

Chapter 12: Rulings and Cases

Substantial Authority	659
Evaluation of Authorities	659
Nature of Analysis.....	659
Authority Hierarchy	660
Judicial System for Tax Disputes	661
Case Commencement	662
The U.S. Tax Court.....	662
IRS Actions on Decision	666
Business Expenses.....	667
IRS Loses Interest Case.....	667
Taxpayer Loses the Documentation Game.....	668
No Tax Relief on Stolen Funds	671
Expense Substantiation Not So Common for Greatest Common Factor	672
Corporations	674
IRS Notice Waives Corporate AMT Estimated Tax Penalty	674
Credits	675
Taxpayers Lost the Opportunity for Education Credit	675
Deductions	676
Troubleville for Degourville.....	676
Inflation Adjusted Amounts for Health Savings Accounts.....	678
Digital Assets.....	679
Delay in Required Brokerage Reporting of Digital Assets	679
Tax Court Washes Hands of Unclean Argument	679
Estate and Trust.....	681
Claim of Right Goes Wrong.....	681
Executor in (Un)Compromising Situation.....	683
Step-Up Shuffle: When Trusts Skip the Party for Asset Basis Boosts.....	685
Foreign Income	686
Biting Back Benefits Bittner	686
Gross Income	688
Dern't Forget to Include Damages Received in Gross Income.....	688
Bankruptcy Court Makes U-Turn for Self-Driving Vehicle Pioneer.....	689
Rodgers Attempts Dodging Tax on Interest Income	690
Long-Term Contract Rules Apply Regardless of Whether Taxpayer Owns Property.....	691

2023 Workbook

Innocent Spouse.....	692
Blogged Down With Evidence	692
IRS Procedures — Miscellaneous.....	693
IRS Not Required to Alert Taxpayers of Summons.....	693
Blues and Booze Offer No Excuse	695
IRS Releases “Dirty Dozen” List of Tax Scams.....	697
Early Filers in 2023 Should Consider Amending Returns For Certain State 2022 Tax Refunds	699
Less Than A Minute Didn’t Win It.....	700
Numerous Nuisances for Neuberger.....	701
IRS Procedures — Penalties.....	704
Relief from Deadlines For Filing Claims for Refunds	704
Retirement	705
Taxpayer Cannot Use Disability to Avoid Early Withdrawal Penalties	705
S Corporation	707
Military Design-Build Firm Qualifies for Credit for Increasing Research Activities.....	707

Note. Corrections were made to this workbook through January of 2024. 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, 2023. 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.

2023 Workbook

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.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.

- 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)).

¹ Treas. Reg. §1.6662-4(d)(3)(iii).

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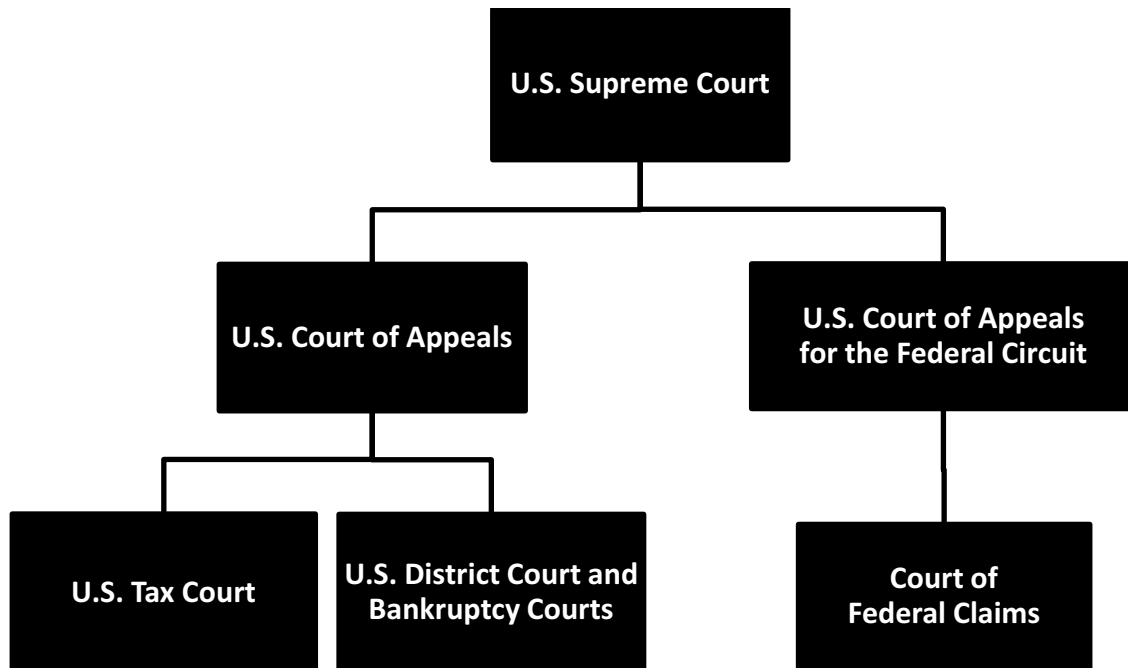
GCM. GCM detail the legal reasoning behind the issuance of a revenue ruling.

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.

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.

2023 Workbook

CASE COMMENCEMENT

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

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

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

THE U.S. TAX COURT

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

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

As of July 2023, the Tax Court is composed of 19 judges (three 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 online at **pay.gov**, or by check or money order made out to “Clerk, United States Tax Court.”² Jury trials are not available in this forum.

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.

² *How to Pay the Filing Fee.* United States Tax Court. [ustaxcourt.gov/pay_filing_fee.html] Accessed on Jul. 17, 2023.

2023 Workbook

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

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

To invoke the jurisdiction of the Tax Court, the taxpayer must file a petition in Tax Court within 90 days after the IRS notice of deficiency (or notice of final determination) is mailed.³ **The 90-day date cannot be extended by the IRS.** Similarly, the Tax Court has no statutory authority to extend the 90-day period.⁴ 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.⁵

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.pdf]

³. IRC §6213(a).

⁴. *R. S. Schoenfeld v. Comm'r*, TC Memo 1993-303 (Jul. 13, 1993); *Schake v. Comm'r*, TC Memo 2002-262 (Oct. 10, 2002).

⁵. *R. M. Crandall v. Comm'r*, 650 F.2d 659 (5th Cir. 1981); *N. E. Carstenson v. Comm'r*, 57 TC 542 (1972).

2023 Workbook

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.

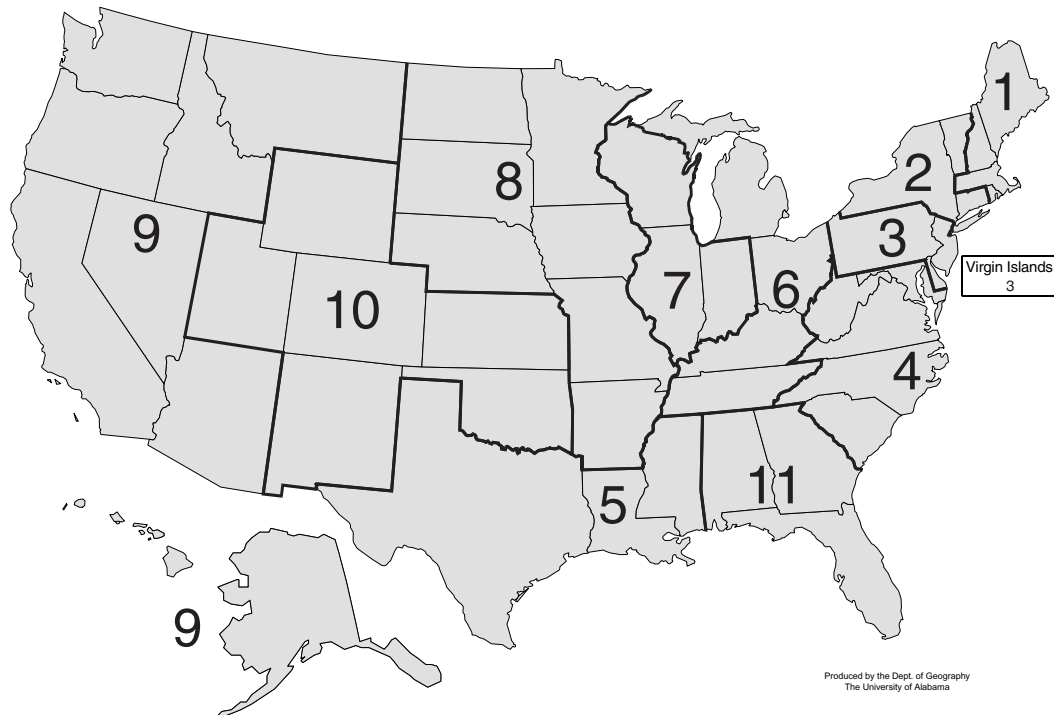
A final appeal can be made to the U.S. Supreme Court; but, because the Court's jurisdiction is discretionary, it hears relatively few tax cases. Many of the court transcripts from these cases can be accessed online at **uofi.tax/15b7x6** [www.uscourts.gov].

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. 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].

2023 Workbook

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	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, Hawaii, 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



2023 Workbook

IRS ACTIONS ON DECISION⁶

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** [irs.gov/actions-on-decisions]. 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#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.

⁶ *Actions on Decision (AOD)*. IRS. [apps.irs.gov/app/picklist/list/actionsOnDecisions.html] Accessed on Aug. 21, 2023; IRM 36.3.1 (2013).

BUSINESS EXPENSES

Interest Expense

Alexander C. Deitch et al. v. Comm’r, TC Memo 2022-86 (Aug. 25, 2022)

IRC §163

IRS Loses Interest Case

Facts. Alexander Deitch and Jonathan Barry formed West Town Square Investment Group, LLC (WTS) as a Georgia limited liability company (LLC) to acquire real estate for development as a local hospital’s physical therapy facility. Both had experience in commercial real estate, giving them confidence that they could develop, manage, and eventually sell at a profit the shopping center, which a Walmart store had once anchored. Mr. Barry had access to loaned money from PLI, a subsidiary of Protective Life Corporation, an insurance company. WTS acquired the property with a \$4.4 million loan from PLI, later borrowing additional sums to make needed renovations and provide the hospital with an allowance for moving costs.

The amounts loaned by PLI constituted almost 100% of the project’s financing because Mr. Deitch and Mr. Barry formed WTS by contributing only \$5 of capital each. Because borrowers could only secure conventional mortgages when the amount loaned was 75% or less of the property’s value, acquiring the property required a special type of loan.

The special loan product turned out to be a **participating loan**. A participating loan is one in which a lender participates in the real estate’s profits, either from the property’s monthly cash flow or through a percentage of the profits when the borrower sells the property. WTS required both conventional and participating loans. Part of the additional interest was based on the appreciation of the property when sold, and the loan documents identified it as “appreciation interest.”

These documents expressly provided that PLI and WTS would have a relationship of creditor and lender. The loan documents contained the following language.

Nothing contained in any Loan Document or instrument made in connection with the loan, shall be deemed or construed to create a partnership, tenancy-in-common, joint tenancy, joint venture, or co-ownership by or between Lender and Borrower, or any relationship other than that of creditor or debtor

All loan documents consistently stated that PLI and WTS had a creditor-debtor relationship and only referred to the money WTS paid to PLI as interest.

Despite its thin capitalization, WTS made necessary payments and sold the property for \$6.3 million. PLI benefitted from its assumption of risk with the payment of appreciation interest of \$1,035,683, which was 50% of the net proceeds of the sale. WTS also fared well, as the transaction resulted in partner capital on its tax return for the year of \$1,099,342.

This appreciation interest payment, however, caught the IRS’s attention. The agency claimed that the participating loan made PLI effectively an equity partner in the project. WTS classified the transaction as interest on its tax return, but the IRS took the position that it was not interest but a guaranteed payment.

Therefore, the IRS adjusted Mr. Dietch’s and Mr. Barry’s tax returns by their shares of the appreciation interest payments made to PLI. After asserting changes of \$517,842 in the taxable incomes of Mr. Dietch and the Barrys, the IRS issued statutory notices of deficiency to each. Mr. Dietch and Mr. Barry petitioned the Tax Court to redetermine the deficiency.

Issues. The issue in this case is whether WTS properly classified its payment of “appreciation interest” to PLI, its creditor, as deductible interest.

2023 Workbook

Analysis. The Tax Court decided it had jurisdiction in this case because of the small partner exception in IRC §6231(a)(1)(B). However, it could not decide issues at the **partnership** level because the IRS had failed to issue a final partnership administrative adjustment (FPAA) in the case, failing to even mention WTS in the statutory notice of deficiency.

The IRS said that it wanted the Tax Court to sustain its position that the relationship between WTS and PLI, the lender, constituted a partner. If it were successful in this contention, WTS could not treat payments of participatory interest as deductible.

Because PLI was a corporation and WTS was taxed as a partnership, the small partnership exception did not apply. Thus, the Tax Court lacked jurisdiction to decide whether a partnership existed between WTS and PLI.

The Tax Court turned to the central issue of whether the WTS's payment of "participation interest" actually satisfied the statutory definition of interest, concluding that it did. The following points led the court to this conclusion.

- The court observed that the parties had agreed that the agreements arose from an arm's length transaction.
- The court further observed that these agreements amounted to actual indebtedness by WTS to PLI.

The IRS was bound by its stipulation to these facts and disclaimed any allocation between debt and equity in the funds PLI extended to WTS. This stipulation forced the IRS to argue that the entire loan proceeds to WTS constituted an equity contribution, which it had disclaimed. Thus, the IRS's stipulations that the four loan agreements provided evidence of "genuine indebtedness" contradicted its argument that the payments to PLI were guaranteed payments. The court held that PLI did not have a "single equity interest" in WTS that would change the interest payments into guaranteed payments.

Holding. In view of the consistency between documents stipulating that the payments be considered interest, the Tax Court held that payments were indeed interest and were, therefore, deductible under IRC §163.

Substantiation of Business Expenses

Nnabugwu C. Eze v. Comm'r, TC Memo 2022-83 (Aug. 4, 2022)

IRC §§162(a), 163(h), 274(d), and 280F

Taxpayer Loses the Documentation Game

Facts. Nnabugwu Eze graduated from Rutgers University but had not established a clear career direction when the IRS audited his returns for 2015 and 2016. He filed two separate Schedules C, *Profit or Loss From Business*. One Schedule C was for his work as an information technology (IT) consultant, specifically in electronic healthcare. The other Schedule C was for his work in residential construction. This involved various home improvement tasks similar to handyman duties for individual customers. Mr. Eze's expenses for this endeavor greatly exceeded his income. No income was reported to Mr. Eze from his customers on a Form 1099-MISC, *Miscellaneous Income*. No records, even bank statements, supported the income or expenses appearing on Schedule C for the construction business. For his IT contracts, Mr. Eze worked as an independent contractor for Northrup Grumman, which paid him by direct deposit. His duties in the electronic healthcare field required him to visit medical clinics and doctors' offices.

He owned three vehicles to pursue these ventures: a 2008 luxury vehicle he used exclusively for IT consulting, a 2002 Ford SUV used exclusively for his residential construction business, and a 2004 Chrysler reserved exclusively for personal use. In conjunction with his IT consulting business, Mr. Eze claimed significant deductions for vehicle expenses, \$21,490 in 2015 and \$30,533 in 2016.

Mr. Eze timely filed his 2015 and 2016 federal income tax returns as head of household (HoH) with two dependents. His 2015 return reported taxable income of \$3,314, with a refund of \$774. His 2016 return reported taxable income of \$0, with a refund of \$744.

Upon examination, the IRS disallowed the following deductions.

- Itemized deduction for mortgage insurance of \$2,847
- All vehicle expenses reported on both Schedules C
- Approximately 90% of the business expenses reported on the Schedule C for IT consulting
- All the business expenses associated with Mr. Eze's residential construction business

Not agreeing with the IRS, Mr. Eze engaged a California attorney to petition the Tax Court, who requested a Los Angeles, California, situs. Two months before the trial started, the attorney withdrew from representing Mr. Eze for the following reasons.

- Breakdown in the attorney-client relationship
- Mr. Eze's refusal to follow counsel's advice

The court granted this motion to withdraw and rescheduled the trial. The new attorney never appeared in court, and a second continuance due to COVID-19 postponed the trial again. Mr. Eze then informed the court he would represent himself, requesting a change in venue to Baltimore, Maryland. The court denied the request and tried the case via the Zoomgov computer network.

Issues. The issues in the case are the following.

- Whether Mr. Eze met the substantiation requirements for the mortgage insurance premium paid
- Whether Mr. Eze met the heightened requirements for substantiation associated with listed property used in his consulting business
- Whether Mr. Eze met the requirements for all deductions claimed, particularly those requirements for normal substantiation in the consulting business
- Whether Mr. Eze met the heightened requirements for vehicle expenses for his construction business
- Whether Mr. Eze purchased the building supplies, materials, and tools for use on building sites at which his construction business operated

Analysis. Mr. Eze produced a Form 1098, *Mortgage Interest Statement*, for the court, which substantiated the itemized deduction he had claimed on his tax return for 2016. He further established to the court's satisfaction the mortgage interest appearing on it was for his principal residence.

The court concluded that Mr. Eze "wholly failed to satisfy the requirements" in substantiating his vehicle expenses, finding the following three problems.

1. Mr. Eze did not document the vehicle expenses near the time they were made, rather waiting to reconstruct them in the face of the IRS audit. The court observed he could not explain how the details could have been recalled after so much time had passed.
2. Mr. Eze could neither identify a specific client nor provide evidence he had actually made trips to an address associated with the clients.
3. The court did not find plausible the entries Mr. Eze produced in his log, specifically visiting a client in Manhattan on January 1 in both years or a client in Brooklyn each year. The court's opinion stated, "[w]e did not find this plausible."

As a result of its audit, the IRS allowed only about \$1,000 of expenses related to Mr. Eze's IT consulting business for both 2015 and 2016. Although Mr. Eze claimed a deduction for continuing education expenses, in court, he admitted the amounts on the return were for his daughter's tuition, not his own professional education. He could not provide any evidence his business incurred the computer expenses for business reasons. The court sustained the IRS's disallowance of most expenses Mr. Eze claimed for his IT business.

2023 Workbook

Mr. Eze's claims for deductions related to vehicle expenses were supported by the same calendar used for the IT business. The court used the term "annotated" to describe the calendars but attributed no credibility to them. Mr. Eze provided a mileage log for 2015 only, and it contained work descriptions the court found "repetitive." The court found that the documents submitted by Mr. Eze were missing "the indicia of reliability," noting explicitly that the **beginning** odometer reading was the same for **every** trip. The court determined Mr. Eze did not have any deductible mileage in 2015 for his construction business.

In the court's view, these flaws were compounded by Mr. Eze preparing the documents long after he incurred the expenses and likely in anticipation of the IRS's scrutiny. Given the more stringent substantiation requirements that Temp. Treas. Reg. §1.274-5T(c) impose, the court sustained the IRS's complete denial of vehicle deductions for Mr. Eze's construction business.

Mr. Eze presented a hodgepodge of paper receipts to support his claim of other deductions relative to his construction business. The IRS objected to admitting these receipts into evidence, an objection the court sustained. The court could not associate them with Mr. Eze, as he could furnish no contracts, bills, or invoices. The IRS claimed that the receipts originated with purchases made by other persons. The court agreed with this claim, particularly after Mr. Eze admitted the purchases were made by his spouse "and maybe somebody else."

Mr. Eze's claim of expenses for construction materials fared no better. The receipts often exceeded \$5,000 but were all paid in cash. Mr. Eze stated he got the cash from ATMs or bank tellers but could not produce bank documentation to support this claim. Mr. Eze refused the court's request to include bank records with other evidence he provided.

The court stated it failed to see how Mr. Eze had the financial resources to sustain the purchases of materials and tools, given the total revenue reported. Based on Mr. Eze's tax return, the court concluded a claim of \$175,000 deducted for materials and tools was unreasonable, given his financial circumstances.

The court thought the volume of materials Mr. Eze purchased was "implausibly large," considering where he purchased them and the relatively small vehicle in which Mr. Eze would have transported them. Noting the \$21,000 spent on tools, Mr. Eze could not explain to the court's satisfaction what function the tools served.

Holding. Mr. Eze satisfied the statutory requirement to sustain the itemized deduction for mortgage insurance because the Form 1098 he retained satisfied the substantiation requirement. Only on this issue did he succeed.

For his consulting business, the court held Mr. Eze did not meet the heightened substantiation requirement for vehicle expenses because the records were not plausible. Similarly, the other expenses reported for this business were denied. The court sustained the IRS's denial of both types of expenses for the consulting business.

The court similarly sustained the IRS's denial of the vehicle expenses claimed for Mr. Eze's construction business. It also denied expenses for the purchase of construction supplies, materials, and tools.

Mr. Eze conceded the accuracy-related penalties as assessed by the IRS.

Note. This case provides a clear lesson on the importance of business records. Mileage logs should be constructed at the time of the trip, clearly showing accurate odometer readings and business purposes. Transactions that appear on bank statements are preferred over cash transactions. The involvement of a third-party provides credible evidence that a transaction took place. They also confirm the taxpayer made the expenditure. Lastly, noting the purpose of an expenditure near the time it was made substantiates the business purpose of the purchase.

Business Deduction Denied for Theft Loss

***Dennis and Suzanne Gomas v. U.S.*, No. 8:22-cv-01271 (M.D. Fla. Jul. 17, 2023)**

IRC §§162, 165, and 408

No Tax Relief on Stolen Funds

Facts. Dennis and Suzanne Gomas retired in June 2016 after owning and operating their pet food business for several years. After closing the corporation's bank accounts, they turned the business over to Mrs. Gomas's daughter, Suzanne Anderson. Ms. Anderson had worked for the Gomas's business for a couple of years.

In May 2017, Ms. Anderson told Mr. and Mrs. Gomas that a former employee had opened sub-accounts under Mr. Gomas's identity to defraud customers. Per Ms. Anderson, this fraud had resulted in Merchant Services prosecuting the business and Mr. Gomas personally for the fraudulent transactions. She recommended hiring an attorney, Anthony Rickman, to represent Mr. Gomas to prevent his purported arrest.

Subsequently that year, the Gomas's withdrew funds from their individual retirement arrangements (IRAs) to pay for the legal services provided by Mr. Rickman, whom they had never met. Despite using \$1,133,250 of IRA distributions to pay the attorney, they only corresponded with Ms. Anderson about the case. She supposedly facilitated all communication between the two parties.

In 2019, Mr. and Mrs. Gomas discovered that Ms. Anderson had lied to them when two of their friends reached out to Mr. Rickman directly. Mr. Rickman informed their friends that neither the Gomases nor Anderson were clients of his. As a result, the police were contacted and in due time, Ms. Anderson was arrested and sentenced to 25 years imprisonment for multiple theft and fraud charges.

In February 2020, Mr. and Mrs. Gomas filed an amended 2017 tax return to claim a business deduction for the amount of funds Ms. Anderson stole. To substantiate the deduction, they issued a Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, to Ms. Anderson showing income to her equal to the \$1,174,020 in pension and IRA distributions they reported on their 2017 return. Per the documentation they submitted with the amended return, the payment of was for "fictitious invoices, fake attorneys' fees, and other fraudulent mechanisms used by...Anderson." The amended return showed a refund of income tax and penalties totaling \$412,259.

In February 2021, the IRS disallowed the Gomases the deduction and rejected their claim for refund. In March 2021, the Gomases filed a protest and requested an appeal, stating the business nature of the deduction. In March 2022, the IRS rejected the appeal. In response, the Gomases sought summary judgement from the court.

Issues. The issue in this case is whether the IRA distributions are excludable from income.

Analysis. IRC §408(d)(1) requires retirement plan distributions to be included in the distributee's gross income. The distributee is generally the entitled participant or beneficiary⁷, but some courts recognize an exception where the taxable distributee is a party other than the recipient.

However, the Gomases exercised their discretion over the fund payments from the retirement accounts. Although they distributed the funds to Ms. Anderson under false and fraudulent pretenses, they were the ones who requested and received the funds from their retirement account.

IRC §162 allows taxpayers to deduct ordinary and necessary expenses for engaging in a trade or business. For the business expense to be deductible, the expenditure must be intended to help realize a profit or to advance the business.⁸ While the Gomases were under the impression that their retirement distributions were for legal services, the fact was that the funds were not actually used for attorney fees.

⁷ See *Roberts v. Comm'r*, 141 TC 569 (2013).

⁸ See *Brannen v. Comm'r*, 722 F.3d 695, 704 (11th Cir. 1984).

2023 Workbook

The presumption or belief that funds were used for business purposes does not change the nature or characteristic of the actual use of the funds. Furthermore, the legal fees in this situation would not be considered qualifying business expenses, because the Gomases had both been retired when they turned their business over to Ms. Anderson.

Holding. The court acknowledged that it was in fact Ms. Anderson who enjoyed the benefits of the funds. However, it held that the Gomases were the distributees of the IRA distributions. Consequently, the distributions must be included in Mr. and Mrs. Gomas's gross income. The court also held that the distributions did not qualify as ordinary and necessary business expenses and were therefore nondeductible as such.

Observation. It is not clear from the summary judgement why the taxpayers did not claim a deduction for theft loss instead of trying to claim a business expense for the stolen funds. In the judgement, the court noted "It is highly unlikely that Congress, when it eliminated the theft loss deduction beginning in 2018, envisioned injustices like the case before this Court. Be that as it may, the law is clear here and it favors the IRS." However, because most of the funds were stolen in 2017, the court's observation would likely not apply to this case.

Home Office Deduction for Corporations

Greatest Common Factor v. Comm'r, TC Memo 2023-39 (Mar. 23, 2023)

IRC §§162, 167, 274, and 6662

Expense Substantiation Not So Common for Greatest Common Factor

Facts. Greatest Common Factor (GCF) was taxed as a C corporation for the 2013 and 2014 tax years. During that time, Glenn Fyfe and his ex-wife Rhonda Fyfe were both 50% shareholders of GCF. Mr. Fyfe represented the company as an authorized officer.

As an employee of GCF, Mr. Fyfe provided technical consulting on classified projects at the Los Angeles Air Force Base as a subcontractor for Kinsey Technical Services. His duties required him to perform the services on site and adhere to restrictions on document removal. In 2013 and 2014, GCF reported \$274,448 and \$265,126 of income, all from Kinsey.

On GCF's returns, the company claimed deductions for home office costs and various car and truck expenses. GCF did not have a rental agreement with Mr. Fyfe to maintain a home office, and it did not pay for any such costs. GCF also claimed depreciation deductions for three vehicles but failed to provide supporting documents for the vehicles' purchase prices, ownership, or business use when requested by the IRS. The mileage logs provided by Mr. Fyfe included commuting between his home and the air force base he classified as business trips. None of the mileage logs or receipts for vehicle expenses substantiated a business purpose for the trips.

The IRS disallowed these deductions in a notice of deficiency issued on March 30, 2021. Per the notice, GCF owed \$49,817 in tax deficiencies for 2013 and \$12,454 for 2014, including accuracy-related penalties under IRC §6662(a).

Issues. The issues in this case are the following.

- Whether GCF is entitled to deduct expenses for a home office and vehicle expenses on its 2013 and 2014 income tax returns.
- Whether GCF is liable for accuracy-related penalties under §6662(a)

Analysis. A C corporation is allowed deductions to lease home office space from an employee or its owner as rent if the expense is ordinary and necessary, and directly connected with the corporation's trade or business. Mr. Fyfe did not provide evidence of a rental agreement with GCF. Therefore, the court determined that GCF could not deduct any home office expense.

Furthermore, if Mr. Fyfe were the taxpayer, rather than GCF, the court determined that he still would not be eligible to deduct a home office expense because the dwelling was not used exclusively as the principal place of business for his trade or business. Rather, Mr. Fyfe worked out of the Los Angeles Airforce Base and was prohibited from bringing any of his confidential work home.

Certain expenses specified in IRC §274, such as car and truck expenses, are subject to strict substantiation rules. To meet these rules, the taxpayer must substantiate the amount of the expense, the time and place of its occurrence, and the business purpose behind it. This can be achieved through adequate records and documentary evidence or by the taxpayer's statement corroborated by documentary or other direct evidence.

Although Mr. Fyfe provided mileage logs, those logs did not list a required business purpose for the trips. The logs included trips from his house to the airforce base, which are considered commuting expense and not deductible. As such, the court disallowed the car and truck expenses.

In addition, the depreciation deduction for property used in a trade or business requires substantiating the property's depreciable basis, including its cost, useful life, and previously allowable depreciation. Heightened substantiation requirements apply to listed property, which includes passenger automobiles. GCF did not provide evidence supporting the business purpose of the vehicles, the cost of the vehicles, nor any documents showing its ownership of the vehicles. The Court sustained the IRS's disallowance of GCF's depreciation deductions.

The accuracy-related penalty is imposed on an underpayment of tax due to negligence or disregard of rules and regulations. It encompasses any failure to comply with internal revenue laws or to keep adequate books and records. To avoid the penalty, a taxpayer must demonstrate reasonable cause and good faith. Because GCF did not show reasonable cause or good faith for their underpayment of tax, the court determined that GCF was liable for the 20% accuracy-related penalty attributable to negligence.

Holding. The court held that GCF was **not** entitled to deduct expenses for a home office or vehicle expenses on its 2013 and 2014 income tax returns because of the company's lack of proper substantiation. The court also held that the corporation was liable for 20% accuracy-related penalties under §6662(a).

CORPORATIONS

Corporate Alternative Minimum Tax

IRS Notice 2023-42 (Jun. 7, 2023)

IRC §§55, 59A, and 6655

IRS Notice Waives Corporate AMT Estimated Tax Penalty

Purpose. IRS Notice 2023-42⁹ provides relief for corporations from “penalties” for underpayment of estimated income taxes to the extent the underpayment is due to the new **corporate alternative minimum tax** (AMT) added to IRC §55 by the Inflation Reduction Act of 2022. This relief is only available for a corporation’s tax year beginning in 2023.

Note. IRC §6655(a) imposes an “addition to tax” rather than “penalty” on corporations that fail to make timely and sufficient payments of estimated taxes required by this provision. Thus, this IRS notice uses the phrase “relief from certain additions to tax” as opposed to “relief from penalty.”

The corporate AMT is a minimum tax on large C corporations based on the corporations’ **adjusted financial statement income (AFSI)**.¹⁰ It only applies to domestic C corporations with average AFSI greater than \$1 billion.¹¹ Multinational corporations with foreign parents are subject to it if their average AFSI is greater than \$100 million.¹² Corporations meeting these requirements are called applicable corporations.¹³

Analysis. The IRS issued this relief because of the uncertainties involved in calculating the corporate AMT for estimated tax purposes while the regulations are still under development. Section 3 of Notice 2023-42 makes three announcements for applicable corporations.

1. The IRS waives the addition to tax under IRC §6655 for 2023 for not making estimated tax payments.¹⁴ This is because the IRS has had difficulty in determining which corporations are subject to the corporate AMT and in determining their corporate AMT liability. The addition to tax is often referred to as a penalty.
2. The IRS will modify the instructions for Form 2220, *Underpayment of Estimated Taxes by Corporations*.¹⁵ Additional language is needed to explain that a failure to make payments for an estimated corporate AMT liability does not result in an addition to tax under §6655. However, this is expected to apply only for tax years that begin during 2023.
3. Affected corporations are still required to file Form 2220, even though they have no corporate AMT liability.¹⁶ Form 2220 must be completed without reporting the corporate AMT liability that appears in Form 1120, *U.S. Corporation Income Tax Return*, Schedule J. They must show a number on Form 1120, line 34, the estimated tax penalty, even if they show \$0. The IRS may send a penalty notice to corporations that do not follow the instructions. Although the corporation could request abatement of the penalty, they would have to send an abatement request.

Note. This waiver applies to failure to make estimated tax payments only for the corporate AMT. It does not waive penalties for failure to pay other estimated income tax amounts.

⁹ IRS Notice 2023-42, 2023-26 IRB 1085.

¹⁰ *Inflation Reduction Act of 2022*, PL 117-169, §10101.

¹¹ IRC §59(k)(1)(B).

¹² IRC §59(k)(2).

¹³ IRC §59(k)(1).

¹⁴ IRS Notice 2023-42, 2023-26 IRB 1085, §3.01.

¹⁵ *Ibid*, §3.02.

¹⁶ *Ibid*, §3.03.

CREDITS

Education Credits

***John and Eliza Vassiliades v. Comm’r*, TC Summ. Op. 2023-1 (Jan. 9, 2023)**

IRC §25A, 6001; Treas. Reg. §1.6001-1(a)

Taxpayers Lost the Opportunity for Education Credit

Facts. John and Eliza Vassiliades are married and reside in California. Mr. Vassiliades has a daughter (AM) from a previous relationship who attended the University College London (UCL). AM was a full-time student at UCL from 2017 until 2020, working on her bachelor’s degree. Throughout 2017 and 2018, Mr. Vassiliades transferred money to his daughter’s account in Europe to cover tuition, fees, and other expenses.

With the help of a paid preparer, Mr. and Mrs. Vassiliades filed their 2018 income tax return. The return claimed AM as a dependent and the American Opportunity Credit (AOC). Their Form 8863, *Education Credits (American Opportunity and Lifetime Learning Credits)*, showed a refundable AOC of \$1,000 for qualified education expenses and a nonrefundable education portion of \$1,500. The couple did not receive a Form 1098-T, *Tuition Statement*, from UCL for 2018.

The IRS denied the \$2,500 education credit because Mr. and Mrs. Vassiliades did not establish that they paid education expenses during the year in question.

Issues. The issue in this case is whether Mr. and Mrs. Vassiliades are entitled to the AOC.

Analysis. The AOC is a tax credit for qualified education expenses paid for an eligible student for the first four years of higher education. The maximum AOC per eligible student is \$2,500, calculated as the sum of 100% of the first \$2,000 of qualifying expenses and 25% of the next \$2,000.¹⁷ Qualified tuition and related expenses include fees paid to an eligible institution on behalf of a taxpayer, their spouse, or their dependents. Related expenses include amounts paid for course materials. The student must be enrolled at least half-time for at least one academic period beginning in the year. AM met all the qualifications for the AOC.

However, Mr. Vassiliades could not produce a tuition receipt due to the theft of many important documents during a burglary of his home in 2018. Mr. Vassiliades produced records of money transfers, currency conversion amounts, and a receipt for an online payment to UCL during the previous year to the one in question. Mr. Vassiliades claimed he was unable to acquire any supporting documents from UCL.

Holding. Although sympathetic to Mr. Vassiliades’s inability to procure supporting documentation due to circumstances, the court held that Mr. and Mrs. Vassiliades were not entitled to the AOC because there was no support that they paid the qualified tuition and related expenses.



¹⁷ IRS Pub. 970, *Tax Benefits for Education*.

DEDUCTIONS

Filing Status, EIC, Business Deductions, and Fraud Repercussions

Lakeisha Degourville v. Comm’r, TC Memo 2022-93 (Sep. 12, 2022)

IRC §§32, 6695(g), and 6663

Troubleville for Degourville

Facts. Lakeisha and Kenneth Degourville were married on October 15, 1999. Together they share three children and lived together until mid-2016. Mrs. Degourville was a licensed cosmetologist and owned a tax preparation firm, TaxTime Service (TaxTime). She owned a hair salon, Xplosions Hair Design (Xplosions), and co-owned a restaurant with her husband. Mrs. Degourville worked as a tax preparer for the years prior to hosting her own tax preparation courses from 2011 to 2016.

On July 28, 2014, the IRS assessed a return preparer earned income credit (EIC) due diligence penalty against Mrs. Degourville of \$45,000 for the 2012 tax year.

On June 10, 2016, the State of Georgia convicted Mrs. Degourville of state tax evasion for not reporting income on her Georgia return and theft by taking for improperly filing state income tax returns for her TaxTime clients. Consequently, the State of Georgia sentenced Mrs. Degourville to 15 years of probation and imposed a \$31,300 fine. Additionally, the State of Georgia permanently barred Mrs. Degourville from preparing income tax returns for other people.

Mrs. Degourville testified that TaxTime earned fees in 2012 of \$552,865, of which she reported \$168,466 as profit on an amended 2012 state income tax return. Additionally, she testified that Xplosions had revenues of \$150,000, and her restaurant had a substantial loss.

Mr. and Mrs. Degourville each filed a Form 1040, *U.S. Individual Income Tax Return*, for 2012. They both elected HoH filing status, despite living together during the entire year. The IRS adjusted Mrs. Degourville’s filing status to married filing separately. Additionally, both spouses claimed the EIC on their respective tax returns from 2007 to 2012. The IRS disallowed the claim for 2012.

Mrs. Degourville attached a Schedule C for Xplosions reporting gross receipts of \$20,316 and a second Schedule C for TaxTime that reported gross receipts of \$15,811. The IRS rejected a rent/lease expense for Xplosions and commission expenses for TaxTime as there was no supporting documentation. Mrs. Degourville reported net profits of \$980 and \$9,088 for Xplosions and TaxTime, respectively.

Upon examination, Mrs. Degourville could not produce any business records. At trial, she claimed Georgia state officials were holding the records as part of their criminal investigation. The IRS conducted bank deposit analyses on the Degourville’s seven bank accounts to determine the couple’s adjusted gross income. The bank statements showed over a million dollars in deposits during 2012. The IRS calculated unreported gross receipts of \$439,705.

Issues. The issues in this case are the following.

- Whether proceeds in Mrs. Degourville’s accounts are taxable
- Whether Mrs. Degourville qualifies for HoH filing status
- Whether Mrs. Degourville is entitled to the EIC
- Whether Mrs. Degourville is entitled to the business deductions on her Schedules C
- Whether Mrs. Degourville is subject to a civil fraud penalty
- Whether Mrs. Degourville is subject to the EIC 10-year ban due to fraud

Analysis. The IRS used the bank deposits method to recreate the Degourvilles' income as the couple did not maintain records. Through this method, the IRS determined that the Degourvilles had taxable income exceeding \$1 million, of which over \$800,000 went unreported. The taxable income translated to \$439,705 of gross receipts. Mrs. Degourville did not disagree with the IRS' methods or the amount. She disputed that she was solely responsible for the entire amount of gross receipts. Mrs. Degourville stated that other contractors at TaxTime earned gross receipts. However, Mrs. Degourville could not provide records supporting the amount, if any, that the other contractors earned. Similarly, she was unable to support the \$250,000 loss on her restaurant.

Mrs. Degourville argued that she did not have records because they were in the custody of Georgia state authorities as part of her state criminal case. However, she did not request the documents. The court determined that because she could not prove otherwise, Mrs. Degourville was responsible for the \$439,705 of gross receipts.

To qualify for HoH filing status if married, the taxpayer must:¹⁸

1. File a separate tax return,
2. Maintain a household for more than one-half of the taxable year as the principal place of abode of the taxpayer's child for whom the taxpayer would be entitled to claim a dependency exemption,
3. Furnish over one-half of the cost of maintaining such household during the taxable year, and
4. Not be a member of the household with their spouse during the last six months of the taxable year.

Mrs. Degourville admitted that although she and her husband listed separate addresses on their tax return, they lived together the entire year and were not legally separated. As such, they were ineligible to claim the HoH status.

The EIC is a credit based on a percentage of a taxpayer's earned income. To qualify for the credit under IRC §32(d), a married individual must file a joint return with their spouse. Because the Degourvilles filed separately as HoH, they did not qualify for the EIC. The court noted that they likely would not have qualified anyway because the additional gross receipts would have exceeded the phase-out limits for high-income earners.

The court denied Mrs. Degourville's expenses on her Schedules C due to a lack of records. Under certain circumstances, the court can estimate allowable expenses when the taxpayer can prove that they incurred the expenses but cannot substantiate the amount.¹⁹ In this case, there were so few records that the court was unable to estimate the expenses.

The court determined that Mrs. Degourville was liable for civil fraud penalties. To be subject to the 75% of the underpayment of tax, the IRS must prove that there was an underpayment of tax during the year and that some part of the underpayment was because of fraud.²⁰ As illustrated in the previous discussion, there was an underpayment of taxes.

Proving fraudulent intent depends on the facts of the case. However, the following are some indicators of fraud.²¹

- Understating income
- Failing to maintain adequate records
- Offering implausible or inconsistent explanations
- Concealing income or assets
- Failing to cooperate with tax authorities

¹⁸ IRC §7703(b).

¹⁹ *Cohan v. Comm'r*, 39 F.2d 540, 543–44 (2nd Cir., 1930).

²⁰ IRC §6663(a).

²¹ *Bradford v. Comm'r*, 796 F.2d 303, 307 (9th Cir., 1986), *aff'g* TC Memo 1984-601 (Nov. 19, 1984).

2023 Workbook

- Engaging in illegal activities
- Providing incomplete or misleading information to the taxpayer's tax return preparer
- Offering false or incredible testimony
- Filing false documents, including filing false income tax returns
- Failing to file tax returns
- Engaging in extensive dealings in cash

Generally, more than one indicator should be present to establish fraud. The court also considers the taxpayer's intelligence, education, and tax experience. The evidence in the case demonstrates that Mrs. Degourville acted with fraudulent intent by significantly underreporting her income and lying about her address and filing status in an attempt to claim the EIC, among other actions. As a tax preparer, the court determined that she had the required knowledge; therefore, her actions to evade taxes were deliberate and fraudulent. The court did not agree with her claim that she was merely negligent.

The court declined to address whether Mrs. Degourville is subject to the 10-year EIC ban. The IRS did not prove sufficient information to the court for it to make a judgement.

Holding. The court held that Mrs. Degourville underreported gross receipts and underpaid her taxes. She could not file as HoH because she was married and lived with her husband for the entire year. As a result of her HoH filing status and underreported income, she could not claim the EIC. Because she provided no records to support her Schedules C deductions, the court denied them. The court held that Mrs. Degourville was subject to the civil fraud penalty because her actions reflected fraudulent intent, and as a tax preparer, she would know her actions were incorrect. The court did not judge whether Mrs. Degourville was subject to the 10-year EIC ban.

Tax Forms and Instructions

Rev. Proc. 2023-23, 2023-22 IRB 883 (May 30, 2023)

IRC §223

Inflation Adjusted Amounts for Health Savings Accounts

Purpose. The IRS is providing the inflation-adjusted amounts for health savings accounts (HSAs) and the maximum amount available for excepted benefit health reimbursement arrangements (HRAs) for 2024.

Analysis. For individuals with self-only coverage under a high deductible plan, the maximum deductible contribution allowed under IRC §223(b)(2)(A) is \$4,150. For individuals with family coverage, the maximum deductible contribution under §223(b)(2)(B) is \$8,300.

A **high deductible health plan** for 2024 is defined as a health plan with an annual deductible of at least \$1,600 for self-only coverage or \$3,200 for family coverage. Additionally, the annual out-of-pocket expenses, excluding premiums, must not exceed \$8,050 for self-only coverage or \$16,100 for family coverage.

Regarding HRAs, the inflation-adjusted item states that for plan years starting in 2024, the maximum amount available for an excepted benefit HRA under Treas. Reg. §54.8931-1(c)(3)(viii) is \$2,100.

Effective Date. This revenue procedure applies to HSAs for the calendar year 2024 and excepted benefit HRAs for plan years beginning in 2024.

DIGITAL ASSETS

Digital Asset Reporting

IRS Ann. 2023-2, 2023-2 IRB 344

IRC §§6045 and 6045A

Delay in Required Brokerage Reporting of Digital Assets

IRC §6045(a) requires all brokers to prepare a return that lists their customers' names, addresses, and details regarding gross proceeds and other such information. Brokers must also file information returns and provide payee statements to each customer to which the broker sold stocks, certain commodities, and other categories of assets for cash. Additionally, brokers must provide the payee statements to customers by February 15 of the year following the sale. Brokers must file Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, with the IRS by February 28 (or March 31 if filing electronically) of the year following the sale. However, the current regulations do not specifically list digital assets as a specified security that requires basis reporting.

The Infrastructure Investment and Jobs Act²² clarifies how brokers should report digital assets. The following amendments apply to returns requiring filing after **December 31, 2023**.

1. Revised §6045(c)(1) defines brokers to include any person who regularly provides any service transferring digital assets on behalf of another person for compensation.
2. Specified securities subject to basis reporting under §6045(g) specifically include digital assets treated as covered securities if acquired on or after January 1, 2023.
3. A digital asset is any digital representation of value recorded on a cryptographically secured distributed ledger (or similar technology).
4. Brokers must report transfers of digital assets that are covered securities, provided the transfer is not part of a sale or exchange, and not to someone the broker knows or should know is also a broker.

Until the issuance of the new final regulations, brokers may report gross proceeds, basis, and statements of transfers of covered securities per the existing law and regulations as of December 23, 2022. Similarly, the additional reporting of digital assets dispositions does not apply until the IRS issues new final regulations.

Tax on Crypto Currency Gains

James H. Kim v. Comm'r, TC Memo 2023-91 (Jul. 20, 2023)

IRC §§61, 1001, 1212, and 1221

Tax Court Washes Hands of Unclean Argument

Facts. During the periods from 2013 through 2017, James Kim traded Bitcoin, Litecoin, and Ethereum through an account he held with Coinbase, Inc. On his timely filed Forms 1040 for 2013 through 2016, Mr. Kim reported no gains or losses from these transactions. On his 2017 return, he reported a short-term capital gain of \$42,069 from sales of \$18,557,230 of virtual currencies with a basis of \$18,515,161.

²² *Infrastructure Investment and Jobs Act*, PL 117-58, §80603.

2023 Workbook

The IRS selected Mr. Kim's 2013 through 2017 tax returns for examination. When he failed to provide a computation of his cryptocurrency gains and losses, the IRS used records obtained from Coinbase to determine his gains and losses for the years at issue. The IRS applied a first-in, first-out (FIFO) method to match purchases and sales. Based on these calculations, the IRS concluded that Mr. Kim had a short-term capital gain of \$75,400 for 2013, loss carryforwards for 2014-2016, and taxable gains of \$4,115,177 for 2017.

On May 19, 2021, the IRS issued Mr. Kim a timely notice of deficiency, assessing tax deficiencies of \$12,310 for 2013 and \$1,572,391 for 2017, along with accuracy-related penalties. Mr. Kim did not dispute the amount or character of the net capital gains determined in the notice of deficiency.

Mr. Kim petitioned the court to prevent the IRS from collecting the tax due on the gains because the U.S. Government was purportedly to blame for the cryptocurrency losses he incurred in subsequent years. He had taken out a large loan to finance his cryptocurrency transactions. When the virtual currencies declined precipitously in a single day in 2020, he was unable to meet a margin call. As a result, his virtual currency positions were liquidated at a very substantial loss. Mr. Kim asserted that the actions (or inaction) of the U.S. Government in response to the COVID epidemic "directly caused [that] harm" and that, "under the Clean Hands doctrine of US law," the IRS should be estopped from collecting tax on his 2013 and 2017 gains.

Issues. The issue in this case is whether Mr. Kim owes capital gains tax for 2013 through 2017 on his cryptocurrency assets.

Analysis. Gross income encompasses all income from any source, including gains from property transactions under IRC §61(a)(3). Mr. Kim did not contest that the investments involved in his transactions from 2013 to 2017 were considered capital assets. Therefore, he was subject to taxation for 2013 and 2017 on the net capital gains resulting from these virtual currency transactions.

Rather, Mr. Kim asserts that under the Clean Hands doctrine, the IRS should be estopped from collecting tax on his gains. The "unclean hands" principle denies equitable relief to those who have acted improperly. For it to apply to this case, the IRS would have to be seeking equitable relief from Mr. Kim. Recovering taxes owed under the Code is not the same as seeking equitable relief.

Furthermore, the "unclean hands" defense only applies to conduct immediately related to the cause of the controversy. There was no evidence that any government agency, including the IRS, acted improperly regarding Mr. Kim's tax liabilities. The actions taken by the government in response to the COVID epidemic, which occurred in 2020, have no bearing on the determination of Mr. Kim's tax liabilities for 2013 and 2017.

Holding. The court concluded that Mr. Kim's arguments lacked a legal basis. The court affirmed the tax deficiencies for 2013 and 2017.



ESTATE AND TRUST

Claiming a Refund

Richard J O'Neill Trust v. Comm'r, TC Memo 2022-108 (Oct. 27, 2022)

IRC §§1311 through 1314 and 1341

Claim of Right Goes Wrong

Facts. Richard O'Neill established a revocable trust, the Richard J. O'Neill Trust, on April 18, 1968. Mr. O'Neill transferred his assets to the trust before his passing on April 4, 2009. The trust then became irrevocable. At the time, the trust held an 86.12% ownership interest in RMV Total Diversification, LLC (RMV).

In 2009 and 2010, RMV sold capital assets at a gain. The trust reported the passthrough income on its 2009 and 2010 Form 1041, *U.S. Income Tax Return for Estates and Trusts*. Additionally, at the time of Mr. O'Neill's passing, his estate borrowed money from RMV. The loan charged 9% interest, which the estate paid, and RMV reported as income. Consequently, the trust reported this flowthrough income on its tax returns.

After Mr. O'Neill's estate filed Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, on June 30, 2010, the IRS sent a notice with proposed adjustments to the return. The estate objected to these changes, and a settlement followed on February 3, 2015. The settlement included adjustments that reduced the estate's interest deduction of the RMV loan from 9% interest to 6% interest and increased the estate's RMV interest asset from \$30,725,000 to \$40,614,822. Accordingly, RMV rewrote the loan to reflect these changes, reducing the trust's accrued 2010 interest income by \$500,538.

The trust filed Form 1045, *Application for Tentative Refund*, in October 2015 for the 2014 tax year to recover its overpayment of \$1,537,780 in taxes for the 2009 and 2010 tax years. RMV did not amend its 2009, 2010, 2014, or 2015 partnership income tax returns. For those years in question, the trust did not file Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*, pertaining to income treatment from RMV.

On July 17, 2017, the trust received a notice from the IRS stating a deficiency of \$1,554,917 for the 2014 tax year, claiming the trust was not entitled to the refund requested on its filed Form 1045. As such, the IRS instructed that the trust return the refund proceeds in addition to penalties and interest. The trust disagreed, stating as support that the filed Form 1045 met the claim of right requirements under IRC §1341. Additionally, the trust asserted its entitlement to the refund met the provisions of IRC §§1311 through 1314. Finally, the trust defended its position under an equitable recoupment doctrine.

Issues. The issues in this case are the following.

- Whether the trust satisfies the claim of right requirements for the 2014 tax year refund under §1341
- Whether the trust meets the provisions of §§1311 through 1314 in claiming the refund
- Whether the trust is legally entitled to the refund under an equitable recoupment doctrine

Analysis. The trust argued that it was entitled to the refund under §1341. The code section allows a deduction in a tax year for income that a taxpayer claimed in a prior year that they had no unrestricted right to, and in retrospect, the taxpayer should not have claimed that income. The court found this argument invalid. Under IRC §6221, the partnership determines its treatment of income, whereas the individual partners do not make their own separate determination. Unless a partner files Form 8082, the partner must treat income consistently with the partnership's treatment. The partnership did not amend its 2009 and 2010 income tax returns regarding its capital gain and interest income treatment. Therefore, the trust's treatment of that income which served as the basis for claiming the refund on Form 1045 was inconsistent with the partnership. The trust, however, did not file Form 8082 to address this inconsistency.

Furthermore, the court explained that §1341 would not apply to the trust's argument regarding the unrestricted right to income concept. RMV, and the trust as its partner, had an unrestricted right to the proceeds from the sale of capital assets. Nothing changed the status of these rights, as RMV did not repay or otherwise restore the capital asset sale proceeds for any legal or contractual disputes revolving around RMV's claim to those proceeds. Therefore, the trust's right to the proceeds of the sale of capital assets remained unrestricted, contradicting the nature of §1341. Regarding the interest income, the court noted that RMV's negotiation with Mr. O'Neill's estate about reducing the interest terms from 9% to 6% did not retroactively change or restrict RMV's right to the interest income they reported in prior tax years. Consequently, the trust, as a partner of RMV, retained the trust's right to the interest income.

In addition to §1341, the trust claimed §§1311 through 1314 as support for its entitlement to the 2014 tax year refund. The Code sections grant a refund claim for a correction of an error. The court, however, stated that the trust did not follow the correct process to rely on these Code sections. The error occurred in the 2009 and 2010 tax years, which are the tax years that the trust should have filed a refund claim. However, the trust filed a refund claim for the 2014 tax year, invalidating its argument.

Lastly, the trust argued that its claim to the refund was valid through the doctrine of equitable recoupment. This doctrine provides relief in cases "where the Government has taxed a single transaction, item, or taxable event under two inconsistent theories."²³ The court found this argument to lack merit for two reasons. First, the deficiency serving as the basis for the trust's claim for recoupment pertains to Mr. O'Neill's estate taxes, not those of the trust. Second, the IRS did not apply two inconsistent theories in denying the refund. The IRS disallowed the refund based on the trust's claim for refund under §1341 specifically, which has no transactional connection to the trust's tax liabilities for tax years 2009 and 2010.

Holding. The court held that the trust did not satisfy the claim of right requirements for the 2014 tax year refund under §1341. Furthermore, the trust did not meet the provisions of §§1311 through 1314 in claiming the refund. Additionally, the court did not find that the trust was entitled to the refund through the doctrine of equitable recoupment. The court denied the trust's motion for partial summary judgment, instead granting the motion for partial summary judgment to the IRS.



Practitioner Planning Tip

This case highlights the importance of following correct procedures in claiming refunds, deductions, and any tax position in general. Distinguishing which parties are responsible in a multi-taxpayer situation is critical, especially in cases of passthrough entities and fiduciary relationships. The case illustrated instances where the argument's logic was sound, but the incorrect party performed some of the actions undertaken. Practitioners should also be mindful of which tax years pertain to the position under consideration and which of those years taxpayers should either amend, apply a change, or otherwise handle.

²³ *U.S. v. Dalm*, 494 U.S. 596 (1990).

Assumption of Liability of Unpaid Estate Taxes

Estate of Kwang Lee v. Comm’r, No. 21-2921 (3d Circ. 2022), *aff’g* TC No. 20531-18L
USC §3713(b) and IRC §7122

Executor in (Un)Compromising Situation

Facts. Kwang Lee passed away testate on September 30, 2001. Anthony J. Frese, the successor executor of Mr. Lee’s estate, filed an estate tax return but undercalculated the amount of estate tax liability. Consequently, the IRS issued a notice of deficiency to the estate for the remaining tax due in 2006. After challenging the IRS in the U.S. Tax Court, the estate received a formal assessment of tax liability in 2010.

The estate did not have the funds to pay the assessed tax due, as Mr. Frese had already disbursed over \$1 million in distributions to its beneficiaries. Notably, of the total disbursements, the estate paid \$640,000 to beneficiaries **after** receiving the notice of deficiency. Upon receiving a tax lien in 2013 for the remaining balance of tax due, Mr. Frese sought relief on behalf of the estate by making an offer in compromise (OIC) in the form of settling the liability with assets still held by the estate. These assets, which only included a checking account, reflected around one-third of the amount of the outstanding tax deficiency claim.

The IRS rejected the estate’s OIC on the grounds that more funds were obtainable from all sources, including the estate beneficiaries and Mr. Frese as the executor. The estate challenged this decision in the U.S. Tax Court in 2021,²⁴ stating that the amount of reasonable collection probability (RCP) that the IRS used to reject the OIC was inflated by inappropriately including distributions to beneficiaries in its calculation. The Tax Court held that beneficiary distributions were correctly included in the RCP, stating that before the \$640,000 distribution payout, the estate had sufficient funds to pay the deficiency claim, which takes precedence over other debt and claims.²⁵ Additionally, the Tax Court held that sufficient notice of the claim was provided to Mr. Frese through the issued notice deficiency that the estate received before making the distribution in question. In July 2022, the estate sought to appeal this decision before the U.S. Court of Appeals.

Issues. The issues in this case are the following.

- Whether the IRS abused its discretion in refusing the OIC
- Whether the time to collect from Mr. Frese has run out
- Whether Mr. Frese escapes liability under USC §3713 by distributions under operation of law
- Whether Mr. Frese avoids personal liability by relying on professional advice

Analysis. The estate argued that the time to collect funds from Mr. Frese to satisfy the outstanding tax deficiency claim had run out. An IRS Manual advises the inclusion of dissipated assets in RCP is generally appropriate using a 3-year time frame.²⁶ More than three years had passed since the \$640,000 distribution and the IRS’s assessment of RCP. The court determined that this argument was irrelevant, as the IRS was not alleging dissipation (intentionally disposing assets to avoid tax liability payment) of the beneficiary distribution. Moreover, even if the IRS alleged dissipation, the 3-year period described in the Manual is **guidance** and not mandatory criteria.

²⁴ *Estate of Kwang Lee v. Comm’r*, TC Memo 2021-92 (Jul. 20, 2021).

²⁵ 13 USC §3713.

²⁶ IRM 5.8.5.18(2) (2021).

The estate made another point that the distributions to beneficiaries included non-probate stock options. The estate argued that the distribution of these assets constituted an act of operating under law and that Mr. Frese was fulfilling his legal obligation in making the distribution. Because he was bound by law and had no discretion in whether to make the distribution or not, the estate asserted Mr. Frese was free of personal liability under USC §3713. In response, the court clarified that its review was limited in scope and could only consider arguments raised before the Tax Court in the case under appeal. In the Tax Court case, the estate had only objected to the relevance of the distribution of the stock options, as opposed to whether Mr. Frese used discretion in making the distribution. Consequently, the court did not allow this new point under consideration for its review. Regardless, the court did note that the filed estate tax return listed the stock options as assets and the estate listed them incorrectly as probate assets, conflicting with the estate's argument.

Finally, the estate presented the argument that due to his reliance on professional advice, Mr. Frese could not be held personally liable for the outstanding tax deficiency claim. The court disagreed, illustrating that Mr. Frese's use of professional advice was for the preparation of the estate tax return as opposed to beneficiary distributions. The court further commented that when a tax deficiency is known to an executor, professional reliance is not a valid defense against personal liability. In this case, Mr. Frese had knowledge of the tax deficiency by receiving the tax lien notice issued to the estate.

Holding. The court held that the IRS did not abuse its discretion in refusing the estate's OIC and the Tax Court granted summary judgement appropriately. The time to collect the outstanding tax deficiency from Mr. Frese had not run out, and guidance from an IRS Manual did not reflect a binding timetable for the IRS. Mr. Frese did not avoid personal liability for the tax deficiency through professional reliance, as Mr. Frese was aware of the tax deficiency and could not use the advice of a practitioner as a defense for escaping liability. The court did not consider the argument of Mr. Frese avoiding liability under USC §3713 in the capacity of this appeal, as the estate did not argue before the Tax Court that the beneficiary distributions fell under operation of law instead of the discretion of the executor. The court affirmed the judgement of the Tax Court.



Practitioner Planning Tip

This case illustrates the magnitude of responsibility that falls upon estate executors and that mistakes made while undertaking this role can potentially have costly repercussions. Executors, as well as beneficiaries depending on the circumstances, could be personally liable for deficiencies in estate tax payment. Practitioners can add value to fiduciary engagements by simply communicating the need to exercise caution in navigating the settlement of an estate and alerting them to the potential personal risk. An option that could mitigate some of this risk is an executor waiting until receipt of an estate tax closing letter before making final distributions out of an estate to beneficiaries.

Basis Step-Up for Trusts Excluded From Taxpayer's Taxable Estate

Rev. Rul. 2023-2, 2023-16 IRB 658 (Apr. 17, 2023)

IRC §1014

Step-Up Shuffle: When Trusts Skip the Party for Asset Basis Boosts

Purpose. This revenue ruling discusses whether there is a basis adjustment for assets held in a trust upon the death of the trust owner, but the trust assets are not includable in the owner's gross estate.

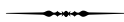
Under the scenario presented in the revenue ruling, Individual A is the owner of an **irrevocable trust**. While Individual A retains a power over the trust resulting in Individual A's ownership of the trust for income tax purposes, no power was held that would result in the inclusion of the trust assets in Individual A's taxable estate. Six years after creating and funding the trust, Individual A dies, and the assets held in the trust have appreciated in value since the trust's creation.

Analysis. IRC §1014(a) requires property receiving a basis adjustment be acquired or passed from a decedent. The Code identifies seven types of property that meet this criterion.

1. Property acquired by bequest, devise, or inheritance as described in §1014(b)(1)
2. Property transferred during the decedent's life in a revocable trust for paying income to the decedent or upon the decedent's direction as described in §1014(b)(2)
3. Property with the same attribute as #2, except that it applies to decedent's dying after December 31, 1951, and that the decedent had the power to alter, amend, or terminate the trust as described in §1014(b)(3)
4. Property is a transfer passing without consideration under a power of appointment that the decedent exercised by will as described in §1014(b)(4)
5. Property is the decedent's surviving spouse's one-half share of community property as described in §1014(b)(6)
6. Property is the transfer of property by reason of a decedent's death, form of ownership, or other reasons if the property is included in the decedent's gross estate as described in §1014(b)(9), except for annuities and foreign stock and securities
7. Property is includable in the decedent's gross estate under the marital deduction as described in §1014(b)(10)

The trust does not qualify as the first type, as the court in *Collins v. U.S.* clarified that a decedent could not transfer property by bequest, devise, or inheritance unless it was part of their probate estate under their resident state's laws.²⁷ Because Individual A did not retain the power to revoke or amend the trust, the assets in Individual A's trust do not qualify as the second, third, or fourth types of property. The assets held in Individual A's trust were not community property, and therefore fail to meet the fifth type of property. The assets in Individual A's trust fail both the sixth and seventh type of property tests, because the assets in the trust were not includable in Individual A's taxable estate.

Because the assets in Individual A's do not fall within any of the types of property under §1014, the assets in the trust do not receive a basis adjustment at the time of Individual A's death. Therefore, Individual A's death does not cause any change to the basis of the assets held in Individual A's trust, where the basis remains the same as it was before Individual A's death.



²⁷ *Collins v. U.S.*, 318 F.Supp.382, 386 (C.D. Cal. 1970).

FOREIGN INCOME

FBAR Failure to File Penalty

***Bittner v. U.S.*, 598 U.S. 85 (2023)**

31 USC §§5314 and 5321

Biting Back Benefits Bittner

Facts. Alexandru Bittner, is a dual citizen of Romania and the United States. He emigrated to the United States in 1982, obtained American citizenship, and lived there until 1990 when he moved back to Romania. Between 1990 and 2011, Mr. Bittner invested in various assets in Romania, earning over \$70 million. During this time, he maintained dozens of Romanian and other foreign accounts, each having high balances exceeding \$10,000.

According to the Bank Secrecy Act of 1970 (BSA) and 31 CFR §1010.306, a U.S. citizen or resident²⁸ with foreign accounts exceeding \$10,000 are required to report those accounts to the IRS. Under previous rules, they were required to file an FBAR, *Report of Foreign Bank and Financial Accounts*, form by June 30 of the following year. Under current rules, they are required to file Form FinCEN 114, *Report of Foreign Bank and Financial Accounts*, by the due date for federal tax returns.²⁹ Failure to disclose foreign accounts properly or in a timely manner can result in penalties.

Mr. Bittner was unaware of the FBAR filing requirement and failed to file FBARs for his foreign accounts until May 2012. These FBARs did not accurately report all of Mr. Bittner's foreign accounts, however, so another tax professional filed amended FBARs that properly reported in 2013 all of Mr. Bittner's foreign accounts. In 2017, the IRS calculated civil penalties of \$2,720,000 against Mr. Bittner for his nonwillful violation of failing to timely disclose 272 instances of maintaining foreign accounts between 2007 and 2011. Mr. Bittner admitted to maintaining 177 of the undisclosed accounts from 2007 to 2010. The United States filed a motion for partial summary judgment, requesting \$1,770,000 for those accounts.

Mr. Bittner disputed the penalties, claiming a reasonable-cause exception and denying liability. He argued that the penalty under §5321 of the BSA applies per failure to file an annual FBAR, not per account. The United States argued that Mr. Bittner's penalties should be based on the 177 separate violations. Both parties asked the district court to interpret BSA §5321.

The district court denied Mr. Bittner's defense of reasonable cause and found him liable for BSA violations. However, it held that the penalty for violating the BSA applies to each failure to file an annual FBAR, reducing Mr. Bittner's penalties to \$50,000 for the five FBAR returns.

The United States appealed the district court's ruling to the Fifth Circuit Court of Appeals. The Fifth Circuit affirmed Mr. Bittner's liability but reversed the ruling on penalties, stating that failure to report each qualifying foreign account constitutes a separate violation of the BSA.

Mr. Bittner filed a petition for a writ of certiorari with the U.S. Supreme Court to challenge the Fifth Circuit's reversal ruling.

²⁸ 31 USC §5314(a).

²⁹ *Surface Transportation and Veterans Health Care Choice Improvement Act of 2015*, PL 114-41, §2006(b)(11).

Issues. The issues in this case are the following.

- Whether the nonwillful failure to report multiple foreign accounts during a single reporting period constitutes a single violation or multiple violations under the BSA
- Whether a violation under the BSA is defined as the failure to file an annual FBAR, regardless of the number of foreign accounts, or if there is a separate violation for each individual account that was not properly reported
- Whether the penalty for nonwillful failure to file applies on a per-account basis or per-form basis

Analysis. The Court began its interpretation of the law by distinguishing the differences between §§5314 and 5321 of the BSA. The Court stated that §5314 outlines an individual's legal responsibilities to file a report. Therefore, the Court interpreted that a violation of §5314 is that an individual failed to file a report, and that any omissions or errors contained in a filed report would constitute as one violation. BSA §5321, on the other hand, describes the penalties for violations of §5314, where the Secretary of the Treasury may impose a civil penalty of up to \$10,000 for "any violation." Because the Court found that §5314 describes a violation as a failure to file a report subject to the BSA's requirements, one error or multiple errors constitute a single violation. Regarding the penalty, §5321 differentiates between willful and nonwillful violations, where willful violation penalties include a per-account stipulation, but nonwillful violation penalties make no such specification. In the eyes of the Court, this differentiation is proof that the intent of the law is that nonwillful violation penalties should be made on a per-report basis instead of a per-account basis.

Furthermore, the Court provided examples of communication to the public from the Department of Treasury and other government agencies that do not specify that the \$10,000 penalty is on a per-account basis, including the instructions to the FBAR itself. While the Court acknowledged that such documents do not control or dictate the Court's interpretation of the law, courts in general may consider an agency's views and communications on the subject matter that it brings before a court.³⁰

The Court also stated that when Congress amended the law for penalties for nonwillful violations in 2004,³¹ it did not include language to mirror the penalties for willful violations specifying that such penalties were to have per-account stipulations. In addition to this argument of intent, the Court found that the purpose of the reports is to provide the government with information to aid in investigations, not to profit from penalties for every nonwillful mistake.³² Reinforcing this interpretation was the Court's example showing that the government's interpretation of a per-account basis for nonwillful violations creating higher penalties compared to willful violations, which the Court argued did not make sense and would deviate from Congress's intent.

The Court asserted the rule of lenity³³ for doubt regarding the best interpretation of the law. This principle consists of a court applying law that is unclear or ambiguous in the most favorable way to a defendant. The Court stated that the Code and other federal statutory law does not impede the rule of lenity and described two reasons why it should apply to this case. First, under due process, individuals must receive fair warning in a way that is commonly understood. Not only do the BSA provisions not explicitly discuss per-account penalties for nonwillful violations, but accounting professionals were also confused as to the interpretation of those provisions, indicating that a "common understanding" would not be achieved if professionals specializing in the accounting field lacked an understanding. Second, if the government's interpretation is that nonwillful violation penalties should be on a per-account basis, the criminal sanctions associated with them would give rise to unintended severe criminal violations that would include prison time.

³⁰ *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

³¹ *American Jobs Creation Act of 2004*, PL 108-357, §821(a).

³² 31 USC §5311.

³³ *Rule of lenity*. May 2022. Cornell Law School. [www.law.cornell.edu/wex/rule_of_lenity] Accessed on Jul. 26, 2023.

2023 Workbook

Holding. The Court held that nonwillful failure to report multiple foreign accounts during a single reporting period constitutes a single violation under the BSA. The Court further held that a violation under the BSA is a failure to file an annual report regardless of the number of foreign accounts described in said report. Finally, the Court held that penalties for nonwillfully failing to file FBARs are on a per-form basis instead of a per-account basis. Consequently, the Court reversed the Fifth Circuit’s reversal ruling, concluding Bittner’s penalties are \$50,000 instead of \$1,770,000.

Note. The IRS has updated its procedures for FBAR examinations to incorporate the Supreme Court’s decision in the *Bittner* case to provide clear language consistent with the Court’s holding.³⁴

GROSS INCOME

Wrongful Termination Settlement Payment

Thomas J. and Peggy M. Dern v. Comm’r, TC Memo 2022-90 (Aug. 30, 2022)

IRC §§61(a) and 104

Dern’t Forget to Include Damages Received in Gross Income

Facts. Thomas J. Dern received a settlement payment of \$327,416 from P.F.I., Inc. (PFI), Mr. Dern’s former employer. This payment resulted from a lawsuit the Dernos filed against PFI, alleging, among other things, wrongful termination, deliberate infliction of emotional distress, and violation of California’s disability discrimination law. The lawsuit did not allege any physical injury or physical illness. PFI terminated Mr. Dern’s employment in 2016 because of his inability to perform sales tasks following a heart attack and gastrointestinal bleeding he suffered in December 2015 and January 2016.

In the settlement agreement, PFI and its co-defendants agreed to pay Mr. Dern \$550,000 to compensate him for “alleged personal injuries, costs, penalties, and all other damages and claims.” The agreement also included a general release of claims which was “intended to include in its effect, without limitation, all claims known or unknown at the time of the execution” of the settlement agreement. However, it did not specifically cite physical injuries.

Mr. Dern reported none of the settlement as income on his 2017 tax return, where he only reported \$6,000 of nonemployee income related to an appraisal business. The IRS determined that Mr. Dern had unreported nonemployee compensation of \$324,000, based on a Form 1099-MISC, *Miscellaneous Income*, issued to him by his attorney for \$330,000 (\$550,000 gross settlement – \$220,000 attorney fees).

Mr. Dern argued that the settlement payment was excludable from income under IRC §104(a)(2) because it arose from personal physical injuries or physical sickness.

Issues. The issue in the case is whether an amount received as a settlement of damages is includable as gross income without specifying that it arose from physical injury or sickness.

Analysis. IRC §61 states that gross income includes all income from whatever source derived unless it is specifically excluded. An exclusion exists under IRC §104(a)(2) for payments made on account of personal physical injuries or physical sickness. Emotional distress is not covered in the exclusion. Mr. Dern suffered some physical sickness, but this was not noted in either the lawsuit or the settlement.

Holding. The court found Mr. Dern failed to prove a “direct causal link” between his physical illness and the settlement payment. Therefore, the settlement payment was not excludable under §104(a)(2), and the Mr. Dern owed tax on the unreported income.

³⁴ *Interim Guidance on FBAR Examination Case Procedures Due to Supreme Court Decision (Bittner v. US)* — SBSE-04-0723-0034. Lauer, Daniel. Jul. 6, 2023. IRS. [irs.gov/pub/foia/ig/sbse/sbse-04-0723-0034-redacted.pdf] Accessed on Jul. 26, 2023.

Settlement Payment

U.S. and California Franchise Tax Board v. Levandowski, No. 4:22-cv-02781 (N.D. Cal. Mar. 14, 2023)

IRC §61(a) and 11 USC §505

Bankruptcy Court Makes U-Turn for Self-Driving Vehicle Pioneer

Facts. Anthony Levandowski is a pioneer in self-driving cars and worked at a Google, LLC subsidiary at one time.³⁵ Mr. Levandowski left Google and formed his own company known as Ottomotto, LLC, which he subsequently sold to Uber Technologies, Inc. As part of the sale, Uber agreed to indemnify Mr. Levandowski for certain claims that could be brought against him by Google. Ultimately, Google did sue Mr. Levandowski in arbitration. After arduous and contentious litigation, Google obtained a judgment totaling over \$179 million.

Mr. Levandowski filed for bankruptcy. Google, Uber, and Mr. Levandowski entered into a global settlement. Under the settlement, Uber would pay Google directly for damages Mr. Levandowski owed Google. Mr. Levandowski asked the bankruptcy court to approve the settlement and to deem these payments not subject to income tax on either a federal or state level.

The IRS and the California Franchise Tax Board (FTB) objected to Mr. Levandowski's motion that payments were not taxable. The bankruptcy court disagreed. The bankruptcy judge found that Uber's payment to Google was like an insurance transaction, which the judge believed was not taxable. Thus, the court concluded that the settlement payments on Mr. Levandowski's behalf were not income to him. The IRS and the FTB appealed the bankruptcy court's decision to a U.S. district court.

Issues. The issues in this case are the following.

- Whether the bankruptcy court has jurisdiction to approve the settlement with no tax reserve
- Whether the determination of future tax liabilities by the bankruptcy court is binding
- Whether the main payment Uber made to Google is gross income to Mr. Levandowski
- Whether the bankruptcy court's confirmation order of the settlement is proper, given the issues under consideration

Analysis. The appeals court found that the bankruptcy court had the authority to determine the tax issue. Although the Declaratory Judgment Act³⁶ generally does not permit federal courts jurisdiction over federal taxes, 11 USC §505(a)(1) authorizes the bankruptcy court to have jurisdiction in the determination of **any** tax.

However, the appeals court stated that the law is not clear on whether a bankruptcy court can make a forward-looking opinion on the future tax liabilities of Uber or Mr. Levandowski. It stated that the U.S. Constitution does not permit courts to decide abstract issues.³⁷ However, the appeals court noted that the Levandowski case did not have abstract issues, but rather actual facts at issue before the court. The appeals court found the fact that the IRS and FTB opposed the bankruptcy plan supported this point, even though they argued that only abstract matters were before the court. Further, the bankruptcy court realized that the amounts involved in the case were so large that without providing for tax consequences, the bankruptcy plan would not work.

The appeals court questioned the bankruptcy court's determination that the main payment was not subject to income tax. The bankruptcy court had relied on the claim that "all insurance is not deemed taxable." The appeals court found that the bankruptcy court did not consider the broad scope of gross income included by the Code. While Mr. Levandowski argued that the main payment was equivalent to insurance, the appeals court noted that insurance is **not always** excluded from taxation such as in IRC §61(a)(9), which includes life insurance in gross income.

³⁵ *Anthony Levandowski*. May 23, 2023. Wikipedia [en.wikipedia.org/wiki/Anthony_Levandowski] Accessed on Jul. 15, 2023.

³⁶ 28 USC §2201(a).

³⁷ U.S. Const. art. III, §2.

2023 Workbook

All parties agreed that whether the confirmation order was appropriate depended on whether the tax order was appropriate. If the tax order was incorrect in its assumptions, the proposed debtor's plan to work out repayment should not have been confirmed by the bankruptcy court. The IRS claimed that the main reason for the bankruptcy plan was the avoidance of taxes. However, the bankruptcy court found that the main purpose for the bankruptcy was **not** the avoidance of taxes.

However, how the bankruptcy court handled set-off rights created a problem for the appeals court. Set-off in a bankruptcy proceeding is the right of a creditor to deduct a debt it owes to the debtor from the claim. The appeals court thought that the IRS's and the FTB's concerns were theoretical, yet expressed the view that the bankruptcy court had dismissed this issue with language that was too broad.

Holding. The appeals court found that the bankruptcy court had jurisdiction over the tax matters in Mr. Levandowski's bankruptcy case. Next, the appeals court found that the bankruptcy court was working within its limits when it concluded that the bankruptcy court issued an advisory opinion on the tax consequences of the settlement.

The appeals court found that the bankruptcy court used faulty logic when it concluded that the settlement payments were not subject to income tax. Thus, it reversed the bankruptcy court's tax order and remanded the case back to that court for further consideration due to legal error associated with the tax order.

Finally, the appeals court also found that the confirmation order did not properly consider legal precedent. It asked the bankruptcy court to reconsider the case in view of these precedents concerning set-off rights. However, it agreed with the bankruptcy court that Mr. Levandowski's main purpose in the agreement was not tax avoidance.³⁸

Child Support Interest Taxable

***Susan D. Rodgers v. Comm'r*, TC Memo 2023-56 (May 9, 2023)**

IRC §§61 and 71

Rodgers Attempts Dodging Tax on Interest Income

Facts. During 2011 and 2012, Susan Rodgers and her former spouse were involved in litigation in the Circuit Court of Mobile County, Alabama, over the termination of her former spouse's child support obligation. The state court entered an order in 2011 stating that Ms. Rodgers' former spouse was in arrears in the sum of \$18,000, issuing a judgment against him in favor of Ms. Rodgers for the amount representing child support arrearages. In 2012, the state court amended its order, stating Ms. Rodgers was owed \$16,044 from her former spouse, consisting of \$5,362 in principal and \$10,682 in interest. She received a series of payments from the State of Alabama from 2012 through 2014 that were identified with the code "CS NA AR" and collectively matched the \$5,362 of the arrearage principal determined in the state court's order. During 2015 payments marked "CP INT" totaled \$7,859.

Ms. Rodgers received a Form 1099-INT, *Interest Income*, from the State of Alabama showing \$7,824 in interest income for 2015. When she filed her 2015 income tax return, she did not include this in her gross income, which led to the IRS issuing her a deficiency determination for \$3,473 of unpaid tax.

Issues. The issue in this case is whether the \$7,824 of income that Ms. Rodgers received should be characterized as interest that is includable in her gross income or instead as child support that is not includable in her gross income.

Analysis. The IRS's determinations in a notice of deficiency carry a presumption of correctness, and it is the taxpayer's responsibility to prove otherwise. In this case, Ms. Rodgers conceded that she received an unreported sum of \$7,824, but contested whether it should be taxed as interest or classified as nontaxable child support. The evidence she provided was insufficient to challenge the deficiency determination made by the IRS.

³⁸ This is stated in the court's conclusion as though the appeals court agreed with the bankruptcy court that Mr. Levandowski's principal purpose was tax avoidance, but this is an error, given the clear language in the court's discussion on this specific point.

According to federal tax law, a taxpayer's gross income includes all income sources, including interest under IRC §61(a)(4). Alimony and separate maintenance payments are also part of the recipient's gross income, except for child support payments fixed by the terms of a divorce or separation instrument, which are not taxable to the recipient under §71(a). However, interest paid on child support arrearages is considered taxable income under §61(a)(4).³⁹ In this case, Ms. Rodgers received interest on child support arrearages as reported by the State of Alabama.

The characterization of alimony, child support, or interest payments for federal tax purposes is determined by federal law. To establish whether a taxpayer received interest payments related to child support arrearages, the court considers various forms of evidence, including the taxpayer's admission, state court child support payment records, and the existence of a state court order directing interest payments on arrearages.⁴⁰

In this particular case, the evidence supports Ms. Rodgers received interest income related to child support arrearages. Ms. Rodgers did not dispute receiving the reported amount on Form 1099-INT for a child support arrearage or her former spouse failing to make timely child support payments. Furthermore, the state court's order specifically directed payment of child support and interest in specific amounts, consistent with Alabama law that requires interest on past due child support obligations to be included in any judgment on arrearages.

Ms. Rodgers's argument about a discrepancy in the arrearage principal from county payment records does not invalidate the interest classification. She failed to present evidence that the state court modified the judgment or took action based on her letter to the court regarding the discrepancy. The court explained that even if the arrearage principal was larger, it would only increase the interest due to Ms. Rodgers, not change the interest classification for tax purposes.

Holding. The court held that the \$7,824 of income received by Ms. Rodgers from the State of Alabama during 2015 should be characterized as interest that is includable in her gross income pursuant to §61(a)(4). Therefore, the payment did not reflect nontaxable child support. As a result, the court sustained the IRS's deficiency determination.

Long-Term Contracts

Ltr. Rul. 202318008 (Feb. 7, 2023)

IRC §460

Long-Term Contract Rules Apply Regardless of Whether Taxpayer Owns Property

Facts. A taxpayer provides services to a customer at specified facilities under a contract. The contract may last several years. Although the customer continues to own the land under the facilities, the taxpayer receives title to the facilities. The taxpayer also acquired an easement to access the facilities to perform the services. Under the easement's terms, its customer had the right to require the taxpayer to relocate facilities.

When the customer exercised this right, the taxpayer was required to perform specific construction work to relocate an item of property owned by its customer from one facility to another. The contract required the customer to reimburse the taxpayer only for the related costs. The taxpayer claimed it would not profit from the reimbursement payments but only maintain its financial position.

³⁹ See *Fankhanel v. Comm'r*, TC Memo 1998-403 (Nov. 12, 1998).

⁴⁰ Ibid.

2023 Workbook

Analysis. IRC §460(f)(1) defines “long-term contract” to mean any contract for the construction of property if the taxpayer does not complete the contract within the same tax year that it enters into the contract.⁴¹ Treas. Reg. §1.460-1(b)(1) requires the use of the percentage-of-completion method (PCM) to account for its income under the contract. It is irrelevant if the taxpayer does not own the property or bear the risk of loss. It is also irrelevant if the taxpayer does not have to deliver the property to its customer.

Generally, a taxpayer must account for income under the PCM by determining the percentage of the contract completed.⁴² This is done by comparing the allocated contract costs already incurred with the total estimated contract costs.⁴³

In this case, the contract required the taxpayer to perform construction work that it did not complete within the same calendar year. Although there are exceptions that do not require the PCM method,⁴⁴ the taxpayer did not qualify for any of them.

Holding. The IRS concluded that the taxpayer must treat the contract as a long-term contract. The taxpayer must account for income using the PCM method. Using this method, it must recognize income as it incurs and deducts expenses.



INNOCENT SPOUSE

Relief From Joint and Several Liability

Sydney Ann Chaney Thomas v. Comm’r, 160 TC 4 (2023)

IRC §§6013 and 6015



Blogged Down With Evidence

Facts. Sydney Thomas and her husband Tracy filed joint tax returns for tax years 2012 through 2014. The couple still owed unpaid tax at the time of Mr. Thomas’s death in 2016. Mrs. Thomas requested equitable relief from the amount of tax still due on those returns under IRC §6015(f). In 2020, the IRS denied the request, and Mrs. Thomas petitioned the Tax Court on the issue as a California resident.

The court tried the case in San Francisco in 2022 with Mrs. Thomas representing herself. Part of the evidence the IRS sought to enter for the case consisted of a series of Mrs. Thomas’s personal blog posts dated from 2016 to 2022. The IRS wished to use this evidence to provide insight into Mrs. Thomas’s financial position and her relationship with Mr. Thomas. While Mrs. Thomas objected, the court admitted the blog posts as evidence. The court held on proceeding the trial to give Mrs. Thomas the ability to file a motion to remove the blog posts as evidence, which she did a couple of months later after obtaining legal representation. The IRS in turn objected to Mrs. Thomas’s motion for the evidence removal on the grounds that the blog posts represented newly discovered evidence pursuant to the scope as outlined in §6015(e)(7).

Issues. The issue in this case is whether the IRS may enter Mrs. Thomas’s blog posts as evidence under §6015 as additional or newly discovered evidence.

⁴¹ See also Treas. Reg. §1.460-1(b)(1).

⁴² Treas. Reg. §1.460-4(b)(1).

⁴³ Treas. Reg. §1.460-4(b)(4).

⁴⁴ IRC §460(e)(3).

Analysis. The court began its interpretation of the §6015 phrase of “newly discovered evidence” by assessing its ordinary meaning. The court concluded that the ordinary meaning of the phrase was “recently obtained sight or knowledge of for the first time.” Using this definition for the case, the court found that the blog posts met the criteria as newly discovered evidence. While Mrs. Thomas argued that the IRS had not conducted a reasonable search for this evidence to discover the blog posts during her administrative proceeding, the court found that §6015 does not impose a reasonable diligence standard. Congress not only excluded such language in the Code, but included an expanding qualifier in its language of “any additional” newly discovered evidence. This reinforced the court’s interpretation of the intention of Congress in phrasing the Code as present.

Holding. The court held that Mrs. Thomas’s blog posts were admissible as evidence under §6015 as newly discovered evidence. The court denied Mrs. Thomas’s motion to strike the blog posts as evidence from the record.

IRS PROCEDURES — MISCELLANEOUS

IRS Notice Policy

Hanna Polselli et al. v. IRS, No. 21-1599 (2022)

IRC §7609

IRS Not Required to Alert Taxpayers of Summons

Facts. Remo Polselli was found to have underpaid his federal taxes by more than \$2 million over a 10-year period. The IRS initiated an investigation to locate Mr. Polselli’s assets and discovered that he had used various legal entities to evade asset collection. Evidence indicated that Mr. Polselli had paid a tax liability from an unrelated business entity’s account instead of his own. IRS Revenue Officer Michael Bryant uncovered that Mr. Polselli had concealed his assets in bank accounts using Hanna, his wife’s name. Mr. Bryant served summonses on Wells Fargo Bank and the law firm representing Mr. Polselli to obtain information useful for asset recovery. The IRS sought to determine the source of Mr. Polselli’s funds, his connected bank accounts, the entities he owned or controlled, and the bank accounts linked to those entities. The law firm claimed attorney-client privilege and denied retaining the requested documents.

Mr. Bryant issued additional summonses to JPMorgan Chase and Bank of America to obtain financial information about Mr. Polselli and the law firm. Neither Mrs. Polselli nor the law firm were informed about the summonses. However, Wells Fargo notified Mrs. Polselli, and the other banks informed the law firm. Both the law firm and Mrs. Polselli filed motions to quash the summonses, arguing that proper notice was not given as required by IRC §7609. The IRS claimed lack of subject-matter jurisdiction and asserted that Mrs. Polselli and the banks were not entitled to notice. The IRS offered the law firm the opportunity to review the summoned records to ensure they were related to Mr. Polselli and the entities holding his assets. The District Court ruled in favor of the IRS, stating that notice was not necessary.⁴⁵

Both the law firm and Mrs. Polselli appealed to the U.S. Court of Appeals for the Sixth Circuit. The Sixth Circuit upheld the district court’s ruling, rejecting the petitioners’ concerns about their ability to challenge third-party summonses and asserting that Congress has the authority to prioritize the IRS’s asset collection over taxpayer privacy.⁴⁶

Mr. Polselli filed a petition for certiorari to the U.S. Supreme Court, and the Court granted certiorari on December 9, 2022.

⁴⁵ *Polselli v. U.S.*, 2020 WL 12688176 (ED Mich., Nov. 16, 2020).

⁴⁶ *Polselli v. IRS*, 23 F.4d 616, 623 (6th Cir. 2022).

2023 Workbook

Issues. The issue in this case is whether a delinquent taxpayer must have legal interest in the accounts or records summoned by the IRS to meet the exception to the notice requirement in §7609(c)(2)(D)(i).

Analysis. Generally, the IRS must provide notice of summons to anyone identified in the summons to provide an opportunity for the named parties to quash the summons. There is an exception to this rule in §7609(c)(2)(D)(i). To satisfy this exception, the summons must meet the following conditions.

1. The summons must be issued in aid of collection.
2. The summons must aid the collection of an assessment made or judgement rendered.
3. The summons must aid the collection of assessments or judgements against the person with the liability to which the summons was issued.

Note. None of the three conditions mention having a legal interest in the records that the IRS is requesting. There is especially no mention that a taxpayer must maintain such an interest for the notice exception to apply.

The Polsellis argued that “in the aid of collection” in the first condition means that the summons will only directly advance the IRS’s collection efforts if the summons are targeted at an account that the IRS can collect assets from to satisfy the taxpayer’s liability. As such, collectible assets can only be produced if the taxpayer has a legal interest in the account.

The Court countered that the term “aid” refers to helping or assisting. Therefore, even if a summons does not uncover taxpayer assets, it may help or assist the IRS in finding assets. In this case, the IRS issued summons to three banks. The summons may not result in the IRS identifying assets at those banks, but it could assist the IRS in uncovering entities that Mr. Polselli controlled, which could lead it to collectible assets to satisfy the \$2 million liability.

The Polsellis next argued that there is no real distinction between conditions 1 and 2. Essentially, condition 1 covers every summons that the IRS would issue. There must therefore be an implied “legal interest” requirement to give condition 2 a reason to exist.

The Court disagreed. It interpreted the condition 1 as applicable upon an **assessment**, whereas the condition 2 is applicable upon the finding of a **liability**. A taxpayer’s liability exists before the IRS makes an official assessment. However, a formal assessment is not required before the IRS begins collection efforts. The Court also asserted that the Polsellis overlooked that condition 1 addresses taxpayers, whereas condition 2 addresses a transferee or fiduciary. Therefore, the Court identified that the two conditions are distinct requirements.

Holding. The Court concluded that the plain language of the statute does not require a legal interest limitation for the exception and affirmed the judgment of the Court of Appeals for the Sixth Circuit.



Reasonable Cause for Abatement and Granting of Installment Agreement *George Anton and Ellen Jones-Remisovsky v. Comm’r, TC Memo 2022-89 (Aug. 30, 2022)* IRC §§6320(c), 6330(d), and 6651(a)

Blues and Booze Offer No Excuse

Facts. George Anton Remisovsky was a medical doctor in 2013, while his wife Ellen was a retail manager. The couple failed to file their joint federal income tax return for 2013 until May 25, 2016. The delinquent return reported a tax liability of \$57,197 and a balance due of \$19,690. The filed return did not include payment for the tax due. In response, the IRS assessed tax due of \$19,690 and additions to tax totaling \$7,845 under IRC §6651(a).

After receiving multiple notices of deficiency regarding their 2013 tax liability, Dr. and Mrs. Remisovsky timely submitted a request for a collection due process (CDP) hearing on March 22, 2019. Dr. and Mrs. Remisovsky sought to challenge the additions to their tax liability and discuss collection alternatives. The settlement officer (SO) from the IRS Office of Appeals overseeing the case communicated with Dr. and Mrs. Remisovsky that the tax liability and additions to tax assessments were correct and followed applicable law and procedure. When Dr. and Mrs. Remisovsky then requested first time abatement of the additions to tax, the SO explained that they did not qualify, as the couple had also been subject to additions to tax for the 2011 tax year.⁴⁷

Subsequently, Dr. Remisovsky supplied alcoholism and depression as arguments for “reasonable cause” in failing to timely file their 2013 tax return. He explained that he had been hospitalized for alcoholism in 1990 and suffered a relapse in 2012, stating he could continue working due to being “a binge drinker while active.” As additional support, Dr. Remisovsky supplied a letter from his psychiatrist dated July 23, 2019. The letter disclosed that Dr. Remisovsky had a history of alcoholism with periods of sobriety, and “his cognitive capacity to comply with his financial obligations and to pay his taxes in a timely fashion were severely diminished.” The SO denied the penalty abatement under reasonable cause, explaining the argument did not adhere to the criteria in the Internal Revenue Manual.⁴⁸

The SO offered the couple a \$654 per month installment agreement, which included additions to tax. Dr. and Mrs. Remisovsky rejected this offer and did not provide any alternative or pursue other options. Consequently, the SO closed the case. Dr. and Mrs. Remisovsky then received a notice of determination dated September 2, 2020, sustaining the levy and lien notices for the 2013 tax year.

After receiving the notice, Dr. and Mrs. Remisovsky filed a petition with the U.S. Tax Court. They asserted that the SO erred in declining the reasonable cause abatement of 2013 additions to tax and refused to grant an installment agreement without merit.

Issues. The issues in this case are the following.

- Whether the SO erred in declining reasonable cause abatement of the additions to tax
- Whether the SO abused her discretion in sustaining an installment agreement

Analysis. A taxpayer can argue reasonable cause for a delay in filing if the taxpayer “exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time.”⁴⁹ Similarly, a taxpayer could argue reasonable cause for a delay in payment if the taxpayer “exercised ordinary business care and prudence in providing for payment of his tax liability and nevertheless was either unable to pay the tax or would suffer undue hardship if he paid the tax on the due date.”⁵⁰ Dr. and Mrs. Remisovsky did not state that **financial hardship** played any role in their failure to file and pay. Instead, they reasoned that their failure to file their tax return and pay their tax liability on time was attributable to Dr. Remisovsky’s alcoholism and depression.

⁴⁷ IRM 20.1.1.3.3.2.1 (2020).

⁴⁸ IRM 20.1.1.3.3.2.1 (2011).

⁴⁹ Treas. Reg §301.6551-1(c)(1).

⁵⁰ *Hardin v. Comm’r*, TC Memo 2012-162 (Jun. 11, 2012).

2023 Workbook

The court noted that Dr. Remisovsky did not provide testimony or evidence that he suffered from depression and alcoholism at times pertaining to the filing and payment, including early in 2014 when the 2013 tax return was due, and in May 2016 when they filed the delinquent return but did not submit payment. The court further noted that the doctor's letter did not specify time periods or a timeframe when Dr. Remisovsky suffered from alcoholism. That omission would have been important in assessing the reasonableness for the lack of filing and payment, especially when the letter acknowledged Dr. Remisovsky experienced periods of sobriety. The court also found that Dr. Remisovsky failed to provide any evidence regarding the severity of his alcoholism and depression. For example, Dr. Remisovsky was neither admitted to a mental illness hospital nor an alcohol treatment center. The severity of his alcoholism and depression must be debilitating to meet the criteria for successfully arguing reasonable cause in performing financial obligations. That Dr. Remisovsky could practice medicine during this timeframe did not help his case. The court pointed out that it regularly rejects "reasonable cause" defenses based on similar illnesses where the taxpayer continued to work during the relevant time periods.

Additionally, the court explained that even if Dr. Remisovsky could prove he was too ill to file and pay on time, Mrs. Remisovsky provided no arguments or reasons as to why she could not file or pay. Mrs. Remisovsky received wages in 2013 for her retail manager position and had an independent filing obligation. Furthermore, Mrs. Remisovsky could not use her husband's illness as a per se excuse for failing to file their return.⁵¹ The court also identified that Dr. and Mrs. Remisovsky had used an accountant to prepare and file their 2012 tax return, noting the couple did not explain why they could not reach out to that accountant for help in preparing and filing their 2013 return.

Dr. and Mrs. Remisovsky claimed that the SO handling their case arbitrarily refused to grant an installment agreement. The court's review of the record found that the SO fulfilled her statutory responsibilities in this matter by properly verifying the requirements of applicable law and administrative procedure were met, considering any relevant issues the taxpayers raised, and considering the balance between collecting the taxes and having the collection not exceeding a necessary level of intrusiveness concerning the taxpayers. When Dr. and Mrs. Remisovsky refused the SO's \$654 per month offer and did not counter with an alternative proposal, the court stated that the SO was under no obligation to pursue a collection alternative.

Holding. The court held that the SO did not err in declining Dr. and Mrs. Remisovsky's request to abate additions to their 2013 tax liability through reasonable cause. Additionally, the court found that the SO did not abuse her discretion in sustaining collection actions as Dr. and Mrs. Remisovsky failed to offer and seek a collection alternative.



Practitioner Planning Tip

This case highlights the importance of following the criteria for arguing reasonable cause for failure to file a tax return and pay a tax liability. The burden of proof falls on the taxpayer to show that they reasonably made an effort to comply or that making a payment would cause undue hardship. This case also shows that spouses who file jointly are both equally responsible and that even if one is incapacitated, that fact alone does not preclude someone from filing a tax return or paying a tax liability in the eyes of the IRS.

⁵¹ *Fambrough v. Comm'r*; TC Memo 1990-104 (Feb. 28, 1990).

Tax Scams

IRS News Rel. IR-2023-71 (Apr. 5, 2023)

IRS Releases “Dirty Dozen” List of Tax Scams

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

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

1. **Employee retention credits (ERC).** Scammers promote large refunds related to the ERC, attempting to con ineligible individuals to claim the credit. Often the scammer’s promotion is based on inaccurate information related to an individual’s eligibility for the ERC and the computation of the credit. The scammers collect personally identifiable information and use that information to carry out identity theft.
2. **Phishing and smishing.** Scammers pose as legitimate organizations and send unsolicited text messages (smishing) or email (phishing), to entice unsuspecting victims to provide their personal and financial information. The thieves then use that information for identity theft. The IRS reminds everyone that it initiates most contact through regular mail, rather than email, text, or social media.
3. **Online account help from third-party scammers.** Taxpayers should not accept help from third parties who offer to help the taxpayer to set up an IRS Online Account. Once the taxpayer provides the third party with their personal information, the swindlers can use that valuable information for nefarious gains. Taxpayers should establish their own online accounts.
4. **False fuel tax credit claims.** The fuel tax credit is available for off-highway and farming use. Most taxpayers are not eligible for the credit. Unscrupulous practitioners and promoters entice taxpayers to incorrectly inflate their tax refunds by claiming the credit on Form 4136, *Credit for Federal Tax Paid on Fuels*.
5. **Fake charities.** Defrauders set up fake organizations whenever a crisis or natural disaster strikes to take advantage of the donor’s generosity. The scammers acquire taxpayer’s money and personal information, to ultimately exploit the donors. Individuals are only eligible to claim an itemized deduction if they donate to a qualified tax-exempt IRS-approved organization.
6. **Unscrupulous tax return preparers.** Common warning signs of a corrupt tax preparer include charging a contingency fee based on the size of a refund, refusing to sign the return as the preparer, or refusing to provide their preparer tax identification number.
7. **Social media: fraudulent form filing and bad advice.** A recent example of bad advice on social media the IRS has seen, is the recommendation to fraudulently file Forms W-2, *Wage and Tax Statement*, or Form 8944, *Preparer e-file Hardship Waiver Request*. The scheme encourages individuals to file these forms using false, inaccurate information to get a refund.
8. **Spearphishing and cybersecurity for tax professionals.** Spearphishing is a type of phishing (emails or text messages to entice individuals to provide personal information) that targets a specific business or organization. Tax professionals have a greater potential for harm if they are the victim of spearphishing because of all the client data they maintain. Scammers can use client data and the tax practitioner’s identities to file fraudulent claims.

Note. For more information on practitioners’ responsibility to protect their client data from attacks, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 1: Written Information Security Plans and Protecting Client Data.

2023 Workbook

9. **OIC mills.** IRS OICs help individuals who are unable to pay their tax liability in full reach a settlement with the IRS. “Mills” aggressively promote OIC to individuals who do not meet the qualifications, often costing the taxpayer thousands of dollars.
10. **Schemes aimed at high-income filers.** The IRS identified two specific schemes that are aimed at high-income individuals.
 - a. **Charitable remainder annuity trust (CRAT).** CRATs are irrevocable trusts that allow individuals to donate their assets to a charity and draw an annual income for life or a specific period. Some trusts are misused to eliminate ordinary income or capita gain on the sale of property.
 - b. **Monetized installment sales.** Promoters focus on individuals who are attempting to defer the recognition of gain when they sell appreciated property. In exchange for a fee, these scammers facilitate an alleged monetized installment sale.
11. **Bogus tax avoidance strategies.** The IRS identified two specific tax avoidance strategies of which to be aware.
 - a. **Micro-captive insurance arrangements.** Micro-captive insurance companies are insurance companies whose owners are taxed on the captive’s investment income only. These schemes lack many of the characteristics of legitimate insurance and include improbable risks, failure to match legitimate business needs, and unnecessary duplication of insurance coverage for the taxpayer.
 - b. **Syndicated conservation easements.** Conservation easements are restrictions on an individual’s right to use real property. Generally, the taxpayer claims a charitable contribution for the fair market value of a conservation easement that they contribute to a qualified charity. The transfer must meet the requirements of IRC §170. Promoters abuse the system by grossly inflating the associated tax deduction.
12. **Schemes with international elements.** The IRS identified three specific international schemes of which to be aware.
 - a. **Offshore accounts and digital assets.** The IRS continues to investigate individuals with offshore accounts. In recent years, it has increased scrutiny on accounts with digital assets, such as cryptocurrency. Individuals who attempt to conceal their assets in offshore banks, brokerage accounts, digital asset accounts, and nominee entities are subject to exposure by the IRS. The IRS can identify and track seemingly anonymous transactions involving foreign financial accounts and digital assets.
 - b. **Maltese IRAs misusing treaty.** This scheme involves U.S. residents and citizens who contribute to IRAs in Malta (and other host countries also) but lack any local connection to the host country to avoid U.S. tax. The individuals claim the foreign arrangement is a pension fund and, based on the tax treaty, qualifies for an exemption from U.S. income tax on gains and earnings in and distributions from the foreign IRA.
 - c. **Puerto Rican and foreign captive insurance.** This scheme involves U.S. business owners of closely held entities entering into an alleged insurance arrangement with a Puerto Rican or other foreign corporation in which the U.S. business owner maintains a financial interest. The U.S. business owner then claims a deduction for premiums paid for insurance coverage to a fronting carrier, which reinsures the coverage with the foreign corporation. However, the “insurance” arrangement typically lacks the characteristics of legitimate insurance.

Note. More information on each of these scams can be found at **uofi.tax/23x12x1** [www.irs.gov/newsroom/dirty-dozen].

2023 Workbook

Amending Returns

IRS News Rel. IR-2023-77 (Apr. 11, 2023)

Early Filers in 2023 Should Consider Amending Returns For Certain State 2022 Tax Refunds

The IRS instructed taxpayers who filed their federal income taxes early in 2023 and reported certain state 2022 tax refunds as taxable income to consider filing an amended return. During a review, the IRS determined that taxpayers in many states did not need to report these payments on their 2022 tax returns. Consequently, the IRS will not challenge the taxability of state payments related to **general welfare and disaster relief**. Taxpayers in the following states did not need to report these state payments on their 2022 return.

- Alaska⁵²
- California
- Colorado
- Connecticut
- Delaware
- Florida
- Hawaii
- Idaho
- Illinois
- Indiana
- Maine
- New Jersey
- New Mexico
- New York
- Oregon
- Pennsylvania
- Rhode Island

Taxpayers in Georgia, Massachusetts, South Carolina, and Virginia will not include special state 2022 tax refunds as income for federal tax purposes if the payment is a refund of state taxes paid and the recipient either claimed the standard deduction for tax year 2022 or itemized their tax year 2022 deductions but did not receive a tax benefit.

Taxpayers who filed before February 10 in the states mentioned should check their tax return to ensure they paid tax on a state refund before filing an amended return. In addition, taxpayers who used a tax professional can consult with them to determine whether an amended return is necessary.

If taxpayers need to file an amended return and they submitted their original 2022 tax return electronically, they can also file their amended return electronically and may select direct deposit for any resulting refund. Taxpayers also have the option to submit a paper version of the Form 1040-X, *Amended U.S. Individual Income Tax Return*, and receive a paper check. Direct deposit is not available on amended returns submitted on paper.

Caution. Several states provided payments during 2023 that could be considered for general welfare and disaster relief. The IRS has not yet issued guidance on how those 2023 payments should be treated for federal purposes.

12

⁵² Applies only to the special supplemental Energy Relief Payment received.

2023 Workbook

Timely Filing Petitions with the IRS

***Antawn Sanders v. Comm’r.*, 160 TC 16 (2023)**

IRC §§6213, 7451 and 7502

Less Than A Minute Didn’t Win It

Facts. Antawn Jamal Sanders received a notice of deficiency from the IRS dated September 8, 2022. The notice instructed that Mr. Sanders could file a petition with the tax court for this matter no later than December 12, 2022. Prior to that date, Mr. Sanders created an account with the court’s electronic filing system, DAWSON, to file a petition with the tax court regarding the deficiency notice.

Mr. Sanders did not attempt to file the petition until 11:03 p.m. on December 12, 2022, leaving him less than one hour to timely file the petition. For over 30 minutes, he attempted to file the petition through DAWSON via his smartphone but was unable to upload his documents through the system. After several failed attempts, Mr. Sanders switched to his Windows computer, where he had difficulty logging into DAWSON until 11:56 p.m. After referring to the instructions throughout the process and completing steps within the petition application, Mr. Sanders was able to file the petition 11 seconds after midnight.

On January 25, 2023, the IRS filed a motion to dismiss, citing a lack of jurisdiction due to Mr. Sanders’s petition not being timely filed. The IRS noted that, per DAWSON logs, the system was accessible throughout December 12, 2022, and therefore was not inaccessible to the general public.

Mr. Sanders filed an objection to this motion on February 21, 2023, stating that he logged in and filed the petition on time. He explained that he made several attempts to file the petition well before midnight and was able to successfully upload the petition at exactly 12:00 a.m. The Center for Taxpayer Rights submitted an amicus brief arguing Mr. Sanders’s petition was timely filed when he relinquished control of the submission through the lens of equitable tolling under IRC §7502.

Issues. The issues in this case are the following.

- Whether Mr. Sanders timely filed his petition under §7451
- Whether the filing location was inaccessible, resulting in an otherwise untimely filing being considered timely
- Whether equitable tolling applies to Mr. Sanders’s case

Analysis. The court identified that IRC §6213(a) as the applicable prescription for the time for filing a petition for matters of tax deficiency. The Code mandates the timely filing of a petition as 90 days after the IRS mailed the notice of deficiency (excluding weekends and holidays as the last day). The petition is ordinarily deemed as filed when the Tax Court receives it.⁵³ Under Tax Court Rule 22(d), electronic submissions are considered timely filed at or before 11:59 PM Eastern Time on the last day of the filing period. Furthermore, electronic filing is considered accomplished when the server receives the transmission, not at the time when an applicant logs into the system or begins the filing process.⁵⁴ Per these criterion, Mr. Sanders did not timely file his petition on December 12, 2022, under §6213(a). While the court acknowledges that Mr. Sanders logged in and begin preparing his petition on December 12, 2022, the day that he filed his petition fell on December 13, 2022, 11 seconds after midnight.

⁵³ See *Leventis v. Comm’r.*, 49 TC 353, 354 (1968).

⁵⁴ See *In re Sands*, 328 BR 614, 619 (Bankr. NDNY 2005).

Mr. Sanders argued that the filing location, in his case the DAWSON system, was inaccessible under §7451, thus rendering his submission as timely. The IRS disagreed, stating that logs proved that the system was accessible to the general public throughout December 12, 2022. In determining whether §7451 applied to Mr. Sanders's case, the court distinguished between the availability of DAWSON and user-specific errors. Because Mr. Sanders was able to log into the system using both his phone and his computer, DAWSON was accessible and available. The issues that Mr. Sanders's faced when filling out the forms on his phone did not pertain to the DAWSON filing system, because filling out the forms is completed separately and outside of the filing portal. Mr. Sanders's argument that he had to undertake multiple steps before filing his submission also did not have relevance to the DAWSON system being accessible. The court explained that the realities of filing, whether electronic or otherwise, involved multiple steps in the process, and was not a reflection of the availability of a filing location. Furthermore, the court's own records showed that DAWSON was operational and available at all relevant times on December 12, 2022. Because Mr. Sanders's difficulties were unique to him, §7451 does not apply to his case.

The court also assessed the argument of applying the doctrine of equitable tolling, where relief is provided to the litigant in cases where they diligently pursued their rights but extraordinary circumstances resulted in them failing to meet a deadline. The court identified that the petition filing deadline is jurisdictional under §6213(a) and therefore the court must enforce the deadline regardless of equitable considerations. Consequently, the court cannot apply the doctrine of equitable tolling to deadlines for filing a petition in a deficiency case.

Holding. The court held that Mr. Sanders did not timely file his petition under §6213(a). The court identified that §7451 does not apply to Mr. Sanders's case because the circumstances surrounding his inability to file on time pertained to user error instead of the accessibility and availability of the DAWSON system to the general public. The court also held that equitable tolling does not apply in the matter of an untimely petition in a deficiency case. The court dismissed Mr. Sander's petition for lack of jurisdiction.

Note. This case is an example of the risks associated with last-minute filing, particularly through electronic means. The time it takes to go through the submission process and user-specific difficulties do not provide leniency in late submissions, even in matters where the submission was late by seconds.

Corporate President's Liability for Unpaid Taxes

U.S. v. Isaac Neuberger, No. 1:22-cv-02977 (Jul. 10, 2023)

IRC §§6321 and 6323; 31 USC §3701

Numerous Nuisances for Neuberger

Facts. On **November 20, 2019**, the IRS issued a notice of deficiency to Lehcim Holdings, Inc. (Lehcim), indicating that the company had tax liabilities arising from underreported taxes during the tax years 2010 through 2015. Consequently, Lehcim was liable for \$2,091,455.16 in unpaid taxes.

The IRS sent the notice of deficiency to Lehcim's president, Isaac Neuberger at his law firm, Neuberger, Quinn, Gielen, Rubin & Gibber, P.A. The IRS informed Lehcim that it could contest the notice by submitting a petition to the U.S. Tax Court. However, Lehcim did not file a petition, and the tax liabilities were assessed against it on **July 13, 2020**.

During the period between the receipt of the notice of deficiency and the assessment of tax liability, Mr. Neuberger, acting as Lehcim's president, transferred the company's account balance to repay purported loans from third parties. After these payments Lehcim did not have sufficient assets to settle its tax liabilities.

2023 Workbook

On November 16, 2022, the United States filed a complaint in the U.S. District Court of Maryland, invoking the Priority Statute under 31 USC §3713, to assert that Mr. Neuberger bears personal liability for Lehcim's outstanding tax liability to the IRS. The United States contended that Mr. Neuberger became liable when he transferred the available funds to third parties with inferior claims while Lehcim was insolvent.

Subsequently, on January 25, 2023, Mr. Neuberger submitted a **motion to dismiss** the United States's complaint. He argued that the United States had not adequately alleged the existence of a claim in the relevant time period under the Federal Tax Lien Act (26 U.S.C. §6321 *et seq*). Per his logic, because the claim was not perfected, the Priority Statute is not applicable. Additionally, Mr. Neuberger argued that even if it were applicable, the complaint lacked essential facts to constitute a valid cause of action under the Priority Statute.

In response, the United States contended that the Priority Statute is applicable in cases where the government does not seek priority for a tax lien against secured creditors and asserted that an unassessed tax liability qualifies as a claim under the statute. The United States maintained that the complaint included all necessary facts to support a claim pursuant to the Priority Statute.

Issues. The issues in this case are the following.

- Whether the United States adequately alleged the existence of a claim within the scope of the Tax Lien Act
- Whether a claim existed when Mr. Neuberger made the transfers to third party creditors
- Whether the United States's complaint fails to allege sufficient facts to state a claim under the Priority Statute

Analysis. In response to the United States's claim that the Priority Statute applies to the collection of unpaid tax debt, Mr. Neuberger argued that the Tax Lien Act should be the applicable law. According to him, in cases involving tax deficiencies, the government is required to obtain a tax lien against the taxpayer first before applying the priority rules established by the Tax Lien Act. To support this position, Mr. Neuberger cited the case of *U.S. v. Estate of Romani*, in which the Court emphasized the necessity of obtaining a tax lien before applying the rules of the Tax Lien Act. However, the United States countered this argument by asserting that the Priority Statute is not restricted to nontax claims and that Mr. Neuberger's creditors did not hold liens or debts superior to those of the United States, thereby warranting the application of the Tax Lien Act.

Mr. Neuberger contended that the Supreme Court's decision in *U.S. v. Estate of Romani* unequivocally supports their position. However, the United States refuted this interpretation, clarifying that in *Estate of Romani*, the Court specifically addressed priority concerning real property in the context of an unpaid tax liability of the deceased. The Court rejected the notion that the Priority Statute should grant priority to the United States over a judgment creditor's perfected and secured lien for real property. Contrary to Mr. Neuberger's broad assertion, the Court's analysis in *U.S. v. Russell* further illuminated the application of the Priority Statute following the *Estate of Romani* ruling. The Court in *Russell* explained that the *Estate of Romani* decision did not entirely exclude the application of the Priority Statute in all tax cases but necessitated that the government follows the correct procedures to secure and maintain its tax lien, ensuring priority over other secured creditors. In this case, the United States did not allege the existence of a tax lien at the time of Mr. Neuberger's purported transfers. Consequently, if any of Mr. Neuberger's creditors belonged to the specific categories outlined in the Tax Lien Act, it would be applicable. However, as the United States's complaint indicated that Mr. Neuberger transferred funds to repay purported loans from third parties, a category not explicitly addressed in the Tax Lien Act, the Priority Statute applies. Thus, the court rejected Mr. Neuberger's motion to dismiss based on the argument that any claim of priority related to a tax debt must be filed under the Tax Lien Act.

Next, Mr. Neuberger asserted that no claim existed within the scope of the Priority Statute at the time the transfers under consideration took place, and therefore, no personal liability could be attributed in the matter. Mr. Neuberger argues that only a lien, which the United States could not legally obtain until after the tax deficiency assessment on July 13, 2020, could qualify as a claim under the Priority Statute. In response, the United States contended that the Priority Statute’s plain language defines “claim” more expansively, encompassing a tax liability even prior to the assessment of a tax deficiency and the establishment of a lien. The Priority Statute defines a claim as any amount of funds or property determined by an appropriate federal government official to be owed to the United States by an individual, organization, or entity other than another federal agency. Furthermore, the Supreme Court directed lower courts to interpret the Priority Statute liberally, and accordingly, courts have applied it to various types of government claims, including federal tax liabilities. Given the complaint alleged the issuance of a notice of deficiency to Mr. Neuberger before any of the alleged transfers occurred and his knowledge of Lehcim’s unpaid tax liabilities, the United States maintained that it adequately alleged the existence of a claim within the meaning of the Priority Statute.

According to the United States, the notice of deficiency, issued on November 20, 2019, informed the Mr. Neuberger of the government’s claim for unpaid tax liability before any transfers took place. The notice of deficiency specifically stated that the IRS determined additional tax or other amounts owed by Lehcim for the tax years 2010 through 2015, thereby providing the amount of debt determined by an appropriate government official (the IRS) as owed to the United States. Therefore, this information satisfied the definition of a “claim” under the Priority Statute, and courts should not unduly restrict the term “claim” within narrow or technical interpretations. Consequently, the United States’s allegation that Mr. Neuberger received the notice of deficiency on November 20, 2019, disclosing the amount of Lehcim’s tax liability and subsequently engaged in fund transfers with this knowledge sufficiently supported the presence of a claim within the meaning of the Priority Statute.

Finally, Mr. Neuberger asserted that even if the Priority Statute was applicable, the complaint fails to provide sufficient facts to support a claim under the Priority Statute. Specifically, the United States had not alleged the occurrence of an insolvency proceeding, a crucial element of the Priority Statute. In response, the United States contended that the statute does not explicitly mention the term “insolvency proceeding” and argued that such a proceeding is unnecessary for the Priority Statute to apply, as long as there is a voluntary assignment of property. The Priority Statute should then apply in cases where an insolvent debtor voluntarily assigns property, as demonstrated by the situation where Mr. Neuberger, as the corporate officer of Lehcim, transferred funds to repay purported loans while the corporation was insolvent.

The relevant section of the Priority Statute, 31 USC §3713, stipulates that a “Claim of the United States Government shall be paid first when” certain conditions are met, including when a person indebted to the government is insolvent and makes a voluntary assignment of property or when an act of bankruptcy is committed. Insolvency within the context of the Priority Statute refers to a situation where the liabilities of an entity exceed its assets. Furthermore, Section 3713(b) of the statute imposes personal liability on a representative, including corporate officers, who pays a non-federal debt on behalf of a corporation before satisfying a federal claim. To establish a cause of action under the Priority Statute, the plaintiff must allege that a corporate officer acting on behalf of the corporation paid a non-federal debt before the United States’s claim, at a time when the corporation was insolvent, and with knowledge or notice of the federal claim. Mr. Neuberger did not dispute the United States’s allegations that other creditors received payment before the United States while the corporation was insolvent, and after he had knowledge of the United States’s claim. Therefore, the issue revolves around whether Mr. Neuberger’s actions constitute a “voluntary assignment of property” within the meaning of the Priority Statute, as alleged by the United States.

2023 Workbook

Mr. Neuberger's argument centered on the contention that the United States's complaint lacked an essential requirement for the application of the Priority Statute, namely an insolvency proceeding. He insisted that to meet this requirement, the United States must allege the occurrence of an insolvency proceeding in which the debtor's property was transferred to a fiduciary. The United States, however, maintained that the Priority Statute does not specifically demand the allegation of an insolvency proceeding and emphasized that such a term is absent from the statute and its interpretations. Furthermore, the statute's language clearly focuses on the debtor's insolvency as a pivotal condition for its application. The complaint stated that at the time of Mr. Neuberger's transfer of Lehcim's assets to third parties, Lehcim was either insolvent or became insolvent, as its assets were insufficient to cover its expenses. As such, the United States contended it has adequately alleged Lehcim's insolvency, thus fulfilling the requirement for invoking the Priority Statute.

Additionally, the Priority Statute necessitates an allegation that the debtor made a payment of a non-federal debt through a voluntary assignment of property, the provision in question in the case. Mr. Neuberger argued that a voluntary assignment denotes a specific legal concept where a debtor vests a receiver, trustee, or assignee with the authority to administer and distribute property to settle outstanding debts, and that liability can only attach if a corporate representative accepts the role of a receiver but fails to prioritize payment to the United States. The United States rebutted this argument by asserting that Mr. Neuberger's knowledge of Lehcim's insolvency and its debt to the United States, followed by transferring Lehcim's assets to other creditors instead of paying the United States, constituted a voluntary assignment of property under the Priority Statute.

Holding. The court held that the United States adequately alleged the existence of a claim, and that the Tax Lien Act was not required for claims of priority related to a tax debt. The court also held that Mr. Neuberger's knowledge and receipt of the notice of deficiency at the time he made the transfers to third parties resulted in the existence of a claim within the meaning of the Priority Statute. Finally, the court held that the United States adequately stated a claim for relief pursuant to the Priority Statute. Consequently, the court denied Mr. Neuberger's motion to dismiss.

IRS PROCEDURES — PENALTIES

Deadlines for Filing Claims for Credits or Refunds

IRS Notice 2023-21, 2023-11 IRB 563 (Mar. 13, 2023)

IRC §§6511, 6513, and 7508A

Relief from Deadlines For Filing Claims for Refunds

Purpose. The IRS notice provides relief for taxpayers affected by the COVID-19 emergency. The IRS issued the notice in response to the emergency declaration made by the President on March 13, 2020. The notice grants relief under IRC §7508A to affected individuals and businesses that may file claims for credits or refunds.

Analysis. IRC §7508A grants the Secretary of the Treasury the authority to postpone deadlines for certain tax-related acts by taxpayers affected by a federally declared disaster. The notice clarifies that a postponement under §7508A is not an extension of the due date but allows for disregarding a certain period when determining the timeliness of acts, interest, penalties, taxes, credits, or refunds.

The notice explains that previous notices (Notices 2020-23⁵⁵ and 2021-21⁵⁶) postponed certain tax return filing and payment obligations due to the COVID-19 pandemic. It did not extend them. Consequently, the 3-year lookback periods⁵⁷ for claiming credits or refunds were not affected. Taxpayers must submit claims for refunds or credits within three years of filing a return or two years of when they pay a tax, whichever expires later.⁵⁸ IRC §§6513(b)(1) and (2) deem a taxpayer to have paid taxes on the return's due date, generally April 15. This date applies to withheld and estimated taxes.

Section 3 of the notice grants relief to taxpayers filing series 1040 returns during the COVID-19 emergency. For these taxpayers, the IRS disregards the period between April 15, 2020, and July 15, 2020, or between April 15, 2021, and May 17, 2021, respectively, in determining the beginning of the lookback period for claiming credits or refunds under IRC §6511(b)(2)(A) of the Code. Without this notice, withheld or estimated taxes would not be eligible for a refund after April 15, 2023. This date is three years after the deemed date of deposit of the taxes.

The notice provides an example to illustrate the relief granted. If a taxpayer filed their 2019 federal income tax return on June 22, 2020, they would have until June 22, 2023, to file a claim for credit or refund. However, without the relief in the notice, the lookback period for claiming the refund would go back to only June 22, 2020. It would exclude the withheld income taxes deemed paid on April 15, 2020. The relief provides for the deemed paid taxes to be included. It disregards the period between April 15 and July 15, 2020, in the lookback period calculation.

Notably, the notice emphasizes that the relief granted in this notice is automatic. Affected taxpayers do not need to contact the IRS, file any forms, or submit additional documentation to receive relief.

RETIREMENT

IRC §401(k) Distribution for Medical Disability

Robert B. Lucas v. Comm'r, TC Memo 2023-9 (Jan. 17, 2023)

IRC §§72(m)(7), 72(t), and 401(k); Treas. Reg. §1.72-17A(f)

Taxpayer Cannot Use Disability to Avoid Early Withdrawal Penalties

Facts. In 2017, Robert B. Lucas lost his job at Life Cycle Engineering, where he worked as a software developer. To accommodate for his loss of income, Mr. Lucas received a \$19,365 distribution that year from his IRC §401(k) plan. Matrix Trust Co. (Matrix) administered the §401(k) plan. Matrix issued a 2017 Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, to Mr. Lucas, reporting the \$19,365 as an early distribution with no known exception to the early withdrawal penalty.

Mr. Lucas's filed 2017 income tax return reported the §401(k) distribution but excluded it from taxable income. Upon review of the return, the IRS issued a notice of deficiency to Mr. Lucas for \$4,899. The deficiency included an income tax assessment on the \$19,365 distribution and a 10% early withdrawal penalty, as Mr. Lucas had not yet reached the age of 59½ at the time of the distribution.

⁵⁵ IRS Notice 2020-23, 2020-18 IRB 742.

⁵⁶ IRS Notice 2021-21, 2021-15 IRB 986.

⁵⁷ IRC §6511(b)(2)(A).

⁵⁸ IRC §6511(a).

2023 Workbook

Mr. Lucas contested the tax deficiency, explaining that the §401(k) distribution is not taxable income because he has a medical disability. Mr. Lucas was diagnosed with diabetes in 2015. Mr. Lucas used a website to defend his position that having diabetes allowed him to exclude the distribution from gross income reported on his tax return. Mr. Lucas believed this website was knowledgeable on medical disabilities and retirement account withdrawal issues.

Issues. The issues in this case are the following.

- Whether Mr. Lucas's §401(k) distribution is taxable income
- Whether Mr. Lucas is subject to the 10% early withdrawal penalty

Analysis. While Mr. Lucas acknowledged receipt of a §401(k) distribution that he made in 2017, he asserted that he correctly excluded the distribution from gross income, using a website to determine that the distribution was not taxable due to his diabetes constituting a medical disability exception. The court inspected the website and found that the information Mr. Lucas relied on pertained to the early withdrawal penalty and not the taxability of a §401(k) distribution. Moreover, the website did not constitute legal authority. The court noted that no authoritative guidance, such as the Code, Treasury Regulations, or relevant caselaw, supported Mr. Lucas's assertion. The court clarified that gross income includes distributions from employees' trusts, which include §401(k) plans.⁵⁹ Consequently, Mr. Lucas must include the §401(k) distribution as gross income on his 2017 tax return.

Regarding the 10% early withdrawal penalty, the court noted that such penalties are assessed on qualified retirement account distributions when the taxpayer is under the age of 59½ at the time of distribution.⁶⁰ There are exceptions to the penalty under certain circumstances, one of which is when the distribution is attributable to an individual's disability.⁶¹ To qualify, the disability must result in the individual's inability "to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration."⁶²

The court found that the facts and circumstances surrounding Mr. Lucas's diabetes did not meet the criteria for a disability exception to the early withdrawal penalty. The court acknowledged that Treas. Reg. §1.72-17A(f)(2) identifies diabetes as a cause of preventing an individual from engaging in substantial gainful activity. However, Treas. Reg. §1.72-17A(f)(2) further clarifies that the impairment must have factually caused the prevention of engagement. Mr. Lucas's diagnosis of diabetes occurred in 2015, but he continued to work for the same employer until he lost his job in 2017. Therefore, the court did not find that Mr. Lucas's diabetes prevented him from engaging in a customary substantial gainful activity and would not qualify as a disability for an exception to the early withdrawal penalty.

Holding. The court held that Mr. Lucas should have included his §401(k) distribution as taxable income on his 2017 tax return and that the IRS was correct in subjecting the distribution to the 10% early withdrawal penalty.

⁵⁹ IRC §401(k).

⁶⁰ IRC §72(t)(1).

⁶¹ IRC §72(t)(2)(A)(iii).

⁶² IRC §72(m)(7).



Practitioner Planning Tip

This case highlights the importance of considering the consequences of taking an early retirement account distribution and that facts surrounding it matter in determining whether they may be penalties that the taxpayer could face as a result. A disability in and of itself is not guaranteed to qualify as an exception to an early withdrawal penalty. Rather, the impact of the disability on a taxpayer's ability to engage in a substantial gainful activity is a key component in determining the qualification for an exception.

Another takeaway from this case is the importance of relying on authoritative guidance over nonauthoritative sources. Well-intentioned taxpayers may find themselves trying to research and resolve an issue on their own by using advice that is not factual or misinterpreting correct guidance. Practitioners can market their experience and resources to help taxpayers in avoiding similar situations to those found in this case.

S CORPORATION

Credit for Increasing Research Activities

Jeffrey and Katherine Harper v. Comm'r, TC Memo 2023-57 (May 10, 2023)

IRC §41



Military Design-Build Firm Qualifies for Credit for Increasing Research Activities

Facts. Jeffrey and Katherine Harper claimed the research and development (R&D) credit under IRC §41. The credit was connected with their S corporation, Harper Construction Co. (HCC), and was for \$46,656 and \$778,610 for the tax years 2012 and 2013, respectively. HCC specializes in military design-build projects. The IRS disallowed these credits and asserted deficiencies in federal income tax and accuracy-related penalties for 2012 and 2013. It also made lesser adjustments unrelated to the R&D credit. The IRS alleged that HCC's construction designs failed to meet the definition of "business components." The business components requirement is one of four threshold tests for qualified research that is required for the R&D credit.

The IRS requested that the court dismiss the Harpers' action in a motion for partial summary judgment.

Issues. The issue in this case is whether HCC's construction designs meet the definition of "business components" under §41(d)(1)(2)(B).

Analysis. The court analyzed whether HCC's construction designs meet the definition of "business components" under §41(d)(1)(2)(B). The court considered HCC's projects' unique aspects, such as a particular location, client need, and set of specifications, as well as regulatory and environmental constraints.

2023 Workbook

HCC argued that their construction designs qualified for the R&D credit because the company conducted extensive R&D activities. The company claimed that it engaged in a process of continuous improvement and used feedback from its clients and employees to enhance its designs and its construction processes. HCC also pointed out that it faced unique challenges in its work, such as environmental regulations and the need to comply with stringent military specifications.

The case ultimately came down to whether HCC's construction designs met the definition of "business components" under §41(d)(1)(2)(B). The court's analysis focused on the specifics of HCC's projects and the activities and services the company engaged in during preconstruction, construction, design/development, and postconstruction phases. The IRS contended that the HCC activities did not qualify for the R&D credit for the following four reasons.

1. HCC's designs were not "new or improved."
2. HCC did not produce a product.
3. HCC did not own the buildings it constructed for the U.S. military but instead built them on government land.
4. HCC did not use the designs in the way intended for the R&D credit.

Regarding the four points raised by the IRS, the tax court found the following.

1. HCC engaged in a long process of conceptual design that is useful for a new or improved business component.
2. The court agreed that HCC did not produce a product but found that its designs still were qualified processes, regardless.
3. HCC developed processes, techniques, and potential inventions that satisfied the business component requirement, even if it did not produce products.
4. The case record clearly contradicted the IRS's claim that HCC did not "use" the business components in a meaningful way.

The court ultimately concluded that HCC's construction designs meet the definition of "business components" under §41(d)(1)(2)(B).

Holding. The court denied the IRS's motion for partial summary judgment and supported the Harpers' claim that they were entitled to the R&D credit.

