal was required to maintain health insurance or its equivalent for the children until they were emancipated. The term **emancipated** was not defined in the agreement.

Exhibit B of the separation agreement was titled "Unallocated Support." It stated that Mr. Quintal would pay Ms. Gramlich-Quintal $900 each week. Any alimony would terminate at the earlier of the death of Mr. Quintal or Ms. Gramlich-Quintal, or Ms. Gramlich-Quintal's remarriage. Furthermore, both parties acknowledged that the payments were deductible for Mr. Quintal and includable in Ms. Gramlich-Quintal's income.

Exhibit J of the separation agreement initially referred to Mr. Quintal's obligation to make child support payments. That statement in the exhibit was struck and replaced with a reference to exhibit B. The exhibit acknowledged that two of Mr. Quintal's children are disabled and might never become self-sufficient or emancipated. The statement defined "emancipated" as occurring at the child's death, marriage, entering military service, or graduation from either a high school or 4-year college program. Additionally, the exhibit stated that both Mr. Quintal and Ms. Gramlich-Quintal agreed to designate all required support payments as excludable and nondeductible payments.

On October 22, 2014, the family court filed a stipulation for judgment in response to Ms. Gramlich-Quintal's complaint for modification of the settlement agreement. The important modification was a statement saying that "the Father pay to the Mother $900 per week as **child support** for the parties' three children."

For the tax years 2011, 2012, and 2013, Mr. Quintal claimed an alimony deduction of $46,800 per year. However, Ms. Gramlich-Quintal did not include the payments as income on her tax returns.

Issue. The issue is whether payments that Mr. Quintal made to his ex-wife constitute deductible alimony expenses.

Analysis. IRC §71(a) provides that all income, including alimony, is generally included in gross income. IRC §215(a) provides a deduction to the payor for the amount of alimony paid to the extent the alimony is included in the recipient's income under §71(a). Alimony is defined as any cash payment if:[38]

- The payment is received by a spouse under a divorce or separation instrument,
- The divorce or separation instrument does not designate such payment as a payment that is not includable in gross income under §71 and not allowable as a deduction under §215,
- The payor and payee spouses are not members of the same household when the payment is made, and
- The payment obligation terminates at the death of the payee spouse and there is no liability to make either a cash or a property payment as a substitute for the payment after the death of the payee spouse.

Payments attributable to child support are not includable in the recipient's gross income.[39] Any amount specified in the divorce agreement that will be reduced upon the occurrence of a contingency that relates to the child of the payor is considered child support in the amount of the reduction.

The IRS contended that Mr. Quintal's payments are not alimony because Mr. Quintal and Ms. Gramlich-Quintal's separation agreement included an exhibit that designated all payments as excludable and nondeductible. In addition, the IRS maintained that the unallocated payments were child support payments because the payments were subject to contingencies in accordance with §71(c)(2).

Mr. Quintal contended his "unallocated support" payments did not specify if the payments were alimony or child support in an exhibit attached to the agreement. He also asserted that negotiations with Ms. Gramlich-Quintal intended to ensure the payments were treated as alimony.

The court acknowledged that the exhibit in the divorce agreement did not specify a fixed amount of alimony or child support. However, the court looked at the agreement as a whole to determine the intention of the parties. Although one exhibit was revised to state that Mr. Quintal and Ms. Gramlich-Quintal understood the payments would be deductible for him and includable in her income, another exhibit contradicted the other statement by stating that the couple agreed that all payments are excludable and nondeductible under §§71 and 215. The court relied on the more definitive statement that the payments were excludable and nondeductible. Therefore, the payments did not satisfy the definition of alimony, and Mr. Quintal was not allowed the deduction on his income tax returns.

Holding. The Tax Court held that unallocated support payments Mr. Quintal made to his ex-wife were not alimony and thus were nondeductible.

38. IRC §71(b)(1).

39. IRC §71(c)(1).

EMPLOYMENT TAX ISSUES

Failure to Pay Penalty

***Robert McClendon v. U.S.*, No. 4:15-cv-02664; U.S. District Court for the Southern District of Texas (Nov. 17, 2016)**
IRC §6672

☞ Employer Willfully Fails to Pay Employee FICA and Income Tax Withholdings

Facts. In 1979, Dr. McClendon founded Family Practice Associates of Houston (Family Practice), a medical-services provider. In 1995, Family Practice hired Richard Stephen, Jr., as its chief financial officer. By 2009, Family Practice owed over $10 million in withholding taxes. Dr. McClendon discovered that these taxes had not been paid over to the government because Mr. Stephen has embezzled money from Family Practice.

Subsequently, Family Practice stopped operating and Dr. McClendon loaned $100,000 to the company "for the restricted purpose of ... using the funds to pay the May 15, 2009 payroll." The loan was used to pay wages to employees.

After being assessed a total of $4.3 million in tax penalties under IRC §6672(a), Dr. McClendon paid a small amount to the IRS, then sued for a refund and abatement of the remaining penalty amount. The government then made a motion for summary judgment.

Issue. The issue in this case is whether the government is entitled to summary judgment.

Analysis. A moving party is entitled to summary judgment when "...there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law."[40] "A genuine dispute of material fact exists when the 'evidence is such that a reasonable jury could return a verdict for the nonmoving party.'"[41]

Employers must withhold the employees' share of social security and income taxes from their wages. Dr. McClendon conceded that he was a "responsible person" for the purposes of penalties under IRC §6672(a) for failure to collect and pay over employee withholding taxes. A responsible person has a duty to ensure that a taxpayer's unencumbered funds are used to pay federal taxes first before repaying debts owed to other creditors. To ensure that the taxes are remitted to the government, §6672(a) imposes a penalty equal to the entire amount of the unpaid taxes.

When Dr. McClendon discovered that Family Practice owed back taxes, he loaned Family Practice money to satisfy their payroll obligations. Family Practice used that money to make employee wage payments rather than to pay the taxes it owed. Dr. McClendon made two arguments for why this does not create liability under §6672(a). First, Dr. McClendon argued that the loan was encumbered because he required it to be used to fund employee wages. The court dismissed this argument, finding that the debt owed the government takes precedence over other debts. Moreover, corporate funds should not be considered encumbered simply because the lender requires them to be used in a certain way. Dr. McClendon's second argument was that because "he acted morally and generously in using his own money to make sure Family's staff . . . were paid for the work they had performed," this gave him reasonable cause to find a way to pay the employees. The court also rejected this argument as having no basis in the law.

Holding. The court granted the government's motion for summary judgment.

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40. *Trent v. Wade*, 776 F.3d 368, 376 (5th Cir. 2015).

41. *Nola Spice Designs, LLC v. Haydel Enters., Inc.*,783 F.3d 527, 536 (5th Cir. 2015) (quoting *Anderson v. Liberty Lobby*, 477 U.S. 242, 248 (1986)).

Trust Fund Recovery Penalties
***Christina Fitzpatrick v. Comm'r,* TC Memo 2016-199 (Nov. 2, 2016)**
IRC §§6320, 6321, 6330, and 6672

☞ Business Owner's Wife Not Responsible Person for Purposes of Trust Fund Recovery Penalties

Facts. James Stamps and Edward Fitzpatrick decided to become equal partners in a restaurant and wine bar franchise, called the Grape, in Jacksonville, Florida. Mr. Stamps and Mr. Fitzpatrick incorporated and registered Dey Corp. to purchase and operate the Grape franchise. Mr. Fitzpatrick's wife, Christina Fitzpatrick, had no ownership interest in the business. Her primary responsibility was caring for her disabled son who required nearly constant adult supervision. Mrs. Fitzpatrick was unable to devote any significant time to the business.

During January and February 2005, Mr. Stamps and Mr. Fitzpatrick went to the Grape headquarters in Atlanta for training. While they were gone, Mr. Stamps asked Mrs. Fitzpatrick to retain the services of a payroll company. Mrs. Fitzpatrick subsequently retained the services of Paychex. Dey Corp. contracted with Paychex for full payroll support that included preparing employee paychecks, determining payroll tax liability, debiting the business's bank account, directly depositing federal payroll taxes, and electronically filing Forms 941, *Employer's Quarterly Federal Tax Return.*

Mrs. Fitzpatrick was also asked to open a bank account on behalf of Dey Corp. at Wachovia Bank. She retained signatory authority on the account.

The Grape opened in March 2005. Mr. Stamps was the president and heavily involved in the initial hiring and business structure but was less involved during periods when he was away from Jacksonville. He was in constant contact with Kris Chislett, the general manager of the Grape. Mr. Chislett was responsible for the day-to-day operations.

Mrs. Fitzpatrick did not have a specific role in the company. She became less involved once the business was operational. Her main responsibilities were delivering checks, relaying bank account balances to Mr. Chislett, and delivering business mail delivered to her home address. Mrs. Fitzpatrick occasionally transferred funds and issued checks at the direction of Mr. Stamps or Mr. Fitzpatrick. She did not make any operational decisions and did not have the proper education, training, or experience to hold a management position.

Mr. Chislett maintained control over the payroll process. He compiled the payroll information into a spreadsheet and transmitted the data to Paychex. Paychex needed to hand deliver the paychecks on Tuesday mornings. However, employees were rarely on site Tuesday mornings to sign for the checks, so the checks were delivered to Mr. and Mrs. Fitzpatrick's residence. Mrs. Fitzpatrick was directed to sign the checks and deliver them to the business on Tuesday afternoons. Mrs. Fitzpatrick was not responsible for and did not review financial statements in the Paychex package.

Within a year of opening, the Grape began losing money. In July 2008, the Wachovia account was frozen. Mr. Stamps directed Mrs. Fitzpatrick to open a new bank account. She then opened an account with First Guaranty Bank.

In November 2008, Paychex tried to withdraw money for taxes and an invoice from the First Guaranty account. The electronic withdrawals were rejected and Paychex never again attempted to debit any taxes from a Dey Corp. bank account. Paychex continued to produce payroll checks and reference copies of Forms 941. The payroll checks and invoices for payroll services continued to be deducted. However, Paychex did not debit the payroll tax portion from the account, make payroll deposits on the business's behalf, or file Forms 941. Mrs. Fitzpatrick was unaware that Paychex stopped providing those services.

On June 16, 2011, Revenue Agent Lanita Wells visited Dey Corp.'s CPA regarding unpaid payroll taxes. The CPA contacted the Fitzpatricks about the visit. That was the first time they had knowledge that federal payroll deposits had not been made and Forms 941 were not filed.

Ms. Wells expanded her investigation from Dey Corp. to Mr. Stamps, Mr. Chislett, Mr. Fitzpatrick, and Mrs. Fitzpatrick. She recommended assessing trust fund recovery penalties (TFRPs) against Mr. Stamps, Mr. Chislett, and Mrs. Fitzpatrick.

On December 12, 2011, Ms. Wells sent Mrs. Fitzpatrick Letter 1153, *Trust Fund Recovery Penalty Letter*, via certified mail to her last known address. The U.S. Postal Service did not deliver the letter and returned the envelope to the IRS. The letter stated that Mrs. Fitzpatrick had 60 days to file a formal protest contesting the assessment of the TFRPs.

On February 7, 2012, the deadline for filing a formal protest, Ms. Wells and Mrs. Fitzpatrick spoke on the telephone. Ms. Wells never mentioned that a Letter 1153 had been issued and returned to the IRS. On March 19, 2012, TFRPs were assessed against Mrs. Fitzpatrick. The IRS filed a notice of federal tax lien against Mrs. Fitzpatrick on July 2, 2012.

Issue. The issue is whether Mrs. Fitzpatrick is liable for the TFRPs.

Analysis. Employers have a responsibility to withhold income and employment taxes from their employees' wages.[42] These are often called trust fund taxes. IRC §6672 allows the IRS to impose penalties on **responsible persons** who fail to withhold and remit trust fund taxes. The penalty is equal to the amount of tax withheld but not paid and is imposed on any responsible person required to collect, truthfully account for, or pay any tax withheld who willfully fails to do so.

The Court of Appeals for the 11th Circuit has noted that indicators of responsibility include "the holding of corporate office, control over financial affairs, the authority to disburse corporate funds, stock ownership, and the ability to hire and fire employees."[43] The IRS argued that Mrs. Fitzpatrick possessed the identified characteristics of a responsible person. It asserted that Mrs. Fitzpatrick exercised significant financial control over Dey Corp. because she opened two separate bank accounts, had signatory authority on both accounts, and signed checks on behalf of the corporation.

Mrs. Fitzpatrick argued that she did not have decision-making authority and did not exercise significant control over the finances. Although she had signatory authority over the accounts, Mrs. Fitzpatrick claimed she had a limited role in the payroll process and merely signed the payroll checks as a convenience for the corporation.

The court believed Mrs. Fitzpatrick lacked the authority to control the financial affairs of the business or exercise any significant authority over the disbursement of Dey Corp.'s funds. Based on all the testimony, the court believed Mrs. Fitzpatrick lacked any actual authority and Mr. Stamps and Mr. Chislett had the actual control over the finances. The court further noted Mrs. Fitzpatrick did not hold corporate office, had no ownership interest, had no authority to hire and fire employees, and had little or no decision-making power beyond ministerial duties.

Holding. The Tax Court held that Mrs. Fitzpatrick **was not a responsible person** liable for trust fund recovery penalties on the unpaid employment taxes.

Employment Status

***Scott Singer Installations Inc. v. Comm'r,* TC Memo 2016-161 (Aug. 24, 2016)**
IRC §7436

☞ Court Holds That Some Shareholder Advances were Valid Loans

Facts. Scott Singer started Scott Singer Installations Inc. (SSI), an S corporation, in 1981. The business was primarily engaged in servicing, repairing, and modifying recreational vehicles. Mr. Singer was the president, sole shareholder, and sole corporate officer.

Between 2006 and 2008, Mr. Singer advanced $646,443 to SSI. SSI reported all of the advances as loans from shareholder on its general ledgers and Forms 1120S, *U.S. Income Tax Return for an S Corporation.* However, there were no promissory notes between SSI and Mr. Singer. Additionally, no interest was charged or maturity dates imposed.

42. IRC §§3102(a) and 3402(a).

43. *Thibodeau v. U.S.,* 828 F.2d 1499, 1503 (11th Cir. 1987).

Between 2009 and 2011, Mr. Singer borrowed an additional $513,099 and advanced the funds to SSI. Mr. Singer also began charging business expenses on his personal credit cards. SSI reported losses in both 2010 and 2011 but paid $181,872 of Mr. Singer's personal expenses. These payments were treated as repayments of shareholder loans and not deducted as business expenses.

Mr. Singer worked full time for SSI. Occasionally, SSI hired a service technician, two laborers, and an individual to help with Internet sales. SSI did not report paying any wages to Mr. Singer in 2010 or 2011.

The IRS determined that Mr. Singer was an employee of SSI in 2010 and 2011 and that the $181,872 of expenses paid constituted wages that should have been subject to employment taxes.

Issues. The issues in the case are as follows.

- Whether the $181,872 paid to Mr. Singer is wages or loan repayment in 2010 and 2011
- Whether Mr. Singer's personal expenses should be characterized as wages subject to federal employment taxes

Analysis. For FICA and FUTA purposes, an employee includes any officer of a corporation.[44] An officer who performs more than minor services and receives remuneration is considered an employee. An officer can avoid employee status only if they perform no services or only minor services for the corporation and are not entitled to remuneration, directly or indirectly, for services performed. SSI did not disagree with the IRS's finding that Mr. Singer was an employee based on the evidence that Mr. Singer was the president, sole shareholder, and that he performed significant services for the corporation.

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Regarding the issue of whether SSI's payments to Mr. Singer were wages, SSI argued that Mr. Singer's advances were loans and SSI's payments made on Mr. Singer's behalf were repayments of those loans. The IRS argued that the advanced funds were contributions to capital and the payments made on Mr. Singer's behalf were wages.

The ultimate question was whether there was a genuine intent to create a debt between SSI and Mr. Singer with a reasonable expectation of repayment and if that intention aligned with the economic reality of creating a debtor-creditor relationship. The court analyzed the following factors.

- The relative financial status of SSI when the advances were made
- The financial status of Mr. Singer at the time of repayment
- The relationship between Mr. Singer and SSI
- The method by which the advances were repaid
- The consistency with which the advances were repaid
- The manner in which the advances were accounted for on SSI's financial statements and tax returns

After looking at all the criteria, the court believed Mr. Singer intended his advances to be loans for a substantial portion of the advances. This belief was partly based on SSI reporting the advances as loans on its general ledgers and Forms 1120S. Additionally, each year SSI reported expenses paid on behalf of Mr. Singer as repayments of shareholder loans rather than as business expenses. Furthermore, SSI's payments were consistent regardless of the value of the services Mr. Singer provided to the corporation and occurred even when the company was operating at a loss. These factors strongly suggest a debtor-creditor relationship.

Mr. Singer had a reasonable expectation of SSI repaying his loans when he advanced funds to SSI between 2006 and 2008. The company was profitable and growing rapidly; therefore, the court concluded that Mr. Singer reasonably assumed his loans would be repaid. This aligned with the economic reality of a debtor-creditor relationship.

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44. IRC §§3121(d)(1) and 3306(i).

However, after 2008, SSI's business dropped off sharply and Mr. Singer should have known that future advances would not be consistently repaid. No reasonable creditor would lend to SSI. Therefore, advances made after 2008 were more in the nature of capital contributions.

Holding. The court held that because Mr. Singer was the sole officer of SSI and he performed substantial services for the company, he was properly characterized as an employee. Additionally, the court found that Mr. Singer's loan repayments made between 2006 and 2008 were valid and should not be characterized as wages subject to employment taxes. Advances he made after 2008 were in the nature of capital contributions.

> **Note.** In early 2017, the IRS announced that it was acquiescing to the court's decision in result only. The IRS noted it would continue to assert that the payment of personal expenses by an S corporation on behalf of its corporate officer/employee constitute wages subject to federal employment taxes. There is an exception if a taxpayer objectively substantiates both the existence of a loan and that the payments were in repayment of that loan.[45]

Trust Fund Recovery Penalties

***Philip and Amber Brown v. Comm'r,* TC Memo 2017-18 (Jan. 24, 2017)**

IRC §§6671, 6672, and 7501

☞ Taxpayers Denied Trust Fund Recovery Penalty Deduction

Facts. Philip Brown and his wife Amber Brown own Quantum Group, LLC (LLC). The Browns also claim to own 100% of Quantum Inc. The two entities were separate and distinct despite their similar names.

Quantum Inc., an S corporation, was administratively dissolved in 2007 by the State of Arizona for failure to file an annual report. In 2012, Quantum Inc. was not registered to do business in any state, provided no services, and generated no income.

Between 2000 and 2002, Quantum Inc. accumulated unpaid payroll tax liabilities. Trust fund recovery penalties (TFRPs) were assessed against the Browns. In 2012, they owed over $180,911 of TFRPs.

In December 2012, the Browns transferred $215,000 from the LLC's bank account to their attorney's trust account. The same day, the attorney sent the IRS a letter and a certified check for $215,000. The letter stated that the payment was for employee withholding amounts (i.e., trust fund taxes) for Quantum Group, Inc. The letter stated that any remaining amount should apply to accrued interest arising from the nonpayment of the trust fund taxes.

Quantum, Inc. did not file any tax returns for 2003 through 2011. In 2013, it filed its 2012 Form 1120S, *U.S. Income Tax Return for an S Corporation,* and marked the return as final. The return indicated the company held no assets, had no income, and had no deductions except a $180,911 deduction for salaries and wages. Quantum Inc. attached two Schedules K-1, *Shareholder's Share of Income, Deductions, Credits, etc.,* for each of the Browns. The Browns reported the losses from the Schedules K-1 on their 2012 Form 1040, *U.S. Individual Income Tax Return.*

Quantum Inc. did not issue any Forms W-2, *Wage and Tax Statement.* The Browns did not include any salary or wage income on their 2012 Form 1040. During an IRS audit, the Browns contended that the wage deduction on Quantum Inc.'s 2012 tax return was for salary and wage expenses not deducted for tax years 2000 through 2002.

The IRS issued a notice of deficiency to the Browns for tax years 2010 through 2012. In addition to other adjustments that were later resolved, the IRS disallowed the $180,911 salaries and wages deduction for Quantum Inc.'s 2012 tax year. This disallowance resulted in adjustments to the Brown's Schedule E, *Supplemental Income and Loss,* for the corresponding flow-through loss from Quantum Inc.

45. AOD 2017-04, 2017-15 IRB 1072.

Issue. The issue is whether Quantum Inc. can deduct TFRPs owed by Philip and Amber Brown and pass that loss to the Browns.

Analysis. Employers generally must withhold income and employment taxes from their employees' pay.[46] The withheld payroll taxes are known as a trust fund tax because the collected taxes are held in a special fund in trust for the United States.[47] An employer who fails to withhold and pay over payroll taxes is liable for a TFRP equal to the amount of tax not collected or paid over.[48]

The Browns argued that they were allowed a deduction for ordinary and necessary business deductions under IRC §162(a). They contended that this included payroll taxes. The Browns claimed the payment of payroll taxes benefited Quantum Inc. because the IRS was demanding payment from the company.

The Browns asserted that the payment should be considered a continuation of the corporation's business and that filing a tax return demonstrates that Quantum Inc. was still carrying on a trade or business. The IRS countered that the LLC, not Quantum Inc., paid the payroll expense. Quantum Inc. was dissolved, was not engaged in a trade or business, and had not filed a return for a decade.

The court noted that whether a taxpayer is engaged in a trade or business is based on a review of all relevant facts and circumstances. When weighed against the lack of any assets, activity, or income, the act of filing a return does not establish the existence of a trade or business. Therefore, the court concluded that Quantum Inc. was not engaged in a trade or business during 2012.

The court noted that if the $215,000 payment was made to settle payroll tax liabilities from the prior conduct of a trade or business, not being engaged in a current trade or business would not prevent the deduction. However, Quantum Inc. would still have needed to be in existence in 2012 to be eligible for the deduction.

The court stated that Quantum Inc. was not in existence in 2012 because it had been administratively dissolved by the state of Arizona in 2007. Treas. Reg. §1.6012-2(a)(2) states that a corporation does not exist once it "ceases business and dissolves, retaining no assets, whether or not under State law it may thereafter be treated as continuing as a corporation for certain limited purposes connected with winding up its affairs, such as for the purpose of suing and being sued." There was no evidence that Quantum Inc. had any assets or engaged in any activities after 2002.

Even if Quantum Inc. existed in 2012 and could have filed a return and claimed deductions, it could not have deducted the $180,911 payment because it did not actually pay the amount. Quantum Inc. did not have a bank account when the payment was made, and there was no evidence that it ever held title to the money. The LLC distributed the funds into the trust account for the Brown's attorney, which was then transferred to the IRS. The funds bypassed Quantum Inc. entirely.

In addition, IRC §162(f) prohibits the deduction of fines and penalties paid to the government for a law violation. Therefore, a payment for a TFRP is not deductible. The letter from the Browns' attorney that was sent with the payment stated that the check was for TFRPs. The court held that the Browns failed to prove the payment was for any purpose other than TFRPs.

Holding. The court held that Quantum, Inc. was not entitled to a deduction in 2012 of $180,911.

46. IRC §§3102(a) and 3402(a).

47. IRC §7501(a).

48. IRC §6672(a).

ESTATE AND GIFT

Estate Tax

***Estate of Nancy H. Powell v. Comm'r*, 148 TC No. 18 (May 18, 2017)**
IRC §§2033, 2035, 2036, 2038, and 2043

☞ Estate Must Include Value of LP Interest in Death-Bed Planning Case

Facts. Nancy Powell died on August 15, 2008, in California. A power of attorney (POA) was executed on August 7, 2008, appointing her son Jeffrey Powell as her representative. The POA gave Mr. Powell wide authority to deal with his mother's property and the ability to make gifts up to the maximum amount of the federal annual gift tax exclusion under IRC §2503(b). In 2008, the annual gift tax exclusion was $12,000. Once Mr. Powell obtained POA authority, he was involved in the following transactions.

1. On August 8, 2008, cash and securities valued at $10 million were transferred from Ms. Powell's revocable trust to NHP, a limited partnership (LP) formed on August 6, 2008, by Mr. Powell. In exchange for the assets transferred to NHP, Ms. Powell's revocable trust was given a 99% limited partnership interest in NHP. NHP's LP agreement gave Mr. Powell, as general partner, sole discretion to determine the timing and amount of distributions, and the agreement provided for dissolution of NHP upon consent of all partners.

2. On August 8, 2008, Mr. Powell, acting on behalf of his mother under the POA, assigned Ms. Powell's 99% NHP limited partnership interest to a charitable lead annuity trust (CLAT). The CLAT entitled the Nancy H. Powell Foundation to an annuity for the remainder of Ms. Powell's life. Upon her death, the remaining CLAT assets were to be divided equally between two trusts for the benefit of Mr. Powell and his brother.

   Duff & Phelps appraised the value of the 99% interest to the CLAT for gift tax purposes. Duff & Phelps applied a 25% discount for lack of control and marketability and arrived at a value of approximately $7.5 million. The remainder interest, which constituted a taxable gift, was valued at approximately $1.7 million.

A 2008 gift tax return was filed for Ms. Powell that reported a taxable gift of $1.7 million. An estate return was also filed that did not include the value of the assets transferred to NHP. The IRS issued notices of deficiency for each, disagreeing with the valuations and the amount included in Ms. Powell's estate. Mr. Powell, as executor, filed a Tax Court petition.

The IRS made the following arguments to the Tax Court.

1. Under IRC §2036(a)(2), if a decedent transferred property but retained the right to designate (either alone or with others) the subsequent persons who will enjoy or possess the property or its income, the property is includable in the estate. The IRS argued that the assets transferred to NHP are includable in her estate because Ms. Powell had the ability, acting with her sons, to dissolve NHP and designate others who would possess the assets.

2. The gift of assets to NHP was not valid because Ms. Powell retained the power to revoke the gift through the ability to dissolve NHP and again obtain control over the assets. Because the gift was revocable, the value of the assets are includable in her estate under IRC §2038(a).

Mr. Powell's counterargument was that his mother did not retain an interest in the property for life because of the transfer of the property interest to the CLAT.

Issues. The issues in the case are the following.

- Whether the gift to the CLAT was valid
- Whether the value of Ms. Powell's LP interest is includable in her estate

Analysis. Mr. Powell's argument that the CLAT transfer terminated Ms. Powell's interest in the property for purposes of IRC §2036(a)(2) is based on the premise that the CLAT transfer was valid. However, the POA only provided Mr. Powell with the authority under California law to make gifts up to the annual federal gift tax exclusion of $12,000. Moreover, even if the transfer was deemed valid, IRC §2035(a) would compel inclusion of the assets in the estate because the transfer was made within three years of death.

While the Tax Court agreed with the IRS on the inclusion of the assets in the estate, the court addressed another issue related to the **amount** includable in Ms. Powell's estate. The court noted that the amount to be included under IRC §§2036(a)(2) or 2035(a) is different than the amount includable because of a void gift. The court was concerned about possibly "double counting" the same economic interest in the estate.

The court pointed out that neither §§2036(a)(2) nor 2035(a) warrant the inclusion of the full date-of-death value of the cash and securities transferred to NHP. IRC §2043(a) must be read in conjunction with §§2036 and 2035. Generally, IRC §2043 limits the estate inclusion to the excess of the date-of-death fair market value (FMV) of the property transferred over the value of any consideration received for that property. This prevents a "double inclusion" in the estate of the amount of consideration received by including both the full FMV of the property and the consideration received for it.

The Tax Court pointed out that §2043 was analogous to the bona fide sale rule found in §2036. Under this rule, either the date-of-death FMV of the property is includable in the estate or the value of "adequate and full consideration" received in a bona fide sale is included, but not both.

Holding. The gift to the CLAT is void because Mr. Powell exceeded his authority under the POA. The value of Ms. Powell's LP interest is includable in her estate.

Failure to File

***Janice Specht et al. v. U.S.,* U.S. Court of Appeals, 6th Circuit; No. 15-3095 (Sep. 22, 2016)**
IRC §6651

☞ Estate's Failure to File and Pay Taxes Was Not Due to Reasonable Cause

Facts. When Virginia Escher died in December 2008, her estate was valued at $12.5 million. Several months before she died, she and her cousin Janice Specht met with attorney Mary Backsman to execute Ms. Escher's will. Ms. Backsman had over 50 years' estate-planning experience. During this meeting, Ms. Specht agreed to serve as the executor of Ms. Escher's estate. Ms. Specht was 73 years old at the time, had no formal education after high school, and had never served as an executor.

After Ms. Escher died, Ms. Specht retained Ms. Backsman to represent the estate. Ms. Specht was unaware that Ms. Backsman had brain cancer and her competency was deteriorating.

In January 2009, Ms. Backsman informed Ms. Specht that the estate would need to liquidate its shares in United Parcel Service (UPS) to pay an estate tax liability of approximately $6 million. Ms. Backsman told Ms. Specht that the estate taxes were due on September 30, 2009.

Although Ms. Specht signed a form that specified her duties as executor, she later testified that she probably did not understand what the form meant and that she never thought to ensure that the tasks listed on the form were completed. She did not ask Ms. Backsman to explain any part of the form before she signed it.

Ms. Specht relied heavily on Ms. Backsman. Ms. Specht's actions as estate executor were mostly limited to calling Ms. Backsman and inquiring about the estate's status. When Ms. Specht inquired about the tax return filing and payment, Ms. Backsman assured her that she had obtained an extension. However, Ms. Specht did not ask for a copy of the extension, and Ms. Backsman's assurances turned out to be false. She had never requested an extension.

Before the estate's filing deadline, Ms. Specht received four notices from the probate court stating that the estate had missed probate deadlines. Ms. Specht called Ms. Backsman to ask why she had missed the deadline and accepted Ms. Backsman's repeated response that she had obtained an extension and was handling the matter.

In July 2010, Ms. Specht received a call from friends of Ms. Escher who had also hired Ms. Backsman as an estate attorney. They told Ms. Specht that Ms. Backsman was incompetent and told her they were trying to have Ms. Backsman removed as co-executor of their family member's estate. After these conversations, Ms. Specht met with Ms. Backsman and again accepted Ms. Backsman's assurances that the estate execution was proceeding smoothly. At this meeting, Ms. Backsman had Ms. Specht sign a blank paper that Ms. Backsman said would allow her to sell the estate's UPS stock. Ms. Backsman later told Ms. Specht she sent a letter to UPS to initiate the stock sale.

In August 2010, the Ohio Department of Taxation informed Ms. Specht that the estate's Ohio state tax return was delinquent. Ms. Specht contacted Ms. Backsman, who assured her that everything was fine. A month later, Ms. Specht received two more notices from the Ohio Department of Taxation. She also received two calls from Ms. Escher's friends who implored her to fire Ms. Backsman and recommended attorney Vincent Salinas as a replacement.

In October 2010, Ms. Specht called UPS and learned that the company never received a letter regarding the sale of the estate's UPS stock. This information finally caused Ms. Specht to fire Ms. Backsman.

Ms. Specht subsequently hired Mr. Salinas to represent the estate. At this time, Ms. Specht learned that the estate return had not been filed and the taxes had not been paid. Within a month of hiring Mr. Salinas, the estate liquidated the UPS stock for $8.25 million. On January 26, 2011, the estate filed its federal tax return and paid its tax liability and interest.

The IRS assessed penalties against the estate for failure to meet the September 30, 2009 deadline, which the estate subsequently paid. In October 2013, Ms. Specht brought an action on behalf of the estate to recover $1.189 million of penalties and interest assessed against the estate by the IRS. The district court concluded that Ms. Specht's reliance on Ms. Backsman to file the tax return and pay the liability was not a reasonable cause for missing the deadline. The district court also found that Ms. Specht's failure to supervise Ms. Backsman constituted willful neglect of her duties.

Issue. The issue is whether the facts show that the estate's failure to file its tax return and pay its liability by the deadline was due to reasonable cause and not willful neglect.

Analysis. IRC §§6651(a)(1) and (2) imposes penalties for failure to file a tax return and failure to pay a tax liability, respectively. These penalties are mandatory unless the taxpayer can prove that the failure is due to reasonable cause and not due to willful neglect. The Code does not define "reasonable cause," but Treas. Reg. §301.6651-1(c)(1) states that "[i]f the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause."

In *U.S. v. Boyle,* the Supreme Court concluded "Congress has charged the executor with an unambiguous, precisely defined duty to file the return within nine months . . . That the attorney, as the executor's agent, was expected to attend to the matter does not relieve the principal of his duty to comply with the statute."[49]

The estate pointed out that Ms. Specht was a less sophisticated executor than Robert Boyle, the executor in *Boyle.* The court agreed but noted that even if Ms. Backsman had been healthy but committed a clerical error of the kind that occurred in *Boyle,* the deadline would have been missed because Ms. Specht failed to provide adequate oversight.

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49. *U.S. v. Boyle,* 469 U.S. 241, 250 (1985).

The court acknowledged that Ms. Specht was the victim of "staggeringly inadequate legal counsel and there is no evidence of purposeful delay." However, case law makes it clear that the duties to file a tax return and pay taxes cannot be delegated, and mere good-faith reliance does not constitute reasonable cause. Ms. Specht knew the initial filing deadline and understood that there were consequences for failure to timely file the return. She received multiple warnings about Ms. Backsman's deficient performance but took no steps to replace her until more than a year after the filing deadline. The court noted that Ms. Backsman's representation was certainly an obstacle but Ms. Specht was not **unable** to file the estate's return or pay the liability.

Holding. The court held that the estate had not met its burden of showing reasonable cause for its failure to file its tax return and pay its tax liability by the deadline. Consequently, the court did not need to determine whether Ms. Specht willfully neglected her duty to do so.

GROSS INCOME

Gross Income

Christopher and Ingrid Harrell v. Comm'r, **TC Memo 2017-76 (May 8, 2017)**
IRC §§72 and 461

☞ Court Determines Tax-Free Portion of Annuity

Facts. During 2009 and 2010, Ingrid Harrell received distributions of $28,937 from the New York City Employees' Retirement System (NYCERS) as beneficiary of her deceased father. NYCERS is a defined benefit plan (DBP). According to the NYCERS plan description, her father's NYCERS contributions into the DBP were tax-deferred. The contributions, therefore, were not taxable in the year of contribution but instead were taxable when the DBP made a distribution. These tax-deferred contributions were mandatory for employees. NYCERS members also had an option to make an additional contribution (not tax-deferred).

Mrs. Harrell received a NYCERS letter dated February 9, 1995, indicating she would receive a total benefit of $403,829. The amount was composed of a member's share of $11,245 and employer share of $392,584. The letter provided no further explanation on whether the member share was attributable to mandatory or optional contributions. Mrs. Harrell elected to receive an annual annuity of $28,937, payable in equal monthly installments effective November 3, 1994.

During 1994 and 1996, Mrs. Harrell paid various expenses related to her father's death and estate administration. These expenses included funeral expenses, attorney's fees, and accounting fees.

Mrs. Harrell reported the $28,937 annuity as taxable income on the joint returns she filed with her husband for 2009 and 2010. She later asserted that $16,245 was excludable from income. Mrs. Harrell also contended that she is entitled to claim the $27,400 of estate expenses as a deduction on her 2009 Schedule A, *Itemized Deductions,* because these expenses created a net operating loss (NOL) that carried forward.

Issues. The issues in this case are the following.

- Whether any part of the NYCERS annual annuity is excludable from income
- Whether Mr. and Mrs. Harrell may deduct the estate administration costs on their 2009 return

Analysis. Under IRC §72(b), a portion of an annuity payment may be excluded from income. The amount excludable is that portion of the payment that bears the same ratio to the payment as the investment in the contract bears to the expected contract return as of the inception of the annuity. Under §72(c)(1)(A), the investment in the contract is generally defined as the amount of premiums or other consideration paid for the contract. Amounts paid by the employer are not considered an investment in the contract unless those payments are included in the income of the employee. There is no evidence that Mrs. Harrell's father included the employer's contributions in his income. However, for decedents dying before August 21, 1996, the first $5,000 of death benefits qualifies as an investment in the contract under former IRC §101(b).

The court calculated the expected return on the contract by multiplying the total of the annual annuity benefits of $28,937 by the factor in the applicable table of Treas. Reg. §1.72-9. The factor considered Mrs. Harrell's age when her father died and determined that the appropriate multiple was 58. Therefore, the expected return of the NYCERS annuity was $1,678,346 ($28,937 × 58). The court calculated an exclusion ratio of .002979 ($5,000 investment in contract ÷ $1,678,346 expected return). Mrs. Harrell was able to exclude $86 ($28,937 annual annuity payment × .002979 exclusion ratio) in each of the 2009 and 2010 tax years.

The estate administration expenses did not qualify as the types of expenses that would result in an NOL under IRC §172(d)(4). These were personal in nature. Even if the expenses were deductible, the Harrells did not deduct them in the year in which they were paid. This is required of cash basis taxpayers. IRC §461 requires a taxpayer to deduct expenses for the year required under their accounting method.

Holding. The Tax Court concluded that the Harrells could only deduct $86 of the annual annuity in 2009 and 2010. The court also held that the Harrells were not entitled to a deduction for funeral or estate administration expenses on their 2009 tax return.

Legal Settlement Funds

***Danielle and Lucas Bates v. Comm'r,* TC Memo 2017-72 (May 1, 2017)**
IRC §§104 and 6662

☞ Emotional Distress Settlement Funds Taxable

Facts. Danielle Bates injured her back while working as a customer service agent for ABX Air, Inc. (ABX). Her injury precluded her from maintaining her work schedule. ABX terminated her employment on November 30, 2006, approximately four months after the injury, because she violated employee attendance policy. After her termination, Mrs. Bates subsequently applied for and received state worker's compensation benefits. She then filed a lawsuit against ABX, alleging sex discrimination, retaliation against her for filing the worker's compensation claim, and wrongful discharge. Her suit sought recovery of lost wages, compensatory damages for emotional distress, punitive damages, and attorney's fees. While her complaint explained how her injury occurred, she did not seek to recover any damages from ABX in connection with her injury.

In March 2012, Mrs. Bates and ABX agreed to settle the case. Under the settlement terms, Mrs. Bates received $65,000 ($5,000 in lost wages, $38,286 relating to emotional distress, and $21,714 for attorney's fees and costs). ABX issued a Form W-2, *Wage and Tax Statement*, and Form 1099-MISC, *Miscellaneous Income,* to Mrs. Bates, reporting the wage and emotional distress amounts.

After Mrs. Bates and her husband filed their 2012 joint return, the IRS issued a notice of deficiency. The IRS indicated that the couple owed additional tax of $14,532 because the 2012 return failed to report the $38,286 attributable to emotional distress. In addition, a $2,906 accuracy-related penalty was assessed under IRC §6662.

Issues. The issues are whether the emotional distress amount was reportable on the Bates' 2012 return and whether they are liable for a §6662 accuracy-related penalty.

Analysis. Under IRC §104(a)(2), a settlement payment relating to a personal physical injury is excludable from income. However, IRC §104(a)(6) and Treas. Reg. §1.104-1(c)(1) indicate that **amounts received for emotional distress** are not considered to be received on account of personal physical injury. Mrs. Bates' settlement agreement provided that she received the amount due to emotional distress. The payment is therefore not excludable from income.

There was no credible evidence the Bates made a reasonable effort to assess their proper federal tax liability or that they believed in good faith that this liability was accurately reported. Therefore, the court determined that Mr. and Mrs. Bates were liable for a §6662(a) penalty.

Holding. The court held that Mr. and Mrs. Bates are liable for the tax deficiency. In addition, they are also liable for the accuracy-related penalty.

Foreign Earned Income Exclusion

Timothy Qunell Jr. v. Comm'r, **TC Summ. Op. 2016-86 (Dec. 19, 2016)**
IRC §§911, 6651, and 6662

☞ Armed Service Member Denied Foreign Earned Income Exclusion

Facts. Timothy Qunell Jr. enlisted in the U.S. Army and served on active duty for 17 years. He began working with AECOM Technology as an atmospheric manager on July 7, 2010. The position was in Afghanistan in connection with a contract between AECOM and the U.S. Department of Defense.

During his employment with AECOM, Mr. Qunell lived on a U.S. military facility in Kabul, Afghanistan. His passport records show multiple trips out of the country during 2011, including travel back to the United States. On February 14, 2011, Mr. Qunell was married in the United States and shortly afterwards returned to Afghanistan without his wife.

During 2011, Mr. Qunell and his wife owned a home in Illinois. His wife and their children lived in the home while Mr. Qunell worked in Afghanistan. Neither his wife nor any of their children visited Mr. Qunell in Afghanistan. He had several bank accounts in the United States during this time period.

On November 18, 2011, he resigned from his position with AECOM.

Mr. Qunell filed his 2011 tax return, due April 15, 2012, on November 5, 2013. His return included Form 2555, *Foreign Earned Income,* on which he took the position that the income he earned in Afghanistan was excluded from taxable wages because his tax home was Afghanistan. Mr. Qunell took this position based on the advice of the Army and an acquaintance who professionally prepared federal income tax returns.

The IRS determined that Mr. Qunell was not entitled to the IRC §911(a) foreign earned income exclusion. The IRS also determined that Mr. Qunell was liable for additions to tax under IRC §§6651(a)(1) and (2) and for an accuracy-related penalty under IRC §6662.

Issues. The issues are the following.

- Whether the wages that Mr. Qunell earned in Afghanistan during 2011 were excludable from gross income under §911(a)
- Whether Mr. Qunell is liable for §6651(a)(1) and (a)(2) additions to tax for failure to file or pay, respectively
- Whether Mr. Qunell is liable for a §6662 accuracy-related penalty

Analysis. United States citizens are taxed on their worldwide income unless an exception applies. IRC §911(a) allows individuals to exclude foreign earned income from their gross income. To be entitled to the deduction, the taxpayer must have a tax home in a foreign country and must be a bona fide resident of one or more foreign countries or be physically present in such country during at least 330 days in a 12-month period.

A tax home is generally the location of a taxpayer's regular or principal place of business. However, an individual is not treated as having a tax home in a foreign country for any period for which their abode is within the United States.[50] The "abode" is generally the country with which the taxpayer has the greatest economic, family, and personal ties.

During 2011, Mr. Qunell owned a home in Illinois and maintained bank accounts in the United States. His family never visited him in Afghanistan and he never appeared to travel within the country except for his employment. Furthermore, Mr. Qunell quit his job to return to the United States. His ties to Afghanistan were transitory. The court held that Mr. Qunell's abode was the United States and, as such, he could not exclude the income he earned in Afghanistan as foreign earned income.

IRC §6651(a)(1) provides for an addition to tax of 5% of the amount of tax shown on a delinquent return for each month or fraction of a month during which the return remains delinquent, up to a maximum of 25% for returns more than four months delinquent. An exception exists if there was a reasonable cause for the late filing. Mr. Qunell's tax return was due April 15, 2012, but was not filed until November 5, 2013. He did not prove any reasonable cause for the delay in filing; therefore, the court sustained the addition to tax.

IRC §6651(a)(2) provides for an addition to tax for failure to timely pay the tax shown on a return unless the failure was due to reasonable cause and not willful neglect. The amount of addition under §6651(a)(2) reduces the addition to tax under §6651(a)(1) for any month for which both additions apply. The court held that the IRS did not meet their burden of proof with respect to the §6651(a)(2) addition to tax and therefore Mr. Qunell is not liable for it.

The court held that Mr. Qunell was not liable for an accuracy-related penalty under §6662(a) because he disclosed all his wages on Form 2555. In addition, the court believed that Mr. Qunell relied on the advice of tax professionals and acted in good faith.

Holding. The court held that Mr. Qunell could not exclude the income he earned as a member of the U.S. Army. He was liable for an addition to tax for late filing but not for late payment or for accuracy-related penalties.

INNOCENT SPOUSE

Innocent Spouse Relief

***Adetutu Canty v. Comm'r,* TC Memo 2016-169 (Sep. 13, 2016)**
IRC §§6013 and 6015

☞ Wife Denied Innocent Spouse Relief From Husband's Law Practice Understatement

Facts. Charles and Adetutu Canty were married in July 1986 and are still married. Mrs. Canty has a bachelor's degree in economics and a master's degree in business and public administration. She worked as a financial management analyst. Mr. Canty owned and operated the Charles Canty Law Office.

Mr. Canty prepared the couple's 2010 and 2011 joint Forms 1040, *U.S. Individual Income Tax Return.* He attached a Schedule C, *Profit or Loss From Business*, for the law firm to both years' returns. The Schedules C for 2010 and 2011 reported the following.

	2010 Schedule C	2011 Schedule C
Gross receipts	$ 0	$148,119
Returns and allowances	66,981	42,100
Net gross receipts	123,334	106,019
Net profit	39,452	3,512

50. IRC §911(d)(3).

Mrs. Canty did not ask to review the 2010 or 2011 tax returns. She was not forced to sign the returns under duress, threat of harm, or other form of coercion. She had no mental or physical health problems which prevented her from understanding the contents of the tax returns. She was not a victim of spousal abuse or domestic violence.

In September 2013, a notice of deficiency was mailed to Mr. and Mrs. Canty for their 2010 and 2011 tax returns. In the notice, the IRS made adjustments to the Schedule C income and expenses.

In October 2013, the IRS received a Form 8857, *Request for Innocent Spouse Relief,* from Mrs. Canty. In an attachment to Form 8857, Mrs. Canty claimed she was not involved in the operation of the law firm and did not have any knowledge of the business's finances. Therefore, she had no way to determine the accuracy of the figures on the 2010 and 2011 tax returns with regard to the business.

On May 8, 2014, the IRS denied Mrs. Canty relief from joint and several liability for 2010 and 2011. The IRS determined Mrs. Canty knew, or had reason to know, of the business's income and expenses. She was not eligible for relief because of her current marital status and because she did not show that it would be unfair to hold her responsible.

Issue. The issue is whether Mrs. Canty was eligible for innocent spouse relief.

Analysis. A married couple who elects to file a joint income tax return is jointly and severally liable for the entire tax shown on the return.[51] Relief is available from joint and several liability for spouses who meet the following conditions.[52]

1. The taxpayers filed a joint return.
2. The joint return has an understatement attributable to an erroneous item of one of the individuals filing the return.
3. The other individual filing the return establishes that, by filing the return, they did not know, and had no reason to know, that there was an understatement.
4. Based on all of the facts and circumstances, it is inequitable to hold the other individual liable for the deficiency in tax.
5. The other individual elects relief from joint and several liability no later than two years after the date when the IRS begins collection activities.

The failure to meet any one of the previously listed requirements precludes relief. The IRS claims that Mrs. Canty did not meet the requirements for tests 3 and 4.

Regarding test 3, a spouse knows, or has reason to know, of an understatement if a reasonable person in similar circumstances would have known of the understatement. A reasonable person in similar circumstances would have reviewed the tax returns before filing and inquired about certain items reported on the return. Mrs. Canty acknowledged that zero gross receipts for 2010 was an obvious error. She was a highly educated individual who worked as a financial management analyst. A cursory review of the return would have revealed the obvious error. She also acknowledged that the 2011 net profit looked low. Mrs. Canty testified that she asked Mr. Canty about the low profit, and he replied that the amount was accurate. The court did not find her testimony credible because Mrs. Canty continued to change her testimony regarding the level of detail with which she reviewed their return. The court determined Mrs. Canty did not prove that she did not know or have reason to know about the understatements.

Regarding test 4, Treas. Reg. §1.605-2(d) evaluates certain factors to determine whether it is inequitable to hold a taxpayer liable for a deficiency in tax, including whether the requesting spouse significantly benefited, directly or indirectly, from the understatement. The court determined that the record does not indicate whether Mrs. Canty **significantly** benefited from the understatement. However, Ms. Canty bears the burden of establishing that it is inequitable to hold her liable for the tax deficiencies. She failed to satisfy this burden.

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51. IRC §6013(d)(3).

52. IRC §6015(b).

IRC §6015(f) allows for relief for individuals who do not otherwise qualify under §6015 if it is inequitable to hold the individual liable for any unpaid tax or any deficiency. A requesting spouse must satisfy seven threshold conditions for §6015(f) to be considered. The IRS conceded that Ms. Canty met all seven conditions. Because Mrs. Canty met the seven threshold requirements, she may qualify for a streamlined determination for relief if all of the following conditions are met.[53]

- The requesting spouse is no longer married to the nonrequesting spouse on the date the IRS makes its determination.
- The requesting spouse will suffer economic hardship if relief is not granted.
- On the date the joint return was filed, the requesting spouse did not know or have reason to know that there was an understatement or deficiency.

Mrs. Canty did not qualify for a streamlined determination because she was still married to Mr. Canty when the IRS made its determination. However, she may still be eligible for **equitable relief** if based on the facts and circumstances it would be inequitable to hold her liable. The court took the following nonexclusive factors into account when determining whether to grant equitable relief.

1. **Marital status** — Mrs. Canty was still married to Mr. Canty, rendering this test neutral.
2. **Economic hardship** — An economic hardship occurs if the satisfaction of the tax liability, in whole or in part, would cause a taxpayer to be unable to pay for basic living expenses. Mrs. Canty reported on her Form 8857 that she incurred monthly household expenses of $10,114 and had monthly income of $13,208. The court reasoned that Mrs. Canty would not suffer economic hardship if she was denied relief; therefore, this factor is neutral.
3. **Knowledge or reason to know of the items giving rise to the understatement or deficiency** — Mrs. Canty failed to prove that she had no reason to know of the understatements on the Schedules C. Therefore, this factor weighs against relief.
4. **Legal obligations** — Because the Cantys are still married, this factor regarding whether either spouse has a legal obligation to pay the outstanding tax liability is neutral.
5. **Significant benefit** — Mrs. Canty did not provide any testimony that influenced the court to believe she significantly benefited from the understatement. Therefore, this factor is neutral.
6. **Compliance with income tax laws** — Mrs. Canty did not file her 2012 income tax return until more than a year after the due date. As such, she failed to make a good-faith effort to comply with tax laws in the years following the years for which relief is requested. Therefore, this factor weighs against relief.
7. **Mental or physical health** — Mrs. Canty testified that she had no physical or mental health problems at the time she signed the 2010 and 2011 tax returns. Therefore, this factor is neutral.

After reviewing all the factors, the court determined it would not be inequitable to deny Mrs. Canty relief under §6015(f).

Holding. The court held that Mrs. Canty was not entitled to innocent spouse relief from a liability originating from Mr. Canty's law practice because she had reason to know of the tax understatements. It would not be inequitable to hold her jointly and severally liable for the tax liability.

53. Rev. Proc. 2013-34, 2013-43 IRB 397.

Innocent Spouse Relief

***Windy Harris v. Comm'r,* TC Summ. Op. 2017-21 (Mar. 30, 2017)**

IRC §§183, 6013, and 6015

☞ Innocent Spouse Relief Granted

Facts. Richard and Windy Harris were married in 1992. Ms. Harris was a full-time real estate agent, and Mr. Harris switched from full-time to part-time work as a chief information officer in order to start his own cattle ranching activity. Mr. Harris researched types of livestock and their profitability. After he purchased vacant land adjacent to the marital home for the cattle ranching business, he cultivated the land, built a fence, and erected a 6,000 square-foot barn. He maintained records for the cattle ranching activity. Ms. Harris was not involved with the cattle ranching activity, but she continued actively working as a real estate agent.

Mr. and Ms. Harris filed a joint 2011 tax return, with two Schedules C: one for Ms. Harris's real estate agent activity and another for Mr. Harris's cattle ranching activity. Ms. Harris's Schedule C showed net income of approximately $95,000. Mr. Harris's Schedule C indicated a net loss of approximately $133,000.

During 2011, the couple separated. They subsequently divorced in 2012. Under the terms of their property settlement, Mr. Harris became sole owner of the cattle ranching property. Ms. Harris became sole owner of the marital property.

In 2013, the IRS examined the 2011 joint return, focusing on Mr. Harris's cattle ranching Schedule C. Because the IRS took the position that the cattle ranching was a hobby business and disallowed deductions that Mr. Harris claimed, a $30,467 understatement of tax liability resulted. This was due, in large part, to the disallowance of his depreciation deduction of approximately $124,000, thereby reducing the amount of loss claimed against other income reported on the joint return.

Ms. Harris filed a request with the IRS for innocent spouse relief, which the IRS denied. Accordingly, she petitioned the Tax Court requesting such relief.

Issue. The issue is whether Ms. Harris is entitled to innocent spouse relief.

Analysis. Generally, each taxpayer who files using the married filing jointly (MFJ) status is jointly and severally liable for tax due. However, innocent spouse relief may be available under IRC §§6015(b) or (c) if the taxpayer seeking relief meets the requirements.

IRC §6015(b) provides an eligible taxpayer with relief from joint and several tax liability due to an understatement of tax. To be eligible, the **taxpayer must establish that they did not know, or have reason to know, of the understatement**. A taxpayer is considered to have reason to know of an understatement in tax liability if a reasonably prudent person in the taxpayer's position could be expected to know the return contained the understatement at the time they signed the return. Ms. Harris acknowledged that she reviewed the return before consenting to file it. The Tax Court concluded that she therefore knew, or had reason to know, of the understatement, making her ineligible for innocent spouse relief under IRC §6015(b).

Under IRC §6015(c), an election may be made to treat former spouses as if they filed separate returns, with each spouse's liability being limited to the amount of tax deficiency respectively allocable to them. Under this provision, the requesting spouse may elect to have a tax liability allocated among the former spouses if the following four conditions are met.

- An MFJ return was filed.
- At the time of the election, the spouses are no longer married.
- The election is made no later than two years after IRS collection activities have commenced.
- The deficiency remains unpaid.

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Relief is not permitted if the IRS demonstrates that the requesting spouse had actual knowledge of any item giving rise to a deficiency that is not allocable to the requesting spouse. This requires more than showing that Ms. Harris had knowledge that an item was improperly deducted on the return or that she knew the cattle ranching activity had an operating loss for the year. The IRS was required to prove that Ms. Harris had knowledge of the factual circumstances that made the deductions disallowable. She was aware that the activity was not profitable, but the IRS failed to demonstrate that she knew that Mr. Harris's activity was operated without a profit objective.

Holding. The court held that Ms. Harris is entitled to innocent spouse relief under IRC §6015(c).

IRS PROCEDURES — MISCELLANEOUS

IRS Collection Action

***Jonathan and Cheryl Hunsaker v. U.S.,* No. 6:16-cv-00386; U.S. District Court for the District of Oregon (Oct. 20, 2016)**
11 USC §362(k)

☞ Court Reverses Emotional Distress Damage Award

Facts. On November 5, 2012, Jonathan and Cheryl Hunsaker filed for Chapter 13 bankruptcy protection. This filing triggered the automatic stay provided by 11 USC §362(a), which blocks creditors from collection attempts outside of court-supervised reorganization proceedings. The parties agree the IRS violated the automatic stay four times. The IRS's violations allegedly caused significant emotional harm to Mr. and Mrs. Hunsaker.

In January 2016, the bankruptcy court awarded emotional distress damages to the Hunsakers. The IRS subsequently argued that sovereign immunity completely bars the Hunsakers' claims.

> **Note.** For a summary of the bankruptcy court proceeding, see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Rulings and Cases.

Issue. The issue is whether the United States waived sovereign immunity for emotional distress damages under 11 USC §362(k).

Analysis. "Sovereign immunity" means that the United States "is immune from suit unless it has expressly waived such immunity and consented to be sued."[54] The scope of any waiver of sovereign immunity is strictly construed in favor of the United States.[55] The party suing the United States must demonstrate the existence of "an unequivocal waiver of immunity."[56]

Section 106(a) of the bankruptcy code waives sovereign immunity for some claims under 11 USC §362(k). Section 362(k) allows debtors injured by a creditor's willful violation of the automatic stay to recover "actual damages." In *F.A.A. v. Cooper,*[57] the Supreme Court addressed the question of whether a waiver of actual damages includes emotional distress damages. The Court concluded that it did not. In its ruling, the Supreme Court identified multiple plausible readings of "actual damages." Because there are multiple interpretations of "actual damages," the Court in this case noted that it must accept the reading most favorable to the government, which excludes emotional distress damages.

Holding. The court concluded that sovereign immunity bars claims against the federal government for emotional distress damages. Therefore, the bankruptcy court lacked jurisdiction to award the Hunsakers emotional distress damages, and the judgment of the bankruptcy court is reversed.

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54. *Dunn & Black, P.S. v. U.S.,* 492 F.3d 1084, 1087-88 (9th Cir. 2007).
55. Ibid at 1088.
56. *Holloman v. Watt,* 708 F.2d 1399, 1401 (9th Cir. 1983).
57. *F.A.A. v. Cooper*, 132 S. Ct. 1441, 1447-1448 (2012).

Limitations Period

***Neil and Tracy Whitesell v. Comm'r,* TC Memo 2017-84 (May 18, 2017)**

IRC §§6501 and 7122

☞ IRS Assessments were Within Statute of Limitations Period

Facts. Neil and Tracy Whitesell timely filed their 2011 Form 1040, *U.S. Individual Income Tax Return,* on October 12, 2012. Their 2012 personal return was filed on October 15, 2013. Mr. Whitesell owned several S corporations, which filed Forms 1120S, *U.S. Income Tax Return for an S Corporation,* for 2011 and 2012 on September 17, 2012, and September 16, 2013, respectively.

The IRS issued a notice of deficiency to Mr. and Mrs. Whitesell on July 27, 2015, in connection with their 2011 and 2012 personal returns. No notices of deficiency were issued in connection with the S corporation returns. However, the notice of deficiency relating to the personal returns included income amounts from the S corporations that flowed through to Mr. and Mrs. Whitesells' personal returns.

After filing a Tax Court petition, Mr. and Mrs. Whitesell mailed an offer in compromise (OIC) form to the IRS for their 2006–2012 tax liabilities, including the tax liabilities associated with the S corporation flow-through income for 2012 and 2013. They mailed the form and a check for $3 million to the IRS to satisfy their tax liabilities. The IRS received and deposited the check. However, on January 21, 2016, the IRS sent the Whitesells a letter informing them that the OIC was rejected and was being returned. Subsequently, the IRS sent a letter dated February 9, 2016, informing the Whitesells that the IRS was closing the OIC file. The IRS returned the $3 million tax payment to the Whitesells. The exact date of the returned payment was not admitted into evidence, but the Whitesells deposited $3 million into their bank account on April 8, 2016.

Issues. The issues are the following.

- Whether the expiration of the statute of limitations period for assessing deficiencies attributable to the S corporations' income barred the IRS from determining flow-through income for Mr. Whitesell from his wholly owned S corporations
- Whether the IRS and the Whitesells entered into a contract settling the Whitesells' income tax liabilities for 2011 and 2012

Analysis. The Whitesells argued that the expiration of the statute of limitations period for the S corporation precluded the IRS from determining a deficiency on their personal return relating to S corporation flow-through income. The IRS contended that the period for assessment is determined by the taxpayers' return and not by the returns of related entities whose attributes flow through to the taxpayers' return.

Under IRC §6501(a), the authority of the IRS to assess income tax deficiencies is limited to a period ending three years after the filing of the taxpayer's return. The term "return" in this Code provision refers to the return of the taxpayer that is the subject of the notice of deficiency. Accordingly, the applicable limitations period is for the Whitesells' Forms 1040, not the Forms 1120S. This issue had already been decided in previous cases. The IRS notice of deficiency was within the required 3-year period.

Additionally, the Whitesells argued the IRS was bound by their receipt of the OIC form and the depositing of the $3 million check. They argued the Uniform Commercial Code (UCC) dictated governing contractual terms, and under these terms, when the IRS negotiated the check and failed to reject the OIC within 90 days, the tax liabilities were satisfied.

The UCC, which provides various contract rules, including those for satisfaction of obligations, is a state law provision. The Tax Court noted the UCC was not applicable to federal tax law and the IRS is therefore not bound by its provisions. In addition, the IRS rejected the Whitesells' OIC, so no contract existed that would bind the IRS.

Holding. The court held that the IRS's notice of deficiency for the Whitesells' 2011 and 2012 tax years was issued within the limitations period. The court also held that the IRS and the Whitesells did not enter into a settlement agreement or contract to settle the income tax liabilities for 2011 and 2012 because the Whitesells' OIC was rejected on a timely basis.

Reportable Transaction Penalty

***Patrick Bitter, Jr. v. Comm'r,* TC Memo 2017-46 (Mar. 20, 2017)**

IRC §§6330 and 6707A

☞ Taxpayer Could Not Challenge Liability Previously Raised Against IRS

Facts. Patrick Bitter was the sole shareholder of his S corporation. On January 1, 2002, the S corporation adopted a defined benefit pension plan (DBPP), of which Dr. Bitter was the only participant. The death benefit under the DBPP was $701,300. The DBPP purchased a life insurance policy on Dr. Bitter's life with a death benefit of $4,728,718. This resulted in an excess death benefit of $4,027,418 ($4,728,718 – $701,300). Each year, the S corporation deducted annual contributions it made to the DBPP, which paid for the life insurance policy premiums. For 2004, 2005, and 2006, the S corporation deducted DBPP contributions used to pay policy premiums of $225,422, $225,353, and $224,159, respectively.

The IRS issued Rev. Rul. 2004-20[58] on February 13, 2004. This revenue ruling described a life insurance transaction similar to the one in which Dr. Bitter was engaged. It indicated that transactions that are the same as, or substantially similar to, the transaction described in the revenue ruling are listed transactions under IRC §6011 if there was an excess death benefit exceeding $100,000. A listed transaction generally requires specific disclosure using Form 8886, *Reportable Transaction Disclosure Statement.*

Dr. Bitter filed timely his 2004, 2005, and 2006 returns, but he did not file Forms 8886 in any of those years and did not otherwise report the listed transactions. On June 26, 2012, the IRS notified Dr. Bitter of its proposal to assess penalties under IRC §6707A for 2004–2006 because the DBPP and life insurance transaction was substantially similar to the example outlined in the revenue ruling and was a listed transaction. The §6707A penalty, therefore, was assessable because of Dr. Bitter's failure to make a listed transaction disclosure with his personal returns for those three years. The penalties were $51,725, $55,139, and $60,019 for 2004, 2005, and 2006, respectively.

The IRS stated that if Dr. Bitter did not agree with the proposed assessment, he could request an Appeals Office conference by filing a written protest. Dr. Bitter requested the conference on July 24, 2012. His protest indicated that his S corporation's DBPP and life insurance transaction was not substantially similar to the one outlined in the revenue ruling. In addition, he noted in his protest that he substantially complied with the disclosure requirements, because a Form 8886 was attached to the S corporation returns each year even though that disclosure was not made with his personal return, as required. Lastly, Dr. Bitter argued that even if the penalties applied, the IRS calculated them incorrectly because of a settlement agreement he entered into with the IRS in 2011. Under this settlement agreement, some of the terms and the administration of the DBPP had changed in order to cover Dr. Bitter's employees retroactively to January 1, 2009. This resulted in a recalculation of deductible contributions by the IRS actuary. Dr. Bitter argued that these revised deductible contributions should be used as a basis for the penalty calculations, and smaller penalty amounts would result.

Appeals Officer Paladini was assigned to Dr. Bitter's case. She sent Dr. Bitter's representative a memo disagreeing with all of his assertions and adhering to the penalty amounts as originally calculated. After a conference with Dr. Bitter's representatives, Ms. Paladini indicated that the IRS could offer no concession and would proceed with assessing the penalties.

58. Rev. Rul. 2004-20, 2004-1 CB 546.

On July 3, 2014, in an effort to collect the amounts owed, the IRS sent Dr. Bitter a notice of intent to levy. Dr. Bitter timely requested a collection due process (CDP) hearing. A telephone hearing was scheduled for October 14, 2014. In a letter sent to the IRS for the hearing, Dr. Bitter's representative reiterated the same arguments made earlier to Ms. Paladini. No collection alternative was sought. IRS Settlement Officer (SO) Fernando was assigned to the CDP hearing. At the hearing, SO Fernando concluded that Dr. Bitter could not challenge the liability for the penalties because he had a prior opportunity to do so and took advantage of that opportunity through his July 2012 protest to Ms. Paladini in the Appeals Office. SO Fernando agreed with Ms. Paladini and subsequently issued Dr. Bitter a notice of determination adhering to the collection of the penalties as originally calculated. Dr. Bitter challenged the notice of determination in Tax Court, arguing that SO Fernando erred in failing to consider that the penalties should be eliminated or reduced.

Issue. The issue is whether SO Fernando was correct in barring Dr. Bitter from raising the issue of his liability for the penalties at the CDP hearing because Dr. Bitter previously raised it at a conference with the Appeals Office.

Analysis. Under IRC §6330(c)(2)(B), a taxpayer can raise a CDP challenge to the existence or extent of tax liability only if no statutory notice of deficiency was received for that liability or if the taxpayer did not otherwise have an opportunity to dispute that liability. The regulations distinguish between tax liabilities that are subject to deficiency procedures and those that are not. For liabilities that are subject to deficiency procedures, an opportunity for a post-examination conference with the Appeals Office does not prohibit a taxpayer from a later CDP challenge regarding the existence or extent of tax liability. However, for liabilities that are not subject to deficiency procedures, such as Dr. Bitter's IRC §6707A penalties, a prior opportunity to dispute the tax liability at Appeals serves to bar a later CDP challenge on the tax liability. SO Fernando followed the regulation correctly. Dr. Bitter's prior opportunity to challenge his liability for the §6707A penalties at an Appeals Office conference precludes him from challenging his liability for those penalties again at the later CDP conference.

Holding. The court held that the IRS may proceed with its collection actions against Dr. Bitter because he previously had the opportunity to challenge his liability.

Timely Filing

Robert Tilden v. Comm'r, **U.S. Court of Appeals, 7th Circuit; No. 15-3838 (Jan. 13, 2017)**
IRC §§6212, 6213, and 7502

☞ Court of Appeals Found Taxpayer Timely Filed Petition

Facts. The IRS sent Robert Tilden a notice of deficiency covering his tax years 2005, 2010, 2011, and 2012. Under IRC § 6213(a), a taxpayer who lives in the United States has 90 days to file a petition with the Tax Court to review a notice of deficiency. Mr. Tilden had until April 21, 2015, to file a petition in response to the IRS notice.

Staff from the law firm representing Mr. Tilden purchased postage through Stamps.com and took the petition to the post office. No postmark was applied, and the label from Stamps.com was dated April 21, 2015. The Tax Court received Mr. Tilden's petition on April 29, 2015, eight days after the deadline. Accordingly, the Tax Court dismissed the petition as untimely.

Under IRC §7502, the date of mailing is treated as the date of filing. A postmark not made by the United States Postal Service (USPS) is treated as follows under the regulations.[59]

- The postmark must bear a legible date on or before the last date prescribed for filing the document or making the payment.
- The document or payment must be received by the office with which it is required to be filed not later than the time when a document or payment contained in an envelope would ordinarily be received if it were postmarked at the same point of origin by the USPS on the last date prescribed for filing the document or making the payment.

59. Treas. Reg. §301.7502-1(c)(1)(iii)(B)(1).

In the Tax Court case, the IRS agreed that the petition was delivered to the USPS on April 21, 2015. However, the IRS contended that eight days was more than the USPS ordinarily takes to deliver certified mail from Utah (the point of origin) to Washington, D.C. The Tax Court focused on Treas. Reg. §301.7502-1(c)(1)(iii)(B)(3), which states that if an envelope has a USPS postmark and a non-USPS postmark, the non-USPS postmark is disregarded. There was no USPS postmark on Mr. Tilden's petition, but it was entered into the USPS tracking system for certified mail on April 23, 2015. The Tax Court determined the tracking system was as good as a postmark and ruled the petition was filed on April 23, 2015, and was thus two days late.

Mr. Tilden observed that neither party raised the question of whether tracking data must be treated as a substitute for a postmark made by the USPS. The IRS abandoned its earlier position and agreed with Mr. Tilden that the Tax Court had been mistaken. The Tax Court denied the parties' motion because the 90-day limit is jurisdictional and the court was not obligated to accept the agreement between Mr. Tilden and the IRS. The case then went to the Court of Appeals.

Issues. The issues are as follows.

- Whether the 90-day limitation in the original case is a jurisdictional issue
- The proper treatment of regulations regarding timely mailing

Analysis. A court must enforce jurisdictional limits even if the parties do not raise the issue during trial. The Court of Appeals looked to the language in §6213(a), which states that "The Tax Court shall have no **jurisdiction** to enjoin any action or proceeding or order any refund under this subsection unless a timely petition for a redetermination of the deficiency has been filed and then only in respect of the deficiency that is the subject of such petition [emphasis added]." For decades, various courts have deemed that §6213(a) is a jurisdictional limit. Therefore, the Court of Appeals found that the statutory filing deadline was a jurisdictional issue.

The IRS conceded that Mr. Tilden's petition was put in the mail on April 21, 2015, and also that eight days was a reasonable period of time to reach the Tax Court. The only remaining argument for dismissing Mr. Tilden's petition would be the legal conclusion that Treas. Reg. §301.7502-1(c)(1)(iii)(B)(3), regarding two conflicting postmarks, is the controlling statute. That regulation, however, concerns an envelope with both a USPS postmark and a non-USPS postmark. Mr. Tilden's petition only had one postmark; the USPS does not equate their tracking system with a postmark. In addition, the Court of Appeals doubted the Tax Court's assertion that the date an envelope enters the USPS tracking system is proof that this is the date the envelope was placed in the mail.

Holding. The court found that §6213(a) was a jurisdictional issue. After reviewing the Tax Court case, the Court of Appeals reversed the Tax Court's judgment that Mr. Tilden's petition was not timely filed. The case was remanded for a decision on the merits.

Note. For a summary of the Tax Court case *Tilden v. Comm'r,* see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Rulings and Cases.

Collection Due Process

***Patricia J. Anderson and Thomas Brodersen v. Comm'r,* TC Memo 2016-211 (Nov. 21, 2016)**

IRC §§6320, 6321, and 6330

☞ The IRS Did Not Abuse Its Discretion During Collection Due Process Case

Facts. Patricia Anderson and Thomas Brodersen were attorneys practicing real estate law in Florida. They were married and the sole owners of their law firm, Anderson & Brodersen, P.A. Ms. Anderson and Mr. Brodersen filed their tax returns for 2006–2010 late. They timely filed their 2011 and 2012 tax returns.

The IRS assigned revenue officer Joshua Cockerell to collect Ms. Anderson and Mr. Brodersen's outstanding liabilities. On August 24, 2012, Mr. Cockerell contacted the representative for Ms. Anderson and Mr. Brodersen, requesting they take the following actions.

- Provide a collection information statement
- Provide proof of estimated tax payments for 2012
- File income tax returns for 2006 and 2007

The deadline to complete the tasks was September 21, 2012. A week past the deadline, Ms. Anderson and Mr. Brodersen faxed Mr. Cockerell a Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals,* and the 2006 and 2007 tax returns. They also informed Mr. Cockerell they did not make any estimated tax payments for 2012.

On December 10, 2012, the IRS assessed trust fund recovery penalties (TFRP) to Ms. Anderson and Mr. Brodersen for failing to collect and pay taxes for their law firm for seven quarters.

On January 7, 2013, Ms. Anderson and Mr. Brodersen were each issued a notice of intent to levy for their joint income tax liability for 2006 and for the TFRPs. On January 17, 2013, they were also issued a notice of federal tax lien for the same liabilities.

Wallace Anderson, the attorney for Ms. Anderson and Mr. Brodersen, timely filed two Forms 12153, *Request for a Collection Due Process or Equivalent Hearing,* on January 18, 2013. Several days later, Mr. Anderson sent Mr. Cockerell updated Forms 433-A. Mr. Cockerell reviewed the Forms 433-A and suggested Ms. Anderson liquidate her retirement account to partially pay their outstanding balances.

Ms. Anderson liquidated her retirement account and mailed Mr. Cockerell a letter and a check for $61,669. The letter indicated that the check should be applied to the delinquent taxes.

Mr. Cockerell applied the payment to the TFRPs, paying the liabilities in full. He applied the remaining balance of her check against the joint income tax liability for 2007–2011. The balance satisfied the entire liability for all years except 2009. None of the balance was applied to the 2006 liability. The balances for 2006 and 2009 exceeded $50,000.

Mr. Cockerell recommended an installment agreement of $825 per month. Mr. Anderson stated they would be unable to pay that amount and proposed filing an offer-in-compromise.

On April 3, 2013, Mr. Cockerell submitted the case to Appeals. On April 16, 2013, the Jacksonville Appeals office sent letters to Ms. Anderson and Mr. Brodersen. The letters stated that if they were interested in a face-to-face hearing, they had to request one within 15 days. On April 24, 2013, Mr. Anderson faxed a response in which he requested the case be transferred to the Tampa, Florida Appeals office. He was told that in order to transfer the case, Ms. Anderson and Mr. Brodersen must be in compliance with all filings and estimated tax payments.

On May 6, 2013, the IRS Settlement Officer, Mr. Blue, received Form 656, *Offer in Compromise.* Ms. Anderson and Mr. Brodersen offered $6,000 to satisfy over $50,000 in income tax liabilities, additions to tax for failure to timely file, and accrued interest.

On May 9, 2013, Mr. Blue mailed Ms. Anderson and Mr. Brodersen a detailed letter, proposing a telephone conference for June 3, 2013. He reiterated that all tax payments had to be made before an offer-in-compromise could be accepted. He reminded them the IRS records did not show any estimated payments for 2012 or 2013. Additionally, Ms. Anderson and Mr. Brodersen needed to be current on their payroll tax obligations for the current quarter. Mr. Blue informed the couple they had 14 days to send certain documentation.

As of May 31, 2013, Mr. Blue had not received any of the requested documentation. The parties agreed to set up a new date for the phone conference on June 3, 2013. However, Mr. Anderson did not call at the prearranged time to reschedule the phone conference nor did he return any of Mr. Blue's phone calls. Mr. Anderson did fax a completed Form 433-B along with supporting documentation.

Mr. Blue reviewed the documentation and informed Mr. Anderson that certain documents were not provided. Mr. Blue again reminded them that all estimated tax payments for 2012 and 2013 needed to be paid for an offer-in-compromise to be considered.

On July 3, 2013, Mr. Anderson inquired how the $61,669 was allocated. Mr. Blue ordered transcripts and faxed copies to Mr. Anderson.

Mr. Anderson did not call in for a scheduled conference call on August 1, 2013, nor did he answer calls from Mr. Blue. Mr. Anderson faxed requests for additional time to complete Form 433-A (OIC) because Ms. Anderson was undergoing surgery and had several client hearings scheduled for August. He requested an extension until September 30, 2013, to submit additional documents and have property professionally appraised.

On August 5, 2013, Mr. Blue sent a letter summarizing all the missed calls. Based on the couple's asset/equity table and the income/expense table previously submitted, he concluded that Ms. Anderson and Mr. Brodersen would be able to pay their liability and their offer in compromise of $6,000 could not be accepted.

Mr. Anderson was frustrated with Mr. Blue's letter. He faxed Mr. Blue stating that he would not be available for a conference call requested by Mr. Blue. Mr. Anderson refused to return any of Mr. Blue's phone calls attempting to reschedule.

The Appeals team manager and Mr. Blue agreed to allow Mr. Anderson an opportunity to complete a third collection information statement along with supporting documentation. The deadline was October 4, 2013.

The day before the deadline, Mr. Anderson mailed a cover letter and several enclosures, including Form 433-A (OIC). Mr. Blue noticed some errors. On October 25, 2013, Mr. Blue faxed Mr. Anderson about the errors and noted the total equity in assets was miscalculated. Mr. Anderson agreed there were discrepancies and he would fax new information. Mr. Blue told Mr. Anderson any new information must be submitted with business bank statements. On November 3, 2013, Mr. Anderson submitted personal bank statements but none for the business.

Mr. Blue informed Mr. Anderson all outstanding issues would need to be resolved by the end of the day on November 25, 2013, or he would issue determination letters. The notices of determination were issued on December 16, 2013, rejecting the offer-in-compromise and sustaining collection actions. Ms. Anderson and Mr. Brodersen timely petitioned the court to review the determination.

Issues. The issues in this case are the following.

- Whether Ms. Anderson and Mr. Brodersen may challenge the allocation of a voluntary payment
- Whether Mr. Blue abused his discretion by denying Ms. Anderson and Mr. Brodersen a face-to-face hearing
- Whether Ms. Anderson and Mr. Brodersen received a proper and impartial collection due process (CDP) hearing
- Whether the IRS abused its discretion by rejecting Ms. Anderson and Mr. Brodersen's offer in compromise

Analysis. The court looked at the $61,669 voluntary payment allocation. Ms. Anderson and Mr. Brodersen claimed Mr. Cockerell improperly allocated the payment and that the amount should have first offset the oldest liability. The IRS countered by stating that this issue was never raised during their CDP hearing. A taxpayer generally must raise any issue during their CDP hearing in order for the court to consider it. The court agreed with the IRS that the couple did not raise the issue during their CDP hearing and therefore the court could not readdress the issue.

The court next looked at whether Ms. Anderson and Mr. Brodersen received a proper CDP hearing. The couple asserted that because Mr. Blue denied them a face-to-face CDP hearing, they were not afforded a CDP hearing. However, a proper CDP hearing may occur by telephone or correspondence.[60]

Denial of a face-to-face hearing is not considered an abuse of discretion when a taxpayer refuses to provide requested financial information. Additionally, a face-to-face hearing will not be granted when a taxpayer makes an offer in compromise but is ineligible for one. A taxpayer is ineligible for an offer in compromise if they have not filed required returns or made estimated tax payments. Ms. Anderson and Mr. Brodersen were ineligible for an offer in compromise because they were not in compliance with estimated tax payments. The court concluded that the 7-month exchange of correspondence constituted a CDP hearing.

Ms. Anderson and Mr. Brodersen argued that Mr. Blue abused his discretion by refusing to accept their offer in compromise. In addition, they argued that Mr. Blue relied on outdated financials and did not allow them sufficient time to file the correct Form 433-A (OIC). The taxpayers submitted three different collection information statements over the seven months. They frequently failed to submit requested supporting financials. The offer in compromise amount was unacceptable because it was less than the reasonable collection potential that Mr. Blue calculated. The court believed Ms. Anderson and Mr. Brodersen had sufficient time to provide more supporting documentation.

Holding. The court held that Ms. Anderson and Mr. Brodersen could not challenge the allocation of a tax payment because they failed to challenge it during collection proceedings. Furthermore, Mr. Blue did not abuse his discretion by denying a face-to-face CDP hearing or by rejecting their offer in compromise.

OPR Demand for Information

***James. C. Sexton v. Karen L. Hawkins,* No. 2:13-cv-00893; U.S. District Court for the District of Nevada (Mar. 17, 2017)**
IRC §§6694, 6695, and 6713

☞ IRS Cannot Compel Production of Documents from Tax Preparer or Advisor

Facts. James C. Sexton's status as a practitioner before the IRS was suspended in 2008 by the IRS Office of Professional Responsibility (OPR) after he pleaded guilty to mail fraud and money laundering. Sexton, an attorney, was disbarred in South Carolina as a result. However, throughout his suspension, he continued to work with clients of his firm, assisting with return preparation for individuals, managing the firm, and marketing his services.

Sexton prepared the tax return for Louise Kern, a client, and offered to provide her with written tax advice on options regarding her business tax liability. After discovering that Sexton had been disbarred, Ms. Kern not only fired him as her tax preparer and advisor, but also filed a complaint against Sexton with the OPR. The OPR commenced an investigation of Sexton's activities.

In early 2013, the OPR sent Sexton a letter regarding their investigation of alleged unauthorized practice. The letter demanded several documents and Sexton's responses to questions and indicated that his status as a practitioner before the IRS required his response or he would face a penalty under Circular 230. The letter required Sexton to produce documents that contain personal, private, and proprietary information. Because Sexton would be obligated to advise his clients of the need to turn over such information, compliance with the IRS request to do so would cause irreparable harm to Sexton's relationship with his clients and to his business.

60. *Katz v. Comm'r,* 115 TC 329 (Oct. 13, 2000).

Sexton filed suit against the IRS, asking the court for the following.

1. A court declaration that he is not a practitioner before the IRS and therefore not subject to the IRS's regulatory authority and that he does not need to respond to their request for information
2. A court declaration that the IRS is prohibited from regulating the provision of tax advice except as specifically provided by statute
3. An injunction against the IRS to prevent it from demanding the documents sought in the letter

> **Note.** *In Loving v. U.S.,*[61] the court held that IRS authority to regulate does not extend to those who are not representatives of persons before the IRS. It also held that tax preparation does not constitute representation before the IRS.

Issues. The issues are as follows.

- Whether Sexton is subject to IRS regulation because of his tax return preparation activities
- Whether Sexton's provision of tax advice subjects him to IRS regulation
- Whether Sexton is entitled to the court declaration ("declaratory judgment") and injunction he seeks

Analysis. The IRS argued that it may still regulate practitioners who are suspended, but not completely terminated and that Circular 230 still extends to such practitioners. However, nothing in the applicable law (31 USC §330) or regulations thereunder (Circular 230) expressly provides this authority. The IRS argued that a professional licensing body, such as that for attorneys, continues to maintain authority over a suspended member to investigate that member's conduct while suspended, but the court noted the IRS failed to cite any binding authority or federal case law for this proposition. The court also rejected the IRS's position that it has "inherent jurisdiction" over unauthorized practice before the IRS, given the absence of any binding law on this point. The court adhered to the *Loving* decision, concluding Sexton's tax preparation activities do not subject him to IRS regulation, because his tax preparation does not constitute practice before the IRS.

In addition, the IRS argued *Loving* did not apply to the section of 31 USC §330 that addresses tax advice, and this provision permits IRS regulation over Sexton. The court rejected this argument, indicating that *Loving* precludes IRS regulation over the offering of tax advice. The court noted that even if the IRS was correct that *Loving* did not affect the statutory tax advice provision, nothing in its language provided the IRS with the ability to regulate or sanction tax advice or the offering of such advice.

The court also found that Sexton successfully established the factors necessary for declaratory judgment and the injunction sought. Sexton demonstrated that irreparable harm would occur if he complied with the IRS request for documents because clients would need to be informed of the disclosure and this would effectively terminate his client relationships and business. In addition, Sexton demonstrated that a permanent injunction would serve the public interest because 31 USC §330 does not provide the IRS with the authority to regulate tax preparers such as Sexton.

Holding. Sexton is not a practitioner under Circular 230 and the IRS lacks authority to regulate his tax preparation or provision of tax advice. Further, the IRS is permanently enjoined from seeking to assert authority over Sexton or his tax firm regarding tax preparation activities under either Circular 230 or 31 USC §330.

[61] *Loving v. U.S.*, 742 F.3d 1013 (D.C. Cir. 2014).

Whistleblower Statute

***Whistleblower 21276-13W v. Comm'r,* 147 TC No. 4 (Aug. 3, 2016)**

IRC §7623

☞ Whistleblower Award Based on Collected Tax, Criminal Fines, and Forfeitures

Facts. In a previous case involving the same whistleblowers[62] (a husband and wife), the Tax Court held the whistleblowers' claims for awards were timely. The Tax Court ordered the whistleblowers and the IRS to resolve their differences and keep the Tax Court informed of their progress on the subject of the award amount for the whistleblowers. The parties reached agreement that the whistleblowers are entitled to an award of 24% of the collected proceeds. However, the parties could not reach agreement on the amount of the collected proceeds to include in the award calculation.

The taxpayer targeted for nonpayment of taxes was charged with a federal criminal offense and paid the following amounts.

Tax restitution	$20,000,001
Criminal fine	22,050,000
Civil forfeiture to the U.S. government	15,821,000
Relinquishment of claims to the U.S. government	16,260,693
Total	$74,131,694

The IRS and the whistleblowers agreed that the tax restitution payment constituted collected proceeds under the Code's whistleblower provision and is therefore included in the calculation of the whistleblower award. The parties disagreed on whether the other amounts paid by the targeted taxpayer should be included.

Issue. The issue is whether the amounts paid by the targeted taxpayer, other than the tax restitution amount, are included in calculating the whistleblower award.

Analysis. The Code's whistleblower provision, enacted in 2006, provides for a mandatory award if the tax, penalties, interest, additions to tax, and additional amounts in dispute exceed $2 million, as long as other requirements are met as specified in that provision. The IRS provided further guidance in 2010 in the Internal Revenue Manual regarding what constitutes collected proceeds for purposes of calculating the whistleblower award. IRM 25.2.2.12 states that collected proceeds are the monies the IRS obtains directly from a taxpayer based on the information provided by the whistleblower. The IRM further states that for claims filed after December 20, 2006, awards are "paid out of the proceeds collected, including penalties, interest, additions to tax and additional amounts." Criminal fines which must be deposited into the Victims of Crime Fund cannot be used for payment of whistleblower awards.

The IRS maintained that only those amounts collected and assessed under the Code may be used to calculate a whistleblower award, because IRC §7623 relates only to violations of federal tax law. Accordingly, the IRS argued that criminal fines and other amounts do not qualify for inclusion into the overall amount upon which the whistleblower award is calculated. The IRS further asserted that including criminal fines and forfeiture amounts for whistleblower awards may cause conflict with other federal statutes that specify other purposes for those funds.

The whistleblowers' position was that the entire $74.1 million should be taken into account as collected proceeds because this was the total settlement payment resulting from the targeted taxpayer's violation of the Code. The Tax Court noted the language of §7623(b) is straightforward in its statement that "…the whistleblower is entitled to an award based on a percentage of the collected proceeds resulting from the [IRS's] action (as well as any related actions) or from any settlement in response to such action." However, the court noted the term "collected proceeds" was not statutorily defined. After referring to dictionary definitions for "proceeds" and noting the broad scope given in precedent to the term "any property," the court believed a similar broad definition should be given to the term "collected proceeds."

62. *Whistleblower 21276-13W v. Comm'r,* 144 TC No. 290 (2015).

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The court further noted that Congress meant for the whistleblower program to be an expansive awards program, and used other broad, sweeping terms in §7623(b)(1) such as "any administrative or judicial proceeding," "any related actions," and "any settlement in response to such action." If Congress wanted to limit the meaning of the term "collected proceeds" to collected tax amounts, it could have done so, but no such limitation was included in the statute. Because the term "collected proceeds" is broadly interpreted, criminal fines are included. Moreover, because a forfeiture is similar to a criminal fine, the forfeiture amounts are likewise included in collected proceeds.

Holding. The court held that the whistleblowers' award will be based on the "total amount brought in" by the government from the targeted taxpayer. Therefore, the amount of the award is $17,791,607 ($74,131,694 × 24%).

IRS PROCEDURES — PENALTIES

Accuracy-Related Penalties

***Lawrence and Lorna Graev v. Comm'r,* 147 TC No. 16 (Nov. 30, 2016)**
IRC §§170, 6212, 6662, and 6751

☞ Tax Court Struggles with IRS Penalty Procedure

Facts. In a 2013 opinion,[63] the Tax Court agreed with the IRS that Lawrence and Lorna Graev's claimed charitable contribution deduction for a façade conservation easement should be disallowed. The contribution was made to the National Architectural Trust (NAT) in New York City during 2004. They made the contribution with the understanding that the NAT would issue a "side letter" to the Graevs indicating that, in the event their charitable contribution deduction in connection with their conservation easement was disallowed by the IRS, the NAT would refund part or all of the contribution.

During 2008, after examination of the Graevs' 2004 and 2005 returns, IRS Revenue Agent Stephen Feld determined that the charitable contribution deduction should be disallowed. The IRS disallowed the deduction because the side letter made the donation a nondeductible conditional gift. At the time of the donation, NAT's refund of the contribution was not "so remote as to be negligible" under applicable charitable contribution deduction regulations. The IRS issued a notice of deficiency that included accuracy-related penalties under IRC §6662.

The §6662 penalties were the subject of the subsequent 2016 case the Graevs filed against the IRS. The Graevs asked the Tax Court to redetermine the penalties. After the return examination and disallowance of the charitable deduction, Mr. Feld concluded that the 40% gross valuation misstatement penalty under §6662(h) should apply.

Mr. Feld prepared the appropriate "Penalty Approval Form" for the 40% penalty, and this was the only penalty shown on that form. Mr. Feld's immediate supervisor, John Post, approved the form. Mr. Feld subsequently prepared a draft notice of deficiency (NOD) reflecting the 40% penalty, which was referred in accordance with IRS procedure to the Office of Chief Counsel (OCC) for review.

The draft NOD was reviewed by OCC attorney Gerard Mackey, who approved the draft NOD, but only after making one addition. After the NOD's discussion of the 40% penalty, Mr. Mackey added the sentence: "Alternatively, you are liable for the 20% accuracy-related penalty imposed under IRC §6662(a) for 2004 and 2005." Treas. Reg. §1.6662-2(c) indicates the 40% and 20% penalties are alternatives, and only one can be applied to a deficiency. Neither Mr. Feld nor Mr. Post addressed the 20% penalty. The NOD indicated that the formula for the 20% penalty showed a reduction of the tax underpayment amount to zero as a line item to avoid stacking both penalties on the same underpayment. Because the IRS made a concession in Tax Court that the 40% penalty was inapplicable, only the 20% penalty was at issue.

63. *Graev v. Comm'r,* 140 TC 377 (Jun. 24, 2013).

IRC §6751(a) indicates that an NOD must indicate each penalty by name, Code section, and provide the taxpayer with a computation of each penalty. Because the NOD showed a zero amount for the 20% penalty, the Graevs argued that the requirements of §6751(a) were not met. Moreover, §6751(b)(1) states that "No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination…" The Graevs argued that because Mr. Feld made the initial decision to impose the 40% penalty and not the 20% penalty and because the 20% penalty was not approved by his supervisor, Mr. Post, the 20% penalty was not assessable. The Graevs argued that attorney Mackey was not authorized under §6751(b) to make this determination because he was not Mr. Feld's "immediate supervisor."

Issues. The issues in the case are the following.

- Whether the 20% penalty is assessable against the Graevs
- Whether the "immediate supervisor" approval requirement of §6751(b)(1) was met

Analysis. The 20% and 40% penalties are alternative penalties under §§6662(a) and (h). Only one of them can apply to a deficiency. The 40% penalty was initially the basis of the IRS's position, and the 20% penalty was correctly shown as zero to prevent the stacking of these penalties. The NOD notified the Graevs about the penalty and set out the appropriate calculation, albeit as an alternative. Accordingly, the terms of §6751(a) were met.

In addition, the language of §6751(b)(1) does not specify that a written approval of the initial determination of an assessment must be made before actual assessment. Assessment is the formal recording of a taxpayer's tax liability in IRS records. In a Tax Court proceeding, assessment cannot occur until a Tax Court decision is final and unappealable under IRC §§6213(a), 6665(a), and 7485. Therefore, the Graevs cannot raise this issue for review until the penalty has been assessed in alleged violation of the supervisory-approval requirement.

Holding. The court held that the requirements of §6751(a) were met, but any argument of whether the 20% penalty may be assessed under §6751(b)(1) is premature until the Tax Court's decision becomes final and unappealable. However, the 20% penalty is sustained for 2004 and 2005.

Note. Seventeen Tax Court judges reviewed this important case regarding the procedure that the IRS is required to follow under §6751 to properly impose a penalty. Nine judges joined in this holding. Three judges concurred on different grounds. The remaining five judges dissented, disagreeing that the assessment issue was premature because the Tax Court routinely decides whether a liability should be assessed through its holdings. Assessment need not take place in order to "ripen" a §6751 case for adjudication. In an unrelated case in March 2017, *Chai v. Comm'r* (discussed next), the Second Circuit essentially agreed with the position of the dissenting Tax Court judges in *Graev.*

Accuracy-Related Penalties

***Jason Chai v. Comm'r,* U.S. Court of Appeals, 2nd Circuit; No. 15-1653 (Mar. 20, 2017)**
IRC §6751

☞ Reversal of Tax Court in *Graev* Makes Penalties Harder to Enforce

Facts. This case was an appeal of a 2015 Tax Court case,[64] which involved a complex set of facts regarding a Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) audit, personal tax audit, and the implications of various tax procedure rules.

At the urging of his cousin's husband, Andrew Beer, Jason Chai became an "accommodating party" to facilitate the sales of tax-shelter investments through Mr. Beer's businesses. Mr. Chai received substantial compensation, and Mr. Beer assured Mr. Chai that any additional tax liabilities he incurred as a result of his facilitation of the investment sales would be offset by losses.

Mr. Chai facilitated the sale of at least 131 tax-shelter investments, and during 2000 and 2001, he reported over $3.2 billion in income from the tax shelters as an accommodating party. He also reported equal, offsetting losses. In 2003, Mr. Chai received a final $2 million payment after the planned liquidation of his interests as the accommodating party in the tax shelters. The financial staff of Mr. Beer's business advised Mr. Chai that the $2 million was taxable income. However, Mr. Chai reported this amount as a return of capital, despite the fact that he never made any capital contribution to the tax shelters.

Mr. Chai was also a partner in Mercato, a partnership unrelated to Mr. Beer or the tax shelters. Mercato reported losses, and Mr. Chai reported a large partnership loss on his 2003 return.

The IRS ultimately conducted concurrent audits of the 2003 returns for Mr. Chai and the Mercato partnership. The partnership-level proceeding involved whether the large partnership losses were allowable. The personal deficiency proceeding was to determine how the $2 million payment should be characterized.

The following is a summary of the steps that occurred in connection with the personal and partnership audits.

- The IRS issued a notice of deficiency (NOD) for self-employment (SE) tax on the $2 million payment, plus a related 20% accuracy-related penalty. This NOD did not involve an income tax liability because the separate TEFRA partnership-level determination regarding the large losses was not complete. It was therefore not yet clear if Mr. Chai's large Mercato loss, reported on his personal return, was allowable. The Mercato loss that Mr. Chai reported on his 2003 return was large enough to fully offset the $2 million he received if the Tax Court were to hold that this amount should be characterized as taxable income on his 2003 return.
- After Mr. Chai received the NOD for the SE tax and related penalty, he filed a petition in Tax Court for a redetermination of the SE tax deficiency. The IRS filed an answer in response to the petition.
- While the Tax Court proceeding on the NOD for the SE tax was pending, the IRS disallowed Mercato partnership losses that Mr. Chai claimed on his 2003 return in the separate partnership-level proceeding.
- The IRS amended its answer to Mr. Chai's Tax Court petition in the SE tax proceeding, claiming an income tax deficiency because Mr. Chai did not properly report the $2 million as taxable income.
- The Tax Court ruled in favor of the IRS on the SE tax issue (and the related penalty) but held that it did not have jurisdiction over the later-asserted income tax deficiency issue.
- Mr. Chai filed a post-trial brief with the Tax Court, arguing for the first time that the IRS did not meet its burden of proof that it complied with the IRC §6751(b)(1) requirement that the penalty related to the SE tax liability must be personally approved by a supervisor. The Tax Court refused to consider Mr. Chai's belated post-trial argument.

64. *Chai v. Comm'r,* TC Memo 2015-42 (Mar. 11, 2015).

> **Observation.** In *Graev*, the Tax Court indicated that the IRS penalty assessment cannot occur until a Tax Court decision is final and held that the taxpayer's contention that the IRS did not comply with the IRC §6751 written-approval requirement was premature. In *Chai*, Mr. Chai's post-trial brief, filed after the Tax Court's determination regarding the penalty, seems to be an awkward procedural attempt to comply with the need for a post-trial challenge of an IRS failure to meet the statutory written approval requirement in light of the *Graev* decision.

In his appeal, Mr. Chai challenged the Tax Court's refusal to consider his post-trial argument regarding the related penalty.

> **Note.** There were other issues that the Second Circuit addressed in this case, including the disposition of several holdings from the Tax Court case. This analysis focuses on the impact of the Second Circuit's holding on the interpretation of IRC §6751(b)(1) as it relates to the accuracy-related penalty that the IRS sought to impose on Mr. Chai.

Among the concerns in this case was that, in separate proceedings, it may be possible to prevent collection of the non-TEFRA adjustments, such as an income tax deficiency and corresponding 20% accuracy-related penalty, because of the time it may take for the TEFRA proceeding to finalize a determination on any losses allowable to pass through to partners. It is possible for any personal income tax deficiency and accuracy-related penalties at the partner level to become uncollectible due to the expiration of the limitations period. Accordingly, the timing of when the IRS agent must obtain the written approval from an immediate supervisor under IRC §6751(b)(1) is important, so that the penalty may be assessed and collected before the expiration of the limitations period.

The appellate court had to "...decide which side in *Graev* got it right." The appellate court noted that the *Graev* majority held that, under IRC §6751(b)(1), written approval from an immediate supervisor can be obtained any time before the assessment of the penalty. A challenge to the written approval requirement from the taxpayer, however, must be made in a second, post-assessment Tax Court proceeding because assessment is not permitted until the Tax Court makes a final ruling in a first proceeding. However, the five dissenting *Graev* judges held the view that the written approval must be obtained before the initiation of a Tax Court proceeding.

Issue. The issue is whether the Tax Court abused its discretion in declining to consider Mr. Chai's post-trial argument that the IRS had not met its burden of proof regarding compliance with the written-approval requirement of IRC §6751(b).

Analysis. Based on a plain reading of the language in IRC §6751(b)(1), it is unclear when written approval must be obtained. The *Graev* majority indicated that the lack of any specific time provision in the statute meant no time requirement exists, but this results in too much ambiguity in the statute. Looking at the legislative history behind IRC §6751(b)(1), Congress intended this provision to prevent penalties from being used by IRS agents as bargaining chips in threatening taxpayers to settle. This is at odds with the ambiguity inherent in the Tax Court's majority view.

In order for any IRS supervisory approval of a penalty under IRC §6751(b)(1) to be meaningful, it must be made before the Tax Court's decision becomes final. After a Tax Court decision, the IRS no longer has discretion on penalty assessment.

Moreover, it is not enough that the written IRC §6751(b)(1) penalty approval be made before a final Tax Court decision. Such approval must also come before the Tax Court proceeding is even initiated. IRC §6751 requires supervisory approval of the "initial" determination of such assessment. The court concluded that approval of the initial determination must occur no later than the date the IRS issues an NOD.

In addition, in a court proceeding, the IRS must initially produce evidence that it is appropriate to apply a particular penalty to the taxpayer before the court can impose the penalty. It is up to the taxpayer to come forward with evidence of any reasonable cause, substantial authority, or similar evidence establishing the inappropriateness of the penalty.

Holding. The court held that the IRS failed to meet its burden of proving compliance with §6751, which is a prerequisite to assessment of the accuracy-related penalty. Therefore, the court reversed the Tax Court's holding in *Graev* with respect to IRC §6751(b)(1).

> **Observation.** The *Chai* decision has a significant impact on the ability of the IRS to enforce penalties covered by IRC §6751(b)(1) in Tax Court. Such enforcement will be highly unlikely unless the IRS can establish compliance with the requirements set forth by the Second Circuit.

LIKE-KIND EXCHANGES

Like-Kind Exchange

The Malulani Group Limited et al. v. Comm'r, **TC Memo 2016-209 (Nov. 16, 2016)**
IRC §1031

☞ Related Parties Not Entitled to Nonrecognition under IRC §1031

Facts. The Malulani Group, Limited, is a Hawaiian corporation that specialized in leasing commercial real estate in various states, including Hawaii and Maryland. Malulani Group filed consolidated returns with its wholly owned subsidiary, MBL Maryland (MBL). During the relevant years, Malulani Group owned 69.67% of Malulani Investments, Limited (MIL). MIL owned real estate throughout the United States.

Prior to September 2004, MIL and the Malulani Group had the same president and board of directors. In September 2004, a hostile shareholder acquired approximately 30% of MIL's common shares. Following that transaction, each company established a separate board of directors and a different president.

On October 26, 2006, an unrelated third party made an offer to MBL to purchase commercial real estate located in Maryland. The letter of intent outlined the anticipated terms of the sale, which included the right to exchange property under IRC §1031. The third-party purchaser was obligated to cooperate with making the IRC §1031 exchange.

Malulani Group and MBL began looking for suitable replacement property. On January 4, 2007, MBL engaged First American Exchange Co. (FAEC) as an intermediary to help execute the tax-deferred exchange. On January 10, 2007, MBL transferred the Maryland property to FAEC. FAEC sold the property to the unrelated third party for $4.7 million.

To qualify under §1031(a)(3), MBL needed to identify a replacement property on or before February 24, 2007 (45 days after the sale of the Maryland property). Between October 31, 2006, when the letter of intent was signed, and February 23, 2007, real estate brokers identified multiple properties owned by unrelated parties as potential replacement properties for MBL and the Malulani Group. MBL unsuccessfully negotiated for one of the identified buildings.

On February 23, 2007, MBL identified three potential replacement properties, all owned by MIL. On July 3, 2007, FAEC purchased a property located in Hawaii from MIL for $5.52 million and transferred it to MBL as a replacement property.

The Malulani Group timely filed a consolidated Form 1120, *U.S. Corporation Income Tax Return,* for 2007. On the 2007 return, the Malulani Group reported a realized gain of $1.89 million from the sale of the Maryland property but deferred recognition of the gain under §1031. The Malulani Group also reported an unrelated NOL of $748,273. It carried the NOL back to 2005.

MIL recognized a gain of $3.13 million on its 2007 Form 1120 from the sale of the Hawaii property. MIL had sufficient NOLs to eliminate the $1.09 million of increased regular income tax from the sale. However, it did pay $44,774 in alternative minimum tax.

The IRS issued a statutory notice of deficiency to Malulani Group. The notice stated that the $1.89 million gain on the sale of the Maryland property did not qualify as a tax-deferred exchange under §1031 but that Malulani Group could offset the gain with its NOL of $748,273, leaving a deficiency of $387,494 for 2007. Therefore, the NOL was not available to carry back to 2005, resulting in a $264,171 deficiency for that year.

Issue. The issue is whether Malulani Group's gain relating to its disposition of real property in 2007 is entitled to nonrecognition treatment under IRC §1031(a).

Analysis. IRC §1031(a) allows the deferral of gain from an exchange of like-kind property held for productive use in a trade or business or investment. The gain may qualify for nonrecognition when the relinquished property is transferred before the taxpayer acquires replacement property if the taxpayer identifies the replacement property within 45 days and receives it within 180 days of the transfer of the relinquished property.

If property involved in a related-party §1031 exchange is disposed of shortly after the exchange, the original exchange should not be granted nonrecognition treatment. IRC §1031(f)(1) states that nonrecognition treatment does not apply if either related party disposes of the property received in a like-kind exchange **within two years.** In this situation, the gain or loss must be recognized as of the date of the disposition. A transaction with the appearance of being structured to avoid the purposes of §1031(f) may have the nonrecognition treatment disallowed if the exchange only indirectly involved related persons because of the interposition of qualified intermediaries.[65]

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The IRS did not dispute that the transaction qualified as a like-kind exchange under §1031(a)(1). The IRS agreed MBL appropriately used an intermediary to facilitate the sale. However, the IRS contended that MBL structured the exchange solely to avoid taxation and was therefore disqualified from nonrecognition treatment under §1031(f)(4).

Malulani Group argued that it did not structure the property exchange to avoid the related-party rules of §1031(f). MBL did not have a prearranged plan with MIL to exchange the properties, and it first sought a replacement property from unrelated parties. The Hawaii property was acquired because the deadline to complete the deferred exchange was imminent. MBL only decided to acquire the replacement property from a related party after employing a qualified intermediary.

If sold to a third party, Malulani Group would have recognized a $1.89 million gain, would have used NOLs to offset a portion of the gain, and would have paid an additional tax of $387,494 for 2007. For the 2005 tax year, Malulani Group would owe an additional $264,171 because of the loss of the NOL carryback. As a like-kind exchange, MIL recognized $3.12 million of gain that was almost entirely offset by NOLs. Because Malulani Group and MBL cashed out of the transaction almost tax-free, the court inferred that the transaction was structured with a tax-avoidance purpose.

Holding. The court held that Malulani Group failed to demonstrate that avoiding federal income tax was not one of its principal purposes in conducting the exchange between MBL and MIL. The exchange was structured to avoid the purposes of §1031(f). Therefore, Malulani Group was not entitled to defer recognition of the gain realized on the exchange of property.

65. See *Ocmulgee Fields, Inc. v. Comm'r,* 613 F.3d 1360, 1367 (11th Cir. 2010); see also *Teruya Bros., Ltd. & Subs. v. Comm'r,* 580 F.3d 1038 (2009), *aff'g* 124 TC 45 (2005).

Like-Kind Exchange

Estate of George Bartell Jr. et al. v. Comm'r, **147 TC No. 5 (Aug. 10, 2016)**
IRC §1031

☞ Like-Kind Exchange Through a Facilitator Qualified Under IRC §1031

Facts. The Bartell family owned and operated Bartell Drug Co. (Bartell Drug), a chain of retail drugstores, since its founding in 1890. Amidst increased pressure from national drug store chains, in the mid-1990s, Bartell Drug began a strategy of employing IRC §1031 like-kind exchanges to update the company's real estate portfolio and acquire new store locations. Bartell Drug worked with Section 1031 Services, Inc., a corporation that provided qualified intermediary services, and EPC Two, LLC (EPC Two), which served as an exchange intermediary. EPC Two was a single-purpose entity formed solely to provide services to Bartell Drug.

Bartell Drug was interested in moving its store in Lynnwood, Washington, across the street to a more attractive location. Bartell Drug approached Section 1031 Services about exchanging the Lynnwood store with an older store identified as the White Center site. The parties agreed that EPC Two would take title to the Lynnwood property with the expectation of making a §1031 exchange. Simultaneously, Bartell Drug was working with KeyBank National Association (KeyBank) to structure a credit package for new borrowing facilities and extensions or renewal of existing loans. KeyBank was willing to make a loan based on Bartell Drug's financial strength, long operating history, management team, and name recognition.

Construction began on the Lynnwood property on August 1, 2000. Meanwhile, Bartell Drug acquired a retail drugstore in Everett, Washington, in a §1031 exchange involving the sale of another property. That §1031 exchange was completed through Section 1031 Services. In the spring of 2001, KeyBank extended the loan on the Lynnwood property. The loan was extended because Bartell Drug needed more time to determine the most appropriate repayment source, "either from sale/leaseback of the company's White Center Store as originally planned or from the sale of the existing Everett Store."

Around September 21, 2001, Bartell Drug entered into a purchase agreement to sell the Everett location. The Bartell Drug board of directors approved the sale on November 28, 2001. They observed that the proceeds would be used to purchase the Lynnwood property.

On December 17, 2001, Bartell Drug and Section 1031 Services executed an agreement to exchange the Everett property for the Lynnwood property in a transaction to qualify under §1031. The purchase agreement between Bartell Drug and the purchasers of the Everett location would be assigned to Section 1031 Services. Section 1031 Services would transfer the Everett property to the purchasers, acquire the Lynnwood property from EPC Two, and transfer the Lynnwood property to Bartell Drug. This exchange was finalized between December 26, 2001, and January 3, 2002.

Bartell Drug filed Form 1120S, *U.S. Income Tax Return for an S Corporation,* for 2001 and attached a Form 8824, *Like-Kind Exchanges.* Form 8824 detailed the transfers of the Everett and Lynnwood properties. Because Bartell Drug treated the gain realized from the sale of the Everett property as deferred, it did not report any gain on the Schedules K-1, *Shareholder's Share of Income, Deductions, Credits, etc.*

In early 2004, the IRS proposed an adjustment to Bartell Drug's 2001 corporate return. It disallowed the tax deferral treatment under §1031 for the $2.8 million reported as realized in the like-kind exchange of the Lynnwood and Everett properties.

Issue. The issue in the case is whether Bartell Drug's property transaction qualified for nonrecognition as a like-kind exchange under §1031.

Analysis. IRC §1031 allows taxpayers to defer recognition of gain or loss on exchanges of like-kind property held for productive use in a trade or business or for investment. The taxpayer must not have owned the property received in the exchange before the exchange occurs, otherwise they are engaged in a nonreciprocal exchange with themselves.

The IRS contends that the court should apply a benefits and burdens test. The IRS claims that Bartell Drug already owned the Lynnwood property prior to the disposition of the Everett property. It claims that Bartell Drug, not EPC Two, had all the benefits and burdens of owning the property, including the following.

- Capacity to benefit from any appreciation in the property's value
- Risk of loss from any diminution in its value
- Burden of ownership such as taxes and liabilities arising from the property

Conversely, EPC Two had no equity interest in the property, made no economic outlay to acquire it, was not at risk because all the financing was nonrecourse to EPC Two, paid no real estate taxes, and all construction on the property was financed and directed by Bartell Drug.

Both the Tax Court and the Court of Appeals for the Ninth Circuit, to which an appeal in this case would be tried, have expressly rejected the proposition that a person who takes title to the replacement property for the purpose of effecting a §1031 exchange must assume the benefits and burdens of ownership in that property to satisfy the exchange requirement. The Tax Court evaluated previous relevant cases[66] and noted that, for situations in which an exchange is contemplated from the outset and a third-party exchange facilitator takes possession of the replacement property prior to the exchange, the exchange facilitator does not need to assume the benefits and burdens of ownership for the §1031 exchange to be valid.

Holding. The court held that Bartell Drug's disposition of the Everett property and acquisition of the Lynnwood property qualified for nonrecognition treatment under §1031.

PARTNERSHIPS

Self-Employment Tax

***Vincent and Marie Castigliola v. Comm'r,* TC Memo 2017-62 (Apr. 12, 2017)**
IRC §§1401, 1402, and 6662

☞ Partnership Distributive Shares Subject to Self-Employment Tax

Facts. Vincent Castigliola, John Banahan, and Harry Mullen were attorneys who worked in their own firm, which was structured as a professional limited liability company (PLLC) in Mississippi. Their member-managed PLLC had no operating agreement, but the members' agreement called for each of the three members to receive guaranteed payments each year, based on local legal salaries. The PLLC paid any excess profits over the amount of the guaranteed payments to the members in accordance with the members' agreement.

The members and the PLLC had the same CPA, who completed the members' personal returns and partnership return for the PLLC. The CPA advised the members that self-employment (SE) tax applied to the guaranteed payments, but SE tax did not apply to the distributive shares in excess of the guaranteed payments. The members adhered to this advice.

The PLLC had $15,167 in its trust account. The trust account was regularly used to hold client funds and appropriately pay fees to the firm. However, because records were lost during Hurricane Katrina, the members did not know to whom the $15,167 belonged.

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66. *Alderson v. Comm'r,* 317 F.2d 790 (9th Cir. 1963); *Biggs v. Comm'r,* 69 TC 905 (Mar. 13, 1978); *DeCleene v. Comm'r,* 115 TC 457 (Nov. 17, 2000).

The IRS issued notices of deficiency stating that the amounts distributed in excess of guaranteed payments were also subject to SE tax and that the $15,167 in the trust account was taxable income to the members. Accuracy-related penalties were also imposed. The members argued that the amounts they received in excess of guaranteed payments were exempt from SE tax under the limited partner exception to SE tax.

Issues. The issues are the following.

- Whether the members are entitled to the SE income exclusion for limited partners for amounts distributed in excess of guaranteed payments
- Whether the $15,167 in trust is taxable income to the members
- Whether the members are liable for accuracy-related penalties

Analysis. IRC §1401(a) imposes tax on net earnings from self-employment. IRC §1402(a) generally defines SE income as the gross income derived by an individual from any trade or business carried on by that individual, including any distributive share of income or loss from any trade or business of a partnership of which the individual is a member.

However, IRC §1402(a)(13) states that the distributive share of income subject to SE tax excludes a distributive share to a limited partner (other than a guaranteed payment, which is subject to SE tax). This exception was enacted in 1977 before limited liability companies (LLCs) or PLLCs were widely used. Federal tax law provides no definition of "limited partner." Because the term is not defined, the Tax Court looked to the ordinary meaning of the term at the time of enactment. The Tax Court also referred to a previous case,[67] which indicated that the meaning of "limited partner" was not confined solely to the limited partnership context, but could apply to other types of entities.

The Tax Court then referred to the Uniform Limited Partnership Act of 1916 and the Revised Uniform Limited Partnership Act of 1976 (RULPA), noting that both looked to the degree of control over business affairs in determining whether a partner was a limited partner. Under the version of RULPA adopted by Mississippi, a limited partner generally loses limited liability protection if that partner participates in the control of the business.

Messrs. Castigliola, Banahan, and Mullen all had management power over the firm's business. The PLLC was a member-managed firm, and all three partners were members. All three members participated in collective business decision-making regarding their distributive shares, borrowing money, hiring, firing, and employee compensation. They all issued checks on behalf of the firm and supervised associate attorneys. Therefore, the court concluded that because of the control each of them exercised over the business of the firm, they cannot be considered limited partners.

The Tax Court noted the credible testimony from two of the members that they did not know to whom the $15,167 in the trust account belonged, and it would be a violation of bar ethics to withdraw those funds as compensation. At some point, these funds will revert to the state of Mississippi. Until then, the funds must be maintained in a separate trust account because the funds do not belong to the members.

IRC §§6662(a), (b)(1), and (b)(2) impose a penalty of 20% of the amount of tax underpayment attributable to any one of a number of factors, including negligence or disregard of rules or regulations and any substantial understatement of income tax. For a substantial understatement of tax to exist, a $5,000 threshold must be exceeded. Because the deficiencies calculated for each member amounted to less than $5,000, there was no substantial understatement of tax.

67. *Renkemeyer, Campbell, & Weaver, LLP v. Comm'r,* 136 TC 137 (Feb. 9, 2011).

In addition, negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code, and a "disregard of rules and regulations" includes any careless, reckless, or intentional disregard under §6662(c). A penalty will not be imposed if the taxpayer acted with reasonable cause and in good faith. Under the precedential case *Neonatology Associates, P.A. v. Comm'r,*[68] reliance on a tax professional may constitute reasonable cause and good faith if the following criteria are satisfied.

- The adviser was a competent professional with sufficient expertise to justify reliance.
- The taxpayer provided necessary and accurate information to the adviser.
- The taxpayer actually relied in good faith on the adviser's advice.

The Tax Court found that the partners met all of these requirements, and no penalty was appropriate.

Holding. The court held that the IRS was correct in asserting that the distributive share amounts each member received in excess of their guaranteed payments was subject to SE tax. The court also held that the funds in the trust account do not constitute taxable income to the members. In addition, the members are not liable for accuracy-related penalties.

PASSIVE ACTIVITIES

Real Estate Activities

***Patricia Windham v. Comm'r,* TC Memo 2017-68 (Apr. 24, 2017)**
IRC §§67, 162, 212, 274, 469, 6662, and 6664

☞ Stockbroker Qualifies as Real Estate Professional

Facts. Patricia Windham was a stockbroker for 30 years. While employed at Wells Fargo, she managed a number of individual accounts with total assets of approximately $70 million. Ms. Windham typically worked at her Wells Fargo office from 12:30 in the afternoon until the markets closed each weekday at 3:00 in the afternoon. Her compensation consisted of commissions and a small quarterly "trail" on the investments within customer accounts.

The only reason Ms. Windham was required to be in her office while markets were open was to provide service to her clients who preferred to actively trade stocks. Frequently, after the markets closed, Ms. Windham would remain in her office until 4:30 p.m. to do volunteer charity work. She did not work during the nine days during the year markets were closed. Ms. Windham had one administrative assistant to whom she paid a bonus in 2010.

Ms. Windham frequently met with brokerage clients during business lunches and dinners. Wells Fargo reimbursed her $500 annually for expenses related to client meals and entertainment. The amount she paid for meals and entertainment was $9,688 for 2010, for which she had receipts. Most of the receipts included the name of the individual or client entertained, but the receipts did not include any indication of business purpose. There were some duplicates and several were illegible.

In addition to her stock brokerage activity, Ms. Windham owned 12 rental properties and a half-interest in a vacant lot, which she administered from her home office in the morning before heading to her Wells Fargo office. She conducted her real estate activities under Windham, LLC, a Florida limited liability company, but the properties were in her name. Her rental real estate activity included vetting tenants, collecting rent, and evicting tenants. Ms. Windham also negotiated with contractors, hired them, and supervised their work on the properties. She maintained records on each property and completed the required documents her CPA needed for tax return preparation.

[68] *Neonatology Associates, P.A. v. Comm'r,* 115 TC 5 (Jul. 31, 2000).

During 2010, Ms. Windham considered selling some of her properties and showed them to potential buyers. She kept records of the approximate hours spent on work associated with each individual property during 2010. The total number of hours for all properties was 901.25, with the time expended on each individual property ranging from zero to 107.5 hours. The three properties on which she expended the most time were the Via de Luna property (107.5 hours), the Bayshore property (104.5 hours), and the Port Royal property (103 hours). Ms. Windham expended less than 100 hours on all other properties, including 12 hours spent on the vacant lot. A total of 889.25 hours (901.25 hours – 12 hours) was spent on all properties other than the vacant lot.

Ms. Windham withdrew approximately $182,000 from retirement accounts to pay rental real estate expenses. She duly reported the taxable amount of the retirement account withdrawals on her 2010 return.

Ms. Windham paid a CPA to prepare her 2010 return. Her 2010 return showed wage income of $285,437 from Wells Fargo and $182,000 of retirement account distributions. The return also included a Schedule C, *Profit or Loss From Business,* for the real estate rental activity. The Schedule C showed gross income of $103,629 and expenses of $411,562, which resulted in a loss of $307,933. Ms. Windham attached to her return a document providing a breakdown of the gross income amounts by property, but she did not elect to treat all properties as a single activity. She claimed the rental loss against her wage income.

Ms. Windham also claimed approximately $50,000 of unreimbursed employee business expenses on Schedule A, *Itemized Deductions.* The expenses consisted of meals and entertainment expenses, vehicle expenses, an employee bonus expense, cell phone expenses, and other business expenses.

Ms. Windham received a notice of deficiency from the IRS indicating her real estate activities were passive. This precluded her from claiming the real estate loss against her wage income. The IRS moved the reporting of the real estate activity from Schedule C to Schedule E, *Supplemental Income and Loss*. The IRS also included an accuracy-related penalty.

Issues. The issues in the case are the following.

- Whether Ms. Windham was a qualified real estate professional in 2010
- Whether Ms. Windham's approximately $50,000 of unreimbursed employee business expenses was deductible on her Schedule A
- Whether Ms. Windham was liable for the accuracy-related penalty

Analysis. A passive activity is any trade or business in which the taxpayer does not materially participate. Real estate rental activities are considered per se passive. However, if the taxpayer proves they qualify as a real estate professional, their real estate rental activities will not be considered per se passive. In order to qualify as a real estate professional under IRC §469(c)(7)(B), the taxpayer must meet both of the following conditions.

- More than half of the personal services performed in trades or businesses by the taxpayer during the year must be performed in real estate trades or businesses in which the taxpayer materially participates.
- The taxpayer must expend more than 750 hours during the year in real estate trades or businesses in which they materially participate.

To determine whether Ms. Windham materially participated in her real estate activities, each real estate interest is viewed separately in the absence of an election to treat the properties as a single activity. There are seven material participation tests under Temp. Treas. Reg. §1.469-5T. Under Temp. Treas. Reg. §1.469-5T(a)(3), an individual may be treated as a material participant if they expend more than 100 hours on an activity. Ms. Windham expended more than 100 hours each on the Via de Luna, Bayshore, and Port Royal properties; therefore, her activity constitutes material participation.

Under Temp. Treas. Reg. §1.469-5T(a)(2), a taxpayer may be treated as a material participant if their participation constitutes substantially all of the participation on the property. For all of the properties (other than the Via de Luna, Bayshore, and Port Royal properties), her participation was more than that of anyone else. Ms. Windham handled all aspects of the business, and no contractor expended more time on any property than Ms. Windham. Ms. Windham is a material participant because her activity constitutes substantially all of the participation on each of these properties.

With respect to the vacant lot in which Ms. Windham owns 50%, there were no details regarding the degree of participation of the other owner.

Ms. Windham worked 577.5 hours during 2010 as a stockbroker. She spent 889.25 hours during 2010 on real estate rental activities in which she materially participated. The IRS argued she should include the time expended for her meals and entertainment with stockbroker clients. However, even if all receipts submitted, at an average of 2.5 hours for each, were attributed to her stockbroker activity, Ms. Windham would still have spent more than half of her time on real estate activities in which she materially participated. Therefore, Ms. Windham meets the requirements to qualify as a real estate professional.

Ms. Windham's receipts for the unreimbursed employee business expenses were inadequate to substantiate most of her business expenses, other than a $3,550 bonus to her administrative assistant that was paid by check, some state licensing fees, and a $2,750 tax preparation fee (which she should have claimed as a miscellaneous deduction). However, the Tax Court applied the *Cohan* rule to allow one-third of the office supply expenses claimed.

Note. The *Cohan* rule used by the Tax Court allows the court to estimate allowable expenses for the taxpayer in situations in which the taxpayer cannot substantiate the amount of the deduction but there is other evidence that supports allowing at least some part of the deduction. However, the *Cohan* rule cannot be applied to deductions subject to the strict substantiation requirements of IRC §274 (relating to expenses for travel, meals and lodging, entertainment, gifts, or use of listed property including passenger automobiles). For further details on the *Cohan* rule, see *Cohan v. Comm'r,* 39 F.2d 540 (2d Cir. 1930).

While reliance on a professional may constitute good faith and reasonable cause for eliminating the liability for the accuracy-related penalty, paying a CPA to prepare a return does not constitute reliance on that CPA for advice. Ms. Windham's CPA was not called as a witness at trial, and she provided no evidence to corroborate her testimony in regard to the CPA or to otherwise prove her CPA's credentials. She provided no evidence to prove she relied upon her CPA's advice for items reported on her return. Ms. Windham was therefore liable for the penalty.

Holding. The court held that Ms. Windham was a real estate professional in 2010. The court allowed deductions for some of the expenses that Ms. Windham was able to substantiate, estimated some expenses, and disallowed others. Ms. Windham was held liable for accuracy-related penalties.

Passive Activities

***Zane and Monika Penley v. Comm'r,* TC Memo 2017-65 (Apr. 17, 2017)**

IRC §§469 and 6662

☞ Tax Court Rejects Exaggerated Records to Show Real Estate Professional Qualification

Facts. During 2012, Zane Penley worked for HSS, Inc. (HSS) as a full-time sterilization technician and sales account representative. His employment duties, including local and state-wide travel throughout Colorado, required at least 2,194 hours during 2012.

Mr. Penley was also actively engaged as a Colorado licensed real estate broker and had an active business marketing properties for clients. He and his spouse, Monika, owned two residential rental properties through HHI, an S corporation, in which each spouse had a 50% interest. The spouses spent time finding tenants, managing HHI's finances, and making repairs to the two properties.

The Penleys served as real estate advisor to client Betty Lou St. Clair. They advised Ms. St. Clair to purchase a duplex on Sterne Circle in Littleton, Colorado. Ms. St. Clair planned to live in the rear unit and rent the front unit to a tenant. Before Ms. St. Clair's purchase, it was not possible to inspect the rear unit because it was occupied by unauthorized tenants. Ms. St. Clair purchased the property in August 2011 and financed the purchase with a mortgage. When the rear unit was finally inspected, it was found to be unsuitable for Ms. St. Clair's residence. It was filthy and required substantial flooring, electrical, and plumbing work. Ms. St. Clair found alternate living space and remained liable on her mortgage.

Regardless of any legal obligation that may have existed to Ms. St. Clair, the Penleys decided to provide Ms. St. Clair with some assistance in order to protect their reputation as realtors. They felt the rear unit could be rehabilitated. Through HHI, they leased the front unit and, during 2012, spent significant time repairing the rear unit, completing substantially all of the work themselves.

From April through August 2012, the Penleys also spent time performing due diligence associated with the possible purchase of Evergreen Park, a trailer home park that was about an hour's drive from their home. They purchased Evergreen Park in August 2012 and subsequently made several trips to make improvements to it.

The Penleys used a tax preparer to complete their 2010–2012 returns. HHI's 2012 Form 1120S, *U.S. Income Tax Return for an S Corporation,* reported a nonpassive ordinary business loss of $96,354. The return showed no passive losses from real estate activities. The nonpassive loss flowed through to the Penleys in accordance with their 50/50 interests. The spouses' personal return reported the pass-through loss and showed zero taxable income. The characterization of the loss was based on Mr. Penley qualifying as a real estate professional.

After examining the Penleys' returns for 2010 through 2012, the IRS determined $56,863 of the reported nonpassive loss was a passive loss from real estate activities. After other adjustments, the passive loss deduction was entirely disallowed. The IRS further determined that Mr. Penley did not qualify as a real estate professional and imposed an accuracy-related penalty.

Issues. The issues are whether Mr. Penley qualified as a real estate professional for 2012 and whether the Penleys are liable for accuracy-related penalties.

Analysis. Generally, under IRC §469(c)(2), real estate rental activities are per se passive, regardless of whether the taxpayer materially participates. However, if the taxpayer qualifies as a real estate professional, rental losses may be treated as nonpassive and may be used to offset other nonpassive income, as long as the taxpayer materially participates. Under §469(c)(7)(B), a taxpayer may qualify as a real estate professional if:

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

If the previous requirements are met, the "per se passive" rule for real estate rental activities does not apply and the real estate professional's rental activities are subject to the material participation requirements of §469(c)(1). While either spouse may meet these requirements in order to characterize a real estate loss as nonpassive, the Penleys do not contend that Mrs. Penley meets these requirements. Only Mr. Penley's status as a real estate professional is an issue.

A taxpayer may use any reasonable means to prove the extent of participation in real estate activity. Appointment books, calendars, or other narrative summaries may be used, but a post-event approximation is not sufficient. Mr. Penley's calendar indicated the property where he worked on a particular day with a brief description of the work performed and an estimate of the number of hours worked. It also indicated the number of miles driven to and from properties. However, the calendar greatly exaggerated the time spent on real estate activities. Mr. Penley claimed to have worked on real estate activities 10 to 14 hours each Saturday and Sunday and 4 to 6 hours most weekdays. Mr. Penley claimed to have worked a total of 2,520 hours on real estate activities during 2012. However, he worked full time for HSS. The hours he claimed he worked on real estate activities, added to the 2,194 hours worked for HSS, means Mr. Penley worked a total of 4,714 hours in 2012, averaging 12.88 hours per day throughout the year. The Tax Court refused to "naively accept" this claim.

Further, the calendar time entries were rounded to the nearest half-hour, did not specify start or end times for the work, and included driving time without separating out time for breaks or meals. In addition, large blocks of time logged in the calendar were corroborated only with brief emails, evidence of a phone call, or a hardware store purchase. Mr. Penley's substantiation was not credible.

The accuracy-related penalty is applicable to understatements of tax due to the taxpayer's negligence. Negligence includes failure to keep adequate books and records needed to substantiate items properly. In addition to being negligent in this regard, Mr. Penley's reliance on a tax preparer is insufficient to show reasonable cause and good faith, because the preparer completed the return based on the information the Penleys provided.

Holding. The court held that Mr. Penley failed to substantiate his claim that he met the requirements to qualify as a real estate professional; therefore, he does not qualify as a real estate professional for 2012. The court also held that the Penleys are liable for the accuracy-related penalty.

Passive Rental Income

***Alvin and Chanee Jones v. Comm'r,* TC Summ. Op. 2017-6 (Feb. 7, 2017)**
IRC §469

☞ Taxpayer Denied Passive Loss Deduction

Facts. Alvin Jones owned and operated Georgia First Insurance, LLC, through which he sold policies for American Family Insurance. In addition to his managerial duties, Mr. Jones was responsible for taking pictures of properties subject to insurance policies underwritten by Georgia First. Georgia First paid Mr. Jones for 520 hours worked in 2011 and for 173 hours in 2012. These hours did not necessarily reflect the total hours Mr. Jones spent working in connection with the business.

Mr. Jones owned 10 rental real estate properties in 2011 and 11 rental properties in 2012. The properties were single-family homes, three of which were located in Texas and the remainder in Georgia. At least nine of the properties were Section 8 housing. The requirements for Section 8 housing placed substantial time demands on Mr. Jones. He was primarily responsible for managing and maintaining the rental properties, which included the following activities.

- Conducting annual inspections
- Reviewing tenant qualifications
- Meeting with prospective tenants

- Corresponding with tenants
- Negotiating and preparing leases
- Purchasing supplies for repairs
- Meeting with contractors
- Overseeing repairs
- Making repairs personally
- Paying various bills
- Collecting rent due from tenants

Mr. Jones maintained contemporaneous logs of the time he spent working with his rental properties. According to his logs, Mr. Jones spent 951 hours performing services for the rental properties in 2011 and 1,040 hours in 2012. Some of these hours were attributable to his wife, Chanee Jones.

The Joneses reported net losses in 2011 of $32,790 and $54,959 in 2012 on their jointly filed tax returns. The IRS sent the Joneses a notice of deficiency, denying the rental losses because the Joneses did not meet the requirements of IRC §469(c)(7).

Issue. The issue is whether the Joneses are entitled to deduct passive losses from their rental real estate activity.

Analysis. Generally, §469(a) disallows deductions for passive activity losses (PALs). A PAL is the excess of passive losses over passive income in a tax year. A passive activity is any trade or business in which the taxpayer does not materially participate.

Rental income is considered per se passive regardless of a taxpayer's material participation.[69] However, there is an exception for real estate professionals. Rental real estate activity conducted as a trade or business or for the production of income is not considered a passive activity if the taxpayer materially participates.

The disagreement between the IRS and the Joneses pertained to the number of hours Mr. Jones spent working at Georgia First and the hours he spent working at his rental properties. To be considered a real estate professional, Mr. Jones must establish that he worked more hours at his rental properties than at Georgia First. Mr. Jones kept a contemporaneous log of the time he spent on his rental activities, but he did not keep an accurate log of the time he spent working for Georgia First. His work at the insurance company did not require Mr. Jones to be present, and he hired a manager to conduct office business in his absence. However, Mr. Jones was unable to produce any evidence or estimate of how many hours he performed services for Georgia First. He acknowledged the payroll records for Georgia First did not reflect the actual time he spent performing services for the company. Therefore, Mr. Jones did not prove that he spent more hours performing services for his rental activities than he did working for Georgia First.

Holding. The Tax Court held that the IRS correctly disallowed the deduction for rental real estate losses. Mr. Jones did not qualify as a real estate professional because he did not prove that he spent more time performing services for the rental activity than he did for Georgia First.

69. IRC §469(c)(2).

Passive Income

***Stephen and Angela Hardy v. Comm'r,* TC Memo 2017-16 (Jan. 17, 2017)**
IRC §§162, 212, 469, and 6662

☞ Doctor's Interest in Surgery Center is Passive Activity

Facts. Dr. Stephen Hardy is a plastic surgeon who performs procedures in multiple facilities. In 2001, Dr. Hardy and his wife considered opening their own surgery center for cost efficiency and greater scheduling latitude. Before they started construction on their own center, Missoula Bone & Joint Surgery Center (MBJ) and two other surgery centers contacted Dr. Hardy about becoming a member of their center. The Hardys decided it would be a wiser decision to join an already operational surgery center rather than incurring the expenses to construct and operate their own facility.

MBJ was a limited liability company formed by a group of physicians in 2004. It is treated as a partnership for federal tax purposes. MBJ operated a surgery center that was equipped for the physicians to perform procedures that require local or general anesthesia without overnight stays. In 2006, Dr. Hardy purchased a 12.5% interest in MBJ. Dr. Hardy does not manage MBJ, has no day-to-day responsibilities, has no input in management decisions, and is not involved in making personnel decisions.

Walter Kero, CPA, has prepared the Hardys' tax returns since 2004. He has over 40 years of experience. Mr. Kero relied on the Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, from MBJ to determine if the Hardys' income from MBJ was passive or nonpassive. The Schedule K-1 showed income from a trade or business and included self-employment tax. For 2006 and 2007, he determined the MBJ income was nonpassive. Mr. Kero did not group Dr. Hardy's MBJ interest with Dr. Hardy's medical practice. The Hardys reported the following amounts on their 2006–2007 Forms 1040, *U.S. Individual Income Tax Return.*

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Year	Nonpassive Income	Unallowed Losses
2006	$279,988	$ 58,786
2007	199,121	119,615

In 2008, Mr. Kero went through a checklist of passive activity criteria and analyzed Dr. Hardy's relationship with MBJ. He consequently determined the MBJ income was passive and reported it accordingly on the Hardys' return. Mr. Kero did not believe the change from nonpassive to passive income was material and did not amend the Hardys' 2006 or 2007 return.

The Hardys reported the following amounts on their Forms 1040 for 2008–2010.

Year	Passive Income	Allowable Loss Reported	Suspended Loss	SE Tax
2008	$250,494	$250,494	$ 5,917	$26,745
2009	245,012	104,224	26,530	
2010	270,521	157,187		

The IRS issued a notice of deficiency for 2008 through 2010. For each year, the IRS disallowed the passive activity loss (PAL) deduction. Additionally, the IRS imposed an IRC §6662(a) accuracy-related penalty.

Issues. The issues are as follows.

- Whether Dr. Hardy's income from MBJ was passive income
- Whether Dr. Hardy can use passive activity loss carryovers from prior years to offset his MBJ income
- Whether the Hardys are liable for §6662 accuracy-related penalties

Analysis. IRC §469 generally disallows PAL deductions. In general, a passive activity is any trade or business in which the taxpayer does not materially participate. Material participation is involvement in the activity on a regular, continuous, and substantial basis. A PAL that is disallowed in one year is carried forward to future years. The court determined that Dr. Hardy's participation in MBJ did not meet the test for material participation.

Regulations provide that multiple activities can be grouped together into a single activity if the activities constitute an appropriate economic unit. Whether activities constitute an **appropriate economic unit** depends on the facts and circumstances.

The IRS asserted that the Hardys grouped Dr. Hardy's medical practice with his MBJ interest because they previously reported the MBJ income as nonpassive. However, the Hardys never explicitly grouped the activities together and they were not required to do so. The court stated that grouping the activities together was not supported by the evidence. Merely reporting the income as passive did not prove the Hardys intended to group MBJ with Dr. Hardy's medical practice. Additionally, Mr. Kero explained that he did not group the activities and that he applied his expertise and experience when he determined that the MBJ income was nonpassive. Mr. Kero claims he did not consider the grouping rules under Treas. Reg. §1.469-4(c)(2) and the court believed his claim. The court noted that the Hardys did not regroup the activities in 2008 when they began reporting the MBJ income as passive. This further proved that they viewed the activities as separate economic units.

The IRS can regroup a taxpayer's activities if any of the activities resulting from the taxpayer's grouping is not an appropriate economic unit and a principal purpose of the grouping is to circumvent the PAL rules. The Hardys argued that the two activities are unrelated; MBJ is a rental surgical facility and Dr. Hardy's practice is an active medical practice. The two activities do not share any building space, employees, billing functions, or accounting services. Dr. Hardy receives distributions from MBJ regardless of whether he performs any surgeries in its facility. He does not receive income from his medical practice if he does not perform any surgeries. The activities are unrelated, and the court ruled that the activities may be treated as separate economic units.

After determining that the Hardys may report the MBJ income as passive for the years at issue, the court must decide if the Hardys can use PALs from prior years. Because MBJ income was found to be passive, the nonpassive income amounts reported on the 2006 and 2007 tax returns were incorrect. If the income had been reported as passive in those years, the MBJ income would have fully absorbed the PALs and there would be no passive loss carryforward to 2008. The court held that the Hardys were not entitled to the entire PAL deduction claimed.

The Hardys argued that they overpaid self-employment taxes for 2008 and 2009. Generally, a partner must include any distributive share of partnership income in calculating their net earnings from self-employment.[70] IRC §1402(a)(13) provides an exclusion for the distributive share of limited partners, other than guaranteed payments. The IRS argued that Dr. Hardy is not a limited partner because he performed surgeries at MBJ. The court disagreed and held that Dr. Hardy was a limited partner because he received his distributive share in his role as an investor. Therefore, the income is not subject to self-employment tax.

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70. IRC §702(a)(8).

IRC §6662 imposes a 20% accuracy-related penalty on underpayments of tax from negligence, disregard of rules or regulations, or a substantial understatement of income tax. The IRS did not provide evidence that any of the Hardys' underpayment of tax was from a failure to make a reasonable attempt to comply with the Code, lack of due care, failure to do what a reasonable and ordinarily prudent person would do, or failure to maintain sufficient records. The Hardys relied on the advice of a tax preparer with more than 40 years of experience. Mr. Kero was a competent professional, and the Hardys provided him with all necessary and accurate records.

Holding. The court held that the Hardys can treat their MBJ income as passive income. However, the Hardys do not have PAL carryovers available to offset the passive income. Additionally, the Hardys overpaid their self-employment tax. They were not liable for an accuracy-related penalty attributable to the PAL carryover because the IRS did not meet the burden of proof for negligence.

RETIREMENT

Retirement Distributions

***John and Susan Trimmer v. Comm'r,* 148 TC No. 14 (Apr. 20, 2017)**
IRC §402

☞ Major Depression Constitutes Disability under Rollover Hardship Waiver Rules

Facts. John Trimmer worked as a police officer with the New York Police Department for 20 years before retiring at age 47. Prior to retiring, he obtained a new job as a security guard at the New York Stock Exchange to supplement his pension and pay for education costs for his two sons, but this job fell through after he retired.

Three weeks after retirement, Mr. Trimmer began experiencing symptoms of major depressive disorder. His behavior drastically departed from his previous behavior when he was working. Mr. Trimmer became antisocial, irritable, and uncommunicative with his wife and two sons. He rarely left the house, had trouble sleeping, and lost weight, while neglecting his hygiene and grooming. Mr. Trimmer stopped coaching his sons' sporting events and attending their school events, which he previously attended without fail. Marital and financial tensions surfaced. His wife, Susan, concluded that she could no longer depend on him to carry out tasks that he traditionally performed and felt she needed to monitor him and assist him because of his depressive behavior.

During 2011, after his major depression began, Mr. Trimmer received retirement account distribution checks of $99,990 and $1,680. These two checks remained on his dresser at home for over a month until Mr. Trimmer deposited them to a joint bank account held with Mrs. Trimmer. Mr. Trimmer issued some checks after his wife's request to do so.

In early 2012, Mr. Trimmer received Forms 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* regarding the two retirement account distributions. He gave these to the tax preparer who noted the distribution code of "1," which indicated an early distribution with no known exception. The tax preparer advised Mr. Trimmer to deposit the distribution amounts into an IRA. On April 16, 2012, in accordance with the tax preparer's advice, Mr. Trimmer opened an IRA at the same bank where he deposited the two distribution checks and rolled the funds over into the new IRA. The two distributions were reported as nontaxable when the Trimmers filed their tax return.

On December 16, 2013, the IRS sent the Trimmers a CP2000 notice asserting that they failed to report the taxable income from the retirement distributions. The CP2000 showed additional tax of $39,963, including the 10% penalty under IRC §72(t). Mr. Trimmer responded with a letter that attempted to tell his story of depression and the financial hardship that the payment of the additional taxes would cause to his family. The IRS sent a letter to the Trimmers denying the request for relief. The IRS denial explained the 60-day time limit for an IRA rollover in order to ensure the distribution amount is not taxable. The letter did not mention the IRS's authority to grant a hardship waiver or any procedure for applying for one and did not acknowledge the hardship-type circumstances in Mr. Trimmer's letter.

On August 18, 2014, the IRS issued a notice of deficiency reflecting the changes proposed in the CP2000 notice. The Trimmers petitioned the Tax Court for relief.

Issue. Although several issues were raised in this case, the following analysis focuses on whether the Trimmers qualify for the hardship waiver.

Analysis. The Trimmers argued that Mr. Trimmer qualified for a hardship waiver under IRC §402(c)(3)(B) because his failure to meet the 60-day rollover deadline was due to his major depressive disorder. The IRS countered that the hardship waiver was inapplicable to the Trimmers because they did not apply for one under the terms of Rev. Proc. 2003-16. Moreover, the IRS argued that while Rev. Proc. 2016-47 provides a self-certification procedure that taxpayers may use to claim a hardship exemption for 11 different reasons, this procedure did not exist for the 2011 tax year. Therefore, the examination division did not have the authority to determine whether Mr. Trimmer qualified for the waiver.

Even though Rev. Proc. 2016-47 did not exist when the Trimmer's 2011 return was under examination, there was no language in Rev. Proc. 2003-16 (which was in effect at the time of examination) that limited the examination division's ability to consider a waiver during the course of an examination. In fact, the IRS's argument is in conflict with IRM 4.10.7.4(2), which states examiners have the authority to recommend the proper disposition of all identified issues, as well as any issues raised by the taxpayer. In addition, Mr. Trimmer's letter, outlining his hardship, clearly indicated that he was seeking a hardship waiver.

The IRS cited several Tax Court cases denying relief from failure to adhere to the 60-day time limit. However, all of these cases are distinguishable from the Trimmers' case because Mr. Trimmer's letter constitutes a request for administrative relief, which did not exist in any of the other cases cited by the IRS.

IRC §402(c)(3)(B) indicates that the IRS may waive the 60-day rollover requirement when failure to do so would be against equity or good conscience. This includes casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement. The Tax Court concluded it should interpret "equity or good conscience" to reflect a broad and flexible concept of fairness.

The Trimmers did not use or profit from the retention of the funds received from the distributions while they had the money in their joint account. In addition, the evidence indicates that Mr. Trimmer's major depression disorder constituted a disability under IRC §402(c)(3)(B). Moreover, Mr. Trimmer completed the rollover shortly after being advised to do so by the tax preparer. Even though Mr. Trimmer did write some checks at his wife's request, the Tax Court did not believe he was capable of carrying out the more involved task of identifying another retirement plan in which to roll over the distributions. In fact, the distribution checks remained on Mr. Trimmer's dresser for over a month, which attested to his difficulty with more involved tasks.

Holding. The court held that the Trimmers qualify for a hardship waiver.

Gross Income

***Kent E. Keeter v. Comm'r*, TC Summ. Op. 2017-36 (May 30, 2017)**

IRC §§61, 104, and 7430

☞ Veteran's Disability Retirement Income is Excludable From Gross Income

Facts. In January 1984, Kent Keeter began his service in the U.S. Army. Shortly afterwards, he sustained a head injury while in boot camp training that required a hospital stay and led to a seizure disorder. Mr. Keeter was eventually placed on permanent disability, and he retired in July 1985 with an honorable discharge. Around the time of his discharge, Mr. Keeter met with Veterans' Affairs (VA) representatives and understood at that time that he would qualify for disability benefits from the VA. However, he did not apply for such benefits.

After his discharge, Mr. Keeter continued the college education he began before enlistment and graduated with a degree in computer science. Since graduation, he has worked in the computer science field.

In 2012, Mr. Keeter received disability retirement income of $5,936 from the Army. He did not report this income on his tax return. The IRS sought to include this amount in Mr. Keeter's gross income. On two prior occasions, Mr. Keeter received notices from the IRS that his Army disability retirement income must be included in his gross income. On both of these occasions, Mr. Keeter filed a petition with the Tax Court, and the IRS subsequently agreed that the amount should be excluded. The Tax Court entered judgments in Mr. Keeter's favor that reflected the IRS agreement.

Issue. The issue is whether Mr. Keeter's Army disability retirement income is excludable from gross income.

Analysis. Generally, pensions and retirement income, including military retirement income, are included in gross income unless specifically excluded by law. An exclusion may be available for amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces. Under IRC §104(b)(1)(D), if Mr. Keeter was entitled to receive disability compensation from the VA, he is entitled to exclude the military disability retirement income he received in 2012.

The military and VA apply the same disability standards and rules. However, the military uses these standards to determine the appropriate compensation for military career interruption, whereas the VA uses them to assess the service member's ability to engage in civilian employment. The IRS contended that the court should apply the VA standard to Mr. Keeter. Because Mr. Keeter had a career in computers after he was honorably discharged, he would be ineligible. The court instead reviewed the case based on the information Mr. Keeter had at the time, which was that he would qualify for VA benefits.

Holding. The court held that Mr. Keeter's disability retirement income is excludable from his 2012 gross income.

IRA Distributions

***Suzanne D. Oster Ozimkoski v. Comm'r*, TC Memo 2016-228 (Dec. 19, 2016)**

IRC §§72(t), 408, 6651, 6662, and 7491

☞ Widow Liable for Early Distribution Penalties from Incorrect Rollover

Facts. Thomas Ozimkoski, Sr., died in August 2006. Before his death, he executed a simple will that left almost all his property to his wife, Suzanne Ozimkoski, and named her as the personal representative of the estate. At the time of his death, Mr. Ozimkoski, Sr., owned a traditional individual retirement arrangement (IRA) with Wachovia Securities.

Mr. Ozimkoski, Sr., had a grown son, Mr. Ozimkoski, Jr., who was Mrs. Ozimkoski's stepson. Mr. Ozimkoski, Jr., filed two petitions with the probate court: one to revoke his father's will and one for declaratory relief. When Mr. Ozimkoski, Jr., filed the petitions, Wachovia froze the IRA pending the outcome of the litigation.

In March 2008, Mrs. Ozimkoski and Mr. Ozimkoski, Jr., reached a settlement. Under the agreement, Mrs. Ozimkoski was to pay her stepson $110,000 and transfer title of a Harley Davidson motorcycle to him.

Mr. Ozimkoski, Jr., contacted a manager at Wachovia. He informed Wachovia he did not want an inherited IRA. The manager relayed this information to Mrs. Ozimkoski's attorney with the caveat that Wachovia could not honor a line in the certified court agreement that all payments would be free of tax.

On July 2, 2008, Wachovia transferred $235,495 from Mr. Ozimkoski, Sr.'s IRA to Mrs. Ozimkoski's traditional IRA. On July 14, 2008, Mrs. Ozimkoski received a distribution from her IRA of $141,997. The next day, she wrote a personal check to Mr. Ozimkoski, Jr., for $110,000. Later in 2008, she received additional IRA distributions, bringing her total distributions for 2008 to $174,597.

In 2009, Wachovia issued Mrs. Ozimkoski a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* A code on the Form 1099-R indicated the distributions were early distributions with no known exception because Mrs. Ozimkoski had not reached the age of 59½ in 2008.

On May 9, 2009, Ms. Ozimkoski filed her Form 1040, *U.S. Individual Income Tax Return.* She did not report any of the IRA distributions as income on her 2008 tax return.

On November 22, 2010, the IRS issued Mrs. Ozimkoski a notice of deficiency for the 2008 tax year. The deficiency included the following.

- IRC §72(t) additional tax of $17,460 for early withdrawal from a retirement account
- IRC §6651(a)(1) addition to tax of $3,100 for failure to timely file an income tax return
- IRC §6662(a) accuracy-related penalty of $12,437 for a substantial understatement of income tax

Issues. The issues are the following.

- Whether the distributions from Mrs. Ozimkoski's IRA are taxable income to her
- Whether Mrs. Ozimkoski's distributions are subject to the additional 10% tax under IRC §72(t)
- Whether Mrs. Ozimkoski is liable for the IRC §6651(a)(1) addition to tax
- Whether Mrs. Ozimkoski is liable for an IRC §6662(a) accuracy-related penalty

Analysis. Unless an exception exists, any amount paid or distributed out of an IRA must be included in the gross income of the payee or the distributee.[71] An IRA owner can designate beneficiaries to receive funds from the IRA if the owner dies before all the funds are distributed. However, there is no exception from inclusion in gross income for distributions made after the owner's death. Therefore, the distributions to the beneficiaries after the owner's death are taxable.

Wachovia transferred $235,495 from Mr. Ozimkoski, Sr.'s IRA into Mrs. Ozimkoski's IRA. She then received distributions of $174,597 from her IRA. Mrs. Ozimkoski argued that the distributions should not have been included in her gross income because her stepson was entitled to $110,000 of Mr. Ozimkoski, Sr.'s IRA. The IRS countered that the distributions were taxable to Mrs. Ozimkoski because they came out of her IRA.

Generally, an IRA payable to a specific beneficiary is not considered a probate asset and is not included in the probate estate. Mrs. Ozimkoski was a Florida resident during the relevant period of the proceedings. Under Florida law, if Mr. Ozimkoski, Sr., had named his son as beneficiary, the funds would have been paid to the trustee and distributed according to the terms of the IRA.

71. IRC §408(d)(1).

Under Florida law, Wachovia should have transferred the funds from Mr. Ozimkoski, Sr.'s IRA to his estate either because it was named as the beneficiary or because no beneficiary was named and the settlement agreement did not direct the disposition of the IRA. Although Wachovia incorrectly rolled over the funds into Mrs. Ozimkoski's IRA, the court could not unwind the transaction and must determine how much tax Mrs. Ozimkoski owed on the transfer and subsequent distributions from her IRA.

It was unclear how much advice Mrs. Ozimkoski received about her liabilities from the IRA transaction. It was clear in the court record, however, that the probate attorney did not counsel Mrs. Ozimkoski on the full ramifications of paying Mr. Ozimkoski, Jr., from her own IRA. Despite poor advice, the distributions did come out of Mrs. Ozimkoski's IRA and are taxable income to her.

IRC §72(t)(1) provides for a 10% additional tax on distributions from an IRA before the IRA owner reaches age 59½ unless an exception exists. Distributions to a beneficiary are an exception to the 10% additional tax. A beneficiary who rolls over the funds into their account from the deceased taxpayer's IRA and later withdraws the money from their personal IRA loses the entitlement to claim the exception under §72(t)(2)(A)(ii). Funds transferred into a beneficiary's account become their personal funds. Wachovia transferred $235,495 from Mr. Ozimkoski, Sr.'s IRA into Mrs. Ozimkoski's IRA. The funds were then considered owned by Mrs. Ozimkoski. The distributions from Mrs. Ozimkoski's IRA to Mr. Ozimkoski, Jr., were therefore not protected from the 10% additional tax.

IRC §6651(a)(1) imposes a penalty for failure to timely file an income tax return unless the failure is due to reasonable cause and not willful neglect. The penalty is 5% of the tax shown on the delinquent tax return for each month or fraction of a month the return is delinquent, up to a maximum penalty of 25% for a return more than four months delinquent. Mrs. Ozimkoski filed her income tax return on May 9, 2009, 24 days after the filing due date. She was unable to show she had reasonable cause for the delay. Mrs. Ozimkoski claimed she was overwhelmed by the contested will and this caused her filing delay. The court noted that litigation is not a reasonable cause for filing a return late. Therefore, Mrs. Ozimkoski is liable for the additional §6651(a)(1) penalty.

The IRS imposes a 20% penalty on a substantial underpayment of income tax attributable to a substantial understatement of income tax. A "substantial understatement" exists when the understatement for the tax year exceeds the greater of 10% of the tax required to be shown on the return or $5,000. The penalty is not imposed on any portion of the underpayment if a taxpayer can show they acted with reasonable cause and in good faith. The determination of whether the taxpayer acted with reasonable cause and good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. An honest misunderstanding of fact or law in light of all the facts and circumstances, including the experience, knowledge, and education of a taxpayer may indicate reasonable cause and good faith.[72] The court held that because Wachovia incorrectly transferred Mr. Ozimkoski's IRA balance to Mrs. Ozimkoski instead of to Mr. Ozimkoski, Jr., Mrs. Ozimkoski acted in good faith regarding the $110,000 in light of all the circumstances. Therefore, Mrs. Ozimkoski was not liable for the 20% penalty for failing to include the $110,000 in her taxable income. However, she took additional distributions from her IRA during the year that she also failed to report. The court held that she was liable for the 20% penalty on those amounts that she did not include in her taxable income.

Holding. The Tax Court held that Mrs. Ozimkoski's IRA distributions were taxable income to her. Mrs. Ozimkoski was also liable for an early distribution penalty under §72(t), a failure to timely file penalty under §6651, and an accuracy-related penalty under §6662.

72. Treas. Reg. §1.6664-4(b)(1).

S CORPORATION

S Corporation Basis

***Rupert and Sandra Phillips v. Comm'r,* TC Memo 2017-61 (Apr. 10, 2017)**
IRC §1366

☞ Actual Economic Outlay Required for Basis Increase

Facts. Olson & Associates of NW Florida, Inc. (Olson) was an S corporation that was established in 2001 and was dissolved in 2011. Carl Olson and Sandra Phillips each owned 50% of Olson's common stock. Olson developed and sold real estate and relied heavily on debt financing for its projects. To develop a project, Olson typically established a subsidiary entity to obtain the financing and develop the real estate. All of the loans the banks extended to Olson and the subsidiaries were fully collateralized with business property and were also guaranteed by Olson's two shareholders. No evidence exists that the shareholders pledged any personal assets or provided collateral to support their guarantees.

Starting in 2007, Olson's business began a dramatic decline, from which it never recovered, and it defaulted on virtually every loan. The banks sued for repayment, and foreclosed on business property, but the property values had significantly declined, which left insufficient collateral to satisfy the loans. The banks therefore sued the guarantors, seeking enforcement of the personal guarantees. This resulted in several final judgments amounting to approximately $105 million against the loan guarantors, including Mr. Olson and Mrs. Phillips. All co-guarantors were jointly and severally liable for each of the judgments.

Based on professional tax advice, Mrs. Phillips took the position that she was entitled to a basis increase in her shares because of the judgments. Her pro rata share of the judgments was used to determine the amount of deemed capital contributions and basis increase. Mrs. Phillips claimed basis increases of $1.6 million in 2008 and $30.1 million in 2009. Mrs. Phillips based this on a legal opinion that did not take a definitive position on the share basis increase, but indicated that a stepped-up stock basis "may be more probable" than an increase in debt basis. Mrs. Phillips opted for a share basis increase.

As a result of these share basis increases, Mr. and Mrs. Phillips filed an amended 2008 return and a timely 2009 return claiming substantial S corporation losses. The IRS examined the returns and concluded that Mrs. Phillips was not entitled to any basis increase from the loan judgments. The claims were denied and a notice of deficiency was sent to Mr. and Mrs. Phillips. Mrs. Phillips claimed she was entitled to the additional share basis, and, if not, then she was entitled to additional debt basis.

Issue. The issue is whether the loan judgments provide Mrs. Phillips with additional share basis or debt basis.

Analysis. Generally, an S corporation shareholder may claim losses only to the extent of stock and debt basis. Losses in excess of share or debt basis may not be claimed but are instead carried forward until basis is restored so that part or all of the loss may be claimed. The Code does not specify in detail how a debt basis may be obtained, but the Senate Finance Committee report accompanying the enactment of subchapter S indicated the shareholder's "investment in the corporation" should be the ceiling for losses flowing through to that shareholder. In order to claim increased share or debt basis, there must be an actual economic outlay by the shareholder.

Mrs. Phillips argued that the loan judgments resulted in an economic outlay, because lenders looked to her as a source of payment. These judgments led to liens against their real and personal property in Florida, despite the fact they have not actually paid any amounts toward the judgments. She relied primarily on *Selfe v. U.S.*,[73] which indicated that, while economic outlay is necessary to increase basis, it is not necessarily essential that the shareholder absolve a corporation's debt before increasing basis as guarantor. The shareholder may be entitled to a basis increase when facts demonstrate that, in substance, the shareholder has borrowed funds and subsequently advanced them to their corporation. Accordingly, Mrs. Phillips argued that the substance formed the basis for economic outlay and that substance should be looked to rather than the form of the transactions.

The Tax Court, however, disagreed that Mrs. Phillips's case was analogous to *Selfe.* It further disagreed with her use of this case to demonstrate that the substance of the transaction transcended its form to result in the necessary economic outlay required for basis. The Tax Court noted that, in Mrs. Phillips's case, the banks had no prior lending relationship with Mr. Olson or Mrs. Phillips before lending to Olson, there was no pledge of personal assets from them, and Olson was an established business with a good reputation with ample collateral at the time the loans were made. In addition, there was no evidence that the banks sought primarily to look to Mr. Olson and Mrs. Phillips for repayment of the loan.

Holding. The court held that Mrs. Phillips is not entitled to either share or debt basis increase because of the absence of any actual economic outlay from her to Olson.

Related Parties

***Steven and Pauline Petersen et al. v. Comm'r,* 148 TC No. 22 (Jun. 13, 2017)**
IRC §§267, 401, 446, 461, and 6662

☞ Related Party Rule Applies to S Corporations and ESOP Participants

Facts. Steven Petersen and his business partner, John Johnstun, were shareholders of Petersen, Inc., a closely held S corporation. Petersen, Inc. (Petersen) established an employee stock ownership plan (ESOP) for the benefit of its employees, and transferred Petersen stock and some cash into the ESOP. The S corporation uses the accrual method of accounting.

In 2009 and 2010, the corporation accrued wages, vacation pay, and related payroll items. Some of these expenses were not actually paid to the employees until the following year. The S corporation deducted the accrued amounts on its Forms 1120S, *U.S. Income Tax Return for an S Corporation.* In turn, as pass-through shareholders, Messrs. Petersen and Johnstun's personal returns reflected their pro-rata shares of the deducted accrued amounts for 2009 and 2010.

The IRS disallowed the deduction of accrued amounts attributable to the employees covered by the ESOP. It also disallowed the corresponding pass-through deductions on the personal returns for the Petersens and the Johnstuns. The IRS sent the Petersens and the Johnstuns notices of deficiency for additional tax due from the disallowance of the relevant deductions and imposed accuracy-related penalties.

Issues. The issues in this case are the following.

- Whether the S corporation and the employees participating in the ESOP are related parties under IRC §267
- Whether the Petersens and the Johnstuns are liable for accuracy-related penalties

73. *Selfe v. U.S.,* 778 F.2d 769 (11th Cir. 1985).

Analysis. Under IRC §461, an accrual basis taxpayer may generally deduct business expenses in the year in which all events have occurred that establish the fact of the liability, the amount of the liability is set, and economic performance with respect to the liability has occurred. However, when such expenses are owed to a **related cash basis taxpayer,** IRC §267 provides that the payor may deduct the expenses only for the tax year for which the amounts are includable in the payee's gross income.

The position of the IRS was that the ESOP was a "trust" under IRC §267(c)(1). Therefore, the trust beneficiaries are deemed to own their proportionate share of Petersen shares held by that trust. This stock ownership makes the ESOP participants and Petersen "related" under this Code provision.

IRC §267(e) deems S corporations and their shareholders to be "related persons" regardless of the amount of stock owned by each shareholder. IRC §267(c)(1) indicates that stock owned directly or indirectly by a corporation, partnership, estate, or **trust** is considered owned proportionately by its shareholders, partners, or beneficiaries. Therefore, if §267(c) makes the ESOP participants constructive owners of Petersen stock, those participants are related to Petersen under §267(e), which would preclude Petersen from deducting any accrued amounts until the participants include the amounts in income.

Based on the plain meaning of §267(c)(1) and the express terms of the ESOP documents (which included a plan agreement and a trust agreement and referred to itself as a "trust" and had a "trustee"), the ESOP stock was attributed to its participants. The ESOP easily qualified as a trust under regulations and common law definitions. Because the ESOP is a trust, §267(c)(1) deems the ESOP's Petersen stock to be held by the participating employees. Under §267(b), Petersen and the ESOP participants are related persons. Therefore, Petersen cannot deduct the accrued wage amounts that have not yet been included in the participants' incomes.

IRC §6662 imposes a 20% penalty on any underpayment of tax attributable to negligence or disregard of rules or any substantial understatement of income tax. No penalty is imposed for any portion of an understatement if the taxpayer acted with reasonable cause and good faith. The court found that the taxpayers made a good-faith effort to assess their tax liabilities properly. The application of §267(a) to employers and ESOP participants is a question of first impression in the court. The court declines to impose a penalty "where it appeared that the issue was one not previously considered by the Court and the statutory language was not entirely clear."[74]

Holding. The court held that Petersen, Inc. and the ESOP participants are related persons. Accordingly, Petersen Inc.'s deductions for the accrued but unpaid expenses must be deferred to the year in which the pay was received by the ESOP participants and includable in their gross income. While the IRS notices of deficiency are correct with respect to the tax liability, the Petersens and the Johnstuns are not liable for accuracy-related penalties.

[74] *Hitchins v. Comm'r,* 103 TC 711, 719-720 (1994).

S Corporation Losses

***Harvey Tucker v. Comm'r,* U.S. Court of Appeals, 11th Circuit; No. 16-11042 (Nov. 21, 2016)**

IRC §§165 and 6662

☞ Shareholder Denied Deduction Based on Worthlessness of S Corporation

Facts. Paragon Homes Corporation was a Florida S corporation in the business of real estate acquisition, development, and sales. Harvey Tucker was the president, director, and sole shareholder of Paragon. Paragon remained an active corporation until September 28, 2012. It had mortgages with several banks to purchase real property.

The housing market went into a sharp decline in 2007 and 2008. According to Mr. Tucker, Paragon was insolvent by the end of 2008. The company had no income or sales. Mr. Tucker testified that Paragon ceased operations at the end of 2008; it closed its office, dismissed its employees, and stopped paying mortgages, insurance premiums, and taxes. The company had slightly over $12,000 in its bank accounts at the end of 2008. At this point, Mr. Tucker deemed Paragon's real estate properties to be worthless. He claimed that at the end of 2008, he owed more than $2 million on the "underwater" properties.

In the summer of 2009, Mr. Tucker transferred over $1.38 million of personal funds to Paragon. He stated he was trying to use the company as a conduit to discharge liabilities and protect himself. He wanted to continue completing homes and selling homes under construction to pay off the outstanding mortgages and limit his personal losses.

Mr. Tucker did not consider the payments from his personal funds to be capital contributions. He claimed he was only trying to limit his losses, not save or protect Paragon.

Mr. Tucker and Paragon disposed of the following properties and mortgages.

- **Properties secured by mortgages from Platinum.** On October 27, 2008, Platinum filed a foreclosure lawsuit against Paragon and Mr. Tucker. A final judgment of foreclosure was entered in favor of Platinum on February 11, 2009. Paragon and Mr. Tucker were relieved of all liabilities on the property in exchange for $275,000. Mr. Tucker testified that he paid the settlement amount personally.

- **Properties secured by mortgages from BB&T.** On September 24, 2008, BB&T filed a foreclosure lawsuit against Paragon and Mr. Tucker. A final judgment of foreclosure was entered in favor of BB&T on March 4, 2009. Paragon and Mr. Tucker were relieved of all liabilities on the property, as well as Paragon's line of credit with BB&T, in exchange for $160,000. Mr. Tucker testified that he paid the settlement amount personally. However, Paragon's business account showed a $160,000 check drawn on September 4, 2009.

- **Properties secured by mortgages from Fidelity.** On May 12, 2009, Mr. Tucker, through Paragon, signed and filed a notice of commencement naming Paragon as the owner and contractor for a single-family residence to be built on Walden Reserve. During the fall of 2009, two of Paragon's other properties in Walden Reserve were sold, satisfying the properties' mortgage obligations. On March 1, 2010, Fidelity filed a foreclosure suit against Paragon and Mr. Tucker for 33 lots in Walden Reserve. A final judgment of foreclosure was entered in favor of Fidelity on February 23, 2011.

- **Properties secured by mortgages from Wachovia.** In September 2010, Wells Fargo Bank (formerly Wachovia) filed a foreclosure suit against Mr. Tucker and Paragon. On October 8, 2010, Paragon began development of one of the foreclosed lots. Mr. Tucker, through Paragon, signed and filed a notice of commencement that identified Paragon as the owner and contractor of the residence to be built on the land.

On November 30, 2009, Paragon had a balance in its bank account of $839,745. In December 2009, Mr. Tucker established the Harvey L. Tucker Family, LLLP, on the advice of his attorney. Mr. Tucker transferred $358,256 from Paragon's account to the LLLP. He also transferred over $400,000 from Paragon into his personal account to purchase a variable annuity life insurance policy to protect himself from banks and other creditors.

Paragon's 2008 tax return reported a loss of approximately $10.8 million. Approximately $8.9 million of the loss related to a write-down of Paragon's real estate inventory to current market value as of December 31, 2008. On his personal tax return, Mr. Tucker claimed a flow-through loss from Paragon of approximately $6.78 million. He reported a 2008 NOL of more than $6.7 million. He elected to carry the 2008 NOL back to 2003, 2004, 2005, 2006, and 2007. Based on the NOL carrybacks, Mr. Tucker sought a refund of almost $2 million for tax years 2003 through 2006.

The IRS conducted an audit and determined that Paragon's loss for 2008 should only have been $1.5 million. It then issued Mr. Tucker a notice of deficiency, disallowing the NOL carrybacks for 2004, 2005, and 2006.

The Tax Court looked at whether Paragon could deduct losses from properties becoming worthless or being abandoned to determine whether Mr. Tucker was eligible to take the NOL carrybacks. The general rule when real property is secured by a recourse obligation is that the taxpayer is not entitled to a loss deduction until the year of the foreclosure sale, regardless of abandonment or worthlessness. Because Mr. Tucker continued to attempt to sell the properties, construct homes, and settle claims with the bank in 2009 and 2010, the court held the properties were not abandoned or worthless. The Tax Court concluded that Mr. Tucker did not meet his burden of establishing the properties were worthless or abandoned by the end of 2008. The Tax Court also rejected Mr. Tucker's claims that Paragon could not pay a deficiency judgment because Paragon had money in its accounts during 2009.

Mr. Tucker appealed the decision of the Tax Court.

Issue. The issue is whether Mr. Tucker is entitled to a loss deduction for 2004, 2005, and 2006.

Analysis. A loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the tax year.[75] The requirement for a "closed and completed transaction" may be satisfied if the property is abandoned or becomes worthless.[76] A taxpayer shows abandonment by demonstrating both an intent to abandon and some act evidencing that intention.[77]

Paragon's office was closed, its employees dismissed, and it stopped making payments on its obligations at the end of December 2008. Mr. Tucker pointed to this as evidence of abandonment. However, both the Tax Court and the Court of Appeals found there was no evidence to prove the Paragon properties were abandoned. Paragon continued to develop and sell properties in 2009 and 2010 and never offered to reconvey the properties back to the mortgagees in lieu of foreclosure. Additionally, Paragon continued to file reports with the state of Florida, it signed settlement agreements, it was listed as owner/builder on notices of commencement, and it was listed as seller on realty sales documents after December 31, 2008.

A mere decline, diminution, or shrinkage in value is not sufficient to prove worthlessness.[78] The taxpayer bears the burden of proving worthlessness. Mr. Tucker interpreted Treas. Reg. §1.165-1(d)(2) to say that certain loss events can constitute a closed and completed transaction. He asserted that the housing market crash should be considered a closed and completed transaction and that there was no reasonable prospect at the end of 2008 that Paragon would be able to pay a deficiency judgment. However, Mr. Tucker did not provide any case law to support his interpretation. Treas. Reg. §1.165-1(d)(2) states that a taxpayer may only claim the loss deduction in the year the loss becomes readily ascertainable. The total loss to Paragon was not readily ascertainable at the end of 2008 because none of the homes had been formally foreclosed upon or sold.

The Court of Appeals also looked to the fact that the properties could be sold to satisfy the mortgages, used as consideration in a settlement, or updated to increase the value, which would reduce Paragon's liability. This liability reduction has value. A deduction based on worthlessness requires that the taxpayer's equity in the property be worthless. The Paragon properties retained enough value to avoid being "worthless" within the meaning of IRC §165(a).

Holding. The Eleventh Circuit Court of Appeals affirmed the Tax Court decision that Mr. Tucker may not deduct losses from Paragon because he failed to establish the abandonment or worthlessness of the Paragon properties.

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75. Treas. Reg. §1.165-1(b).

76. *Proesel v. Comm'r,* 77 TC 992 (Oct. 29, 1981).

77. *Dezendorf v. Comm'r,* 312 F.2d 95, 96 (5th Cir. 1963).

78. *Proesel v. Comm'r,* 77 TC 992, 1006 (Oct. 29, 1981).

S Corporation Debt

***William and Amaryllis Tinsley v. Comm'r,* TC Summ. Op. 2017-9 (Feb. 28, 2017)**

IRC §1366

☞ S Corporation Shareholder Cannot Deduct Losses Due to Insufficient Basis

Facts. William Tinsley was the sole shareholder of Command Computers of West Florida, Inc. Command Computers was an S corporation engaged in the business of computer design and service. On April 5, 2006, Command Computers borrowed $150,000 from a bank, and Mr. Tinsley guaranteed the loan. In August 2010, when Command Computers was liquidated, the loan balance was $110,480. Mr. Tinsley had no stock or debt basis in the corporation at that time.

After Command Computers was liquidated, it continued operations under its former name. The 2006 loan was renewed in 2011 under the corporation's name, even though it no longer legally existed. Mr. Tinsley signed the renewed loan as the corporation's president and guaranteed the loan. The renewed loan was in the amount of $104,772. Mr. Tinsley made all payments on the renewed loan but the record did not indicate whether the payments were from his personal funds or from the corporation's account.

The IRS disallowed the $110,480 loss deduction related to Command Computers claimed on Mr. and Mrs. Tinsley's 2010 tax return. The IRS claimed that the flow-through loss was limited to Mr. Tinsley's basis and the Tinsleys did not establish that the amount was a loss they personally sustained. Therefore, the amount was not deductible.

Issue. The issue is whether Mr. Tinsley had enough basis in Command Computers to deduct $110,480.

Analysis. An S corporation shareholder may take into consideration their pro rata share of the corporation's losses, deductions, or credits.[79] The aggregate amount of losses and deductions a shareholder may deduct is limited to the sum of the adjusted basis of their stock in the S corporation (arising from capital contributions to the S corporation) and the shareholder's adjusted basis in any indebtedness of the S corporation. At the time of liquidation, Mr. Tinsley did not have any stock or debt basis in Command Computers. However, Mr. Tinsley claimed that after the liquidation, he assumed the balance on the note due as guarantor and that this assumption was a contribution to capital, which should allow him to deduct losses. He also contended that the bank expected him to repay the loan as guarantor, which should be sufficient to generate basis in Command Computers.

Merely guaranteeing a loan is insufficient to generate basis under IRC §1366(d)(1)(B). The shareholder must pay part or all of the obligation to give rise to indebtedness from the corporation to the shareholder. To increase basis, the shareholder must have an economic outlay.

The Tinsleys failed to provide evidence that the bank looked to them personally for repayments on the loan rather than Command Computers. In addition, there was no indication the payments were made from Mr. Tinsley's personal funds rather than Command Computers' funds with Mr. Tinsley signing the checks as president. The loan was made to Command Computers and Mr. Tinsley was the guarantor, not the maker of the loan. Moreover, the loan was secured by Command Computers' inventory and agreement. The court observed that Command Computers continued to exist after liquidation and that the bank looked to it as the primary obligor on the loan.

The Tinsleys argued that Mr. Tinsley assumed the bank debt when Command Computers liquidated. The bank was aware of the liquidation but nonetheless chose to renew the loan instead of issuing a new loan. As the sole remaining obligor, Mr. Tinsley claimed that for tax purposes the loan repayments should be treated as contributions to the capital of Command Computers. The IRS disagreed because when Command Computers liquidated, the debt remained undisturbed; the corporation did not default, the terms were not altered, and payments continued.

Holding. The Tax Court held that the Tinsleys did not prove that they had sufficient basis in Command Computers. The Tinsleys did not prove that the loans were made to Mr. Tinsley rather than the S corporation. Therefore, they were not entitled to deduct the losses.

[79]. IRC §1366(a)(1)(A).

S Corporation Income

***Ryan Fleischer v. Comm'r,* TC Memo 2016-238 (Dec. 29, 2016)**
IRC §§61 and 482

☞ Financial Consultant Must Report Income on Personal Tax Return

Facts. Ryan Fleischer was a financial consultant who developed financial portfolios for clients. After working for bank and investment firms, Mr. Fleischer decided to start his own company.

On February 2, 2006, Mr. Fleischer entered into a relationship with Linsco/Private Ledger Financial Services (LPL) as an independent contractor. He signed the representative agreement in his personal capacity.

On February 7, 2006, Mr. Fleischer incorporated Fleischer Wealth Plan (FWP) as an S corporation. Mr. Fleischer was the sole shareholder and the president, secretary, and treasurer of FWP. He entered into an employment agreement with FWP on February 28, 2006.

FWP paid Mr. Fleischer an annual salary to perform "duties in the capacity of Financial Advisor." Mr. Fleischer's agreement with FWP allows the corporation to modify the duties at its discretion. Mr. Fleischer signed the employment agreement twice; once in his personal capacity and once as the president of FWP.

On March 13, 2008, Mr. Fleischer entered into a broker contract with MassMutual. There was no mention of FWP in the contract. The contract stated that there was no employer-employee relationship between MassMutual and Mr. Fleischer. At the time he entered into the contract, Mr. Fleischer was selling only fixed insurance products.

In 2009, Mr. Fleischer reported taxable wages of $34,851 from FWP on his Form 1040, *U.S. Individual Income Tax Return.* Mr. Fleischer did not report self-employment (SE) tax but did claim an SE health insurance deduction of $1,351. He did not attach any Forms 1099 from either LPL or MassMutual to his return.

For 2009, FWP reported ordinary business income of $11,924 on its Form 1120S, *U.S. Income Tax Return for an S Corporation.* Gross receipts were calculated from the Forms 1099 that MassMutual and LPL issued to Mr. Fleischer. The Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.,* issued to Mr. Fleischer reported ordinary business income of $11,924. Mr. Fleischer reported this on his Schedule E, *Supplemental Income and Loss*.

In 2010, Mr. Fleischer reported taxable wages of $34,856 from FWP on his Form 1040. He did not report any SE tax but claimed an SE health insurance deduction of $1,356. All the income reported to Mr. Fleischer on Forms 1099 from MassMutual and LPL were reported on FWP's return and flowed through to Mr. Fleischer from the Schedule K-1. He reported $147,642 of ordinary business income from FWP on his Schedule E. On page 2 of Mr. Fleischer's Schedule C, *Profit or Loss From Business,* he reported "other expenses" of $284,963 but did not report any income or expenses on page 1.

In 2011, Mr. Fleischer reported taxable wages of $34,996 from FWP on his Form 1040. He did not report any SE tax but claimed an SE health insurance deduction of $1,496. Mr. Fleischer included a Schedule C with his tax return that showed "Ryan Fleischer" as both his principal business and his business name. He reported income on the Schedule C of $266,292 and other expenses of $266,292, for a net profit or loss of zero. All income reported to Mr. Fleischer on Forms 1099 from MassMutual and LPL were reported on FWP's return and flowed through to Mr. Fleischer's return from Schedule K-1. The Schedule K-1 reported ordinary business income of $115,327.

The IRS issued Mr. Fleischer a notice of deficiency, showing deficiencies of $14,189, $13,985, and $13,389 for 2009, 2010, and 2011, respectively. The IRS claimed that Mr. Fleischer should have reported FWP's gross receipts as SE income on Schedules C attached to his Form 1040 rather than on FWP's Forms 1120S.

Issue. The issue is whether the income Mr. Fleischer earned selling insurance products should be reported by him personally or by the S corporation.

Analysis. Income must be reported by the person or entity that earned it. The focus becomes "who controls the earning of the income" when the choices are a corporation or an individual who earned the income.[80] For a corporation to control the earning, the two following conditions must both be met.

1. The individual providing services must be an employee of the corporation whom the corporation can direct and control.
2. A contract or similar document must exist between the corporation and the individual providing the service recognizing the corporation's controlling position.

The court found there was no contract showing that FWP controlled Mr. Fleischer, so the court focused on the second element. The court looked at whether FWP entered into a contract or other document with either LPL or MassMutual that indicated its control over Mr. Fleischer.

Mr. Fleischer entered into his agreement with LPL before FWP was incorporated. FWP was not mentioned in the contract between LPL and Mr. Fleischer. Furthermore, Mr. Fleischer did not enter into an agreement that created the employee-employer relationship until three weeks after he signed the contract with LPL.

The contract between Mr. Fleischer and MassMutual was signed after FWP was incorporated but there was still no mention of FWP in the contract. The contract explicitly states that there is no employee-employer relationship between MassMutual and Mr. Fleischer. FWP could have signed the contract because the only products that would be sold were fixed insurance products. However, Mr. Fleischer signed the contract in his individual capacity to maintain the possibility of selling variable insurance products later.

Mr. Fleischer claimed that FWP could not enter into representative agreements and broker contracts with LPL and MassMutual because FWP was not a registered entity under the securities laws and regulations. While 15 USC §78o(a)(1) provides that neither a natural person nor a person other than a natural person can conduct transactions related to securities unless that person is properly registered, the court held that there was nothing preventing FWP from becoming registered. Mr. Fleischer claimed it would cost millions of dollars for FWP to become registered but submitted no proof of his claim to the court. The court held that the fact that FWP was not registered was not a valid reason for Mr. Fleischer to assign the income he earned personally to the S corporation.

Holding. The court held that Mr. Fleischer did not meet the second element of the control test. Therefore, Mr. Fleischer should have personally reported the income earned selling insurance products rather than the S corporation.

> **Note.** This case is also discussed in the 2017 University of Illinois *Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues.

80. *Johnson v. Comm'r,* 78 TC 882, 891 (1982) (citing *Vercio v. Comm'r,* 73 TC 1246, 1254-1255 (1980)), *aff'd* without published opinion, 734 F.2d 20 (9th Cir. 1984).

TAX FRAUD

Fraud
***Bradley and Poncella Ballard v. Comm'r,* TC Memo 2017-57 (Apr. 6, 2017)**
IRC §6651

☞ Underreporting of Fraudulent Income

Facts. Bradley Ballard operated Quik Copy, a sole proprietorship that specialized in illegal duplication of copyrighted works. Mr. Ballard concealed his illegal activity by dealing mostly in cash. He kept no financial or business records and maintained numerous bank accounts.

His wife, Poncella Ballard, timely filed her 2008 tax return as head of household (HoH), independently supporting her three children. Mr. Ballard filed nearly five months late as a single filer, with no dependents. For 2009, Mr. Ballard again filed late, using HoH filing status and claiming Mrs. Ballard's children as dependents. Mrs. Ballard did not sign the 2009 return, and did not file a separate return. Mr. Ballard reported some of his Quik Copy receipts and expenses on his 2008 and 2009 returns but failed to report any income or expenses associated with the illegal Quik Copy activity.

After advising Mr. Ballard that his 2007 return was selected for audit, the IRS subsequently expanded the examination to his 2008 and 2009 returns. A bank deposit analysis for 2009 and 2010 led the IRS to conclude Mr. Ballard underreported Quik Copy's gross receipts by $1.1 million for 2008 and over $740,000 for 2009.The IRS did not perform a bank deposit analysis for 2010. Subsequently filed amended returns for 2008 and 2009, while professionally prepared, still reported less income than determined through the bank deposit analysis. These amended returns, as well as the Ballards' late-filed joint 2010 return, showed unsubstantiated expenses and capital losses. The IRS disallowed deductions for the unsubstantiated items for 2008 through 2010 and adjusted 2008 and 2009 income in accordance with the bank deposit analysis. The IRS also sought additions to tax for failure to file and fraud penalties against each spouse. A notice of deficiency for the 2008-2010 tax years was issued to the Ballards on March 6, 2014.

The Ballards became uncooperative after receiving the notice of deficiency. They filed their petition with the Tax Court for a redetermination of their tax liability. After the IRS duly responded to the petition with information supporting the notice of deficiency determinations, the Ballards failed to respond as required. They also failed to cooperate with the IRS in preparing for the trial and failed to further act on their Tax Court petition as required. Moreover, the Ballards did not respond to a Tax Court order, which led the Tax Court to treat them as admitting all facts as set forth by the IRS.

Because the Ballards were treated as admitting all facts as set forth by the IRS, the IRS argued the standard for summary judgment in favor of the IRS was met. In addition, the Ballards failed to appear for the trial.

Issues. For the 2008–2010 tax years, the issues are the following.

- Whether the Ballards underreported their income and overstated deductions
- Whether they are liable for additional tax for failure to file
- Whether they are liable for fraud penalties

Analysis. The burden of proof is on the taxpayer to show an IRS determination of underreported income or overstated deductions is incorrect. The Ballards are deemed to admit to all the facts as set forth by the IRS. They failed to provide any substantiation regarding other income or expense amounts; therefore, the IRS is entitled to summary judgment.

Regarding the failure to file penalties, the IRS established the Ballard's liability for tax and the failure to file returns timely. The Ballards failed to show any reasonable cause that would eliminate these penalties.

Fraud must be separately established for each taxpayer and for each tax year through clear and convincing evidence. The fraud of one spouse may not be imputed to the other; separate proof is required. Regarding the fraud penalties for 2008 and 2009, the IRS met its burden of proof by establishing a pattern of fraudulent behavior. Mr. Ballard significantly underreported income from illicit Quik Copy activity. He did not keep books or records and he trafficked funds through several bank accounts intermingled with personal assets. These acts, along with filing false returns, were an effort to conceal income and prevent the collection of tax. Even the professionally prepared amended returns underreported income and overstated expenses.

There was insufficient evidence for the court to conclude that Mrs. Ballard acted fraudulently in 2008 or 2009. She filed her own return in 2008, and nothing indicated she knew about or aided in the preparation of Mr. Ballard's 2009 return. Moreover, nothing indicates she took an active role in the illegal Quik Copy activities or acted to conceal income or subvert tax collection.

The IRS did not conduct a bank account analysis for 2010 or allege the same fraudulent activity took place in 2010.

Holding. The Ballards are liable for the deficiencies for 2008 through 2010, and the IRS is entitled to summary judgment. The Ballards are also liable for the failure to file penalties because they filed their 2008, 2009, and 2010 returns late. Mr. Ballard is liable for the fraud penalty for 2008 and 2009. Mrs. Ballard is not responsible for such penalties. Neither spouse is liable for any 2010 fraud penalty.

Tax Fraud
***U.S. v. Diane Kroupa,* No. 0:16-cr-00084; U.S. District Court for the District of Minnesota (Oct. 21, 2016)**

☞ Former Tax Court Judge Pleads Guilty to Conspiracy to Defraud

Facts. From 2003 until June 2014, Diane Kroupa was employed as a Tax Court judge. She was married to Robert Fackler, and they filed joint tax returns from 2004 through the 2010 tax year.

Mr. Fackler was a self-employed lobbyist and political consultant, and he provided services to three primary clients. He owned Grassroots Consulting, which he reported on Schedule C, *Profit or Loss From Business.* Mr. Fackler's clients reported the amounts they paid him on Form 1099. He was usually reimbursed by clients for meals, travel, and other expenses he incurred for services provided to his clients.

Beginning no later than 2002 and continuing through 2012, Ms. Kroupa conspired with Mr. Fackler to impede, impair, and obstruct the IRS from correctly ascertaining and computing their joint income taxes. Their fraudulent activities included the following.

- From 2004 through 2010, Ms. Kroupa and Mr. Fackler reported at least $500,000 of personal expenses as business deductions for Grassroots Consulting.
- Ms. Kroupa reported certain personal expenses as unreimbursed employee expenses incurred in connection with her position as a Tax Court judge.
- Ms. Kroupa purposefully failed to report $44,520 that she received in 2010 from the sale of a real estate parcel.
- Ms. Kroupa falsely claimed that approximately $33,000 of cancellation of indebtedness income that she and Mr. Fackler received in 2008 was not taxable because they were insolvent. However, they had substantial assets that exceeded their liabilities; therefore, they were solvent.
- In 2012, Ms. Kroupa and Mr. Fackler made false and misleading representation and delivered false and misleading documents to the IRS agent conducting an audit of their 2009 and 2010 tax returns.

For the 2004 through the 2010 tax years, Ms. Kroupa and Mr. Fackler understated their taxable income by approximately $1 million and understated the tax they owed by approximately $455,000. As part of the plea agreement, Ms. Kroupa agreed to pay restitution in the total amount of the tax loss caused by her conduct.

Holding. The court will consider the sentencing guidelines to determine the appropriate sentence. The parties stipulated to the guideline calculations, under 18 USC §3551, *et seq.* The stipulations are binding on the parties but do not bind the court.

Note. In a separate proceeding, Mr. Fackler pleaded guilty to obstructing an IRS audit.

Note. On June 22, 2017, Ms. Kroupa was sentenced to 34 months in prison and Mr. Fackler was sentenced to 24 months. They must also pay over $457,000 in restitution.[81]

81. *Former tax judge sentenced to prison for tax fraud.* Jones, Barbara L. Jun. 22, 2017. Minnesota Lawyer. [http://minnlawyer.com/2017/06/22/former-tax-judge-sentenced-to-prison-for-tax-fraud/] Accessed on Jun. 29, 2017.