2022 Workbook

Chapter 3: Rulings and Cases

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Note. Corrections were made to this workbook through January of 2023. No subsequent modifications were made. For terms used in this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

Note. This chapter contains selected cases, revenue rulings, revenue procedures, Treasury regulations, announcements, and letter rulings issued during the past year, through approximately July 31, 2022. Each appears as a condensed version and should not be relied on as a substitute for the full document. A full citation appears for each item. This chapter is not intended to be a comprehensive coverage of all tax law changes. Rather, it reports the rulings and cases most likely to be of interest to tax professionals.

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SUBSTANTIAL AUTHORITY

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

EVALUATION OF AUTHORITIES

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

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

NATURE OF ANALYSIS

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

The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. Private rulings, technical advice memoranda (TAM), general counsel memoranda (GCM), 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).

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- Revenue rulings
- Revenue procedures
- Tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties
- Federal court cases interpreting such statutes
- Congressional intent, as reflected in committee reports
- Joint explanatory statements of managers included in congressional conference committee reports, and floor statements made prior to enactment by one of a bill's managers
- General explanations of tax legislation prepared by the Joint Committee on Taxation
- Letter rulings and TAM issued after October 31, 1976
- Actions on decisions and GCM 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 (IRB)

Additional information on some of the preceding items follows.

IRC. 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 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)).

GCM. GCM detail the legal reasoning behind the issuance of a revenue ruling.

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

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

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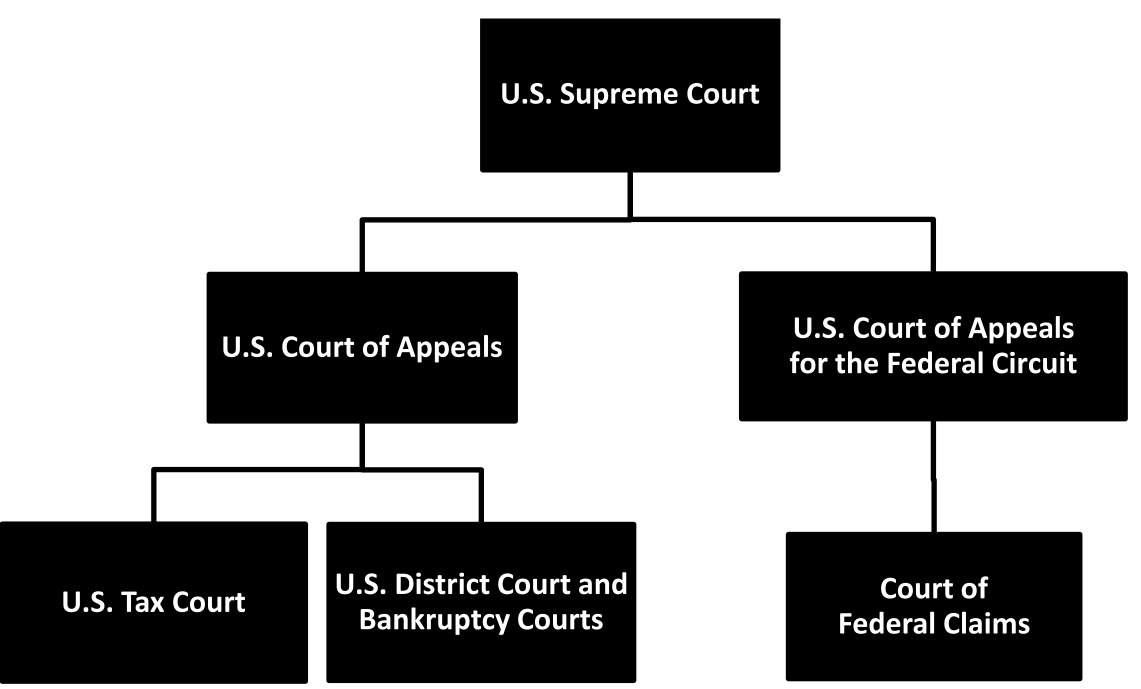
JUDICIAL SYSTEM FOR TAX DISPUTES

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



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

CASE COMMENCEMENT

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

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

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

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THE U.S. TAX COURT

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

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

As of August 2022, the Tax Court is composed of 19 judges (two currently vacant), 10 senior judges, and five 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. The jurisdiction of the Tax Court includes the authority to hear tax disputes concerning the following.

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

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

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

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

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

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

Who May Practice in the U.S. Tax Court

A taxpayer may represent themselves in Tax Court, or they may be represented by a practitioner admitted to the bar of the Tax Court. Generally, an attorney who is a member of the bar of any state (or the District of Columbia) may be admitted to the bar of the U.S. Tax Court. The attorney must complete the required application for admission to practice (which must be notarized), attach the required proof of good standing in their state bar, and pay the required $50 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]

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

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Tax Court Decisions

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

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

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

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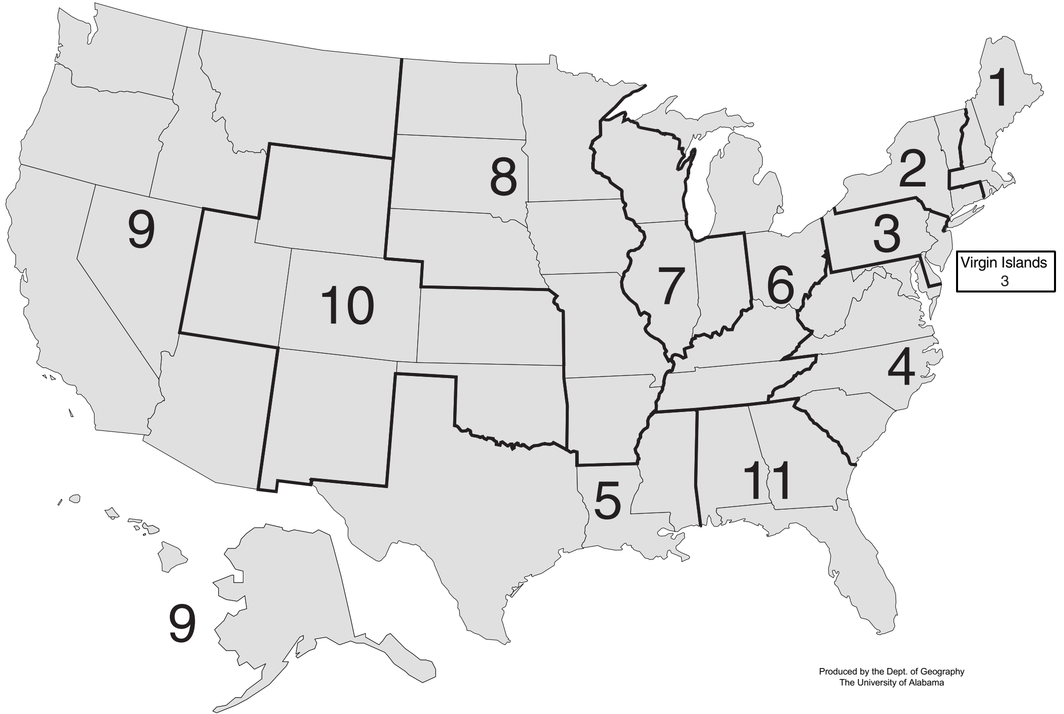
The 13 judicial circuits of the United States are constituted as follows.

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



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IRS ACTIONS ON DECISION [5]

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

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

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

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

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

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

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

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

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BUSINESS EXPENSES

Tuition Deduction

***Sherwin Community Painters, Inc. v. Comm'r*, TC Memo 2022-19 (Mar. 9, 2022)**
IRC §§162 and 262

☞ No Tuition Deduction for Amounts Paid For Daughter's Boyfriend

Facts. Sherwin Community Painters, Inc. is a commercial painting contractor with stock owned by Swanette Ward. Mrs. Ward and her husband Robert both work for Sherwin.

In addition to deductions for office equipment, supplies, gas, entertainment, and promotional materials, Sherwin claimed a deduction for tuition at Northwestern University for a coding class for Lucas Kocemba, the boyfriend of the Wards' daughter. Mr. Kocemba had no coding experience before taking the course and previously worked in the construction industry. He used what he learned in the course to update Sherwin's website (for which he was not paid).

Among other items, the IRS denied the expense for Mr. Kocemba's tuition on the Sherwin return.

Issues. The issue in this case is whether Sherwin is entitled to deduct the tuition expense for Mr. Kocumba.

Analysis. Ordinary and necessary expenses are deductible to the extent that they are spent to carry on a trade or business. Under IRC §262, deductions are not permitted for personal, family, or living expenses. Although Sherwin claimed that Mr. Kocemba received the tuition in exchange for the web services he later provided, the Tax Court believed other factors indicate that the expense was personal in nature and was merely paid through Sherwin. Mr. Kocemba provided free services to Sherwin, was not an employee of Sherwin, and Sherwin paid the tuition without any expectation of a return. The only real link, the Tax Court noted, that Mr. Kocemba had with the company was that he was dating the owner's daughter. Mr. Kocemba had no legal obligation to provide the web services to Sherwin.

Holding. The court held that Sherwin was not entitled to deduct the tuition expense for Mr. Kocemba's coding classes because it was not an ordinary and necessary business expense but rather a personal expense by the company.

Accounting Method

***Continuing Life Communities Thousand Oaks, LLC et al. v. Comm'r*, TC Memo 2022-31 (Apr. 6, 2022)**
IRC §§446 and 451

☞ Continuing Care Facility Properly Accounted for Deferred Fees

Facts. Continuing Life Communities Thousand Oaks, LLC provides housing and continuing care to seniors as their needs change. Its principal place of business is in Thousand Oaks, California.

At first, a resident may only need food and housing, but Continuing Life promises to provide for the residents' needs all the way through skilled nursing care. For their services, Continuing Life charges three types of fees.

1. **The contribution amount** — In the years at issue in this case, the entry fee to move into the community ranged from $245,000 to $570,000, depending on the resident's choice of floor plan. The resident pays the contribution amount to a master trust, and they then become a grantor of the trust.
2. **The deferred fee** — If a new resident changes their mind or dies during the initial 90-day cancellation period, they are not liable for any portion of the deferred fee. After that initial period, the deferred fee accrues at 5% of the contribution amount per year, with a maximum fee of 25% after four years. This deferred fee comes out of the contribution amount held by the master trust only when a resident dies or moves out and a new resident buys the unit. Continuing Life is not entitled to any portion of the deferred fee if it expels a resident.
3. **Monthly fees** — The monthly fees are for other expenses, such as utilities. The amount of the monthly fee is determined by the floor plan that the resident chose and is reevaluated every year.

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Continuing Life followed generally accepted accounting principles (GAAP) in accounting for the fees that it received. Continuing Life did not recognize any income when a resident paid the contribution amount. Instead, Continuing Life amortized and recognized as income a portion of the deferred fees by using the straight-line method and the actuarially determined estimated life expectancy of each resident. Then, when the resident moved out or died, Continuing Life recognized the balance of the unamortized deferred fee as income.

For the 2008 through 2010 tax years (the years at issue), Continuing Life reported substantial losses on its Forms 1065, *U.S. Return of Partnership Income.* Its losses and deferred fee income shown on its tax returns for those years follows.

Tax Year	Loss	Deferred Fee Income Recognized
2008	$9,200,000	$ 34,188
2009	3,150,000	420,187
2010	850,000	421,727

The IRS audited Continuing Life and issued a notice of final partnership administrative adjustment for the 2008 through 2010 tax years. The notice proposed increasing Continuing Life's taxes due by almost $20 million.

Issue. The issue is whether Continuing Life's accounting for the deferred fees is allowed under the Code.

Analysis. A taxpayer generally is allowed to follow its own method of accounting.[6] An exception exists for accounting methods **that do not clearly reflect income or that a taxpayer does not follow consistently.**[7] Continuing Life asserts that it treats deferred fees in accordance with GAAP standards for the continuing care industry.

The court noted that Continuing Life has consistently applied GAAP. Under the American Institute of Certified Public Accountants Audit and Accounting Guide Statement of Position 90-8, Continuing Life's treatment of deferred fees followed one of two main views on the proper accounting method for such fees. The court inferred from this that Position 90-8 states common industry practice.

Continuing Life's method of accounting recognizes income each year that a resident lives in the community, during the period when Continuing Life incurs expenses on the resident's behalf. The IRS contends that, under the residence agreement, Continuing Life earns a portion of the deferred fee each year as the accrual percentage increases from 5% to 25% and this amount should be recognized as income. The court observed that Continuing Life incurs expenses because of its continuing care services over the entire lifespan of each resident but is only entitled to the deferred fees when residents die or move out of the community. The court concluded that the method Continuing Life follows matches income and expenses better than the accelerated treatment proposed by the IRS.

The court noted that the facts in this case show there is no reason to conclude that Continuing Life's accounting for deferred fees violates the rule that an accounting method consistent with GAAP should "clearly reflect income" under IRC §446.

6. See IRC §446(a).

7. IRC §446(b).

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Treas. Reg. §1.451-1(a) states that "income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." The key question is when a taxpayer has a fixed right to compensation. Treas. Reg. §1.451-1(a) further states, "if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made." This is the **all-events test** that is the key to accrual accounting. The court noted that under this test, it looks for when the taxpayer has a fixed right to income, rather than whether it has received payment. **The right to income is fixed when the taxpayer has an unconditional right to receive payment.**[8]

The IRS does not dispute that Continuing Life receives the deferred fee when the trustee closes out a resident's account after the resident's death or departure. However, the parties disagree about when Continuing Life has performed the services that entitle it to receive the deferred fee. Continuing Life asserts that it is obligated to provide care for the resident's life and that its performance ends only when a resident dies or moves out. Continuing Life therefore reasons that its right to the deferred fee also becomes fixed and definite only when the resident dies or moves out. The IRS argues that it is the passage of time and not the provision of services that entitles Continuing Life to the deferred fee.

The court disagreed with the IRS's position. The terms of the residence agreement state that the resident pays the deferred fee only when they die or move out.

As an alternative argument, the IRS contended that Continuing Life's obligation to provide services is not a **condition precedent;** instead, the IRS contends it is only a **condition subsequent.** The court explained that a condition precedent is one that must be met before the taxpayer has a fixed right to income. A condition subsequent terminates an existing right to income but does not impede the accrual of income.[9] A condition subsequent can be ignored for purposes of the all-events test.

Continuing Life contends that its obligation to provide lifetime care is the condition precedent to receiving a deferred fee. It notes that the residence agreement as well as California state law require Continuing Life to provide lifetime care for a resident to have a fixed right to the deferred fee.

The IRS argues that Continuing Life has a fixed right to the deferred fee in exchange for providing service for only the first four years. Under this argument, the "essential service" is that first four years of care. The IRS further contends that it is very unlikely Continuing Care will not uphold its part of the agreement after four years. It is also very unlikely that it will not be paid.

The court noted that §446 and the underlying regulation mean that Continuing Life's adherence to GAAP clearly reflected income with respect to the deferred fees. Under IRC §451 and its underlying regulation, Continuing Life's duty to provide lifetime care means that it does not have to recognize income when the amount of the deferred fees is fixed by the passage of time.

Holding. The court found that Continuing Life used a method of accounting for deferred fees that clearly reflected income and therefore granted its motion for summary judgment.

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8. *Hallmark Cards, Inc. & Subs. v. Comm'r,* 90 TC 26, 32 (1988).

9. *Keith v. Comm'r,* 115 TC 605, 617 (2000); *Charles Schwab Corp. v. Comm'r,* 107 TC 282, 293 (1996), *aff'd* 161 F.3d 1231 (9th Cir. 1988); *Harkins v. Comm'r,* TC Memo 2001-100 (Apr. 26, 2001).

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Business Expenses

***Gamble and Jamison v. Comm'r*, TC Summm. Op. 2021-22 (Jul. 28, 2021)**

IRC §§162, 212(1), and 6662(a)

☞ Doctor's Business Deductions Require a Business

Facts. Dr. Tondalaya Gamble practiced medicine in Cook County, Illinois, specializing in gynecology and obstetrics. She incorporated Total Woman Wellness, Inc. (TWW) in 1999, intending to educate other doctors and the community with lectures and consultations. However, the business did not germinate. In 2013 and 2014, the years at issue, Dr. Gamble's own education was continuing in these subspecialties. Dr. Gamble worked at two large Chicago hospitals as an employee at the time.

During this time, Mr. Ronald Jamison, with whom Dr. Gamble filed joint tax returns, purchased lottery tickets but neglected to keep clear records. He constructed records after the fact that showed no winnings but approximately $40 of lottery ticket purchases each day during 2013.

The couple's tax professional prepared both their 2013 and 2014 Forms 1040, *U.S. Individual Income Tax Return,* and Forms 1120-S, *U.S. Income Tax Return for an S Corporation.* The returns reflected no income in 2013 and $680 of income in 2014. Each of the Forms 1120-S returns showed more than $20,000 of expenses, despite TWW's lack of business activity in 2013 and 2014.

The IRS disallowed TWW's losses and recharacterized the "gross receipts" as "other income." Additionally, the IRS determined that many of TWW's expenses were unreimbursed employee business expenses and disallowed many nondeductible personal expenses. The IRS also disallowed many of the gambling loss deductions and imposed penalties.

Practitioner Planning Tip

Practitioners should consider that merely setting up a corporate structure does not automatically entitle a taxpayer to business deductions when they are not operating a trade or business.

Issues. The issues in this case are the following.

- Whether Dr. Gamble is entitled to the business deductions claimed on Forms 1120-S
- If so entitled, whether Dr. Gamble should claim these business deductions on Form 1120-S for TWW or whether the associated deductions should be handled as unreimbursed employee expense deductions on Form 1040, Schedule A, *Itemized Deductions*
- Whether Mr. Jamison and Dr. Gamble are entitled to a larger gambling loss deduction than allowed by the IRS
- Whether Mr. Jamison and Dr. Gamble are liable for an accuracy-related penalty under IRC §6662(a) for either 2013 or 2014

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Analysis. IRC §162 permits deductions for ordinary and necessary expenses associated with the conduct of a lawful trade or business. Similarly, IRC §212(1) allows deductions for production or collection of income. However, the expenses deducted on Form 1120-S belonged on Dr. Gamble's Schedule A because they arose from her employment by the hospital, according to the IRS. Although some personal non-deductible expenses found their way onto Form 1120-S, many of these expenses were legitimate unreimbursed employee expenses. In some cases, the same expenses were used as deductions on both Form 1120-S and Schedule A.

The Tax Court considered whether TWW had actually commenced business. Based on Dr. Gamble's testimony, the court found that TWW had not yet cleared the hurdle of being a going concern, capable of performing the activities for which Dr. Gamble had formed it. The court further concluded that TWW did not conduct its business with regularity or continuity. It agreed with the IRS that most of the expenses belonged on Dr. Gamble's Schedule A because they were unreimbursed employee business expenses.

Mr. Jamison did not appear in Tax Court, nor did he otherwise participate in the proceedings. Based on lack of prosecution, the court disallowed the deduction for lottery ticket purchases in an amount greater than the IRS had already allowed.

Holding. The Tax Court held for the IRS that Dr. Gamble and Mr. Jamison could deduct some of her expenses on Schedule A as unreimbursed employee business expense deductions, but not as expenses of her business. The income on TWW's 2014 books should be reported on Dr. Gamble's Form 1040 as other income. Mr. Jamison's deductions for the purchases of lottery tickets were limited to the amount already accepted by the IRS.

The Tax Court found they relied on the same tax return preparer for many years to prepare their returns, including both Forms 1040 and 1120-S. It concluded that Dr. Gamble and Mr. Jamison acted in good faith and had reasonable cause for underpaying their tax for 2013 and 2014. Therefore, the court held that they were not liable for the §6662 accuracy-related penalty.

Business Income

***Ames Ray v. Comm'r,* U.S. Court of Appeals, Fifth Circuit; 13 F.4th 467 (Sep. 14, 2021)**
IRC §§162(a), 212, 6662(a)

☞ Just a Small Ray of Light in Avoiding Substantial Underpayment Penalty

Facts. Ames Ray divorced his wife, Christina Ray, in 1977, but they continued to live together on and off until 1992. Ms. Ray had a successful career in the New York City financial industry and developed mathematical models for commodities trading. Ms. Ray also wrote several books on risk management and options trading.

Ms. Ray owed her ex-husband money for various real estate they purchased together after their divorce. She later acquired his share with debt secured by the real estate. Notarized loan agreements documented the amount due and another loan agreement held Ms. Ray liable for purchases that she made with six of Mr. Ray's credit cards. In April 1993, Ms. Ray signed a judgment by confession in favor of Mr. Ray, admitting she owed him over $532,000. This amount included almost $100,000 in credit card debt. Mr. Ray did not enter this judgment into any court.

In early 1993, Ms. Ray proposed that Mr. Ray use a proprietary options and futures trading method that she had developed. She would manage his money, and he agreed to give her sole discretion of trading on his account. Ms. Ray agreed to liability for any losses that reduced the value of his account below $350,000. The value of the account declined to $1,285 when she stopped trading. Ms. Ray signed another letter acknowledging that she owed Mr. Ray another $384,388 for losses on Mr. Ray's account plus interest.

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Mr. Ray deducted the trading loss on his 1993 tax return using Schedule C, *Profit or Loss From Business*. The IRS disallowed the loss. After receiving the Tax Court's help to sort things out, in 1997 the IRS and Mr. Ray agreed to a stipulated decision[10] in which he was charged a deficiency of almost $89,000 but was still allowed to deduct $374,000 on Schedule C using the occupation, "Futures Trader."

The Rays met in court to litigate the matter, starting in 1998. Mr. Ray sued Ms. Ray numerous times and, when that was unsuccessful, he sued her attorneys. Several times he filed litigation alleging fraudulent conveyance of the real estate interest she had purchased from him. During this period, Mr. Ray incurred significant legal fees.

Mr. Ray reported his legal fees as negative income on his 2014 tax return. He did not file a Schedule C with it. Mr. Ray received an IRS notice of deficiency, informing him that it was disallowing the deduction for another year of legal expense he had attempted to deduct. The IRS also imposed a 20% accuracy-related penalty.

Mr. Ray appealed to the Tax Court on both points. He asserted that the legal fees were deductible under "IRC §162, §212, or as a capital loss." The court concluded that some of his legal expenses were deductible to the extent that they were associated with the trading agreement, but not the portion arising from Ms. Ray's indebtedness for the real estate or the credit cards. Invoking the *Cohan* rule[11], the Tax Court proceeded to use the ratio of damages to determine that Mr. Ray would be able to deduct 39.5% of his legal expenses under two of the cases, but that he was still liable for an accuracy-related penalty. Mr. Ray appealed to the U.S. Court of Appeals for the Fifth Circuit.

Issues. The issues in this case are the following.

- Whether the IRS Commissioner could litigate the matter of Mr. Ray's 2014 legal expenses considering the 1997 stipulated decision
- Whether the Tax Court clearly erred in finding Mr. Ray was **not** entitled to business expense loss deductions for legal expenses related to the futures trading losses
- Whether the Tax Court clearly erred in finding Mr. Ray was **not** entitled to a deduction for legal expenses arising from Ms. Ray's use of his credit card accounts
- Whether the reasonable cause and good faith defenses to the accuracy-related penalties on his 2014 tax return were available to Mr. Ray

Analysis. The appeals court denied Mr. Ray's contention that the IRS was "collaterally estopped" from litigating the legal fees related to the trading agreement losses because Mr. Ray did not raise the matter until he filed a post-trial brief. The IRS further argued that because the matter was stipulated in 1997, instead of decided by a court, it was able to raise the matter in subsequent court proceedings, regardless. Appeals courts generally work with the principle that they cannot address an argument unless a party has previously raised it in a trial court.[12] Furthermore, the Tax Court's rules of practice and procedure provide that an affirmative defense, such as collateral estoppel, must appear in a party's pleading; otherwise, the court considers it abandoned. The appeals court ruled in favor of the IRS on this point, allowing it to litigate the matter.

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10. A stipulated decision is one drafted and signed by the parties to the controversy. It is reviewed by the court in question. If the court finds it acceptable, the stipulated decision is entered instead of a decision by trial. See www.ustaxcourt.gov/petitioners_glossary.html #:~:text=to%20the%20public.-,Stipulated%20Decision,when%20a%20case%20is%20settled. Accessed on Nov. 30, 2021.

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

12. *U.S. v. McCall,* 235 F.3d 1211, 1216 (10th Cir. 2000). ("The general rule is that this court will not consider an issue on appeal that was not raised below.")

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The Tax Court found that Mr. Ray could deduct his legal expenses related to the futures trading losses under §212, but not under §162(a). The latter section imposed a burden on Mr. Ray to demonstrate that the expenses were associated with a business enterprise. The business enterprise requirement establishes a requirement for regularity and continuity in business operations. Deducting the fees under §162(a) would have provided Mr. Ray with a larger deduction and a smaller 2014 tax liability because treating the legal expense in this manner would have directly reduced business income. Instead, §212 treats the legal expenses as itemized deductions subject to a 2% of adjusted gross income (AGI) threshold. Signing a contract giving trading authority to another individual does not typically rise to the level of an ongoing trade or business. The appeals court decided this issue in favor of the IRS. The appeals court also decided that Mr. Ray could not deduct the legal expenses associated with the real estate or credit cards because it found that the Tax Court did not clearly err in finding that Mr. Ray did not have a profit motive in investing in the real estate. Instead, Mr. Ray acquired the properties for personal reasons and therefore could not contend that their debt was associated with a business or profit motive.

The IRS had assessed a §6662(a) accuracy-related penalty against Mr. Ray for underpaying his 2014 tax liability. In general, the appeals court determined that the Tax Court had not erred in finding that Mr. Ray was subject to the understatement penalty.

However, in one small aspect, the appeals court sided with Mr. Ray. It found that he had reasonably relied on the 1997 stipulated decision to determine that he could treat the legal expenses as deductible under §162(a). For this reason, the difference in the tax caused by deducting the legal expenses under §212 and §162(a) should not be subject to the significant underpayment penalty, according to the appeals court.

Holding. The appeals court found that the Tax Court had made no error in its decision, apart from deciding that Mr. Ray would **not** be subject to the underpayment penalty on the incremental tax associated with deducting legal expenses under §162(a) instead of §212. Thus, Mr. Ray received a small ray of light for his trouble in appealing the Tax Court's decision.

CORPORATIONS

Reasonable Compensation

Clary Hood, Inc. v. Comm'r, **TC Memo 2022-15 (Mar. 2, 2022)**
IRC §§162 and 6662

☞ IRS Challenges Reasonable Compensation

Facts. Clary Hood learned about the construction profession from his father, who operated a land grading business. When Mr. Hood graduated from high school in 1967, he joined his father's company to gain more experience in the land grading business.

In 1980, Mr. Hood founded Clary Hood, Inc. (a C corporation). He and his wife were the company's sole shareholders and members of the board of directors. Mr. Hood had decisional control for all of Clary Hood, Inc.'s operations from its beginning through 2015 and 2016, which are the years at issue in this case. The company performed land grading and excavation services for construction projects in South Carolina, usually as a subcontractor. The company started operating with only two employees and used equipment valued at approximately $60,000 but grew into a company with 150 employees and almost $70 million in revenue by the end of its 2016 tax year.

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During 2000 to 2010, the company grew slowly, and profits were less than $1 million in net income after taxes for most of those years. During the Great Recession, the company was in a precarious financial position and sustained operating losses for the three tax years ending May 31, 2009, to May 31, 2011. Many of the company's competitors terminated operations during this time, but Clary Hood, Inc. survived because of its reputation and the following important decisions in which Mr. Hood played an instrumental role.

1. Conserving cash outlays by maintaining a low debt profile and not declaring dividends
2. Temporarily reducing employee pay
3. Withholding Mr. Hood's salary, when necessary, to ensure funds were available to cover the company's payroll
4. Selling equipment valued at $800,000 to offset losses and supplement cash reserves

Clary Hood, Inc. also faced another threat in 2012, but this one was of its own making. The company shifted away from one of its largest and most consistent revenue sources, which was site grading work for Walmart shopping centers. The Walmart projects made up more than 20% of the company's annual revenue between 1999 and 2011. However, the Walmart projects were subject to significant job bidding and pricing pressures, and this led to weakened operating margins. The Walmart projects also constrained Clary Hood, Inc.'s resources, which reduced the company's ability to pursue other high-paying projects. Mr. Hood was convinced that the company needed to shift away from the Walmart projects. In the summer of 2011, without seeking input from any of the company's other executives, Mr. Hood notified the Walmart developer that Clary Hood, Inc. would not participate in any future Walmart projects. Many of the other Clary Hood, Inc. executives questioned whether the company would survive without this reliable source of revenue. However, the decision led to financial rewards for the company.

Clary Hood, Inc. finished up its existing work on Walmart projects in July 2011 and began its transition from retail-related work to the commercial and industrial market sectors. Through Mr. Hood's efforts, the company won a bid for a sizable project that became the largest and most profitable job in the company's history, bringing in over $30 million of revenue and a gross profit margin over 40%. Mr. Hood's efforts landed the company another large grading project that accounted for almost $9.5 million of revenue over the next few years, and a gross profit margin of 41%. Mr. Hood's efforts also secured one of the company's largest grading jobs that generated over $23 million in revenue and $5.4 million in gross profit for the company by the end of the 2016 tax year.

Even though the company experienced great financial success, **it never declared or paid a cash dividend** to its shareholders (Mr. and Mrs. Hood) at any time during the tax years ending May 31, 2000, to May 31, 2016 (review period).

There was no written employment agreement between Mr. Hood and Clary Hood, Inc. Instead, the company's board of directors, which consisted only of Mr. and Mrs. Hood, determined the amount of Mr. Hood's annual compensation, including bonuses. Mr. Hood received the following compensation amounts during the review period.

Year	Salary	Bonus	Total	Year	Salary	Bonus	Total
2000	130,000	122,000	252,000	2009	130,000	0	130,000
2001	130,000	107,000	237,000	2010	132,500	0	132,500
2002	130,813	0	130,813	2011	83,400	35,000	118,400
2003	127,337	0	127,337	2012	21,100	200,000	221,100
2004	130,000	0	130,000	2013	381,707	1,000,000	1,381,707
2005	130,000	1,000	131,000	2014	181,538	1,500,000	1,681,538
2006	131,000	242,000	373,000	2015	168,559	5,000,000	5,168,559
2007	130,000	221,685	351,685	2016	$196,500	$5,000,000	$5,196,500
2008	130,000	320,981	450,981				

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In the fall of 2014, Mr. Phillips, the company's controller, discussed Mr. Hood's compensation with the company's accounting firm, Elliott Davis, LLC. Mr. Phillips thought that Mr. Hood had been undercompensated in previous years, and he wanted advice on how to structure Mr. Hood's compensation going forward. Jeff Greenway, one of the audit partners at Elliott Davis, sent a summary of salary surveys to Mr. Phillips. Using this information, Mr. Phillips began preliminary computations to determine how much Mr. Hood had been undercompensated during the review period.

Mr. Phillips, Mr. Hood, Mr. Greenway, and Stacy Stokes, who was a tax partner at Elliott Davis, discussed Mr. Hood's compensation during a yearend business meeting in May 2015. They agreed that Mr. Hood was undercompensated during the review period for the services he had performed for the company and that he deserved a bonus of $5 million.

Mr. Phillips created an Excel spreadsheet to support the calculation of the $5 million bonus amount. The spreadsheet laid out a model with the company's income statements for each year of the review period through May 31, 2015, Mr. Hood's annual compensation for each of those years, and a series of items for each year, consisting of the following.

- A base salary starting with $200,000 for the May 31, 2000, tax year and increasing by 5% annually
- An annual bonus of 20% of profits before taxes
- An annual fee of $100,000 for bonding guaranties
- An annual debt guaranty fee equal to approximately 1% of the debt and capital leases personally guaranteed by Mr. Hood

The spreadsheet also used data from the salary surveys submitted by Mr. Greenway.

After the May 2015 meeting, Mr. Stokes gave Mr. Phillips additional research on reasonable executive compensation. After incorporating these inputs, the model calculated a proposed $5 million bonus for Mr. Hood.

At the board of directors' meeting in May 2015, the board approved $5 million as a bonus to Mr. Hood for the company's 2015 tax year. At the board of directors' meeting held in 2016, the board approved another $5 million bonus to Mr. Hood.

The IRS audited Clary Hood, Inc.'s federal income tax returns and issued a notice of deficiency for the 2015 and 2016 tax years. The notice stated that Mr. Hood's compensation for those years exceeded reasonable compensation under §162(a)(1) and disallowed portions of his compensation. The IRS allowed $517,964 as Mr. Hood's compensation for 2015 and $700,792 as compensation for 2016. The total deficiencies the IRS reported were $1.58 million and $1.61 million for the 2015 and 2016 tax years, respectively. The IRS also assessed §6662 accuracy-related penalties for substantial understatements of income tax of $316,240 and $322,662 for the 2015 and 2016 tax years, respectively.

Issues. The issues in this case are the following.

- The amount Clary Hood, Inc. can deduct as reasonable compensation paid to Mr. Hood for the 2015 and 2016 tax years
- Whether Clary Hood, Inc. is liable for accuracy-related penalties under §6662

Analysis. Under §162(a)(1), a corporation can deduct all ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. This includes a reasonable allowance for salaries or other compensation for services rendered.

An employer can deduct compensation paid to an employee in a year even though the employee performed the services in a prior year. The employer must demonstrate that the employee's compensation in the prior year was not sufficient and that the current year's compensation was to make up for that underpayment.[13]

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[13] *Estate of Wallace v. Comm'r,* 95 TC 525, 553-554 (1990), *aff'd* 965 F.2d 1038 (11th Cir. 1992).

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When an officer-shareholder controls a closely held corporation and sets their own compensation, a careful analysis must be undertaken to determine if the alleged compensation is in fact a nondeductible dividend.[14]

The U.S. Court of Appeals for the Fourth Circuit (where an appeal of this case would be held) requires that multiple factors be considered in determining reasonable compensation. These factors and the Tax Court's observations regarding Mr. Hood's situation follow.

- **Employee's qualifications** — Mr. Hood had over 50 years of relevant knowledge and experience. He had an excellent reputation in the market, and this allowed the company to compete for and win subcontracting jobs.
- **Nature, extent, and scope of the employee's work** — Mr. Hood was the company's key employee and driving force from its inception. His services were essential to the company's success. Besides managing and building up the business, soliciting and obtaining jobs, and supervising all work performed, he made the decision to cut ties with Walmart and transition to the commercial and industrial sectors, which led to the company's significant financial growth.
- **Size and complexities of the business** — During the review period, the company experienced exceptional growth in terms of employees and revenues. The number of employees grew from approximately 80 to 150, and annual revenue increased from $9 million in 2003 to more than $68 million by 2016. The company specialized in land grading and excavation, which involves performing services to exacting specifications. Through Mr. Hood's contributions, the company formed a niche in the specialty market by competing on a cost-effective basis and developing a strong reputation in the field.
- **Comparison of salaries paid with gross income and net income** — The company paid approximately 42% and 26% of pretax income to Mr. Hood as compensation in its 2015 and 2016 tax years, respectively. The court noted that these amounts do not necessarily show a pattern of disguised dividends, when taking into consideration that these amounts include compensation for prior years of service.
- **Prevailing general economic conditions** — The company's revenue increased from approximately $16 million to more than $68 million during the review period, which cannot be attributed solely to economic conditions. Two expert witnesses testified that the company's success was due to factors other than general economic conditions. Therefore, it is appropriate to recognize Mr. Hood's contributions to the company's success.
- **Comparison of salaries with distributions to stockholders** — A complete absence of dividends to shareholders during a profitable period justifies an inference that some of the purported compensation paid to shareholder-employees represents a distribution of profits. Clary Hood, Inc. was profitable during the review period but never declared a cash dividend. The company claimed that it needed to meet working capital needs during the Great Recession and maintain a competitive edge through strong balance sheets. However, these reasons do not address the fact that Mr. Hood deferred monetary recognition through a dividend for the entire 16-year review period. In addition, the company chose to not address those deferrals through a dividend but rather to reward Mr. Hood exclusively through a bonus after it had sufficient capital and cash in the years at issue.
- **Prevailing rates of compensation for comparable positions in comparable concerns** — To decide whether compensation paid to an employee is reasonable, the court compares it to compensation paid to persons holding comparable positions in similar companies. To make this assessment, the court heard the testimony of expert witnesses. The court is free to use its judgment as to whether to accept or reject expert testimony in whole or in part. The court found the testimony of one of the three expert witnesses most credible. That witness concluded that reasonable compensation for Mr. Hood when considering surety bond guaranties was $3.68 million and $1.36 million for the 2015 and 2016 tax years, respectively. Alternatively, when excluding compensation for the surety bond guaranties, the expert concluded reasonable compensation for Mr. Hood was $2.20 million and $1.31 million for the 2015 and 2016 tax years, respectively.

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[14] *Richlands Med. Ass'n v. Comm'r,* 953 F.2d 639, 1992 WL 14603 (4th Cir. 1992), *aff'g* TC Memo 1990-660; *Estate of Wallace v. Comm'r,* 95 TC 37 at 556 (Nov. 14, 1990).

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- **Salary policy of the taxpayer for all employees** — Courts have looked at salaries paid to other employees of a company in deciding whether compensation is reasonable. Clary Hood, Inc. had no structured system to determine nonshareholder employee compensation. Mr. Hood personally set the salary and bonus amounts for other employees and officers. His salary and bonus in the years at issue was almost 90% of the total amount of compensation the company paid to its officers despite the fact that certain nonshareholder officers in the company worked almost as many hours as Mr. Hood did and shared many of his responsibilities.

- **Amount paid to the particular employee in previous years** — When a large salary increase is an issue, it is sometimes useful to compare past and present duties and salary payments to determine whether the current payments are compensation for services performed in prior years that may be deductible in the current year. In the 2015 tax year, Mr. Hood's compensation increased over 300%, but there was no increase in his duties in that year. The corporate minutes state that this increase is because Mr. Hood was undercompensated in prior years. The court does not disagree that Mr. Hood was undercompensated in certain years, but this does not give the company a free hand to deduct his bonus amount for backpay. The court noted that the company did not sufficiently show how each of the 2015 and 2016 compensation amounts was proportionate in value to the purported past services performed by Mr. Hood.

- **Personal guaranties of debts or other corporate obligations** — The company justified Mr. Hood's higher compensation for the years at issue in part because of his debt guaranties and surety bond guaranties during the review period. The record shows that owners of construction companies customarily guarantee debts and bonds, and compensation for such guaranties is appropriate. In addition, the IRS's expert witness found that the compensation the company paid to Mr. Hood for the years at issue related to the guaranties was reasonable.

After considering all the factors, the court concluded that the company did not adequately demonstrate how the amounts paid to Mr. Hood for the 2015 and 2016 tax years were both reasonable and paid solely as compensation for his services to the company during the review period. Certain factors favor the company but not all factors are given equal weight.

In determining the appropriate amount of compensation, the court found the testimony of one of the expert witnesses very helpful. The expert considered the multifactor approach, included compensation for the surety bond guaranties, and offered a helpful comparison of Mr. Hood's salary in relation to industry standards. Accordingly, the court held that the evidence supports reasonable compensation of $3.68 million for the 2015 tax year and $1.36 million for the 2016 tax year.

Under §6662, a 20% penalty applies to any portion of an underpayment of tax that is attributable to a substantial understatement of tax. For a C corporation, a substantial understatement of tax is an understatement that exceeds the lesser of 10% of the tax required to be shown on the return for the tax year (or, if greater, $10,000) or $10 million. Clary Hood, Inc.'s understatements for the years at issue qualify as substantial because each exceeds 10% of the tax required to be shown on the return.

The substantial understatement penalty does not apply for any portion of an underpayment for which the taxpayer acted with reasonable cause and in good faith.[15] A taxpayer may meet this standard if they relied on the advice of a competent professional with sufficient expertise, the taxpayer provided accurate information to the adviser, and the taxpayer relied in good faith on the adviser's judgment. The court noted that the company relied in good faith for its 2015 tax year because it sought the advice of its external CPAs who had sufficient expertise, they provided the CPAs with necessary and accurate information, and they relied on the advisers' judgment.

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15. IRC §6664(c)(1).

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The company claimed it also reasonably relied on professional advice in determining the amount of Mr. Hood's compensation for the 2016 tax year. The external CPA firm prepared an updated compensation due spreadsheet for the 2016 amount but there is no evidence that the company's board of directors considered this worksheet when deciding how much compensation to give Mr. Hood. The CPAs testified that they performed an analysis for 2016 that was similar to the one performed for 2015, but there is no evidence to support a finding that advice was actually rendered in connection with the 2016 amount. This advice is even more critical because the record does not show that the company still believed Mr. Hood was entitled to additional backpay compensation for the review period. The board minutes did not state why it felt the 2015 amount was insufficient in this regard.

Holding. The court held that reasonable compensation for Mr. Hood was $3.68 million for the 2015 tax year and $1.36 million for the 2016 tax year. The court further held that Clary Hood, Inc. is liable for a substantial understatement penalty for the 2016 tax year but not for the 2015 tax year.

CREDITS

Premium Tax Credit

***Ronald and Joan Knox v Comm'r*, TC Memo 2021-126 (Nov. 9, 2021)**
IRC §§36B and 86

☞ Lump Sum Social Security Benefits Trigger Premium Tax Credit Repayment

Facts. Ronald and Joan Knox lived in Indiana and reported nearly $60,000 of social security benefits in 2015, including lump sum benefits for prior years. During 2015, they also received $7,332 in advance premium tax credit (APTC) payments. In total, the Knoxes had modified adjusted gross income (MAGI) for 2015 of $72,444.

The IRS issued a notice of deficiency that the full $7,332 had to be paid back and that an accuracy-related penalty was due in the amount of $1,466.

Issue. The issue in this case is whether the Knoxes must include their social security benefits in their MAGI to calculate their premium tax credit (PTC).

Analysis. The PTC was established to help low-income individuals offset the cost of obtaining health insurance through a health insurance exchange. The credit is calculated based on an individual's family size and household income. Household income is generally based on the MAGI of the taxpayer and family members. A taxpayer with household income between 100% and 400% of the federal poverty line is generally eligible for the PTC based on the number of members in the household. During 2015, the federal poverty line for a family of two residing in Indiana was $15,730. The Knoxes' MAGI of $72,444 exceeded 400% of the applicable federal poverty line ($62,920).

Per IRC §86(d)(1), social security benefits include any amount the taxpayer receives by reason of entitlement to either a monthly social security benefit or a tier 1 railroad retirement benefit. The Tax Court, citing its prior decision in *Johnson v. Comm'r,*[16] decided that, for purposes of determining PTC eligibility, the Knoxes' social security benefits were required to be included in their MAGI, including their lump-sum amounts relating to prior years that they excluded from gross income. By including such amounts in MAGI, the Knoxes' MAGI exceeded 400% of the federal poverty level, thereby making them ineligible for the PTC.

16. *Johnson v. Comm'r,* 152 TC 121 (2019).

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Holding. The court held that the Knoxes must include their social security benefits in their MAGI. As a result, their MAGI exceeds the acceptable poverty level to be eligible for the PTC.

Caution. Although the taxability of lump sum social security benefits may be reduced by considering income in prior tax years, there is no such provision for calculating the repayment of APTC. Repayment of APTC is determined solely by MAGI in the year the benefits are received.

DEDUCTIONS

Hobby Losses

***William R. and Cathy M. Huff v. Comm'r*, TC Memo 2021-140 (Dec. 21, 2021)**
IRC §183

☞ Ugly Donkeys Get Beautiful Results in Tax Court

Facts. William Huff grew up in a tough New York City neighborhood but built a large fortune in investment management with a little education and a lot of hard work. Eventually, he owned an investment firm specializing in identifying underpriced assets. He developed research methods and skills enabling his firm to acquire valuable assets at low prices and later sell them at significant profits.

Mr. Huff and his wife wanted to supplement the income of their adult daughter through interests of her own, which centered on animal care, not investments. Because Mr. and Mrs. Huff had personally invested in some New Jersey farmland, researching the best use of that property was second nature to Mr. Huff. His research concluded that breeding and raising miniature donkeys would be profitable. Investors valued the small donkeys based on their height (under 30 inches), coloration, and conformance to equine standards. The research also led Mr. and Mrs. Huff to study the optimal types of hay for raising miniature donkeys, the optimal soil, and other things they could do to optimize the value of the donkeys.

The Huffs operated the farm through Ecotone Farm, LLC, which was taxed as a partnership. They improved the farm intending to increase the likelihood that the donkey-raising business would be profitable. However, they did not prepare a written business plan, even as they invested considerable effort in maintaining records that could establish the parentage of the miniature donkeys. The Huffs kept good financial records.

Unfortunately, Mr. Huff found that raising miniature donkeys was a horse of a different color, figuratively speaking, relative to his investment activities. His research skills that brought value to investments did not result in profitable miniature donkey sales. The Ecotone partnership tax returns produced losses for the Huffs. Their tax returns left the IRS chomping at the bit to pursue statutory notices of deficiency, which alleged amounts due of $56,637 for 2013 and 2014, plus accuracy-related penalties.

The notices arose from an IRS audit finding consistent losses and indications that Mr. Huff started the donkey-raising venture without a profit motive. As evidence supporting a profit motive was lacking, the IRS cited the absence of a written business plan and the Huffs' failure to use the financial records to correct Ecotone's unprofitability.

Issue. The issue in this case is whether the Huffs engaged in the miniature donkey-raising business with a profit motive, enabling them to deduct losses.

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Analysis. Because the IRS's notices of deficiency are presumed correct, Mr. and Mrs. Huff have the burden of proving that they engaged in Ecotone Farm, LLC, with a profit motive. Without a profit motive, taxpayers generally cannot deduct expenses associated with business activities, which happens when engaging in hobby activities. The tax court cited the frequent use by wealthy taxpayers of horse breeding operations as a way of gaining the "Uncle Sam's [subsidy of] the weekend farm."[17] These taxpayers frequently managed successful businesses and were willing to be held accountable by their banks and business associates if they failed to do so. In contrast, weekend activities on their horse farms indicated they derived enjoyment from being at the farm and from their activities there.

Mr. Huff testified that he derived little pleasure from the miniature donkeys. In testimony before the tax court, he stated the following regarding the animals' care.

> *It's a lot of work... I don't cuddle them. I don't pet them. [T]here is no satisfaction of having these. They are not pets. This is livestock.*

Mr. Huff testified that the donkeys are "quite ugly" and that each resembles a "giant hairball."

The court found that Mr. Huff applied his investment expertise to the donkey business when he rejected an advisor's offer to sell him 12 donkeys for $10 plus a share of future rights in the animals. Mr. Huff realized he would be liable for the animals' feeding and care expenses yet would relinquish a substantial portion of the profits. Perceiving that this reflected his investment insight, the court concluded this decision reflected his ambition to make money in the miniature donkey breeding business. In writing the court's opinion, Judge Urda did not resist the impulse to add some humor, stating that Mr. Huff realized it was better to "look the gift donkey in the mouth."

Not sharing the judge's sense of humor, the IRS argued Mr. Huff's limited time on the farm indicated a lack of a profit motive. Nevertheless, the tax court found that Mr. Huff was not required to spend time at the farm to have a profit motive; he employed knowledgeable and experienced persons to run the operation.

The IRS further argued the history of financial losses indicated the lack of a profit motive. The tax court did not agree, finding that the start-up phase for equine breeding ventures typically lasts five to 10 years. The Ecotone venture was still within its start-up phase, described in Treas. Reg, §1.183-2(b)(6). This regulation states that a business does not lack a profit motive simply because it experiences losses during an initial phase.

Holding. The court held that the Huffs had a profit motive in the miniature donkey-raising business. They are entitled to the losses claimed on their tax returns.

Practitioner Planning Tip

Tax practitioners may find it advantageous to discuss with clients starting businesses the impact of Treas. Reg. §183-2(b)(6). This regulation speaks to how new businesses frequently do not show profitability during their start-up phase. Nevertheless, their owners can still assert they operate the business with a profit motive.

17. *Helmick v. Comm'r,* TC Memo 2009-220 (Sep. 22, 2009).

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Dependents

***Denise Griffin v. Comm'r,* TC Summ. Op. 2021-26 (Aug. 16, 2021)**

IRC §§151 and 152

☞ Nieces and Nephews Are Qualified Children Despite Unfiled Form 8332

Facts. In 2015, Denise Griffin lived with her mother and served as her caretaker. Independent Living compensated Ms. Griffin for the care she provided to her mother. Additionally, Ms. Griffin cared for her niece and two nephews for more than half of 2015. All three of her nieces and nephews were 15 and under during the year. The children stayed overnight with Ms. Griffin from the last two weeks of May through mid-August, in addition to weekends, school closures, and holidays. On school nights the children stayed with their single father who was disabled. Ms. Griffin paid for the children's food, housing utilities, and entertainment while they stayed with her. The children also received public assistance.

Ms. Griffin claimed dependency exemption deductions and child tax credits for all three children on her 2015 income tax return. Additionally, she claimed the earned income credit.

After the IRS selected Ms. Griffin's 2015 return for examination, her brother signed and provided a Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent,* for his three children. However, **because this signed form was not included with her return, the IRS issued Ms. Griffin a notice of deficiency and disallowed the dependency exemption deductions, the child tax credits, and the earned income credit.**

Issues. The issues in this case are the following.

- Whether Ms. Griffin is entitled to the dependency exemption deduction for her niece and nephews
- Whether Ms. Griffin is entitled to child tax credits
- Whether Ms. Griffin is entitled to the earned income credit

Analysis. A taxpayer is entitled to a dependency exemption deduction for a qualified relative or a qualified child. A qualifying child meets the following requirements.

- **Relationship** — A qualifying child is a child, descendent, brother, sister, stepbrother, or stepsister of the taxpayer or a descendent of any of those relatives.
- **Residence** — A qualifying child shares the same residence as the taxpayer for more than half of the year.
- **Age** — A qualifying child must be under age 19 or 24 if a student.
- **Support** — A qualifying child does not provide more than half of their own support.

The IRS agrees that the Griffin children qualify based on the relationship, age, and support tests. Ms. Griffin provided a school calendar to support her claim that the children shared her residence for more than half of the year. The court gives less credibility to the late-prepared Form 8332 than the calendar Ms. Griffin provided supporting the nights she and the children resided together.

A taxpayer with a qualifying child under the age of 17 may be entitled to a child tax credit, a portion of which may be refundable. Because the children met the requirements to be qualified children and were all under the age of 17, the court determined Ms. Griffin was eligible to claim the child tax credit as well the refundable portion.

An eligible individual with a qualifying child (or who meets the requirements of IRC §32(c)(1)(A)(ii)) is entitled to the earned income credit. The court determined that because Ms. Griffin's niece and nephews are qualified children, she is entitled to the earned income credit for 2015.

Holding. The court held that Ms. Griffin passed all the tests to support the children qualified as dependents and was entitled to the dependency exemption deduction. Because her niece and nephews are Ms. Griffin's qualified children, the court held that she is entitled to both the child tax credits and the earned income credit.

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Dependency Exemption

***Babajide Muhammed Ola-Buraimo v. Comm'r,* TC Summ. Op. 2022-2 (Feb. 14, 2022)**

IRC §§1(b), 2(b), 32, 151, 152, and 6662

☞ No Dependency Exemption Allowed for Parent Without Form 8332

Facts. Babajide Ola-Buraimo's former spouse had custody and control of their three children, although Mr. Ola-Buraimo had visitation rights. For 2014 and 2016, Mr. Ola-Buraimo claimed a dependency exemption for one of the children, as well as a dependent-related earned income credit. However, he did not include with his return Form 8332, *Release/Revocation of Claim to Exemption for Child by Custodial Parent,* that was signed by his ex-wife indicating that she released or revoked any right to claim the exemption for the child as the custodial parent.

The IRS assessed a notice of deficiency, claiming that Mr. Ola-Buraimo was not entitled to the dependency exemption which changed his filing status from head of household (HoH) to single. Additionally, he would not be entitled to claim the earned income credit.

Issues. The issues in this case are the following.

- Whether Mr. Ola-Buraima is entitled to a dependency exemption for one of his children
- Whether Mr. Ola-Buraima is eligible to claim the HoH filing status
- Whether Mr. Ola-Buraima can claim the earned income credit

Analysis. To claim a dependency exemption, a taxpayer must have a dependent which includes a qualifying child. A qualifying child must have a specified relationship with the taxpayer, live together for more than half of the year, meet age requirements, not have provided more than half of their own support, and not have filed a joint return for the year. Because none of Mr. Ola-Buraima's children lived with him for more than half the year, he did not have a qualifying child or dependent.

Mr. Ola-Buraima would have been entitled to claim a dependent if the custodial parent (his ex-wife) signed a Form 8332 or similar document attested that she would not claim the child on her return. **As the noncustodial parent, Mr. Ola-Buraima must attach the signed form to his return.**

The amount of the earned income credit to which a taxpayer is entitled increases if they have a qualifying child. Because the court determined that Mr. Ola-Buraima did not have a qualifying child, his earned income credit for 2014 was eliminated, and it was significantly reduced for 2016.

HoH filing status is granted to unmarried individuals who maintain a home for more than half the year to a qualifying child. Because Mr. Ola-Buraima is not considered to have a qualifying child, he cannot file as HoH.

Holding. The Tax Court held that Mr. Ola-Buraima failed to present any evidence that any of his children met the definition of **qualifying child** during the tax year in issue and failed to include a declaration signed by the custodial parent via Form 8332. As such, the court denied Mr. Ola-Buraima's dependency exemption which eliminated or significantly reduced his earned income credit and made him ineligible to claim the HoH filing status.

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Itemized Deductions

***Shawn Salter v. Comm'r*, TC Memo 2022-29 (Apr. 5, 2022)**

IRC §§63(e), 72(t)(2), and 6651(a)(1)

☞ Taxpayer is Salty Over Substitute for Return Penalty

Facts. Shawn Salter was a district loss prevention manager for Home Depot. He worked from home but traveled to various stores. After being laid off in mid-2013, Mr. Salter received a distribution of $37,647 from his retirement plan. He was under the age of 59½ at the time of the distributions. Mr. Salter failed to file a tax return for 2013, so the IRS prepared a substitute for return based on of third-party reporting. The substitute for return took the standard deduction rather than itemized deductions, which resulted in an assessed deficiency of $6,109.

Issues. The issues in the case are the following.

- Whether Mr. Salter is entitled to itemized deductions on his substitute for return
- The computation of additional tax on the early distribution from Mr. Salter's retirement plan
- Whether Mr. Salter is liable for the addition to tax for failure to file

Analysis. If a taxpayer does not file a tax return and the IRS prepares a substitute return, then the taxpayer has made no election and may not claim itemized deductions. Mr. Salter did not file for 2013 and made no election to itemize but he was entitled to the standard deduction.

If a taxpayer is younger than 59½ years at the time of an early distribution from a retirement account, a tax equal to 10% of the distribution is assessed. However, an exception to the tax exists if the distributions do not exceed the amount of the taxpayer's deductible medical expenses. Because Mr. Salter failed to substantiate his medical expenses, the court determined that he cannot qualify for the exception.

IRC §6651(a)(1) provides for an addition to tax of 5% of the tax required to be shown on the return for each month or fraction thereof for which there is a failure to file the return, not to exceed 25% in total. The taxpayer bears the burden of proof to show reasonable cause. The court determined that Mr. Salter was unable to prove that he had reasonable cause for failure to file a return.

Holding. The court held that Mr. Salter is not entitled to itemized deductions on his substitute for return because he did not provide support for his expenses. Additionally, Mr. Salter is liable for the additional tax on the early distribution from his retirement plan and the additional tax for failure to file his tax return.

Mileage Deduction

IRS Ann. 2022-13, 2022-26 IRB 1185 (Jun. 9, 2022)

IRC §170(i)

☞ Midyear Mileage Rate Update

Purpose. The revised standard mileage rates set forth apply to deductible transportation expenses paid or incurred for business, medical, or moving expenses on or after July 1, 2022. Taxpayers may use the optional standard mileage rates to determine deductible automobile costs rather than tracking actual costs. The rates were adjusted to reflect the increase in fuel prices during the year.

Analysis. The revised standard mileage rates are the following.

	Jan. 1, 2022 through Jun. 30, 2022	Jul. 1, 2022 through Dec. 31, 2022
Business	$0.585	$0.625
Medical and moving	0.18	0.22
Charitable	0.14	0.14

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ESTATE TAX

Unpaid Taxes

***U.S. v. Moshe Lax et al.,* No. 1:18-cv-04061; U.S. District Court for the Eastern District of New York (Mar. 31, 2022)**
IRC §§6212, 6901, 7121, and 7122

☞ The IRS Strikes Paydirt in Examination of Diamond Merchant

Facts. Chaim Lax was a real estate developer and diamond merchant, with operations in New York. In 2008, he died from stomach cancer. Mr. Lax was married to Judith Lax. Moshe Lax and Zlaty Schwartz are his son and daughter, and they are the executors of the Lax Estate.

In October 2005, the IRS began examining Mr. and Mrs. Lax's joint tax returns for the 2002, 2003, and 2004 tax years. In June 2009, the IRS issued notices of deficiency to the Laxes for unpaid taxes for those years.

In 2010, the Lax Estate, Moshe Lax, Ms. Schwartz (as executors of the Lax Estate), and Mrs. Lax entered into stipulated agreements with the IRS concerning Mr. Lax's 2002, 2003, and 2004 federal income tax liabilities. As specified by the stipulated agreements, the Tax Court entered judgments in favor of the United States in the following amounts.

Tax Year	Tax	Penalty	Total
2002	$6.28 million	$1.25 million	$7.53 million
2003	7.80 million	1.56 million	9.36 million
2004	6.05 million	1.53 million	7.58 million

Mr. Lax did not file a 2006 income tax return during his life. In April 2011, Moshe Lax and Ms. Schwartz, as executors of the Lax Estate, filed a 2006 tax return on behalf of Mr. Lax. In August 2012, a person who had a power of attorney for the Lax Estate signed an IRS Form 870, *Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment,* consenting to the IRS's assessment of $5.22 million in federal tax for 2006 and $2.35 million in penalties.

In November 2009, the IRS began an examination of Mr. and Mrs. Lax's joint tax return for 2007. The United States alleges that Mr. Lax was diagnosed with stomach cancer around November 2006 and that to avoid paying the taxes he owed and that his estate would owe when he died, he engaged in a series of sham transactions intended to shield his assets from collection by the IRS. The United States also alleges that the Lax's children continued these sham transactions after Mr. Lax died in November 2008.

One of the alleged sham transactions involved a transfer of ownership of LX Holdings to the Lax Family Trust. In consideration of this transfer, Moshe Lax and Ms. Schwartz, who were trustees of the Lax Family Trust, signed a self-canceling installment note, under which the Lax Family Trust was to pay Mr. Lax $40.75 million in semiannual payments of $3.887 million until Mr. Lax died. After he died, the note would self-cancel. The United States asserts that this transfer was made for no consideration and the Lax Estate should still be responsible for taxes as the owner of LX Holdings.

In February 2010, the IRS issued a notice of deficiency to Mr. Lax (now deceased) and Mrs. Lax regarding income taxes for the 2007 tax year. In December 2012, the Tax Court entered a judgment in favor of the United States regarding the Lax Estate's 2007 tax liability in accordance with a stipulated agreement entered into by the Lax Estate, Moshe Lax (as executor), and Mrs. Lax. The amount shown in the judgment was $273,309 in federal taxes and $54,662 in penalties, for a total of $327,971.

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The IRS also examined the Lax Estate's Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return.* In December 2012, Moshe Lax and Ms. Schwartz (as executors) signed a Form 890, *Waiver of Restrictions on Assessment and Collection of Deficiency and Acceptance of Over-Assessment — Estate, Gift and Generation-Skipping Transfer Tax,* consenting to the IRS's assessment of $4.46 million in federal estate tax.

Issue. The issue in this case is whether the United States should be granted partial summary judgment.

Analysis. A finding of summary judgment is appropriate when there are no genuine issues involving any material fact and the moving party is entitled to judgment as a matter of law.[18] The court must draw all reasonable inferences with respect to the material facts in favor of the nonmoving party, and the moving party must demonstrate the absence of a genuine issue of material fact.[19]

The IRS must send a notice of deficiency to the last known address of the taxpayer.[20] The **last known address** to which the notice of deficiency must be sent is "the taxpayer's last permanent address or legal residence known by the Commissioner or the last known temporary address of a definite duration to which the taxpayer has directed the commissioner to send all communications."[21]

Ms. Schwartz argued that the notice of deficiency was sent to her previous address. However, she failed to provide any evidence to demonstrate that she updated her address with the IRS. In addition, the evidence shows that the IRS provided notice to the Lax Estate at Mr. Lax's last known address, Moshe Lax (one of the two executors), and to counsel. The court observed that these notices provided the Lax Estate with clear knowledge of the tax assessments. In fact, two petitions were filed in Tax Court challenging four of the assessments, a Form 870 was completed to resolve a fifth assessment, and a Form 890 was submitted (by Moshe Lax and Ms. Schwartz) to resolve a sixth assessment.

After hearing all the parties' arguments, the court concluded that the Government is entitled to summary judgment for some of the tax assessments levied against Mr. Lax and the Lax Estate. With respect to the stipulated amounts covering tax years 2002, 2003, 2004, and 2007, the Lax Estate had notice of the IRS's assessments, challenged them in Tax Court, and then agreed to amounts that were so ordered by the Tax Court. Therefore, the Government is entitled to summary judgment for those returns. In addition, the Government is entitled to summary judgment for the amount contained in the 2006 Form 870. None of the defendants submitted any evidence about the amount shown on that form.

However, the Government is not entitled to summary judgment regarding the amount shown on the Form 890, which covers the estate tax levied against the Lax Estate. The fact that Ms. Schwartz executed the Form 890 does not prevent her from challenging the amount of the assessment. She submitted a declaration from a forensic accountant, who raised a material question about the IRS's valuation of the Lax Estate. This prevents the entry of summary judgment on this issue.

Holding. The court held that the Government is entitled to summary judgment for the 2002, 2003, 2004, 2006, and 2007 tax years totaling $55.11 million, including interest assessed. The Government is not entitled to summary judgment for the estate tax levied against the Lax Estate.

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18. *Nelkenbaum v. Caliber Home Loans, Inc.,* No. 18-CV-1848, 2019 WL 3464507 (EDNY, Jul. 31, 2019).

19. *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 255 (1986).

20. See IRC §6212(b).

21. *Sicari v. Comm'r,* 136 F.3d 925, 928 (2d Cir. 1998) (quoting *Tadros,* 763 F.2d at 91).

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Estate and Gift Tax

***Estate of David T. Leighton v. U.S.*, No. 21-840T (Aug. 9, 2021)**

IRC §§2010(a), 2010(c)(5)(A), and 6651(a).

☞ Anchors Aweigh for Reasonable Cause

Facts. When Commander David Leighton died in 2017, his son Frank assumed duties of the executor of his father's estate. The estate used the services of three advisors to conclude that it had no filing requirement for Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, because Commander Leighton's assets did not reach the exemption amount. The advisors included:

- Mr. Leighton's tax preparation firm, Freshwater Consultants;
- A family office, JDJ Family Office Services; and
- Attorney Richard Allen.

Mr. Allen advised Frank that an estate tax return was only required if the value of the 2017 decedent's estate exceeded $5,490,000.[22] Mr. Allen, Frank, and JDJ worked together and determined that Commander Leighton's estate held assets in the range of $1–$2 million. However, they did not consider the possibility that Commander Leighton had made lifetime gifts, and Freshwater did not search its records for any Forms 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*. No Form 706 was filed for the estate.

In 2019, David Leighton, Frank's brother, brought up the possibility that their father might have established trusts during his life and funded them with gifts that would count toward the exemption amount. Freshwater Consultants responded with a copy of a 2012 Form 709 when Mr. Allen specifically asked if one existed. That return reported gifts in 2012 of $5,094,000, triggering the requirement to file a Form 706.

Armed with this new knowledge, Frank filed a Form 706 on April 9, 2019, over one year late. The estate paid $1,626,928 in estate taxes, penalties, and interest. The IRS subsequently calculated an estate tax liability of $1,145,387, a late-filing penalty of $257,712, a late payment penalty of $85,904, and interest of $87,859. It refunded the overpayment of $50,066 less than two months later.

Having complied to the best of his ability with the requirement to file an estate tax return, Frank filed a claim for a refund with the Court of Federal Claims. This claim asserted that the penalty was not reasonable because Frank took reasonable steps to determine the size of his father's estate and reasonably relied on his attorney's advice. None of the parties were aware at the time of the lifetime gifts.

Issues. The issue in this case is whether the estate had reasonable cause for not filing Form 706 on a timely basis.

Analysis. IRC §6651(a) states that the failure to file penalty should not be imposed if the failure to file is due to reasonable cause and not willful neglect. The regulation associated with this section states, "If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause."[23]

The court noted that reliance on the advice of an advisor does not necessarily establish reasonable cause unless such reliance was reasonable, and the taxpayer acted in good faith. The taxpayer must allege and prove that the late filing or payment, in the words of *U.S. v. Boyle*, "was the result neither of carelessness, reckless indifference nor intentional failure."[24] A failure to file must be beyond a taxpayer's control to avoid the penalty. The executor in the *Boyle* case knew that an estate return had to be filed and presented the tax return preparer with the relevant information. The tax preparer for the *Boyle* estate overlooked the filing.

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22. IRC §2010(a).
23. Treas. Reg. §301.6651-1(c)(1).
24. *U.S. v. Boyle*, 469 U.S. 241, 246 (1985).

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The court's opinion described as "circular" the IRS's logic that the advice received by the executor was objectively unreasonable. The United States made this assertion because Mr. Allen's advice was not based on all pertinent facts and circumstances. The court opined that finding for the United States on this point would mean that missing information could **never** constitute reasonable cause. The court concluded that this argument is an invalid reason to decide the case in favor of the United States and against the estate of Commander Leighton.

The court's opinion contrasted the *Leighton* case with the *Boyle* case. While taxpayers cannot delegate the responsibility to file timely returns, the court stated the *Boyle* case does not address whether they must file a return. The court decided that the arguments advanced by the United States failed because they presuppose that the taxpayer or one of their advisors "should have known" that the estate's valuation exceeded the exemption amount. The court stated, "Tax advisors cannot reasonably give advice on unavailable information."

Holding. The court found that Commander Leighton had sufficient factual allegations to establish a viable claim for the reasonable cause exception in §6651(a).

Practitioner Planning Tip

If a Form 706 with a portability election[25] had been filed for Commander Leighton's wife when she died several years before him, his estate might have owed no tax. Practitioners should consider implementing a standard practice of discussing with surviving spouses the possibility of filing estate tax returns to preserve any unused estate tax exemptions. For more information on estate issues, including unused estate tax exemptions, see the 2022 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Tax Considerations in the Distribution of Estate Assets.

FOREIGN INCOME

Foreign Income

George Harrington v. Comm'r, **TC Memo 2021-95 (Jul. 26, 2021)**
IRC §§61, 6501, and 6663

☞ Taxpayer Cannot Hide Foreign Income

Facts. George Harrington spent his career in the forest product industry. His wife, Monica, was a dual U.S.-German citizen, sometimes using the last name Schröder. Although a U.S. citizen, Mr. Harrington began his career in eastern Canada with an exporter of lumber to Europe, Eastern Wood Harvesters (EWH). He eventually assumed a senior leadership position with the company, through which he came to know attorney John Glube. Mr. Glube was the impetus behind EWH, designing its structure to minimize the taxes that EWH's owners owed to Canada and their respective countries. EWH had a company in Malta, for which Mr. Glube opened an account with the Royal Bank of Canada's Cayman Islands branch. Later, Mr. Glube went to prison for embezzlement.

25. IRC §2010(c)(5)(A).

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Mr. Harrington provided Mr. Glube with a check for $350,000 after selling his house. This money was deposited in a Union Bank of Switzerland (UBS) account for an entity incorporated in the Cayman Islands, Reed International, Ltd. Mr. Harrington held a power of attorney that permitted him to manage Reed's assets. Mr. Harrington testified to the Tax Court that he loaned this money to EWH to stabilize the company. Without an executed loan agreement, the court did not find Mr. Harrington's testimony on this point persuasive. Instead, the court found Mr. Harrington was motivated by Mr. Glube's ability to place assets in foreign bank accounts, presumably with the intent to conceal income. He gave the attorney $350,000, which was most of the proceeds from the sale of his house. Mr. Glube deposited these funds in a UBS bank branch in the Cayman Islands.

Mr. Harrington told the court that he lacked access to Reed's assets, including the ability to get his money back. Aware of the power of attorney, the court did not find this testimony persuasive. In 2007, some of the entities were being closed or dissolved. UBS recommended establishing a European trust-like account called a stiftung, and subsequently, the Schröder Stiftung was created in Liechtenstein to benefit Mr. Harrington and his family. Around the time UBS admitted to the U.S. Department of Justice that it had participated in a scheme to defraud the U.S. government, UBS informed Mr. Harrington it had decided to end the stiftung. It shifted the money to a life insurance policy issued by a Liechtenstein insurance company. UBS then canceled the life insurance policies in 2013, and the proceeds went to a Liechtenstein bank account in Mrs. Harrington's name.

During the period at issue, Mr. Harrington prepared personal income tax returns that he filed with his wife. These returns reported no income associated with the foreign accounts. **However, UBS provided the IRS with 844 pages of evidence relating to Mr. Harrington's foreign bank accounts.** Armed with this information, the IRS initiated examinations of the Harrington tax returns. The IRS issued notices of deficiency, asserting that the Harringtons had unreported income of $791,661 that had been earned in their various foreign accounts. The IRS calculated this amount using its "sampling method." The revenue agent proposed a civil penalty for fraud, which was approved by her manager, a fraud technical advisor. The IRS also added "negligence penalty" as an alternate position for asserting the penalty. The dates on the IRS's documents became an issue later during the trial. After several discussions with their attorney, the Harringtons filed amended tax returns that included additional income from the foreign entities totaling almost $800,000. The revenue agent assigned to the case also received delinquent Reports of Foreign Bank and Financial Accounts (FBAR).

At trial, the IRS failed to produce Harringtons' originally filed 2010 income tax return. The amended return was available, although it did not have information about capital gains or losses.

Issues. The issues in this case are the following.

- Whether Mr. Harrington established that the IRS's calculation of unreported income was arbitrary or erroneous
- Whether Mr. Harrington committed fraud in filing his tax returns, in which case no statute of limitations applies to the IRS's ability to bring action against him

Analysis. Once the IRS establishes a plausible connection between a taxpayer and an income-producing activity, the burden of proof shifts to the taxpayer to prove that the IRS's determination of missing income is arbitrary or erroneous. The standard for this proof is a "preponderance of the evidence," a very high standard. In contrast to the 844 pages of evidence produced by the IRS, Mr. Harrington and his attorneys introduced no evidence to indicate that he did not have control over the funds. On the contrary, the evidence established that he discussed the investments with UBS officers and even initiated transfers between accounts.

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Because of the time that transpired since the foreign investments, it was critical to the IRS's case to establish fraudulent intent. Failing this, the statute of limitations would bar prosecution of at least some portions of the case.[26] If a court finds fraud, the penalty is 75% of the underpayment attributable to fraud.[27] The IRS has the burden of proving fraud for each year.[28] The court's opinion discussed seven badges of fraud that were present in the *Harrington* case.

1. Understating income
2. Keeping inadequate records
3. Giving implausible or inconsistent explanations
4. Concealing income or assets
5. Failing to cooperate with tax authorities
6. Providing testimony that lacks credibility
7. Filing false documents, including tax returns

Because the IRS could not produce the original 2010 tax return that the Harringtons filed, the court ruled that the IRS could assess neither a deficiency penalty nor a fraud penalty for that year.

The IRS is required to obtain a supervisor's approval before asserting penalties.[29] In the *Harrington* case, the IRS revenue agent obtained her group manager's approval and the fraud technical manager's approval for the penalties. The presence of a stamped date on the document clouded the matter, however. It could have placed the approval after the assessment of the penalty. Mr. Harrington accused the IRS in his testimony of backdating the date of approval to conform with IRC §6751(b)(1). The court stated that there was no evidence to support a conclusion that the IRS had intentionally falsified documents. The decision held the errant date was irrelevant in light of the hand-written dates on Forms 4549, *Income Tax Examination Changes*, and 11661, *Fraud Development Recommendation — Examination.* Both documents contained dates supporting the court's conclusion the managers had approved the fraud penalties on a timely basis.

Holding. The court decided that the IRS had established by "clear and convincing evidence" that tax underpayments were due to fraud. This finding applied to tax years 2005, 2006, 2008, 2009, and a portion of 2007. Accordingly, the Harringtons were subject to large penalties for fraudulent understatement of tax for the years involved. There was no fraudulent tax penalty for 2010, however.

FBAR Penalty

***U.S. v. Walter Schik,* No. 1:20-cv-02211, U.S. District Court for the Southern District of New York (Mar. 8, 2022)**
31 USC §5321

☞ Government Not Entitled to Summary Judgment for $8.8 Million FBAR Penalty

Facts. Walter Schik is a survivor of the Holocaust and is nearly 100 years old. When he was 13, he was separated from his family and sent to a concentration camp in Hungary. Mr. Schik's formal schooling was curtailed because of the Holocaust, and he has only an elementary-level education. Mr. Schik's family died in the concentration camps, but he survived. In 1947, Mr. Schik moved to the United States and became a U.S. citizen 10 years later.

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26. IRC §6501(c)(1).
27. IRC §6663(a).
28. *Vanover v. Comm'r*, TC Memo 2012-79 (Mar. 12, 2012), quoting *Temple v. Comm'r,* TC Memo 2000-337 (Nov. 1, 2000).
29. IRC §6751(b)(1).

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Soon after he became a U.S. citizen, Mr. Schik opened a bank account at UBS AG in Switzerland to deposit money recovered from relatives who died in the concentration camps. The money had no ties to the United States, and Mr. Schik did not touch the money.

Mr. Schik left the management of the money in the Swiss account to David Beck and his son, Josef Beck. At various times, David and Josef Beck opened accounts on behalf of Mr. Schik. Mr. Schik did not fill out any of the documents but signed his name to stacks of forms. Over the years, the Becks opened and closed various accounts. In 2007, one of the accounts relevant to this case had a maximum balance of $1.59 million, and the other account had a maximum balance of $15.65 million.

Mr. Schik's tax returns for 2007 were prepared by Kenneth Laufer. Mr. Laufer never asked Mr. Schik if he had funds outside the United States. In addition, Mr. Laufer never asked Mr. Schik to complete a tax preparation questionnaire.

Question 7(a) of Schedule B, *Interest and Ordinary Dividends,* of Mr. Schik's 2007 return asked "whether [Mr. Schik] had an interest in or signature or other authority over any foreign financial accounts in 2007." Mr. Laufer's tax preparation software pre-filled the answer to this question as "no." Mr. Schik had a chance to review his 2007 return after Mr. Laufer prepared it, but he did not do so before he signed it. He stated that he "looked generally at his 2007 tax return before signing it."

A few years later, Josef Beck was indicted on charges of "conspiring with U.S. taxpayers and foreign financial institutions, including UBS, to enable Beck's U.S. taxpayer clients to hide Swiss bank accounts and income generated in those accounts from the IRS." UBS agreed to provide the U.S. government with the identities of certain U.S. customers under a deferred prosecution agreement. Mr. Schik read about the deferred prosecution agreement in 2010 and submitted a voluntary disclosure to the IRS for his foreign accounts. The disclosure was rejected by the IRS "due to timeliness and/or completeness." Mr. Schik then filed a FinCEN Form 114, *Report of Foreign Bank and Financial Accounts,* (FBAR) for 2007, reporting the amounts held in the Swiss accounts.

The IRS assessed penalties that totaled $8.82 million against Mr. Schik for willful failure to comply with the FBAR filing requirements. Mr. Schik did not pay the penalty, and the United States brought an action seeking to recover the penalty. The Government then moved for summary judgment.

Issue. The issue is whether the Government is entitled to summary judgment for the $8.82 million FBAR penalty assessed against Mr. Schik.

Analysis. Summary judgment is appropriate "if the movant shows that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law."[30] The court must draw all reasonable inferences with respect to the material facts in favor of the nonmoving party, which is Mr. Schik in this case.[31]

Under 31 USC §5321(a)(5), a penalty may be assessed "[i]n the case of any person willfully violating, or willfully causing any violation of, any provision of section 5314." The United States is seeking to collect the $8.82 million civil FBAR penalty assessed against Mr. Schik for his alleged willful failure to report his interests in his foreign accounts for the 2007 calendar year.

To be found liable for a willful violation under 31 USC §5321(a)(5), the United States must prove by a preponderance of the evidence that:

1. Mr. Schik is a U.S. citizen;
2. Mr. Schik had an interest in, or authority over a foreign financial account;
3. The account had a balance exceeding $10,000 at some point during the reporting period; and
4. Mr. Schik willfully failed to disclose the account and file an FBAR.

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30. *Process Am., Inc. v. Cynergy Holdings, LLC,* 839 F.3d 125, 133 (2d Cir. 2016) (quoting Fed. R. Civ. P. 56(a)).

31. *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 255 (1986).

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The first three items are not in dispute. However, the parties disagree as to whether Mr. Schik's failure to file the 2007 FBAR was a **willful** violation of §5321.

The term **willful** is not defined in §5321. The Supreme Court has stated that the meaning of **willful** is elusive because the word has many meanings that are construed differently depending on the context.[32] The Supreme Court further stated that "where willfulness is a statutory condition of civil liability" courts generally interpret willful to include "not only knowing violations of a standard, but reckless ones as well."[33]

The court observed that it was undisputed that Mr. Schik did not manage the Swiss accounts himself, nor did he prepare his 2007 tax returns himself. Mr. Schik's tax preparer did not ask him about foreign accounts. Viewed in the light most favorable to Mr. Schik, it is clear that he did not withhold disclosure of the Swiss accounts for any nefarious purpose.

Mr. Schik asserts that he did not willfully violate the FBAR reporting requirements because he relied on his tax preparer. He also asserted that he was unaware of the duty to report his foreign accounts.

The court noted that Mr. Schik presented evidence from which a jury could conclude that he did not act willfully because he did not manage the foreign accounts, he was unaware of the requirement to disclose those funds, his tax preparer did not inform him of the requirement, he relied on his preparer in connection with the submission of his 2007 tax returns, and his preparer's software auto-filled key portions of the filing. At least one other court has held that when the defendant relied on his tax preparer's competence in preparing the return, it was not reckless for him to refrain from reading the FBAR instructions.[34] In Mr. Schik's case, there is a genuine dispute about whether his conduct is willful rather than merely negligent.

The court observed that Congress delineated between failures to report that are and are not willful when it included penalties for willful violations of §5321(a)(5). In Mr. Schik's case, the Government seeks to interpret the law to find that willfulness should be found categorically even when an unsophisticated taxpayer did not know of his obligation to report and relied on his tax preparer. This would nullify the distinction between willfulness and mere negligence.

The court noted that whether Mr. Schik's conduct was willful rather than merely negligent is a question of fact. The court cannot conclude that his failure to disclose his foreign accounts was willful as a matter of law. Taken in the light most favorable to Mr. Schik, the evidence creates a genuine dispute of material fact.

Holding. The court held that because there is a genuine dispute of material fact, the Government is not entitled to judgment as a matter of law on the issue of willfulness. The case will now proceed to trial.

Foreign Earned Income Exclusion

Douglas Cutting v. Comm'r, **TC Memo 2020-158 *aff'd.,* No. 21-70235, 2021 U.S. App. LEXIS 37928 (9th Cir. Dec. 22, 2021)**
IRC §911

☞ Pilot Not Cleared to Land Foreign Earned Income Exclusion

Facts. Douglas Cutting was a U.S. citizen residing in Thailand. He worked as a pilot for a company headquartered in Tulsa, OK that had a contract with the U.S. Department of Defense. Mr. Cutting primarily transported military personnel and cargo. He spent most of his days off in Thailand and would also visit Thailand on a temporary transit and nonimmigrant visa that would expire in 30 days. Mr. Cutting's wife resided in Thailand. He did not pay any taxes to Thailand.

32. *Safeco Ins. Co. v. Burr,* 551 U.S. 47, 57 (2004).

33. Ibid.

34. *U.S. v. Flume,* 2018 WL 4378161, at *9 (S.D. Tex. 2018).

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Mr. Cutting's wages were direct deposited into his bank account at a bank headquartered in California. His employment agreement required him to have a home base which he chose as San Jose, California because his parents and brother lived near there in Campbell. He listed Campbell, California as his mailing address. Mr. Cutting did not own or lease a residence in the United States during the years in issue, but shopped for groceries several times in Campbell, paid for haircuts in a nearby town, and went to the eye doctor in San Jose. All Mr. Cutting's training was done in the United States.

For the years at issue, Mr. Cutting never spent the majority of the days of the year in Thailand. He filed his returns reporting his filing status as "single" and using his father's Campbell address. He claimed a foreign earned income (FEI) exclusion on his Form 1040, *U.S, Individual Income Tax Return,* for each year in issue, reporting his entire salary as foreign earned income and claiming the maximum exclusion for each year.

The IRS disallowed the FEI exclusion in its entirety for each year on the basis that Mr. Cutting failed to establish either a bona fide residence or physical presence in a foreign country.

Issues. The issue in this case is whether Mr. Cutting met his burden of proof that he was entitled to the FEI exclusion.

Analysis. Under IRC §911, a qualified individual is allowed to exclude foreign earned income from gross income. A qualified individual has their tax home in another country and is either a bona fide resident of that country for an uninterrupted time or physically present in the country for a period of time. FEI is the amount a taxpayer earns from sources within the foreign country based on their services.

An individual's tax home is considered at their regular place of business or abode. Mr. Cutting argued that his place of abode is Thailand. Precedent states that a pilot's tax home is their duty station. In this case, Mr. Cutting's duty station is San Jose. The court did not need to evaluate whether Mr. Cutting was a bona fide resident after concluding his tax home was not in a foreign country. On appeal, the court agreed that Mr. Cutting did not have FEI eligible for the exclusion.

Holding. The appellate court affirmed on the basis that the Tax Court had properly determined that Mr. Cutting did not meet his burden of proof that he was entitled to the FEI exclusion.

GROSS INCOME

Gross Income

***Andrew and Donna McNulty v. Comm'r*, 157 TC 10 (2021)**
IRC §§408 and 6662

☞ Gold Coins in IRAs Cost a Pretty Penny

Facts. Both Andrew and Donna McNulty decided to alter their investment strategies for their individual retirement arrangements (IRAs) to include gold. They did it in a big way, ultimately transferring $750,000 out of established annuities and IRC §401(k) accounts.

The McNultys researched IRA investments in gold on Check Book IRA, LLC's website. This firm helped them set up a sole member LLC named Green Hill Holdings, LLC ("Green Hill") that legitimated the transaction, if only in its own and McNulty's eyes. They appointed an independent trustee named Kingdom Trust Company. **They did not observe the Kingdom Trust's website warning to hold the coins in a depository.**

Mrs. McNulty instructed Kingdom Trust to purchase units of Green Hill with funds from her IRA. The IRA purchased membership interests three times during 2015 and 2016. As Green Hill's manager, Mrs. McNulty had Green Hill purchase American Eagle gold coins from Miles Franklin, Ltd, a coin dealer. Green Hill used almost all the IRA funds in its accounts to buy coins, with funds wired directly from the Green Hill bank account to Miles Franklin, an authorized coin dealer.

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Mr. Franklin then sent the coins using shipping labels listing Mrs. McNulty individually as the recipient on each shipment, although some also listed her IRA as a recipient. The invoices, however, listed Green Hill as the purchaser. Mrs. McNulty received the coins at her home. Mrs. McNulty then deposited the coins in the safe located in their home, in which were also stored coins purchased with Mr. McNulty's IRA and some assets owned by Mr. and Mrs. McNulty directly, not through an IRA.

Mr. and Mrs. McNulty filed their joint 2015 and 2016 tax returns using the services of a CPA. They neither consulted with him before making the IRA change nor informed him after the fact. As a result, he prepared the returns not knowing Mrs. McNulty took physical possession of an asset supposedly owned by her IRA.

The IRS issued a notice of deficiency in 2018, claiming that both Mr. and Mrs. McNulty had received taxable distributions from their IRAs unreported on their tax return. The notice also asserted their liability for penalties resulting from substantially underreporting their tax and disregarding regulations.

Issues. The issues in this case are the following.

- Whether Mrs. McNulty received distributions from her IRA when she accepted gold coins that were mailed to her home and stored in a home safe
- Whether Mr. and Mrs. McNulty are liable for substantial understatements of income tax because they did not report taxable distributions from their IRAs on their 2015 and 2016 income tax returns

Analysis. An IRA is technically a trust having a trustee who works as a fiduciary. A custodial account set up for the beneficiary can be treated as a trust. The trustee can be a bank, but it can also be another person that convinces the IRS it has met the fiduciary requirements of IRC §408.

The regulations supporting §408 impose two requirements on the trustee's custody of the IRA.[35]

1. The trustee must deposit the assets in an "adequate vault" and then maintain a record of assets deposited into it or withdrawn from it.
2. The trustee must not allow the investments to be commingled with other **property** unless the other property is pooled in a common investment fund.

If these factors were not satisfied, Mr. and Mrs. McNulty are deemed to have received distributions from their IRAs each time they received gold coins.

The IRS argued that Mrs. McNulty took possession personally of the coins when she received them. She and her husband countered that the coins were assets of Green Hill and her receipt of them was not a taxable distribution from her IRA. During arguments in the case, the IRS and the McNultys expressed differences of opinion on the following issues.

- Whether Mrs. McNulty or her IRA was the sole member of Green Hill
- Who owned the gold coins
- Whether the gold coins were bullion
- Whether the McNultys commingled IRA assets with non-IRA assets by storing them in the same vault
- Who can physically possess gold coins a taxpayer purchased with an IRA's assets

35. Treas. Reg. §1.408-2(e)(5)(v).

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The court decided the case on the last point. It determined that by receiving physical custody of the gold coins, Mrs. McNulty had a taxable distribution from her IRA. Citing Supreme Court cases from 1955 and 2005,[36] the court observed that:

> *It is a basic axiom of tax law that taxpayers have income when they exercise complete dominion over it… Constructive receipt occurs where funds are subject to the taxpayer's unfettered command and she is free to enjoy them as she sees fit.*

By receiving the coins at her home where the trustee could exercise no control, Mrs. McNulty exercised complete control over the assets. Thus, she realized income. The court found no relevance in having chosen to put the coins in a safe in her home.

Furthermore, the court found that Mr. and Mrs. McNulty showed a lack of good faith in their tax reporting because they did not disclose the gold coin transactions to their tax preparer, a Rhode Island CPA. Although Mr. and Mrs. McNulty claimed to have performed tax research on the format, it appears that they relied on a promoter's website rather than tax law and regulations. Accordingly, the court sustained the IRS's imposition of substantial understatement penalties for 2015 and 2016.

Holding. The Tax Court held that Mrs. McNulty made taxable distributions when she accepted physical custody of the American Eagle gold coins, taking complete control over them. Mr. Franklin sent the gold coins to her LLC, which Ms. McNulty's IRA owned.

The court upheld the IRS's imposition of deficiencies of $250,558 for 2015 and $18,094 for 2016. The court also upheld an IRC §6662(a) accuracy penalty.

Gross Income

***Irvin Catlett Jr. v. Comm'r,* TC Memo 2021-102 (Aug. 16, 2021)**
IRC §§7206, 7212(a)

☞ Horizontal Pinstripes Are Not Persuasive in Tax Court

Facts. Irvin Catlett was a tax practitioner in Maryland. During the early 2000s, he coordinated with Mark Hunt, an IRS officer, to create a tax scheme involving the incorporation of sham entities he described as vehicle leasing and sales companies. Mr. Catlett claimed the entities generated taxable losses and would eliminate his clients' taxable income and tax liabilities. First, Mr. Catlett determined the amount of tax that he wanted his client to pay and then generated sufficient the taxable loss to offset his clients' taxable income to the amount he wanted them to pay.

Mr. Catlett was convicted for conspiracy to defraud the United States, as well as aiding and assisting in the preparation of false tax documents.[37] The icing on the conviction cake was his attempt to obstruct and impede the administration of internal revenue laws.[38] Ultimately, the IRS found that Mr. Catlett had filed at least 250 fraudulent tax returns, carrying approximately $22 million in fabricated tax losses.

Convicted in November 2010, Mr. Catlett was sentenced to 210 months' imprisonment and ordered to pay $3,810,244 in restitution for the federal government's lost tax revenue. After going to jail, the IRS started a civil examination of Mr. Catlett's tax liabilities for 2006 through 2010.

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36. *Comm'r v. Banks,* 543 US 426, 434 (2005); and *Comm'r v. Glenshaw Glass Co.,* 348 US 426, 431 (1955).
37. IRC §7206(a).
38. IRC §7212(a).

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Mr. Catlett declined to comply with document requests associated with his examination. He proceeded to file multiple lawsuits in attempts to quash summonses to banks he used under the tax shelter's name. Although these suits delayed the government's receipt of bank records by 11 months, the IRS eventually received extensive records showing the existence of bank accounts holding cash for the fraudulent entities. During the period under examination, Mr. Catlett deposited more than $1.2 million into the tax shelter account and $540,000 into his personal accounts.

The IRS used the bank deposits method to conclude that Mr. Catlett understated his income on his individual income tax returns in 2006, 2007, and 2008. Because Mr. Catlett filed no individual income tax returns for 2009 and 2010, the IRS prepared substitutes for return.

Mr. Catlett petitioned the court for redetermination in June 2014. Because he was incarcerated and not available for trial, the case was continued multiple times. **Mr. Catlett died in prison in January 2020.** Mr. Catlett died intestate, and his next of kin declined to participate on their late relative's behalf. The IRS moved that the case be dismissed for lack of prosecution, as no one would represent the deceased petitioner.

Issues. The issues in this case are the following.

- Whether the court can dismiss the case for lack of prosecution
- Whether the IRS issued notices of deficiency within the periods of limitations for the tax years in question
- Whether the IRS meets the burdens of proof and production about unreported income, penalties, and additions to tax

Analysis. The Tax Court can dismiss a case against a taxpayer if the taxpayer does not advance their case or fails to comply with the court's orders and rules. If a taxpayer dies before the case is decided, the court attempts to substitute a representative or successor, preferably one with a monetary interest in the case's outcome. All three of Mr. Catlett's identified family members declined to appear before the court and expressed no interest in the case. Thus, the court had no choice but to dismiss for lack of prosecution, as the decedent had the burden of proof but did not prosecute the case.

The court cited a 2012 case that imposed a burden of proof on the government for each year when it alleges a taxpayer has committed fraud over several years.[39] Thus, the IRS had the burden of proving Mr. Catlett committed fraud through underreporting income and underpayment of tax for 2006 through 2008. Fraud cannot be presumed or based on suspicion, but circumstantial evidence may indicate its existence;[40] direct proof of fraudulent intent rarely exists. The court found the following six badges of fraud.

1. Understating income
2. Keeping inadequate records
3. Concealing income or assets
4. Failing to cooperate with tax authorities
5. Engaging in illegal activities
6. Filing false documents

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39. *Vanover v. Comm'r,* TC Memo 2012-79 (Mar. 21, 2012).

40. *Petzoldt v. Comm'r*, 92 TC 661, 699-700 (1989).

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The IRS contended these badges of fraud support its conclusion that Mr. Catlett's returns had large amounts of unreported income and unsubstantiated deductions. It determined that Mr. Catlett's tax returns should be assessed with the following.

- Accuracy-related penalties[41]
- Addition to tax for failure to timely file[42]
- Addition to tax for failure to timely pay[43]
- Addition to tax for failure to pay estimated tax[44]
- Addition to tax for fraudulent failure to file[45]

Holding. Given that Mr. Catlett died before the court decided the case and no relatives expressed interest, the court sustained the IRS's imposition of taxes and penalties, except for the fraudulent failure to file penalties associated with 2009 taxes. The court held that it has the authority to dismiss the case brought by Mr. Catlett. Mr. Catlett did not appear before the Tax Court before his death, and no family members took an interest in pursuing this. Since Mr. Catlett had the burdens of proof in the case he brought before the court, these burdens were not met.

The court decided the IRS filed all notices of deficiency within the periods of limitations. The periods of limitations for 2007 and 2008 were extended by the greater than 25% understatement of gross income for those years. Mr. Catlett's attempt to quash the IRS summonses to his banks extended the period of limitations for the 2006 return.[46]

Mr. Catlett also had the burden of proving the IRS was incorrect in the determinations it had made in the notice of deficiency. However, in moving to dismiss, the IRS accepted responsibility for the burdens of production related to fraud and the fraudulent failure to file. The court agreed that the IRS had met these burdens, except for Mr. Catlett's 2009 individual income tax return. For this return only, the court reasoned his criminal prosecution may have distracted him, among other things. Accordingly, the court did not agree to the fraudulent failure to file addition to Mr. Catlett's 2009 tax. With this small exception, the court agreed with the adjustments to Mr. Catlett's income, the imposition of fraud penalties, and additional taxes that the IRS had determined.

41. IRC §§6662(a) and (b)(1); Treas. Reg. §1.6662-3(b)(1).
42. IRC §6651(a)(1).
43. IRC §6651(a)(2).
44. IRC §6654.
45. IRC §6651(f).
46. IRC §7609(e)(1).

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IRS PROCEDURES — MISCELLANEOUS

Jurisdiction

***Boechler, P.C. v. Comm'r*, 596 U.S. ___ (Apr. 21, 2022)**
IRC §6330

☞ For Whom Does the Filing Deadline Toll?

Facts. Boechler, P.C. is a law firm in Fargo, North Dakota. In 2015, the IRS informed Boechler about a discrepancy in its tax filings. Boechler did not respond, so the IRS assessed a penalty for "intentional disregard" and informed Boechler of its intent to levy its property to satisfy the penalty. To prevent the levy, Boechler requested a collection due process (CDP) hearing. At the hearing, Boechler argued that there was no discrepancy in its tax filings and that the penalty was excessive.

The IRS Independent Office of Appeals sustained the proposed levy. Under IRC §6330(d)(1), Boechler had 30 days to petition the Tax Court to review the CDP determination. However, Boechler filed its petition one day late. The Tax Court then dismissed the petition for lack of **jurisdiction.** The Eighth Circuit affirmed the Tax Court ruling, asserting that the 30-day filing deadline is jurisdictional and therefore cannot be **equitably tolled** (i.e., extended).

> **Note.** Equitable tolling applies when it is unfair to hold a taxpayer to a statutory deadline because of an extraordinary event that impeded the taxpayer's compliance.[47]

Issue. The issue in this case is whether the 30-day filing deadline under §6330(d)(1) is jurisdictional and thus cannot be extended.

Analysis. Jurisdictional requirements cannot be waived or forfeited. As relevant to this case, such requirements are not subject to equitable exceptions. The Court treats procedural requirements as jurisdictional only if Congress **"clearly states"** that it is.[48] Therefore, the outcome of this case depends on whether Congress clearly stated that the deadline imposed by §6330(d)(1) for review of a CDP determination is jurisdictional.

IRC §6330(d)(1) states:

> *The person may, within 30 days of a determination under this section, petition the Tax Court for review of such determination (and the Tax Court shall have jurisdiction with respect to such matter).*

The only reference to jurisdiction in this Code section appears in the parenthetical at the end of the sentence. The parties to this case agree that the parenthetical gives the Tax Court jurisdiction over petitions for review of CDP determinations and that the provision imposes a 30-day deadline to file a petition. However, the question exists as to the meaning of "such matter" in the parenthetical.

Boechler argues that it refers only to the immediately preceding phrase, i.e., "petition the Tax Court for review of such determination." The IRS asserts that "such matter" refers to the entire first clause of the sentence, which includes the deadline and grants jurisdiction only over petitions filed during the 30-day window.

The Court notes that the phrase "such matter" lacks a clear antecedent. Under the last-antecedent rule, the correct antecedent is usually "the nearest reasonable one,"[49] which favors Boechler's interpretation, although the Court states that this is hardly a "slam dunk."

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47. *2020 Purple Book,* p. 85. Dec. 31, 2019. National Taxpayer Advocate. [www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/ARC19_PurpleBook.pdf] Accessed on Jul. 28, 2022.

48. *Arbaugh v. Y & H Corp.,* 546 U.S. 500, 515 (2006).

49. *Reading Law: The Interpretation of Legal Texts.* Scalia, Antonin & Garner, Bryan A. 2012. [https://jm919846758.files.wordpress.com/2020/09/rlilt.pdf] Accessed on Jul. 29, 2022.

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The Court further notes that the IRS's interpretation is plausible. However, to satisfy the clear-statement rule for procedural requirements, the jurisdictional condition must be exactly that: clear. The court did not find the IRS's interpretation to be clear. It is not enough that the provision contains the word "jurisdiction." Instead, it is necessary to establish a clear link between the deadline and the jurisdictional grant.

The Court emphasized that its ruling does not mean that Boechler is entitled to equitable tolling under the facts of this case. That issue should be determined on remand.

Holding. The Court held that the 30-day time limit under §6330(d)(1) to file a petition for review of a CDP determination is an ordinary, nonjurisdictional deadline subject to equitable tolling (extension). The Court reversed the contrary judgement of the Court of Appeals and remanded the case for further proceedings consistent with this opinion.

> **Note.** This was a unanimous ruling by the Supreme Court. The opinion was authored by Justice Amy Coney Barrett.

IRS PROCEDURES — PENALTIES

Frivolous Position Penalties

***Larry Williams v. Comm'r*, TC Memo 2022-7 (Feb. 7, 2022)**
IRC §§162, 6651, 6662, and 6673

☞ Is a Taxpayer Subject to Penalties if the U.S. Government Does Not Exist?

Facts. In 2016, Larry Williams worked as a consultant for Lows Consultant, LLC. He filed his income tax return 3½ months late, claiming gross business income of $174,956 and business expenses totaling $174,829. The IRS disallowed the expenses due to a lack of substantiation. As such, the IRS charged Mr. Williams with a late filing penalty of $12,273 and an accuracy-related penalty of $9,820.

Mr. Williams concedes to the IRS that he cannot substantiate his expenses. He argues that despite not being entitled to the expenses, he is not responsible for the additions to tax because, among other assertions, the U.S. Government is bankrupt and no longer exists, the Code is not "law", and he is not a citizen of the United States.

Issues. The issues in this case are whether Mr. Williams is liable for a late filing penalty, an accuracy-related penalty, or a penalty for a frivolous position on his 2016 tax return.

Analysis. Mr. Williams provided no reasonable cause for filing his return 3½ months late. The court determined that Mr. Williams is liable for the late-filing penalty.

The IRS charges that Mr. Williams took a frivolous position and is subject to a $25,000 penalty under IRC §6673. The court declined to assess a §6673 penalty but warned Mr. Williams it will not be so lenient in the future if he continues to make frivolous arguments.

Holding. The court held that Mr. Williams is liable for the additions to tax assessed by the IRS.

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TAX EXEMPT

Tax Exempt Status

Ltr. Rul. 202210022 (Dec. 16, 2021)
IRC §501

☞ Tax Exemption Goes Up in Smoke

Facts. Taxpayer's bylaws state that it is a church that blends different religious and philosophical concepts and has a constantly evolving structure that allows it to change with science and stay current and relevant for its members.

Taxpayer filed Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code.* The application for exemption from federal income tax states that taxpayer conducts worship services in a group setting. These worship services take two forms.

1. A traditional-style formal service with a set time and place and which includes music and song
2. A personal and intimate worship service held in a quiet setting, which can be done alone or in a group setting with other members

After submitting its application, Taxpayer's representative had a subsequent conversation with the IRS, in which the representative stated that the Taxpayer used cannabis in its church services. Members of the congregation donate seeds to the church; these seeds are immersed in holy water for 12-24 hours. After this period, sanctification occurs, and the seeds are then cultivated and prepared for use in church services.

Analysis. IRC §501(c)(3) allows an exemption from federal income tax for corporations organized and operated exclusively for charitable or educational purposes. Treas. Reg. §1.501(c)(3)-1(a)(1) states that, to be exempt, an organization must be both organized and operated exclusively for one or more exempt purposes. If an organization does not meet either the organizational test or the operational text, it is not exempt.

Treas. Reg. §1.501(c)(3)-1(c)(1) states than an organization operates exclusively for exempt purposes only if it engages primarily in activities that accomplish exempt purposes, which are specified in §501(c)(3). An organization is not operated exclusively for exempt purposes if more than an insubstantial part of its activities are not in furtherance of an exempt purpose.

Marijuana is listed in 21 USC §821(c) as a hallucinogenic substance included on schedule 1 of the Schedules of Controlled Substances. The Controlled Substances Act[50] states that it is illegal for anyone to knowingly or intentionally manufacture, distribute, or dispense a controlled substance.

Rev. Rul. 75-384[51] states that all charitable organizations are subject to the requirement that their purpose cannot be illegal or contrary to public policy.

The consumption of cannabis, although not obligatory, is a substantial part of Taxpayer's exempt activity and worship services. Because the consumption and distribution of cannabis is illegal under federal law, Taxpayer serves a substantial nonexempt purpose.

Taxpayer does not satisfy the operational test of Treas. Reg. §1.501(c)(3)-1(c)(1). Only an insubstantial part of the activity of an exempt organization can further a nonexempt purpose. Because Taxpayer engages in activities that contravene federal law, it serves a substantial nonexempt purpose. As the Supreme Court held in *Better Business Bureau of Washington, D.C., Inc. v. U.S.,*[52] the presence of a single nonexempt purpose, if it is substantial, destroys the exemption regardless of the number or importance of exempt purposes.

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50. 21 USC §841(a).
51. Rev. Rul. 75-384, 1975-2 CB 204.
52. *Better Business Bureau of Washington, D.C., Inc. v. U.S.,* 326 U.S. 279, 283 (1945).

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Holding. The IRS held that Taxpayer is not operated exclusively for exempt purposes because it engages in a substantial activity of cultivating and consuming cannabis, which violates federal law and furthers a substantial nonexempt purpose. Accordingly, Taxpayer does not qualify for exemption under §501(c)(3).

SELF-EMPLOYMENT TAX

Real Estate Rentals

Chief Counsel Advice 202151005 (Nov. 19, 2021)

IRC §§469 and 1402

☞ IRS Addresses Whether Real Estate Rentals are Subject to Self-Employment Tax

Issue. The IRS Chief Counsel's office was asked whether the characterization of an activity as a rental activity under IRC §469(c)(2) determines whether the activity is considered "rentals from real estate" excluded from net earnings from self-employment (NESE) under IRC §1402(a)(1). The Chief Counsel's office responded that whether an activity is a rental activity under §469(c)(2) does not determine whether the exclusion in §1402(a)(1) applies.

In situations that do not involve a real estate dealer, the Chief Counsel addressed when rentals of living quarters are considered "rentals from real estate" excluded from NESE under §1402(a)(1). The Chief Counsel's office stated that in situations not involving a real estate dealer, net rental income from the rental of living quarters is considered rentals from real estate excluded from NESE when no services are rendered for the occupants. However, if services are rendered for the occupants, the net rental income received is not excluded under §1402(a)(1) and **is included in NESE** when the services rendered meet both of the following conditions.

1. Are not clearly required to maintain the space in **a condition for occupancy**
2. Are of such a substantial nature that the compensation for these services can be said to constitute **a material portion of the rent**

The IRS addressed two general fact patterns involving short-term customer use of a property.

- **Fact Pattern #1:** The taxpayer is an individual who owns and rents a fully furnished vacation property using an online rental marketplace. The taxpayer's activity is conducted in the course of a trade or business, and the taxpayer is not a real estate dealer. The taxpayer provides items including linens and kitchen utensils and provides daily maid services, access to Wi-Fi service, access to beach and recreational equipment, and offers prepaid vouchers for ride-share services. For the year at issue, the average period of customer use of the property is seven days. Therefore, the activity is not considered a rental activity for purposes of §469.[53] The taxpayer materially participates in the activity; therefore, the activity is not passive under §469(c).
- **Fact Pattern #2:** The taxpayer is an individual who owns and rents a fully furnished room and bathroom in a dwelling using an online rental marketplace. The taxpayer's activity is conducted in the course of a trade or business, and the taxpayer is not a real estate dealer. Occupants can only access the common areas of the home to enter and exit the room and bathroom. They have no access to other common areas such as the kitchen and laundry room. The taxpayer cleans the room and bathroom in preparation for each occupant's stay. For the year at issue, the average period of customer use of the property is seven days. Therefore, the activity is not considered a rental activity for purposes of §469.[54] The taxpayer materially participates in the activity; therefore, the activity is not passive under §469(c).

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53. Temp. Treas. Reg. §1.469-1T(e)(3)(ii)(A).

54. Ibid.

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Analysis. A passive activity is generally any trade or business activity in which the taxpayer does not materially participate or any rental activity. Temp. Treas. Reg. §1.469-1T(e)(3)(ii)(A) provides that an activity involving the use of tangible property is not a rental activity if, for the tax year, the average period of customer use for the property does not exceed seven days.

IRC §1401 imposes tax on self-employment income, which is defined as NESE, with certain modifications. However, net rental income from real estate is excluded from NESE, unless it is received in the course of a trade or business as a real estate dealer.

Treas. Reg. §1.1402(a)-4(c)(1) provides that rentals from living quarters, when no services are provided for the occupants, are generally considered rentals from real estate under §1402(a)(1), except for real estate dealers. However, Treas. Reg. §1.1402(a)-4(c)(2) provides:

> *Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant... are included in determining net earnings from self-employment. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.*

Conclusion. In Fact Pattern #1, the net rental income is not excluded from NESE because the taxpayer provides substantial services beyond those required to maintain the space in a condition suitable for occupancy. The services are beyond those necessary to maintain the space in a condition for occupancy and are of such a substantial nature that the compensation for these services can be determined to constitute a material portion of the rent. Therefore, the payments are included in NESE.

In Fact Pattern #2, the net rental income is excluded from NESE because the taxpayer does not provide substantial services beyond those necessary to maintain the space in a suitable condition for occupancy. The services provided for the convenience of the occupants must be of such a substantial nature that compensation for them can be determined to constitute a material part of the payments made by the occupants.

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