Chapter 4: Rulings and Cases

Please note. Corrections were made to this workbook through January of 2022. 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, 2021. Each appears as a condensed version and should not be relied on as a substitute for the full document. A full citation appears for each item. This chapter is not intended to be a comprehensive coverage of all tax law changes. Rather, it reports the rulings and cases most likely to be of interest to tax professionals.

About the Authors

Terri Kobel, EdM, has been director of the University of Illinois Tax School since 2000. She has written and edited content for the *University of Illinois Federal Tax Workbook* and other publications throughout her time with Tax School.

John W. Richmann, EA, is a Tax Materials Specialist at the University of Illinois Tax School. Prior to joining Tax School in 2021, he owned a tax practice in St. Charles, Illinois, and held positions in private industry and consulting firms. John earned a Masters Degree in Business Administration from the University of Texas and an electrical engineering degree from the Massachusetts Institute of Technology.

Carolyn Schimpler, CPA, was Assistant Director, Tax Materials, at the University of Illinois Tax School from 2008 until 2020. She joined Tax School after holding a variety of positions in public accounting and private industry. She graduated with honors from Governors State University in 1988 and passed the CPA examination later that year.

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

SUBSTANTIAL AUTHORITY

If there is substantial authority for a position taken on a tax return, neither the taxpayer nor the tax preparer will be subject to the penalty for underreporting income even if the IRS successfully challenges the position taken on the return. By contrast, if there is no substantial authority for a position taken on a tax return, the underreporting penalties may be imposed unless the position has been adequately disclosed and there is a reasonable basis for the position.

EVALUATION OF AUTHORITIES

There is substantial authority for the tax treatment of an item only if the weight of the authorities that support the treatment is substantial in relation to the weight of the authorities that support a contrary treatment.

- All the authorities relevant to the tax treatment of an item (including the authorities contrary to the treatment) are taken into account in determining whether substantial authority exists.
- The weight of the authorities is determined in light of the pertinent facts and circumstances. There may be substantial authority for more than one position with respect to the same item.
- Because the substantial authority standard is an objective one, the **taxpayer's belief** that there is substantial authority for the tax treatment of an item **is not relevant** in determining whether that is in fact true.

NATURE OF ANALYSIS

The weight accorded to an authority depends on its relevance and persuasiveness, as well as the type of document providing the authority. For example, a case or revenue ruling that has some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts or otherwise inapplicable to the tax treatment. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted (such as a private letter ruling) is diminished to the extent that the deleted information may have affected the authority's conclusions.

The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. Private rulings, technical advice memoranda, general counsel memoranda, revenue procedures, and/or actions on decisions issued prior to the Internal Revenue Code (IRC) of 1986 generally must be accorded less weight than more recent ones.

There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

AUTHORITY HIERARCHY

The following factors are considered in determining whether there is substantial authority for the tax treatment of an item, in descending order of authority.[1]

- Applicable provisions of the IRC and other statutory provisions
- Temporary and final Treasury regulations construing such statutes

> **Note.** A proposed regulation presents a **tentative** IRS position that may be changed when a temporary and/or final regulation is issued.

1. Treas. Reg. §1.6662-4(d)(3)(iii).

- Revenue rulings
- Revenue procedures
- Tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties
- Federal court cases interpreting such statutes
- Congressional intent, as reflected in committee reports
- Joint explanatory statements of managers included in congressional conference committee reports, and floor statements made prior to enactment by one of a bill's managers
- General explanations of tax legislation prepared by the Joint Committee on Taxation
- Letter rulings and technical advice memoranda issued after October 31, 1976
- Actions on decisions and general counsel memoranda issued after March 12, 1981
- IRS information or press releases, and notices, announcements, and other administrative pronouncements published by the IRS in the Internal Revenue Bulletin

Additional information on some of the preceding items follows.

Internal Revenue Code. Except where provisions violate the U.S. Constitution, IRC provisions are binding in all courts.

Treasury Regulations (Income Tax Regulations). The regulations are the Treasury Department's official interpretation and explanation of the IRC. Regulations have the force and effect of law unless they are in conflict with the statute they explain.

Revenue Rulings. The IRS is bound by the position taken in a revenue ruling. Revenue rulings that interpret Treasury regulations are entitled to substantial deference.

Letter Rulings and Technical Advice Memoranda (TAM). Private letter rulings and TAM are IRS rulings directed at particular taxpayers. A private letter ruling is issued for a fee. The IRS is bound to such a ruling only for the particular taxpayer who requested it. A TAM is issued in response to a request for a legal opinion.

Chief Counsel Advice (CCA). A CCA is an IRS ruling issued to IRS field operations by the Office of Chief Counsel. It may be directed at a particular taxpayer or a particular issue. Included in this category are various legal memoranda (e.g., Internal Legal Memoranda (ILM) and Litigation Guideline Memoranda (LGM)).

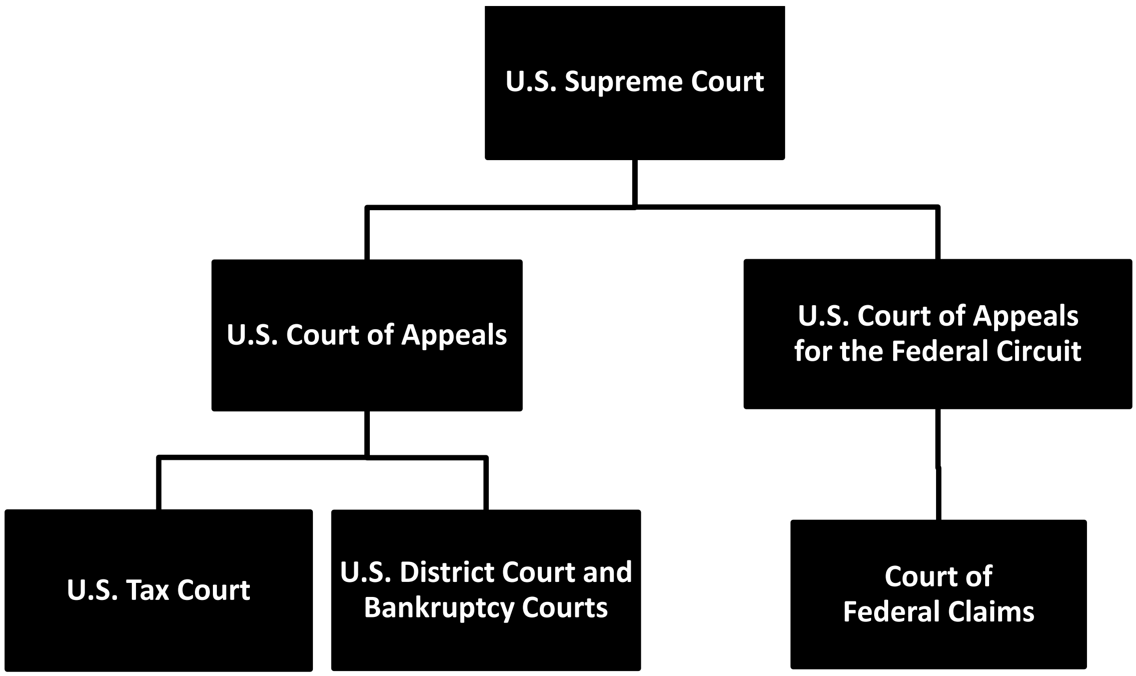
General Council Memoranda (GCM). GCMs detail the legal reasoning behind the issuance of a revenue ruling.

Service Center Advice (SCA). SCAs are issued by the IRS in response to a question coming from an IRS center. There are two types of SCAs: routine and significant. A **routine SCA** is answered by district counsel and not coordinated with the national office. A routine SCA is not issued to the public. A **significant SCA** (SSCA), on the other hand, is issued only with the approval of the national office. An SSCA is not legal advice and addresses only the interpretation or application of the Internal Revenue laws. SSCAs are made public, but any information identifying taxpayers is deleted.

Tax Court Summary Opinions. A case decided under the small-case procedures cannot be appealed by the taxpayer or the IRS. Without the appeals process, incorrect legal interpretations by the Tax Court cannot be challenged. Therefore, the Tax Court's decision is binding only on that particular case. However, reviewing the cases can still be useful; they explain the IRS's arguments, the taxpayer's arguments, and the Tax Court's reasoning.

JUDICIAL SYSTEM FOR TAX DISPUTES

Three levels of federal courts have jurisdiction to hear tax cases. The following diagram illustrates the three levels. The diagram is followed by a brief description of each court.



> **Note.** Although tax liabilities are addressed by bankruptcy courts, they are generally addressed in a bankruptcy context under the terms of the Bankruptcy Code in a different manner than in the other courts noted in the above diagram.

CASE COMMENCEMENT

A taxpayer in a dispute with the IRS generally has two choices after they receive a statutory notice or notice of final determination (a 90-day letter).

1. File a petition in the Tax Court without paying the tax.
2. Pay the tax and file a claim of refund. If the IRS rejects the claim, the taxpayer can file suit in a U.S. District Court or the Court of Federal Claims.

> **Note.** U.S. District Courts also have jurisdiction to hear federal tax cases. However, these courts are generally used only for very substantial tax disputes because of the high costs and the complexities of using them to resolve tax issues. Consequently, these courts are rarely used by individual taxpayers to resolve tax disputes with the IRS.

THE U.S. TAX COURT

The U.S. Tax Court is a federal court of record that was established in 1942 by Congress under Article I of the Constitution. It replaced the Board of Tax Appeals. Congress created the Tax Court to provide a judicial forum in which taxpayers could dispute tax deficiencies determined by the Commissioner of Internal Revenue prior to the payment of the disputed amounts.

The Tax Court is located at 400 Second Street, N.W., Washington, DC 20217. Although the court is physically located in Washington, the judges travel nationwide to conduct trials in various designated cities.

As of August 2021, the Tax Court is composed of 19 judges (two currently vacant), 10 senior judges, and four special trial judges. The judges generally have expertise in tax law.

This is the only forum in which a taxpayer can contest a tax liability **without** first paying the tax. However, there is a $60 filing fee that may be paid by check or money order made out to "Clerk, United States Tax Court." Jury trials are not available in this forum. More than 90% of all disputes concerning taxes are litigated in the Tax Court.

The jurisdiction of the Tax Court was greatly expanded by the Revenue Reconciliation Act of 1998 (RRA '98). The jurisdiction of the Tax Court includes the authority to hear tax disputes concerning the following.

- Notices of deficiency
- Notices of transferee liability
- Certain types of declaratory judgments
- Readjustment and adjustment of partnership items
- Review of the failure to abate interest
- Administrative costs
- Worker classification
- Relief from joint and several liability on joint returns
- Review of certain collection actions

The Tax Court also has limited jurisdiction under IRC §7428 to hear an appeal from an organization that is threatened with the loss of its tax-exempt status. Under IRC §7478, the Tax Court can also issue a declaratory judgment for a state or local government that has failed to get a tax exemption for a bond issue.

The IRS issues a statutory notice of deficiency in tax disputes in which the IRS has determined a deficiency. In cases in which a deficiency is not at issue, the IRS issues a notice of final determination. A notice of final determination is issued in the following types of tax disputes.

- Employee versus independent contractor treatments
- Innocent spouse claim determinations
- Collection due process cases

To invoke the jurisdiction of the Tax Court, the taxpayer must file a petition in Tax Court within 90 days after the IRS notice of deficiency (or notice of final determination) is mailed.[2] **The 90-day date cannot be extended by the IRS.** Similarly, the Tax Court has no statutory authority to extend the 90-day period.[3] However, the Tax Court does have the discretion to accept a timely but nonconforming document as a petition and allow later amendments to that document that relate to the originally timely filed nonconforming petition.[4]

Observation. Taxpayers and practitioners should not rely on the Tax Court's discretion to extend the 90-day period by filing a nonconforming document that is not a valid Tax Court petition. There is no guarantee that the Tax Court will grant relief from the 90-day deadline.

Who May Practice in the U.S. Tax Court

A taxpayer may represent themselves in Tax Court, or they may be represented by a practitioner admitted to the bar of the Tax Court. Generally, an attorney who is a member of the bar of any state (or the District of Columbia) may be admitted to the bar of the U.S. Tax Court. The attorney must complete the required application for admission to practice (which must be notarized), attach the required proof of good standing in their state bar, and pay the required $35 fee.

A nonattorney may also be admitted to practice before the U.S. Tax Court. To do so, the nonattorney practitioner must pass a 4-hour examination consisting of the following four parts and pay the $150 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** [www.ustaxcourt.gov/forms/Admission_Attorney_Form_30.pdf]
- **Nonattorneys: uofi.tax/15b7x2** [www.ustaxcourt.gov/resources/forms/Admission_Nonattorney_Info_and_Form_18A.pdf]

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

Tax Court Decisions

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

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

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

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.dawson.ustaxcourt.gov].

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

Tax Court Appeals

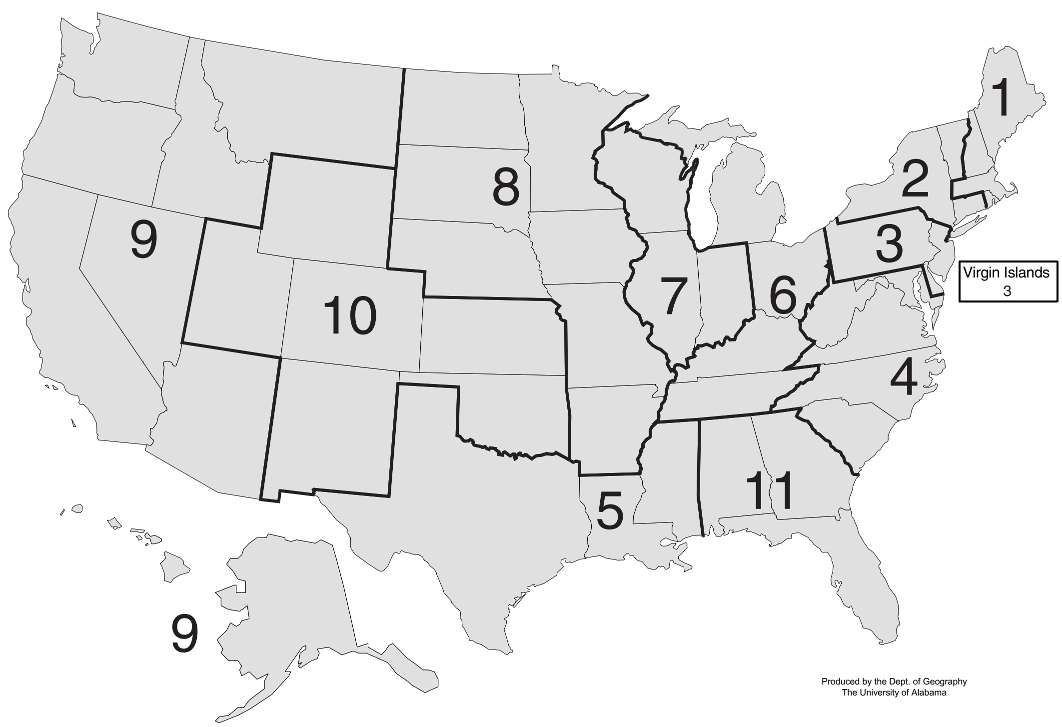
A Tax Court opinion or memorandum opinion may be appealed in a U.S. Court of Appeals. However, a taxpayer who commences their case in the U.S. Court of Federal Claims must appeal their case to the U.S. Court of Appeals for the Federal Circuit.

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

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

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

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



IRS ACTIONS ON DECISION [5]

The IRS has the ability to refuse to accept a court's legal reasoning in a tax case (unless the case was resolved by the U.S. Supreme Court). Generally, the IRS may issue an Action on Decision (AOD) for a case that it did not appeal but that decided issues that were adverse to it.

An AOD is a formal memorandum that alerts IRS officials and the public about the position the IRS will take in future litigation. An AOD is issued at the discretion of the IRS, and the IRS is not bound by it. An AOD does not have the force of a regulation or revenue ruling.

An AOD may take one of the following forms, depending on the position the IRS takes regarding the litigated case.

- **Acquiescence.** The IRS accepts the holding of a court in the case and will follow it in disposing of other cases in which the same facts are controlling.
- **Acquiescence in result only.** The IRS accepts the holding of a court in the case and will follow it in disposing of other cases in which the same facts are controlling. However, the IRS has general disagreement or concern with the court's reasoning in the case.
- **Nonacquiescence.** The IRS has decided against appealing the case but does not agree with the holding of the court and will not apply the court's decision in resolving similar cases with other taxpayers.

Observation. An AOD may provide a practitioner with insight on the stance the IRS will take on an issue that has been litigated. In this regard, an AOD may provide a useful source of information about taxpayers in the same or similar circumstances as those involved in the litigation.

The practitioner can view AODs online at **uofi.tax/15b7x7** [http://apps.irs.gov/app/picklist/list/actionsOnDecisions.html]. In addition, the Internal Revenue Manual provides information about when the IRS will consider issuing an AOD and the criteria used to determine when doing so is appropriate. This information can be found at **uofi.tax/15b7x8** [www.irs.gov/irm/part36/irm_36-003-001.html#d0e51].

Note. Although the IRS is bound by a particular Tax Court or federal court ruling with regard to the taxpayer(s) involved in that case, it is not bound to follow that decision in subsequent cases that have the same or similar facts. In addition, the IRS is not obligated to appeal a case from Tax Court or any other court.

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

BUSINESS EXPENSES

Substantiation of Expenses

***Viola Chancellor v. Comm'r,* TC Memo 2021-50 (May 4, 2021)**
IRC §§162 and 274

☞ Taxpayer's Reliance on Cohan Rule Hits a Sour Note

Facts. Viola Chancellor was a self-employed notary and paralegal during 2015. She performed notary services for veterans at no charge. She also worked as a paralegal, preparing files, and conducting research for a few clients. Although her business's revenue for the year was only $400, her Schedule C, *Profit or Loss From Business,* showed expenses of $19,250, notably including the following.

- Deductible meals and entertainment — $1,480
- Insurance — $1,030
- Utilities — $920
- Car and truck expenses — $12,600

Her Form 1040, *U.S. Individual Income Tax Return,* reflected taxable pensions and annuities income of $39,694, itemized deductions of $14,339, and business losses of $18,850. The itemized deductions included $6,000 for cash contributions to her church plus $500 for expenses associated with volunteer work for the church. Itemized deductions also included $4,500 for sales tax associated with purchases.

Ms. Chancellor was not good at maintaining records. The IRS denied deductions for her Schedule C expenses. The IRS also denied charitable donations because she retained none of the receipts associated with contributions to her church.

Issue. The issue in this case is whether Ms. Chancellor is entitled to the deductions she claimed on her 2015 individual income tax return.

Analysis. When a notice of deficiency is issued, the findings of the IRS are presumed correct. Ms. Chancellor, representing herself before the Tax Court, had a significant challenge to reconstruct her expenses without adequate records and receipts. She had the burden of proving the IRS was incorrect in its allegations.[6]

IRC §162(a) permits the deduction of "ordinary and necessary expenses paid or incurred during the taxable year,"[7] but the expenses must support the conduct of a business. A taxpayer may make a general statement that they incurred certain expenses to support their business. But a statement lacking specificity does not establish that relationship by itself.[8] Business expenses exclude any personal expenses.[9] The taxpayer has the responsibility to substantiate the expenses associated with the business deductions.[10]

The court's opinion establishes several categories of expenses to accomplish this segregation. Each bucket has a different set of substantiation rules.

---

6. *Rules of Practice and Procedure, Rule 142. Burden of Proof.* United States Tax Court. [www.ustaxcourt.gov/resources/ropp/Rule-142.pdf] Accessed on Jul. 17, 2021. See Rule 142(a)(1).
7. IRC §162(a).
8. *Sham v. Comm'r*, TC Memo 2020-119 (Aug. 12, 2020).
9. IRC §262(a).
10. Treas. Regs. §§1.6001-1(a) and (e).

The first bucket has the highest substantiation standards because it is associated with travel, meals, and lodging while away from one's tax home. It also includes entertainment, gifts, and listed property. IRC §274(d) prohibits any deduction that is not substantiated with the amount, time and location, business purpose, and the relationship between the taxpayer and the individual who benefits from the expenditure. Although evidence can be verbal, a court lends greater credence to written evidence, especially if it originates contemporaneously with the expense.[11]

Most of Ms. Chancellor's expenses fell into this first bucket, which has the highest substantiation requirements that IRC §274(d) strictly imposes. Without records, Ms. Chancellor attempted to rely on the *Cohan* rule to reconstruct her records.[12] But a 1969 case held that taxpayers must provide solid substantiation for §274(d) expenses, effectively eliminating the *Cohan* rule for them.[13] Thus, Ms. Chancellor lost the ability to deduct expenses associated with meals and her car.

Other expenses that Ms. Chancellor incurred were not subject to §274(d) substantiation requirements and fall into the second bucket. If a taxpayer loses evidence of these expenses through no fault of their own, they may reconstruct them invoking the guidelines of the *Cohan* rule. These include the following.

- **Utilities.** Although Ms. Chancellor testified that she used a portion of her bedroom as an office, she did not prove to the court's satisfaction that she used it regularly and exclusively, as required.[14]
- **Legal and professional services.** The expenses that Ms. Chancellor incurred were for the probate of a deceased sibling's estate, not for the pursuit of her business.
- **Advertising.** Ms. Chancellor's original return claimed advertising expense of $80. She could only produce one receipt for a $25 printing bill. She could not provide the court a printing bill for her business cards and she did not have a business card to show the court. The court's opinion described her testimony supporting the claim for this expense as "vague and not persuasive." The court disallowed the $55 portion for which she could not produce receipts.
- **Computer/Internet.** The "other expense" category on Ms. Chancellor's Schedule C included $2,200, for the cost of replacing a stolen computer and the Internet service bill she received monthly. She offered no apportionment of these expenses between business and personal usage, nor could she produce evidence of the cost of either. The court sustained the IRS's denial of this expense.
- **Post Office Box.** Ms. Chancellor claimed another $120 of other expense to rent a post office box. The only substantiation for this expense was a 2018 renewal invoice, which was not the year under examination. Although the court's opinion found her testimony credible about wanting to use a post office box for her business, in the absence of evidence for 2015, the court sustained the disallowance of this expense.

The judge recited the rules governing the use of the *Cohan* rule. The rule is named for the American entertainer, George M. Cohan, who wrote classic patriotic songs and had an extended vaudeville career. Alas, Mr. Cohan could write music and perform better than he could maintain business records. When the IRS challenged his use of travel expenses in the early 1920s, he testified that he traveled and had to have incurred the expense, but he could produce no receipts.[15] The following requirements governing the rule's use have emerged over the 90 years since the court announced its ruling.

---

11. Temp. Treas. Reg. §1.274-5T(a) *et seq;* See also *Sanford v. Comm'r*, 50 TC 823 827-828 (1968), *aff'd* 412 F.2d 201 (2nd Cir. 1969).
12. *Cohan v. Comm'r,* 39 F.2d 540, 543-544 (2d Cir. 1930).
13. *Sanford v. Comm'r,* 50 TC 823, 827-828 (1968), *aff'd* 412 F.2d 201 (2nd Cir. 1969).
14. IRC §280A(c)(1).
15. *Cohan v. Comm'r,* 39 F.2d 540, 543-544 (2d Cir. 1930).

1. **Confirm the expense.** The taxpayer must establish that it incurred the expense and was entitled to deduct it. The Tax Court invoked the precedent in the *Norgaard v. Comm'r* case involving gambling expenses to state that taxpayers must establish that they are entitled to a deduction.[16] In this case, the Court of Appeals for the Ninth Circuit disallowed gambling expenses even though the taxpayer produced clean, untorn racetrack tickets with roughly sequential numbering. The court denied the taxpayer's claim of gambling loss deductions because he did not maintain a daily log of gambling transactions.

2. **Provide a basis for the estimate.** The taxpayer must provide a basis for their estimate of the expense incurred.[17] Furthermore, taxpayers must not invoke the *Cohan* rule for expenses that are allowed by §274(d).[18] For example, a taxpayer may not rely on the *Cohan* rule to reconstruct records associated with meals expense.

3. **Reconstruct the expense.** If a taxpayer loses records of an expense through no fault of their own, they must try to reconstruct their records. In doing so, they must use third parties' records and use reasonable means to estimate the expenses. For example, suppose a fire destroys a taxpayer's records for utility and advertising expenses, which are not subject to §274(d) requirements. In that case, the taxpayer should contact the utility company and the advertising agency for copies of bills or invoices. The court cites a case in which the taxpayer did not attempt to reconstruct records lost in a wind and hailstorm and lost the deduction.[19]

4. **Establish unavailability of records.** The records should be unavailable to the taxpayer through no fault of theirs.

5. **Separate business from personal expenses.** The records must distinguish business expense amounts from personal expenses.

Holding. Apart from a minor concession to allow a $25 expense for advertising, the Tax Court sustained the IRS's denial of deductions for unsubstantiated expenses on Ms. Chancellor's 2015 individual income tax return.

> **Note.** The IRS looks for records to substantiate any expense. If there are no records, the taxpayer has the opportunity to reconstruct records to validate the deduction. If the taxpayer cannot validate the deduction, it will likely be disallowed.

Tax Home

***Akeem Soboyede v. Comm'r,* TC Summ. Op. 2021-3 (Jan. 26, 2021)**

IRC §§162, 262, and 274

☞ Practices Do Not Make Perfect

Facts. Akeem Soboyede is an attorney licensed to practice law in both Minnesota and Washington, D.C. During 2015 (the year at issue in this case), he had solo law practices in Minnesota and the Washington, D.C. area, dividing his time between these two locations.

Mr. Soboyede also performed document review work. In 2015, he received $46,130 **in wages** from multiple companies for such work. He reported that amount on his 2015 Form 1040, *U.S. Individual Income Tax Return*. Of that amount, $7,582 was for work performed in Minnesota and $38,548 was for work performed in the Washington, D.C. area.

---

16. *Norgaard v. Comm'r,* 939 F.2d 874, 879 (9th Cir. 1991).
17. *Vanicek v. Comm'r*, 85 TC 731 (1985), citing *Williams v. U.S.*, 245 F.2d 559, 560 (5th Cir. 1957).
18. *Sanford v. Comm'r,* 50 TC 823, 827-828 (1968), *aff'd* 412 F.2d 201 (2nd Cir. 1969).
19. *Harlan v. Comm'r*, TC Memo 1995-309 (Jul. 13, 1995), *aff'd in part* 103 F.3d 138 (9th Cir. 1996).

Mr. Soboyede filed his 2015 tax return using the married filing separately status. His return included a Schedule C, *Profit or Loss From Business,* on which he reported income of $10,650 and expenses of $26,816 from his law practice.

The IRS audited Mr. Soboyede's 2015 return and determined that he failed to substantiate or was otherwise not entitled to deduct many of the expenses reported on his Schedule C. The IRS disallowed the following expenses.

Expense	Amount
Hotel and apartment rent in Maryland	$8,400
Minnesota office rent	2,400
Internet and phone	2,000
Paper, stationery, and ink	760
Flights	500
Tolls and fees	1,682
Parking	1,254
Continuing legal education classes	600

Issue. The issue in this case is whether Mr. Soboyede is entitled to deductions claimed on Schedule C.

Analysis. A taxpayer can deduct ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business.[20] To deduct travel-related expenses under IRC §162(a)(2), the following requirements must also be satisfied.[21]

- The expense must be reasonable and not lavish or extravagant.
- The expense must be incurred while the taxpayer is **away from home.**
- The expense must be incurred in the pursuit of a trade or business.

In addition, the taxpayer must establish the amount of the travel expense, the time and place of the travel, and the business purpose of the travel expense.[22]

Mr. Soboyede reported $8,400 on his 2015 Schedule C for lodging expenses in Maryland while he worked in the Washington D.C. area. He substantiated approximately $7,073 of those costs but the lodging expenses were not incurred while he was away from home, as required under §162(a)(2). The IRS argued that Maryland, rather than Minnesota, was Mr. Soboyede's tax home in 2015.

A taxpayer's **tax home** generally "means the vicinity of the taxpayer's principal place of employment [or business] and not where his or her personal residence is located."[23] In determining where Mr. Soboyede's principal place of business is, the court considered the following factors.[24]

1. Where he spent most of his time
2. Where he engaged in greater business activity
3. Where he derived a greater proportion of his income

20. IRC §162(a).

21. See *Comm'r v. Flowers, 326* U.S. 465, 470 (1946) and *Comm'r v. Heininger,* 320 U.S. 467, 475 (1943).

22. IRC §274(d).

23. *Mitchell v. Comm'r,* 74 TC 578, 581 (1980).

24. See, e.g., *Montgomery v. Comm'r,* 64 TC 175, 179 (1975), *aff'd* 532 F.2d 1088 (6th Cir. 1976).

Mr. Soboyede spent at least 161 days in the Washington, D.C. area and at least 115 days in Minnesota in 2015. In addition, he spent 54 nonworking days in Nigeria. The remaining 35 days are unaccounted for. However, even if he spent all those unaccounted days in Minnesota, he still spent more than 50% of his working days in the Washington, D.C. area in 2015.

In addition, Mr. Soboyede earned at least $38,548 in income related to his work in the Washington, D.C. area in 2015, compared to only $7,582 earned in Minnesota. Even if the entire amount of the $10,650 reported on his Schedule C is attributable to his practice in Minnesota, he still earned a larger portion of his total income in the Washington D.C. area in 2015.

Mr. Soboyede also claimed deductions on his 2015 Schedule C for transportation-related fees, which included parking expenses, tolls, and car and truck expenses. Some of these transportation expenses were §162(a)(2) travel expenses; however, Mr. Soboyede failed to properly substantiate them. Some of the transportation expenses were **not** §162(a)(2) travel expenses, and he failed to show how these items were ordinary and necessary business expenses rather than nondeductible personal expenses. Mr. Soboyede admitted that he did not keep the necessary documentation because he did not know he was going to get audited.

Moreover, Mr. Soboyede **did not provide** any documentation regarding the remaining disputed expenses.

He tried to substantiate the Internet and telephone expenses by providing a checking account statement showing payments that totaled $1,489 for such services. However, he testified that he also used the Internet and telephone for personal reasons, and his documents did not show the amounts that related to business expenses.

Holding. The court held that Mr. Soboyede is not entitled to deduct the $8,400 of lodging expenses he reported on his 2015 return because he was not away from home as required by §162(a)(2). In addition, he cannot deduct the transportation expenses and other disputed expenses because he failed to comply with documentation requirements.

Unreimbursed Employee Expenses

***Jesus M. Santillan v. Comm'r,* TC Summm. Op. 2020-28 (Nov. 9, 2020)**

IRC §§162 and 274

☞ Carpenter Fails to Nail It

Facts. Jesus Santillan and his wife were married in California in 2013. The couple separated in 2015, and the wife and children stayed in the family home, while Mr. Santillan moved into his mother's house. Mr. and Mrs. Santillan had not started legal divorce proceedings at the time the trial commenced.

Mr. Santillan was a journeyman carpenter employed by Power Scaffold Services in 2015 and 2016 (the years at issue in this case). He did not work at the Power Scaffold's offices. Instead, he received dispatches from the company with a description of a project and its location. If Mr. Santillan chose to accept the project, he drove directly from his home to the project worksite.

Power Scaffold paid its employees for travel on projects that required a drive of two or more hours. In 2015 and 2016, Mr. Santillan received travel reimbursements from Power Scaffold of $4,670 and $7,650, respectively. These reimbursements were not included in the wages reported on the Form W-2, *Wage and Tax Statement,* issued to Mr. Santillan for either year.

Power Scaffold's policy was that its employees were not expected to incur any expenses other than for travel. If an employee incurred other expenses, the company reimbursed the employee. Power Scaffold's records show that it reimbursed Mr. Santillan only for travel expenses during the years at issue. He did not request reimbursement for other expenses.

Mr. Santillan timely filed his federal tax returns for 2015 and 2016. He checked the box for the **single filing status** on Form 1040, *U.S. Individual Income Tax Return* for each year, even though he was **legally married to his wife** for those years.

Mr. Santillan's 2015 and 2016 returns included Schedules A, *Itemized Deductions,* on which he claimed various deductions, including the following unreimbursed employee expenses. These expenses were reported on Form 2106, *Employee Business Expenses,* for 2015, and on Form 2106-EZ, *Unreimbursed Employee Business Expenses,* for 2016.

Unreimbursed Employee Expenses	2015	2016
Vehicle	$15,784	$11,483
Parking, fees, tolls, and transportation	0	11,483
Travel expenses while away from home overnight	2,600	6,056
Meals and entertainment (50%)	0	1,800
Business expenses	2,765	0
Total	$21,149	$30,822

In addition to the expenses reported on the 2015 Form 2106, Mr. Santillan included a statement reporting an additional $5,820 of unreimbursed expenses. Similarly, in addition to the expenses reported on the 2016 Form 2106-EZ, Mr. Santillan reported an additional $550 of unreimbursed expenses on an attached statement. The total unreimbursed employee expenses reported on Mr. Santillan's tax returns were $26,969 for 2015 and $31,372 for 2016.

For the 2015 tax year, Mr. Santillan reported an average daily round-trip commuting distance of 40 miles. However, of the 32,155 total miles reported that year on his Form 2106, he only reported 2,400 commuting miles. For the 2016 tax year, he reported 2,400 commuting miles and 21,264 business miles on his Form 2106-EZ. He did not report the travel reimbursement he received from Power Scaffold on his return for either year.

The IRS issued a notice of deficiency to Mr. Santillan for the 2015 and 2016 tax returns using the married filing separately (MFS) status and disallowing all unreimbursed expenses.

Issues. The issues in this case are as follows.

- Whether Mr. Santillan is entitled to use the single filing status for the 2015 and 2016 tax years
- Whether he is entitled to deduct unreimbursed employee business expenses of $26,969 and $31,372 for the 2015 and 2016 tax years, respectively

Analysis. Mr. Santillan testified at trial that he was legally married under California law during the years at issue but provided no evidence. The court concluded that the IRS **properly changed** his filing status from single to MFS.

IRC §162(a) allows deductions for ordinary and necessary business expenses paid or incurred during the tax year in carrying on a trade or business. Performing services as an employee constitutes a trade or business.

To deduct employee business expenses, a taxpayer must not have received reimbursement or have the right to obtain reimbursement from their employer.[25]

When a taxpayer establishes that they paid a deductible trade or business expense but is unable to properly substantiate the amount, the court may estimate the amount and allow a deduction to that extent.[26] However, certain categories of expenses require strict substantiation under IRC §274(d). If the taxpayer has no evidence to show the exact amount of such expenses, deductions for them are disallowed entirely. Expenses subject to the strict substantiation requirements of §274(d) include travel, meals, and lodging while away from home, entertainment, gifts, and listed property. A taxpayer must substantiate the amount, time, place, and business purpose of these expenditures.

25. See *Orvis v. Comm'r,* 788 F.2d 1406, 1408 (9th Cir.1986), *aff'g* TC Memo 1984-533 (Oct. 3, 1984).

26. *Cohan v. Comm'r,* 39 F.2d 540, 543-544 (2d Cir. 1930).

The IRS disallowed all Mr. Santillan's unreimbursed employee business expenses for 2015 and 2016. The IRS asserted that Mr. Santillan failed to substantiate the reported expenses, prove that he was required to incur the expenses in the course of his employment, or prove that any of the incurred expenses were not reimbursable by his employer. Mr. Santillan produced various credit card and bank account statements to substantiate the expenses. Some of the expenditures were cross-referenced with spreadsheets he provided that listed the dates and amounts of certain expenses. **However, the records did not include any contemporaneous indication of the business purpose for any of the expenditures.** In addition, Mr. Santillan failed to indicate which of his reported expenses were covered by the travel reimbursements he received from Power Scaffold for 2015 and 2016 or establish that he requested and failed to receive reimbursement for the remaining expenses.

After reviewing Mr. Santillan's records, the court agreed with the IRS that Mr. Santillan did not comply with the strict substantiation requirements of §274(d), which applied to the expenditures he deducted for vehicle, parking, fees, tolls, transportation, travel, and meals and entertainment. Similarly, for the business and other expenses that Mr. Santillan deducted as unreimbursed employee expenses, he did not submit evidence that would provide the court with a basis upon which an estimate of allowable expenses may be made. Consequently, the court disallowed these expenses.

Holding. The court held that Mr. Santillan is not entitled to use the single filing status for 2015 or 2016. In addition, the court disallowed the unreimbursed employee business expenses claimed by Mr. Santillan for those years.

Substantiation of Expenses

***Paul and Karen Bruneau v. Comm'r,* TC Summ. Op. 2021-1 (Jan. 21, 2021)**
IRC §§61, 167, 274, and 6662

☞ Dog's Day in Court

Facts. During 2014 and 2015 (the years in issue in this case), Paul and Karen Bruneau operated Dog's Day Inn (DDI), which is a kennel facility that provides boarding and grooming services for dogs and cats. Mrs. Bruneau also earned $35,000 to $50,000 during the years at issue as a professional handler at dog shows and competitions.

Mr. and Mrs. Bruneau filed joint federal tax returns for the years at issue. The returns included Schedules C, *Profit or Loss From Business,* on which they reported receipts and expenses for DDI and Mrs. Bruneau's dog show activities.

The IRS examined the Bruneaus' return for 2014. The couple reported gross receipts of $385,178 on their 2014 Schedule C. After conducting a bank deposits analysis, the IRS determined they had underreported gross receipts by $9,945.

The Bruneaus' 2014 gross receipts and depreciation information is summarized in the following table with the deficiency and accuracy-related penalty assessed by the IRS.

Gross Receipts Reported	Understatement of Gross Receipts	§179 Expense	Depreciation on Items Placed in Service Before 2014	Depreciation on Items Placed in Service During 2014	Deficiency	§6662(a) Accuracy-Related Penalty
$385,178	$9,945	$12,637	$17,691	$263	$32,692	$6,538

The IRS allowed the deduction for §179 expenses but disallowed the remaining 2014 depreciation deductions for lack of substantiation. Mr. and Mrs. Bruneau did not provide direct evidence of the improvements to DDI for which they took depreciation deductions, or the amounts of depreciation deductions claimed for years before 2014. Mr. Bruneau stated that their former accountant had their original records and the accountant could not be found.

The IRS also examined the Bruneaus' 2015 return. The couple reported gross receipts of $421,169 on Schedule C for the year. The IRS performed a bank account analysis and accepted the gross receipts as reported. However, before the trial commenced, Mr. and Mrs. Bruneau asserted that they had overstated 2015 gross receipts by $36,745. They said they made some deposits to DDI's account from nontaxable sources.

The following table summarizes the taxpayers' 2015 business receipts and depreciation items, the deficiency found by the IRS, and the associated accuracy-related penalty.

Gross Receipts Reported	Understatement of Gross Receipts	§179 Expense	Depreciation on Items Placed in Service Before 2015	Depreciation on Items Placed in Service During 2015	Deficiency	§6662(a) Accuracy-Related Penalty
$421,169	$0	$0	$18,190	$18,700	$33,558	$6,711

Mr. and Mrs. Bruneau deducted travel expenses of $5,660 and $6,169 for 2014 and 2015, respectively. They claimed that these expenses were for Mrs. Bruneau's trips to dog shows. They produced a calendar with entries identifying the places where Mrs. Bruneau acted as a dog handler and the miles she traveled by car to attend the shows. They also produced schedules showing the hotels where they stayed overnight, restaurants where they ate, and amounts paid for meals and lodging.

Mr. and Mrs. Bruneau's returns for the years at issue were prepared by a tax return preparer. Mr. Bruneau stated that the couple **did not review the completed returns for accuracy and completeness before they signed them.**

Issues. The issues in this case are as follows.

- Whether the Bruneaus' gross receipts were incorrectly reported on their tax returns for 2014 and 2015
- Whether the Bruneaus are entitled to depreciation deductions of $23,204 and $37,091 for 2014 and 2015, respectively
- Whether the Bruneaus are entitled to deductions for travel expenses of $5,660 and $6,169 for 2014 and 2015, respectively
- Whether the Bruneaus are liable for accuracy-related penalties for 2014 and 2015

Analysis. With respect to the gross receipts the Bruneaus reported for 2014, the IRS conceded that the couple demonstrated they made deposits of $7,122 to DDI's account from nontaxable sources, leaving $2,823 in dispute. Mr. and Mrs. Bruneau failed to provide evidence to account for the balance of the deposits in dispute. As a result, the court concluded they had unreported gross receipts of $2,823 for 2014.

Mr. and Mrs. Bruneau reported gross receipts of $421,169 for 2015, which was close to the total deposits to DDI's account for that year. However, before trial, they asserted that their tax preparer had overstated DDI's gross receipts by including $36,745 from nontaxable sources. Mr. and Mrs. Bruneau primarily relied on a spreadsheet prepared by their bookkeeper in 2017 (after they filed their 2015 return), which purportedly showed that DDI collected a total of $330,934 for boarding, grooming, and certain fees from clients.

The court was not convinced the 2017 spreadsheet provides a good record of their gross receipts. DDI's bookkeeper did not appear at trial and there was no evidence explaining what process the bookkeeper used in preparing the spreadsheet or why it was prepared after the Bruneaus had filed their 2015 tax return. The court observed that Mr. and Mrs. Bruneau provided an incomplete and unreliable summary of their 2015 receipts. As a result, the court upheld the IRS's determination that Mr. and Mrs. Bruneau had correctly reported their 2015 gross receipts on Schedule C.

Mr. and Mrs. Bruneau claim they were entitled to depreciation deductions of $23,204 for 2014 and $37,091 for 2015, but they offered very little reliable evidence of the depreciable basis of the assets in question or previously allowable depreciation. Mr. Bruneau provided estimates of the dates of completion and the amounts paid for various improvements, a supplemental property assessment notice, and a 2014 depreciation schedule to support their position. However, the court noted that depreciation schedules prepared to facilitate filing a tax return are insufficient to satisfy the taxpayer's burden of proof. Moreover, Mr. and Mrs. Bruneau did not provide tax returns for years before 2014 to demonstrate previously allowable depreciation. The court therefore found the evidence the Bruneaus offered was insufficient to substantiate the disputed depreciation deductions.

IRC §274(d) provides stringent substantiation requirements that must be met before a taxpayer can deduct certain types of expenses, including travel expenses, meals and lodging while away from home, and expenses for listed property. To satisfy the §274(d) requirements, a taxpayer must maintain adequate records or produce sufficient evidence to corroborate their own statements that are sufficient to establish the amount, date and time, and business purpose for each expenditure.[27] **Adequate records** generally consist of an account book, a diary, a log, a statement of expense, trip sheets, or a similar record made at or near the time of the expenditure, along with supporting documentation.

Mr. and Mrs. Bruneau claimed they were entitled to deduct travel expenses for 2014 and 2015 for Mrs. Bruneau's trips to dog shows. They relied on a calendar with notations showing travel dates and mileage, a spreadsheet listing meals and lodging expenses, and related bank records.

Mrs. Bruneau did not appear at trial. There was little evidence provided to show payments to Mrs. Bruneau for dog handler services and the accuracy and reliability of her calendar. To the extent the court was able to match certain travel dates and related expenses with payments to Mrs. Bruneau for dog handler services, the court concluded that the Bruneaus adequately substantiated that Mrs. Bruneau drove 532 miles and paid expenses of $1,074 for business purposes in 2014. However, there was insufficient evidence to show that Mr. and Mrs. Bruneau are entitled to a deduction for travel-related expenses for 2015.

IRC §6662 imposes a 20% accuracy-related penalty for an underpayment of tax that is due to the taxpayer's negligence or disregard of rules or regulations. Mr. and Mrs. Bruneau failed to maintain adequate books and records needed to substantiate most of the expenses they reported on Schedules C. Mr. and Mrs. Bruneau did not offer a meaningful defense to the imposition of the penalties. Mr. Bruneau asserted that they relied on their tax return preparer to properly prepare their returns, but he admitted they did not review the returns for accuracy and completeness before signing them. Accordingly, the court sustained the IRS's determination that the Bruneaus are liable for penalties under §6662.

Holding. The court concluded that the taxpayers had unreported gross receipts of $2,823 for 2014 and that they correctly reported their gross receipts for 2015. The court sustained the IRS's disallowance of disputed depreciation deductions for 2014 and 2015. The court further concluded that Mr. and Mrs. Bruneau provided adequate substantiation for certain travel expenses in 2014 but **disallowed all** travel-related expenses for 2015. Finally, the court sustained the IRS's determination of accuracy-related penalties for the Bruneaus' 2014 and 2015 returns.

27. Temp. Treas. Regs. §§1.274-5T(b)(2), (6) and (c)(1).

Business Expenses

***William Bruce Costello et ux. v. Comm'r,* TC Memo 2021-9 (Jan. 25, 2021)**

IRC §§195(a) and 6651(a)

☞ Tax Court Puts Farming Deductions Out to Pasture

Facts. Martiza Legarcie, the wife of William Costello, engaged in farming activities for seven years, including 2012 and 2013. The farming activities included raising chickens, growing vegetables, and raising cattle. These endeavors were not financially successful.

She also owned several rental real estate properties for which they reported income for 2012 and 2013 on Schedule E, *Supplemental Income and Loss*. Although four properties appeared on the 2012 Schedule E, only two appeared on the 2013 form. They reported that they were real estate professionals for both years and therefore claimed to have had materially participated in real estate activities. They included a Schedule C, *Profit or Loss From Business*, that reported deductions for additional expenses related to real estate for both years. Mr. Costello reported these expenses on Schedule C because he had not tracked them by property.

Because of the lengthy period of losses that accumulated, the IRS denied deductions for the farming losses. It claimed they were startup costs associated with investigating new business ventures. It also denied deductions for the losses claimed on one of the properties for which Mr. Costello and Ms. Legarcie made no earnest effort to rent. Consequently, the IRS claimed it was not a rental property. It disallowed the 2012 passive activity loss on the other three properties but permitted it to offset passive activity income in 2013. The 2012 return included a net operating loss (NOL) carryover deduction that the IRS also disputed. Mr. Costello and Ms. Legarcie conceded that they improperly claimed the NOL deduction.

Mr. Costello and Ms. Legarcie filed their 2012 tax return late and represented themselves before the U.S. Tax Court. The IRS asserted accuracy-related penalties based on a combination of negligence and a substantial understatement of income for the same year. The penalty for 2013 only applied to negligence; the understatement for that year was \$1,648, less than the \$5,000 threshold for a substantial understatement.[28] The supervisor of the IRS employee had properly approved the penalties.

Issues. The Tax Court had the following four issues to decide.

- Whether Mr. Costello and Ms. Legarcie can deduct expenses associated with attempts to establish a farming business
- Whether the IRS was mistaken in disallowing real estate loss deductions
- Whether Mr. Costello and Ms. Legarcie are liable for penalties associated with the late filing of their 2012 tax return
- Whether they are liable for accuracy-related penalties on their 2012 and 2013 tax returns

Analysis. The IRS argued that Ms. Legarcie conducted farming operations without a profit motive. Therefore, the test implied by IRC §162(a) fails because there is no trade or business. Without a trade or business, permission to deduct "ordinary and necessary" expenses is not available. Although Mr. Costello convinced the court that his wife pursued farming activities with diligence and determination, the opinion still recognizes her activities as startup expenses that are not deductible.[29] Thus, they may not deduct her farming losses.

Mr. Costello and Ms. Legarcie claimed that they did not attempt to rent one property because it had flooded. But they were unable to prove this to the satisfaction of the court. Without a verifiable rental attempt, the court concurred with the IRS that this one property did not qualify as a rental.

28. IRC §6662(d)(1)(A).

29. IRC §§195(a) and (b)(1).

Mr. Costello and Ms. Legarcie managed a small victory in persuading the court that they should be able to deduct rental losses on the other three properties. However, this was because the IRS missed the capital gain that sales of two of the rental properties generated in 2012. When the court offset the loss against capital gains, no passive losses remained from 2012 to be carried forward to 2013 taxable income.

Their 2012 return was filed in late November 2013, making it late by seven months as the court's opinion mentions no extension. Mr. Costello and Ms. Legarcie carried the burden of proving they filed the return late for reasonable cause and not out of willful neglect.[30] However, they made no argument on this point, so the court sustained the penalties assessed by the IRS.

Their 2012 return was not only late, but it also understated the actual tax owed by a significant amount. The IRS assessed accuracy-related penalties for both 2012 and 2013. The amount owed for 2012 exceeded the threshold for being a substantial underpayment imposed by IRC §6662(d)(1)(A). However, the court did not concur with all the IRS adjustments proposed for Mr. Costello and Ms. Legarcie's 2012 joint return. Because the IRS succeeded in establishing that Mr. Costello and Ms. Legarcie were negligent in preparing 2012 and 2013 returns, the court concluded it did not need to determine that the 2012 understatement was substantial to impose the accuracy-related penalty.[31] The negligence stemmed from the following.

- The erroneous claim of farming losses on Schedule C and Schedule F, *Profit or Loss From Farming*; and
- The improper claim of an NOL on their 2012 return.

The court's opinion states that these petitioners did not address the penalties in their pleadings. The court sustained the IRS's impositions of the penalties.

Holding. The court disallowed the farming-related losses because they were nondeductible startup expenses. It disallowed the operating loss deduction for the one rental property that they did not attempt to rent. However, the court held that the IRS erred in its determination of the passive loss, and as a result, it did not agree with the IRS's disallowance of the loss deduction. Finally, the court sustained the IRS's imposition of the failure-to-timely file penalty on the 2012 return, as well as the accuracy-related penalties.

CAPITAL GAINS AND LOSSES

Depreciation Recapture

***Blossom Day Care Centers, Inc., v. Comm'r,* TC Memo 2021-87 (Jul. 13, 2021)**
IRC §§280F and 311

☞ Child Care Centers Learn Not to Play Hide and Seek with Property Transfers

Facts. Blossom Day Care Centers, Inc. (Blossom) operated childcare centers in the Tulsa, Oklahoma, area since 1986. Mr. and Mrs. Hacker were knowledgeable about childcare and were active members of the Oklahoma Child Care Association. In 2002, they formed Hacker Corp., for which they filed an S corporation election. From 2004 until 2008, Blossom paid management fees to Hacker Corp., which paid wages to the Hackers. During 2005, Blossom transferred ownership of the real estate for five of its six daycare centers to Hacker Corp. The Hackers themselves owned the real estate for the sixth daycare center, and it was transferred to Hacker Corp.

30. IRC §6651(a)(1).

31. IRC §6751(b).

The Hackers' attorneys recorded the transfers as quitclaim deeds in county records according to state law. Blossom made rent payments to Hacker Corp., even without a signed lease. Sometimes Blossom made payments to a bank to cover mortgage payments due. Hacker Corp. began to claim depreciation deductions for the real estate starting in 2005, as well as other expenses associated with real estate ownership, such as property taxes and mortgage interest. Blossom also made payments on vehicles owned by the Hackers and their adult children. None of the Hackers maintained mileage logs, so there was no evidence to support deductions for business expenses.

In May 2005, Blossom purchased some rental real estate in Sand Springs, Oklahoma, from which it received monthly rent payments. Blossom failed to report this rental income on its tax return. Instead, a limited liability company (LLC) established by Mr. and Mrs. Hacker, Hacker Investment, LLC, listed the rental income on its return, even though it did not own the property. Only Mr. and Mrs. Hacker were members of the LLC, not Blossom. Consequently, Blossom had unreported rental income.

The capital gains aspect of this case arises from the personal use of vehicles owned by Blossom. An IRS examination held Blossom liable for not reporting capital gain income of $58,980 on its 2004 income tax return. Most of this amount, $39,676, arose from the recapture of prior-year excess deprecation on two of these vehicles. The balance of the capital gain, $19,304, stemmed from trading in a third vehicle that Blossom owned, a Ford Expedition. The title for the replacement car, a BMW, was in the name of the Hackers' son, and he made no business use of it. Although the son was liable for the loan on his car, Blossom made car payments on his behalf.

Issue. The issue in this case is whether tax law required the Hackers to recognize capital gain that arose from recapturing excess depreciation on two vehicles and from recapturing depreciation on the trade-in of their third vehicle.

Analysis. The IRS took up the following three issues in its examination that pertain to capital gain income.

- Recapturing excess depreciation on the first two vehicles
- Capital gain on the exchange of the third vehicle for the son's car
- Capital gain income arising from transfer of real estate from Blossom to Hacker Corp.

IRC §280F limits depreciation when an owner uses their business's vehicle for personal purposes. If the original use of a business-owned vehicle is substantially all related to the business, but in a subsequent year business use declines below 50%, then the owner must include the excess depreciation since purchase in gross income in that year.[32]

The Hackers used the first two vehicles primarily for personal purposes in 2004, including commuting, even though they were titled in Blossom's name. Perhaps because the statute of limitations had run on earlier years, the IRS's argument assumed business use for the years before 2004. The Hackers did not maintain business mileage documentation in prior years, even though they claimed excess depreciation.[33] For this reason, §280F(b)(1) required them to recapture the excess depreciation in 2004. The IRS characterized the recapture of excess depreciation as capital gain income rather than ordinary income. The excess depreciation thus created $39,676 of the capital gain income that the IRS said that Blossom should have reported but did not.

The exchange of the third vehicle that Blossom owned for a car owned by the Hackers' son created another capital gain quagmire for the Hackers. The IRS based its conclusion on IRC §311. If a corporation distributes appreciated property to a shareholder, it recognizes capital gain on that property.[34] The capital gain is the difference between the fair market value of the property and the corporation's adjusted basis in the property.[35]

32. IRC §280F(b)(2)(A).

33. IRC §280F(b)(2)(B). Generally, excess depreciation is depreciation greater than straight-line depreciation.

34. IRC §311(b).

35. Ibid.

Capital gain treatment for these vehicles had a significant impact on Blossom. It did not own the replacement car, even though it owned the vehicle that was surrendered in exchange for it. Consequently, the economic substance of the transaction is that Blossom distributed the traded in vehicle, the Ford Expedition, with an adjusted basis of $5,615, to the Hackers. They acquired a BMW worth $24,919 with the trade-in, resulting in a capital gain of $19,304. This amount is the difference between the value of the BMW and the adjusted basis of the Expedition. The court's opinion does not mention any cash consideration that the Hackers provided. Although the Hackers disagreed with this determination in court, they offered no evidence that would have supported a smaller value for the BMW or a greater adjusted value for the Ford Expedition.

The third aspect of the capital gain income determination by the IRS was the transfer of the real estate to Hacker Corp. The IRS asserted that Blossom distributed the properties to the Hackers, who subsequently transferred the real estate to Hacker Corp. The Hackers claimed that the real estate transfer was not substantive. They invoked the term "bare naked title" to describe the transaction because Hacker Corp. supposedly did not acquire property ownership rights. The Hackers argued that Blossom retained the rights of property ownership.

However, the Tax Court cited Oklahoma property law, which recognizes that a property transaction has occurred when a quitclaim deed substantially complies with state law.[36] The court cited another case decided by the U.S. Supreme Court that established the principle that federal courts look to state law to reckon whether the transfer of the "benefits and burdens" of the property has taken place.[37] Because the provisions of Oklahoma's laws governing the conveyance of property had been satisfied, the court ruled that the transfer of property had taken place and that the distributions constructed by the IRS were valid.

Holding. Blossom is liable for the deficiencies determined by the IRS, plus additional accuracy-related penalties. Although the IRS introduced more issues than capital gains, the Hackers lost on all points.

> **Caution.** Tax practitioners should not assume that their clients' verbal descriptions of property transactions are complete. It is reasonable to think that a different outcome might have occurred if the CPA firm preparing the returns for the Hackers had the opportunity to advise their clients on the consequences of the structure of their transactions. This case also highlights the pitfalls of corporate ownership of rental real estate.

CASUALTY AND THEFT LOSSES

Theft Loss Deduction

Michael C. Giambrone et al. v. Comm'r, **TC Memo 2020-145 (Oct. 19, 2020)**
IRC §165

☞ No Safe Harbor Sinks the Taxpayer

Facts. Michael and William Giambrone are brothers who worked in the mortgage business. In 1999, they founded Platinum Community Bank (Platinum), which was a federally chartered stock institution headquartered in Rolling Meadows, Illinois. Platinum's business included mortgage, home equity, and consumer and commercial real estate loans. The Giambrone brothers owned Platinum through a holding company, Platinum Bancshares, Inc. (Holding). As of January 2007, they held a 52.2% interest in Holding.

36. Okla. Stat. title 16, secs. 4, 5, 15, 16, and 18.

37. *U.S. v. Nat'l Bank of Commerce,* 472 U.S. 713, 722 (1985).

Platinum was unprofitable from its inception. In December 2007, Holding entered into a common stock purchase agreement with a Florida corporation, Taylor Bean & Whitaker Mortgage Corp. (TBW) to raise capital. By January 2009, TBW held an 82.6% interest in Holding, while the brothers held a 9.1% interest.

After TBW acquired a controlling interest in Holding, Lee Bentley Farkas, who was TBW's majority shareholder, was appointed chairman of Holding and Platinum. Mr. Farkas directed TBW to transfer large amounts of its Federal Home Loan Mortgage Corporation (FHLMC) escrow deposits into Platinum. Mr. Farkas then ordered Platinum to use the same deposits to purchase TBW mortgage loans. Platinum ultimately purchased $481 million in TBW mortgage loans.

Platinum was unable to sell the loans to third parties or back to TBW when required to do so by FHLMC. As a result, Platinum was closed by the Office of Thrift Supervision and placed into receivership by the Federal Deposit Insurance Corporation in September 2009.

In June 2010, a federal grand jury indicted Mr. Farkas, charging him with conspiracy and with bank, wire, and securities fraud. The indictment stated that Mr. Farkas had schemed to misappropriate over $1 billion in funds from various financial institutions, including TBW, the FHLMC, the Government National Mortgage Association, and the Troubled Asset Relief Program. Mr. Farkas was convicted in April 2011 and later sentenced to 30 years in prison.

The Giambrones claimed theft loss deductions of 95% of the value of their investments in Platinum on their 2012 tax returns. The Giambrones based their claimed deductions on Rev. Proc. 2009-20, which allows "an optional safe harbor treatment for taxpayers that experienced losses in certain investment arrangements discovered to be criminally fraudulent."

In March 2018, the IRS issued separate deficiency notices to Michael Giambrone and to William and Michele Giambrone. The claimed theft loss deductions were disallowed because the Giambrones failed to satisfy the requirements of Rev. Proc. 2009-20. The notice issued to Michael Giambrone determined his income tax deficiencies totaled $1.51 million for the 2012–2015 tax years, with an additional $302,649 in accuracy-related penalties for those years. The notice issued to William and Michele Giambrone determined their income tax deficiencies totaled $1.45 million for the 2012–2015 tax years, with an additional $290,602 in accuracy-related penalties for those years.

Issue. The issue in this case is whether the Giambrones can claim the safe harbor theft loss deduction under Rev. Proc. 2009-20.

Analysis. To qualify for a theft loss deduction, a taxpayer must prove the following.[38]

- A theft occurred
- The amount of the theft loss
- The year in which the taxpayer discovered the theft loss

A theft loss is treated as sustained during the tax year in which the taxpayer discovers the loss.[39]

In 2009, the IRS published Rev. Proc. 2009-20, which provides an optional safe harbor under which qualified investors can treat a loss as a theft loss deduction if they meet certain conditions. The safe harbor is available to a qualified investor who experiences a qualified loss. A **qualified loss** is defined as a loss from a fraudulent arrangement in which the lead figure was charged by indictment or information with the commission of fraud, embezzlement, or a similar crime that, if proven, would meet the definition of theft for purposes of IRC §165.[40] A **qualified investor** is one who is qualified to deduct theft losses under §165 and who did not have knowledge of the fraudulent nature of the investment arrangement before it became known to the general public.[41]

---

38. IRC §165.

39. IRC §165(e).

40. Rev. Proc. 2009-20, 2009-14 IRB 749.

41. Ibid.

The safe harbor allows a deduction of 95% of a qualified investor's qualified investment.

The court noted that the Giambrones did not qualify for the safe harbor. The safe harbor specifies that the taxpayer must elect safe harbor treatment on their tax return in the discovery year (i.e., the year in which an indictment, information, or criminal complaint is filed against the lead figure).

Mr. Farkas was indicted in June 2010, which makes 2010 the discovery year. Therefore, the Giambrones were required to claim safe harbor treatment on their 2010 federal tax returns. They did not do so; consequently, they are not eligible for the safe harbor.

Holding. The court held that the Giambrones are not entitled to claim safe harbor theft loss deductions under Rev. Proc. 2009-20.

Theft Loss

Lisa A. Bruno v. Comm'r, **TC Memo 2020-156 (Nov. 16, 2020)**
IRC §165

☞ Scorned Spouse Not Allowed Theft Deduction

Facts. Lisa and Stephen Bruno married in 1987. By 2005, Mr. Bruno was earning $2.1 million annually from his career in the financial sector. In that year, Ms. Bruno discovered that her husband was having an affair. He subsequently filed for divorce in Connecticut Superior Court (divorce court). The divorce court dissolved the marriage on March 17, 2008.

The divorce decree ordered that the Brunos' marital property be equitably distributed. Mr. Bruno possessed most of the assets at that time and he was ordered to transfer specified property to Ms. Bruno. Ms. Bruno possessed some marital property, including a bank account in her name and real property on Pumping Station Road in Ridgefield, Connecticut (Pumping Station property). The divorce decree stated that these assets were to be liquidated and the proceeds split between Ms. Bruno and her former husband.

Mr. Bruno filed an appeal, but the appellate court did not change the general parameters of the property distribution established in the divorce decree. However, Mr. Bruno did not transfer any marital property to Ms. Bruno following the appellate proceedings.

Mr. Bruno repeatedly disregarded the orders of the divorce court, which held him in contempt numerous times and ordered him to pay interest on the unpaid obligations. In August 2010, the divorce court transferred title on one of the marital assets to Ms. Bruno. This was a residence on Spring Valley Road in Ridgefield, Connecticut (Spring Valley property). The divorce court ordered that the property be sold and the first $300,000 of proceeds awarded to Ms. Bruno, with the rest to be placed in escrow. Ms. Bruno sold the property, realizing proceeds of $1.9 million, but she did not place proceeds in excess of $300,000 in escrow. In April 2015, the divorce court held her in contempt on that issue.

In October 2015, Mr. Bruno filed for chapter 7 bankruptcy in New Hampshire. Among other claims, he sought to discharge Ms. Bruno's claims against him for her share of the marital property. Mr. Bruno contended that he no longer possessed any marital property. He alleged that his bankruptcy estate consisted of about $2,500 in miscellaneous assets and that he held claims against Ms. Bruno under the divorce decree totaling $1.08 million, which consisted of 50% of the proceeds from the bank account, Spring Valley property, and Pumping Station property.

In February 2016, Ms. Bruno filed a complaint in New Hampshire state court against Christina Bruno (the woman Mr. Bruno had the affair with and later married) and several New Hampshire limited liability companies (LLCs). The complaint alleged that Mr. Bruno and Christina Bruno conspired with the LLCs to conceal and convert marital property owed to Ms. Bruno under the divorce decree.

The complaint alleged that Mr. Bruno withdrew most of the funds in a Charles Schwab account they owned jointly and used those funds to purchase (and later sell at a profit) multiple pieces of real property that were titled in the name of the New Hampshire LLCs. At the time the complaint was filed, one of the LLCs owned a residence on Drinkwater Road in Hampton Falls, New Hampshire (Drinkwater property). It had been purchased for $825,000 and then listed for sale at $995,000.

Ms. Bruno allegedly learned of Mr. Bruno's scheme after the first meeting of creditors in his bankruptcy case, which was held in January 2016. In that meeting, Mr. Bruno admitted that Christina Bruno owned some of the New Hampshire LLCs and that he had signatory authority over their bank accounts. In connection with Ms. Bruno's filing of the complaint, the New Hampshire state court awarded her a judicial lien against the Drinkwater property.

In October 2017, the bankruptcy trustee commenced an adversary proceeding against Mr. Bruno, Christina Bruno, Mr. Bruno's mother, the New Hampshire LLCs, and other parties. This complaint alleged fraudulent transfers and sought to pierce the corporate veil. The case was settled in early 2019, and Ms. Bruno signed the settlement agreement on January 29, 2019.

The settlement of the adversary proceeding allowed Ms. Bruno to receive most of the proceeds from the sale of the Drinkwater property in exchange for releasing her lien on that property and her claims against all adversary proceeding defendants except Mr. Bruno.

In June 2020, the bankruptcy trustee reported that the Drinkwater property had been sold for $765,000. The trustee then sent Ms. Bruno a check for $450,000, which was her share of the sale proceeds.

Ms. Bruno claimed several theft loss deductions (and related net operating loss (NOL) carryforward deductions) in connection with Mr. Bruno. All these theft loss deductions were disallowed by the IRS. She claimed a theft loss from Mr. Bruno's failure to transfer marital property on a 2015 Form 1040X, *Amended U.S. Individual Income Tax Return.* The property that she claimed was stolen consisted of approximately $2.5 million of marital property that Mr. Bruno had not transferred to her. The IRS processed her 2015 Form 1040X as a claim for a refund, which it denied.

On her 2016 return, Ms. Bruno claimed an NOL carryforward deduction, which included the $2.5 million theft loss she reported on her 2015 Form 1040X.

Issue. The issue is whether Ms. Bruno sustained a deductible theft loss of $2.5 million in 2015 from Mr. Bruno's failure to transfer marital property to her.

Analysis. IRC §165 allows individual taxpayers to deduct losses from theft that are sustained during the tax year and not compensated by insurance or otherwise. A taxpayer must prove a theft occurred under the law of the relevant jurisdiction. The taxpayer then must establish the amount of the loss and the year in which the loss was sustained.[42]

Ms. Bruno contended that Mr. Bruno's actions constitute felony embezzlement under Connecticut law. The IRS agreed that Connecticut law controls and that embezzlement is a theft.[43] However, the IRS did not agree that Mr. Bruno's actions constituted felony embezzlement under Connecticut law.

The court questioned Ms. Bruno's interpretation of Connecticut law. Connecticut appears to treat the unpaid amount of a marital property settlement as a debt of the delinquent spouse. Ms. Bruno did not provide case law or other Connecticut authority establishing that an ex-spouse commits embezzlement when held in contempt for failing to pay a marital property debt.

Even if the court decided that Mr. Bruno committed a theft of marital property, Ms. Bruno would not be entitled to a deduction unless she can establish the amount of the loss and the year in which it was sustained.[44]

42. Treas. Regs. §§1.165-1(c) and (d)(1).

43. See Treas. Reg. §1.165-8(d).

44. Treas. Regs. §§1.165-1(c) and (d)(1).

A theft loss is generally treated as sustained in the year the taxpayer discovers the loss.[45] However, if there exists a claim for reimbursement for which there is a reasonable prospect of recovery, no part of the loss for which reimbursement may be received is sustained until the tax year in which it can be determined with reasonable certainty whether such reimbursement will be obtained.[46]

At the end of 2015, Ms. Bruno had in her possession $1.08 million of marital property that she owed to Mr. Bruno. She conceded that she had a reasonable prospect of recovering that amount to offset the total theft loss at issue. In the divorce action, she had obtained an injunction that secured her claim for an additional $200,000 of marital property. Therefore, Ms. Bruno had effectively recovered $1.278 of marital property at the end of 2015 and had commenced litigation to recover the balance.

Ms. Bruno noted that she did not know where Mr. Bruno may have hidden his assets until January 2016, after the first meeting of his bankruptcy creditors. However, the fact that she did not know in December 2015 exactly where Mr. Bruno had hidden his assets does not negate the fact that, at that time, she had a reasonable prospect of recovery from various sources on her existing claims.

Within a few months after the end of 2015, Ms. Bruno secured a lien on the Drinkwater property, which was listed for sale at $995,000 at that time. In addition, she retained all her claims against Mr. Bruno in the divorce case and against his bankruptcy estate, both of which were ongoing for several years.

The court concluded that Ms. Bruno had bona fide claims for recoupment from Mr. Bruno in December 2015 and that there was a substantial possibility that such claims would be decided in her favor. Because Ms. Bruno had a reasonable prospect of recovery on her claim for reimbursement, no portion of her loss is deemed sustained until the year in which it can be determined with reasonable certainty whether reimbursement will be received.

Holding. The court held that Ms. Bruno **was not entitled** to deduct the theft loss she claimed on her 2015 return.

CHARITABLE CONTRIBUTIONS

Contributions

***Jon and Helen Dickinson v. Comm'r,* TC Memo 2020-128 (Sep. 3, 2020)**
IRC §170

☞ A Gift by Any Other Name is Still a Gift

Facts. Geosyntec Consultants, Inc. (GCI) employed Jon Dickinson as its chief financial officer during the period 2013 through 2015. The GCI board of directors (Board) took formal action to enable shareholders, including Mr. Dickinson, to donate GCI shares to Fidelity Investments Charitable Gift Fund, a tax-exempt organization. This donor-advised fund operated under Board procedures that required prompt liquidation of the donated stock. Mr. Dickinson donated appreciated GCI shares to Fidelity in 2013, 2014, and 2015.

> **Note.** A donor-advised fund is generally a separately identified fund or account maintained and operated by an IRC §501(c)(3) organization. Each account is composed of contributions made by individual donors. After the donor makes the contribution, the organization legally controls it. The donor or the donor's representative, however, retains advisory privileges with respect to the distribution of funds and the investment of assets in the account.[47]

45. IRC §165(e); Treas. Reg. §1.165-1(d)(3).

46. Treas. Regs. §§1.165-1(d)(3) and 1.165-8(a)(2).

47. *Donor-Advised Funds.* Feb. 13, 2020. IRS. [www.irs.gov/charities-non-profits/charitable-organizations/donor-advised-funds] Accessed on Sep. 24, 2020.

A letter of understanding (LOU) signed by Mr. Dickinson accompanied each stock donation. Each LOU explicitly stated that the donated stock was "exclusively owned and controlled by Fidelity," that Fidelity "maintains full discretion over all conditions of any subsequent sale," and "is not and will not be under any obligation to redeem, sell, or otherwise transfer" the stock. Fidelity redeemed the GCI shares for cash soon after each donation.

Mr. and Mrs. Dickinson claimed a charitable contribution deduction on their 2013, 2014, and 2015 federal income tax returns for the donated shares. In March 2019, the IRS issued the Dickinsons a deficiency notice, which recharacterized the stock donations as taxable redemptions, followed by donations of the cash proceeds. This deficiency notice included penalties under IRC §6662(a). The Dickinsons filed a motion for summary judgment with the Tax Court, contending that the form of the transaction should be respected and their charitable contributions should be allowed.

Issue. The issue is whether the taxpayers are entitled to a charitable contribution deduction for the GCI shares that Mr. Dickinson gave to a donor-advised fund.

Analysis. A taxpayer can deduct the fair market value (FMV) of appreciated property donated to a charitable organization,[48] even if the deduction is limited to 30% of the taxpayer's adjusted gross income (AGI) because it is capital gain property.[49] This allows the taxpayer to avoid paying the tax that the taxpayer would incur if they sold the property and then donated the cash proceeds.

The IRS determined that each donation of the GCI shares should be treated as a redemption of the shares for cash by Mr. Dickinson, followed by his donation of the cash proceeds to Fidelity. In *Humacid Co. v. Comm'r,*[50] the court concluded that the form of this kind of transaction is respected if a 2-prong test is satisfied.

1. The donor gives the property away absolutely and parts with the title to the property.
2. The donation occurs before the property is sold.

The IRS could have defeated the first prong of the test if it had set forth specific facts showing there was a genuine dispute as to whether Mr. Dickinson had made a perfected gift of the GCI stock before the redemption. But GCI gave letters to Fidelity confirming the ownership transfer, and Fidelity subsequently gave letters to the Dickinsons confirming that Fidelity had "exclusive legal control" over the donated stock. This supported Mr. Dickinson's claim that he transferred all his rights in the shares.

The IRS asserted that Fidelity redeemed the GCI shares shortly after each donation. The IRS argued that this sequence suggested Mr. Dickinson, GCI, and Fidelity could have arranged the redemptions before the gifts. However, the court noted that an understanding among the three parties that Fidelity would redeem donated stock does not convert a redemption after the donation into a predonation redemption. Mr. Dickinson's contemporaneous documentation provided evidence of an absolute gift, and the IRS offered no contrary evidence strong enough to suggest that this first prong of the *Humacid* test was at issue.

48. IRC §170.

49. IRC §170(b)(1)(C) contains other limits.

50. *Humacid Co. v. Comm'r,* 42 TC 894, 913 (1964).

The second prong of the test requires the taxpayer makes the donation before the stock is sold. Under the assignment of income doctrine, a taxpayer who earned income cannot avoid taxation by assigning their right to receive payment.[51] When a donee redeems shares shortly after a donation, the assignment of income doctrine would apply only if the redemption was virtually certain to occur at the time the gift was made and would have occurred regardless of whether the shareholder made the gift.[52] As noted earlier, the IRS argued that the parties may have prearranged for Fidelity to redeem the stock. The court observed that even if that were the case, it would not affect the second *Humacid* requirement. The court respected the form of the transaction because Mr. Dickinson did not avoid receipt of redemption proceeds by donating the GCI shares.

The court grants a motion for summary judgment regarding an issue when there is no genuine dispute of material fact and a decision can be rendered as a matter of law.[53]

Holding. The court held that Mr. Dickinson made an absolute gift of the GCI shares before the stock was sold in each tax year at issue. Therefore, the court granted the Dickinsons' motion for summary judgment allowing a charitable contribution deduction for their donated GCI shares.

DEDUCTIONS

Allowable Deductions

***San Jose Wellness v. Comm'r,* 156 TC No. 4 (Feb. 17, 2021)**
IRC §§280E and 6662

☞ Taxpayer's Arguments Regarding Claimed Deductions Go Up in Smoke

Facts. San Jose Wellness (SJW) is a corporation principally operated in San Jose, California. During the tax years ending October 31, 2010, 2011, 2012, 2014, and 2015, SJW operated a medical cannabis dispensary under California law.

SJW sold cannabis to individuals who had a valid doctor's recommendation to use cannabis. SJW also sold items other than cannabis, including T-shirts, pipes, and batteries. In addition, it offered acupuncture and chiropractic services. SJW did not charge a separate fee for membership, acupuncture, chiropractic care, or any other service.

SJW used the accrual accounting method. For the tax years at issue, SJW's gross receipts and relevant deductions were as follows.

Year	Gross Receipts	Depreciation	Charitable Contributions
2010	$5.753 million	$102,920	$3,211
2011	6.283 million	24,250	0
2012	6.730 million	9,740	10
2014	4.998 million	2,958	1,035
2015	5.477 million	434,253	125

51. See *Helvering v. Horst,* 311 U.S. 112, 116 (1940).

52. See *Palmer v. Comm'r,* 62 TC at 684, 694-695 (1974); see also *Ferguson v. Comm'r,* 174 F.3d 997, 1003-1004 (9th Cir. 1999).

53. U.S. Tax Court Rule 121(b).

The IRS issued deficiency notices disallowing deductions and other costs for the 2010, 2011, 2012, 2014, and 2015 tax years. The disallowed amounts for the years at issue included the deductions for depreciation and charitable contributions. In addition, the notices determined that SJW was liable for accuracy-related penalties under IRC §6662 for 2014 and 2015, but the IRS eventually conceded the 2014 penalty.

Issues. The issues in this case are the following.

- Whether SJW is entitled to deductions for depreciation and charitable contributions
- Whether SJW is liable for an accuracy-related penalty

Analysis. IRC §280E provides that no deduction or credit is allowed for any amount paid or incurred during the tax year in carrying on any trade or business that consists of trafficking in controlled substances that are prohibited by federal law or the law of any state in which the trade or business is conducted.

The court noted that the statute makes clear that a deduction will be denied if each of the following conditions is satisfied.

1. The deduction is for an amount paid or incurred during the tax year.
2. The amount was paid or incurred in carrying on any trade or business.
3. That trade or business consisted of trafficking in certain controlled substances.

SJW contends that its deductions for depreciation and charitable contributions do not meet these conditions. Regarding the third statutory condition listed above, SJW contended that because its trade or business includes more than the sale of cannabis (e.g., it sells T-shirts and provides acupuncture), its trade or business does not "consist of" trafficking in controlled substances. Because its business does not exclusively consist of selling cannabis, SJW concludes that the statutory conditions are not satisfied and §280E does not apply. However, the court rejected the same argument in *Patients Mutual Assistance Collective Corp. v. Comm'r,*[54] in which it held that §280E denies business deductions to any trade or business that traffics in controlled substances, even if the trade or business also engages in other activities.

SJW also argued that the IRC §167 depreciation deduction does not fall within the scope of §280E because depreciation is not "paid or incurred during the taxable year." The court rejected this argument, noting that in *Comm'r v. Idaho Power Co.,*[55] the Supreme Court held that "the cost [represented by depreciation], although certainly presently incurred, is related to the future and is appropriately allocated as part of the cost of acquiring an income-producing capital asset." According to the court, this leaves no doubt that depreciation constitutes an "amount paid or incurred during the taxable year," and therefore §280E applies to SJW's circumstances.

Next, SJW argued that its charitable contributions should be deductible because they were not paid "in carrying on" a trade or business as required by §280E. The court disagreed, noting that SJW was engaged in a trade or business when it made the charitable contributions. SJW chose to contribute the amounts at issue, and the court did not see any reason to conclude that SJW's actions were somehow separate from, or outside the scope of, its business activities. Therefore, the court held that SJW contributed the amounts at issue "in carrying on" its trade or business.

IRC §6662 imposes a 20% penalty on an underpayment of tax attributable to any substantial understatement of income tax. SJW's understatement of income tax for 2015 was substantial because it exceeded the lesser of $10 million or 10% of the tax required to be shown on the tax return.[56] A taxpayer can avoid this penalty if the IRS determines that they acted with reasonable cause and in good faith. However, the court found little evidence that SJW acted reasonably and in good faith with respect to the 2015 underpayment. Therefore, the court sustained the penalty.

---

54. *Patients Mutual Assistance Collective Corp. v. Comm'r,* 151 TC 176, 196-197 (2018).

55. *Comm'r v. Idaho Power Co.,* 418 U.S. 1, 10-11 (1974).

56. See IRC §6662(d)(1)(B).

Holding. The court held that SJW was not entitled to the depreciation and charitable contribution deductions it claimed on its returns for the years at issue. In addition, the court held that SJW is liable for the §6662 accuracy-related penalty for the 2015 tax year.

> **Note.** For a detailed explanation of the tax issues that apply to businesses that produce or sell marijuana, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Gambling Losses

***John M. Coleman v. Comm'r,* TC Memo 2020-146 (Oct. 22, 2020)**

IRC §165

☞ Gambler Cuts His Losses in Tax Court

Facts. John Coleman was a licensed insurance agent before he retired in 2004. After he retired, he started an insurance consulting business that had a small amount of income in 2014, the year at issue in this case.

Mr. Coleman is a compulsive gambler. He started gambling on card games in high school and began playing slot machines in Atlantic City, New Jersey, during the 1980s. When casinos opened closer to his Maryland home, he gambled more frequently at those locations. He gambled even more often after he retired.

During 2014, Mr. Coleman received taxable nongambling income of $76,784 and a nontaxable personal injury insurance settlement of $150,000. In addition, he received $350,241 of gambling winnings, which were reported to him on **160 separate Forms W-2G, *Certain Gambling Winnings,*** by the casinos at which he gambled.

Mr. Coleman gambled at four casinos in 2014, almost exclusively on slot machines. None of the casinos kept complete records of his gambling transactions. Casinos are required to issue Forms W-2G to report slot machine winnings of $1,200 or more,[57] and all four casinos did so.

Mr. Coleman gambled on at least 193 days in 2014. If he did not have cash winnings left over from his last trip to a casino, he would stop to withdraw cash on the way to the casino. He usually made withdrawals from his account at Industrial Bank in amounts ranging between $2,000 and $3,000.

Mr. Coleman had two credit cards and two credit union accounts. If he ran out of money while he was gambling, he would withdraw money from an automated teller machine at the casino, obtain an advance on a debit or credit card, or get a cash advance from the casino. During 2014, he made 210 withdrawals from his credit cards and credit union accounts when he was gambling. These withdrawals totaled $240,113.

Mr. Coleman's financial accounts did not show any increase in net worth that could be attributed to net gambling winnings. His wife had separate bank accounts, and there is no evidence that he deposited any gambling winnings into her accounts.

Mr. Coleman did not file a timely return for 2014 and did not make any estimated tax payments. The IRS prepared a substitute for return (SFR) for him and issued a notice of deficiency based on the SFR. The notice showed a deficiency of $128,886, which was largely attributable to $350,241 in unreported gambling winnings.

Issue. There were a number of issues presented in this case, but this discussion focuses on whether Mr. Coleman substantiated gambling losses in excess of $350,241.

---

57. Rev. Proc. 77-29, 1977-2 CB 538.

Analysis. At trial, the court heard testimony from Mr. Coleman, his wife, and from the adult daughter who lives with them. The court also heard testimony from Mark Nicely, who is recognized as an expert in mathematics, the casino industry, and casino gaming equipment, particularly slot machines.

Using statistical techniques, Mr. Nicely estimated the likely outcome of Mr. Coleman's gambling transactions during 2014 based on the frequency at which he gambled and the expected win percentages at the casinos where he gambled. Mr. Nicely concluded that Mr. Coleman had overall net gambling losses of at least $151,690 during 2014.

Mr. Nicely stated that if a player gambles long enough and does not win any prizes that are exceptionally large relative to the size of the wager, it would be virtually impossible for that player to have annual net gambling winnings. The casinos at which Mr. Coleman gambled configured their slot machines so that the average player return percentages ranged between 87% and 95%. The average player return percentage could not exceed 95% without written permission from the state lottery. Mr. Nicely testified, that in his opinion, the odds against Mr. Coleman having even $1 of net gambling profit for 2014 were at least 140 million to 1.

For a taxpayer who does not engage in gambling as a trade or business, losses from wagering are allowable as an itemized deduction, but "only to the extent of the gains from such transactions."[58] Taxpayers are required to prove they are entitled to all deductions claimed. However, gamblers often do not keep complete records of their gaming wins and losses. In some circumstances, the court estimates the amount allowable when a taxpayer establishes that they paid or incurred a deductible expense but does not establish the exact amount.[59]

The IRS determined that Mr. Coleman had gambling winnings in 2014 of $350,241, based on the amounts reported on Forms W-2G. However, Mr. Coleman's financial records supported his contention that he did not have net winnings during 2014. He withdrew $240,113 from his credit card and credit union accounts on casino premises. His financial accounts did not show any increase in his net worth that could establish that he had net gambling winnings in 2014. His credit union accounts had aggregate opening balances of $1,365 and aggregate closing balances of $608. His Industrial Bank account had an opening balance of $233 and a closing balance of $8,598, although he deposited a $150,000 insurance settlement into that account in March 2014. Mr. Coleman testified that most of the $150,000 was lost gambling, and the court found his testimony credible.

Mr. Coleman had no other financial accounts. His sole retirement account was worth about $75,000 in 2004 but had been reduced to $2,725 by the end of 2014.

Mr. Coleman lived modestly (except for his gambling), and he made no major lifestyle changes in 2014. He did not purchase real estate, jewelry, or other expensive property, and he made no large gifts. In addition, Mr. Coleman was often late paying bills, and his house was subject to a tax sale in 2014. This evidence convinced the court that he did not have any net gambling winnings in 2014.

Holding. The court held that Mr. Coleman provided sufficient evidence to show that his gambling losses were at least $350,241 in 2014.

58. IRC §165(d).

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

Business Property

***Carlos and Pamela Langston v. Comm'r,* U.S. Court of Appeals, 10th Circuit; No. 4270-17 (Oct. 2, 2020)**

IRC §§165, 274, and 280F

☞ Taxpayers' Case Sinks Due to Lack of Substantiation

Facts. In 2011, Carlos and Pamela Langston, a married couple, bought Port Carlos Marina (Port Carlos) from Mr. Langston's mother for $50,000 cash and a $1 million promissory note. Port Carlos consists of a primary location, which has 100 covered dock slips and a secondary location, Masthead Marina, which is a sailboat cove with 50 uncovered boat slips. Soon after the purchase, the Langstons organized Port Carlos as a domestic limited liability company.

Before the couple purchased Port Carlos, Mr. Langston bought a recreational vehicle (RV) for $69,092 and a yacht for $245,920. He testified that both assets were contributed to Port Carlos LLC and used solely for business purposes. He stated that the yacht was used as a boat sales office and the RV was used at Masthead Marina as an office and facility for nighttime security personnel. No formal documents show that these assets were transferred to the business entity.

In 1997, Mr. and Mrs. Langston bought a home (the Property) for $143,000. In 2001, they obtained an appraisal that showed the Property had a fair market value (FMV) of $290,000. From 2001 through 2004, the Langstons made renovations to the Property.

Starting in 2005, the Langstons began another round of renovations. They moved out of the Property and into an apartment. The Langstons lived in the apartment for over three years until they purchased a home in 2008.

The Langstons spent over $722,000 on the second phase of renovations on the Property by the time the renovations were substantially completed in 2010. However, the Property remained empty until 2011, when the Langstons tried to rent it. The fair market rent was approximately $2,500 to $2,800 per month, but the Langstons rented the Property to one of Mr. Langston's college friends for $500, because he only used the home five days per month. Nearly a year later, the Langstons listed the Property for sale for $563,860 and eventually sold it for $540,000 in February 2013.

For the 2012 tax year, the Langstons claimed $139,996 of depreciation for the yacht and RV. They also reported $6,000 of rent and $56,875 of rental expenses for the Property, for a net loss of $50,875.

For the 2013 tax year, the Langstons claimed $46,655 of depreciation for the yacht and RV. For the Property, the Langstons reported depreciation of $4,009 and the $50,875 net loss suspended on their 2012 tax return, for a net loss of $54,884. They also claimed a $436,633 loss from the sale of the Property.

Kathy Burch, a CPA and attorney, prepared the Langstons' 2012 and 2013 returns. She stated at trial that she did not receive any documentation showing the contribution of the yacht and RV to Port Carlos LLC or any records substantiating the business use of either asset. She further stated that she used a cost basis of $1.027 million to calculate the loss on the sale of the Property.

In 2014, the IRS began an examination of the Langstons' 2012 and 2013 tax returns. During the examination, an IRS agent toured Port Carlos, including the yacht and RV. The agent noted several personal items on the yacht that were inconsistent with its alleged use as a sales office and nothing that identified the yacht as a sales office. The agent also saw several personal items in the RV and nothing to indicate it was used as an office.

The IRS denied the deductions for the RV and yacht and the losses on the sale of the Property. The IRS also determined that the Langstons substantially understated their taxes for both years, and they were therefore liable for accuracy-related penalties. The Tax Court upheld the IRS's determinations, and the Langstons appealed.

Issues. The issues in this case are the following.

- Whether the Langstons are entitled to depreciation on the yacht and RV
- Whether they can deduct losses on the sale of the Property
- Whether they are liable for accuracy-related penalties

Analysis. Certain business deductions, including depreciation, are not allowed for "listed property" unless the taxpayer substantiates the business use of the property with **adequate records** or sufficient corroborating evidence.[60] **Listed property** is defined to include "any… property used as a means of transportation" or "any property of a type generally used for purposes of entertainment, recreation, or amusement."[61] The yacht and the RV are both considered listed property under this definition.

No deduction or credit is allowed for listed property unless the taxpayer substantiates the requisite elements of use. These elements are as follows.[62]

1. The amount of each business use and the total use of the property for the tax period
2. The date of the use
3. The business purpose for the use

The Langstons testified that they used the yacht and RV exclusively for business, but their testimony failed to meet the substantiation requirements. They offered only general testimony, without any details such as the dates of use. In addition, they did not produce any records or documents regarding either the yacht or RV. Therefore, the court held that the Langstons failed to meet the substantiation requirements for listed property.

The next issue the court considered is the loss on the sale of the Property. An individual taxpayer is allowed a loss deduction only for losses incurred in any transaction entered into for profit.[63] A loss on the sale of residential property purchased or constructed for the taxpayer's use as their personal residence is allowed if the property is converted to income-producing purposes and used for such purposes up to the time of its sale.[64]

The loss on the sale of converted property is calculated using the lesser of the FMV of the property at the time of conversion or the adjusted basis at the time of conversion.[65] Therefore, the loss cannot be calculated without a determination of FMV.

The Tax Court found that the Langstons failed to demonstrate they converted the Property to income-producing use. The Appeals court noted that it could not reverse the Tax Court's findings unless they are not supported by substantial evidence and are clearly erroneous. The Appeals court reviewed those findings and concluded they are supported by the evidence.

Further, the Langstons failed to produce any evidence of the Property's FMV at the time of conversion in 2005. Without this evidence, there is no way to calculate the loss.[66]

The IRS can impose accuracy-related penalties on the portion of an underpayment attributable to any substantial understatement of income tax.[67] A taxpayer can avoid the penalties by showing there was a reasonable cause for the underpayment and the taxpayer acted in good faith. The most important factor in determining reasonable cause is the extent of the taxpayer's effort to assess their proper tax liability considering all the facts and circumstances, including the experience, knowledge, and education of the taxpayer. The court noted that the Langstons are well-educated and sophisticated individuals.

---

60. IRC §274(d)(4).
61. Ibid; IRC §§280F(d)(4)(ii)–(iii).
62. Temp. Treas. Reg. §1.274-5T(b).
63. IRC §165(c)(2).
64. Treas. Regs. §§1.165-9(a) and (b).
65. Treas. Reg. §1.165-9(b).
66. *Estate of True v. Comm'r,* 390 F.3d 1210, 1245 (10th Cir. 2004).
67. IRC §§6662(a)–(b).

Reliance on the advice of a professional tax adviser can constitute reasonable cause and good faith. However, the exception does not apply if the taxpayer did not disclose a fact that they know or should know to be relevant to the proper tax treatment of an item.[68]

The Tax Court found that the Langstons did not provide necessary information to their tax adviser. Specifically, the Langstons did not provide any documentation to Ms. Burch regarding the contribution of the assets to Port Carlos or any documentation substantiating their business use. Ms. Burch advised the Langstons that they needed to keep documents showing the business purpose of the yacht and RV. She also advised them that she needed to know the FMV of the Property in 2005 in order to calculate the loss. However, this information was not provided.

Holding. The court affirmed the Tax Court's holding that the Langstons are not entitled to depreciation on the yacht and RV because they did not meet the substantiation requirements for listed property. They could not deduct losses on the sale of the Property because they failed to prove it was converted to income-producing use. They are liable for accuracy-related penalties because they did not prove they acted with reasonable cause and in good faith.

Substantiation of Deductions

***Malik Franklin v. Comm'r,* TC Memo 2020-127 (Sep. 3, 2020)**

IRC §§162, 166, 274, 6651, and 6662

☞ Third Time Not Always a Charm

Facts. In 2003, Malik Franklin married Wendy Liu, and they have one child. In 2007, Mr. Franklin and Ms. Liu purchased timeshare property in Las Vegas. Mr. Franklin and Ms. Liu divorced in 2010, but she retained her interest in the timeshare until late 2014, when she quitclaimed it to him. Mr. Franklin visited his son and Ms. Liu on trips to California for which he claimed business deductions for 2014.

In that year, Mr. Franklin worked for Northbridge Group, Inc. as an independent contractor providing real estate brokerage services. Northbridge Group issued a 2014 Form 1099-MISC, *Miscellaneous Income,* on which it reported that it paid him $293,250 in nonemployee compensation. Mr. Franklin also provided real estate investment consulting services in 2014 as a member of Northbridge Partners, LLC, but reported neither income nor losses associated with this work on his 2014 tax return.

In addition, Mr. Franklin performed real estate investment consulting for Integrated Health Centers (IHC) in 2014. No income from his work for IHC appeared on his 2014 return, but he nevertheless reported travel expenses, as well as meals and entertainment expenses associated with travel for IHC, which operated in Africa.

Mr. Franklin reported gross income of $293,250 and business expenses of $141,402 on his 2014 Schedule C, *Profit or Loss From Business.* He prepared his 2014 return without contemporaneous records of his business expenses.

After the IRS notified Mr. Franklin that it was examining his 2014 return, he created three travel logs to substantiate his travel expenses. The first log was largely constructed from memory and contained an incomplete record of expenses. Referring to credit card statements, bank statements, and receipts, he created a second travel log that was sent to the IRS Office of Appeals. However, this log contained meals expenses with his former spouse. The IRS's attorneys received a third log in 2019. None of these travel logs contained information that corroborated the business purposes that Mr. Franklin asserted with expenses. At trial, representing himself before the Tax Court, he admitted that his foreign travel costs were not business expenses.

The IRS disallowed Mr. Franklin's Schedule C deductions for $64,655 of travel expenses and $8,610 of meal and entertainment expenses.

68. Treas. Regs. §§1.6664-4(b)(1) and (c)(1).

Mr. Franklin reported losses of $86,640 on his 2014 Form 4797, *Sales of Business Property.* He subsequently amended the losses reported on his Form 4797 to $95,230, consisting of:

- Worthless loans to Sterling Analytics, Inc. of $50,000;
- Worthless loans to Strategic Urban Development Alliance, LLC (SUDA) of $17,500;
- Loss of software of $3,495; and
- Abandoned timeshare of $24,235.

Issues. The issues involving Mr. Franklin's 2014 tax return concerned the following.

- Whether meal and travel expenses could be sustained even though poorly reconstructed records were produced that were not contemporaneous
- Whether the business purpose of travel must be substantiated to distinguish it from personal travel
- Whether requirements were met to sustain a deduction for worthless loans
- Whether the business use of property must be substantiated to distinguish it from personal-use property
- Whether a signature and a valid date is necessary for timely filing a tax return

Analysis. Mr. Franklin's travel log and testimony were not credible in the eyes of the court. He did not present contemporaneous documents to support his assertion that the travel expenses were incurred for business purposes. Instead, he created travel logs after he received notification of an IRS examination that did not meet the "adequate records" test under IRC §274(d), which imposes strict substantiation requirements for travel, meals, entertainment, and vehicle expenses. To qualify as a deduction, the taxpayer must have adequate records or other corroborating evidence showing the amount, time and place, and business purpose for each expenditure. To satisfy the requirement for being contemporaneous, each element or expenditure must be recorded at or near the time the expenditure is made. If expenses are subsequently reconstructed, they must be supported with corroborative evidence. Mr. Franklin's travel logs and his testimony did not convince the court that the expenses were ordinary or necessary or incurred in connection with a trade or business. Because Mr. Franklin did not meet the strict substantiation requirements of §274(d), the court sustained the IRS's determination that the travel expenses should be disallowed.

Meal expenses are generally not deductible unless they are ordinary and necessary and constitute travel expenses under IRC §162. Such expenses are also subject to the §274(d) strict substantiation requirements. Mr. Franklin's unsubstantiated claim that his meal expenses were for business purposes was unpersuasive. As a result, the court sustained the IRS's determination that his meal expenses should also be disallowed.

IRC §166(a)(1) allows a deduction for any debt that loses all value during the tax year. Worthlessness is based on all the relevant circumstances, including the debtor's financial condition and the value of any security. If the collateral securing a debt has any value, the debt itself is not worthless, and no deduction is allowed. A taxpayer must document their request for payment, their attempt to collect the debt, and their efforts to validate the debt's worthlessness. In the absence of this, no deduction is available.

Mr. Franklin did not establish that the Sterling debt was worthless in 2014. He provided no evidence of specific, identifiable events that made him believe the loans were uncollectible or became worthless in 2014. Neither did he attempt collection or contact Sterling in 2014 regarding repayment, nor did he bring suit to collect the note from Sterling. Consequently, the court sustained the IRS's disallowance of the Sterling losses.

With respect to the SUDA loans, Mr. Franklin did not submit evidence or testimony explaining what led him to believe the loans were worthless. He did not meet his burden of persuading the court that the loans were worthless in 2014. As a result, the court sustained the IRS's disallowance of the loss.

IRC §167(a) permits depreciation for commercially available software, and as a general rule it must be depreciated using the straight-line method over 36 months. The loss recognized when it is retired is determined by its adjusted basis less its estimated salvage value or the FMV.[69]

Regarding the loss claimed with software, Mr. Franklin offered no documentary evidence or testimony supporting the software's basis at the time of retirement or depreciation deductions before its retirement. As a result, the court sustained the IRS's disallowance of the loss deduction.

Regarding the loss on the timeshare property, a loss deduction is allowed for nondepreciable property for the year the loss is sustained if all the following conditions are met.

1. The loss is incurred in a business or a transaction entered into for profit.
2. The loss arises from the sudden termination of usefulness in the business or transaction.
3. The property is permanently discarded from use, or the business or transaction is discontinued.[70]

Mr. Franklin did not persuade the court that he used the timeshare in his trade or business or that he used it for producing income, nor did he provide evidence that the property was abandoned in 2014. The court sustained the IRS's disallowance of the loss claimed on the timeshare.

The IRS determined that Mr. Franklin is liable for an addition to tax under IRC §6651(a)(1) for failure to timely file his 2014 tax return. Mr. Franklin mailed this return before the extended due date but **failed to sign the return.** Eventually he filed a return with a signature date of February 29, 2016, although the IRS's records show that it was received on December 14, 2015. He did not provide any credible evidence showing reasonable cause for filing his 2014 return late. As a result, the court sustained the IRS's imposition of the addition to Mr. Franklin's tax under §6651(a)(1).

IRC §6662 imposes a 20% accuracy-related penalty on a substantial understatement of federal income tax that exceeds the greater of $5,000 or 10% of the tax that should have been shown on the return. Mr. Franklin did not make any assertions at trial regarding the applicability of the reasonable cause exception. Accordingly, the court sustained the IRS's determination that he is liable for the accuracy-related penalty.

Holding. The court held that Mr. Franklin's meal and entertainment expenses and travel expenses claimed on his 2014 return are not deductible. The court also held that the losses claimed on his 2014 return are not deductible. In addition, the court sustained the IRS's imposition of the accuracy-related penalty and an addition to tax for failure to timely file his 2014 return.

Real Estate Rental

***Ronald and Mary Lucero v. Comm'r,* TC Memo 2020-136 (Sep. 29, 2020)**

IRC §§280A and 469

☞ Taxpayers Cannot Claim Real Estate Rental Losses

Facts. Ronald Lucero owned a short-term rental property in The Sea Ranch, California. The property is several hours away from his home in Sacramento, California. He rented the property to tenants for 146 days in 2014 and 152 days in 2015.

69. Treas. Reg. §1.167(a)-8(a)(3).

70. Treas. Reg. §1.165-2(a).

Mr. and Mrs. Lucero paid Sea Ranch Escapes, LLC, a property management company, to manage the property's day-to-day rental operations. This included advertising to prospective tenants, collecting deposits and rent, maintaining and cleaning the property, landscaping, assisting in hiring repair subcontractors, and responding to tenants' complaints. Mr. Lucero controlled certain administrative issues, which included setting rental rates and approving expenses over $100.

Mr. and Mrs. Lucero performed some maintenance on the Sea Ranch property themselves. Mr. Lucero drove to the property six to nine times each year to do landscaping, cleaning, taking inventory, and making or supervising any necessary repairs. In 2015, Mrs. Lucero accompanied him to help with the cleaning, decorating, and taking inventory. Some trips required one or both of them to stay multiple nights at the property. They also stayed at the property with family for approximately one week each year during the Christmas holidays.

Mr. and Mrs. Lucero did not keep contemporaneous logs or other documentation showing the number of hours they spent on activities connected to the Sea Ranch property. Instead, Mr. Lucero created a log after the case went to the IRS Office of Appeals. He attempted to reconstruct the number of hours they spent on relevant activities, using invoices and receipts. Mr. Lucero estimated he spent a total of 267 hours on activities connected with the Sea Ranch property in 2014 and he and Mrs. Lucero spent a total of 273 hours on such activities in 2015. These activities included paying bills, buying supplies, performing maintenance and repairs, traveling between their home and the Sea Ranch property, coordinating with the management company, and preparing their tax returns.

Mr. Lucero timely filed his 2014 Form 1040, *U.S. Individual Income Tax Return,* using the single filing status. The return included a Schedule E, *Supplemental Income and Loss,* on which he reported total rents for the Sea Ranch property of $26,223 and expenses of $43,854, for a loss of $17,631. He timely filed his 2015 Form 1040 using the married filing jointly status. The 2015 Schedule E reported total rents for the Sea Ranch property of $26,710 and expenses of $51,200, for a loss of $24,490.

The IRS issued notices of deficiency, disallowing any deduction for the Schedule E losses for 2014 and 2015.

Issue. The issue is whether any of the Luceros' real estate losses are deductible for 2014 or 2015.

Analysis. The IRS argued that Mr. and Mrs. Lucero used the Sea Ranch property as a residence and vacation rental rather than as a residential or business rental property, and therefore they are not entitled to deduct their rental real estate losses. Under IRC §280A, no deduction is allowed for a dwelling unit used by the taxpayer as a residence during the tax year. A dwelling unit is considered to be a taxpayer's residence if the taxpayer's personal use exceeds the greater of 14 days or 10% of the number of days the property is rented at a fair rental value during the year.[71] A taxpayer uses a dwelling unit for personal purposes when the taxpayer or any member of their family uses the unit for personal purposes or any individual uses the unit for less than a fair rental value.

The court noted that it was not convinced by Mr. Lucero's testimony regarding the total hours he spent maintaining the Sea Ranch property. However, the court accepted his claim that most of his trips to the property were for upkeep. If every trip the Luceros made to the property, other than at Christmas, was for upkeep, then the time they spent at the property for personal purposes was fewer than 14 days in each year. The IRS did not dispute that the Luceros rented the property to tenants for 146 days in 2014 and 152 days in 2015 or allege that they charged any tenant less than a fair rental amount. Therefore, the court concluded that §280A does not limit any real estate loss deductions the Luceros claimed for the years in issue.

---

71. IRC §280A(d)(1).

IRC §469 limits a taxpayer's deductible loss from passive activities in a tax year to the taxpayer's income from passive activities. Mr. and Mrs. Luceros' operating of the Sea Ranch property was a passive activity under §469(c)(1) unless they can establish that they were materially participating in the activity during the years in issue. A taxpayer materially participates in an activity if they satisfy any one of seven tests.[72] Mr. Lucero claims that he met the third test for material participation in both years, which requires that the individual participate in the activity more than 100 hours during the year and that the individual's participation in the activity is not less than the participation of any other individual.

The log that Mr. Lucero created shows time that he spent paying bills, coordinating with the management company, and preparing tax returns. Temp. Treas. Reg. §1.469-5T(f)(2)(ii)(A) provides that work performed by an individual in their capacity as an investor is not treated as participation in the activity unless they are directly involved in the day-to-day management or operations of the activity. Mr. and Mrs. Lucero were not involved in the day-to-day management or operations of the property because Sea Ranch Escapes managed and operated the property. The court found that the time Mr. Lucero spent paying bills, coordinating with Sea Ranch Escapes, and preparing tax returns constitutes investor activities that do not count toward the 100-hour requirement.

The court also excluded the time Mr. Lucero spent driving between the Sea Ranch property and his home. Commuting is a personal expense unless an allocation for additional expenses can be made between personal and business expenses.[73]

The court observed that Mr. Lucero's log reported hours that appeared excessive in relation to the task described. Including time for trips that combined business and personal purchases further eroded the credibility of the logs.

Because the log cannot be relied on, it is not a reasonable means of establishing the hours needed for material participation. The court noted that even if it assumed Mr. Lucero spent 100 hours on relevant activities during the years in issue, the record does not include any documentation showing the hours other parties, such as Sea Ranch Escapes, spent on activities connected with the property. Therefore, Mr. and Mrs. Lucero failed to show that his participation exceeded the participation of any other individuals in either of the years in issue.

Holding. The court held that the real estate losses claimed by the Luceros were passive activity losses and sustained the IRS's disallowance of the loss deductions for 2014 and 2015.

Ordinary and Necessary Expenses

***VHC, Inc. v. Comm'r,* U.S. Court of Appeals, 7th Circuit; Nos. 18-3717 and 18-3718 (Aug. 6, 2020)**

IRC §§162 and 166

☞ No Good Outcome for Bad Debt Deduction

Facts. VHC was founded in 1985 by Ron Van Den Heuvel's father. The company provides services to the paper manufacturing industry. Ron and his four brothers all worked for VHC or its subsidiaries in various capacities, but Ron was particularly successful. He started two VHC subsidiaries, directed some of its other companies, and started his own companies separate from VHC.

VHC advanced $111 million to Ron and his companies between 1997 and 2013. By 2013, Ron and his companies owed VHC $132 million, including interest, but eventually repaid only $39 million.

In 2002, Associated Bank, a creditor to Ron and VHC, demanded that VHC guarantee all debts that Ron owed to Associated, which was approximately $27 million. This guarantee was a condition of maintaining VHC's line of credit with Associated. VHC agreed and made similar arrangements the following year with two other banks.

---

72. See Temp. Treas. Reg. §1.469-5T(a).

73. *Ellison v. Comm'r,* TC Memo 2017-134 (Jul. 5, 2017), (citing *Fausner v. Comm'r,* 413 U.S. 838, 839 (1973)); see also *Comm'r v. Flowers,* 326 U.S. 465, 473 (1946); Treas. Reg. §1.262-1(b)(5).

Ron's companies were not profitable, and VHC began writing off its payments to Ron as bad debts in 2004. It wrote off $95 million by 2013. The IRS conducted an audit and issued a deficiency notice to VHC, rejecting $92 million of these write-offs.

VHC petitioned the Tax Court to review the IRS's assessment. The Tax Court upheld the deficiency, determining that VHC could not deduct the payments to Ron as bad debts because Ron and VHC lacked a bona fide debtor-creditor relationship. In addition, the Tax Court rejected VHC's alternative argument that its payments to Ron were ordinary and necessary business expenses because of VHC's 2002 agreement with Associated Bank. VHC appealed the Tax Court's ruling.

Issue. The issue is whether the amounts owed by Ron Van Den Heuvel to VHC were bona fide debts qualifying for a deduction.

Analysis. VHC's ability to claim a bad debt deduction for the loans it made to Ron that he did not repay depends on whether VHC had a debtor-creditor relationship with Ron under which he had an enforceable obligation to pay VHC. The Tax Court looked to 10 factors to determine that Ron and VHC did not have a debtor-creditor relationship. VHC did not dispute these factors. Instead, it argued that the only relevant factor is the parties' intent.

VHC contends that it held out to third parties that the advances were debts and signed promissory notes, asserting that it believed the advances were debt for which it expected to be repaid. However, the Tax Court noted that VHC routinely deferred payment or renewed the notes without receiving any payment, even though the promissory notes had fixed maturity dates. In addition, the Tax Court referred to evidence that VHC did not expect to be repaid unless certain events occurred, such as Ron obtaining additional investments and projects. The court noted that this type of relationship is that of an investor, not a creditor. Accordingly, the court concluded that VHC's payments were not bad debts that qualified for a deduction.

As an alternative argument, VHC contends that it could deduct the payments to Ron as ordinary and necessary business expenses under IRC §162. VHC argues that Associated Bank threatened to terminate VHC's line of credit if it did not advance money to Ron to help him pay his debts to Associated. If the bank were to close the line of credit, VHC would be forced into bankruptcy.

VHC supported its position by referring to *Lohrke v. Comm'r,*[74] in which the Tax Court determined that payments made by a taxpayer for the benefit of a third party may be deductible as ordinary and necessary expenses if the taxpayer benefited from the payment. To determine if payments qualified under the *Lohrke* exception, the Tax Court used a 2-part test.

1. The court ascertains the purpose or motive causing the taxpayer to pay the obligations of another person.
2. The court determines if that motive constitutes an ordinary and necessary expense of the taxpayer's business.

However, the Tax Court determined that VHC did not meet its burden of substantiating its claimed business expenses or that the claimed business expenses, if substantiated, qualified for the deduction under §162.

VHC referred to its summary records and spreadsheets as evidence of its expenditures. However, the Tax Court has "repeatedly concluded that self-generated or nonitemized receipts or expense records are insufficient to substantiate expenses."[75] VHC has the burden to show any error by the Tax Court, and it failed to do so.

74. *Lohrke v. Comm'r,* 48 TC 679, 688 (1967).

75. *Gorokhovsky v. Comm'r*, TC Memo 2012-206 (Jul. 23, 2012), *aff'd* 549 F. Appx 527 (7th Cir. 2013).

Even if VHC had substantiated the expenses, the court observed that its payments to Ron did not qualify as ordinary and necessary. To qualify for deduction, an expenditure must be:

1. Paid or incurred during a tax year,
2. For the purpose of carrying on a business, and
3. Necessary and ordinary.[76]

The fact that Associated required VHC to guarantee Ron's loans does not make any related expenses ordinary and necessary. Moreover, even if the payments were necessary for purposes of §162, VHC made no showing that such payments ordinarily occur in the paper services industry. VHC and Associated entered into an unusual arrangement through which VHC's credit depended on its support of a third party. VHC had the burden to show that its payments to support Ron under this arrangement were ordinary in its industry. It did not do so and therefore cannot establish that it is entitled to the deduction.

Holding. The court held that VHC was not entitled to a deduction for the amounts owed by Ron Van Den Heuvel.

> **Note.** The court's opinion does not state whether VHC thought that Ron had incurred cancellation of debt income. This is a logical result of VHC's claim that it was entitled to a bad debt deduction.

ESTATE AND GIFT

Estate Valuation

***Estate of Michael J. Jackson v. Comm'r,* TC Memo 2021-48 (May 3, 2021)**
IRC §§6018, 6751, and 2032

☞ Tax Court Tells IRS to "Beat It"

Facts. Michael Jackson died in 2009 after a career that made him one of the most famous musical performers in the world. His professional career was tainted in later years by allegations of personal improprieties. Mr. Jackson managed to acquire significant assets during his life, including a share of copyrights in musical compositions. However, Mr. Jackson's spending exceeded his income, even considering the substantial passive income generated by his assets. He attempted to address his cash flow problems by staging a final concert tour. But the inability to find a single sponsor willing to align itself with Mr. Jackson thwarted his attempt to right his financial ship. Although 50 performances sold out, the tour never started because Mr. Jackson died prior to the first scheduled performance.

His death precipitated an estate tax frenzy, joined by the IRS, numerous advisors who worked with Mr. Jackson during his life, and a flock of creditors. His advisors worked assiduously, even commercializing one of the eulogies of Mr. Jackson given at a memorial held at Los Angeles's Staples Center. His advisors were able to pull together a documentary film from footage of Mr. Jackson's rehearsals for the final concert tour. This film produced significant revenue for the estate within a year after the death of Mr. Jackson.

The IRS anticipated a high value for the decedent's estate and engaged a well-known consultant famous for working with celebrity estates. The estate's representatives were aware of the impairment of the estate based on Mr. Jackson's spending and alleged actions. Preparation of the estate tax return required the assistance of a large accounting firm and numerous advisors who provided values for the various assets that comprised the estate.[77]

---

76. *Comm'r v. Lincoln Sav. & Loan Ass'n*., 403 U.S. 345, 352 (1971).

77. IRC §6018.

In 2013, the IRS examined the estate tax return and established a value for Mr. Jackson's estate that was dramatically larger than that provided in Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*. Based on the IRS's values, the Commissioner concluded that the estate underpaid Form 706 estate tax by $500 million, and that $200 million of penalties were also due. But no evidence was introduced that corroborated the penalties' approval by the immediate supervisor of the IRS employee who made the determination.[78] The Tax Court declined the Commissioner's attempt to introduce such evidence later.

The IRS faced the small army of advisors assembled by the estate with a single advisor of its own. Although he had valued assets for many other celebrities, he testified in open court that he had never been retained by the IRS Commissioner previously. As the judge stated in the opinion, "[t]hat was a lie." After additional misstatements during the trial, the estate moved that the IRS's sole expert witness testimony be stricken, because it was "tainted by perjury." The judge denied this but stated in the opinion that the expert witness had been "parsimonious with the truth."

Approximately 200 pages of the court's opinion describe the valuation of the estate's assets. The valuation in Mr. Jackson's case is complicated because of the speculative nature of valuing future revenues. Ultimately, the Tax Court decided that Mr. Jackson's tarnished image severely impaired the value of these assets and that the IRS's expert witness had made substantial errors in valuing the assets.

Issue. The issues in this case are what the value of Mr. Jackson's estate was at the time of his death and whether any estate tax was due.

Analysis. After reciting the facts and testimony in the case, the opinion summarizes various ways of estimating the value of the closely held assets, such as those Mr. Jackson's estate owned. The experts who valued the Jackson estate used approaches based on the discounted cash-flow method that considers a discounted stream of income over time. Not surprisingly, the experts differed in their estimations of the assets' future revenues. Both the IRS and the estate considered the value of Mr. Jackson's estate assets owned in a single entity. The court's opinion referred to this as synergy.

The judge in the case found significant errors in the approach used by the IRS's expert witness to value the cash flows generated by the estate's assets. One expert valued Mr. Jackson's image and likeness at $2,105. The judge in the case compared this value with the price of a "heavily used 20-year-old Honda Civic." The expert's testimony withstood the court's scrutiny.

Holding. The Tax Court held that Mr. Jackson's troubles impaired the value of the assets held by his estate at the time of his death. The judge's opinion indicated that the value of the assets would increase after his death because of their active management when in the care of professional managers. But their value on the date of death is the proper value unless the estate elects the alternate valuation date, which the estate chose not to do in this case.[79] The court held that the value of the estate was less than the estate tax filing requirement and no estate tax was due.

78. IRC §6751(b)(1).

79. IRC §2032.

FOREIGN INCOME

Foreign Tax Credit

***Maher and Nermine Bassily v. Comm'r,* TC Summ. Op. 2021-20 (Jul. 19, 2021)**
IRC §§901, 904, 905, and 6001

☞ All in the Family

Facts. Maher and Nermine Bassily received a notice of deficiency claiming they owed $200 on their 2016 taxes. Part of this arose from including a $3,550 foreign tax credit as part of their federal income tax withheld on line 64 ("Federal income tax withheld from Forms W-2 and 1099") of Form 1040, *U.S. Individual Income Tax Return.*

The Bassilys have two sons, David and Daniel, with whom Mr. Bassily jointly owned brokerage accounts. During 2016, both David's and Daniel's brokerage accounts generated foreign-source income. All the foreign source income was reported on their son Daniel's tax return, however, not on the Bassilys's joint return. Adding the foreign source income to their sons' returns did not stop the couple from claiming the foreign tax credit for Canadian taxes paid through the brokerage account. This resulted in a novel family arrangement in which the sons reported the income, but the parents claimed the foreign tax credit associated with the income that their sons reported.

To add a twist to the situation, the Bassilys prepared a Form 1116, *Foreign Tax Credit,* that reported a foreign tax credit of zero, which also appeared on Form 1040. Without the inclusion of foreign source income on their return, the Bassilys received no benefit from the foreign tax credit. To overcome this problem, they supplemented their federal withholding amount with the $3,550 foreign tax credit. Hence, the federal withholding showed $44,535 instead of the $40,985 withheld and remitted to the IRS.

The IRS examined the Bassily's tax return for 2016 and found that they failed to report retirement income of $479, dividends of $9, and payments in lieu of dividends of $112. The Bassilys claimed that the payments in lieu of dividends were a refund of fees collected by their broker. Nevertheless, the IRS asserted a tax deficiency of $200 after disallowing the foreign tax credit claimed as federal income tax withheld.

Issue. The issues in this case are the following.

- Whether the Bassilys failed to report retirement income of $479 and payments in lieu of dividends of $112
- Whether the Bassilys are entitled to a foreign tax credit of $3,550

Analysis. The Bassilys maintained that the unreported retirement income of $479 was actually a rollover into a different retirement account. However, they failed to present any evidence to the court that they rolled the amount into another account.[80] In the absence of that evidence, the court interpreted the presence of retirement income on the Bassilys's wage and income transcript as evidence of a taxable distribution, citing several cases.[81] In the same way, the Bassilys failed to present evidence that the payments in lieu of dividends were a refund of fees paid to their broker and not income.

The Bassilys had the burden of proving that the IRS's determination that they owed $200 was wrong. They did not prove that tax law entitled them to the foreign tax credit, as the tax code requires them to maintain evidence that establishes the amount of the credits.[82]

---

80. IRC §408(d)(3)(A).
81. *U.S. v. Campbell,* 351 F.2d 336 (2nd Cir. 1965).
82. IRC §6001; Treas. Reg. §1.6001-1(a).

The Tax Court stated that it had no jurisdiction over an adjustment to federal income tax withholding, citing a 1980 case.[83] However, it asserted jurisdiction to review the Bassilys's claim of entitlement to a foreign tax credit.[84] Thus, the Tax Court could examine and rule whether the Bassilys were entitled to the foreign tax credit, but not whether the Bassilys could consider the foreign tax paid as an addition to federal tax withheld.

The court looked to IRC §§901 and 904 for the reasoning behind the tax credit, as well as its limitations. The foreign tax credit is available to a taxpayer if they can "establish to the satisfaction" of the IRS that it was paid or accrued in association with income arising from sources outside the United States.[85] In the court's opinion, IRC §901 operates to reduce U.S. tax when a taxpayer has already paid foreign tax on the same income. IRC §904(c) operates to limit the reduction in U.S. tax so that income arising from U.S. sources is not reduced by the foreign tax credit, citing a 1993 Tax Court case.[86] Because the Bassilys reported no foreign source income, the tax code permitted them no foreign tax credit.

The court's opinion noted that the IRS did not attempt to increase the Bassilys' income to include the foreign source income reported by the brokerage; it remained on Daniel's income tax return. The court by itself was unable to transfer the income to the parents' tax return absent an attempt by the IRS to adjust the Bassily's income tax. The court noted Mr. Bassily's reason for reporting the income on his son's tax return: Daniel had no tax liability for 2016. Thus, the Tax Court did not change the returns to reflect the ownership of income as it might have appeared in the IRS's wage and income transcript, but it did keep the income "all in the family."

Holding. The court held that the Bassilys were responsible for reporting the retirement income and payments in lieu of dividends and failed to do so. The court also held that the Bassilys were not entitled to a foreign tax credit because their 2016 income tax return reported no foreign source income. The court sustained the IRS's notice of deficiency of $200.

Foreign Financial Accounts

***U.S. v. Estate of Dean R. Danielsen,* No. 2:19-cv-00496; U.S. District Court for the Middle District of Florida (Oct. 6, 2020)**
IRC §61

☞ Taxpayer's Failure to Report Foreign Accounts Costs Estate $6.4 Million

Facts. In 1993, Dean Danielsen started selling Swiss annuities. A few years later, he was sued by an individual in the United States and became concerned with protecting his assets. As a result, Mr. Danielsen formed Sugar Creek Stiftung in 1999 to protect his assets. Sugar Creek was originally funded with $200,000 of profits from the sale of Swiss annuities.

Mr. Danielsen opened accounts in Sugar Creek's name in Liechtenstein and Canada. Between 2003 and 2006, Mr. Danielsen transferred $646,294 into the two foreign accounts. He withdrew $13.6 million from these accounts between 2003 and 2008.

Although he was required to do so, Mr. Danielsen failed to report his interest in the two accounts from 2006 through 2010. On his 2006 through 2009 income tax returns, he answered "no" to the question of whether he had a foreign bank account. Because of his willful failure to file Foreign Bank Account Reports (FBARs) regarding his interest in the foreign accounts, the Department of the Treasury assessed penalties totaling $5.5 million for 2006 through 2009.

---

83. *Bregin v. Comm'r*, TC 1097 (1980).

84. *Ax v. Comm'r,* 146 TC 153 (2016).

85. IRC §§905(b)(1) and (2).

86. *Perkin-Elmer Corp. & Subs. v. Comm'r,* TC Memo 1993-414 (Sep. 8, 1993).

Mr. Danielsen's estate failed to pay the penalties assessed against him. The U.S. government contends it is owed $6.4 million for statutory penalties and accrued interest.

Issue. The issue is whether a motion for default judgment for the outstanding balance of federal penalties assessed against Mr. Danielsen should be granted.

Analysis. When a defendant fails to plead or defend their actions, a district court can enter judgment by default. A defaulted defendant is deemed to admit all well-pleaded allegations of fact.

U.S. citizens are required to pay taxes on their gross income, regardless of where the income is earned.[87] Individuals must report their interests in foreign financial accounts by completing line 7 of Schedule B, *Interest and Ordinary Dividends,* and an FBAR if the balance in the foreign account is over $10,000 during the prior year.

The IRS can assess civil penalties against any person who does not report their interest in a foreign account on an FBAR. If the person's failure to report is deemed to be a willful violation, then the IRS can assess a maximum penalty of the greater of $100,000 or 50% of the balance in the foreign account at the time of the violation.[88]

Mr. Danielsen was a naturalized U.S. citizen, and he had a financial interest in two foreign bank accounts. The aggregate monthly balance in the accounts always exceeded $10,000 during the years at issue. He was required to disclose his ownership and interest in the foreign accounts for the years 2006 through 2009 by timely filing an FBAR, but he failed to do so.

The Government alleged that Mr. Danielsen acted willfully in failing to disclose his interest in the foreign accounts. He filed FBARs in 1994 and 1995 for foreign accounts, which proves he knew of his obligation to file an FBAR. Further, he answered "no" on his Schedules B when asked if he had a foreign bank account. These actions show that he acted willfully in failing to report his ownership and interests in the foreign accounts.

Holding. The court finds the Government satisfied the requirements for default judgment against Mr. Danielsen's estate for assessed civil penalties and fees of $6.4 million.

Foreign Earned Income Exclusion

***Janice and Julian Haskins v. Comm'r,* U.S. Court of Appeals, 11th Circuit; No. 20-10692 (Sep. 8, 2020)**
IRC §911

☞ Taxpayer's Abode in United States Disqualifies Her for Foreign Earned Income Exclusion

Facts. Janice Haskins worked in Afghanistan in 2011–2012. She and her husband claimed this qualified them for a foreign earned income exclusion under IRC §911. The Tax Court found that Mrs. Haskins maintained an abode in the United States during that time and therefore did not qualify for the exclusion. Mr. and Mrs. Haskins sought to overturn this decision in the Eleventh Circuit Court of Appeals.

Issue. The issue is whether Mrs. Haskins was eligible for the foreign earned income exclusion because she still had a home in Arizona.

Analysis. Under §911, qualified individuals can exclude their foreign earned income and exempt such amounts from income tax, up to a statutory limit. To be a qualified individual, a taxpayer must meet the following requirements.

1. The taxpayer must have a tax home in a country other than the United States.
2. The taxpayer must be either a bona fide resident of a foreign country or be physically present in a foreign country for at least 330 days.

87. IRC §61.

88. 31 USC §§5321(a)(5)(C)–(D).

The Tax Court found that Mrs. Haskins satisfied the requirement to be physically present in a foreign country for more than 330 days, and the IRS conceded this point. Therefore, the only question is whether she had a tax home in Afghanistan. During the relevant period, **tax home** was defined in §911(d)(3) as:

> *. . . such individual's home for purposes of section 162(a)(2) (relating to traveling expenses while away from home). An individual shall not be treated as having a tax home in a foreign country for any period for which his abode is within the United States.*

Note. The Bipartisan Budget Act of 2018[89] amended §911(d)(3) to: "An individual shall not be treated as having a tax home in a foreign country for any period for which his abode is within the United States, unless such individual is serving in an area designated by the President of the United States by Executive order as a combat zone for purposes of section 112 in support of the Armed Forces of the United States." This amendment applies to tax years beginning after December 31, 2017.

4

In deciding the location of an individual's abode, the relative strength of "the taxpayer's domestic ties (i.e., their familial, economic, and personal ties) to the United States [compared] with their ties to the foreign country in which they claim a tax home" is analyzed during the relevant period.[90]

The Tax Court held that Mrs. Haskins' abode was in the United States because she had strong connections to the United States through her home in Arizona, her bank account, and her driver's license and was therefore not eligible for the exclusion. The Tax Court observed that her continued involvement with her family's finances supported this conclusion. In contrast, her Afghanistani associations were limited, as she lived exclusively on military bases, was restricted in travel off the base to which she was assigned, was prohibited from joining Afghanistanis in their homes, and had no choice in where she lived in Afghanistan. In addition, her family could not visit her there.

Holding. The Eleventh Circuit Court of Appeals affirmed the Tax Court ruling that Mrs. Haskins' abode was in the United States and she was therefore ineligible for the foreign earned income exclusion.

Caution. Practitioners should determine the facts and circumstances for any client who may be eligible for the foreign earned income exclusion. Conclusions should be well documented.

GROSS INCOME

Cash Refunds

***Yohannes Lakew and Seble Bete v. Comm'r,* TC Summ. Op. 2020-27 (Nov. 4, 2020)**
IRC §§61 and 6662

☞ Taxpayer Takes A Wrong Turn by Reducing Gross Receipts by Cash Refunds

Facts. In 2015, Yohannes Lakew owned and operated a driving school. Customers made appointments and payments for the driving school using a computerized system offered by a third-party contractor, Stripe, Inc. During 2015 (the year in issue in this case), some of Mr. Lakew's customers were unhappy with the service he provided, and he made cash refunds to them outside of the Stripe payment system.

---

89. *Bipartisan Budget Act of 2018,* PL 115-123.

90. *Harrington v. Comm'r,* 93 TC 297, 307-08 (1989).

Stripe reported 2015 payments of $29,295 to Mr. Lakew on a 2015 Form 1099-K, *Payment Card and Third Party Network Transactions.* However, Mr. Lakew did not see the Form 1099-K until after he filed the petition for the court case.

Mr. Lakew and his wife, Seble Bete, electronically filed a joint 2015 tax return. Their return included a Schedule C, *Profit or Loss From Business,* which reported gross income of $7,290 and total expenses of $11,447, for a total loss of $4,157. They did not report any returns or allowances on their return.

The IRS's automated underreporter (AUR) program flagged the couple's return because the income reported on their tax return did not match the amounts reported on the Form 1099-K that Stripe sent to the IRS. In August 2017, the AUR program sent the couple a Notice CP2000 showing that they owed $9,005 in tax and were liable for an accuracy-related penalty. The AUR notice instructed the taxpayers to respond by September 13, 2017, if they did not agree with the proposed adjustments.

Mr. Lakew and Ms. Bete did not respond to the Notice CP2000. As a result, the AUR system issued the couple a notice of deficiency on November 6, 2017. The couple then petitioned the court for redetermination of the deficiency and penalty. They did not contend that Mr. Lakew received the money reported on the Form 1099-K but argued that the gross receipts of the driving school should be reduced by unreported cash refunds that Mr. Lakew paid to customers.

Issues. The issues in this case are the following.

- Whether the taxpayers are entitled to offset gross receipts by unreported cash refunds
- Whether they are liable for an IRC §6662(a) accuracy-related penalty

Analysis. IRC §61(a) provides that gross income includes all income from whatever source it is derived. However, taxpayers can offset gross receipts from their business with returns and allowances when they calculate the business's gross income.[91] Taxpayers must retain records sufficient to substantiate the returns and allowances reported. Such records must be retained as long as the contents "may become material in the administration of any internal revenue law."[92] Because the general assessment period is three years from the time a return is filed, a taxpayer must keep records for at least three years after the return is filed.[93]

Mr. Lakew issued cash refunds to customers in connection with his driving school, but he provided very little, if any, credible evidence on which to make a rational determination or estimate of the amounts of those refunds. Mr. Lakew did not produce any receipts, bank account statements, or other financial records to support the amount of his claimed refunds, even though he was obligated to do so. The only record of refunds that he provided was a tracking sheet that did not indicate what year it related to, and the taxpayers did not testify as to when it was prepared. Mr. Lakew testified that he found the tracking sheet a few days before trial. None of the amounts in the tracking sheet could be tied to the couple's return or the Form 1099-K. In addition, the tracking sheet could not be cross-checked against any other document or information about any transaction in the 2015 tax year. Accordingly, the court sustained the IRS's redetermination of the taxes owed by Mr. Lakew and Ms. Bete.

IRC §6662 imposes a 20% penalty on an underpayment of tax attributable to a substantial understatement of income tax. An understatement is "substantial" if it exceeds the greater of $5,000 or 10% of the tax required to be shown on the return.[94]

---

91. See *Pittsburgh Milk Co. v. Comm'r,* 26 TC 707, 717 (1956); *Smith v. Comm'r,* TC Memo 2015-214 (Nov. 3, 2015).

92. IRC §6001; Treas. Regs. §§1.6001-1(a) and (e).

93. IRC §§6501(a) and (e).

94. IRC §6662(d)(1)(A).

The deficiency in the taxpayer's 2015 income tax return reflects an understatement that exceeds the greater of $5,000 or 10% of the total tax required to be shown on their 2015 return. If a taxpayer can show that there was a reasonable cause for a portion of the underpayment and the taxpayer acted in good faith, the §6662(a) penalty does not apply to that portion of the underpayment. However, Mr. Lakew and Ms. Bete offered little argument or evidence to establish that they had reasonable cause for the underpayment. Therefore, the court sustained the IRS's imposition of the accuracy-related penalty.

Holding. The court held that Mr. Lakew and Ms. Bete could not offset gross receipts with unreported cash refunds. The court also held that the couple is liable for the accuracy-related penalty.

Settlement Proceeds

***Timothy and Cindy Stassi v. Comm'r,* TC Summm. Op. 2021-5 (Feb. 8, 2021)**

IRC §§61 and 104

☞ Taxpayer Rashly Excludes Settlement Proceeds from Gross Income

Facts. Cindy Stassi was employed at Vident, d.b.a. Vita North America (Vident) from July 1, 2011, until she resigned on January 13, 2015. In February 2014, she was diagnosed with shingles (herpes zoster). Her supervisor placed her on a 30-day improvement plan starting May 21, 2014. From May 22, 2014, until she resigned on January 13, 2015, she was on an unpaid leave of absence.

On May 27, 2014, Mrs. Stassi sent a letter to Vident's board of directors complaining about the company's work environment. Her letter mentioned specific problems connected with her work at Vident but did not mention physical injury or sickness. On December 12, 2014, her attorney sent a document to Vident demanding damages for wage and hour violations, constructive termination, and "emotional distress and punitives."

In March 2015, Mrs. Stassi entered into a settlement agreement with Vident, under which she would receive $80,000. The settlement described Mrs. Stassi's claims as follows: "[Mrs. Stassi] claims she is owed wages and that she was constructively discharged and retaliated against for making certain complaints, … [and that] she has suffered emotional distress with physical manifestations of same." The words "physical manifestations" had not been part of Mrs. Stassi's initial complaint but were added into the settlement agreement during negotiations.

The parties to the agreement agreed that $10,350 of the settlement proceeds would be designated "consideration for lost wages," and Vident would issue a Form W-2, *Wage and Tax Statement,* to Mrs. Stassi for that amount. The parties also agreed that the remaining $69,650 of the settlement proceeds would be "consideration for physical manifestations of [Mrs. Stassi's] emotional distress claims." Vident was to issue a Form 1099-MISC, *Miscellaneous Income,* to Mrs. Stassi for that amount.

Mrs. Stassi received the agreed amounts from Vident and subsequently received a Form W-2 reporting the $10,350 as "wages, tips, other comp.", and a Form 1099-MISC reporting the $69,650 as nonemployee compensation.

When Mr. and Mrs. Stassi filed their 2015 tax return, they reported the $10,350 portion of the settlement as taxable wages and reported $1 of the $69,650 as "other income." They attached a statement to their tax return explaining why they were reporting only $1 of the $69,650 proceeds and a letter from Mrs. Stassi's attorney regarding the settlement agreement.

Issue. The issue in this case is whether any part of the $69,650 settlement payment is excludable from the income of Mr. and Mrs. Stassi under IRC §104(a)(2).

Analysis. IRC §61(a) provides that gross income includes income from all sources unless an exclusion applies under the Code. IRC §104(a)(2) provides an exclusion from gross income for "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness." Emotional distress is not treated as a physical injury or physical sickness under §104(a).

Treas. Reg. §1.104-1(c) defines **damages** as "an amount received (other than workers' compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution."

To qualify for an exclusion from income under §104(a), the taxpayer must show that settlement proceeds were in lieu of damages for physical injuries or physical sickness.[95] The parties reached a settlement agreement, which brings the settlement proceeds under the definition of "damages." The IRS contends that the Stassis did not satisfy the requirements of §104(a)(2) because the proceeds were not made for personal physical injuries or physical sickness. The Stassis argue that the words "physical manifestations" in the settlement agreement establish that the payments were for physical injury or sickness. However, the documents Mrs. Stassi's attorney sent to Vident did not mention physical injuries or sickness. Instead, the documents referred only to "wage and hour," "constructive termination," and "emotional distress and punitives."

The court noted that the Stassis failed to prove a link between Mrs. Stassi's shingles and the claims against Vident. They provided no evidence that her shingles was related to or caused by her job at Vident. Because Mrs. Stassi's complaint against Vident was not based on physical injury or sickness and the settlement agreement did not state that the payment was in lieu of damages for physical injury or physical sickness, the $69,650 settlement payment is not excludable under §104(a)(2).

Holding. The $69,650 settlement payment received by Mrs. Stassi is **not excludable** from gross income.

Unreported Income

Shelley Wienke et al. v. Comm'r, **TC Memo 2020-143 (Oct. 14, 2020)**
IRC §§61, 162, 481, and 6651

☞ Taxpayer's Cancelled Debt and Constructive Dividends Must Be Included in Income

Facts. Shelley Wienke and her husband jointly owned 28 residential rental properties near Clear Lake, California. In 2013, the lender for one of the rental properties foreclosed on the mortgage and discharged the outstanding debt on the property. The lender issued a 2013 Form 1099-C, *Cancellation of Debt,* to Ms. Wienke for $79,226. The lender checked the box on the form showing that Mrs. Wienke was personally liable for repayment of the debt.

Mr. and Mrs. Wienke jointly owned two nonrental properties in California. In 2012, the lenders foreclosed on the respective mortgages. The lenders discharged the outstanding debt on each property and issued Forms 1099-C. A box on each form was checked indicating that Mr. Wienke was personally liable for repayment of the debt.

Mr. and Mrs. Wienke also owned Evergrow, a California corporation formed in 2007. Evergrow operated a grocery market and pizza store in San Francisco, California. Mr. and Mrs. Wienke each owned a 50% interest in Evergrow.

Evergrow's books for 2012–2015 reflected purchases each year of approximately $1 million. Mr. and Mrs. Wienke personally used approximately $75 to $100 of those purchases per week. In addition, Evergrow's books for 2013 and 2015 reflected irregular payments to the Wienkes for draws and payments of their personal expenses totaling $25,346 and $26,638, respectively. Evergrow did not file employment tax returns or issue Forms W-2, *Wage and Tax Statement,* for any of those payments.

95. See *Green v. Comm'r,* 507 F.3d 857, 867 (5th Cir. 2007), *aff'g* TC Memo 2005-250 (Oct. 31, 2005); *Bagley v. Comm'r,* 105 TC 396, 406 (1995), *aff'd* 121 F.3d 393 (8th Cir. 1997).

Mrs. Wienke filed separate tax returns from her husband each year. She reported 18 rental properties on her 2012 return and 17 rental properties on her 2013 return. Mr. Wienke reported the other properties on his returns.

Evergrow filed Forms 1120, *U.S. Corporation Income Tax Return.* Mrs. Wienke was responsible for Evergrow's tax reporting and signed its returns.

The IRS determined that the Wienkes incorrectly reported income from the rental properties on their returns. An IRS representative calculated the Wienkes' total income and expenses for all 28 properties and reallocated half of the income and expenses to Mrs. Wienke. He did not adjust the rental income reported or expenses deducted other than the depreciation claimed. The representative used county property tax records to calculate each rental property's cost basis when it was first placed in service and then determined the proper depreciation deduction for each property. He reduced Mrs. Wienke's depreciation deductions by $56,558 for 2012 and $39,803 for 2013 based on his calculations.

The IRS representative further determined that Mr. and Mrs. Wienke had claimed total depreciation of $1.027 million for the rental properties from 1994 to 2011 but were only entitled to $539,935. He made an IRC §481(a) adjustment to the Wienke's 2012 income to include the total disallowed depreciation deductions for all 28 rental properties for those prior years and allocated half of the total amount ($243,405) to Mrs. Wienke.

The IRS also audited Evergrow's Forms 1120 for 2012–2015. The IRS adjusted Evergrow's cost of goods sold (COGS) for each year to reflect discrepancies between the COGS listed on Evergrow's Forms 1120 and the Wienkes' consumption of part of Evergrow's purchases for their own use. In addition, the representative also reduced Evergrow's 2012 business deductions by $27,345 and disallowed the entire amount of officers' compensation deductions reported on Evergrow's 2013 and 2014 returns.

Issues. There are several issues presented in this case, but this discussion focuses on the following.

- Whether Mrs. Wienke must include cancellation of indebtedness of $144,516 and $39,613 in her gross income for 2012 and 2013, respectively
- Whether Mrs. Wienke received constructive dividends of $9,707 and $14,593 for 2012 and 2013, respectively
- Whether Mrs. Wienke is entitled to depreciation deductions in amounts greater than those the IRS allowed for 2012 and 2013

Analysis. Under IRC §61(a)(12), a taxpayer must generally report income from the discharge of indebtedness. Mrs. Wienke contended that her discharged debts were nonrecourse because the lenders did not pursue her or her husband for the outstanding balances after the debts were discharged. She therefore argues that the cancelled debts should not be included in her income. However, the Forms 1099-C issued for the cancelled debts indicated that the borrower was personally liable for repayment. Mrs. Wienke had not raised a reasonable dispute about the accuracy of the Forms 1099-C, and she did not provide any documentation to support her contention that the debts were nonrecourse. The court therefore held that the debts were all recourse and upheld the IRS's inclusion of the cancellation of indebtedness in her gross income for 2012 and 2013.

When a corporation distributes money or property to a shareholder out of the corporation's earnings and profits, the distribution constitutes a dividend that must be included in the shareholder's income.[96] Corporate funds diverted to personal use by a controlling shareholder generally are characterized as constructive dividends for tax purposes.[97]

96. IRC §§61(a)(7), 63, 301(a), and 316.

97. See *Erickson v. Comm'r*, 598 F.2d 525, 531 (9th Cir. 1979); *Meridian Wood Prods. Co. v. U.S.,* 725 F.2d 1183, 1191 (9th Cir. 1984).

Mr. and Mrs. Wienke diverted portions of Evergrow's corporate funds in 2012 and 2013 to themselves for personal use. Mrs. Wienke contended that these distributions were not taxable dividends but instead were repayments of loans she made to Evergrow. However, she did not provide any credible evidence that she made any loans to Evergrow or that Evergrow took any actions indicating that loans existed. The court therefore concluded that Mrs. Wienke's receipt of Evergrow's corporate funds was unreported constructive dividends rather than loan repayments. Accordingly, the court upheld the IRS's inclusion of $9,707 and $14,593 for 2012 and 2013, respectively, in Mrs. Wienke's gross income.

To determine the annual depreciation deduction for property used in a trade or business or for the production of income, taxpayers are generally required to use the modified accelerated cost recovery system (MACRS). MACRS dictates a 27.5-year recovery period and straight-line depreciation method for residential rental property.[98] Land is not depreciable, but improvements added to land may be depreciable. When a taxpayer pays a lump sum for property comprising both depreciable improvements and nondepreciable land, they must apportion the cost between the land and improvements for depreciation purposes.

Mrs. Wienke admitted that she calculated depreciation for each rental property using the entire purchase price as the depreciable cost rather than apportioning the purchase price between the land and preexisting improvements. She added the costs of capital improvements that she and her husband made to each property after they purchased it. She claimed that some of the properties required extensive renovations before the property could be placed into service. However, she could not provide documentation for the improvements she and her husband made after the purchases or show whether she deducted some of the costs as repairs. In addition, the invoices she did provide could not be tied to a particular property or renovation. Moreover, she did not produce any schedules showing how she calculated her depreciation deductions.

The court held that Mrs. Wienke used an impermissible method to calculate the depreciation deductions for the rental properties and sustained the IRS's change of method for calculating the depreciation deductions.

Holding. The court held that cancellation of indebtedness and constructive dividends must be included in Mrs. Wienke's gross income, as determined by the IRS. In addition, the court upheld the IRS's adjustments to depreciation claimed on her returns.

Credit Card Rewards

Konstantin and Nadezhda Anikeev v. Comm'r, **TC Memo 2021-23 (Feb. 23, 2021)**
IRC §61

☞ Gift Cards That Keep on Giving

Facts. During 2013 and 2014, American Express offered a reward program called Blue Cash. The Blue Cash program paid **reward dollars** to credit card holders who made eligible purchases using their American Express cards. The amount of reward dollars that a card holder earned under the rewards program was based on a percentage of the card holder's eligible purchases. **Eligible purchases** were purchases made on the card for goods and services minus returns and other credits. Eligible purchases did not include fees and interest charges, balance transfers, cash advances, purchases of traveler's checks, purchases or reloading of prepaid cards, or purchases of any cash equivalents. Card holders could redeem reward dollars for Amazon gift cards or as statement credits on their American Express card balances.

98. See IRC §§168(b)(3)(B) and (C).

For the first $6,500 of purchases in each reward year, Konstantin and Nadezhda Anikeev received reward dollars equal to 1% of everyday purchases and 0.5% of all other eligible purchases. For purchases that exceeded $6,500 in each reward year, they received reward dollars equal to 5% of everyday purchases and 1% of all other eligible purchases. The rewards program defined **everyday purchases** as eligible purchases made in the United States at supermarkets, at gas stations for purchases of $400 or less of gasoline, and at select drugstores. All of Mr. and Mrs. Anikeev's purchases in 2013 and 2014 qualified for reward dollars.

To earn as many reward dollars as possible, Mr. and Mrs. Anikeev used their American Express cards to buy as many Visa gift cards as they could from local grocery stores and pharmacies. They used the gift cards to purchase money orders, which they deposited in their bank accounts.

When they paid their monthly American Express bills, Mr. and Mrs. Anikeev received the applicable reward percentage (either 1% or 5%) of their total purchases in reward dollars that they could use for a statement credit or redeem for Amazon gift cards.

Mr. and Mrs. Anikeev sometimes paid their American Express bills through MoneyGram, which is a money transfer company that offers its services at Walmart stores. When they used MoneyGram, they paid the American Express bill as well as the applicable service fee with a reloadable debit card, and MoneyGram transmitted the payment electronically to American Express. Mr. and Mrs. Anikeev used their American Express cards to purchase the reloadable debit cards they used to pay their American Express bills. The purchase of debit cards and the reloads also earned reward dollars.

In addition, Mr. Anikeev sometimes purchased money orders from Rite Aid using one of the couple's American Express cards. The purchase of these money orders also earned reward dollars.

In 2013, Mr. and Mrs. Anikeev's purchases for Visa gift cards, reloadable debit cards, and money orders charged to their American Express cards totaled $1.208 million. In 2014, their purchases for Visa gift cards, reloadable debit cards, and money orders charged to their American Express cards totaled **$5.184 million.**

The purchase of money orders with Visa gift cards provided a means for the Anikeevs to deposit the amounts charged on the American Express cards into their bank accounts. Mr. and Mrs. Anikeev usually purchased the money orders with the Visa gift cards, but sometimes they purchased the money orders directly with their American Express cards. In 2013 and 2014, they deposited a total of **$4.03 million in money orders into their bank accounts.**

Mr. and Mrs. Anikeev redeemed $36,200 in reward dollars as statement credits in 2013 and **$277,275** in 2014. They did not report any income from the rewards program for either the 2013 or 2014 tax year.

The IRS determined that the Anikeevs had "other income" of $36,200 for 2013 and $277,275 for 2014 from the rewards program. The IRS assessed tax deficiencies of $9,928 for 2013 and $93,845 for 2014.

Issue. The issue in this case is whether the Anikeevs must recognize income on the basis of rewards they acquired from American Express.

Analysis. Rev. Rul. 76-96 concerns the tax treatment of rebates paid by an automobile manufacturer to qualifying customers who purchased automobiles. The ruling held that the customer's receipt of the rebate did not result in the receipt of gross income. Instead, the rebate was a reduction in the purchase price of the automobile, which requires a reduction in the basis of the automobile.

The IRS's position is that when a payment is made by a seller to a customer as an incentive to purchase property, the payment is not considered income but instead it is treated as an adjustment to the basis of the property.[99] In this case, the IRS asserted that the Anikeevs did not purchase goods or property to which a basis adjustment applied. Instead, they purchased Visa gift cards, reloads for debit cards, and money orders, which are cash equivalents according to the IRS. The IRS viewed the reward dollars paid to the Anikeevs as statement credits for the charges relating to cash equivalents as an accession to wealth and income received by them under IRC §61.

The Anikeevs contend that the gift cards are goods and services and the subsequent use of such cards is irrelevant. The IRS contends that the gift cards are cash equivalents because the Anikeevs intended to use them to purchase money orders.

In *Felt v. Comm'r,*[100] the court described the application of the cash equivalent concept to a note that was a promise to pay by a solvent debtor. The reward dollars the Anikeevs received were not notes, but they were commitments by American Express to allow them credits against their card balances. The court observed that the IRS's analysis leaps to the cash equivalence position without analyzing the origin of the reward dollars. The IRS's position only has merit if the reward dollars were not an effect of the purchase price of goods and services. Otherwise, all reward dollars would be cash equivalent income and taxable as such. American Express's rewards program was an inducement for card holders to use their American Express cards. The court noted that the IRS made a choice to avoid the application of the rebate analysis to the taxability of the cash rewards as a reduction of basis. The court concluded that the reward dollars associated with the purchases of Visa gift cards were not includable in income.

However, the Anikeevs' direct purchases of money orders and reloads of cash into debit cards using the American Express cards presents a different issue from the purchase of Visa gift cards. The Visa gift cards have characteristics of a product. The Visa gift cards are not redeemable for cash, but the money orders purchased with American Express cards and the reloading of cash on the debit cards is not easily reconciled with the IRS policy on credit card rewards. The only product or service obtained in these uses of the American Express cards is cash transfers. The money orders cannot be treated as a purchase price adjustment because they can be deposited into the Anikeevs' bank accounts at the time the money orders are acquired. In the same way, reloading cash on the debit cards was not product purchases. Accordingly, the court upheld the IRS's inclusion in income of the reward dollars for the direct purchases of money orders and cash infusions to the reloadable debit cards.

Holding. The court held that reward dollars associated with the Anikeevs' purchases of Visa gift cards were not includable in income but that the reward dollars used for the direct purchases of money orders and reloading of cash on debit cards were properly includable in their income.

Settlement Agreement

***Joseph and Amy McKenny v. U.S.,* U.S. Court of Appeals, 11th Circuit; No. 18-10810; (Sep. 1, 2020)**
IRC §§162, 1362, 1366, and 7121

☞ Taxpayers Unsettled by Income Inclusion

Facts. Joseph McKenny was an independent contractor providing consulting services to car dealerships. In the late 1990s, he engaged Grant Thornton, an accounting firm, to advise him on tax strategy and to prepare his tax returns.

Grant Thornton advised Mr. McKenny to structure his consulting business as an S corporation. In addition, Grant Thornton recommended that the S corporation be wholly owned by an employee stock ownership plan (ESOP), of which Mr. McKenny would be the sole beneficiary. It was Mr. McKenny's understanding that the income from the business would pass through the S corporation and then accumulate tax-free in the ESOP until it made distributions to him. Therefore, he could defer taxation on the income from his consulting business by combining the S corporation with an ESOP.

---

99. *Pittsburgh Milk Co. v. Comm'r,* 26 TC 707 (1956); Rev. Rul. 76-96, 1976-1 CB 23.

100. *Felt v. Comm'r,* TC Memo 2009-245 (Oct. 28, 2009).

In 2000, Mr. McKenny became the sole employee of Joseph M. McKenny, Inc., an S corporation. However, the S corporation election was allegedly filed improperly with the IRS at the direction of Grant Thornton. The S corporation was to be owned by the Joseph M. McKenny, Inc. ESOP (JMM ESOP), of which Mr. McKenny was the sole beneficiary. However, Mr. and Mrs. McKenny allege that no ESOP was created or approved by the IRS because Grant Thornton failed to prepare the proper documents for the ESOP and failed to take actions to ensure the ESOP was properly formed and operated.

Mr. McKenny also acquired a 25% interest in a Florida GMC car dealership in 2000. The 25% interest was held in a separate S corporation on the advice of Grant Thornton. This S corporation was also wholly owned by the JMM ESOP.

Starting in 2000, Mr. and Mrs. McKenny filed joint tax returns using the tax strategy suggested by Grant Thornton. For several years, they paid little or no federal income tax. However, the IRS audited their returns and determined that the McKennys underpaid their taxes between 2000 and 2005. The IRS determined that the tax strategy used by the McKennys with respect to the GMC car dealership was an unlawful and abusive tax shelter.

Mr. and Mrs. McKenny settled their unpaid liabilities with the IRS in 2007. In the settlement agreement, they conceded the tax benefits from the ESOP transactions and acknowledged they owed taxes for the consulting business and their interest in the car dealership. They committed to paying the liabilities from the ESOP transactions and later paid the IRS $2.2 million in income taxes, interest, and penalties.

In 2008, Mr. and Mrs. McKenny sued Grant Thornton in state court, alleging that the firm committed accounting malpractice and was responsible for their unpaid tax liabilities between 2000 and 2005. Grant Thornton settled the suit in 2009 by paying the McKennys $800,000. However, Grant Thornton expressly denied the claims against it and the liability related to the tax advice it provided to the McKennys.

On their 2009 tax return, the McKennys:

- Deducted $419,490 in legal fees they paid to litigate the malpractice claim,
- Claimed an unreimbursed loss for the difference between the settlement payment they received from Grant Thornton and the settlement payment they made to the IRS, and
- Excluded the $800,000 settlement payment from their gross income.

After claiming these deductions and exclusions, the McKennys claimed a net operating loss, which they carried forward to 2010 and 2011.

In 2013, the IRS issued a notice of deficiency, rejecting all these claimed deductions and exclusions. The IRS recharacterized the legal expenses as a miscellaneous itemized deduction rather than a business deduction. The IRS also disallowed the loss deduction and denied the exclusion of the settlement payment. As a result of these adjustments, the McKennys had to pay additional taxes of $813,407.

The McKennys filed a refund claim with the IRS for that amount. The IRS denied the refund.

In July 2016, the McKennys sued the government seeking a refund of approximately $586,000, which is the amount of the disallowed exclusions and deductions for 2009 and 2011. The parties filed cross-motions for summary judgment.

The district court concluded that the legal expenses incurred by the McKennys in the litigation were not deductible business expenses because they sued Grant Thornton on their own behalf, rather than on behalf of the consulting business. In addition, the district court held that the McKennys were barred by their 2007 settlement with the IRS from claiming losses related to the ESOP transactions. However, the district court agreed with the McKennys that the $800,000 settlement was a return of capital and therefore excludable from their gross income. The district court case was appealed by both sides.

Issues. The issues in this case are as follows.

- Whether the McKennys are entitled to deductions for legal expenses they incurred
- Whether the McKennys are entitled to a $1.4 million deduction for their purported loss
- Whether the McKennys are entitled to exclude the $800,000 settlement they received from Grant Thornton from their gross income

Analysis. The IRS disallowed the McKenny's business deduction for legal fees and recharacterized them as a miscellaneous itemized deduction. The McKennys contend that their legal costs are deductible as a business expense because their lawsuit against Grant Thornton was related to Mr. McKenny's business operations. The court noted that the determinative factor is "the origin and character of the claim with respect to which an expense was incurred."[101] The litigation between the McKennys and Grant Thornton was personal in character and origin because it concerned the McKennys' personal tax liability, rather than the tax liability of any business. The McKennys' complaint alleged that Grant Thornton breached an agreement with the McKennys, not Mr. McKenny's businesses. Moreover, the complaint alleged malpractice for services provided to the McKennys, not the businesses. Therefore, the court affirmed the district court's ruling that the legal expenses incurred in the litigation were not deductible business expenses.

The McKennys' $1.4 million deduction for a purported loss represents the difference between the $2.2 million they paid to settle the IRS audit and the $800,000 they received from Grant Thornton to settle the malpractice suit. The court noted that the settlement agreement with the IRS committed the McKennys to pay taxes attributable to the disallowance of certain transactions. It barred the McKennys from claiming any other deductions and/or losses relating to those transactions.

The McKennys argued that their $1.4 million claimed loss was not related to those transactions, but instead was due to Grant Thornton's failure to fully reimburse them in the lawsuit. The court noted that this is a "distinction without a difference." Therefore, the settlement bars them from claiming any deduction based on the payment.

The McKennys contend that their exclusion of the $800,000 settlement from their gross income was appropriate because gross income does not include a payment made as compensation for damages or loss that was caused by a third party's negligence in the preparation of a tax return.[102] The McKennys contend that the settlement is not taxable because it constitutes a return of their capital, which they lost due to Grant Thornton's accounting malpractice.

The government argued that the McKennys failed to carry their burden of proof with respect to their argument as to the exclusion of the $800,000 settlement. The government maintained that nothing in the record showed the McKennys would have been entitled to the ESOP or its tax benefits. The McKennys did not produce an expert witness who could testify that they would have received tax benefits if Grant Thornton had performed differently.

The court noted that the McKennys had the burden of proving their refund claim by a preponderance of the evidence. It was not enough for them to simply make an assertion, devoid of specific information, that they overpaid taxes or would not have incurred any federal taxes or penalties if Grant Thornton had followed through on the S corporation/ESOP strategy. The McKennys did not meet their burdens of showing they were entitled to the exclusion and the amount of that exclusion. As a result, they are not entitled to exclude the $800,000 settlement from their gross income.

Holding. The court affirmed the district court's summary judgment that the McKennys were not entitled to deduct the legal expenses or the $1.4 million purported loss. The court reversed the district court's grant of summary judgment in favor of the McKennys with respect to the $800,000 exclusion, finding that they are **not** entitled to exclude the $800,000 settlement from their gross income.

101. *U.S. v. Gilmore,* 372 U.S. 39, 49 (1963).

102. See *Clark v. Comm'r,* 40 BTA 333, 335 (1939).

Practitioner Planning Tip

Tax practitioners should consider asking for a copy of the original claim if a client advises that they may receive a settlement agreement, especially one that involves losses on securities. Under the precedent of the *Gilmore*[103] case, the way the claim is stated may permit the settlement to be treated as a capital gain, rather than ordinary income. In this event, the tax practitioner should consider including a disclosure of treatment with the tax return.

INNOCENT SPOUSE

Joint and Several Liability
***Donna M. Sutherland v. Comm'r,* 155 TC No. 6 (Sep. 8, 2020)**
IRC §6015

☞ Court Considers Taxpayer's Motion in Innocent Spouse Case

Facts. In 2010, Donna Sutherland's husband was indicted for tax crimes. He pleaded guilty and entered into a plea agreement, under which he was required to file delinquent returns for 2005 and 2006. Ms. Sutherland believed she was required to file joint returns with her husband. At his request, she signed the returns in the courthouse cafeteria less than one hour before he was sentenced.

In September 2016, Ms. Sutherland requested innocent spouse relief for 2005 and 2006. On Form 8857, *Request for Innocent Spouse Relief,* she stated that she signed the returns during a "confusing and emotional" time, that the returns had been prepared by her husband's accountant without her input, and that she simply signed the returns as her husband instructed. She did not check the box on Form 8857 indicating that she had any mental or physical health problems. She believed that she would have been required to provide a medical diagnosis if she answered "yes" to that question.

In April 2017, Ms. Sutherland received a preliminary determination from the IRS denying her request. She appealed the determination and appointed a representative to act on her behalf. During administrative review of the request, Ms. Sutherland's representative decided that the IRS Appeals officer was applying the innocent spouse factors incorrectly.

At that time, the standard of review that the court used for stand-alone innocent spouse cases was **de novo.** Ms. Sutherland's representative believed that his client would have a better outcome before the court. He accordingly decided not to submit further evidence on her behalf to the Appeals Office.

Note. "De novo" means that the court may consider evidence introduced at trial that was not included in the administrative record. Under this standard, the court considers the case anew, without giving deference to the IRS's determination to deny relief.[104]

---

103. *U.S. v. Gilmore,* 372 U.S. 39, 49 (1963).

104. *2011 Annual Report to Congress.* Dec. 31, 2011. National Taxpayer Advocate. [www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/10/2011_ARC_Legislative-Recommendations.pdf] Accessed on Mar. 31, 2021.

In November 2017, the IRS issued a letter denying Ms. Sutherland's request for innocent spouse relief. In February 2018, she filed a timely petition for review.

The Taxpayer First Act (TFA),[105] which was signed into law on July 1, 2019, added IRC §§6015(e)(7) and (f)(2). IRC §6015(e)(7) limits the court's review in innocent spouse cases to:

- The administrative record established at the time of the determination, and
- Any newly discovered or previously unavailable evidence.

The TFA specified that these amendments "shall apply to petitions or requests filed or pending on or after the date of the enactment of this Act."

In November 2019, Ms. Sutherland filed a motion to remand the case (i.e., send the case back to the IRS). She asserted that if §6015(e)(7) had been the law when her request was pending with the IRS, she would have submitted additional evidence into the administrative record. She contended that the amended scope of review will put her at a disadvantage by preventing her from providing additional evidence unless she can demonstrate that such evidence is "newly discovered or previously unavailable." She wanted to remand the case to the IRS Appeals Office so she could introduce evidence concerning her mental state when she signed the returns and other factors not previously introduced.

Issue. The issue is whether to remand Ms. Sutherland's innocent spouse case to the IRS.

Analysis. When married taxpayers file a joint return, each spouse is jointly and severally liable for the entire tax due for that year. However, a spouse who filed a joint return can seek relief from joint and several liability under §6015.

Under §6015(f), relief may be available if "taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either)." Relevant factors include the requesting spouse's mental or physical health at the time the return was filed, marital status, and knowledge about information on the return.

IRC §6015(e) allows a taxpayer to file a petition for review by the court if their request for innocent spouse relief is denied. "Such cases are referred to as 'stand-alone' cases, in that they are independent of any deficiency proceeding."[106] Since 2006, the court has applied the de novo standard of review to innocent spouse cases.

The IRS opposed Ms. Sutherland's motion to remand, citing the court's holding in *Friday v. Comm'r,*[107] that the court cannot remand stand-alone innocent spouse cases. Ms. Sutherland requested that the court reconsider that holding because of the TFA amendment to §6015(e)(7), which limits the scope of review in such cases to the administrative record established at the time of the determination and any additional newly discovered or previously unavailable evidence. Ms. Sutherland believes the revised scope of review would put her at a disadvantage. Accordingly, she requested remand to allow her to submit additional evidence into the IRS record.

Congress stated that the TFA amendments "shall apply to petitions or requests filed or pending on or after" July 1, 2019 (the date of the TFA's enactment). The court interpreted this to mean that §6015(e)(7) applies to petitions filed in the court on or after July 1, 2019, and §6015(f)(2) applies to requests pending with the IRS on or after that date. Because Ms. Sutherland filed her petition in court before July 1, 2019, §6015(e)(7) does not apply to her case.

Because the TFA provision does not apply, the standard of review in Ms. Sutherland's case remains de novo. Ms. Sutherland is free to introduce any evidence that she wants at trial. The premise for her motion to remand does not apply; therefore, a remand would serve no useful purpose.

Holding. The court denied Ms. Sutherland's motion for remand.

105. *Taxpayer First Act,* PL 116-25.

106. *Davidson v. Comm'r,* 144 TC 273, 273-274 (2015).

107. *Friday v. Comm'r,* 124 TC 220, 222 (2005).

Innocent Spouse Relief

***Lori D. Sleeth v. Comm'r,* 991 F.3d 1201; U.S. Court of Appeals, 11th Circuit (Mar. 19, 2021)**

IRC §6015

☞ Taxpayer Denied Innocent Spouse Relief

Facts. Lori and David Sleeth were married in 1988, living in Dallas, Texas, where Mr. Sleeth practiced law. He decided to become a doctor, went to medical school, and served in a residency program. Although Mrs. Sleeth was not fully supportive of this decision, she went along with it. In 2004, they moved to Guntersville, Alabama, where Mr. Sleeth worked for a hospital system. Along with a larger income, they acquired a larger house and a second home near a local lake. They also bought a luxury automobile, a boat, and a small airplane, all titled in Mrs. Sleeth's name, along with the second home.

The Sleeths jointly filed their 2005 income tax return, but because they did not have the money to pay the tax due, they established an installment agreement. The extension filed by their accountant for their 2006 tax return triggered a series of events that prompted the IRS to terminate the installment agreement for their 2005 tax liability. In the ensuing years, the Sleeth's tax liability for each year remained unpaid, so their accumulated tax debt grew to over $363,000, excluding interest and penalties. They made no payments on this debt.

To add personal complications to their tax problems, creditors repossessed the couple's principal residence and airplane. A marina fire destroyed their boat.

In 2015, the couple divorced. Mrs. Sleeth retained the second home under the divorce decree's terms, which provided for Mr. Sleeth to pay the mortgage on it. The divorce court ordered Mr. Sleeth to distribute $51,000 to his ex-wife from what the court described as "his retirement accounts." This court also instructed him to give Mrs. Sleeth an additional $10,000 in spousal support.

Most significantly for the case before the Appeals Court, Mr. Sleeth accepted full responsibility for the tax liabilities and agreed to support Mrs. Sleeth's claim for innocent spouse relief. If successful, he would bear sole responsibility for their income tax debt.

In her request for innocent spouse relief, Mrs. Sleeth claimed that she was unaware that Mr. Sleeth was not making payments on taxes due when she signed the joint returns for 2008, 2009, and 2010. The IRS contested her claim, asserting that it was not reasonable when she signed the returns. The IRS further stated that her presentation to the court did not establish that she would experience economic hardship if the court did not grant her innocent spouse relief. Mr. Sleeth supported Mrs. Sleeth in this claim, as provided in the divorce decree. Nevertheless, the IRS prevailed before the Tax Court. This decision thwarted Mrs. Sleeth's attempt to claim innocent spouse relief, so she appealed to the U.S. Court of Appeals for the 11th Circuit.

Issue. The issue in this case is whether the Court of Appeals for the 11th Circuit should overturn the Tax Court's denial of innocent spouse status for Mrs. Sleeth.

Analysis. The appeals court has the responsibility to review the Tax Court's decision for abuse of discretion. It also has the authority to take a fresh look at the facts of the case and questions of law upon which the Tax Court based its decision. Abuse of discretion only happens when the court "applies an incorrect legal standard, relies on clearly erroneous factual findings, or commits a clear error of judgment."[108] Mrs. Sleeth requested that the appellate court find that the Tax Court had abused its discretion, the first of the three ways in which she claimed that the court made errors in its judgment.

108. *U.S. v. $70,670.00 in U.S. Currency,* 929 F.3d 1293 (11th Cir. 2019) quoted in *Lori D. Sleeth v. Comm'r,* 20-10221 (11th Cir. 2021).

The court referred to three avenues for relief from the joint and several liability established by a joint return.[109] Although IRC §6015 does not refer to the term "economic hardship," it does refer to the possibility that it would be "inequitable to hold the other individual liable for the deficiency in tax…"[110] Rev. Proc. 2013-34 added the economic hardship test as one factor in determining eligibility for equitable relief under §6015(f).[111] This 2013 pronouncement introduced an economic hardship test to innocent spouse relief cases based on rules that already existed in Treas. Reg. §301.6343-1(b)(4).

Although this regulation pertains to the release of a levy, Rev. Proc. 2013-34 still refers to its economic hardship test. The court found that in Mrs. Sleeth's case, the economic test was a neutral one, not one that the court would count in favor of granting her innocent spouse relief. The appellate court found that Mrs. Sleeth had some assets, such as $100,000 of equity in the home near the lake and money she had received from her ex-spouse. In general, the court did not have much to base a case for Mrs. Sleeth's economic hardship.

The second way in which Mrs. Sleeth claimed the court made an error in judgment was based on her knowledge of her ex-spouse's financial difficulties. If it was not unreasonable for her to believe that he could have paid the tax, that would weigh against her receiving innocent spouse relief. The revenue procedure contains an example in which the party requesting innocent spouse relief knew about their spouse's financial problems, such as bankruptcy.[112] In this situation, it would have been reasonable for them to expect a problem paying a tax liability, and for this reason, be a factor weighing against granting innocent spouse relief. The court can consider facts and circumstances relevant to the case, such as the following.[113]

- The requesting spouse's level of education
- The requesting spouse's involvement in generating income
- The requesting spouse's participation in the household's financial management
- Deceit on the part of the other spouse
- Lavish expenditures compared with past spending

In the case of the Sleeths, the court noted that they had made no estimated tax payments during any of the three years in question. They filed the returns for two of the three years late by a year or more. Finally, because Mrs. Sleeth signed the returns, the court presumes that she had knowledge of the returns' content.[114]

Mrs. Sleeth testified that she visited the IRS's Huntsville, Alabama, office to resolve an issue involving the 2005 income tax payment. Therefore, she knew that payment had been made late. Aware she had made this visit, the court concluded it was unreasonable for her to contend that she had no knowledge of Mr. Sleeth not paying the taxes due.

Her third and final argument was that the court placed "too much weight" on that one factor, her knowledge that should have led her to conclude that Mr. Sleeth would not have paid the tax. The court dismissed that argument by citing the Tax Court's opinion that her knowledge counted "strongly against relief."

Holding. The appeals court affirmed the Tax Court's decision against granting innocent spouse relief to Mrs. Sleeth.

> **Note.** Within two months after the Court of Appeals ruled on this case, the Tax Court cited it as a precedent in another case.[115]

109. IRC §6013(d)(3).
110. IRC §6015(b)(1)(D).
111. Rev. Proc. 2013-34, 2013-43 IRB 397.
112. Ibid. See §4.03(2)(c)(ii) regarding underpayment cases, especially second paragraph.
113. Ibid. See §4.03(2)(c)(iii).
114. *Porter v. Comm'r,* 132 TC 203 (2009).
115. *Maria Claudia Ginos v. Comm'r,* TC Summ. Op. 2021-14 (May 19, 2021).

IRS PROCEDURES — MISCELLANEOUS

Economic Impact Payments

***Colin Scholl et al. v. Steven Mnuchin et al.*, No. 4:20-cv-05309; U.S. District Court for the Northern District of California (Oct. 14, 2020)**
IRC §§6428 and 7422

☞ Court Bars IRS From Denying Economic Impact Payments to Incarcerated Persons

Facts. The Coronavirus Aid, Relief, and Economic Security Act (CARES Act), which was signed into law on March 27, 2020, provides a tax credit for eligible individuals under IRC §6428. The credit is $1,200 ($2,400 for married taxpayers filing a joint return), plus $500 for each qualifying child. An **eligible individual** is defined as any individual other than those who fall into one of the following categories.[116]

- Nonresident alien individual
- Individual who is allowed as a dependent on another taxpayer's return
- An estate or trust

The economic impact payment (EIP) is an advance refund of this tax credit. The IRS and the Department of the Treasury are responsible for administering EIPs to eligible individuals. On March 30, 2020, the IRS issued a news release stating that it would calculate and automatically issue EIPs to eligible individuals.

On May 6, 2020, the IRS published answers to frequently asked questions (FAQ) on its website. In response to the question, "Does someone who is incarcerated qualify for the Payment?" the IRS responded:

> *No. A Payment made to someone who is incarcerated should be returned to the IRS by following the instructions about repayments. A person is incarcerated if he or she is described in one or more of clauses (i) through (v) of Section 202(x)(1)(A) of the Social Security Act (42 U.S.C. § 402 (x)(1)(A)(i) through (v)). For a Payment made with respect to a joint return where only one spouse is incarcerated, you only need to return the portion of the Payment made on account of the incarcerated spouse. This amount will be $1,200 unless adjusted gross income exceeded $150,000.*

On June 30, 2020, the Treasury Inspector General for Tax Administration (TIGTA) released a report on the 2020 filing season. The report included results of an audit on the IRS's issuance of EIPs. TIGTA noted that some of the EIPs issued by the IRS on April 10, 2020, were sent to incarcerated individuals and deceased individuals. TIGTA expressed its concern to IRS management regarding the payments issued to incarcerated individuals. TIGTA's report stated "IRS management noted that payments to these populations of individuals were allowed because the CARES Act does not prohibit them from receiving a payment. However, the IRS subsequently changed its position noting that individuals who are prisoners or deceased are not entitled to an EIP."

The IRS then provided taxpayer identification numbers of incarcerated individuals to the Bureau of Fiscal Service (BFS) and requested that BFS remove those individuals from subsequent payments issued on May 1, 2020, and May 8, 2020. Accordingly, no payments were made to incarcerated persons in these later batches.

In response to the payments totaling approximately $100 million already sent to incarcerated persons, the IRS issued guidance stating that individuals who received a direct deposit payment in error should repay the advance refund to the IRS.

116. IRC §6428(d).

Plaintiffs Colin Scholl and Lisa Strawn filed a class action lawsuit on behalf of incarcerated and formerly incarcerated individuals who did not receive such payments. The plaintiffs claim that the IRS unlawfully withheld EIP benefits to incarcerated individuals. They contend that the IRS and the Department of the Treasury have no discretion to decide which persons are eligible individuals.

Issue. The issue in this case is whether the IRS improperly denied EIPs to incarcerated persons.

Analysis. The plaintiffs assert that the CARES Act does not leave open the question of who an eligible individual is for purposes of the EIP. The IRS and Department of the Treasury did not provide an argument in opposition to this assertion. The court reaffirmed a finding it made in a preliminary injunction that incarcerated individuals are not excludable as eligible individuals under the CARES Act. Therefore, the IRS's interpretation of the CARES Act is contrary to law and in excess of statutory authority.

The plaintiffs further claim that the IRS's action is arbitrary and capricious because the IRS failed to provide an adequate reason for its decision. A decision is arbitrary and capricious when "the agency has failed to 'examine the relevant data' or failed to 'articulate a rational explanation for its actions.'"[117]

The plaintiffs argue that the IRS failed to provide an adequate reason for its decision, and the policy relies on factors that Congress did not intend for it to consider. The IRS countered that because §6428 does not require the IRS to issue advance refund payments to the plaintiffs, the IRS has not acted arbitrarily and capriciously.

The IRS noted that it regularly received information about possible fraudulent tax refunds or other activity involving incarcerated persons. However, the IRS did not publicly advance this explanation at the time it made its determination. Therefore, this constitutes an impermissible post hoc rationalization. Accordingly, the court found the IRS's policy of excluding incarcerated individuals from receiving an EIP solely because of their incarcerated status is arbitrary and capricious.

Holding. The court found the IRS's policy of denying advance payments under the CARES Act arbitrary and capricious and not in accordance with law. The court further entered a permanent injunction enjoining the IRS and Treasury Department from withholding benefits under §6428 from plaintiffs or any class member solely based of their incarcerated status.

> **Note.** The IRS resumed processing EIPs for incarcerated individuals following the permanent injunction. The Consolidated Appropriations Act of 2021[118] and the American Rescue Plan Act of 2021[119] established the second and third round of EIPs, respectively, and did not amend the definition of eligible individuals to exclude incarcerated individuals.[120]

117. *Genuine Parts Co. v. EPA,* 890 F.3d 304, 311-12 (D.C. Cir. 2018).

118. *Consolidated Appropriations Act of 2021,* PL 116-260.

119. *American Rescue Plan Act of 2021*, PL 117-2.

120. *Scholl v. Mnuchin and Economic Impact Payments.* Mar. 26, 2021. Congressional Research Service. [crsreports.congress.gov/product/pdf/LSB/LSB10586] Accessed on Mar. 29, 2021.

Direct Deposits

TD 9940, 85 Fed. Reg. 83446-83448, 2021-2 IRB 311 (Dec. 22, 2020)

IRC §6402

☞ IRS Updates Procedures for Recovering Misdirected Direct Deposit Refunds

Background. Treasury Decision (TD) 9940 provides guidance on the procedures used to identify and recover tax refunds issued by electronic funds transfer (direct deposit) that were not delivered to the account designated on the federal tax return or other claim for refund. TD 9940 amends IRC §6402(n), which was added to the Code by the Taxpayer First Act.[121]

Analysis. Treas. Reg. §301.6402-2(g)(1) defines **misdirected direct deposit refund** as including "any refund of an overpayment of tax that is disbursed as a direct deposit but is not deposited into the account designated on the claim for refund to receive the direct deposit refund." Under this definition, a misdirected direct deposit refund does not include an overpayment that is credited against another outstanding tax liability of the taxpayer.

Under the regulation, a taxpayer can report to the IRS that they never received a direct deposit refund and request a replacement refund. The report must include the following information.

- Name of taxpayer who requested the refund
- Taxpayer identification number
- Mailing address
- Type of return to which the refund is related
- Account number and routing number that the taxpayer requested the refund be deposited into
- Any other information necessary to locate the misdirected direct deposit refund

The taxpayer can report a misdirected direct deposit refund using any of the following methods.

- Calling the IRS
- Using Form 3911, *Taxpayer Statement Regarding Refund*
- Contacting the Taxpayer Advocate's office by telephone, mail, fax, or in person
- By submitting the appropriate form in person at a Taxpayer Assistance Center

After the IRS receives the report of a misdirected direct deposit refund, it will confirm that the overpayment was issued as a direct deposit. If the direct deposit was issued, the IRS will initiate a refund trace to request the assistance of the Bureau of the Fiscal Service (BFS). The BFS coordinates with the financial institution that holds the deposit account into which the refund was made and request the return of the misdirected refund.

When the IRS determines that a misdirected direct deposit refund has been made, it will issue a replacement refund in the full amount of the misdirected refund.

121. *Taxpayer First Act,* PL 116-25.

Offer in Compromise

***Craig L. Galloway v. Comm'r,* TC Memo 2021-24 (Feb. 24, 2021)**
IRC §§6320 and 6330

☞ Court Finds No Abuse of Discretion

Facts. Craig Galloway is a car salesman. He reported taxable income of $249,718 and income tax of $95,293 on his 2014 federal income tax return. His 2014 income tax withholding was only $32,998. The IRS subsequently assessed the unpaid tax due, an addition to tax for failure to timely pay, an addition to tax for failure to pay estimated tax, and statutory interest.

In 2016, Mr. Galloway submitted an offer in compromise (OIC) of $9,138 to the IRS Centralized Offer in Compromise (COIC) unit in an attempt to settle his 2014 tax liability. His offer was rejected on the grounds that he could pay the full balance due. Mr. Galloway then submitted Form 656, *Offer in Compromise,* in January 2017, proposing to settle for $8,900.

Mr. Galloway contended that he liquidated his retirement savings to cover living expenses during a long period of unemployment, which resulted in the tax liability at issue. He further stated that although he held a job as a car salesman since October 2015, his salary was based on commissions and fluctuated significantly.

Mr. Galloway requested that the COIC disregard certain assets when determining his ability to pay, including his personal residence and a car used by his daughter. He submitted Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals,* on which he reported monthly income and monthly expenses of $2,400. He also listed various personal assets including his residence, two 2007 Toyotas, one 1997 Toyota, a motorcycle, and $297 in a bank account. He proposed settling his debt for $8,900, the purported value of two of his cars and his motorcycle.

The COIC rejected the 2017 OIC on the grounds that Mr. Galloway had the ability to fully pay his liability. The IRS calculated that Mr. Galloway's gross monthly income was $4,902 and his monthly allowable expenses were $3,217. This left $1,685 of disposable income per month that could be paid toward his tax liability. According to this calculation, he could pay off his liability in 53 months.

Mr. Galloway appealed the rejection of his OIC to the Office of Appeals. He asserted that the IRS had inflated his likely earnings because his job was commission-based, and his future earnings were uncertain. He asserted that the $4,902 salary determined by the COIC did not accurately reflect his monthly income over the course of a year. He stated that he had no disposable income to pay his liability and that the IRS erred in concluding otherwise.

In February 2018, the Office of Appeals sustained the rejection of the 2017 OIC, stating that the amount Mr. Galloway could pay exceeds the amount of his offer.

In March 2018, the IRS issued a notice of federal tax lien to Mr. Galloway. He responded by filing a Form 12153, *Request for a Collection Due Process or Equivalent Hearing.* He checked the boxes on the form indicating he wanted an OIC, and he could not pay the balance.

An IRS settlement officer (SO) scheduled a telephone collection due process (CDP) hearing for July 19, 2018, and requested certain financial information from Mr. Galloway. He did not respond to the letter and did not submit the requested financial information, but the hearing was held as scheduled. During the hearing, Mr. Galloway criticized the COIC for assessing his ability to pay based on his disposable income over the statutory collection period rather than over 12 months.

The SO told Mr. Galloway he could submit a new OIC if his monthly income changed but that the submission of the same offer would lead to the same result. The SO further stated that she would consider a longer-term agreement with lower monthly payments of $975. She asked Mr. Galloway to tell her by July 30, 2018, if he wanted to pursue either option.

Mr. Galloway did not respond by the due date. A few days later, the SO called and left a message asking him to respond by August 6, 2018. Mr. Galloway did not respond, and the SO closed the case. On August 16, 2018, the Office of Appeals sustained the filing of the tax lien for 2014.

Issue. The issue is whether the IRS should be granted summary judgment against Mr. Galloway.

Analysis. A court can grant summary judgment when there is no genuine dispute as to any material fact and a decision can be rendered as a matter of law.

In this case, the underlying tax liability is not at issue, so the court reviewed the Office of Appeals determination for abuse of discretion. Mr. Galloway contended the Office of Appeals abused its discretion when it sustained the rejection of his 2017 OIC.

The court reviewed whether the SO verified the requirements of applicable law or procedures. The court concluded from its review of the record that the SO conducted a thorough review of the account and verified that all applicable requirements were satisfied.

Mr. Galloway contended that the 2017 OIC was improperly rejected during the CDP proceeding and that he should have been given the chance to resubmit that collection alternative or negotiate a different amount. However, a taxpayer is prohibited from raising an issue during a CDP hearing when the issue was raised during a previous administrative or judicial proceeding and the taxpayer meaningfully participated in that hearing or proceeding. Mr. Galloway appealed the rejection of the 2017 OIC to the Office of Appeals, where it was rejected. The courts have held that consideration by the Office of Appeals constitutes an administrative proceeding. In addition, Mr. Galloway meaningfully participated in the Office of Appeals hearing.

Because Mr. Galloway raised the 2017 OIC in an administrative proceeding in which he meaningfully participated, he could not raise that issue in his CDP proceeding. The court's review is limited to the issues properly raised in the CDP hearing; therefore, Mr. Galloway is barred from raising the issue in the court.

Holding. The court found no abuse of discretion. Therefore, the court granted summary judgment to the IRS and sustained the collection action.

Signature Requirement

***Cameron and Kathleen Gregory v. U.S.,* U.S. Court of Federal Claims; No. 1:19-cv-00386 (Aug. 17, 2020)**
IRC §§6061, 6065, and 7422

☞ Taxpayer's Requirement to Sign a Tax Return Cannot be Waived

Facts. Cameron and Kathleen Gregory are U.S. citizens who have worked as government defense contractors in Australia since 2015. The Gregorys filed their original 2015 federal tax return by April 15, 2016, on which they claimed a refund of $348.

In 2018, the Gregorys retained Castro & Co., LLC (Castro) to review their 2015 returns, prepare an amended return to claim the employer-provided lodging exclusion under IRC §119(a)(2), and correct other errors. Castro timely filed the Gregorys' 2015 amended return, but it did not contain the signatures of either Mr. or Mrs. Gregory. Instead, the amended return was signed by Tiffany Hunt, who was a tax preparer employed by Castro. The amended return was not accompanied by a Form 2848, *Power of Attorney and Declaration of Representative,* authorizing Ms. Hunt to sign returns on behalf of the Gregorys, although the IRS later received one under separate cover.

In November 2018, the IRS sent the Gregorys a letter, notifying them that the IRS made some corrections to their Form 1040X, *Amended U.S. Individual Income Tax Return,* that may have affected their refund or balance due. The letter indicated that the Gregorys' original return included other income and taxes on that income that was not included on the amended return.

In December 2018, the IRS sent the Gregorys a notice indicating that the requested changes regarding their self-employment tax, foreign-earned income exclusion, and other changes were granted. On the same day as the December notice, the IRS issued a refund to the Gregorys for $21,252, which was $1,039 less than the Gregorys requested in their amended return. In March 2019, the Gregorys filed a tax refund suit seeking a $1,039 refund for the 2015 tax year.

Issues. The issue is in this case are as follows.

- Whether the Court of Federal Claims should dismiss the Gregorys' complaint because they failed to sign the tax returns relevant to their claim
- Whether the IRS waived the signature requirements by examining and taking action on the merits of the Gregorys' amended 2015 tax return

Analysis. The United States sought to dismiss the Gregorys' complaint on the grounds that the specific court hearing the case, the United States Court of Federal Claims, lacked subject matter jurisdiction. The Gregorys failed to meet several prerequisites needed for the Court of Federal Claims to have jurisdiction. The United States argued that because the Gregorys did not sign their 2015 amended return, the return was not "duly filed," and a prerequisite was not satisfied. The Gregorys argued that the United States waived the requirement when it investigated the merits of the amended return, even though they did not sign the return. The Gregorys noted that the IRS eventually concluded that they qualified for the foreign-earned income exclusion but did not qualify for the §119 employer-provided lodging exclusion.

To comply with the requirements for a tax refund established by the Code, a tax return must be duly filed. Treas. Reg. §301.6402-2(b)(1) states that to be "duly filed," a return:

> *Must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof. The statement of the grounds and facts **must be verified by a written declaration that it is made under the penalties of perjury** [emphasis added]. A claim which does not comply with this paragraph will not be considered for any purpose as a claim for refund or credit.*

The only exception to the signature requirement is when a legal representative certifies the claim and attaches a valid power of attorney to the return.[122] A valid Form 2848 was later sent to the IRS instead of with the amended return.

IRC §6061 provides that, "any return, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall be signed in accordance with forms or regulations prescribed by the Secretary." IRC §6065 provides that, "[e]xcept as otherwise prescribed by the Secretary, any return, declaration, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall contain or be verified by a written declaration that is made under the penalties of perjury." Treas. Reg. §301.6402-2(c) allows a person other than the taxpayer to sign only if a valid Form 2848 accompanies the return.

The Gregorys asserted that the taxpayer signature requirement is regulatory and therefore can be waived by the IRS. The United States countered that the Code creates a statutory rule that cannot be waived by the IRS. The court noted that the IRS can waive compliance with regulatory requirements by investigating the merits of a refund claim and taking action. However, the court decided the Gregorys were seeking waiver of a statutory requirement imposed by an act of Congress,[123] not a regulatory requirement imposed by the IRS. Therefore, the waiver doctrine does not apply, the United States Court of Federal Claims lacked jurisdiction and must dismiss the complaint, and the Gregorys did not receive a refund of the additional $1,039.

Holding. The court held that the IRS cannot waive the statutory taxpayer signature requirement and consequently, the court lacks jurisdiction to hear the suit. Therefore, the court grants the United States' motion to dismiss the Gregorys' complaint.

---

122. Treas. Reg. §301.6402-2(e).

123. *Angelus Milling Co. v. Comm'r,* 325 U.S. 293 (1945).

Employment Tax Deadlines

IRS Notice 2021-11, 2021-6 IRB 827 (Jan. 19, 2021)
IRC §7508A

☞ Employment Tax Deadlines Extended

Purpose. To provide guidance on the postponement of the due date for submitting employment taxes in response to the COVID-19 emergency.

Background. Due to the COVID-19 emergency, IRS Notice 2020-65 is modified with this notice to postpone the due date for withholding and paying employment taxes from April 30, 2021, to December 31, 2021. Interest, penalties, and additions to tax for late payment on unpaid applicable taxes will begin to accrue on January 1, 2022, rather than on May 1, 2021.

Tax Schemes

IRS News Rel. 2021-135, Jun. 28, 2021
IRS News Rel. 2021-137, Jun. 29, 2021
IRS News Rel. 2021-141, Jun. 30, 2021
IRS News Rel. 2021-144, Jul. 1, 2021
IRC §§41, 453, 6111, 6112 and 6700

☞ IRS Announces 2021 "Dirty Dozen" Tax Schemes and Scams

The IRS compiled information to alert taxpayers about common scams that fraudsters use. In 2021, the IRS organized the "Dirty Dozen" into four separate categories.

- Pandemic-related scams
- Personal information cons
- Ruses focusing on unsuspecting victims
- Schemes to persuade taxpayers into unscrupulous actions

Pandemic-Related Scams[124]

Economic Impact Payment Theft. Taxpayers should be alert for the following tell-tale signs of a scam.

- Text messages, random incoming phone calls or emails inquiring about bank account information, requesting the recipient click on a link, or to verify information should be considered suspicious and deleted without opening.
- Mailbox theft — taxpayers should frequently check mail and report suspected mail loss to the postal inspector.
- Receiving a phone call related to economic impact payments and asking for social security numbers or other personal information — sometimes the caller poses as the IRS — is another version of this scam.

124. IRS News Rel. 2021-135 (Jun. 28, 2021).

Unemployment Fraud Leading to Inaccurate Forms 1099-G. In 2020 and 2021, scammers filed false unemployment claims using stolen personal information of individuals who did not file unemployment claims. Unemployment benefit payments went to the identity thieves. The IRS advises taxpayers to be alert for receiving Form 1099-G, *Certain Government Payments,* reporting unemployment compensation they did not receive. If a taxpayer receives a Form 1099-G in this situation, they should contact the state agency to get a corrected form. If the state refuses to provide a corrected Form 1099-G, the IRS advises taxpayers to **report only income received** on their tax return. The taxpayer should alert the IRS about identity theft and take necessary measures to protect their tax returns (e.g., obtain an identity protection personal identification number (IP PIN)).

Unemployment Insurance Fraud.[125] There are a variety of scams associated with unemployment insurance that are not pandemic-related, but nonetheless also important to understand. States, employers, and financial institutions need to be aware of the following scams.

- **Identity-Related Fraud.** Filers apply for unemployment benefits using stolen or fake identification to take over the victim's account.
- **Employer-Employee Collusion Fraud.** While still being paid by an employer, the employee receives unemployment benefits. The employer pays reduced, unreported wages.
- **Misrepresentation of Income Fraud.** The employee returns to work and fails to report income to continue receiving unemployment benefits. The employee claims higher wages to receive higher unemployment benefits.
- **Fictitious Employer-Employee Fraud**. Filers falsely claim they work for a legitimate company, or they create a fictitious company and provide fictitious employee and wage records to receive unemployment benefits.
- **Insider Fraud.** State employees (insiders) use their credentials to inappropriately access or change unemployment claims. This results in unqualified applications, improper payments, and movement of funds to accounts that are not included on the application.

The IRS lists some indicators of unemployment insurance fraud.

- Unemployment payments are coming from a state other than where the individual resides or used to work.
- Multiple unemployment payments are received from various states within the same time period.
- Payments are made in the name(s) of someone other than the individual who filed the claim.

Personal Information Cons[126]

Tax-Related Phishing Scams. This scam involves fake emails, text messages, websites, and social media attempts to steal personal information. The communication appears to come from a legitimate source, and they can be cleverly disguised to look like they are from the IRS or others in the tax community. These scams target individual taxpayers and professional tax preparers.

The scams targeting professional tax preparers attempt to obtain their electronic filing identification number (EFIN) and centralized authorization file (CAF) number. The IRS advises individuals and tax professionals to not click on links in emails. Tax professionals should not transfer EFIN, CAF, or electronic transfer identification number by sale, merger, loan, or gift to another entity.

Another scam is the "new client" scam. A tax professional may receive an email indicating a taxpayer is new to the area and wishes to engage with the tax professional. The email may contain attachments such as the tax return and IRS notice. The IRS advises tax professionals not to open any attachments or click on any links.

---

125. IRS News Rel. 2021-141 (Jun. 30, 2021).

126. IRS News Rel. 2021-137 (Jun. 29, 2021).

Phone Calls Impersonating the IRS. An individual may receive a phone call from someone purporting to be from the IRS (or FBI, etc.) asking for personal financial information. The IRS urges taxpayers to refrain from engaging with the potential scammers online or on the phone. Usually the first contact the IRS has with a taxpayer about unpaid tax is by postal mail, not by phone. The IRS may attempt to reach individuals by phone but does not insist upon payment with gift cards or money orders. The IRS never requests personal information or financial information by email, text message, or social media.

Social Media Scams. Scam artists use personal information to email potential victims and include a link to something of interest. The link may contain malware intended to commit more crimes. Scammers infiltrate emails and cell phones to connect with family and friends, making the communication look like it is authentic, for example, soliciting small donations to charities that appeal to victims. Individuals using social media should be aware that the information they publicly share could be used against them. They should review privacy settings and limit personal information that is publicly shared.

Ransomware. Hackers use malicious software (malware) designed to block access to a computer or network. The hackers extort ransom money in order to unlock the encryption they place on the computer or network. The tactics used by hackers to infiltrate computer networks and desktops involves inducing individuals to download a malicious file or go to a malicious website. Allowing others to remotely control a desktop is another way hackers exploit vulnerabilities.

Ruses Focusing on Unsuspecting Victims[127]

Fake Charities. Scammers set up fake charities to take advantage of generous individuals. These ruses are more prevalent immediately following tragedies and disasters. The requests can come via phone or email. Taxpayers should always investigate the charity before they donate. An IRS tool, "Tax-Exempt Organization Search," can be used to check the status of a charity. This can be found at **uofi.tax/21b4x1** [irs.gov/charities-non-profits/tax-exempt-organization-search].

Immigrant/Senior Fraud. IRS impersonators and other scammers target groups with limited English proficiency, as well as senior citizens. The scams usually involve scare tactics, such as threatening jail time, deportation, or revocation of a driver's license unless money is paid. The IRS does not threaten to revoke licenses or to deport a person.

The IRS recognizes the pervasive nature of fraud targeting senior citizens. Other agencies that are well aware of these fraudulent actions are the Justice Department, the FBI, the Federal Trade Commission, and the Consumer Financial Protection Bureau. Senior citizens and those who care about them should be on alert for tax scams targeting older individuals.

Unscrupulous Tax Return Preparers. Taxpayers should be wary of tax return preparers who do not sign tax returns they prepare. These type of return preparers are frequently referred to as **ghost preparers.** These preparers may be looking to make a quick profit by promising a big refund or by charging fees based on the size of the refund. They may require payment in cash without providing a receipt. They may also invent income when none exists to qualify clients for refundable tax credits,[128] claim fake deductions to increase the size of a refund, and direct refunds into the preparer's bank account instead of the taxpayer's bank account. The IRS has a website offering assistance with choosing a tax professional, which can be found at **uofi.tax/21b4x2** [irs.gov/tax-professionals/choosing-a-tax-professional].

127. IRS News Rel. 2021-141 (Jun. 30, 2021).

128. IRC §32(k)(1), for one example.

Schemes to Persuade Taxpayers into Unscrupulous Actions[129]

There are a variety of tax schemes promoters peddle to taxpayers. The IRS warns taxpayers to watch for promotions offering large tax deductions from abusive arrangements. These promotions make false claims about being legitimate and charge high fees. Taxpayer may try to play the "audit lottery," and hope they do not get noticed by the IRS.

The IRS recently established the Office of Promoter Investigations to focus on participants in and promoters of abusive tax schemes. In announcing the formation of this office, the IRS Commissioner, Chuck Rettig, stated that the office will address "abusive syndicated conservation easements and abusive micro-captive insurance arrangements, as well as other transactions."[130] Persons who earn gross income exceeding $50,000 through sales of reportable transactions to individuals or exceeding $250,000 to other investors are material advisors and are required to maintain lists of persons they advise.[131]

Offer in Compromise Mills.[132] Promoters claim their services are essential to dealing with the IRS and their claims can be settled for "pennies on the dollar." These advertisements often mislead taxpayers about the promoter's ability to resolve the taxpayer's tax liability while charging them excessive fees, sometimes amounting to thousands of dollars. The IRS urges taxpayers to be aware that these promoters cannot do anything for taxpayers that the taxpayers could not do for themselves by contacting the IRS directly.

> **Note.** See the 2021 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Representation Before the IRS, and Chapter 2: Financial Distress, for information about the offer in compromise process.

Syndicated Conservation Easements. Promoters of this tax scheme take a tax law provision for conservation easements and twist it using inflated appraisals of undeveloped land and partnerships. This scheme is designed to create inflated and unwarranted tax deductions for undeveloped land and partnerships that have no legitimate business purpose.

Abusive Micro-Captive Arrangements. This tax scheme has appeared on the "Dirty Dozen" list since 2014. Tax law allows businesses to create "captive" insurance companies to protect against certain risks. Certain small insurance companies can choose to pay tax only on their investment income; their premiums are tax deductible; and underwriting profits are not subject to immediate tax. In abusive structures, promoters, accountants, or wealth planners persuade owners of closely held entities to participate in arrangements that lack many of the attributes of genuine insurance. In October 2020, the IRS issued News Release 2020-226 to notify taxpayers who participated in micro-captive insurance transactions to consult their independent tax advisors before the October 15 filing deadline. The IRS encouraged these taxpayers to consider exiting their micro-captive insurance transactions and to consider **not** claiming deductions on their tax returns associated with these transactions.[133]

Potentially Abusive Use of the U.S./Malta Tax Treaty. Some U.S. citizens and residents rely on an interpretation of a tax treaty between the United States and Malta to take a position that may allow them to contribute appreciated property to certain Maltese pension plans without tax consequence when the plan sells the assts and distributes proceeds to the U.S. taxpayer. The IRS is evaluating this issue and may challenge the associated tax treatment. Taxpayers and their tax practitioners should use Form 8833, *Treaty-Based Position Disclosure Under Section 6114 or 7701(b),* to disclose all positions on tax returns that are based on tax treaties.

---

129. IRS News Rel. 2021-144 (Jul. 1, 2021) and IRC §6700.

130. IRS News Rel. 2021-88 (Apr. 19, 2021).

131. IRC §§6111 and 6112.

132. IRS News Rel. 2021-141 (Jun. 30, 2021).

133. IRS News Rel. 2020-226 (Oct. 1, 2020).

Improper Claims of Business Credits. The credit for increasing research activities has very specific requirements.[134] Improper claims involve failure to participate in or substantiate qualified research activities and/or satisfy requirements related to qualified research expenses. Taxpayers and their tax practitioners must carefully review reports or studies to ensure they accurately reflect the taxpayer's activities and meet substantiation requirements.

> **Note.** See the 2021 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues, for information on business tax credits.

Improper Monetized Installment Sales.[135] Promoters advertise to taxpayers who seek to defer recognition of gain upon the sale of appreciated property. They organize an abusive shelter by selling the taxpayer monetized installment sales. Such a transaction occurs when an intermediary purchase appreciated property from a seller in exchange for an installment note. This note typically provides for payments of interest only, with principal being paid at the end of the term. In these arrangements, the seller receives the proceeds but improperly delays the gain recognition on the appreciated property until the final payment on the installment note, often scheduled for many years later.

Credits Misapplied to Account

***Christopher Hadsell v. U.S.,* U.S. District Court, Northern District of California, 20-cv-03512 (Feb. 3, 2021)**
IRC §§7433 and 6402

☞ Giving Credit Where Credit is Due

Facts. Christopher Hadsell requested that the IRS credit the overpayment on his 2016 individual income tax return to his 2017 tax liability. Instead, the IRS refunded a portion of the overpayment in July 2018. By the time he received the 2016 refund, Mr. Hadsell had already filed his 2017 return, taking credit for the overpayment he had assumed would be applied from 2016. The 2017 return showed that he owed $2,448 under the Patient Protection and Affordable Care Act (ACA).[136] Mr. Hadsell paid it, even though he questioned whether he owed it. However, the IRS had used a portion of Mr. Hadsell's 2016 overpayment to satisfy an overdue child support obligation.

Later in July 2018, an IRS notice informed Mr. Hadsell that he owed $2,448 in ACA associated tax for 2017. To preclude further collections actions by the IRS, Mr. Hadsell paid it a **second** time in August 2018. With his response to the IRS, he requested correction of the ACA tax matter and that the IRS credit the most recent payment to any 2018 tax liabilities. The IRS agreed that Mr. Hadsell did not owe the duplicate ACA amount but credited a portion of the extra payment to the amount due on his 2017 return. The IRS refunded the balance to Mr. Hadsell instead of applying it to 2018 tax liabilities as he requested. The following sequence of events summarizes Mr. Hadsell's interaction with the IRS.

- Mr. Hadsell files his 2016 tax return with an election to apply the overpayment to his 2017 tax liability.
- He files his 2017 tax return assuming that the IRS followed his election to apply the 2016 overpayment to 2017 tax liabilities, including $2,448 for ACA tax.
- May 2018: The IRS remits $7,152 from the 2016 overpayment to the California Department of Child Support Services to pay his overdue child support obligations.

134. IRC §41. This credit is also known as the R&D credit.

135. IRC §453.

136. *Patient Protection and Affordable Care Act,* PL 111-148; The court's opinion is not specific as to whether the ACA amount arose from the advance premium tax credit or for the individual responsibility payment.

- July 9, 2018: The IRS refunds the balance of Mr. Hadsell's 2016 overpayment rather than applying it to his 2017 tax liability.
- July 16, 2018: The IRS notifies him that he owes $2,448 in ACA tax for 2017, even though he paid it with the originally filed return.
- August 6, 2018: To preclude further collections action, Mr. Hadsell pays the ACA tax again, this time with a request to correct the ACA tax overpayment and to apply the extra payment to 2018 tax liabilities.
- The IRS subsequently determines that Mr. Hadsell does not owe the second payment of ACA tax but applies it first to the balance due for 2017 tax liabilities. The balance was refunded rather than applied to 2018 tax liabilities, as he requested.
- May 2019: The IRS remits $74 from the August 2018 payment to the California Department of Child Support Services.

Mr. Hadsell claimed that the only reason there was a balance due on his 2017 return was that the IRS failed to apply the credit election from 2016, as he requested. His complaint before the court claims damages under IRC §7433. This section of the code provides for civil damages to taxpayers who face certain unauthorized collection actions. Mr. Hadsell also based his case on the Federal Tort Claims Act (FTCA).[137]

The United States moved to dismiss Mr. Hadsell's complaint, arguing that the court lacked subject matter jurisdiction. It further stated that he failed to satisfy one of the requirements for an FTCA action, namely that he exhaust all administrative remedies to his claim.

Issue. The issue in this case is whether Mr. Hadsell is entitled to damages from the IRS for not applying his income tax overpayments as he specified.

Analysis. Mr. Hadsell claimed that the IRS had no authority to apply the overpayment in any manner other than how he directed it and therefore has a cause against the United States under IRC §7433. The United States argued that IRC §6402 confers the responsibility to offset amounts due to another liability.[138] In Mr. Hadsell's case, the other liability included child support obligations.[139] To strengthen its argument, the United States cited a subsequent provision that no court has jurisdiction even to hear an action seeking to restrain a reduction of a refund under §6402(c).[140] However, the IRS is required to inform the taxpayer why it disallows a refund or credit.[141]

Mr. Hadsell did not question the IRS's right to apply the funds as it did. But he did question the timing of its application. Because he received information about the application of his 2016 overpayment after filing his 2017 tax return, he prepared the 2017 return assuming the IRS had accepted his election to apply the 2016 overpayment to his 2017 tax liability. The court's opinion cited another case indicating that such an election "is irrevocable and binding upon both the taxpayer and the Internal Revenue Service."[142]

Holding. The court denied without prejudice the United States' motion to dismiss Mr. Hadsell's claim for lack of subject matter jurisdiction. This decision enables Mr. Hadsell to proceed with his claim. However, it granted the motion to dismiss based on the FTCA. Thus, the court dismissed Mr. Hadsell's claim on this point.

137. 28 USC §§1346(b) and 2671-80.

138. IRC §6402(a) and Treas. Reg. §301.6402-5(a).

139. IRC §6402(c).

140. IRC §6402(g).

141. IRC §6402(l).

142. *Martin Marietta Corp. v. U.S.,* 572 F.2d 839, 842 (Fed.Cl. 1978).

Practitioner Planning Tip

Reviewing client's account transcripts provides tax practitioners with an early warning regarding unexpected misapplications of prior year overpayments and estimated tax payments.

Passport Revocation

***Robert A. McNeil v. U.S.,* Civil action no. 20-329-JBD; U.S. District Court for the District of Columbia (Mar. 18, 2021)**

IRC §7345

☞ Taxpayer Does Not Get Passport by Tilting at District Court's Windmills

Facts. To learn why the U.S. Department of State (State Department) rejected his passport application, Robert McNeil filed a Freedom of Information Act (FOIA) request seeking explanatory documentation. He found out that the IRS certified to the State Department that he had "seriously delinquent tax debt." The State Department can deny passports to persons owing substantial tax debt under the criterion established in IRC §7345(b)(1) by the Fixing America's Transportation Act.[143] However, the State Department could not provide Mr. McNeil with a copy of the IRS's certification. IRC §7345(d) requires the IRS to notify the allegedly delinquent taxpayer contemporaneously with the IRS's certification to the State Department. Mr. McNeil claimed that he never received this notification.

Mr. McNeil filed a complaint against the State Department for "violat[ing] FOIA by failing and/or refusing to employ search methods reasonably likely to lead to the discovery"[144] of the IRS's certification. Both Mr. McNeil and the State Department entered motions and cross-motions for summary judgment in the summer of 2020. He subsequently filed another FOIA request, this time with the IRS, to determine why the IRS had not notified him of its certification to the State Department. The IRS released records in response to the FOIA request showing that it had sent notices to him in Tucson, Arizona. Mr. McNeil stated that he had never lived at the address in the notice.

Because Mr. McNeil represented himself before the court, the judge had difficulty determining the relief that Mr. McNeil sought. He initially sought resolution on four issues.

1. An order requiring the IRS to inform the State Department that its certification to Mr. McNeil's tax debt being "seriously delinquent" was in error,
2. Removal of his name and other personal information from the list of Americans with "seriously delinquent tax debt,"
3. Classification of the tax debt for years 2000 to 2018 as uncollectible, and
4. The "return of ALL monies unlawfully confiscated from [him] during the years 2000 thru 2018… plus interest."[145]

In subsequent testimony, Mr. McNeil conceded that the court could not resolve several of these issues. He limited the injunctive relief sought from the court to a finding that the certification was erroneous.

---

143. *Fixing America's Transportation Act,* PL 114-94.

144. *McNeil v. U.S.*, Civil action no. 20-329-JDB (D.D.C. Mar. 18, 2021).

145. Ibid.

Issue. The issue in this case is whether the court could compel the IRS to notify the State Department that its certification of Mr. McNeil's tax debt as seriously delinquent tax debt was in error.

Analysis. The court accepted Mr. McNeil's statement that he never received the IRS's notices. When he found out that the IRS had incorrectly addressed its notifications to him, Mr. McNeil added the IRS as a defendant in an amended complaint. He wanted to initiate a judicial review of the IRS's certification under §7345(e). Because the amended complaint focused on the judicial review issue, rather than the FOIA matter, the district court granted the State Department's motion for summary judgment in the original controversy. The court interpreted his amended claim to challenge the IRS on the issue of whether his tax debt was seriously delinquent only and that Mr. McNeil dropped his contention that he owed no tax debt at all.

However, §7345(e) only grants the court the authority to order the IRS to notify the State Department that its prior certification of serious tax delinquency was incorrect. The court found that it cannot use §7345 to compel the State Department to issue a passport to Mr. McNeil. The court decided that it had no authority to order the IRS to strike his name and other information from the list of persons with seriously delinquent tax debt.

Mr. McNeil argued that the IRS invalidated the certification to the State Department by never notifying him about the certification. But the absence of notification does not constitute grounds for finding the certification erroneous, the court found. The judge reasoned that the requirement for the notification being contemporaneous implies that notification is not a prerequisite for certification. Hence, the court sustained the validity of the certification.

With this logic, the court interpreted Mr. McNeil's complaint to be an attempt to overturn the IRS's computation of his tax debt. The court viewed this as an attempt to expand the limited waiver of sovereign immunity under §7345(e) into a way to challenge the legitimacy of tax debts and even the way the IRS monitors and keeps records of tax debts. The court noted that Mr. McNeil had brought multiple actions in courts to challenge the Anti-Injunction Act.[146] The court offered the following observation in footnote 6 to the McNeil decision.

> *"[Mr.] McNeil is undoubtedly familiar with the Anti-Injunction Act because, in the past five years, courts in this district have on multiple occasions-including just this past January-cited it when dismissing cases that he brought or joined in he which he challenged IRS procedures for the assessment of taxes against non-filers."*

It appears that Mr. McNeil has contested on multiple occasions the IRS's authority to collect taxes from him, obviously attracting the court's attention for his persistence. The court's opinion in one case accused Mr. McNeil of "tilting at windmills" in his continuing attempts to prevent the IRS from collecting unpaid taxes.[147] Mr. McNeil lost each time.

Holding. The court granted the IRS's motion to dismiss and declined to compel the IRS to notify the State Department that its certification was in error.

146. IRC §7421(a).

147. *Ellis v. Jackson*, 319 F.Supp.3d 23 (D.D.C. 2018); *McNeil v. Comm'r,* 179 F.Supp.3d 1 (D.D.C. 2016).

IRS PROCEDURES — PENALTIES

FBAR Penalties

U.S. v. Alexandru Bittner, **Civil Action No. 4:19-cv-415, U.S. District Court for the Eastern District of Texas, Sherman Division (Jun. 29, 2020)**
31 USC §5314 and 31 USC §5321(a)(5)

☞ Nonwillful Penalty Applies Per FBAR Form Not Per Foreign Account

Facts. Alexandru Bittner, a dual Romanian/U.S. citizen, lived in Romania from 1990 to 2011. As a successful businessman, he held personal bank accounts and interests in a variety of corporations that owned foreign bank accounts. While living in Romania, he was not aware of his requirement to file U.S. income tax returns and report his foreign income. He was also not aware of his obligation to file report of foreign bank and financial account (FBAR).

Mr. Bittner failed to timely file FBARs for the tax years 2007 to 2011. Upon his return to the United States in 2011, he discovered that he should have filed tax returns, and he immediately engaged a CPA to file them. The CPA informed Mr. Bittner he also needed to file FBARs, and he filed them as well.

The IRS determined his delinquency was not willful. However, instead of imposing the penalty for a non-willful violation of $10,000 per form for a total of $50,000, it assessed a penalty of $2.72 million based on the number of accounts Mr. Bittner held over those five years.

Various courts found that nonwillful FBAR violations were limited to a penalty of $10,000 per form. In a motion for summary judgment, the IRS appealed the district court decision, arguing the penalty should be based on the number of accounts held rather than number of FBAR forms filed.

Issue. The issue in this case is whether the nonwillful penalty for not timely filing FBARs is per FBAR form or per foreign account owned by taxpayer.

Analysis. The Bank Secrecy Act (BSA) and associated regulations require individuals to report foreign bank accounts on a single FBAR form.[148] Applicable FBAR rules require U.S. citizens and residents who have a financial interest in, or signature authority over, one or more foreign bank accounts with an aggregate balance exceeding $10,000 at any time during the year to file an annual FBAR form. Specific information for each account is required when the individual holds fewer than 25 accounts. If the account holder has 25 or more accounts, they must simply state the number of accounts with no further information required.[149]

Prior to 2004, the only penalty for failure to timely file an FBAR was for willful failure, and the penalty was the greater of $25,000 or half the amount held in the account, but not more than $100,000.[150] Before 2004, a penalty for a nonwillful failure to file did not exist. After 2004, Congress modified the penalties with the enactment of the American Jobs Creation Act, increasing the penalty for willful failure to file. It also added a penalty for nonwillful failure to file, which according to the law,[151] is not to exceed $10,000 per form.[152]

---

148. 31 CFR §1010.350(a) and 31 CFR §103.24.

149. 31 CFR §1010.350(g)(1).

150. 31 USC §5321(a)(5).

151. *American Jobs Creation Act,* PL 108-357.

152. 31 CFR §5321(a)(5)(B)(i).

The FBAR form instructions provide a single form to be filed, and the $10,000 threshold for filing is an aggregate value of all accounts over which the individual has a financial interest or signature authority.[153] An individual is considered to have a financial interest if they own at least 50% of a corporation's stock regardless of whether they hold signature authority over the account.[154] Mr. Bittner held interests in multiple companies that satisfied this criterion.

In reviewing related decisions, the court, which is in the fifth federal circuit, took exception with the decision rendered in a case heard in the ninth circuit, specifically *U.S. v. Jane Boyd*.[155] Referring to this case, the judge hearing the *Bittner* case wrote that the court in deciding *Boyd* did not justify its opinion that "the Government has advanced the more reasonable explanation." Given that a decision in the ninth circuit is not binding on the *Bittner* case because it is in another federal circuit, the judge hearing the *Bittner* case followed the plain language of the BSA from which the penalties for nonwillful violations of the FBAR filing requirement originate.[156] The United States Court of Appeals for the ninth circuit overturned the *Boyd* decision in March 2021, citing the language of the BSA that authorizes only one penalty for filing a late, but accurate, FBAR, regardless of the number of accounts.[157]

Holding. The court granted Mr. Bittner's motion for partial summary judgment, effectively agreeing with his argument that the law imposes a penalty on a per-form basis, not a per-account basis.

Note. The court's decision means that the penalty cannot exceed $10,000 per form. The district court found the IRS's request for a broad summary judgment inappropriate, stating, "The government misconstrues evidence, derives unfavorable factual conclusions and inferences from its misinterpretation of evidence, and ignores facts put forth by Mr. Bittner for which it has no contrary evidence."

Although the district court found in Mr. Bittner's favor by deciding that the penalty is imposed on a per-form basis, it granted the government's motion for partial summary judgment for the narrow purpose of finding that Mr. Bittner's nonwillful FBAR violations were **not** due to a reasonable cause.

Since the court's decision in June 2020, both the IRS and Mr. Bittner have filed response and reply briefs. The IRS continues to argue that the earlier portions of the BSA require reporting on a per-account basis.[158] Mr. Bittner argues that the appeals court should reverse the district court's finding that Mr. Bittner did not have reasonable cause in his FBAR violations. The case is pending before the United States Court of Appeals for the Fifth Circuit.

See the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Foreign Asset Disclosure, for more information on FBAR reporting requirements. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

---

153. *Report of Foreign Bank and Financial Accounts (FBAR)*. Sep. 23, 2020. IRS. [www.irs.gov/businesses/small-businesses-self-employed/report-of-foreign-bank-and-financial-accounts-fbar]; *BSA Electronic Filing Requirements For Foreign Bank and Financial Accounts (FinCEN Form 114)*. Jan. 2017. [www.fincen.gov/sites/default/files/shared/FBAR%20Line%20Item%20Filing%20Instructions.pdf] Accessed on Jul. 12, 2021.

154. 31 CFR §§1010.350(a) and 1010.306(c).

155. *U.S. v. Jane Boyd,* No. 2:18-cv-0080030MWF-JEM (C.D. Cal. Apr. 23, 2019).

156. 31 USC §§5321(a)(5)(A) and (B)(i).

157. *U.S. v. Jane Boyd,* 991 F.3d 1077 (9th Cir. 2021).

158. 31 USC §5314.

FBAR Penalties

***U.S. v. Kenneth G. Kronowitz,* No. 19-cv-62648; U.S. District Court, Southern District of Florida, (Jan. 8, 2021)**
31 USC §5314 and 31 USC §§5321(a)(5)(C) and (D)

☞ FBAR Law Ignorance is Not Bliss and It Is Costly

Facts. Kenneth Kronowitz is a CPA and professional tax preparer. During the span of his almost 60-year career, he typically prepared 30-40 tax returns per year. Throughout his career, he participated in continuing education courses to maintain his credentials. He took courses pertaining to tax shelters, foreign taxation, offshore trusts, and asset protection/estate planning. He does not recall ever learning about the Report of Foreign Bank and Financial Accounts (FBAR) in any of these courses. He began winding down his practice in 2008 because of poor health. In 2019 and 2020, he prepared 10-15 federal income tax returns. His tax practice usually included preparation of personal returns and S corporation returns.

In the 1970s, Mr. Kronowitz began investing in properties in different countries. After learning about offshore protection of assets, Mr. Kronowitz established two bank accounts in the Cayman Islands because he was concerned about protecting his assets from lawsuits pertaining to potentially fraudulent activities.

In 1999, Mr. Kronowitz was listed as the beneficial owner of an entity based in Liechtenstein, although he claimed that he never remembered being part of the entity. However, his signature appears on documents associated with this entity.

In 2005, Mr. Kronowitz opened an account at a Swiss bank and was listed as the beneficial owner from 2005 to 2009. In 2009, the funds were transferred to a different Swiss bank account.

By 2008, his various investments generated significant gains. To protect these gains, Mr. Kronowitz created a trust. He instructed institutions to transfer funds to one of his Cayman Island accounts. A yellow legal pad was used to document gains from his investments on his trust tax returns.

In 2010, Mr. Kronowitz directed all investments to be liquidated and the funds transferred to his Cayman Island bank account.

Mr. Kronowitz prepared his own tax returns in 2005 to 2010, the years in question. He did not disclose his foreign financial accounts on Form 1040, Schedule B, *Interest and Ordinary Dividends,* for any of these returns. In 2008 to 2010, he prepared returns for his trust and marked "no" in response to the question "at any time during the calendar year did the estate or trust have an interest in or a signature or other authority over a bank, securities, or other financial account in a foreign country." On the 2008 trust return, he disclosed a $370,700 gain from investments in Brazil, Panama, and Israel. On the 2009 trust return, he disclosed a $281,725 gain from investments in the Cayman Islands and Brazil. On the 2010 trust return, he disclosed a $296,218 gain from investments in foreign countries. Other than writing names of certain investments, he did not otherwise disclose his interest in any foreign accounts or assets.

Mr. Kronowitz admitted he did not timely file FBAR forms for tax years 2005 to 2010. He testified that he had not heard of FBAR filing requirements and was unaware that he was the beneficiary of the Swiss bank accounts. He believed that he fulfilled his tax obligations by reporting the investment gains on his trust return. Since being made aware of his omissions, he admitted he made a mistake.

Upon examination in 2017, the IRS assessed FBAR penalties for willful violations. As of October 2019, no payment was made and the total, including interest and assessed penalty fees, was over $753,000.

Issue. The issue in this case is whether Mr. Kronowitz is liable for **willful** FBAR penalties.

Analysis. The Bank Secrecy Act (BSA) directs the Treasury Secretary to create regulations that require information reporting about relationships and transactions with foreign financial agencies.[159] The regulations require "each U.S. person having a financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country to file an FBAR."[160] The FBAR is required when a "foreign financial account exceeds $10,000 at any time during the previous calendar year."[161] The authority to assess and collect civil penalties for FBAR noncompliance rests with the IRS.[162] Assessed penalties may be either willful or nonwillful.[163]

For an FBAR penalty to be considered "willful," **all** the following elements are required.[164]

- The person must be a U.S. citizen.
- The person must have, or had an interest in, or authority over a foreign financial account.
- The foreign financial account had a balance greater than $10,000 at some point during the reporting period.
- The person must have willfully failed to disclose the account and file an FBAR.

Although **willfulness** is not defined in statutes and regulation, various courts determined what constitutes willfulness.[165] "When imposing a civil penalty for an FBAR violation, willfulness based on recklessness is established if the defendant (1) clearly ought to have known that (2) there was a grave risk that an accurate FBAR was not being filed and if (3) he was in a position to find out for certain very easily." [166]

The court notes that Mr. Kronowitz does not dispute his obligation to file FBARs for tax years 2005 to 2010 and that he did not file them. The court determined he recklessly failed to report his interests in foreign accounts. This was determined as follows for Mr. Kronowitz.

- He was a professional tax return preparer.
- He testified that he prepared many Schedules B over his career and did not read the instructions for Schedule B.
- He affirmatively answered "no" to questions regarding his interests in foreign accounts on his personal and trust returns.
- He incorrectly assumed that reporting gains on his trust return was sufficient to satisfy his tax obligations.
- He opened accounts in the Cayman Islands to keep assets out of the reach of potential creditors.
- Once learning of significant gains in foreign assets, he directed entities to transfer funds to accounts in the Cayman Islands.

The court determined that Mr. Kronowitz ought to have known that there was grave risk that he was failing to comply with FBAR requirements. He also was able to easily learn about the reporting requirements that applied to his foreign assets.

Holding. The court found his FBAR violations for tax years 2006 to 2010 were willful.

> **Note.** See the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Foreign Asset Disclosure, for more information on FBAR reporting requirements. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

159. 31 USC §§5311, *et seq.*
160. 31 CFR §1010.350(a).
161. 31 CFR §1010.306(c).
162. 68 Fed. Reg. 26489 (May 16, 2003).
163. 31 USC §5321(a)(5).
164. 31 USC §5314 and 31 CFR §1010.350(a).
165. *Safeco Ins. Co. of Am. v. Burr,* 551 US 47, 57 (2007); *U.S. v. Rum,* F.3d, 2021 WL 1589153 (11th Cir. Apr. 23, 2021).
166. *U.S. v. Horowitz,* F.3d, 80, 89 (4th Cir. 2020).

Trust Fund Penalties

***James Preimesberger v. U.S.,* No. 20-40597, 1:19-CV-1441-AWI-SAB; U.S. District Court, Eastern District of California (Aug. 5, 2020)**

IRC §6672

☞ Responsible Person Caught Between a Rock and a Hard Place

Facts. James Preimesberger, a nursing home administrator in California, ran five nursing homes owned by Meridian Health Services Holdings, Inc. Mr. Preimesberger owned less than 10% of Meridian stock. Beginning in 2010 through 2015, the nursing homes experienced serious cashflow problems due to delayed payment from Medicare and Medi-Cal (Medicaid for California). Eventually, the nursing homes could not meet all their operational expenses. Mr. Preimesberger initially secured a line of credit to bridge the cashflow gap, but over time the lender would not authorize enough funds to cover payment of withholding tax obligations.

Unlike other businesses, nursing homes cannot cease operations when they can no longer pay employee wages and withholding taxes. Under state and federal laws, nursing home closure requires a lengthy and detailed process. In the interim, nursing homes must remain open and maintain existing standards of care for all residents. Failure to follow these laws is punishable through civil and criminal penalties.

Mr. Preimesberger had to first apply funds to expenses necessary to maintain the standard of care for each resident. This meant paying for rent, utility bills, and employee wages. This prevented paying withholding tax obligations. He met the requirements to be considered the responsible person for paying withholding taxes, potentially subjecting him to IRC §6672 trust fund penalties.

In response to the funding crisis, Mr. Preimesberger negotiated the sale of the nursing homes to Providence Health Group (Providence) in the summer of 2014. Providence agreed to close the sale no later than November 2014 and agreed to satisfy each nursing home's outstanding withholding tax liability. Unfortunately, the sale did not close until March 2015 and Providence did not satisfy the withholding tax liabilities as specified in the contract.

The IRS assessed Mr. Preimesberger with §6672 trust fund penalties for each of the nursing homes' unpaid withholding tax liabilities for the applicable tax periods. Mr. Preimesberger made payments to the IRS toward the penalties totaling $6,601. He based his petition to the court to recover these payments on the following three points.

1. He did not willfully fail to pay payroll withholding taxes because numerous state and federal laws required the continuing operation of the nursing home facilities, and he did not have funds available to pay the withholding taxes.
2. The federal government itself contributed to the situation by not making Medicare and Medicaid payments to the nursing homes (equitable estoppel).
3. The principal of setoff or offset should be invoked, in which the debt owed by the United States should be offset against the trust fund taxes owed to the United States.

Issue. The issue in this case is whether the IRS properly assessed a trust fund penalty in light of the legal requirements to keep the nursing homes operational and providing services to individuals dependent on Medicare and Medi-Cal.

Analysis. Mr. Preimesberger attempted to secure loans to cover wage payments to employees and the associated withholding tax obligations. The lender, however, only made funds available to cover wages, not the associated withheld taxes. The various government requirements also require that a standard of care be maintained for the nursing home residents. When these two requirements are considered, the funds available to Mr. Preimesberger were effectively encumbered in that he did not have flexibility in how they were to be spent.

He also argued that the federal government contributed to the problem by not paying amounts due to the nursing homes by Medicare; this is the "equitable estoppel" argument. However, his initial complaint did not use either the term "estoppel" or "equitable estoppel," causing the court to take issue with the equitable estoppel argument raised. Further, his complaint would have had to prove either "affirmative misrepresentation" or an affirmative concealment.

Finally, the court noted that the liability for **penalties** on withholding taxes was personal to Mr. Preimesberger as the responsible person, not to Meridian. Because the Medicare amounts were due to Meridian, there was no right of setoff on which Mr. Preimesberger could rely.

Holding. On August 5, 2020, the court denied the IRS's motion to dismiss Mr. Preimesberger's complaint but only with regard to willful nonpayment of withholding taxes. He is able to pursue his complaint to recover a trust fund penalty paid based on the absence of willfulness in nonpayment of trust fund taxes. However, the court sustained the IRS's arguments regarding equitable estoppel and setoff, dismissing Mr. Preimesberger's arguments on those points.

> **Note.** Although this is a rare victory for a taxpayer on trust fund penalties, it is a very narrow one.

PARTNERSHIPS

Cancellation of Debt

***Michael Hohl et al. v. Comm'r,* TC Memo 2021-5 (Jan. 13, 2021)**
IRC §§704 and 752

☞ **Partners Echoed Debt Income**

Facts. In 2009, Michael Hohl, Braden Blake, James Bowles, and Eduardo Rodriguez formed Echo Mobile Marketing Solutions, LLC (Echo). Echo provided text message advertising.

The partners entered into an operating agreement, which stated that Mr. Hohl, Mr. Blake, and Mr. Bowles each contributed no money and owned a 30% interest in Echo, while Mr. Rodriguez contributed $265,000 in exchange for a 10% interest. The agreement provided that the partners' capital accounts would be established and maintained in accordance with Treas. Reg. §1.704-1(b)(2)(iv). In addition, the agreement provided a formula for allocating the profits and losses of the business to the partners based on their capital accounts. If the partnership needed capital, all partners were to be notified in writing to give them an equal opportunity to contribute.

Echo filed a 2009 Form 1065, *U.S. Return of Partnership Income.* It reported a net loss of $45,335. The deductions mostly consisted of guaranteed payments to the partners. Echo's balance sheet showed a liability of $345,366, which was described on an attachment as "note payable — member." This amount matches the total that Mr. Rodriguez provided to the partnership in 2009, including the $265,000 listed in the operating agreement as a capital contribution.

The 2009 Schedules K-1, *Partner's Share of Income, Deductions, Credits, etc.,* allocated the loss and the liability 30% each to Mr. Hohl, Mr. Blake, and Mr. Bowles, and 10% to Mr. Rodriguez.

Echo's 2010 Form 1065 reported a loss of $379,739, which was largely from Echo's deduction of $297,120 of guaranteed payments to its partners. Echo's balance sheet showed total notes payable of $564,322, which reflected an additional $218,956 infusion of funds from Mr. Rodriguez.

The 2010 Schedules K-1 allocated the loss in the same percentages as 2009. However, Echo allocated the entire amount of the liability to Mr. Rodriguez.

Echo's 2011 Form 1065 reported a loss of $168,960, of which $155,922 arose from guaranteed payments. The balance sheet liability representing Mr. Rodriguez's loans increased by $75,000 to a total of $639,322.

The 2011 Schedules K-1 allocated the loss in the same percentages as 2009 and 2010. Echo allocated 100% of the recourse liability to Mr. Rodriguez, as it had done for 2010.

Echo's 2012 Form 1065 was marked as a final return. It reported no income, deductions, losses, or guaranteed payments. Its liability increased by $14,184 to a total of $653,506. No partner reported an allocation of any share of that liability. The partnership did not report any income from the discharge of indebtedness and did not allocate to any partner any share of such income.

The IRS examined the Hohls' and the Blakes' 2012 returns and subsequently issued deficiency notices to them. Each notice increased the taxpayer's income on Schedule E, *Supplemental Income and Loss,* by $178,210, the amount of the partner's negative capital account balances. This amount represented the partner's share of cancellation of indebtedness income.

Issue. The issue in this case is whether Mr. Hohl and Mr. Blake had income from the discharge of Echo's indebtedness in 2012.

Analysis. The court observed that it must decide whether Mr. Rodriguez provided loans or capital contributions to Echo before deciding whether the partnership recognized cancellation of indebtedness income. Mr. Hohl and Mr. Blake argued that Mr. Rodriguez provided capital contributions, citing the operating agreement, the lack of any written agreements between Echo and Mr. Rodriguez, and the lack of any repayment or collection activity. The IRS argued that the deposits were loans, because they were treated as such on all Echo's returns except the final return.

The court did not find Mr. Hohl's and Mr. Blake's argument credible that Mr. Rodriguez made capital contributions. The partners clearly intended to treat, and did treat, the amounts received from Mr. Rodriguez as loans. Echo reported the amounts as liabilities each year. The Schedules K-1 reported the amounts as liabilities every year and allocated a share of such liabilities to each partner in 2009.

In addition, if Mr. Rodriguez had made a capital contribution in 2009 of $265,000, the operating agreement would have required Mr. Rodriguez to include that contribution in his initial capital account balance. He did not do so. The agreement also required that the partnership notify all partners in writing if it needed additional capital contributions, but there is no evidence of any such notices.

Based on the available evidence, the court found that the amounts Echo received from Mr. Rodriguez were loans.

Discharge of a debt occurs when it becomes clear the debt will never be repaid. It became certain in 2012 that Echo would not repay the debt it owed to Mr. Rodriguez because the partnership ceased operations in that year. Therefore, Echo had income from the discharge of debt for 2012.

Echo's operating agreement allocates distributive shares of income to its partners according to a formula based on the partners' capital accounts. If such allocations have substantial economic effect, the income from the discharge of the debt is allocated in the manner provided by the operating agreement. To have **substantial economic effect,** allocations must be consistent with the underlying economic arrangement of the partners. The court noted that the allocations made by Echo's operating agreement do not have substantial economic effect. In all other respects, the partners shared items 30% to each partner except Mr. Rodriguez, who received 10%. This does not follow the formula provided by the operating agreement, which says allocations are based on capital accounts.

Because the allocations provided by the operating agreement do not have substantial economic effect, the partners' distributive shares of income are calculated based on their interests in the partnership. During all four years of Echo's operations, it allocated losses according to the 30-30-30-10 ownership interests. The 2012 allocation should follow the same allocation of losses as for every other year the partnership existed. Accordingly, Mr. Hohl and Mr. Blake should have each included a 30% share of the income from the discharge of debt in their 2012 income.

Holding. The court held that Mr. Hohl and Mr. Blake received income from the discharge of Echo's indebtedness in 2012.

§754 Election Basis Adjustment
Ltr. Rul. 202042011 (Jul. 23, 2020)
IRC §754

☞ §754 Election Granted Up to 120 Days After Request

Facts. Taxpayer, a limited liability company (LLC), is taxed as a partnership for federal tax purposes. It wishes to make an election under IRC §754. The taxpayer timely filed a partnership return for the year in question and inadvertently failed to make a valid §754 election with the return. In requesting relief, the taxpayer believes it acted responsibly and in good faith, and its request will not prejudice the government.[167]

Analysis. Under §754, a partnership can elect to adjust the basis of partnership property in the case of a distribution of property in the manner of IRC §734, and in the case of a transfer of a partnership interest in the manner of IRC §743. The election applies to all distributions of partnership property, and to all transfers of partnership interests during the taxable year and all subsequent taxable years.[168]

The election must be made with a written statement filed with the partnership return for the taxable year that the distribution or transfer occurred.[169] For the election to be valid, the return must be timely filed.[170]

The IRS may grant a reasonable extension of time to make the election if the taxpayer provides evidence of acting reasonably and in good faith, and the relief will not prejudice the interests of the government.[171]

Holding. The IRS granted the taxpayer an extension of 120 days from the date of the letter to make a §754 election for its taxable year. The election should be made in writing and filed with the applicable service center associated with the taxpayer's return. A copy of the letter ruling should be attached to the statement filed.

The ruling is contingent on the taxpayer adjusting basis of partnership properties to reflect any §734(b) or §743(b) adjustments that would have been made if the §754 election had been timely made. The adjustments must also reflect additional depreciation allowable if the election had been timely made regardless of whether the statute of limitations on assessment or claim for refund has expired.

The partners must adjust the basis of their interests to reflect what the basis would be if the §754 election had been timely made regardless of whether the statute of limitations on assessment or claim for refund has expired. Specifically, the partners must reduce the basis of their interest by the amount of any additional allowable depreciation as if the election had been timely made.

> **Note.** Treas. Reg. §301.9100-2(a)(2)(vi) provides for an automatic 12-month extension for making the §754 election. If the return that is the subject of this letter ruling had complied with the requirements in this regulation, no letter ruling would have been required. A 12-month extension would have enabled the late election that the tax practitioner had overlooked on the originally filed return.

167. Treas. Reg. §301.9100-3(a).
168. IRC §754.
169. Ibid. See also Treas. Reg. §1.754-1(b).
170. Treas. Reg. §1.754-1(b)(1).
171. Treas. Reg. §300.9110-3(a).

PASSIVE ACTIVITIES

4

Passive Activities

***Gurpreet Padda and Pamela Kane v. Comm'r,* TC Memo 2020-154 (Nov. 16, 2020)**
IRC §§301, 316, and 469

☞ Court Reaches Diagnosis of Material Participation in Six Activities

Facts. Gurpreet Padda and Pamela Kane are a married couple who lived in Missouri during the relevant period of this case. They are both medical doctors. Dr. Padda practices medicine through his wholly owned C corporation, Interventional Center, which is a pain-management clinic. Dr. Padda is the president of the corporation and is primarily responsible for its operations.

Dr. Padda worked three 8-hour workdays and two 4-hour workdays at Interventional Center during a typical week. His normal work week was Monday through Friday at the clinic, but he occasionally worked a few hours on a Saturday.

Ami Grimes was hired as the chief financial officer of Interventional Center in 2006. In addition, Dr. Padda partnered with Ms. Grimes to open five restaurants in the St. Louis area between 2008 and 2012. Each restaurant was operated by a separate partnership. Dr. Padda and Ms. Grimes each owned a 50% interest in each of the restaurant partnerships.

Dr. Padda also owned a 90% interest in a brewery operated by Ninkasi, LLC. Ms. Grimes owned 5% and Dr. Padda's brother owned the remaining 5%.

In 2010, Dr. Padda used Interventional Center's corporate credit card to pay for $81,828 of travel, meals, and event tickets.

Dr. Padda and Dr. Kane reported the following losses from the restaurants and brewery as **nonpassive losses** on their tax returns. They netted the losses against their nonpassive income.

Company	2010	2011	2012
CA Group (restaurant and bar)	$ 375,390	$186,298	$ 49,418
Cafe Ventana (restaurant)	323,776	210,848	323,763
Hendricks BBQ (restaurant and bar)	25,344	72,192	211,470
Ninkasi (brewery)	149,657	38,692	214,019
Agave STL (restaurant and bar)	278,739	47,677	100,665
Diatina (restaurant and bar)	n/a	317,394	329,002
Total	$1,152,906	$873,101	$1,228,337

Dr. Padda and Dr. Kane filed an election to group activities on their 2010 return. They elected to group Ninkasi with 3914 Lindell, LLC, and Café Ventana with 3919 West Pine, LLC. Both 3914 Lindell and 3919 West Pine are entities that are not at issue in this case.

The IRS issued a notice of deficiency to Dr. Padda and Dr. Kane regarding their 2010, 2011, and 2012 tax returns. The notice assessed deficiencies for all three years because the IRS determined the restaurants and the brewery were passive activities for all three years and that Dr. Padda and Dr. Kane failed to report constructive dividend income for 2010.

Issues. There were several issues presented in this case, but this discussion focuses on the following.

- Whether Dr. Padda met the material participation requirements for the five restaurants and a brewery
- Whether Dr. Padda received a constructive dividend in 2010 because his medical corporation paid his personal expenses

Analysis. Taxpayers materially participate in an activity if they are involved in the activity's operations on a regular, continuous, and substantial basis.[172] Material participation can be established by any reasonable means, including appointment books, calendars, and narrative summaries.[173]

Temp. Treas. Reg. §1.469-5T(a) sets forth seven tests by which a taxpayer can establish material participation in an activity. The fourth test is met if the "activity is a significant participation activity… for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours." A **significant participation activity** is a trade or business activity in which the individual participates for more than 100 hours during the year.[174]

Dr. Padda gave detailed testimony to establish the hours he spent on the restaurant and brewery activities. In addition to his testimony, 12 individuals testified about Dr. Padda's involvement in every aspect of the restaurants and the brewery. On the basis of the testimony of Dr. Padda and the other witnesses, the court found that the nontravel time he spent on each activity exceeded 100 hours for each year at issue.

The court noted that because there are six activities involved (five restaurants and one brewery), this means Dr. Padda devoted over 600 hours of nontravel time per year to the activities. The court concluded this despite the skepticism expressed by the IRS that Dr. Padda could have spent significant time on the activities given the demands of his work at his highly successful medical practice. The court noted that the record in this case is consistent with its conclusions about Dr. Padda's hours.

In addition to Dr. Padda's nontravel time, the evidence included spreadsheets and credible testimony that showed Dr. Padda spent at least 25 hours of travel time each year on each of the five restaurants and the brewery.

For each of the six activities, Dr. Padda's hours exceeded the 100-hour threshold required for a significant participation activity. His aggregate participation in all significant participation activities during the year exceeded the 500-hour threshold of Temp. Treas. Reg. §1.469-5T(a)(4). Accordingly, the five restaurants and the brewery were not passive activities for Dr. Padda.

Under IRC §301(c)(1), a distribution that is a dividend is includable in the shareholder's income. A dividend is any distribution a corporation makes to shareholders out of earnings and profits.[175] To determine whether a shareholder received a **constructive dividend,** the court looks to whether the distribution primarily benefited the shareholder rather than the corporation.[176]

Dr. Padda used Interventional Center's corporate credit card during 2010 to pay $81,828 of travel, dining, and entertainment expenses for himself, his family, and his friends. Interventional Center reported these amounts on its corporate tax return. Dr. Padda and Dr. Kane argued that the IRS examined Interventional Center's corporate return for 2010 and allowed a business expense deduction for all or some of the $81,828. Dr. Padda and Dr. Kane contend that the IRS is legally barred from determining that the $81,828 is a constructive dividend when the same payments were allowed as a deduction for Interventional Center. However, the court noted the settlement agreement reached at the conclusion of the audit was between the IRS and Interventional Center. The agreement has no effect on the determination of Dr. Padda's and Dr. Kane's income. Interventional Center was a party to the settlement agreement, and Dr. Padda and Dr. Kane were not.

Whether the expenses in question constitute a constructive dividend depends on whether Interventional Center primarily benefited from paying the expenses. If it did, the payment is not a constructive dividend. If it did not, then the payment is a constructive dividend.

---

172. IRC §469(h)(1).

173. Temp. Treas. Reg. §1.469-5T(f)(4).

174. Temp. Treas. Reg. §1.469-5T(c).

175. IRC §316(a).

176. *Hood v. Comm'r,* 115 TC 172, 179-180 (2000).

Dr. Padda testified there was a business purpose for the expenses of $81,828. However, his testimony suggested the business purpose of the expenses was related to the five restaurants and the brewery, rather than Interventional Center. The court noted that the evidence shows that the $81,828 did not benefit Interventional Center and, therefore, Dr. Padda and Dr. Kane received a $81,828 constructive dividend in 2010.

Holding. The court held that Dr. Padda met the material participation requirements for the five restaurants and the brewery. The court also held that the taxpayers received a constructive dividend of $81,828 in 2010.

RETIREMENT

IRA Distribution
Ltr. Rul. 202033008 (May 18, 2020)
IRC §408

☞ Time Machine Cannot Fix 60-Day Rollover Period Violation

Facts. Taxpayer and his spouse worked with a real estate agent to sell their home and purchase a new one. The real estate agent advised Taxpayer to use funds from his individual retirement arrangement (IRA) to make a cash offer for the purchase of a new home. The real estate agent told Taxpayer that he could repay the amount to his IRA after he sold his current residence without mentioning the 60-day window for rollovers.

Using the financial institution's form, Taxpayer advised the IRA custodian about their intent to use the distribution to purchase a new residence. Language on the form affirmed that the individual requesting the distribution and signing the form understands that a 10% penalty and ordinary income taxes may apply to the distribution and that the individual agrees to obtain tax and legal advice to make this determination. The form did not mention the 60-day rollover period but did refer to a rollover option.

Taxpayer withdrew an amount from his IRA to purchase a new residence. After the 60-day rollover period expired, Taxpayer sold his prior residence and attempted to repay a portion of the original distribution back into his IRA ("Amount 2"). The custodian declined to accept the rollover, however, informing Taxpayer that it could not accept the repayment after the 60-day rollover period had expired.

Taxpayer requests a waiver of the 60-day rollover period under IRC §408(d)(3) for the distribution of Amount 2 from the IRA.

Issue. This letter ruling concerns the ability to apply §408(d)(3) to extend the rollover period when Taxpayer temporarily uses proceeds from an IRA withdrawal to purchase a residence.

Analysis. IRC §408(d)(3) provides that an amount distributed from an IRA is not included in the distributee's gross income if the entire amount received is paid into an IRA or eligible retirement plan for the benefit of such individual not later than the 60th day after the day on which the individual receives the distribution.

Rev. Proc. 2003-16 provides that the IRS will issue a ruling to waive the 60-day rollover requirement in cases where the failure to waive the requirement would be "against equity or good conscience,"[177] including events beyond the reasonable control of the taxpayer. Under this revenue procedure, the relevant facts and circumstances that bear on a waiver might include the following.

- Errors made by a financial institution
- Inability to complete a rollover because of death, disability, hospitalization, incarceration, restrictions imposed by a foreign county, or postal error
- Use of the amount distributed
- Time since the distribution occurred

Instead of referring to this set of potential facts and circumstances, Taxpayer attributed the failure to make a timely rollover to not being informed of the 60-day rollover period by either the real estate agent or the custodian. However, the Code does not require an IRA custodian to inform individuals of the rollover rules. The failure of the real estate agent and the custodian to inform Taxpayer of the requirement do not constitute a financial institution error.

Although the use of the funds distributed is a factor in Rev. Proc. 2003-16, the documented intent of Congress was to facilitate portability among eligible plans. Using a distribution as a short-term loan is inconsistent with Congressional intent.

Holding. The IRS declined to waive the 60-day rollover requirement for the distribution of Amount 2 from the IRA.

401(k) Early Distribution

***Mary Walsh Woll et vir v. Comm'r,* No. 7024-20, TC 2021 (Apr. 29, 2021)**

IRC §§72(t) and 6662

☞ Early Distribution Subject to 10% Additional Tax and §6662 Penalty

Facts. Mary Woll, a licensed attorney, lived with her husband in Minnesota. In 2017, Ms. Woll was laid off by her employer. This resulted in a termination of her 401(k) plan, which had a balance of $86,000. She withdrew the $86,000 from the plan before she reached age 55. Of the withdrawal, $39,000 was used to repay a loan in accordance with its terms. Some of the money was used to pay medical expenses ($9,462), including health insurance premiums. She paid student loans with some of the money, used some to pay their mortgage and house bills, and paid other bills that came due.

Ms. Woll prepared the couple's 2017 tax return and reported the distribution. She did not report the 10% additional tax for early withdrawal of the funds. The Form 1099-R, *Distributions From Pension, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts, etc.,* received from the plan trustee showed the distribution code in box 7 as the number 2, which indicated the taxpayer was under age 59½ and that a specific exception to the additional tax applied. Ms. Woll met none of the exceptions to avoid the 10% additional tax as identified in the Form 1099-R instructions. She did not complete or attach Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts,* that would show she qualified for an exception to the additional tax. Ms. Wolls relied on computer software to prepare her tax return.

The IRS added the 10% additional tax and assessed a substantial understatement of tax penalty to the Wolls' return.

---

177. Rev. Proc. 2003-16, 2003-4 IRB 359.

The Wolls stated in their petition that the "family was in hardship due to unemployment. [The] remaining funds [were] used for household necessities and educational expenses owing (loans), mortgage, medical, dental insurance premiums and other."

Issues. The issues in this case are the following.

- Whether the Wolls were liable for the 10% additional tax on an early withdrawal from Ms. Woll's retirement plan
- Whether the Wolls were subject to a substantial understatement of tax penalty

Analysis. IRC §72(t) imposes an additional tax of 10% on early withdrawals unless an exception applies. Ms. Woll identified no exception that could apply to her situation. Although she used code 2 from box 7 of the 2017 Form 1099-R that the plan trustee of her 401(k) provided, she did not include Form 5329, as required by the instructions for Form 1040, line 59. Form 5329, line 2, provided her with the opportunity to indicate which exception to the 10% additional tax applied in her situation. She did not file this form, as required by the instructions for Form 1040. Although the assessment of penalties normally requires an IRS supervisor's approval, an assessment of the §72(t) additional tax does not require this approval because it is a tax, not a penalty. This was confirmed in a January 2021 case.[178]

> **Note.** See the 2020 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Retirement Plan Distributions, for a description of exceptions to the 10% additional tax on early withdrawals from retirement plans.

The IRC §6662 penalty for substantial understatement of tax applies when the understatement is the greater of $5,000 or 10% of the tax required to be shown on the tax return. When the IRS computer system identifies the understatement, it automatically includes a notice of deficiency and adds a penalty to the return, as was the case with the Wolls' return.

Although it is clearly a penalty and not a tax, the court concluded that no supervisory approval was needed. The court's conclusion was based on IRC §6751(b)(2)(B), which provides an exception to the requirement for supervisory approval if the penalty can be "automatically calculated through electronic means." The penalty for substantial understatement met this requirement, the court decided, and this shifted the responsibility to Ms. Woll to prove that she and Mr. Woll had reasonable cause for not reporting the additional tax.

The court decided that she did not meet this criterion, either taking note of her education and intelligence. Although she relied on her computer to prepare the tax return, she did not show the court how the computer program had misled her. Thus, her attempt to shift responsibility for the tax understatement to the incorrect distribution code on her Form 1099-R and to her tax software was not reasonable, and the court sustained the substantial understatement penalty.

Holding. The court holds the 10% additional tax and the substantial understatement of tax penalty apply.

> **Caution.** The logic that the court applied to Ms. Woll regarding reliance on the accuracy of the distribution code on her Form 1099-R and on her tax software could be easily applied to tax practitioners. Consequently, tax practitioners working with a Form 1099-R having distribution code 2 in box 7 should document the steps taken to confirm that the exception claimed applies to their client's situation.

[178] *Grajales v. Comm'r,* 156 TC 3 (2021).