Chapter 4: Rulings and Cases

Substantial Authority B176
- Evaluation of Authorities B176
- Nature of Analysis B176
- Substantial Authority Hierarchy B176

Judicial System for Tax Disputes B178
- Case Commencement B178
- The U.S. Tax Court B179
- IRS Actions on Decision B183

Business Expenses B184
- Court Allows Reduced Amount of Business Bad Debt Deduction B184
- Automobile Racing Mechanic Did Not Adequately Rebuild His Tax Records B186
- Court Prunes Taxpayer's Per Diem Expenses for Timber Properties B187

Credits B189
- Street Vendor Fails to Sell Tax Court on Eligibility for the Earned Income Credit B189

Deductions B190
- Court Unable to See a Donation of Eyeglass Frames Due to Inadequate Appraisal Report B190
- Tax Court Blows Away Taxpayer's Casualty Loss Deduction for Hurricane Damage B192

Divorce Issues B195
- Court Reclassified Alimony Payments That Were Contingent on the Age of a Child B195

Foreign Income B196
- Failure to Disclose Foreign Bank Account on Return Triggers Large Penalty B196

Gifts B198
- Evidence of Inability to Repay Transforms Loans to Gifts B198

Gross Income B200
- Payments Received Under Medicaid Waiver Program are Earned Income for Tax Credits B200
- Relief for Taxpayers with Certain Discharged School Loans B201
- Taxpayer Was Demolished By Not Reporting Constructive Dividends; Not Good Thinking B202
- Car Awarded to High School Student Accelerates Her Taxable Income B203
- Settlement Award for Damages from In Vitro Fertilization is Excluded from Taxable Income B204

Innocent Spouse B205
- Taxpayer Granted Relief from Joint and Several Liability for One Year, But Not for Another B205

Installment Agreement B207
- $7 million Stash of Cryptocurrency Leaves Taxpayer Ineligible for Installment Agreement B207

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IRS Procedures — Miscellaneous B208
Responsible Person's Feet Held to the Fire B208
Preparer's Refund Suit Dismissed for Lack of Jurisdiction B210
United States Pays Tax Preparer Court Costs and Fees B211
Court Cancels Date Stamped by Private Postage Meter B212
Failure to Provide Requested Information Results in Summary Judgment B213
Losses B215
Golf Course Loss Deduction Declared a Mulligan B215
Like-Kind Exchange B219
IRC §§121 and 1031 Can Be Applied to Same Disposition of Property B219
Passive Activities B220
Taxpayer Foreclosed as a Real Estate Professional and Cannot Offset Nonpassive Income B220
Taxpayers Inflated Hours of Service to Qualify as Real Estate Professional B222
Payroll Issues B223
IRS Issues Nonacquiescence Regarding Employer Classification B223
Retirement B224
Taxpayers Subject to Additional Tax on Early Distribution from Qualified Retirement Plan B224
Taxpayer Was Not Subjected to Duplicative Examination B224
Outstanding Loan Balance Treated as Deemed Distribution from Retirement Plan B226
Uncashed Retirement Plan Check Must be Included in Gross Income B227
Self-Employment Tax B228
Nonqualified Deferred Compensation from Mary Kay Is Subject to Self-Employment Tax B228

Please note. Corrections were made to this workbook through January of 2021. No subsequent modifications were made.

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, 2020. 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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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).

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- 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.

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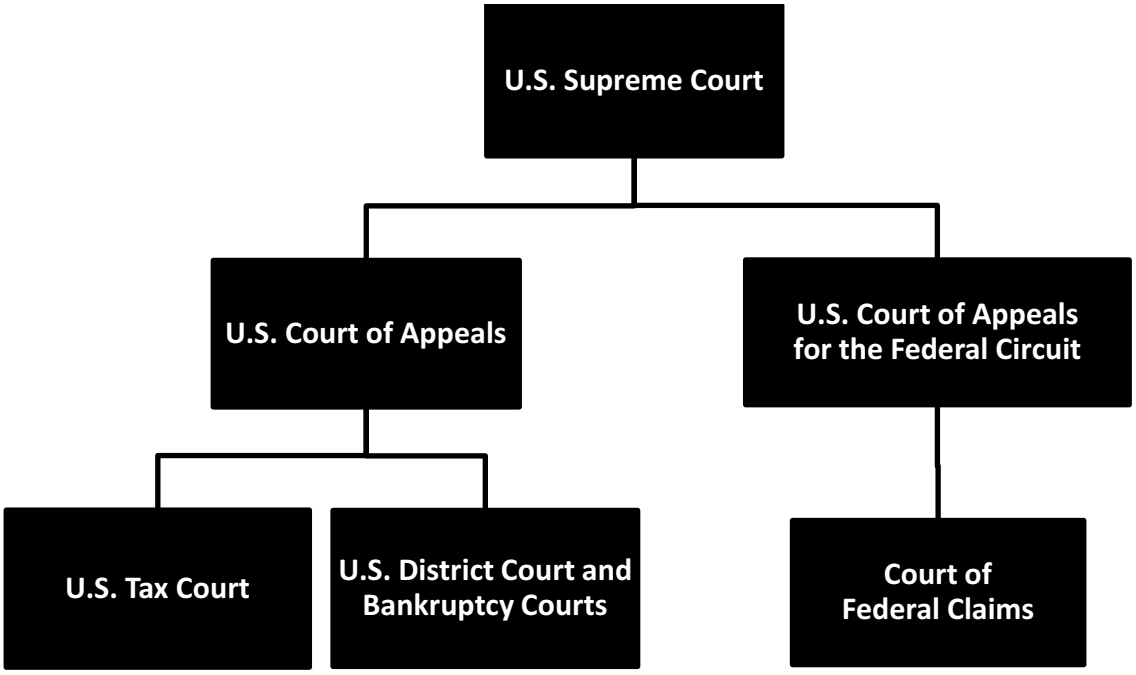
JUDICIAL SYSTEM FOR TAX DISPUTES

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.

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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

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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).

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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].

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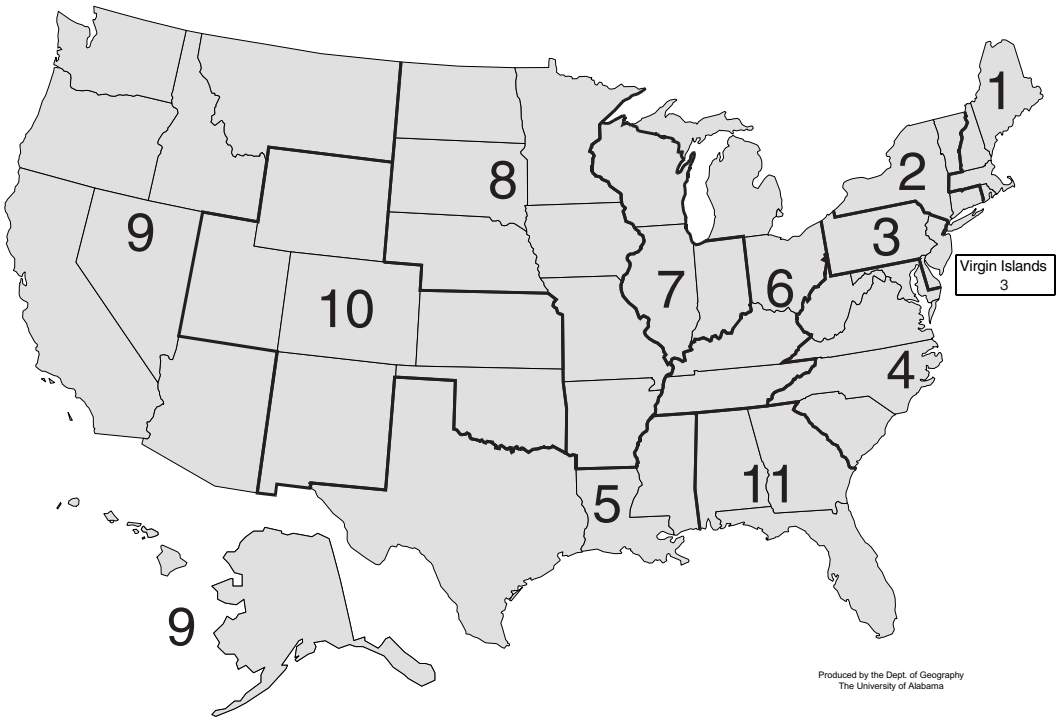
The 13 judicial circuits of the United States are constituted as follows.

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).

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BUSINESS EXPENSES

Business Bad Debt

***Charles Bercy et al. v. Comm'r,* TC Memo 2019-118 (Sep. 11, 2019)**
IRC §166

☞ **Court Allows Reduced Amount of Business Bad Debt Deduction**

Facts. Charles Bercy was a licensed real estate broker in California. He was the president and major shareholder of the Argus Group (Argus), which was mainly engaged in making mortgage loans secured by real estate. Argus, which was organized as an S corporation, had loaned approximately $750 million since its founding in 1989.

In 2007, Darryl Aken approached Mr. Bercy and proposed a personal loan. Mr. Aken operated a furniture business in Los Angeles that did business under the trade name Girari. Girari manufactured high-end furniture, which it sold to consumers from its own showroom. It also rented furniture for use at social events, conferences, and museum openings.

In 2007, Mr. Aken was looking for funds to allow him to expand Girari's business to Las Vegas. Mr. Aken told Mr. Bercy that he wanted to borrow $200,000 and told him that Girari already had debt of $400,000. This debt consisted of $200,000 owed to Mr. Aken's mother, Sylvan Aken; $100,000 owed to his daughter, Sandra Aken; and $100,000 owed to an unrelated party, Richard Kern.

Mr. Bercy did not want to lend the full $200,000 himself, so he asked another lender, Dennis Levitt, to split the loan with him. Mr. Bercy and Mr. Levitt had previously made a personal property loan together, and each agreed to lend Girari $100,000 on substantially identical terms. The promissory note they executed bore interest at 11.25%, had a 1-year maturity, and was structured as a $200,000 line-of-credit. Mr. Aken personally guaranteed the note. The parties executed a security agreement under which Girari gave equal security interests in its assets to Mr. Bercy and Mr. Levitt.

Shortly after the closing, Mr. Bercy and Mr. Levitt each loaned $50,000 to Girari. Each loaned an additional $50,000 to Girari a month later.

The financial crisis in 2007–2008 had strong repercussions for Girari. Demand for its furniture diminished as demand for new homes shriveled. In addition, businesses, conventions, and party hosts scaled back their entertaining, so demand for high-end furniture rental was significantly reduced. Consequently, when the promissory note was due in March 2008, Girari was unable to repay it.

Mr. Bercy **declined to enforce the security agreement** because that would have required legal expenses and left him with large amounts of furniture for which there was little demand. Instead, he decided to let Mr. Aken attempt to restructure Girari and find a way to repay the loan.

In 2010, Mr. Aken concluded that selling Girari was the only way he could repay his debts. He explored various possibilities but, by early 2013, Girari had not been sold. By that time, Mr. Levitt had become impatient and agreed to take $25,000 in complete satisfaction of the $100,000 that was owed to him. Mr. Bercy and the other lenders believed they could recover more if they waited until Mr. Aken found a buyer for Girari.

In 2014, Girari sold its assets to Kool Party Rentals (Kool) for $235,000. Kool paid $30,000 in cash and executed a promissory note for the balance. The note required monthly installments of $3,500, plus applicable interest at 5% annually.

Girari used part of the initial cash from Kool to refurbish the rental furniture that was to be delivered to Kool and paid the balance of the claim that was due to Mr. Levitt. The $193,000 balance of the promissory note was to be paid 20% to Mr. Bercy, 20% to Mr. Kern, 20% to Sondra Aken, and 40% to Sylvan Aken. Therefore, Mr. Bercy's share of the principal was $38,600 ($193,000 × 20%).

Kool made all scheduled payments of interest and principal. Kool fully discharged the $205,000 note in April 2017.

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Mr. Bercy and his wife claimed a business bad debt deduction of $65,000 on their 2014 income tax return. They reported this loss on the Schedule C, *Profit or Loss From Business,* for Mr. Bercy's sole proprietorship activity. Mr. and Mrs. Bercy's accountant calculated the $65,000 loss by valuing Mr. Bercy's interest in the Kool note at $35,000, applying a discount to the $38,600 principal that was due to him. The accountant believed the discount was appropriate because:

- The interest rate was 5% on the Kool note, compared to the 11.25% that Girari had contracted to pay;
- Repayment of the Kool note took place over several years; and
- The Kool note was a multiparty loan in which Mr. Bercy had a minority interest, which allegedly complicated his ability to proceed with legal enforcement actions.

The IRS audited Mr. and Mrs. Bercy's 2014 return. It then issued them a notice of deficiency disallowing the $65,000 bad debt deduction. The notice stated: "You did not establish that the business expense shown on your tax return was paid or incurred during the taxable year and that the expense was ordinary and necessary to your business."

Issue. The issue is whether the taxpayers are entitled to a business bad debt deduction under IRC §166(a).

Analysis. IRC §166 allows a deduction for a business debt that becomes wholly or partially worthless during the tax year. For a nonbusiness bad debt held by a noncorporate taxpayer, the taxpayer is allowed a short-term capital loss for the year in which the debt becomes worthless.[6]

The IRS conceded that Mr. Bercy was engaged in the business of real estate lending. However, the IRS contended that making personal property loans was outside the scope of that business and that Mr. Bercy's non-real estate lending activity was "insufficiently robust" to constitute a trade or business apart from Mr. Bercy's business of real estate lending.

The court was not persuaded to define the term "trade or business" so narrowly in this situation. In previous cases, the court had not segmented the taxpayer's lending business according to the nature of the loan or type of customer. Instead, it had simply asked whether the taxpayer was in the business of lending money, separate and distinct from any other gainful employment. In this context, the court found that the Girari loan was a business debt for purposes of §166.

Determining when a debt becomes worthless requires examining all the circumstances. The taxpayer must establish objective facts from which worthlessness can be determined.

The court noted that the sale of Girari's assets to Kool was an identifiable event that reasonably caused Mr. Bercy to lose any hope of recovery beyond the amount he was entitled to under the terms of the Kool note. Once the sale of Girari's assets was consummated, the creditors treated the note as a final settlement that extinguished any claims against Girari or Mr. Aken personally. After examining all the circumstances, the court found that, in 2014, Mr. Bercy reasonably abandoned any hope of recovering more from the Girari loan than his pro rata share of the Kool note.

IRC §166(b) provides that the amount of a bad debt deduction is the adjusted basis provided in IRC §1011 for determining the loss from the sale or disposition of property. IRC §1011 cross references IRC §1012, which provides that the basis of property is usually its cost.

Mr. Bercy's original cost basis in the Girari loan was $100,000. To determine the bad debt deduction, this basis must be adjusted for the value of property he received in partial repayment.

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6. IRC §166(d)(1); Treas. Reg. §1.166-5(a)(2).

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The face value of Mr. Bercy's 20% interest in the Kool note was $38,600, which would provide a bad debt deduction of $61,400. Mr. and Mrs. Bercy reported a bad debt deduction of $65,000, applying a discount to the face value of the property interest Mr. Bercy received. The court noted that the Bercys did not carry their burden of proving that a discount is warranted. The fact that the Girari note bore a higher interest rate than the Kool note is irrelevant. Mr. Bercy cannot claim a tax loss for interest Girari never paid. A bad debt deduction for accrued but unpaid interest is allowable only if the interest was previously reported by the taxpayer as taxable income.[7]

The court found that Mr. Bercy made a business loan of $100,000 to Girari in 2007. In 2014, he received a 20% interest in a note with a $193,000 face value. He did not show that any discount was warranted, so the property he received was worth $38,600, the face value of his interest in the note. At that time, Mr. Bercy had no reasonable prospect of recovering any more of his principal investment.

Holding. The court held that Mr. and Mrs. Bercy were entitled to a business bad debt deduction of $61,400 under §166(a) for 2014.

Taxpayer Recordkeepng

***Brent Katusha v. Comm'r,* TC Summ. Op. 2019-31 (Oct. 10, 2019)**

IRC §§274 and 280F

☞ Automobile Racing Mechanic Did Not Adequately Rebuild His Tax Records

Facts. Brent Katusha has worked as a professional automobile racing mechanic since 1999. He specializes in car fabrication and maintenance. During 2014, he worked as a contract race mechanic for several professional racing teams. In addition, he worked for an engineering firm building robotic machines for use in vehicle manufacturing overseas.

Mr. Katusha timely filed a 2014 federal tax return, which was prepared by a CPA in Santa Rosa, California. His Schedule C, *Profit or Loss From Business,* reported nonemployee compensation of $61,399 and expenses of $13,146.

The IRS assessed a deficiency of $4,090 in Mr. Katusha's 2014 federal income taxes as a result of unreported income. Mr. Katusha agreed that he did not report $10,081 of nonemployee compensation. However, he asserted that he is entitled to additional expense deductions of $7,355 on his Schedule C. These additional expenses consist of $7,171 for meals and entertainment, $69 for gifts, and $115 for office expense.

Mr. Katusha gave his CPA receipts and other documents to substantiate his business-related expenses. Unfortunately, many of the documents were lost when the CPA's house was destroyed in a wildfire in October 2017. As a result, the CPA could not assist Mr. Katusha in reconstructing and assembling documents needed to support the claimed expense deductions before trial.

Because of the fire, Mr. Katusha's business expense records are limited. Mr. Katusha gave the court 49 pages of monthly checking account statements for 2014, which provide the vendor's name, date, and the amount of each charge. He also produced an email dated February 18, 2014, that details the 2014 schedule for the World Speed Motorsports racing team. Mr. Katusha asserted that he attended test days or race weekends for five of the 10 racing events listed on the schedule.

Issue. The issue in this case is whether Mr. Katusha is entitled to deduct certain purported business expenses in excess of those the IRS allowed.

Analysis. The court noted that it received credible evidence that the home of Mr. Katusha's CPA was, in fact, destroyed in a wildfire. However, Mr. Katusha did not provide evidence about his usual recordkeeping practices and what specific records were destroyed.

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7. See *Fed. Home Loan Mortg. Corp. v. Comm'r,* 121 TC 279, 284 (2003).

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When a taxpayer's records have been lost because of circumstances beyond the taxpayer's control, they must undertake a "reasonable reconstruction," which includes substantiation through secondary evidence.[8] Mr. Katusha presented 49 pages of checking account statements with notations "providing partial but inadequate details" on the business purpose of the expense deductions claimed. His recollection of purchases from certain vendors was only general and it was not clear whether the expenditures were primarily for business or personal reasons. At trial, Mr. Katusha acknowledged that his notations could be inaccurate because he was attempting to piece together purchases several years after the expenditures were incurred.

In addition, Mr. Katusha's checking account statements appear to conflict with the email detailing the race weekends he claimed to have attended. He said he attended five of the 10 race weekends listed in the email, but his checking account statements appear to indicate his involvement in only one race weekend, for which he incurred $47 of charges at vendors near the raceway. For the other race weekends, his checking account statements either do not reflect any charges noted as business expenses or show multiple charges near his home and workplace. Accordingly, the court could not ascertain which of Mr. Katusha's meals and entertainment expenses were incurred while attending races.

The court noted that the IRS allowed $109 in meals and entertainment expenses as originally reported on Mr. Katusha's 2014 Schedule C. This is more than the $47 Mr. Katusha was able to specifically associate with a racing event. He was unable to provide evidence about whether any business expenses recorded on his checking account statements relate to amounts previously reported and allowed. Therefore, the court could not conclude that any given charge for meals or entertainment is an additional business expense rather than one previously reported and allowed. Mr. Katusha was similarly unable to substantiate the gift or office expenses he reported.

Holding. The court held that Mr. Katusha was not entitled to deduct additional gift, meals, entertainment, or office expenses for 2014.

Per Diem Expenses

***Roger Maki and Lilane Gervais v. Comm'r,* TC Summ. Op. 2019-34 (Nov. 4, 2019)**

IRC §162

☞ Court Prunes Taxpayer's Per Diem Expenses for Timber Properties

Facts. In 2013, Roger Maki lived in Des Moines, Washington. Mr. Maki owned more than 100 acres of land in the state of Washington. This land was in two counties, and he traveled extensively every week to care for and monitor the timber on the land. The round trip from his home to and from the properties was approximately 300 miles.

Mr. Maki has long suffered physical problems, for which he needs to walk and stay active. One of the ways he does this is by planting and taking care of trees, which can be harvested for his future financial needs. Mr. Maki began this process in the 1980s after he inherited the land from his mother. During the relevant period of this case, the trees were nearing maturity and two of the properties had trees with a harvest value exceeding $1 million.

Before 2013, one of Mr. Maki's properties was stripped of fir trees during a period when he was very sick and unable to check on the properties. Commercial timber companies hire people to patrol their timberland to curb illegal harvesting but Mr. Maki was unable to afford the cost of hiring people to do this. One of the reasons he regularly visited the properties was to ensure he did not lose value because of illegal harvesting or other damage.

8. See, e.g., *Boyd v. Comm'r,* 122 TC 305, 320 (2004); *Probandt v. Comm'r,* TC Memo 2016-135 (Jul. 21, 2016).

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Mr. Maki kept a log listing the days he visited the properties. He kept the log in the building he uses when he visits the properties. He used the log to make a summary of his 2013 visits so he could give it to the IRS. However, after he prepared the summary, the original contemporaneous logs and other records were stolen when the building in which they were kept was vandalized. The summary showed that Mr. Maki was present at the properties for 161 days in 2013 and he made 47 round trips from his home to the properties.

Mr. Maki's 2013 timber activity was reported on a Schedule C, *Profit or Loss From Business,* which he included with the joint tax return he filed with his wife. The Schedule C reported no income from the timber activity and various deductions, including $7,011 of travel expenses and $55,925 of per diem expenses. The IRS disallowed the travel and per diem expenses and assessed a $17,925 income tax deficiency with respect to the 2013 tax return.

Issue. The issue in this case is whether the taxpayers paid business expenses and, if so, whether they are ordinary and necessary travel expenses.

Analysis. IRC §162(a)(2) provides for the deduction of ordinary and necessary business expenses, including travel expenses incurred while away from home for trade or business purposes. These expenses must be incurred while away from home overnight.[9]

The IRS's main argument is that Mr. Maki did not adequately substantiate the travel and per diem expenses because he did not provide a log and his information was inaccurate. The court noted that Mr. Maki established a normal pattern of travel, which was usually three days per week. He always traveled to the same locations and his pattern of travel rarely varied. His testimony regarding the log was credible and his summary was extracted from the log. Accordingly, the court found that Mr. Maki made 47 trips and spent 161 days at his timber properties in 2013. The court also found that Mr. Maki's travel expenses were ordinary and necessary because of the need to monitor the timber and maintain and plant trees.

A self-employed person can deduct meal expenses at the federal rate established for the locality in which they incur meal expenses.[10] However, Mr. Maki used the per diem rates for "luxury water travel" to calculate his per diem deduction. These rates ranged from $320 to $374 per day and are intended for expenses incurred on an ocean liner or cruise ship. Using these rates, Mr. Maki calculated and deducted $55,925 of per diem expenses.

Under Rev. Proc. 2011-47, the federal per diem rate for meals that applies to the counties in which Mr. Maki's timberland is located is $46. Because Mr. Maki established that he was away from home on business for 161 days in 2013, he is entitled to deduct $7,406 of per diem expenses.

Mr. Maki's $7,011 travel deduction was calculated at the allowed per mile rate multiplied by the number of round trips he made in 2013 to his properties. Because the court found that Mr. Maki's travel was for business and the mileage in his logs was substantiated, he is entitled to the $7,011 deduction.

Holding. The court held that Mr. Maki is entitled to the $7,011 travel deduction but reduced his per diem deduction from $55,925 to $7,406.

9. *Comm'r v. Flowers,* 326 U.S. 465, 470-472 (1946).

10. Rev. Proc. 2011-47, 2011-42 IRB 520.

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CREDITS

Earned Income Credit

Diana Doucoure v. Comm'r, **TC Summ. Op. 2019-20 (Aug. 12, 2019)**
IRC §32

☞ Street Vendor Fails to Sell Tax Court on Eligibility for the Earned Income Credit

Facts. Diana Doucoure was a self-employed street vendor in New York who sold socks, t-shirts, and hats. She acquired her merchandise from people who approached her on the street. Ms. Doucoure did not keep inventory records and paid for purchased merchandise in cash. She did not provide her customers with receipts and rarely recorded her sales.

At the end of each day, Ms. Doucoure counted her cash and decided how much to retain for personal use. Occasionally, she deposited her cash into her Citibank account. Ms. Doucoure did not retain any records for her bank account and closed it in 2016.

Ms. Doucoure filed a Schedule C, *Profit or Loss From Business,* with her Form 1040, *U.S. Individual Income Tax Return,* for 2014 and 2015 for her street vendor activity. She reported the following information.

	2014	2015
Gross sales receipts	$16,889	$17,110
Business expenses	(1,355)	0
Net profit	$15,534	$17,110

The IRS audited Ms. Doucoure for 2014 and 2015. She only produced six receipts for items she purchased for resale totaling $1,612 in 2014. She contended that she was entitled to an earned income credit (EIC) of $5,460 for 2014 and an EIC of $5,548 for 2015. She decided to pursue relief through the Tax Court and represented herself in those proceedings.

Issue. The issue in this case is whether Ms. Doucoure is eligible for the EIC for 2014 or 2015.

Analysis. Ms. Doucoure would qualify for the highest EIC based on the net profit (earned income) and number of dependents that she reported for 2014 and 2015. However, she provided only six receipts and testified that she relied on her Citibank statements (none of which were produced).

Ms. Doucoure claimed business expenses in 2014 of $1,355 based on her memory. However, the receipts she produced for the year exceeded that amount ($1,612). Ms. Doucoure also reported $0 business expenses for 2015 but testified at trial that her 2015 expenses were identical to those in 2014.

Because of the anomalies and inconsistences in Ms. Doucoure's testimony and her inability to explain her missing bank records, the court determined that her testimony was not credible. She did not support her earned income amount for either 2014 or 2015 with any evidence with which the court could estimate the amounts of her income or expenses.

Ms. Doucoure contended that she is entitled to a refund for 2015 because she timely filed her return and submitted the documents that were requested of her. The court noted that Ms. Doucoure did not qualify for a refund solely because she timely filed a return and claimed a credit. Ms. Doucoure argued that she has a constitutional right to receive a refund. The court disagreed. Ms. Doucoure has no right to a refund if she did not meet the statutory requirements for the EIC.

Holding. The court held that Ms. Doucoure was not eligible for the EIC for 2014 or 2015.

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DEDUCTIONS

Charitable Contribution

Roderick and Sandra Campbell v. Comm'r, **TC Memo 2020-41 (Apr. 7, 2020)**
IRC §§170, 6662, 6751, and 7491

☞ Court Unable to See a Donation of Eyeglass Frames Due to Inadequate Appraisal Report

Facts. In December 2006, Roderick Campbell learned about a charitable contribution program through CPA Victor Kawana, who was a one-third owner and managing partner of Kruse Mennillo, LLP, an accounting and management consulting firm. The charitable contribution program involved over 170,000 designer eyeglass frames that ZD Products, Inc. possessed, which were divided into units of approximately 3,432 frames each. These units were for sale to 50 buyers for $50,000 per unit. After a 1-year holding period, each buyer would then purportedly be eligible to donate their frames to Lions in Sight, an IRC §501(c)(3) nonprofit organization (or a different charitable organization of the buyer's choosing) and claim a charitable contribution deduction of the appraised fair market value (FMV) at the time of donation.

Mr. Campbell received a copy of an offering memorandum detailing the program and its tax implications, which was prepared by Mr. Kawana and two other Kruse Mennillo partners. The offering memorandum said that qualified individuals could donate the frames to qualified charities at FMV. As a result, the qualified individuals would be eligible for a tax deduction at the appraised FMV. The memorandum also said that ZD Products would take care of all arrangements regarding storage of the frames, insurance, drop shipment to a qualified charity, and completion of IRS Form 8283, *Noncash Charitable Contributions,* signed by a qualified appraiser. Furthermore, the memorandum identified Lions in Sight as the targeted donee, explaining that ZD Products had already made arrangements to ship the frames to it.

The offering memorandum stated that ZD Products had retained Marshall & Stevens, Inc. to make an analysis and valuation of the frames. Marshall & Stevens would provide an appraisal at the time of the donation, provide and sign a Form 8283, and defend its appraisal if challenged by the IRS.

Marshall & Stevens' initial written appraisal was dated November 27, 2006. The appraisal described a quantity of 171,600 eyeglass frames of various styles and designer brand names, with the wholesale price per model ranging from $37 to $80. Marshall & Stevens stated that the FMV of the property as of November 27, 2006, was $11.3 million.

Mr. Campbell decided to participate in the eyewear charitable contribution program. On December 22, 2006, he paid $50,000 for an inventory of 3,432 eyeglass frames from ZD Products.

On December 28, 2007, Lions in Sight sent Mr. Campbell a letter acknowledging his gift. The letter did not mention whether Lions in Sight provided any goods or services in exchange for the donation.

Marshall & Stevens prepared a follow-up written appraisal for ZD Products dated December 26, 2007. The 2007 appraisal contained the same description and physical condition as the 2006 appraisal except that the total quantity of eyeglass frames had increased from 171,600 to 349,629 and included some additional brand names. Like the inventory list attached to the 2006 appraisal, the wholesale price per model ranged from $37 to $80. Marshall & Stevens stated that the FMV of the property as of December 26, 2007, was $24 million.

With the aid of Kruse Mennillo, Mr. and Mrs. Campbell filed their joint 2007 tax return. They reported a negative adjusted gross income (AGI) of more than $1 million. They attached a Schedule A, *Itemized Deductions,* claiming $97,621 of itemized deductions. This included a $225,596 donation to Lions in Sight and a charitable contribution carryover from a prior year. Because of their negative AGI, they could not claim a charitable contribution deduction for 2007, but claimed it as a carryover deduction on their 2008 Schedule A.

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Mr. and Mrs. Campbell attached a Form 8283 to their 2007 return. The information entered on the form indicated they had donated new eyeglass frames having an appraised FMV of $225,596. They also attached the 2007 appraisal prepared by Marshall & Stevens.

Mr. and Mrs. Campbell timely filed their joint tax return for 2008. Their 2008 return reported AGI of $2.97 million. On the Schedule A attached to their return, they claimed itemized deductions, which included the carryover contribution deduction from the 2007 return.

Following an examination of Mr. and Mrs. Campbell's 2008 return, the IRS determined that their carryover charitable contribution deduction for the Lions in Sight donation should be disallowed and that accuracy-related penalties should be imposed.

Issues. The issues in this case are as follows.

- Whether taxpayers are entitled to a carryover charitable contribution deduction for a 2007 donation of eyeglass frames
- Whether taxpayers are liable for IRC §6662 accuracy-related penalties

Analysis. For any noncash charitable contribution exceeding $5,000, Treas. Reg. §1.170A-13 requires the following.

- A qualified appraisal for the contributed property
- A fully completed appraisal summary attached to the tax return
- The maintenance of records containing information required by Treas. Reg. §1.170A-13(b)(2)(ii)
- A contemporaneous written acknowledgment (CWA) from the charitable organization (for any contribution of $250 or more)

The IRS contended that Mr. and Mrs. Campbell did not comply with the substantiation requirements under IRC §170. The IRS asserted that the 2007 appraisal prepared by Marshall & Stevens was not a qualified appraisal because it did not include a description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the appraised property was the property that was (or will be) contributed.[11] The court agreed but observed that the 2007 appraisal suffers from a more fundamental problem; specifically, it is not an appraisal of what Mr. Campbell donated. Instead of his donation of 3,432 eyeglass frames, it is an appraisal of 349,629 frames. Although the 2007 appraisal included Mr. Campbell's 3,432 frames, the court and the IRS have no way to determine whether what he contributed was properly valued. The 349,629 frames were valued between $37 and $80 each, but the taxpayers could not discern the price that applied to each of the frames Mr. Campbell donated. Therefore, the 2007 appraisal did not comply with the requirement that the taxpayer obtain an appraisal of the property they contributed that gave rise to their claimed deduction.

In addition, the IRS claims that Lions in Sight's December 28, 2007, letter to Mr. Campbell was not a proper CWA because it did not address the issue of whether the donee provided any goods or services in consideration for the contribution.[12] The court agreed and held that the taxpayers did not comply with the requirement to obtain a CWA.

11. Treas. Reg. §1.170A-13(c)(3)(ii).

12. Treas. Reg. §1.170A-13(f)(2).

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On the issue of whether Mr. and Mrs. Campbell are liable for accuracy-related penalties under §6662, the IRS bears the burden of production with respect to a taxpayer's liability for any penalty. The initial burden of production under IRC §7491(c) includes certain procedural requirements. IRC §6751(b)(1) requires that the initial determination of certain penalties be personally approved in writing by the immediate supervisor of the person making the determination. The court determined that the IRS failed to carry its burden of production to comply with the §6751(b) procedural requirements because, although the civil penalty approval form was properly signed and dated before the issuance of the notice of deficiency, it failed to state with any specificity which penalties should be asserted. The court observed that §6751(b)(1) would be meaningless if written supervisory approval of an unspecified penalty was sufficient. Accordingly, Mr. and Mrs. Campbell are not liable for the penalties.

Holding. The court held that Mr. and Mrs. Campbell are not entitled to a charitable contribution deduction for their 2007 donation of eyeglass frames but they are not liable for penalties under §6662.

Casualty Loss Deduction

Robert G. Taylor, II v. Comm'r, **TC Memo 2019-102 (Aug. 19, 2019)**

IRC §§165 and 6662

☞ Tax Court Blows Away Taxpayer's Casualty Loss Deduction for Hurricane Damage

Facts. The River Oaks neighborhood in Houston is one of the most exclusive and prestigious subdivisions in the United States. The famous architect John Staub designed several houses in the River Oaks neighborhood, including Robert Taylor's house, which was originally designed for Harry Hanszen. Hanszen House was built in 1930 and is considered Mr. Staub's "greatest picturesquely romantic house."

In 1998, Mr. Taylor purchased the property for $9.25 million. Sometime after he purchased the property, some or all of certain fixtures and sculptures included in the purchase price were conveyed to an entity named the Yote Trust.

In 2007, Mr. Taylor listed the property for sale at $18.5 million. The listing agreement specifically excluded from the sale all personal property that was attached to the real property.

On September 13, 2008, Hurricane Ike struck Harris County. Mr. Taylor's property, which is located in Harris County, sustained significant damage.

Mr. Taylor had insured the "dwelling" for $15.554 million, "other structures" for $3.11 million, personal property for $10.89 million, and fine art for $3.34 million. On September 17, 2008, Mr. Taylor filed a claim with his insurance company, Chubb Lloyd's Insurance Co. of Texas (Chubb), for hurricane damage.

Mr. Taylor spent several months repairing, replacing, and remediating the property and its contents. The "contents" included 6,889 bottles of wine, which were valued as of September 12, 2008, at $994,481. Chubb paid Mr. Taylor $1.574 million for the value of the wine.

Chubb also reimbursed Mr. Taylor for repairs and replacements that included mahogany doors, cabana windows, tree removal, fence repairs, fabrication and installation of flooring, ceiling repairs, replacement of silk drapes, and extensive repairs to stained glass windows. Chubb paid Mr. Taylor a total of $2.386 million.

Mr. Taylor's 2008 Form 1040 was prepared by the same accounting firm he had retained for many years to prepare his individual and business returns. The firm used a multistep process for his return, which included three reviews. Mr. Taylor's return reported adjusted gross income of $3.97 million, with total tax due of $364,288, which he paid in full when he filed the return. He claimed a casualty loss deduction of $888,345. His 2008 Form 4684, *Casualties and Thefts,* reported a basis in the property of $6.5 million, insurance reimbursements of $2.3 million, fair market value (FMV) before the casualty of $15.44 million, and FMV after the casualty of $12.25 million.

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In November 2016, Mr. Taylor filed a supplement to his petition seeking a casualty loss deduction in excess of what he claimed on his 2008 return. In doing so, he relied on a retrospective appraisal performed by Gayle Robertson Woodum, a licensed real estate appraiser with over 30 years of experience appraising premium properties in the Houston area. Ms. Woodum determined that the property's FMV before the casualty was $18.468 million ($10.650 million for land and $7.818 million for the house and other improvements) and the FMV after the casualty was $11.081 million ($10.650 million for the land and $430,600 for the house and other improvements). Ms. Woodum's appraisal report included detailed descriptions of the improvements on the land, including some of the property that had been conveyed to the Yote Trust.

At trial, Ms. Woodum stated that the property was "stigmatized" because of the flood. She believed that flooding could lead to diminished value attributed to public perception. According to Ms. Woodum, part of the stigma was because asbestos was discovered during the remediation process.

The IRS issued a notice of deficiency to Mr. Taylor. The IRS determined that Mr. Taylor was not entitled to deduct a casualty loss for 2008 and he was liable for an accuracy-related penalty.

Issues. The issues in this case are the following.

- Whether Mr. Taylor is entitled to a 2008 casualty loss deduction for hurricane damage to his residence
- Whether Mr. Taylor is liable for an accuracy-related penalty under IRC §6662(a)

Analysis. Subject to certain limitations, an individual is allowed a deduction for losses sustained during the tax year that "arise from fire, storm, shipwreck, or other casualty, or from theft" and that are not compensated for by insurance or otherwise.[13] The net casualty loss is generally allowed only to the extent it exceeds $100 and 10% of the taxpayer's adjusted gross income (AGI). The general rule was modified by the Tax Extenders and Alternative Minimum Tax Relief Act of 2008,[14] which made the 10% of AGI limit inapplicable for a "net disaster loss." This means that a taxpayer incurring a net disaster loss in a federally declared disaster area in 2008 was allowed a casualty loss deduction even if the net casualty loss did not exceed 10% of the taxpayer's AGI.

> **Note.** The Tax Cuts and Jobs Act of 2017 limited individual casualty loss deductions to the extent attributable to a federally declared disaster.[15]

To calculate a casualty loss deduction, the following property values must be established.

- FMV before the casualty
- FMV after the casualty
- Taxpayer's basis in the property

The precasualty and postcasualty values must generally be determined by competent appraisal.[16] A competent appraisal must recognize the effects of any general market decline that may occur at the same time as the casualty so that any deduction will be limited to the actual loss resulting from property damage.

The court noted that Ms. Woodum's appraisals showed a decline in FMV of $7.387 million. However, there was no indication that Ms. Woodum excluded any property held in the Yote Trust from her valuation. In addition, her postcasualty appraisal relied heavily on the stigmatization of Hanszen House because of the flooding.

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13. IRC §§165(a), (c)(3), (h)(1) and (2).
14. PL 110-343.
15. IRC §165(h)(5).
16. Treas. Reg. §1.165-7(a)(2)(i).

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Traditionally, the court has held that physical damage to property is a prerequisite to deducting a casualty loss under IRC §165. In addition, various court cases have noted that attempts to base a deduction on market devaluation without proving the extent of property damage is contrary to existing law.[17] Moreover, "no allowance can be made for purported immediate buyer resistance to purchases in a flood-damaged area, particularly in the absence of evidence of postflood sales of comparable properties."[18] Ms. Woodum did not include any post-hurricane sales of comparable properties in her appraisal summary.

Ms. Woodum asserted that the property was "stigmatized," partly as a result of the discovery of asbestos in the basement of the house. However, the asbestos was present in the house when Mr. Taylor purchased it, and any loss in value because of the discovery of the asbestos is not part of his casualty loss.[19]

The court was not persuaded that the value of Hanszen House and other improvements declined by 95% as Ms. Woodum concluded. Even if the value did decline that much, the court was not persuaded that it did so solely because of the hurricane damage. Accordingly, Mr. Taylor did not establish his loss through a competent appraisal.

Mr. Taylor spent several months repairing and replacing the property after the hurricane. He would generally be entitled to a casualty loss deduction for the cost of such repairs that did not exceed his adjusted basis in the property and that were not compensated for by insurance. Mr. Taylor did not argue that he made repairs that were not compensated for by insurance. He purchased the property in 1998 for $9.25 million. On his Form 4684, he reported his basis as $6.5 million. He did not provide an explanation as to the difference in basis. In any event, his adjusted basis in the property exceeded the cost of any repairs he made. He received insurance payments totaling $2.392 million, which was well in excess of the cost of repairs he would otherwise be entitled to deduct as a casualty loss. Therefore, he is not entitled to a casualty loss deduction for 2008.

IRC §6662 imposes a 20% accuracy-related penalty on an underpayment of income tax attributable to a taxpayer's negligence or disregard of rules. The penalty does not apply to any portion of the underpayment if the taxpayer had reasonable cause and acted in good faith. The court noted that Mr. Taylor reasonably relied on his accounting firm to prepare his 2008 return correctly. He gave his CPA all pertinent information for his return and relied in good faith on the CPA's judgment. Accordingly, he is not liable for an accuracy-related penalty.

Holding. The court held that Mr. Taylor was not entitled to a casualty loss deduction for 2008 but declined to hold him liable for the §6662 accuracy-related penalty.

17. See, e.g., *Chamales v. Comm'r,* TC Memo 2000-33 (Feb. 3, 2000).

18. *Thornton v. Comm'r,* 47 TC 1, 7 (1966).

19. See *Pulvers v. Comm'r,* 48 TC 245, 249 (1967).

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DIVORCE ISSUES

Child Support and Alimony

***Timothy Biddle v. Comm'r,* TC Memo 2020-39 (Apr. 6, 2020)**

IRC §§71 and 215

☞ Court Reclassified Alimony Payments That Were Contingent on the Age of a Child

Facts. Timothy Biddle and his ex-wife have four children. They officially dissolved their marriage on April 19, 2010. Under the divorce decree, Mr. Biddle was ordered to pay monthly child support of $1,796 starting April 19, 2010, and ending when each child reaches 18 years old, dies, marries, enters military school, or becomes self-sufficient. The decree also stated that Mr. Biddle would pay monthly alimony of $1,593 for at least five years or until one of the following events occur.

1. The youngest child turns 18 years old
2. The death of the husband or wife
3. The wife remarries at the 5-year mark or any time after
4. The wife becomes self-supporting

Additionally, if Mr. Biddle receives a salary increase during the time he is required to make alimony payments, his ex-wife is entitled to half of the increase.

On November 7, 2011, the couple modified their divorce agreement because Mr. Biddle took custody of another child. The monthly child support payments were reduced to $407. The modified decree did not change the monthly alimony payments or the terms that would terminate the payments. Mr. Biddle's monthly $2,000 payments allocated $1,593 to alimony and $407 to child support. He continued to make these payments until March 2018, when his ex-wife became entitled to half of Mr. Biddle's military retirement pay and the court relieved him of his support obligations.

Mr. Biddle claimed an alimony deduction of $28,000 on his 2015 federal income tax return. The IRS disallowed the deduction.

Issue. The issue in this case is whether Mr. Biddle's payments to his ex-wife were deductible alimony payments.

Analysis. A payor is allowed a deduction under IRC §215 for alimony paid equal to the amount that the recipient spouse claims as income. To be considered as alimony, the payments must meet the following qualifications.[20]

- The payment is received by a spouse under a divorce or separation agreement.
- The divorce or separation agreement does not state that the payment is not includable in income or allowed as a deduction.
- The spouses are not members of the same household when the payor makes the payment.
- The obligation to pay is terminated at the death of the receiving spouse and there is no obligation to make substitute payments after the payee spouse dies.

IRC §71(c) provides that any payments with a **contingency** that references a child are considered child support payments rather than alimony. Because Mr. Biddle's divorce decree stated that the payments would stop when the youngest child turns 18 years old, the court determined that **the payments qualify as child support.**

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20. IRC §71.

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Mr. Biddle argued that the payments should be deductible because the decree differentiates between alimony payments and child support payments. The court discounts the argument because even though there are specific designations for alimony and child support, the "alimony" payments are associated with a child. Mr. Biddle asserts that he and his ex-wife did not intend to make the 18th birthday of their youngest child a contingency for the payments. However, the court cannot look to the "intent" of the parties in determining whether a payment qualifies as alimony.

Holding. The court held that the monthly payments Mr. Biddle made to his ex-wife were all child support and therefore he could not deduct the payments.

> **Note.** IRC §215 was stricken by the Tax Cuts and Jobs Act.[21] Accordingly, for divorce or separation agreements executed after December 31, 2018, alimony is not deductible by the paying spouse and is not taxable to the receiving spouse.

FOREIGN INCOME

Foreign Bank Account Disclosure

***U.S. v. Dennis Ott,* No. 2:18-cv-12174; U.S. District Court for the Eastern District of Michigan (Feb. 26, 2020)**
31 USC §5321

☞ Failure to Disclose Foreign Bank Account on Return Triggers Large Penalty

Facts. Dennis Ott is a U.S. citizen who resides in Michigan. In 1993, he opened brokerage accounts with a Canadian financial institution, and he deposited additional funds in his Canadian accounts over the years. Mr. Ott used his sister's address in Canada on the accounts.

In 2007, the highest aggregate balance of the accounts exceeded $1.9 million. In 2008, the highest aggregate value exceeded $770,000. In 2009, the highest aggregate balance exceeded $1.7 million.

Mr. Ott's long-time CPA prepared his income tax returns for the years in question. The CPA prepared the returns based on the information that Mr. Ott provided. Mr. Ott signed his returns, acknowledging that the returns were "true, correct, and complete."

The returns for each year included a Schedule B, *Interest and Ordinary Dividends.* The returns that Mr. Ott submitted to the IRS had the "no" box marked in response to the question about whether the taxpayer had a foreign interest in, or signature authority over, a financial account in a foreign country. **By default, the CPA's software checks the box "no."**

> **Caution.** It is important for practitioners to ask clients the question on Schedule B regarding foreign accounts. Some software automatically checks the box "no." The preparer needs to check software diagnostics for a prompt that addresses the question about foreign accounts and make certain "no" is not the default.

21. PL 115-97, §11051.

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Mr. Ott did not file a Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts,* (FBAR) for 2007 through 2009. The FBAR is required to be filed when a U.S. citizen's interest in a foreign account exceeds $10,000 per year.

After learning that Mr. Ott had foreign accounts, his CPA referred Mr. Ott to a tax attorney. In 2011, the tax attorney recommended that Mr. Ott disclose the existence of the foreign accounts as part of the IRS's offshore voluntary disclosure initiative (OVDI). As required by the OVDI, Mr. Ott provided the following to the IRS.

- Copies of his original and amended income tax returns
- Statements for his Canadian accounts
- FBARs
- Payment of the additional income tax due

The IRS later published information on its website advising taxpayers who were participants in the 2011 OVDI that they should withdraw (opt out) from the OVDI if the taxpayer's potential penalties under Title 26 and Title 31 statutes would be less (because the taxpayer's conduct was not willful) than under the OVDI. The IRS's opt-out procedures were intended for taxpayers who did not willfully fail to file FBARs and report the income on their foreign accounts. Based on discussions with his CPA and tax attorney, Mr. Ott formally requested to opt out of the OVDI.

After Mr. Ott opted out of the OVDI, the IRS audited Mr. Ott's income tax returns and FBARs for 2003 through 2009. It assessed income tax deficiencies and civil fraud penalties for 2007 through 2009, which were related to the voluntary disclosures for foreign accounts. In a separate procedure, the IRS also assessed penalties for willful failure to report the Canadian accounts on FBARs for 2007 through 2009.

Issue. The issue in this case is whether Mr. Ott **willfully** failed to file FBARs for his Canadian accounts for 2007 through 2009.

Analysis. The IRS claimed that Mr. Ott had constructive knowledge of his reporting requirements by signing his tax returns, which included a reference to the FBAR on Schedule B. Additionally, the IRS believed that using his sister's Canadian address on the accounts was an act of concealment. Furthermore, the IRS asserted that the foreign balances were an overwhelming portion of Mr. Ott's total income. The IRS alleged that all these factors demonstrate that Mr. Ott acted recklessly and willfully by not filing the FBARs. Mr. Ott argued that he was at most negligent and there was no willful failure to file the FBARs.

To obtain penalties for willfulness under 31 USC §5321, the IRS must prove that Mr. Ott willfully failed to file his FBARs by a preponderance of the evidence. In determining whether Mr. Ott acted willfully, the court considered the following facts.

- **Mr. Ott had constructive knowledge of his FBAR filing requirements by signing the income tax returns, which supports a charge of willfulness.** By signing his returns, Mr. Ott asserted that he reviewed the returns and that they were accurate and complete, regardless of whether he actually read the returns.
- **Mr. Ott acted recklessly, and therefore willfully, by not informing his accountant of his Canadian accounts.** Although Mr. Ott argues that his reliance on incorrect advice at most proves negligence rather than willful behavior, the court believes that by not disclosing his foreign accounts to his accountant, Mr. Ott made a "conscious effort to avoid learning about reporting requirements." Mr. Ott should have known there was a risk of noncompliance but he did not mitigate the risk by taking any investigative or corrective action.
- **Mr. Ott's use of his sister's address in Canada was an act of concealment demonstrating willfulness.** Using the foreign address suggests that Mr. Ott was attempting to avoid detection. By failing to read any of the mail that came to his sister's address, his conduct was "marked by careless disregard" and met the civil recklessness standard.

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- **Mr. Ott acted recklessly and therefore willfully because he remained in contact with his broker, regularly checked the account balance online, and the actual balance was disproportionately higher than the reported amount.** This behavior indicates that Mr. Ott was well informed about the existence and balances of his accounts. He regularly wrote checks out of the Canadian account but claimed he could not remember when the withdrawals were made or on what the money was spent. The court noted that it was not credible that Mr. Ott, whose claimed income was near the poverty level, would not remember taking out large amounts from his Canadian accounts.

Holding. The court held that Mr. Ott willfully failed to file the FBARs for 2007–2009 and assessed penalties for the years at issue in the amount of $988,245.

GIFTS

Gifts and Inheritances

Estate of Mary Bolles et al. v. Comm'r, **TC Memo 2020-71 (Jun. 1, 2020)**

IRC §§2001, 2031, and 2033

☞ Evidence of Inability to Repay Transforms Loans to Gifts

Facts. Mary Bolles was the mother of five children. She wanted to distribute her assets to her children equally. To ensure this, she kept a record of her advances and repayments for each child. She treated the advances as loans and forgave the "debt" account of each child based on the annual gift tax exemption amount.

Mary married John Savage Bolles in 1935. In connection with their divorce in 1977, Mary and John Bolles established the Bolles Trust to hold some of their jointly owned property. Mary and her five children were among the beneficiaries of the Bolles Trust at the time of her death in 2010. John Bolles died in 1983.

Peter was the oldest of Mary and John Bolles' five children. His career as an architect showed great promise but he eventually began to have financial difficulties. By 1983, Peter's practice was behind on its bills. In July 1983, Peter entered into an agreement with the Bolles Trust to use trust property to secure $600,000 in bank loans. When Peter failed to meet the terms of the agreement, the trust was held liable for the $600,000. Mary knew about these events.

From 1985 through 2007, Mary transferred $1.6 million to or for the benefit of Peter. Peter did not repay Mary after 1988.

Mary was the settlor of the Mary Piper Bolles Revocable Trust, which was dated October 27, 1989. Under the terms of the trust, Mary specifically excluded Peter from any distribution from her estate when she died.

In 1994 or 1995, Mary started working with an attorney, Karen Hawkins, who assisted Mary in organizing her finances. Ms. Hawkins prepared various documents, including estate planning documents. As part of the estate planning, Mary signed an amendment to her trust, in which she no longer explicitly excluded Peter from any distribution. Instead, a formula was provided to account for the loans to Peter made during Mary's lifetime. Under this formula, the value of the trust after expenses is divided equally; each child's share is then reduced by the amount of the child's outstanding loans, if any, plus accrued interest. That amount is redistributed pro rata among the other beneficiaries.

The IRS issued a notice of deficiency, asserting that the fair market value (FMV) of the promissory note and receivable due from Peter under IRC §2031 was $1.06 million, instead of zero as reported. In addition, interest of $1.2 million on the promissory note and receivable is includable in the gross estate under IRC §2033. Therefore, the value of the gross estate is increased by $2.2 million.

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The notice further stated that if it was determined the FMV under §2031 and interest is zero, then it is determined that Mary transferred property to Peter during her life such that "adjusted taxable gifts" in the amount of $1.06 million is included in calculating estate tax liability under IRC §2001(b).

Issue. The issue in this case is whether the advances Mary Bolles made to Peter Bolles should be treated as loans or as gifts.

Analysis. The IRS conceded its primary position in the deficiency notice that the estate tax return undervalued Peter's debt and now relies solely on its alternative argument that Mary's advances to Peter were gifts.

In addressing the issue of whether the advances were loans or gifts, the court looked to the analysis presented in *Miller v. Comm'r.*[22] These factors are as follows.

1. There was a promissory note or other evidence of indebtedness.
2. Interest was charged.
3. There was security or collateral.
4. There was a fixed maturity date.
5. A demand for repayment was made.
6. Actual repayment was made.
7. The transferee had the ability to repay.
8. Records maintained by the transferor and/or the transferee reflect the transaction as a loan.
9. The manner in which the transaction was reported for tax purposes is consistent with a loan.

For a family loan, an actual expectation of repayment and an intent to enforce the debt are critical to characterizing the transaction as a loan.[23]

Although Mary recorded the advances to Peter as loans and kept track of interest, there were no loan agreements or attempts to force repayment. The estate argued that Mary always considered these advances as loans during her life. However, the court noted that it could not reconcile this argument with the deterioration of Peter's finances and the ultimate failure of his architectural practice.

The court observed that Mary expected Peter to make a success of his practice and was slow to lose that expectation. However, it was clear she realized he was highly unlikely to repay the loans by October 1989, when her trust provided for a specific block of Peter's receipt of assets at the time of her death. As a result, in 1990, the "loans" lost that characterization for tax purposes and became advances on Peter's inheritance from Mary.

Holding. The court held that the advances to Peter were loans through 1989 but after that were gifts.

22. *Miller v. Comm'r,* TC Memo 1996-3, *aff'd* 113 F.3d 1241 (9th Cir. 1997).

23. *Estate of Van Anda v. Comm'r,* 12 TC 1158, 1162 (1949), *aff'd per curiam* 192 F.2d 391 (2d Cir. 1951).

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GROSS INCOME

Difficulty of Care Payments

AOD 2020-02 (Mar. 30, 2020), addressing *Feigh v. Comm'r,* 152 TC No. 15 (2019)
IRC §131

☞ Payments Received Under Medicaid Waiver Program are Earned Income for Tax Credits

Facts. IRS Notice 2014-7 provides that as of January 3, 2014, the IRS will treat qualified Medicaid waiver payments as difficulty of care payments excludable from gross income under IRC §131. The notice concerns Medicaid waiver payments received by a care provider as part of a state's Medicaid waiver program. Qualified Medicaid waiver payments are defined as payments made by a state, political subdivision of a state, or certified Medicaid provider to an individual care provider for nonmedical services provided under a plan of care to an eligible individual living in the care provider's home.

For purposes of determining a taxpayer's eligibility for the earned income credit (EIC) and additional child tax credit (ACTC), earned income generally includes wages and other employee compensation, unless the compensation is not includable in the taxpayer's gross income.[24]

In 2015, Mary Feigh received wages of $7,353 that were qualified Medicaid waiver payments. Mr. and Mrs. Feigh excluded the amount of these payments from gross income and included it in their earned income to claim an EIC and an ACTC. The IRS disallowed the Feighs' EIC and ACTC, stating that an amount excluded from gross income under IRS Notice 2014-7 is not earned income for purposes of determining eligibility for the EIC and the ACTC.

Issue. The issue in this Action on Decision (AOD) is whether the IRS will follow the Tax Court's opinion in *Feigh* that:

- Medicaid waiver payments received as wages for the care of the taxpayers' disabled adult children in their own home are not excludable from income under §131; and
- If such payments are treated as excludable from gross income pursuant to IRS Notice 2014-7, the payments may nevertheless be earned income for determining a taxpayer's eligibility for the EIC and the ACTC.

> **Note.** For more information about the treatment of Medicaid waiver program payments, see the 2020 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Unexpected Issues for Individual Taxpayers.

Analysis. The Tax Court agreed with the taxpayers and held that the payments Mrs. Feigh received as wages for the care of her disabled adult children in their own home were not excludable under §131. Moreover, even though the IRS continues to allow taxpayers to exclude such payments under §131, the IRS cannot reclassify a taxpayer's income so that it no longer qualifies as earned income for purposes of determining eligibility for the EIC or the ACTC.

Holding. The IRS will follow the *Feigh* opinion. In cases in which the IRS permits taxpayers to treat qualified Medicaid waiver payments as difficulty of care payments excludable under §131, the IRS will not argue that such payments are not earned income for purposes of determining eligibility for the EIC and the ACTC merely because they are excludable under IRS Notice 2014-7.

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24. See IRC §§32(c)(2) and 24(d)(1)(B)(i).

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Debt Relief

Rev. Proc. 2020-11, 2020-6 IRB 406 (Jan. 15, 2020)

IRC §6050P

☞ Relief for Taxpayers with Certain Discharged School Loans

Purpose. The IRS is providing a safe harbor to extend relief to taxpayers who took out federal or private student loans to finance attendance at a nonprofit or a for-profit school and who had their loans discharged by the Department of Education. Additionally, certain creditors that are normally required to provide payee statements and file information returns for the discharge of indebtedness are relieved of that obligation.

Analysis. The Department of Education may discharge federal student loans obtained by a student (or parent on behalf of a student) if the borrower establishes, as a defense against repayment, that the school's actions would give rise to a cause of action against the school under state law.

Relief was previously allowed for taxpayers who took out federal student loans to attend a school owned by Corinthian College, Inc. or American Career Institutes, Inc. The relief is now extended to loans used to attend any nonprofit or other for-profit school if the federal loans are discharged by the Department of Education under the Closed School or Defense to Repayment discharge process, or if the loan is discharged because of a legal cause of action against the nonprofit or other for-profit school and certain private lenders.

Various federal and state governmental agencies have brought suit against for-profit schools and certain private lenders that financed student loans to attend those schools for unlawful business practices. Unlawful business practices include unfair, deceptive, and abusive acts and practices.

The Closed School discharge process allows the Department of Education to discharge a federal student loan for a student who attended a school at the time that it was closed or who withdrew from the school within a certain period of time prior to the date it closed. The Defense to Repayment discharge process allows the Department of Education to discharge a federal direct loan if the school's actions would give rise to a cause of action against the school under state law.

A taxpayer whose federal student loan is discharged under the Closed School or the Defense to Repayment process does not recognize gross income as a result of the discharge. In addition, the taxpayer should not report the discharged loan amount in gross income on their tax return.

A taxpayer whose private student loan is discharged because of a settlement of a legal cause of action resulting from various allegations of unlawful business practices against nonprofit, for-profit, or private lenders should not recognize gross income from the discharge. In addition, they should not include the discharged loan amount in gross income on their income tax return.

Taxpayers should not owe additional taxes or have higher gross income under the Closed School or the Defense to Repayment process when their student loan is discharged. This includes taxpayers who received an education tax credit, took a deduction for interest paid on a discharged loan, or took a deduction for qualified tuition and related expenses.

Moreover, creditors that are applicable entities as defined under IRC §6050P should not file information returns or furnish payee statements as a result of discharging the loans.

Effective Date. This revenue procedure is generally effective for federal student loans discharged by the Department of Education and certain private student loans discharged in tax years beginning on or after January 1, 2016.

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Constructive Dividends

***Patrick Combs v. Comm'r,* TC Memo 2019-96 (Aug. 5, 2019)**

IRC §§301, 6651, 6662, and 6673

☞ Taxpayer Was Demolished By Not Reporting Constructive Dividends; Not Good Thinking

Facts. Patrick Combs was an author, performer, and motivational speaker who performed one-person comedy shows and participated in speaking engagements. Compensation for his performances was generally paid to his C corporation, The Good Thinking Co., Inc. (Good Thinking).

Good Thinking was established as part of a tax-avoidance strategy which involved paying Mr. Combs's personal expenses through the corporation. Mr. Combs was the sole shareholder, president, chief executive officer, chief financial officer, sole director, and treasurer. His significant other, Deanna Larson, was the secretary. Ms. Larson and Mr. Combs were the only individuals with signature authority over the Good Thinking bank account and the Good Thinking credit card.

Mr. Combs filed his Form 1040, *U.S. Individual Income Tax Return,* on time for 2010 and 2012. His 2011 tax return was due April 17, 2012, and Mr. Combs filed it on June 24, 2013.

Good Thinking filed a 2010 Form 1120, *U.S. Corporation Income tax Return,* which reported gross profits of $217,789 and total expenses of $221,457. The 2011 Form 1120 reported gross profits of $65,520 and total expenses of the same amount. The 2012 Form 1120 reported gross profits of $9,611 and total expenses of the same amount.

The IRS audited Mr. Combs's and Good Thinking's returns. It issued a notice of deficiency on July 3, 2014, that disallowed most of the deductions for Good Thinking because of a lack of substantiation. The gross income for Good Thinking was subsequently adjusted upwards for 2011 and 2012 by the disallowed expenses. The IRS also determined that the personal expenses paid by Good Thinking were constructive dividends to Mr. Combs that he failed to report. As a result, Mr. Combs had constructive dividends of $207,707, $72,710, and $39,646 for 2010, 2011, and 2012, respectively. The IRS further determined that Mr. Combs was liable for an accuracy-related penalty under IRC §6662(a) due to negligence or disregard of rules or regulations, a substantial understatement of income tax, or a substantial valuation overstatement.

Issues. The issues in this case are the following.

- Whether Mr. Combs received constructive dividends from Good Thinking during 2010, 2011, and 2012
- Whether Mr. Combs is liable for an IRC §6651(a)(1) addition to tax for failure to timely file his 2011 tax return
- Whether Mr. Combs is liable for §6662(a) accuracy-related penalties for 2010, 2011, and 2012
- Whether Mr. Combs is subject to an IRC §6673(a) penalty

Analysis. A constructive dividend results when a controlling shareholder redirects corporate funds for their personal use. Mr. Combs was the 100% owner of Good Thinking, maintained authority for the credit card and bank account, and was the sole source of income for the company.

A corporation must have sufficient earnings and profits (E&P) for distributions to a shareholder to be classified as a dividend. Any amount of the distribution that exceeds E&P is considered a nontaxable return of capital to the extent of the shareholder's basis. Any additional amount greater than the shareholder's basis is taxable as a gain from the sale or exchange of property. Mr. Combs did not provide any evidence regarding Good Thinking's E&P and therefore did not meet his burden of proving that there was insufficient E&P to support the IRS's determination of constructive dividends to him.

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Mr. Combs failed to show that the expenditures paid by the corporation gave rise to deductions on behalf of Good Thinking. The remaining question is whether the expenditures created "economic gain, benefit, or income to the owner-taxpayer."[25] During the trial, Mr. Combs produced hundreds of pages of unsorted documentation. He tried to prove a few of the documents were deductible expenses for Good Thinking. However, the court did not find his testimony credible and believed that Mr. Combs did not provide any reasonable means to estimate which of the hundreds of expenses were ordinary and necessary business expenses. The documentation did reflect many personal expenses for items such as child care, clothing, groceries, and fast food restaurants. This supports the contention that the distributions were made for Mr. Combs's personal gain, benefit, or income. The court therefore determined that Mr. Combs received and failed to report constructive dividends for 2010, 2011, and 2012.

The IRS assessed a **§6651 addition to tax** to Mr. Combs for not filing a timely return for 2011. He filed the return over 14 months late and did not show reasonable cause for the delay. The court upheld the addition to tax.

The IRS also assessed a **§6662(a) accuracy-related penalty of 20%** on the portion of the underpayment from negligence or disregard of rules or regulations. Failing to make a reasonable attempt to follow the Code or maintain adequate books and records is considered negligent behavior. The court determined that Mr. Combs did not make a reasonable effort to comply with the Code and did not keep adequate books and records. Additionally, the court believed that Mr. Combs did not act with reasonable cause and in good faith. Rather, the court concluded that he intentionally participated in a tax-evasion scheme to reduce his income. Therefore, the court held the penalty was appropriate.

The Tax Court can assess a **penalty of up to $25,000 under §6673(a)(1)** if the taxpayer maintained proceedings primarily for delay, if their position was frivolous or groundless, or if the taxpayer unreasonably failed to pursue available administrative remedies. The court determined that Mr. Combs argued frivolous and groundless positions. He was repeatedly warned about the §6673(a) penalty but he continued to waste the court's time and resources. The court assessed Mr. Combs a $2,500 penalty.

Holding. The court held that Mr. Combs received constructive dividends in 2010, 2011, and 2012. Additionally, he is liable for the late-filing penalty for his 2011 return and accuracy-related penalties for 2010, 2011, and 2012. The court held that Mr. Combs wasted significant time and resources of the court and was therefore liable for the §6673(a) penalty.

Prizes and Awards

***Alejandra Conyers v. Comm'r,* Docket No. 13969-18 (Sep. 11, 2019)**

IRC §§74 and 102

☞ Car Awarded to High School Student Accelerates Her Taxable Income

Facts. Alejandra Conyers was a high school senior in Columbia, Tennessee, in 2016. A local car dealership held an annual "Strive to Drive" competition, which was a contest that encourages good grades and attendance for local high school seniors. Schools enter students in the contest who have good grades or perfect attendance. At the end of the school year, the dealership randomly chooses a name from the qualifying students whose names have been entered in the drawing. The winner receives a free car and insurance for one year.

The dealership drew Ms. Conyers' name for the prize in 2016 and she won a 2016 Jeep Renegade. She accepted the car and registered it in her name.

Ms. Conyers timely filed her 2016 return. She did not include the fair market value (FMV) of the vehicle in her 2016 gross income, although the dealership issued a Form 1099-MISC, *Miscellaneous Income,* that reported the value of the car given to Ms. Conyers as $23,780. The IRS then sent her a notice of deficiency for 2016, determining additional income of $23,780 and a tax deficiency of $3,267.

25. *P.R. Farms, Inc. v. Comm'r,* 820 F.2d 1084 (9th Cir. 1987).

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Ms. Conyers filed a petition with the court, claiming that the car was a gift under IRC §102 and should be excluded from her taxable income. The IRS filed a motion for summary judgment, arguing that the car was a prize, rather than a gift, and therefore the FMV is taxable income to Ms. Conyers.

Issue. The issue in this case is whether the value of the car that Ms. Conyers won was includable in her income.

Analysis. IRC §102 allows taxpayers to exclude gifts from gross income. The landmark case *Comm'r v. Duberstein* states that a gift "proceeds from a detached and disinterested generosity, out of affection, respect, admiration, charity or like impulses."[26] *Duberstein* referred to the 1939 Code, which excluded gifts from gross income. When Congress overhauled the Code in 1954, it retained the gift exclusion by creating §102 but it also made prizes includable in gross income.[27]

The Supreme Court in *Duberstein* recognized that when Congress enacted IRC §74, it prohibited taxpayers from treating prizes and awards as excludable gifts unless the prize was made "primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement."[28] Such prizes are exempt under §74(b) only if:

1. The recipient was selected **without any action on their part** to enter the contest,
2. The recipient is not required to render substantial future services as a condition to receiving the prize, and
3. The prize is transferred by the payor to a governmental unit or IRC §170(c) organization.

The court noted that Ms. Conyers received the car as a prize and, as such, she cannot exclude its value from her income. IRC §74 makes clear that this prize is not a gift for tax purposes. Ms. Conyers' receipt of the car is not exempt under §74(b) because she accepted the car and transferred title to her name. She did not ask the dealership to transfer the car to a governmental or charitable organization as required for exemption under §74(b).

Holding. The court held that Ms. Conyers received a prize from the dealership and must include the value of the car in her 2016 taxable income.

Settlement Award

Ltr. Rul. 201950004 (Sep. 13, 2019)
IRC §104

☞ Settlement Award for Damages from In Vitro Fertilization is Excluded from Taxable Income

Facts. The taxpayer contracted with the clinic to receive an anonymous donor egg and an embryo transfer via in vitro fertilization. The clinic did not test the egg or the embryo for genetic mutations. The taxpayer conceived using the donor egg and gave birth to a baby with multiple physical, cognitive, and behavioral disabilities.

The taxpayer sued the clinic for failing to test the egg or embryo for genetic mutations prior to the implanting procedure. She sought and was awarded damages for the physical injuries and physical sickness the baby suffered as a result of the genetic condition as well as for her emotional distress.

Analysis. IRC §104(a)(2) and Treas. Reg. §1.104-1(c)(1) exclude from gross income the amount of damages received as the result of personal physical injuries, physical sickness, and emotional distress that resulted from a physical injury or sickness. The amount excluded from gross income does not include amounts attributable to any deductions allowed under IRC §213 (for medical, dental, etc., expenses) for any prior tax year.

Holding. The taxpayer can exclude from gross income her award for the personal physical injuries her child suffered because the clinic did not test the donor egg for genetic mutations. She can also exclude the amount awarded for her emotional distress attributable to those injuries, except for the amounts she was reimbursed for medical expenses incurred and previously deducted.

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26. *Comm'r v. Duberstein,* 363 U.S. 278 (1960).
27. IRC §§102 and 74.
28. IRC §74(b).

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INNOCENT SPOUSE

Innocent Spouse Relief

***Jane Lassek v. Comm'r,* TC Memo 2019-145 (Oct. 28, 2019)**

IRC §6015

☞ **Taxpayer Granted Relief from Joint and Several Liability for One Year, But Not for Another**

Facts. Jane Lassek was married to Michael Smith in 1989; they divorced in December 2013. She worked for a telephone company for over 38 years and participated in the company's 401(k) plan. Mr. Smith worked for the same telephone company for 33 years. He also participated in the company's 401(k) plan.

During their marriage, Ms. Lassek and Mr. Smith maintained a joint bank account that they used to pay the mortgage, insurance, utilities, groceries, and other household expenses. Their telephone company salaries were automatically deposited into the joint bank account. Mr. Smith also had a separate bank account that he used to fund his hobby of buying cars, fixing them, and selling them.

During their marriage and until August 2012, Mr. Smith managed the couple's finances by paying bills, managing the joint bank account, and preparing and filing their income tax returns. In August 2012, Ms. Lassek took over managing their joint bank account after she received several unexpected overdraft notices from their bank.

In 2011, Ms. Lassek took a distribution of $15,000 from her 401(k) plan and deposited it in the joint bank account. Unknown to her, Mr. Smith also took a $46,477 distribution from his 401(k) plan. He did not deposit his distribution in the joint account.

Ms. Lassek gave Mr. Smith her 2011 Form W-2, *Wage and Tax Statement,* and her 2011 Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* Mr. Smith then prepared their 2011 tax return using tax preparation software and filed the return electronically on April 16, 2012, before Ms. Lassek had a chance to review it. The 2011 joint return correctly reported Ms. Lassek's 401(k) distribution as taxable but incorrectly reported Mr. Smith's 401(k) distribution as nontaxable.

The IRS issued a notice of deficiency to the couple for their 2011 return. The deficiency arose from Mr. Smith's failure to report his $46,477 distribution as taxable.

In 2012, Ms. Lassek took a taxable distribution of $11,000 from her 401(k) plan and Mr. Smith took a $23,510 distribution from his 401(k) plan, of which $23,461 was taxable.

Ms. Lassek gave Mr. Smith her 2012 Forms W-2 and 1099-R. He then prepared their 2012 tax return, reporting tax owed of $5,448. Ms. Lassek and Mr. Smith signed their 2012 joint return and timely filed it without remitting payment. They did not discuss how their tax liability would be paid.

In August 2014, the IRS issued a levy notice regarding the 2011 and 2012 tax liabilities. In response to the levy notice, Ms. Lassek filed a request for a collection due process hearing. She also filed a Form 8857, *Request for Innocent Spouse Relief,* requesting relief from joint and several liability for 2011 and 2012.

In July 2015, the IRS made a preliminary determination that Ms. Lassek was entitled to partial relief for 2011 under IRC §6015(f). The determination proposed to grant her relief of $17,995 and deny relief of $163 for the 2011 tax liability. The IRS also made a preliminary determination that Ms. Lassek was entitled to partial relief for 2012 under §6015(f). The IRS determined that she should be granted relief of $4,897 and defined relief of $487 for the 2012 liability.

Mr. Smith then submitted a letter to the IRS appealing the preliminary determinations. His letter stated that Ms. Lassek was aware of the distributions and received a substantial benefit because the distributions were used to pay the mortgage, vacations, and other household expenses.

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Issue. The issue in this case is whether Ms. Lassek is entitled to relief from joint and several liability for the 2011 and 2012 tax returns she filed with her former spouse.

Analysis. IRC §6013(d)(3) provides that if a joint return is filed, each spouse is jointly and severally liable for the entire tax due for the year. However, §6015 provides exceptions to the general rule of joint and several liability. One of the exceptions to joint and several liability is set forth in §6015(c), which limits a spouse's liability to the portion of the deficiency properly allocable to that spouse under §6015(d).

Mr. Smith contends that Ms. Lassek knew about his 2011 distribution from his 401(k) plan and her knowledge of it disqualifies her from relief under §6015(c). He also contends that she may have had "reason to know" about the understatement of tax on the return. However, the court observed that a requesting spouse's reason to know of the item is not sufficient to deny relief under §6015(c). If all of the other requirements of that section were satisfied, as is the case here, relief is denied to the requesting spouse only if the IRS demonstrates that the requesting spouse had actual knowledge at the time the individual signed the return of any item giving rise to a deficiency.[29]

Mr. Smith contends that Ms. Lassek was aware of his 401(k) distribution in 2011 because he used it to pay the mortgage, household expenses, and vacations. However, the record does not support his position, nor does it establish that she had actual knowledge at the time of filing their 2011 return that Mr. Smith took a distribution in 2011 or that his distribution was used to pay those household expenses. The record does not establish that the couple discussed the items reported on the joint return or that she had a meaningful opportunity to review the return before it was filed.

The court concludes that Ms. Lassek did not have actual knowledge of Mr. Smith's 401(k) distribution in 2011. Therefore, she is entitled to relief from joint and several liability for 2011.

IRC §6015(f) grants the IRS discretion to relieve an individual from joint and several liability where relief is not available under §§6015(b) or (c), if, considering all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or deficiency. Under §6015(f), the requesting spouse must meet certain threshold requirements to be considered for relief. The parties and the court agree that Ms. Lassek met the threshold requirements for 2012. However, she did not qualify for streamlined determinations granting relief in accordance with Rev. Proc. 2013-34. In this situation, Rev. Proc. 2013-34 lists seven nonexclusive factors to be considered in determining whether equitable relief should be granted under §6015(f). Although many of the factors for equitable relief either favored Ms. Lassek or were neutral, the court found that Ms. Lassek could not reasonably believe that Mr. Smith would or could pay the tax liability reported on their 2012 return. The **knowledge factor** weighs too heavily against her for the court to allow relief for 2012.

Holding. The court held that Ms. Lassek is entitled to relief from joint and several liability for 2011 but is not entitled to such relief for 2012.

29. IRC §6015(c)(3)(C).

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INSTALLMENT AGREEMENT

Installment Agreement

Alexander and Laura Strashny v. Comm'r, **TC Memo 2020-82 (Jun. 11, 2020)**

IRC §§6159 and 6330

☞ $7 million Stash of Cryptocurrency Leaves Taxpayer Ineligible for Installment Agreement

Facts. Alexander and Laura Strashny timely filed a 2017 tax return but did not pay the tax shown as due on the return. In June 2018, the IRS assessed the amount shown as due and an addition to tax for failure to pay. In July 2018, Mr. and Mrs. Strashny sent the IRS a Form 9465, *Installment Agreement Request,* proposing to pay their 2017 tax liability over a 6-year period. They attached a Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals.*

As of December 2018, Mr. and Mrs. Strashny's outstanding liability for the 2017 tax year (including interest) was over $1.1 million. The IRS sent the taxpayers a Notice CP90, *Intent to Seize Your Assets and Notice of Your Right to a Hearing.* Mr. and Mrs. Strashny requested a collection due process hearing, stating they were interested in an installment agreement (IA). They did not dispute their 2017 liability.

The Strashnys' case was assigned to a settlement officer (SO). After reviewing the file, the SO confirmed that their 2017 liability was properly assessed and all applicable law and administrative procedures had been followed. The SO scheduled a conference with the taxpayers for May 2019. She reviewed the previously submitted Form 433-A, which showed that the Strashnys owned substantial investment assets, which mainly consisted of cryptocurrency.

Before the scheduled conference, the SO received a copy of the Strashnys' 2018 tax return, which reported wages exceeding $200,000 and investment statements showing cryptocurrency assets valued at over $7 million. During the conference, the SO asked why the Strashnys could not liquidate or borrow against those assets to discharge their tax liability in full. The Strashnys' representative said he would discuss that issue with them and get back to the SO. **The SO stressed that the Strashnys could not qualify for an IA if they had the ability to pay their tax liability in full and simply chose not to do so.**

The SO had another call with the Strashnys' representative on June 3, 2019. The representative did not provide any evidence that the Strashnys could not draw on their cryptocurrency account to pay their liability. However, he stated that they could still qualify for an IA by agreeing to pay their liability in full over a 6-year period. The SO replied that the 6-year rule only applied when a taxpayer lacks the ability to pay the entire liability currently.

On June 25, 2019, the IRS issued a notice of determination sustaining the proposed levy and rejected the Strashnys' request for an IA. The Strashnys petitioned the court for review. On February 13, 2020, the parties filed cross-motions for summary judgment.

Issue. The issue in this case is whether the SO abused her discretion in sustaining the proposed collection action.

Analysis. The court can grant summary judgment when there is no genuine dispute of material fact and a decision can be rendered as a matter of law.[30] When there is no dispute as to the taxpayer's underlying tax liability, the court reviews the IRS decision for abuse of discretion.[31] Abuse of discretion exists when a determination is arbitrary, capricious, or without sound basis in fact or law.

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30. Rule 121(b); *Elec. Arts, Inc. & Subs. v. Comm'r,* 118 TC 226, 238 (2002).

31. *Goza v. Comm'r,* 114 TC 176, 182 (2000).

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In reviewing the SO's determinations, the court considered whether she:

1. Properly verified that the requirements of applicable law or administrative procedure were met,
2. Considered any relevant issues the taxpayers raised, and
3. Considered whether any proposed collection action balances the need for the efficient collection of taxes with the taxpayers' legitimate concern that any collection action be no more intrusive than necessary.[32]

After reviewing the record, the court determined that the SO properly discharged all of her responsibilities.

In considering whether a taxpayer qualifies for an IA, an SO does not abuse her discretion by following guidelines set forth in the Internal Revenue Manual (IRM). The IRM provides that a taxpayer must liquidate assets in order to qualify for an IA, unless special circumstances (e.g., old age, ill health, or economic hardship) exist.[33]

The Strashnys provided no evidence that they could not withdraw from their cryptocurrency account sufficient amounts to pay their tax liability in full. They did not assert that any economic hardship or other special circumstances existed. Therefore, the SO did not abuse her discretion in denying the Strashnys' request for an IA.

Holding. The court found that the SO did not abuse her discretion and granted summary judgment for the IRS. Accordingly, the IRS can proceed with its levy.

IRS PROCEDURES — MISCELLANEOUS

Collection Due Process

***David Chadwick v. Comm'r,* 154 TC No. 5 (Jan. 21, 2020)**

IRC §§6330 and 6672

☞ Responsible Person's Feet Held to the Fire

Facts. David Chadwick was the sole member of two limited liability companies (LLCs) — Integrated Communications Network, LLC (ICN) and Netcast BPO Staffing, LLC (Netcast). Each LLC failed to pay employment taxes with respect to employee wages. An IRS revenue officer determined that Mr. Chadwick was a responsible person for ICN because he hired staff, set wages, and signed payroll checks. A **responsible person** is one who is required to "collect, truthfully account for, and pay over" employment taxes.[34] A different revenue officer determined that Mr. Chadwick was a responsible person for Netcast because he was the sole member of the LLC and his signature was on previously filed employment tax returns.

Each revenue officer completed Forms 4183, *Recommendation re: Trust Fund Recovery Penalty Assessment.* They recommended that trust fund recovery penalties (TFRP) be assessed against Mr. Chadwick. IRS supervisors gave written approval to the recommendation, and the IRS issued Letters 1153, *Trust Fund Recovery Penalty Letter,* to Mr. Chadwick notifying him of the determination and of his right to appeal. He did not appeal, and the IRS assessed the penalties. The IRS gave notice of intent to levy to collect the unpaid tax and Mr. Chadwick requested a collection due process hearing.

32. IRC §6330(c)(3).

33. IRM 5.14.1.4(5) (Sep. 19, 2014).

34. IRC §6672(a).

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The settlement officer determined that Mr. Chadwick had not filed his personal income tax returns for 2015–2017 in addition to the delinquent employment tax returns. At the hearing, Mr. Chadwick requested that his account be placed into "currently not collectible" (CNC) status. The hearing officer informed Mr. Chadwick that to do so, he would need to file delinquent returns and submit financial information. Mr. Chadwick did not do so, and the IRS sustained the levy. Mr. Chadwick filed suit in Tax Court.

Issues. The issues in the case are the following.

- Whether Mr. Chadwick can raise a collection due process challenge
- Whether the IRS agent abused their discretion in sustaining the proposed levy

Analysis. A collection due process challenge can be raised by a taxpayer who believes they did not receive any statutory notice of deficiency for the tax liability or did not have an opportunity to dispute the tax. A taxpayer has an opportunity to dispute the liability by filing an appeal after receiving a Letter 1153. The record shows that Mr. Chadwick received both Letters 1153 and did not appeal. Therefore, the court determined that Mr. Chadwick may not raise a collection due process challenge.

The court looked at the following factors to determine whether the IRS agent abused their discretion in sustaining the proposed levy.

1. Whether the agent properly verified that the requirements of any applicable law or administrative procedure were met
2. Whether the agent considered any relevant arguments that Mr. Chadwick made
3. Whether the agent determined if "any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of … [Mr. Chadwick] that any collection action be no more intrusive than necessary."[35]

The court determined that the agent had properly discharged all of his responsibilities under §6330(c).

IRC §6751(b)(1) may be relevant in a collection due process case. It provides, "No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination." The IRS contends that the §6751(b)(1) approval requirements do not apply to the TFRPs because IRC §6672 imposes a tax rather than a penalty. However, the Tax Court determined that a TFRP is a "penalty" under §6751(b)(1) and is subject to the written supervisory approval requirement for the initial determination. Letter 1153 satisfied that requirement by formally notifying Mr. Chadwick of the IRS decision to assert penalties. The Tax Court also determined that the IRS satisfied the §6751(b)(1) requirement by obtaining written supervisory approval of the TFRP on each Form 4183 on the same day that the Letter 1153 was mailed to Mr. Chadwick.

Mr. Chadwick requested that his account be placed in CNC status because he had no current ability to pay the tax. To justify placing an account in CNC status, the taxpayer must supply evidence of his financial circumstances. An appeals officer does not abuse his discretion in denying CNC status when the taxpayer has not submitted the necessary financial information. The settlement officer gave Mr. Chadwick several opportunities to provide the required information but he failed to submit anything. In addition, he failed to comply with his tax filing obligations for 2015–2017. The settlement officer could properly reject any proposed collection alternative solely on that ground. Thus, there was no abuse of discretion.

Holding. The court held that Mr. Chadwick could not raise a collection due process challenge in contesting his employment taxes. Additionally, the IRS agent did not abuse his power in sustaining the levy against Mr. Chadwick.

35. IRC §6330(c).

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Tax Preparer Penalties

***Tiffany Washington Davis v. U.S.,* No. GJH-18-2852; U.S. District Court for the District of Maryland (Aug. 14, 2019)**
IRC §6694

☞ Preparer's Refund Suit Dismissed for Lack of Jurisdiction

Facts. Tiffany Washington Davis founded a tax preparation business called Washington Accounting Service, Inc. The IRS assessed $115,000 of penalties against Ms. Davis under IRC §6694(b) for the understatement of tax due to willful or reckless conduct during 2010, 2011, and 2012.

Ms. Davis filed a lawsuit challenging the validity of the penalties. The United States filed a motion to dismiss for lack of subject matter jurisdiction, claiming that Ms. Davis's failure to make full payment of her tax penalties bars her from bringing the lawsuit. Ms. Davis opposed the motion, claiming that her full payment of a divisible tax establishes jurisdiction.

Issue. The issue in this case is whether the United States' motion to dismiss the lawsuit should be granted.

Analysis. A federal court must have subject-matter jurisdiction to decide a case before it. The United States is immune to suit except where Congress has "unequivocally expressed" its consent to be sued.[36] Without such consent, federal courts have no jurisdiction to consider claims against the United States. Congress has granted consent to be sued by persons seeking a refund of return preparer penalties.[37] However, Congress generally has not consented to be sued over the abatement of unpaid penalties. Full payment of a tax penalty is generally a jurisdictional prerequisite to suit. An exception to the full-payment rule applies when both the following conditions are met.[38]

- Within 30 days after the date on which the IRS notifies the tax return preparer of the penalty, the preparer pays at least 15% of the amount of the penalty and files a claim for refund of the amount paid.
- The preparer files a refund suit within 30 days of the earlier of the denial of the claim or six months from the filing of the claim.

Ms. Davis did not file her claim with the IRS until September 2017, which was over four months after the penalty was assessed against her. Moreover, her refund suit was filed in September 2018, which was approximately one year after she filed the claim. Therefore, she does not meet either of the statutory conditions for the exception to the full-payment rule.

Ms. Davis argues that the tax at issue is divisible. In *Flora v. U.S.,* the Supreme Court noted that when a tax assessment is "divisible" (e.g., an excise tax that is levied on multiple transactions or events), payment of a single instance of the tax may be sufficient to satisfy the full-payment rule.[39] However, courts have found that a tax is only divisible when the resolution of one tax dispute necessarily determines the outcome for each of the other tax disputes.[40]

Each of the tax penalties levied on Ms. Davis assert that she willfully or recklessly prepared separate tax returns that contained understatements of liability. The merits of each of the penalties must be evaluated separately as to understatement, willfulness, and/or recklessness. Accordingly, the penalties cannot be divisible. Resolving one would still leave each remaining penalty to be resolved. Therefore, Ms. Davis's penalties are subject to the full-payment rule.

Holding. The court held that it lacks jurisdiction to consider Ms. Davis's claims. The United States' motion to dismiss is granted.

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36. *U.S. v. Nordic Village, Inc.,* 503 U.S. 30, 33 (1992).
37. 28 USC §1346(a)(1).
38. IRC §6694(c).
39. *Flora v. U.S.,* 362 U.S. 145, 175 (1960).
40. See, e.g., *Cencast Servs., L.P. v. U.S.,* 729 F.3d 1352, 1366 (Fed. Cir. 2013).

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Court Costs and Fees

***Marshall Lowery v. U.S.,* No. 3:16-cv-00701; U.S. District Court for the Western District of North Carolina (Mar. 11, 2020)**
IRC §6694 and 7430

☞ United States Pays Tax Preparer Court Costs and Fees

Facts. After conducting an investigation that began in February 2012, the IRS proposed tax preparer penalties against Marshall Lowery under IRC §6694(b). These penalties arose out of 34 tax returns and totaled $170,000.

In January 2016, the IRS appeals office dismissed nine of the 34 penalties and reduced the penalty on the 19 returns prepared by persons other than Mr. Lowery from $5,000 to $2,500. Accordingly, the IRS assessed §6694(b) penalties against Mr. Lowery totaling $77,500, arising out of 25 returns.

In March 2016, Mr. Lowery filed a claim for refund and remitted payment of 15% of each penalty. After the IRS failed to take action on the refund claim, Mr. Lowery filed an action for refund in October 2016.

In September 2018, the court partially granted Mr. Lowery's motion for summary judgment and dismissed the penalties assessed against him in connection with the 19 returns that Mr. Lowery did not prepare or sign.

> **Note.** For a summary of the September 2018 court proceeding, see the 2019 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 4: Rulings and Cases.

In May 2019, the parties reached a settlement, under which Mr. Lowery accepted liability for three of the remaining six tax returns at issue and agreed to limit his claim for costs and fees at $50,000.

As a result of the administrative and judicial proceedings, $140,000 of the initial proposed $170,000 in penalties was dismissed. The settlement resulted in liability of $15,000, in connection with three returns, instead of liability of $170,000 in connection with 34 returns.

Issue. The issue in this case is whether Mr. Lowery is entitled to court costs and fees.

Analysis. Under IRC §7430, in any administrative or court proceeding brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty, the prevailing party may be awarded a judgment or settlement for the following.

- Reasonable administrative costs incurred in connection with an administrative proceeding within the IRS
- Reasonable litigation costs incurred in connection with such court proceeding

Under §7430(a), Mr. Lowery is entitled to costs and attorney's fees if he is the "prevailing party." Generally, the prevailing party is the party that "has substantially prevailed with respect to the amount in controversy," or "has substantially prevailed with respect to the most significant issue or set of issues presented," and which meets certain net worth requirements.[41]

However, a party is not treated as the prevailing party if the United States established that its position in the proceeding was substantially justified.[42]

Mr. Lowery argues that he is the prevailing party and therefore entitled to recover his costs and attorney's fees because:

1. He substantially prevailed in the proceedings,
2. He meets the statutory net worth requirements, and
3. The United States cannot show that its position is substantially justified.

41. IRC §7430(c)(4)(A).
42. IRC §7430(c)(4)(B).

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The court agreed that Mr. Lowery had "substantially prevailed" in the proceedings. Initially, the IRS assessed penalties totaling $170,000 in connection with 34 returns. Shortly before trial, the parties settled and agreed that Mr. Lowery would accept responsibility for three returns and limit his claim for costs and fees to $50,000. The court found that settling this matter for $15,000 in connection with three returns constitutes "substantially prevailing."

Regarding the second condition, Mr. Lowery meets the net worth requirement because he showed that his net worth did not exceed $2 million at the time the civil action was filed.[43]

Regarding the third condition, the court found that the United States' position is "substantially justified" only as to the six returns that Mr. Lowery actually signed. These were the matters over which the parties negotiated just before trial, and Mr. Lowery accepted liability for three of those returns. As to the matters that were administratively dismissed and those for which Mr. Lowery was awarded summary judgment, the court found that the United States' position was **not substantially justified.**

Holding. The court held that Mr. Lowery is the prevailing party and costs and fees are owed to him in the amount of $48,354.

Timely Filing

***Sara and David Thomas v. Comm'r,* TC Memo 2020-33 (Mar. 11, 2020)**
IRC §7502

☞ Court Cancels Date Stamped by Private Postage Meter

Facts. On November 30, 2017, the IRS mailed Sara and David Thomas a notice of deficiency for the 2015 tax year. The notice, which was dated December 4, 2017, advised Mr. and Mrs. Thomas that they had 90 days from the date of the notice to file a petition in Tax Court for a redetermination of the deficiency. The notice further stated that the last day to file the petition was March 5, 2018.

Mr. and Mrs. Thomas decided to file a petition seeking redetermination of the deficiency. On March 5, 2018, Mrs. Thomas stamped an envelope using a **private postage meter from her employer's office.** She went home later that day and gave the stamped envelope to her husband. After Mr. Thomas finished preparing the petition, he put it in the stamped envelope. Then, on either March 5 or 6, 2018, Mr. Thomas put the envelope in a U.S. Postal Service (USPS) mailbox in Fernley, Nevada.

The Tax Court received the petition on March 12, 2018, which was 98 days after the date of the deficiency notice. The envelope had two postmarks on it. The first postmark was a private postage mark dated March 5, 2018, and the second was made by the USPS and was dated March 6, 2018.

The IRS filed a motion to dismiss for lack of jurisdiction on the grounds that the petition was not timely filed. Mr. and Mrs. Thomas objected and argued that their petition was timely filed because they mailed it on March 5, 2018.

Issue. The issue in this case is whether Mr. and Mrs. Thomas's petition was timely filed.

Analysis. The court can exercise jurisdiction to redetermine a deficiency only if the following requirements are satisfied.

1. The IRS issued a valid notice of deficiency.
2. The taxpayer timely filed a petition with the court.

The parties do not dispute that the notice was valid. They disagree about whether the petition was timely filed.

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43. 28 USC §2412(d)(2)(B).

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IRC §7502(a) provides the rule that if a document is timely mailed, it is treated as timely filed. A document delivered by U.S. mail is timely mailed if the postmark date is on or before the prescribed date and the document is mailed in an envelope with proper postage and properly addressed to the recipient. Under these conditions, the date of the USPS postmark stamped on the envelope is deemed to be the date of delivery.

In the case of postmarks not made by the USPS, a document is treated as timely filed if the postmark shows a legible date on or before the last day of the prescribed period. In addition, the item must have been received within the same amount of time as it would have if it had been postmarked at the same origin point by the USPS on the last day of the prescribed period.[44]

The IRS argued that the envelope containing the petition had a USPS postmark dated March 6, 2018, which shows that it was mailed one day late. The court agreed.

Treas. Reg. §301.7502-1(c)(1)(iii)(B)(3) provides that, "If the envelope has a postmark made by the U.S. Postal Service in addition to a postmark not so made, the postmark that was not made by the U.S. Postal Service is disregarded. . . " Therefore, because the envelope had a legible USPS postmark, the mark made by the private postage meter is disregarded.

Mr. and Mrs. Thomas assert that Mr. Thomas took the petition to the Fernley USPS office on March 5, 2018, and placed it in the mailbox before 5 p.m., which was the last pickup time at that office. However, the Fernley post office postmarked the envelope on March 6, 2018.

The court noted that it must follow the regulations, which provide that because the envelope contained a legible USPS postmark, the postmark must be dated on or before the last date prescribed for filing for it to be considered timely filed. Accordingly, the petition is considered not timely filed because the USPS postmark was dated one day after the deadline for filing.

The court noted that Mr. and Mrs. Thomas may still be able to have their day in court. To do so, they must pay the determined amount and file a claim for refund. Then, if the claim is denied or not acted on within six months, they can bring a suit for refund in the appropriate federal court.

Holding. The court held that Mr. and Mrs. Thomas's petition was not timely filed.

Collection Due Process

***Ronald Sullivan v. Comm'r,* TC Memo 2019-153 (Nov. 19, 2019)**

IRC §6330

☞ Failure to Provide Requested Information Results in Summary Judgment

Facts. Ronald Sullivan is a clinical professor of law at Harvard Law School. He did not file federal tax returns for 2005–2013. The IRS prepared substitute returns for 2012 and 2013, calculating a combined liability of $1.23 million. Most of the liability is attributed to the sale of Mr. Sullivan's former residence in Newton, Massachusetts, for $1.865 million.

The IRS sent Mr. Sullivan's 2012 and 2013 notices of deficiency to his Newton address. The 2013 notice was returned to the IRS as undeliverable. Mr. Sullivan did not petition the court, and so the IRS assessed the tax amount that it calculated for each year. He did not pay the amounts assessed.

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

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On May 5, 2017, the IRS issued a "Notice of Intent to Levy" and "Notice of Your Right to a Hearing." The notice was sent to Mr. Sullivan at the address of the Winthrop residential facility at Harvard College. He filed Form 12153, *Request for a Collection Due Process or Equivalent Hearing.* On the form, Mr. Sullivan listed his address as the Winthrop house and checked the box labeled "I cannot pay balance."

The IRS replied on July 3, 2017, acknowledging receipt of Mr. Sullivan's hearing request and advising him that he needed to file federal income tax returns for 2012–2015 to be eligible for a collection alternative. Mr. Sullivan also needed to complete a Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals.* He did not provide any of the requested documents.

The settlement officer assigned to Mr. Sullivan's case sent him a letter on October 11, 2017, to schedule a telephone collection due process hearing. The hearing was to be held on November 21, 2017. The letter reminded Mr. Sullivan that he needed to become current on his federal income tax obligations before the IRS could consider a collection alternative. Mr. Sullivan did not call in for the scheduled hearing and did not provide the required documents.

The IRS sent a "last chance" letter on November 21, 2017. The letter stated that if Mr. Sullivan did not provide the additional information within 14 days, the settlement officer would make her determination based on the information in the administrative file. He did not reply, so the settlement office closed the case on February 5, 2018, and issued a notice of determination.

On March 6, 2018, Mr. Sullivan petitioned for redetermination based on his belief that:

1. He had no notice of appeals hearing or pre-hearing meetings,
2. He had no notice of IRS-filed tax returns or opportunity to correct, and
3. It was impossible that he owed the amount described given his salary.

On April 2, 2019, the court granted a continuance and instructed Mr. Sullivan to provide a statement by June 15, 2019, showing all his income and deductions for 2012 and 2013. Mr. Sullivan did not comply and the IRS filed a motion for summary judgment. He was warned that a judgment could be entered against him if he failed to respond to the motion for summary judgment, but he did not file a response.

Issue. The issue in this case is whether the IRS should be granted summary judgment against Mr. Sullivan.

Analysis. The purpose of summary judgment is to expedite litigation and avoid a trial. Generally, summary judgment is granted in situations where there is no genuine dispute of material facts and a decision may be rendered as a matter of law. The court determined that there are no material facts in genuine dispute; therefore, the case is appropriate for summary judgment. Next, the court looked to whether Mr. Sullivan had a legitimate underlying tax liability.

A taxpayer can request a collection due process challenge for their underlying tax liability if they "did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity"[45] to challenge the liability. Mr. Sullivan does not dispute that the notices were sent to his appropriate last-known address but argued that he never received the notices. The 2013 notice was returned to the IRS as undeliverable; therefore, for the sake of argument, the court assumed that Mr. Sullivan did not receive either notice. Accordingly, Mr. Sullivan was entitled to dispute his underlying liabilities for 2012 and 2013 at a collection due process hearing. However, despite multiple opportunities to dispute the substitute returns the IRS prepared, Mr. Sullivan did not submit any contrary information. As a result, he cannot challenge his liability in court.

Holding. The court granted summary judgment for the IRS and sustained collection action against Mr. Sullivan. The court noted that Mr. Sullivan could submit an offer-in-compromise or an installment agreement to the IRS.

45. IRC §6330(c)(2)(B).

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LOSSES

Loss Deductions

David and Pamela Cuthbertson v. Comm'r, **TC Memo 2020-9 (Jan. 14, 2020)**
IRC §§165 and 6662

☞ Golf Course Loss Deduction Declared a Mulligan

Facts. David and Pamela Cuthbertson were developers of a golf course and the surrounding residential housing area through several entities that they owned. Among these entities were Craft Development, LLC (Development), Craft Holdings, LLC (Holdings), and Edgewater Golf Club (EGC).

Between the late 1990s and 2005, Development purchased 1,902 acres of land in Lancaster, South Carolina, with the intention of developing the Edgewater golf course. In November 2006, Development signed a deed transferring the land to Holdings but continued building the golf course until 2008. In essence, Development built a golf course on land that it no longer owned. During this time, Development also built a clubhouse on land that it had transferred to Holdings.

In April 2008, EGC signed a lease with Development to become the tenant of the Edgewater golf course premises. The lease listed Development as the lessor, even though the property was legally owned by Holdings.

In an effort to get the golf course off the books, Mr. Cuthbertson hired an appraiser in November 2009 to value the golf course property. The golf course real estate was appraised at $660,000 and the furniture, fixtures, and equipment were appraised at $490,000.

On December 29, 2009, Holdings entered into a land purchase agreement (LPA) with B&C III, an entity owned by the Cuthbertsons' daughter and son-in-law. Under the agreement, the golf course was purportedly sold to B&C III for $660,000. However, the LPA was never publicly recorded. B&C III did not have any liquid assets and was not required to make a down payment. The terms of the agreement stated that B&C III's obligation to exercise its rights to purchase the golf course would mature and come due on December 31, 2014. At that date, B&C III was required to tender the purchase price plus 6% annual interest in exchange for a special warranty deed from Holdings. B&C III issued to Holdings an unsecured note for $660,000, plus 5% interest (instead of the stated 6%), for money borrowed.

On December 31, 2014, Holdings transferred the deed to B&C III. At that time, B&C III had not paid the agreed-upon amount or the interest due. By November 2016, B&C III had only paid $68,000 of the note, including interest.

Despite "selling" the golf course, Mr. Cuthbertson continued to manage the golf course through his related entities. For example, EGC executed a lease for the golf course with B&C III less than a month after the LPA. Under the lease, EGC paid rent of $1 per year, plus 25% of annual net profits over $100,000 and 50% of annual net profits over $250,000. The lease specified that the lessee (EGC) was responsible for operating expenses and the lessor (B&C III) was responsible for capital improvements.

Holdings reported a $3.2 million loss on its 2009 Form 1065, *U.S. Return of Partnership Income.* This included a loss of $100,137 from the alleged sale of the golf course land. Development reported an $8.9 million loss on its 2009 Form 1065. This included a $5.3 million loss on improvements to the golf course that Development reported on Form 4797, *Sales of Business Property.*

Mr. and Mrs. Cuthbertson reported nonpassive losses of $12.5 million on their 2009 Schedule E, *Supplemental Income and Loss,* that flowed through from Holdings' and Development's Schedules K-1, *Partner's Share of Income, Deductions, Credits, etc.* For 2009, the Cuthbertsons also filed a Form 1045, *Application for Tentative Refund,* on which they claimed a net operating loss carryback of $1.89 million based on the losses from Holdings and Development. As a result of the Form 1045, the Cuthbertsons' tax liability decreased by $176,000 for 2004 and $309,000 for 2005.

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In December 2010, the Cuthbertsons' entities held 14 different promissory notes. The total face amount of the notes was $2.925 million and they had an outstanding principal amount and adjusted tax basis of $2.8 million. The notes were all set to mature in 2014 or 2015. Mr. Cuthbertson never attempted to collect from his daughter and son-in-law and the banks determined that the notes had virtually zero value.

David Tucker, a friend of Mr. Cuthbertson and business partner of Mr. Cuthbertson's daughter, agreed to purchase the 14 notes for $406,000. Mr. Tucker did not conduct any credit checks and knew that the notes were unsecured.

On the same day as the bulk note purchase, Mr. Cuthbertson entered into a lot purchase agreement with Mr. Tucker for $412,000 for a 50% tenancy-in-common interest and 100% interest in a plot of land. However, Mr. Tucker could buy back the parcels for $412,000 plus 15% of that amount any time before December 31, 2015.

On January 2, 2014, Mr. Tucker modified the terms of all 14 notes to extend their maturity dates to 2019 or 2020. By this time, several of the notes had already matured and were in default. Mr. Tucker reasoned that modifying the terms was more likely to result in him being repaid. He did not receive any payments of principal or interest between 2011 and 2014.

On their 2010 Forms 1065, Development and Holdings claimed losses from the bulk sale of the promissory notes that totaled $2.4 million. This loss flowed through to the Cuthbertsons' income tax return.

In addition to the real estate transactions already detailed, Development sold five parcels of land during 2008 and 2009. Development deferred a portion of each of the transfers but did not report an installment sale or file a Form 6252, *Installment Sale Income.* For 2008, Development reported $684,000 for the non-deferred portion of income for property valued at $1.27 million. For 2009, Development reported $1.84 million for non-deferred portion of income for property valued at $3.6 million. The Schedules K-1 from Development to Mr. and Mrs. Cuthbertson did not reflect any distributions from Development.

An accountant prepared tax returns for both the Cuthbertsons' personal returns and for their business entities. It was unclear what information the accountant asked for in order to prepare the returns.

The IRS audited the 2009, 2010, and 2011 income tax returns for the Cuthbertsons' entities and issued a notice of deficiency. In addition to deficiencies for 2009 and 2010, the IRS made correlative adjustments for the losses that the Cuthbertsons carried back on Forms 1045 for 2004, 2005, and 2006. The IRS adjusted the Cuthbertsons' Schedules E by $9 million, $1.4 million, and $96,000 for 2009, 2010, and 2011, respectively.

The IRS made two adjustments to Holdings — $100,137 for the golf course transaction and $1.6 million for the sale of the promissory notes.

The IRS adjusted Development's 2009 income by $5.3 million to correct the sale of the golf course. It also adjusted Development's 2010 income by $397,575 to correct for the note sale. To correct for the use of the installment sale treatment to defer income, the IRS adjusted income $2.8 million, $975,299, and $78,289 for 2009, 2010, and 2011, respectively.

Lastly, the IRS assessed accuracy-related penalties to the Cuthbertsons for 2009 and 2010.

Issues. The issues in the case are the following.

- Whether the Cuthbertsons were entitled to deduct $100,137 of losses from Holdings for the purported golf course sale in 2009
- Whether the Cuthbertsons were entitled to deduct losses of $5.28 million from the sale/abandonment of the golf course improvements in 2009 by Development
- Whether the Cuthbertsons were entitled to a loss deduction under IRC §165 on the purported sale of promissory notes
- Whether the selling LLC improperly used the installment method to report transfers of real estate parcels between LLCs
- Whether the Cuthbertsons were liable for accuracy-related penalties under IRC §6662

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Analysis. In order to deduct a loss under §165, the "loss must be evidenced by closed and completed transactions, fixed by identifiable events, and …actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss."[46] Family or related party transactions are subject to additional scrutiny. If family transactions do not follow the terms of the agreement, the courts can dismiss the transaction.

The court determined that the sale of the golf course between Holdings and B&C III lacked economic reality and that B&C III did not actually assume the benefits and burdens of owning the land. Accordingly, Holdings was not entitled to deduct the loss.

The Cuthbertsons contended that Development owned the improvements to the golf course, which is necessary in order to claim it abandoned the improvements and eventually sold them. However, Development transferred legal title of the golf course to Holdings in 2006. Despite this, the court proceeded under the assumption that Development owned the golf course improvements.

To be entitled to claim a loss in 2009, Holdings must have sold the land. The sale to B&C III is only complete after the buyer assumes the benefits and burdens of owning the property. Determining whether the benefits and burdens have been assumed depends upon the facts and circumstances. The LPA "transfers" the land and improvements from Holdings to B&C III. However, the Cuthbertsons argued that Holdings did not own the improvements and the court conceded that point previously. Therefore, the LPA could not bestow the benefits and burdens of ownership to B&C III.

The court further looked to prove whether B&C III had the benefits and burdens of owning the property by examining its lease with EGC. Within the lease was a requirement that B&C III must approve all insurance policies. It did not appear that EGC maintained any insurance policies as required by the lease nor did B&C III approve any insurance policies. If something catastrophic occurred, B&C III would lose little, if any, money because it had not paid money under the LPA and had not accepted legal title. Additionally, B&C III was thinly capitalized, and the promissory note to Holdings was unsecured by collateral or personal guaranties.

Holdings continued to pay real estate taxes on the property that was purportedly sold to B&C III. This further illustrated that the benefits and burdens had not shifted to B&C III. Based on all these facts, the court determined that Holdings did not truly sell the property to B&C III. Therefore, Holdings was not entitled to claim any loss on the sale of the golf course.

The court determined that there was no substance to the sale of the golf course land from Holdings to B&C III. The court concluded that the only intent for the "sale" was to get the property off Mr. Cuthbertson's books to satisfy the lenders. There were no serious negotiations, no collateral, no credit checks, no requests for tax returns, no demonstrated liquidity, no personal liability, and no premium charge to compensate for risk or time value of money. The parties appeared to intend to keep their situations unchanged.

The court next looked at whether the Cuthbertsons abandoned the improvements to the golf course as they claimed, rather than selling the improvements. To be considered abandoned, an asset must be permanently retired from use in the trade or business.[47] The Cuthbertsons argued that Development sold the maintenance equipment to EGC and that Development wrote off the cost of the improvements on its accounting and financial statements. The equipment sale was from one entity that was owned 100% by Mr. and Mrs. Cuthbertson to another entity that was owned 100% by Mr. and Mrs. Cuthbertson. Despite being "abandoned," the golf course continued its normal operations. Although the "owner" changed hands, there was no change visible to an outside observer. The court concluded that the Cuthbertsons and their entities did not intend to abandon the improvements.

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46. Treas. Reg. §1.165-1(b).

47. Treas. Reg. §1.167(a)-8(a)(3).

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The bulk notes sale, similar to the sale of the golf course land, appeared to lack any serious intent between the buyer and the seller. Both Mr. Tucker and Mr. Cuthbertson testified that they did not make any collection efforts on the notes, even as the notes matured and were not repaid. Unlike a serious lender who would increase interest rates on the notes or seek additional security as the lender defaulted on the loans, Mr. Tucker extended the maturity dates and reduced the interest rates. The court concluded that the note sale was not a bona fide sale.

Rather, the court looked at the note sale and the LPA together as a note-for-land exchange. Mr. Cuthbertson testified that he purchased the land in order to incentivize Mr. Tucker to buy the notes. The amounts exchanged were virtually identical. As a notes-for-land arrangement, the facts do not support that the bulk notes sale was a closed and completed transaction, as is required to be deductible under §165.

Next, the court addressed whether Development used the installment method to transfer real estate properties between entities. The notice of deficiency adjusted Development's income to recognize all the gain in the year of the sale rather than deferring any gain. The Cuthbertsons argued that the transfers of real estate were transfers of equity rather than sales. Although Development reported the real estate transactions as "sales" on its audited financial statements, it only reported part of the proceeds as income on its tax return. Additionally, Development did not report an installment sale on Form 6252. The Cuthbertsons concede that the bookkeeping was poor, but the intention was for the transfer to be an equity contribution. The court dismissed this logic because Development recorded similar transactions that were clearly not equity contributions as sales, using the same incorrect accounting method.

The court determined that the Cuthbertson did not intend to treat the transfer as a capital contribution but rather as a sale. The Cuthbertsons and Development must treat these transactions as they characterized them (i.e., as sales) and use a proper method of accounting to do so. The use of the installment method is not appropriate under the circumstances.

To avoid the accuracy-related penalty under IRC §6662, the Cuthbertsons needed to prove that they relied in good faith on an adviser. This can be proven when the adviser is a competent professional with sufficient expertise, the taxpayer provides the adviser with necessary and accurate information, and the taxpayer actually relies in good faith on the adviser. The Cuthbertsons failed to prove that they provided their accountant with the necessary and accurate information to prepare their returns and the returns for their entities. In addition, the testimony from their accountant was unpersuasive and possibly evasive.

Holding. The court held that the Cuthbertsons were not entitled to deduct losses from the golf course transfer, property abandonment, and financial transactions. The court also held that the selling LLC used an impermissible method of accounting to transfer real estate parcels between the LLCs. Therefore, the Cuthbertsons could not defer the gain from the transferred property. The Cuthbertsons were liable for accuracy-related penalties under §6662 because they did not have reasonable cause for the underpayment of tax.

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LIKE-KIND EXCHANGE

Sale or Exchange of Property

Ltr. Rul. 201944006 (Jul. 31, 2019)
IRC §§121 and 1031

☞ IRC §§121 and 1031 Can Be Applied to Same Disposition of Property

Facts. Taxpayers 1 and 2 (collectively, "Taxpayers") used Property 1 as their principal residence. Taxpayers later moved to Property 2, which is their current principal residence.

After their move, Taxpayers rented Property 1 or listed the property for rent until Property 1 was destroyed in a fire. Taxpayers received insurance proceeds in the year of the destruction. Taxpayers later sold the land on which the dwelling unit was located. They then acquired Property 3.

Taxpayers requested rulings on the following issues.

- Whether IRC §§121 and 1031 can be applied to the same transfer of property
- Whether the property disposed of is held for investment for purposes of deferring the remaining gain under §1031

Analysis. IRC §121(a) provides that the gain from the sale or exchange of property is not included in gross income if the taxpayer owned the property and used the property as their principal residence for two years or more during the 5-year period ending on the date of the disposition. The amount of gain excluded from gross income cannot exceed $250,000, or $500,000 for a married couple who file a joint return for the year of the sale or exchange.

IRC §1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of a like kind that is to be held either for productive use in a trade or business or for investment.

The destruction of the dwelling unit and the subsequent receipt of insurance proceeds qualify as a sale or exchange of the dwelling unit. Further, Taxpayers meet the other requirements of §121 with respect to the land. Although the sale or exchange of the dwelling unit and the land occurred in different tax years, they are treated as one sale or exchange for purposes of §121.

Taxpayers assert that they held Property 1 as investment property from the date it was available for rent until the date on which they sold the land on which the dwelling unit was located. Accordingly, the Taxpayers held Property 1 for investment as described in §1031. Under Rev. Proc. 2005-14, a transfer of property qualifying for the §121 exclusion can also qualify for like-kind exchange treatment under §1031 if all the §1031 requirements are met for the transfer.

Holding. The IRS held that the fact that Taxpayers excluded gain under §121 does not preclude them from deferring all or part of the remaining gain under §1031. The IRS also held that the Taxpayers held Property 1 for investment for purposes of §1031.

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PASSIVE ACTIVITIES

Passive Losses

***Zaid Hakkak and Layla Naji v. Comm'r,* TC Memo 2020-46 (Apr. 13, 2020)**

IRC §469

☞ **Taxpayer Foreclosed as a Real Estate Professional and Cannot Offset Nonpassive Income**

Facts. Zaid Hakkak and Layla Naji are a married couple living in California with their two children. Mr. Hakkak primarily worked as a personal injury attorney and Ms. Naji was a homemaker. His personal injury activity ran through his 100%-owned S corporation, Z Dean Hakkak, A Professional Law Corp. (Z Dean Hakkak). The income from Z Dean Hakkak was reported on Schedules E, *Supplemental Income and Loss*. Mr. Hakkak's non-personal injury related activity was reported on Schedules C, *Profit or Loss From Business.* Additionally, Mr. Hakkak owned interests in several flow-through entities that held real estate.

Mr. Hakkak owned 98% and 99% of the interest in Joshua Plaza, LLC in 2011 and 2012, respectively. Joshua Plaza held commercial rental property subdivided into five rental units in Joshua, Texas. The LLC did not perform any activities beyond holding the property and renting the units.

Additionally, Mr. Hakkak owned 99% of the interest in Conroe Plaza, LLC. Conroe Plaza held commercial rental property in Conroe, Texas, that was subdivided into 10 rental units. Like Joshua Plaza, most of the units were rented during 2011 and 2012, but the leases were either executed prior to Mr. Hakkak's involvement or were executed by Mr. Hakkak before the years at issue.

Jung Yu of JYU Realty Management in Austin, Texas, managed both the Joshua Plaza and Conroe Plaza properties. He collected and deposited rent checks and followed up with tenants regarding any late rents. Mr. Yu had signature authority over the bank accounts for both LLCs and occasionally paid bills for the properties. Tenants contacted Mr. Yu with any problems, and Mr. Yu then contacted Mr. Hakkak. Mr. Hakkak did not have direct contact with the tenants during the years at issue.

Mr. Hakkak traveled to Texas approximately twice a year for three to four days during the years at issue to ostensibly check on his properties. However, **there is no record that Mr. Hakkak actually checked on the properties.**

Mr. Hakkak prepared financial reports for Joshua Plaza and Conroe Plaza based on various financial documents that were sent to his home in California.

Mr. Hakkak and Ms. Naji timely filed their joint Forms 1040, *U.S. Individual Income Tax Return,* for 2011 and 2012. They claimed the following income.

	2011	2012
Wages from S corporation	$ 98,000	$48,193
Schedule C for non-personal injury work	(5,457)	(2,197)
Schedule E:		
Z Dean Hakkak	351,437	33,584
Other real estate properties	(214,354)	(38,793)
Other net passive income		5,209
Prior years unallowed passive losses	(1,786)	

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The IRS audited the returns for 2011 and 2012. Mr. Hakkak and Ms. Naji provided handwritten calendars to support the time Mr. Hakkak allegedly devoted to Joshua Plaza and Conroe Plaza. Many of the tasks listed were investor-type activities. The total hours identified were 1,521.5 for 2011 and 755 for 2012. The calendars did not provide the hours that Mr. Hakkak spent on his Schedule C legal business or on Z Dean Hakkak. Although Mr. Hakkak suffered from medical issues during 2011 and 2012, he testified that he was able to continue working as an attorney during those years, albeit mostly from home.

The IRS determined that income from Z Dean Hakkak that Mr. Hakkak reported as passive should be nonpassive. Accordingly, the nonpassive income could not be netted against the passive income from Joshua Plaza and Conroe Plaza.

Issue. The issue in this case is whether Mr. Hakkak and Ms. Naji can deduct nonpassive rental real estate losses they previously treated as passive on Schedule E.

Analysis. IRC §469 generally disallows passive activity losses for the year the loss is sustained. Such losses are carried forward to the next tax year. A passive activity loss is defined as the excess of aggregate losses from all passive activities for the tax year over the aggregate income from all passive activities for that year.[48] Generally, passive activities are activities in which the taxpayer does not materially participate (i.e., participate on a regular, continuous, and substantial basis).[49] Rental activity is considered a passive activity regardless of whether the taxpayer materially participates in the activity unless the taxpayer is a real estate professional.[50]

Mr. Hakkak and Ms. Naji argued that Mr. Hakkak was a real estate professional. To be considered a real estate professional, a taxpayer must meet the following requirements.[51]

- More than half of the personal services performed in trades or businesses by the taxpayer during the tax year are performed in real property trades or businesses in which the taxpayer materially participates.
- The taxpayer performs more than 750 hours of service during the year in real property trades or businesses in which they materially participate.

> **Note.** For a more detailed discussion of real estate professionals, see the 2020 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Schedule E.

The court determined that Mr. Hakkak did not meet either of the requirements to be considered a real estate professional. The calendar entries that the couple provided were abbreviated and did not provide specifics on how he spent his time or on which property Mr. Hakkak was working. Mr. Hakkak provided vague testimony about the nature and time of his activities to support his calendar entries. The court declined to rely on his "self-serving and uncorroborated testimony."

The court noted that Mr. Hakkak's activities were more akin to those of an investor and therefore do not count toward the 750-hour requirement to be a real estate professional. The calendars were insufficient to establish that Mr. Hakkak spent more than half of his personal service hours on his rental real estate activities. Mr. Hakkak testified that he only worked as an attorney for three hours a day, twice a week during the years at issue. However, despite this, he earned income of $449,437 in 2011 and $81,777 in 2012 from the law practice. **The court concluded that Mr. Hakkak and Ms. Naji did not properly establish the hours he worked or explain the work he performed.**

Holding. The court held that Mr. Hakkak was not a real estate professional during the years at issue and, as such, was not entitled to treat the losses from Joshua Plaza and Conroe Plaza as nonpassive.

48. IRC §469(d)(1).
49. IRC §469(c)(1).
50. IRC §§469(c)(2) and (4).
51. IRC §§469(c)(7)(B)(i) and (ii).

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Rental Real Estate

***Ronnie and Gloria Cruz Hairston v. Comm'r,* TC Memo 2019-104 (Aug. 20, 2019)**

IRC §469

☞ Taxpayers Inflated Hours of Service to Qualify as Real Estate Professional

Facts. Prior to 2013, Ronnie and Gloria Hairston purchased two contiguous single-family homes adjacent to their residence. Both properties were rented to long-term tenants until 2014, when one of the tenants was evicted for failure to pay rent. That property remained vacant from October 2014 until December 19, 2019. During the vacancy, Mr. Hairston performed maintenance, advertised the property, fielded questions from potential tenants, showed the property, and screened applicants.

The property leases state that the tenants pay rent to Mrs. Hairston, pay utility expenses, perform minor house repairs, maintain the yard, and keep the driveways clear of snow. The tenants have rights to use the shed on the property, but the Hairstons retain primary use of the garage on one of the properties to park their cars and store Mr. Hairston's tools.

During 2014, Mr. Hairston was retired and Mrs. Hairston worked full-time for the Department of Homeland Security. Mrs. Hairston was responsible for most of the financial and administrative tasks for the rental properties. Mr. Hairston was responsible for the upkeep of the rental properties. He did some of the work himself but hired contractors for major repairs and maintenance.

The Hairstons filed their 2014 Form 1040, *U.S. Individual Income Tax Return,* with a Schedule E, *Supplemental Income and Loss.* The Schedule E reported a total loss of $27,488 from the rental properties. The IRS examined their return and determined that neither of the Hairstons was a real estate professional.

Issue. The issue in this case is whether Mr. or Mrs. Hairston qualified as a real estate professional in 2014, which is necessary in order for them to offset their ordinary income with a loss on their rental real estate properties.

Analysis. IRC §469(a) generally disallows a deduction for passive activity losses, including rental activity losses, unless the taxpayer is a real estate professional. To qualify as a real estate professional, a taxpayer must perform more than 750 hours of service during the year in real property trades or businesses in which they materially participate.[52] For taxpayers filing a joint return, at least one spouse must satisfy the 750-hour requirement. The requirement for material participation applies separately to each property unless the taxpayer made an election to treat all real estate activities as a single activity.[53]

The Hairstons submitted a calendar with entries that identified the tasks and associated hours. The calendar showed that the taxpayers spent 932 hours working on the properties. However, the entries all appear to be in the same handwriting, do not identify which spouse performed the work, and were all in round hours. Approximately one-third of the entries were for precisely one hour. Some of the one-hour tasks included receiving a rent payment, issuing a receipt for rent payment, depositing checks, paying the mortgage, reminding a tenant to pay rent, and inspecting vacant property (i.e., walking next door to make sure the property was not broken into). The inflation of the hours undermined the credibility of the entire calendar.

During 2014, the calendar reported between 93 and 105 hours for snow removal. The leases state that snow removal is the responsibility of the tenants. Therefore, the court determined that the snow removal was primarily for the benefit of the Hairstons. Additionally, Mr. Hairston recorded 40 hours supervising contractors who were painting the rental property. The court described that as "an entire week watching paint dry."

The court concluded that the 781 hours that Mr. Hairston claimed to prove he was a real estate professional were likely inflated by 150 hours or more. Therefore, the Hairstons did not satisfy the 750-hour requirement.

Holding. The court held that neither Mr. nor Mrs. Hairston devoted 750-plus hours to real estate activities during the year. As such, neither qualified as a real estate professional and they could not offset their ordinary income with the loss from the rental real estate.

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52. IRC §469(c)(7)(B)(ii).

53. Treas. Reg. §1.469-9(e)(1).

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PAYROLL ISSUES

Definition of Employer

AOD 2020-01 (Mar. 16, 2020), addressing *Paychex Business Solutions LLC et al. v. U.S.,* No. 8:15-cv-01455; U.S. District Court for the Middle District of Florida (2017)

IRC §3401

☞ IRS Issues Nonacquiescence Regarding Employer Classification

Facts. Paychex Business Solutions, LLC et al. (Plaintiffs) were professional employer organizations (PEOs) during the years at issue. Plaintiffs entered into a client service agreement (CSA) with each client company under which they provided employer payroll functions and certain human resource functions. The CSAs provided that Plaintiffs had full responsibility for reporting, collecting, and paying employment taxes to the IRS for the clients' employees.

The clients would submit employees' hours and rates of pay to the Plaintiffs for each pay period. The Plaintiffs calculated the appropriate amount of wages and employment taxes. Then, Plaintiffs initiate a debit to the clients' bank account via automated clearing house (ACH) for the amount of the employees' compensation and employment taxes. The clients remained liable for those payments if their funds were insufficient to satisfy the ACH.

The IRS and Plaintiffs agreed that Plaintiffs are not the common-law employers of the clients' employees. Plaintiffs considered themselves to be the statutory employers of the clients' employees under IRC §3401(d)(1).

Plaintiffs filed Forms 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund,* to claim refunds of the overpayment of the employer's portion of the social security tax. The IRS denied the Plaintiffs' refund claims, and Plaintiffs filed suit in federal district court.

Issue. The issue in this Action on Decision (AOD) is whether control over the bank account from which wage payments are made is sufficient for an entity to be a statutory employer under §3401(d)(1).

Analysis. The court identified the issue in *Paychex* as determining **who had control** over the payment of wages to employees — the Plaintiffs or the client companies. The court concluded that the Plaintiffs were the statutory employers under §3401(d)(1) because they controlled the bank accounts from which the wage payments were made.

IRC §3401(d) defines **employer** as "the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that (1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term 'employer' . . . means the person having control of the payment of such wages. . . " When the exception applies, liability for employment taxes shifts from the common-law employer to the person in control of wage payments.

The court concluded that whether a person is a §3401(d)(1) employer depends on whether that person has exclusive control over the bank account from which wages are paid. The IRS disagrees, asserting that in order for a person other than the common-law employer to be the "employer," a 2-part test must be satisfied.

1. The common-law employer must **not** have control of the payment of wages.
2. The other person **must have** control of the payment of wages.

The IRS reasoned that the court failed to apply the underlying statute and disregarded Congressional intent and case law. A statutory employer exists only when the common-law employer does not have control over the payment of wages. The IRS asserts that Plaintiffs were merely acting as conduits through which wages and taxes were paid because the Plaintiffs almost always received the funds from their clients before issuing paychecks to the clients' employees. Absent statutory authority, it is the IRS's position that an employer may not simply delegate or contract away its taxing responsibilities.

Holding. The IRS's position is nonacquiescence with *Paychex Business Solutions LLC et al. v. U.S.* The IRS will continue to litigate this issue in court.

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RETIREMENT

Retirement Plan Distribution

***Dale and Alicia Laue v. Comm'r,* TC Summ. Op. 2020-14 (Apr. 20, 2020)**

IRC §72(t)

☞ Taxpayers Subject to Additional Tax on Early Distribution from Qualified Retirement Plan

Facts. Dale Laue worked as an aviation engineer but has generally been unemployed since 2002, when he was 46 years old. In 2015, a previous employer offered Mr. Laue the option to take a lump-sum distribution from his pension plan. It was a limited-time offer, and Mr. Laue exercised the option. He deposited the $25,170 distribution on November 14, 2015. Mr. Laue was 59 years old at the time of the deposit but was not yet 59½.

Mr. and Mrs. Laue reported gross distributions from pensions and annuities of $32,250 on their 2015 Form 1040, *U.S. Individual Income Tax Return,* which included the $25,170 distribution. However, they did not report an additional 10% tax for an early distribution under IRC §72(t)(1). The IRS issued a notice of deficiency for the additional tax.

Issue. The issue in this case is whether Mr. and Mrs. Laue are liable for the 10% additional tax for an early distribution of funds from a qualified retirement plan.

Analysis. Unless a taxpayer meets an exception, distributions from qualified retirement plans that they receive prior to turning 59½ years old are subject to an additional 10% tax. One such exception is provided under §72(t)(2)(A)(v) for a taxpayer who is 55 years old and separated from service. Mr. Laue argued that he was both age 55 and separated from service when he received the distribution.

The IRS countered that the taxpayer must be age 55 prior to the time they separated from service. The IRS supported its position by showing the congressional intent was that the taxpayer must have attained age 55 on or before separation from service. Furthermore, the exception does not apply, for example, to a participant who separates from service at age 52 but does not receive their distribution until after they are 55 years old.[54] The court agreed that the statute was very clear that the exception is **only** met when the taxpayer is over age 55 when they separate from service.

Holding. The court held that Mr. and Mrs. Laue were liable for the 10% additional tax on the early distribution of funds from his qualified retirement plan.

Examination of Books and Records

***Richard Essner v. Comm'r,* TC Memo 2020-23 (Feb. 12, 2020)**

IRC §§6662 and 7605

☞ Taxpayer Was Not Subjected to Duplicative Examination

Facts. In 2013, Dr. Richard Essner's mother died and he inherited an individual retirement arrangement (IRA) that she had inherited from her late husband. Dr. Essner took distributions from the inherited IRA of $360,800 and $148,084 in 2014 and 2015, respectively. Before he received the first distribution, he researched the tax implications of an inherited IRA on the IRS website and concluded that he would not owe tax on the distributions.

Dr. Essner had his 2014 and 2015 tax returns prepared by a tax professional. He did not inform the tax preparer that he received IRA distributions in 2014 and 2015 and did not ask for guidance from the tax preparer about the proper tax treatment of such distributions.

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54. H.R. Conference Report No. 99-841 (Vol. II), 1986-3 CB 456.

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Dr. Essner received Forms 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* reporting IRA distributions of $360,800 and $148,084 in 2014 and 2015, respectively. However, he did not report either distribution on his tax returns for those years.

On March 21, 2016, the IRS's automated underreporting (AUR) program generated a notice regarding the discrepancy between the payments made to Dr. Essner and the amount of taxable income he reported on his 2014 tax return. The notice gave Dr. Essner the option of agreeing to the proposed changes or to provide more information regarding the discrepancy. On May 31, 2016, the AUR program generated another notice regarding the discrepancy and again provided Dr. Essner with the opportunity to provide records supporting his position. Dr. Essner responded to both notices on June 28, 2016, with a handwritten note stating that he did not agree with the proposed changes. On January 3, 2017, the AUR program generated a notice of deficiency for the 2014 tax year. Dr. Essner timely petitioned the Tax Court for a redetermination of his 2014 deficiency.

On October 20, 2016, an IRS tax compliance officer, Mr. Joshi, sent Dr. Essner a letter informing him that his 2014 tax return had been selected for examination. **Mr. Joshi's examination focused on travel, meal, and legal expenses but did not mention the IRA distribution** that was identified by the AUR program. Mr. Joshi was unaware that the AUR program had issued a notice of deficiency for the 2014 tax year. Accordingly, he continued his examination of Dr. Essner's 2014 return after the date of the 2014 notice. On January 10, 2017, Mr. Joshi sent Dr. Essner an examination report and proposed adjustments relating to the 2014 tax return. Mr. Joshi's report did not include an adjustment relating to Dr. Essner's IRA distribution in 2014. Dr. Essner responded on March 10, 2017, by sending a letter to Mr. Joshi requesting that he provide a copy of his report to confirm that the IRA distribution Dr. Essner received in 2014 was not taxable.

On October 23, 2017, the IRS issued a notice of deficiency to Dr. Essner relating to his 2015 tax return. The notice determined a deficiency and an accuracy-related penalty under IRC §6662(a). Dr. Essner timely petitioned the court in response to the 2015 notice.

Issues. The issues in this case are as follows.

- Whether Dr. Essner failed to report distributions from an inherited IRA as income for 2014 and 2015
- Whether the IRS subjected Dr. Essner to a duplicative inspection of his books and records for the 2014 tax year in violation of IRC §7605(b)
- Whether Dr. Essner is liable for the §6662(a) accuracy-related penalty for the 2015 tax year

Analysis. At trial, Dr. Essner did not contest that he received IRA distributions in the amounts shown on the Forms 1099-R. However, he contends that a portion of each distribution is not taxable because it represents his late father's original investment in the account. Dr. Essner stated that he contacted the financial institutions that held the IRA, asking for documentation to determine the portion that represented his father's original investment. Unfortunately, neither financial institution had the records he requested. At trial, he admitted that he could not substantiate that any portion of the distributions represented a return of his father's original investment. The court found his testimony credible and sympathized with his situation. However, Dr. Essner had the burden of proving that the IRS's determinations were incorrect and he could not. Therefore, the court sustained the IRS's determinations.

Dr. Essner contends that the IRS should be barred from assessing the proposed deficiency for 2014 because it violated §7605(b) by conducting a second inspection of his books and records for that year. IRC §7605(b) provides:

> *No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.*

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Dr. Essner contends that because both Mr. Joshi and the AUR program concurrently examined his 2014 tax return, the IRS violated §7605(b). The IRS countered that it issued the 2014 notice on the basis of the AUR program's review of Dr. Essner's 2014 return, not Mr. Joshi's examination. The IRS further contends that the AUR program's review was solely based on third-party information returns and Dr. Essner's already-filed 2014 tax return. According to the IRS, this means that the AUR program review was conducted without reference to Dr. Essner's books and records. Therefore, the IRS asserts that §7605(b) does not apply.

The court agreed with the IRS that the AUR program's matching of third-party information was not an examination of Dr. Essner's records. Therefore, no second examination of his books and records occurred.

IRC §6662(a) authorizes a 20% penalty on an underpayment of tax attributable to a substantial understatement of income tax. A substantial understatement is defined as an understatement that exceeds the greater of $5,000 or 10% of the income tax required to be shown on the return. A taxpayer is not liable for the penalty if they can show there was reasonable cause and they acted in good faith. Dr. Essner understated his 2015 income tax by $98,962, which is greater than 10% of the tax that should have been reported. Dr. Essner tried to determine the tax consequences of the IRA distribution by referring to the IRS website. However, he did not inform his tax preparer that he received the distribution or ask the preparer about the tax consequences. The court noted that this was not reasonable, given Dr. Essner's background and the size of the distribution. Therefore, he did not have reasonable cause for his underpayment.

Holding. The court held that Dr. Essner failed to report distributions from his IRA for 2014 and 2015. Further, he was not subjected to a duplicative examination of his records for 2014. In addition, he was liable for the 20% accuracy-related penalty for the 2015 tax year.

Deemed Distribution

***Gerard and Regina McEnroe v. Comm'r,* TC Summ. Op. 2019-21 (Aug. 20, 2019)**

IRC §§72 and 402

☞ Outstanding Loan Balance Treated as Deemed Distribution from Retirement Plan

Facts. In 2015, Gerard McEnroe was 51 and had been employed for approximately 15 years for the New York City School Construction Authority (SCA). He participated in the New York City Employees Retirement System (NYCERS), which is an employer-sponsored pension plan within the meaning of IRC §401(a).

In July 2014, Mr. McEnroe borrowed $26,045 from his NYCERS retirement account to pay college tuition expenses for one of his children. He began to repay the loan through biweekly payroll withholding.

In May 2015, Mr. McEnroe left SCA for a new position in the private sector. However, he soon became disillusioned with his new job and returned to SCA in September 2015.

Mr. McEnroe did not make loan payments to NYCERS after he left SCA. When he returned to SCA, he learned that his outstanding loan balance would be treated as a distribution. He then contacted the SCA human resources office, hoping to rectify the situation. The human resources office contacted NYCERS and requested that Mr. McEnroe's loan not be treated as a distribution and that his biweekly payroll deductions for the loan be reinstated. NYCERS responded that it would process a revision by November 20, 2015. In December 2015, Mr. McEnroe resumed making loan payments through biweekly payroll withholding.

NYCERS issued a 2015 Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* reporting that Mr. McEnroe had received a $22,284 distribution from his retirement account. However, Mr. and Mrs. McEnroe filed a 2015 joint Form 1040 but did not report any income from pension or annuity payments.

The IRS determined that Mr. and Mrs. McEnroe received a deemed distribution of $22,284 and assessed a deficiency of $9,638 on the McEnroes' 2015 federal income tax return and an accuracy-related penalty under IRC §6662(a).

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Issue. The issue in this case is whether Mr. and Mrs. McEnroe are liable for federal income tax on a deemed distribution of $22,284 from Mr. McEnroe's retirement account.

Analysis. IRC §402(a) provides the general rule that any distribution from an employees' trust described in §401(a) is taxable to the distributee under IRC §72. IRC §72(p)(1)(A) provides the general rule that if a participant receives a loan from a qualified employer plan, the amount of the loan is treated as a distribution from the plan. IRC §72(p)(2) provides an exception for a loan that does not exceed a specified limit and when the loan must be repaid within five years from the date of inception. If a plan participant fails to make a loan payment on the due date or within an allowed grace period, the loan no longer satisfies the requirements of §72(p)(2).

Mr. McEnroe failed to make loan payments from June to December 2015. The grace period would have expired no later than September 30, 2015.[55] However**, he did not resume making loan payments until December 2015.** In addition, **when he did resume making loan payments, he did not make a lump-sum payment to cover the payments and interest that he failed to remit earlier.**

Under these circumstances, NYCERS properly determined that Mr. McEnroe defaulted on the loan in 2015 and correctly reported his loan balance at the time of the default as a deemed distribution.

Holding. The court upheld the IRS's determination that Mr. and Mrs. McEnroe are liable for federal income tax and additional tax under §72(t) for the deemed distribution.

Retirement Plan Distribution

Rev. Rul. 2019-19, IRB 2019-36 (Sep. 3, 2019)
IRC §§401 and 402

☞ Uncashed Retirement Plan Check Must be Included in Gross Income

Purpose. This revenue ruling addresses the question of whether an individual can exclude a distribution check she received from a qualified retirement plan from her income if she does not cash it.

Under the scenario presented in the revenue ruling, Employer M administers a qualified retirement plan under IRC §401(a) that does not include a qualified Roth contribution plan. A $900 distribution is required to be made from Plan X to Individual A in 2019. Individual A has no investment in the contract with respect to the retirement plan.

Employer M, as the administrator of Plan X, makes the required $900 distribution by mailing a check (minus the required withholding) to Individual A. Individual A receives the check and could cash it in 2019 but does not do so. Individual A does not make a rollover contribution for any portion of the distribution and no other exception to income inclusion under IRC §402(a) applies.

Analysis. IRC §402(a) provides that any amount distributed to a distributee by an employees' trust described in §401(a) is generally taxable to the distributee in the tax year in which it is distributed. Certain exceptions are provided in §402 (e.g., a rollover under §402(c)(1)).

Plan X distributed the designated distribution to Individual A in 2019. Individual A has no investment in the contract and no exception to §402(a) applies; therefore, the amount of the designated distribution is includable in her gross income in 2019. Individual A's failure to cash the distribution check does not permit her to exclude the amount of the distribution from her 2019 gross income.

55. See Treas. Reg. §1.72(p)-1, Q&A-10(a).

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SELF-EMPLOYMENT TAX

Self-Employment Tax

***James and Eileen Dunlap v. Comm'r,* TC Summ. Op. 2020-10 (Feb. 18, 2020)**

IRC §§409A, 1401, and 1402

☞ Nonqualified Deferred Compensation from Mary Kay Is Subject to Self-Employment Tax

Facts. Eileen Dunlap was a national sales director with Mary Kay cosmetics when she retired in 2006. She started as a consultant for Mary Kay, became a sales director in 1981, and became a national sales director in 1988. Consultants are independent contractors rather than employees. They are paid commissions and bonuses based on products sold. As a sales director, Ms. Dunlap was paid commissions on the sales that the beauty consultants under her make.

National sales directors with Mary Kay are eligible to participate in the Family Security Program (FSP). The FSP provides national sales directors with financial security if they cannot work or when they retire. Under the FSP, once the national sales director reaches age 65, their contracts with Mary Kay terminate and they no longer receive commissions or payments for sales. At age 65, assuming they were a national sales director for at least 15 years, they receive FSP payments based on their high average tiered sales activity over the last 15 years. Ms. Dunlap was eligible to receive FSP payments beginning in January 2006.

In 1991, Ms. Dunlap received a restatement of the FSP plan that was prepared specifically for her. A part of that restatement read that "each National Sales Director desires to participate in this program in exchange for the offer by Mary Kay Cosmetics, Inc. to acquire at retirement the valuable goodwill and all other rights associated with the business, including future goodwill generated by her continued support and loyalty to Mary Kay Cosmetics, Inc." In 1995, Mary Kay expressed to its national sales directors that the FSP payments were subject to self-employment (SE) tax.

In 2001, Mary Kay sent out a restatement of the FSP plan that stated, "The Plan is intended to be a nonqualified deferred compensation arrangement and is not intended to meet the requirements of Section 401(a) of the [Internal Revenue] Code. The Plan is intended to meet the requirements of Section 409A of the Code and shall be construed and interpreted in accordance with such intent." In 2008, the company sent another restatement that affirmed the same points as the 2001 restatement.

In 2014 and 2015, Ms. Dunlap received Forms 1099-MISC, *Miscellaneous Income,* which reported that she received $115,261 for each of those years from Mary Kay. The amounts were marked as nonemployee compensation. **Ms. Dunlap reported the payments as "other income" and did not pay SE tax on the amounts.**

The IRS assessed income tax deficiencies to the Dunlaps of $14,181 and $14,096 for 2014 and 2015, respectively.

Issue. The issue in this case is whether the Mary Kay payments that Ms. Dunlap received were subject to SE tax.

Analysis. Under §409A, deferred compensation from a nonqualified deferred compensation plan is included in gross income. Gross income derived from a trade or business is subject to SE tax, even if attributable to services rendered in a prior year in which the taxpayer was not subject to SE tax.[56]

The IRS relied on *Peterson v. Comm'r*[57] to assert that the FSP payments were subject to SE tax. In that case, Mrs. Peterson was a national sales director with Mary Kay and the court held that the FSP payments were subject to SE tax. The main differences between the cases were that Mrs. Peterson retired in 2009 (Ms. Dunlap retired in 2006), and the Court of Appeals for the Peterson case was the Eleventh Circuit, whereas Ms. Dunlap resided in the Ninth Circuit.

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56. Treas. Reg. §1.1402(a)-1(c).

57. *Christine and Roger Peterson v. Comm'r,* 827 F.3d 968 (11th Cir. 2016), *aff'g* TC Memo 2013-271.

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The court dismissed Ms. Dunlap's argument that she is not bound by the Eleventh Circuit decision in *Peterson* because she is in the Ninth Circuit. The court reasoned that it is a court of national jurisdiction and their holding would be the same as the Eleventh Circuit.

> **Note.** For more details on the *Peterson* case, see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Rulings and Cases. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Ms. Dunlap argued that she sold goodwill in her trade or business to Mary Kay in exchange for the FSP payments. This argument was supported by the 1991 restatement, which specified that the FSP payments are in exchange for the valuable goodwill and other rights associated with the business. As goodwill, Ms. Dunlap contended the payments should receive capital gain treatment. However, she reported the payments as ordinary income on her 2014 and 2015 returns. The court determined that there was no evidence to support Ms. Dunlap's claim that the income was for a sale of goodwill. The FSP payments were based on her sales and commissions, not goodwill.

Ms. Dunlap further claimed that the FSP payments were not from a deferred compensation plan. The court dismissed her arguments because they were based on principles that were not founded in law or the record.

Holding. The court held that Ms. Dunlap's payments from Mary Kay were from a nonqualified deferred compensation plan and were subject to SE tax.

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