Chapter 4: Rulings and Cases

Please note. Corrections were made to this workbook through January of 2020. 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 short URLs. 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, 2019. 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.

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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)).

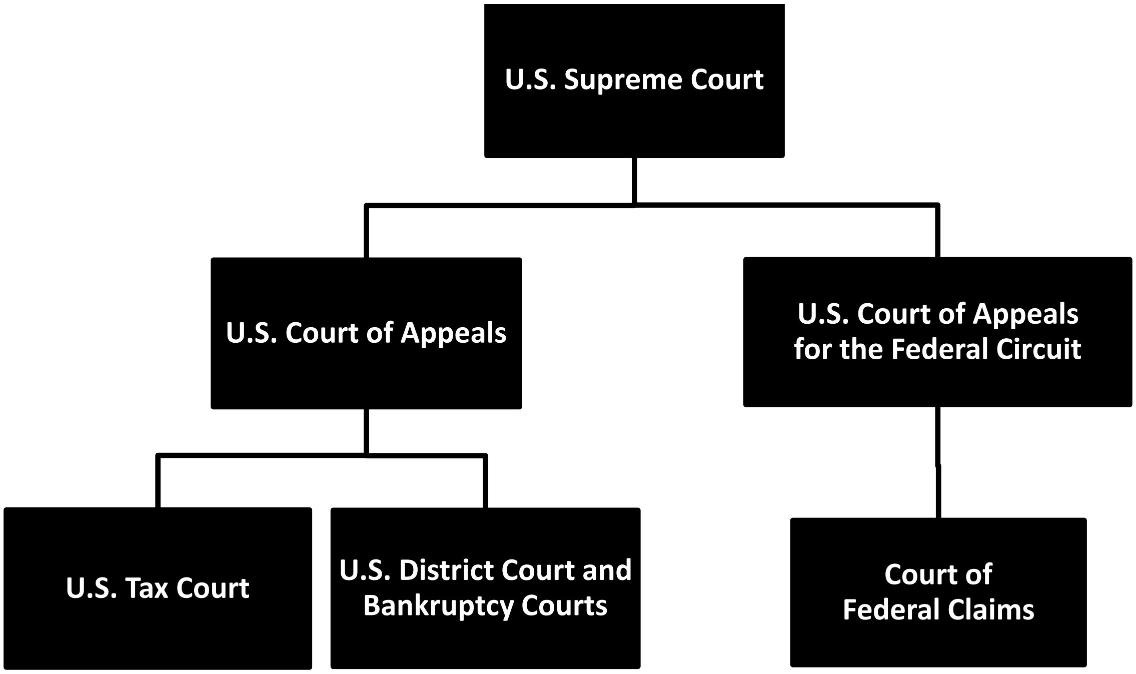
General Council Memoranda (GCM). GCMs detail the legal reasoning behind the issuance of a revenue ruling.

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]

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

Tax Court Decisions

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

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

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

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

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

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

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

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

Tax Court Appeals

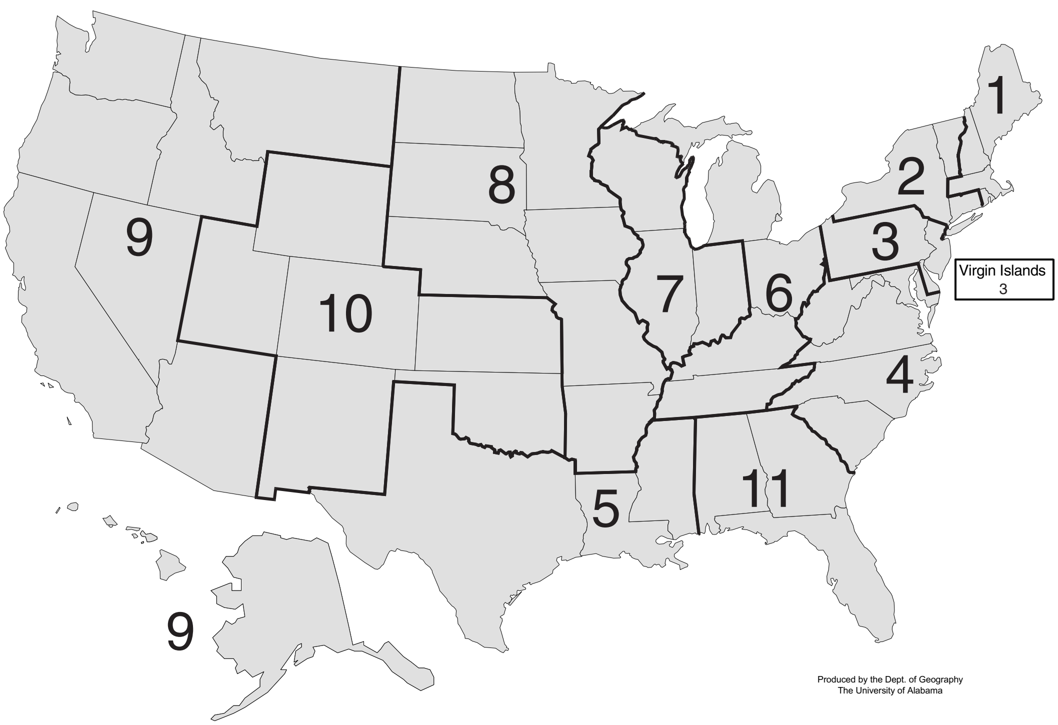
A Tax Court opinion or memorandum opinion may be appealed in a U.S. Court of Appeals. However, a taxpayer who commences their case in the U.S. Court of Federal Claims must appeal their case to the U.S. Court of Appeals for the Federal Circuit.

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

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

The 13 judicial circuits of the United States are constituted as follows.

Circuits	Hears Appeals from Federal District Courts and U.S. Tax Court Cases Originating in:
D. C.	U.S. Tax Court cases originating in D.C., Federal Administrative agencies, and Federal District Court cases for the District of Columbia
1st	Maine, Massachusetts, New Hampshire, Puerto Rico, Rhode Island
2d	Connecticut, New York, Vermont
3d	Delaware, New Jersey, Pennsylvania, Virgin Islands
4th	Maryland, North Carolina, South Carolina, Virginia, West Virginia
5th	District of the Canal Zone, Louisiana, Mississippi, Texas
6th	Kentucky, Michigan, Ohio, Tennessee
7th	Illinois, Indiana, Wisconsin
8th	Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, South Dakota
9th	Alaska, Arizona, California, Northern Hawaiian Islands, Idaho, Montana, Nevada, Oregon, Washington, Guam
10th	Colorado, Kansas, New Mexico, Oklahoma, Utah, Wyoming
11th	Alabama, Florida, Georgia
Fed.	Any federal case involving subject matter within its jurisdiction; U.S. Court of Federal Claims; U.S. Court of International Trade



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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).

AFFORDABLE CARE ACT

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Hardship Exemption

IRS Notice 2019-05, 2019-02 IRB 283 (Sep. 12, 2018)
IRC §5000A

☞ Certificate Not Required to Claim Hardship Exemption for 2018

Purpose. The notice lists additional hardship exemptions that a taxpayer may claim on their 2018 federal income tax return to avoid the individual shared responsibility payment under IRC §5000A without an exemption certificate.

Analysis. Taxpayers are required to maintain minimum essential coverage (MEC) for themselves and any dependents. A taxpayer without MEC must either have a hardship exemption or pay a shared responsibility payment. For tax years beginning after December 31, 2018, the shared responsibility payment is zero. A hardship exemption certificate verifies that a taxpayer suffered an event affecting their ability to maintain MEC for the month. A taxpayer can claim the exemption without a certificate if:

- The taxpayer and their dependent, if applicable, are eligible for a hardship exemption as determined by the Department of Health and Human Services (HHS); and
- The exemption is identified in IRS Notice 2014-76 as not requiring a certificate.

For the 2018 tax year, HHS expands hardship exemptions without a certificate to an eligible individual. An eligible individual is one who meets the following requirements for at least the month before, the month(s) during, and the month after the event that caused the hardship.

- A significant, unexpected increase in essential expenses prevented the taxpayer from obtaining MEC.
- Purchasing MEC would cause the taxpayer to be unable to afford basic necessities.
- Other circumstances prevented the taxpayer from obtaining coverage.

The notice applies to tax years beginning after December 31, 2017, and before January 1, 2019.

Premium Tax Credt

Charles and Rebecca Monroe v. Comm'r, **TC Memo 2019-41 (Apr. 24, 2019)**
IRC §§36B and 86(e)

☞ Taxpayers Ineligible for Premium Tax Credit Because of Lump-Sum Social Security Payments

Facts. Charles and Rebecca Monroe are a married couple who resided in California in 2015. Their family size is two people for federal income tax purposes.

In 2015, Mr. Monroe received $35,652 of social security benefits, which consisted of the following.

Social security benefits for 2015	$ 5,297
Lump-sum payment for 2014	348
Lump-sum payment for 2013	10,247
Lump-sum payment for 2012	10,943
Lump-sum payment for 2011	2,607
Attorney's fees	6,000
Medicare Part B premiums deducted from benefits	210
Total	$35,652

Mr. and Mrs. Monroe were enrolled in a health insurance plan through the California Marketplace from January 1 through August 31, 2015. For those months, they received monthly advance payments of the premium tax credit (APTC) of $1,059, for total APTC payments of $8,472.

Mr. and Mrs. Monroe timely filed a joint tax return for 2015 on which they made an IRC §86(e) election. A §86(e) election allows taxpayers to calculate the taxable portion of a lump-sum payment for an earlier year separately, using their income for the earlier year.[6] After making the election, the couple had 2015 adjusted gross income of $38,497, consisting of the following.

Wages	$34,176
Unemployment compensation	237
Taxable social security benefits	4,084
Total	$38,497

They did not report any excess APTCs, nor did they file a Form 8962, *Premium Tax Credit (PTC).*

The IRS audited the Monroes' 2015 return and determined that they were ineligible for the premium tax credit (PTC) because their household income for a family size of two exceeded 400% of the federal poverty line. The IRS issued a notice of deficiency, and the Monroes filed a petition with the court.

Issue. The issue in this case is whether the taxpayers are eligible for the PTC for 2015.

Analysis. The PTC is generally available to taxpayers whose household income is at least 100% but not in excess of 400% of the federal poverty line.[7] Household income is the sum of the taxpayers' modified adjusted gross income (MAGI) plus the MAGI of applicable family members.

The Monroes contended that MAGI does not include social security benefits received during the tax year that are attributable to prior years because of a §86(e) election. If the Monroes' contention is correct, then their MAGI is less than 400% of the federal poverty line. The IRS contended that MAGI includes all social security benefits received during the tax year, regardless of whether the taxpayers make a §86(e) election. If the IRS's contention is correct, then the Monroes' MAGI exceeds 400% of the federal poverty line.

In *Johnson v. Comm'r,*[8] the court determined that MAGI for purposes of the PTC under IRC §36B includes all social security benefits the taxpayer received during the tax year, regardless of whether a §86(e) election was made. Accordingly, the Monroes' MAGI exceeded 400% of the federal poverty line for 2015.

Holding. The court held that the Monroes are ineligible for the PTC for 2015 because their MAGI exceeded 400% of the federal poverty line.

> **Note.** For a detailed explanation of the PTC, see the 2019 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Individual Taxpayer Issues.

6. IRS Pub. 915, *Social Security and Equivalent Railroad Retirement Benefits.*

7. IRC §36B(c)(1); Treas. Reg. §1.36B-2(b)(1).

8. *Johnson v. Comm'r,* 152 TC No. 6 (2019).

BUSINESS EXPENSES

Medical Marijuana

***Alternative Health Care Advocates et al. v. Comm'r,* 151 TC No. 13 (Dec. 20, 2018)**
IRC §§162, 263A, 280E, and 6662(a)

☞ Medical Marijuana Dispensary Denied Expenses Incurred in Drug Trafficking Activities

Facts. In 2004, Donald Duncan opened Alternative Health Care Advocates (Alternative), a medical marijuana dispensary in southern California. Alternative is a California nonprofit mutual benefit corporation with members rather than shareholders. It is treated as a C corporation for federal tax purposes.

In 2008, Mr. Duncan organized Wellness Management Group, Inc. (Wellness), an S corporation that handled Alternative's daily operations. This included hiring employees and paying expenses such as advertising, wages, and rent. Alternative reimbursed Wellness for all expenses. Wellness provided its services solely to Alternative during the years at issue. The four shareholders who owned Wellness were Mr. Duncan, Jeremy Kwit, Grant Rozmarin, and Cori Escalante.

As a collective and cooperative association, Alternative only purchased from or sold medical marijuana to its members. Some of the marijuana was purchased ready for resale, while some product required additional processing. Wellness employed processors who prepared the marijuana products for retail. The majority of Alternative's floor space and employee time was devoted to acquiring, processing, or selling marijuana although it also sold items other than marijuana.

Alternative provided its accountant with financial statements to prepare the 2009 and 2010 Forms 1120, *U.S. Corporation Income Tax Return.* No additional documents were provided to complete the returns.

Mr. Duncan reported income from Wellness on his 2009 and 2010 Schedules E, *Supplemental Income and Loss.* Mr. Kwit reported Schedule E income from Wellness for 2012, but not 2011. Mr. Rozmarin did not file a Form 1040, *U.S. Individual Income Tax Return,* for 2011 or 2012.

Issues. The issues in this case are as follows.

- Whether Alternative is permitted a deduction of its expenses under IRC §280E
- Whether Mr. Duncan, Mr. Kwit, and Mr. Rozmarin underreported income because Wellness is not permitted a deduction of its expenses under §280E
- Whether Alternative is entitled to a larger cost of goods sold (COGS) deduction
- Whether Alternative is liable for an accuracy-related penalty under IRC §6662(a)

Analysis. IRC §162 generally allows a taxpayer to deduct ordinary and necessary expenses that are paid or incurred during the tax year in carrying on a trade or business. However, §280E states that a deduction or credit is not permitted if the trade or business consists of trafficking controlled substances. All parties agreed that marijuana, even medicinal marijuana, is a controlled substance. The focus is on what is considered "trafficking." Trafficking is not defined in §280E but the court has defined it as the act of engaging in a commercial activity (buying and selling regularly). Dispensing medical marijuana is considered trafficking within the meaning of §280E.[9]

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9. *Olive v. Comm'r,* 139 TC 19 (Aug. 2, 2012).

Alternative claims that because its activities do not consist solely of trafficking marijuana, it should be entitled to deductions for its expenses. These are the identical arguments made in a previous case[10] that the court rejected and that was upheld on appeal. The court therefore found that Alternative was involved in trafficking controlled substances within the meaning of §280E.

Alternative argues that it operates a separate business for nonmarijuana items and it is entitled to allocate its expenses between its trafficked business and its nontrafficked business. The court found that the percentages allocated to nonmarijuana products appeared improvised and that the nonmarijuana activities were only ancillary to the marijuana business. As such, Alternative is not entitled to a deduction for those expenses.

Mr. Duncan, Mr. Kwit, and Mr. Rozmarin argue that the IRS wrongfully denied Wellness' expenses that flowed through to their Forms 1040. They contend that the expenses should be allowed because Wellness did not engage in the activities banned under §280E. The court did not find the activities of Wellness to be substantially separate from those of Alternative. Therefore, Wellness was also engaged in trafficking and the expenses are disallowed. The shareholders must report additional income from the deductions disallowed under §280E.

Alternative argued that it was entitled to a COGS deduction for both direct and indirect costs of its inventory. However, Alternative did not specify what additional expenses should be allowed beyond the COGS that the IRS already allowed. IRC §263A allows only expenses otherwise deductible in COGS. Because Alternative's other expenses are not deductible, they are not permitted in COGS.

Alternative further argued that, as a producer of marijuana, it is entitled to a COGS deduction for its production costs. The court disagreed that Alternative is a producer because there was no evidence it grew, created, or improved marijuana as required by §263A.

Alternative also lacked any evidence that it owned the marijuana products until it paid its members for their products. As such, the court believes Alternative is a reseller of its member's marijuana products rather than a producer, and its COGS is limited to the amounts already permitted.

A penalty under §6662(a) may be imposed on an underpayment of tax that is attributable to negligence or disregard of rules and/or a substantial understatement of income tax. The penalty may be reduced if the taxpayer had substantial authority or a reasonable basis for its position. Alternative did not argue that it had substantial authority or a reasonable basis for its position. Accordingly, the court held that Alternative had a substantial understatement of tax and was liable for the §6662(a) penalty.

Holding. The court held that neither Alternative nor Wellness was entitled to deduct business expenses under §280E. Accordingly, the shareholders of Wellness underreported their flow-through income. In addition, Alternative was not entitled to a larger COGS deduction and was liable for the accuracy-related penalty under §6662(a).

Note. For more information about the tax issues connected with the production and sale of marijuana, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues.

10. Ibid.

Loss on Investment

Kim Ence v. Comm'r, **TC Memo 2018-151 (Sep. 11, 2018)**

IRC §165

☞ Loss on Investment was Not Actually Sustained During Tax Year

Facts. Kim Ence owns 98% of Tri Vector, LLC, which is taxed as a partnership. Through Tri Vector, Mr. Ence also owned an interest in Executive Fitness, which was a Utah limited liability company taxed as a partnership. By the end of 2010, Tri Vector had invested $85,000 in Executive Fitness.

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During the latter part of 2011, Mr. Ence realized that Tri Vector had not received a 2010 Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* from Executive Fitness. Executive Fitness's majority owner informed Mr. Ence that Executive Fitness would not be providing a 2010 Schedule K-1 to Tri Vector.

Mr. Ence contacted his attorney about recovering the money that Tri Vector had invested in Executive Fitness. He spent $15,000 to $20,000 in legal fees pursuing the issue. In July 2014, he decided not to pursue any additional legal action and to give up on the investment.

Mr. Ence told his accountant that he had invested $85,000 in Executive Fitness in 2010 and that the investment was worthless by the end of that year. His accountant prepared Mr. Ence's 2010 Form 1040, *U.S. Individual Income Tax Return,* on the basis of this information. In October 2011, Mr. Ence filed his 2010 Form 1040 and reported a short-term capital loss of $85,000 on his Schedule D, *Capital Gains and Losses.*

Issue. The issue in this case is whether Mr. Ence sustained an $85,000 loss during the 2010 tax year.

Analysis. IRC §165(a) allows a deduction for a loss sustained during the tax year that is not compensated for by insurance or otherwise. To be allowable as a deduction, a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and **actually sustained during the tax year.**[11]

Mr. Ence stated that he did not even question the status of Tri Vector's investment in Executive Fitness until 2011, when he realized he was missing the Schedule K-1. Moreover, he paid legal fees through 2014 in pursuit of the investment. This suggests that he did not think the investment was worthless at the end of 2010.

Holding. The court concluded that Mr. Ence did not actually sustain the loss from Tri Vector's investment in Executive Fitness in 2010.

[11]. Treas. Reg. §1.165-1(b).

CLERGY

Clergy Housing Allowance Exclusion

***Annie Gaylor et al. v. Steven Mnuchin et al.*, U.S. Court of Appeals for the 7th Circuit; Nos. 18-1277 and 18-1280 (Mar. 15, 2019)**
IRC §§107 and 119

☞ Housing Allowance Exclusion for Ministers Does Not Violate the Establishment Clause

Facts. IRC §107 permits ministers to exclude the rental value of a home that is part of their compensation or a rental allowance used to rent or provide a home. Freedom From Religion Foundation (FFRF) is a nonprofit organization that "takes legal action challenging entanglement of religion and government, government endorsement or promotion of religion."[12] FFRF paid its co-presidents (Annie Gaylor and Dan Barker) and its former president (Nicol Gaylor) a housing allowance as part of their salary. None of the individuals met the definition of a "minister." FFRF sued[13] the IRS claiming the housing allowance for ministers is a tax benefit based on religion and violates the First Amendment. The suit was dismissed because FFRF lacked any standing: FFRF and its employees were never denied the housing allowance under §107 because they never applied for it.

Following the dismissal, Annie Gaylor, Barker, and Nicol Gaylor filed amended returns claiming refunds for the housing allowances. The IRS denied the claims because the taxpayers were not ministers. In a new lawsuit, the court determined that FFRF now had standing to challenge §107(2).[14] The court held that §107(2) violated the Establishment Clause of the First Amendment because the statute "provide[s] aid to a group of religious persons." The Treasury Department appealed that decision.

Issue. The issue in this case is whether §107(2) violates the Establishment Clause by providing a tax benefit based on religious status.

Analysis. The court looked to the 3-prong test established in *Lemon v. Kurtzman*[15] and the historical significance test of *Town of Greece v. Galloway.*[16] The 3-prong test establishes that the statute must have a secular legislative purpose, its principal or primary effect must be one that neither advances nor inhibits religion, and must not foster an excessive government entanglement with religion. If a statute fails any of the three prongs, it violates the Establishment Clause.

A statute violates the secular legislative purpose test "when there is no question that the statute was motivated wholly by religious considerations."[17] The Treasury Department argued that §107 was passed to entitle ministers to the same deduction other employees were allowed under the convenience-of-the-employer doctrine. Prior to the passage of §107, the convenience-of-the-employer doctrine was not available to ministers. FFRF argued that the rights under §107 for ministers are better than the rights for secular employees. As such, this promotes religious ideas and is not secular. The court analyzed the convenience-of-the-employer doctrine to determine if §107 fails the secular legislative purpose test. The Code provides for employer-provided housing exemptions for a variety of employees, not just for ministers. Accordingly, the court believes that §107(2) is one of many rules in the Code that allow employees a tax exemption for employer-provided housing and is not motivated wholly by religious considerations.

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12. *About the Foundation FAQ.* Freedom From Religion Foundation. [ffrf.org/faq/item/15001-what-does-the-foundation-do] Accessed on Jun. 11, 2019.
13. *Freedom From Religion Foundation, Inc. v. Lew,* 773 F.3d 815 (7th Cir. 2014).
14. *Gaylor v. Mnuchin,* 278 F. Supp. 3d 1081 (W.D. Wis. 2017).
15. *Lemon v. Kurtzman,* 403 U.S. 602 (1971).
16. *Town of Greece v. Galloway,* 572 U.S. 565, 576 (2014).
17. *Lynch v. Donnelly,* 465 U.S. 668, 680 (1984).

The Treasury Department further argues that the intention of §107(2) was to provide a similar tax deduction for ministers of smaller or poorer denominations who could not afford in-kind housing. FFRF argues that the true intention of §107(2) was to subsidize religion, based on the comments of the representative sponsoring §107(2) in the 1950s: "Certainly, in these times when we are being threatened by a godless and anti-religious world movement we should correct this discrimination against certain ministers who are carrying on such a courageous fight against this foe."[18] At the same hearing, the representative said the purpose was because the current laws discriminated against clergy. The court believes that there is no singular motive behind §107(2). Legislative history is unreliable.

The second prong of the *Lemon* test is that a statute **neither advances nor inhibits** religion. FFRF argues that there is no difference between a tax exemption for religion and a government subsidy for religion. However, the Supreme Court previously ruled[19] that there is a difference between the two and that a tax exemption does not imply that the government is actively involved in religious activity.

The third prong of the *Lemon* test is the government's **avoidance of excessive entanglement** with religion. The court focused on the term "excessive." In its opinion, requiring churches to satisfy the requirements of the convenience-of-the-employer doctrine causes more entanglement with the government than §107(2).

Lastly, the court looked to the **historical significance test.** FFRF does not provide any evidence that §107(2) was historically interpreted as an establishment of religion. Conversely, there is substantial evidence of tax exemptions for religion in various forms for over two centuries, dating back to 1802 and evolving continuously into the present. Accordingly, the court concludes that §107(2) passes the historical significance test.

Holding. The court held that §107(2) does not violate the Establishment Clause and reversed the judgment of the district court.

Clergy Income

***Wayne and Deondra Felton v. Comm'r,* TC Memo 2018-168 (Oct. 10, 2018)**

IRC §§61, 102, 6651, 6662, and 6664

☞ Congregation's Donations were Income Rather than Gifts

Facts. Reverend Wayne Felton and his wife Deondra Felton established Holy Christian Church in West St. Paul, Minnesota, in 2000. The church's congregation consisted of approximately 600 families, and Sunday services averaged approximately 500 people.

The church used three different envelopes to collect contributions in the years at issue: white, gold, and blue. Church congregants used white offering envelopes for the normal contributions that sustained the church. These white envelopes also included a line marked "pastoral." The church tracked donations in these envelopes and included them in the members' annual contribution statements. Reverend Felton received a breakdown of pastoral donations that showed how much income he had to report. Contributions that congregants made in gold envelopes were used for special programs and retreats. These contributions were also included in the members' annual contribution statements.

18. *Hearings Before the Committee on Ways and Means: Statement of Hon. Peter F. Mack, Jr., on H.R. 4275, Concerning the Taxability of a Cash Allowance Paid to Clergymen in Lieu of Furnishing Them a Dwelling,* 83d. Cong. 1, at 1576 (June 9, 1953).

19. *Walz v. Tax Commission of the City of New York,* 397 U.S. 664 (1970).

Blue envelopes were introduced later than white and gold envelopes. White envelopes already included a line for pastoral donations, but some congregants told Reverend Felton they did **not** want a tax deduction for amounts they gave him. Instead, they wanted to give him a gift. Blue envelopes were used for this purpose. Another difference between white and blue envelopes was that blue envelopes were handed over to Reverend Felton unopened. In 2008 and 2009, Reverend Felton received approximately $258,001 and $234,826, respectively, in blue envelopes.

Reverend Felton preached at the church for almost 13 years without taking a salary. The executive board authorized a salary for him in 2008 and 2009, but he did not take it. Reverend Felton did receive pastoral donations that congregants made in white envelopes, which totaled over $40,000 for 2008. The church also gave Reverend Felton a parsonage allowance of $6,500 per month. In addition to these amounts, Reverend Felton earned money from private counseling and speaking engagements.

Reverend Felton prepared his own returns but he filed the 2008 and 2009 returns more than a year after they were due. The Feltons did not report any income from the contributions they got in blue envelopes. However, they did report approximately $40,000 in wages for each of the years at issue, which were the amounts given in white envelopes that congregants designated as "pastoral" donations. The Feltons excluded the parsonage allowance from gross income under IRC §107(2), deducted over $50,000 in mortgage interest expense, and claimed approximately $50,000 in charitable deductions for each of the years at issue. As a result of the exclusions, exemptions, and deductions, the Feltons reported no taxable income on either the 2008 or the 2009 return.

The IRS audited the Feltons' 2008 and 2009 returns and issued a notice of deficiency.

Issues. The issues are as follows.

- Whether the donations Reverend Felton received in blue envelopes are income or gifts
- Whether the Feltons are liable for additions to tax under IRC §6651(a)(1) and accuracy-related penalties under IRC §6662(a)

Analysis. IRC §61(a)(1) states that gross income includes "compensation for services, including fees, commissions, fringe benefits, and similar items." IRC §102(a) excludes from gross income "the value of property acquired by gift" but this exclusion does not apply to "any amount transferred by or for an employer to, or for the benefit of, an employee."[20] The Feltons contended that the donations given in blue envelopes were gifts from congregants and are therefore excludable from gross income. The IRS disagreed and contended that they are income under §61(a).

In *Comm'r v. Duberstein,* the Supreme Court stated that a gift "proceeds from a 'detached and disinterested generosity'… 'out of affection, respect, admiration, charity or like impulses.'"[21] Case law on clergy donations shows that the following factors are important to distinguish between taxable payments and gifts.

1. Whether the donations are objectively provided in exchange for services
2. Whether the clergy member (or other church authority) requested the personal donations
3. Whether the donations were part of a routinized, highly structured program and given by individual church members or the congregation as a whole
4. Whether the clergy member receives a separate salary from the church and the amount of that salary in comparison to the personal donations

20. IRC §102(c)(1).

21. *Comm'r v. Duberstein,* 363 U.S. 278, 285 (1960) (first quoting *Comm'r v. LoBue,* 351 U.S. 243, 246 (1956) and then quoting *Robertson v. U.S.,* 343 U.S. 711, 714 (1952)).

Regarding the first factor, the court noted that Congress required a "contemporaneous written acknowledgment" for all but small gifts to a charity.[22] In addition, the Supreme Court in *Duberstein* stated that the focus should be on objective evidence of a donor's intent. The court in this case concluded that the contributions in blue envelopes were not gifts but were instead meant to keep Reverend Felton preaching where he is. This factor suggests the contributions were income.

Discussing the second factor, the court observed that the church did not solicit blue-envelope donations. This is an objective sign that the donations proceeded "from a 'detached and disinterested generosity'… 'out of affection, respect, admiration, charity or like impulses.'" This factor, therefore, suggests the contributions were gifts.

In analyzing the third factor, the court considered the large size of the blue-envelope donations and the fact that the amounts given in 2008 and 2009 were very similar. This "indicates that they were the result of a highly organized program to transfer cash from church members"[23] to Reverend Felton. The donations were regular, sizable payments made by congregants, and the court concluded they are hard to distinguish from compensation.

In discussing the fourth factor, the court noted that Reverend Felton testified that he preached at the church for 13 years without receiving a salary. He received personal donations in white envelopes and reported those as wages and he received a generous parsonage allowance. However, the amounts received in blue envelopes were approximately twice the total amount of his deemed salary and parsonage allowance for both of the years at issue. This indicates the money is income.

IRC §6662(a) imposes a 20% penalty for a substantial understatement of income tax. The taxpayer can avoid this penalty by showing they acted with reasonable cause and in good faith.[24] The Feltons contended they had reasonable cause because their facts are unique. However, they cited no precedent that was favorable to them, and they prepared and filed their tax returns only after the IRS contacted them. The court found no evidence concerning the Feltons' efforts to compute their proper tax liability when they filed their returns, which Treas. Reg. §1.6664-4(b)(1) states is generally the most important factor for reasonable cause. In addition, the Feltons are liable for the late-filing penalty under §6651(a)(1).

Holding. The court held that the donations the Feltons received in blue envelopes were income and that they are liable for additions to tax under §6651(a)(1) and accuracy-related penalties under §6662(a).

CORPORATION

Suspended Corporation

***Timbron International Corporation v. Comm'r,* TC Memo 2019-31 (Apr. 8, 2019)**
IRC §6213

☞ Court Lacks Jurisdiction to Hear Case from Suspended Corporation

Facts. Timbron Holdings Corp. is the parent company of Timbron International Corp. In 2009, the California Franchise Tax Board suspended Timbron International for failure to pay state taxes. In 2013, Timbron Holdings was also suspended. The companies' powers, rights, and privileges were suspended and remained suspended during the trial.

22. IRC §170(f)(8).

23. *Banks v. Comm'r,* TC Memo 1991-641 (Dec. 26, 1991).

24. IRC §6664(c)(1).

The IRS issued notices of deficiencies on July 14, 2016, for the 2010 and 2011 tax years. On October 11, 2016, Timbron filed petitions with the court. The IRS moved to dismiss the case due to lack of jurisdiction because the companies were suspended and continued to be suspended during the 90-day period in which the companies could timely file petitions.

Issue. The issue in this case is whether the Tax Court has jurisdiction to rule on whether Timbron had the legal capacity to petition the court because they were suspended by California.

Analysis. Under IRC §6213, a taxpayer has 90 days after a notice of deficiency is mailed in which to request a redetermination of the tax owed. However, in order to properly file a petition, the taxpayer must have the "capacity to engage in litigation." The IRS contended that because Timbron's corporate powers, rights, and privileges were suspended, they did not have the capacity to file a petition.

The corporation was reinstated in California in September 2017. Timbron argued that under California law the corporations still had "sufficient vitality" to file the petition. The court determined that once the 90-day period to petition the court passed, it was irrelevant when the companies restored their corporate powers. The cases Timbron cited to support its position did not involve issues with a statute of limitations.

Holding. The court held that Timbron lacked the capacity to petition the court and dismissed the case for lack of jurisdiction.

CREDITS

Research Expenses

***Siemer Milling Company v. Comm'r,* TC Memo 2019-37 (Apr. 15, 2019)**
IRC §§41 and 174

☞ Research Credit Denied for Failing the Process of Experimentation Test

Facts. Siemer Milling Co. is based in Illinois and has been involved in milling and selling wheat flour since the 1950s. During the tax year ended May 31, 2011, Siemer had four projects for which it claimed a credit of $122,424 for research expenses. For the tax year ended May 31, 2012, Siemer had five projects for which it claimed a credit of $116,246 for research expenses. All of the projects were related to Siemer's trade or business.

CliftonLarsonAllen, LLP (CLA) prepared tax returns for Siemer for over two decades. An accountant for CLA with several years of experience preparing credit studies calculated the credits based on interviews with several Siemer employees. The vice president of production for Siemer provided estimates and contemporaneous documents to support the credit calculation. CLA calculated Siemer's fixed-base percentage and prepared several amended returns as the result of determining a lower percentage. Siemer timely filed its returns, which included Forms 6765, *Credit for Increasing Research Activities.*

The IRS disallowed the credits, asserting that Siemer did not provide credible evidence to support claiming the expenses as qualified research expenses. The IRS also assessed an accuracy-related penalty.

Issues. The issues in this case are the following.

- Whether Siemer established that the expenses incurred for increasing research activities are qualified research expenses
- Whether Siemer is liable for IRC §6662 accuracy-related penalties

Analysis. A research credit of 20% of the excess of qualified research expenses over a base amount is available for taxpayers who incurred research expenses in carrying on a trade or business. **All** of the following tests must be met for an activity or project to be considered qualified research.

1. **IRC §174 test.** Research expenses must be eligible to be expensed under §174, which provides methods of accounting for research or experimental costs that would otherwise be capitalized. The regulations define research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.[25]

2. **Technological information test.** Qualified research must be undertaken to discover technological information relying on "principles of the physical or biological sciences, engineering, or computer science."[26]

3. **Business component test.** Research must be conducted to discover data "intended to be useful in the development of a new or improved business" of the taxpayer.[27]

4. **Process of experimentation test.** Eighty percent or more of the research activities must constitute elements of a process of experimentation. The project must follow the scientific method of testing a hypothesis, analyzing the data, refining the hypothesis, and retesting.

Research expenses must exceed a base amount. The base amount is calculated based on the fixed-base percentage and average annual gross receipts for the preceding four tax years.

The IRS argued that Siemer failed the §174 test because many of the projects bridged multiple years and the company could not face the same uncertainty for multiple years. The court disagreed because there is no requirement that a taxpayer face a unique uncertainty each year.

The IRS argued that Siemer did not employ anyone qualified to perform the technical research and failed the technological information test. The court asserted that there is no requirement that a taxpayer employs someone with a specific title to perform the research in order to qualify for the credit.

The IRS contended that Siemer failed the business component test because it was inconsistent in labeling the business components related to processes or products. The court disagreed that using particular verbiage prohibited Siemer from passing the business component test.

The IRS argued that Siemer did not engage in a process of experimentation on any of its projects. There is no evidence to support that Siemer created a hypothesis, tested the hypothesis, engaged in any system of trial and error, or evaluated alternatives. Siemer did not establish that all of the activities related to the research credits involved a process of experimentation. Accordingly, the court determined that all of Siemer's projects failed to meet all four required tests to claim the credits. Because the projects failed to meet the required tests, the court did not evaluate the fixed-base percentage issue.

The court believed that Siemer reasonably relied on CLA to prepare the tax returns. Accountants at CLA were competent and Siemer provided all necessary information to CLA. The court found that Siemer was not liable for the 20% accuracy-related penalty.

Holding. The court held that Siemer failed the process of experimentation test on all of its projects and, therefore, the expenses failed to qualify for the research credit. However, Siemer reasonably relied on the expertise of its tax preparer and was not liable for the §6662 accuracy-related penalty.

25. Treas. Reg. §1.174-2(a)(1).

26. Treas. Reg. §1.41-4(a)(4).

27. IRC §41(d)(1)(B)(ii).

DEDUCTIONS

Noncustodial Parent Dependency Rules

***Jason Aaron Cook v. Comm'r,* TC Memo 2019-48 (May 7, 2019)**
IRC §152

☞ Signed Form 8332 or Substitute Required for Noncustodial Parent to Claim Dependent

Facts. Jason Cook and Tara Taylor share a minor daughter. In October 2011, Ms. Taylor secured a court order compelling Mr. Cook to pay her $788 per month in child support and to pay for their daughter's medical and dental expenses when they exceeded $250 per year. Mr. Cook complied with the order. The court order did not specify which parent could claim their daughter as a dependent. However, Mr. Cook and Ms. Taylor had an oral agreement that Mr. Cook could claim her as a dependent on his income tax return.

On his 2012 return, Mr. Cook claimed their daughter as his dependent, which made him eligible for several tax benefits such as the child tax credit and an earned income credit (EIC). He filed as head of household for 2012. Mr. Cook did not attach a signed Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent,* or an equivalent form to his Form 1040, *U.S. Individual Income Tax Return.*

Issue. The issue in this case is whether Mr. Cook is eligible to claim his daughter as a dependent.

Analysis. A qualifying child must have a specified relationship to the taxpayer, live with the taxpayer for more than half of the tax year, not have attained age 19 during or before the tax year, not provide more than half of their own support during the year, and not file a joint return for the year. The IRS concedes that Mr. Cook's daughter meets all the requirements of a qualifying child except sharing the same principal place of abode for more than half of the year. The daughter lived all of 2012 with her mother.

Mr. Cook did not attach either a signed Form 8332 or any other written declaration from Ms. Taylor to his tax return supporting that she was releasing her claim to their daughter as a dependent for 2012. He believed that, because Ms. Taylor did not have income during the year and did not file a Form 1040, she did not need to provide him with a signed Form 8332 or substitute form.

To qualify as a head of household, the taxpayer must be unmarried at the end of the year and maintain the principal place of abode for a qualifying child or dependent for more than half of the year. Mr. Cook's daughter was not considered a qualifying child and also did not meet the definition of a qualified relative. A qualifying relative must be related to the taxpayer, have income below the exemption amount, receive more than half of their support from the taxpayer, and not be a qualifying child of another taxpayer. Because his daughter was a qualifying child of Ms. Taylor, she could not be a qualifying relative for Mr. Cook. Therefore, Mr. Cook was ineligible to claim head of household status in 2012.

Moreover, because Mr. Cook's daughter is not considered his qualifying child, he is barred from claiming either the child tax credit or the EIC.

Holding. The court held that Mr. Cook's daughter did not qualify as either a qualifying child or qualifying relative. Accordingly, Mr. Cook could not file as head of household and was not eligible for the child tax credit or the EIC.

Charitable Contributions or Personal Expenses

***Robert Oliveri v Comm'r,* TC Memo 2019-57 (May 28, 2019)**

IRC §170(f)(8)(A)

☞ Evangelist's Deductions Disallowed as Personal Expenses, Not Charitable Contributions

Facts. Since 1987, Robert A. Oliveri, a self-described devout Catholic, traveled across the country conducting evangelical activities. Mr. Oliveri cofounded the Brothers and Sisters of the Divine Mercy (BSDM) to "provide religious and spiritual counseling to people of need." The Catholic Church was not affiliated with the corporation. Mr. Oliveri considered every interaction with an individual as a potential opportunity to spread his faith. He evangelized the general public with whom he interacted during his normal personal activities, such as eating in restaurants, traveling, and piloting private planes. Generally, his evangelism was impromptu and Mr. Oliveri did not have a plan regarding when and to whom he would evangelize. He discussed his faith with his friends, extended family, and members of BSDM.

During 2012, Mr. Oliveri spent almost $40,000 on his evangelism activities. He did not maintain contemporaneous written acknowledgement for any of his expenses. The money was spent on meals and gifts to strangers and acquaintances to further his religious outreach. During 2012, Mr. Oliveri deducted the cost of every meal he ate at a restaurant. On some receipts, Mr. Oliveri included the name of the person to whom he was evangelizing. On five occasions, the only name included was that of the server. Mr. Oliveri would leave large tips so that the servers would "think… that God cares for them and they're very special."

Mr. Oliveri claimed transportation and airplane expenses that covered the costs of renting private planes and airplane equipment costs. Mr. Oliveri evangelized airport staff and pilot training instructors that he came into contact with while on training flights. Among the airplane expenses, Mr. Oliveri deducted the associated costs for flying the rector of the Basilica of the National Shrine of the Immaculate Conception in Washington, D.C. to New Jersey for the funeral of the rector's cousin and the cost to fly a member of his theology class to Ocean City for lunch. Mr. Oliveri also deducted transportation costs that included mileage to and from airports, tolls, and parking.

During 2012, Mr. Oliveri deducted the cost for six trips throughout the United States. The costs covered commercial airline tickets, private airplane rentals, car rentals, and meals. During these trips, Mr. Oliveri took flying lessons, attended a family reunion, took his sister-in-law to a birthday lunch, and other unspecified activities. He did not provide any additional details other than the trips were related to his general evangelism.

Mr. Oliveri deducted payments for clothes, groceries, lodging, travel, and other miscellaneous gifts to people to whom he evangelized as "charitable grants." The administrative expenses that Mr. Oliveri claimed included the costs for an umbrella insurance policy that covered him and his ex-wife, legal fees from an audit of his personal tax return, shipping items to his sister-in-law and his doctor, and expenses for his home phone line, cell phone, fax machine, Internet, and cable.

Mr. Oliveri filed an extension on his federal income tax return. On August 16, 2014, he filed his 2012 Form 1040, *U.S. Individual Income Tax Return,* on which he claimed expenses totaling $39,979 as charitable contributions. Upon audit, the IRS disallowed the deduction.

Issues. The issues in this case are the following.

- Whether Mr. Oliveri's expenses incurred in the furtherance of his ministry are personal, nondeductible expenses or are charitable contributions
- Whether Mr. Oliveri is liable for a penalty for failure to timely file a tax return
- Whether Mr. Oliveri is liable for an IRC §6662(a) accuracy-related penalty

Analysis. An unreimbursed expense must be directly connected with and solely attributable to a service provided to a qualified organization in order to be deductible. Mr. Oliveri contended that his expenses were not personal and the expenses were related to his services to BSDM or the Catholic Church. The IRS conceded that BSDM is a tax-exempt organization and that Mr. Oliveri provided records to substantiate his expenses. However, the IRS argued that the expenses were at least in part personal and that they were not contributions "to or for the use of" BSDM or the Catholic Church. Neither BSDM nor the Catholic Church coordinated or supervised Mr. Oliveri's evangelism activities. Expenses with the primary purpose of personal benefit are not deductible.

An expense that is sustained while providing services to a qualified charitable organization has dual character. It is the taxpayer's responsibility to prove that the primary purpose was not personal. Travel expenses are not charitable deductions if the taxpayer receives substantial personal pleasure. Even if the taxpayer performs charitable services while on a trip made for primarily personal reasons, the travel expenses are not deductible. Similarly, meals are not deductible when there is substantial personal benefit. The court determined that most of Mr. Oliveri's expenses were incurred in whole or in part for personal benefit. Therefore, his travel and meal expenses do not qualify as a charitable deduction.

Deductible contributions must be subject to the coordination, supervision, or oversight by the charitable organization. Mr. Oliveri's evangelism activities were mostly random and unplanned. They were not directed by either BSDM or the Catholic Church.

Contributions of $250 or more require contemporaneous written acknowledgement from the donee organization. Mr. Oliveri argued that his organization was self-created and therefore exempt from the documentation rules of IRC §170(f)(8)(A). He did not supply any authority for this position and the court rejected it. The court disallowed all expenses over $250 because they lacked contemporaneous written acknowledgement from either BSDM or the Catholic Church.

Mr. Oliveri argued that disallowing his charitable contributions violates his First Amendment rights. His right to free exercise of religion is affected because he would have less money to evangelize. The court disagreed and stated that even a substantial burden to evangelize is justified by "maintaining a sound tax system." Mr. Oliveri further argued that the IRS audits of three of his tax returns within 10 years caused excessive government entanglement with his ability to freely exercise his religion. The court disagreed because Mr. Oliveri did not provide valid support for his argument.

Mr. Oliveri filed his 2012 tax return in August 2014. He contended there was reasonable cause for the delay because he diligently substantiated his expenses on his return as a result of being frequently audited by the IRS. The court determined that maintaining appropriate records is not reasonable cause for late filing and that Mr. Oliveri is liable for the late-filing penalties.

Accuracy-related penalties must have appropriate supervisory approval. The IRS did not provide support for this approval. Therefore, Mr. Oliveri is not liable for the accuracy-related penalty.

Holding. The Tax Court agreed with the IRS and held that Mr. Oliveri's expenses did not qualify as tax deductible charitable contributions. Most of the deductions were denied. The court determined that Mr. Oliveri was liable for a failure-to-file penalty but not a §6662(a) accuracy-related penalty.

Charitable Contribution of Conservation Easement

Belair Woods LLC et al. v. Comm'r, **TC Memo 2018-159 (Sep. 20, 2018)**
IRC §170

☞ Form 8283 Attachment Without Basis Information Does Not Satisfy Substantiation Requirement

Facts. In August 2007, HRH Investments, LLC (HRH) purchased a 1,490-acre tract of land in Effingham County, Georgia, for $3.9 million, or about $2,605 per acre. HRH transferred approximately 10% of the property to Belair Woods, LLC (Belair) on December 18, 2008. In December 2009, Belair entered into a deed of easement with a qualified charitable organization for 141.15 of the 145.15 acres that it owned.

Belair timely filed a short-year Form 1065, *U.S. Return of Partnership Income,* for 2009. It claimed a charitable deduction for the easement of $4.8 million, or $33,707 per acre. Belair attached a Form 8283, *Noncash Charitable Contributions,* that did not include basis information for the easement based on advice from Forever Forests, LLC (Forever Forests). Belair consulted with Forever Forests, which imparted advice that it received from a law firm in 2008 about preparing Form 8283. The law firm concluded that "it should not be necessary to include the basis information… if you attach an explanation to Form 8283 providing a reasonable cause for why it is not included." Following this advice, Belair wrote "see attached" in the relevant boxes on Form 8283 and attached a 2-page letter stating that the donated property was a conservation easement that covered 141.15 acres of woodland, had an appraised fair market value (FMV) of $4.8 million, and was acquired by purchase/exchange on August 1, 2007. The attachment did not include Belair's basis. In addition, Belair attached an appraisal of the donated property to its 2009 tax return, but this also did not contain cost basis information.

The IRS examined Belair's 2009 return. In December 2012, the IRS issued a summary report stating that the charitable deduction was disallowed because Belair did not provide required basis information. Belair replied to the IRS with the basis information about a month later.

Issue. The issue in this case is whether Belair complied with the substantiation requirements for a donation of a conservation easement.

Analysis. IRC §170 allows for a charitable deduction made during the year. For donated property other than money, the contribution amount is generally the FMV of the property at the time of the donation. Donated property valued in excess of $5,000 requires an appraisal. The appraisal or an appraisal summary must be attached to the return. Form 8283 qualifies as an appraisal summary. However, the regulations provide that a deduction will not be disallowed simply because a taxpayer is unable (with reasonable cause) to provide the required information.

The court concluded that the explanation Belair attached did not strictly comply with the requirements because it asserted that the information was **unnecessary** rather than **unavailable.** Belair argues that the term **basis** is ambiguous and could refer to the cost of the tract, the cost of the conserved portion of the tract, the adjusted basis of the conserved portion less reserved homesite parcels, or the basis of the easement itself. Due to the ambiguity, Belair believes it had a reasonable stance for not including basis information. The court observed that Belair did not provide any of those basis amounts or explain the ambiguity on the attachment and instead relied on the belief that the IRS did not need this information.

Belair provided cost basis information to the IRS during its audit. The regulations state that a deduction will not be disallowed for not attaching an appraisal summary if the taxpayer provides the required information to the IRS within 90 days of an IRS request. However, the court believed that Belair did not "fail to attach" an appraisal summary but rather intentionally included an incomplete Form 8283. Furthermore, the court observed that Belair did not provide the argument regarding the ambiguity of basis until the IRS informed Belair that the deduction would be disallowed. Then, Belair unilaterally supplied that information to avoid the denial of the deduction, not because the IRS requested it.

Substantial compliance can be proven if a taxpayer provided most of the required information or if any omitted information was inadvertent. The court believed that Belair did not disclose basis because it was claiming a deduction based on a value for the easement that increased by 1,380% during 2½ years ($2,605 per acre in August 2007 to $35,900 per acre in 2009).

Belair claimed that it disclosed information from which the cost basis could be derived on Schedule L, *Balance Sheets per Books,* Schedule M-1, *Reconciliation of Income (Loss) Per Books With Income (Loss) Per Return,* an IRC §743(b) election and calculation sheet, and the attached appraisal. The court responded that revenue agents should not have to sift through the entire return looking for clues about the cost basis.

Holding. The court held that Belair did not comply with the substantiation requirements. Belair did not do "all that is reasonably possible" to disclose the required information but rather made a conscious decision to not provide the cost basis. However, it found there were disputes of material fact as to whether Belair had reasonable cause for not properly providing a completed appraisal summary. Therefore, the court granted in part and denied in part the IRS's motion for partial summary judgment.

Casualty Losses

Marc L. Mancini v. Comm'r, **TC Memo 2019-16 (Mar. 4, 2019)**
IRC §§165 and 6662

☞ Taxpayer Cannot Deduct Gambling Losses Incurred While on Medication as a Casualty Loss

Facts. Marc Mancini was diagnosed with Parkinson's disease in 2004. In 2016, his doctor, Dr. Lew, prescribed Pramipexole for him. Dr. Lew gradually increased the dose and Mr. Mancini's symptoms greatly improved. In 2008, Mr. Mancini became compulsive about cleaning, began falling asleep while driving, had suicidal thoughts, and began gambling a lot.

Prior to his diagnosis, on the occasional times that Mr. Mancini gambled, it was never more than $100 at a time. After beginning Pramipexole, Mr. Mancini began buying lottery tickets, then escalated to casinos and ultimately online gambling. He did not maintain records of his gambling activity and minimized the amount he was gambling in discussions with Dr. Lew. Mr. Mancini gambled away all the money in his bank accounts and all but $10,000 of his retirement accounts.

In 2009, Mr. Mancini sold his property in Manhattan Beach for $995,000 that he believed had a fair market value (FMV) of $1.2 million. He also sold a property in Massachusetts for $90,000 that he believed had an FMV of $300,000. The proceeds paid off gambling debts.

In 2010, Mr. Mancini's wife and daughter told Dr. Lew about the excessive gambling. Dr. Lew took Mr. Mancini off of Pramipexole and the compulsive behaviors ceased.

Pramipexole helps Parkinson's patients control their movements by activating dopamine receptors in the brain. This has the effect of distorting the patient's risk/reward analysis. By the early 2000s, users of the drug began reporting the development of impulse control disorders (ICDs) such as overeating, compulsive shopping, gambling, and hypersexuality. Users of these drugs are two-and-a-half to three times more likely than a nonuser to develop an ICD. The ICDs usually disappear when the user stops taking the medicine. Hundreds of lawsuits against the makers of Pramipexole ensued.

With the help of a tax preparer, Mr. Mancini timely filed his 2008 and 2009 tax returns. The 2008 return reported gambling winnings of $149,000, gambling losses of the same amount, and no casualty losses. The 2009 return reported gambling winnings of $107,000, gambling losses of the same amount, and no casualty losses. Mr. Mancini self-prepared his 2010 tax return and reported gambling winnings of $45,000, gambling losses of the same amount, and a casualty loss of $603,000 for "investment portfolio and home." The casualty loss triggered an IRS audit.

In response to the audit, Mr. Mancini filed self-prepared amended returns for 2008 and 2009 in December 2012. The amended 2008 return reported a $1 million casualty loss for "investment portfolio." He reduced his reported taxable income to a $640,000 loss. His amended 2009 return claimed a $1.8 million "investment portfolio" casualty loss, which reduced his taxable income to a loss of $700,000.

The IRS issued a notice of deficiency for 2010 in July 2013. It disallowed the casualty loss of $603,000 and added a penalty for substantial underpayment of income tax. Mr. Mancini provided an amended 2010 return that his attorney prepared for the IRS Appeals office. The amended return increased his casualty loss to $678,000. Mr. Mancini deducted the $1.4 million excess casualty loss that he carried forward from 2008 and 2009. The IRS did not accept or process the amended 2010 return.

Issues. The issues in this case are the following.

- Whether Pramipexole caused Mr. Mancini's compulsive gambling
- Whether Mr. Mancini can deduct his compulsive gambling losses as casualty losses if Pramipexole caused the compulsive gambling
- Whether Mr. Mancini substantiated his gambling losses
- Whether Mr. Mancini was liable for an IRC §6662(a) penalty

Analysis. A board-certified psychiatrist and neurologist provided expert testimony on Pramipexole and ICDs in general and whether the drug caused Mr. Mancini to compulsively gamble. Based on the expert testimony and numerous scientific review articles on Pramipexole, the court believed that gambling is a known side effect of large doses of the drug. Because Mr. Mancini only exhibited compulsive gambling while on high doses of Pramipexole, the court found that it was more likely than not that the drug caused Mr. Mancini's compulsive gambling.

Nonbusiness losses that exceed $100 and 10% of a taxpayer's adjusted gross income that are caused by a "fire, storm, shipwreck, or other casualty, or from theft" are deductible for the year the loss actually occurred. "Other casualty" is not defined in the Code but generally means an event that is "sudden, unexpected, or unusual," and similar to those described in IRC §165(c)(3). Mr. Mancini claims that his Pramipexole-induced ICD was sudden, unexpected, and unusual. As such, he believes he suffered an "other casualty."

The IRS disagreed because a taxpayer must suffer physical property damage to be considered as suffering a casualty loss. Mr. Mancini did not suffer from any physical loss. Case law supports the IRS's assertion that a physical loss must occur. However, Mr. Mancini counters that the case law focuses on whether an event was a casualty, not whether physical loss was a requirement for a casualty loss deduction. The court disagreed with Mr. Mancini. As part of the decisions for numerous cases over the last 60-plus years, the courts established that physical property must suffer damage to qualify for a casualty loss. Mr. Mancini cited IRS Pub. 547, *Casualties, Disasters, and Thefts,* (2017) which states that a taxpayer may deduct a casualty loss on "deposits [that occur] when a bank, credit union, or other financial institution becomes insolvent or bankrupt." This suggests that a physical loss is not required. However, IRS publications are not binding precedent. The court dismissed Mr. Mancini's claim in favor of decades of case law.

Losses under §165(c)(3) are calculated as the difference in the FMV of the property immediately before the casualty and immediately after the casualty, less any compensation from insurance. Mr. Mancini would have to prove the FMV of the money in his bank accounts immediately before and immediately after the casualty loss. Mr. Mancini claims the onset of his ICD was immediately before his gambling losses. Even if the court had an exact date his ICD started and used his account balances on that date, the "immediately after" date (when he stopped using Pramipexole) was three years later. Three years is not considered a sudden event.

Mr. Mancini submitted Forms W-2G, *Certain Gambling Winnings,* from various casinos in which he gambled. However, there was limited information on those forms to support the losses he claimed. The information he provided indicates losses much less than he claimed. He provided no additional support or witness testimony to reinforce his losses.

The IRS argued that Mr. Mancini is liable for the substantial underpayment penalty because his liability is greater than $5,000 and more than 10% of the tax he should have reported. Mr. Mancini countered that he had substantial authority for his position because the IRS "approved" his amended returns for 2008 and 2009. The court ruled that amended returns are not considered substantial authority and Mr. Mancini would be liable for the penalty. However, the IRS failed under IRC §6751 to prove that an immediate supervisor approved the penalty. Accordingly, Mr. Mancini is not required to pay the penalty.

Holding. The court held that Mr. Mancini suffered from compulsive gambling as a direct result of the medicine he took for his Parkinson's disease. However, his gambling losses were not physical and spanned more than three years, disqualifying him from deducting them as a casualty loss. Furthermore, Mr. Mancini failed to substantiate the losses he claimed from gambling. Mr. Mancini does not have to pay the substantial underpayment penalty because the IRS did not provide evidence that the penalty was approved by a supervisor.

Education Expenses

***Enrique Fernando Dancausa Valle v. Comm'r,* TC Summm. Op. 2018-51 (Nov. 5, 2018)**

IRC §162

☞ Education Expenses Incurred in Obtaining LL.M. Degree Not Deductible

Facts. Enrique Dancausa Valle earned his law degree in Spain. He worked as a full-time associate at the Madrid, Spain office of PricewaterhouseCoopers (PwC) starting in September 2006. He obtained his LL.M. degree with a major in corporate law from a law school in Spain in July 2008. Mr. Valle began working as an associate at Bird & Bird LLP's office in Madrid in November 2009. In January 2010, he was admitted to the Madrid bar association and maintained a license to practice law in Spain. In September 2010, he started work at the Madrid offices of Olswang LLP, which is an international law firm. He was stationed at the London, England office of Olswang LLP in the latter part of 2011. Mr. Valle described his jobs at PwC, Bird & Bird, and Olswang as "among others, drafting specialized legal documents, such as contracts and memoranda, researching and analyzing legal and business requirements for clients and providing advice on legal matters."

Mr. Valle moved to New York City and enrolled at New York University (NYU) in September 2013. He earned an additional LL.M. degree from NYU in May 2014. He paid tuition expenses of $27,435 to attend NYU's LL.M. program during 2014.

In September 2014, Mr. Valle began working at Shearman & Sterling LLP (Shearman), an international law firm. He described his work at Shearman as "drafting specialized legal documents, such as contracts and memoranda, researching and analyzing legal and business requirements for clients and providing advice on legal matters."

Mr. Valle's LL.M. degree from NYU satisfied the requirements to take the New York State bar exam. He would not have met the requirements to take the bar exam before earning the additional LL.M. from NYU. In October 2016, after passing the New York State bar exam, Mr. Valle was admitted to practice law in New York.

Mr. Valle timely filed a 2014 Form 1040NR, *U.S. Nonresident Alien Income Tax Return.* He reported wage income of $43,226 and claimed itemized deductions of $30,901, which included $27,435 in education expenses. The IRS subsequently sent Mr. Valle a notice of deficiency, disallowing his claimed deductions for education expenses.

Issue. The issue is whether Mr. Valle is entitled to deductions for education expenses incurred in 2014.

Analysis. Mr. Valle contended that the education expenses he claimed are ordinary and necessary business expenses related to his work as an international attorney. The IRS asserted that Mr. Valle's expenses are not deductible under IRC §162 because he did not prove they are ordinary and necessary business expenses, and his program of study at NYU qualified him for a new trade or business.

Education expenses are deductible under §162 as ordinary and necessary business expenses if the education:

1. Maintains or improves skills required by the taxpayer in his employment or other trade or business; or
2. Meets the express requirements of the taxpayer's employer, or of applicable law or regulations, imposed as a condition to the retention by the taxpayer of an established employment relationship, status, or rate of compensation.[28]

Expenses that fall into either of these categories are not deductible if the education:

1. Is necessary to meet the minimum education requirements for qualification in the taxpayer's employment, or
2. Qualifies the taxpayer for a new trade or business.[29]

Mr. Valle contended that he was an international attorney before earning his LL.M. and his additional degree merely improved the skills that are required in his existing occupation. The court noted there was no dispute that Mr. Valle worked in the field of law both before and after receiving the LL.M. degree. The proper focus is the effect the LL.M. had on the work Mr. Valle is qualified to perform.

Education is deemed to qualify a taxpayer for a new trade or business when it qualifies the taxpayer to perform tasks and activities significantly different from those the taxpayer could perform before obtaining the education.[30] Therefore, the taxpayer must prove that the education did not qualify him to perform significantly different tasks from those he performed before obtaining the education.

Mr. Valle cited *Allemeier v. Comm'r,*[31] in which a taxpayer performed various functions before and after receiving a master of business administration (MBA) degree. The court held that the expenses incurred to obtain the MBA were deductible because the degree did not qualify the taxpayer for a new trade or business. The MBA improved the taxpayer's existing skills and did not qualify him to perform tasks significantly different from those he could perform before obtaining the MBA. Mr. Valle asserted that his situation is comparable to *Allemeier* because the LL.M. improved his skills but did not significantly change the duties he was qualified to perform.

The court observed that Mr. Valle's duties before and after obtaining the LL.M. were somewhat similar. However, unlike the taxpayer's education expenses in *Allemeier,* Mr. Valle incurred education expenses to obtain a degree that allowed him to take the New York State bar examination and become qualified to practice law in the United States.

The court accepted Mr. Valle's contention that the LL.M. degree improved his skills as an international attorney, but, nonetheless, the degree also qualified him to perform tasks significantly different from those he could perform before obtaining it. As in *O'Connor v. Comm'r,*[32] which was cited by the IRS, the taxpayer was not eligible to sit for the New York State bar exam before obtaining the degree and had not established himself as an attorney in the United States before incurring the education expenses.

Holding. The court held that Mr. Valle's degree qualified him for a new trade or business, which was the practice of law in New York. Accordingly, his education expenses are personal expenditures rather than ordinary and necessary business expenses, and he is not entitled to claim the deductions on his 2014 tax return.

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28. Treas. Reg. §1.162-5(a).
29. Treas. Reg. §1.162-5(b).
30. *Robinson v. Comm'r,* 78 TC 550, 552 (1982).
31. *Allemeier v. Comm'r,* TC Memo 2005-207 (Aug. 31, 2005).
32. *O'Connor v. Comm'r,* TC Memo 2015-155, *aff'd* 653 F.App'x 633 (10th Cir. 2016).

DIVORCE ISSUES

Transfers Incident to Divorce

Ltr. Rul. 201901003 (Sep. 4, 2018)
IRC §§1041 and 2516

☞ Transfers Incident to Divorce Not Subject to Tax

Facts. Taxpayers A and B were divorced. Less than seven months after their divorce became final, a court order put into effect Stipulation and Order 1, an agreement A and B reached to reconcile their respective property rights.

Under the terms of Stipulation and Order 1, A and B agreed that they would hold equal interests in Property as tenants in common. Each would be responsible for payment of an equal share of mortgage, taxes, insurance, utilities, homeowner's association fees, and similar expenses. Improvements and repairs to Property would require the consent of both A and B and these costs would be shared equally. If A or B wanted to sell their interest in the property, he or she would give written notice to the other owner during which time the other party could purchase the interest of the owner giving notice.

The Property sustained heavy smoke and water damage during a fire at an adjoining home. Consequently, the Property required repairs that significantly exceeded the repairs A and B considered when they agreed to Stipulation and Order 1. Additionally, Stipulation and Order 1 did not have a mechanism for resolving disagreements such as those that arose when A and B tried to obtain consent for the necessary repairs. As a result, A, the person who was better able to handle unforeseen expenses, made disproportional contributions to pay the cost of repairs that were not covered by insurance.

After the repairs to the Property were completed, A and B negotiated a buyout of B's interest in the Property, which was in accordance with the provisions of Stipulation and Order 1. A petitioned the court to reopen the divorce case so that A and B could enter a new stipulation with revised terms, in order to ensure that the buyout agreement did not violate the terms of Stipulation and Order 1.

In Stipulation and Order 2, A and B stipulated that each had obtained an independent appraisal of the Property, that the Property's fair market value (FMV) was $X and the FMV of B's undivided half interest in Property was half of $X. A and B also stipulated that A had paid $Y and B had paid $Z in costs related to the Property. Additionally, A and B stipulated that A would deliver to B the Net Purchase Price, which would equal half of $X (the Property's FMV) less the amount that A paid in costs related to the Property less the amount that B paid in costs related to the Property divided by two (1/2$X – (($Y – $Z) ÷ 2)). B would deliver the deed for the Property to A and a bill of sale for personalty located in the Property.

The taxpayers requested rulings on the following issues.

1. The payment by A to B of the Net Purchase Price and the transfer of interest from B to A constitute transfers between former spouses that are "incident to divorce" under IRC §1041.
2. The payment by A to B of the Net Purchase Price and the transfer by B to A of B's 50% interest in the Property constitute transfers for "full and adequate consideration in money or money's worth" under IRC §2516.

Analysis. IRC §1041(a) provides that no gain or loss is recognized on a transfer of property to a former spouse if the transfer is incident to a divorce. IRC §1041(b) provides that any transfer of property to which §1041(a) applies is treated as acquired by the transferee by gift, and the transferee's basis in the property is the adjusted basis of the transferor.

Temp. Treas. Reg. §1.1041-1T(b) provides that a transfer of property is treated as related to the cessation of the marriage (and, therefore, incident to the divorce) if the transfer is pursuant to a divorce or separation instrument and the transfer occurs not later than six years after the date the marriage ends. A divorce or separation instrument includes a modification or amendment to such instrument. A transfer not pursuant to a divorce or separation instrument and any transfer occurring more than six years after the end of the marriage is presumed to not be related to the cessation of the marriage. However, this presumption can be rebutted by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage.

The transfer of B's undivided half interest in the Property to A and the transfer of Net Purchase Price from A to B are pursuant to a divorce or separation instrument. Although the transfers occurred more than six years after the date the marriage ended, Stipulation and Order 2 was a modification and amendment to Stipulation and Order 1. The transfers were made to effect the division of property owned by the former spouses at the time their marriage ceased.

IRC §2512(b) provides that when property is transferred for less than an adequate and full consideration in money or money's worth, the amount by which the property's value exceeded the value of the consideration is deemed a gift.

IRC §2516 provides that when spouses enter into a written agreement related to their marital and property rights and divorce occurs within the 3-year period beginning on the date one year before the agreement is entered into, any transfers of property or interests in property under such agreement to either spouse in settlement of their marital or property rights or to provide a reasonable allowance for the support of children will be deemed to be transfers made for a full and adequate consideration in money or money's worth.

A and B divorced less than one year before Stipulation and Order 1 was entered by the court. Accordingly, stipulations concerning the Property under Stipulation and Order 1 are within the purview of §2516. Therefore, transfers A and B make pursuant to Stipulation and Order 1 are deemed made for full and adequate consideration in money or money's worth.

The court entered Stipulation and Order 2 to effectuate transfers contemplated in Stipulation and Order 1 to resolve ultimate ownership of Property. Therefore, §2516 is applicable to transfers A and B made under Stipulation and Order 2, and these transfers are deemed made for full and adequate consideration in money or money's worth and are not subject to gift tax.

Holding. In response to the ruling requests, the IRS concluded as follows.

1. The payment by A to B of the Net Purchase Price and the transfer of B's interest from B to A constitute transfers between former spouses that are incident to divorce under §1041.
2. The payment by A to B of the Net Purchase Price and the corresponding transfer by B to A of B's 50% interest in the Property constitute transfers for full and adequate consideration in money or money's worth under §2516 that do not result in a taxable gift by either A or B.

ESTATE TAX

Estate Expenses

***Ingrid and Christopher Harrell, Sr. v. Comm'r,* U.S. Court of Appeals, 2nd Circuit; No. 17-4133 (Mar. 13, 2019)**
IRC §§72 and 262

☞ No Personal Deduction for Estate Expenses

Facts. Ingrid Harrell was the beneficiary of her father's, Howard Wilkerson's, defined benefit plan. During his life, Mr. Wilkerson made "basic employee contributions" to the plan from his salary. The contributions were made from pretax income subject to income tax when distributed. Mr. Wilkerson made additional employee contributions from post-tax earnings that were subject to income tax in the year he made the contributions.

Mr. Wilkerson died in 1994. The plan administrator notified Mrs. Harrell that the total benefit payable was slightly over $400,000. Approximately 97% of the amount was derived from the employer's share. There was no indication regarding how much of the other 3% came from post-tax additional employee contributions.

During 2009 and 2010, Mrs. Harrell received gross distributions of $28,937. She reported the full amount of the annuity distributions for those years, but claimed that $16,245 of each payment was excludable from gross income.

The Tax Court determined that none of Mr. Wilkerson's death benefit was an investment in the contract but that Mrs. Harrell was entitled to exclude $5,000, because the law in effect before August 21, 1996, treated up to $5,000 in employer benefits "paid by reason of the death of the employee" as an additional investment in the contract.[33]

In addition, the Tax Court calculated the exclusion ratio based on the expected return and Mrs. Harrell's age at the time of her father's death and determined that Mrs. Harrell may exclude $86 per year from gross income for 2009 and 2010.[34]

During 1994 and 1996, Mrs. Harrell paid various expenses associated with the estate, including administration costs such as funeral expenses and professional fees. She claimed these expenses on her 2009 Schedule A, *Itemized Deductions,* as a net operating loss carryforward. The Tax Court held that Mr. and Mrs. Harrell may not deduct the estate expenses because the costs were personal or family expenses, which are not deductible. The Harrells were not entitled to a deduction for the federal estate tax paid because there was no evidence that they filed a federal estate return. Additionally, because the Harrells are cash basis taxpayers and the expenses were paid in 1994 and 1996, they were not entitled to a deduction in 2009.

The Harrells appealed the Tax Court decision.

Issues. The issues in the case are the following.

- Whether the Harrells are entitled to exclude any of their annuity income from gross income
- Whether the Harrells could deduct the estate expenses on their personal return

Analysis. The Court of Appeals agreed with the Tax Court's analysis that only $86 of the Harrells' annuity is excludable from their gross income.

The Court of Appeals also agreed that the Harrells were not eligible to deduct the estate expenses on their personal return. They did not identify a provision in the Code or any basis for their claim that they can claim estate deductions on their personal income tax return.

Holding. The Court of Appeals affirmed the Tax Court decision that the Harrells were entitled to exclude $86 of the annuity distributions from their gross income. It also affirmed that the Harrells could not deduct any of the estate expenses on their personal return.

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33. IRC §§101(b)(1), (2)(A), (2)(D), repealed by the Small Business Job Protection Act of 1996 (PL 104-188).

34. See *Harrell v. Comm'r,* TC Memo 2017-76 (May 8, 2017).

Estate Tax

***U.S. v. Donna Ringling et al.*, No. 4:17-CV-04006; U.S. District Court, District of South Dakota, Southern Division (Feb. 21, 2019)**
IRC §6324(a)(2)

☞ Summary Judgment Applies Against Taxpayers With Unpaid Estate Tax Liability

Facts. Harold and Margery Arshem had three daughters, Donna Ringling, JoAnn Jandreau, and Kathryn Standy, and a grandson, Kory Standy. Mrs. Arshem predeceased her husband, who passed away on December 24, 1999. Mr. Arshem bequeathed his estate to his daughters equally. He also specifically bequeathed real property to Ms. Ringling.

The estate contained the following assets.

- 13 bonds jointly owned with Ms. Ringling, valued at $12,000 at the time of death
- 10 bonds jointly owned with Ms. Jandreau, valued at $12,500 at the time of death
- Seven bonds jointly owned with Ms. Standy, valued at $6,500 at the time of death
- Pickup truck titled with the three daughters, valued at $25,000 at the time of death
- Van titled with Ms. Standy, valued at $8,000 at the time of death
- Checking account with Ms. Standy as joint owner
- Two life insurance policies with the three daughters listed as beneficiaries, combined value of $21,616 at the time of death

None of the daughters made any contributions towards the bonds or vehicles.

Prior to his death, Mr. Arshem engaged in the following transactions with his grandson.

- **A contract for deed to purchase real property.** Mr. Standy contracted to pay Mr. Arshem $32,000 with $100 due at the time of the contract, $1,900 due on December 20, 1996, and the remainder paid in equal installments. On December 14, 1999, Mr. Arshem forgave the remaining balance of $27,601.
- **A warranty deed for the family farm.** Mr. Arshem conveyed a warranty deed on May 9, 1996. He retained a life estate and received rental income and profits during his lifetime. At the time of his death, the farm had an fair market value of $345,700.
- **A contract for deed to purchase a second piece of real property.** Mr. Standy was to pay $90,000, with $10,000 due on December 18, 1999, and the remainder paid in equal payments. Mr. Standy was not entitled to take possession, receive rent, issues, and profits until March 1, 2000. At the time of Mr. Arshem's death, Mr. Standy still owed $80,093.
- **A certificate of deposit.** Mr. Arshem cashed in a certificate of deposit to pay off a loan in the name of Mr. Standy and Mr. Arshem. The certificate was valued at $32,989, of which $28,845 was used to pay off the loan and the remaining $3,779 (after penalty for early withdrawal) was paid to Mr. Standy.
- **Approximately 6,000 bushels of corn.** In December 1999, Mr. Arshem gave Mr. Standy corn that was valued at $10,200 at Mr. Arshem's date of death.

Ms. Ringling signed the federal estate tax return on April 14, 2008. The return reported a gross estate of $834,336 and tax due of $28,939. The estate did not make any payments with the return. On July 14, 2008, the estate was assessed a late-filing penalty of $6,511, a failure-to-pay penalty of $7,235, and interest of $23,190.

In July, August, and November, the IRS sent notices demanding payment. In January 2010, Ms. Ringling requested that the IRS abate the interest and penalties. The IRS denied her request because she did not prove reasonable cause or demonstrate due diligence. The IRS provided information on how to file a claim for refund or pursue additional IRS administrative review. Neither the estate nor Ms. Ringling filed a claim. In November 2010, 2011, and 2012, the IRS sent notices of balance due and demands for payment.

The daughters received a check from an attorney on April 18, 2011, with a letter advising them that the estate tax was still outstanding. On July 15, 2013, the daughters each received a Form 10492, *Notice of Federal Taxes Due.* A tax lien was filed against the estate and notice was mailed to the estate on July 24, 2013.

The following payments were made against the estate's liability.

Date of Payment	Amount	Person Making the Payment
February 22, 2010	$ 4,300	Ms. Ringling
March 22, 2010	241	Ms. Ringling
September 5, 2017	4,514	Ms. Jandreau
September 11, 2017	4,514	Ms. Standy
October 2, 2017	15,153	Mr. Standy

The balance owed on May 25, 2018, was $63,479.

Issues. The issues in this case are the following.

- Whether Ms. Ringling, Ms. Jandreau, Ms. Standy, and Mr. Standy are liable for the unpaid estate tax, penalties, and interest
- Whether any affirmative defenses can resist a motion for summary judgment
- Whether the statute of limitation prevents the tax claim

Analysis. A transferee, surviving tenant, or beneficiary who receives property upon a decedent's death is personally responsible for paying any unpaid federal estate tax. The IRS must prove that the estate tax was not paid and that the individual received property from the gross estate. An estate tax return is due nine months from the date of death. The estate return for Mr. Arshem was filed eight years after his death. The total liability for the estate was $65,875 with penalties and fines included. The amount of payments made totaled $24,165. The remaining liability as of May 25, 2018, was $63,479.

Ms. Ringling does not dispute the amounts owed. However, she argues that an error on the U.S. motion for summary judgment was "material and forbids summary judgment." The remaining liability per the U.S. memorandum was $63,470 but the supporting evidence stated the liability was $63,479. The government acknowledges the error, but argues it was due to a systematic typographical error.

To prove "a fact …is genuinely disputed," Ms. Ringling must cite materials in the record. Ms. Ringling referenced mistakes in a motion/memorandum, which are not considered citable materials. She did not provide credible evidence that the liability amount of $63,479 was in dispute. As such, there was no dispute of material facts, and summary judgment was not precluded. The undisputed facts establish that Mr. Arshem's estate tax was not paid.

None of the daughters or Mr. Standy denied that they received property upon Mr. Arshem's death. The estate must include as gifts the transfers that Mr. Arshem made to Mr. Standy within three years of his death. The family farm must be included in the estate because Mr. Arshem retained a life estate. The estate must include all of the jointly owned property and the life insurance policies. Because Ms. Jandreau, Ms. Standy, and Mr. Standy did not dispute any of the material facts and the court denied Ms. Ringling's response, the court found that the estate tax liability existed.

Ms. Ringling attempted to prevent the motion for summary judgment by asserting affirmative defenses. She argued that the doctrines of accord and satisfaction, waiver, estoppel, statute of limitation, and reasonable care barred the government's claims. Ms. Ringling presented an additional fact that, in 2014, the daughters and Mr. Standy met with an IRS employee on one or more occasions regarding the liability. According to Ms. Ringling, the employee led them to believe the interest and penalties would be waived. However, Ms. Ringling did not provide any evidence that these meetings occurred. She did not meet the burden of proof to claim the affirmative defenses.

Ms. Ringling claimed reasonable cause to avoid penalties and interest on the liability of the estate. She hired a tax attorney to advise them on the estate tax and did not initially pay the tax based on their reliance on the tax attorney's advice. After she was informed that a balance remained, Ms. Ringling made payments of what she believed was her share of the outstanding liability. However, Ms. Ringling did not present any evidence to support her defense. The court denied her use of the reasonable cause defense.

The IRS has 10 years from the date an assessment is made against an estate to establish liability. The IRS made its assessment on July 14, 2008, and filed the case on January 23, 2017. The statute of limitations was satisfied and Ms. Ringling did not provide any evidence disputing that fact.

Holding. The court held that Mr. Arshem's daughters and grandson were liable for the estate tax. The estate tax was unpaid and they received property out of the estate. Ms. Ringling's affirmative defenses were denied because they were unsubstantiated. The IRS properly filed its claim within the statute of limitations.

FOREIGN TAXES

Foreign Earned Income Exclusion

Andrew Wentworth v. Comm'r, **TC Memo 2018-194 (Nov. 20, 2018)**
IRC §§911 and 6662

☞ Taxpayer Found to be Bona Fide Resident of Foreign Country

Facts. After graduating from high school in 2000, Andrew Wentworth enlisted in the U.S. Marine Corps Reserves. Mr. Wentworth was called to duty and spent six months and 16 days in Kuwait and Iraq between June 1, 2004, and May 31, 2005.

In 2006, Mr. Wentworth returned to Iraq and worked for a private security company, Cochise Consultancy, Inc. Cochise provided personal security to individuals who destroyed munitions stockpiles throughout the country. Mr. Wentworth continued to provide similar services from September 2006 through April 2007 for EOD Technology, Inc., the successor to the private security contract.

Between March 2006 and April 2007, Mr. Wentworth was permitted to leave Iraq every four months but was not required to leave. He came back to the United States for a 10-day visit.

In July 2007, Mr. Wentworth was chosen to train in the U.S. Army Special Forces qualification course in the United States. In February 2009, Mr. Wentworth was dropped from the program following an injury. Mr. Wentworth returned home to Wisconsin, and he listed his parents' address as his home address when he renewed his driver's license in 2008.

On May 15, 2009, Mr. Wentworth entered into a contract with Triple Canopy, Inc., to train as a protective security specialist in Iraq. The term was for 12 months, and Mr. Wentworth entered into a subsequent contract with the company on August 9, 2010. Between May 15, 2009, and April 22, 2011, Mr. Wentworth worked at least 12 hours per day, six days per week. He was required to live in the "green zone" in Baghdad and could not leave the area freely because of safety concerns.

Housing and food were provided, and Mr. Wentworth did not purchase any real estate in Iraq. He had limited knowledge of the Arabic language. Mr. Wentworth did not apply for Iraqi citizenship but held a visa that allowed him to work in the country. He kept local currency on his person but did not maintain bank accounts. He opened three bank accounts in Iraq but closed them within two months because the bank did not have cash whenever he attempted to withdraw funds.

Mr. Wentworth was required to leave Iraq during his off-duty periods. Triple Canopy paid for Mr. Wentworth's travel back and forth from the United States during his leave. During this period, Mr. Wentworth listed a friend's house in Brentwood, Tennessee, as his home of record. Mr. Wentworth would have stayed in Iraq during these periods if permitted, just as he had done while employed by Cochise and EOD.

Mr. Wentworth voluntarily left Iraq and his position with Triple Canopy in April 2011. He returned to Tennessee to complete a degree in geoscience, with the expectation that he would return to northern Iraq to work. After Mr. Wentworth completed his degree and earned the required certificate to work in the petroleum field in 2014, he decided not to return to Iraq because the area was more dangerous than when he left in 2011.

Mr. Wentworth hired a CPA to prepare his income tax returns who had significant experience in preparing returns for clients with foreign income. The CPA claimed the foreign earned income exclusion (FEIE) for both 2010 and 2011. For 2010, Mr. Wentworth claimed an FEIE of $91,500 and listed his residence as Iraq. For 2011, Mr. Wentworth claimed a prorated FEIE of $28,520 and listed his residence as Iraq for the period between May 15, 2009, and April 22, 2011.

Issues. The issues in this case are the following.

- Whether Mr. Wentworth is entitled to exclude the income he earned while living in Iraq
- Whether he is liable for accuracy-related penalties

Analysis. Generally, citizens of the United States are taxed on the income earned anywhere in the world unless an exemption applies. IRC §911(a) allows a qualified individual to exclude foreign earned income, with limitations. IRC §911(d) defines a **qualified individual** as a person who has a tax home in a foreign country and is either:

- A citizen of the United States who was a bona fide resident of a foreign country for an uninterrupted period that covered an entire tax year **(bona fide residency test),** or
- A citizen or resident of the United States who was present in a foreign country for at least 330 full days during any 12 consecutive months **(physical presence test).**

Mr. Wentworth acknowledged that he did not meet the physical presence test, so he must prove that Iraq was his tax home and that he was a bona fide resident of Iraq in 2010 and 2011. Determination of bona fide residency is made based on the facts and circumstances. The court looked to 11 factors in establishing bona fide residency.[35] These factors, and the court's reasoning on Mr. Wentworth's situation, follow.

1. **Intention of the taxpayer.** The court determined that Mr. Wentworth sincerely intended to stay and work in Iraq as evidenced by his continued acceptance of employment in the country. Mr. Wentworth's employment contracts were for periods not less than 12 months and there was an expectation that the assignment would continue indefinitely because of the need for security in the area.
2. **Establishment of taxpayer's home temporarily in the foreign country for an indefinite period.** It was unnecessary for Mr. Wentworth to secure housing because living arrangements were provided to him as part of his contract. This factor favors Mr. Wentworth.

[35] *Golsen v. Comm'r,* 54 TC 742, 757 (1970), *aff'd* 445 F.2d 985 (10th Cir. 1971).

3. **Participation in the activities of the taxpayer's chosen community on social and cultural levels, identification with the daily lives of the people and, in general, assimilation into the foreign environment.** The court determined that this factor is slightly unfavorable to Mr. Wentworth because the majority of his interactions with the Iraqi people and his limited knowledge of the Arabic language were directly associated with his employment.

4. **Physical presence in the foreign country consistent with the taxpayer's employment.** Mr. Wentworth spent more time in Iraq than the United States during the years in question. Therefore, this factor favors him.

5. **Nature, extent, and reasons for temporary absences from taxpayer's temporary foreign home.** Because he was required to take leave outside of Iraq, Mr. Wentworth's temporary absences weigh marginally in his favor.

6. **Assumption of economic burdens and payment of taxes to the foreign country.** Mr. Wentworth did not pay taxes in Iraq and had no personal expenses because room and board were provided to him. This factor, therefore, weighs against him.

7. **Status of residency contrasted to that of a transient or sojourner.** Mr. Wentworth was not a citizen, but was present long enough in Iraq to be considered more than a transient. This factor was determined to be neutral.

8. **Treatment accorded taxpayer's income tax status by his employer.** This factor was neutral because although Triple Canopy withheld U.S. taxes from Mr. Wentworth's wages, he could have opted not to have the company withhold taxes.

9. **Marital status and residence of taxpayer's family.** Mr. Wentworth was unmarried and stayed with a friend rather than returning to his parents' home. This factor was slightly adverse to Mr. Wentworth.

10. **Nature and duration of taxpayer's employment; whether taxpayer's assignment abroad could be promptly accomplished within a definite or specified time.** Mr. Wentworth worked 12-hour days, six days per week. Therefore, this factor weighed in his favor.

11. **Good faith in making the trip abroad; whether for purpose of tax evasion or legitimate business reasons.** Nothing in the record indicated that Mr. Wentworth acted in bad faith. He hired a competent CPA to prepare his returns and declared all his income. Therefore, this factor weighed in his favor.

The majority of the factors establish "strong proof" that Mr. Wentworth was a bona fide resident of Iraq in 2010 and 2011.

A tax home is the area in which a taxpayer works rather than the location of their personal residence. The courts review a taxpayer's familial, economic, and personal ties to the United States as compared to a foreign country. The taxpayer's abode is considered the United States if their ties to the country remain strong even while the taxpayer has ties to a foreign country.

Mr. Wentworth worked in Iraq during the years in question and did not have a spouse or children in the United States. During his trips back to the United States, Mr. Wentworth did not return to his parent's home but rather stayed with a friend. Mr. Wentworth would have stayed in Iraq, but he was required to leave. The court determined that Mr. Wentworth's tax home was Iraq. Because his tax home was Iraq and he was a bona fide resident of Iraq, he was a qualified person for the FEIE and eligible to claim the FEIE.

The court determined that Mr. Wentworth was not liable for IRC §6662 accuracy-related penalties because he was entitled to the FEIE.

Holding. The court held that Mr. Wentworth was considered a resident of Iraq and entitled to the FEIE. He is not liable for §6662 penalties.

GROSS INCOME

Unreported Income

***Martha Smith and George Lakner et al. v. Comm'r,* TC Memo 2018-127 (Aug. 13, 2018)**
IRC §§104, 162, 274, 469, 6651, and 6662

☞ Taxpayers Liable for Penalties on Underreported Income and Unsubstantiated Expenses

Facts. Prior to holding teaching positions at various prestigious universities as a doctor and psychiatrist, George Lakner served in the U.S. Army, rising to the rank of colonel. Starting in 1999, Dr. Lakner was employed by the Veterans Administration (VA) Medical Center in Loma Linda, California, until he was dismissed in 2001 after expressing concerns over the mental healthcare the veterans were receiving. Dr. Lakner filed a complaint with the Equal Employment Opportunity Commission (EEOC), alleging that he was terminated as "reprisal for protected activity in which he had engaged."

He continued working with the Army overseas and retired from the Army in 2008, following an injury that he sustained while in Bosnia in 2003. At that point, Dr. Lakner began operating a medical consulting practice. In 2010, Dr. Lakner testified in his EEOC hearing that he was discriminated against by the VA because he is Jewish. He reached a settlement with the VA for $328,000, plus $172,000 for attorney fees and $178,552 for accrued annual leave.

Dr. Lakner's wife, Martha Smith, worked as a property manager, both independently and as an employee of Realtor Cathie Gill, Inc. During the years at issue, the couple owned as many as six rental properties in the United States that Ms. Smith managed.

The couple attached a Schedule C, *Profit or Loss From Business,* to their tax returns for each year between 2007 and 2011 in which they commingled the income and expenses of Dr. Lakner's medical consulting practice and the activity from Ms. Smith's rental properties. The couple also claimed various itemized deductions, real estate losses, and net operating losses (NOL).

The IRS selected the 2007–2011 returns for review. After performing a bank deposit analysis, the IRS determined that the couple underreported income from Dr. Lakner's medical practice, the VA settlement, and rental properties. The IRS disallowed many of the couple's itemized deductions on their Schedules A, *Itemized Deductions,* and all of their Schedule C expenses due to a lack of substantiation. The IRS recharacterized Ms. Smith's rental real estate activity on a Schedule E, *Supplemental Income and Loss.* Notices of deficiencies were issued, along with late-filing penalties, accuracy-related penalties, and fraud-related penalties.

Issues. The issues in this case are the following.

- Whether the couple received unreported income
- Whether the couple is entitled to claim deductions on their Schedules A, C, and E greater than the amount the IRS allowed
- Whether the couple is entitled to NOLs
- Whether the couple is liable for late-filing penalties and accuracy-related penalties

Analysis. The IRS can recreate a taxpayer's income using any reasonable method if the taxpayer does not maintain appropriate records. It is the burden of the taxpayer to then dispute that any such income is nontaxable.

For tax years 2008 and 2010, the IRS used the bank statement method to determine the couple's taxable income. Ms. Smith and Dr. Lakner argue that the IRS erred by including as taxable income the VA settlement, other alleged nontaxable amounts, and by mischaracterizing receipts as rental income.

The couple argued that the VA settlement was excludable from income because it represented income from damages for physical injury. If the purpose of the settlement is not disclosed, the intent of the taxpayer is vital to determine whether the payment is made for nontaxable reasons. The intent is determined by reviewing the facts and circumstances. In his EEOC complaints, Dr. Lakner stated that he was discriminated against because of his religion. There was no mention in his complaints of physical injuries that he sustained. During the EEOC trial, Dr. Lakner's attorney made no reference to any physical injuries. As part of the settlement, Dr. Lakner agreed to "withdraw, in their entirety, all discrimination complaints." Because he did not raise a complaint of any physical damages, the court determined that the settlement was not related to Dr. Lakner's physical injuries and is taxable income.

The IRS revenue agent (RA) reviewed the bank accounts the couple maintained in 2008 and 2010. Through his analysis, the RA determined there was unreported income in 2008 of $125,922 and $699,264 in 2010, allocated as follows.

Item	2008	2010
Litigation settlement proceeds	$ 0	$275,000 [a]
Medical consulting (Schedule C)	92,887	334,175
Rental real estate (Schedule E)	33,035	90,089
Total	$125,922	$699,264

[a] The IRS conceded this amount related to a nontaxable deposit due to a casualty loss on one of the rental properties, which reduced the amount of unreported income from $699,264.

Dr. Lakner and Ms. Smith did not provide any credible evidence to dispute the RA's classification of taxable income. The court held that the couple was responsible for including the taxable income on their Schedules C and E as shown in the preceding table. The court also determined that the couple had unreported taxable interest income in 2007 of $34,357.

Dr. Lakner and Ms. Smith did not provide any credible evidence disputing the RA's reallocation of the couple's commingled expenses on Schedule C between the medical consulting practice and the rental real estate activities. Moreover, the court agreed with the IRS's allocation of the income between Schedule C and Schedule E.

To deduct their rental real estate losses, Ms. Smith must establish that she was a real estate professional. To qualify as a real estate professional, Ms. Smith must prove that she spent more than 750 hours working in real property trades or businesses in which she materially participates. Any hours that a spouse spends on real property trades or businesses does not count for this purpose. Ms. Smith did not submit any evidence to support the hours she spent on the real estate activity during 2011. Dr. Lakner testified that Ms. Smith spent 500 to 600 hours every year and that he spent 1,000 to 1,200 hours annually managing the properties. The court did not find Dr. Lakner's testimony to be credible and disallowed the couple's $25,000 rental real estate loss.

On their 2007 tax return, the couple claimed an NOL carryover from 2006. To claim an NOL, a taxpayer must attach "a concise statement setting forth the amount of the… NOL deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the… NOL deduction."[36] The couple did not provide the required evidence for the NOL allegedly sustained between 2004 and 2006. The IRS disallowed the carryover and, as a result of the other adjustments to the couple's returns, their returns reported positive adjusted gross income. Accordingly, the court determined that all the NOLs were properly disallowed.

The couple did not timely file their tax returns. They asserted that the delay was due to Dr. Lakner being deployed overseas. However, he returned in 2006 and they did not file the tax returns for 2007 through 2011. The couple also claimed that health problems kept them from timely filing their returns; however, they submitted no support for that claim. The court sustained the failure-to-file addition to their returns.

36. Treas. Reg. §1.172-1(c).

The court upheld the 20% accuracy-related penalties against Dr. Lakner and Ms. Smith. The couple did not call their CPA to testify on their behalf and provide evidence of reasonable reliance on a competent professional. Because the court held that the couple failed to include significant income on their returns, it concluded that the couple likely did not provide all necessary information to their preparer.

Holding. The court held that Ms. Smith and Dr. Lakner had unreported income. The court disallowed much of the couple's itemized deductions, business expenses, and NOL deductions. As a result, the accuracy-related penalty and late-filing penalty were appropriately added. The fraud penalties under IRC §6663 were not upheld.

Self-Employment Tax

***Karin Slaughter v. Comm'r,* TC Memo 2019-65 (Jun. 4, 2019)**

IRC §§1401, 1402, and 6662

☞ Income from Publishing is Self-Employment Tax for Author

Facts. Karin Slaughter is a successful author who has worked since the 1990s to build her brand as an author. A brand author bestows prestige and profits on a publishing house. After decades of writing and working with media coaches and publishers, Ms. Slaughter established herself as brand author. As a brand author, she spends additional time meeting with publishers, agents, media contacts, and others to maintain her status.

Ms. Slaughter's contract is divided into two payments. She is paid a nonrefundable advance and a royalty based on the sales of her manuscripts.

Over the years, Ms. Slaughter's brand has grown and includes her name, likeness, goodwill, reputation, and existing readership. She developed relationships with booksellers and librarians. As a result, readers request Ms. Slaughter's books by her name rather than the book title. Accordingly, her typical advance increased eightfold. Ms. Slaughter spends 12 to 15 weeks to produce a manuscript. The increase in her advance is related to her other attributes as a brand author rather than additional time spent working.

On her 2010 and 2011 federal income tax returns, Ms. Slaughter deducted various business expenses related to her authoring activities. These expenses included leasing a vehicle to attend interviews and promotional events, cost of hosting her own events, and rent on her New York City apartment to facilitate many of her marketing events in New York City.

Karen Wesley was an experienced tax preparer in the firm that prepared Ms. Slaughter's tax returns for approximately 20 years. After reviewing Ms. Slaughter's income, Ms. Wesley concluded that income from the use of Ms. Slaughter's name and likeness was investment income. Without the guidance of any definitive authority, the preparer reported all of Ms. Slaughter's advances and royalties on Schedule E, *Supplemental Income and Loss.* The income and expenses of writing were reported as business income subject to self-employment (SE) tax on Schedule C, *Supplemental Income and Loss.* The income was allocated based on a calendar approach. Ms. Slaughter did not provide a work calendar so the preparer relied on her statement that she produced a manuscript in 12 to 15 weeks and worked approximately five days per week. The percentage of time spent writing was applied to her total payments during the year.

The preparer presented the plan to split the income to Ms. Slaughter. They disclosed that there was no authority for the treatment, but that the allocation was reasonable. The firm did not provide any written advice. Ms. Slaughter relied on their conclusions and judgment.

Issues. The issues in this case are the following.

- Whether Ms. Slaughter's royalty income was derived from her business as an author and subject to SE tax
- Whether Ms. Slaughter is subject to IRC §6662 penalties if she understated her SE income

Analysis. Taxpayers are responsible for tax on SE income. SE income is "the gross income derived by an individual from any trade or business carried on by such an individual, less the deductions … attributable to such trade or business."[37] The definition of trade or business is often based on the facts and circumstances and generally requires that the individual be engaged in the activity with continuity and regularity with a profit motive.

Ms. Slaughter contends that her contract can be divided between authoring (SE income) and her brand (non-SE income that is not associated with a trade or business). The IRS argues that all of Ms. Slaughter's income is related to her trade or business of writing and is subject to SE tax. It supported its position with several cases and revenue rulings. However, none of the cases established that an author's brand is directly linked to their writing income and consequently subject to SE tax.

Ms. Slaughter asserts that the income from her brand is separate and distinct from her writing income, which is her trade or business. She based her argument on Rev. Rul. 68-499,[38] which concludes that royalties paid to an employee are not paid for services, are not wages, and therefore are not subject to payroll taxes. Ms. Slaughter contends that her publisher **intended** to pay separate amounts for writing and for her brand.

An expert witness testified that payment for writing a manuscript is a small percentage of the value of a contract. The contract amount includes an unstated amount for branding. Both parties are aware other elements, such as branding, exist although the amount is unspecified.

The IRS argued that the **intent** of Ms. Slaughter and her publisher should be disregarded because Ms. Slaughter attempted to alter the meaning of her contract using declarations that were not part of the agreement. Additionally, the IRS contended there is only one payment because all the income is directly related to selling Ms. Slaughter's books. Because the contract does not provide an allocation between authoring and Ms. Slaughter's brand, the IRS asserted that the court must analyze the intent of the parties. The court disagreed that it needed to analyze Ms. Slaughter's and her publisher's intent because Ms. Slaughter's reliance on Rev. Rul. 68-499 was erroneous. The court concluded that Ms. Slaughter was applying an inappropriate analogy that compares employment to a trade or business. Any allocation of Ms. Slaughter's contracts is irrelevant because the court believes that all her income is allocated to a trade or business.

The court analyzed the facts and circumstances to determine that Ms. Slaughter developed her brand in a businesslike fashion. Her brand was built with the primary purpose of income and profit. Monitoring her sales and engaging in promotional and marketing activities is routine and part of Ms. Slaughter's trade or business. Developing a loyal fan base leads to higher book sales, which results in an enhanced brand. Ms. Slaughter's brand and her writing generate money by selling her books and then by substantiating higher advances and royalty rates from her publisher.

Additionally, the court reviewed Ms. Slaughter's Schedule C expenses, which included her apartment in New York City. The apartment was necessary to facilitate her branding activities while in New York. If Ms. Slaughter claimed the branding-related expenses on her Schedule C as trade or business expenses, then the associated brand income should also be claimed on the Schedule C.

Ms. Slaughter's contracts included provisions for additional and separate payments for income from advertising in her books. The court determined that if the contracts specified separate payments for that income, then none of Ms. Slaughter's advances or royalties are allocable to that revenue. The so-called noncompete clauses in her contracts do not prevent Ms. Slaughter from working with another publisher, only that she completes her work with her contracted publisher first. The court concluded that Ms. Slaughter cannot exclude any income from her trade or business income that she alleges is from noncompete clauses.

37. IRC §1402(a).

38. Rev. Rul. 68-499, 1968-2 CB 421.

Ms. Slaughter relied on the advice of qualified professionals who prepared her tax returns. She provided all requested documentation and it was reasonable that she relied on the preparers' advice. The court determined that Ms. Slaughter was not liable for negligence penalties.

Holding. The court held that Ms. Slaughter's brand income and her writing income were both derived from her trade or business of writing. Therefore, all her associated income was subject to SE tax. Because Ms. Slaughter relied on the expertise of experienced tax preparers, the court held that she was not liable for negligence penalties.

Cancellation of Debt Income

Mary Bui v. Comm'r, **TC Memo 2019-54 (May 21, 2019)**
IRC §108

☞ Partial Qualified Principal Residence Indebtedness Exclusions Allowed on Cancellation of Debt Income

Facts. Mary Bui owned two single-family residences in San Jose, California. She lived in the Red River property from 1981 through March 14, 2011, as her primary residence. After selling the Red River property, Ms. Bui moved into the Cedar Grove property, which she acquired in 2002.

Prior to 2011, Ms. Bui used the properties as collateral on three home equity lines of credit for $250,000, $40,000, and $101,942. In 2011, Ms. Bui received three Forms 1099-C, *Cancellation of Debt,* for each of the loans. Boxes on the forms were checked to indicate that Ms. Bui was personally liable for repayment of the loans. The canceled debt was in the amounts of $243,299, $11,999, and $100,190.

Ms. Bui had additional deeds of trusts executed prior to 2011. The indebtedness on these additional deeds was not canceled in 2011.

Ms. Bui carried out a variety of home improvement projects prior to 2011 on the Red River property. She also paid approximately $10,000 for custom drapes and $12,000 for driveway repair. However, she provided no documentation supporting any of her expenses. Ms. Bui did not testify that she made any home improvements on the Cedar Grove property.

The IRS disallowed the entire exclusion of discharged indebtedness income on Ms. Bui's 2011 return.

Issue. The issue in this case is whether Ms. Bui must include her cancellation of indebtedness income in her 2011 gross income.

Analysis. The face value of discharged obligations less any amounts paid in satisfaction of the canceled debt are generally included in income for the year in which the debt is canceled. Ms. Bui argues that her debt cancellation income should not be included in her gross income because it was qualified principal residence indebtedness and she was insolvent in 2011. Qualified principal residence indebtedness is not included in gross income for acquisition debt used to acquire, construct, or substantially improve a taxpayer's principal residence. Only the amount of the discharged loan in excess of the nonqualified principal residence indebtedness is excluded from gross income. Ms. Bui argues that her three loans were not used to acquire her properties, but rather to substantially improve her primary residence. However, during 2011, her primary residence was Red River. Therefore, any loans secured by the Cedar Grove property are not qualified principal residence indebtedness. In addition, any improvements made before the loan was secured are not qualified principal residence indebtedness, because the residence must secure the loan.

The court determined that the only expense that Ms. Bui identified that would qualify as principal residence indebtedness was the driveway project. The drapes were not considered a substantial improvement to the property. The driveway cost $12,000, which the court determined was qualified principal residence indebtedness. However, when only a portion of a discharged loan is qualified principal residence indebtedness, the amount that may be excluded is only the amount discharged that exceeds the amount of the loan that is not qualified principal residence indebtedness.[39] The court calculated that, of the original $250,000 loan, $238,000 was not qualified principal residence indebtedness (after subtracting the $12,000 driveway project). Ms. Bui could therefore only exclude from her income $5,299 ($243,299 canceled debt – $238,000 not qualified principal residence indebtedness).

Ms. Bui also argued that her income should be excluded because she was insolvent in 2011. A taxpayer with liabilities that exceed the fair market value of their assets immediately before the discharge of indebtedness is considered insolvent. The IRS conceded that Ms. Bui was insolvent in the amount of $42,852 and that amount is excludable from her gross income.

Holding. The court held that Ms. Bui was entitled to exclude from her gross income $48,151 ($42,852 insolvency exclusion + $5,299 qualified principal residence indebtedness exclusion).

Attribution of Income

***Brian and Betsy Ray v. Comm'r,* TC Memo 2018-160 (Sep. 20, 2018)**

IRC §§61, 73, 6651, and 6662

☞ Erroneous Attribution of Taxpayers' Income to their Children

Facts. During the tax years 2006 through 2011, the years at issue, Brian and Betsy Ray lived on their 6-acre farm in Oregon with six of their eight children. Mr. and Mrs. Ray home-schooled their children.

During the years at issue, Mr. Ray worked full-time at National Home Education Research Institute (NHERI), a tax-exempt IRC §501(c)(3) organization, cofounded by him to perform, analyze, and disseminate research on home schooling to the media, policymakers, and legislators. Mr. Ray had exclusive authority to determine wages and salaries for all of NHERI's workers, including himself, but NHERI did not pay Mr. Ray for his service during the years at issue.

Besides his unpaid NHERI position, Mr. Ray received income from consulting services, giving speeches, and providing expert testimony regarding home education that was reported on Schedules C, *Supplemental Income and Loss.* Some of this income went into the couple's Visa account at the Oregon State University Credit Union (OSU Visa account) but, typically, Mr. Ray cashed income received by check. The Rays did not report all of this income on Mr. Ray's Schedule C for the years at issue.

During the years at issue, Mrs. Ray received income from making speeches at various home education retreats and seminars. This income was deposited into the Rays' OSU Visa account but was not reported to the IRS.

Five of the Rays' children purportedly worked at NHERI as office assistants, for which they were paid a total of $260,120 during the years at issue by NHERI checks signed and authorized by Mr. Ray. The children then cashed the NHERI checks at the bank where NHERI maintained its bank account, deposited some of that cash into the OSU Visa account, and retained the rest. Records of cash deposited and retained were not available.

Mr. and Mrs. Ray did not timely file their Forms 1040, *U.S. Individual Income Tax Return,* for any of the years at issue. The IRS initially audited the taxpayers' 2010 tax return but then expanded their audit to the other years at issue. About that time, the Rays engaged their counsel to prepare late-filed tax returns for the years at issue and later to represent them before the IRS.

39. IRC §108(h)(4).

In response to IRS information-document requests for each of the years at issue, the Rays provided estimates of household expenses for two of their children but did not provide all of the documents requested by the IRS. Consequently, the IRS summoned bank records, which it then analyzed to reconstruct the Rays' income. After comparing the reconstructed self-employment income with amounts reported on Schedule C, the IRS determined there was unreported Schedule C income. Accordingly, the IRS issued notices of deficiency based on their findings, which also included late-filing and accuracy-related penalties.[40] In response, the Rays timely petitioned the Tax Court for redetermination.

Issues. The issues in this case are as follows.

- Whether income from NHERI checks to the Rays' children should be attributed to Mr. and Mrs. Ray
- Whether the Rays failed to report income on Schedule C
- Whether the Rays are liable for late-filing and accuracy-related penalties

Analysis. Gross income is defined in IRC §61(a) as all income from whatever source derived, and this income is taxable to the person who earns it.[41] An important distinction that the courts noted is that the **true earner** of income is the person who controlled the earning of such income, rather than the person who received the income.[42] Therefore, if the assignor retains sufficient power and control over the assigned property or over the receipt of the income, it is reasonable to treat the assignor as the recipient of the income for tax purposes.[43]

The court dismissed as without merit the Rays' contention that the NHERI amounts paid to their minor children must not be included in their gross income. Although IRC §73(a) requires inclusion of amounts received for the services of a child in the child's own gross income rather than that of the parents, the court noted that this only applies to income the child is deemed to have earned.[44] Here, the court found that the **true earners** of the income were the Rays and not their children.

Turning to the issue of the IRS's reconstruction of the Rays' income for the years at issue, the court noted that a taxpayer must maintain books and records establishing the amount of their gross income.[45] When a taxpayer fails in this task, the IRS is authorized to determine the existence and amount of the taxpayer's income by any method that clearly reflects income.[46]

The Rays contended that the IRS's analysis was incorrect because of the following issues.

1. Certain reimbursements, transfers between accounts, and gifts were taxable deposits.
2. Certain cash deposits were double counted.

Because the Rays offered no corroboration supporting their first contention, the court found in favor of the IRS's bank deposits analysis. Regarding the Rays' second contention, the court noted that they did not provide any evidence of double counting. However, the court agreed that the IRS's bank deposits analysis would have double counted at least some portion of the Rays' income. Therefore, the court decided that the deposits into the OSU Visa account most likely to have been double counted were those deposits that were evenly divisible by 100 and not otherwise the subject of a stipulation by either party.

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40. IRC §§6651(a)(1) and 6662(a).

41. *Lucas v. Earl*, 281 U.S. 111, 114-115 (1930).

42. *Barmes v. Comm'r*, TC Memo 2001-155 (Jun. 28, 2001).

43. Ibid, quoting *Comm'r v. Sunnen*, 333 U.S. 591, 604 (1948).

44. *Fritschle v. Comm'r*, 79 TC 152, 157-158 (1982).

45. IRC §6001; *Petzoldt v. Comm'r*, 92 TC 661, 686 (1989); Treas. Reg. §1.446-1(a)(4).

46. IRC §446(b); *Petzoldt v. Comm'r*, 92 TC at 693.

Consequently, the court reduced the IRS's reconstructed income by the following amounts for the years at issue.

Tax Year	2006	2007	2008	2009	2010	2011
Income reduction	$6,200	$4,000	$17,000	$42,500	$48,000	$29,800

The late-filing penalty does not apply if the taxpayers show their failure to file was due to reasonable cause and not willful neglect. The Rays failed to file timely returns for the years at issue, arguing that they had reasonable cause because they were unaware of their filing requirement. Therefore, their failure to timely file was neither conscious nor intentional. The court noted that the Rays' mistaken understanding or ignorance of the law does not amount to reasonable cause and thus does not relieve them from this penalty.[47]

The court determined that if substantial understatements of income tax exist for the years at issue, then the IRS is entitled to assess accuracy-related penalties. The Rays were required, but failed, to maintain adequate records to substantiate their deductions.[48] Furthermore, the Rays failed to establish they had reasonable cause for the tax understatements and that they acted in good faith with respect thereto.[49]

Holding. The court agreed with the IRS's reassignment of income to the Rays from their children. Furthermore, the court generally agreed with the IRS's reconstruction of the Rays' income except for double-counting adjustments. Lastly, the court upheld the IRS's assessment of late-filing and accuracy-related penalties.

INNOCENT SPOUSE

Joint and Several Liability

***Brian Benson and Dannielle Welch-Benson v. Comm'r,* TC Memo 2018-157 (Sep. 19, 2018)**
IRC §6015

☞ Spouse Denied Relief From Joint and Several Liability

Facts. Dannielle Welch-Benson owned Dankar Enterprise, Inc., an S corporation that maintained parking meters and collected revenue as a subcontractor for the city of St. Louis. At Ms. Welch-Benson's direction, Dankar fraudulently overcharged the city for work in 2011. Her husband, Brian, worked as a pharmaceutical sales representative and was unaware of her fraudulent actions. Mr. Benson became aware of the fraud in August 2012, when his wife was charged. The couple maintained separate bank accounts and Mr. Benson was not involved in Dankar's daily operations.

The Bensons hired Neil Packman to prepare both their personal and business tax returns. Dankar Enterprise elected S corporation status effective January 1, 2011. Dankar's 2011 Form 1120S, *U.S. Income Tax Return for an S Corporation,* reported all its income, including the fees from the fraudulent billings. In October 2012, the couple filed their joint return for 2011, including all of the pass-through income from Dankar. However, they did not pay their entire liability.

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47. *Rayhill v. Comm'r*, TC Memo 2013-181 (Aug. 8, 2013); *Joyce v. Comm'r*, 25 TC 13, 15 (1955); *West v. Comm'r*, TC Memo 2011-272 (Nov. 16, 2011).

48. Treas. Reg. §1.6662-3(b).

49. IRC §6664(c)(1).

In 2013, Ms. Welch-Benson started a 27-month sentence in prison. Mr. Benson filed for divorce during her sentence, but the divorce was not finalized. Mr. Benson filed returns, but did not pay his entire tax liability for 2013 and 2014. On January 27, 2015, Mr. Benson filed a Form 8857, *Request for Innocent Spouse Relief,* and was granted preliminary full relief from his 2011 liability. In reply, Ms. Welch-Benson filed a Form 12509, *Statement of Disagreement.* She objected to the preliminary relief granted to Mr. Benson. The IRS denied the petition for relief.

Issue. The issue in this case is whether Mr. Benson is entitled to relief from joint and several liability for 2011.

Analysis. A taxpayer who files joint returns is jointly and severally liable for the entire tax liability unless relief is granted under IRC §6015(f). Relief is granted if it is inequitable to hold a spouse liable for any unpaid tax. There is a 3-step analysis to evaluate equitable relief.

1. Required threshold conditions
2. Required three elements to grant streamlined relief when the threshold conditions are met
3. Seven nonexclusive factors to determine if relief can be granted if the threshold conditions are met but streamlined relief is not available

The court determined that Mr. Benson satisfies all the threshold conditions except that the income tax liability from which Mr. Benson is requesting relief is attributable to an item of his wife or an underpayment from her income. The court did not analyze this condition because Mr. Benson failed other tests for relief.

Streamlined relief is available if:

1. The spouses are separated or divorced when the IRS makes its decision;
2. The requesting spouse will suffer economic hardship if relief is not granted, and
3. The requesting spouse did not know, or had no reason to know, when the return was filed that the nonrequesting spouse would not or could not pay the joint tax liability.

Mr. Benson meets the first requirement because the couple separated after Ms. Welch-Benson went to prison.

Regarding the second element for streamlined relief, economic hardship is determined if the requesting spouse's income is below 250% of the poverty level, or their monthly income exceeds their reasonable basic monthly living expenses by $300 or less, and they do not have sufficient assets to make payments on the tax and still meet reasonable basic living expenses. The court calculated that Mr. Benson's current monthly income was $12,717, which is far greater than 250% of the poverty level. It also determined that Mr. Benson's reasonable basic living expenses each month are $10,184. His monthly income exceeds his reasonable basic living expenses by $2,553. Thus, he fails the economic hardship test.

For the third requirement for streamlined relief, the court looked at whether Mr. Benson had reason to know that his wife would be unable to pay the 2011 tax liability when the return was filed. In previous years, Ms. Welch-Benson paid the tax liability from her Dankar income. Mr. Benson filed the return two months after his wife was charged with fraud so he had reason to know that she would be unable to pay the tax liability. Mr. Benson argued that he was not expecting the increase in tax that resulted when Dankar elected S status in 2011. However, Mr. Benson was aware of this increase when he filed the return in October 2012.

The court looked at additional factors for relief. Because the divorce is not final, neither spouse has an additional legally binding agreement to pay the outstanding income tax liability; therefore, this is a neutral factor. However, it weighs in favor of relief that the couple was separated at the time. Mr. Benson would not suffer an economic hardship from paying the liability; therefore, this is a neutral factor. It was unreasonable for Mr. Benson to believe that Ms. Welch-Benson would pay the 2011 liability, which weighs against relief. Although Mr. Benson enjoyed a significant benefit from the unpaid liability, he did not live an extravagant lifestyle. This was another neutral factor. Mr. Benson failed to timely pay his tax liabilities for 2013 and 2014. His lack of tax compliance weighed against relief. Lastly, Mr. Benson was not in poor mental or physical health when he filed the 2011 tax return. This was another neutral factor.

Holding. After reviewing all the facts and circumstances, the court held that Mr. Benson was not entitled to relief from his joint and several liability on his joint return with Ms. Welch-Benson.

IRS PROCEDURES — MISCELLANEOUS

Collection Due Process

***Jevon Kearse v. Comm'r,* TC Memo 2019-53 (May 20, 2019)**
IRC §§6320(c) and 6330(d)

☞ Appeals Officer Abused Discretion by Not Verifying Taxpayer Received Notice of Deficiency

Facts. Jevon Kearse was a professional football player in the National Football League from 1999 through 2010. For 2010, the IRS disallowed a $1.4 million "business bad debt expense," which resulted in a deficiency on Mr. Kearse's return for that year. The IRS mailed a letter of deficiency to Mr. Kearse's last known address dated May 11, 2012. Mr. Kearse denied receiving the notice and the IRS could not produce proof of mailing or establish that the notice was in fact delivered to Mr. Kearse.

On November 5, 2012, the IRS assessed $432,015 to Mr. Kearse for his outstanding 2010 tax liability. On December 4, 2012, the IRS sent Mr. Kearse a notice of federal tax lien and informed him of his right to appeal the collection action.

Issue. The issue in this case is whether the IRS abused its discretion by failing to properly verify that Mr. Kearse received an assessment of his 2010 tax due prior to mailing a notice of deficiency.

Analysis. A taxpayer who does not pay their tax liability after the IRS issues a notice is liable for penalties and interest in addition to the tax. The IRS may place a lien on the taxpayer's property, which is perfected when the IRS makes the assessment. Under IRC §6320(a), the IRS must provide the taxpayer with written notice of the lien and a chance to review the propriety of how the lien was filed during an administrative hearing. The appeals office conducts the administrative hearing and determines whether to sustain the filing of the lien. To make that decision, the appeals officer analyzes the following factors.

1. Whether the IRS met the requirements of applicable law and administrative processes
2. All pertinent issues the taxpayer presents
3. Whether the IRS employed collection actions that were more intrusive than required

The IRS abuses its discretion if it employs its discretion "arbitrarily, capriciously, or without sound basis in fact or law."[50] A taxpayer has the opportunity to dispute their liability during a collection due process hearing if they did not receive a notice of deficiency or have a prior opportunity to dispute the liability. An appeals officer must determine whether a notice of deficiency was properly mailed to the taxpayer prior to the IRS assessing the tax.

50. *Woodral v. Comm'r,* 112 TC 19, 23 (1999).

Several courts have established that a properly completed U.S. Postal Service (USPS) Form 3877, *Firm Mailing Book For Accountable Mail,* or an equivalent, is sufficient to prove that a notice of deficiency was appropriately mailed. The IRS was unable to produce a USPS Form 3877 or an equivalent for Mr. Kearse.

The appeals officer contends that she reviewed the IRS's integrated data retrieval system to verify that the IRS issued the May 11, 2012 notice of deficiency to Mr. Kearse. This is an acceptable method to authenticate a notice of deficiency assessment according to the Internal Revenue Manual (IRM). However, the court determined that the IRM guidance was a general rule. Once a taxpayer claims a notice was not sent to them, it becomes an irregular case and the general rule does not apply. The appeals officer must then review the notice and the USPS Form 3877 or its equivalent.

During the case, the IRS produced a USPS Form 3877 to prove it mailed the notice of deficiency to Mr. Kearse. The IRS claimed that an improved system for retrieving certified mailing lists located the Form 3877. The court did not allow the Form 3877 to be entered into evidence.

Holding. The court held that the appeals officer failed to perform the required verification that Mr. Kearse received a notice of deficiency prior to an assessment for his unpaid 2010 liability. The court determined that this was an abuse of discretion.

Exempt Organization Reporting

***Stephen Bullock v. IRS,* No. CV-18-103-GF-BMM; U.S. District Court for the District of Montana (Jul. 30, 2019)**
IRC §§6033 and 6103

☞ Court Invalidates Rule Allowing Tax-Exempt Organizations to Withhold Donor Details on Return

Facts. Under IRC §6033, exempt organizations must file an annual return that includes items of gross income, receipts, disbursements, and other information required by regulations. Most exempt organizations are required to report the names and addresses of people who contributed $5,000 or more (more than $1,000 for certain social clubs, fraternal beneficiary societies, and domestic fraternal societies) on the Form 990, *Return of Organization Exempt From Income Tax,* Schedule B, *Schedule of Contributors.* The returns can be shared with states to confirm that people and organizations are following the laws. For example, New Jersey used the information reported on Schedule B to track contributions to identify suspicious behavior and ascertain whether the organization is soliciting donations within the state.

Rev. Proc. 2018-38[51] eliminated the requirement that IRC §501(c) organizations (excluding §501(c)(3) organizations) must report donor information on Schedule B. The information must still be maintained by the organization and available to the IRS upon request.

The Administrative Procedure Act (APA) requires that government agencies inform the public of any proposed change to legislation and allow the public to make comments. Montana and New Jersey sued the IRS on the basis that Rev. Proc. 2018-38 did not follow the appropriate APA procedure allowing for comments prior to the revocation of the disclosure requirements.

Issue. The issue in this case is whether Rev. Proc. 2018-38 violated the APA's public notice-and-comment procedure.

Analysis. The IRS admitted that it did not follow the APA's public notice-and-comment procedure. It did not provide an opportunity for the public to submit conflicting views or disagreements prior to changing long-standing reporting requirements.

Holding. The court held that Rev. Proc. 2018-38 is unlawful because it violated the APA. The revenue procedure will be set aside until the IRS follows the notice-and-comment procedures for a similar rule.

51. Rev. Proc. 2018-38, 2018-31 IRB 280.

Tax Court Jurisdiction on Lookback Period

***Roberta Borenstein v. Comm'r,* U.S. Court of Appeals, 2nd Circuit; No. 17-3900 (Apr. 2, 2019)**

IRC §6512(b)(3)

☞ Tax Court Can Order Refund During 3-Year Lookback Period

Facts. Roberta Borenstein's federal income tax return for 2012 was due on April 15, 2013. For tax year 2012, Ms. Borenstein made income tax payments of $112,000 by the due date. She filed an extension, postponing the due date to October 15, 2013. However, Ms. Borenstein did not file her return, and the IRS mailed her a notice of deficiency on June 19, 2015. The notice stated that Ms. Borenstein owed 2012 taxes of $1.7 million and penalties of $582,756.

Ms. Borenstein filed her 2012 income tax return on August 29, 2015. Her return reflected a liability of $79,559, an amount that the IRS agrees is correct. The IRS and Ms. Borenstein agree she has an overpayment of $32,441 ($112,000 payments – $79,559 liability).

On September 16, 2015, Ms. Borenstein filed a petition to have her deficiency redetermined and her overpayment refunded. The issue for the Tax Court to decide was whether it had jurisdiction to refund her overpayment.

The Tax Court ruled that it did not have jurisdiction because Ms. Borenstein was only entitled to a 2-year look-back period for her refund. Because the overpayment occurred more than two years prior to when the IRS mailed the notice of deficiency, the court could not order a refund. Ms. Borenstein filed an appeal.

Issue. The issue in this case is whether the Tax Court had jurisdiction to order a refund of Ms. Borenstein's overpayment.

Analysis. The Tax Court has jurisdiction to order a refund or credit for overpayments made during the 2-year lookback period, which is the two years immediately preceding when the IRS mailed a notice of deficiency. Additionally, the court has jurisdiction for overpayments that occur during the three years immediately preceding the date the IRS mails a notice of deficiency "plus the period of any extension of time for filing the return" if a taxpayer files a return and the notice was mailed within three years after the filing. The "flush" language Congress added to IRC §6512(b)(3) provides that the lookback period is three years if the taxpayer does not file a return before the notice of deficiency is mailed and the notice is mailed during the third year after the due date (with extensions) for filing the tax return.

Ms. Borenstein's taxes for 2012 were deemed paid on April 15, 2013. The IRS mailed the notice of deficiency on June 19, 2015. The determining factor is whether June 19, 2015, is during the third year after the due date (with extensions) for filing the return. If the answer is "yes," then Ms. Borenstein is entitled to a 3-year lookback period and the Tax Court has jurisdiction to order the refund. If the answer is "no," then Ms. Borenstein is entitled to a 2-year lookback period and the Tax Court may not order the refund. Ms. Borenstein argues that the "third year after the due date (with extension)" means the third year after the return due date, plus a 6-month extension (April 16, 2015, to October 15, 2016). The IRS argues that the period refers to the third year after the conclusion of the 6-month extension period (October 16, 2015, to October 15, 2016).

The court believes that the flush language of §6512(b)(3) is ambiguous and thus looks to legislative history to determine Congressional intent. It believes the intent was to eliminate an unwarranted treatment disparity by expanding the Tax Court's jurisdiction to order refunds for a taxpayer who did not file a return before the IRS mailed a notice of deficiency. The unwarranted treatment disparity results because the court would have unquestioned jurisdiction if Ms. Borenstein did not have an extension (that she did not use), or if the IRS mailed the notice either six months earlier or later. The court concludes that "with extensions" revises "third year after the due date" so that when the IRS mails a notice during the third year after the return due date plus an extension, the 3-year lookback applies. Accordingly, the Tax Court has jurisdiction to order the refund for Ms. Borenstein.

Holding. The court reversed the decision of the Tax Court and determined that the Tax Court had the jurisdiction to order Ms. Borenstein's refund based on a 3-year lookback period.

Preparer Tax Identification Number

***Brittany Montrois v. U.S.*, No. 1:14-cv-01523; U.S. District Court for the District of Columbia (Mar. 1, 2019)**
IRC §7422(a)

☞ The IRS Has the Authority to Impose a Fee to Obtain and Renew PTINs

Facts. Tax return preparers are required to obtain a preparer tax identification number (PTIN) and list it on every return they prepare. PTINs are used instead of a preparer's social security number on returns to protect any inappropriate use of the social security number.

In 2010, the IRS started requiring uncredentialed taxpayers to undergo background checks, pass a competency test, and fulfill continuing education requirements. All preparers were required to obtain a PTIN. This allowed the IRS to "identify tax return preparers, centralize information, and effectively administer the rules relating to tax return preparers."[52] Additionally, the IRS charged a $50 fee (plus vendor fee) to obtain and to annually renew PTINs. The fee would cover the IRS's costs to develop and maintain the IRS's information technology system and "personnel, administrative, and management support needed to evaluate and address tax-compliance issues, investigate and address conduct and suitability issues, and otherwise support and enforce the programs that require individuals to apply for or renew a PTIN."[53]

A class action lawsuit *(Loving v. IRS)*[54] challenged the IRS's authority to establish the registered tax return preparer system. The court agreed with the ruling in *Loving.* The preparer regulations were invalidated and anyone with a PTIN could prepare tax returns.

Another lawsuit followed that challenged the IRS's authority to impose the PTIN fee. The suit alleged that the IRS's decision to levy the PTIN fee was arbitrary and capricious. While the case was at trial, the IRS reduced the PTIN fee to $33. The decrease reflected that, after the *Loving* decision, the IRS no longer needed funds to manage the registered tax return preparer system. The district court held that the IRS lacked the authority to charge the fee but that PTINs were required. The ruling was based on the fact that, following *Loving,* any preparer could obtain a PTIN and the fee no longer benefited a specific group of individuals. The court held that the IRS did not appropriately argue that the benefit of using a PTIN was to protect preparer's social security numbers. The IRS appealed this decision.

Issues. The issues in the case are the following.

- Whether the preparers were obligated to first pursue their claim against the IRS before taking the case to federal court under the jurisdictional exhaustion requirement
- Whether the PTIN fee is unlawful

Analysis. Under the IRC §7422(a) exhaustion provision, "[n]o suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary" of the Treasury. The court determined the provision did not apply because the PTIN fee was established under a statute outside the Internal Revenue Code. The statute applied to all federal agencies. The exhaustion provision under §7422(a) only applies to refund requests of "internal revenue" taxes. This case therefore falls outside the purview of §7422(a) and the taxpayers were not obligated to submit their claim to the IRS before taking the case to federal court.

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52. 75 Fed. Reg. 60,309 (Sep. 30, 2010).
53. 75 Fed. Reg. 60,319 (Sep. 30, 2010).
54. *Loving v. IRS,* 742 F.3d 1013 (D.C. Cir. 2013).

The tax return preparers argued that the PTIN fee is illegal because there is no appropriate statutory authority for the fee and because the decision to impose the fee was arbitrary and capricious. The fee was approved under the Offices Appropriations Act that allows the head of government agencies to prescribe regulations to establish a charge for a service. An agency must prove that a service is provided in exchange for the fee, the service provides a specific benefit, and the benefit is granted to identifiable individuals. The court concluded that the IRS does provide a service in exchange for the PTIN fee. The IRS generates and maintains the database of numbers to enable tax preparers to avoid reporting their social security numbers on returns. Although the IRS provides fewer PTIN-related services after *Loving,* there is still a service provided. The specific benefit to tax preparers is that they protect their social security numbers from unauthorized uses. The tax return preparers assert that the IRS did not invoke privacy concerns when it initially proposed the PTIN regulations and should not be allowed to introduce that justification now.

The court countered with various IRS statements supporting the claim that PTINs protect preparers from identity risks. The tax preparers argued those statements were from regulatory commentary requiring preparers to obtain a PTIN and not regarding the PTIN **fee.** The court believes that the PTIN and the PTIN fee are interrelated and dismissed the argument. The taxpayers contended that the PTIN does not provide additional identity protection because the IRS allows preparers to omit their social security numbers from returns presented to taxpayers. In 1998, when Congress amended the Code to allow the use of PTINs, the IRS had been allowing preparers to omit their social security numbers from taxpayers' returns for over 20 years.

The tax preparers lastly argued that even if there is justification for the initial PTIN fee, there is no validation for the annual renewal fee. The court disagreed because the IRS maintains a database of the numbers and that validates the need for a renewal fee.

The court determined that tax return preparers qualified as identifiable recipients. Even though any member of the general public could request a PTIN following Loving, those people who actually pay the fee receive the associated benefit.

The court addressed the issue of whether the PTIN fee was arbitrary and capricious. Return preparers argued that the IRS did not provide a defense of the fee that was still valid following *Loving.* The court determined that the IRS provided explanations that the PTINs would protect preparers' identities that went beyond the services provided under the defunct registered tax return preparer program. The fee to cover the substantial cost to generate and maintain the PTIN database is most appropriately recouped from the return preparers rather than the general public. The court held that the PTIN fee was not arbitrary and capricious.

Holding. The court held that the jurisdictional exhaustion requirement is inapplicable to this case. The court further held that the IRS has the authority to charge preparers to obtain and renew their PTIN. The issue of whether the PTIN fee unduly exceeds the costs to issue and maintain PTINs was remanded for further proceedings.

Tax Debt

Treasury Inspector General for Tax Administration Report 2019-30-018 (Dec. 31, 2018)
IRC §6306

☞ Assessment of Private Collection Agency Performance

Purpose. The 2015 Fixing America's Surface Transportation (FAST) Act required the IRS to begin using private collection agencies (PCA) to collect inactive tax receivables from taxpayers. The Treasury Inspector General for Tax Administration (TIGTA) performed a review to independently evaluate the performance of the PCAs to satisfy reporting requirements of the FAST Act.

Background. In April 2017, the IRS started delivering information on inactive tax receivables to PCAs. Congress requires information from the Department of the Treasury to determine whether the IRS can manage the use of private debt collectors (PDC) in a cost-efficient and effective manner that does not harm taxpayers or injure tax administration.

Analysis. Since April 2017, the IRS has assigned more than 700,000 taxpayer accounts to private collectors. As of September 2018, the PDC program collected $88.8 million (2%) of the $5.7 billion assigned to the PCAs. In comparison, the IRS spent $66.5 million to implement and maintain the program.

The PCAs have performed well under quality metrics established by the IRS. The IRS implemented a quality assessment program of the PCAs and the PCAs are also required to maintain an internal quality assessment program. The PCAs use 21 quality attributes that largely mirror the attributes the IRS uses to assess its own customer service representatives. The overall quality scores of the PCAs have averaged approximately 99%. However, TIGTA noted that aspects of case management are not reflected in the IRS's quality scoring but should be, such as accuracy of payment agreements and other issues uncovered in the IRS's operational reviews.

If taxpayers cannot pay in full but are willing to satisfy their balance due, they may be eligible for a payment arrangement. Each PCA developed its own payment arrangement calculator, which is used to determine the number of months needed to pay off the taxpayer's debt. The IRS approved each PCA calculator during the initial implementation phase of the PDC program. During the approval process, the IRS uses its integrated automated technology (IAT) tools to analyze a taxpayer's current and future balance due information. TIGTA compared the PCAs' payment arrangement terms with the IRS's IAT tool terms for over 2,500 payment arrangements that the PCAs sent to the IRS for approval during the 2018 fiscal year. TIGTA found that only 8% of the PCA's proposed payment arrangements agreed with the IRS's IAT tool on the number of months needed to pay off the taxpayer's debt. TIGTA raised concerns about the discrepancies between PCA and IRS payment calculations. The IRS agreed that there were differences and developed a plan to reduce calculation errors.

The IRS conducts quarterly operational reviews and daily quality reviews of each PCA's work, which evaluate how well the PCA is complying with IRS guidance and to assess overall PCA performance. There was variance in how well each PCA performed with respect to the review criteria, but some of the issues were common to more than one PCA. For example, the PCAs sometimes mishandled taxpayer accounts that had disaster area freeze codes. At other times, the PCAs did not return taxpayer accounts to the IRS when they were required to do so. The IRS made 33 recommendations to address such issues, and the PCAs planned to take corrective actions.

The IRS solicits feedback from customers as part of its goal to provide high-quality customer service. The IRS uses a third-party vendor to offer taxpayers assigned to the PCAs a customer satisfaction survey as a means to assess their overall experience with the PCA. All four PCAs' survey results were in the low-to-mid 90% satisfaction range.

The IRS addressed the effectiveness of the program in a report to Congress. The quality score the IRS reported was supposed to reflect both IRS and PCA quality review results. However, although both the IRS and the PCAs assess performance on up to 36 attributes, the quality score reported to Congress was limited to one attribute, "customer accuracy." The IRS told TIGTA that their policy prohibits externally reporting performance information other than customer accuracy. However, TIGTA believes that the FAST Act requirement to report annually on the program's effectiveness supersedes the IRS's policy.

When taxpayers agree to make payments to satisfy their tax debt, the PCA must provide taxpayers with payment options. Taxpayers can use several methods to make payments to the IRS. TIGTA observed instances in which taxpayers had problems processing payments using certain methods. As a result, many taxpayers who attempted to make payments during telephone calls with the PCA never made the payments. The data collected by TIGTA indicates that improvements in payment options could result in increased revenue and more payments.

TIGTA made 13 recommendations to improve the efficiency of the program and protect taxpayer rights. The IRS agreed or partially agreed with nine of those recommendations and plans to take corrective actions.

Tax Scams

IRS News Rel. IR-2019-49 (Mar. 20, 2019)

☞ IRS Releases "Dirty Dozen" List of Tax Scams

Facts. The IRS issued its "dirty dozen" list of tax scams and reminded taxpayers to remain vigilant to these schemes throughout the year. Such scams may peak during tax season but taxpayers may encounter them at any time.

Following is a recap of this year's top scams.

1. **Phishing.** Taxpayers should be alert to potential fake emails or websites attempting to steal personal information. The IRS never initiates contact with taxpayers via email.
2. **Phone Scams.** Phone calls from criminals impersonating IRS personnel pose an ongoing threat to taxpayers. The IRS has seen an increase in these phone scams recently, with con artists threatening taxpayers with arrest, deportation, license revocation, and other penalties.
3. **Identity Theft.** Taxpayers should remain constantly alert to tactics designed to steal their identities.
4. **Return Preparer Fraud.** The IRS noted that the vast majority of tax professionals are honest, but taxpayers should be on the lookout for unscrupulous return preparers. Some dishonest preparers seek to scam clients, perpetuate refund fraud, steal identities, and engage in other schemes that harm taxpayers.
5. **Inflated Refund Claims.** Taxpayers should be wary of preparers promising inflated tax refunds. Such preparers may ask clients to sign a blank return, promise a large refund before looking at taxpayer records, or charge fees based on a percentage of the refund amount.
6. **Falsifying Income to Claim Credits.** Scammers often try to convince taxpayers to invent income to erroneously qualify for tax credits. This scam can lead to taxpayers facing large bills for back taxes, interest, and penalties.
7. **Falsely Padding Deductions on Returns.** The IRS cautions taxpayers to avoid the temptation to falsely inflate deductions or expenses on their returns to pay less than what they owe or to receive larger refunds.
8. **Fake Charities.** Groups sometimes masquerade as charitable organizations to solicit donations. Taxpayers should be wary of charities with names similar to well-known organizations. IRS.gov has tools taxpayers need to check on the status of charitable organizations.
9. **Excessive Claims for Business Credits.** Taxpayers should not improperly claim the fuel tax credit, which is generally limited to off-highway business use, including farming. Taxpayers should also avoid misuse of the research credit.
10. **Offshore Tax Avoidance.** Taxpayers involved in offshore tax avoidance are urged to voluntarily contact the IRS and get caught up on their tax-filing responsibilities.
11. **Frivolous Tax Arguments.** Promoters of frivolous tax schemes encourage taxpayers to make unreasonable claims about the legality of paying taxes. The penalty for filing a frivolous tax return is $5,000.
12. **Abusive Tax Shelters.** Abusive tax shelters, including trusts and syndicated conservation easements, are sometimes used to avoid taxes. The IRS reminds taxpayers to be on the lookout for scammers promoting tax shelters that sound too good to be true. When in doubt, taxpayers should seek an independent opinion regarding complex products they are offered.

> **Note.** More information on each of these scams can be found at **uofi.tax/19a4x1** [www.irs.gov/newsroom/irs-concludes-dirty-dozen-list-of-tax-scams-for-2019-agency-encourages-taxpayers-to-remain-vigilant-year-round].

Offer in Compromise

***Kathryn Gillette and Raif Szczepanski v. Comm'r,* TC Memo 2018-195 (Nov. 20, 2018)**

IRC §§72, 6330, and 7122

☞ Taxpayers Liable for Additional Taxes Despite Compulsive Gambling Addiction

Facts. Kathryn Gillette served in the military and worked as a firefighter. In addition, she purchased and managed rental properties, for which she collected rents, managed financials, and performed most of the maintenance work. Ms. Gillette is married to Raif Szczepanski.

In the early 2000s, Ms. Gillette began taking Mirapex, which was prescribed to her for restless leg syndrome. She continued taking Mirapex until approximately 2008, when her insurance company required that she change to the generic medication Pramipexole. This medication became less effective over the years, and Ms. Gillette's doctor increased her dosage.

After a dosage increase in April 2010, Ms. Gillette began exhibiting severe compulsive behavior, especially compulsive gambling. This was first evident when Ms. Gillette and Mr. Szczepanski (the taxpayers) were on board a cruise ship celebrating Ms. Gillette's retirement from the fire department. She gambled through the nights on this 7-day cruise.

After she returned home, her gambling activity increased significantly. She often traveled hours from her home to gamble. She opened lines of credit at various casinos and soon defaulted on many of them.

Ms. Gillette's gambling problem worsened. She sometimes went days without sleep. Most of the money she collected from her rental properties went to casinos. When she ran out of money, she borrowed from friends and did not pay them back. In 2012, she withdrew money from her retirement account. She neglected her rental properties and distanced herself from family and friends.

In June 2013, Ms. Gillette accompanied her son to cosign for a car loan. The manager informed Ms. Gillette that she could not cosign for her son's loan because many of her rental properties were in foreclosure and her credit score was very low. Ms. Gillette's son was worried, and he questioned her about her prescription medication. He learned that a known side effect of Pramipexole for some individuals is several compulsive behavior, especially compulsive gambling.

Ms. Gillette talked to her doctor, and they implemented a plan to take her off the medication. Despite reducing her medication, she continued to gamble in 2013, 2014, and 2015. She finally stopped taking Pramipexole and stopped gambling in 2015.

The taxpayers filed a joint 2012 return. They reported the following.

Wages	$ 60,455
IRA distribution	104,001
Pensions and annuities	29,335
Income from rental properties	126,465
Gambling winnings	1,317,348
Gambling losses	(1,315,227)

They reported a tax liability of $85,231, which included additional tax of $10,400 for a premature IRA distribution and $17,851 of alternative minimum tax (AMT). After subtracting withholdings, their balance due was $75,954, which they did not pay.

The IRS issued notices of intent to levy in 2014, and the taxpayers requested a hearing. They stated they wanted to pursue an installment agreement and an offer in compromise (OIC).

The taxpayers provided a completed OIC form to the settlement officer, citing exceptional circumstances. To support their claim for exceptional circumstances, they included Ms. Gillette's medical records and documentation about Pramipexole and its side effects. The taxpayers offered to compromise their 2012 liability for $38,968.

The OIC was forwarded to an IRS offer examiner. The offer examiner rejected the taxpayers' OIC. The offer examiner stated that the reason for his rejection was that the taxpayers had the ability to pay the liability in full and that Ms. Gillette's special circumstances did not qualify as a hardship. An IRS settlement officer agreed with the offer examiner's rejection.

The taxpayers filed a timely petition with the court. The petition stated that their 2012 IRA withdrawal was done to save Ms. Gillette's homes from foreclosure and that Ms. Gillette's true income was negative when the gambling losses are taken into account. They further argued that her gambling was an extraordinary event caused by her medication, which rendered her mentally impaired and incompetent.

The parties held a supplemental hearing to address a public policy or equity OIC. Ms. Gillette supplied additional evidence of her compulsive behavior. She argued that she should not be liable for the AMT or the 10% additional tax on premature IRA distributions because of her condition.

After reviewing the additional documents, the IRS issued a supplemental notice sustaining the proposed levy. The settlement officer's report stated that the side effects of Pramipexole have been known since 2006, and Ms. Gillette chose to continue taking the medication. He stated that her actions were not reasonable or responsible and the fact that the taxpayer thinks the law is unfair does not support public policy acceptance of an OIC.

Issues. The issues are as follows.

- Whether the taxpayers are liable for the 10% additional tax on premature IRA distributions under IRC §72(t)
- Whether the taxpayers are liable for the AMT
- Whether the settlement office abused his discretion in rejecting the taxpayers' proposed collection alternative on grounds of effective tax administration

Analysis. A 10% additional tax is generally imposed on taxpayers who receive an early distribution from a qualified retirement plan. IRC §72(t) provides exceptions to the tax, including an exception for a distribution that is "attributable to the employee's being disabled within the meaning of subsection (m)(7)."[55]

A taxpayer is disabled if they are "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration."[56] An individual's substantial gainful activity "is the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability."[57]

The court noted that even if Ms. Gillette suffered an impairment in 2012, her impairment was remediable and was therefore not a disability under §72(m)(7). She was able to return to managing her properties and finances and has not gambled since 2015. Therefore, she does not qualify for an exception under §72(t)(2).

The taxpayers' 2012 return reported an AMT of $17,851. They argued that it was not fair or just that Ms. Gillette was taxed an AMT rate due to her medication-induced gambling and that the AMT would not have been due under ordinary circumstances. They contended that they should be taxed as though the gambling had not occurred. However, they cited no legal authority for this position other than IRS Pub. 1, *Your Rights as a Taxpayer.* The court noted there was no legal authority that would exempt the taxpayers from the AMT; therefore, they are liable for it.

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55. IRC §72(t)(2)(A)(iii).
56. IRC §72(m)(7).
57. Treas. Regs. §§1.72-17(f)(1) and 1.72-17A(f)(1).

The IRS "may compromise to promote effective tax administration where compelling public policy or equity considerations identified by the taxpayer provide a sufficient basis for compromising the liability."[58] Such a compromise is justified if, "due to exceptional circumstances, collection of the full liability would undermine public confidence that the tax laws are being administered in a fair and equitable manner."[59]

The taxpayers contended the settlement officer abused his discretion because he did not engage in reasoned decision-making. They contended he rejected their OIC based on prejudice instead of facts. The court disagreed, noting the settlement officer verified all requirements of applicable law and administrative procedure had been met. The settlement officer reviewed the taxpayer's OIC at both the collection hearing and the supplemental hearing with a specific focus on public policy or equity compromises under Treas. Reg. §301.7122-1(b)(3). He considered all the issues raised by the taxpayers and answered all their inquiries and explained the applicable law. The court concluded the settlement officer did not abuse his discretion in rejecting the taxpayers' public policy or equity OIC. The court noted the taxpayers did not meet their burden of establishing that acceptance of their public policy or equity OIC would not undermine compliance.

Holding. The court held the taxpayers failed to establish that they qualified for an exception to the 10% additional tax on a premature distribution under §72(t); therefore, they are liable for the additional tax. The taxpayers are also liable for the AMT. In addition, the court held the settlement officer did not abuse his discretion in rejecting the taxpayers' public policy or equity OIC.

Collection Proceedings

James Loveland, Jr. and Tina C. Loveland v. Comm'r, **151 TC No. 7 (Sep. 25, 2018)**
IRC §§6159, 6320, 6330, and 7122

☞ IRS Abused its Discretion During Collection Proceedings

Facts. James and Tina Loveland are a retired married couple. Mr. Loveland became disabled as a result of a heart condition and had to leave the workforce, and Mrs. Loveland survived breast cancer. The Lovelands lost their home to foreclosure and then stopped paying their taxes, resulting in outstanding tax liabilities for 2011–2014 totaling over $60,000.

In 2015, after receipt of an IRS notice of intent to levy, the Lovelands entered into negotiations with a collections officer. During those negotiations, the Lovelands made an offer in compromise (OIC) and informed the IRS of their health problems and the recent bank foreclosure on their home. The OIC was rejected by the collections officer. After appealing the decision, the Lovelands were told that an installment agreement (IA) could not be considered unless they withdrew their appeal of the OIC, which they agreed to do.

The Lovelands agreed to make monthly voluntary payments of $800 and subsequently made at least two $800 payments. However, while working on the IA with the collections officer, they were also negotiating a loan on a property they owned so they could make an $11,500 payment to bring their tax owed below $50,000, qualifying them for streamlined processing of their IA. On October 21, 2016, they submitted their loan application. The IRS filed a lien on the property on the same day. Consequently, the Lovelands were unable to secure the loan and the IA negotiations terminated.

58. Treas. Reg. §301.7122-1(b)(3)(ii).

59. Ibid.

In response to the IRS notice of federal tax lien filing on October 25, 2016, the Lovelands timely requested an appeals office hearing under IRC §6320, requesting release of the lien on the basis that it disrupted a mortgage refinance and was causing economic hardship. In response, an appeals officer sent the Lovelands a letter scheduling a hearing for March 2, 2017, and informing them that they would need to submit Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals,* with supporting documents before a collection alternative would be considered. Mr. Loveland responded requesting reconsideration of the OIC information he had provided earlier and reminding the IRS of their health problems and economic hardship.

The appeals officer declined to review both the OIC and the proposed $800 per month IA, concluding that the OIC was not properly appealed and the necessary financial information for the proposed IA had not been received. Instead, the appeals officer proposed an 84-month IA at $853 per month to fully discharge the liability.

On March 2, 2017, an appeals conference took place by telephone. Mr. Loveland explained that he had not appealed the IRS rejection of his OIC because he had hoped to work out an IA. Moreover, he had been working to secure a loan against their property but the IRS filing of the notice of federal tax lien had halted the loan application. The appeals officer rejected the Lovelands' proposed $800-per-month IA and evidently did not consider the financial information that they had provided.

The appeals officer closed the Lovelands' appeal on April 7, 2017, and notified the Lovelands of this decision, while informing them of their right to appeal the decision to the Tax Court. The notice stated that the appeals officer did not consider the Lovelands' proposed IA because they did not provide any financial information. There is no evidence that the appeals officer considered Mr. Loveland's medical condition or the effect of his disability on the Lovelands' ability to pay the tax liability.

The Lovelands petitioned the Tax Court on May 11, 2017, requesting a redetermination of the decision to sustain the lien because it caused economic hardship, their due process rights were violated, and their special circumstances were not considered.

Issues. The issues in this case are whether the IRS abused its discretion by failing to consider the Lovelands' proposed OIC, proposed IA, and claim of economic hardship.

Analysis. The court observed that when the underlying liability is not at issue, it must review the IRS's collection determination for abuse of discretion. Generally, the IRS's collection determination must consider all of the following.[60]

1. Verification that the requirements of applicable law and administrative procedure have been met
2. Issues raised by the taxpayer
3. Whether any proposed collection action balances the need for efficient tax collection with the legitimate concern of the taxpayer that any collection action be no more intrusive than necessary

The IRS has the discretionary authority to enter into written agreements with any taxpayer.[61] In such case, the taxpayer is allowed to pay any tax in installments if the IRS determines that such an agreement will facilitate full or partial collection of the liability. However, the IRS also has the discretion to accept or reject an IA proposed by a taxpayer.

According to the facts, the IRS requested that the Lovelands provide a completed Form 433-A to have their proposed IA considered. The Lovelands provided a completed Form 433-A with their OIC request. The stated reason for the IRS's rejection of the Lovelands' proposed IA was that they did not provide financial information. However, they did. Therefore, the court determined that the IRS abused its discretion in failing to consider that information.

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60. IRC §§6320(c) and 6330(c)(3); *Lunsford v. Comm'r*, 117 TC 183, 184 (2001).

61. IRC §6159(a).

The court noted that throughout their negotiations with the IRS and during the court proceedings, the Lovelands argued that their poor health affects their ability to pay and that collection of the full liability would cause them economic hardship. While the IRS noted the Lovelands' economic hardship argument in the administrative record and the notice of determination, there is no evidence that the IRS evaluated this claim. It is an abuse of discretion for the IRS to neglect to consider all the issues raised by a taxpayer.[62]

Holding. The court held that based on the administrative record, the IRS abused its discretion when refusing to consider the Lovelands' OIC and IA. Furthermore, the IRS abused its discretion in refusing to consider whether full payment of the liability would cause the Lovelands economic hardship. Consequently, the court remanded the case to the IRS appeals office for further consideration consistent with the court's opinion.

Field Examinations

TIGTA Report No. 2018-30-073 (Sep. 17, 2018)
IRC §7602

☞ TIGTA Review of IRS Field Examinations

Purpose. IRS field examination policy is that field examiners are not restricted to covering only the single tax period that initiated the examination but should also consider all open tax periods. When field examiners do not consider expansion of the examination, there is a risk of revenue loss if noncompliance similar to that identified in the examination year exists in other open tax periods.

The Treasury Inspector General for Tax Administration (TIGTA) review of IRS field examinations was conducted to determine the extent to which field examiners considered extending their audit to other open tax periods.

Background. In fiscal year 2017, the IRS examined 1.06 million tax returns. Of these tax returns, 309,062 (29%) were field examinations and 750,862 (71%) were correspondence examinations. These examinations resulted in approximately $24 billion in recommended additional tax assessments.

Analysis. TIGTA reviewed 103 field examination case files and determined that 34 of them (33%) were not adequately expanded. When projected to the population, TIGTA estimated that the IRS could have examined 18,860 prior and/or subsequent year tax returns, which could have yielded approximately $246 million in further revenue to the government.

For the 34 field examination case files inadequately expanded, TIGTA determined that this was because of the following reasons.

The IRS field agent determined that there was insufficient time until the expiration of the statute of limitations.	13 cases
The field examiner documented that there were no large, unusual, or questionable (LUQ) items but TIGTA determined that LUQ items were present.	13 cases
The field examiner documented compliance issues in the case histories but did not appropriately follow up on the issues.	8 cases

Furthermore, TIGTA observed during their review of all 103 cases that IRS field examiners did not adequately document case files during examinations. These inadequacies included not always documenting the reasons for not expanding and not always retaining the examination request form in the case file when expanding the reviews to prior and/or subsequent years.

62. IRC §§6320(c) and 6330(c)(3).

Recommendations. Following their review, TIGTA made the following recommendations.

1. The IRS should update the Internal Revenue Manual (IRM) with additional guidance on when it is appropriate to expand an examination even though the statute of limitations on assessment expires in less than 12 months.

   The IRS agreed with this recommendation and will update the IRM to clarify examination cycle exceptions and when it is appropriate to start an audit with less than 12 months remaining on the statute of limitations on assessment.

2. The IRS should provide additional training to field examiners on when to expand examinations. This training should include appropriate requirements regarding documenting adequate explanations for not expanding and retaining appropriate approval documentation.

   The IRS agreed with this recommendation and will create a training presentation for field examination managers and examiners that emphasizes proper documentation of required filing checks. The training will explain related IRM updates clarifying examination cycle exceptions and when it is appropriate to start an audit with less than 12 months remaining on the assessment statute of limitations.

3. The IRM should be updated with guidance on when field examiners should conduct a more detailed comparative analysis on multiple years' tax returns.

   The IRS partially agreed with this recommendation. Management will update the IRM to clarify when field examiners may need to conduct a detailed comparative analysis for individual nonbusiness returns.

4. The IRS should provide additional training to field examiners to ensure that files include an adequate explanation for not expanding examinations.

   The IRS agreed with this recommendation and will create a training presentation for managers and examiners that emphasizes proper documentation. It will also explain IRM updates clarifying examination cycle exceptions and when it is appropriate to start an audit with less than 12 months remaining on the statute of limitations.

5. The IRS should update the IRM to require that forms include the manager's signature. In addition, field examiners should be reminded of the need to retain proper forms in the case files of all years examined.

   The IRS partially agreed with this recommendation. It will publish an article reminding field examiners and managers of the need to retain proper forms in the case file.

Validity of Tax Assessment and Levy

***Ronald E. Davis v. Comm'r,* TC Memo 2018-197 (Dec. 3, 2018)**

IRC §§6020, 6320, and 6330

☞ IRS Tax Assessment Was Proper; Levy Sustained

Facts. Ronald Davis did not file tax returns for tax years 1998 through 2012, the tax year at issue. Due to Mr. Davis's failure to file his 2012 tax return, the IRS prepared a substitute for return (SFR).[63] On April 6, 2015, it mailed a notice of deficiency based on the SFR to Mr. Davis's last known address in Bucyrus, Kansas.

63. See IRC §6020(b).

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Subsequently, the notice of deficiency was returned to the IRS by the U.S. Postal Service because it was undeliverable. After waiting the appropriate amount of time after the notice of deficiency, the IRS timely assessed the 2012 tax deficiency on August 31, 2015.

In December 2015, the IRS updated their records with Mr. Davis's current mailing address in Mission, Kansas (Mission address). Then, on December 26, 2015, the IRS mailed to Mr. Davis at his Mission address a notice of intent to levy to collect the unpaid 2012 liability.

On January 19, 2016, Mr. Davis sent a timely Form 12153, *Request for a Collection Due Process or Equivalent Hearing,* to the IRS appeals office disagreeing with the proposed levy on the basis that he had filed a timely return and paid "all or part" of his taxes.

Valerie Chavez of the IRS appeals office confirmed that the 2012 tax liability was properly assessed but offered audit reconsideration and a face-to-face hearing if Mr. Davis would provide his 2012 tax return and other relevant documents for consideration. Despite being offered several opportunities to comply, Mr. Davis failed to do so. Consequently, the appeals office issued a Notice of Determination Concerning Collection Action(s) sustaining the levy action.[64]

Mr. Davis timely petitioned the court on August 8, 2016, contending that:

1. The tax assessment underlying the collection action was invalid because the IRS failed to send the notice of deficiency to his last known address,
2. He was denied a face-to-face hearing with the IRS, and
3. He filed the 2012 tax return and paid "all or part" of the tax.

Issues. The issues in this case are as follows.

- Whether the IRS's 2012 tax assessment is valid even though it was not sent to the taxpayer's last known address
- Whether the IRS appeals office abused its discretion in sustaining the proposed levy

Analysis. Regarding Mr. Davis's first contention, the court determined that at the time the notice of deficiency was issued, Mr. Davis had failed to notify the IRS of his Mission address in a clear and concise manner. Therefore, the IRS was correct in sending the notice to Mr. Davis in Bucyrus, Kansas (his last known address), and this constituted a valid notice of deficiency that properly assessed the 2012 tax liability.

In response to Mr. Davis's assertion that the IRS appeals office abused its discretion in denying his request for a face-to-face hearing, the court noted that such hearing "may, but is not required to, consist of a face-to-face meeting."[65] Furthermore, Mr. Davis was offered a face-to-face hearing if he filed his 2012 tax return, but he failed to comply. Therefore, the court found no abuse of discretion in Ms. Chavez's refusal to grant Mr. Davis a face-to-face hearing.

Because Mr. Davis provided no credible evidence that he filed his 2012 tax return or made any tax payments with respect thereto, the court agreed with the IRS appeals office's determination that he failed to file a 2012 tax return.

Holding. The court held that the 2012 assessment was valid and that the IRS did not abuse its discretion. Accordingly, the court determined that the IRS could proceed with collection of the 2012 tax assessment by levy.

64. See IRC §§6320 and 6330.

65. Treas. Reg. §301.6330-1(d)(2).

IRS PROCEDURES — PENALTIES

Trust Fund Recovery Penalties

***Randy Green v. U.S.*, No. 2:17-cv-00433; U.S. District Court for the District of Arizona (Mar. 11, 2019)**
IRC §6672

☞ Owner of Related Companies is a Responsible Person for Unpaid Payroll Liabilities

Facts. Randy Green and Joseph Guerra were each 50% owners in both Consolidated Group Services, LLC (CGS) and Consolidated Group Services, SA, LLC (SA). Both companies supplied temporary staffing services within the construction industry. The two companies were virtually indistinguishable. They shared an address, ownership, and management. The companies had separate bank accounts, but funds were often transferred between the accounts. CGS provided services in Arizona, while SA provided services in other states.

Mr. Green was the "president" of both companies. There were no corporate officers because the companies were not corporations, but Mr. Green was the "face" of the company. There was no formal discussion of Mr. Green and Mr. Guerra's roles within the companies, but generally Mr. Green provided sales services and Mr. Guerra managed operations. Mr. Guerra was responsible for the accounting and tax departments despite not having any formal education in the fields. Mr. Green was aware of the financial position of the companies, such as billing, the expenses paid, and the balances in the bank accounts. He shared check-writing responsibilities with Mr. Guerra.

CGS filed a Form 941, *Employer's Quarterly Federal Tax Return,* for the first quarter of 2013 that reported a balance due of $244,809. Mr. Guerra informed Mr. Green in April 2013 that CGS was not making necessary payroll or tax payments. According to Mr. Green, this was the first time he was aware there was an IRS issue and Mr. Guerra was not making required payments. On April 23, 2013, Mr. Green left a message with the IRS requesting information on the tax issue and how to get current with their payments. The IRS did not return the call.

Mr. Green continued to discuss the IRS issues with Mr. Guerra. He believed that Mr. Guerra was fully aware of the payroll tax issue and that Mr. Guerra hired an accountant to take care of it. Mr. Green continued to charge expenses and pay non-IRS creditors. He never asked if SA had similar tax issues.

On August 20, 2013, Valerie Pichette, an IRS Revenue Officer, met with Mr. Green and Mr. Guerra. Mr. Green believed that this meeting was required to get an installment agreement (IA) approved for the payroll issues in 2012 and 2013. Ms. Pichette informed Mr. Green and Mr. Guerra that the IRS would assess a trust fund recovery penalty (TFRP) against them for the unpaid federal payroll taxes withheld from employees but not paid to the IRS. Mr. Green signed a Form 4180, *Report of Interview with Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes,* stating that Mr. Guerra maintained the access to the electronic federal tax payments system. The form also stated that Mr. Green was aware the withheld taxes were not paid, had joint responsibility for electronic filing, authorized financial payments along with Mr. Guerra, and knew the payroll tax issues were a serious problem. However, Mr. Green continued to take a salary of $125,000, take an auto allowance, and make payments to non-IRS creditors.

Ms. Pichette sent Mr. Green a letter on September 30, 2013, informing him that the IRS considered him a personally liable person responsible for the payroll taxes. On January 13, 2014, the IRS assessed the TFRP against Mr. Green. Mr. Guerra worked with the IRS on an IA that was approved in either October or December 2013. At the time of the IA, CGS owed $336,640, to be paid over 24 months. CGS made four timely payments and the fifth payment was dishonored.

Mr. Green did not do anything after the initial meeting with Ms. Pichette because he believed the meeting addressed the problem and CGS was going to make the necessary payments. Mr. Green consulted with Mr. Guerra periodically to make sure installment plans were being made. According to Mr. Green, CGS made payments until they hired a tax attorney who could secure better payment terms for the company.

On August 12, 2014, the IRS sent a letter to Mr. Green informing him of a meeting to discuss his liability for SA's unpaid trust fund taxes. This was the first time Mr. Green was aware SA had unpaid taxes. On January 31, 2013, the IRS assessed a TFRP against Green for $122,768. Mr. Green made partial payments on both CGS's and SA's payroll tax obligations. In February 2017, he sued the United States for a refund of $1,000 related to each of the third and fourth quarter payroll liabilities. The United States countersued against Mr. Green and Mr. Guerra, asserting that Mr. Green owed unpaid trust fund taxes of $468 for CGS and $267,319 for SA. Mr. Guerra did not respond to the action and was assessed a default judgment for the unpaid trust fund taxes.

Issues. The issues in this case are the following.

- Whether Mr. Green is a responsible person for the unpaid trust fund taxes for CGS and SA
- Whether Mr. Green acted willfully in not paying the withheld taxes for CGS and SA

Analysis. A responsible person has the authority to exercise significant control over a company's financial position. Courts consider several factors in evaluating responsibility, including whether the person has the authority to hire and fire staff, sign checks, and access bank accounts, even if the person does not actually exercise the authority. Mr. Green was a 50% owner and performed all of those functions of a responsible person. He signed the Form 4180, stating that he had financial responsibilities for CGS and personally called the IRS regarding the taxes. Because CGS and SA were virtually identical, the court determined that Mr. Green was a responsible party for both companies.

The court considered whether Mr. Green acted willfully in failing to pay the taxes. Willfulness under IRC §6672 is shown through "voluntary, conscious, and intentional act[s] to prefer other creditors over the United States." A responsible person who should have known that there was a possibility that the taxes were not being paid and was in a position to find out if they were being paid is acting with reckless disregard. Mr. Green unquestionably knew of the unpaid CGS liability in April 2013. After that date, he continued to pay himself and other non-IRS creditors. Mr. Green does not contest that he acted willfully.

Mr. Green continued to make payments to himself and other non-IRS creditors out of SA's account after its fourth quarter 2013 return was filed reflecting payment due of $347,104. However, Mr. Green was not informed of the delinquency until August 2014 when the IRS sent a letter. The United States argued that Mr. Green should have asked Mr. Guerra about SA's liability after learning that CGS was delinquent because the companies were so intertwined. Mr. Green did not ask Mr. Guerra about SA and the court determined that he acted willfully with regard to SA's liability.

Holding. The court held that Mr. Green was a responsible person for both CGS's and SA's unpaid trust fund taxes. He acted willfully with regard to both companies by continuing to pay non-IRS creditors after he knew, or should have known, about the delinquencies.

Penalties
Rev. Proc. 2019-9, 2019-2 IRB 292 (Dec. 20, 2018)
IRC §§6662(d) and 6694

☞ Adequate Disclosure Can Reduce Certain Penalties

Purpose. Rev. Proc. 2019-9 updates Rev. Proc. 2018-11 guidance on whether certain disclosures on income tax returns are sufficient to reduce the understatement of income tax penalty under IRC §6662(d) and the preparer penalty under IRC §6694(a).

Analysis. IRC §6662 adds a 20% penalty on any substantial underpayment of tax (40% for certain underpayments). A substantial underpayment for individuals exists if the understatement exceeds the greater of 10% of the tax on the return or $5,000. A substantial underpayment for corporations, excluding S corporations and personal holding companies, exists if the underpayment exceeds the lesser of 10% of the tax on the return or $10 million.

A taxpayer with a reasonable basis for the tax treatment of a non-tax shelter item on the return can reduce understatement penalties by adequately disclosing relevant facts on the return or on an attached statement.

A preparer is subject to a penalty for taking an unreasonable position if the preparer knew or reasonably should have known of the unreasonable position. A position is considered unreasonable unless there is substantial authority for the position or the position was adequately disclosed and had a reasonable basis. Items related to a tax shelter are unreasonable unless the position would more likely than not be sustained on its merits.

A taxpayer must provide all the required information identified in the forms and instructions. The amounts reported on tax forms must be verifiable. An amount is verifiable if the taxpayer can provide the source of the amount and they used good faith when entering the amount. A taxpayer can substantiate an amount by keeping adequate books and records.

Disclosure can be made on Form 8275, *Disclosure Statement,* or Form 8275-R, *Regulation Disclosure Statement.* Schedule UTP, *Uncertain Tax Position Statement,* can be substituted for Form 8275 or 8275-R. The revenue procedure lists items on Schedule A, *Itemized Deductions,* certain trade or business expenses, differences in book and income tax reporting, foreign tax items, and other items, which through clear and proper disclosure on a tax return, could reduce penalties.

Effective Date. The revenue procedure is effective for income tax returns filed on a 2018 tax form. This includes tax years beginning in 2018 and short years beginning in 2019.

Trust Fund Taxes

***Robert L. McClendon v. U.S.*, No. 4:15-cv-02664; U.S. District Court for the Southern District of Texas (Jan. 22, 2019)**
IRC §6672

☞ Court Determines that CFO is Responsible Person for $4.3 Million in Trust Fund Taxes

Facts. In 1979, Dr. Robert McClendon founded Family Practice Associates of Houston (FPA), a professional medical association. Richard Stephen, Jr. was the chief financial officer (CFO) of FPA from 1995 to 2009. Mr. Stephen ran FPA's operations, managed its finances, controlled its bank accounts, prepared and filed its payroll tax returns, paid its creditors and determined the order of payment, and was authorized to hire and fire employees.

FPA started accumulating tax debt in 2003, and, by 2009, it owed over $11 million in employee payroll taxes. Mr. Stephen knew of FPA's failure to make federal tax deposits. However, from 2003 to 2009, he paid FPA's other creditors after learning of the tax debt.

In 2011, the IRS assessed $4.3 million in trust fund recovery penalties against Mr. Stephen, alleging that he was liable for FPA's failure to pay federal payroll taxes from July 2003 to December 2008. The government also assessed penalties against Dr. McClendon, who paid a nominal portion of the assessment but then sued the government for a refund of the amount paid and an abatement of the penalties. The government counterclaimed against Dr. McClendon and Mr. Stephen to recover the assessments.

The government moved for summary judgment on the counterclaim against Mr. Stephen, arguing that he is liable under IRC §6672 to pay trust fund recovery penalties because he was a "responsible person" who willfully failed to deposit FPA's payroll taxes.

Issue. The issue is whether Mr. Stephen was a responsible person with respect to FPA's payroll taxes and is therefore indebted to the government for the unpaid taxes.

Analysis. Businesses are required to withhold federal payroll taxes from employees' earnings.[66] Employers hold such funds "in trust" for the government.[67] These funds are for the exclusive use of the government and cannot be used to cover operational or business expenses.[68]

IRC §6672 states:

> *Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.*

IRC §6672 penalizes **responsible persons** who **willfully** fail to pay withheld taxes. Responsibility is determined by looking at one's duty and authority to withhold and pay taxes for the business. Indicators of responsible-person status include whether the person:

1. Is an officer or member of the board of directors,
2. Owns a substantial amount of stock in the company,
3. Manages the day-to-day operations of the business,
4. Has the authority to hire or fire employees,
5. Makes decisions about the disbursement of funds and payment of creditors, and
6. Possesses the authority to sign company checks.[69]

The government contends Mr. Stephen is a responsible person because he was FPA's CFO during the period at issue. He was the company's authorized check signer and was responsible for preparing and filing corporate tax returns.

The evidence confirmed that Mr. Stephen met five of the factors indicating responsible-person status from July 2003 to December 2008. In deposition testimony and other records, he conceded that he was FPA's CFO, managed the company's affairs, had the authority to hire and fire employees, paid creditors and determined the order of payment, was an authorized signer on FPA's accounts, and was responsible for payroll and filing corporate tax returns. Mr. Stephen admitted that he determined FPA's financial policy and was aware of the company's failure to pay the tax obligations. The court observed that these facts show that Mr. Stephen was a responsible person during the period at issue.

To establish liability under §6672, the responsible person's failure to pay taxes must be willful. The government contended that Mr. Stephen's failure to pay was willful because he knew of the duty to withhold, account for, and deposit the payroll taxes. Nonetheless, he signed checks to pay FPA's other creditors after learning of the company's unpaid tax debt.

Mr. Stephen did not submit evidence disputing that he willfully failed to pay the taxes. Instead of rebutting the government's argument, he did not respond.

Holding. The court determined that Mr. Stephen was a responsible person who willfully failed to pay FPA's payroll taxes from July 2003 to October 2008. Accordingly, he owes the government $4.3 million, plus interest.

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66. IRC §§3102(a) and 3402(a).

67. IRC §7501(a).

68. *Verret v. U.S.,* 542 F.Supp.2d 526, 533 (E.D. Tex. 2008).

69. *Barnett v. IRS*, 988 F.2d 1449, 1455 (5th Cir. 1993).

***Marshall O. Lowery v. U.S.*, No. 3:16-CV-701-DCK; U.S. District Court for the Western District of North Carolina (Sep. 26, 2018)**

IRC §§6694 and 7422

☞ Tax Preparer Not Liable for Penalties on Returns He Did Not Sign

Facts. In 2009 and 2010, Marshall Lowery was the sole member of Computer Plus, LLC, d/b/a Rapid Tax (Computer Plus). During those years, Computer Plus provided paid tax preparation services to its clients. Mr. Lowery as well as other employees and independent franchisees of Computer Plus provided these services.

In August 2014, the IRS assessed $170,000 in tax preparer penalties against Mr. Lowery pertaining to 34 tax returns. These preparer penalties were assessed under IRC §6694(b) for willful or reckless conduct.

Mr. Lowery appealed the $170,000 assessment. Around January 26, 2016, the IRS reduced the assessment to $77,500 ($5,000 each for six returns prepared by Mr. Lowery and $2,500 each for 19 returns prepared by independent franchisees or employees of Computer Plus).

On May 29, 2018, the parties filed a "joint stipulation," which stated that the combined IRS penalty assessments for 2009 and 2010 on Mr. Lowery totaled $77,500. Both parties agreed that as of May 24, 2018, Mr. Lowery had paid $67,375 towards this assessment. The IRS sought summary judgment of the balance of the assessment, which was computed to be $11,416, plus statutory interest. Mr. Lowery sought a refund of the $67,375 paid, plus any additional amounts paid through statutory offsets and statutory overpayment interest.

Issue. The issue to be decided is whether Mr. Lowery is liable for return preparer penalties on 25 returns.

Analysis. A **tax return preparer** is "any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title or any claim for refund of tax imposed by this title."[70] An individual is a tax return preparer, subject to §6694 preparer penalties, if the individual is primarily responsible for the position(s) on the return or claim for refund giving rise to an understatement.[71]

If there is no signing tax return preparer or that person is not primarily responsible for the position, the nonsigning tax return preparer within the firm with overall supervisory responsibility for the position(s) giving rise to the understatement generally is considered the return preparer for purposes of §6694.

Mr. Lowery contended that for each of the 19 tax returns signed by other preparers, the IRS was required to determine if he signed the tax return as preparer or whether some other preparer signed the return. In this regard, Mr. Lowery noted that the IRS admitted in deposition testimony that they found no evidence that Mr. Lowery signed or prepared any part of these returns. Even if it is determined that Mr. Lowery had a role in the preparation of these returns, Mr. Lowery argued that there is no evidence that he disregarded any information provided to him, or intentionally or recklessly disregarded any rule or regulation.

For the six tax returns that he signed, Mr. Lowery argued that the IRS cannot show that he disregarded information given to him or that the understatement of tax liability was willful or reckless. Moreover, he further noted that the IRS alleged willfulness but failed to meet its burden of showing that he disregarded information furnished by the taxpayers or other persons in an attempt to wrongfully reduce the taxpayers' liabilities.[72]

70. IRC §7701(a)(36); *U.S. v. Heggins*, 240 F.Supp.3d 399, 405 (W.D.N.C. 2017).

71. Treas. Reg. §301.7701-15(b)(3).

72. Treas. Reg. §1.6694-3(b).

In its opposition brief, the IRS focused on the following reasons it believed that Mr. Lowery's motion was defective.

1. Mr. Lowery's motion is unsupported by admissible evidence and the only question before the court is whether Mr. Lowery and his employees willfully, or with an intentional or reckless disregard of the applicable rules and regulations, understated the taxpayers' liabilities for the 25 returns at issue.

2. Mr. Lowery is a **return preparer** as an employer, because he is the sole member of Computer Plus, which employed the return preparers who prepared the returns.

3. Mr. Lowery fits the statutory definition of a **return preparer** and is liable for understatements of tax liability on the returns at issue if they were the result of willful, intentional, or reckless disregard of the applicable regulations.

4. The IRS acknowledges its burden of proving that the understatement was willful but contends that Mr. Lowery must prove the understatement was not the result of reckless or intentional disregard of the applicable rules or regulations.

After this initial briefing, the court noted that it did not appear that the IRS had presented legal authority supporting a finding that Mr. Lowery was vicariously liable for the actions of his alleged employees. However, the court nevertheless allowed both parties an opportunity to file supplemental briefs.

Following the supplementary briefs, the court noted the following.

1. The IRS admitted that Mr. Lowery did not sign these returns.

2. The IRS did nothing to determine that the signing preparer was not primarily responsible for these returns.

3. There is no evidence that Mr. Lowery prepared any part of the 19 returns signed by other preparers.

Therefore, the court asked the IRS to identify authority that might support finding a tax return preparer liable when he had little, if any, involvement in the actual return preparation. In response, the IRS cited the *Bui* and *Schneider* cases.[73] The court accepted that both *Bui* and *Schneider* support a finding that the employer can meet the statutory definition of **tax return preparer** but noted that both cases base liability for penalties on the fact that the employer was **also** the signer of the return.

Holding. The court held that Mr. Lowery was not liable for preparer penalties on the 19 returns that were signed by other preparers. For the six returns that Mr. Lowery signed as preparer, the court found that if Mr. Lowery and the IRS were unable to resolve the matter, the issue of whether Mr. Lowery acted willfully or recklessly should be decided by a jury.

73. *Bui v. U.S.*, 2001 WL 1244754 (W.D. Wash. 2001); *Schneider v. U.S.*, 257 F.Supp.2d 1154, 1160 (S.D. Ind. 2003).

NET OPERATING LOSS

Irrevocable Election to Waive NOL Carryback

Javon and Vita Bea v. Comm'r, **U.S. Court of Appeals, 11th Circuit; No. 18-10511 (Jan. 31, 2019)**
IRC §172

☞ **Couple Cannot Revoke Election to Waive NOL Carryback Made by Tax Preparer**

Facts. Javon and Vita Bea hired Jo Ann Schoen, an enrolled agent, to prepare their individual and business tax returns starting in1987 and continuing through 2011–2014 (the years at issue). Ms. Schoen prepared Forms 1065, *U.S. Return of Partnership Income,* for the Beas' investment company, Oronoco Investments, LLC, in addition to their Forms 1040, *U.S. Individual Income Tax Return.*

The Beas own Oronoco Investments, LLC, which is an investment company organized as a partnership. In 2013, the Form 1065 reflected a loss, although later Ms. Schoen revised the Form 1065 to correct the amount of losses attributable to the couple on their respective Schedules K-1, *Partner's Share of Income, Deductions, Credits, etc.* However, Ms. Schoen neglected to update their Form 1040 with the revised Schedule K-1 loss amounts. Consequently, the couple's 2013 income tax return reflected an overstated net operating loss (NOL) of $4.7 million. This NOL was then carried back to 2011 and 2012, generating tax refunds for those years.

In 2014, Oronoco reported a $12 million loss that was appropriately reported on the Beas' individual return. Ms. Schoen elected to waive the carryback period for the 2014 NOL, allegedly without consulting the Beas because she believed that the 2011 and 2012 liabilities were sufficiently eliminated by the 2013 NOL carryback. In 2017, the IRS issued a notice of deficiency that included deficiencies for 2011 and 2012 based on errors discovered on their 2013 tax return. The Beas attempted to carry back their 2014 NOL to offset the 2012 liability but were barred from doing so because the IRC §172(b)(3) election made on their 2014 tax return to waive the NOL carryback was irrevocable.

The Beas took their case to Tax Court. In addition to the facts of the case, they included "additional material facts" to support their ignorance of the election. The Tax Court held that the additional material facts were irrelevant and immaterial and that the Beas were liable for a $685,703 deficiency in their 2012 taxes. The Beas appealed.

Issues. The issues in this case are the following.

- Whether the Beas can carry back their 2014 NOL because the irrevocable §172(b)(3) election was made without their knowledge
- Whether the additional material facts are relevant to the case

Analysis. Taxpayers are generally eligible to deduct the sum of any NOL carryovers and carrybacks to offset taxable income. During the years at issue, an NOL can be carried back to the two immediately preceding tax years with the remainder carrying forward for 20 years. A taxpayer may elect under §172(b)(3) to waive the 2-year carryback and only carry the NOL forward. The election is made by attaching a statement to the return for the year in question. The statement should declare the election is made under §172(b)(3) and contain information about the election, including the years it applies and the taxpayer's basis for making the election. The election is irrevocable.

Ms. Schoen followed all the required steps to make the election on the Beas' 2014 return. The Beas signed and filed the return, which indicated that they thoroughly reviewed the return, including the irrevocable election. They argue that they did not know or understand the implications of the election, but they did not ask Ms. Schoen for an explanation. The Tax Court held that despite not knowing or understanding the election they made, the Beas could not refute the unambiguous language of the election. The additional material facts were immaterial because there is no ambiguity in the Code or regulations that a taxpayer's knowledge of the election impacts its revocability.

Holding. The Court of Appeals affirmed the decision of the Tax Court. The Beas could not carry back their 2014 NOL because of the irrevocable election filed with the original return, and the additional material facts were irrelevant.

NOT FOR PROFIT

Hobby Income
***Edward Kurdziel, Jr. v. Comm'r,* TC Memo 2019-20 (Mar. 21, 2019)**
IRC §§183 and 6751

☞ Taxpayer's One-of-a Kind Airplane Activity Deemed Not-For-Profit

Facts. Edward Kurdziel was an experienced pilot with over 45 years of flying experience. He was also a highly skilled mechanical engineer. In 1994, Mr. Kurdziel purchased a World War II fighter aircraft known as the Fairley Firefly. The plane had not flown for decades and was located in Australia. He borrowed against his house and paid $200,000 for the Firefly, plus an additional $60,000 in shipping costs. Mr. Kurdziel planned to sell rides on the plane. He investigated the cost to restore and maintain the plane and insurance to cover people flying the plane.

It took eight years and 45,000 man hours, with up to 10 full-time employees, to restore the Firefly. It was a full-time job, and Mr. Kurdziel had to design many of the replacement parts because there were no spare parts available for purchase.

In 2002, the Firefly earned an "air worthiness certificate" and Mr. Kurdziel obtained a license to fly the plane. He continues to be the only person with this specific license.

To fly in military airshows, Mr. Kurdziel became a government contractor. The Firefly began winning prizes at air shows but did not earn much money. The income did not cover Mr. Kurdziel's out-of-pocket expenses. Federal Aviation Administration regulations deemed that his initial plan to sell rides was illegal.

Starting with his 2005 return, Mr. Kurdziel reported Firefly's income and expenses on his Schedule C, *Profit or Loss From Business,* as "airplane leasing." However, Mr. Kurdziel never leased out the Firefly. He listed the Firefly on his return with an adjusted basis of $1.6 million and claimed first-year depreciation of nearly $82,000. On his 2005 return, Mr. Kurdziel reported Firefly expenses of $129,230 and a business loss of $115,280. Returns filed in subsequent years reflected a similar depreciation and expense pattern. Mr. Kurdziel did not have a formal business plan, keep books and records for the Firefly activities, or maintain a separate business bank account. In 2012, the Firefly crashed while landing in an airshow. Mr. Kurdziel continued to work on repairing the plane following the crash.

The IRS issued a notice of deficiency for 2007 through 2009. It disallowed the Schedules C and net operating losses (NOL) and issued a 20% IRC §6662(a) penalty. A second notice of deficiency disallowed the Schedules C and NOLs in addition to various other adjustments and added another §6662(a) penalty.

At trial, Mr. Kurdziel testified that the Firefly was an investment and essentially was his retirement because he lost his pension when his former employer declared bankruptcy. The IRS argued that the value of the plane was significantly reduced after the crash in 2012, making it unlikely to generate a capital gain. Various expert witnesses testified that the value of the Firefly ranged between $3.5 million and $8 million.

Issues. The issues in this case are the following.

- Whether Mr. Kurdziel had a profit motive with the Firefly during 2007 through 2010
- Whether Mr. Kurdziel substantiated his Schedule C and Schedule A expenses for 2010
- Whether Mr. Kurdziel is entitled to NOL deductions for 2007 through 2010
- Whether Mr. Kurdziel is liable for accuracy-related penalties for 2007 through 2010

Analysis. To determine whether Mr. Kurdziel had a profit motive, the court looked at the 9-factor test provided in Treas. Reg. §1.183-2(a).

1. **Whether Mr. Kurdziel conducted the Firefly activity in a "businesslike manner."** The absence of books and records, a business plan, and separate bank accounts led the court to conclude that the Firefly activity was not conducted like a business. This was also supported by the fact that Mr. Kurdziel did not alter his plans after learning it was illegal to sell plane rides. Looking at the facts and circumstances, the court did not believe that Mr. Kurdziel intended to sell the Firefly. This factor weighed against Mr. Kurdziel.

2. **Mr. Kurdziel's expertise in restoring the plane.** Mr. Kurdziel obviously had tremendous expertise given his 45 years of experience and ability to make replacement parts to restore the Firefly, but he failed to conduct basic business inquiries. Because he did not know that it was illegal to sell rides in the Firefly, this led the court to believe Mr. Kurdziel was more of a hobbyist than a businessman.

3. **The time and effort that Mr. Kurdziel spent on the Firefly.** He spent significant hours restoring and maintaining the plane, training, and traveling to airshows. However, the court believed that Mr. Kurdziel enjoyed substantial personal satisfaction from flying the Firefly. Additionally, he remained a full-time employee of Delta during the period in question. The court determined this was a neutral factor.

4. **Whether Mr. Kurdziel had success in similar activities.** Mr. Kurdziel contended that his profits in buying and selling real estate in California was proof of his successes. The court disagreed that real estate and airplane restorations were similar activities. This factor favored the IRS.

5. **The history of Firefly-related losses.** The losses continued for more years than the court thought they should have and were continuing to increase. The court asserted that if Mr. Kurdziel was interested in making a profit, he would have sold or attempted to sell the Firefly soon after winning its most prestigious award or after he learned he could not monetize rides in the plane. This factor favored the IRS.

6. **Amount of occasional profits, if any.** This factor weighed in favor of the IRS. Any Firefly profits were occasional and not large enough to cover even insurance costs. There was no evidence that Firefly would ever become profitable.

7. **Mr. Kurdziel's financial status.** This factor looked at Mr. Kurdziel's financial status to determine if the Firefly activities were his main source of income. The court determined that because he received retirement pay from the U.S. Navy and an average annual salary of over $180,000 from Delta, he did not use the Firefly as a source of income.

8. **Whether Mr. Kurdziel gained personal pleasure or recreation from the Firefly.** The court sided with the IRS that the Firefly's success brought Mr. Kurdziel fame and he felt great satisfaction in flying the plane, showing off the restoration, and being the lone individual qualified to fly it in the country.

9. **Whether Mr. Kurdziel had an expectation that he would be able to sell the Firefly for a profit and cover his accumulated losses.** Despite the crash in 2012 and the Firefly subsequently being grounded for four years, experts put the value of the plane during the years in question at between $3.5 million and $8 million. Mr. Kurdziel testified that he flew in the airshows to increase the Firefly's value. Accordingly, the court determined that Mr. Kurdziel did have an expectation the plane would appreciate in value.

After analyzing all the factors, the court was not convinced that Mr. Kurdziel had a good-faith plan to sell the Firefly and realize a profit. He did not have a clear business plan, he reported the Firefly activities as "airplane leasing" on his tax returns without ever leasing the plane, he never had an appraisal done on the Firefly prior to 2014, and he reported that he was not holding the Firefly for sale or profit on California property tax documents. Viewing all these activities as a whole, the court concluded it was more likely than not that Mr. Kurdziel did not have a profit motive with respect to the Firefly.

The IRS allowed Mr. Kurdziel to deduct annual inspection expenses as an alternative to the not-for-profit argument. The other expenses were disallowed for lacking a business purpose. However, because Mr. Kurdziel did not report any Firefly income for the year, the deduction is limited to zero.

The IRS disallowed Mr. Kurdziel's vehicle, parking, and travel expenses as nondeductible commuting expenses. Mr. Kurdziel chose to live in San Diego despite Delta's hub being located in Detroit. The cost for Mr. Kurdziel to travel to Detroit was personal commuting. The IRS disallowed portions of expenses for home mortgage interest and real estate taxes that Mr. Kurdziel did not substantiate or address at trial. Mr. Kurdziel only supplied a June 2010 bank statement that showed a check for $800 to substantiate his tax preparation fee deduction. His testimony did not add any additional support and the court disallowed the deduction.

The court disallowed all of Mr. Kurdziel's NOL deductions because it held that there was no profit motive for his Firefly activities.

The IRS argued that Mr. Kurdziel is liable for a substantial underpayment penalty for 2007 and 2009 because his understatement was more than $5,000 and 10% of the tax he should have reported on the returns. It further argued that Mr. Kurdziel is subject to negligence penalties for all years. Mr. Kurdziel countered that he used reasonable care and good faith by reporting all Firefly's activities. The court disagreed that Mr. Kurdziel acted in good faith because he misrepresented Firefly's activities by identifying it as "airplane leasing." However, because the IRS did not introduce any evidence that an immediate supervisor personally approved the penalties, the court held that Mr. Kurdziel was not liable for any of the accuracy-related penalties.

Holding. The court held that Mr. Kurdziel's Firefly activities were not engaged in for profit. As such, all the related NOLs were denied. Many of the expenses that Mr. Kurdziel reported on his Schedule C and Schedule A were denied due to lack of proper substantiation. The court held that Mr. Kurdziel was not liable for accuracy-related penalties because an immediate supervisor at the IRS did not approve the penalties.

PASSIVE ACTIVITIES

Passive Activity Losses

***Roberta and William Birdsong v. Comm'r,* TC Memo 2018-148 (Sep. 10, 2018)**
IRC §§469 and 6662

☞ Taxpayer Is Considered a Real Estate Professional Based on Adequate Recordkeeping

Facts. During 2014, Roberta and William Birdsong owned two residential rental properties in Oakland, California. Dr. Birdsong was a full-time emergency physician and Mrs. Birdsong cared for their children while being the sole party actively managing the properties. Occasionally, Mrs. Birdsong hired outside contractors to perform work she could not complete herself.

She supplied two spreadsheets with details of her rental management activities. One reflected 844.75 hours spent managing the properties while the other spreadsheet reported 1,136.25 hours. The second spreadsheet included various travel time and investment time that was omitted from the first spreadsheet. The time entries for the first half of the year were reconstructed based on Mrs. Birdsong's calendar and receipts. Mrs. Birdsong maintained a contemporaneous log for the second half of the year. She produced receipts and invoices to substantiate her hours.

The Birdsongs hired an accountant to prepare their tax return. In 2014, they reported a rental real estate loss on Schedule E, *Supplemental Income and Loss,* as if Mrs. Birdsong qualified as a real estate professional. The IRS issued a notice of deficiency in 2016, disallowing the 2014 loss in excess of the passive activity loss limitation. Additionally, the IRS assessed an accuracy-related penalty.

Issues. The issues in this case are the following.

- Whether the Birdsongs' rental real estate loss is subject to the passive loss limitations
- Whether the Birdsongs are liable for accuracy-related penalties

Analysis. Passive activity losses are disallowed under IRC §469 unless a taxpayer materially participates in the activity. A real estate professional is not subject to passive activity loss rules, but rather treats their income and expenses as a trade or business. To qualify as a real estate professional, the taxpayer must perform more than half of their personal services during the year on real estate activities and must perform more than 750 hours during the year on the activity in which they materially participate.

Because Mrs. Birdsong had no other employment during 2014, she passes the first test of performing more than half of her personal services on real estate activities. Logs documenting time spent are not required to be maintained contemporaneously. The court analyzed Mrs. Birdsong's testimony, receipts, logs, and records and found them to be reliable. It was convinced that she worked more than 750 hours, qualifying as a real estate professional. As such, Mrs. Birdsong is not subject to passive activity loss limitations and no accuracy-related penalty applies.

Holding. The court held that Mrs. Birdsong qualified under the 750-hour rule as a real estate professional. The Birdsongs are not subject to passive activity loss limitations and the accuracy-related penalty does not apply.

Rental Real Estate Passive Activities

***Estate of Lydia Ramirez v. Comm'r,* TC Memo 2018-196 (Nov. 28, 2018)**

IRC §§469, 6662, and 7491

☞ Taxpayer Denied Real Estate Professional Treatment But Avoids Underpayment Penalties

Facts. Lydia Ramirez took over a number of real estate businesses when her husband died in 2000. In 2008 and 2009, she owned between 11 and 13 commercial and residential rental properties. Ms. Ramirez reported net passive losses on many of these properties and claimed deductions for management fees ranging from $600 to $4,000.

Ms. Ramirez also owned and handled a variety of non-real estate businesses. She owned Truhealth Inc., which operated an assisted-living facility for patients with Alzheimer's and dementia. She worked as an administrator for Truhealth and earned a salary in addition to her flow-through income. Ms. Ramirez reported the flow-through income as passive income on her Schedule E, *Supplemental Income and Loss.* Her Schedule E also reported passive flow-through income from an S corporation, Ranew Corporation, which operated a convenience store.

Ms. Ramirez earned wages from Ranew of approximately $50,000 and $70,000 in 2008 and 2009, respectively. Additionally, Ms. Ramirez reported losses on her Schedule C, *Profit or Loss From Business,* and on her Schedule F, *Profit or Loss From Farming.*

The IRS audited Ms. Ramirez and determined that she materially participated in Truhealth and Ranew. Accordingly, the income from the corporations was reclassified as active and was not offset by her passive losses on the real estate. After Ms. Ramirez died, her daughter took over the case on behalf of her estate.

Issues. The issues in this case are the following.

- Whether Ms. Ramirez's rental losses were active
- Whether Ms. Ramirez is liable for IRC §6662(a) penalties
- Whether the IRS must produce evidence that §6662 penalties were approved in writing by an IRS supervisor

Analysis. Loss deductions from passive activities in which a taxpayer does not materially participate are limited. Real estate activities are considered passive unless the taxpayer is a real estate professional. To be considered a real estate professional, more than half of the taxpayer's personal services performed must have been in real property trades or businesses in which they materially participated and the taxpayer must have materially participated more than 750 hours during the year.

Personal services are any type of work performed in connection with a trade or business (excluding investor-type work). The court believed that Ms. Ramirez performed personal services but that the estate did not establish the hours Ms. Ramirez spent on the properties. The regulations allow any reasonable means to prove hours, but the estate only submitted the unreliable testimony of Ms. Ramirez's daughter. The testimony was uncorroborated by logs, receipts, or contemporaneous reports. The court found that the amount of time Ms. Ramirez's daughter "guesstimated" that her mother worked on the various properties was improbable given that she held two other jobs outside real estate and hired out management duties on the real estate properties. Without further proof, the court determined that Ms. Ramirez did not satisfy the material participation test and was not a real estate professional. Accordingly, she was denied the passive activity losses.

Ms. Ramirez never elected to aggregate all her rental properties into a single activity as a real estate professional. An election must be attached to an original return and is required to allow taxpayers to aggregate their activities. Not only did Ms. Ramirez not attach an election, she did not treat her properties as aggregated and she reported them as passive activities. A late election is available through a letter ruling or filing an amended return with an aggregation-election statement attached. The estate did not request a letter ruling or file an amended return. The court determined that even if the estate had filed an amended return, Ms. Ramirez would not have qualified for relief. It appeared that Ms. Ramirez was not aware of the aggregation election until after the IRS audit. In addition, she did not file her returns consistent with having made the aggregation election.

Ms. Ramirez failed to show she had reasonable cause for not making the election. Although Ms. Ramirez hired a CPA to prepare her returns, there is no evidence that she provided all the necessary information for the CPA or that she relied on the CPA's expertise. Accordingly, the court decided that the rental activities were passive.

Ms. Ramirez substantially understated her tax liabilities for 2008 and 2009. An understatement is **substantial** if it exceeds the greater of $5,000 or 10% of the tax required to be shown on the return.[74] Ms. Ramirez's understatements were more than $5,000 and 10% of the required tax.

The estate argued it should not be held liable for penalties because Ms. Ramirez had reasonable cause and acted in good faith. The estate contended that Ms. Ramirez relied on a CPA to prepare her returns. The court determined that for the same reasons it held she did not have reasonable cause regarding the aggregation election, Ms. Ramirez also did not have reasonable cause for the understatement penalties.

However, the IRS cannot assess the penalty unless it is "personally approved (in writing) by the immediate supervisor of the individual making such determination." The penalty cannot be asserted in a notice of deficiency of an amended answer without approval. The IRS has the burden of production on the penalties in "any court proceeding with respect to the liability of an individual." When Ms. Ramirez died, her estate became the party to the case and is not an **individual.**

The court analyzed whether the proceedings related to Ms. Ramirez's liability as an individual or as an estate. Because the debt was established while she was still alive, it determined that the liability related to her as an individual. As such, the IRS has the burden of production on penalties. The IRS agent who assessed the penalties did not have the proper signature from his immediate supervisor and therefore did not comply with the requirements of IRC §6751. Therefore, the estate did not owe the penalty.

Holding. The court held that Ms. Ramirez was not a real estate professional and her rental real estate activity was passive. Although there was a substantial underpayment of taxes, the IRS did not appropriately approve the penalty and the estate was not liable for accuracy-related penalties.

74. IRC §§6662(a), (b)(2), and (d)(1)(A).

Material Participation

Fred and Lisa Barbara v. Comm'r, **TC Memo 2019-50 (May 13, 2019)**

IRC §§469 and 6662(a)

☞ Materially Participating Taxpayers Liable For Underpayment Penalties

Facts. Fred Barbara operated a money-lending business. He performed executive functions for the business, including deciding when to make loans and how to handle defaulted loans. Mr. Barbara managed over 40 outstanding loans and had no other employment during the years in question.

Mr. Barbara split his time between Chicago and Florida. While in Chicago, Mr. Barbara maintained a regular schedule, working at the office about 5.75 hours each workday for an annual total of at least 460 hours. He worked about two hours each workday while in Florida for an annual total of 240 hours. Consequently, Mr. Barbara worked 700 hours annually on his lending business.

The IRS issued notices of the following deficiencies and penalties to Mr. and Mrs. Barbara.

Year	Deficiencies	Penalties
2009	$336,666	$67,333
2010	0	0
2011	90,699	8,140
2012	109,355	21,871

Issues. The issues in this case are the following.

- Whether Mr. Barbara materially participated in his money-lending business
- Whether the Barbaras are liable for underpayment penalties

Analysis. A passive activity is an activity in which the taxpayer does not materially participate. Material participation must be regular, continuous, and substantial. Under one of the tests provided in Temp. Treas. Reg. §1.469-5T(a), a taxpayer materially participates if they participate more than 100 hours in the activity during the year and the facts and circumstances show that participation was regular, continuous, and substantial. Mr. Barbara's 700 hours exceed the 100-hour test and his participation was regular, continuous, and substantial. The court determined that there is a preponderance of evidence proving that Mr. Barbara materially participated in the lending business.

The Barbaras contended that if the court ruled against their material participation argument, they would not be liable for an understatement penalty because they acted with good faith. The court ruled in favor of the Barbaras regarding Mr. Barbara's material participation and therefore the court did not need to determine whether the Barbaras acted in good faith. No IRC §6662(a) penalties applied for the material participation issue. However, there were other adjustments unrelated to the material participation issue. The Barbaras did not provide any evidence to dispute those penalties; therefore, the court determined that underpayment penalties apply to those issues.

Holding. The court held that Mr. Barbara materially participated in his money-lending business. However, the Barbaras were liable for underpayment penalties on other adjustments.

Rental Real Estate Loss

***Walter J. and Georgiana Antonyshyn v. Comm'r,* TC Memo 2018-169 (Oct. 10, 2018)**
IRC §469

☞ Rental Real Estate Activities Considered Investment-Related; Losses Not Currently Deductible

Facts. During 2009 and 2010, Walter Antonyshyn was employed as a project manager. His wife, Georgiana, was the property manager for their residential rental properties but was otherwise unemployed. The couple owned various residential properties in North Carolina, Missouri, Texas, Georgia, and Pennsylvania. Management companies maintained the properties in North Carolina, Georgia, and Missouri.

Mrs. Antonyshyn kept a log of the 1,007 and 1,228 hours she devoted to the properties during 2009 and 2010, respectively. However, she spent many of these hours on nonmanagerial activities, performing investor-type services.

The IRS issued the following notices of deficiency.

Year	Deficiency IRC §6662(a)	Penalty
2009	$25,407	$5,081
2010	21,244	4,249

Issue. The issue in this case is whether Mrs. Antonyshyn qualifies as a real estate professional and is therefore entitled to deduct the rental real estate losses incurred on the couple's 2009 and 2010 tax returns.

Analysis. IRC §469 generally disallows deductions for passive activity losses in the current tax year. Instead, these losses are carried over and offset against future passive income. Generally, a rental activity is considered passive regardless of whether the taxpayer materially participates. However, there is an exception for real estate professionals who are not subject to the passive loss limitation. To be considered a real estate professional, more than half of the taxpayer's personal services performed in businesses during the year must be performed in real property trades or businesses in which the taxpayer materially participates, and the taxpayer must perform more than 750 hours in the real estate business. Mrs. Antonyshyn's material participation and whether her residential rental activities were a real property trade or business were not in question. The court's only concern was whether Mrs. Antonyshyn met the 750-hour requirement.

The court found that many entries in Mrs. Antonyshyn's log pertained to investment activities that did not count toward the 750-hour requirement unless the taxpayer was involved in the day-to-day operations of the properties. Because Mrs. Antonyshyn outsourced many of the day-to-day operations to management companies, her activities were not considered those of a real estate professional. Additionally, the log had entries for seminars although there was no evidence relating them to the real estate activities. The log contained other discrepancies, and no supporting documentation for the log was available.

Holding. The court held that Mrs. Antonyshyn did not meet the 750-hour requirement and consequently was not a real estate professional. Therefore, the couple's losses from rental real estate activities were passive in nature and not currently deductible.

RETIREMENT

Taxability of Federal Pension

***James Dawson v. Dale Steager*, 586 U.S.__ (Feb. 20, 2019)**

4 USC §111

☞ **State of West Virginia Cannot Prohibit a State Tax Exemption for Retired Federal Employees**

Facts. James Dawson retired from his job with the U.S. Marshals and began collecting a federal pension. He resided in the state of West Virginia, which taxed the benefits as it does to all former federal employees. However, West Virginia has a statute that exempts pension benefits of certain former state and local law enforcement employees from being taxed at the state level. Mr. Dawson sued the state based on the state statute violating the intergovernmental tax immunity doctrine. The intergovernmental tax immunity doctrine declares that states may tax a federal employee's pay or compensation only if the state does not treat a state employee better than a federal employee, assuming there are no significant differences between the job responsibilities.

The trial court found there were no significant differences between Mr. Dawson's job description as a federal marshal and that of a similar state and local law enforcement officer. A state and local law enforcement officer would be exempt from West Virginia state income tax whereas Mr. Dawson was not. The trial court held that West Virginia's statute violates 4 USC §111.

The decision was reversed on appeal. The West Virginia Supreme Court of Appeals argued that the state income tax exemption only applied to a few categories of retirees. The exemption was never meant to oppress former federal marshals. The U.S. Supreme Court heard the case.

Issue. The issue in this case is whether the state of West Virginia violates 4 USC §111 by allowing an exemption for retired state employees that is not permitted for retired federal employees.

Analysis. The Court disagreed that the intergovernmental tax immunity doctrine should not apply because only a narrow group of individuals are impacted. The doctrine disallows **any** state tax that oppresses a federal employee.

The State argued that retired federal employees and state law enforcement retirees do not share a similar job description. However, the trial court and the West Virginia Supreme Court of Appeals found no differences in the job descriptions. The State further argued that the distinction between federal and state employees is not their job descriptions but rather the generosity of pension benefits. However, the statute does not categorize persons based on the generosity of pension benefits.

Holding. The Court held that West Virginia violated 4 USC §111 by permitting retired state employees a tax exemption that it denies to retired federal employees who performed similar jobs.

Qualified Plan

Ltr. Rul. 201833012 (May 22, 2018)

IRC §401

☞ 401(k) Plan Allowed to Add Student Loan Repayment Provision

Facts. Taxpayer sponsors a 401(k) plan that allows eligible employees to contribute a portion of their compensation to the plan as pre-tax or Roth 401(k) elective deferrals, or after-tax employee contributions. For eligible employees who make elective contributions of at least 2% of their eligible compensation, the taxpayer makes a matching contribution equal to 5% of the employee's eligible compensation.

Taxpayer wants to amend the plan to offer a student loan benefit program under the plan, under which the taxpayer would make an employer nonelective contribution on behalf of an employee when that employee makes student loan repayments (SLR nonelective contribution). Employees that participate in the program would still be eligible to make elective contributions to the plan but would not be eligible to receive regular matching contributions with respect to those elective contributions while the employee participates in the program.

For employees who make student loan repayments during a pay period of at least 2% of their eligible compensation, the taxpayer will make an SLR nonelective contribution of 5% of the employee's eligible compensation. If the employee does not make a student loan repayment for a pay period of at least 2% of their eligible compensation but does make an elective contribution of at least 2% of the employee's eligible compensation, then taxpayer would make a matching contribution of 5% of the employee's eligible compensation.

Based on these facts, taxpayer requests a ruling that its proposal to amend the plan to provide SLR nonelective contributions under the program will not violate the contingent benefit prohibition of IRC §401(k)(4)(A) and Treas. Reg. §1.401(k)-1(e)(6).

Analysis. IRC §401(k)(4)(A) provides that:

> *A cash or deferred arrangement of any employer shall not be treated as a qualified cash or deferred arrangement if any other benefit is conditioned (directly or indirectly) on the employee electing to have the employer make or not make contributions under the arrangement in lieu of receiving cash. The preceding sentence shall not apply to any matching contribution (as defined in section 401(m)) made by reason of such an election.*

Similarly, Treas. Reg. §1.401(k)-1(e)(6) states that:

> *A cash or deferred arrangement satisfies this paragraph (e) only if no other benefit is conditioned (directly or indirectly) upon the employee's electing to make or not make elective contributions under the arrangement. The preceding sentence does not apply to (A) any matching contribution (as defined in §1.401(m)-1(a)(2)) made by reason of such an election . . .*

SLR nonelective contributions under the program are dependent on whether an employee makes a student loan repayment during a pay period. They are not dependent on the employee making elective contributions under a cash or deferred arrangement. Moreover, an employee who makes student loan repayments and in turn receives SLR nonelective contributions is still permitted to make elective contributions. Therefore, the SLR nonelective contribution is not conditioned on the employee electing to have the employer make or not make contributions under the arrangement in lieu of receiving cash.

Holding. The IRS concluded that the taxpayer's proposal to amend the plan to provide SLR nonelective contributions under the program will not violate the contingent benefit prohibition of §401(k)(4)(A) and Treas. Reg. §1.401(k)-1(e)(6).

S CORPORATION

S Corporation Losses

***Homero F. Meruelo v. Comm'r*, U.S. Court of Appeals, 11th Circuit; No. 18-11909 (May 6, 2019)**
IRC §1366

☞ Taxpayer Did Not Establish Basis Through Intercompany S Corporation Loans

Facts. Homero Meruelo was a real estate developer in Florida. Mr. Meruelo owned 49% of an S corporation, Merco, in addition to several other S corporations, partnerships, and limited liability companies.

Mr. Meruelo acquired a condominium complex in part through a personal loan. He transferred $5 million of the loan proceeds to an S corporation in which he and his mother each owned 50%. The IRS did not dispute that Mr. Meruelo had shareholder basis of $5 million from this transfer.

Between 2004 and 2008, Merco and the other business entities in which Mr. Meruelo owned interests engaged in hundreds of financial transactions. The transactions were often recorded as accounts receivable and accounts payable. At the end of the year, Mr. Meruelo's certified public accountant netted Merco's accounts payable to its affiliates against Merco's accounts receivable from its affiliates. Any net accounts payable balance was reclassified as a shareholder loan and a percentage of the indebtedness was allocated to Mr. Meruelo's ownership.

Mr. Meruelo reported taxable income of $13.9 million and $4.8 million tax due on his 2005 tax return. In 2008, the banks foreclosed on the condominium and Mr. Meruelo incurred a $13 million loss. On his 2008 tax return, Mr. Meruelo reported a net operating loss (NOL) of $11.8 million. He carried the loss back to his 2005 return and received a refund of $3.9 million. The IRS examined Mr. Meruelo's 2005 and 2008 returns and disallowed $8.1 million of the flow-through loss in 2008 due to a lack of basis.

The Tax Court determined that Mr. Meruelo was not entitled to any of the $8.1 million of disputed basis. Mr. Meruelo appealed.

Issue. The issue in this case is whether the monetary transfers between Merco and several of Mr. Meruelo's partially owned business entities established a "bona fide indebtedness" resulting in basis to offset his losses.

Analysis. A shareholder must prove that an actual economic outlay occurred. Shareholder debt basis is limited to "bona fide indebtedness of the outlay" and must be directly attributable to a shareholder in order to deduct their share of the corporation's NOL.[75]

Mr. Meruelo argued that he was entitled to basis under either the "back-to-back" loan theory or the "incorporated pocketbook" theory. A back-to-back loan occurs when an affiliated entity lends a shareholder money that the shareholder then loans directly back to the S corporation. The Tax Court held that there was insufficient evidence to support that Mr. Meruelo engaged in a genuine back-to-back loan. Additionally, taxpayer-shareholders cannot reclassify intercompany accounts receivable and accounts payable as shareholder loans for tax-only purposes. The court determined that Mr. Meruelo did not have an actual outlay of funds from the Merco affiliates to the S corporation. Therefore, the transfers could not be classified as a shareholder loan.

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75. Treas. Reg. §1.1366-2(a)(2).

The incorporated pocketbook theory creates basis when a taxpayer has a "habitual practice of having his wholly owned corporation pay money to third parties on his behalf."[76] In situations in which the court allowed the incorporated pocketbook theory, the taxpayer used a single, wholly owned corporation to pay their third-party expenses. Mr. Meruelo could not prove that the Merco affiliates habitually paid his expenses. Corporations that are engaged in genuine incorporated pocketbook activities record any disbursements as shareholder loans. However, Merco affiliates recorded the distributions as intercompany accounts payable and receivable and reclassified them as shareholder loans at the end of the year. The court held that Mr. Meruelo was not entitled to basis under the incorporated pocketbook theory.

Holding. The court affirmed the Tax Court's holding that Mr. Meruelo did not establish bona fide indebtedness.

TAX FRAUD

Tax Return Fraud

John and Joan Finnegan v. Comm'r, **U.S. Court of Appeals, 11th Circuit; No. 17-10676 (Jun. 11, 2019)**
IRC §6501

☞ Statute of Limitations Extended Because of Preparer Fraud

Facts. John and Joan Finnegan hired a return preparer. The preparer included bogus items on their returns of which they were apparently oblivious.

An informant tipped off the IRS regarding the Finnegans' return preparer. The IRS launched an investigation and found that the preparer and his associates prepared approximately 750 to 800 fraudulent returns every year for 11 years. The returns often included large refunds resulting from large partnership losses. The preparers changed the partnerships' addresses so the returns would be filed at different IRS centers to prevent detection.

The Finnegans formed a partnership but never transferred their rental property into the partnership as advised by their preparer. Moreover, they never entered into a partnership agreement. No finances were transferred between the Finnegans and the partnership but the partnership showed a capital contribution from one of the Finnegans. On their individual returns, the Finnegans claimed losses from a second partnership. However, they were unaware of this partnership until the IRS got involved.

The return preparer testified against a former business partner that virtually every return he prepared had some fraudulent activity. He also swore in an affidavit that he knowingly prepared fraudulent entries on the Finnegans' returns. Five years after the preparer's criminal proceedings, the IRS issued a notice of deficiency to the Finnegans for the eight years that the preparer submitted fraudulent returns. The IRS added accuracy-related penalties.

The Finnegans brought suit against the IRS, claiming the IRS exceeded the 3-year statute of limitations to bring a claim. The IRS countered that there is an exception to the 3-year statute for cases involving fraud or evasion of taxes. During the trial in Tax Court, the IRS relied on the verdict in *Allen v. Comm'r,*[77] which held that the fraud exception was triggered by the return preparer's fraud and the 3-year statue was suspended. The Finnegans argued that the IRS could not prove that the preparer fraudulently prepared the Finnegans' returns. The court determined that the IRS proved fraud because the Finnegans' returns contained many of the fraud markers identified in other fraudulent returns the preparer filed.

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76. *Broz v. Comm'r,* 727 F. 3d 621, 627-628 (6th Cir. 2013).

77. *Allen v. Comm'r,* 128 TC 37 (2007).

During the trial, a similar case, *BASR Partnership v. U.S.,*[78] was decided in the federal circuit. In *BASR,* the court held that only the **taxpayer's** fraud could trigger the fraud exception. The IRS sent a letter to the court and to the Finnegans outlining the *BASR* case. Despite this, the Finnegans did not ask the court to consider *BASR* in ruling on their case. Additionally, the Finnegans did not challenge *Allen* during trial and explicitly asserted that to the court.

At the last moment, the Finnegans asserted that because the tax preparer rather than the taxpayers themselves engaged in fraudulent activities, their returns did not trigger the fraud exception. The Tax Court held that the Finnegans waited too long to bring up this defense and rejected it.

The Tax Court held that the Finnegans were liable for the deficiencies and accuracy-related penalties. The Finnegans hired new attorneys and appealed the decision.

Issues. The issues on appeal in this case are the following.

- Whether the fraud exception applies, which extends the statute of limitations
- Whether the Tax Court should have been permitted to admit the testimony and affidavit from their return preparer

Analysis. The Finnegans argued during their appeal that the Tax Court should have revisited the *Allen* decision, even though the couple explicitly stated during trial they were aware of the case and waived the issue. The Finnegans made a number of unpersuasive arguments to support their assertion. They claimed it would have been unethical to ask the court to overrule *Allen* before the verdict in *BASR* was issued.

The Circuit Court generally will not hear arguments that were not brought up in the original case except in the following circumstances.[79]

1. When the issue "involves a pure question of law" and "refusal to consider it would result in a miscarriage of justice"
2. When "the appellant raises an objection to an order which [they] had no opportunity to raise at the [lower] court level"
3. When "the interest of substantial justice is at stake"
4. When "proper resolution is beyond any doubt"
5. When the "issue presents significant questions of general impact or of great public concern"

The Finnegans argued that conditions one and five apply to the fraud-exception issue. The court agreed that it is an important issue but it would not create a miscarriage of justice if the court did not hear the case. Ultimately, the court held that despite being a significant issue, the benefit to hearing the case does not outweigh the burden of retrying the case.

The Finnegans attempted to use the *Allen* defense at the last moment and the Tax Court denied it. The Circuit Court determined that it would not hear a case on appeal based on an afterthought strategy that failed in a lower court unless there is "some manifest injustice."

78. *BASR Partnership v. U.S.,* 795 F.3d 1338 (Fed. Cir. 2015).

79. Quoting *Wright v. Hanna Steel Corp.,* 270 F.3d 1336, 1342 (11th Cir. 2001).

The IRS was unsuccessful in serving the Finnegans' preparer with a subpoena 10 times and could not call him as a witness. As a substitute, the IRS admitted testimony from the preparer against his former business partner and his affidavit in which he confessed to his fraudulent activities. Although the Tax Court determined that the testimony and the affidavit were hearsay, they satisfied the statement-against-interest exception to the sanction on hearsay. When a declarant is unavailable to testify, the statement-against-interest exception is a statement that:[80]

- A reasonable person in the declarant's positions would have made only if the person believed it to be true because it is contrary to the declarant's proprietary or pecuniary interest; and
- The statement is supported by "corroborating circumstances that clearly indicate its trustworthiness, if it is offered in a criminal case as one that tends to expose the declarant to criminal liability."

The Finnegans contended that the exception was not satisfied. The Tax Court determined that the preparer's statements subjected him to lawsuits from former clients as evidenced by the fact that at least one former client already commenced legal proceedings against him. The Finnegans claim that the preparer made his statements as part of a plea deal and were in his best interest. However, the preparer was not promised any leniency or protection against a more severe sentence. The court held that the statements were supported by the testimony from the Finnegans and the preparer's former associate and the fact that the Finnegans' returns exhibited the common markers of fraud used by the preparer. The court determined that the statements were trustworthy.

Holding. The Circuit Court affirmed the decision of the Tax Court. The statute of limitations remained open because the Finnegans filed fraudulent returns. The court declined to consider the finding in *BASR* that the taxpayer, rather than the tax preparer, must commit fraud. In addition, the court held that admitting the preparer's statements did not abuse the Tax Court's discretion.

80. Rule 804(b)(3).