Chapter 4: Rulings and Cases

4

Please note. Corrections were made to this workbook through January of 2019. 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, 2018. 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

Kelly Golish, CPA, is a Tax Materials Specialist at the University of Illinois Tax School. She was previously a manager at Crowder, CPAs in Danville, IL and worked for both public and private accounting firms in Decatur, IL, Cleveland, OH, and San Jose, CA. Kelly earned a Masters in Accounting with an emphasis in Taxation and a Bachelors in Accounting at the University of Notre Dame.

Marshall J. Heap, PhD, EA, is a Tax Content Development and Instruction Specialist at the University of Illinois Tax School. An EA since 1984, Marshall is an ex-Senior Manager of PriceWaterhouseCoopers and has seven years of recent experience as an approved IRS continuing education provider. Marshall's academic background is in Computing and associated fields with degrees from the following UK Universities: The Open University (BSc), London, Birkbeck College (MSc), and Reading (PhD).

Marc C. Lovell, JD, LLM, MS, has headed a private tax law practice since 2001 with principal practice areas in federal, state, local and international taxation and tax litigation. He served as Assistant Director, Tax Education and Outreach of the University of Illinois Tax School program from 2011 to 2016. In addition to his private practice, Marc heads a team of seven research and reference law librarians at the Department of Justice and the DOJ Main Library in Washington DC as a contractor through The Cadence Group. Marc obtained his JD and LLM from Wayne State University Law School, and his MS in Library and Information Science from the University of Illinois.

Carolyn Schimpler, CPA, is Assistant Director, Tax Materials, at the University of Illinois Tax School. She joined Tax School in 2008, after holding a variety of positions in public accounting and private industry. She graduated with honors from Governors State University in 1988 and passed the CPA examination later that year. Carolyn serves as editor of the annual Federal Tax Workbook. She is a member of the Illinois CPA society.

Other chapter contributors and reviewers are listed at the front of this volume.

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)**).

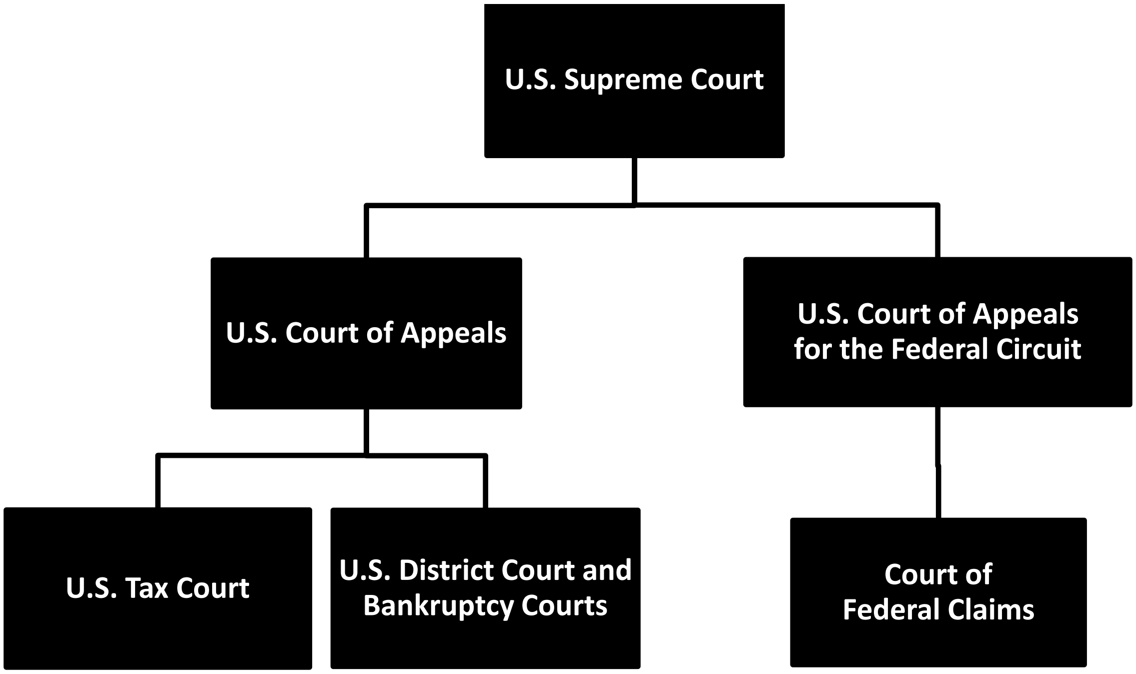
General Council Memoranda (GCM). GCMs detail the legal reasoning behind the issuance of a revenue ruling.

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]

---

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

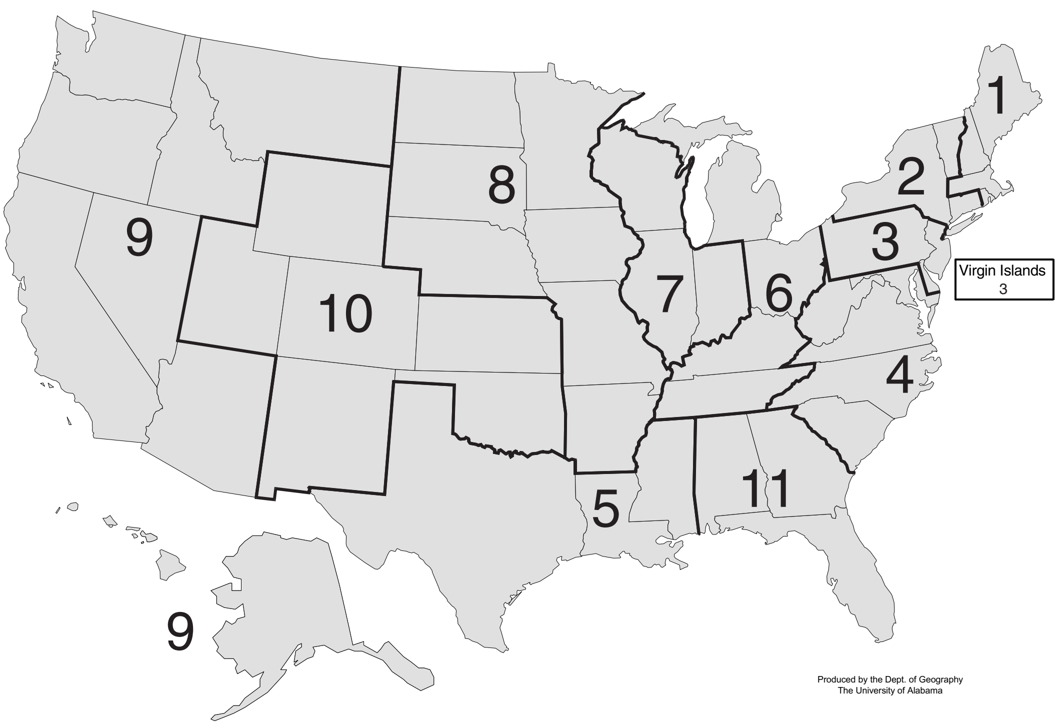
A Tax Court opinion or memorandum opinion may be appealed in a U.S. Court of Appeals. However, a taxpayer who commences their case in the U.S. Court of Federal Claims must appeal their case to the U.S. Court of Appeals for the Federal Circuit.

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).* [apps.irs.gov/app/picklist/list/actionsOnDecisions.html] Accessed on Aug. 15, 2018; IRM 36.3.1(2013).

BUSINESS EXPENSES

Capital Expenditures

***Shane Havener and Amy Costa v. Comm'r,* TC Summm. Op. 2018-17 (Apr. 4, 2018)**
IRC §§162, 212, 263, and 1221

4

☞ Taxpayer's Remodeling Activity is not a Trade or Business

Facts. After working in a number of positions, Shane Havener retired around 2007. He became restless during his retirement and wanted to find a project to occupy his time. In late 2011 or 2012, Mr. Havener and his wife, Amy Costa, purchased a house in Salem, New York, with the intent that Mr. Havener would remodel it and sell it for a profit. The Salem house is approximately 250 miles from the taxpayers' home in Pembroke, Massachusetts.

The Salem house was "uninhabitable" at the time of purchase and required extensive repairs. Mr. Havener performed most of the work himself and paid for all remodeling expenses with personal funds.

In 2013, Mr. Havener traveled to and worked on the Salem house during the work week. These trips usually lasted between three and five days, and he returned to the Pembroke residence on weekends.

Mr. Havener owned three vehicles and made 42 round trips and drove a total of 25,145 miles in 2013. He kept mileage logs for the vehicles, and recorded the miles relating to the Salem house remodeling activity. He also kept toll receipts and service invoices for the vehicles.

Mr. Havener also owned a Piper Warrior airplane. He occasionally flew his airplane for his weekly trips to the Salem house. He spent $2,566 to operate the airplane for these trips.

Mr. Havener and Ms. Costa timely filed a 2013 Form 1040, *U.S. Individual Income Tax Return.* The return reported Ms. Costa's salary income and Mr. Havener's taxable distributions from an IRA and pension and his social security benefits. They attached a Schedule C, *Profit or Loss From Business,* on which the sole activity reported was the Salem house remodeling activity. The Schedule C showed zero gross receipts and claimed expense deductions totaling $39,520, including $2,566 for travel expenses and $18,453 for car and truck expenses.

The IRS issued a deficiency notice to the taxpayers, asserting that the taxpayers had no indication of a profit motive with respect to the Schedule C activity.

Issue. The issue is whether the taxpayers are entitled to deduct mileage and travel expenses related to Mr. Havener's house remodeling.

Analysis. Taxpayers can deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business and for the production or collection of income.[6] However, taxpayers cannot deduct amounts "paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."[7] Such amounts must be capitalized.[8]

---

6. See IRC §§162 and 212.
7. IRC §263(a)(1).
8. Treas. Reg. §1.263(a)-3.

Mr. Havener maintained records to verify his mileage and travel expenses but did not produce any evidence indicating that he conducted the Salem house remodeling activity as a trade or business. He did not keep books and records reflecting that he conducted the activity in a business-like manner. He did not maintain an office. He paid for all expenses connected with the remodeling using personal funds. In addition, Mr. Havener and Ms. Costa did not receive any income from the Salem house or from any other real estate properties. Based on these facts, the court concluded that Mr. Havener was not engaged in a trade or business and therefore sustained the IRS's determination that the house was a capital asset.

Holding. The court held that Mr. Havener and Ms. Costa cannot deduct the travel and mileage expenses for 2013.

Business Expenses

***James Edward Bradley Jr. and Margaret Letitia Hayes-Hunter v. Comm'r,* TC Summ. Op. 2018-13 (Mar. 19, 2018)**
IRC §§162, 174, and 461

☞ Value of Taxpayer's Pro Bono Work Not Deductible

Facts. During 2014, James Bradley provided litigation consulting services through his sole proprietorship. Mr. Bradley used the cash method of accounting for his business and billed clients at a rate of $250 per hour. During 2014, he performed 100 hours of pro bono legal research, reviewing evidence, and preparing expert testimony on a project involving the standard of care owed to plaintiffs in a District of Columbia lawsuit. For this project, Mr. Bradley only performed legal research and he did not conduct experiments, work in a laboratory, or incur any expenses related to this particular project.

On Mr. Bradley's 2014 Schedule C, *Profit or Loss From Business*, he included gross receipts of $8,525 for the litigation consulting business. His Schedule C expenses included, among other expenses incurred, research expense of $25,000 (100 hours of pro bono work × $250 hourly rate). After claiming other expenses, such as utilities, Mr. Bradley reported a Schedule C business loss for 2014 of $29,512.

The IRS issued a notice of deficiency and disallowed the $25,000 expense.

Mr. Bradley argued that the $25,000 expense deduction should be allowed because he has a "unique specialty" and is an "expert …in the establishment of a National Standard of Care in Police Procedure" and that the claimed research expenses were for the "research and development of a product and technique…"

Issue. The issue is whether the $25,000 business expense should be allowed on Mr. Bradley's 2014 Schedule C, either as an ordinary or necessary business expense or as a research or experimental expense.

Analysis. IRC §162 allows a deduction for ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business. It is well established based on precedent[9] that this Code section does not permit a business expense deduction **based on the value** of the taxpayer's own labor.

Grant v. Comm'r[10] specifically involved an attorney who sought to deduct the value of pro bono work. In *Grant*, the court held that an attorney performing pro bono work may not deduct the value of their legal services rendered because the expenditure of labor does not constitute payment of a deductible business expense.

---

9. See *Maniscalco v. Comm'r*, TC Memo 1978-274 (Jul. 24, 1978), *aff'd* 632 F.2d 6 (6th Cir. 1980), *Remy v. Comm'r*, TC Memo 1997-72 (Feb. 10, 1997), and *Grant v. Comm'r*, 84 TC 809 (1985), *aff'd without published opinion*, 800 F.2d 260 (4th Cir. 1986).

10. *Grant v. Comm'r*, 84 TC 809 (1985), *aff'd without published opinion*, 800 F.2d 260 (4th Cir. 1986).

Moreover, IRC §174(a)(1) states that a taxpayer may deduct research or experimental expenses paid or incurred during the tax year in connection with a trade or business. Under Treas. Reg. §1.174-2(a), "research and experimental" expenses under IRC §174 are defined as those expenses incurred "in the experimental or laboratory sense." Mr. Bradley's legal research labor does not fall under this definition.

In addition, the term "paid or incurred" requirement under both IRC §§162 and 174 cannot be met through the deduction of one's own labor.

Holding. The Tax Court held that Mr. Bradley's $25,000 expense deduction was not deductible under IRC §162 as an ordinary or necessary trade or business expense, or under IRC §174 as a research or experimental expense.

Gross Income

***Neil and Andrea E. Feinberg. v. Comm'r,* TC Memo 2017-21 (Oct. 23, 2017)**

IRC §280E

☞ Redetermination Unavailable in Medical Marijuana Case Due to Lack of Evidence

Facts. Total Health Concepts (THC) is a Colorado limited liability company (LLC) that was established on October 12, 2009. Neil Feinberg was a shareholder for the 2010 and 2011 tax years. The state of Colorado licensed THC to grow and sell medical marijuana, and business operations began in December 2009. THC held two licenses to operate at least two medical marijuana dispensaries and leased a separate warehouse facility for which it held a license to grow marijuana.

For the 2009 through 2011 tax years, THC was an S corporation. Each year, total income was calculated by subtracting cost of goods sold (COGS) from gross receipts. THC claimed expenses for salaries, repairs and maintenance, rents, depreciation, advertising, and a detailed statement of "other deductions." The Feinbergs did not receive any compensation from THC. They reported pass-through losses from THC on their joint returns.

On December 6, 2012, the IRS issued an examination report for THC's 2009, 2010, and 2011 returns. The examination report proposed adjustments based on IRC §280E, and also made adjustments to COGS. The IRS reclassified several of the expenses that were claimed as below-the-line deductions to COGS. For 2010 and 2011, the IRS's net adjustments allowed greater COGS than originally claimed on the returns. However, the IRS disallowed all other expenses that it did not reclassify as COGS. In accordance with these adjustments, the IRS issued the Feinbergs notices of deficiency.

Issues. The issues are whether:

- The Feinbergs are allowed COGS greater than those allowed in the IRS's examination report, and
- IRC §280E was properly applied.

Analysis. At trial, the Feinbergs did not produce any contemporaneous financial or business records. They relied solely on a report from their expert, Jim Marty, CPA. They contended that Mr. Marty was an expert in cost accounting, with an emphasis on the marijuana industry. His report encompassed his opinion for medical marijuana businesses in Colorado during 2009 through 2011. Before trial, the IRS filed a motion to exclude Mr. Marty's report from evidence on the grounds that the Feinbergs refused to comply with discovery requests, that the report attempted to substitute its own unsupported factual assertions and Mr. Marty's legal conclusions for those of the court, and that the report's factual conclusions were not reliable.

Applying the *Daubert*[11] standard that was applicable to expert witnesses, the Tax Court concluded that Mr. Marty's report was unreliable. Multiple statements in the report were not supported by an underlying information source. For those statements that cited a source, Mr. Marty failed to include the information or data that he relied upon. Moreover, the report was not based on any personal knowledge of THC's business. It used average purchase prices and assumed a 55% COGS without any explanation of how Mr. Marty arrived at that amount. To determine the correct COGS for THC, THC's expenses needed to be substantiated. A reconstructed tax return based on assumptions and averages was not sufficient and could not serve as a substitute for THC's returns. The Tax Court concluded that Mr. Marty's report was not admissible into evidence.

> **Note.** The *Daubert* case and subsequent related cases provide standards that expert witness testimony or reports must meet in order to be admissible. The *Daubert* standard is applied in federal courts and some state courts.

The Tax Court resorted to the Cohan rule[12] that, under certain circumstances, allows it to approximate deductible expenses. The Tax Court proceeded on the basis that THC sold medical marijuana, even though nothing in the record allowed it to make a finding of fact that this was true. The court noted that the IRS allowed some COGS. The Cohan rule provided the court with the ability to adjust the COGS if there was sufficient evidence in the record. However, the court noted that there was no evidence in the record to justify an adjustment to the amount that the IRS allowed.

With respect to business expenses, IRC §261 states that "no deduction shall in any case be allowed in respect of items specified in this part" and the part being referred to includes §280E, "Expenditures in Connection With the Illegal Sale of Drugs." However, the court indicated that it had no need to address whether §280E applied because the Feinbergs failed to substantiate any expenses. Without business records or any supporting documents, they did not meet their burden of proof that the IRS notices of deficiency were incorrect.

Holding. The court held that the IRS's COGS adjustments are sustained because an absence of evidence to the contrary precluded the Tax Court from making any adjustments under the Cohan rule. Moreover, the IRS notices of deficiency issued to the Feinbergs are sustained. The court did not address proper application of §280E.

CAPITAL GAINS AND LOSSES

Disposition of Residence

Robert Fiscalini v. Comm'r, **TC Memo 2017-163 (Aug. 24, 2017)**

IRC §§121, 1001, 1011, 1012, 1015, 1016, 6651, and 6662

☞ Taxpayer Liable for Capital Gain from Sale/Gift of Home

Facts. In 1993, Robert Fiscalini and his parents purchased a house in Hollister, California. Mr. Fiscalini paid $234,312 for his interest in the property and his parents paid $40,000 for their interest. He financed the purchase of his interest by borrowing $234,312 that was secured by a mortgage on the property.

Mr. Fiscalini lived in the home from the time of purchase until at least August 1, 2007. He made improvements to the home in 2002, including building a swimming pool on the property with equipment that he used in the construction business that he operated. He also converted a detached garage on the house into a game room.

---

11. See *Daubert v. Merrell Dow Pharmaceuticals, Inc.,* 509 U.S. 579 (1993).

12. See *Cohan v. Comm'r*, 39 F.2d 540 (2d Cir. 1930).

In April 2003, Mr. Fiscalini's parents transferred their interest in the property to him. Mr. Fiscalini did not give them any cash or other property in exchange for their interest.

On several occasions, Mr. Fiscalini refinanced his mortgage loan on the property. During 2007, he was unable to make certain loan payments that became due on the property. To avoid foreclosure on the property, he sold the home to his parents around August 1, 2007.

To finance the purchase of the property, Mr. Fiscalini's parents borrowed $682,500. They used most of the borrowed funds to pay the balances of two outstanding loans that Mr. Fiscalini owed on the property, which totaled $664,048. The closing statements on the transaction showed that the total consideration involved in the sale/purchase was $975,000 and that Mr. Fiscalini was making a "gift of equity to buyer the Fiscalinis" of $295,655. The closing statements also showed that Mr. Fiscalini incurred settlement charges totaling $16,751.

Mr. Fiscalini did not timely file a 2007 tax return because he was unable to pay the tax due for that year. In 2013, he filed his 2007 tax return but did not report any gain from the sale of his residence.

The IRS issued a notice of deficiency to Mr. Fiscalini, which asserted that he must recognize $975,000 of long-term capital gain from the sale. The notice also stated that he was liable for an addition to tax under IRC §6651(a)(1) and the accuracy-related penalty under IRC §6662(a).

Issues. The issues are whether Mr. Fiscalini is:

- Required to recognize long-term gain from the sale of his personal residence,
- Liable for the addition to tax under §6651(a)(1), and
- Liable for the accuracy-related penalty under §6662(a).

Analysis. The parties disagreed on the amount of capital gain that Mr. Fiscalini realized from the sale of the property. According to Mr. Fiscalini, his adjusted basis in the property when he sold it was $329,687 and the amount he realized from the sale was $650,199. According to the IRS, his adjusted basis in the property was $234,312, and the amount realized from the sale was $958,249 ($975,000 total consideration − $16,751 settlement costs).

Mr. Fiscalini contended that his adjusted basis in the property when he sold it in 2007 was his cost basis of $234,312, increased by the cost basis of $40,000 that his parents had in their interest in the property. He reasoned that his parents made a gift of that interest to him in 2003. The court noted that Mr. Fiscalini did not give his parents any cash or other property in return for their interest in the home when they transferred their interest to him. Therefore, the court agreed that the parents made a gift of their interest to Mr. Fiscalini. Under IRC §1015(a), Mr. Fiscalini's basis in the interest that his parents gave to him is the same as their $40,000 cost basis.

Mr. Fiscalini further contended that his adjusted basis in the property should be increased by total costs of $50,000 that he claims he incurred in building a swimming pool on the property and converting a detached garage into a game room. The court declined to rely on his "self-serving, uncorroborated, and general testimony regarding the amount of those claimed costs." The court concluded that Mr. Fiscalini's adjusted basis in the property when he sold it to his parents was $274,312 ($234,312 initial cost basis + $40,000 parents' cost basis).

The court next considered the parties disagreement over the amount realized from Mr. Fiscalini's sale of the property to his parents. The parties agreed that the amount realized from the sale included Mr. Fiscalini's discharged liabilities of $664,048.[13] According to Mr. Fiscalini, the amount realized should include no other amount because his sale of the property to his parents was in part a sale and in part a gift to them. He maintained that the amount of that gift is the difference between the total consideration for the sale ($975,000) shown in the closing statements and his discharged liabilities of $664,048; therefore, the amount of the gift was $310,952. The IRS argued the total consideration of $975,000 shown in the closing statements controls the determination of the amount realized under IRC §1001(b). The court disagreed with the IRS, noting that §1001(b) provides that the amount realized from the sale of property is the sum of any money received plus the fair market value (FMV) of other property received. Treas. Reg. §1.1001-2(a)(1) provides that the amount realized from the sale of property generally includes the amount of liabilities from which the transferor is discharged. The court concluded that the amount realized before taking settlement costs into account is $664,048, which is the total amount of Mr. Fiscalini's two mortgage loans that his parents discharged. After deducting the settlement costs of $16,751, the amount realized is $647,297.

The court determined that Mr. Fiscalini's gain from the sale of the property is $372,585 ($647,297 amount realized − $274,312 adjusted basis − $400 unexplained difference). Mr. Fiscalini is entitled to a $250,000 exclusion from gross income under IRC §121 for the sale of his personal residence. Therefore, he must recognize $122,585 of long-term capital gain from the sale.

The court next considered the addition to tax under §6651(a)(1) for Mr. Fiscalini's failure to timely file a tax return. The addition to tax does not apply if the failure is due to reasonable cause and not willful neglect. Mr. Fiscalini testified that he did not timely file a return because he was unable to pay the tax due for that year. However, a taxpayer's inability to pay tax does not constitute reasonable cause for the failure to file. Therefore, the court found that his failure to timely file was due to willful neglect.

Finally, §6662(a) imposes an accuracy-related penalty of 20% of an underpayment that is attributable to negligence, disregard of rules, or a substantial understatement of tax. The penalty does not apply to any portion of an underpayment if the taxpayer shows they had reasonable cause and acted in good faith. In his late-filed 2007 return, Mr. Fiscalini did not include any gross income from the sale of the property. He failed to do so despite knowing that, when his parents acquired the property, they discharged the balances of his outstanding loans on the property. The court concluded that Mr. Fiscalini made no attempt to comply with Code requirements to determine the amount of gain from the sale and that he failed to do what a reasonable person would do under the circumstances.

Holding. The court held that Mr. Fiscalini is required to recognize long-term capital gain from the sale of his residence. He is also liable for the addition to tax under §6651(a)(1) and the accuracy-related penalty under §6662(a).

Characterization of Income

***CRI-Leslie LLC et al. v. Comm'r,* U.S. Court of Appeals, 11th Circuit; No. 16-17424 (Feb. 15, 2018)**

IRC §§167, 1221, 1231, and 1234A

☞ Forfeited Deposit Retained by Taxpayer on Defaulted Sale is Ordinary Income

Facts. In 2005, CRI-Leslie, LLC (CRI) paid $13.8 million to acquire a Radisson Hotel in Tampa, Florida, along with the hotel's restaurant, Crabby Bill's. CRI hoped to eventually resell this prime waterfront property for a profit. It hired a third party to manage the hotel and restaurant during the period of CRI's ownership.

About a year later, CRI reached an agreement to sell the property. Over the next two years and after several amendments to the sale contract, the parties agreed to a $39.2 million purchase price. However, in 2008, the buyer defaulted on the agreement, forfeiting a $9.7 million deposit on the purchase price.

---

13. See Treas. Reg. §1.1001-2(a)(1).

CRI reported the forfeited deposit as a long-term capital gain on its 2008 return. The IRS recharacterized the deposit as ordinary income. CRI filed a petition in Tax Court and later the parties jointly submitted the issue to the Tax Court to decide without trial.

CRI argued that the Code intended to provide the same tax treatment for gains related to the sale of "trade or business" property regardless of whether the property was actually sold. The IRS countered that the plain text of the governing Code provisions distinguishes between consummated and terminated sales of such property. The IRS provides capital gain treatment only for consummated sales. The Tax Court agreed with the IRS, and CRI appealed to the 11th Circuit.

Issue. The issue is whether CRI is entitled to capital gain tax treatment on the forfeited deposit.

Analysis. The 11th Circuit Court noted that this appeared to be a case of first impression. It is a case involving solely a statutory interpretation of the relevant Code provisions and applicable regulations.

The court noted that if the sale was made as planned, the $9.7 million deposit would have been applied to the purchase price and taxed as capital gain under IRC §1231. IRC §1231 states that any recognized gain on the sale or exchange of property used in the trade or business is treated as long-term capital gains. The parties agreed that the property was used in CRI's trade or business.

However, because the property was not sold, the treatment of the deposit is **not** governed by §1231. Rather, IRC §1234A applies to "gains or losses from certain terminations." This section states, in relevant part:

> *Gain or loss attributable to the cancellation, lapse, expiration, or other termination of. . . a right or obligation. . . with respect to property which is. . . a capital asset in the hands of the taxpayer. . . shall be treated as a gain or loss from the sale of a capital asset.*

The court's analysis revolved around three Code sections.

1. IRC §1234A provides capital gain treatment for income that results from a canceled property sale transaction, but only for an asset that is a capital asset in the hands of the taxpayer.
2. Under IRC§1221(a)(2), a capital asset is property held by the taxpayer regardless of whether it is connected with the taxpayer's trade or business. Capital assets do not include property used in a trade or business for which depreciation is allowed. It also does not include real property used in a trade or business.
3. IRC §1231(b)(1) defines "property used in a trade or business" as property subject to a depreciation allowance that is held for more than one year. It also includes real property used in the trade or business held for more than one year.

The parties agreed that the hotel property was not a capital asset because it was real property used in CRI's hotel and restaurant business under IRC§1221(a)(2). For CRI, this agreement is fatal to obtaining capital gains tax treatment under IRC §1234A because §1234A only applies to a capital asset.

CRI further argued, however, that this yields a result that is "illogical, absurd and contrary to the objective of IRC §1234A." CRI noted that the parties agree that had the sale taken place, the deposit would have been applied to the sale price and be subject to capital gains treatment. The sale failed through no fault of CRI, and the deposit must therefore be treated as a capital gain. Moreover, CRI argued that the exclusion of real property under §1234A effectively penalizes taxpayers for operating a trade or business as opposed to being a passive investor in real estate.

Despite this argument, the 11th Circuit found no reason to depart from the Code's clear language. The court stated that while CRI's arguments may establish that the incongruities caused by adhering to a plain meaning of these Code provisions may be odd, this fell short of an absurdity.

CRI identified past cases in which commercial real estate lessors obtained capital gain treatment under §1234A. These cases involved retained deposits that resulted from the termination of a departing lessee's contractual obligations to restore the rented premises back to original condition. CRI argued that Congress intended for §1234A to apply to payments from terminated leases. Although leased real estate is clearly trade or business property, it cannot be a capital asset under §1221, but instead qualifies as §1231property. It is rational to conclude that Congress intended for §1234A to apply to property outside the §1221 definition of "capital asset" and, specifically, to include trade or business property under §1231. CRI concludes that under §1234A, "capital asset" must include §1231 property.

The 11th Circuit Court noted that CRI's argument was not without merit. The issue has attracted some scholarly attention, noting that a treatise indicated that capital gain treatment should be given to a payment related to a lapse, termination, or expiration of a right or obligation with respect to a §1231 asset. However, the court noted that the problem in accepting this argument is that the Code's plain language flatly forecloses it. Under the plain reading of the Code, an asset that is §1231 property is not §1234A property.

Holding. The 11th Circuit Court affirmed the Tax Court's holding. CRI is not entitled to capital gain tax treatment on the deposit.

Capital or Investment Asset

***David and Candace Keefe v. Comm'r,* TC Memo 2018-28 (Mar. 15, 2018)**
IRC §§263A, 1221, 6651, and 6662(a)

☞ Renovations of Rental Property Without Rental Activity Make Property Capital Asset

Facts. David and Candace Keefe are married and have seven children. In 1996, Dr. Keefe and his family moved to Newport, Rhode Island. While living in Newport, the Keefes purchased a historic waterfront mansion on Ocean Avenue for $1.35 million. When the Keefes purchased the property, it had been vacant for four decades and was uninhabitable.

Shortly after they purchased the property, the Keefes divided the Ocean Avenue property into two units: the Wrentham House Mansion (WHM), which the Keefes retained, and the Carriage House, which was sold. The Keefes did not intend to live in WHM. Renovations began at the end of 2002 and continued until 2008.

In 2006, the Keefes contacted a local rental agent to discuss renting out WHM. The rental agent visited WHM in both 2006 and 2007, but the renovations were not complete and WHM was not in a condition to be rented. In 2008, she again visited WHM while it continued to be renovated. The Keefes were hopeful it would be ready to rent for the 2008 summer season. At that point, the rental agent communicated the availability of WHM orally to her clients.

During the renovations, Bank of America, one of the Keefe's lenders, required the Keefes to offer WHM for sale during the construction process in order for the Keefes to carry two mortgages on the property. It was listed for sale as required during renovations. Eventually, under financial strain, the Keefes sold WHM in a short sale on July 31, 2009 for $6.51 million.

The Keefe's returns for 2004 through 2009 were prepared by a CPA firm. They failed to timely file the returns for 2006, 2007, and 2008. The Keefes failed to pay their tax liabilities for the 2004, 2005, 2006, and 2007 tax years, for which the IRS issued notices of intent to levy to collect.

On their 2009 return, the Keefes reported that their adjusted basis in WHM was $8.6 million, and they treated WHM as a capital asset. After subsequently speaking with an estate planner, they determined WHM should have been treated as a business asset, and they hired another CPA firm to amend their returns for 2004 through 2009.

The amended 2009 return reflected WHM as a business asset with an adjusted basis of $10 million on the sale date. As a result of the change in character of the property, the Keefes reported a net operating loss (NOL), which they carried back to 2004 and then forward to 2010, eliminating tax on the amended returns. The IRS received and processed the amended returns. During 2014, the IRS sent the Keefes notices of deficiency for the tax years 2004 through 2010.

The IRS and the Keefes agreed that the appropriate basis of WHM is $751,750. The parties also agreed that the Keefes are entitled to increase their basis by $4.5 million to reflect various capital expenses associated with the restoration of WHM. The parties disagreed on whether $3.3 million in interest on the loans secured by mortgages on WHM must be capitalized.

Issues. The issues are whether:

- WHM is a capital asset or business property,
- The $3.3 million of interest costs are included in WHM's basis, and
- The Keefes are liable for §6662(a) penalties and §6651(a)(1) additions to tax because of their failure to timely file their returns for 2006, 2007, and 2008.

Analysis. Under IRC §1221(a)(2), a capital asset is property held by a taxpayer (whether or not connected with a trade or business) but is not property that is subject to depreciation and used in a trade or business, and is not real property used in the taxpayer's trade or business.

The Tax Court noted that the 2nd Circuit Court of Appeals, to which this case would be appealable, requires that taxpayers be engaged in continuous, regular, and substantial activity in relation to the management of the property in order to conclude that the property was used in a trade or business as opposed to being a capital asset. The Keefes contend that they held WHM as an asset used in a rental real estate business.

In evaluating the continuity, regularity, and substance of the taxpayer's rental-related activities, the 2nd Circuit Court of Appeals has considered a taxpayer's efforts to rent the property, the maintenance and repairs supplied by a taxpayer or a taxpayer's agent, a taxpayer's employment of staff to manage the property or provide tenant services, the purchase of materials, collection of rent, and the payment of expenses. The totality of the facts and circumstances surrounding the use of the property must support the conclusion that the alleged rental activities were sufficient, continuous, and substantial enough to constitute a rental trade or business. The Tax Court noted that despite huge efforts to renovate WHM, the evidence showed that WHM was never held out for rent or rented after the restoration was complete. The rental activity was never commenced in any substantive manner. A rental trade or business was never started.

IRC §263A requires that certain direct and indirect costs associated with producing property, including property held for investment, must be capitalized as part of the property's basis. Interest expenses are capitalized to the extent that they are paid or incurred during the period in which the property is being constructed or produced. Improvements to property, including rehabilitation or preservation of a building, constitute production of property under §263A. Generally, the production period begins on the date when the physical production activity is first performed and ends on the date when the property is ready to be placed in service or held for sale. However, under Treas. Reg. §1.263A-12(d)(2), the production period does not end before the completion of physical production activities by the taxpayer, even though the property is held for sale or lease. The Keefes held WHM as a capital asset and restoration work is the type of improvement for which interest is appropriately capitalized under IRC §263A. The production period began on the date that renovation work commenced and ended when renovations were completed and WHM was ready to be placed in service or held for sale.

The Keefes did not offer any evidence that their failure to file timely tax returns was due to reasonable cause and not willful neglect. In addition, the Keefes failed to prove that they had reasonable cause and acted in good faith in order to eliminate their liability for the penalties under IRC §6662(a). The Keefes did not make a reasonable, good-faith effort to correctly assess their tax liabilities, and their claimed reliance on the CPA firms retained was both unreasonable and not credible. Their attempt to recharacterize their property as an investment property was opportunistic and appeared motivated by their financial difficulties.

Holding. The Tax Court held that the Keefes held WHM as a capital asset, not as an investment property. Moreover, the court held that the interest expense was properly capitalized, and should be considered part of the Keefe's basis in WHM. Lastly, the Keefes are liable for the accuracy-related penalties assessed as well as the additions to tax.

CLERGY

Clergy Housing Allowance Exclusion

***Annie Gaylor et al. v. Steve Mnuchin et al.,* No. 3:16-cv-00215; U.S. District Court for the Western District of Wisconsin (Oct. 6, 2017)**
IRC §§107, 119, and 280A

☞ **Clergy Housing Allowance Exclusion Deemed Unconstitutional**

Facts. IRC §107(1) excludes from the gross income of a "minister of the gospel" the rental value of a home furnished to the minister as part of that minister's compensation. In addition, IRC §107(2) excludes from a minister's income a rental allowance paid as part of the minister's compensation if such amount is used to rent or provide a home. The amount excludable from gross income may not exceed the fair rental value of the home, including furnishings and appurtenances (such as a garage) and utilities.

The suit was filed by the Freedom from Religion Foundation (FFRF) and its officers, who include Annie Laurie Gaylor and her spouse, Dan Barker. Defendants in this suit include the U.S. Treasury Secretary and the IRS Commissioner.

The plaintiffs challenged the constitutionality of IRC §107(2) on the grounds that it discriminates against secular employees and violates the First Amendment's establishment clause and the Fifth Amendment's equal protection clause. This is the second time that the plaintiffs challenged §107(2). The plaintiffs originally also challenged IRC §107(1), but that part of the lawsuit was dismissed for lack of standing.

When the plaintiffs first challenged this Code provision, this same court and judge (the U.S. District Court, Western District of Wisconsin and District Judge Barbara Crabb) held that IRC §107(2) violated the establishment clause because it provides a benefit to religious persons and no one else, even though this is not necessary to alleviate any special burden on religious exercise. However, on appeal, the 7th Circuit vacated that judgment, indicating that the FFR did not have standing to sue.

In this second challenge, the plaintiffs believe they now have standing. "Standing" means that plaintiffs must actually suffer an injury in fact that is fairly traceable to the defendant's conduct that is capable of being redressed by a court's decision in the plaintiff's favor.

To obtain the requisite injury in fact to gain standing, Gaylor and Barker amended their 2012 tax return to claim the minister's housing allowance exclusion after receiving a housing allowance as part of their compensation as co-presidents of the FFRF. They indicated to the IRS that they were not ministers, however. As anticipated, the IRS disallowed their claim. Because Gaylor and Barker were secular workers whose amended returns and disallowed IRC §107(2) claims demonstrated they could not obtain the same beneficial tax treatment with the housing allowance that ministers could, they obtained standing to challenge this Code provision.

Issue. The issue is whether IRC §107(2) violates either the establishment clause or the equal protection clause.

Analysis. The court adhered to its earlier holding that concluded this Code provision violates the establishment clause because it does not have a secular purpose or effect and because a reasonable observer would view it as an endorsement of religion. The court rejected the defendant's argument that this provision represents an effort by Congress to treat ministers fairly and avoid religious entanglement, because the Code provision's plain language as well as its legislative history and application demonstrate a preference for ministers over secular employees. Contrary to what the defendants argued, this Code provision is not part of a greater, overall effort to assist employees with special housing needs; rather, this provision provides a special housing benefit unique to ministers.

The court indicated that its earlier conclusion that this provision violated the establishment clause in the plaintiff's first challenge made it unnecessary to consider whether it also violated the equal protection clause. The court referred to its previous decision, outlining different tests courts have applied in establishment clause challenges, including the analysis under *Lemon v. Kurtzman*[14] and more recent modified versions of this test of constitutionality applied by the Supreme Court and the 7th Circuit Court of Appeals. This establishment clause analysis, referred to as the "Lemon test," generally requires a court to invalidate a statute if any one of the following are true.

- The law has no secular purpose.
- The law's primary effect advances or inhibits religion.
- It fosters an excessive entanglement with religion.

The court noted that it had previously concluded that IRC §107(2) was invalid because it failed all three of these Lemon test factors. In the present hearing, the government defended IRC §107(2) under the "convenience of the employer" doctrine, analogizing the minister's housing allowance exemption to IRC §280A(c)(1), under which an employee may exclude the value of a housing allowance from gross income if the employee is required to accept the lodging as a condition of employment. However, the court rejected this argument because it is available to all taxpayers, including ministers, who can show they meet its requirements, and the argument did not justify the expansion of this by enacting IRC §107(2). Moreover, nothing in the legislative history of IRC §107(2) indicated that convenience of the employer concerns were part of the rationale for its enactment.

In addition, IRC §107(2) was also defended on the basis that it should be viewed as an overall "package" of housing-related Code provisions covering a wide spectrum of taxpayers, including IRC §§280A (employer housing), 162(a)(2) (travel expenses deduction for lodging), 134 (military member housing deduction), 911 (overseas housing exclusion), and 912 (federal employees working overseas). However, the court noted the absence of any legislative history confirming that these provisions were considered by Congress as an overall effort or broad package of tax exemptions.

The court was also unpersuaded by the argument that IRC §107(2) is necessary to prevent financial hardship for ministers, noting that the provision did not restrict its application to lower-income ministers. The court pointed out a 2002 case, *Warren v. Comm'r,*[15] in which a minister sought a $100,000 exemption under IRC §107(2), leading Congress to limit the exemption amount to the fair rental value of a home. Moreover, no limit on the expense of the home was included in the amendment. The court also cited the 1984 Department of Treasury report to the president in which it concluded that IRC §107(2) provides "a disproportionately greater benefit to relatively affluent ministers" because their incomes are subject to higher marginal tax rates.

Holding. The court adhered to its prior rationale and conclusion that IRC §107(2) is unconstitutional because it violates the establishment clause.

With respect to a remedy for the parties, the FFR was open to various forms of relief, and the court stopped short of issuing an injunction precluding the enforcement of IRC §107(2) or expanding its scope. The court noted that the parties to this case did not develop arguments regarding a tax refund for the plaintiffs because of the denial of the exclusion or the issuance of an injunction, and it invited the parties to later provide additional supplemental materials regarding specific remedies.

---

14. *Lemon v. Kurtzman*, 403 U.S. 602 (1971).

15. *Warren v. Comm'r,* 114 TC 343 (2002).

CORPORATIONS

Corporate Distributions

Western Property Restoration Inc. et al. v. Comm'r, **TC Memo 2017-190 (Sep. 26, 2017)**
IRC §§301, 316, 6214, 6662, and 6664

☞ Corporation's Distributions to Shareholder are Dividends Rather than Returns of Capital

Facts. Michael Sprague was the sole shareholder of Western Property Restoration, Inc., a C corporation, during the 2011 and 2012 tax years.

Western Property made direct payments to Mr. Sprague that totaled $107,500 and $130,000 for the 2011 and 2012 tax years, respectively. It also paid $4,961 and $5,007 of Mr. Sprague's personal expenses during the 2011 and 2012 tax years, respectively.

Western Property's tax returns reported that it paid $30,000 and $32,500 in compensation to Mr. Sprague for the 2011 and 2012 tax years, respectively. The compensation was appropriately reported on Mr. Sprague's tax returns for both years. His returns reported no dividends for either 2011 or 2012.

In September 2014, the IRS mailed a notice of deficiency to Mr. Sprague for the 2011 and 2012 tax years. The notice asserted deficiencies and IRC §6662 penalties for both years.

In September 2014, the IRS also mailed a notice of deficiency to Western Property asserting deficiencies and §6662 penalties for the 2011 and 2012 tax years. Along with other adjustments, the notice disallowed portions of amounts reported in each year for advertising, COGS, and other deductions. The notice also disallowed the net operating loss deduction that Western Property claimed on its 2012 return.

Mr. Sprague and Western Property filed petitions for redetermination of the deficiencies. The IRS subsequently amended its answer to assert that Mr. Sprague received dividends of $82,616 and $101,635 for 2011 and 2012, respectively. It also amended the amount of deficiencies assessed for both years.

Before trial, the parties resolved several issues through stipulations. They disagreed about how $77,500 of the amounts directly paid to Mr. Sprague in 2011 should be treated. The IRS contended that these payments were dividends, while Mr. Sprague argued that this amount was a tax-free return of capital. In addition, the stipulations did not resolve the tax treatment of Western Property's $4,961 payment of Mr. Sprague's personal expenses in 2011.

The parties likewise disagreed about how $97,500 of the amounts directly paid to Mr. Sprague in 2012 should be treated; the IRS claimed that this amount should be treated as dividends, while Mr. Sprague took the position that the amount was a tax-free return of capital. The parties did not resolve the tax treatment of $5,007 paid by Western Property for Mr. Sprague's personal expenses in 2012.

Issues. The issues are whether:

- Mr. Sprague received dividends from Western Property totaling $82,461 in 2011, and $102,507 in 2012, and
- Western Property is liable for IRC §6662 penalties for 2011 and 2012.

Analysis. IRC §316(a) defines a dividend as a distribution of property by a corporation to its shareholders out of its earnings and profits. A distribution is considered paid out of earnings and profits to the extent of the corporation's earnings and profits.

Mr. Sprague did not dispute that, for the 2011 tax year, Western Property had earnings and profits at least equal to the distributions it made to him ($4,961 personal expenses paid + $107,500 total direct payments − $30,000 reported as compensation = $82,461). However, he argued that Western Property intended $77,500 in payments to be distributions of capital. It recorded the distributions in its books as reductions to paid-in capital rather than as dividends.

Mr. Sprague made similar arguments regarding the 2012 tax year. Western Property had earnings and profits at least equal to the distributions it made to him ($5,007 personal expenses paid + $130,000 total direct payments − $32,500 reported as compensation = $102,507). However, he argued that Western Property intended $97,500 in payments to be distributions of capital. It recorded the distributions in its books as reductions to paid-in capital rather than as dividends.

The court observed that the distributions paid by Western Property in 2011 and 2012 did not exceed the amount of the earnings and profits it made during those years. Therefore, the amounts paid are dividends under §316(a). It is irrelevant that Western Property intended the distributions to be returned capital and that it treated the distributions as such on its books.

IRC §6662 imposes an accuracy-related penalty of 20% of the portion of an underpayment of tax that is attributable to the taxpayer's negligence or disregard of rules or regulations or is attributable to any substantial understatement of tax. Negligence includes the failure to exercise ordinary and reasonable care in preparing a tax return. Western Property demonstrated a lack of ordinary and reasonable care by improperly claiming certain deductions for both 2011 and 2012 and by not maintaining adequate books or records.

Holding. The court held that Mr. Sprague received dividends from Western Property totaling $82,461 in 2011 and $102,507 in 2012 and that Western Property is liable for §6662 penalties for 2011 and 2012.

Deductions

***Christopher C.L. Ng MD, Inc. APC v. Comm'r*, TC Memo 2018-14 (Feb. 5, 2018)**

IRC §162

☞ Self-Rental Requires Bona Fide Rental Arrangement

Facts. Christopher Ng MD, Inc. APC (APC) is a corporation organized in California by Dr. Christopher Ng. Dr. Ng was the corporation's only employee during 2012 and 2013. During both of these tax years, Dr. Ng had a contract with the Emergency Department Physicians Medical Group, Inc., and was assigned to work at a Los Angeles hospital as an independent contractor.

APC's business address is the same as Dr. Ng's personal residence. The second story of the residence is used solely for business. It consists of 968 square feet of a converted master bedroom, den, and bathroom area, and has a separate entrance and alarm panel. Dr. Ng uses this space for administrative tasks, such as remote access to the hospital's medical records to complete physician notes, complete continuing education training, and medical board certification activities. He does not use the space to see patients, and the only other individuals with whom he meets in this space are his paid assistant and malpractice defense attorneys who must meet with him occasionally.

In 2012 and 2013, Dr. Ng made mortgage payments for his residence from his bank account. For those years, he received a Form 1098, *Mortgage Interest Statement*, for $14,539 and $14,461, respectively.

On the advice of a tax preparer that he used since 1987, Dr. Ng prepared and timely filed Form 1120, *U.S. Corporation Income Tax Return,* for APC. For 2012, the return showed gross receipts of $369,864 and deductions of $345,473. Among these deductions was 100% of the mortgage payments made, shown as "rents" in the amount of $30,899. For 2013, gross receipts reported were $335,835, with total deductions of $332,819 that included "rents" of $29,321, which was 100% of the mortgage payments made in 2013.

On Schedule A, *Itemized Deductions*, for 2012 and 2013, Dr. Ng claimed his home mortgage interest as shown on the Forms 1098 he received. Each year he also filed a Schedule E, *Supplemental Income and Loss,* reporting rent received from and depreciation expenses for a residential property in Los Angeles that Dr. Ng owned and rented out to his assistant. Neither the 2012 nor the 2013 Schedule E showed any rent received by Dr. Ng from APC for the second story of his residence.

The IRS examined APC's Form 1120 for 2012 and 2013. It issued a notice of deficiency specifying that the rent deductions should be disallowed because they were mortgage payments made by the corporation for the shareholder's personal residence. The notice also included an accuracy-related penalty. The corporation petitioned the Tax Court for a redetermination of the deficiency and penalties.

Issue. The issue is whether the corporation is entitled to deduct the "rent" expense for 2012 and 2013 for the rental of the second story of Dr. Ng's residence.

Analysis. IRC §280A allows a deduction for home office expenses, but this Code section does not apply to a C corporation. A C corporation may deduct rent payments for home office space within an employee's home if such expenses qualify as ordinary and necessary expenses under IRC §162(a). Under Treas. Reg. §1.162-1(a), such expenses must be directly related to the corporation's trade or business. Expenses are "necessary" if they are appropriate and helpful to that business and "ordinary" if they are common or frequent expenses in the corporation's type of business.

Whether an expense is deductible under §162 is a question of fact, decided on the basis of all relevant facts and circumstances. Moreover, a close relationship between lessor and lessee does not mean a valid lease agreement cannot exist between them. A careful examination of the circumstances surrounding the arrangement is necessary to determine whether payments made are, in fact, payments for the rental of property.

APC failed to prove that a bona fide rental agreement existed between itself and Dr. Ng for the rental of the second story of his residence. No written rental agreement or other documentation was provided to support the existence of such an arrangement. Moreover, Dr. Ng did not report any reciprocal rental income on his Schedule E for either 2012 or 2013.

Holding. The rental deductions claimed by the taxpayer corporation are disallowed.

CREDITS

Premium Tax Credit

Rev. Proc. 2018-34, 2018-23 IRB 748 (May 21, 2018)
IRC §36B

☞ Updated Applicable Percentages for Individual Premium Credit

Purpose. Rev. Proc. 2018-34 updates the applicable percentage table in IRC §36B(b)(3)(A)(i) for 2019. The table calculates an individual's **premium tax credit,** the sum of premium assistance amounts for months a taxpayer was covered under a qualified health plan. A taxpayer's household income is multiplied by the applicable percentage to arrive at the annual contribution for healthcare.

The revenue procedure also updates the required contribution percentage for plan years beginning after calendar year 2018. The required contribution percentage is used to determine whether an individual is eligible for affordable employer-sponsored minimum essential coverage.

Analysis. Rev. Proc. 2018-34 updates the applicable percentage table found in §36B(b)(3)(A)(i) and Treas. Reg. §1.36B-3(g) with the following amounts.

Household Income Percentage of Federal Poverty Line	Initial Percentage	Final Percentage
Less than 133%	2.08%	2.08%
133% to 150%	3.11%	4.15%
150% to 200%	4.15%	6.54%
200% to 250%	6.54%	8.36%
250% to 300%	8.36%	9.86%
300% to 400%	9.86%	9.86%

For plan years beginning in 2019, the required contribution percentage is 9.86%.

Effective Date of Rev. Proc. 2018-34. The revenue procedure is effective for tax years and plan years beginning after December 31, 2018.

DEDUCTIONS

Services of a Child

***Tony Pedregon Lopez and Andrea Lopez Pedregon v. Comm'r,* TC Memo 2017-171 (Aug. 30, 2017)**
IRC §73

☞ Child's Pageant Expenses Cannot be Deducted by Parents

Facts. Tony Pedregon Lopez and Andrea Lopez Pedregon (taxpayers) have several children, including C.P., who was born in 1999. C.P. began competing in beauty pageants when she was nine years old. The taxpayers incurred several thousand dollars of expenses for travel, outfits, and other items that were necessary for C.P. to participate in the pageants. In 2011 and 2012, C.P. won several events and received cash prizes. These prizes were paid by checks payable to C.P., which were deposited into her college savings account. In 2011, her winnings totaled $1,325. In 2012, her winnings totaled $1,850. The taxpayers' pageant expenses totaled $21,732 in 2011 and $15,445 in 2012.

The taxpayers hired Frank Bohannon to prepare their federal tax returns for 2011 and 2012. When the taxpayers brought their tax organizer to Mr. Bohannon, they included information regarding C.P.'s pageant winnings and expenses. Mr. Bohannon believed these amounts were allocable to the taxpayers rather than to C.P. based on his understanding of child labor laws. Accordingly, Mr. Bohannon prepared Schedules C, *Profit or Loss From Business,* for the taxpayers' tax returns reporting income and expenses from C.P.'s pageant competitions.

In 2011, the taxpayers sold a rental property they owned. They provided Mr. Bohannon with the depreciation schedule for the property. However, the depreciation schedule was prepared by the taxpayers' previous accountants and included an accounting mistake — it swapped the basis of the property that was sold for another property with a similar address. Mr. Bohannon used this erroneous information to report the sale of the property on the taxpayers' 2011 return. Consequently, the taxpayers' 2011 return showed a capital loss of $139,835 when it should have shown a capital gain of $364.

The IRS disallowed C.P.'s pageant expenses for 2011 and 2012, as well as the capital loss for 2011. The IRS also determined accuracy-related penalties for both years.

Issues. The issues are whether:

- The taxpayers are entitled to loss deductions for expenses related to their child's pageant activity, and
- They are liable for IRC §6662(a) accuracy-related penalties.

Analysis. IRC §73(a) requires amounts received for the services of a child to be included in the child's gross income rather than that of the parents. IRC §73(b) treats all expenditures attributable to amounts includable in the child's gross income under §73(a) as paid or incurred by the child. This is true even if the parent made the expenditure.

Under IRC §74(a), prize winnings are generally included in a taxpayer's gross income. Specifically, prize winnings from satisfying a contest's terms or requirements are includable as income because they are considered payment for services rendered.[16] The court noted that the winnings reported on the taxpayers' Schedules C were clearly earned by C.P. She performed in the pageants and was the direct recipient of the pageant winnings. Because the winnings she earned are compensation for her services, they are includable in her gross income. Accordingly, only C.P. can deduct pageant-related expenditures.

---

16. *Robertson v. U.S.,* 343 U.S. 711, 713-714 (1952).

Under IRC §6662, a taxpayer can be liable for a 20% penalty on the portion of an underpayment attributable to negligence or disregard of rules or regulations. However, a taxpayer is not liable for the penalty if there was reasonable cause for the underpayment and they acted in good faith.[17] The taxpayer can establish that they acted with reasonable cause and in good faith if they reasonably relied on the judgment of a competent tax adviser.

The taxpayers relied on Mr. Bohannon, an enrolled agent with over 40 years of return preparation experience. They provided him with all relevant information regarding C.P.'s pageants and what they believed was the necessary financial information regarding the 2011 sale of their rental property. Although the information they gave Mr. Bohannon was erroneous, the errors were attributable to their former accountant and were not readily apparent to the taxpayers. The court concluded that the taxpayers relied on Mr. Bohannon in good faith. The taxpayers had no formal training in accounting or taxation and have always relied on the guidance of experts in these areas. Accordingly, the court declined to hold them liable for any accuracy-related penalties.

Holding. The court held that the taxpayers cannot deduct their losses pertaining to C.P.'s pageant expenses, but they are not liable for accuracy-related penalties.

Claim of Right

***Nora Mihelick v. U.S.,* No. 2:16-cv-00741; U.S. District Court for the Middle District of Florida (Oct. 10, 2017)**
IRC §§165 and 1341

☞ Settlement Payment to Ex-Husband Does Not Qualify as a Deduction

Facts. Nora Mihelick and Michael Bluso were married in 1978. They both worked for Gotham Staple Co. during their marriage. Gotham was founded by Mr. Bluso's father and owned by the Bluso family. Mr. Bluso eventually became the CEO and majority shareholder of Gotham, and his salary was approximately $1 million per year. Ms. Mihelick earned a significantly lower salary for her limited role in the company. During their marriage, Ms. Mihelick and Mr. Bluso filed joint tax returns.

In September 2004, Ms. Mihelick filed for divorce. While the divorce was pending, Pamela Bluso Barnes, who is Mr. Bluso's sister and a minority shareholder in Gotham, sued Mr. Bluso, Gotham, and others (hereafter referred to as "Barnes litigation"). She alleged that Mr. Bluso was excessively compensating himself from 1999 to 2004 and therefore wrongfully depleting the company's assets.

Ms. Mihelick was not named in the Barnes litigation. However, Mr. Bluso wanted Ms. Mihelick to pay half of any liability he might incur in the Barnes litigation. As a result, the divorce decree contained a separation agreement that provided that any liability from the litigation would be deemed a marital liability. Ms. Mihelick and Mr. Barnes would be jointly and severally liable for any damages and other expenses incurred in the litigation. Ms. Mihelick ultimately gave permission to her divorce attorney to keep the provision in the separation agreement.

The divorce was final in 2005, but the Barnes litigation was not settled until 2007. As a result of the settlement, Mr. Bluso paid Ms. Barnes $600,000 for the excess compensation claims. In 2009, Ms. Mihelick paid Mr. Bluso $300,000 to conform to the divorce agreement.

In 2012, Ms. Mihelick submitted an amended 2009 tax return to the IRS, stating that she was entitled to deduct $300,000 of her 2009 income because of the payment she made to Mr. Bluso that year to settle a liability that arose during their marriage. The deduction would result in a tax refund of $111,802 to Ms. Mihelick.

Issue. The issue is whether Ms. Mihelick is entitled to a tax refund for 2009 in connection with a payment she made to her ex-husband.

17. IRC §6664(c)(1); Treas. Reg. §1.6664-4(a).

Analysis. Ms. Mihelick asserted that she is entitled to deduct the $300,000 payment under IRC §1341. The IRS argued that the $300,000 payment Ms. Mihelick made was not a taxable event that generated a deduction.

Under §1341, which is often called the claim-of-right doctrine, a taxpayer must establish three elements to qualify for favorable treatment.

1. That an item was included in the taxpayer's gross income in a prior year because it appeared that the taxpayer had an unrestricted right to the item in the prior year
2. That, after the close of the prior year, it is established that the taxpayer did not have an unrestricted right to such item
3. That the taxpayer is entitled to a deduction (in excess of $3,000) under another Code section for the loss resulting from the payment of the item to another in the current tax year

The court noted that it must first determine whether "another code section would provide a deduction for the item in the current year."[18] Ms. Mihelick contended that she should be entitled to deduct the $300,000 payment as a loss incurred in a transaction entered into for profit under IRC §165(c)(2). That Code section allows individual taxpayers to deduct "losses incurred in any transaction entered into for profit, though not connected with a trade or business." Ms. Mihelick stated that the repayment of income was clearly a loss, and she entered into the transaction to repay past income in order to be released from further liability.

The court disagreed with Ms. Mihelick's contentions, observing that she paid Mr. Bluso under a private settlement agreement and did not make the payment because of any personal obligation arising from the Barnes litigation. The loss had nothing to do with a business venture or investment, and Ms. Mihelick failed to identify either a trade or business in which she engaged, or a for-profit transaction through which she incurred a loss. In addition, Ms. Mihelick did not produce any evidence that she entered into the settlement agreement with a profit motive or economic advantage. Instead, the parties entered into the agreement as one part of the divorce settlement, the payment of which was characterized as fulfilling an obligation under the divorce decree.

Holding. The court held that the amount Ms. Mihelick paid did not qualify as a deduction. Consequently, she is not entitled to a refund of taxes paid for the 2009 tax year.

Bad Debt Deduction

William Rutter v. Comm'r, **TC Memo 2017-174 (Sep. 7, 2017)**
IRC §§166 and 6662

☞ Court Determines that Taxpayer's Advances to Company Were Equity

Facts. William Rutter is a world-renowned scientist in the field of biotechnology. He began his career in 1955 as a professor of biochemistry at the University of Illinois. He subsequently held positions at the University of Washington and the University of California, San Francisco (UCSF). He published 400 scientific papers during his career and holds over 25 patents.

Before leaving UCSF, Dr. Rutter formed Chiron Corp. Under his direction, Chiron made major contributions in the areas of infectious diseases and vaccines.

After a Swiss pharmaceutical company acquired 49% of Chiron's outstanding stock, Dr. Rutter made other startup investments in the biotechnology field. In 1999, he formed Synergenics, a company that provided support for the startup companies in which he invested. During 2009, the year at issue in this case, Synergenics was a disregarded entity and Dr. Rutter reported its income and expenses on a Schedule C, *Profit or Loss From Business.*

---

18. *Fla. Progress Corp. v. Comm'r*, 348 F.3d 954, 963 (11th Cir. 2003).

Dr. Rutter acquired iMetrikus in 1999. In 2002, he incorporated iMetrikus International, and iMetrikus became its wholly owned subsidiary. For purposes of this discussion, these companies are referred to collectively as IM.

Dr. Rutter owned no common stock in IM. The company had approximately 70 common shareholders, but common stock formed a small portion of its capital structure. From the time Dr. Rutter incorporated IM through December 2009, IM's primary source of funding was cash advances from Dr. Rutter.

Between September 2000 and February 2002, Dr. Rutter made 39 cash advances to IM totaling $10.6 million. For each advance, IM executed a convertible promissory note. Each note provided that IM had the right to convert the note into common or preferred stock. Each of these notes bore 7% interest, and IM paid all interest when due.

Between February 2002 and May 2005, Dr. Rutter advanced another $22 million to IM, of which only $3.4 million was covered by promissory notes. IM recorded all these advances as loans, and the advances accrued interest at 7%. However, IM paid no interest on any of these loans after February 2002.

By May 2005, Dr. Rutter had advanced approximately $43.4 million to IM. IM converted all this purported debt to preferred stock.

Between May 2005 and December 2009, Dr. Rutter advanced an additional $43.04 million to IM. These advances were the sole source of IM's funding during this period. IM executed no promissory notes for these advances. It recorded these advances on its books as loans and accrued interest at 7%, but it never paid any interest on any of these advances. As of December 31, 2009, Dr. Rutter's advances to IM, including interest, totaled $47.5 million.

IM incurred substantial losses during its existence. Its total losses from 1999 through 2009 were over $82 million.

Dr. Rutter began questioning the collectability of his advances. In late 2009, he asked Laurence Bardoff, Synergenics' senior vice president, to evaluate IM's financial condition. Mr. Bardoff told Dr. Rutter that its condition was precarious. The company would have to fold unless Dr. Rutter continued to advance money to it.

Dr. Rutter discussed the possibility of claiming a bad debt loss deduction for his advances with Mr. Bardoff and Dr. Rutter's personal accountant. Mr. Bardoff took the position that all of Dr. Rutter's advances were debt and that the advances should be written off under a "first-in, first-out" approach. At the end of December 2009, Mr. Bardoff determined that the writedown should be $8.55 million.

Dr. Rutter timely filed his 2009 federal income tax return, which included a Schedule C for Synergenics that reported an $8.55 million business bad debt loss reflecting the writedown of the advances to IM. The IRS examined this return, and disallowed the business bad debt deduction in full.

Issues. The issues are whether:

- Mr. Rutter is entitled to a business bad debt deduction under IRC §166(a), and
- He is liable for the accuracy-related penalty.

Analysis. IRC §166(a)(1) allows a deduction for a bona fide debt that becomes worthless during the tax year. For tax purposes, whether a purported loan is a bona fide debt is determined from the facts and circumstances of the case. Advances made by an investor to a closely held or controlled corporation may be characterized as a capital contribution rather than as a bona fide loan. Dr. Rutter asserted that all his advances to IM constituted bona fide debt, but the IRS contended that Dr. Rutter's advances were made in his capacity as an investor.

The 9th Circuit Court of Appeals identified 11 factors to determine whether an advance of funds gives rise to bona fide debt or equity. These factors, and the conclusion for each in this case, follows.[19]

1. **The labels on the documents evidencing the alleged indebtedness** — The absence of a promissory note or other evidence of debt for the $8.55 million written off supports characterizing the advances as equity.

2. **The presence or absence of a maturity date** — The absence of any fixed maturity dates for any of the advances at issue supports characterizing them as equity.

3. **The source of payment** — Dr. Rutter testified that he hoped to obtain repayment for the advances when IM was sold or a third party invested in the company. Because a corporate buyout was Dr. Rutter's expected source of repayment, this strongly supports characterization of the advances as equity.

4. **The right of the alleged lender to enforce payment** — There was no written evidence of indebtedness securing IM's obligation to repay at a specific time, and none of Dr. Rutter's advances was secured by collateral. In addition, Dr. Rutter's continued cash advances were the only thing keeping IM afloat. This strongly supports characterization of the advances as equity.

5. **Whether the alleged lender participates in management of the alleged borrower** — None of Dr. Rutter's advances gave him increased voting rights or a larger equity share in IM. However, this means little because he already had complete control of the company. To the extent this factor is relevant, it supports characterization of the advances as equity.

6. **Whether the alleged lender's status is equal to or inferior to that of regular corporate creditors** — Dr. Rutter was the only source of cash to IM. No "regular creditor" would have lent funds to IM on the same terms. To the extent this factor is relevant, it supports characterization of the advances as equity.

7. **The intent of the parties** — Dr. Rutter did not execute promissory notes for the advances at issue. He received no interest on the advances and made no effort to collect interest or enforce repayment. He expected to be repaid upon sale of the company or through a third-party investment. This factor weighs in favor of treating the advances as equity.

8. **The adequacy of the alleged borrower's capitalization** — Typically, a large "equity cushion" is important to creditors because it protects them if the company is financially stressed. Because Dr. Rutter supplied almost all of IM's equity cushion, he would not derive much benefit if the shareholders' investment was exhausted first. The court concluded that this factor slightly favors Dr. Rutter or is neutral.

9. **If the advances are made by shareholders, whether the advances are made ratably to their shareholdings** — Dr. Rutter was not IM's sole shareholder, but he controlled the company and owned between 78% and 92% of IM's capital structure during the relevant period. There was therefore a considerable, although incomplete, identity of interest between Dr. Rutter's capacities as owner and alleged lender. The court found that this factor slightly favors Dr. Rutter or is neutral.

10. **Whether interest is paid out of "dividend money"** — IM paid no interest on any of the advances that Dr. Rutter made between February 2002 and December 2009. This factor strongly supports characterization of the advances as equity.

11. **The alleged borrower's ability to obtain loans from outside lenders** — The court noted that no third party operating at arm's length would have lent large amounts of money to IM without insisting on promissory notes, regular interest payments, collateral to secure the advances, and a personal guaranty from Dr. Rutter. This factor supports characterization of the advances as equity.

After evaluating all the factors, the court found that Dr. Rutter's advances were equity investments rather than debt.

---

19. See *Hardman v. U.S.,* 827 F.2d 1409, 1411 (9th Cir. 1987).

A taxpayer can avoid the accuracy-related penalty by showing they acted with reasonable cause and in good faith. A taxpayer's reliance on the advice of a tax professional can demonstrate reasonable cause and good faith. Mr. Bardoff reviewed IM's financial condition and researched the deductibility of bad debts. On the basis of the information Mr. Bardoff provided, Jason Graham, Dr. Rutter's personal accountant, concluded that a portion of the advances could be written off. However, Mr. Bardoff told Mr. Graham that promissory notes existed and that IM had paid interest on them. Dr. Rutter knew that this was not true but did not correct Mr. Bardoff's misstatements. Therefore, the court concluded that Dr. Rutter did not supply accurate information to Mr. Graham and, accordingly, cannot avail himself of the "reliance on professional advice" defense to the accuracy-related penalty.

Holding. The court held that Dr. Rutter is not entitled to a business bad debt deduction under IRC §166(a) and that he is liable for the accuracy-related penalty.

Legal Fees

***Arthur Dulik, Jr. and Ellen B. Kugler Dulik v. Comm'r,* TC Summ. Op. 2017-51 (Jul. 13, 2017)**

IRC §§56, 68, 162, 409A, 6662, and 6664

☞ Legal Fees Deductible on Schedule A, not on S Corporation Return

Facts. Arthur Dulik was employed by Byk-Gulden (BG), a small domestic generic pharmaceutical company, as vice president of finance in 1980. In 1982, while still an employee of BG, he and BG executed an "Employee Secrecy Agreement" (ESA), which included a noncompete clause preventing Mr. Dulik from rendering services to a competitor within the United States or a foreign country for two years after terminating employment, with limited exceptions.

A series of mergers and acquisitions led to BG becoming part of Nycomed US, Inc. (Nycomed), which was Mr. Dulik's employer from 2006 until May 2010. As of May 2010, Mr. Dulik was senior vice president, chief financial officer, and a member of Nycomed's board of directors. As an executive, Mr. Dulik participated in Nycomed's supplemental executive retirement plan (SERP).

On May 26, 2010, Nycomed terminated Mr. Dulik's employment. The following day, Nycomed provided Mr. Dulik with a proposed "Confidential Separation Agreement and General Release" (severance agreement) which provided the terms for his termination, including severance pay (52 weeks of salary), a bonus, and continuing COBRA healthcare coverage for 12 months after termination. The severance agreement also incorporated by reference the ESA Mr. Dulik signed in 1982. In exchange for the benefits, Mr. Dulik would agree to secrecy agreement compliance, a release of all employment claims against Nycomed, and a nondisparagement clause in which he agreed to refrain from making disparaging comments about Nycomed.

Mr. Dulik declined to sign the severance agreement. He retained two law firms, the Wagner Law Group and Farrell Fritz, P.C. to assist with negotiating the terms of the severance agreement.

On June 18, 2010, he contacted Nycomed's vice president of human resources and requested some modifications, including the removal of the incorporation by reference of the ESA and making the nondisparagement clause mutual. During this conversation, Mr. Dulik also disagreed with Nycomed's position on his post-employment SERP benefits. On July 29, 2010, Wagner Law sent a letter on Mr. Dulik's behalf regarding his SERP benefits.

On August 18, 2010, Nycomed sent a letter to Mr. Dulik's attorney indicating that the severance agreement would remain open only until August 25, 2010, at noon. At that time, it would be withdrawn if Nycomed's office did not receive an original signature on the existing agreement, but Mr. Dulik would still be bound by its terms. After consulting with his attorneys, Mr. Dulik signed the agreement and submitted it by the due date.

On September 24, 2010, Mr. Dulik formed a new S corporation, AED Associates II, Inc. (AED), of which he was sole shareholder and president.

In 2010, Mr. Dulik paid Wagner Law $16,229 in legal fees for their services, which included their work in research and telephone calls to Nycomed regarding IRC §409A, addressing the SERP issue, and consulting on the severance agreement. Mr. Dulik paid Farrell Fritz $10,096 in legal fees for similar work and advice. Accordingly, he paid a total of $26,325 in legal fees in 2010.

Mr. Dulik prepared and filed a 2010 Form 1120S, *U.S. Income Tax Return for an S Corporation,* for AED. AED had no gross income, but Mr. Dulik claimed a total of $31,125 in expenses, which included legal fees of $26,781, and this resulted in a loss of $31,125 for 2010. The IRS disallowed the legal fees deduction relating to AED, determining that the fees should have been deducted on Mr. Dulik's Schedule A, *Itemized Deductions,* as miscellaneous itemized deductions. Mr. Dulik petitioned the Tax Court, asserting that the legal fees represented business expenses for AED because he retained the attorneys so he could continue to conduct his business and earn income consulting in the pharmaceutical industry.

Issue. The issue is whether the legal fees are properly deductible as ordinary and necessary expenses of the S corporation or as a miscellaneous itemized deduction on Mr. Dulik's Schedule A.

Analysis. Generally, legal fees are deductible as an ordinary and necessary business expense only if the matter with respect to which the fees were incurred originated in the trade or business and only if the claim is sufficiently connected to that trade or business. The treatment of the legal fees for tax purposes does not depend on the consequences that might result from a win or loss of a legal claim. Legal fees not incurred in carrying on a trade or business but in the production or collection of income are deductible only as miscellaneous itemized deductions to the extent that such expenses exceed 2% of the taxpayer's adjusted gross income (AGI).

> **Note.** Under the Tax Cuts and Jobs Act, miscellaneous itemized deductions subject to the 2% of AGI floor are suspended for tax years beginning after December 31, 2017, and ending before January 1, 2026. For more information, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Legislation — Individual Concerns.

Mr. Dulik argued that after Nycomed terminated him, he was pursuing his business and seeking to work as an independent contractor. Because of the noncompetition clause, no one would hire him. He did not assert the claim against Nycomed was rooted in the consulting business; rather, he argued that the origin of the claim is Nycomed's restriction on his ability to work. He further asserted that he hired counsel solely to renegotiate the terms of the severance agreement so he could operate a business as a consultant in his industry.

The Tax Court noted, however, that the origin of the claim is looked to, not the potential consequences of a win or loss in negotiating the terms of the severance agreement. Mr. Dulik's claim arose from his status as a former employee of Nycomed, not from his consulting business.

Holding. The court held that Mr. Dulik cannot deduct the legal fees on AED's S corporation return. The legal fees are properly deductible on his Schedule A as a miscellaneous itemized deduction.

Charitable Contributions

***Mart D. Green v. U.S.,* U.S. Court of Appeals, 10th Circuit; No. 16-6371 (Jan. 12, 2018)**

IRC §§170 and 642

☞ Trust Not Permitted to Obtain a Double Benefit from Deduction of Unrealized Gains

Facts. Mart Green is the trustee of the David and Barbara Green 1993 Dynasty Trust (GDT). The governing trust document included a clause that expressed the intent for the trust and further provided for charitable contributions, stating that:

- A distribution may be made from the trust to charity only when both the purpose of the distribution and the charity are described in IRC §170(c); and
- The number of charities eligible to receive a distribution from the trust at any given time will be limited so as not to prevent the trust from qualifying either as an electing small business trust or an S corporation shareholder under the Code.

The trust owns 100% of GDT, a single-member LLC. GDT is a disregarded entity because of the trust's ownership. All of GDT's income, deductions, and credits are passed on to and reported by the trust.

During the 2002 through 2004 tax years, the trust was a 99% limited partner in Hob-Lob, a limited partnership. Hob-Lob operates the Hobby Lobby stores located throughout the United States. The trust's distributive share of Hob-Lob's ordinary business income and the amount of distributions received from Hob-Lob for 2002–2004 are summarized in the following table.

Tax Year	Trust's Distributive Share of Ordinary Income	Distributions Received
2002	$72,465,646	$38,722,126
2003	68,303,318	41,076,436
2004	60,543,215	29,480,397

Between 2002 and 2004, GDT acquired three properties. In 2004, GDT donated the properties to charities that qualified under IRC §170. The properties were acquired with funds from Hob-Lob distributions to the trust during the year of acquisition. The donation details, including some key amounts from the trust's 2004 tax return, are summarized in the following table.

Property	Donation Date	Basis as of Date of Donation	Fair Market Value (FMV) on Date of Donation	Donee
Virginia	March 19, 2004	$10,368,113	FMV was in excess of basis	National Christian Foundation Real Property, Inc.
Oklahoma	October 5, 2004	160,477	$355,000	Southwest Oklahoma District Church of the Nazarene
Texas	October 5, 2004	145,180	150,000	Lighthouse Baptist Church

The trust's 2004 return reported income of approximately $58.8 million, of which $58.7 million was unrelated business income. The return claimed a charitable deduction totaling $20.5 million, which included the property donations shown in the preceding table, plus an additional cash donation of $1.9 million.

The return reported total adjusted basis of approximately \$10.7 million for the three donated properties. It also reported that the FMV of the properties at the time of donation was approximately \$30.3 million. The trust did not report the unrealized appreciation in the properties of approximately \$19.6 million (\$30.3 million FMV – \$10.7 million basis).

The 2004 return was amended in October 2008 to claim a \$3.2 million refund as a result of changing the charitable deduction amount from \$20.5 million to \$29.7 million. The IRS disallowed the refund, limiting the amount of the charitable contribution deduction to the basis of the real property contributed.

In November 2013, Mr. Green, as trustee of the Trust, filed suit to obtain the refund. Mr. Green argued that the FMV of the properties was the applicable amount to deduct, while the IRS countered that the deductible amount was limited to basis. The District Court agreed with Mr. Green.

Mr. Green and the IRS reached an agreement on the FMV of the Oklahoma and Texas properties. A trial took place to determine the FMV of the Virginia property. The District Court entered judgment in favor of the trust in the amount of \$2.8 million in overpaid taxes, plus interest. The IRS appealed.

In the appeal, the IRS argued that the District Court's holding that the FMV was the appropriate amount of the deduction was contrary to the language in IRC §164(c)(1). This treatment is not appropriate because it allows the deduction for amounts that were never previously taxed, and therefore allows a duplicative benefit to the taxpayer.

Issue. The issue is whether the appropriate charitable deduction amount is the adjusted basis or the FMV of the properties.

Analysis. The Court of Appeals analyzed the requirements imposed by IRC §642(c)(1) that govern charitable contributions made by trusts and estates (as opposed to those made by individuals and corporations, which are governed by IRC §170). These three requirements are as follows.

1. The taxpayer must be a trust or estate.
2. During the tax year (or during the calendar year following the tax year at issue), the trust or estate makes a qualifying charitable contribution under §170(c).
3. The contribution must be authorized by the terms of the governing instrument of the trust or estate.

IRC §642(c)(1) permits a deduction for "any amount of the gross income, without limitation" that is authorized by the governing document. One interpretation of "any amount of gross income" is that the charitable contribution for the year must be made out of gross income earned by the trust in the tax year in which the contribution is made. The IRS urged the Supreme Court to adopt this interpretation in *Old Colony Trust Co. v. Comm'r.*[20] The Supreme Court rejected this interpretation, concluding that there were no such words in the statute limiting a deductible contribution in that manner. However, the Court did not go on to define the meaning of "any amount of gross income."

The Court of Appeals noted other interpretations of the phrase "any amount of gross income." One interpretation is that the contribution must be made exclusively from gross income earned by the trust at some point, as long as it is kept separate from principal. Another interpretation is that the contribution need only be traceable to current or accumulated gross income.

The Court of Appeals concluded this language was ambiguous. The court looked to Treas. Reg. §1.642(c)-1 for guidance, which it stated was indicative that the contribution must be made out of a trust's gross income. This aligns with the additional two interpretations noted previously but does not distinguish between these two interpretations. Nothing in the regulation indicates whether real property purchased with gross income can be treated as the equivalent of gross income for purposes of the deduction, as the IRS argued. The court observed that the regulation narrows the possible constructions of the statute but does not completely resolve the issue.

20. *Old Colony Trust Co. v. Comm'r,* 301 U.S. 379 (1937).

The IRS further argued that the deduction is limited to the taxpayer's adjusted basis in the property, which is the amount that the taxpayer originally paid for the property. The IRS noted that, in this case, the properties were never sold or exchanged, and therefore the gains on the properties remained unrealized by the trust. The trust was never taxed on those gains, and construing §642(c)(1) to allow the deduction of an unrealized gain would confer a double benefit (untaxed gains and the deduction of those untaxed gains against other gross income) in a manner inconsistent with the treatment of gross income under the Code. The court noted that this interpretation was reasonable and also found support in a leading tax treatise.

Holding. The judgment of the U.S. District Court in Oklahoma is reversed and the case is remanded to the District Court with directions to enter summary judgment in favor of the IRS.

Cost of Goods Sold

***Thomas R. and Carole L. Huzella, Deceased v. Comm'r,* TC Memo 2017-210 (Oct. 23, 2017)**
IRC §§61, 162, and 6662

☞ Coin Collector Subject to Penalties On Unreported Income

Facts. Thomas Huzella has been a coin collector since 1958. He had no records to establish his basis in any of his coins, regardless of whether they were acquired by purchase, inheritance, gift, or trade. Moreover, Mr. Huzella did not record any acquisition dates.

Unemployed during 2013, Mr. Huzella actively bought and sold coins on eBay, and received sales proceeds through PayPal. These payments were reflected on a 2013 Form 1099-K, *Payment Card and Third Party Network Transactions,* that showed aggregate payments of $37,013 from a total of 399 separate payment transactions. Mr. Huzella incurred eBay and PayPal fees, Internet costs, as well as packaging and shipping cost in his coin dealer business.

On their joint 2013 return, Mr. Huzella and his wife Carole reported social security benefits of $28,175, but showed the taxable amount as zero. A Schedule C, *Profit or Loss From Business,* was included with the return for Mrs. Huzella's business, but not for Mr. Huzella's coin business.

The IRS determined that Mr. Huzella received $37,013 of additional income based on the Form 1099-K issued by PayPal. However, the IRS's notice of deficiency erroneously stated that $24,056 of those receipts were reported on Mr. and Mrs. Huzella's return, and the $3,563 tax deficiency was based on unreported income of $12,957 (the difference between the 1099-K amount of $37,013 and the erroneous $24,056).

The Huzellas petitioned the Tax Court for a redetermination of tax, and the court permitted the IRS to first correct its notice of deficiency. In its amendment, the IRS stated that the Huzellas not only had $37,013 of unreported income, but also imposed an additional deficiency of $12,905. The notice of deficiency also alleged a substantial understatement of tax and an accuracy-related penalty under IRC 6662(a) of $2,581.

Issues. The issues are:

- The amount of COGS that Mr. Huzella is entitled to deduct for 2013, and
- Whether Mr. and Mrs. Huzella are subject to understatement and accuracy-related penalties.

Analysis. Taxpayers must substantiate necessary and ordinary expenses in order to deduct them, and the failure to keep such records counts heavily against the taxpayer attempting to prove them. The IRS agreed that Mr. Huzella was entitled to claim eBay fees, PayPal fees, and Internet costs of $2,188, $942, and $600, respectively. Based on his testimony and other evidence, the Tax Court concluded that Mr. Huzella was also entitled to deduct $600 for postage and $100 for packaging costs. These expenses total $4,430.

The Tax Court observed that COGS is an offset subtracted from gross receipts in determining net income and is technically not a deduction. In addition, the amount claimed as COGS must be substantiated and taxpayers are required to maintain sufficient records to do so.

Mr. Huzella had no records to substantiate a COGS amount for the coins sold. He testified that he turned over his inventory quickly, but despite the court providing him additional time to produce documentation on the cost of coins that he purchased on eBay and resold, Mr. Huzella failed to present any such documentation. Instead, he submitted records of his sales and submitted coin catalogs from 2011 and 2013 that tracked market prices.

The court noted that based on the records provided and Mr. Huzella's testimony, many items listed for sale were issued in 2013 and sold later in the year, with little time to appreciate much in value. However, his collection also consisted of other coins from his collecting efforts that began in 1958 and included coins from his father's collection.

The Tax Court used the Cohan rule[21] to determine an allowable COGS for the coins that Mr. Huzella sold. Under the Cohan rule, if a taxpayer with inadequate records proves they have incurred certain expenses but cannot substantiate the amount, the court, in appropriate circumstances, may estimate the allowable amount. The court cannot guess at a number, but must have some basis upon which the estimate is made, based on some reasonable evidentiary basis. Under the Cohan rule, the court concluded that Mr. Huzella was entitled to COGS of $12,000. The appropriate net income for 2013 was $20,583 ($37,013 gross receipts − $12,000 COGS − $4,430 other expenses).

With respect to the substantial understatement penalty, the IRS argued that Mr. Huzella did not make a good faith effort to determine his federal income tax liability. Therefore, reasonable cause and good faith did not exist in Mr. Huzella's conduct. He failed to report all of the gross receipts from the Form 1099-K and failed to keep accurate records of expenses and COGS. Accordingly, if the amount of net income determined by the Tax Court of $20,583 results in a substantial understatement of income tax that exceeds the greater of $5,000 or 10% of the amount required to be shown on the return after the return is recalculated, Mr. Huzella will be liable for the revised understatement penalty amount.

Holding. The court held that Mr. Huzella was entitled to COGS of $12,000 and recalculated his net income accordingly. Additionally, Mr. Huzella will be liable for understatement penalties if the understatement of his revised income tax exceeds the greater of $5,000 or 10% of the amount of income tax.

Conservation Easement

Wendell Falls Development, LLC et al. v. Comm'r, **TC Memo 2018-45 (Apr. 4, 2018)**
IRC §§170 and 6662

☞ Conservation Easement Not Deductible as Charitable Contribution

Facts. Wendell Falls Development, LLC (WFD) was established by three members, two land developers, Greg Ferguson and Mike Jones, and a corporation. WFD was taxed as a partnership and Mr. Ferguson and Mr. Jones were active in WFD's day-to-day operations. The corporation was a passive investor.

Between 2004 and 2007, WFD purchased 27 adjacent parcels of vacant land that consisted of a total of 1,280 acres in Wake County, North Carolina. The parcels were outside the boundaries of the town of Wendell. WFD intended to subdivide the 1,280 acres into a community that included residences, commercial spaces, a school, and a park, then sell the residential and commercial lots to other builders for development.

In its subdivision plans, WFD identified 125 acres for parkland, located on the eastern shore of Lake Myra, a man-made lake that was not owned by WFD. Marks Creek, which flowed into Lake Myra, ran through the 125 acres owned by WFD.

---

21. The Cohan rule comes from *Cohan v. Comm'r,* 39 F.2d 540 (2nd Cir. 1930).

In mid-2005, WFD and Wake County discussed the possibility of Wake County purchasing the 125 acres of WFD's parkland for use as a county park. The remainder of the 1,280 acres would be annexed by the town of Wendell prior to further development. At some point after these discussions with Wake County, WFD proposed placing a conservation easement on the 125 acres to restrict this land to park use. The easement rights would ultimately be owned by a conservation organization. Throughout 2006, WFD and Wake County exchanged emails regarding the restrictions the easement would include and which charitable organization would hold the easement rights.

On March 17, 2006, WFD submitted to the town of Wendell for approval a master development plan for the 1,280 acres. At the time of the submission, some of the 1,280 acres was still under contract for purchase. On four occasions over the next seven months, the submitted master plan was amended four times to reflect WFD's gradual purchases of land within the 1,280 contiguous acres. At some point, the town of Wendell annexed the 1,280 acres, with the exception of the 125-acre parkland area that did not become part of the town of Wendell.

On October 9, 2006, the town of Wendell approved the final master development plan that included up to 4,000 residential lots. The approved plan stated that the 125 parkland acres would be dedicated to the creation of "Wendell Falls Park," and the plan's accompanying map designated the 125 acres as such. However, while the map designated the 125 acres as a park, another portion of the plan erroneously stated that the park consisted of 160 acres instead of 125 acres.

The approval of the plan meant that the town of Wendell would issue permits under its zoning ordinances for the uses of the land described in the approved master plan. Of the 1,280 acres covered by the plan, only the 125 parkland acres were unaffected by the approval because they were outside the town's boundaries and therefore not subject to its zoning ordinances. Moreover, the approved master plan stated that WFD received no preferential zoning because of its decision to set aside 125 acres for parkland.

On November 27, 2006, Wake County hired an appraiser to value the 125 parkland acres because the county was negotiating to purchase this parkland from WFD. The appraiser placed a $3.2 million value on the 125 acres of parkland. However, the appraiser focused on the error in the approved master plan that specified 160 acres instead of 125 acres, and this value reflected 160 acres.

Wake County purchased the parkland but the county's meeting minutes approved the purchase of 160 acres rather than 125 acres. The purchase agreement included a description of the land referring to the master plan's map, accurately describing the 125 acres, but the purchase agreement itself incorrectly referred to the mapped area as a 160-acre area. In the purchase agreement, the parties agreed that a precondition to the sale was the placement of a mutually agreeable conservation easement on the land. Wake County agreed to pay $3.186 million for the land (close to the appraiser's value of $3.2 million).

After the parties signed the purchase agreement, the error in the number of acres was discovered. To correct the error, the county had another appraisal completed for 125 acres, and a different appraiser valued the 125 acres at $3 million. This value did not reflect the restrictions of a conservation easement, however. The county reauthorized the purchase of 125 acres for $3 million. In December 2006, the purchase agreement was amended to reflect the acreage and purchase price. Under the terms of the amended agreement, the donation of a mutually agreeable conservation easement was a precondition to the sale. The sale took place in 2007. On June 7, 2007, the conservation easement, in favor of the Smokey Mountain National Land Trust and the general warranty deed were registered at the Wake County Register of Deeds office, both bearing identical date and time stamps.

On October 3, 2008, WFD filed a timely partnership return for the 2007 tax year. It retained two appraisers to appraise the easement. On the accompanying Schedule K, *Partner's Share of Income, Deductions, Credits, etc.*, WFD reported a $1.8 million charitable contribution deduction for its contribution of the conservation easement. WFD attached an appraisal of the conservation easement, prepared by its own appraiser, which valued the easement at $4.8 million. The partnership return reported the deduction as if Wake County paid WFD $3 million for a $4.8 million easement, leaving a difference of $1.8 million for a charitable contribution. However, Wake County actually paid for the land, not an easement.

On April 23, 2009, WFD amended its 2007 partnership return. It claimed the full $4.8 million as a charitable contribution deduction for the easement and explained that the original amount claimed of $1.8 million was incorrect.

On November 25, 2013, the IRS sent a notice of final partnership administrative adjustment. The notice stated that the charitable deduction was zero. In Tax Court, WFD's expert witness appraised the easement's value at $5.9 million, while the IRS's expert witness appraised it at $1.6 million. The IRS also imposed an IRC §6662(a) understatement of tax penalty or in the alternative, a 40% substantial understatement penalty under §6662(h).

Issues. The issues are:

- Whether WFD was entitled to a charitable contribution deduction in connection with the conservation easement, and
- The appropriate value of the easement that may be claimed as a deduction.

Analysis. IRC §170 allows a charitable contribution deduction for contributions or gifts made to various charitable organizations or governments. However, no such deduction is allowed if the taxpayer expects a substantial benefit from the contribution. A deduction may still be allowed if the benefit to the taxpayer is merely incidental to the charitable purpose. In determining whether the taxpayer expected a substantial benefit from the easement, the external features of the transaction are evaluated.

The Tax Court found that WFD expected a substantial benefit from the contribution because when it made the donation, it owned the adjacent remainder of the 1,280 acres. The approved master plan provided WFD with the ability to provide the residential areas with access to the 125-acre park through a system of "greenways" that were inherent in the plan. This increased the value of the lots WFD would sell to developers. One of Mr. Ferguson's emails to Wake County indicated that WFD needed to "ensure that the County uses the park for its intended use," confirming the additional value WFD expected to receive from the easement. The Tax Court concluded that no charitable contribution was allowed because of this expectation of substantial benefit.

Moreover, the Tax Court concluded that the value of the easement was zero. Because the parties offered no evidence of comparable easement sales and prices, the value of the easement was equal to the excess of the land's value before the easement over the land's value after the easement. Land is valued at its highest and best use. The highest and best use of the 125 acres was as parkland in the middle of the planned community. Therefore, the conservation easement did not diminish the land's value because the easement did not prevent it from being put to its best use.

WFD is not liable for an IRC §6662(a) or (h) penalty. The deduction WFD claimed was based on whether it had a substantial expected benefit and whether that benefit was incidental. These tests were subject to the broad discretion of the Tax Court. WFD's failure to assess its deduction under these tests did not diminish the effort it made to assess the proper tax treatment of the easement. It retained two appraisers, and while neither appraiser accounted for the substantial benefit accrued to WFD, the IRS's expert witness appraiser likewise failed to account for this factor. Therefore, reasonable cause for reporting the deduction existed and it was claimed in good faith.

Holding. The court held that WFD was not entitled to a charitable contribution deduction because they expected a substantial benefit. Even if a deduction was allowed, the value of the easement was zero.

Charitable Contributions

***Paul A. Gardner v. Comm'r,* TC Memo 2017-165 (Aug. 24, 2017)**

IRC §170

☞ Donated Hunting Trophy Items Must Be Valued Using Comparable Sales Method

Facts. Paul Gardner was an avid big-game hunter who hunted since an early age. He hunted big game in Africa, Asia, Europe, South America, and throughout the United States. Mr. Gardner decided to donate some of the less-desirable trophies to the Dallas Ecological Foundation (DEF). He relied on an appraisal completed by Richard W. Fullington, Ph.D. Dr. Fullington and Mr. Gardner selected 177 trophies from his collection and Dr. Fullington used the replacement cost method to determine the fair market value (FMV) of the specimens. He estimated what it would cost to replace each item with a specimen of like quality by adding the expected out-of-pocket costs for traveling to the hunting site, being on safari for the requisite number of days, killing the animal, its removal and preservation, shipping back to the United States, and the cost of taxidermy services.

Relying on Dr. Fullington's appraisal, Mr. Gardner donated the 177 specimens to DEF and claimed a charitable contribution deduction of $1,425,900 on his 2006 return. Because this amount exceeded the maximum allowable deduction for 2006, he carried forward the excess amount to 2007 and 2008.

Dr. Fullington's appraisal report was attached to Mr. Gardner's 2006 return. It contained a separate sheet for each of the 177 specimens. Each sheet contained a photograph of the specimen, a summary that listed the place at which the animal was killed (if known), and an estimate of the specimen's quality (invariably noted as "excellent"). At the bottom of each sheet was Dr. Fullington's appraised value.

Dr. Fullington arranged for the delivery of the specimens to DEF in March 2006. In an April 26, 2006 letter, DEF thanked Mr. Gardner for his contribution of 177 trophy animals.

The IRS examined Mr. Gardner's 2006–2008 returns and determined that the value of the contributed hunting trophies was at most $163,045. Deficiencies of $137,647 and $274,288 were determined for 2007 and 2008, respectively. The IRS argued that a comparable sales method should be used to determine the donated specimens' FMV. However, Mr. Gardner contended that a replacement cost method should be used because there were no true comparables on the open market.

Issues. The issues are:

- Which methodology should be used to value the hunting trophies,
- Whether the trophies are commodities or collectibles, and
- What is the appropriate value of the hunting trophies.

Analysis. Mr. Gardner and the IRS retained experts to testify at trial. The Tax Court, citing evidence rules and case precedent, noted that an expert witness's opinion is admissible if it assists the trier of fact to understand the evidence or determine a fact in issue. Moreover, if experts offer different FMV estimates, the court weighs the estimates by looking at the factors considered in reaching those values. The court is not bound by any expert opinion it finds contrary to its judgment, and it may accept an opinion in its entirety or it may be selective in the portions it finds reliable. The court noted that it may assign a FMV based on its examination of the evidence.

Dr. Fullington did not testify at trial and none of the 177 specimens were available for physical inspection by any of the experts at trial. Only Dr. Fullington's photographs that were small and of poor resolution were available for quality assessment by the experts. Experts on both sides had to rely on Dr. Fullington's report that the court said left "much to be desired." Dr. Fullington gave each item a rating for specimen quality and taxidermy quality, and every specimen was given a rating of "excellent" on both scores. However, the photographs often indicated that a lower rating would have been more appropriate. Entries under the "provenance" category were meager and use of the work "unknown" throughout the provenance section may have indicated Dr. Fullington's lack of confidence in the actual provenance of some of the specimens. Dr. Fullington provided no evidence to support the premise that there were no comparable sale items in existence in justifying a replacement cost method.

Mr. Ketner, the IRS expert, had been involved in the taxidermy trade for over 30 years and owned and operated a taxidermy business. He was licensed, taught classes, and authored books on the subject. Since 2013, he was a certified appraiser specializing in taxidermy items and conducted at least 20 appraisals for insurance or donation purposes. He was retained by museums, state and local governments, and the IRS, and was the only expert that the court recognized at trial as a taxidermy expert.

Mr. Ketner prepared an appraisal report using the market approach for the 177 specimens. Taking Dr. Fullington's "excellent" ratings as true, Mr. Ketner determined their value was $41,140. However, Mr. Ketner indicated that his observation of some of Dr. Fullington's photographs revealed some possible defects in many of the specimens. Taking these defects into consideration, Mr. Ketner reduced his appraised value to $34,240.

The court found Mr. Ketner's testimony credible and convincing. Mr. Ketner described the donated specimens as mostly "remnants and scraps" of a trophy collection, comprised of "what's left over when you're done mounting an animal" or what is "not needed for what's hanging on the wall." His report noted that the specimens included 29 partial skins or backskins, which are left over after a shoulder mount. The specimens also included skulls, tails, hooves, and other leftover items.

To obtain comparables, Mr. Ketner consulted market data from auction houses, online auction sites (such as eBay) and other websites specializing in hunting specimens. He testified that there was always a market for such items, because taxidermists buy, sell, swap, or trade these items as needed to complete projects or for their own collections. For each of the 177 species, Mr. Ketner sought to identify the best available comparables, based on size and quality. For some items, he found as many as 10 or 20 comparables and he selected the one in the middle. Mr. Ketner used an average if he only found two comparables.

Mr. Gardner's first two experts were Anibal Rodriguez and Victor Wiener. Mr. Rodriguez retired after 37 years as a technical consultant in the anthropology division of a New York Natural History Museum. He was neither an appraiser nor taxidermist and never hunted or purchased or sold items such as the specimens in this case. Mr. Weiner was an art historian and an appraiser specializing in decorative and fine arts. The court recognized him as an expert in appraisal and appraisal methods, but he acknowledged that he had no expertise in appraising hunting specimens. Mr. Weiner offered no opinion on the FMV of the 177 specimens. Nonetheless, he insisted the replacement cost approach was best.

Neither expert assigned a dollar value to the 177 specimens but sought to only define "replacement cost" as the proper method. The court noted that the "thrust of their testimony was that Mr. Ketner's market approach could not capture the FMV of the 177 specimens because they were museum-quality pieces "uniquely valuable for research." Neither witness provided any factual support for this theory.

Mr. Gardner's third expert, Jack Atcheson, was an international hunting consultant whose firm specializes in providing cost estimates for "fair chase" hunts. He placed a $2,554,300 value on the 177 specimens, ($1,128,400 more than Mr. Gardner reported on his return). Mr. Atcheson arrived at this amount by estimating the out-of-pocket costs a hunter would incur to go on 177 separate safaris organized as luxurious "fair chase" hunts. To account for the possibility that his estimates were "at the high end" he applied a flat 15% reduction, without any basis for this amount. He conceded that several animals could be hunted in one trip, that multiple specimens could be harvested from one animal, and that several items could be shipped in one crate. He nevertheless insisted that using costs for 177 separate trips was the appropriate method to use to determine the FMV of the specimens. The court found the testimony of Mr. Gardner's three experts unreliable.

An important factor in determining whether a replacement cost or comparable sales methodology should be used is whether the specimens are commodities or collectibles. If a hunting trophy is a collectible, relevant factors used in the valuation would include who shot the animal, where it was shot, and who were previous collectors of that specimen. However, such factors are irrelevant if they are valued as commodities. Commodities have a value that may be determined by a reasonably active market. Examples of commodities are steel or sugar, which may be valued by comparing the prices that comparable items obtain in the marketplace. The court stated that it had "no difficulty in concluding that the 177 specimens were commodities and that [the IRS's] market price approach supplies the proper methodology for ascertaining their value."

Holding. The court held that the 177 items were commodities, not collectibles. Accordingly, market prices are generally used to determine their value. The court found Mr. Ketner's testimony and methodology most credible and noted that Mr. Gardner did not seriously challenge Mr. Ketner's assertions, nor did Mr. Gardner introduce any market price evidence.

Mr. Gardner failed to carry his burden of proof that the 177 items had an FMV that exceeded the $163,045 allowed by the IRS on the notice of deficiency. The notice of deficiency is appropriate.

High-Deductible Health Plans

Rev. Proc. 2018-27, 2018-20 IRB 591 (May 21, 2018)
IRC §223

☞ Modification to Annual High-Deductible Health Plan Limitations

Purpose. Rev. Proc. 2018-27 modifies the annual limitation on deductions for contributions to health savings accounts (HSAs) for families with coverage under a high deductible health plan (HDHP) to $6,900 for the 2018 calendar year.

Analysis. Rev. Proc. 2017-37,[22] which was released on May 4, 2017, established $6,900 as the 2018 inflation-adjusted amount for families with an HDHP. However, the Tax Cuts and Jobs Act (TCJA) enacted on December 22, 2017, established the inflation-adjusted amount at $6,850 for 2018. This is a $50 decrease from the amount released in May 2017.

Implementing the $50 reduction would impose unintended administrative and financial burdens. Some families with an HDHP made the maximum contribution before the amount was reduced. Other individuals made annual salary reduction elections through their employers' cafeteria plans based on the $6,900 limit. The costs to modify various systems to reflect the reduced amount in addition to any costs associated with distributing the $50 excess contribution and potential earnings are significantly greater than any tax benefit from the increased HSA contribution. Therefore, taxpayers are permitted to treat $6,900 as the annual limitation for 2018.

22. Rev. Proc. 2017-37, 2017-21 IRB 1252.

An individual who receives an HSA distribution of an excess contribution based on the $6,850 limit may repay the distribution to the HSA and treat the distribution as a mistake of fact due to reasonable cause. The portion of the distribution, including earnings, repaid to an HSA by April 15, 2019, will not be included in the individual's gross income or subject to the 20% additional tax and is not subject to excise tax on excess contributions. Mistaken distributions that are repaid are not required to be reported on Form 1099-SA, *Distributions From an HSA, Archer MSA, or Medicare Advantage MSA,* or Form 8889, *Health Savings Accounts (HSAs).* They are not required to be reported as additional HSA contributions.

An individual who receives an HSA distributions of an excess contribution based on the $6,850 limit and **does not repay** the distribution to the HSA may avoid including the distribution in gross income. The excess contribution will not be included in gross income or subject to the 20% additional tax if the distribution is received on or before the last day for filing the individual's 2018 tax return (including extensions).

Distributions from an HSA that are attributable to employer contributions are included in gross income if the employer does not include any portion of the contributions in the employee's wages because the employer treats $6,900 as the annual limitation. The distribution is subject to the 20% additional tax. An exception exists if the distribution is used to pay qualified medical expenses.

Effective Date of Rev. Proc. 2018-27. This revenue procedure is effective for the 2018 calendar year.

DIVORCE ISSUES

Alimony Deduction

***Gary A. Wolens v. Comm'r,* TC Memo 2017-236 (Nov. 27, 2017)**
IRC §71(b)

☞ Payment to Ex-Spouse Under English Divorce Order Does Not Qualify as Alimony

Facts. Gary Wolens is a U.S. taxpayer who resided in the United Kingdom at the time he divorced his wife. The divorce was finalized under English law on January 24, 2006. They originally married in New York in 1986 before moving to the United Kingdom.

The divorce order issued by an English court required a lump-sum payment to be made by Mr. Wolens to his former spouse in each tax year from 2005 through 2009, inclusively. Mr. Wolens paid all such amounts, including the final lump-sum payment of £441,666 (or $650,088).

Mr. Wolens filed his 2009 U.S. tax return, on which he claimed an alimony paid deduction of $650,088. The IRS issued a notice of deficiency denying the deduction for alimony paid, resulting in an income tax deficiency of $183,864.

Issue. The issue is whether the 2009 payment constituted alimony under IRC §71(b).

Analysis. Alimony is defined in IRC §71(b)(1). To qualify as alimony, one of the four factors that must be met is that there must be no liability to make the payment (or a substitute form of payment) after the payee spouse's death. This is the only factor that Mr. Wolens and the IRS disagree on, and the Tax Court had to determine whether he would have such liability if his ex-wife's death were to occur.

The Tax Court looked to the divorce order issued by the English court to determine if a post-death obligation exists. The Tax Court noted that if the divorce order is silent on the post-death obligation, the payments can only meet the requirement under §71(b)(1) if the obligation so terminates under operation of law.[23] Moreover, further precedent indicated that if state law is ambiguous on the post-death obligation issue, the court could make its own determination based on the document's language.[24]

23. *Johanson v. Comm'r,* 541 F.3d 973, 977 (9th Cir. 2008), *aff'g* TC Memo 2006-105 (May 15, 2006); *Hoover v. Comm'r,* 102 F.3d 842, 846 (6th Cir. 1996).

24. *Hoover v. Comm'r,* 102 F.3d 842, 846 (6th Cir. 1996).

While the parties disputed whether New York or English law applied, the Tax Court concluded that because the divorce order was issued under English law, English law would be applied in interpreting the divorce order. The court looked to The Matrimonial Causes Act 1973, which governs divorce orders, separation agreements, and related orders within England and Wales. The court noted that under this English law, Mr. Wolens' 2009 payment fell under the definition of a "lump-sum payment" and not a "periodic payment."

This English act expressly provides that periodical payments terminate upon the death of either party to the marriage or upon the remarriage of the payee spouse but was silent on the issue with respect to a lump-sum payment. The Tax Court concluded that this statutory language was intentional on the part of the English Parliament, and, therefore, the obligation to pay the lump sum would have continued after the death of Mr. Wolens' former spouse. The court, concluding the divorce order was not ambiguous on the issue, cited English case precedent supporting this conclusion.

Mr. Wolens' obligation to pay the lump sum he paid in 2009 would have continued after the recipient spouse's death under English law. Accordingly, the payment does not meet the fourth qualification under IRC §71(b)(1) that must be met in order for the payment to qualify as alimony.

Holding. The court held that Mr. Wolens is not entitled to an alimony paid deduction for 2009. The IRS notice of deficiency stands.

FOREIGN INCOME

Foreign Earned Income

Jesse and Dawn Linde v. Comm'r, **TC Memo 2017-180 (Sep. 18, 2017)**
IRC §§61, 162, 274, 911, and 6662

☞ Taxpayer Living and Working in Iraq Entitled to Foreign Earned Income Exclusion

Facts. Jesse and Dawn Linde are U.S. citizens. In 1982, Mr. Linde joined the U.S. Army and trained to become a helicopter pilot. He retired from the Army in 1992. He resumed his piloting career in the private sector in 1995 and lived and worked as a trainer of helicopter pilots in Saudi Arabia from 1995 to 1997. He then obtained a similar job in Bosnia and worked there until 2000. He rejoined the Army after the terrorist attacks on September 11, 2001, serving initially as an instructor pilot in Alabama and then in the Sinai Peninsula. Mr. Linde retired from the Army for a second time in 2005.

In 2009, Mr. Linde was offered a job in Iraq as a helicopter pilot with government contractor Blackwater Security Consulting. Mr. Linde was in his mid-50s at the time and was concerned about his employment prospects in the United States. His age was not an obstacle in Iraq, as long as he could pass a physical examination. Mr. Linde and his wife agreed that he would accept the job offer and work in Iraq until he permanently retired. Mrs. Linde would remain in Alabama.

In April 2009, Mr. Linde began working for Blackwater. Blackwater lost its government contract in November 2009, and Mr. Linde became an employee of Blackwater's successor, DynCorp International. The Iraqi government issued Mr. Linde a residency visa. During 2010, 2011, and 2012 (the years at issue in this case), Mr. Linde worked in Iraq as an employee of DynCorp.

Mr. Linde's primary responsibility during the years at issue was to fly "all over Iraq," transporting government officials to various locations in support of the U.S. ambassador to Iraq. His work schedule consisted of 60 straight days of 12-hour shifts, followed by a 30-day break. DynCorp could not keep all its employees in Iraq at the same time, so it required its helicopter pilots to leave Iraq every 60 days. Accordingly, DynCorp provided Mr. Linde with a round-trip ticket to Kuwait at the end of each 60-day period. From Kuwait, Mr. Linde flew to the United States at his own expense.

Except for travel time, Mr. Linde spent his break periods at the marital home he shared with Mrs. Linde in Daleville, Alabama. The special healthcare needs of Mr. Linde's son-in-law made overseas travel very difficult for Mrs. Linde and the couple's children. Otherwise, Mr. Linde would have arranged for Mrs. Linde and their children to join him in Europe for some of his break periods.

In Iraq, Mr. Linde lived in a housing unit provided by DynCorp. When he was not working, Mr. Linde went on excursions to local markets to purchase food and building materials, which he used for small projects to improve his housing unit. He also spent time socializing with several Iraqi interpreters, whom he had befriended.

Since he joined the Army in 1972, Mr. Linde maintained a bank account at the Armed Forces Bank. He also maintained an Iraqi bank account at the U.S. Embassy from February 2010 through May 2011. He closed the account when the Iraqi bank closed its branch there.

Issue. The primary issue is whether Mr. Linde is entitled to exclude portions of the wages he earned during the tax years 2010, 2011, 2012 as foreign earned income under IRC §911(a).

Analysis. IRC §911(a) provides that a qualified individual can elect to exclude foreign earned income from their gross income. To be entitled to this exclusion, a taxpayer must satisfy the following requirements.

1. Be an individual whose tax home is in a foreign country
2. Be **one** of the following
   a. A bona fide resident of one or more foreign countries for an uninterrupted period that includes an entire tax year
   b. Physically present in the foreign country or countries for at least 330 days in a 12-month period (physical presence test)

Mr. Linde conceded that he did not satisfy the physical presence test. Therefore, he must prove that his tax home was in Iraq and he was a bona fide resident of Iraq during the years at issue.

An individual's tax home is generally in the vicinity of the taxpayer's principal place of employment and not where their personal residence is located.[25] However, an individual is not treated as having a tax home in a foreign country during any period in which their abode is in the United States.[26] Maintenance of a dwelling in the United States by an individual, regardless of whether that dwelling is used by the individual's spouse and dependents, does not necessarily mean that the individual's abode is in the United States.[27]

Mr. Linde's principal place of employment was in Iraq during the years at issue. Therefore, the location of his tax home depends on whether his abode was in the United States during the years at issue. If the taxpayer's ties to the United States are strong, the court has held that the taxpayer's home remains in the United States, especially when their ties to the foreign country were transitory or limited during that period.[28] Based on the following facts, the court concluded that Mr. Linde had stronger ties to Iraq than he did to the United States during the years at issue.

- Mr. Linde's economic and social life was centered in Iraq at all relevant times.
- He credibly testified that he could work as a helicopter pilot in Iraq for the foreseeable future, while it was becoming almost impossible for him to do so in the United States.
- He did not work in any country besides Iraq, and he spend two-thirds of each year at issue there.

25. *Mitchell v. Comm'r,* 74 TC 578, 581 (1980); see also Rev. Rul. 75-432, 1975-2 CB 60.

26. IRC §911(d)(3); see also *Harrington v. Comm'r,* 93 TC 297, 307 (1989).

27. Treas. Reg. §1.911-2(b).

28. See *Harrington v. Comm'r,* 93 TC 297, 308 (1989).

- He opened a bank account in Iraq in 2010 and accepted a promotion from DynCorp in 2012.
- The time he spent in Iraq socializing, making improvements to his housing unit, and visiting local restaurants and markets demonstrated an effort to create a domestic and personal life for himself in Iraq.

The IRS contended that Mr. Linde's abode was in Alabama because he owned a home there and visited his family there. He also had an Alabama driver's license and voter registration. However, Mr. Linde credibly testified about his desire to remain in Iraq indefinitely and the lack of piloting opportunities in the United States. He also testified that he would have preferred to meet his family in Europe but could not do so because of his son-in-law's disability. Based on the facts and circumstances of this case, the court concluded that Mr. Linde's tax home was in Iraq.

In determining whether an individual is a bona fide resident of a foreign country, the courts have examined the following factors.[29]

- The taxpayer's intent
- The taxpayer's physical presence
- The taxpayer's social, family, and professional relationships
- The taxpayer's representations

After considering all the facts in the case, the court held that Mr. Linde proved he was a bona fide resident of Iraq during the years at issue.

Holding. The court held that Mr. and Mrs. Linde are entitled to the foreign earned income exclusions claimed on their returns.

Foreign Earned Income Exclusion

Robert and Eleanor M. Hudson v. Comm'r, **TC Memo 2017-221 (Nov. 8, 2017)**
IRC §911

☞ Pilot Working for Foreign Airline Does Not Qualify for Foreign Earned Income Exclusion

Facts. Robert Hudson was a retired airline pilot who graduated from Iowa State University with a degree in distributive studies. Mr. Hudson retired from Northwest Airlines in February 2007 without any restriction on his ability to work as a pilot for another airline. He sought employment with foreign airlines because of their favorable seniority policies. He submitted his application through a U.S. agency, Global Airline Pilots (GAP), who submitted his application to Korean Airlines (KA). On March 19, 2007, he entered into a 5-year employment contract with GAP that stated that he was "…an independent contractor and...not an employee or agent of GAP." This agreement with GAP stated that Mr. Hudson's flight base was in Korea.

At the beginning of his employment as a KA pilot, Mr. Hudson was required to complete a training course at the KA facility, complete the KA simulator program, and pass an exam about Korean air law, after which he received a Korean pilot's license as a 747-400 captain. While employed, Mr. Hudson was required to abide by the Korean Airlines policies and procedures and was based in Inchon, South Korea. He obtained an E5 visa and was a registered alien in South Korea, where he lived in a Hyatt hotel paid for by KA. Mr. Hudson stored large suitcases of his belongings at the hotel while away and would have these belongings brought to his room upon his check-in. He cooked in a designated area of the hotel, rode a bicycle provided by the hotel, and used the hotel's golf course. He had a Korean bank account and cell phone for a limited time.

29. *Vento v. Dir. of V.I. Bureau of Internal Revenue,* 715 F.3d 455, 467-468 (3d Cir. 2013).

Mr. Hudson flew many international routes while working, with layovers that could last for several days at a time. He received nine days off per month, typically given in blocks, and 24 vacation days per year. However, Mr. Hudson would sometimes be asked to take flights on his days off but could request to use his vacation days in the same period as his days off. When he vacationed, he had the option of traveling to any direct-flight city to which KA flew at no cost. Mr. Hudson seldom vacationed in South Korea, but instead spent as much time as possible in the United States, as much as 132 days per year.

KA did not pay Mr. Hudson directly, but instead paid his salary to GAP. GAP withheld Korean taxes, deducted GAP's fees, and deposited the remainder into Mr. Hudson's U.S. bank account. Mr. Hudson also received per diem allowances that were deposited into his Korean bank account. His annual Korean tax statement indicated he was a "non-resident" and he did not consider himself to be a permanent resident of Korea, but a registered alien paying Korean taxes.

Mr. Hudson and his wife Eleanor owned three homes in the United States during 2011 and 2012. Their primary residence was in Apple Valley, Minnesota. Their other two homes were located in Surprise, Arizona, and Chicago, Illinois. The mortgage on the primary residence in Minnesota was paid off in 2011, and after that, only the latter two homes continued to have mortgages.

Mr. Hudson sought an attorney's advice regarding his relationship with KA and tax compliance. He understood from the attorney that he became an employee of KA when he signed the agreement. He hired a CPA in Minnesota to prepare married filing jointly (MFJ) returns for 2011 and 2012. Mr. Hudson provided the CPA with the Forms 1098, *Mortgage Interest Statement,* in connection with mortgage interest paid in 2011 and 2012 and answered questions in the CPA's organizer. The 2011 return claimed a deduction for the mortgage interest on the Minnesota and Arizona homes, while the 2012 return claimed a deduction for the interest paid on the Arizona and Illinois homes.

Mr. Hudson also sought advice from counsel regarding his eligibility for the foreign earned income exclusion (FEIE). He completed the attorney's questionnaire but did not provide the attorney with the GAP agreement, and he was not asked to provide it. The attorney advised him he was eligible for the FEIE in a letter dated January 6, 2011. However, the IRS issued a notice of deficiency for the 2011 and 2012 returns, disallowing the FEIE claims shown on those returns because of failure to establish either bona fide residence or physical presence in a foreign country for the relevant period. Moreover, the notice of deficiency determined self-employment (SE) tax for both years and a 20% accuracy-related penalty. Mr. and Mrs. Hudson petitioned the Tax Court for a redetermination.

Issues. The issues are whether:

- Mr. Hudson qualified for the FEIE in 2011 and 2012,
- Mr. Hudson is an employee of or independent contractor for KA, and
- The Hudsons are liable for the 20% accuracy-related penalty.

Analysis. To qualify for the FEIE, under IRC §911, a taxpayer must be either a bona fide resident of a foreign country or be physically present in that country for a certain required time period. Under the bona fide residence test, the taxpayer must offer strong proof of genuine residency in a foreign country. Courts consider a number of factors in making a determination of whether this test is met, outlined in *Sochurek v. Comm'r*,[30] including the following.

- The intention of the taxpayer
- Establishment of the taxpayer's home temporarily in the foreign country for an indefinite period
- Participation in activities of the taxpayer's chosen community on social and cultural levels and, in general, assimilation into the foreign environment
- Physical presence in the foreign country consistent with employment
- The nature, extent, and reasons for temporary absences from the temporary foreign home
- The assumption of economic burdens and payment of taxes in the foreign country
- The status of the taxpayer in the foreign country as resident or transient
- The treatment accorded the taxpayer's income status by the employer
- Marital status and residence of the taxpayer's family
- The nature and duration of employment, and whether the assignment abroad could be promptly accomplished within a definite or specified time
- Good faith in making the trip abroad and whether such trip was made for tax evasion purposes

The Tax Court noted that not all of the above factors may exist in every case, and those that do apply should be considered and weighed.

Mr. Hudson relied on two prior cases to conclude that pilots for foreign airlines are eligible for the FEIE. In the first of these two cases,[31] the Fifth Circuit Court of Appeals, reversing the Tax Court's decision, concluded the taxpayer was a bona fide resident of Japan given the taxpayer's intent to remain in Japan until retirement approximately eight years later and the return of a dividend check to Alaska. The Court of Appeals indicated that intent plays perhaps the most important part in determining the establishment and maintenance of a foreign residence. In addition, the Court of Appeals indicated that it was not essential for the taxpayer to establish a fixed, permanent place of abode in a foreign country in order to be a resident of that country, so living in a hotel could be conducive to bona fide residence. The taxpayer in this case was away from the foreign country only when work required or when on vacation, and the fact his spouse did not join him in the foreign country should not detract from his bona fide foreign residency. The Court of Appeals also noted that the taxpayer was not assimilated into the foreign country's culture and determined that the majority of the *Sochurek* factors weighed in favor of bona fide residency in a foreign country for the taxpayer.

In the second case Mr. Hudson relied on,[32] the taxpayer was an airline pilot transferred to the foreign country, who lived in a hotel, paying discounted rates during his stays. He left his bags in storage at the hotel while away. His wife and children lived in California while he was in the foreign country, where he was neither assimilated into the culture nor an extensive participant in activities other than to join the swim club and play tennis and golf. He paid income tax in the foreign country. On those facts, the Tax Court held he was a bona fide resident of the foreign country. For the most significant factor of intent, the Tax Court found the taxpayer intended to remain in the foreign country based on the taxpayer's documentary evidence.

30. *Sochurek v. Comm'r*, 300 F.2d 34 (7th Cir. 1962).

31. *Jones v. Comm'r*, 927 F.2d 849 (5th Cir. 1991).

32. *Cobb v. Comm'r*, TC Memo 1991-376 (1991).

However, the Tax Court, looking at other precedent and despite the similarities with the two cases Mr. Hudson relied upon, concluded that he was not a bona fide resident of South Korea. He intended to spend all of his time off in the United States, traveling home as much as work would allow.

With respect to Mr. Hudson's status as either employee or independent contractor, courts looks to several factors inherent in the worker-and-firm relationship to determine that status. These factors include the following.

- The degree of control exercised by the firm over the details of the work
- Which party invests in the facilities used in the work
- The opportunity of the worker for profit or loss
- Whether or not the firm has the right to discharge the worker
- Whether the work is part of the firm's regular business
- The permanency of the relationship
- The relationship the parties believe they are creating

All of the facts and circumstances within each case are considered and no one factor is conclusive, with the degree of control of the firm over the worker being a central consideration. The Tax Court noted that KA exercised considerable control over Mr. Hudson's work because he was required to abide by employee manual policies and procedures of which he received a copy. In addition, his schedule, including layovers and vacation time, was determined by KA. Finally, the court rejected the IRS's argument that Mr. Hudson's agreement with GAP was determinative. In doing so, the court referred to the Employment Tax Regulations that look to whether an employer-employee relationship actually exists, disregarding any contrary description as immaterial.

Holdings. The court held that because Mr. Hudson was not a bona fide resident of South Korea, he could not exclude his income as a KA pilot using the foreign earned income exclusion. He was an employee of KA due to the degree of control KA has over his work and was therefore not liable for SE tax on the income he earned while working as a KA pilot.

Mr. Hudson consulted with a CPA and counsel on tax issues. He demonstrated reasonable cause and good faith, and an effort to assess the proper tax liability for 2011 and 2012. His reliance on professionals was reasonable and the accuracy-related penalty did not apply.

Foreign Financial Accounts

***Arthur Bedrosian v. U.S.*, No. 2:15-cv-05853; U.S. District Court for the Eastern District of Pennsylvania (Sep. 20, 2017)**
31 USC §§5314 and 5321

☞ Taxpayer's Failure to File FBAR Was Not Willful

Facts. Arthur Bedrosian is a successful businessman who is currently the chief executive officer of Lannett Co., Inc., a manufacturer and distributor of generic medications. In the early 1970s, he held a position that required a significant amount of international travel. Around 1973, he decided to open a savings account in Switzerland so that he would not have to rely solely on traveler's checks to make purchases abroad. His savings account was later converted into an investment account. As a result, a second account was created, although Mr. Bedrosian claimed that he considered them one account.

From 1972 until 2007, Mr. Bedrosian used the same accountant to prepare his tax returns. Mr. Bedrosian did not tell the accountant about his Swiss account until the mid-1990s. At that point, the accountant informed Mr. Bedrosian that he had been breaking the law every year that he did not report the account on his tax return. Mr. Bedrosian asked for the accountant's advice, and the accountant recommended that he take no action because he could not "unbreak the law."

In 2007, Mr. Bedrosian's accountant died and he engaged a new accountant, Sheldon Bransky. The return that Mr. Bransky filed for Mr. Bedrosian for the 2007 tax year included, for the first time, an affirmative answer about whether he had an interest in or signature or other authority over a financial account in a foreign country. Mr. Bedrosian also filed a Report of Foreign Bank and Financial Accounts (FBAR) for the first time. The FBAR reported his Swiss account that had assets of approximately $240,000. The FBAR did not report any information regarding the other Swiss account, which had assets of approximately $2 million.

Around this time, Mr. Bedrosian became more aware of the serious nature of reporting foreign bank accounts. He met with his personal lawyer in late 2008 and told him the history of what happened with the Swiss account and his former accountant's advice. Mr. Bedrosian's lawyer brought a tax attorney into the discussion, who advised him to engage an accounting firm to amend his returns from 2004 up to the present. Mr. Bedrosian followed the attorney's advice, amended his returns, and paid taxes on the gains from his Swiss accounts.

In 2011, the IRS began auditing Mr. Bedrosian's returns. Mr. Bedrosian was cooperative in dealing with the IRS agents who were investigating him. As a result of the investigation, Mr. Bedrosian paid $9,758 for the violation of the FBAR requirement. He filed suit to obtain a refund of this amount, and the government counterclaimed for the full amount of the penalty for a willful violation, which was $1.01 million.

Issue. The issue is whether Mr. Bedrosian willfully violated 31 USC §5314.

Analysis. All U.S. citizens must annually report any "financial interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country" under 31 USC §5314 and the corresponding regulations.[33] Penalties for violations of the FBAR reporting requirement are imposed under 31 USC §5321. Non-willful violations of the requirement are subject to a penalty not to exceed $10,000, while willful violations are subject to a penalty that is the greater of $100,000 or 50% of the balance in the account at the time of the violation. The court noted that the precise definition of "willful" has not been clearly established by statute or precedent. However, the court observed that the requisite willful intent can be shown by finding that the defendant knowingly or recklessly violated the statute.

Mr. Bedrosian's testimony showed that he is an educated and financially literate businessman who took a calculated risk by not complying with his tax reporting obligations for several years. However, the issue in this case is solely whether his failure to file an accurate FBAR **for the 2007 tax year** was willful. The court observed that it was not clear from the record that Mr. Bedrosian was willful in submitting his inaccurate 2007 FBAR. He could have easily discovered that he had two Swiss bank accounts rather than one but he did not take any action that would have revealed this fact. Mr. Bedrosian should have been more careful about reviewing the 2007 FBAR and in being aware of the particulars of his Swiss accounts. On the other hand, he did check the box on his 2007 tax return indicating he had a foreign account and he did file an FBAR for 2007. Additionally, he consulted his personal lawyer about the reporting requirement and engaged an accounting firm to file amended returns. The court concluded that the evidence points to an unintentional oversight or a negligent act rather than a willful violation.

Holding. The court held that Mr. Bedrosian's conduct did not constitute a willful violation of 31 USC §5314. The court further held that because the government had not met its burden to establish that Mr. Bedrosian willfully violated §5314, the $9,758 that he paid in partial satisfaction of his allegedly willful violation was illegally exacted from him and the government owes him that amount.

33. 31 CFR §1010.350(a); 31 USC §5314(a).

GROSS INCOME

IRA Distributions
Rev. Rul. 2018-17, 2018-25 IRB 753 (May 29, 2018)
IRC §§408 and 3405

☞ Payments From IRAs to State Unclaimed Property Funds Subject to Federal Withholding

Purpose. Rev. Rul. 2018-17 was issued to clarify a set of facts submitted in which an individual retirement arrangement (IRA) trustee was required to pay a traditional IRA owner's interest to a state unclaimed property fund. In 2018, the trustee paid the interest in the IRA that had a value of $1,000.

Analysis. Distributions from an employer deferred compensation plan, an IRA, or commercial annuity is treated as includable in gross income under IRC §3405. Federal income tax withholding is required for periodic payments under §3405(a) and nonperiodic payments under §3405(b). Nonperiodic payments are distributions that are not annuities or similar payments made over a period of time. Payors should withhold 10% of the distribution for nonperiodic payments but an individual may elect not to have any withholdings apply.

For the set of facts provided in the revenue ruling, the payments from the traditional IRA to the state unclaimed property fund is includable in gross income. The payment is a nonperiodic distribution. The individual did not make a withholding election and therefore the 10% withholding rate applies to the distribution. The IRA trustee must withhold federal income tax of $100 (10% × $1,000 IRA value) and report the $1,000 distribution on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*

Effective Date of Rev. Rul. 2018-17. The effective date of this revenue ruling is the earlier of January 1, 2019, or the date it is reasonably practical to comply with the requirements.

Gross Income
Joseph E. Bormet v. Comm'r, **TC Memo 2017-201 (Oct. 16, 2017)**
IRC §§72, 402, and 6662

☞ Taxpayer Must Include Defaulted Retirement Plan Loan As Income

Facts. Joseph Bormet held a qualified retirement account (QRA) with Fidelity Investments (Fidelity) since 2012. In September 2012, he received a $30,290 loan from this QRA. Mr. Bormet had not attained age 59½ when he received the funds from the QRA. Mr. Bormet neither had a copy of the loan agreement nor provided any supplemental information to the Tax Court.

Mr. Bormet sustained a work-related injury and began receiving short-term disability benefits in October 2012. He began making biweekly loan repayments of $259 in January 2013 and continued until April 2013. In May, he made an additional repayment of $131. Mr. Bormet did not make any further payments until after he returned to work and resumed biweekly loan repayments of $279 from September through December 2013.

Despite these loan repayments, the loan was in default because the payments were not received in accordance with the loan agreement. Mr. Bormet claimed Fidelity refinanced the loan, but he had no written documentation about any refinancing. Fidelity issued a letter to the IRS confirming a loan default of $26,954.

Mr. Bormet's timely-filed 2013 tax return showed a tax liability of $1,631 for the year. He made total tax payments of $6,079, resulting in a tax refund of $4,448, which he received in February 2014. However, in December 2015, the IRS issued a notice of deficiency of $7,498, which indicated that he failed to include $26,954 that was reported on a Fidelity Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*

Mr. Bormet petitioned the Tax Court for redetermination of the deficiency, additional tax (comprised of the 10% penalty imposed under IRC §72(t)), and IRC §6662 accuracy-related penalty shown on the notice of deficiency.

Issues. The issues are:

- Whether Mr. Bormet failed to include in his 2013 gross income the amount of the defaulted QRA loan reported by Fidelity, and
- Whether he is liable for penalties.

Analysis. If a taxpayer receives a loan from a QRA, the amount of the loan is a taxable distribution in the year received under IRC §§402(a) and 72(p)(1)(A). However, under Treas. Reg. §1.72(p)-1, a loan is not taxable if the following three requirements are met.

1. The principal amount of the loan does not exceed a statutory amount
2. The loan is repayable within five years, unless it is a home loan
3. Except as provided in regulations, the loan requires substantially level amortization over its term, with payments not less frequent than quarterly

If the QRA plan does not notify the taxpayer that the loan distribution was taxable in the year received, the Tax Court may assume that the loan initially qualified for the §72(p) exception. However, even an initially qualifying loan may become taxable as a deemed distribution at the first instance when the three requirements are not satisfied, either in form or in operation.

Mr. Bormet failed to produce any evidence that the §72(p) exception applied to his loan. He did not provide a copy of the original loan agreement, amortization schedule, or any refinancing agreement, and did not provide any documentation that he would repay the loan within the required time frame. Consequently, the Tax Court assumed that any such documentation that existed would prove harmful to Mr. Bormet's argument.

There is a 10% penalty on early distributions from a qualified retirement plan unless an exception applies. Mr. Bormet does not dispute that he is not eligible for an exception and received the distribution before he reached age 59½.

An IRC §6662 accuracy-related penalty is imposed for an underpayment of tax attributable to a substantial understatement of income tax. A substantial understatement of tax exists for the year if the amount of the understatement exceeds the greater of 10% of the tax required to be shown on the return, or $5,000. This penalty does not apply if the taxpayer can show reasonable cause, such as honest misunderstanding of fact or law, reasonable in light of the taxpayer's experience, education, knowledge, and other facts and circumstances. Mr. Bormet's understatement of $7,498 was greater than $5,000, which was greater than 10% of the tax required to be shown on the return ($913). The transaction was complicated but Mr. Bormet offered no evidence of any reasonable cause for his failure to support his legal and factual position.

Holding. The Tax Court held that Mr. Bormet's loan was taxable as a deemed distribution. Mr. Bormet was liable for the §72(t) penalty for early distribution because he had not attained age 59½ at the time of the distribution. Additionally, Mr. Bormet was liable for the accuracy-related penalty because he did not provide any evidence to support his position.

Gross Income

***FloEtta Bullock v. Comm'r,* TC Memo 2017-219 (Nov. 6, 2017)**

IRC §61

☞ Debt Guarantor Not Liable for Cancellation of Debt Income

Facts. FloEtta Bullock's son and his wife ran a car-hauling business. In 2007, the business required a loan to purchase a pickup truck so that they could continue the business. Ms. Bullock, along with her son and daughter-in-law, discussed loan options with a credit union recommended by the truck dealership. Ms. Bullock intended to cosign the loan for her son, but instead unwittingly signed paperwork indicating she was the primary debtor on the loan obligation. However, after the loan was finalized, the dealership dealt only with her son and daughter-in-law, who made the required loan payments.

In 2008, the truck was stolen while parked in front of the house where the three of them lived. The truck insurance only covered part of the outstanding loan balance. When the insurance company paid the credit union, the son and daughter stopped making loan payments. The loan still had an outstanding balance of $8,164 after the insurance company payment was applied, and this outstanding balance was subsequently discharged. Ms. Bullock never received any collection phone calls or correspondence from the credit union to obtain further payment, nor did she ever receive any information regarding the loan's discharge.

The IRS received a 2013 Form 1099-C, *Cancellation of Debt,* from the credit union for cancellation of debt income to Ms. Bullock in the amount of $8,164. Ms. Bullock did not report this income on her return. In January 2016, the IRS sent Ms. Bullock a notice of deficiency indicating that she had unreported income of $8,164. Ms. Bullock filed a Tax Court petition for a redetermination of the deficiency.

Issue. The issue is whether Ms. Bullock must report cancellation of debt income of $8,164.

Analysis. The notice of deficiency is presumed correct, and the taxpayer bears the burden of proving otherwise. For cancellation of debt income to exist, there must be a bona fide debt. Whether a transaction constitutes a debt is a factual determination, and the Tax Court as well as other courts have articulated different factors to look to in analyzing whether a bona fide debt exists. However, the ultimate inquiry regarding a bona fide debt is whether there was a genuine intention to create a debt with a reasonable expectation of repayment, and whether that intention comported with the economic reality of creating a debtor-creditor relationship.

A guarantor creates a contingent liability, and the guarantor does not recognize income upon discharge of a debt, because the guarantor does not benefit from an accretion in assets upon the loan's discharge in the way the primary debtor does.

The loan was not a bona fide debt to Ms. Bullock. At the dealership, she did not intend to be the primary debtor, and in fact, did not realize she signed paperwork as primary debtor until trial. Ms. Bullock did not intend to personally repay the loan and made no such payments. The credit union also understood that she intended to be only a cosigner and never looked to her for payments. Her conduct in the transaction was that of a cosigner, and she never used the truck. As guarantor, Ms. Bullock did not have the same increase in net worth that a primary debtor has upon the discharge of a loan.

Holding. The court held that Ms. Bullock did not have unreported income and did not owe the tax liability amount shown on the notice of determination.

Gross Income

***Edward Collins v. Comm'r,* TC Summ. Op. 2017-74 (Sep. 11, 2017)**

IRC §104

☞ Emotional Distress Damage Award is Includable in Gross Income

Facts. Edward Collins began working at Public Service Electric & Gas (PSEG) in 1972. He transferred to another office in March 2010 and was subjected to a racially hostile work environment. In January 2011, his doctor diagnosed him with depression, general anxiety disorder, and other related ailments. Mr. Collins left work on disability leave. In May 2011, he filed a lawsuit against PSEG in New Jersey court. The lawsuit alleged that PSEG:

- Subjected Mr. Collins to a racially hostile work environment,
- Discriminated against Mr. Collins because of his race, and
- Retaliated against him because of his complaints regarding racial discrimination.

The lawsuit stated that as a result of these actions by PSEG, Mr. Collins suffered severe emotional distress and anxiety, with physical manifestations, including high blood pressure. Additionally, the harassment and discrimination caused Mr. Collins to begin taking antidepressants and to be treated by a therapist and psychiatrist.

Mr. Collins' lawsuit included a demand for lost wages, benefits, insurance and pension coverage, and fringe benefits. The suit included a separate demand for compensation for severe emotional distress, humiliation, and anguish he suffered. There was no demand in the suit for compensation on account of any physical injury or physical sickness.

The lawsuit settled, and the parties executed a settlement agreement in which PSEG agreed to pay Mr. Collins the following amounts for a total of $275,000.

- $90,000 payable to attorneys
- $15,000 to Mr. Collins for reimbursement of unpaid medical expenses
- $85,000 to Mr. Collins for emotional distress
- $85,000 to Mr. Collins, less federal and state withholding taxes

On his 2012 tax return, Mr. Collins reported the $85,000 amount for emotional distress as "Other Income." On line 36 of the return (a computational line not requiring an income inclusion or deduction), Mr. Collins deducted $85,000, because he contended that the $85,000 received for emotional distress is not taxable.

The IRS issued a notice of deficiency disallowing the $85,000 deduction.

Issue. The issue is whether the $85,000 attributable to the emotional distress damage award is excludable from income.

Analysis. Under IRC §104(a), emotional distress is not treated as a personal physical injury or sickness. However, damages for emotional distress attributable to a physical injury or physical sickness are excluded from gross income under IRC §104(a)(2) and Treas. Reg. §1.104-1(c)(1). Moreover, damages not in excess of the amount paid for medical care attributable to emotional distress are also excludable under IRC §104(a).

Mr. Collins argued that the $85,000 was mischaracterized in the settlement as payable for emotional distress. He believed it should have been described as a payment for physical injury and physical sickness. The IRS argued that the settlement agreement specifically stated that the $85,000 is for emotional distress, and even in the absence of any specific characterization, the $85,000 would not be construed as received for physical injuries. The Tax Court pointed to precedent indicating that an express allocation in the settlement agreement is generally binding for tax purposes provided the agreement was entered into by adversarial parties acting at arm's length and in good faith.

In addition, while Mr. Collins stated that he was required by PSEG to do more meter-readings on Saturdays than his white workers, he made no allegation that he suffered physical injury or sickness from the extra work. His lawsuit's complaint stated that he suffered "severe emotional distress and anxiety, with physical manifestations" as a result of PSEG's racially hostile work environment, not as a result of any physical injury or sickness. Further, the complaint indicated that his depression was the result of PSEG's harassment and discrimination, not as the result of any physical injury or sickness. Even his specific demand called for compensation for "severe emotional distress…" and not physical injury or sickness. The settlement agreement was executed at arm's length and in good faith.

Mr. Collins offered no good reason as to why the $85,000 would have been mischaracterized in the settlement agreement. Legislative history regarding IRC §104(a) indicates that it "is intended that the term emotional distress includes symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress." Suffering physical symptoms from emotional distress does not mean the damage award for such symptoms may be characterized as damages for physical injury or sickness.

Holding. The court sustained the IRS's disallowance of the $85,000 deduction because emotional distress amounts are not excludable from income under IRC §104(a)(2).

Gross Income

***Joanna Klubo-Gwiezdzinska v. Comm'r,* TC Summ. Op. 2017-45 (Jun. 28, 2017)**
IRC §§864, 871, and 894

☞ Researcher's Payments from Hospital not Excludable Under Treaty

Facts. Joanna Klubo-Gwiezdzinska was born in Poland and is a Polish citizen. She earned both a medical degree and Ph.D. in Poland and is a noted, well-respected expert on the subject of thyroid cancer. Joanna is a member of the Endocrine Society (ES), which connects endocrinologists with each other through placement in research positions at top institutions outside of their home countries. Through this ES program, Joanna met an official at Washington Hospital Center (WHC), who ultimately offered her a position as research fellow. She received a WHC letter, which indicated that the appointment was effective February 15, 2009, for a period of one year, with an opportunity for renewal for an additional second and third year. The letter specified that her stipend would be $48,000 plus benefits and noted that this was considered to be a fully-salaried position and that Joanna would be eligible for appointment to the faculty of the Georgetown University School of Medicine as Assistant Professor.

Joanna accepted this position and entered the United States on a J-1 visa. She completed the first year and renewed her contract for the two additional 1-year periods at a salary of $53,500 for the second year and $56,200 for the third year. She worked at least 40 hours per week and she gave presentations on her research, with her findings appearing in various medical publications and journals.

For the 2010 and 2011 tax years, WHC issued Joanna a Form W-2, *Wage and Tax Statement,* showing wages of $49,502 and $51,795, respectively. Both Forms W-2 indicated she was covered by a retirement plan. On her 2010 and 2011 tax returns, she disclosed that she was a resident and citizen of Poland and she claimed that these wage amounts were exempt from income taxation under article 18 of the tax treaty between Poland and the United States.

On WHC's publicly available Form 990, *Return of Organization Exempt From Income Tax*, WHC is not described as a school under the charitable organizations rules but instead is described as a hospital. Moreover, this form also indicated that WHC gave no monetary grants or assistance to individuals.

In March 2015, the IRS sent Joanna a notice of deficiency indicating that she had received income for 2010 and 2011 in the amounts of $47,502 and $49,795, respectively, which was not exempt from federal income taxation. Joanna petitioned the Tax Court for a redetermination. While Joanna relied on article 18 of the tax treaty, she also argued an alternative ground for tax exemption based on article 17 of the tax treaty regarding income of teachers.

Issue. The issue is whether the payments Joanna received from Washington Hospital Center during 2010 and 2011 are exempt from taxation under the tax treaty.

Analysis. Generally, under IRC §871(b), a nonresident individual engaged in a U.S. trade or business in the United States is subject to U.S. income taxation on income effectively connected with the conduct of that trade or business. A person who performs personal services in the United States at any time during the year is considered to be conducting a trade or business within the United States under IRC §864(b). A nonresident alien receiving compensation for personal services in the United States has income effectively connected with the conduct of a trade or business in the United States and therefore has gross income for tax purposes.[34] However, IRC §894(a) provides for the application of any treaty obligation of the United States to be applied to the taxpayer and, accordingly, a tax treaty obligation of the United States can change a taxpayer's tax liability under the Code.

The Tax Court first looked to case precedent to conclude that the interpretation of treaty provisions begins with the wording of the treaty, and that the court's role was to decide the underlying intent or purpose of the treaty provision. The wording of article 18 of the tax treaty, in relevant part, is as follows.

> *An individual who is a resident of one of the Contracting States at the time he becomes temporarily present in the other Contracting State and who is temporarily present in that other Contracting State for the primary purpose of. . . Studying or doing research as a recipient of a* ***grant, allowance, or award*** *from a governmental, religious, charitable, scientific, literary, or educational organization. . . shall be exempt from tax by that other Contracting State with respect to amounts described in subparagraph (b) for a period not exceeding 5 taxable years from the date of his arrival in that other Contracting State. . . Income from personal services performed in that other Contracting State in an amount not in excess of 2,000 United States dollars. . . for any taxable year. [Emphasis added]*

The IRS and Joanna agreed that she was a resident of Poland and temporarily present in the United States during all relevant times in 2010 and 2011 for the primary purpose of conducting research and that WHC is a U.S. charitable organization. However, the IRS argued that Joanna's payments received from WHC were not a "grant, allowance, or award" under article 18, and, therefore, those payments are not exempt from taxation. The IRS instead contends those payments are taxable compensation from employment.

The court reviewed a prior case in which the taxpayer made a similar claim to Joanna's. Like Joanna, the taxpayer in the prior case did not directly receive any grants or awards. Instead, the record was replete with references to the taxpayer being an employee, and as such, the payments to him were compensation that was not exempt from tax under a similar treaty provision.[35]

The agreement that Joanna entered into with WHC provided she would "earn a salary" and receive benefits (paid time off, such as sick, vacation, and personal time, liability insurance, and family and medical leave). Moreover, the agreement stated she would receive her salary in equal installments on a biweekly basis. Receiving remuneration in the form of salary and benefits like this is generally indicative of an employment relationship.

In addition, the agreement indicated that WHC could "terminate" Joanna for any legitimate reason, including "workplace misconduct." The right to discharge a worker also indicates an employment relationship.

The Tax Court noted that the reporting of payments to Joanna on Form W-2 in each year also indicated an employment relationship and that WHC's Form 990 indicated that the organization did not issue any grants to individuals in 2010 or 2011.

---

34. See IRC §§864(c)(1)(A), (2), 871(a)(1)(A), and Treas. Reg. §1.864-4(c)(6)(ii).

35. *Sarkisov v. U.S.,* 2005-1 USTC; 03-1870T (Fed. Cl. 2005).

While Joanna contended that she received a grant and certain donations were "earmarked" for her salary, the Tax Court found nothing in the record to support this finding. The record only showed that donations were made to WHC for the general purpose of cancer research, not for Joanna's personal benefit or payment, and no such payments were made contingent on her participation in such research.

Joanna also posed an alternative argument, relying on article 17 of the tax treaty for teachers. Article 17 provides as follows.

> *Where a resident of one of the Contracting States is invited by the Government of the other Contracting State, a political subdivision or a local authority thereof, or by a university or other recognized educational institution in that other Contracting State to come to that other Contracting State for a period not expected to exceed 2 years for the purpose of teaching or engaging in research, or both, at a university or other recognized educational institution and such resident comes to that other Contracting State primarily for such purpose, his income from personal services for teaching or research at such university or educational institution shall be exempt from tax by that other Contracting State for a period not exceeding 2 years from the date of his arrival in that other Contracting State.*

The term "recognized educational institution" is not defined in the tax treaty. The Tax Court noted that another treaty provision indicates that in the event there is an undefined term, the meaning of that term under the laws of the contracting state will control. For such definition of "recognized educational institution," both parties cited IRC §170(b)(1)(A)(ii), which indicates that an "educational organization" is one "which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." Underlying regulations exclude from this definition organizations engaging in both educational and noneducational activities, unless the noneducational activities are merely incidental to the educational activities.

Joanna argued that her payments from WHC are exempt because WHC is a teaching hospital, and therefore is a "recognized educational institution" under article 17. The Tax Court disagreed, noting that WHC's noneducational activities were not "merely incidental to the educational activities," as clearly indicated by WHC's Form 990, where its mission statement indicated that patient care is the predominant purpose and activity of WHC. Moreover, the Form 990 expressly states WHC is not a school described in IRC §170(b)(1)(A)(ii).

Holding. The court held that the payments Joanna received from WHC do not qualify for exemption under the tax treaty. The IRS notice of deficiency appropriately includes Joanna's payments in her income because those payments constitute compensation.

Gross Income
***Andrey Andreyevich Dovzhenok v. Comm'r,* TC Memo 2017-86 (Nov. 30, 2017)**
IRC §894

☞ Payments Received by Student Not Exempt from Tax Under Treaty

Facts. Andrey is a citizen of Russia and is also considered a resident of Russia as defined in article 4 of the Convention for the Avoidance of Double Taxation between the United States and Russia (tax treaty). He entered the United States in August 2006, holding an F-1 student visa in order to pursue a graduate math degree at Indiana University-Purdue University Indianapolis (IUPUI).

After the first two years of graduate study, he was awarded a research assistantship for the 2008–2009 academic year, which included a stipend of $18,500 for the period July 1, 2008, through June 30, 2009. Also included was a tuition waiver for up to nine credit hours per semester and health insurance. He received a letter from IUPUI outlining these assistantship terms that also stated he was responsible for paying certain out-of-pocket costs, paying tuition of about $500 per semester, maintaining full-time enrollment, and maintaining satisfactory progress toward his Ph.D. degree as a condition to receiving this financial support. The letter also stated that, as part of the assistantship appointment, Andrey may be asked to do emergency teaching, proctoring and grading work for the department of mathematical sciences and/or his research mentor.

He was awarded a similar assistantship for each of the next two academic years, but as a 50% full-time equivalent employee working for the math department. For the 2009–2010 and 2010–2011 academic years, he received a stipend of $19,500 and $20,000, respectively. Letters from IUPUI each year described the work Andrey was to do for the math department, which included 20 hours of work per week during the fall and spring semesters, and an additional 10 hours per week for six weeks of the summer semester. During summer, he had the option of requesting additional work and, if such work was assigned, Andrey would be paid amounts for such additional work in addition to the stipend amount. Letters for each of these two years indicated the funds were being paid from grant money.

During the 2009 and 2010 tax years, Andrey was paid $18,917 and $19,708 from IUPUI, respectively. IUPUI reported these amounts on a Form W-2, *Wage and Tax Statement*, for each year. Andrey reported these amounts on Form 1040NR-EZ, *U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents.* He reported these payments as "wages, salaries, tips, etc." and claimed the amounts were exempt from U.S. taxation under the tax treaty. The tuition waiver, which also was provided to him for these two years, was not reported on either return.

After filing these returns, Andrey sent to the IRS Form 9210, *Alien Status Questionnaire,* indicating that he was employed in the United States and that IUPUI was his employer. The form asked whether there were any restrictions on the length of employment, and Andrey indicated his employment was allowed as long as he was a student.

Andrey also provided the IRS with Form 9250, *Questionnaire – Tax Treaty Benefits,* on which he reported that he was claiming benefits under article 18 of the tax treaty. He also stated that he received a salary from IUPUI and that he was a full-time student. There was a question on the form to indicate the source of any grant (and to attach a copy of such grant), but Andrey left this question blank and did not attach any additional item to the form.

Upon filing each return, Andrey obtained a refund for the federal tax withholding that was remitted by IUPUI. Subsequently, the IRS issued a notice of deficiency to Andrey, indicating tax deficiencies for 2009 and 2010 in the amounts of $1,761 and $1,993, respectively. No mention was made of the tuition waiver in the notice.

Issue. The issue is whether the W-2 amounts received by Andrey for 2009 and 2010 are includable in his income.

Analysis. Article 18 of the tax treaty states that:

1. *An individual who is a resident of a Contracting State at the beginning of his visit to the other Contracting State and who is temporarily present in that other State for the primary purpose of:*

   a. *studying at a university or other accredited education institution in that other State, or*

   b. *securing training required to qualify him to practice a profession or professional specialty, or*

   c. *studying or doing research as a recipient of a grant, allowance, or other similar payments from a governmental, religious, charitable, scientific, literary, or educational organization, shall be exempt from tax by that other State with respect to payments from abroad for the purpose of his maintenance, education, study, research, or training, and with respect to the grant, allowance, or other similar payments.*

The Tax Court noted that this provision addresses situations in which payments are received by an individual from Russia who is temporarily in the United States for the primary purpose of studying, obtaining professional training, or studying or doing research as a grant recipient. The Tax Court further noted that two types of payments are exempt from taxation as follows.

- Payments received from abroad for the purpose of the individual's maintenance, education, study, research or training
- A grant, allowance, or other similar payment from a governmental or educational organization (among others)

In Tax Court, Andrey argued that he was temporarily in the United States and that his payments fell under the second type of payment listed above. However, the Tax Court noted that his letters from IUPUI required him to work in exchange for the stipend. For the first year he received a stipend, he provided his services as a researcher for his adviser. For the subsequent two tax years, the letters from IUPUI stated that his appointment was characterized as a 50% full-time equivalent employment, and he taught and graded one course during each of the two summer sessions. He was provided an office and health insurance, and IUPUI withheld taxes on the payments. Andrey indicated he was an employee on the Form 9210 that he furnished to the IRS.

Given the evidence characterizing Andrey's payments as employment compensation, the court indicated there was no evidence that Andrey received a grant, allowance, or other similar payment. He acknowledged at trial that he had no letter awarding a grant, and admitted he had no connection to the grants awarded to the professors for whom he worked. He also failed to provide any grant information on the Form 9250.

Holding. Andrey was not the recipient of a grant, allowance, or other similar payment for 2009 and 2010. He failed to prove that he received payments of this nature that would exempt him from U.S. taxation. Therefore, the 2009 and 2010 tax deficiencies were upheld.

Gross Income
***John A. Voigt and Lorinda C. Martin v. Comm'r,* TC Summ. Op. 2018-25 (May 14, 2018)**
IRC §§117, 132, and 451

☞ Former Employee's Tuition Waiver Benefit Taxable When Used

Facts. John Voigt was employed in the computer services department of Tulane University from 1985 to 1991. In response to financial difficulties, Tulane University reduced its workforce and Mr. Voigt was one of the employees to receive a severance package. His severance package included, among other items, an extended tuition waiver policy. The severance package documents indicated that the reason for Mr. Voigt's severance was the elimination of his position, not for reasons associated with retirement or disability. Under the terms of the severance package, employees with five or more years of full-time service received tuition waivers for their dependents equal to the employee's number of years of service. Mr. Voigt had six years of service. After his layoff from Tulane, Mr. Voigt worked for other employers.

Gabrielle, the daughter of Mr. Voigt and his wife, Lucinda Martin, attended Tulane as a full-time student from the fall of 2012 through the spring of 2015. Mr. Voigt filed applications to receive tuition waivers for Gabrielle. For 2013, Tulane billed Gabrielle's tuition account for $21,575, and subsequently credited her account for the same amount. In 2014, Tulane issued Mr. Voigt a 2013 Form W-2, *Wage and Tax Statement,* showing wages of $21,575, with social security and Medicare taxes withheld totaling $1,650. The Form W-2 was accompanied by an invoice from Tulane for the $1,650 in FICA taxes in connection with the 2013 tuition waiver. Mr. Voigt did not report the $21,575 wage amount on his 2013 return.

In 2016, Mr. Voigt emailed Tulane's payroll department requesting some clarification regarding the 2013 Form W-2. The assistant director for payroll responded to Mr. Voigt that because he was not an employee of the university and received the tuition waiver benefit, the waiver amount was considered income to him. The assistant director also confirmed the dates that his employment with Tulane commenced and ceased.

The IRS sent Mr. Voigt and Ms. Martin a notice of deficiency that made several adjustments to their return including an increase in his 2013 income of $21,575. However, the IRS did not send such a notice or make a similar adjustment for the 2012 tuition waiver benefit.

Issue. The issue is whether the 2013 tuition waiver amount is taxable to Mr. Voigt and Ms. Martin.

Analysis. In Tax Court, Mr. Voigt argued that the tuition waiver amount was not taxable in 2013 because it represented "money that [he] earned 20 years ago." He asserted that the amount should have been taxed in 1991, when he received the tuition waiver. However, the court looked to the doctrine of constructive receipt of income and noted that the tuition waiver benefit could not be used until substantial qualifying requirements were met. One of the qualifying requirements was having a dependent who met Tulane's admission requirements and enrolled in the university. The court concluded this was a substantial limitation on the receipt of the tuition waiver benefit, and precluded the inclusion of income in 1991 when the benefit was originally received. The court concluded that the tuition waiver was properly taxable in 2013 when the benefit was actually received.

Under IRC §117(d)(1), gross income does not include any qualified tuition reduction provided to an employee of a qualified education institution, for education at a qualified educational institution below graduate level for the employee or someone treated as an employee under IRC §132(h). IRC §132(h) specifies, in relevant part, that those treated as employees include former employees separated from service "by reason of retirement or disability" and the dependents of employees. Accordingly, under the terms of §132(h), the tuition waiver benefit is excludable from gross income for a current employee or for someone treated as an employee due to separation by reason of disability or retirement.

Mr. Voigt argued that he was an employee because Tulane issued him a 2013 Form W-2 for the tuition waiver benefit amount. In the alternative, he argues he was separated because of retirement and his layoff from Tulane was tantamount to early retirement. He also argued that the 2013 tuition benefit should be excluded because the IRS did not require the inclusion of the 2012 benefit in gross income for 2012.

The court stated that the issuance of a Form W-2 does not create an employment relationship. Forms W-2 are frequently required when there is no longer an employer-employee relationship between the issuer and recipient. Whether such a relationship exists is a question of fact. The court noted that Mr. Voigt did not provide any evidence indicating an employment relationship existed with Tulane in 2013 and the email from the assistant director of payroll confirmed the date he ceased to be employed. The court maintained that Mr. Voigt was not an employee of Tulane in 2013.

The Code does not define the term "by reason of retirement," so the court looked to the common definition of the term. Black's Law Dictionary (10th Edition, 2014), defines "retirement" as the "termination of one's own employment or career, esp. upon reaching a certain age or for health reasons; retirement may be voluntary or involuntary." This definition makes it clear that "retirement" is different than other reasons for termination of employment, such as a layoff. Mr. Voigt's severance documentation clearly indicated that his termination was due to the elimination of his position and not for reasons of disability or retirement. The court concluded that Mr. Voigt's termination was not predicated on health, age, or years of service. Furthermore, Mr. Voigt did not retire because he continued to work for other employers after leaving Tulane.

Holding. The court held that Mr. Voigt's separation from Tulane did not fall under the definition of retirement and the 2013 tuition waiver benefit was not excludable from gross income for that year. In addition, each tax year stands on its own, and the lack of a similar IRS adjustment for 2012 does not require the IRS to ignore the income inclusion for 2013.

INNOCENT SPOUSE

4

Joint and Several Liability

Eric A. Harris v. Comm'r, **TC Summ. Op. 2017-77 (Oct. 3, 2017)**
IRC §6015

☞ Husband Not Entitled to Tax Relief After Wife Files Offer in Compromise

Facts. Eric and Colleen Harris were married on December 21, 2012, and were still married at the time of the trial. Each contributes to the household finances and they consult with each other in financial matters. They have separate bank accounts as well as two joint bank accounts, and they pay household bills using all of these accounts.

Mr. and Mrs. Harris timely filed a joint 2012 tax return. The return reported Mr. Harris's wages of $3,877 and Mrs. Harris's income from three Schedules C, *Profit or Loss From Business,* which totaled $71,684. The couple reported total tax of $7,649 and federal income tax withheld of $154. They made a payment of $3,200 when they filed their return, resulting in unpaid tax of $4,295. Mr. and Mrs. Harris were both involved in preparing the 2012 return.

Before the couple was married, Mrs. Harris filed federal income tax returns for the 2007 through 2011 tax years using a single filing status. She was working as an independent contractor during those years and did not have any federal income tax withheld on her income or make estimated tax payments. As a result, each of her returns for 2007 through 2011 showed a balance due. She did not remit payment with her returns for those years, and she requested an installment agreement after filing each of the returns. The IRS initially granted her requests for an installment agreement each year, but subsequently terminated the agreements because she did not have sufficient income tax withholding or estimated tax payments.

When Mr. and Mrs. Harris filed their joint 2012 tax return, Mr. Harris knew about Mrs. Harris's underpayments of tax and terminated installment agreements for 2007 through 2011. He also knew that she still owed taxes for those years and was in the process of applying for an offer in compromise (OIC).

Mrs. Harris submitted Form 656, *Offer in Compromise,* for the 2007 through 2012 tax years, which she signed and dated May 23, 2013. She offered a $5,000 lump-sum payment to compromise the total balance due for all six years. On February 14, 2014, she submitted an addendum to Form 656, in which she increased her initial offer to $7,358. The IRS accepted Mrs. Harris's $7,358 offer for the 2007 through 2012 tax years. Mr. Harris was not included as an applicant on Mrs. Harris's Form 656 even though she included the 2012 joint income tax liability in her offers.

After the IRS accepted Mrs. Harris's OIC, it assessed the balance due for 2012 to Mr. Harris. He then submitted four separate Forms 656-L, *Offer in Compromise (Doubt as to Liability),* each of which offered either zero or $1 to compromise the liability. He asserted the tax could not be assessed against him because the 2012 liability was included in his wife's OIC, which the IRS had accepted. The IRS denied each of his OIC applications.

In March 2014, Mr. Harris submitted Form 8857, *Request for Innocent Spouse Relief.* In the form, he asserted that the IRS had advised Mrs. Harris to include the balance of their 2012 tax liability along with her OIC for her separate liabilities for the 2007 through 2011 tax years. He also asserted that the Form 656 should have included his name. In May 2016, the IRS denied Mr. Harris's request for relief from joint and several liability.

Issue. The issue is whether Mr. Harris is entitled to relief from joint and several liability under IRC §6015(f) for the 2012 tax year.

Analysis. Married taxpayers who elect to file a joint federal income tax return are generally jointly and severally liable for the entire tax due for that tax year.[36] When a tax liability arises from an underpayment of tax reported on the return, relief from joint and several liability is only available under IRC §6015(f). The IRS can grant innocent spouse relief from §6015(f)(1) if "taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either)."

If the taxpayer meets certain threshold conditions for innocent spouse relief, the IRS conducts a fact-specific inquiry to determine whether it "is inequitable to hold an individual liable for all or part of any unpaid tax or deficiency arising from a joint return."[37] The court consulted the IRS's guidelines when it reviewed the IRS's denial of relief to Mr. Harris. The court noted, however, that it was not bound by them as its analysis ultimately depends on an evaluation of all the facts and circumstances. The court considered the following factors in making its determination.

1. **Knowledge of whether the tax liability would be paid —** Mr. Harris reviewed the 2012 joint return before it was filed and was aware that he and Mrs. Harris did not remit a sufficient amount with the return. He was also aware that his wife had a history of not paying her income tax liabilities when due, had outstanding liabilities for prior tax years, and was applying for an OIC. This factor weighs against Mr. Harris.

2. **Economic hardship —** After reviewing Mr. Harris's financial situation, the court noted that Mr. Harris had not proved that he would suffer economic hardship if relief was not granted.

3. **Additional factors —** The remaining factors set forth in Rev. Proc. 2013-34 are neutral or weigh slightly against relief. The facts considered include the following.

   a. There was no legally binding agreement between Mr. and Mrs. Harris limiting her obligation to pay the joint liability.

   b. They were still married.

   c. Mr. Harris did not assert that his mental or physical health is impaired.

   d. He did not receive a significant benefit as a result of the underpayment of the tax liability.

Mr. Harris asserted that it was inequitable to hold him liable for the 2012 taxes because he should have been a party to the OIC. However, he was **not** an applicant on Mrs. Harris's Form 656. When the IRS accepted her OIC, only her liability for the 2012 tax year was compromised. Because the couple filed jointly, the entire 2012 liability could still be assessed against him after the IRS accepted Mrs. Harris's OIC.

Holding. The court held that Mr. Harris is not entitled to relief from joint and several liability under IRC §6015(f) for the 2012 tax year.

Innocent Spouse Relief

***Colin C. Bishop et al. v. Comm'r,* TC Summ. Op. 2018-1 (Jan. 4, 2018)**
IRC §§6013 and 6015

☞ Taxpayer Entitled to Innocent Spouse Relief Despite Ex-Spouse's Challenge

Facts. Colin and Lisa Bishop were married on October 31, 2007. They were temporarily separated twice in 2014, finally separated in June 2015, and divorced in 2016.

Ms. Bishop inherited a retirement account that was held at Edward D. Jones & Co. (EJ) in her name. She received taxable distributions before 2014 in amounts ranging from $4,000 to $48,000. These taxable distributions were reported on the spouses' returns.

36. IRC §6013.

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

During 2014 until the permanent separation, the couple maintained a joint checking account into which they deposited their respective paychecks. Transfers were made to and from other accounts, and the household expenses were paid from this joint checking account. Both spouses had access to the funds in this account using debit cards.

During 2014, Ms. Bishop received a $15,068 distribution from the retirement account. EJ withheld $2,712 from the distribution and reported both the distribution and the tax withheld to the IRS. In August 2014, $6,000 of the net distribution amount was deposited into the couple's joint checking account, with the remainder being used for the benefit of Ms. Bishop's daughter.

The couple provided a tax preparer with information for their 2014 joint return. However, they did not report the EJ distribution on that return.

The IRS issued a notice as a result of the failure to report the distribution, showing a deficiency of $3,545 in income tax for 2014. Before filing his Tax Court petition, Mr. Bishop filed a request for innocent spouse relief with the IRS. The IRS determined that he was not entitled to relief under IRC §6015(b) because he had constructive knowledge of the distribution, but was entitled to relief under IRC §6015(c) because of a lack of proof of his actual knowledge.

In Tax Court, Mr. Bishop contended he is entitled to relief from the full amount of the deficiency and, in the alternative, the most he should be liable for is the deficiency relating to the $6,000 that was deposited to the joint bank account. However, Ms. Bishop intervened to oppose the IRS grant of relief to her former husband.

Issue. The issue is whether Mr. Bishop should be relieved as an innocent spouse from all or part of the deficiency resulting from a failure to report a taxable distribution from Ms. Bishop's separately owned retirement account.

Analysis. Under IRC §6015(c), relief denial requires evidence that the taxpayer had actual knowledge of the distribution.

The Tax Court has addressed the issue of who has the burden of proof in a case such as this in which the intervener opposes the relief to the petitioner granted by the IRS. Looking to case precedent, the court concluded that the case should be resolved by determining whether actual knowledge was established by a preponderance of the evidence provided by all parties.[38] Moreover, the court noted that whether the taxpayer had actual knowledge turns on all of the facts and circumstances to determine whether the taxpayer had an actual clear awareness of the items causing the deficiency (as opposed to only a "reason to know").

Mr. Bishop denied actual knowledge of the distribution, but he admitted knowing about the retirement account and about past withdrawals made to cover various family expenses. He also acknowledged fault for not checking the joint bank account records maintained by both spouses.

Ms. Bishop argued that Mr. Bishop had actual knowledge because the distribution was deposited into their joint bank account seven months before the preparation of their return and he accessed the funds using checks and his debit card. However, Ms. Bishop did not claim she specifically told Mr. Bishop about the distribution when it was received or at the time their return was prepared. She did not provide any evidence indicating that Mr. Bishop had an actual clear awareness (as opposed to a reason to know) of the distribution.

A history of withdrawals from the retirement account and the transactions involving the joint checking account indicates that Mr. Bishop should have known about this distribution. The amount was large in relation to average balances and other account transactions. However, there is no evidence he saw bank records before the joint return was prepared for 2014. His denials of actual knowledge were not incredible, implausible, or contradicted by direct evidence. Despite strong indications of constructive knowledge, the evidence fell short of establishing his actual knowledge of the distribution.

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

---

38. See *Pounds v. Comm'r,* TC Memo 2011-202 (Aug. 17, 2011); *Knight v. Comm'r,* TC Memo 2010-242 (Nov. 2, 2010); *McDaniel v. Comm'r,* TC Memo 2009-137 (Jun. 15, 2009); *Stergios v. Comm'r,* TC Memo 2009-15 (Jan. 22, 2009).

Innocent Spouse Relief

***Jeffrey Wilfred Heedram v. Comm'r,* TC Memo 2018-25 (Mar. 7, 2018)**

IRC §6015

☞ Taxpayer Entitled to Equitable Relief Under Innocent Spouse Doctrine

Facts. Jeffrey Heedram, a native of Jamaica, met Delphia Fegans in 2009. They married in 2011 and remained married through 2014. Their divorce became final in October 2015. However, they continued to live in the same house for financial reasons until August 2016. They filed married filing jointly (MFJ) for the 2012, 2013, and 2014 tax years. While the couple was married, Ms. Fegans was responsible for financial matters, including the preparation and filing of their joint returns. Ms. Fegans had unpaid tax debts before their marriage, and although she entered into a payment plan with the IRS, she ceased making payments after a couple of months.

They reported total wages of $45,735 on their 2014 return. The return reported tax liability of $2,805, and after deducting tax withheld of $1,599, the remaining tax due was $1,206. Of the remaining $1,206 tax due, $147 was attributable to Mr. Heedram's wages. The remaining $1,059 was attributable to Ms. Fegans.

Their 2014 return was timely filed. Mr. Heedram reviewed and signed the return. At the time it was filed, he was aware that they were having difficulty making their mortgage payments and they were seeking relief under the home affordable refinance program (HARP). Moreover, Mr. Heedram was aware of Ms. Fegans' prior tax debt and was aware that they owed tax on the 2014 return that he signed. However, while Ms. Fegans explained the financial difficulties to him, Mr. Heedram had only a general understanding of the tax issues. Ms. Fegans told him that she would arrange for a payment plan to pay the outstanding tax debt.

Ms. Fegans agreed to pay all federal income taxes, including all penalties and interest due on her income after January 1, 2011, as part of their divorce decree. The IRS received Mr. Heedram's request for innocent spouse relief in June 2015. In the request, Mr. Heedram stated that he remained married to and continued to live with Ms. Fegans and that he was aware of their financial issues because he knew it "was a challenge paying the monthly mortgage." On October 3, 2016, the IRS issued a final determination letter denying Mr. Heedram the requested relief.

Mr. Heedram is currently employed. Although he is not required to do so, Mr. Heedram sends approximately $400 per month to his mother in Jamaica in order to support her and his two children who live with her. His current income is sufficient to cover his monthly expenses and the $400 per month he sends to his mother, but there is not much additional income remaining.

The IRS noted that, in 2014, Mr. Heedram received a Form 1099-MISC, *Miscellaneous Income,* in connection with R.J. Carroll. Mr. Heedram ceased working for that employer in 2013. This income was not reported on their 2014 tax return.

The Tax Court's review of equitable relief cases is a de novo review. This means that the Tax Court considers eligibility without deference to IRS determination, considering all the facts and circumstances at the time of the trial.

Issue. The issue is whether Mr. Heedram is entitled to equitable relief from joint and several liability under IRC §6015(f).

Analysis. IRC §6015(f)(1) gives the IRS discretion to grant equitable relief from joint and several liability if, taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or portion of such deficiency). Rev. Proc. 2013-34 outlines the following seven threshold conditions that a spouse must meet to qualify for relief.

1. The requesting spouse filed an MFJ return for the year for which relief is sought.
2. The relief is not available to the requesting spouse under IRC §6015(b) or (c).
3. The claim for relief is timely filed.
4. There were no fraudulent asset transfers between spouses.
5. The nonrequesting spouse did not transfer any disqualified assets to the requesting spouse.
6. The requesting spouse did not knowingly participate in the filing of a fraudulent return.
7. With certain exceptions, the tax liability from which relief is being sought is attributable to an item or underpayment of the nonrequesting spouse (the "attribution rule").

With respect to the $147 of tax liability associated with Mr. Heedram's own income, relief may exist if an exception to the attribution rule applies. The following are exceptions for the attribution rule.

- Tax debts were attributed to the requesting spouse solely because of community property laws of the state in which they reside.
- There was nominal ownership (an item titled to the requesting spouse is presumptively attributable to the requesting spouse).
- The requesting spouse did not know that funds intended for tax payment were misappropriated by the nonrequesting spouse.
- There was abuse before the filing of the return that affected the requesting spouse's ability to challenge the treatment of return items or question payment of any balance due.
- Fraud was committed by the nonrequesting spouse.

The Tax Court noted that none of the exceptions applied to the present case and summarily concluded that Mr. Heedram did not qualify for relief in connection with the $147 of tax liability attributable to his own income.

With respect to the remaining $1,059 of tax liability attributable to Ms. Fegans, the IRS did not challenge the fact that Mr. Heedram met the seven threshold factors for relief. When a requesting spouse meets the seven threshold factors, they may qualify for a streamlined determination of relief from the IRS if all of the following conditions are met.

- The requesting spouse is divorced or legally separated from the nonrequesting spouse or is a widow or widower and is not an heir to the nonrequesting spouse's estate that has sufficient assets to pay the tax liability, or has not been a member of the same household with the nonrequesting spouse any time during the 12-month period ending on the date the IRS makes its determination.
- The requesting spouse will suffer economic hardship without relief.
- For underpayment cases, the requesting spouse has no knowledge or reason to know, at the time the return was filed, that the nonrequesting spouse would not or could not pay the tax liability reported on the MFJ return.

The Tax Court concluded that Mr. Heedram did not qualify for a streamlined determination of relief because he did not demonstrate that he would suffer any economic hardship. However, the court noted that under Rev. Proc. 2013-34, §4.03, if a requesting spouse meets the seven threshold conditions but fails to qualify for a streamlined determination, relief may still be granted if it would be inequitable to hold that spouse liable for the underpayment after taking into account all the facts and circumstances.

The nonexclusive factors considered in determining whether to grant equitable relief in such cases are as follows.

- Marital status
- Economic hardship
- Knowledge or reason to know that the nonrequesting spouse would not or could not pay the tax debt on the MFJ return
- Legal obligation
- Significant benefit
- Compliance with tax laws
- Mental or physical health

With respect to marital status, the IRS argued that relief should not be granted because Mr. Heedram was married to Ms. Fegans at the time he requested relief and they continued to live together after their divorce was final. The Tax Court disagreed, stating that Mr. Heedram credibly testified that they only continued to live together because of financial issues and that the couple was divorced and no longer living together at the time of trial. Based on the Tax Court's jurisdiction to review equitable relief cases on a de novo basis, the Tax Court considered marital status at the time of trial, not when relief was requested. The Tax Court concluded this factor weighed in favor of relief.

With respect to economic hardship, the IRS further argued that Mr. Heedram would not suffer economic hardship if relief is denied. While the Tax Court found Mr. Heedram's testimony credible that he does not have much income left at the end of each month after his expenses and sending money to his mother, the court indicated it could not rely on this testimony alone to establish economic hardship. The Tax Court held this factor weighed neutrally for relief.

Regarding the knowledge factor, Mr. Heedram testified that he knew the tax liability would not be paid when the joint return was filed, but he also credibly testified that he believed Ms. Fegans would establish a payment plan as she stated. Ms. Fegans' testimony supported this assertion. She indicated that he was not financially sophisticated regarding financial matters or the 2014 tax liability. Based on the testimony provided, the Tax Court concluded that Mr. Heedram established this factor weighed in favor of granting relief.

As to the legal obligation factor, despite the IRS's argument that the factor weighed against granting relief because Mr. Heedram knew the tax liability could not be paid at the time he entered into the divorce decree, the court focused on Mr. Heedram's belief that Ms. Fegans would set up a payment plan. The court held this factor weighed in favor of granting relief.

The IRS agreed that neither spouse received a significant benefit from the unpaid tax liability. The court deemed the significant benefit factor favored granting relief.

On the final factor applicable to this case, the IRS argued that Mr. Heedram was not in compliance with tax laws because he failed to report income from R.J. Carroll. However, the Tax Court did not believe it was reasonable to conclude that Mr. Heedram was not in compliance when both spouses credibly testified that Mr. Heedram did not work for R.J. Carroll in 2014, the year for which relief was being sought. No other evidence was offered to connect him with this income. The Tax Court weighed this factor as neutral.

Neither party raised mental or physical health issues.

Holding. Mr. Heedram is not entitled to relief for the $147 tax liability attributable to his own income. However, he is entitled to equitable relief from joint and several liability for the remaining $1,059 attributable to Ms. Fegans' income.

IRS PROCEDURES — MISCELLANEOUS

Unregulated Return Preparers

Treasury Inspector General for Tax Administration Report 2018-30-042 (Jul. 25, 2018)
IRC §6694

☞ IRS Lacks Coordinated Strategy Regarding Unregulated Return Preparers

Purpose. The Treasury Inspector General for Tax Administration (TIGTA) performed an audit to evaluate whether the IRS is effectively using its available tools to address misconduct by tax return preparers. Approximately 60% of tax returns are filed by paid tax preparers, although many of the preparers are unregulated.

Background. Tax professionals (enrolled agents, certified public accountants, attorneys) are subject to oversight by state boards and the IRS's Office of Professional Responsibility (OPR). However, unenrolled tax preparers do not have any training and education requirements and little authoritative oversight. In 2009, the IRS instituted background checks, tax compliance checks, a minimum qualifying examination, and continuing education requirements in an attempt to regulate tax preparers. The IRS established the Return Preparer Office (RPO) to assist in the regulation efforts. In 2013, *Loving v. IRS*[39] invalidated return preparer regulations because they were beyond the authority of the IRS.

Analysis. Despite the finding in *Loving* that the IRS does not have the authority to regulate tax preparers, the IRS does have the tools to hold unregulated preparers accountable for their actions. The TIGTA report analyzes some of the IRS tools available to regulate preparers and offers suggestions on how the tools could be more efficiently used.

Preparer penalties for understating a taxpayer's tax liability range from $1,000 to $5,000, depending on whether the understatement was willful or reckless. Preparers are also subject to a $50 penalty for each failure to provide their preparer tax identification number (PTIN) on a return or claim up to a maximum penalty of $25,000 in a calendar year. Penalty assessment is an important tool to address preparer misconduct.

TIGTA encourages the IRS to prioritize collection efforts. The IRS's limited resources result in a significant number of taxpayer delinquencies assigned to a queue to wait for assignment to a field collection agent for up to one year or longer. Often, these cases are ultimately shelved and agents no longer work actively to collect. During fiscal year 2016, the IRS shelved approximately 1.2 million records involving $8.3 billion in tax delinquencies. The RPO reported that only 8% of penalties assessed against "ghost" preparers are collected. Ghost preparers are tax return preparers who are not using their assigned PTINs. Between calendar years 2012 to 2015, the IRS collected $46.3 million of $317.2 million (15%) of penalties assessed on individual returns.

The Annual Filing Season Program (AFSP) recognizes unenrolled return preparers who voluntarily participate in continuing education in exchange for limited representation rights before the IRS. During calendar year 2017, there were 54,485 volunteers in the program and approximately 374,000 unregulated preparers who did not participate in the AFSP.

The RPO conducts tax compliance checks of certain PTIN applicants. PTINs are granted to almost everyone who applies and the IRS believes that a PTIN can only be revoked if a preparer is currently incarcerated or enjoined by the Department of Justice. As of May 2017, more than 1.3 million PTINs have been issued and approximately 0.1% have been revoked. Tax professionals applying for a PTIN and AFSP participants are subject to the credential and compliance checks, and unregulated preparers remain unscreened. The TIGTA report found that PTINs were issued without regard to criminal background, history of defrauding taxpayers, history of committing identity theft, or any other such criminal activity.

---

39. *Loving v. IRS,* 917 F. Supp. 2d 67 (D.D.C. 2013), *aff'd* 742 F.3d 1013 (D.C. Cir. 2014).

More than 26,000 return preparers admitted that they are not in compliance with their federal tax filings on their PTIN applications. AFSP participants and tax professionals identified as noncompliant may receive up to three letters from the IRS, advising the preparer to become compliant. However, the letters do not detail the noncompliance because the details would have been communicated previously with routine taxpayer compliance notifications. Preparers may be confused when they are informed that they cannot participate in the AFSP due to noncompliance because all the relevant information was not included in one letter. The TIGTA report advises changing the language of the letters to include more relevant information.

Unregulated preparers who continue to misrepresent themselves are often not subject to any further reprimands beyond notification by the Suitability Office. These preparers are not practicing before the IRS and therefore the OPR lacks any jurisdiction to discipline further.

Various departments within the IRS use a return preparer database that includes preparer demographic information and aggregate data by preparer. This includes the number of returns a preparer files, the number of returns filed by method (paper or electronic), returns with refunds, and returns with balances due. The database includes a risk-scoring model called the Preparer Risk Identification and Selection Model (PRISM). The PRISM scores preparers on more than 50 different characteristics and ranks how the preparer compares against other preparers. A preparer who scores at either extreme may warrant further investigation. The IRS is using the PRISM in a pilot program to analyze the top ten PRISM preparers who are not being investigated by other departments. The purpose is to determine whether the PRISM can identify preparers who are filing erroneous returns and have not been referred for corrective action through other means.

As a result of the audit, TIGTA provides the following recommendations to improve efficiency.

1. Develop a preparer misconduct strategy to encourage cooperation among programs with authority to address preparer misconduct to establish goals and track progress towards them.
2. Establish goals to support an IRS-wide return preparer strategy and track progress towards them.
3. Analyze procedures to establish best practices and national procedures.
4. Establish formal procedures and criteria for case selection to review misconduct by tax preparers. Determine appropriate performance measures to compare goals and criteria.
5. Assess the priority and assignment of preparer misconduct penalties and track results to improve collection rates.
6. Develop a compliance strategy to impose IRC §6695(c) penalties on preparers who routinely omit their PTIN on returns that they prepare.
7. Expand the use of the PRISM feature to identify noncompliant preparers.
8. Revise letters informing tax preparers that they are not tax compliant to include language that the IRS previously provided to the tax preparer regarding their alleged noncompliance.
9. Refer cases when credential checks identify a tax preparer who is misrepresenting their professional status for possible investigation.

The IRS agrees with TIGTA on all but recommendation #5. The IRS groups preparer misconduct cases with other high priority cases. Collections for return preparer penalties have declined in connection with an overall decline in collection resources. Additionally, tracking the priority status, inventory assignment, and the dispositions and dollar collected on misconduct penalties would require complex and costly information technology requests.

Information Disclosure

REG-129260-16 (Apr. 2, 2018)

IRC §§6103 and 7345

☞ Disclosure of Returns for Taxpayers with Seriously Delinquent Tax Debt

Purpose. The IRS issued proposed regulations to permit the Department of State to disclose tax return information to its contractors in association with denying or revoking passports for seriously delinquent taxpayers.

Background. The Fixing America's Service Transportation (FAST) Act was enacted on December 4, 2015. The FAST Act added IRC §7345 to the Code and requires the IRS to notify the Department of State of seriously delinquent tax debtors. A seriously delinquent tax debt is an unpaid, legally enforceable and assessed federal tax liability of an individual that is greater than $50,000 (as indexed for inflation), and one in which a notice of lien has been filed against the debtor. Additionally, the administrative rights on the notice of lien must be exhausted or lapsed, or a levy must have been made against the taxpayer. The FAST Act authorizes the Department of State to deny a passport, or the renewal of a passport, or revoke previously issued passports for individuals who have been notified by the IRS that they have seriously delinquent tax debts.

Returns and return information are confidential unless the Code otherwise authorizes disclosure. The IRS is authorized to disclose return information to officers and employees of the Department of State regarding taxpayers with seriously delinquent tax debts. The Department of State may disclose the taxpayer's identity and the amount of the seriously delinquent tax debt. However, any contractors the Department of State engages to carry out its responsibilities regarding passports are not authorized to receive confidential return information. Contractors are not officers or employees of the Department of State.

Analysis. IRC §6103(n) authorizes the disclosure of return and return information to **any person for purposes of tax administration.** Tax administration includes "the administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws or related statutes."[40] The implementation of the FAST Act relates to the administration tasks identified under tax administration. Therefore, the Department of State is authorized to disclose tax return information to its contractors.

> **Note.** For more information regarding passport revocation of seriously delinquent tax debtors, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: IRS Update.

Filing Status

***Fansu Camara and Aminata Jatta v. Comm'r,* 149 TC No. 13 (Sep. 28, 2017)**

IRC §6013

☞ Married Taxpayers Entitled to Joint Return After Initially Filing as Single

Facts. Fansu Camara and Aminata Jatta were a married couple during the relevant period of this case. Mr. Camara erroneously checked the box for single filing status on his 2012 Form 1040, *U.S. Individual Income Tax Return*. Ms. Jatta did not file any 2012 tax return. The IRS issued a notice of deficiency and changed Mr. Camara's filing status to married filing separately. In response, Mr. Camara and Ms. Jatta filed a joint 2012 tax return on May 27, 2016.

The IRS contends that filing as "single" means Mr. Camara did not file a "separate" return. Therefore, he is ineligible to file a joint return for the year under IRC §6013(b).

40. IRC §6103(b)(4).

Issue. The issue is whether IRC §6013(b)(2) bars Mr. Camara from electing joint filing status for the 2012 tax year.

Analysis. IRC §6013(b) permits taxpayers to elect to switch to a joint return after filing a separate return under certain circumstances. If the taxpayer could have filed a joint return but instead filed a separate return, they may amend their return to file jointly for that year. However, the limitations under §6013(b)(2) bar the election to file a joint return after three years from the filing deadline (without extensions) for filing the return for that year. The couple filed their joint return for 2012 on May 27, 2016, more than three years after the April 15, 2013 filing deadline.

Another limitation under §6013(b)(2) bars the election to switch to a joint return after a notice of deficiency is mailed to either spouse if the spouse replies to the notice by filing a petition with the Tax Court within 90 days. Mr. Camara received a notice of deficiency, filed a petition with the Tax Court, and then filed a joint return.

Neither the Code nor regulations define the term **separate return.** The court in this case considered a separate return to be a return on which a married taxpayer claimed the married filing separately status. No court of appeals has held that a single return or head of household return is a separate return under IRC §6013(b). The court in this case stated that a separate return is "a return on which a married taxpayer has claimed the permissible status of married filing separately, rather than a return on which a married taxpayer has claimed a filing status not properly available to him or her." Because single status was not properly available to Mr. Camara, the court held that he did not file a separate return. As such, the limitations under §6013(b)(2) were not applicable.

Holding. The court held that the tax return Mr. Camara filed using the single status was not a separate return and he and his wife were not barred from filing a joint return for 2012.

Filing Status

Patricia Marie Knez v. Comm'r, **TC Memo 2017-205 (Oct. 18, 2017)**
IRC §6013

☞ Married Couple Entitled to File MFJ Return After One Spouse Files HoH Return

Facts. Patricia and George Knez were married throughout 2014 despite living separately during that year. The spouses were not legally separated, however, and reunited in July 2015.

Mr. and Mrs. Knez lived separately at the time that Mrs. Knez filed her 2014 tax return. She elected head of household (HoH) filing status and listed her daughter as a dependent. The return showed an earned income tax credit (EITC) of $1,947. Mr. Knez filed a return for 2014 as a single taxpayer and claimed an EITC of $1,709. Each of the returns listed the same joint checking account direct deposit information for the spouses' respective refunds.

On April 25, 2016, the IRS sent Mrs. Knez a notice of deficiency for 2014. The IRS changed her filing status to married filing separately (MFS) and adjusting her standard deduction accordingly. The notice disallowed her $1,947 EITC claim, showed that same amount as a deficiency, and imposed an IRC §6662 accuracy-related penalty of $102. The notice was accompanied by a Form 886-A, *Explanation of Items,* that explained a married taxpayer must file a married filing jointly (MFJ) return as a prerequisite to EITC eligibility. Given the adjustment to MFS status, Mrs. Knez was ineligible for the EITC. Additionally, Mrs. Knez had a 2-year EITC ban imposed.

On June 27, 2016, Mr. and Mrs. Knez filed a revised MFJ return. They claimed their daughter as a dependent and an EITC claim of $3,305. The revised return showed no regular tax liability but reported self-employment (SE) and other taxes of $1,685. The revised return requested a refund of $2,620.

Mrs. Knez disagreed with the adjustments made by the IRS and petitioned the Tax Court on July 25, 2016. Because the couple was married for the 2014 tax year, they could have filed an MFJ return for 2014. The couple filed an MFJ return, but only after Mrs. Knez received a notice of deficiency and filed a Tax Court petition.

Issues. The issue is whether the initial HoH return that Mrs. Knez filed was a "separate return" required under the statutory language of IRC §6103(b).

Analysis. IRC §6103(a) provides married taxpayers with the ability to file an MFJ return. As a general rule, unless an exception applies, if an individual filed a separate return for a tax year for which a joint return could have been filed and the deadline for filing a return for the tax year has not yet expired, the spouse may file jointly. Of the four exceptions listed under §6103(b)(2), the one relevant to this case states that the option to file an MFJ return under the general rule does not exist if the IRS mailed either spouse a notice of deficiency and that spouse petitions Tax Court. Both the general rule and the exception are predicated on the initial filing of a **separate** return.

The Tax Court looked to a previous case, *Camara v. Comm'r*,[41] for guiding precedent. In *Camara*, a unanimous court-reviewed opinion, the taxpayer initially filed a return with "single" filing status, and the IRS contended such a return constituted a "separate" return. The Tax Court disagreed with the IRS, holding in *Camara* that the previously filed single-status return did not constitute a "separate" return under the statutory language of §6103(b). The court noted that the only relevant difference between *Camara* and Mrs. Knez's case was that *Camara*'s prior return was filed using single filing status while Mrs. Knez elected HoH status. The Tax Court saw no legally significant difference between the two. In both cases, the legally relevant fact was that the filing status initially used by the married taxpayer was legally impermissible. The Tax Court adhered to *Camara*, stating that the term "separate return" under §6103(b) means a permissible MFS return filed by the married taxpayer, not a legally impermissible return.

The court noted that §6103(b) characterizes the right to later file an MFJ return as an "election." Making an election implies the notion of choice, and there is no such valid choice if the initial return is filed using a filing status not legally available to the married spouse. In addition, the relevant legislative history shows Congress intended this provision to alleviate problems that married couples would encounter if they did not have the ability to change a permissible election that courts previously deemed binding and irrevocable before this Code provision was established.

Holding. The court held that Mr. and Mrs. Knez were able to file an MFJ return despite Mrs. Knez's initial HoH return. The initial return was not a "separate" return under §6103(b) and the exception is inapplicable.

Limitation on Credit or Refund

***Roberta Borenstein v. Comm'r,* 149 TC No. 10 (Aug. 30, 2017)**

IRC §§6511, 6512, and 6513

☞ Lookback Period Bars Taxpayer From Eligibility for Refund of Overpaid Taxes

Facts. Roberta Borenstein's 2012 tax return was originally due on April 15, 2013. She filed an extension of time on that date to file her return; her extended due date was October 15, 2013.

Ms. Borenstein made $72,000 in estimated tax payments by January 17, 2013. She paid an additional $40,000 with her extension request. Therefore, her total tax payments for 2012 as of April 15, 2013, were $112,000.

Ms. Borenstein did not file a return for 2012 by the October 15, 2013 due date or during the next 22 months. The IRS sent her a notice of deficiency on June 19, 2015. She then submitted a delinquent return on August 29, 2015, that reported an income tax liability of $79,559, which the IRS agreed was correct. Because she had already paid $112,000 for the tax year, her overpayment was $32,441.

Issue. The issue is whether Ms. Borenstein is entitled to a credit or refund for her overpayment of $32,441 for the 2012 tax year.

41. *Camara v. Comm'r,* 149 TC 13 (Sep. 28, 2017).

Analysis. IRC §6512(b)(3) places a limit on the amount of credit or refund that may be allowed. The limit is determined by the amount of tax paid during one of three "lookback" periods from the date that a notice of deficiency was mailed. The parties agreed that IRC §6511(b)(2) applies in this case. That Code section "provides for two alternative lookback periods: a 3-year period and a 2-year period."[42] The Supreme Court has explained that the provision "directs the Tax Court to determine the applicable period by inquiring into the timeliness of a hypothetical claim for refund filed 'on the date of the mailing of the notice of deficiency.'"[43]

IRC §6511(b)(2)(A) defines the applicable lookback period when a refund claim was filed "within 3 years from the time the return was filed."[44] The hypothetical claim is deemed to have been filed on June 19, 2015, when the notice of deficiency was mailed. Ms. Borenstein's delinquent 2012 return was filed on August 29, 2015. Because the hypothetical claim was filed before the tax return, it was not filed "within 3 years from the time the return was filed."

When the lookback period in §6511(b)(2)(A) does not apply, the applicable lookback period is specified in §6511(b)(2)(B). That Code section states "If the claim was not filed within such 3-year period, the amount of the credit or refund shall not exceed the portion of the tax paid during the 2 years immediately preceding the filing of the claim."

As previously stated, Ms. Borenstein's hypothetical refund claim is deemed to have been filed on June 19, 2015. Her $112,000 tax payments were deemed to have been made on April 15, 2013,[45] which is more than two years earlier. Therefore, no credit or refund is allowable for Ms. Borenstein's $32,411 overpayment under §6512(b)(3)(B) as interpreted by the Supreme Court in *Comm'r v. Lundy.*[46]

In response to the Supreme Court's decision in *Lundy,* Congress amended §6512(b)(3). This change provided a 3-year rather than a 2-year lookback period in certain circumstances. The revised Code section states "In a case described in subparagraph (B) where the date of the mailing of the notice of deficiency is during the third year after the due date (with extensions) for filing the return of tax and no return was filed before such date, the applicable period under subsections (a) and (b)(2) of section 6511 shall be 3 years." Ms. Borenstein asserts that, under this provision, she is entitled to a 3-year lookback period, which would mean she is entitled to a refund of her $32,411 overpayment.

The court noted "the third year after the due date (with extensions) for filing the return of tax" began on October 15, 2015. However, the deficiency notice was mailed on June 19, 2015. That date was during the second year, not the third year as §6512(b)(3) requires. The IRS contended that the exception set forth in §6512(b)(3) therefore does not apply. Consequently, the IRS asserted that a refund of Ms. Borenstein's overpayment is barred by the 2-year lookback rule generally applicable to nonfilers. The court agreed with the IRS's interpretation of the statute.

Holding. The court held that Ms. Borenstein is not entitled to a credit or refund for her overpayment of the taxes shown on her 2012 tax return.

---

42. *Butts v. Comm'r,* TC Memo 2015-74 (Apr. 15, 2015).
43. *Comm'r v. Lundy,* 516 U.S. 235, 242 (1996).
44. IRC §6511(a) (cross-referenced in IRC §6511(b)(2)(A)).
45. See IRC §6513.
46. *Comm'r v. Lundy,* 516 U.S. 235, 243 (1996).

Statute of Limitations

New Capital Fire, Inc. v. Comm'r, **TC Memo 2017-177 (Sep. 11, 2017)**

IRC §§368 and 6501

☞ IRS Notice Not Issued During Period for Assessment

Facts. On December 4, 2002, Capital Fire Insurance Co. (Old Capital) merged into New Capital Fire, Inc. (New Capital). The merger was intended to be a tax-free reorganization under IRC §368(a)(1)(F).

Old Capital did not file a 2002 tax return. On September 12, 2003, New Capital filed a 2002 Form 1120, *U.S. Corporation Income Tax Return.* New Capital's 2002 return included a pro forma Form 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return,* for Old Capital's 2002 tax year. The pro forma return reported Old Capital's income, deductions, and credits for the period from January 1 through December 4, 2002. In addition, New Capital attached the following statement to its 2002 return.

> *On December 4, 2002, The Capital Fire Insurance Company, a New Hampshire insurance corporation, was merged into New Capital Fire, Inc., a Delaware (non-insurance) corporation. At the time of the merger, New Capital ceased its insurance operations. Attached is a copy of the certificate of merger. The operations of The Capital Fire Insurance Company are included in this return on Form 1120-PC Statement.*

The IRS issued a notice of deficiency to Old Capital in July 2012. The notice stated that Old Capital was required to file a return for the short tax year ending December 4, 2002, because the merger did not meet the requirements of IRC §368(a)(1)(F).

Issue. The issue is whether the statute of limitations bars the assessment of the determined deficiency and additions to tax.

Analysis. The IRS must issue a notice of deficiency during the period for assessment.[47] The period for assessment generally ends three years after the taxpayer files the income tax return.[48]

In this case, the IRS issued the notice of deficiency almost nine years after New Capital filed its 2002 return. Consequently, the period of limitations for the 2002 return had expired and assessment is barred unless an exception to the general limitation period applies. The IRS asserted that the failure-to-file exception under IRC §6501(c)(3) applies. Under that Code section, if a taxpayer fails to file a return, the tax may be assessed at any time.

The IRS's position was that there were two separate taxpayers — Old Capital and New Capital — that were each required to file tax returns. The IRS asserted that New Capital's 2002 return with the accompanying pro forma return does not qualify as a valid return for Old Capital's short tax year ending December 4, 2002.

The general statute of limitations does not apply if the facts giving rise to the tax liability are not disclosed. However, if a taxpayer files an incorrect return but the return sets forth all the data necessary to calculate the taxes owed, the statute of limitations begins to run.[49]

The regulations under IRC §381 indicate that when a corporation engages in an reorganization, the resulting corporation must file a single full-year return for the part of the tax year before the reorganization and the part after the reorganization.[50] The IRS argued that the merger was not a reorganization, but the court observed that that raised the issue of whether the filing of the 2002 return began the running of the period of limitations for Old Capital.

47. *Woods v. Comm'r,* 92 TC 776, 779-780 (1989).

48. IRC §6501(a).

49. *Neptune Mut. Ass'n v. U.S.,* 862 F.2d 1546, 1555 (Fed. Cir. 1988).

50. See Treas. Reg. §1.381(b)-1(a)(2); Rev. Rul. 66-284, 1966-2 CB 115; Rev. Rul. 57-276, 1957-1 CB 126.

If a taxpayer files the wrong type of return, that return is sufficient to trigger the running of the limitations period as long as it satisfies the following tests.[51]

- The document must contain sufficient data to calculate tax liability.
- The document must purport to be a return.
- There must be an honest and reasonable attempt to satisfy the tax law requirements.
- The taxpayer must have executed the document under penalties of perjury.

The IRS contended that New Capital's 2002 return failed the third test because it was "purposefully misleading." However, the court noted that even if it accepted the IRS's assertion that the return was "misleading," that does not render a tax return a nullity.[52] The court found the rationale applied in *Mabel Elevator Co. v. Comm'r* persuasive.[53]

> *The return filed purported to be made in accordance with the law; it purported to and did include the income of the taxpayer for the period in question. In the absence of any evidence or claim that such return was false or fraudulent with intent to evade tax, it became the duty of the Commissioner to determine, within the time provided by law, whether or not the return was erroneous in any respect.*

The IRS did not allege that New Capital's 2002 return was false or fraudulent with intent to evade Old Capital's tax obligations. Consequently, it was the IRS's duty to determine whether New Capital's 2002 return, as it concerns Old Capital, was erroneous during the period of limitations. The IRC §6501(c)(3) exception does not apply.

Holding. The court held that the statute of limitations bars assessment of the determined deficiency and additions to tax.

Interest Accrual on Tax Due

***Creditguard of America, Inc. v. Comm'r,* 149 TC No. 17 (Oct. 10, 2017)**
IRC §§501, 6151, 6320, 6330, and 6601

☞ Retroactive Revocation of Tax-Exempt Status has Consequences for Interest Accrual

Facts. Creditguard (CG) was a nonprofit corporation that was incorporated in Florida in 1991. It was engaged primarily in credit counseling. In December 1993, the IRS issued a determination letter indicating it recognized CG as a tax-exempt organization. In May 2003, CG filed a Form 990, *Return of Organization Exempt From Income Tax,* for the 2002 calendar year.

In December 2003, the IRS began an examination of CG's 2002 Form 990. After completing the examination and related administrative steps, the IRS issued a determination letter on February 1, 2012, revoking CG's tax-exempt status retroactively to January 1, 2002. This adverse determination letter also advised CG that it was required to file corporate tax returns for tax periods specified in that letter and for subsequent tax years.

CG did not promptly file a Form 1120, *U.S. Corporation Income Tax Return,* for 2002 and the IRS prepared a substitute for return (SFR) and issued a notice of deficiency on the basis of this SFR. At a Tax Court hearing, the court entered a decision based upon an agreement between CG and the IRS that there was an income tax deficiency of $216,547 for 2002. The decision also reflected the parties' agreement that interest would be assessed as provided by law on the deficiency.

---

51. *Beard v. Comm'r,* 82 TC 766, 777 (1984), *aff'd* 793 F.2d 139 (6th Cir. 1984).

52. See, e.g., *Sakkis v. Comm'r,* TC Memo 2010-256 (holding that a return which was on correct form and accurately reported the taxpayers' income satisfied the *Beard* test, even though the taxpayers "used a frivolous legal claim to reduce their tax liability to zero"); *Steines v.Comm'r,* TC Memo 1991-588 (holding that a return which accurately reported the taxpayer's wages, withholdings, filing status, and number of exemptions satisfied the *Beard* test notwithstanding a claim of frivolous deductions in an amount exceeding $100 billion), *aff'd* 12 F.3d 1101 (7th Cir. 1993).

53. *Mabel Elevator Co. v. Comm'r,* 2 BTA 517 (1925), and cited with approval in *Atlas Oil & Ref. v. Comm'r,* 22 TC 552 (1954).

On March 13, 2013, the IRS assessed the $216,547 deficiency and interest of $142,185 on that deficiency. The IRS calculated interest beginning on March 17, 2003, the due date for a corporate return for the 2002 tax year.

To collect the amount due, the IRS sent CG a notice of federal tax lien (NFTL). CG timely requested a collection due process (CDP) hearing. On the hearing request form, CG checked off the boxes for "installment agreement," "offer in compromise," and for lien "withdrawal."

A settlement officer (SO) and a CG representative had a face-to-face hearing, at which CG sought an abatement of most of the assessed interest. CG contended that the earliest interest could begin accruing was the date on which the IRS assessed the deficiency, which was March 13, 2013, not the March 17, 2003 due date for a corporate return.

The SO rejected CG's argument, indicating that interest is charged on unpaid taxes from the date the taxes were due until the date they are paid. The SO concluded that the IRS calculation for interest was correct.

CG submitted two offers in compromise. The first one, submitted June 10, 2015, was returned for failure to include the necessary initial payment. The second one, submitted July 21, 2015, offered $96,000 in satisfaction of the deficiency, but CG withdrew that offer by letter dated October 30, 2015. No other offer was submitted.

CG also sought withdrawal of the NFTL. However, the SO indicated that because CG was currently making payments toward satisfaction of the 2002 liability with the NFTL in place, there was no reason to withdraw the lien. The SO also determined that CG had not met the other conditions for lien withdrawal.

On December 17, 2015, the IRS sent a notice of determination sustaining the collection action and CG timely petitioned the Tax Court. CG's petition did not dispute the SO's rejection of collection alternatives but challenged the SO for failing to abate interest unlawfully assessed. The petition alleged that the correct start date for interest accrual was February 1, 2012, the date the IRS mailed the final adverse determination letter revoking CG's tax-exempt status.

Issue. The issue is about determining the correct starting date for calculating interest on CG's 2002 tax deficiency.

Analysis. IRC §6601(a)(1) indicates that if any amount of tax is not paid on or before the final due date for payment, interest must be paid from that due date until the date the tax is actually paid. IRC §6151(a) states that when a return is due, tax is due when that return is due, which is also the final due date for payment.

CG is a corporation, and upon revocation of its tax-exempt status, it became obligated to file a corporate tax return for 2002. The due date for such return was March 17, 2003. Because this due date was the final due date for payment of the 2002 tax, interest accrual begins on this date and continues to accrue until actually paid.

CG argued that it was tax exempt during 2002 and correctly filed a Form 990 for that year. It had no obligation to file Form 1120 until its tax-exempt status was revoked. CG argued the beginning accrual date for interest is governed by IRC §6601(b)(5), which provides the rule for "last date for payment not otherwise prescribed." That Code section provides that for taxes payable by stamp and in all other cases in which the last date for payment is not prescribed, the last date for payment (from which interest accrues) is deemed to be the date the tax liability arises.

The Tax Court concluded, however, that IRC §6601(b)(5) is inapplicable, because it only applies to stamp taxes and other taxes for which the last date for payment is not prescribed. Corporate income tax has a prescribed due date for payment, which is the due date for the corporate return.

The court pointed out that CG's tax-exempt status was not revoked on a solely prospective basis, but rather on a retroactive basis, and this has tax consequences. Such a revocation implies that CG was not, in fact, a tax-exempt organization in 2002 and for subsequent years but was instead a taxable corporation. CG is therefore liable for interest, with interest accruing from the due date of its 2002 corporate return.

Holding. The court held that the IRS calculation of interest in the notice of deficiency is correct. Therefore, interest on CG's 2002 return accrues beginning with the March 17, 2003 due date.

Criminal Tax Provisions
Carlo J. Marinello, II v. U.S., **584 U.S. 1 (Mar. 21, 2018)**
IRC §7212

☞ Supreme Court Clarifies Necessary Showing to Convict Under Code Provision

Facts. Between 2004 and 2009, the IRS opened, closed, and reopened an investigation into Carlo Marinello's tax activities. In 2012, Mr. Marinello was indicted and charged with violation of several criminal tax statutes, including the "Omnibus Clause" of the statute (explained later). The IRS charged Mr. Marinello with eight tax violations that included failing to maintain corporate books and records, failing to provide his accountant with complete information, destroying business records, hiding income, and paying employees in cash.

Before jury deliberations at Mr. Marinello's criminal trial, the judge instructed the jury that in order to convict Mr. Marinello, it must find unanimously that he engaged in at least one of the eight tax violations. However, the jury did not need to agree unanimously on which one of the eight violations. The jury was also instructed that it must find the violation was made "corruptly," meaning with the intent to secure an unlawful advantage or benefit for himself or another. However, the judge did not instruct the jury that it must find Mr. Marinello knew he was under investigation and intended corruptly to interfere with that investigation. Mr. Marinello was convicted.

On appeal to the Second Circuit, Mr. Marinello argued that a violation of the Omnibus Clause required the government to show that the defendant tried to interfere with a pending IRS proceeding, such as an investigation. The Second Circuit disagreed and upheld Mr. Marinello's conviction. The court stated that in order to be convicted under the Omnibus Clause, the defendant did not need to be aware of a particular IRS action or investigation.

Mr. Marinello subsequently petitioned the Supreme Court for a review of the Second Circuit's decision. The Supreme Court elected to do so given a split among circuits on this issue.

Issues. The issues are:

- Whether the government must prove a defendant was aware of an IRS proceeding at the time of his or her acts in order to be convicted of obstructing or interfering with that proceeding, and
- What types of IRS actions fall under the scope of "proceeding" for purposes of this statute.

Analysis. IRC §7212(a) consists of two substantive clauses. The first clause, referred to as the "Officer Clause," forbids acts that "…corruptly or by force or threats…endeavor to intimidate or impede any officer or employee of the United States acting in an official capacity under…[the Code]." The second clause, referred to as the "Omnibus Clause," forbids acts that "…corruptly or by force or threats…endeavor to intimidate or impede the due administration of [the Code]."

The Court referred to a similar type of statute and issue that it rendered a decision on in the 1995 case *U.S. v. Aguilar.*[54] In *Aguilar*, the applicable statute, 18 USC §1503(a) made it a felony to "corruptly or by threats or force…influenc[e], obstruct, or imped[e]…the administration of justice." In *Aguilar,* the Court noted its two important reasons for concluding that the government must prove that the defendant had an **intent** to influence judicial or grand jury proceedings. First, the verbs "obstruct" and "impede" suggest an object; that a taxpayer must hinder a particular person or thing. Under the statute, the object is the administration of justice. The word "administration" could be interpreted very broadly to include every act or process of administration, including all acts of managing or conducting any office or performing the executive duties of any institution. However, the better interpretation is that the term refers to a more limited number of those acts. In *Aguilar*, it was held that the defendant's false statements to an investigating agent, rather than a grand jury, did not support a conviction for obstruction of justice.

---

54. *U.S. v. Aguilar*, 515 U.S. 593 (1995).

The Supreme Court noted that this case was similar because the statutory context indicates that the text refers to specific targeted acts of administration. The term "threats of force" is defined in §7212(a) as "threats of bodily harm to the officer or employee of the United States or to a member of his family." In IRC §7212(b), the immediately following section, specific reference is made to the forcible rescue of any property after it has been seized. This indicates that the Omnibus Clause is a "catchall" for all **types** of obstructive conduct, but not for the **objects** of that obstructive conduct, which would include all of the continuous acts constituting the Code's administration.

The Court noted that legislative history also supported this notion, citing a House Report that referred to §7212 as a provision that provided punishment for threats against agents or other officers or employees or members of their families on account of the performance of their official duties. The House Report also noted that this provision would punish the corrupt solicitation of an IRS employee. The Court referred to a Senate Report that referenced §7212 as aimed at targeting officers and employees, covering all cases where an officer is intimidated or injured.

The Court noted that it found nothing in the legislative history of this criminal provision indicating that the Omnibus Clause was a catchall provision that included all routine administration of the Code, including processing returns, receiving payments, and issuing refunds. Indeed, the Code includes numerous provisions constituting misdemeanors. If the Omnibus Clause were interpreted as a catchall for all the administrative conduct the Code requires, it would have the effect of turning these misdemeanors into felonies.

The Court rejected the argument of the government that the need to show the defendant's acts were corrupt cures any overbreadth problem. The Court noted that "corruptly" means acting with the specific intent to obtain an unlawful advantage. In practical terms, the Court noted it would be difficult to imagine a scenario in which a taxpayer violated the Code without such an intention. Moreover, the Court was uncomfortable leaving the interpretation up to prosecutorial discretion.

To convict a taxpayer under §7212(a), the government must (among other things) make two showings. First, it must show that there is some nexus between the defendant's conduct and a particular administrative proceeding, such as an investigation, audit, or other targeted administrative action. The nexus must involve a relationship in time, causation, or logic with the administrative proceeding. Just because the defendant knows the IRS will review their tax return each year does not transform every Code violation into an obstruction charge. Second, in addition to nexus, the government must show that the proceeding was pending at the time the defendant engaged in the obstructive conduct (or at least show that the proceeding was at that time reasonably foreseeable by the defendant).

Holding. The Supreme Court held that an administrative proceeding does not include every act carried out by the IRS to administer the Code, including processing returns. The Court also held that it is not enough that a taxpayer knows that the IRS may become aware of their unlawful scheme. The Supreme Court reversed the Second Circuit's judgment and the case was remanded.

Limitations Period

Mehrdad Rafizadeh v. Comm'r, **150 TC 1 (Jan. 2, 2018)**
IRC §§6038D and 6501

☞ Six-Year Limitations for Foreign Asset Disclosure Commences Only After Code Enactment

Facts. Mehrdad Rafizadeh timely filed his returns for tax years 2006 through 2009 but failed to report income earned on a foreign account he held. The IRS found out about Mr. Rafizadeh's foreign account through use of a John Doe summons. The John Doe summons was resolved on November 16, 2010. On December 8, 2014, the IRS issued to Mr. Rafizadeh a notice of deficiency determining the following deficiencies and accuracy-related penalties.

Year	Deficiency	IRC §6662 Penalty
2006	$ 9,045	$1,809
2007	10,934	2,187
2008	4,117	823
2009	1,619	324

Note. Under tax law, a John Doe summons is issued to a person or organization whose name is not known at the time the summons is served. Such a summons serves as an IRS investigatory tool. For further details on John Doe summons, including the statutory requirements and the reasonable basis for such a summons to be issued, see **uofi.tax/18a4x1** [www.irs.gov/irm/part25/irm_25-005-007].

Mr. Rafizadeh argued that the extended 6-year limitation for the IRS to serve a notice of deficiency did not apply to his unpaid taxes in 2006, 2007, and 2008. The 6-year statute of limitation under IRC §6501(c)(1)(A)(ii) applies when a taxpayer fails to report income from a foreign account that falls under the IRC §6038D reporting requirement. IRC §6501(c)(1)(A)(ii) is effective for all returns filed on or after March 18, 2010, and also to such returns if the general 3-year limitations period for assessment has not expired. Because neither §6038D nor §6501(c)(1)(A)(ii) were enacted until March 18, 2010, Mr. Rafizadeh claimed he did not have a filing requirement at the time the income was omitted.

Note. IRC §6038D requires taxpayers to disclose "specified foreign financial assets" using Form 8938, *Statement of Specified Foreign Financial Assets,* or other specific international information returns. For further details, see **uofi.tax/18a4x2** [www.irs.gov/forms-pubs/form-8938-statement-of-foreign-financial-assets].

Issue. The issue is whether the IRS can issue a notice of deficiency based on a violation of a reporting requirement that was not yet a regulation.

Analysis. Under IRC §6501, the IRS must generally assess tax within three years of the date a tax return was due, without extensions, or the date the return was actually filed, whichever is later. However, there are two exceptions relevant to this case. First, the period of limitations is suspended beginning six months after the service of a John Doe summons and ending with the final resolution of that summons. Second, the IRS may assess tax within six years after a return is filed "if the taxpayer omits from gross income an amount properly includible...and such amount...is attributable to one or more assets with respect to which information is required to be reported under section §6038D" and is in excess of $5,000.

The notice of deficiency was timely only if the 6-year period of limitations applied. Mr. Rafizadeh argued that the defining phrase in §6501(c)(1)(A)(ii) — "assets with respect to which information is required to be reported under section 6038D" — limited application of the 6-year period to assets for which there was a disclosure requirement under §6038D at the time the income was omitted. The Tax Court looked to the plain wording of the key phrase to determine whether the effective date of §6038D was effectively cross-referenced into §6501(c)(1)(A)(ii) as a limitation on the latter section. The court believed that it was, concluding that this was the most natural reading of the language and if Congress intended otherwise, more specific wording would have been used to manifest such intent.

Holding. The Tax Court agreed with Mr. Rafizadeh. The 6-year limitations period under §6501(c)(1)(A)(ii) did not apply for the 2006–2008 tax years for which the IRS issued a notice of deficiency. Therefore, the notice was not timely.

Recovery of Litigation Costs

***Stefan A. Tolin v. Comm'r,* TC Memo 2018-29 (Mar. 19, 2018)**

IRC §§469 and 7430

☞ Taxpayer Engaged in Prior Litigation with IRS Receives Partial Recovery of Litigation Costs

Facts. Stefan Tolin had a case heard in Tax Court in 2014 regarding his tax liability for the 2002, 2003, and 2004 tax years. Mr. Tolin was an attorney engaged in a thoroughbred horse breeding and racing activity. The most significant issue at that trial was whether Mr. Tolin materially participated in the horse activity.

Note. For a write-up of the original case, *Tolin v. Comm'r,* see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Rulings and Cases.

Before the original trial occurred, Mr. Tolin and the IRS agreed in writing to a deficiency of $10,933, along with penalties of $2,088 for the three tax years covered by the notice of deficiency. On April 30, 2009, Mr. Tolin's attorney sent the IRS a letter that was designated a qualified offer under IRC §7430, offering to concede tax liability and pay an additional $1,500 in tax ($500 per year for each of the three years). The IRS failed to respond to this offer within the required 90-day period.

Mr. Tolin's counsel maintained a timesheet showing telephone conferences, reviews, research, and settlement of "side issues" relating to the examination of Mr. Tolin's returns. In October 2009, Mr. Tolin's counsel sent the IRS a detailed affidavit of the breeding facility owner, outlining the facility's number of employees and the hours taken to care for the horses boarded there. This affidavit also provided additional details on the promotional initiatives Mr. Tolin engaged in and the almost daily phone calls between Mr. Tolin and the facility. Counsel also provided the IRS with a revised narrative summary about Mr. Tolin's participation in the horse activity for the three tax years that described the nature of the work performed and estimated the hours spent. He also furnished to the IRS very detailed phone bills for an additional 16 months that spanned the 2003 and 2004 years.

The case was set for trial on November 18, 2009, but was postponed the day before trial due to Mr. Tolin's medical issues. Trial was rescheduled for May 11, 2010. However, one week before the trial date, Mr. Tolin's counsel requested that the trial be accomplished in parts. On May 11, 2010, testimony was taken from Mr. Tolin's two witnesses, who were cross-examined. Mr. Tolin provided his testimony later on August 11, 2010, and was similarly cross-examined. Both parties subsequently filed the necessary briefs to complete the trial proceedings in the parsed fashion approved by the court.

During the trial that eventually took place in 2010, the court held that Mr. Tolin established his material participation and held that the horse activity losses were allowed.

After the court issued its opinion, Mr. Tolin filed a motion for litigation costs. Mr. Tolin sought to recover all litigation costs incurred since May 1, 2009, the day after he contended the qualified offer was made, through January 31, 2011. Mr. Tolin sought to recover $256,920 of attorney's fees ($400 per hour for 642.3 hours) plus out-of-pocket expenses of $4,062.

Issues. The issues are whether Mr. Tolin was entitled to litigation costs under IRC §7430 with respect to the 2010 trial and, if so, the amount he was entitled to recover.

Analysis. IRC §7430 authorizes the court to award reasonable litigation costs to the prevailing party in Tax Court proceedings against the IRS that involve, among other issues, the determination of any income tax. In order to obtain such an award, the prevailing party must have exhausted administrative remedies and must not have unreasonably protracted the court proceeding. "Prevailing party" means that the taxpayer substantially prevailed with respect to the amount of the controversy or the most significant issue or set of issues, and that the taxpayer met an applicable net worth requirement. The taxpayer meeting these requirements, however, will not be considered a prevailing party if the IRS's position in the court proceeding was "substantially justified." Even if the IRS's position was substantially justified, a taxpayer meeting the net worth requirement may still be considered the prevailing party under the qualified offer provision of §7430 if the taxpayer's liability pursuant to the judgment in the Tax Court proceeding is equal to or less than the amount the liability would be if the IRS had accepted the taxpayer's qualified offer.

The parties agree that Mr. Tolin did not unreasonably protract court proceedings, met the net worth requirement, and made a qualified offer on April 30, 2009. However, the IRS argued that the tax liability amount pursuant to the judgment exceeded those amounts made in the qualified offer. It also argued that the IRS's position in the case was substantially justified and that Mr. Tolin was therefore not treated as a prevailing party even though it was agreed that Mr. Tolin substantially prevailed on the case's most significant issue.

The court concluded that the IRS was substantially justified in its position only through November 30, 2009. After this date, Mr. Tolin was the prevailing party. The IRS was no longer substantially justified after Mr. Tolin's counsel provided the revised narrative and detailed phone bills on October 1, 2009. The Tax Court believed it was reasonable to provide the IRS with a 60-day period after the October 1, 2009 submission date to review the records. These records should have served to persuade the IRS that Mr. Tolin met the material participation requirement, and after November 30, 2009, the IRS was no longer substantially justified in its position. However, Mr. Tolin made the qualified offer before November 30, 2009, which was during the period in which he was not a prevailing party under the applicable rules.

The IRS argued that it was substantially justified in its position after November 30, 2009, because Mr. Tolin's activities were considered those of an investor. The time spent on investor activities does not count toward material participation under Temp. Treas. Reg. §1.469-5T(f)(2)(ii). The IRS further contended that this position was supported by the court discussing the investor argument at trial. However, the Tax Court disagreed, pointing out that under the regulations, Mr. Tolin's time spent in investor-type activities **do count** toward meeting material participation requirements if he was directly involved in day-to-day management and operations. The Tax Court noted that the IRS's reliance on Temp. Treas. Reg. §1.469-5T(f)(2)(ii) was not reasonable and did not serve to render its position substantially justified.

The Tax Court also rejected the IRS's argument that the IRS continued to remain substantially justified in its position after November 30, 2009, because of the lack of case law applying the material participation rules to the horse breeding industry. The court noted that, in Mr. Tolin's case, there was no substantial legal issue that had not already been resolved in ample case law regarding this Code section and its regulations. The IRS also cited much of the relevant case law in its own briefs in this case.

Recoverable litigation costs under §7430 include court costs and reasonable attorney's fees, not to exceed $125 per hour (subject to inflation) absent any special factor the Tax Court determines should apply, such as complexity of the issues or availability of local tax expertise to the taxpayer. The IRS argued that it was not reasonable for counsel to work on this case for 642.3 hours and that a reasonable hourly fee was $180 instead of $400. The Tax Court noted that the timesheet from Mr. Tolin's counsel consisted of entries of dates and a description of the nature of the work performed, but there was no description of the particular tasks performed, making the reasonableness of the fee difficult to determine in some instances.

Because the IRS's position was substantially justified through November 30, 2009, the legal fees claimed between May 1, 2009 and November 30, 2009 associated with 192.8 hours were not recoverable. That left 153.7 pre-trial and trial hours and 300.1 post-trial hours expended by counsel. With respect to the pre-trial and trial hours claimed, Mr. Tolin may not recover the hours expended to prepare for the original trial scheduled for November 18, 2009, because the IRS's position was substantially justified at this time. Counsel devoted substantial time for this original trial preparation and the subsequent substantial amount of time spent for the May 11 partial trial was not reasonable because counsel had already prepared for the original trial in November 2009. After reviewing the time spent originally preparing for the November 2009 trial and attributing what the Tax Court believed were reasonable amounts of time for revising paperwork and related items for the May 2010 trial, the Court concluded that 116 pre-trial hours was reasonable. The Tax Court noted it would have been necessary for counsel to refresh his memory for the rescheduled partial trial six months later, but the witnesses and exhibits were largely the same as those already prepared for the original trial.

With respect to the post-trial hours, the Tax Court noted the significant number of hours expended for telephone calls from Mr. Tolin to counsel, which at times amounted to several calls per day. The Tax Court noted that the phone call records from Mr. Tolin to the Louisiana facility and his advisor were also very numerous, reflecting his "micromanagement" style, which the court believed carried into his contact with his counsel. The court therefore concluded that half of the post-trial hours for such communications was reasonable. In total, the court concluded that 160.1 post-trial hours were reasonable.

Holding. The court held that Mr. Tolin was entitled to recover litigation costs incurred after November 30, 2009. The court also held that the inflation-adjusted statutory hourly rate of $180 was reasonable instead of $400 because this case did not require any specialized legal skills unique to the horse industry. This case involved generalized tax and litigation expertise, without the need for the Court to determine questions on breeding rights, stud or sale contracts, distribution of race winnings, or other specialized equine issues under state law.

Bank Deposit Analysis

***Richard A. Canatella v. Comm'r,* TC Memo 2017-124 (Jun. 26, 2017)**

IRC §6213

☞ IRS Bank Deposit Analysis Used to Determine Taxpayer's Unreported Income

Facts. During 2008 through part of 2010, Richard Canatella operated a law firm as a sole proprietorship. The firm was wound up in 2010. As a result of litigation or settlements, Mr. Canatella often received funds payable to clients and had to hold them in trust until payment was made. For this purpose, he maintained 20 bank accounts at six financial institutions from 2008 to 2010.

Mr. Canatella filed his 2008 and 2009 tax returns on June 10, 2011. He filed his 2010 return on November 4, 2011. All these returns were prepared by an accountant. The returns showed no income other than the law firm business income reported on Schedule C, *Profit or Loss From Business*, along with expenses, as summarized in the following table.

	2008	2009	2010
Gross receipts	$509,486	$382,372	$170,654
Expenses	436,096	311,130	210,851
Net profit/loss	73,390	71,242	(40,197)

The IRS, however, received information returns showing that Mr. Canatella received interest payments and social security income. The three returns were audited, and upon request from the IRS, Mr. Canatella provided a QuickBooks ledger and canceled checks that were deposited to his main business checking account. He furnished no documents referencing the other bank accounts receiving interest income or the social security income.

The IRS issued summonses to all the banks at which Mr. Canatella had accounts during 2008 through 2010. Using the account information received, the IRS conducted a deposit analysis, using the following steps.

- Total all deposits in the bank accounts
- Subtract out all deposits determined to be nontaxable
- Subtract the amounts of income Mr. Canatella reported on his return
- Conclude that the remaining amount was unreported gross income

The IRS provided Mr. Canatella with a copy of this analysis and gave him the opportunity to contest it. He did not produce any additional documentation to do so. Accordingly, the IRS mailed a notice of deficiency to him for 2008, 2009, and 2010, showing tax deficiencies of $248,262, $92,758, and $128,167, for those years, respectively. The notice of deficiency provided details of the additional amount of unreported income for each year from the analysis, the disallowed expenses for each year, and information on the unreported interest and social security income for each year.

Mr. Canatella petitioned the Tax Court. Following the petition, Mr. Canatella and the IRS agreed on some of the allowable expenses, the amount of social security, the amount of unreported interest, and other items. The remaining questions were the validity of the bank account analysis and the taxability of four particular deposits.

1. A deposit of $61,487 on February 12, 2008
2. A deposit of $40,960 on April 4, 2008
3. A deposit of $150,000 from Fidelity National Title Insurance Company on May 29, 2008
4. A deposit of $24,000 from Mr. Canatella's son on April 23, 2008

Issues. The issues are:

- Whether the bank deposit analysis used by the IRS is a valid means to determine the amount of Mr. Canatella's unreported income, and
- The taxability of the four deposits that Mr. Canatella argues are not unreported income.

Analysis. The Tax Court addressed each of the four deposits based on the evidence admitted. With respect to the first deposit, Mr. Canatella argued the deposit was not taxable because it went to a client trust account for a client named Zut. Under California bar rules, client funds must be deposited into a trust account and the attorney is not allowed to commingle their own funds with client funds. Such client funds are not taxable to the attorney, who is holding such funds temporarily on behalf of the client. Under the bar rules, adequate records are required to be kept on such accounts. Mr. Canatella routinely deposited his own money, in the form of legal fees earned, into this account in violation of the commingling rules. He provided no records for this account in court but did establish that he issued a $20,000 check from this deposit to the client Zut. The Tax Court concluded that this $20,000 was not treated by Mr. Canatella as belonging to him, but the remaining amount of the deposit was appropriately characterized as unreported income because Mr. Canatella treated those funds as belonging to him.

Mr. Canatella argued that the second deposit was an amount held in trust for a client, but evidence showed that client received a disbursement of $28,970 from other funds, and there was no indication that the client provided Mr. Canatella with any authority or reason to continue holding the second deposit amount. The Tax Court concluded this deposit was also properly characterized as unreported income to Mr. Canatella.

Mr. Canatella argued that the third deposit was made to a client trust account and should therefore not be considered unreported income. However, the account used was not labelled as a trust account, and Mr. Canatella commingled funds in this account while also failing to keep any records. Moreover, evidence showed that after the deposit from the title insurance company, Mr. Canatella issued an $80,000 check from these funds with the notation "settlement" to another individual. The remaining funds were ultimately transferred to his own main operating account and are therefore properly characterized as unreported income. Mr. Canatella argued that some of these funds were used to pay future litigation costs but offered no evidence to establish this fact.

Mr. Canatella argued that the fourth deposit was a loan repayment from his son, but the Tax Court noted that there was no loan document offered into evidence and Mr. Canatella did not report any loan interest on his return for any such loan. However, the court was convinced that because this deposit came from Mr. Canatella's son and it was unlikely Mr. Canatella was performing legal services for his son, the amount was properly characterized as a gift or loan repayment rather than legal fees or another form of taxable income.

In total, after the review of the four deposits, the court concluded that the amount of unreported income computed by the IRS in its bank account analysis should be reduced by a total of $124,000.

The Tax Court also addressed the use of the bank deposit analysis by the IRS as a method to determine unreported income. The court noted that gross income includes income from "whatever source derived" under IRC §61(a) and indicated that the IRS can reconstruct the taxpayer's income by any method reasonable under the circumstances if the taxpayer fails to keep adequate records. The Tax Court cited precedent in concluding that such a reconstruction of income need not be exact, as long as it is reasonable and substantially correct. Moreover, the use of bank deposits has been recognized as an acceptable form of income reconstruction. The taxpayer bears the burden of proving the IRS determinations made in a notice of deficiency are erroneous. Mr. Canatella failed to offer evidence that meets his burden of proof.

Holding. The court concluded that the use of a bank deposit analysis is a valid method of reconstructing a taxpayer's income. The court also held that the unreported income on the IRS notice of deficiency should be reduced by $124,000 that was not taxable income.

Disability Severance Payments

IRS News Release IR-2018-148 (Jul. 11, 2018)

☞ Veterans Can Claim Refunds for Taxes on Disability Severance Payments

Purpose. The IRS announced that certain veterans who received disability severance payments after January 17, 1991, and included those payments in income should file an amended return to claim a credit or refund of the overpayment attributable to taxes on the disability payments.

Analysis. Veterans who received a lump-sum disability severance payment when they separated from the military should receive a letter from the Department of Defense (DoD). The letter explains how to claim tax refunds and includes a description of a simplified method for making the claim.

Veterans can make such claims by the later of:

- One year from the date of the DoD letter, or
- Three years from the due date of the tax return on which the disability payments were included in income.

Veterans can submit a claim based on the actual amount of their disability severance payment by completing Form 1040X, *Amended U.S. Individual Income Tax Return.* Alternatively, veterans can choose to claim a standard refund amount based on the calendar year in which they received the severance payment. If the alternative method is used, "disability severance payment" should be written on line 15 of Form 1040X and the following standard refund amount should be entered on lines 15 and 22.

Tax Year	Standard Refund Amount
1991–2005	$1,750
2006–2010	2,400
2011–2016	3,200

Veterans claiming refunds for overpayments related to lump-sum disability severance payments should write "Veteran Disability Severance" or "St. Clair Claim" at the top of the first page of the Form 1040X. The Form 1040X should be mailed, with a copy of the DoD letter, to the following address.

Internal Revenue Service
333 W. Pershing Street, Stop 6503, P5
Kansas City, MO 64108

If a veteran is eligible for a refund but did not receive a DoD letter, they may claim a refund by including both of the following.

- A copy of a document showing the amount and reason for the disability severance payment
- A copy of the VA determination letter confirming the disability or a determination that the veteran's injury or illness was incurred as a result of armed conflict, during extra-hazardous service, in simulated war exercises, or caused by an instrumentality of war

More information about such claims can be found at **uofi.tax/18a4x3** [www.irs.gov/individuals/military/combat-injured-veterans-tax-fairness-act-claim-information-available].

IRS PROCEDURES — PENALTIES

Trust Fund Taxes

***Kelly D. Davis v. U.S.*, 13-cv-00450; U.S. District Court for the District of Colorado (Feb. 27, 2018)**
IRC §6672

☞ Co-Owner Was Responsible Person for Approximately $1 Million in Trust Fund Penalties

Facts. Between 2005 and 2009, Mr. Kelly Davis and Ms. Allyce Card co-owned WVC, a construction business. Mr. Davis was president and managed the field operations while Ms. Card was the bookkeeper and managed the finances and office staff.

WVC withheld the necessary amounts from employee paychecks to satisfy its payroll tax obligations but never remitted the funds to the government. Instead, the funds were used to pay business expenses and also personal expenses of Mr. Davis and Ms. Card.

Despite Mr. Davis becoming aware of WVC's failure to remit payroll taxes by early 2009, WVC continued to operate through 2009 and Mr. Davis never rectified the delinquency. The IRS assessed almost $1 million in penalties against Mr. Davis personally under IRC §6672 as a responsible person for unpaid trust fund taxes. Mr. Davis filed suit to challenge the IRS assessment, seeking declaratory judgment indicating that he owed nothing.

Issues. The issues are:

- Whether Mr. Davis was a responsible person, and
- Whether his conduct constituted willful failure to pay the delinquent taxes under §6672.

Analysis. Mr. Davis argued that Ms. Card was the only responsible party. The court cited precedent, noting that a person is "responsible" under §6672 if that person is required to collect, account for, or pay over taxes withheld from employee wages. Generally, a responsible person is a managing officer or employee, and there may be more than one responsible party in an entity. The court indicated that a determination of who had the most control over business finances is irrelevant. Citing additional precedent, the court noted that the relevant inquiry to determine whether an individual is a responsible party is whether that person had significant control over the payment of taxes, or more specifically, whether the person had the actual authority or ability to do so with respect to their status within the business.

The question of responsibility is fact-intensive. Indicators of responsibility include being an officer of the business, controlling financial affairs, having the ability to disburse corporate funds, having an ownership interest in the entity, and having the ability to hire or fire employees.

The court noted it is undisputed that Mr. Davis was a WVC co-owner, director, and president. Moreover, Ms. Card had various titles that included owner, CFO, CEO, secretary, and treasurer. In addition, she had the primary responsibilities of managing WVC's finances and maintaining the business's books. Mr. Davis managed field operations and was responsible for hiring and firing staff members, and he set pay rates for employees. Ms. Card also hired office staff. Mr. Davis testified that he hired Ms. Card to set up QuickBooks. Ms. Card's testimony indicated that she did take over the banking and that Mr. Davis did not have any input with regard to the accounting or finances of WVC. The court noted that Mr. Davis had signing authority on the company checking account and signed payroll and vendor checks prepared by Ms. Card.

Mr. Davis provided input concerning which creditor should be preferred over another and directed Ms. Card to issue a company check to him for $113,000 to buy a sports car, which she did. Even if Ms. Card had dominant control over the company's finances, she has such control because Mr. Davis delegated that control to her. Based on these facts, the court found that Mr. Davis was a responsible person under §6672.

Mr. Davis argued that he was not willful for two reasons. First, under the Colorado Trust Fund Statute, all funds paid to WVC from customers had to be held in trust for payment to subcontractors, laborers, and material suppliers. Second, Mr. Davis argued that WVC executed a commercial security agreement with a creditor, MOB. This agreement required WVC to agree that it would not "assign, convey, lease, sell or transfer any of the collateral," which Mr. Davis indicated included physical assets such as cash on hand, without MOB's prior written consent. Mr. Davis argued that the MOB agreement precluded him from making any payments not previously approved by MOB.

However, while the court assumed that Mr. Davis may not have been willful under the terms of the Colorado Trust Fund Statute, it focused on Mr. Davis's second argument regarding the agreement with MOB. Generally, only legally imposed encumbrances to control over company funds have been held by courts as sufficient to demonstrate the absence of willfulness under §6672. The majority rule, adopted by the Tenth Circuit (in which this case is adjudicated) is that a voluntary agreement to encumber funds does not absolve the taxpayer from tax payment obligations. In addition, an MOB representative testified that MOB did not direct WVC in which obligations to pay or avoid with respect to the agreement, but rather was primarily concerned with the liquidation of collateral in the event of a wind-up of operations.

Holding. The court held that Mr. Davis was a responsible person and willfully failed to pay the delinquent taxes under §6672. Judgment was entered in favor of the IRS, awarding the IRS $983,745.

FBAR Penalties

U.S. v. Dominique Colliot, **No. 1:16-cv-01281; U.S. District Court for the Western District of Texas (May 16, 2018)**
31 USC §5321 and 31 CFR §1010.820

☞ IRS Acted Arbitrarily and Capriciously in Assessing Penalties in Excess of Regulatory Maximum

Facts. The IRS assessed civil penalties against Dominique Colliot for his willful failure to timely file Forms TD 90-22.1, *Report of Foreign Bank and Financial Accounts,* from 2007 to 2010. Form TD 90-22.1 is commonly called the FBAR. The IRS assessed penalties of $548,773 for 2007, $196,082 for 2008, and smaller penalties for 2009 and 2010. The IRS stated that the penalties were authorized under 31 USC §5321(a)(5) and 31 CFR §1010.820(g)(2).

Issues. The issue in this case is whether Mr. Colliot should be granted summary judgment on the ground that the IRS incorrectly applied the law when it calculated the penalties assessed against him.

Analysis. Previously, 31 USC §5321(a)(5) allowed the Treasury to impose civil penalties of the greater of $25,000 or the unreported account balance up to $100,000 for the failure to file an FBAR.

In 2002, the authority to assess penalties under §5321(a)(5) was delegated to the Financial Crimes Enforcement Network (FinCEN). FinCEN later delegated the authority to assess such penalties to the IRS.

In 2004, Congress amended §5321 by increasing the maximum civil penalties for willful failure to file an FBAR. The revised statute increased the civil monetary penalties for willful failure to file an FBAR to a minimum of $100,000 and a maximum of 50% of the balance in the unreported account.

Despite the statute change, the regulations that relied on the prior version of the statute remained unchanged. Therefore, 31 CFR §103.57 still indicated that the maximum civil penalty for willful failure to file an FBAR was $100,000. FinCEN later renumbered 31 CFR §103.57 to 31 CFR §1010.820 but did not revise the regulation to take into account the increased maximum penalty now authorized under §5321(a)(5). However, the IRS has repeatedly levied penalties for willful FBAR violations in excess of the $100,000 limit.

Mr. Colliot argued that the IRS acted arbitrarily and capriciously by assessing penalties against him in excess of those allowed by §1010.820. The IRS countered that §1010.820 is inconsistent with the 2004 changes to §5321 and was therefore invalidated by those revisions.

The court noted that there was "little reason to believe §5321(a)(5)(C) implicitly superseded or invalidated §1010.820. Section 5321(a)(5) sets a ceiling for penalties assessable for willful FBAR violations, but it does not set a floor." Instead, §5321(a)(5) gives the Treasury the discretion to determine the penalty amount as long as the penalty does not exceed the ceiling set by §5321(a)(5)(C). Moreover, §1010.820 limits penalties to $100,000. The court further observed that §1010.820 is consistent with the delegation of discretion contained in §5321. Therefore, because §1010.820 can be applied consistently with §5321(a)(5), it does not implicitly invalidate or supersede §1010.820.

Holding. The court concluded that §1010.820 is a valid regulation that limits penalties for willful FBAR violations to $100,000. Therefore, the IRS acted arbitrarily and capriciously when it failed to apply the regulation in assessing the penalties against Mr. Colliot. Because the parties had not briefed the court on what relief might be appropriate for Mr. Colliot, the court ordered the parties to provide additional briefing on the appropriate next steps in the case.

PASSIVE ACTIVITIES

Passive Activity

Charles Brumbaugh and C.E. Holifield v. Comm'r, **TC Memo 2018-40 (Apr. 3, 2018)**
IRC §§162, 212, and 469

☞ Flow-Through Loss Deduction Subject to Passive Activity Restrictions

Facts. Charles Brumbaugh owned 60% of BLH Construction, Inc., a C corporation headquartered in Bakersfield, California, that was engaged in developing real estate. In 2007, Mr. Brumbaugh devoted more than 500 hours to BLH's activities.

BLH had development projects in 2007 in northern California. Mr. Brumbaugh and the other BLH shareholders discussed buying an airplane for the trips connected with these projects but did not do so because one of the other shareholders was concerned about incurring the financial obligations associated with owning an aircraft.

Ultimately, Mr. Brumbaugh decided to purchase an aircraft himself. In 2006, the plaintiff had formed N444SS, LLC, which was taxed as a partnership. Mr. Brumbaugh owned 51% of N444SS and his wife, C.E. Holifield, owned 49%. N444SS purchased an aircraft in 2006 and entered into a management agreement with an aviation company. Under the agreement, the aviation company was responsible for all managerial duties related to the plane and had the exclusive right to charter the plane for commercial flights by third parties whenever Mr. Brumbaugh did not need to use the plane. Mr. Brumbaugh was also given access to other planes when his was being chartered. In 2007, Mr. Brumbaugh used the plane on only one occasion. On four other occasions, he used a different plane because his was being chartered.

The 2007 partnership return for N444SS reported a $683,034 loss from its aircraft chartering activities. Mr. Brumbaugh and Ms. Holifield claimed 51% of the flow-through loss, or $348,347, on their 2007 Schedule E, *Supplemental Income and Loss,* as a nonpassive loss deduction. Upon audit, the IRS recharacterized the loss as a passive loss on the basis that Mr. Brumbaugh had not materially participated in N444SS's activities. The IRS also assessed an accuracy-related penalty.

Issues. The issues are:

- Whether the taxpayers' claimed flow-through loss deduction is subject to IRC §469 passive activity loss restrictions, and
- Whether Mr. Brumbaugh is liable for an accuracy-related penalty.

Analysis. A passive activity is an activity involving a trade or business in which the taxpayer does not materially participate.[55] The focus of the disagreement between the IRS and the taxpayers is whether or not Mr. Brumbaugh materially participated in the aircraft chartering activity in which N444SS engaged. Mr. Brumbaugh contended that N444SS's activity should be grouped with BLH's real estate activity for purposes of testing whether or not he materially participated.

Treas. Reg. §1.469-4(c)(2) provides that one or more business activities "may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469." The regulation lists several factors that are given the greatest weight in determining whether activities constitute an appropriate economic unit.

55. IRC §469(c).

The court found that none of the Treas. Reg. §1.469-4(c)(2) factors favored grouping the two activities together. There was no functional similarity between the two activities, and the plane was not integrated into the real estate activity in any way. The factors for extent of common ownership and common control were neutral — Mr. Brumbaugh held controlling interests in both entities, but the ownership interests were very different. In addition, there was no interdependence between the two businesses. Accordingly, the court concluded that N444SS's aircraft chartering activity could not be grouped with BLH's real estate activity for purposes of determining whether Mr. Brumbaugh materially participated in N444SS.

Mr. Brumbaugh contended that he satisfied one of the regulatory tests for material participation found in Temp. Treas. Reg. §1.469-5T. The significant participation test provides that a taxpayer is treated as materially participating in an activity if the activity is a significant participation activity and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours. One of the tests for significant participation is that the individual must have participated for more than 100 hours during the year. Mr. Brumbaugh asserted that he participated for at least 100 hours in the aviation activity during 2007. However, the court noted that there were no contemporaneous logs, appointment books, calendars, or narrative summaries to support his contention. In any event, the petitioner did not devote 500 or more hours in the aggregate to significant participation activities because BLH did not qualify as a significant participation activity. Therefore, Mr. Brumbaugh did not meet his burden of proving that he materially participated in N444SS during 2007.

In determining whether Mr. Brumbaugh is subject to the accuracy-related penalty under IRC §6662, the court observed that Mr. Brumbaugh is a highly sophisticated businessman. He failed to establish that he made a good-faith effort to correctly determine his federal income tax liability. His argument for grouping BLH with N444SS was "extremely weak." He hired a tax return preparer, but he did not assert reliance on that person as a defense to the penalty. Therefore, the court concluded that the portion of the underpayment reflecting the flow-through loss deduction was attributable to negligence.

Holding. The court held that the flow-through loss deduction that the taxpayers claimed on their Schedule E was a passive loss under IRC §469. In addition, the taxpayers are liable for an accuracy-related penalty.

Real Estate Professional

***Jose and Linda Anne Franco v. Comm'r,* TC Summ. Op. 2018-9 (Mar. 6, 2018)**
IRC §469

☞ Taxpayer Has Sufficient Documentation to Qualify as Real Estate Professional

Facts. Jose Franco, a licensed architect, ran a small architectural business. During 2013, he spent approximately 650 hours providing architectural services. In addition, during 2013, Mr. Franco owned and managed two rental properties in California. One of the properties was a "four-plex" (called "Edgehill") and the other is a single-family home (called "Bayswater Avenue"). Mr. Franco made weekly trips to the properties to ensure bins were set out for collection, cleaned when necessary, and returned to their storage location. He also performed minor repairs to the properties and coordinated more substantial repairs with a handyman, talked to tenants, collected rent, maintained the insurance coverage, purchased needed materials for the properties, paid expenses, and maintained books for tax accounting purposes. Mr. Franco maintained a log that listed the personal property management services he performed and the time spent for such services. The log indicated that Mr. Franco devoted 765 and 372 hours to the management of Edgehill and Bayswater Avenue, respectively

Mr. Franco and his wife, Linda filed a 2013 joint return. They reported gross receipts of $85,605 from the architectural business, offset by various business expenses. Mr. Franco's Schedule E, *Supplemental Income and Loss,* showed rental income of $101,950 from the two properties, offset by expenses of $169,832, resulting in a net loss of $67,882.

The IRS agreed that Mr. Franco was entitled to deduct $25,000 of the $67,882 under the exception provided by IRC §469(i) for real estate professionals. However, the IRS disallowed the deduction of the remaining $42,882.

Issue. The issue is whether Mr. Franco qualifies as a real estate professional in order to deduct the entire amount of his business expenses.

Analysis. IRC §469(a)(1) generally disallows a deduction for passive activity losses and credits. A passive activity is a trade or business activity in which the taxpayer does not materially participate. A rental activity is per se passive regardless of whether the taxpayer materially participates. However, §469(c)(7) provides some additional special rules. Under these rules, rental activities of a qualifying taxpayer are not considered per se passive, and if the taxpayer materially participates, the rental activity is treated as nonpassive. The rules allow more than one activity to be grouped together and considered to be one activity. In this case, the IRS did not contend that Mr. Franco failed to make such an election, and the Tax Court deemed the issue conceded by the IRS. The court treated the two activities as one under such an election.

A taxpayer qualifies as a real estate professional if more than half of the personal services they performed in trades or businesses during the year are performed in real property trades or businesses in which they materially participated. In addition, the taxpayer must perform more than 750 hours of services during the year in real property trades or businesses in which they materially participate.

Under §469 and underlying regulations, "personal services" is defined as any work performed by the taxpayer in connection with a trade or business. In the case of a joint return, the real estate professional requirements are only satisfied if either spouse separately satisfies those requirements. Under Temp. Treas. Reg. §1.469-5T(f)(4), the taxpayer may use any reasonable means to document the number of hours spent. However, the Tax Court has held that a "ballpark guesstimate" is not acceptable.

While the record shows that Mr. Franco worked approximately 650 hours during the year as an architect during 2013, the record also shows that he spent more than 750 hours providing personal services in connection with the management of the rental properties. His testimony describing his time and effort performing the activities was credible, and corroborated his log entries, receipts, emails, and other business records provided. Moreover, his rental activities were regular, continuous, and substantial as required under §469(h).

Holding. The court held that Mr. Franco qualified as a real estate professional for 2013. The amount of the disputed deductions exceeding the $25,000 real estate professional deduction is allowed under §469.

RETIREMENT

IRA Withdrawals

***John R. Kirkpatrick v. Comm'r,* TC Memo 2018-20 (Feb. 22, 2018)**

IRC §§71 and 408

☞ IRA Transfer in Divorce Requires Transfer of an Interest in IRA

Facts. John Kirkpatrick is a medical doctor licensed in Michigan and the District of Columbia. His wife Christiana filed for divorce on April 17, 2012. A divorce hearing took place on September 24, 2012. The divorce court issued an order that required Dr. Kirkpatrick to:

- Transfer to Mrs. Kirkpatrick "the sum of $100,000 directly (and in a nontaxable transaction) into an individual retirement account (IRA) appropriately titled in Mrs. Kirkpatrick's name…," and
- Pay to Mrs. Kirkpatrick a lump sum of $40,000 as temporary support and suit money via direct deposit.

The divorce was finalized on June 30, 2014. Dr. Kirkpatrick failed to make the IRA transfer after the court order was issued and did not make such a transfer prior to the finalization of the divorce. However, he did pay the amount he was ordered to pay to her through a series of checks. To make these payments, Dr. Kirkpatrick withdrew funds from two of his IRA accounts at JPMorgan Chase Bank (JPMorgan). These IRA withdrawals were deposited into his JPMorgan checking account, from which he wrote checks to pay Mrs. Kirkpatrick. He also issued checks to third parties in partial satisfaction of the money he was ordered to pay to her. Dr. Kirkpatrick was over age 59½ when he made the JPMorgan IRA distributions.

JPMorgan issued two 2013 Forms 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* to Dr. Kirkpatrick in connection with these IRA withdrawals. The forms showed gross distributions of $116,489 and $294,666, for a total of $411,155. Each Form 1099-R had a box checked to indicate that the taxable amount of these distributions was not determined. On Dr. and Mrs. Kirkpatrick's 2013 married filing joint (MFJ) return, they reported the total amount of IRA distributions, and indicated that only $116,489 was taxable.

The IRS issued a notice of deficiency for 2013. The notice determined Dr. Kirkpatrick needed to report additional income of $294,665, indicated a deficiency of $98,712 in tax liability, and noted a $19,742 substantial understatement penalty. Dr. Kirkpatrick argued that $140,000 of the taxable retirement income (the amount owed to Mrs. Kirkpatrick under the court's divorce order) was not taxable.

Issue. The issue is whether the $140,000 IRA withdrawal transferred to Mrs. Kirkpatrick is taxable to Dr. Kirkpatrick.

Analysis. Under IRC §408(d)(1), any amount distributed from an IRA is included in gross income in the tax year in which the distribution is made. However, §408(d)(6) provides an exception to this general rule for transfers incident to divorce. Under §408(d)(6), the transfer of a taxpayer's interest in an IRA pursuant to a divorce decree or separation instrument described in IRC §71(b)(2) is not taxable, and the transferred IRA interest is treated as the recipient spouse's IRA.

Dr. Kirkpatrick's position is that the divorce court's order requiring the transfer of $140,000 of funds to Mrs. Kirkpatrick is a divorce decree or separation instrument meeting the requirements of IRC §71(b)(2). He argued that nothing in §408 or the underlying regulations provide any specific guidance on the timing of the transfer in order for such a transfer to qualify for the §408(d)(6) exception. Dr. Kirkpatrick asserts that any such transfer is nontaxable if it occurs between the issuance of a written instrument, such as the consent order, and through the final divorce judgment. He noted that all of his payments to Mrs. Kirkpatrick were made after the court order and before the finalization of the divorce in 2014.

Dr. Kirkpatrick also argued that the funds from his IRA passing through his checking account to Mrs. Kirkpatrick's IRA should have no bearing on the taxability of the transfers because these transfers were done within the allowable timeframe that he describes.

The IRS argued that none of Dr. Kirkpatrick's distributions from his IRAs in 2013 met the requirements of the IRC §408(d)(6) exception because he **did not transfer any interest** in an IRA to an IRA in Mrs. Kirkpatrick's name. In addition, the IRS noted substantial precedent indicating that the §408(d)(6) exception does not apply to proceeds cashed out from an IRA and paid pursuant to a divorce order or judgment or otherwise transferred to a spouse. Moreover, while the IRS agreed that the divorce order met the requirements of IRC §71(b)(2), Dr. Kirkpatrick did not comply with its terms.

The Tax Court concluded that although the parties' arguments were about $140,000 of transfers, the $40,000 transfer for temporary support and suit money did not involve any IRA transfer. Because Dr. Kirkpatrick did not provide any argument to exclude the $40,000, it is includable in his income for 2013.

In order for the §408(d)(6) exception to apply, the following two requirements must be met.

1. There must be a transfer of the IRA participant's interest in the IRA to the spouse or former spouse.
2. The transfer must have been made under a divorce or separation instrument meeting the requirements of IRC §71(b)(2).

Case precedent indicates that, commonly, such IRA transfers are accomplished either through changing title to the IRA from the payor spouse to the recipient spouse, or using a direct transfer from the payor's IRA to an IRA in the recipient spouse's name. The Tax Court has previously rejected the notion that the payor making payments to the recipient spouse through IRA withdrawals and issuing checks directly to the recipient spouse constitutes the requisite transfer of an interest in an IRA.

Holding. The court held that because there was no transfer of an interest in an IRA by Dr. Kirkpatrick, the §408(d)(6) exception does not apply for the $100,000 noted in the divorce order. The amount is includable in Dr. Kirkpatrick's income for the year and is taxable.

Individual Retirement Arrangement
Ltr. Rul. 201736018 (Jun. 9, 2017)
IRC §408

☞ Decedent's IRA Paid to Surviving Spouse Not an Inherited IRA

Facts. Decedent had an IRA and died after reaching age 70½. He designated his estate as the beneficiary of the IRA. At his death, the IRA became part of his residuary estate. His surviving spouse is the executor of his estate. Under the terms of his will, the residuary estate is allocated to a trust.

At the request of the surviving spouse, the state court terminated the trust and ordered the executor of the estate to pay all probate funds to the surviving spouse.

The surviving spouse requested the following rulings.

- That the proceeds she receives from the IRA be treated as directly paid from the IRA to her so she will be treated as the payee or distributee of the IRA
- That the IRA will not be treated as an inherited IRA
- That she is eligible to roll over the IRA distribution into an IRA set up and maintained in her name

Analysis. Generally, any amount paid or distributed out of an IRA is included in gross income by the payee or distributee.[56] However, amounts paid or distributed out of an IRA and rolled over into another IRA within 60 days are not included in gross income.[57] An inherited IRA is not treated as an IRA for purposes of determining whether an amount is a rollover contribution. Inherited IRAs are IRAs acquired by an individual, other than the IRA owner's spouse, as a result of the death of the IRA owner.

The estate was the designated beneficiary of the IRA. The surviving spouse acquired her interest in the IRA proceeds as the estate's sole beneficiary, not as the trust's beneficiary. She is required to pay the proceeds of the IRA to herself. The surviving spouse is effectively the individual for whose benefit the IRA is maintained. She may roll over the distribution into an IRA established and maintained in her own name.

Holding. The IRS ruled that the surviving spouse is treated as a payee or distributee of the IRA proceeds, and the IRA is not treated as an inherited IRA. The surviving spouse is eligible to roll over the proceeds from the IRA to an IRA set up in her own name.

56. IRC §408(d)(1).
57. IRC §408(d)(3).

Retirement Plan Distributions

***Louelia Frias and Mervyngil Salomon v. Comm'r,* TC Memo 2017-139 (Jul. 11, 2017)**

IRC §§72, 401, and 6662

☞ Employer's Failure to Deduct 401(k) Loan Payments Results in Deemed Distribution

Facts. In 2012, Louelia Frias was employed as the assistant administrator and compliance officer at Glen Island Center for Nursing & Rehabilitation, located in New Rochelle, New York. In July 2012, Ms. Frias was granted a leave of absence from work because she was expecting a child. She used her accrued sick, personal, and vacation leave for approximately five weeks of her leave and the remainder of the leave was unpaid. She began her leave on July 30, 2012, and returned to work on October 12, 2012.

Ms. Frias participated in Glen Island's 401(k) plan, which was administered by Mutual of America Life Insurance Co. On July 27, 2012, Ms. Frias entered into a loan agreement with Mutual of America for a $40,000 loan from the 401(k) plan. She also entered into a loan repayment payroll deduction agreement, which required Glen Island to deduct the loan payments from her after-tax salary in each payroll period and to remit the payments to Mutual of America. The biweekly payment amount was $342.

The loan agreement stipulated that payroll deductions would start on the first billing statement after August 10, 2012. If Ms. Frias missed a payment, the loan agreement provided a cure period, under which she could pay the delinquent amount up to the last day of the calendar month following the calendar month in which the delinquent payment was due. If Ms. Frias was delinquent and did not pay the delinquent amounts during the cure period, the entire loan amount would be in default and considered a distribution. In that event, Mutual of America would be required to report the outstanding amount of the loan as a distribution to Ms. Frias.

Ms. Frias' first loan payment was due August 24, 2012. However, Glen Island failed to deduct the loan payments from the amounts it paid to Ms. Frias. She did not know of this failure until a Glen Island representative told her about it when she returned from her leave. When she learned of the failure, she made a $1,000 payment on November 20, 2012. She also instructed Glen Island to withhold loan payments in the increased amount of $500 each through July 15, 2013. After that date, she continued to make payments of the original payment amounts until she repaid the loan in full on July 9, 2014.

Mutual of America issued a 2012 Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* to Ms. Frias, which showed a taxable distribution of $40,065. This form was available online. Ms. Frias had access to the website, but she did not access or review the Form 1099-R. She did not report a distribution on her 2012 federal income tax return.

Issues. The issues are whether:

- Ms. Frias received a taxable deemed distribution resulting from a reclassification of a loan from her 401(k) plan,
- She is liable for an additional tax under IRC §72(t), and
- She is liable for an IRC §6662 accuracy-related penalty.

Analysis. IRC §72(p)(1)(A) provides that loans from a qualified employer plan are generally treated as a distribution to the participant. However, under §72(p)(2), a loan is not treated as a distribution if the loan:

- Is manifested in a legally enforceable agreement,
- Does not exceed the lesser of the amounts set forth in §72(p)(2)(A)(i) or (ii),
- Is required to be repaid within five years,
- Has **substantially level amortization** over the term of the loan with payments made at least quarterly (substantially level amortization requirement).

Even if a loan originally satisfies these requirements, a deemed distribution occurs at any time that the requirements are not satisfied. If loan payments are not made in accordance with the loan provisions, a deemed distribution occurs as a result of the failure to make such payments.[58] If the plan administrator provides the participant with an opportunity to cure the failure, a deemed distribution does not occur unless the participant fails to make the delinquent payment within the cure period.[59]

The IRS contended that Ms. Frias' loan became a deemed distribution when she failed to make her first loan payment on August 24, 2012, and did not correct the failure within the cure period; thus, she violated the substantially level amortization requirement. Ms. Frias contended that this requirement did not apply while she was on leave. The court agreed with the IRS and concluded that because Ms. Frias failed to make her initial loan payment by the due date and failed to make the delinquent payment during the cure period, she defaulted under the loan agreement. Accordingly, the outstanding balance of the loan and accrued interest became a deemed distribution in 2012 that was taxable to Ms. Frias.

IRC §72(t)(1) imposes an additional tax of 10% on early distributions from qualified retirement plans, unless the taxpayer qualifies for an exception. Ms. Frias did not argue that any of the statutory exceptions applied to her. Accordingly, the court held that Ms. Frias is liable for the §72(t) additional tax.

IRC §§6662(a) and (b)(2) allow the imposition of a 20% penalty on the portion of an underpayment attributable to a substantial understatement of income tax. The taxpayer is not liable for the penalty if they demonstrate they had reasonable cause for the underpayment and acted in good faith.

Ms. Frias argued that she had reasonable cause because she did not receive a physical copy of the Form 1099-R and that she made loan payments when she returned from her leave that were accepted by Glen Island and Mutual of America. The court noted that the fact that Ms. Frias did not receive a Form 1099-R is not enough to constitute reasonable cause, especially when an electronic form was available to her but she failed to access it.

However, the court observed that Ms. Frias did not have reason to know that her loan had been treated as a deemed distribution. Glen Island had an obligation to withhold the loan payments from Ms. Frias' paychecks and it failed to meet this obligation. Ms. Frias reasonably relied on Glen Island and Mutual of America to withhold required loan payments and to properly administer her loan. The court observed that it was understandable that Ms. Frias assumed her loan repayments were being made as required.

When Ms. Frias returned to work, a Glen Island representative informed her that the company had failed to withhold loan payments from her paychecks. Ms. Frias immediately took steps to correct the problem. In addition, Mutual of America kept the loan on the books, continued to bill Ms. Frias' account, and sent a letter in 2014 confirming that the loan was repaid in full. Nothing in the conduct of Glen Island or Mutual of America warned Ms. Frias that the loan payment problem had not been properly cured. Therefore, the court concluded that Ms. Frias had reasonable cause for the underpayment and acted in good faith.

Holding. The court held that Ms. Frias received a taxable deemed distribution from her 401(k) plan and is liable for additional tax under IRC §72(t). However, she is not liable for the §6662 accuracy-related penalty.

---

58. Treas. Reg. §1.72(p)-1, Q&A-4(a); *Duncan v. Comm'r,* TC Memo 2005-171 (Jul. 12, 2005); *Molina v. Comm'r,* TC Memo 2004-258 (Nov. 10, 2004).

59. Treas. Reg. §1.72(p)-1, Q&A-10(a); see *Owusu v. Comm'r,* TC Memo 2010-186 (Aug. 23, 2010).

Self-Employment Tax

***Gary and Gwendolyn Sherman v. Comm'r,* TC Summ. Op. 2018-15 (Apr. 2, 2018)**

IRC §§409A and 1401

☞ Mary Kay Deferred Compensation Subject to Self-Employment Tax

Facts. Gwendolyn Sherman had a very successful career with Mary Kay, Inc. She eventually became a national sales director, which is the highest position in the Mary Kay sales force.

Mrs. Sherman entered into Mary Kay's Family Security Program (FSP) in 1993. The FSP offers normal, early, and disability retirement benefits, life insurance coverage, and death benefits to national sales directors. Under the FSP, a national sales director who elects normal retirement benefits is entitled to receive monthly payments equal to one-twelfth of her final average commissions for 15 years. The final average commission is based on the highest three years of commissions during the last five years of service. In a letter from the senior vice president, general counsel, and secretary of Mary Kay dated October 1995, the payments under the FSP are described as "subject to self-employment tax."

Before Mrs. Sherman retired, both she and her husband worked hard to maximize her commissions in order to increase her retirement payments under the FSP. From 2000 to 2005, both Mr. and Mrs. Sherman made developing Mrs. Sherman's Mary Kay business their full-time job. Mrs. Sherman retired at the end of 2004 and started receiving payments under the FSP in 2005.

During 2013 and 2014, Mrs. Sherman received $173,707 each year under the FSP. This amount was reported on Forms 1099-MISC, *Miscellaneous Income,* as nonemployee compensation. Mr. and Mrs. Sherman reported the payments as "other income" on their tax returns and attached documents prepared by their accountant, Mr. Muscio, which asserted that the income under the FSP was not subject to self-employment (SE) tax. They described the income as "termination payments."

In 2013, the IRS examined the Shermans' returns for 2011. The Shermans were represented in the examination by Mr. Muscio. He argued that the FSP payments were not deferred compensation subject to SE tax. Eventually, the IRS conceded that the FSP payments in 2011 were not SE income and that no additional tax was due.

The Shermans received notice that their 2013 return was being examined and that the IRS was challenging the position that FSP payments were not subject to SE tax. In March 2016, the IRS issued a notice of deficiency for 2013 and 2014. The IRS determined that the income the Shermans received from Mary Kay was subject to SE tax and assessed deficiencies for both years.

Issue. The issue is whether Mrs. Sherman's retirement benefits from Mary Kay are subject to SE tax.

Analysis. The court in *Peterson v. Comm'r*[60] held that FSP payments are subject to SE tax. The Court of Appeals agreed. The court in this case observed that the material facts in the case at hand are identical to the facts in *Peterson.*

In *Peterson,* the court found that "the Mary Kay distributions were 'tied to' the quantity and quality of Mrs. Peterson's prior labor."[61] Like the payments in *Peterson,* Mrs. Sherman's FSP payments were based on her average commissions over the five years preceding her retirement. In addition, the FSP agreement describes the payments as deferred compensation, and Mrs. Sherman was explicitly informed by Mary Kay in 1995 that the FSP payments were deferred compensation and subject to SE tax.

> **Note.** For a summary of the Court of Appeals case *Peterson v. Comm'r,* see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Rulings and Cases. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Holding. The court held that Mrs. Sherman's payments under the FSP in 2013 and 2014 are deferred compensation and are subject to SE tax.

60. *Peterson v. Comm'r,* TC Memo 2013-271 (Nov. 25, 2013), *aff'd* in part, dismissed in part, 827 F.3d 968 (11th Cir. 2016).

61. Ibid.

Early Distribution of IRA

***Jeremy Summers v. Comm'r,* TC Memo 2017-125 (Jun. 26, 2017)**

IRC §§72 and 414

☞ Taxpayer's Payment of IRA Proceeds to Ex-Wife Subject to Additional Tax

Facts. In 2013, Jeremy and Karie Summers decided to separate and then to obtain a divorce. They wanted to do this in the least acrimonious way possible. To minimize costs, they decided to obtain their divorce without hiring lawyers.

The couple reached an agreement regarding child custody, visitation rights, child support, spousal maintenance, and property division. Mr. Summers filed a petition for dissolution of marriage in March 2013, which incorporated these agreements. At that time, he had an IRA that he wanted to split 50-50 with Ms. Summers. His divorce petition accordingly stated that "the proceeds of IRA should be divided 50% to Petitioner and 50% to Respondent."

Ms. Summers did not work outside the home but she had several debts. While the divorce petition was pending, she wanted to simplify her finances so she could get a fresh start. To accommodate her desire, Mr. Summers agreed to split the value of the IRA before the divorce became final.

In April 2013, Mr. Summers withdrew the entire balance of the IRA, which was $17,378. He deposited a check in a bank account that he jointly held with his wife. He then wrote a check for $8,618 to pay off Ms. Summers' car loan and later paid her another $71, so she would have the benefit of her full 50% interest in the IRA.

In June 2013, an Arizona court entered a consent decree for the dissolution of marriage, which incorporated nearly all the agreements set forth in Mr. Summers' March 2013 petition. However, because he and Ms. Summers had already split the IRA, an attachment to the decree provided that "neither party has a retirement, pension, deferred compensation, §401(k) plan and/or benefits."

Mr. Summers timely filed a 2013 tax return. On the return, he properly reported the $17,378 proceeds from his IRA as a taxable distribution. However, he did not report any additional tax attributable to the early distribution. The IRS subsequently issued a notice of deficiency to Mr. Summers, which asserted that he was liable for the 10% additional tax under IRC §72(t)(1).

Issue. The issue is whether Mr. Summers is liable for the 10% additional tax imposed by IRC §72(t)(1) on early distributions from a qualified retirement plan.

Analysis. IRC §72(t)(1) imposes a 10% additional tax on early distributions from qualified retirement plans, including IRAs. IRC §72(t)(2) lists various exceptions from this additional tax. Mr. Summers relied on the exception set forth in §72(t)(2)(C), which applies to distributions made "to an alternate payee pursuant to a qualified domestic relations order (within the meaning of section 414(p)(1))." An **alternate payee** is defined in IRC §414(p)(8) as "any spouse, former spouse, child or other dependent of a participant who is recognized by a domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to such participant." IRC §414(p)(1)(B) defines a **domestic relations order** as a "judgment, decree, or order" relating to "the provision of child support, alimony payments, or marital property rights" that "is made pursuant to a State domestic relations law."

The IRS contended that Mr. Summers did not qualify for the §72(t)(2)(C) exception for two reasons. First, the IRA distribution was made directly to Mr. Summers, and he deposited the check into a bank account that he and Ms. Summers held. He then transferred half of the proceeds for her benefit. Although Ms. Summers received these proceeds, the distribution was initially made to Mr. Summers, rather than to a "former spouse… who is recognized by a domestic relations order as having a right to receive" part of the proceeds.[62]

---

62. See IRC §414(p)(8).

Second, the distribution was not made under a qualified domestic relations order. Although Mr. Summers' dissolution of marriage document referenced a 50-50 split of the IRA, no judicial action on that request was carried out because he divided the IRA with Ms. Summers a month before the divorce decree was entered. Accordingly, the IRA distribution was not made under the divorce decree or any other judicial action.

The court noted that a taxpayer must strictly comply with the provisions of §72(t)(2)(C) to be entitled to the exception. The court expressed sympathy for Mr. Summers' position but noted that it could not add equitable exceptions to the statutory scheme enacted by Congress.

Holding. The court upheld the 10% additional tax imposed by the IRS.

S CORPORATION

Reasonable Compensation

***Jeffrey Wycoff and Merrie Pisanno-Wycoff v. Comm'r,* TC Memo 2017-203 (Oct. 16, 2017)**
IRC §§170, 482, and 6662

☞ Compensation Paid From S Corporation to Owners' Management Company Deemed Unreasonable

Facts. Jeffrey Wycoff earned a Bachelor of Arts degree from Ryder College in 1975 and previously held a state contractor's license and a tile contractor's license. His varied career included selling life insurance, managing a Domino's Pizza franchise, managing a construction company, and selling cars. In the early 1990s, Mr. Wycoff and his wife Merrie developed a tile-cleaning product. They used two operating companies, Sirius and Restore 4, to sell the tile-cleaning product using infomercials and similar marketing endeavors. Mr. Wycoff referred to himself as national sales manager and product spokesperson. The Wycoffs were the only directors and officers of Sirius and Restore 4. Both companies were taxed as S corporations during 2001 through 2003 (the years at issue in this case).

On August 18, 2000, a promoter gave a presentation to Barry Marlin, the taxpayers' attorney. The presentation outlined a plan involving the following steps.

- Establish a new S corporation as a management company
- Establish deferred compensation benefits for key employees of the operating companies
- Adopt an employee stock option plan (ESOP)/401(k) plan
- Sell the stock in the new S corporation management company stock to the ESOP/401(k) plan
- Pay a management fee to the S corporation management company from each of the two operating companies
- Manage the funds in the new S corporation management company and fund the deferred compensation benefits and ESOP/401(k)

In the presentation, the promoter indicated that the objectives of the plan included reducing corporate and personal tax liability, getting equity ownership and special benefits in the hands of key people, and creating a tax-advantaged structure.

After the presentation, Mr. Wycoff instructed Mr. Marlin to review the transaction. Mr. Marlin only discussed the plan with two accounting firms and did not issue a written legal opinion. Based on this very limited review, Mr. Wycoff executed a contract with the promoter and paid a $50,000 fee to have the promoter implement the plan. The contract contained a disclaimer indicating that the parties acknowledged the planning "is an aggressive tax planning program" and that Mr. Wycoff was advised of this fact, had the opportunity to seek independent legal counsel, and accepted the risk of an IRS challenge to the program.

In October 2000, the plan was implemented with the establishment of Albion Management, Inc. (Albion), an S corporation that was formed with the Wycoffs as sole directors and owners. Albion hired Mr. Wycoff as the full-time manager for Albion's clients, which were the operating companies Sirius and Restore 4. These operating companies entered into contracts with Albion for Albion to provide management services. The contracts did not specify what management services would be provided. Moreover, Albion established an ESOP and a 401(k) plan, as well as a "Supplemental Retirement Plan and Rabbi Trust" for the sole benefit of Mr. Wycoff.

Management fees paid by the operating companies to Albion were established at 20% of gross receipts after a discussion about the nature of the management services between Mr. Wycoff, Mr. Marlin, and the promoter. Approximately two years later, this was reduced to 10% of gross receipts due to declining revenues and reduced to 3% of gross receipts in the following year. The nature of the management services did not change, however.

The main purpose of the tax plan was for Sirius and Restore 4 to pay high management fees to Albion to shift profit from these operating companies to Albion. Mr. Wycoff then earned a large salary and deferred tax on as much of that compensation as possible into the Supplemental Retirement Plan and Rabbi Trust, and the 401(k) plan and ESOP.

The IRS challenged the plan for the 2001, 2002, and 2003 tax years and sent a notice of deficiency disallowing most or all of the management fees for each operating company for each of the three tax years. The IRS's challenge was based on the management fee payments from the operating companies to Albion being in excess of arm's-length amounts allowable under the Code. Excessive amounts were deducted from the operating companies and used to pay Mr. Wycoff excessively high amounts of compensation beyond a reasonable amount that was used, in turn, to direct excessive amounts into Albion's retirement accounts for Mr. Wycoff's benefit.

The IRS's contention was that arm's-length management fees and reasonable amounts of compensation for 2001 through 2003 would have led to taxable profits and/or taxable distributions to Mr. Wycoff from the operating companies and reasonable amounts of tax deferral within the retirement benefit accounts. In addition, the IRS sought an accuracy-related penalty under IRC §6662(a).

Issues. The issues are whether:

- Mr. Wycoff's compensation was too high to be considered "reasonable compensation,"
- The management fees paid by the operating companies to Albion were in excess of an "arm's-length" amount required by the Code, and
- The Wycoffs were subject to penalties under §6662.

Analysis. At trial, the Tax Court heard expert testimony from experts provided by both the IRS and Mr. Wycoff. The expert witness for the IRS, Kenneth Nunes, was a chartered financial analyst with a master's degree in mechanical engineering from the University of California-Davis and a master's degree in business administration from the University of California-Los Angeles. Mr. Nunes had over 25 years of experience advising companies on financial, valuation and similar issues and testified as an expert in various federal and state courts.

On the issue of reasonable compensation, Mr. Nunes examined the condition of the operating companies, the market for executive compensation in this industry, and Mr. Wycoff's own qualifications. To determine whether Mr. Wycoff's compensation as Albion's CEO was reasonable, Mr. Nunes first identified CEO salaries for similar companies within the same industry. He used a methodology that identified a representative sample of comparable companies and then analyzed the revenue and CEO compensation data for this sample to create an equation that indicated the relationship between a company's revenue and the salary of the CEO. Mr. Nunes then inputted a revenue amount and mathematically determined an appropriate CEO salary at that income level for a company comparable to Albion. The following table compares the amounts Mr. Nunes' analysis indicated for reasonable compensation with Mr. Wycoff's actual compensation for 2001, 2002, and 2003.

	2001	2002	2003
Reasonable compensation from Mr. Nunes' analysis	$1,338,000	$654,000	$118,000
Mr. Wycoff's actual compensation	9,505,225	1,224,454	687,095

Mr. Nunes determined that the services provided by Albion to the operating companies was integral under Treas. Reg. §1.482-2(b)(3) and (b)(7)(iii). Therefore, the regulations require management fees paid by the operating companies to Albion to be the same as such a fee would be between unrelated parties for similar services.

Mr. Nunes found comparable companies to Albion that provided similar management services. He then used a cost markup method to determine the amount of an arm's-length management fee. After taking into consideration the reasonable compensation for Mr. Wycoff for each of the years noted earlier and Albion's other reported expenses, Mr. Nunes concluded that Albion was entitled to management fees of $1.725 million, $1.417 million, and $705,000, respectively, for the years at issue.

Mr. Wycoff's expert, Timothy Dupler, had experience working with companies in direct response marketing. However, he had no training, experience, or education in financial analysis or with the valuation of management contracts or executive compensation. Mr. Dupler maintained that the management fee of 20% of gross receipts paid by the operating companies was reasonable and customary for a direct response marketing company. His opinion was based on his previous experience with such companies but he provided no corroborating sources, documents, or reports.

Mr. Wycoff also submitted an expert report from Francis X. Burns, a graduate of Stanford University who was an accredited senior appraiser in business valuation from the American Society of Appraisers. He was also certified as accredited in business appraisal review by the Institute of Business Appraisers. Mr. Burns also earned a master of management degree in finance and economics from Northwestern University and had over 25 years of experience as an economic consultant, including evaluating executive compensation and determining reasonable compensation under the Code.

In his report, Mr. Burns indicated that the management fee contract, signed on the basis of the information available to the parties at the time of signing, scaling the management fee to gross receipts was reasonable because all of the parties assumed the risk of the success of the operating companies. In addition, Mr. Burns did not find relevant the common control aspect among the companies and concluded the management fees were reasonable. He also indicated that Mr. Wycoff should be entitled to additional compensation for the position of national sales manager and product spokesperson.

The court concluded that Mr. Wycoff's compensation was unreasonable because he had not previously worked in retail or with other companies that use direct response marketing. The court noted that Mr. Wycoff testified that he had to learn how direct marketing worked, and that Mr. Nunes' analysis reflected this lack of experience. Moreover, the court noted that nothing in the case suggested that Mr. Wycoff's work was unusually complex or extensive and that no records were maintained regarding the particular management services provided for each operating company.

Moreover, the court stated that in a closely held corporation context, "…executive compensation…that depletes most of a corporation's value is generally unreasonable when the deductible salary expenses are a disguise for nondeductible profit distributions." The Tax Court noted that in 2001, 87% of the management fee was used to pay Mr. Wycoff's compensation. The court also noted that Mr. Wycoff's compensation levels for 2001 through 2003 was substantially higher than the amounts he received as compensation for prior years for the same work. There was no evidence that Mr. Wycoff was underpaid in prior years.

Holding. The court held that Mr. Wycoff's compensation was unreasonable. In addition, the Tax Court found Mr. Nunes' analysis reliable and produced the most reasonable measure of an arm's-length result for the management fees. The Tax Court held that the operating companies were entitled to management fee deductions of $1.725 million, $1.417 million, and $590,000 for 2001, 2002, and 2003, respectively. This was substantially less than the amounts deducted for tax purposes on the returns filed by the operating companies.

Moreover, the Wycoffs were liable for the accuracy-related penalty under IRC §6662(a). Mr. Wycoff knew the tax planning was aggressive and did not seek independent legal counsel's advice from advisers with the necessary experience. They relied on tax advisers and the promoter group, which was not reasonable.

Debt Basis

***Homero F. Meruelo v. Comm'r,* TC Memo 2018-16 (Feb. 5, 2018)**

IRC §1366

☞ Bona Fide Debt to S Corporation Shareholder is a Prerequisite to Debt Basis

Facts. Homero Meruelo was a south Florida real estate developer with interests in many S corporations, partnerships, and LLCs. One such entity was Merco, which elected S corporation status in March 2004. Mr. Meruelo owned a 49% interest during 2008.

Merco was established to buy a condominium complex in a bankruptcy sale. In early 2004, the bankruptcy court approved the sale and Mr. Meruelo made the required $4.985 million nonrefundable deposit to acquire the property. These funds were proceeds from a personal loan that Mr. Meruelo obtained from City National Bank of Florida (CNB). The funds were initially deposited to Akoya, another S corporation in which Mr. Meruelo and his mother each owned a 50% interest. With an additional $14,965 of funds from Akoya as required for the deposit, the $5 million deposit was then transferred to Merco to cover the deposit.

During 2004–2008, Merco entered into hundreds of transactions with the various other entities in which Mr. Meruelo had an interest. Merco and these affiliates regularly paid expenses on each other's or on Merco's behalf to maintain liquidity or simplify accounting. These transactions were recorded as intercompany accounts receivable (for the payor) and accounts payable (for the payee). During these years, Merco affiliates paid in excess of $15 million on Merco's behalf, and Merco repaid the affiliates less than $6 million, leaving a large amount owing (account payable balance) from Merco to the affiliates.

Mr. Meruelo's tax preparer, Luis, netted Merco's accounts payable with the corresponding accounts receivable from the affiliates. The remaining net account payable shown on Merco's books was then reported as a shareholder loan from Mr. Meruelo to Merco on Merco's return and a percentage of this loan amount was allocated to Mr. Meruelo based on the percentage of his ownership interests in the various affiliates.

In order to document the loan, Luis drafted a promissory note dated March 31, 2004, showing a $10 million line of credit available from Mr. Meruelo to Merco at a 6% interest rate. Luis testified that in preparing 2004–2008 tax returns, he made an annual charge to Merco's line of credit equal to Mr. Meruelo's calculated share of Merco's net accounts payable to the affiliates for the preceding year. However, there was no evidence of such adjustments being made, or that Merco accrued interest annually on its books with respect to this indebtedness to Mr. Meruelo. Moreover, there was no evidence that Merco actually made any payments of principal or interest on this loan, or that Mr. Meruelo made payments on any intercompany amounts between the affiliates and Merco.

In 2008, when banks foreclosed on the condominium complex, Merco incurred a loss of $26.6 million that was reported on Merco's S corporation tax return. Merco allocated 49% of the loss ($13 million) to Mr. Meruelo on Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.*

Mr. Meruelo reported taxable income on his 2005 personal return of $13.9 million and tax due of $4.8 million. On his 2008 return, Mr. Meruelo claimed an ordinary loss deduction on Form 4797, *Sales of Business Property*. The amount of the Form 4797 ordinary loss was comprised of gains from two other S corporations of $1.2 million offset by Mr. Meruelo's 49% allocation of the foreclosure loss of $13 million, for a total net ordinary loss of $11.8 million. After other adjustments, the 2008 return reflected an $11.8 million net operating loss (NOL) that was carried back to 2005. The result was a reduction of the original 2005 tax liability of $4.8 million to $946,506 and a refund to Mr. Meruelo of $3.9 million.

Upon subsequent examination of Mr. Meruelo's 2005 and 2008 returns, the IRS determined that his basis in Merco was only the $4.985 million proceeds of the CNB loan. Accordingly, of the $13 million flow-through loss, the IRS disallowed $8.1 million due to lack of adequate basis. This limited the NOL carryback amount to $3.7 million and the correct tax due for 2005 was adjusted from $946,506 to $3.5 million. The resulting deficiency therefore was $2.6 million, which the IRS reflected on a notice of deficiency. Mr. Meruelo petitioned the Tax Court for redetermination.

Issue. The issue is about the extent to which the intercompany loan provides Mr. Meruelo with debt basis in the S corporation.

Analysis. IRC §1366(d)(1) limits the amount of losses and deductions claimed by an S corporation shareholder to the sum of the shareholder's stock basis and debt basis in the corporation. Any disallowed amount of loss or deduction carries forward, and once the shareholder increases basis, those previously suspended loss or deduction amounts may be claimed to the extent of the additional basis available.

While the Code is silent on how an S corporation shareholder may acquire debt basis, relevant legislative history indicates that losses are limited to the shareholder's "investment in the corporation." The Tax Court has construed this to mean an actual economic outlay by the shareholder. Pointing to case precedent, the Tax Court indicated that such an economic outlay exists when the shareholder incurs a cost or is left poorer in a material sense after the transaction. Moreover, the taxpayer bears the burden of proving basis.

Mr. Meruelo argued that a 2014 regulation applied to the transactions in this case, and the result is that he does not need to show an actual economic outlay to obtain increased basis. He pointed to Treas. Reg. §1.1366-2(a)(2)(i) that states debt basis means basis "…in any bona fide indebtedness of the S corporation that runs directly to the shareholder" and whether the debt is a bona fide debt "…is determined under general Federal tax principles and depends upon all of the facts and circumstances." In addition, Treas. Reg. §1.1366-5(b) indicates that S corporations and shareholders may rely on this rule from Treas. Reg. §1.1366-2(a)(2)(i) regarding any transaction occurring in a year for which the limitations period has not expired before July 23, 2014.

The Tax Court noted that the limitations period had not yet expired for the 2005 or 2008 tax years at issue in this case, but many of the intercompany transactions relied upon occurred during years for which the limitations period has expired. It was unclear how the regulation would apply under such circumstances. However, the Tax Court noted that it was unnecessary to address the limitations issue, because the regulation's requirement for a "bona fide debt" was the same test that substantial case precedent required. Such cases require a corporation's indebtedness to a shareholder to be genuine and reflect economic reality. The controlling text under case precedent is the existence of a bona fide debt that runs directly to the shareholder, with the shareholder having made an actual economic outlay.

Mr. Meruelo used two theories to argue that he had debt basis.

1. That the affiliates lent him money that he, in turn, loaned to Merco (the "back-to-back" loan theory)
2. That he lent money to the Merco affiliates and they used those funds to pay Merco's expenses (the "incorporated pocketbook" theory)

The Tax Court rejected the back-to-back loan theory argument. While the court acknowledged that regulations recognizing back-to-back loans can give rise to additional basis, the requirement is that the loan must run directly to the shareholder in order to create basis. This means that indebtedness of an S corporation running to an entity with pass-through characteristics that advanced the funds and is closely related to the taxpayer does not qualify. The Tax Court pointed to case precedent in support of this distinction.

The Tax Court also acknowledged that payments from an entity to the taxpayer's S corporation on the taxpayer's behalf may also give rise to increased basis under the incorporated pocketbook theory. To obtain basis under this theory, the taxpayer must establish that he had a habitual practice of having his wholly owned corporation pay money to third parties on his behalf. Whether an entity functions as an incorporated pocketbook is a question of fact.

The Tax Court cited several prior cases in which these requirements were successfully met by taxpayers but noted that Mr. Meruelo's facts in this case were very different. First, in the past cases, the shareholder was the sole shareholder of the corporation used to disburse funds on their behalf. However, Mr. Meruelo sought to treat 11 distinct Merco affiliates as his incorporated pocketbook in his argument. Moreover, by netting accounts payable with accounts receivable, Mr. Meruelo's incorporated pocketbook not only disbursed funds but also received funds. The Tax Court noted that in the numerous cases in which it accepted an incorporated pocketbook theory, it never accepted such a theory on Mr. Meruelo's facts.

Moreover, Mr. Meruelo did not prove that the affiliates habitually or routinely paid his expenses in a manner making the affiliates his incorporated pocketbook. In addition, this theory has been accepted in cases in which the shareholder actually disbursed their own funds through the entity found to be the incorporated pocketbook. Mr. Meruelo never disbursed his own funds, but instead, the affiliates disbursed all the funds to or on behalf of Merco. Mr. Meruelo never made an actual economic outlay.

Lastly, the court noted that in past cases in which the incorporated pocketbook theory was successfully proven by the taxpayer, the transactions alleged to create basis were actually booked as loans. The corporations contemporaneously recorded shareholder loans on their ledgers, with principal and interest payments actually being made on the loans. Mr. Meruelo's facts indicated that the transactions were contemporaneously booked as capital contributions, payroll expenses, or intercompany accounts payable and receivable, and later recharacterized as shareholder loans only after the tax year's close. Payments of principal or interest were never made.

Holding. The court held that Mr. Meruelo did not prove he met the requirements of either of the theories he argued. He did not establish the existence of a bona fide debt running directly to him. Mr. Meruelo is therefore not entitled to the increased basis he claimed. The IRS notice of deficiency reflects an appropriate adjustment of his tax liability.

S Corporation Income

Craig P. and Cricket U. Mowry v. Comm'r, **TC Memo 2018-105 (Jul. 5, 2018)**
IRC §§165, 167, 1362, and 6651

☞ S Corporation Not Terminated By Generation of Second Class of Stock

Facts. Craig Mowry and his brother, Geoff, incorporated their construction company, Mowry Rebar, Inc. (Mowry Rebar) as an S corporation. Craig owned 49% and Geoff owned the remaining 51%. The brothers agreed that distributions would be allocated in proportion to their ownership percentages. Craig spent most of his time out at job sites, while Geoff was the president and maintained the administrative aspects of the business.

In July or August 2012, Craig noticed credit cards that he maintained for business purposes were used without his consent for expenses associated with Geoff's children. Craig reviewed the QuickBooks record and discovered numerous items, including hand-written checks, were not entered into the ledger. He determined that substantial check and ATM withdrawals were being made without his knowledge.

The business struggled. On November 19, 2012, Craig sent his brother an email stating that if Geoff would not help Craig fix the business, then Craig would resign and sell his shares to his brother for $1. Geoff accepted immediately. Craig completed tasks for an ongoing project and quit Mowry Rebar on November 20, 2012. Shortly after resigning, Craig began working for a competitor. However, he never received payment for his shares in Mowry Rebar.

Craig and his wife (the Mowrys) filed their joint tax return for 2011 on or around February 21, 2013. They timely filed their 2012 return. The Mowrys attached Schedules E, *Supplemental Income and Loss,* for both years. The schedules showed Craig's ownership percentage but no income or losses from Mowry Rebar. They also attached Forms 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR),* for both years. The Mowrys explained on the forms that they did not receive Schedules K-1, *Shareholder's Share of Income, Deductions, Credits, etc.,* from the company. Mowry Rebar did not file Forms 1120S, *U.S. Income Tax Return for an S Corporation,* or issue Schedules K-1 for either year.

An IRS agent prepared substitute returns. Each year, the agent allowed deductions for salaries, wages, and other business expenses. However, there was no deduction for depreciation. The agent allocated distributable net income according to the ownership percentages.

The Mowrys argued that they should be entitled to depreciation expenses and that Craig should not be allocated 49% of the income.

Issues. The issues in the case are the following.

- Whether the Mowrys must include income from Mowry Rebar
- Whether the Mowrys are entitled to depreciation deductions
- Whether the Mowrys are liable for late-filing penalties under IRC §6651

Analysis. S corporations must not have more than one class of stock. An election to be treated as an S corporation is effective until it is terminated. An automatic termination occurs when a corporation ceases to qualify as an S corporation. The Mowrys contended that Mowry Rebar ceased to be an S corporation because, starting in 2011, it had more than one class of stock. Because Geoff withdrew large amounts of money from the business's accounts without Craig's knowledge and he received disproportionately large distributions from Mowry Rebar, Craig argued that effectively a second class of stock was issued. The Mowrys contended that the company could be treated as a C corporation and Mr. Mowry should only be taxed on his distributions. The court disagreed because disproportionate distributions over multiple years was insufficient to prove a second class of stock was issued. Rather, the corporation's organizational documents and other binding agreements between shareholders establish whether a second class of stock was intended. There was no proof that either Craig or his brother intended a different arrangement.

Craig contended that he should not be allocated any income after November 19, 2012, when he sold his stock to Geoff. However, the Mowrys did not provide any evidence that an actual sale occurred or that legal or beneficial ownership transferred to Geoff. Craig testified that he never received compensation for his shares and he did not report a sale of the stock on their 2012 return.

The Mowrys claimed that they were entitled to deductions for depreciation because Mowry Rebar claimed similar expenses on prior tax returns. However, they could not describe any depreciable property used in the business or provide any calculations for depreciation expenses. The court stated that claiming a deduction on a previous return was not sufficient evidence to substantiate a claim in the current year.

The Mowrys acknowledged that they filed their 2011 tax return late and did not address the late-filing penalties. They did not provide any evidence that the late filing was due to reasonable cause.

Holding. The court held that the Mowrys must report Craig's 49% of income from Mowry Rebar. A second class of stock was not created despite Geoff's excessively disproportionate distributions. The Mowrys were not entitled to depreciation expense because they did not provide any evidence of depreciable property used in the business. The court held that the Mowrys were liable for the additional late-filing penalty because they did not provide any evidence that the delay was due to reasonable cause.

SALES TAX

Sales and Use Tax

***South Dakota v. Wayfair, Inc., et al.,* U.S. Supreme Court, No. 17-494 (Jun. 21, 2018)**
Commerce Clause, Due Process Clause

☞ Legislation Requiring Online Retailers to Collect and Remit Sales Tax Constitutional

Facts. South Dakota imposes a sales tax that applies to the retail sales of goods and services within the state. Sellers are required to collect the tax from customers and remit the tax to the state. However, a state may not require a seller to collect and remit unless the seller has a physical presence in that state. For sellers that the state cannot compel to collect and remit, the state must rely on state residents to report and pay a use tax for their out-of-state purchases. Supreme Court precedent, established through three primary cases, establishes the limitations of state authority over sellers, including the constitutional parameters of such authority. The three precedential cases are *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois,*[63] *Quill Corporation v. North Dakota,*[64] and *Complete Auto Transit, Inc. v. Brady.*[65]

The standard established in *Bellas Hess* and *Quill* generally required a seller's physical presence in a state for the state to exercise its sales tax jurisdiction over that seller. South Dakota's legislature, concerned that this limitation caused the state to lose an estimated $48 to $58 million in annual revenue, lose critical funding for essential state services, and the notorious lack of use tax compliance by state residents making out-of-state purchases, passed a law requiring out-of-state sellers to collect and remit sales taxes as if they had a physical presence in the state. The law covers only sellers that deliver more than $100,000 of goods or services into the state annually or engage in 200 or more separate transactions for the delivery of such goods and services.

Wayfair, a major online retailer with no physical presence in South Dakota, met both the $100,000 and 200 transaction thresholds of South Dakota's new law. However, Wayfair did not collect and remit sales tax to South Dakota. State court litigation ensued between the parties, culminating with South Dakota's Supreme Court concluding that South Dakota's law was unconstitutional, citing the *Quill* case as controlling precedent. South Dakota appealed the case to the Supreme Court.

Issue. The issue is whether South Dakota can require businesses without the requisite physical presence in the state to collect and remit sales taxes.

Analysis. The Court noted that the South Dakota Supreme Court was correct that *Quill* was controlling. However, consumer use tax compliance rates were low, and states were losing large amounts of revenue because of the *Bellas Hess* and *Quill* limitations on states' ability to require out-of-state sellers to collect and remit sales tax. South Dakota is particularly reliant on sales tax because the state has no income tax, and the loss of revenue caused it to declare an emergency in the course of passing the legislation at issue. Remote sellers are eroding South Dakota's tax base. Among the defendants are Wayfair, Overstock.com, and Newegg, Inc., which are major online sellers, collectively with billions of dollars of sales that escape sales tax.

---

63. *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois,* 386 U.S. 753 (1967).

64. *Quill Corporation v. North Dakota,* 504 U.S. 29 (1992).

65. *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977).

Since the early history of the Commerce Clause, the Supreme Court's central function has been to adjudicate disputes that require Commerce Clause interpretation to determine its meaning and scope, and the extent to which it limits state regulation of interstate commerce. Key relevant precedent includes *Complete Auto*, in which the Court held that a state may tax exclusively interstate commerce as long as the tax does not create an effect forbidden by the Commerce Clause. Under *Complete Auto*, the Court will sustain a tax as long as the tax meets the following requirements.

- Applies to an activity with a substantial nexus with the taxing state
- Is fairly apportioned
- Does not discriminate against interstate commerce
- Is fairly related to the services the state provides

In *Bellas Hess*, the Court concluded that the State of Illinois could not tax a mail-order company selling goods to Illinois residents because the company lacked any physical presence or other minimum contacts (property, solicitors, retail outlets) in the state required by both the Due Process Clause and the Commerce Clause. On similar facts, *Quill* later overruled the Due Process Clause ruling of *Bellas Hess* but reaffirmed its Commerce Clause grounds because the physical presence rule was necessary to prevent undue burdens on interstate commerce.

However, the Court noted that the physical presence rule had been the target of substantial criticism. One such criticism was that the rule creates a loophole for online sales, giving out-of-state sellers an advantage over those located in the state. The Court stated that each year, the physical presence rule became further removed from economic reality, resulting in loss of significant revenues to states.

The Court indicated that the *Quill* decision was flawed, because any necessary nexus with a state that must exist in order for the state to exercise sales tax jurisdiction over a seller did not necessarily need to include a physical presence in the state. Modern Commerce Clause decisions avoided the sort of arbitrary, formalistic rationale *Quill* is based on.

The Court focused on statements in *Quill* in which the *Quill* court, despite its reaffirming the physical presence rule, stated that the rule was not aging well with modern economic realities and technology. For example, quoting from *Quill*, the Court noted that "it is an inescapable fact of modern commercial life that a substantial amount of business is transacted … [with no] need for physical presence within a State in which business is conducted."

The Court noted that the Commerce Clause was previously interpreted to prevent states from engaging in economic discrimination so they would not divide into isolated, separable units, but was not intended to allow those engaged in interstate commerce to escape their share of state tax burden. The Court indicated that continuing to uphold the constitutional limits of *Quill* no longer creates an even playing field with businesses, because businesses with a physical presence are at a competitive disadvantage to remote sellers.

The Court stated that *Quill* "has come to serve as a judicially created tax shelter for businesses that decide to limit their physical presence and still sell their goods and services to a State's consumers." Moreover, the Court indicated that the physical presence rule was an extraordinary imposition on a state's authority to collect taxes and perform critical public functions. The Court, referring to a brief filed in this case, noted that "forty-one states, two territories, and the District of Columbia have asked the Court to reject *Quill*'s test."

Referring to the argument of the online sellers to preserve the physical presence rule, the Court cited a brief filed in this case in which Wayfair's advertising was quoted, indicating that "[o]ne of the best things about buying through Wayfair is that we do not have to charge sales tax." The Court reacted to this "subtle offer to assist in tax evasion" by noting that creating a "dream home" assumed solvent state governments, who must have revenues to pay for the police and fire protection to protect those homes and maintain public roads and municipal services.

The Court concluded that *Quill* and related precedents could not continue to be adhered to and it was time to correct the law to reflect modern realities on online consumerism. It noted that the *Quill* court "did not have before it the present realities of the interstate marketplace." The Court realized that "the [I]nternet's prevalence and power have changed the dynamics of the national economy."

The Court overruled *Bellas Hess* and *Quill.* In the absence of those two cases, the Court used the first prong of the *Complete Auto* test and concluded that there was a clearly sufficient nexus between the activity and the state of South Dakota. A seller could not meet the $100,000 sales and 200 transaction thresholds unless it availed itself of the substantial privilege of carrying on business in South Dakota. The Court easily concluded that South Dakota's legislation met the *Complete Auto* test.

In addition, the Court noted that South Dakota's legislation and tax system had several features designed to prevent discrimination against or undue burdens upon interstate commerce. The threshold amounts provided a safe harbor for businesses with only limited amounts of business in South Dakota. The Court recognized the legislature included a provision precluding any retroactive obligation to collect and remit sales tax. Moreover, the Court noted that South Dakota, along with more than 20 other states, adopted the Streamlined Sales and Use Tax Agreement, which standardizes taxes to reduce administrative and compliance costs.

Note. For further details on the Streamlined Sales and Use Tax Agreement, visit the Streamlined Sales Tax Governing Board, Inc.'s website at **uofi.tax/18a4x4** [www.streamlinedsalestax.org/index.php?page=modules].

Holding. The judgment of the Supreme Court of North Dakota that upheld the *Quill* physical presence rule was vacated and the case was remanded for further proceedings. South Dakota has the authority to require out-of-state sellers to collect and remit sales tax under the terms of that legislation.