Chapter 10: Rulings and Cases

Note. Corrections were made to this workbook through January of 2025. No subsequent modifications were made. For clarification about terms used throughout 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, 2024. Each appears as a condensed version and should not be relied on as a substitute for the full document. A full citation appears for each item. This chapter is not intended to be a comprehensive coverage of all tax law changes. Rather, it reports the rulings and cases most likely to be of interest to tax professionals.

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

SUBSTANTIAL AUTHORITY

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

EVALUATION OF AUTHORITIES

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

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

NATURE OF ANALYSIS

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

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

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

AUTHORITY HIERARCHY

The following factors are considered in determining whether there is substantial authority for the tax treatment of an item.[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)

1. Treas. Reg. §1.6662-4(d)(3)(iii).

Additional information on some of the preceding items follows.

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

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

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

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

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

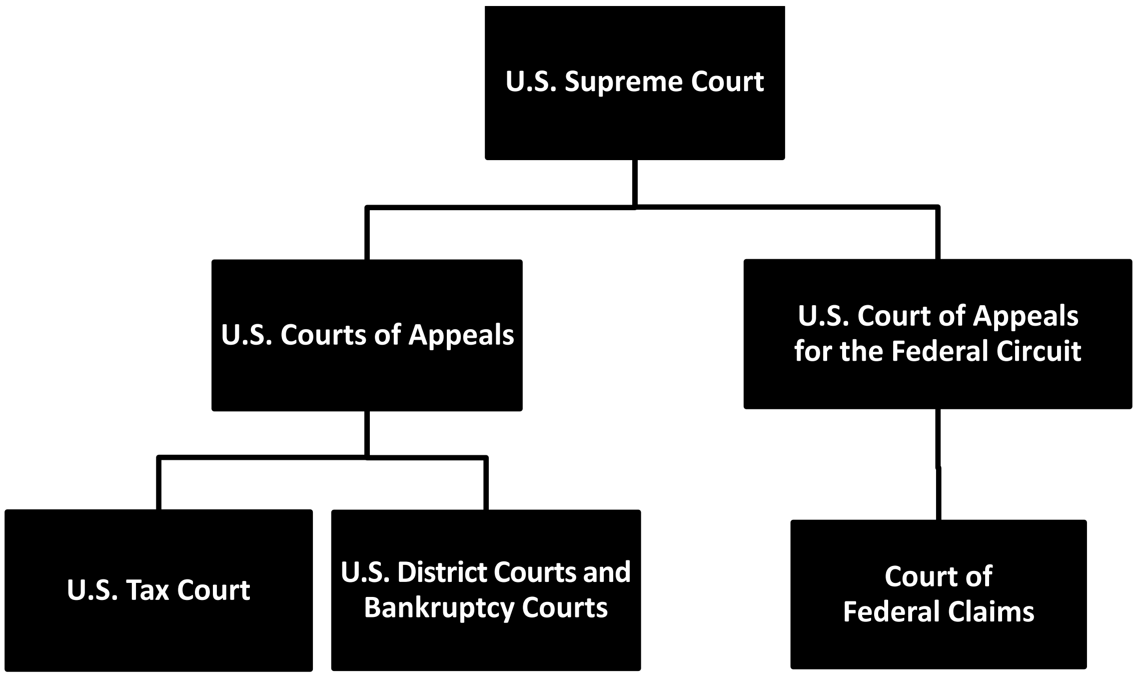
GCM. GCM detail the legal reasoning behind the issuance of a revenue ruling.

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

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

JUDICIAL SYSTEM FOR TAX DISPUTES

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



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

CASE COMMENCEMENT

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

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

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

THE U.S. TAX COURT

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

The Tax Court is located at 400 Second Street, NW, 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 2024, the Tax Court is composed of 19 judges (six currently vacant), 12 senior judges, and six 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.

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

2. *How to Pay the Filing Fee.* United States Tax Court. [ustaxcourt.gov/pay_filing_fee.html] Accessed on Jul. 16, 2024.

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).

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

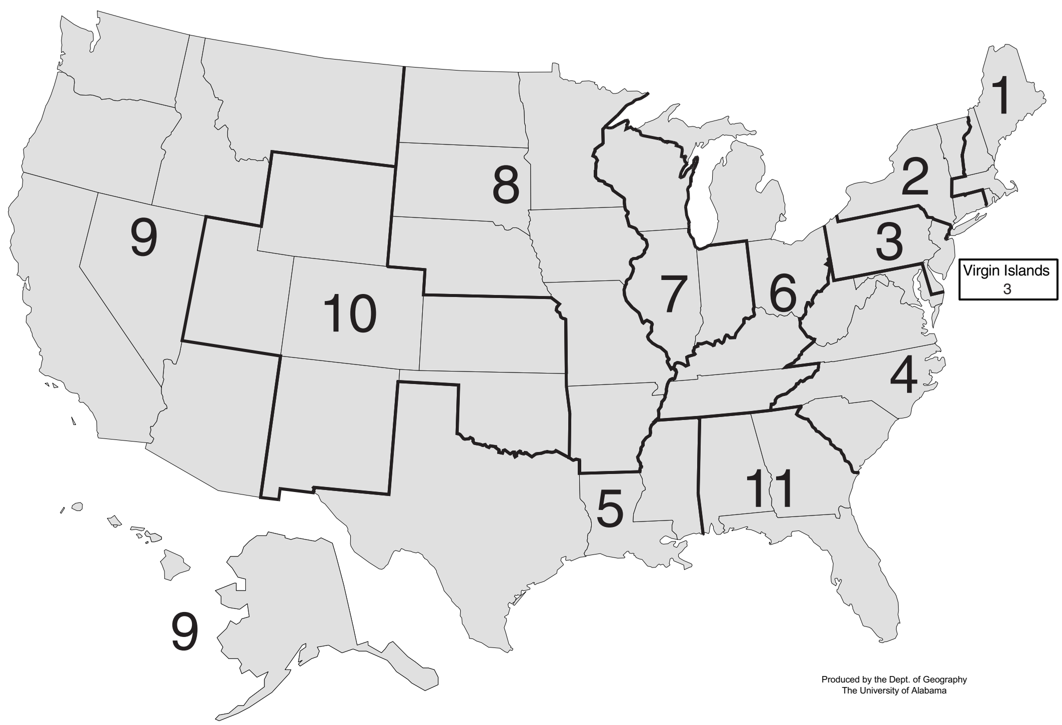
A Tax Court opinion or memorandum opinion may be appealed in a U.S. Court of Appeals. However, a taxpayer who commences their case in the U.S. Court of Federal Claims must appeal their case to the U.S. Court of Appeals for the Federal Circuit.

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].

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



IRS ACTIONS ON DECISION [6]

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. [irs.gov/actions-on-decisions] Accessed on Jul. 24, 2024; IRM 36.3.1 (2013).

CORPORATIONS

Corporate Deductions

***Short Stop Electric, Inc. v. Comm'r*, TC Memo 2023-114 (Sep. 11, 2023)**
IRC §§162, 172, 179, and 6662

☞ Low-Voltage Argument Short Circuits Electrical Contractor's Day in Tax Court

Facts. Short Stop Electric, Inc. (Short Stop) provides residential and commercial electrical contracting services. Originally incorporated in 1989 by Bob Boyum and his wife, Michelle, it has always been a C corporation and has used the **cash method of accounting.**

Short Stop's 2015 and 2016 tax returns claimed deductions for interest payments it never made to Mr. Boyum, who owned almost all of Short Stop's stock. Short Stop recorded these interest payments as increases in what Mr. Boyum called a "revolving line of credit." Mr. Boyum recorded a loan made to Short Stop after determining how much interest he wanted Short Stop to owe him. Although Short Stop never paid the interest to Mr. Boyum, he did recognize income from the interest payments on his personal income tax return. The interest "payments" caused net operating losses (NOL) on Short Stop's returns.

The IRS examined Short Stop's 2006 return. The IRS's revenue agent explained to Mr. Boyum that the unpaid interest could not offset the business's income. Because the agent perceived Mr. Boyum as being receptive to their instruction and eager to learn, the IRS suspended the examination with a "no change" status, even though it effectively converted the retained earnings of the C corporation into deductible interest payments.

Nevertheless, Short Stop continued to record interest payments to Mr. Boyum despite the absence of any cash moving and the revenue agent's instructions. In 2016, Short Stop adopted a new accounting practice, "stranger still," to quote the Tax Court.

In 2012, Mr. Boyum acquired an interest in a cabin on a lake. Mr. Boyum formed a partnership with the property's original owners named Orfei's Landing, LLP, to own and operate the cabin. With $90,000 of personal funds, Mr. Boyum acquired a 25% interest in the partnership but put the interest in Short Stop's name. For a while, the original owners retained the 75% interest but did not transfer the title to the cabin and the associated real estate to the partnership. Mr. Boyum told the court he had wanted to develop the property into a 5-plex.

Claiming that he wanted Short Stop to develop the property, Mr. Boyum acquired another 50% interest in the cabin and an option to acquire the remaining 25%. Mr. Boyum again paid with personal funds, even though Short Stop technically owned the partnership's interest. Short Stop exercised the option, and it indirectly owned an interest in a cabin on a lake. The investment appeared on Short Stop's books in 2016, causing an additional payment of "interest" to Mr. Boyum.

Short Stop never developed the property but used it to entertain its clients and employees. It claimed a deduction for the boat stored on the property, a snowplow, and a forklift. Mr. Boyum later conceded that the boat's cost was not deductible but maintained that the forklift and the snowplow were legitimate business expenses.

For 2015, Short Stop claimed $45,000 of interest deductions, including over $30,000 associated with the new debt associated with the property. This interest expense offset the corporation's taxable income entirely, generating an NOL under IRC §172. For 2016, Short Stop reported over $115,000 in interest expense to Mr. Boyum but used the NOL carryforward to offset its taxable income for that year.

The IRS disallowed the interest deductions and the NOLs that the interest deductions caused. The IRS also disallowed the IRC §179 deductions for the boat, the forklift, and the snowplow because Short Stop did not use them in its business. The IRS added penalties for negligence and substantial underpayment.

Issues. The issues in this case are the following.

- Whether Short Stop can claim interest deductions on its 2015 and 2016 tax returns
- Whether Short Stop is entitled to the NOL that it carried forward
- Whether Short Stop properly claimed deductions under §179
- Whether Short Stop is liable for accuracy-related penalties

Analysis. Cash-basis taxpayers must pay the interest claimed on their returns; the interest cannot be simply added to the debt's principal.[7] The court explained that this differs from capitalizing interest, summarizing the *Heyman* case.[8]

> *Capitalizing interest postpones an obligation to pay; it does not discharge that obligation.*

Observing that this conclusion is settled law, the tax court did not review whether a genuine debtor-creditor relationship existed between Mr. Boyum and Short Stop.

The court noted the "exceptional strangeness" with which Short Stop computed the interest due to Mr. Boyum. The revolving line of credit was associated with a written agreement dated December 31, 2009, between Mr. Boyum and Short Stop, permitting the company to borrow up to $1 million from Mr. Boyum. The agreement provided for **monthly** interest payments. This agreement authorized Mr. Boyum to determine a rate of interest each year and permitted Short Stop either to pay Mr. Boyum or add unpaid interest to the principal amount of the loan. But instead of collecting interest each month, Mr. Boyum calculated an interest rate and then added the unpaid interest on an **annual** basis.

Considering this practice, the court concluded that the loan agreement was fictional and that Mr. Boyum had made capital contributions to the company rather than extending loans. Because Mr. Boyum testified that he considered the financial condition of Short Stop when determining the interest percentage, the court concluded that any payments would amount to dividends rather than interest. Short Stop could not deduct unpaid "interest" amounts under IRC §162 as a C corporation, but its shareholder, Mr. Boyum, would still pay tax on them. Further, the court concluded the following.

> *The real surge that fries [Mr. Boyum's] argument is [his] intent in creating the loan... Boyum admitted that his goal for this "line of credit" was to convert as much of the balance as possible to principal.*

This action was Mr. Boyum's way of transforming Short Stop's retained earnings into the balance of a loan that would be repaid to him without tax effect when he sold Short Stop rather than being treated as a capital gain.

The court examined the legitimacy of the NOLs in light of denying the interest deductions. Because the interest deductions were not valid, the legitimate 2014 NOL reduced from $34,000 to $762. Additionally, because the company failed to elect on its 2014 return to carry the NOLs **forward,** this smaller amount would have to be carried **back** to its 2012 and 2013 returns, which showed positive income when the interest deductions were disallowed. Treas. Reg. §1.172-1(c) requires taxpayers to include a "concise statement setting forth the amount of the net operating loss deduction claimed." The omission of this statement from the 2015 and 2016 returns by itself disqualified the carryforward of the 2014 NOL.[9]

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7. Treas. Reg. §1.461-1(a)(1).

8. *Heyman v. Comm'r*, 70 TC 482 (1978), *aff'd* 652 F.2d 598 (6th Cir. 1980).

9. See *Amos v. Comm'r*, TC Memo 2022-109 (Nov. 10, 2022), in which the taxpayer provided inadequate substantiation for their NOL, resulting in the Tax Court disallowing it.

The court also examined Short Stop's §179 deductions for its snowplow attachment and forklift. Before trial, Short Stop conceded that the boat was not deductible, and the court's opinion indicated that personal use of it made the company's deduction untenable. The court concluded that neither the forklift nor the snowplow was listed property, which would have subjected both assets to the heightened substantiation requirements of IRC §274(d)(4). The court concluded that its use was predominately business-related, meeting the 50% threshold requirement for §179.[10] The court followed the IRS's earlier finding that Short Stop used the plow 50% for business to arrive at this conclusion.

In examining the §179 deduction for the forklift, the court took judicial notice that Minnesota has "lovely seasons that are snow-free." This notice supported the court's acceptance of Mr. Boyum's testimony that Short Stop used the forklift for business purposes. The Tax Court concluded that Short Stop was entitled to claim it used the asset 70% for business.

Because the IRS had already told Mr. Boyum not to add the unpaid interest to the loan, the court applied accuracy-related penalties under IRC §6662.

Holding. The Tax Court held that Short Stop's claim for interest deductions was improper, as was the claim for the NOL. Although the Tax Court allowed the §179 deduction for a portion of its forklift purchase, it denied the deductions for the boat. Finally, the court held that Short Stop was liable for accuracy-related penalties.

Corporate Valuation

***Connelly v. U.S.*, No. 23-146 (Jun. 6, 2024)**
IRC §§2001, 2031, and 2033

☞ Supreme Court Puts a Price on Brotherly Love

Facts. Brothers Michael and Thomas Connelly owned a building supply company organized as a corporation. They entered into an agreement providing that if one brother died, the other brother had the option, but not the obligation, to purchase his deceased brother's shares. If he declined the option, the corporation was obliged to buy the decedent's shares and thereby redeem them. Accordingly, the corporation bought life insurance on each brother's life to pay for the share redemption. When Michael passed away, Thomas decided not to purchase the shares. Consequently, the corporation had to redeem them. Thomas was the executor of Michael's estate and filed a federal estate tax return for it.

This tax return valued Michael's shares at $3 million. The valuation said the company was worth $3.86 million but excluded $3 million in insurance proceeds used to redeem the shares. It assumed that the share redemption obligation offset the life insurance proceeds. The IRS, however, believed the redemption obligation did not offset the life insurance proceeds, implying the company was worth $6.86 million. Multiplying that by Michael's 77.18% interest meant his shares were worth $5.3 million. According to this calculation, the IRS determined the estate owed an additional $889,914 in taxes. The estate paid the deficiency, and Thomas sued for a refund.

Issue. The issue in this case is whether the corporation's obligation to redeem Michael's shares offsets the life insurance proceeds in the company's valuation.

10. Treas. Reg. §1.179-1(d)(1).

Analysis. Tax is owed on the transfer of the taxable estate of every U.S. citizen.[11] The taxable estate includes the value of all property owned by the decedent at the time of their death, minus applicable deductions.[12] The estate includes shares in a closely held private corporation.[13] The fair market value (FMV) of a corporation determines the values of its shares. The proceeds of life insurance policies must be considered when determining the FMV of a corporation.[14]

If a corporation buys a shareholder out, fewer shares remain outstanding because the company spent money to buy the shareholder out. Yet, the value of each outstanding share is unaffected. Therefore, a redemption obligation does not reduce share value; fewer shares are outstanding after the redemption. Also, the executor must assess the corporation's value at the time the shareholder died.

At the time of Michael's death, the company would have been worth the full $6.86 million, as the redemption would not yet have occurred.[15] Additionally, if the share redemption obligation offsets the insurance proceeds, Thomas would receive a larger stake in the company, which would have the same value as before Michael died. When a company spends its money to redeem shares, it reduces the company's value by the expenditure of its own assets rather than another shareholder's money.

Holding. The court held that the corporation's obligation to redeem Michael's shares does not decrease their value.

> **Note.** As a result of this ruling, business owners should review the structure of any buy-sell agreements and consider whether a cross-purchase agreement where shareholders purchase insurance on each other may better serve their estate needs. Additionally, owners should evaluate their life insurance policies and regularly obtain a professional valuation of their business to comply with current market values and relevant tax regulations.[16]
>
> For more information on cross-purchase agreements and estate planning with life insurance, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 11: Agricultural Issues and Rural Investments.

CREDITS

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Credits

***Meyer, Borgman, & Johnson Inc. v. Comm'r,* No. 23-1523 (8th Cir. May 6, 2024), *aff'g* TC No. 7805-16 (Nov. 19, 2020)**
IRC §41

☞ Structural Engineering Firm's Research Tax Credit Claim Does Not Hold Weight

Facts. The structural engineering firm Meyer, Borgman, & Johnson, Inc. (Meyer) claimed $190,000 in research tax credits for the tax years 2010, 2011, and 2013. The credits arose from contracts with architects for custom engineering and design. The IRS denied the tax credits, and at trial, the Tax Court's summary judgment upheld its determination.

The Tax Court reached its decision because Meyer would receive payments regardless of the outcome of the research. The court disregarded the provisions of the contracts that imposed guidelines on Meyer. Because Meyer received payment irrespective of the research's result, the court regarded the research as funded. Under IRC §41(d)(4)(H), only research that is **not funded** by an outside party qualifies for the research tax credit.

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11. IRC §2001(a).
12. IRC §2031(a).
13. IRC §2031(b).
14. Treas. Reg. §20.2031-2(f)(2).
15. IRC §2033.
16. *Supreme Court Upholds Connelly: What It Means For Business Owners.* Erskine, Matthew. Jun. 6, 2024. Forbes. [www.forbes.com/sites/matthewerskine/2024/06/06/supreme-court-upholds-connelly-what-it-means-for-business-owners] Accessed on Jul. 8, 2024.

Issue. The issue in this case is whether the Tax Court's legal conclusion is correct that Meyer is **not** entitled to the research tax credits.

Analysis. Research credits are limited to qualified research expenses.[17] Qualified research is undertaken to discover technological information to develop business components.[18] Research funded by grants, contracts, or other persons is not considered qualified research.[19] A taxpayer can only claim the credit if payment for the research is not funded because it is "contingent on the success of the research."[20]

Meyer claimed its payments were contingent on its research success because it was required to create designs including everything the clients required, and Meyer had to comply with building codes. Contract provisions also allowed for termination if Meyer did not substantially perform. However, none of the contracts explicitly made payment contingent on Meyer's successful research. Additionally, requirements to abide by building codes did not require successful performance.

Meyer also claimed its contracts had quality assurance provisions, making payment contingent upon successful research. However, Meyer's contracts did not have the express terms that courts have identified as important to making payment contingent upon successful research.[21]

Holding. The appellate court affirmed the Tax Court's summary judgment. Meyer was not entitled to the research tax credit because payment from its clients was not contingent upon its successful research.

Low-Income Housing Credit

***23rd Chelsea Associates, LLC v. Comm'r*, 162 TC 3 (Feb. 20, 2024)**
IRC §§42 and 263A

☞ The Benefit of Financing Costs

Facts. Between June 2000 and March 2001, 23rd Chelsea Associates, LLC purchased real estate on West 23rd St. in New York City. Chelsea built an apartment building on the land called the Tate during 2001-2002. The construction was funded by a 31.5-year, $110 million loan from the New York State Housing Finance Agency (HFA). To finance the loan, HFA issued bonds, some of which were tax-exempt.

As a condition of the loan, HFA required Chelsea to agree to certain restrictions on the tenant mix as determined by income. The restrictions were designed to preserve the tax-exempt status of the bonds and qualify the Tate for the low-income housing credit (LIHC). Chelsea spent $107,444,441 out of the $110 million loan by December 2003. The $107 million figure included $5,745,837 that Chelsea spent in financing costs. Chelsea claimed an LIHC of $593,961 for each tax year from 2003-2009.

In 2004, Chelsea presented to the HFA an independently audited final cost certification and included an eligible basis calculation. The eligible basis calculation included a portion of the financing costs, which was $1,218,320. The HFA was responsible for allocating to the Tate an amount no greater than necessary for the project. The HFA did not dispute Chelsea's calculation of eligible basis, qualified basis, or LIHC amount. However, in 2019, the IRS issued a notice of final partnership administrative adjustment for the tax year 2009 to Chelsea, claiming the $1,218,320 should not be included in the eligible basis calculation.

17. IRC §§41(a)(1) and (b).
18. IRC §41(d)(1)(B).
19. IRC §41(d)(4)(H).
20. Treas. Reg. §1.41-4A(d)(1).
21. *Dynetics, Inc. & Subsidiaries v. U.S.,* 121 Fed.Cl. 492, 505 (2015).

Issues. The issues in this case are the following.

- Whether the eligible basis in a qualified low-income residential building includes financing costs
- If financing costs are not includible in eligible basis, whether IRC §42(j) requires credit recapture by the taxpayer

Analysis. The LIHC provides a tax credit for low-income restricted housing. The building must be residential rental property subject to income level restrictions for at least 15 years and must be eligible for the modified accelerated cost recovery system (MACRS). The credit is calculated as a **percentage** of the apartment building's **qualified basis.**

The qualified basis is computed by determining the building's **eligible basis,** which equals its **adjusted basis** at the end of the first year of the credit period. The adjusted basis is the total of the property's direct costs and properly allocable share of indirect costs. Then, the eligible basis is increased by 30% if the building is in an area with a large number of low-income residents, a high poverty rate, or high construction costs. The eligible basis is then multiplied by an **applicable fraction,** which is the lower of the fraction of rental units that are rent-restricted and occupied by low-income tenants or the fraction of residential rental floor space allocated to the low-income units.[22] IRC §42 also provides for recapturing some credits allowed for prior years. The credits are recaptured if, at the end of any year during the first 15 years of credit periods, the building's qualified basis is lower than at the end of the previous year.[23]

The IRS disputed Chelsea's eligible basis calculation, so the court looked to §42(d) to resolve the dispute. The Tate's eligible basis was the sum of Chelsea's direct construction costs and a properly allocable share of the indirect construction costs, minus costs allocable to portions of the building that were not "residential real property" at the end of the first year of the credit period.[24]

Direct costs are the sum of direct material and labor costs,[25] while indirect costs are all other properly allocable costs. Indirect costs must be a "but-for" cause of the taxpayer's production activities.[26] The $1,218,320 of financing costs were an indirect but-for cause of the Tate's construction because Chelsea decided to finance construction by borrowing from the HFA. Thus, the financing costs are part of the adjusted basis, which is part of the eligible basis.

The IRS also argued the LIHC requires a building to be subject to MACRS to be a qualified low-income building,[27] and the costs of obtaining bond proceeds should be capitalized into the underlying loan. The IRS argued further that if Chelsea capitalized the bond costs with the loan, they would be subject to depreciation but not MACRS. Consequently, Chelsea cannot include the bond costs in the eligible basis calculation. Nevertheless, the court ruled that the cost of bond proceeds does not need to be capitalized into an underlying loan as they were indirect costs "incurred by" the Tate's construction.[28] Additionally, the Tate is tangible business property and thus eligible for MACRS under IRC §168.

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The IRS also argued that the legislative history shows that the portion of the costs allocable to tax-exempt bonds is not included in the property's eligible basis, even if some of the financing costs are included. However, the IRS failed to allege any ambiguity in §42, which reads, "The adjusted basis of any building shall be determined without regard to the adjusted basis of any property which is not residential rental property." When the language of a statute is clear, the court does not consider legislative history.[29]

Holding. The court held that the $1,218,320 of financing costs were properly included in the eligible basis. Consequently, the court did not reach the issue of whether the recapture provisions of §42(j) would apply to Chelsea.

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22. IRC §§42(c)(1), (d)(1), (4), (6)(C), and (i)(3).

23. IRC §42(j)(1).

24. See IRC §42(d)(4)(A).

25. Treas. Reg. §1.263A-1(e)(2)(i).

26. *Robinson Knife Mfg. Co., Inc. & Sub. v. Comm'r,* 600 F.3d 121, 131–32 (2d Cir. 2010).

27. IRC §42(c)(2)(B).

28. See Treas. Reg. §1.263A-1(e)(3)(i).

29. *Hughes Aircraft Co. v. Jacobson,* 525 U.S. 432, 438 (1999).

DEDUCTIONS

Taxable Income

***David and Juana Villa v. Comm'r*, TC Memo 2023-155 (Dec. 28, 2023)**
IRC §§61, 162, 274, 6001, 6662, 6751, and 7491

☞ On the Fence About "Costs of Goods Sold"

Facts. David Villa moved to the United States in 1998, entering the fence-building business with his father after they immigrated. Mr. Villa operates the business as a sole proprietorship. During the years in issue, Mr. Villa worked as a subcontractor for 10 Point, Inc., DBA All-Texas Fence (All-Texas), and as a direct contractor for other customers. All-Texas provided the wood for the subcontractor projects, but Mr. Villa had to provide all materials for his direct contracting projects.

All-Texas paid Mr. Villa $26,022 in 2016 and $28,314 in 2017, and it reported those amounts on Forms 1099-MISC, *Miscellaneous Income*. Mr. Villa received $20,817 in 2016 and $40,630 in 2017 for direct contracting work. He deposited the checks but took out cash, marked "less cash" on the bank deposit slips, to pay business and personal expenses. The "less cash" withdrawals were $8,996 in 2016 and $16,480 in 2017. Mr. Villa kept some receipts, but not all.

For each year at issue, Mr. Villa asked his cousin to prepare a joint income tax return for his wife and himself. Mr. Villa's cousin was not a licensed accountant but prepared the returns for free as a favor. For the years at issue, the Villas only reported the payments from All-Texas but not any payments from the direct contracting work. Mr. Villa deducted $8,750 as contract labor expenses for 2016 and $10,501 for 2017. Mr. Villa also deducted "other" expenses of $11,690 for 2016 and $12,096 for 2017.

The IRS analyzed bank deposits, determining that the gross income for both years should be increased by the payments received for direct contracting work. The IRS also adjusted expenses reported on Schedule C, *Profit or Loss from Business*. Contract labor expenses were decreased from $8,750 to $4,814. The "other" expenses were reduced from $11,690 to $2,860. For 2017, contract labor expenses were increased to $11,881, and "other" expenses were decreased from $12,096 to zero. The IRS imposed accuracy-related penalties under IRC §6662(a), including penalties attributable to disregarding the rules or regulations under §6662(b)(1), and a substantial understatement of income tax under §§6662(b)(2) and (d).

Based on receipts that Mr. Villa produced before trial, the IRS agreed to increase contract labor expenses for 2016 to $8,750 and "other" expenses to $4,108. For 2017, the IRS increased "other" expenses from zero to $10,837.

The Villas asked the court to reduce the Schedule C net profit by applying their "less cash" withdrawals, $8,996 for 2016 and $16,480 for 2017, as costs of goods sold. This was based on Mr. Villa's "less cash" withdrawals, as supported by an estimate of his average profit margin, as discussed later. The net profit amounts claimed by the Villas were $24,985 for 2016 and $29,746 for 2017.

Issues. The issues in this case are the following.

- Whether the net profit amounts claimed for the years at issue should be reduced for "costs of goods sold" that were a part of Mr. Villa's "less cash" withdrawals based on his estimated profit margin
- Whether the Villas should be subject to penalties under §6662

Analysis. A taxpayer must maintain sufficient permanent records to substantiate their business's cost of goods sold.[30] If a taxpayer shows they incurred a deductible expense but cannot substantiate the exact amount, the court can estimate it according to the *Cohan* rule.[31] This rule also applies to estimating the cost of goods sold. The rule, however, cannot be used to estimate expenses covered by the substantiation requirements of IRC §274(d), which for the years at issue applied to most expenses for transportation, lodging, meals, etc.

30. IRC §6001.

31. *Cohan v. Comm'r*, 39 F.2d 540, 543-44 (2d Cir. 1930).

Deductions from gross income are allowed only to the extent provided by law. However, the reduction of gross receipts by cost of goods sold is mandatory, as only **income** is taxable according to the 16th Amendment of the U.S. Constitution. The Code defines a taxpayer's income as gross receipts less the cost of goods sold.[32] Mr. Villa testified he used "less cash" withdrawals to pay for business needs and personal expenses but did not specify what proportion of withdrawals went to business needs and personal expenses.

Mr. Villa gave an example of a recent project where 73% of his payment from the client went to pay for materials and contract labor. The court found this to be an accurate representation of his direct contracting work. However, the ratio did not consider the portion of the "less cash" withdrawals that Mr. Villa used for personal expenses without proper substantiation. Nor did it consider the fact that Mr. Villa did not have to purchase materials that he used on subcontracting projects with All-Texas.

Because neither party explained the composition of the "other" expenses for 2016 and 2017, the court was unclear to what extent these amounts included materials from the direct contracting work. Nevertheless, the court was confident that Mr. Villa used a substantial portion of the withdrawals to purchase materials and allowed 50% of the "less cash" withdrawals as cost of goods sold. Thus, the court allowed $4,498 for 2016 and $8,240 for 2017 as cost of goods sold.

A penalty of 20% applies to any underpaid tax due to negligence, disregard of rules, or a substantial understatement of income tax.[33] An understatement is substantial if it exceeds the greater of $5,000 or 10% of the tax required to be shown on the return for the year in question.[34]

The IRS also established that the Villas failed to report any gross receipts from direct contracting work. This omission reflected reckless or intentional disregard for IRC §61, which provides that gross income includes income "from whatever source derived." Thus, the IRS made a prima facie case for a 20% penalty under §6662(a) and (b)(1).

There is an exception to §6662 under IRC §6664(c)(1) "if it is shown that there was a reasonable cause" for the underpayment and "the taxpayer acted in good faith by not reporting all of the income." This is determined on a case-by-case basis. Mr. Villa testified that he failed to report the receipts for direct contracting work because his customers did not send him Forms 1099-MISC and therefore, he "didn't know how to" report that income. Even if Mr. Villa truly believed that he needed to report only income appearing on Forms 1099-MISC, it would not have been a reasonable belief. Mr. Villa's reliance on his cousin to prepare the tax returns was also unreasonable under the circumstances because even if his cousin told him he did not need to report that income, he knew that his cousin was not a professional accountant.

Holding. The court held that there should be a deduction for the cost of goods sold that included a portion of the "less cash" withdrawals that Mr. Villa presumably used to purchase materials. It adjusted the total income amount on the Villas' tax returns to $29,483 for 2016 and $37,986 for 2017. The Villas were held liable for penalties under §6662(a) for both years at issue.

32. Treas. Reg. §1.61-3(a).

33. IRC §6662(a).

34. IRC §6662(d)(1)(A).

***Andrew and Katherine Harrell v. Comm'r,* TC Summ. Op. 2023-31 (Oct. 30, 2023)**
IRC §§162 and 274

☞ Taxpayers' Deductions Go Off the Record

Facts. In 2017, Andrew Harrell was employed by Goodwill, GPR Logistics, LLC, and Village Management Services, Inc. at different times during the year. While working for Goodwill and GPR, Mr. Harrell managed a fleet of buses that served a residential complex and managed maintenance of the roads, clubhouses, and assisted-living facilities in the complex. Mr. Harrell's employment responsibilities required frequent travel through southern California. Mr. Harrell **did not keep** track of the expenses he incurred during his business travels and **did not keep** a record of whether use of his personal vehicle was employment-related or for personal use. Village sometimes reimbursed Mr. Harrell for his business expenses. The Harrells did not provide the employee expense reimbursement policies of any of Mr. Harrell's employers.

Mr. and Mrs. Harrell filed a joint federal income tax return in 2017. The Harrells reported the amounts from their Forms W-2, *Wage and Tax Statement,* and they also claimed a miscellaneous itemized deduction for unreimbursed employee business expenses related to Mr. Harrell's employment. The deduction totaled approximately 50% of the income shown on the Forms W-2. The deductions included amounts for vehicle expenses, travel expenses, meals and entertainment expenses, and other business expenses.

The IRS disallowed the entire deduction because the Harrells did not establish that the business expense on their tax return was paid or incurred during the taxable year and that the expense was ordinary and necessary to Mr. Harrell's business.

Issue. The issue in this case is whether the Harrells are entitled to a miscellaneous itemized deduction for unreimbursed employee business expenses.

Analysis. In a notice of deficiency, the IRS's determination of the taxpayer's federal income tax liability is presumed correct, and the taxpayer bears the burden of proving the determination to be wrong. Deductions are a matter of legislative grace, and the taxpayer bears the burden of proving entitlement to any claimed deduction. A taxpayer is required to substantiate expenses underlying deductions and produce adequate records.

Taxpayers can deduct ordinary and necessary expenses paid in connection with operating a trade or business. The performance of services as an employee constitutes a trade or business. If an employee is required to incur certain expenses, as a condition of employment, the employee is entitled to deduct those expenses unless they are entitled to reimbursement from their employer. If there is sufficient evidence that the taxpayer has incurred a business or trade expense but is unable to provide the amount, the court may estimate the amount of the deduction. In this case, there is no basis in the record that allows the court to estimate the amount of any expense included in the deduction.

Deductible business expenses for travel, meals, entertainment, and vehicle expenses require strict substantiation. Taxpayers are required to substantiate these deductions either by adequate records or by sufficient evidence about the amount of the expense, the time and place the expense was incurred, the business purpose of the expense, and in the case of an entertainment or gift expense, the business relationship to the taxpayer of each expense incurred. Adequate records include keeping an account book, diary, log statement of expense, trip sheets, or other similar records. Substantiation by other evidence requires the production of corroborative evidence supporting the taxpayer's statement. The Harrells failed to establish whether the expenses were paid or incurred and whether the expenses were ordinary and necessary expenses related to Mr. Harrell's employment with any of his employers.

Holding. The court found that the Harrells are not entitled to deduct the expenses and entered judgment for the IRS with respect to the deficiency.

> **Note.** The Tax Cuts and Jobs Act (TCJA) suspended miscellaneous itemized expenses between 2018 and 2025.[35] Because this case related to the 2017 tax year, the TCJA rules did not apply. For more information on the sunsetting of TCJA legislation and associated planning opportunities, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 12: Planning for the Sunset of the TCJA.

35. *Tax Cuts and Jobs Act,* PL 115-97, §11045.

EMPLOYMENT TAX

Trust Fund Recovery Penalty

***Taylor v. Comm'r*, TC Memo 2024-33 (Mar. 25, 2024)**
IRC §§6671 and 6672

☞ Delegating Tax Duties Did Not Exempt the CEO from Liability as a Responsible Person

Facts. Rodney A. Taylor, a seasoned management consulting and executive recruiting professional, founded and led Taylor & Co., Inc. ("the company") as its chief executive officer (CEO) and sole shareholder. Mr. Taylor delegated financial tasks to employees and accountants due to his self-reported math learning disability. Robert Gard, an accountant hired for bookkeeping, embezzled $1–2 million from the company over several years. This embezzlement, discovered after Mr. Gard's heart attack and subsequent confession in 2013, led to legal actions against him and the bank involved in the fraud.

However, Mr. Taylor did not use the settlements from these lawsuits to pay the company's unpaid employment taxes. Instead, in December 2013, he paid himself a significant bonus. In January 2014, he transferred company assets to a new entity he organized.

The IRS determined the company failed to remit employment taxes and attempted to notify Mr. Taylor of a trust fund recovery penalty (TFRP) assessment. During this period, Mr. Taylor updated his address on IRS records from 113 Sandy Shores to 99 Sandy Shores Court in Panama City, Florida, on an updated Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, which also contained additional financial details not provided earlier. He eventually relocated to Atlanta, renting out the property. The IRS's efforts to notify Mr. Taylor via certified mail at the 99 Sandy Shores Court address were unsuccessful, as the residence was vacant. In response to the TFRP assessment, Mr. Taylor contested the tax liability at an administrative hearing, challenging the IRS's claim without seeking an alternative to the Notice of Federal Tax Lien (NFTL) filed against him.

Issues. The issues in this case are the following.

- Whether Mr. Taylor, as the sole shareholder and an officer of the company at the relevant time, was a responsible person as described in IRC §§6671 and 6672
- Whether the IRS properly notified Mr. Taylor of the proposed TFRP assessment under §6672(b)
- Whether the IRS's determination to proceed with collection of the TFRP is an abuse of discretion

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Analysis. IRC §6672(a) imposes a penalty on any person responsible for collecting, accounting for, and paying over federal taxes but willfully fails to do so. To qualify as a responsible person in the corporate context, they should have had sufficient control over a corporation's affairs to ensure the payment of its employment taxes.[36]

Mr. Taylor contended that he was not a responsible person due to his mathematical incompetence and delegation of financial tasks to others, including the embezzling accountant, Mr. Gard. Nevertheless, considering Mr. Taylor's position as the CEO and sole shareholder of the company and his decisions to disburse the company's funds to pay for items other than its employment tax liabilities, the court determined that Mr. Taylor had sufficient control over the company's financial affairs to ensure the payment of employment taxes. Further, the court found that Mr. Taylor's delegation of tax responsibilities did not exempt him from liability as a responsible person. Moreover, the court determined that Mr. Taylor's failure to pay the company's employment taxes was willful, as he prioritized other payments over tax obligations even after being aware of the unpaid taxes.

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36. See IRC §6671(b); *Scott v. U.S.,* 825 F.3d 1275, 1279 (11th Cir. 2016).

Next, the court addressed the procedural aspects of the TFRP assessment. A §6672(a) penalty may be assessed against a taxpayer only after the IRS provides written notice sent to the taxpayer at the taxpayer's **"last known address"** that the IRS intends to assess that penalty.[37] The IRS sent the notice to the address from the most recent communication received from Mr. Taylor, the updated Form 433-A. The court held that the IRS had fulfilled its notification obligations by sending the notice to Mr. Taylor's last known address. Mr. Taylor's argument for a reasonable cause defense, based on his delegation of tax duties, was rejected. Deliberate decisions to use corporate funds for non-tax obligations indicated willful neglect.

Finally, the court indicated that any disputes over the exact amount of the underlying tax liability should be settled through computations made under Tax Court rules. The decision to proceed with the collection of the underlying liability through an NFTL was not considered an abuse of discretion, given the IRS's compliance with procedural requirements and the settlement officer's verification of supervisory approval for the penalty assessment.

Holding. The court held that Mr. Taylor was a responsible person, that the IRS properly notified Mr. Taylor of the proposed TFRP assessment in accordance with §6672(b), and that the IRS's determination to proceed with collection of the TFRP is not an abuse of discretion.

EXCISE TAX

Excise Tax

***British Airways PLC v. U.S.*, No. 1:19-cv-01124 (Fed. Cl. Mar. 21, 2024)**
IRC §4261

☞ The IRS Has the Right to Tax Frequent-Flyer Miles Payments

Facts. IRC §4261(a) applies a 7.5% excise tax to "the amount paid for taxable transportation of any person." Taxable transportation mainly includes domestic air transportation that departs in the United States or in a 225-mile zone and ends in the United States or in the 225-mile zone. If the flight is international but begins or ends in the United States, the fares paid are subject to a $12 excise tax under §4261(c)(1). IRC §4261(e)(3)(A) states that excise taxes are imposed on amounts paid to an air carrier for the right to provide mileage awards for transportation of persons. The §4261 taxes are deposited into the Airport and Airway Trust Fund, which finances programs administered by the Federal Aviation Administration (FAA).

British Airways is an airline with headquarters in the United Kingdom. British Airways had reciprocal mileage agreements with three American domestic airlines where British Airways passengers could earn frequent-flyer miles (FFM) as members of the domestic airline's programs when they flew on British Airways flights. British Airways made payments to the domestic airlines on a per-mile basis for the FFMs awarded to passengers. The domestic airlines billed British Airlines for the FFMs and included the 7.5% excise tax in the bill. Between June 2011 and March 2015, the domestic airlines collected approximately $11.4 million in excise taxes from British Airways. British Airways filed administrative claims for a refund because the payments were not "for the right to provide" FFMs. British Airways also argued in the alternative that it was entitled to a refund of the excise taxes that were not redeemed for taxable air travel and instead redeemed for services and goods. The IRS refunded the taxes redeemed for services and goods but disallowed the remaining refund claims of approximately $5.6 million for the period between 2011 and 2015.

The U.S. government filed a motion to dismiss the complaint for lack of subject-matter jurisdiction and a motion for summary judgment as to all of British Airways' refund claims.

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37. IRC §§6212(b) and 6672(b)(1).

Issue. The issue in this case is whether British Airways' payments to the U.S. domestic airlines are subject to the 7.5% excise tax for transportation.

Analysis. The United States argues that the court lacks jurisdiction because the refund forms were not signed. The court has jurisdiction only over tax refund claims that are duly filed with the IRS. However, previous court decisions held that the "duly filed" requirement does not affect subject-matter jurisdiction.[38] Therefore, the Court of Federal Claims has jurisdiction to hear claims for the refund of taxes paid to the IRS under the Tucker Act.[39]

Statutory interpretation first looks at the language of the statute and the plain meaning.[40] British Airways argued that the payments were not made "for the right to provide mileage awards for the transportation of person by air." The court held that the amounts were for the right to provide mileage awards because the "right" is defined as a power or privilege. British Airways argued that §4261(c)(3)(A) does not apply to payments for FFMs that are earned from actual flight activity. However, the statute states that the application of the tax depends on whether the amounts are for the right to provide FFMs. British Airways made the payment to acquire the right to provide its passengers with FFMs in the domestic airlines' frequent-flyer programs to achieve their goal of receiving marketing advantages. The "right to provide" language is not superfluous because it indicates that payments for mileage awards that the payor provides to another carrier should also be taxed.

If the statutory language is clear, the meaning of the statute controls interpretation unless the legislative history demonstrates an "extraordinary showing of contrary intentions."[41] The legislative history, including the House bill reports and conference agreement, supports the government's interpretation of the statute. The statute's purpose was to finance the FAA programs that benefit airlines, and as a result, its interpretation aligns with that purpose. British Airways argued that it is unfair to be taxed under §4261(a) when domestic airlines can earn FFMs for international flights but only have to pay the §4261(c) tax. Despite this result, the interpretation does not frustrate the law's intent because Congress wanted to tax previously untaxed payments to generate revenue.

British Airways argues that two IRS documents should be given "considerable weight" under *Skidmore v. Swift & Co.* IRS Notice 2002-62 supports the government's interpretation that the British Airways' payments to domestic airlines are subject to the §4261(a) tax.[42] In Rev. Rul. 2002-60, the IRS held that amounts paid for mileage awards that can be redeemed for taxable transportation are subject to tax for miles that are not awarded in connection with the purchase of taxable transportation. This ruling involved similar facts of a foreign airline offering FFMs for flights that did not begin and end in the United States. Therefore, the FFMs were not awarded for the purchase of taxable transportation and are subject to the §4261(a) tax.

Rev. Rul. 55-534 is not analogous because, in that ruling, the transportation involved two or more carriers, but British Airways is the only carrier involved in this case.[43] The IRS issued that ruling more than forty years before §4261(e)(3)(A) was enacted. IRC §4261(a) indicates that the excise tax does not only apply to the customer's payment but also to the carrier's payment. Furthermore, the *Skidmore* case is also not applicable because the payments by British Airways to the domestic airlines fall within the plain language of §4261(e)(3)(A).

Holding. The court denied the United States's motions to dismiss for lack of jurisdiction but granted its motion for summary judgment against British Airways.

38. *Brown v. U.S.*, 22 F.4th 1008 (Fed. Cir. 2022).

39. See *Ont. Power Generation v. U.S.*, 369 F.3d 1298, 1301 (Fed. Cir. 2004); 28 USC §1491.

40. See *Myore v. Nicholson*, 489 F.3d 1207, 1211 (Fed. Cir. 2007).

41. *Bank of Am. Corp. v. U.S.*, 964 F.3d 1099, 1103 (Fed. Cir. 2020).

42. Rev. Rul. 2002-60, 2002-2 CB 641.

43. Rev. Rul. 55-534, 1955-2 CB 655.

FOREIGN INCOME

Foreign Corporation Taxation

***Charles and Kathleen Moore v. U.S.,* No. 22-800 (Jun. 20, 2024)**
IRC §965

☞ Taxpayer Must Pay Moore Taxes on Foreign Undistributed Income

Facts. Charles and Kathleen Moore invested in an American-controlled foreign corporation called KisanKraft in 2006. The Moores did not pay tax on their income because they did not receive income distributions from KisanKraft. In 2017, Congress passed the Mandatory Repatriation Tax (MRT). The MRT was a one-time, backward-looking, pass-through tax on American shareholders of American-controlled foreign corporations.[44] The MRT imposed an 8–15.5% pro rata tax on American-owned shares. The IRS determined that the Moores owed $14,729 in tax for 2006-2017 pursuant to the MRT. The Moores paid the tax, but then filed suit against the U.S. government, arguing the tax was unconstitutional.

Issue. The issue in this case is whether Congress may attribute an entity's realized and undistributed income to an entity's shareholders and partners, and then tax the shareholders or partners for the income.

Analysis. Congress can tax a corporation's shareholders or its partners rather than the corporation itself as passthrough income.[45] Alternatively, Congress can tax the business entity itself and then tax the shareholders when the entity distributes a dividend or when the shareholder sells their shares. Congress considers American-controlled foreign corporations to be passthrough entities per subpart F.

Direct taxes (those imposed on persons or property) must be apportioned among the states based on each state's population. Indirect taxes (those imposed on income) are not apportioned but must be uniform throughout the United States. The Moores argued the MRT was a tax on property and not apportioned, which is unconstitutional. The MRT, however, was not tax on property. The MRT was taxing income that had been realized by KisanKraft and was then attributed to KisanKraft's shareholders. Therefore, it did not need to be apportioned.

The Moores also argued the MRT was different from taxes that have been upheld by the U.S. Supreme Court in the past, such as taxation of partnerships, S corporations, and subpart F income.[46] But the MRT is not meaningfully different from any of those three types of taxes. The MRT attributes the income of American-controlled foreign corporations to their American shareholders, and then taxes the shareholders on that income. This is the same way that Congress taxes partnerships, S corporations, and subpart F income.

Holding. The Court affirmed that Congress has the authority to tax shareholders or partners for the undistributed income attributed to shareholders or partners of an American-controlled foreign corporation when the entity has not already been taxed for that income.

> **Caution.** The Court ruled on a very narrow issue in this case. It declined to rule on the issue of whether "realization" is a constitutional requirement. It seems likely that a similar case with slightly different facts and circumstances could be ruled in favor of the taxpayer.

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44. IRC §§951–952.
45. *Burnet v. Wells,* 289 U. S. 670, 678–79 (1933).
46. IRC §§1361–1362.

Reporting Foreign Business Ownership

***Alon Farhy v. Comm'r*, No. 23-1179 (D.C. Cir. May 3, 2024), *rev'g and rem'g* 160 TC 6 (2023)**

IRC §§6038, 6201, and 6330

☞ Nowhere to Hide Assets

Facts. In 2004, Alon Farhy, a U.S. permanent resident, created a scheme to falsely underreport his income from exercising stock options by transferring over $2 million to a foreign corporation in Belize, which he owned. Mr. Farhy failed to report ownership of the Belizean corporation for eight years and consequently owed the IRS $500,000 in penalties. The IRS notified Mr. Farhy that it intended to levy his property to collect the penalties. Mr. Farhy conceded that he owed the penalties but disputed how the IRS sought to collect the sum. Mr. Farhy claimed the IRS must sue in federal court and cannot administratively collect the money.

Issue. The issue in this case is whether the IRS's method of collecting the IRC §6038 penalties was lawful.

Analysis. Congress amended IRC §6038(b) to provide a fixed-dollar penalty for failing to report foreign business ownership. The statutory change resulted in a flat $10,000 penalty for failure to file a return on a controlled foreign business, which increases by standard increments to $60,000 per year for knowing violations.[47] Mr. Farhy failed to report his income for years, and the penalties grew to approximately $500,000.

The Treasury Secretary has the power to assess this tax liability, and the assessment power is delegated to the IRS.[48] The assessment sets in motion the IRS's collection powers.[49] If a taxpayer fails to pay a tax assessed by the IRS, the IRS "can employ administrative enforcement methods to collect the tax."[50]

The IRS argued that IRC §6201(a) gave it power to assess the penalties. IRC §6201(a) lists several assessable penalties and associated charges but does not specifically include the §6038 penalties. The IRS, however, argued the §6201(a) list is non-exhaustive. Mr. Farhy countered that the fact that §6038 penalties were not explicitly listed meant they were not assessable. Ultimately, the fact that Congress amended the statute to allow a fixed-dollar penalty to make administrative collection easier indicates the penalties are assessable. Additionally, if the IRS had to sue in federal court rather than use an administrative process, the penalties would be harder to collect, not easier.

IRC §6038 also provides for specified defenses to penalties, such as a reasonable cause affirmative defense, which means the taxpayer must establish they exercised ordinary care in attempting to report obligations.[51] IRC §6038(c)(4)(B) grants the IRS, not a court, the power to grant or deny that defense. If the penalties were not assessable, there would be no post-assessment administrative process in which the taxpayer could show reasonable cause, and the IRS could make a ruling. To emphasize the point, the court discussed the role of collection due process hearings, in which taxpayers can converse with the IRS in a relatively informal setting.[52]

Additionally, Congress may revisit a statute with a longstanding administrative interpretation. The court reasoned that if Congress does not revise or repeal that interpretation, it is evident that Congress intends for the IRS and courts to follow it.[53]

Holding. The court held that the penalties imposed under §6038(b) are assessable, and the IRS may collect the penalties against Mr. Farhy using an administrative process.

47. *Taxpayer Relief Act of 1997*, PL 105-34, Title XI, §1142(a).
48. IRC §§6201(a) and 6203.
49. *Phila. & Reading Corp. v. U.S.*, 944 F.2d 1063 (3d Cir. 1991).
50. *U.S. v. Galletti*, 541 U.S. 114, 122 (2004).
51. *U.S. v. Boyle*, 469 U.S. 241, 246 (1985).
52. In this discussion, the court quoted the opinion from *Our Country Home Enters., Inc. v. Comm'r,* 855 F.3d 773, 780 (7th Cir. 2017).
53. *NLRB v. Bell Aerospace Co.*, 416 U.S. 267, 274-75 (1974).

Foreign Tax Credit

***Christensen v. U.S,* 1:20-cv-00935 (Fed.Cl. 2023)**

IRC §§27, 901, 904, 911, 1411, 6511

☞ Vive la Foreign Tax Credit Allowed Against NIIT

Facts. Matthew and Katherine Christensen are U.S. citizens who permanently reside in France. They sought a refund of the $3,851 they paid to the IRS because of the net investment income tax (NIIT) reported on their 2015 income tax return. This action was sought under the 1994 Tax Convention with the French Republic[54] (the "1994 Treaty"). The Christensens filed this return in mid-December 2016 on a timely basis and paid income taxes of $4,672. The return included Forms 1040, *U.S. Individual Income Tax Return*, 1116, *Foreign Tax Credit*, and 8960, *Net Investment Income Tax — Individuals, Estates, and Trusts,* as well as other forms the court found irrelevant to its consideration. In January 2020, Mr. and Mrs. Christensen filed an amended tax return, which included a Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*, and a Form 8275, *Disclosure Statement*.

The Form 8833 indicated they were "disclosing a treaty-based position as required by [IRC] section 6114." "FRANCE" was entered as the treaty country on the form, indicating they relied on articles "2 & 24" of the treaty between the United States and France. The couple specified that they were seeking a refund based on their understanding that they could apply a foreign tax credit against the NIIT imposed by IRC §1411. Form 8275 indicated their dependence on TD 9644.[55]

In February 2020, the IRS disallowed the Christensens' refund claim because the Christensens filed it after the statute of limitations lapsed on October 15, 2019. Their amended return was postmarked on January 8, 2020. Rather than contesting this decision with the IRS, they filed with the Court of Federal Claims.

The litigation focused on applying the "three-bite" rule, each "bite" being the exaction of income tax by the United States or the French government, applying priority as shown below.

1. Treaty-authorized U.S. tax on certain U.S.-source income of a French resident
2. The French tax on income earned by French residents
3. The U.S. tax on worldwide income that the Code imposes based on U.S. citizenship

The three-bite rule implements the provisions of the treaty in the following manner. In the second "bite," France grants U.S. citizens a tax credit against its tax for the tax paid to the United States in the first bite, as provided by paragraph 2(a) of Article 24 of the 1994 Treaty. This paragraph provides French **residents** a credit against French taxes for U.S. tax paid. In the third bite, the United States grants its citizens who are French residents a tax credit for the tax they paid to France in the second bite, as provided by paragraph 2(b) of Article 24 of the 1994 Treaty. However, credits under the third bite do not apply against taxes imposed by the first bite or the second bite. The parties' arguments in court included a dispute about whether the Christensens' attorney provided the United States with the requested calculations of the three-bite foreign tax credits.

Through their attorney, the Christensens argued that the NIIT is identical to the taxes imposed in Chapter 1 of the Code. In opposition, the United States argued that the credit strictly applied to taxes imposed by Chapter 1 of the Code, and requested that the court defer to its interpretation of the Treaty, citing the Supreme Court's decision in *Sumitomo Shoji America, Inc. v. Avagliano*.[56] The Christensens' attorney argued that when a treaty can be interpreted in two manners, the court should prefer the more liberal interpretation, citing another Supreme Court case, *U.S. v. Stuart*.[57]

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54. Tax Convention with the French Republic, Fr.-U.S., Aug. 11, 1985, 1963 U.N.T.S. 67.

55. TD 9644, 2013-51 IRB 676.

56. *Sumitomo Shoji America, Inc. v. Avagliano*, 457 U.S. 176 (1982).

57. *U.S. v. Stuart*, 489 U.S. 353 (1989).

Issue. The issue in this case is whether a U.S. citizen can claim income taxes paid to France as a credit against the NIIT.

Analysis. The IRS asserted that IRC §911 permits qualified individuals to exclude foreign-earned income from their U.S. taxable income.[58] The court found that IRC §27 provides for a **credit** against tax imposed by IRC chapter 1, which includes §§1–1400Z. However, the NIIT is imposed by IRC §1411, which is the sole section contained in Chapter 2A of the IRC.

The court decided it would defer to the interpretation of the treaty by the United States and France, but neither party in the case offered evidence that a shared understanding had been reached on this issue. The court decided against affording deference to the U.S. Treasury Department's technical explanations of the treaty because they are the opinions solely of the United States and not necessarily shared by France.

The court found that IRC §6511 establishes a clear distinction between foreign tax credits under IRC §901 and foreign tax credits allowed by a treaty. In the end, the court's decision hinged on the judicial principle that extends the most liberal interpretation based on *U.S. v. Stuart,* deciding the following.

> *[t]his liberal interpretation would "enlarge" the availability of foreign tax credit "which may be claimed thereunder," and ... is applicable to the interpretation of tax treaties, including the 1994 Treaty, as amended.*[59]

Holding. The court held that paragraph 2(b) of Article 24 of the 1994 Treaty provides a foreign tax credit against the NIIT. The Christensens, therefore, prevailed in their attempt to recover the amount they claimed to have overpaid to the IRS. The court concluded it needed further proceedings regarding the Christensens' calculation of tax credits against other income taxes under the three-bite rule.

GIFT TAX

Impact of Goodwill on Gift Tax

***Cynthia L. Huffman et al. v. Comm'r*, TC Memo 2024-12 (Jan. 31, 2024)**
IRC §§2701, 2703, 6651, and 6662(a)

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☞ The Cost of Keeping It in the Family

Facts. Dukes, Inc. manufactured and supplied engineering parts to the aerospace industry. Lloyd and Patricia Huffman were its employees. In 1970, Dukes made Lloyd president, and he acquired 113,365 company shares. In 1979, Lloyd and Patricia formed the Huffman Family Trust (Trust) and appointed themselves as trustees. Dukes reissued Lloyd's shares to the Trust, which acquired 5,000 more shares in 1990. Lloyd and Patricia's son, Chet, became the CEO in 1987 and received 5,000 Dukes shares.

Mr. Barneson was the majority shareholder of Dukes, with 322,241 shares, representing 43% of outstanding shares. He entered into an assignable agreement with Lloyd Huffman, giving Lloyd the right to purchase his shares upon his death or granting him a right of first refusal to acquire his shares for no more than $2 per share (the Lloyd-Barneson agreement). Lloyd assigned his rights under the agreement to Chet, who exercised the right to purchase all of Mr. Barneson's shares in August 1993. Thus, Chet became the majority shareholder of Dukes.

58. IRC §911(b)(1)(B).

59. *U.S. v. Stuart*, 489 U.S. 353 (1989).

Chet entered into two other right-to-purchase (RTP) agreements for the rest of the shares of Dukes with the entities owning them; Dukes Research and Manufacturing (DRM), owned by Patricia, his mother, and the Huffman Family Trust. The family's intent for the RTP agreements was to retain ownership within the Huffman family rather than for compensatory purposes, and therefore, restrictions limited their assignability. The RTP agreements allowed Chet to purchase DRM's shares for $3.6 million and the Huffman Family Trust's shares for $1.4 million, for a total of $5 million. Under Chet's leadership, Dukes expanded its customer base, increased its revenues, and improved its profitability. The Huffman family formed and acquired other companies to support Dukes, including a Nevada entity, CCC&B, LLC, which Chet and Cindy, his wife, formed to hold intellectual property assets.

In September 2007, Chet attempted to sell Dukes through a stock sale with a complex reorganization. Dukes-affiliated entities transferred their assets to a new entity, Dukes Group, LLC, to which all Dukes shares would be transferred. The next month, Chet exercised his rights under the RTP agreements, resulting in him owning or controlling all Dukes stock. This first attempt to sell Dukes failed. However, in 2009, a subsidiary of TransDigm, a publicly traded corporation, acquired the Dukes assets for $95.75 million. These assets included all of the goodwill associated with Dukes, including Chet's personal goodwill related to the assets and the business. The agreement between Dukes and TransDigm specified that it would be interpreted according to California law.

An appraiser hired by TransDigm valued goodwill at $50 million, attributing $21.8 million of that to Chet's personal goodwill. Chet entered into a noncompete agreement with TransDigm. The Huffman family relied on their accountants to prepare returns for the family and Dukes. In notices of deficiency, the IRS contested these valuations, and its appraiser valued DRM's and the Trust's shares in Dukes at $23.9 million and $9.3 million, respectively, and Chet's personal goodwill at $0.

During this period, Chet and Cindy Huffman filed several personal tax returns late. Late returns were also filed by CCC&B and by Dukes. The family changed accounting firms during this period, and ultimately their 2008 and 2009 Forms 1040, *U.S. Individual Income Tax Return*, were filed in 2011, as was Form 1065, *U.S. Return of Partnership Income*, for CCC&B, and Forms 1120, *U.S. Corporation Income Tax Return,* for years 2008 – 2010. Lloyd and Patricia Huffman timely filed their income tax returns but failed to file any gift tax returns because they were unaware of the responsibility to do so.

This case consolidated the following three cases that the Huffman family undertook to contest IRS notices of deficiency against them.

- Cynthia (Cindy) and Chet Huffman, and after Chet's death, *Cynthia Huffman and the Estate of Chet Huffman v. Comm'r*
- Patricia and Lloyd Huffman, parents of Chet, and after Lloyd's death, *Patricia Huffman and the Estate of Lloyd Huffman v. Comm'r*
- *Infinity Aerospace, Inc. v. Comm'r* (Dukes was renamed Infinity Aerospace after its assets were acquired by TransDigm)

Issues. The issues in this case are the following.

- Whether Patricia and the Estate of Lloyd Huffman made a taxable gift when Chet exercised his rights to buy DRM's and the Trust's shares in Dukes for $5 million
- Whether Cindy, the Estate of Chet Huffman, and Dukes properly reported the gain from the TransDigm acquisition related to Chet's personal goodwill and CCC&B's intellectual property assets

Analysis. The value of any property is generally determined without considering options or agreements to acquire property for less than the fair market value.[60] The exception to using agreements for valuation purposes requires three components of an agreement.

1. It is a bona fide business arrangement.
2. It is not a device to transfer property to a decedent's family members for less than full consideration.
3. It has terms comparable to similar arrangements made in arms-length transactions.[61]

The RTP agreements fulfill the first two requirements because keeping a business asset within the family is a bona fide business arrangement, and there was full consideration when Chet negotiated the agreements and accepted a reduced salary as the CEO. However, the RTP agreements are not comparable to the Lloyd-Barneson agreement, which was an arms-length transaction, so the Huffmans did not satisfy the last requirement of IRC §2703(b). Therefore, the court concluded that the Dukes shares purchased by Chet in 2007 could not be valued based on the RTP agreements.

The IRS argued that Patricia made a taxable gift to Chet with a value of $8 million, and Patricia and Lloyd jointly made another taxable gift of $3.1 million on October 15, 2007, through the RTP agreements. Patricia and Lloyd argued that the Trust and DRM shares were worth $5 million, and therefore, they made no taxable gift on October 15. After evaluating the expert opinions of both parties, the court determined that the elder Huffmans failed to show why their expert's valuation was correct. Under IRC §2512(b), any value attached to the shares in excess of Chet's $5 million payment for them is considered a taxable gift from his parents.

The IRS argued that the sale of intellectual property assets should be attributed to Dukes, with a constructive dividend passing to Chet and Cindy. In response, the Huffmans argued that the CCC&B-Dukes transaction was never fulfilled, and therefore, CCC&B owned the intellectual property assets until the TransDigm acquisition in December 2009. The court concluded that the Huffmans had properly reported the gain, and CCC&B was the proper party to report the gain from the sale. Therefore, Chet and Cindy are not liable for dividend income related to the CCC&B sale.

Chet and Cindy reported $21.8 million as the sale price attributable to Chet's personal goodwill and reported $19.4 million of that amount as installment sale income. The IRS argued that this amount should not be reported by Chet and Cindy; instead, it should be reported by Dukes Group according to Nevada law. However, the asset purchase agreement with TransDigm specified that the transaction is governed by California law, and therefore, California law was used to determine whether goodwill can be attributed to an individual. Chet created personal goodwill through his relationships as Dukes's CEO, and under California law, personal goodwill can be owned by an individual.[62] However, the court reduced the valuation of Chet's personal goodwill, and the amount that was distributed to Chet and Cindy needs to be reclassified as a constructive dividend and taxed under IRC §301. The court also found that the IRS's initial valuation of Chet's goodwill at $0 was arbitrary, and the IRS thereby relinquished the presumption of correctness under IRC §7491(a) on this point.[63] Nevertheless, the court ultimately accepted a valuation offered by the IRS's expert, although with some modifications. This shifted some of the goodwill from being reported on Chet's 2009 Form 1040 as **personal** goodwill to being reported by Dukes on its Form 1120 as **enterprise** goodwill.

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60. IRC §2703(a)(1).

61. IRC §2701(b).

62. See, e.g., *In re Marriage of Nichols*, 33 Cal. Rptr. 2d 13, 20 n.4 (Ct. App. 1994).

63. *Welch v. Helvering*, 290 U.S. 111,115 (1933); *Estate of Simplot v. Comm'r*, 249 F.3d 1191, 1193 (9th Cir 2001), *rev'g* 112 TC Memo 1997-461 (1997).

The IRS determined accuracy-related penalties under IRC §6662 against Cindy and the Estate of Chet Huffman and Dukes. The IRS bears the burden of proving tax liability under an individual, but for nonindividual taxpayers, the burden of production remains with the corporation.[64] Under §6662, there is a penalty for underpayment attributable to "negligence or disregard of rules or regulations" or for underpayment attributable to any "substantial understatement of income tax." Cindy and Chet argue that they had reasonable cause, negating §6662(a) penalties because of reliance on their accountants. The Huffmans relied on their two licensed CPAs to determine how to report the TransDigm sale proceeds. They provided their accountants with as much accurate information as they could gather. Therefore, the Huffmans had reasonable cause and are not liable for the §6662(a) penalties attributable to underpayment. The court ruled that Patricia and Lloyd also had reasonable cause for failing to report gift tax liability because their accountant did not advise them of any potential gift tax liability. Therefore, Patricia and her late husband's estate do not have to pay the IRC §6651(a) penalty for failure to file timely gift tax returns.

Holding. The court held that Patricia and her late husband's estate are liable for tax on the gift given to Chet on October 7, 2007. Chet properly reported personal goodwill on his taxes; however, the amount of goodwill must be lowered. The court also found that Dukes understated the amount of **enterprise** goodwill reported on its 2009 Form 1120, resulting in an increase in 2009 corporate income tax.

Under §6662, Lloyd and Patricia Huffman had reasonable cause to avoid the accuracy-related penalties due to reliance on their accountants. However, the court sustained the late payment and late filing penalties assessed against Cindy and the Estate of Chet Huffman.

GROSS INCOME

Civil Fraud Penalties

***Khurram Gondal and Arooj Asmat v. Comm'r*, TC Memo 2024-36 (Mar. 27, 2024)**

IRC §§6662, 6663, 7454, and 7491

☞ The Highest-Paid Taxi Driver in New York City

Facts. Khurram Gondal and his business partner ran a car-for-hire business in New York during 2017 and 2018. They ran the business through the following C corporations (collectively, Gondal's Transportation Companies or GTC).

- All County Med Cab, Inc.;
- Four Way Taxi, Inc.;
- Green Mountain Medical Transportation, Inc.;
- Capital Cab Corporation; and
- All NY Taxi & Limo, Inc.

Mr. Gondal and his business partner contracted with the New York State Department of Health to provide medical transportation. However, they billed the State for trips that were not medical in nature. Mr. Gondal eventually pleaded guilty to one count of healthcare fraud. For the 2017 tax year, Mr. Gondal and Arooj Asmat filed a joint tax return with a reported income of $30,000. Four Way Taxi issued Mr. Gondal a Form W-2, *Wage and Tax Statement*, reporting $30,000 of wages in 2017. For 2018, Mr. Gondal received Forms W-2 from Capital Cab Corporation and Four Way Taxi, collectively reporting wages of $20,000. Mr. Gondal and Ms. Asmat's joint tax return for 2018 reported total income of $22,305. Also in 2018, Mr. Gondal filed a single Schedule C, *Profit or Loss From Business*, listing $20,659 of gross income and $6,464 of total expenses, resulting in net taxable income of $14,195.

64. IRC §7491(c); See *NT, Inc. v. Comm'r*, 126 TC 191, 195 (2006).

The IRS examined Mr. Gondal and Ms. Asmat's tax and bank records after Mr. Gondal's plea agreement in the healthcare fraud case. The examination agent found that Mr. Gondal paid personal expenses with money from GTC during the years at issue. The agent concluded that Mr. Gondal, fraudulently and with intent to evade tax, withdrew money from GTC to pay personal expenses. In total, Mr. Gondal withdrew $701,125 for 2017 and $715,365 for 2018 and failed to report it as income in the form of constructive dividends. None of the withdrawals were repaid. Mr. Gondal also underreported his tax due by $142,882 for 2017 and $138,311 for 2018.

In August 2021, the IRS agent and his supervisor asserted a civil fraud penalty against Mr. Gondal and an accuracy-related negligence penalty under IRC §6662(a) in the alternative. The IRS also assessed an accuracy-related negligence penalty under §§6662(a) and (c) against Ms. Asmat. The agent's supervisor timely approved the penalties in writing.

The IRS issued a notice of deficiency asserting these penalties in August 2022. In October 2022, Mr. Gondal and Ms. Asmat petitioned the Tax Court to dispute this notice of deficiency. They claimed the income mentioned in the notice of deficiency was business income, not personal income, but they failed to address the penalties in their petition.

Issues. The issues in this case are the following.

- Whether Mr. Gondal and Ms. Asmat understated and underpaid their income tax for 2017 and 2018
- Whether Mr. Gondal is liable for civil fraud penalties for 2017 and 2018

Analysis. Taxpayers are obligated to maintain books and records to establish income and expenses.[65] Otherwise, the IRS can reconstruct income by reviewing the taxpayer's bank deposits. After reviewing GTC's and Mr. Gondal's bank accounts, the IRS determined that Mr. Gondal withdrew $701,125 and $715,365 from GTC's accounts for 2017 and 2018 respectively, far more than Mr. Gondal's reported income. The court agreed with the IRS agent that these payments constituted "constructive dividends," as they were disbursements not intended to be repaid to the company. Mr. Gondal and Ms. Asmat failed to establish that the withdrawals were used for business purposes, treated as loans, or repaid. As they also failed to establish a nontaxable source for the unreported deposits into their personal accounts, Mr. Gondal and Ms. Asmat failed to include these constructive dividends in their income for 2017 and 2018, thus understating their tax for the two years.

The IRS bears the burden of proving taxpayer liability for any penalty.[66] The fraud must be proven by "clear and convincing evidence."[67] To satisfy this requirement, the IRS must prove both of the following.

1. Underpayment of tax for the year at issue, and
2. Some part of the underpayment is attributable to fraud.[68]

If the IRS successfully proves these things, it may impose a 75% penalty for underpayment of tax.[69] The first element was proven as the IRS showed Mr. Gondal underpaid the tax.

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65. IRC §6001.

66. IRC §7491(c).

67. IRC §7454(a).

68. *DiLeo v. Comm'r*, 96 TC 858, 873 (1991).

69. IRC §6663(a).

Fraudulent intent may be shown by circumstantial evidence. A taxpayer's entire course of conduct can establish fraudulent intent.[70] Additionally, a court can infer fraudulent intent when a taxpayer files a document to conceal information that prevents the collection of tax. There are various indicators, or "badges," of fraud courts to consider.[71] The court found several badges of fraud present in this case, as Mr. Gondal understated his income and concealed it through cash withdrawals and payment of personal expenses from business accounts. He also failed to report constructive dividends received from GTC. Mr. Gondal also misreported his exemptions, net investment income tax, self-employment tax, earned income tax credit, additional child tax credit, and tax due. Additionally, he failed to maintain adequate records and submit them in connection with the examination.

Holding. Mr. Gondal and Ms. Asmat underreported their income for 2017 and 2018. Mr. Gondal is also liable for the civil fraud penalties imposed by the IRS.

Settlement Proceeds

Estate of Finnegan et al. v. Comm'r, **TC Memo 2024-42 (Apr. 10, 2024)**

IRC §§61 and 104

☞ Taxpayers' Unsuccessful Exclusion Attempt for Settlement Proceeds

Facts. Roman J. Finnegan, a resident of Indiana, passed away, leading to legal actions involving his estate and family members, who resided in Indiana and Tennessee. Mr. Finnegan had been married to Lynnette since May 2004 and was the stepfather to her children, Katelynn, Johnathon, Tabitha, and J.S. The family faced tragedy when J.S. died at 14 due to several medical issues, leading to investigations by the Indiana Department of Child Services (DCS) and the Indiana State Police (ISP). They alleged neglect and abuse by Mr. and Mrs. Finnegan. Although the criminal charges were dismissed, DCS continued to scrutinize the family, resulting in Katelynn and Tabitha being placed in foster care temporarily.

Mr. and Mrs. Finnegan contested the DCS's allegations in Pulaski Circuit Court, which eventually ordered DCS to remove the substantiations against them. The family, including the children, then filed a lawsuit against various Indiana state employees under 42 USC §1983, alleging civil rights violations under the First, Fourth, Sixth, and Fourteenth Amendments. The lawsuit contended that state employees retaliated against the Finnegan family following Mr. Finnegan's complaints about DCS's handling of their case by falsely accusing the Finnegans of neglect and abuse, and wrongfully detaining their children.

In the litigation, Mr. Finnegan was the only one who mentioned suffering from post-traumatic stress disorder (PTSD), related to the stress and accusations faced during the ordeal. The court cases involved complex legal proceedings, including the dismissal of some claims and retention of others, focusing on the improper actions of the state employees, which allegedly violated the family's constitutional rights. The family sought and was awarded compensatory damages for these violations, but did not secure punitive damages. On April 4, 2017, the parties settled the litigation by executing a settlement agreement where the family received $25 million in compensation for the alleged violations of their civil and constitutional rights.

On June 18, 2018, the IRS initiated an examination of Mr. and Mrs. Finnegan's 2017 tax return. The IRS's contacts with Mr. and Mrs. Finnegan's representative revealed claims of tax exclusions for settlement proceeds, citing constitutional rights, but not PTSD. The IRS maintained that the settlement proceeds were taxable.

Issue. The issue in this case is whether the settlement proceeds Mr. Finnegan's estate and family members received should be excluded from their gross incomes under IRC §104(a)(2).

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70. *Niedringhaus v. Comm'r*, 99 TC 202, 210 (1992).

71. *Bradford v. Comm'r*, 796 F.2d 303, 307 (9th Cir. 1986).

Analysis. The IRS's determinations in a notice of deficiency are presumed correct, and the taxpayers bear the burden of proving those determinations erroneous.[72] IRC §61(a) broadly defines gross income, and taxpayers must clearly show that an exclusion applies to their situation.[73]

IRC §104(a)(2) specifically excludes from gross income **damages** received due to personal physical injuries or sickness. Emotional distress damages are included in gross income unless they stem directly from a physical injury or sickness.[74] When damages are received pursuant to a settlement agreement, the nature of the claim that gave rise to the settlement controls whether the damages are excludable under §104(a)(2).[75] To determine the nature of the claim, the court looks first to the terms of the agreement and, if the terms are ambiguous, to the facts and circumstances surrounding the settlement.[76]

The Finnegans argued that the damages were awarded for PTSD, which they characterized as a physical injury to the brain. However, after examining the nature of the claim, the court found that the settlement agreement compensated the Finnegan family for alleged violations of federal laws, civil rights, and constitutional rights, without specific reference to PTSD or any physical injury or sickness. Further, the complaints, jury instructions, and voir dire questions focused on constitutional violations, not on physical injuries or illnesses. Moreover, the bulk of the evidence presented in court pertained to the emotional and civil rights impacts rather than physical health.

The court concluded that the evidence presented, including the handling of PTSD in the litigation, did not establish it as a direct cause linked to the claimed physical injuries or illnesses necessary to qualify for the tax exclusion under §104(a)(2).

Holding. The court held that settlement payments are not excludable from the Finnegans' gross income under §104(a)(2).

> **Note.** For more information about the taxation of legal settlements, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 2: Individual Taxpayer Issues.

> **Observation.** The short time between the Finnegans filing their 2017 tax return and the initiation of an audit suggests that the IRS was aware of the settlement and had flagged it for expedited review.

72. See Rule 142(a)(1).

73. IRC §61(a).

74. IRC §104(a)(2).

75. See *U.S.v. Burke,* 504 U.S. 229, 237 (1992).

76. *Rivera v. Baker W., Inc.,* 430 F.3d 1253, 1257 (9th Cir. 2005).

Tax on Social Security Benefits

***Donald and Kristen Ecret v. Comm'r*, TC Memo 2024-23 (Feb. 14, 2024)**

IRC §86 and 42 USC §424a(a)

☞ Receipt of Social Security Benefits is Taxable Income

Facts. Donald and Kristen Ecret are a married couple. Mrs. Ecret became injured and medically disabled in 2014. She received workers' compensation starting in 2014 after she could not work as a registered nurse. In 2015, Mrs. Ecret applied for social security disability benefits. In 2017, the Social Security Administration (SSA) awarded her benefits beginning in 2015. However, 42 USC §424a(a) limits the total workers' compensation and social security benefits a person may receive in a year. The SSA found that Mrs. Ecret was over the statutory limit and refused to disburse benefits to her.

Mrs. Ecret requested the SSA reconsider and recalculate her workers' compensation offset amount. In January 2019, the SSA decided in her favor, stating it had miscalculated her monthly average current earnings (ACE). ACE is the figure used to estimate the monthly earnings a person would have received if they were not disabled, and SSA calculates the workers' compensation offset using a number equal to 80% of ACE. Effective January 2018, the SSA increased Mrs. Ecret's ACE to $5,074, increasing 80% of her ACE to $4,059. Additional relevant information is provided in the following table.

Year	Total Reported on Form SSA-1099	Attributable to Year Paid	Attributable to Prior Years	Paid to Mrs. Ecret	Withheld as Federal Tax or Attorney's Fees	Taxable Workers' Compensation Offset
2018	$71,918	$19,322	$52,596	$20,749	$5,375	$45,794
2019	55,248	19,866	35,382	6,120	1,080	48,048

For 2018 and 2019, Mrs. Ecret's Form SSA-1099, *Social Security Benefit Statement,* reported taxable income, some attributed to the year she received it and the balance attributable to prior years. In 2019, her Form SSA-1099 reported $55,248 of taxable income, with $19,866 attributable to 2019, while $35,382 was attributable to 2016 – 2018. Of the $55,248 of taxable income reported for 2019, Mrs. Ecret received only $6,120. However, her social security income also included the amount withheld for federal taxes and the amount of her workers' compensation payments deemed to have been paid by social security. Only $19,866 was potentially reportable income in 2019 because the $35,382 balance was attributable to prior years.

However, for 2019, Mr. and Mrs. Ecret reported only $5,202 in taxable social security benefits. The court speculated that this reflected 85% of Mrs. Ecret's payments for the year ($6,120 × 85%). The SSA withheld $1,080 for federal income tax. This amount ignores the tax withheld by the SSA and the amount of her workers' compensation that is taxable.

The IRS examined the Ecrets' joint 2019 return and determined they should have reported an additional $49,128 in social security benefits ($1,080 in federal tax withholding + $48,048 in taxable workers' compensation offset). The IRS sent the Ecrets a notice of deficiency, to which they responded promptly. The IRS asserted an accuracy-related penalty under IRC §6662(a).

The IRS also applied the same logic to examining the Ecrets' 2018 joint return and sent them a notice of deficiency for that year. However, the Ecrets' filed their response late, and the tax court accordingly dismissed the case with respect to that year.

Issue. The issue in this case is whether Mrs. Ecret underreported taxable social security benefits in 2019 under IRC §86(d)(3).

Analysis. Gross income generally does not include workers' compensation,[77] but it includes social security benefits to the amount required by §86. Social security benefits include "any amount received by the taxpayer by reason of entitlement to a monthly benefit under the Social Security Act."[78] The statute directly addresses whether workers' compensation is considered to be social security benefits. If workers' compensation reduces the social security benefit, then the social security benefits include the reduction in workers' compensation benefits.[79] Congress enacted this law because it wanted to equalize the treatment of taxpayers who lived in states where receipt of social security benefits would reduce workers' compensation benefits.[80]

Taxpayers must consider the entire amount paid by the SSA as potentially taxable income, up to 85%, regardless of whether the SSA distributed it directly to the taxpayer. However, the portion attributable to prior years is not taxable in the year received. Consequently, Mr. and Mrs. Ecret's 2019 taxable social security benefits amount to $16,866 ($19,866 × 85%). The IRS conceded that it was incorrect to assert that Mrs. Ecret should have included the amount paid in 2019 for prior years in her taxable income. It also dropped its assessment of an accuracy-related penalty.

Holding. The court held that Mrs. Ecret properly reported $19,866 of social security benefits in 2019, of which 85% or $16,886 is taxable income.

Change in Accounting Method

***Hyatt Hotels Corporation & Subsidiaries v. Comm'r*, TC Memo 2023-122 (Oct. 2, 2023)**
IRC §§61 and 481

☞ No Points for Excluding Reward Program in Gross Income

Facts. Hyatt Hotels Corp. & Subsidiaries has operated a customer rewards program, known as the Gold Passport Program (the Program), since 1987. Participating members receive rewards points when they stay at Hyatt-branded hotels and can redeem them for a free stay at any Hyatt-branded hotel. Members cannot redeem their points for cash, but they can redeem rewards points for hotel stays, room upgrades, and other goods and services at Hyatt-branded hotels. The Program was highly successful and a central component of its marketing efforts.

Hyatt owned roughly 25% of all Hyatt-branded hotels. The rest were owned by third-party hotel owners (TPHOs), some who contracted Hyatt to manage their hotels, while others operated as a franchise, managing the hotel on their own or using a separate management company. Hyatt required all Hyatt-branded hotels to participate in the Program and did not allow TPHOs to request refunds of payments to the Fund (explained next).

When a Program member received reward points from a Hyatt-branded hotel, the hotel owner paid Hyatt 4% of the revenue from that member's stay. In 2011, Hyatt increased the assessment fee for full-service Hyatt-branded hotels to 4.5%. When a Program member received travel miles instead of rewards points, the hotel owner paid Hyatt the actual cost of the miles. Hyatt also sold rewards points directly to customers, hotel owners, car rental companies, and its timeshare business. These sales payments, 4% payments, and mile payments, known as the Fund, were deposited into bank accounts owned and operated by Hyatt.

Whenever a Program member redeemed rewards points at a Hyatt-branded hotel, Hyatt paid a compensation payment to the hotel owner out of the Fund. The compensation amount was calculated based on the hotel's forecasted monthly average rate for rooms and the hotel's occupancy rate during the award stay. In 2011, Hyatt changed the formula for compensation payments, decreasing annual amounts of payments and increasing the amount of the Fund. The TPHOs had no control over the compensation payments formula.

77. IRC §104(a)(1).

78. IRC §86(d)(1)(A).

79. IRC §86(d)(3).

80. The court's opinion cites Charles T. Hall, *Social Security Disability Practice* §5:19 (2023).

Hyatt invested portions of the Fund in marketable, fixed-income securities through third-party investment advisers. The Fund accrued interest and realized gains from investments. TPHOs had no input or control over the choice of advisers, or the investment strategy, and did not regularly receive communications about the performance of the Fund investments. Hyatt also used the Fund to pay advertising and administrative costs related to operating the Program including the costs of maintaining member call centers, the salaries and benefits of employees involved in operating the Program, and the cost of maintaining the Program's member database. The member database recorded extensive information related to individual members and their preferences. Hyatt's marketing department used the member database for targeted advertising to its customers. TPHOs had no control over how the Fund was spent on administrative costs or advertising.

Hyatt did not include any income or expense activity within the Fund on any of its income tax return filings. After auditing Hyatt's returns for tax years 2009 through 2011, the IRS determined the exclusion of the Fund's income and expenses was an improper tax treatment and that correctly including all prior-year activity from the Program in Hyatt's tax filings would constitute a change in accounting method. Accordingly, the IRS issued a notice of deficiency to Hyatt in March 2017, determining $71,056,669 of tax deficiency on an unreported net revenue of $240,081,335.

In response, Hyatt timely filed a petition with the Tax Court in June 2017. Hyatt argued its exclusion of the Fund's income and expenses was proper due to Hyatt holding the Fund as a trustee instead of an owner for federal income tax purposes. Hyatt also argued that even if improper, the IRS's determination that correcting the Fund's income and expense activity omissions did not constitute a change in accounting method. Furthermore, if Hyatt's exclusion of the Fund's income and expense activity from federal income taxation was improper, Hyatt argued it should be able to offset the Fund's income by the estimated cost of future compensation payments to hotel owners under regulatory provisions of the trading stamp method, explained later.

Issues. The issues in this case are the following.

- Whether Program payments received, accrued interest, and realized investment gains should be included in Hyatt's gross income for the tax years 2009, 2010, and 2011
- Whether a change in Hyatt's tax treatment of these receipts constitutes a change in the method of accounting subject to IRC §481 adjustment
- Whether Hyatt may adopt the trading stamp method to offset its gross receipts with the estimated future compensation payments to hotel owners for the tax years 2009, 2010, and 2011

Analysis. IRC §61 defines gross income as "all income from whatever source derived." Hyatt claimed it had two distinct roles: being the "agent" for the hotel owners and being the owner of 25% of the hotels. As the agent, Hyatt did not include any Program revenue in gross income or claim any deductions for Program expenses. However, as the owner of 25% of the hotels, Hyatt claimed deductions for its share of Program expenses and included in gross income the compensation payments made to it out of the Fund. The majority of domestic TPHOs deducted the 4% payments on their federal income tax returns. Hyatt claimed that the trust funds from gross income should be excluded under the trust fund doctrine, where the funds are legally restricted for a specific use for which the taxpayer does not gain, profit, or benefit from spending the funds for that purpose.[81] Hyatt argued it did not directly benefit from its use of the Fund and was restricted in its use of the Fund by the agreements and its fiduciary duties to the TPHOS.

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81. See *Ford Dealers Advertising Fund, Inc., Jacksonville Div. v. Comm'r*, 55 TC 761, 771 (1971).

The trust fund doctrine disallows any benefit to the taxpayer that is more than incidental and secondary.[82] Hyatt mandated the TPHOs participate in the Program, controlled the amounts of Program payments and compensation payments, decided how to invest the Fund, and determined how to use the Fund to pay for advertising or administrative costs — all without insight or input from the TPHOS. Hyatt only provided a generalized Fund financial statement to the TPHOs and retained the right to reimburse itself out of the Fund at its own discretion. Hyatt directly benefited by paying less for advertising for the 25% of Hyatt-branded hotels that it owned by shifting the advertising costs to the Fund. Hyatt also directly benefited from the Program advertising, which maintained and enhanced the value of Hyatt's goodwill. Hyatt was more than a mere conduit passively holding funds with only an incidental benefit to itself. Hyatt directly benefited from the Fund and had a sufficient beneficial economic interest in the Fund. Therefore, the court found that the Program revenue was includible in Hyatt's gross income.

IRC §481(a) allows the IRS to make an adjustment by including omitted income that escaped taxation. The adjustments to include omitted income can only be made due to a change in the taxpayer's method of accounting.[83] IRC §481 applies to a change in the overall method of accounting for gross income or deductions, or a change in the treatment of a material item.[84] A **material item** is an item that concerns the timing of reporting income or deductions. The lifetime income test is used to determine whether something is a material item by assessing whether the existing treatment would permanently exclude reporting the income or simply postpone reporting the income. If reporting the item is only postponed, then the item is material. If the item is material, the next assessment concerns whether the change in the treatment of the material item would affect the taxpayer's lifetime income. If the item does not affect the lifetime income, the matter is a timing issue and constitutes a change in the method of accounting. Hyatt's previous return treatment permanently excluded Program revenue without claiming deductions. If the Program was ever discontinued, Hyatt planned to refund the remaining balance of the Fund without reporting income or deductions. Therefore, Hyatt's treatment of the Program revenue is not a material item and the issue of whether the proposed change would alter Hyatt's lifetime income is not reached. The court found that the IRS is not allowed to make a §481 adjustment to the Program revenue.

A liability is incurred after it has satisfied the all-events test for accrual method taxpayers. The exception to the all-events test is the **trading stamp method,** where a taxpayer issues trading stamps or premium coupons with sales and such stamps or coupons can be redeemed for merchandise, cash, or other property.[85] Under the exception, the amount of the cost to the taxpayer for the merchandise, cash, or other property used for redemption and the reasonably estimated number of trading stamps or coupons for future redemptions during the taxable year can offset the gross receipts from the sales and accelerate future year deductions. Hyatt argued that the reward points should be included as "other property" within the trading stamp exception. The court held that other property must be physical and tangible property. As such, reward points are not included in "other property" and Hyatt is not entitled to the trading stamp exception. Instead, Hyatt must defer the cost recovery to the year the compensation payments occurred and take the deductions at that time.

Holding. The court held that the Program revenue should be included in Hyatt's gross income for the tax years 2009, 2010, and 2011. The court further held that Hyatt's correction to include the Program's income and expenses did not constitute a change of accounting method subject to a §481 adjustment. Finally, the court held that Hyatt is not allowed to adopt the trading stamp method to offset its gross receipts with the estimated future compensation payments to hotel owners.

82. See *Angelus Funeral Home v. Comm'r* (9th Cir. 1969), *aff'g* 47 TC 391 (1967).

83. See *Rankin v. Comm'r*, 138 F.3d 1286, 1288 (9th Cir. 1998), *aff'g* TC Memo 1996-350 (Jul. 31, 1996).

84. Treas. Reg. §1.481-1(a)(1).

85. Treas. Reg. §1.451-4(a)(1).

Unreported Income

Victor Attisha et al. v. Comm'r, TC Memo 2023-150 (Dec. 18, 2023)

IRC §§446, 6001, and 6662

☞ Taxpayer's Unreported Income from Illegal Activities Included in Tax Liability

Facts. Victor Attisha operated several businesses during 2017.

1. Platinum Processing Services, LLC, a credit card processing company, was established under Michigan law, with Mr. Attisha and partner Sabah Ammouri each holding a 50% ownership.
2. A&S ATM was also established under Michigan law, with Mr. Attisha as the resident agent.
3. ATM of America, Inc., incorporated in Michigan, listed Mr. Ammouri as its resident agent and president, owned by Mr. Ammouri and two other individuals. Mr. Attisha engaged in sales for ATM of America, which shared a location with Platinum Processing.
4. Holy Moly Donut Distribution, LLC, and Holy Moly Donut Shop, Inc., were formed under Michigan law, with Mr. Attisha as the resident agent and an incorporator of Holy Moly Donut Shop. Holy Moly Donut Shop operated alongside Unified Collective, an unlicensed marijuana dispensary.

Mr. Attisha and his wife jointly filed the 2017 federal income tax return, reporting income from businesses including rental income, nonpassive partnership income, gross receipts from ATM and credit card sales businesses, and wages. The return did not report any income from the marijuana sale or business operation.

A federal search warrant executed at Mr. Attisha's residence by a Drug Enforcement Administration (DEA) Special Agent uncovered evidence of involvement in marijuana manufacturing and distribution. This led to further searches and seizures, uncovering significant amounts of U.S. currency and documents related to marijuana operations.

In October 2018, following these investigations, Mr. Attisha faced charges related to marijuana distribution and money laundering. In June 2019, Mr. Attisha ultimately pleaded guilty to a single count of conspiracy to manufacture, possess with intent to distribute, and distribute marijuana. This plea agreement required the forfeiture of substantial assets, totaling $512,777.

In August 2019, the IRS assigned a revenue agent to review Mr. Attisha's tax liabilities for 2017, leading to a jeopardy assessment based on unreported income from the sale of marijuana. In November 2019, the IRS issued a notice of deficiency of $211,451 and an IRC §6662(a) accuracy-related penalty of $42,290.

Issues. The issues in this case are as follows.

- Whether Mr. Attisha had unreported income of $512,777 for 2017 from the sale of marijuana
- Whether Mr. Attisha is liable for a §6662(a) accuracy-related penalty of $42,290

Analysis. Ordinarily, the statutory notice of deficiency carries with it a presumption of correctness which places the burden on the taxpayer to show that the IRS's determination is erroneous. In cases where the IRS alleges unreported income from illegal activities, for the presumption of correctness to attach to the notice of deficiency, the **burden of proof rests on the IRS** to demonstrate a minimal evidentiary foundation showing a nexus between the taxpayer and the illegal tax-generating activity.[86] Mr. Attisha contested the notice of deficiency, arguing it lacked substantial evidence linking him to any specific income-producing activity, particularly illegal marijuana sales. The court found that the IRS had met the burden to connect Mr. Attisha to the income-producing activity, namely illegal marijuana manufacturing and sales, by citing evidence such as items seized from his home, his criminal indictment, plea agreement, asset forfeiture, and statements made during his sentencing hearing. Therefore, the court upheld the IRS's presumption of correctness in determining unreported income, rejecting Mr. Attisha's argument that the notice of deficiency was unsupported by substantive evidence.

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[86] *Garavaglia v. Comm'r*, TC Memo 2011-228 (Sep. 26, 2011); *Solimene v. Comm'r*, TC Memo 1982-370 (Jun. 30, 1982).

The burden thus shifted to Mr. Attisha to establish that, by preponderance of evidence, the IRS's determinations were arbitrary or erroneous. Mr. Attisha argued that he was disassociated from the seized assets and that the forfeited amounts were not indicative of income from illegal activities. The court held that the evidence, including DEA raids, Mr. Attisha's own admissions, and documentation related to his businesses and financial transactions, provided a clear and direct link to the illegal manufacture and sale of marijuana.

Mr. Attisha further argued that the IRS did not use an approved method of calculating the deficiency under IRC §446. The IRS contended that they had great latitude in reconstructing Mr. Attisha's income because he failed to keep books and records and refused to cooperate with the revenue agent's examination.

IRC §6001 requires all taxpayers to maintain sufficient records to determine their correct tax liabilities. Where a taxpayer fails to keep the required books and records, or if the records they maintain do not clearly reflect income, the IRS is authorized by §446 to determine income under such method as, in the opinion of the Secretary, does clearly reflect income.[87]

The Code does not have statutory guidelines specifying the nature and quality of evidence for which the tax administrator must gather to support deficiency determination, or form and contents of a notice of deficiency. Thus, the IRS has great latitude in reconstructing a taxpayer's income, and the reconstruction need only be reasonable in light of all surrounding facts and circumstances. The IRS has even greater latitude when the case involves an illegal enterprise and the taxpayer fails to keep records or cooperate in the ascertainment of their income. Mathematical precision is not required.[88]

The court held that given Mr. Attisha's failure to maintain proper records, refusal to answer IRS inquiries about his marijuana income, and failure to provide requested documents, the IRS had great latitude to reconstruct Mr. Attisha's income for 2017. Overall, it was reasonable for the IRS to reconstruct the income that Mr. Attisha generated from the illegal marijuana business in this manner and that the IRS's calculation of income was supported by substantive evidence.

Finally, regarding the accuracy-related penalty, §6662(a) imposes a 20% penalty on the portion of an underpayment of tax that is attributable to a substantial understatement of income tax. An understatement of income tax is substantial if it exceeds the greater of 10% of the tax required to be shown on the return or $5,000. The court concluded that Mr. and Mrs. Attisha failed to report income of $441,079 ($512,777 − $71,698 (returned property)), which was an underpayment of tax attributable to a substantial understatement of income tax. Mr. Attisha has not shown that he acted with reasonable cause and in good faith under §6664(c)(1) with respect to any portion of the underpayment.

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Holding. The court held that Mr. Attisha failed to report income of $441,079. The court also held that Mr. Attisha is liable for a §6662(a) accuracy-related penalty to be computed in accordance with Rule 155.

87. See *Petzoldt v. Comm'r*, 92 TC 661, 693 (1989).

88. Ibid.

***Michael and Julie Parker v. Comm'r*, TC Memo 2023-104 (Aug. 10, 2023)**
IRC §§108 and 1001

☞ Forgiven Nonrecourse Debt Results in Larger Capital Gain

Facts. In 2012, Michael Parker was the sole member of Exterra Realty Partners, LLC, which was a California real estate development company. From its inception, Exterra elected treatment as an S corporation. Exterra was the sole member of two other limited liability companies (LLCs), PLF-XIII, LLC and PLF-XIV, LLC. Mr. Parker personally was the sole member of an additional LLC, PLF-XI, LLC. The Tax Court documents identify these three entities as the "PLF entities." Each of the two PLF entities that Exterra owned, in turn, contributed capital to two other LLCs, Montevina Phase I, LLC, and Montevina Phase II, LLC. The Tax Court referred to them as the "Montevina entities." The PLF entities and the Montevina entities were disregarded entities as Exterra was the sole owner of the PLF entities.

During 2007, the PLF and the Montevina entities incurred over $32 million in debt to develop property in Livermore, California. The two Montevina entities were debtors for two loans with principal amounts totaling over $24.4 million. These two loans were **nonrecourse** as to Exterra. The two PLF entities borrowed another $7.8 million that was secured by the entities' ownership of the Montevina entities. The PLF entity owned directly by Mr. Parker individually received another $2 million loan. Real estate in Iowa secured this loan. Mr. Parker secured the five debts incurred by the LLCs he controlled with personal guarantees. The debts incurred by the PLF entities were **mezzanine loans**, a term referring to temporary loans secured by an equity interest in another entity.[89] The following table summarizes the loans.[90]

Loan Description	Debtor	Amount	Recourse or Nonrecourse	Security
Loan N709A (Phase I senior mortgage)	Montevina Phase I, LLC	$20,120,000	Nonrecourse as to Exterra	Montevina Phase I real estate
Loan N709B (Phase II senior mortgage)	Montevina Phase II, LLC	4,230,000	Nonrecourse as to Exterra	Montevina Phase II real estate
Loan N712A (Phase I mezzanine loan)	PLF-XIII, LLC	5,030,000	Nonrecourse as to Exterra, Mezzanine loan	PLF-XIII ownership of Montevina, Phase I, LLC
Loan N712B (Phase II mezzanine loan)	PLF-XIV, LLC	2,820,000	Nonrecourse as to Exterra, Mezzanine loan	PLF-XIV ownership of Montevina, Phase II, LLC
Loan N713 (Iowa mezzanine loan)	PLF-XI, LLC	2,000,000	Mezzanine loan	PLF-XI ownership of another LLC owning the Iowa real estate

In 2012, Exterra sold the Livermore property to three unrelated individual buyers. These buyers acquired the Montevina entities that held title to the real estate and agreed to pay $7.4 million on the mortgage. The buyers also assumed Mr. Parker's obligation on the debts. In the transaction, the lender agreed to cancel the unpaid balances. The buyers acquired not just the Montevina entities with the real estate the entities owned, but they also acquired over $40 million of debt, deferred interest, lender advances, and other liabilities. Exterra realized another $12.7 million from other canceled debts.

89. *Risks and Realities of Mezzanine Loans.* Bernman, Andrew. Fall 2007. Missouri Law Review. [scholarship.law.missouri.edu/mlr/vol72/iss4/3] Accessed on Sep. 4, 2024.

90. This table is compiled from a similar table in the Tax Court's opinion and information in the court's decision.

On its 2012 original Form 1120-S, *U.S. Income Tax Return for an S Corporation*, Exterra reported gross receipts of over $53 million and $2.7 million in ordinary business income after expenses. It reported the cancelation of debt income in the same amount. It later amended this return to reduce its gross income by $2,741,399 to reflect the discharge of indebtedness. The amended return included Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*. With this Form 982, Exterra excluded the cancelation of debt income based on insolvency. The insolvency exclusion eliminated Exterra's ordinary business income, which an amended Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.* reflected. With this amended Schedule K-1, Mr. Parker filed an amended Form 1040, *U.S. Individual Income Tax Return*, that reported no income from his ownership of Exterra's stock.

In response, the IRS issued a notice of deficiency to Mr. and Mrs. Parker, asserting a tax deficiency of over $3.1 million for 2012, an addition to tax exceeding $157,000, and an IRC §6662(a) accuracy penalty of $622,327. These changes indicated an increase in the Parkers' taxable income that included the $2,741,399 that they had removed on their amended tax return.

Issue. The issue in the case is whether the release of Exterra's nonrecourse debt should be treated as cancelation of debt income or as an additional amount received upon the sale of the properties.

Analysis. Mr. Parker's attorneys argued that the forgiven loan should be considered cancelation of debt income to Exterra. Because this corporation was insolvent, the Schedule K-1 provided to Mr. Parker could exclude the cancelation of debt income.[91]

However, the court reasoned that another question had to be resolved before reaching this conclusion. This question concerned whether the loan could be forgiven and the property's tax attributes reduced, as Mr. Parker argued, or whether the loan forgiveness had first to be considered an amount realized in the sale of the property.

Making this argument, the IRS contended that invoking the insolvency exclusion for nonrecourse debt is premature when a property with nonrecourse debt is sold and the associated debt is forgiven. Instead, the forgiven amount of the debt canceled is considered an increase in the amount realized through the sale of the property. Thus, the forgiven debt increases the price **Exterra** received for the properties. The court's opinion cited Treas. Reg. §1.1001-2(a)(1), which requires the amount of liabilities forgiven to be included in the property's sale price.

This regulation creates an exception for **recourse** liabilities extinguished through a property sale. Debt forgiveness associated with recourse debt is not included in the amount realized for the property sold.[92] Mr. Parker argued that the debt forgiven was recourse to himself because he had personally guaranteed the loan and was the sole member of Exterra.

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However, the court distinguished the debt owed by Exterra from the debt guarantee Mr. Parker provided. In this case, the canceled debt was an obligation owed by Exterra, for which the debt was nonrecourse. Although Mr. Parker was liable for the loan, the court decided the matter based on the fact that Exterra, as a corporation, had a distinct identity from Mr. Parker, even though he owned all shares of the corporation. It expressed its conclusion favoring the IRS with the following text.

> *In determining whether to sustain [the IRS's] upward adjustment to Exterra's gross receipts..., we respect Exterra's separate corporate existence... Accordingly, [Mr. Parker's] observation, for instance, that Loans N712A and N712B were recourse as to Mr. Parker personally, is simply irrelevant to the issue before us.*

Holding. The Tax Court held that Exterra's forgiven nonrecourse debt should be considered an additional amount received upon the sale of the property. Any cancelation of debt income, which could have been excluded if certain requirements were satisfied, was irrelevant to the court's decision. The court reached this decision because Mr. Parker was not personally a party to the sale; only the S corporation he controlled, Exterra, was involved in the transaction.

91. IRC §108(a)(1)(B).

92. Treas. Reg. §1.1002-2(a)(2).

Personal Injury Exclusion

***Kristen Quevy v. Comm'r*, TC Summ. Op. 2023-34 (Dec. 12, 2023)**
IRC §§104 and 111

☞ Severance Compensation Cannot Be Excluded from Income

Facts. Kristen Quevy worked for Acuity Brand Lighting (Acuity) during a period when she suffered from increasing physical illness and neurological issues. After starting work for the firm in 2009, her anxiety led to migraines and agoraphobia. Her condition worsened after suffering a workplace assault. Acuity allowed her to work from home when these ailments interfered with her work. Unfortunately, the conditions also led to alcoholism.

Before she could be treated for alcoholism, Ms. Quevy was diagnosed with cancer. After successful treatment for this, she started alcoholism treatment. She incurred medical expenses exceeding $125,000, which she deducted on her tax returns for 2016 and 2017.

During this time, Ms. Quevy's disability benefits expired and she shifted to COBRA health insurance coverage.[93] She suffered a relapse into alcoholism. After leaving treatment for this, she suffered spinal injuries in a car accident. When Ms. Quevy told Acuity she would not be able to return to work until November 2017, the company terminated her employment.

In response to a series of demand letters from her attorney, Acuity paid Ms. Quevy $75,000, which it reported on Form 1099-MISC, *Miscellaneous Income*, as nonemployee compensation. Ms. Quevy reported only $7,500 as income on her 2018 tax return, treating the balance as excludable damages under IRC §104(a)(2).

Issue. The issue in this case is whether Ms. Quevy can exclude from taxable income a settlement she received from a former employer for severing her employment.

Analysis. Ms. Quevy argued that Acuity's payments compensated her for physical injuries or sickness. The IRS argued that the payments compensated Ms. Quevy for wrongful termination, which is not excludable from taxable income.

The Tax Court noted that §104(a)(2) permits exclusion from taxable income the payments received for damages arising from "personal physical injuries or physical sickness." These two causes exclude emotional distress, although payments paid for personal injuries or sickness arising from emotional distress may be excludable in limited cases. The court noted that Congress specifically added the restriction to "physical" injuries in 1996.[94]

The court, however, placed greater weight on the claim that resulted in the settlement, which required the court's examination of the settlement agreement that resulted in the payments. This agreement stated that the payment was for "severance compensation" and was intended to "resolve all issues between them." It specified compensation for Ms. Quevy's "personal injuries" but failed to specify **physical** injuries, thereby missing the standard established by §104(a)(2). Although Ms. Quevy argued that Acuity was aware that she was assaulted on company premises, the settlement agreement did not state this.

Ms. Quevy argued in the alternative that she should be able to deduct the payments received as medical expenses. The court found that her 2016 and 2017 tax returns already deducted those expenses. The tax benefit rule of IRC §111 would require her to include the recovery of any amount she had deducted in a prior year unless it did not provide a tax benefit to her. Because Ms. Quevy did not prove the absence of a tax benefit, she also failed on this point to exclude the payments from her income.

Holding. The Tax Court found Ms. Quevy could not exclude compensatory compensation from her income because the settlement agreement with her former employer stated the amount was paid as "severance compensation."

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93. *Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA)*, PL 99-272.

94. *Small Business Job Protection Act of 1996*, PL 104-188, §1605(b).

INDIVIDUAL ISSUES

Tax Return Definition

***Joselito E. Cortez v. IRS*, No. 2:21-CV-01598 (E.D. Cal. Jan. 12, 2024)**
IRC §§6020, 6201, and 6511

☞ Would a Return by Any Other Name Smell as Sweet?

Facts. Joselito Cortez failed to file his 2004 federal tax return or an extension. In December 2009, the IRS assessed a tax of $6,006 against Mr. Cotez under a substitute tax return for the 2004 tax year. In April 2011, Mr. Cortez filed a married filing joint 2004 Form 1040, *U.S. Individual Income Tax Return,* with his now-deceased wife. The Form 1040 reported $87,752 in income and claimed three exemptions for three Cortez children and a child tax credit for one of the children. Mr. and Mrs. Cortez signed their Form 1040 before submitting it, and the IRS assessed an additional $2,113 tax jointly against Mr. and Mrs. Cortez on October 31, 2011.

In 2012, Mr. Cortez submitted an offer in compromise (OIC) for the tax he owed for 2004, and the IRS rejected it. Subsequently, Mr. Cortez entered into an installment agreement with the IRS and made several voluntary payments from early 2017 through early 2018.

However, in January 2021, Mr. Cortez filed a claim for a refund under IRC §6511 for all the payments he made toward the October 2011 assessment for payments made within two years of the claim date. Mr. Cortez filed a lawsuit after the IRS did not respond to his claim for a refund.

In his pleadings, Mr. Cortez argued that submitting the joint Form 1040 in April 2011 to the IRS was "not an honest and reasonable attempt to comply with the Tax Code." Therefore, the filing was not a tax return, and he should be entitled to a refund because the filing is a nullity. Under established law, an assessment based upon a nullity is invalid, null, and void. Therefore, Mr. Cortez claimed that the assessment for the April 2011 filing was invalid, null, and void. Mr. Cortez and the IRS filed cross-motions for summary judgment.

Issue. The issue in this case is whether Mr. Cortez's late submission of Form 1040 qualifies as a "return" for tax purposes.

Analysis. The Code contains no definition of the term "return." The Bankruptcy Code also lacked a definition before 2005, but the Bankruptcy Court continues to use the *Beard* test, a 4-factor test, to determine whether a document is a "return."[95] This test requires the document to "purport to be a return, … be executed under penalty of perjury, …contain sufficient data to allow calculation of tax, and …represent an honest and reasonable attempt to satisfy the requirements of the tax law."[96] Under the Bankruptcy Code, a debtor cannot discharge a tax liability assessed for a required tax return if they did not file it.[97]

Mr. Cortez cited a case where a filing was not a "return" for bankruptcy discharge purposes. In that case, *In re Smith*, Mr. Smith, the plaintiff, filed a Form 1040 seven years after the tax return was due and after he was issued a tax assessment.[98] The IRS responded that this case only determined the issue of whether Form 1040 was a "return" under the Bankruptcy Code and **not whether it was a "return" for all tax purposes.[99]** Mr. Cortez argued for a precedent where, if a term is defined in one section of the federal code, federal courts must adopt that definition for another section of the federal code where the term is undefined. The Seventh Circuit and the Ninth Circuit have rejected this approach and have held that a "return" can have different definitions in separate parts of the Code.

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95. *Beard v. Comm'r*, 82 TC 766 (1984).

96. *In re Hatton,* 220 F.3d 1057, 1060 (9th Cir. 2000).

97. 11 USC §523(a)(B)(i).

98. *In re Smith*, 828 F.3d 1094, 1096 (9th Cir. 2016).

99. Ibid.

Under IRC §6201(a), a Form 1040 turned in late can still be a "return," and the IRS is allowed to make an assessment based on that return. The court stated that it would continue to apply the *Beard* factors to determine whether a Form 1040 is a return, and that it would ignore Mr. Cortez's argument that the late submission is not an "honest and reasonable attempt to satisfy the requirements of the tax law."

Under the *Beard* factors, a Form 1040 was a "return" for the purpose of a tax assessment. The submission was on the proper form, and Mr. Cortez properly completed it. Mr. and Mrs. Cortez both signed the form, attesting that the return was accurate to the best of their knowledge, under penalty of perjury. Mr. Cortez's other actions, including submitting an OIC and signing the installment agreement, also indicate that their Form 1040 was a return.

Holding. The court granted the summary judgment motion for the IRS and denied Mr. Cortez's argument that his late-filed Form 1040 was not a return for tax purposes.

INNOCENT SPOUSE

IRA and Life Insurance Withdrawals

***Joseph Balint v. Comm'r,* TC Memo 2023-118 (Sep. 25, 2023)**
IRC §§61, 72, 408, and 6330

☞ Not My Withdrawal, Not My Problem

Facts. Joseph Balint was incarcerated from December 2013 to January 2015. In March 2014, while still in prison, Mr. Balint signed a power of attorney (POA) allowing his wife, Jacqueline, to handle his affairs. From April 2014 to October 2014, Mrs. Balint made numerous withdrawals from her husband's individual retirement arrangement (IRA) with Pershing, LLC, and his life insurance policy with Pruco Life Insurance Co. In total, Mrs. Balint withdrew $137,469.66 into their joint account, and then withdrew a total of $130,908.64 from the joint account into her personal accounts, leaving a difference of $6,561.02.

Mrs. Balint used the money to move from the Florida residence to Kentucky, to renovate a house in Kentucky, to care for her ailing mother, and to pay living expenses. She then filed for divorce in September 2014, while Mr. Balint was still in prison.

Mr. Balint was released from jail in January 2015, and filed his 2014 tax return in April 2015. His filing status was married filing separately. Mr. Balint reported his gross income as $223,191, which consisted of (1) $375 in taxable interest; (2) $154,477 in taxable IRA distributions; (3) $67,078 in taxable distributions from pensions and annuities; and (4) $1,261 in taxable social security benefits. Mr. Balint said although he did not believe the IRA and life insurance withdrawals were his income, he included them because he thought it might violate the terms of his parole otherwise. The return reported $34,614 as the balance due.

The IRS sent a notice of intent to levy on amounts due for 2013 and 2014. In response, Mr. Balint requested a collection due process (CDP), and timely submitted a Form 12153, *Request for a Collection Due Process or Equivalent Hearing,* concerning 2013, 2014, and 2015 taxable years. Mr. Balint attached a written attachment alleging his wife stole more than $240,000 from his IRA and pension accounts. Mr. Balint also made a claim for innocent spouse relief and submitted Form 8857, *Request for Innocent Spouse Relief*.

An Appeals settlement officer conducted a CDP hearing and sustained the proposed levy, finding that Mr. Balint was ineligible for innocent spouse relief because he and Mrs. Balint had not filed joint returns for the years at issue, and Mr. Balint provided insufficient information about the legal action he took regarding Mrs. Balint's withdrawals to warrant any adjustment of the tax liabilities. Mr. Balint timely filed a petition for review of the SO's determination.

During the couple's divorce proceedings, the state court found Mr. Balint authorized Mrs. Balint to withdraw $10,800 from his IRA, for which he should be liable for the tax. The state court also found, however, that Mrs. Balint should be liable for tax on $179,296 of income consisting of $89,320 in IRA distributions and $89,976 of life insurance distributions, as Mr. Balint did not receive an economic benefit from those funds.

Issues. The issues in this case are the following.

- Whether the withdrawals Mrs. Balint took from the IRA, pension fund, and annuity must be included as taxable income on Mr. Balint's 2014 tax return
- Whether the IRS abused its discretion in sustaining the levy

Analysis. The definition of gross income is very broad under the Code. According to IRC §§61(a)(9), (10), and (11), a taxpayer's gross income encompasses "all income from whatever source derived." Additionally, IRA distributions are generally included in the gross income of the "payee" and "distributee."[100] Amounts "received" from a life insurance policy but not paid as an annuity are also included in the taxpayer's gross income if they exceed the amount invested in the contract.[101] Thus, the definition of gross income appears to include amounts received from IRAs and life insurance policies.

However, there is an exclusion for misappropriated funds. Funds misappropriated from the taxpayer's accounts are not included in the taxpayer's gross income if the taxpayer is not the payee, distributee, or recipient of the funds, and does not receive an economic benefit from the distributions.[102] In *Roberts v. Comm'r*, the taxpayer's wife withdrew money from an IRA account to establish a new household, and the court held the withdrawal should not be included in the taxpayer's gross income because the taxpayer received no economic benefit from the withdrawal.[103] Similarly to *Roberts*, Mrs. Balint misappropriated funds from an IRA account to establish a new household which did not economically benefit the taxpayer. Thus, the money should be included as taxable income on Mrs. Balint's tax return, not Mr. Balint's.

Mrs. Balint, however, argued that she was authorized to make the withdrawal by virtue of her POA. POAs are interpreted according to state law. The POA Mr. Balint signed was governed by Florida law. An agent acting pursuant to a POA has a fiduciary relationship to the principal. The agent "[m]ay not act contrary to a principal's reasonable expectations actually known by the agent," or "in a manner that is contrary to the principal's best interest."[104] Mrs. Balint should have known Mr. Balint did not reasonably expect her to use the money to move to Kentucky, as she did not even tell him about the withdrawals. Indeed, Mr. Balint did not find out until he was released from prison.

Additionally, "an agent may only exercise authority specifically granted to the agent in the power of attorney and any authority reasonably necessary to give effect to that express grant of specific authority,"[105] and "powers of attorney are strictly construed and will be closely examined in order to ascertain the intent of the principal."[106] Thus, in a POA, a more specific grant of authority takes precedent over a more general grant of authority.

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100. IRC §408(d)(1).

101. IRC §§72(e)(1)(A), (5)(A), and (C).

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

103. Ibid.

104. Fla. Stat. §709.2114(1) (2013).

105. Fla. Stat. §709.2201(1) (2011).

106. *Manor Oaks, Inc. v. Campbell,* 276 So. 3d 830, 833 (Fla. Dist. Ct. App. 2019) (quoting *De Bueno v. Castro,* 543 So. 2d 393, 394 (Fla. Dist. Ct. App. 1989)).

Although Mrs. Balint's POA generally allowed actions benefitting her, which might otherwise be construed as self-dealing, the POA limited this power by requiring the actions to be for Mr. Balint's benefit, when it said, "actions that might otherwise be considered prohibited as self-dealing are specifically authorized . . . for the purpose of tax, financial or estate planning, for [petitioner's] benefit." Mr. Balint did not receive an economic benefit from the withdrawals as the money was used to help Mrs. Balint establish a new life in Kentucky.

An appeals officer who issues a determination arbitrarily, capriciously, or without sound basis in fact or law is said to abuse their discretion. The court determined that the settlement officer did not error in her proposed levy.

Holding. The court held the withdrawals made by Mrs. Balint were not includable in Mr. Balint's taxable income because they were not made for his economic benefit, they were made without his knowledge, and they were made outside the scope of Mrs. Balint's authority under the POA.

Joint and Several Liability

***Marisol Severance v. Comm'r,* TC Memo 2023-101 (Aug. 8, 2023)**
IRC §§6015(b) and (f)

☞ Joint and Several Results in Severance Pay

Facts. Marisol and Neil Severance filed joint tax returns for tax years 2010 and 2011. On their 2010 tax return, $91,500 of foreign earned income was excluded from taxable income under IRC §911 that was attributed to Mr. Severance's employment overseas. This amount was reported on the Severances' filed Form 2555, *Foreign Earned Income*. Likewise, on their filed 2011 return, $36,881 of foreign earned income was excluded from taxable income from the same employment and was reported on a filed Form 2555.

The IRS issued a notice of deficiency dated April 10, 2014, to the Severances for tax years 2010 and 2011, where after an examination the IRS disallowed the §911 exclusion of the reported foreign income for both tax years, as well as finding an underreporting of unemployment income for 2011. These errors resulted in deficiencies of federal income tax in the amounts of $20,958 for 2010 and $8,618 for 2011. In addition, the IRS assessed accuracy-related penalties of $4,192 and $1,713 for 2010 and 2011, respectively.

In April 2015, the IRS used a $1,000 overpayment from the Severances' 2014 income tax return to offset some of the outstanding 2010 tax liability. In August 2015, the IRS issued federal tax lien notices associated with the outstanding 2010 and 2011 income tax liabilities. In December 2015, Mr. Severance filed for Chapter 13 bankruptcy, where he listed the IRS as one of his creditors. That same month, the IRS filed a proof of claim with the Bankruptcy Court that included the amount of outstanding 2010 and 2011 income tax liability that the Severances still owed.

In March 2019, the IRS received a filed Form 8857, *Request for Innocent Spouse Relief*, from Mrs. Severance for the 2010 and 2011 tax years. In this filing, she asserted that neither she nor other family members were victims of abuse perpetrated by the spouse, and that she did not have a mental or physical health issue during the time the applicable returns were filed. Mrs. Severance stated that she had some college education at the time the returns were filed and that while she did not deal directly with the CPA who had assisted her and her husband with their 2010 and 2011 tax filings, she did provide tax documents to the CPA. While she signed the tax returns, she was not aware of any errors or omissions with the filings. Mrs. Severance went on to indicate that she was the decision-maker for the spending of the family's money during the applicable tax years when experiencing financial difficulties. Additionally, Mrs. Severance painted a picture of her current financial situation, where she divulged the household received a monthly income totaling $7,875 and monthly expenses totaling $6,219 to support a family of seven people (the taxpayers and their five children).

In June 2019, while waiting for the IRS to process her filed Forms 8857, Mrs. Severance notified the IRS via letter that she would voluntarily pay the outstanding balance of income taxes owed, but she was not waiving her innocent spouse claim. The IRS received the payment the following month, where loan proceeds for the Severances' purchase of a house were used to fund the payment. In August, the IRS denied Mrs. Severance's innocent spouse claim, stating that there was no outstanding balance, no refundable payments were made, and that Mrs. Severance did not provide support showing the payments were made solely by her. Mrs. Severance's attorney responded to the letters, requesting that the IRS review the enclosed supporting documentation and update their records accordingly. In November, the IRS denied Mrs. Severance relief from joint and several liability through the innocent spouse claim. Mrs. Severance appealed the IRS's decision in Tax Court, seeking relief from joint and several liability under IRC §§6015(b) and (f) for the 2010 and 2011 tax years.

Issue. The issue in the case is whether Mrs. Severance is entitled to innocent spouse relief under §§6015(b) or (f).

Analysis. The court first assessed whether Mrs. Severance would be entitled to relief from joint and several liability for the 2010 and 2011 tax years under §6015(b). This requires the requesting taxpayer to meet the following conditions.

- A joint return was filed for the applicable year.
- An understatement of tax arose from errors made by the nonrequesting spouse.
- The requesting spouse did not and could not have known about the errors when signing the applicable tax return.
- It is inequitable to hold the requesting spouse liable for the outstanding tax due, and the requesting spouse elects relief within two years of the IRS beginning collection activities.

Not meeting any one of the required conditions would result in a taxpayer being unable to receive relief under §6015(b).

Mrs. Severance did not meet the timing criteria for requesting relief within two years of the IRS beginning collection activities. She filed Form 8857 in March 2019, which was over two years after the IRS had applied the Severances' 2014 income tax overpayment to the 2010 income tax liability in 2015. The IRS also filed a proof of claim when Mr. Severance filed for Chapter 13 bankruptcy in 2015. Treasury regulations support that both events constitute collection activities, and therefore, Mrs. Severance was not entitled to relief from joint and several liability under §6015(b).[107]

Next, the court assessed whether Mrs. Severance was entitled to relief under §6015(f), which provides relief to a taxpayer when none is available under §§6015(b) or (c), and it is inequitable to hold the requesting spouse liable for the outstanding tax. Because the court had already found that Mrs. Severance was not eligible for relief under §6015(b), and that due to her marital status, she would not be eligible for relief under §6015(c), it considered whether it would be inequitable to hold her liable for the 2010 and 2011 tax deficiency.

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To determine whether equitable relief provisions applied, the court used Rev. Proc. 2013-34, which includes a streamlined process if the following three conditions apply to the requesting spouse.[108]

1. No longer married to the nonrequesting spouse
2. Would suffer economic hardship if relief were not granted
3. Was unaware of any errors or circumstances that resulted in the understatement or deficiency of the filed income tax return

Because Mrs. Severance remained married to Mr. Severance, the streamlined determination was not applicable to her case.

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107. Treas. Reg. §1.6015-5(b)(2)(i).

108. Rev. Proc. 2013-34, 2013-43 IRB 397.

Rev. Proc. 2013-34, in addition to a streamlined determination, also provides seven nonexclusive general conditions under consideration for determining if a taxpayer is eligible for relief under §6015(f). The first threshold is marital status, which weighs in favor of the requesting spouse if they are no longer married to the nonrequesting spouse. As Mrs. Severance remained married to Mr. Severance, this factor was neutral in the court's assessment.

The second threshold is economic hardship, which weighs in favor of the requesting spouse if joint and several liability would result in the requesting spouse being unable to pay reasonable living expenses on their current income. The court found that Mrs. Severance, based on her testimony and other supporting evidence, could still adequately pay living expenses, and therefore the factor was neutral.

The third factor is knowledge or reason to know of the underlying cause of understatement or deficiency. The court found that Mrs. Severance's college education, as well as her management of family finances and providing supporting tax documents to her CPA, resulted in the knowledge factor weighing against her.

The fourth threshold is legal obligation, where a divorce or other binding agreement results in the nonrequesting spouse having the sole legal obligation to pay the tax liability. As Mrs. Severance remained married to Mr. Severance and no such agreement was in place, this factor was neutral.

The fifth threshold is significant benefit, where the factor weighs against relief if the requesting spouse significantly benefitted from the understatement or deficiency. The court found that because neither Mrs. nor Mr. Severance lived lavish lifestyles resulting from the understatement of the 2010 and 2011 tax years, the factor weighed in favor of Mrs. Severance.

The sixth factor is compliance with income tax laws, where nonncompliance weighs against the requesting spouse. Even though the Severances did not timely file their returns, all applicable and subsequent tax returns were filed before the IRS received Mrs. Severance's Form 8857, and therefore, the factor was neutral.

The seventh and final factor is the mental or physical health of the requesting spouse at the time of filing the applicable tax returns, where the factor weighs in favor in situations where the requesting spouse suffers from poor mental or physical health. Mrs. Severance did not indicate that she was in poor mental or physical health, resulting in the factor being neutral in her case.

After weighing all the factors, the court found that Mrs. Severance did not adequately establish that it would be inequitable for her to be held liable for the 2010 and 2011 understatement of tax liabilities and is therefore not entitled to relief under §6015(f).

Holding. The Tax Court held that Mrs. Severance was not eligible for innocent spouse relief from joint and several liability for the 2010 and 2011 tax years under either §§6015(b) or (f).

Innocent Spouse Relief

***O'Nan v. Comm'r*, TC Memo 2023-117 (Sep. 18, 2023)**
IRC §§6015 and 6321

☞ The Widow's Mite Is Mighty Large

Facts. Sarah O'Nan and her husband purchased an Ohio residence in 2012, possessing the real estate with a form of joint tenancy with the right of survivorship known in Ohio as "survivorship tenancy."[109] Not long after the home's purchase, Mr. O'Nan borrowed funds using the home as collateral, as evidenced by a promissory note. At some point later, an additional amount was borrowed against the home, creating a second promissory note with a second bank. Both Mr. and Mrs. O'Nan cosigned the two mortgage deeds, but only Mr. O'Nan's signature was present on the first promissory note.

109. Ohio Rev. Code Ann. §6302.20(A).

At age 43, Mr. O'Nan died in 2014, leaving Mrs. O'Nan with no way to repay the mortgage loans or his substantial federal tax liabilities for 2012 and 2013. Although they timely filed their returns for these years, the O'Nans did not pay the balances due.

Now newly widowed, Mrs. O'Nan listed her home for sale in 2015, but one of the banks began foreclosure. She filed an IRC §6015 request for innocent spouse relief and dropped the home's listing price to accelerate its sale. Her Form 8857, *Request for Innocent Spouse Relief*, was received by the IRS on May 6, 2015. About a week earlier, on April 28, 2015, the IRS filed a notice of a federal tax lien under IRC §6321 against Mrs. O'Nan and her late husband, apparently unaware of his death.

The home sold for $895,000 in June 2015, enough to pay off the mortgages held by both banks. The IRS also received $123,200 in satisfaction of the lien it had placed on the home. After all liabilities were satisfied, Mrs. O'Nan received $76,535 from the sale.

On February 13, 2017, the IRS granted Mrs. O'Nan partial relief from her liability for 2012 taxes and full relief for the tax due from their 2013 return. The IRS still claimed that Mrs. O'Nan owed $3,340 for 2012 taxes, plus interest. However, according to the lien, the IRS denied Mrs. O'Nan's claim for a refund of the $123,200 that it had seized. Mrs. O'Nan subsequently filed a petition with the Tax Court to contest the IRS's refusal to refund the $123,200 lien payment.

Issue. The issue in this case is whether Mrs. O'Nan made overpayments of federal tax that would entitle her to a refund under the innocent spouse provisions of §6015(g)(1).

Analysis. As noted by the Tax Court, this case constitutes an unusual approach to the innocent spouse regulations. Although the innocent spouse usually contests the IRS's denial of relief under §§6015(b), (c), or (f), in this case, the IRS had already granted relief. Mrs. O'Nan disputed the denial of a refund for the funds seized by the IRS.

The Tax Court observed that federal law permits a refund to an innocent spouse only if the tax payment came from the innocent spouse's funds. The court cited a 2006 case denying a refund of payments from a couple's community property.[110] It also found that tax payments made from a deceased spouse's estate were similarly not eligible for a refund to an innocent spouse. The court referred to a principle that an innocent spouse can only trace funds to a joint account if they demonstrate that the funds originated with them.

However, the court distinguished the O'Nan case from these prior cases based on the nature of Ohio law. The joint tenancy with right of survivorship provisions of the state's laws provided that Mrs. O'Nan immediately inherited her husband's half interest in their property upon his passing.[111] This reasoning follows the precedent from a prior case in which a federal district court concluded the following.

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> *When a cotenant in an Ohio survivorship tenancy dies subject to a[n IRC §6321] lien, the surviving cotenant takes the decedent's interest subject to the lien.*[112]

Therefore, Mrs. O'Nan inherited her husband's interest in the property subject to the lien.

The Tax Court determines the requesting spouse's tax liability as if the taxpayer and the spouse had used the married filing separately filing status. This filing status resulted in Mrs. O'Nan having a 2012 tax liability of $3,340 and a $0 liability for 2013.

Holding. The Tax Court held that because Mrs. O'Nan made the IRS payment with funds she had inherited from her late husband, she was entitled to a refund of the IRS lien payment of $123,200. From this amount, the IRS withheld $3,340 for her 2012 tax liability.

110. *Ordlock v. Comm'r*, 126 TC 47 (2006).

111. Ohio Rev. Code Ann. §5302.20(B).

112. *Paternoster v. U.S.*, 640 F.Supp.2d 983 (S.D.Ohio 2009).

IRS PROCEDURES — MISCELLANEOUS

Timely Filed Return

***Madiodio Sall v. Comm'r*, 161 TC 13 (Nov. 30, 2023)**
IRC §§6213, 7451, and 7503

☞ An Early Christmas

Facts. The IRS mailed a notice of deficiency to Madiodio Sall on August 26, 2022. The notice said the last day to file a petition was November 25, 2022. Mr. Sall mailed a petition on November 28, 2022, and it was received and filed by the court on December 1, 2022. The IRS moved to dismiss on the basis that the Tax Court lacked jurisdiction because the petition was untimely.

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

Analysis. The party invoking the court's jurisdiction has the burden of proving the court has jurisdiction.[113] A taxpayer must file a petition within 90 days of the IRS's mailing of the notice.[114] If the filing deadline falls on a Saturday, Sunday, or legal holiday, the deadline is extended to the next business day.[115] Additionally, if the court is closed on the next business day, the deadline is extended for 14 days past that deadline.[116]

In this case, the 90-day deadline fell on Thanksgiving, a legal holiday. Thus, the deadline would have been moved to the next business day, Friday, November 25, 2022. But the court was closed that day, so the deadline would be extended an additional 14 days to December 10, 2022, according to IRC §7451(b)(1). Additionally, December 10 was a Saturday, so the deadline would be extended an additional two days to Monday, December 12, 2022.

Holding. The court held that the petition was timely filed because Mr. Sall's petition was filed on November 28, 2022, and the deadline was extended to December 12, 2022.

Reconstruction of Evidence

***R. J. Channels, Inc. v. Comm'r*, TC Memo 2023-109 (Aug. 28, 2023)**
IRC §6663

☞ IRS Attorneys Fall "Woefully Short" of Tax Court's Expectations

Facts. In February 2021, the IRS issued a notice of deficiency for the 2017 tax year to R. J. Channels, Inc. (RJ), a California corporation. RJ timely petitioned the Tax Court in May 2021, including a partial copy of the notice of deficiency with only the first page of Form 4549-A, *Report of Income Tax Examination Changes,* and Form 886-A, *Explanation of Items*. The first page was stamped "ORIGINAL" and included the IRS deficiency determination and IRC §6663 civil fraud penalty.

In September 2021, the IRS answered RJ's petition with a copy of a notice of deficiency that the IRS claimed was a "complete copy." The first page was stamped "ORIGINAL" and contained a continuation sheet with an "Interest on Deficiencies" section as well as a "Civil Fraud Penalty IRC section 6663" section.

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113. *David Dung Le, M.D., Inc. v. Comm'r,* 114 TC 268, 270 (2000).

114. IRC §6213(a).

115. IRC §7503.

116. IRC §7451(b)(1).

A proposed stipulated decision was filed in October 2022, to which the parties supposedly agreed to an IRC §6662(a) accuracy-related penalty. However, the record contained no reference to a §6662(a) penalty. Just two weeks later, the court struck the proposed stipulated decision (PSD) and ordered revisions.

A month later, the court received a revised PSD along with a November status report. The PSD set forth a deficiency, a civil fraud penalty, and an accuracy-related penalty. The PSD explained that an accuracy-related penalty was **recommended as an alternative to the civil fraud penalty**. The notices presented information using a different font size and different margins, and one section was diagonal relative to the other sections. Noticing the differing appearances, the judge asked for an explanation of the status report.

The IRS responded that several discrepancies were noted between the complete copy attached to the IRS answer and the complete copy attached to the IRS November status report. At the time the IRS answer was filed, the IRS attorneys **did not have** the actual physical administrative file due to the COVID-19 pandemic and were unable to obtain the file prior to the answer deadline. Instead of requesting additional time to provide the court with the requested document, the IRS counsel attempted to reconstruct the notice of deficiency. The reconstruction resulted in the exclusion of the signed civil penalty approval form and Form 886-A along with Letter 531, *Notice of Deficiency*, which excluded the §6662 alternative penalty position. When it filed the document with the court, the IRS attorneys did not advise the court that they had reconstructed the document.

A status hearing was held on February 7, 2023, with IRS attorneys Gonzalez and Wight. Gonzalez explained the procedures the IRS followed due to COVID-19 to reconstruct the notice of deficiency when they did not have access to the administrative file. Wight did not have knowledge of the reconstruction at the time. When asked why the court was not informed about the discrepancies, Wight stated:

> *I was simply hoping that just by attaching a complete copy back with the [s]tatus [r]eport it would at least put the correct notice on record.*

The court ordered RJ to submit a complete copy of the notice of deficiency, but RJ provided a notice unrelated to the years at issue. The court repeated the request, and RJ submitted the IRS's petition notice to the court but not the notice of deficiency that the IRS claimed to have sent.

Issue. The issue in this case is whether the court should strike the PSD from the court's records.

Analysis. Instead of requesting more time to comply with the court's directive, the IRS created a **new** document. Even though the IRS claimed it to be a "complete copy," it was not. Both the answer notice and the status report notice were materially different from all other notices in the record.

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The court was dismayed by the IRS not informing it of the document reconstruction process, stating the following.

> *Respondent's conduct falls woefully short of our expectations for practitioners who regularly appear before this [c]ourt… We have no confidence that the slipshod cut-and-paste Status Report Notice presented to the [c]ourt was the version of the notice of deficiency actually sent to the petitioner.*

Because the statutory notice of deficiency is critical to adjudicating and settling the case, the judge was uncertain that the IRS had actually sent the required notice of deficiency to RJ. The judge ordered the partners to file a revised decision document.

Holding. The court held that the PSD be stricken from the record. The court entered a decision against RJ for unpaid income taxes of $84,358 and refused to allow a §6663 penalty against RJ.

Disaster Relief

***Mohamed Abdo and Fardowsa Farah v. Comm'r*, 162 TC 7 (Apr. 2, 2024)**

IRC §§6662 and 7508

☞ A Helpful Extension

Facts. The IRS issued a notice of deficiency dated December 2, 2019, to Mohamed Abdo and Fardowsa Farah. The notice stated that $9,634 was due in income tax and $166 was due as an accuracy-related penalty under IRC §6662(a) for the tax year 2018. The 90th day after December 2, 2019, was March 1, 2020, which was a Sunday. The notice of deficiency specified the following day, March 2, 2020, as the last day to file a petition. However, the couple did not mail their petition until March 17, 2020. The Tax Court did not receive mail between March 19 and July 9, 2020, as it was closed due to the COVID-19 pandemic. The court received and filed the couple's petition on July 10, 2020.

The President of the United States declared a national emergency on March 13, 2020. The IRS issued Notice 2020-23[117] on April 11, 2020, extending the deadline for filing a Tax Court petition to July 15, 2020, for taxpayers who had a petition due between April 1, 2020, and July 15, 2020. Accordingly, the IRS contended that the couple did not file their petition timely according to the notice. Mr. Abdo and Ms. Farah agreed that the deadline to file a petition was not extended under the **regulation**, but they argued the petition was timely filed under all reasonable constructions of IRC §7508A(d).

Issue. The issues in this case are the following.

- Whether §7508A(d) provides a mandatory 60-day extension when a disaster is declared
- Whether Treas. Regs. §§301.7508A-1(g)(1) and (2) are valid
- Whether Mr. Abdo and Ms. Farah's petition was valid because they filed it during the automatic postponement period

Analysis. IRC §7508A(a) provides that tax deadlines may be extended up to one year by the Secretary of the Treasury if there is a federally declared disaster. IRC §7508A(d) provides that tax deadlines shall be disregarded for the period beginning on the earliest incident date specified in the disaster declaration and ending on the date which is 60 days after the latest incident date specified.

The couple argued that the first incident date of the disaster was January 20, 2020, and so after applying the 60-day extension, the deadline would be March 21, 2020. However, Treas. Reg. §§301.7508A-1(g)(1) and (2) limit the acts subject to the mandatory postponement period of §7508A(d) to "the acts determined to be postponed by the Secretary's exercise of authority under §7508A(a) or (b)." The regulation appears to provide that the extension is not mandatory. But Mr. Abdo and Ms. Farah argued this regulation conflicts with §7508A(d), which provides an automatic extension, thereby making the regulations null and void under the 2-step statutory interpretation test articulated in *Chevron USA, Inc. v. Nat. Res. Def. Council, Inc*.[118]

The statutory interpretation test from *Chevron* is:

1. Whether Congress has spoken on the precise question at issue, and
2. If Congress has not spoken on it, the statute is ambiguous, and the question becomes whether the agency's answer is a permissible construction of the statute.[119]

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

118. See *Chevron, USA, Inc. v. Nat. Res. Def. Council, Inc.,* 467 U.S. 837 (1984).

119. Ibid.

Here, the court first considered step 1, by looking at the plain and literal language of the statute, the context in which the language was used, and the broader context of the statute as a whole. The couple argued that the discretionary language of §7508A(a) compared to the later, mandatory language of §7508(d) indicated Congress wanted the 60-day extension to be mandatory when it added (d).

The IRS countered that §7508A(d) is ambiguous because Congress did not identify specifically what time-sensitive acts are subject to §7508A(d), and so deference to Treas. Regs. §§301.7508A-1(g)(1) and (2) is necessary. But §7508A(d) clearly provides that the defined time period "shall be disregarded." This extension is for the 60 days provided for in subsection (a) because subsection (d) says the extension shall be in the "same manner" as provided by (a), which is unambiguous. Headings can also be used to help resolve doubt about the meaning of the text.[120] The heading of subsection (d) is "mandatory 60-day extension" which is clear and unambiguous, and is not at odds with any of the statute's underlying text. Thus, the plain language of the statute indicates Congress clearly intended to provide mandatory postponement, and deference to the Treasury Regulation is unwarranted.

The IRS also contended §7508A is ambiguous because it did not specify how the mandatory postponement in §7508A(d) applies to a federal disaster declaration without an incident date, and the Nationwide Emergency Declaration did not specify an incident date. But the petitioners argued they were entitled to a postponement under the Ohio Disaster Declaration, which specified an incident date of January 20, 2020.

Holding. The court held that because §7508A is clear, an automatic, 60-day petition filing extension is granted in the event of a federally declared disaster to qualified taxpayers. Because this Code section unambiguously provides for a mandatory filing extension for qualified taxpayers, the IRS regulations in conflict with it are not entitled to the court's deference. Accordingly, Mr. Abdo and Ms. Farah timely filed their Tax Court petition in response to the IRS's notice of deficiency. Thus, the petition in this case was timely.

> **Observation.** Through their attorneys, Mr. Abdo and Ms. Farah successfully argued that the IRS could not impose a regulation in conflict with clear legislation. It is difficult to envision taxpayers making *pro se* appearances in Tax Court having the same success. Perhaps more importantly, if this case had been argued after the Supreme Court's *Loper Bright Enterprises* decision, it would be more difficult for the IRS to claim the Tax Court's deference to its positions.[121]

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Third-Party Summons

***God's Storehouse Topeka Church v. U.S.,* 98 F.4th 990 (10th Cir. 2024)**

IRC §§7609 and 7611

☞ Validity of Third-Party Summons in Church Tax Investigation Affirmed

Facts. Richard and Pennie Kloos founded God's Storehouse Topeka Church (GSH) in 2009, a thrift store with an attached coffee shop in Kansas, with Mr. Kloos serving as a pastor. While GSH was registered as a Kansas not-for-profit corporation in the subsequent year, it opted not to pursue formal tax-exempt status under IRC §501(c)(3). Instead, it designated itself as a church under IRC §508(c)(1)(A), thus avoiding the need for IRS recognition. Despite this classification, GSH predominantly functioned as a thrift store, retailing donated items to the public, with the coffee shop serving patrons at cost. Mr. Kloos ran for the Kansas State Senate in 2020, displaying campaign yard signs referencing his connection to GSH.

120. *Almendarez-Torres v. U.S., 523* U.S. 224, 234 (1998).

121. *Loper Bright Enterprises v. Raimondo*, 45 F.4th 359 (D.C. Cir. 2022), *vac'd and remanded* 603 U.S. _____ (2024).

In February 2021, the IRS launched an investigation into GSH's tax-exempt status for the 2019 and 2020 tax years, alleging potential tax liabilities due to operating as a thrift store, political campaign intervention, coffee shop income, and unpaid employment taxes for the Klooses. Despite GSH's objections, the IRS initiated a church tax examination and issued a third-party summons to Kaw Valley Bank, which held GSH's bank accounts. The summons requested bank records spanning January 1, 2019, to December 31, 2020, seeking to gather financial information pertinent to GSH's tax status. GSH disputed the summons's validity and petitioned the district court to quash it, contending that the IRS failed to meet IRC §7611 requirements. In particular, GSH asserted the Tax Exempt and Government Entities Commissioner (TE/GE Commissioner), the IRS official who signed off on the GSH inquiry, is not an "appropriate high-level Treasury official" for purposes of §7611(a)(2).

In response, the IRS moved for summary denial, asserting that IRC §7609, not §7611, governed the summons's validity. The district court ruled in favor of the IRS, agreeing with its position regarding §7611 third-party summonses related to churches. Further, the district court affirmed the summons's validity under §7609, concluding that the IRS followed all requisite administrative steps under the *Powell* case.[122]

Issue. The issue in this case is whether the TE/GE Commissioner is an appropriate high-level Treasury official to approve church tax inquiries, examinations, and summonses under §7611.

Analysis. The court reasoned that the issue of whether the TE/GE Commissioner could authorize the summons was only relevant if §7609 depended on §7611. This issue, in turn, raises a question of statutory construction.[123] GSH contended that the validity of the IRS's §7609 third-party summons to Kaw Valley depends on the summons's compliance with §7611. This Code section would impose heightened procedural requirements before the IRS could undertake either a "church tax inquiry" or a "church tax examination," but only if the IRS must comply with it before issuing the summons. However, the court held that plain language in §7611 contradicts this argument, as it clarifies that §7609 third-party summonses are not church tax inquiries or examinations.[124]

Thus, the court affirmed that §7609 exclusively governs third-party summonses, even within the context of church tax inquiries and examinations.[125] Contrary to GSH's interpretation, §7611 procedural requirements do not apply to third-party summonses, as clarified by case law.[126] Therefore, IRS compliance with §7611 is irrelevant to the validity of third-party summonses, which are subject only to §7609 administrative steps as analyzed under the *Powell* case.

Holding. The court affirmed the district court's judgment denying GSH's petition to quash the third-party summons because the IRS summons needed to follow only the provisions of §7609, not §7611.

122. IRC §7609, together with the decision in *U.S. v. Powell*, 379 U.S. 48 (1964), govern the validity of the third-party summons. To enforce the summons, the IRS must establish all four of the *Powell* factors. The fourth *Powell* prong requires that IRS shows it followed all requisite administrative steps. As relevant to the issues on appeal, the court discussed the fourth prong only.

123. *Standing Akimbo, LLC v. U.S.,* 955 F.3d 1146 (10th Cir. 2020).

124. See IRC §7611(h).

125. See, e.g., *U.S. v. C.E. Hobbs Found. for Religious Training & Educ., Inc.,* 7 F.3d 169, 173 (9th Cir. 1993).

126. *Bible Study Time, Inc. v. U.S.*, 240 F. Supp. 3d 409, 420–21 (D.S.C. 2017).

Tax Preparer Fraud

***Stephanie Murrin v. Comm'r*, TC Memo 2024-10 (Jan. 24, 2024)**
IRC §6501(c)

☞ Tax Preparer's Fraud Catches Up with Taxpayer 20 Years Later

Facts. Stephanie Murrin and her then-husband employed the services of a tax return preparer, Duane Howell, to prepare their joint federal income tax returns and income tax returns for two partnerships in which Ms. Murrin was a general partner for tax years 1993 through 1999. Unbeknownst to the Murrins, Mr. Howell had previously had his CPA license revoked for preparing false tax returns but was continuing to prepare tax returns without listing his name as the preparer, instead listing various entity names with different addresses. Mr. Howell would later testify that nearly every return he prepared during a decade-long period included fraudulent entries, including the following.[127]

- Setting up false partnerships
- Deducting Keogh plan contributions without verifying the taxpayer made the contributions
- Deducting fabricated business expenses he made up without his clients' knowledge, often using the same amount of expenses across all the returns he prepared, which would result in reported net business income of exactly $2

Mr. Howell entered false and fraudulent information on the returns to evade tax without the knowledge of the Murrins. The Murrins did not enter any false or fraudulent information themselves and did not intend to evade tax. The IRS found the fraudulent information after the 3-year period of limitation had passed. In 2019, the IRS issued a notice of deficiency for the years at issue, utilizing the fraud exception for the statute of limitations.

Issues. The issue is whether IRC §6501(c) applies only when a taxpayer has personally filed a false or fraudulent return with the intent to evade tax.

Analysis. Under Rule 142(b), the IRS has the burden of proof to show fraud with the intent to evade tax. Although the IRS has the burden of proof to prove the issue of fraud, the Murrins claimed Mr. Howell committed fraud with the intent to evade tax. IRC §6501(a) states that there is a 3-year period for the IRS to assess tax after a federal income tax return is filed. Under §6501(c)(1), there is no time limit to assess tax if there is a "false or fraudulent return with the intent to evade tax." Under precedent, §6501(c)(1) applies even when it is the tax return preparer behind the false or fraudulent return with the intent to evade tax.[128] Ms. Murrin requested a reconsideration of this decision and to hold that §6501(c) applies solely to taxpayer fraud.

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The court does not revisit the statutory analysis for a prior decision unless there is special justification. The case proposed by Ms. Murrin as special justification was not clear on the point of contention and the Federal Circuit does not have jurisdiction to appeal any Tax Court decision. Under §6501(c)(1), limitations statutes preventing the collection of taxes are also strictly construed in favor of the Government. When the language in the statute is clear and it aligns with Congress's intentions, that language is regarded as conclusive.[129]

IRC §6501(c)(1) states that "in the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time." If there was intent to evade tax in a false return, it is irrelevant who possessed that intent. There is no requirement that the taxpayer must be the party with the intent to evade tax to qualify under the provision.

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127. *Limitation Period Extended Due to Preparer Fraud.* Beavers, James A. Sep. 1, 2016. AICPA. [www.thetaxadviser.com/issues/2016/sep/limitation-period-extended-due-to-preparer-fraud.html] Accessed on Aug. 6, 2024.

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

129. *Byrd v. Shannon*, 715 F.3d 117, 122 (3d Cir. 2013).

Ms. Murrin argued that §6501(c)(1) should be interpreted similarly to IRC §6663(a). IRC §6663(a) imposes a penalty if there is fraud on a tax return leading to an underpayment of tax. There is an exception in IRC §6664(c)(1) where taxpayers are not penalized if they can show reasonable cause and good faith. Although §6663 was originally close in placement to §6501(c)(1) within the Revenue Act of 1918 (Act), identical terms or phrases in the Code do not have to be interpreted to have the same meaning if the statutes have different legislative purposes.[130] The purpose of §6501(c)(1) is to provide the IRS with adequate time to assess a tax liability in cases of false or fraudulent returns because of the associated higher difficulty in investigation. The purpose of §6663(a) is to impose a civil penalty to punish taxpayers who commit fraud and to reimburse the Government, and therefore, the statute is attached to the intent of a particular taxpayer.

Ms. Murrin also argued that §6501(c)(1) should be interpreted according to IRC §7453(a). IRC §7453(a) states that Congress considers the fraudulent intent of only the taxpayer when pursuing fraudulent actions. Congress included this language in one section of the same Act but did not include that language in §6501(c)(1). The court argued this omission shows Congress acted purposely and intentionally when deciding whether to include or exclude the language in different sections of the Act. The court found the language in §6501(c)(1) unambiguous and saw no need to turn to legislative history to interpret the statute.

Holding. The court held in favor of the IRS, finding Mr. Howell's preparation of false or fraudulent returns with the intent to evade tax qualifies for an indefinite statute of limitation to assess tax on Ms. Murrin.

Offer in Compromise

***Justin C. Cloar v. Comm'r*, TC Memo 2024-17 (Feb. 6, 2024)**
IRC §§6330 and 7122

☞ No Abuse of Discretion in Rejecting Lowball Offer

Facts. Justin Cloar timely filed income tax returns for the years at issue: 2008, 2009, 2010, and 2012. However, he failed to pay the full tax due and had income tax liabilities amounting to $107,410. In 2017, the IRS issued him a Notice LT11, *Notice of Intent to Levy and Notice of Your Right to a Hearing*. Mr. Cloar submitted a Collection Due Process (CDP) hearing request and a Form 9465, *Installment Agreement Request*. Mr. Cloar proposed an installment agreement where he would pay $25 a month. As an alternative, he proposed that the IRS place him in currently-not-collectible (CNC) status, accept an offer in compromise (OIC), and/or abate any penalty.

An IRS settlement officer sent a letter to Mr. Cloar scheduling a CDP hearing and requesting financial documentation. During the hearing, Mr. Cloar's representative stated that Mr. Cloar intended to submit an OIC and was no longer seeking an installment agreement or CNC status. Mr. Cloar submitted an OIC of $756 to settle his tax liability for the years at issue.

IRS's Centralized Offer in Compromise (COIC) unit found that Mr. Cloar had a reasonable collection potential (RCP) of $18,824 and recommended that the IRS Independent Office of Appeals (Appeals) reject his OIC. The COIC unit found that Mr. Cloar had $5,249 of monthly income, total monthly expenses of $4,358, and total assets of $8,132, the value of his state retirement account.

The settlement officer informed Mr. Cloar's representative that the OIC was rejected because he failed to disclose all income and expenses, and the OIC was not in the government's best interest. The settlement officer floated the option of placing Mr. Cloar's account into CNC status if he withdrew his OIC. Mr. Cloar refused this offer, and Appeals upheld the rejection of Mr. Cloar's OIC and issued him a notice of determination in November 2018.

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130. *Yarish v. Comm'r*, 139 TC 290, 297 (2012).

Mr. Cloar was terminated from his job at the Arkansas Public Defenders Commission in September 2019 after he filed his case in court. Mr. Cloar and the IRS jointly requested the remand of Mr. Cloar's case to Appeals in October 2020 because of his unemployment, and another CDP hearing was scheduled. Mr. Cloar liquidated his retirement account, and after state and federal tax deductions, Mr. Cloar transferred the remaining $8,829 to the IRS. Mr. Cloar submitted his OIC and offered $25 to resolve his remaining tax liabilities. He reported zero income and no equity in his retirement account.

However, in examining Mr. Cloar's reports, the COIC unit found that Mr. Cloar had an RCP of $23,155. It found Mr. Cloar had $8,132 in assets, $4,762 in monthly income, and $3,510 in monthly expenses, resulting in $1,252 monthly that could be paid towards his tax liabilities. The monthly income was calculated using the income from 2018 and 2019. At the time of the calculation, Mr. Cloar had been unemployed for two years. The COIC unit rejected the OIC of $25 because it was below the RCP of $23,155. Subsequently, Appeals affirmed the rejection and issued a supplemental notice of determination on May 16, 2022.

Issue. The issue in this case is whether the determination of Appeals to reject Mr. Cloar's OIC offer of $25 was arbitrary, capricious, or without sound basis in fact or law.

Analysis. The court determined whether Appeals abused its discretion using the following factors: whether the settlement officer verified that the requirements of the applicable law or administrative procedure were met, considered relevant issues raised by Mr. Cloar, and whether the proposed collection action balances the efficient collection of taxes with the concern that collection be no more intrusive than necessary.

The settlement officer satisfied the verification requirement, and Mr. Cloar did not claim otherwise or provide any facts to support another position. The IRS can reject an OIC when the taxpayer's RCP exceeds his offer.[131] The court's job is to review for abuse of discretion and determine whether the settlement officer's actions were arbitrary, capricious, or without sound basis in fact or law.[132] The court will not determine the RCP of the taxpayer or whether the COIC unit's determination was completely accurate. The settlement officer considered all the facts and circumstances and found that Mr. Cloar's RCP exceeded his OIC offer of $25. Therefore, the settlement officer did not act in an arbitrary and capricious manner when she rejected Mr. Cloar's OIC.

The IRC §6330(c)(3)(C) balancing test weighs the need for efficient collection of taxes against the objective of making collection action no more intrusive than necessary. The settlement officer balanced the competing interests and considered Mr. Cloar's unemployment when she decided to reject his OIC. The court noted that Mr. Cloar declined to be placed into CNC status. In light of this, the settlement officer did not abuse her discretion in determining that the balancing requirement was met.

Holding. The court upheld Appeal's supplemental determination because it found no abuse of discretion.

> **Note.** For more information on OICs, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 7: IRS Update.

131. See *Johnson v. Comm'r*, 136 TC 475, 486 (2011).

132. See *Thompson v. Comm'r*, 140 TC 173, 179 (2013); *Murphy v. Comm'r*, 125 TC 301, 320 (2005).

Underpayment Penalties

***Burt Kroner v. Comm'r*, TC Memo 2024-41 (Apr. 8, 2024)**
IRC §§6662(c), 6664(c), and 6751(b)

☞ Tax Court Assesses Penalties After IRS Appeal

Facts. Burt Kroner worked in the discounted cashflow industry and developed a relationship with David Haring, who provided emergency funding to Peachtree Settlement Funding. Mr. Kroner received from Mr. Haring $4,425,000 in 2005, $15,350,000 in 2006, and $5 million in 2007. Robert Bernstein, a lawyer who represented both Mr. Haring and Mr. Kroner, told Mr. Kroner that the transfers were excludable from income. Mr. Bernstein gave this advice based on a conversation with Mr. Kroner and a note Mr. Bernstein drafted with Mr. Mitchell, an associate of Mr. Haring. Mr. Kroner did not report any of the transfers as income. During this time, Peachtree investors received substantial payments when the company received an injection of private equity funding, went public on the London Stock Exchange, and eventually was acquired by Credit Suisse. The court used the term "liquidity events" to identify these payments to Peachtree investors.

In the Tax Court's original 2020 decision,[133] it rejected Mr. Kroner's version of events for the following reasons.

- A lack of evidence
- Doubts about the authenticity of the note from Mr. Haring stating he wanted to make Mr. Kroner a monetary gift
- The coincident timing of liquidity events by Mr. Haring as an investor in Peachtree
- Willingness by Mr. Kroner and Mr. Haring to enter into nominee arrangements and the nature of the relationship between the two

Mr. Kroner could not invest in Peachtree because he had signed a noncompete agreement. Peachtree had three liquidity events and shortly after each event, Mr. Haring transferred money to Mr. Kroner.

Mr. Bernstein became Mr. Kroner's tax attorney in 1996, and he also represented and provided Mr. Haring with tax advice for the transfers. Mr. Bernstein did not discuss with Mr. Haring his intentions for the transfers. Mr. Bernstein reviewed the note provided to Mr. Kroner and told Mr. Kroner the transfers would be tax-free. Mr. Kroner's accountant prepared his Form 1040, *U.S. Individual Income Tax Return,* without information about the transfers from Mr. Haring, and Mr. Bernstein prepared Mr. Kroner's Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.*

Although the court found Mr. Kroner liable for tax on the transfers he received, it decided that the IRS supervisor had not provided written approval before the first notice of potential penalties was sent on August 6, 2012. Thus, the Tax Court held in 2020 that the IRS had not complied with procedural requirements, so Mr. Kroner was not liable for accuracy-related penalties.[134]

On appeal, the U.S. Court of Appeals for the Eleventh Circuit did not agree with the Tax Court's conclusion that the IRS had not complied with IRC §6751(b) and reversed the lower court's decision concerning the penalties.[135] Thus, the Tax Court was required to impose the penalties requested by the IRS.

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133. *Burt Kroner v. Comm'r*, TC Memo 2020-73 (Jun. 1, 2020), *rev'd* 48 F.4th 1272 (11th Cir. 2022).

134. IRC §6662(a).

135. *Kroner v. Comm'r,* 48 F.4th 1272 (11th Cir. 2022), *rev'g* TC Memo 2020-73 (Jun.1, 2020).

Issues. The issues in this case are the following.

- Whether Mr. Kroner is liable for IRC §6662 accuracy-related penalties for 2005, 2006, and 2007
- Whether the IRC §6664(c) reasonable cause exception applies to the penalties
- Whether the IRS complied with the supervisory approval requirements of §6751(b)

Analysis. Under §6662, there is a 20% penalty for the amount of underpaid tax if there is either of the following.

- Substantial understatement of income tax, or
- Negligence or disregard of rules or regulations

An understatement is **substantial** if it is at least 10% of the tax required to be reported for the year or $5,000, whichever is greater. As the understatements in this case are substantial, the court did not need to determine whether the underpayments were due to negligence or disregard. If there was reasonable cause for the underpayment and the taxpayer acted in good faith, §6664(c)(1) states that the §6662 penalty does not apply.

Mr. Kroner claimed that he relied on professional advice given by Mr. Bernstein, and therefore, he had reasonable cause and acted in good faith. A taxpayer needs to demonstrate three elements for reasonable cause.

1. The adviser was a competent professional who had sufficient expertise.
2. The taxpayer provided necessary and accurate information to the adviser.
3. The taxpayer indeed relied in good faith on the adviser's judgment.[136]

Mr. Kroner did not demonstrate that he provided Mr. Bernstein with the necessary and accurate information. Mr. Bernstein did not know about the large transfer amounts, the dates of the transfers, or to which accounts the transfers were made. Mr. Bernstein also did not know about the noncompete agreement preventing Mr. Kroner from investing in Peachtree, the Peachtree liquidity events, or details of Mr. Kroner's and Mr. Haring's business and personal relationship. Furthermore, Mr. Bernstein had no knowledge that the transfers were made shortly after liquidity events and distributions were made to Mr. Haring as a Peachtree investor.

The record indicates that Mr. Kroner did not provide Mr. Bernstein with the necessary information to properly advise him about the tax consequences of the transfers. Mr. Kroner also did not rely in good faith on Mr. Bernstein's advice because Mr. Kroner did not inform his accountant about the transfers from Mr. Haring. Therefore, Mr. Kroner has not proven that he had reasonable cause or acted in good faith for the tax underpayments.

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The Appeals Court for the 11th Circuit decided that the IRS has satisfied the timing requirements of §6751(b)

> *[a]s long as a supervisor approves an initial determination of a penalty assessment before it* ***assesses*** *those penalties.* [emphasis added]

The appellate court concluded that the IRS had not assessed the penalties when it provided Mr. Kroner with its August 12, 2012, letter proposing penalties. On the contrary, the IRS made the formal assessment after the supervisor signed the approval document on October 31, 2012. Therefore, the appellate court reversed the Tax Court's prior decision that disallowed Mr. Kroner's penalties and remanded the case to the Tax Court to hold Mr. Kroner liable for the §6662(a) penalties.

Holding. The court held that Mr. Kroner is liable for taxes on the unreported income from liquidity events and accuracy-related penalties for the years at issue. The reasonable cause exception does not apply. The IRS correctly followed procedures for supervisory approval before it assessed penalties.

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136. See *Neonatology Assocs., P.A. v. Comm'r*, 115 TC 43, 99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

Passport Revocation

***Daniel Olin Nye v. Comm'r,* TC Memo 2023-154 (Dec. 28, 2023)**

IRC §§6672 and 7345

☞ Court Grounds Taxpayer for Tax Deficiencies

Facts. Daniel Nye filed timely tax returns for 2011 to 2016 but failed to collect, account for, and pay social security and federal income taxes withheld from employees. Under IRC §6672, the IRS assessed civil trust fund recovery penalties against Mr. Nye for the years 2011 to 2016. For those years, the assessed deficiencies and civil penalties, including interest, totaled $99,222 (including interest of $19,685) as of February 27, 2023.

The IRS filed notices of federal tax lien, sending copies to Mr. Nye to inform him of his right to request a Collection Due Process (CDP) hearing. These notices were mailed between December 2014 and June 2018 for each year and period at issue. On January 11, 2017, Mr. Nye requested a CDP hearing concerning the 2016 notice associated with the 2015 income tax deficiency. The IRS Office of Appeals resolved the hearing in July 2017 and issued a notice of determination. Mr. Nye did not request a CDP hearing concerning any other notice and did not petition the court after the 2017 notice of determination.

On July 30, 2018, the IRS certified Mr. Nye as an individual owing a seriously delinquent tax debt arising from the years and periods at issue and for income tax deficiencies for 2008 and 2009. Mr. Nye entered into an installment agreement with the IRS on October 3, 2018, and established a monthly payment of $318. The installment agreement was conditional upon periodic reviews of Mr. Nye's financial condition. On November 12, 2018, the IRS reversed Mr. Nye's certification as an individual owing a seriously delinquent tax debt. The installment agreement payments were applied against Mr. Nye's tax liabilities for 2008 through 2010, in chronological order, until the remaining balance for each year was written off because the statute of limitations expired.

On November 7, 2022, the IRS mailed Mr. Nye a notice of intent to levy for each year and period at issue. The notice stated that Mr. Nye did not provide the required updated financial statements and that Mr. Nye could either provide the updated financial statements or request a Collection Appeals Program hearing. However, the notice stated that if Mr. Nye failed to do either, his installment agreement would be terminated. Mr. Nye did not request the hearing or provide the requested information.

The IRS terminated the installation agreement on January 9, 2023. On February 27, 2023, the IRS recertified Mr. Nye as an individual owing a seriously delinquent tax debt. The IRS also sent Mr. Nye a Notice CP508C, *Notice of Certification of Your Seriously Delinquent Federal Tax Debt to the State Department* (Passport Notice).

Issue. The issue in this case is whether the IRS erred in certifying Mr. Nye as having seriously delinquent tax debt related to income tax deficiencies for 2012 to 2015 and civil trust fund recovery penalties for 2011 to 2016.

Analysis. When the IRS certifies that a taxpayer has a seriously delinquent tax debt, IRC §7345 requires the certification to be transmitted to the Secretary of State for action concerning the denial, revocation, or limitation of the taxpayer's passport. A seriously delinquent tax debt is a federal tax liability that:

- Has been assessed,
- Exceeds $50,000, adjusted for inflation,
- Is unpaid and legally enforceable, and
- Is the subject of a completed levy or a filed lien notice with all administrative rights exhausted or lapsed.

IRC §7345(e)(1) permits a taxpayer who has been certified as having a seriously delinquent tax debt to petition the court to determine whether the certification was erroneous. If it was erroneous, the IRS must reverse the certification and notify the Secretary of State and the taxpayer.

The IRS met the criteria to certify that Mr. Nye had a seriously delinquent tax debt and supplied the account transcripts and the notices of intent to levy for the years and periods at issue. All the notices (with all administrative rights exhausted or lapsed) had been filed. Mr. Nye did not request a Collection Appeals Program hearing or a CDP hearing for any of the tax liabilities other than the one for 2015. The record shows that at the time of certification, Mr. Nye's liabilities met the statutory definition of seriously delinquent tax debt.

Mr. Nye claimed that when the IRS issued the notices and requested additional documents, he provided the documents within the allowed timeframe. He further asserted that he had not defaulted on the installment agreement and continued making his monthly payments until petitioning the court. However, there was no evidence supporting Mr. Nye's claim from either party that he submitted documentation. Thus, Mr. Nye failed to establish this argument as a disputed material fact.

Holding. The court granted summary judgment to the IRS because the certification of seriously delinquent tax debt was not erroneous.

Importance of Proof of Mailing

***John Peter Zaimes v. Comm'r,* TC Memo 2023-121 (Sep. 26, 2023)**

IRC §6651, 6654, and 7502

☞ Refresher Course on the Mailbox Rule

Facts. Having extended his 2015 tax return before the due date of April 18, 2016, John Peter Zaimes thought he had filed his tax return on October 17, 2016. The return showed that Mr. Zaimes owed $118,145 for his 2015 tax liability. Mr. Zaimes included a check for $58,145 with his tax return, even though it was not the total amount due. His tax practitioner, a CPA, recommended that he send the return by regular U.S. mail. He claimed that he had placed his signed return in a manilla envelope with a postmark from a private meter, not a U.S. Postal Service (USPS) postmark. On his way to board a plane at Los Angeles International Airport later that evening, Mr. Zaimes deposited the envelope in a drive-up mailbox. However, he did not retain evidence of the IRS address to which he mailed the package or evidence of the postage.

At some point within the ensuing 13 months, Mr. Zaimes noticed that the IRS had not cashed his check. Accordingly, he electronically filed his 2015 tax return on November 13, 2017, more than a year after the extended due date. This return showed an unpaid balance of $110,693, including an estimated tax penalty. He did not submit a payment with the electronically filed return.

Within a month of receiving the electronically filed return, the IRS processed it and mailed Mr. Zaimes a notice of tax due and demand for payment on the same day. This notice assessed interest of $8,405, a $24,213 addition to tax for late filing his 2015 return, and a $10,761 addition to tax for not paying the balance due on time. He was also assessed a $3,078 estimated tax penalty.

In March 2018, Mr. Zaimes paid $100,000 toward the balance due. Although the IRS credited his account with that amount, six months later, it sent him a "Notice of Federal Tax Lien Filing and Your Right to a Hearing under IRC 6320." Mr. Zaimes mailed a request for a Collection Due Process (CDP) hearing on a timely basis, which the IRS did receive. In it, Mr. Zaimes claimed that he filed his 2015 return on time and should not be responsible for the penalties. He also claimed to have evidence that he had filed on time.

At the CDP hearing, Mr. Zaimes agreed that he owed the tax due but stated that the IRS should abate the penalties because he claimed he had filed the return on time and included a payment, even though it was not the full payment. He did not request a collection alternative.

Roughly two months later, the settlement officer from the CDP hearing declined his invitation. She determined he did not establish that he had filed his 2015 return on time. Researching the possibility of first-time abatement, she found that he had late-filed and late-paid returns for the three previous years.

Mr. Zaimes filed a petition for review by the Tax Court but raised no additional issues.

Issues. The issues in this case are the following.

- Whether Mr. Zaimes is liable for the addition to tax under IRC §6651(a)(1) for failing to file his 2015 income tax return on time
- Whether Mr. Zaimes is liable for the addition to tax under §6651(a)(2) for failing to pay the amount shown on his 2015 tax return on time

Analysis. The court reviewed the requirements for mailing a tax return on time. It cited Treas. Reg. §301.7502-1(c)(1), which imposes three requirements for the "postbox" rule to apply.

1. The envelope is properly addressed to the IRS office where the IRS requires the return to be filed.
2. The envelope is timely deposited in U.S. mail.
3. The envelope has either a USPS postmark on the envelope **made by the U.S. Postal Service** or another postmark that clearly shows the date mailed and that the date is on or before the due date for the return.

The court concluded that Mr. Zaimes did not file his 2015 return on time, even though he mailed it on the due date. It reached this conclusion after determining that the return was never delivered to the IRS, which is one of the requirements for the mailbox rule.[137] Because Mr. Zaimes had no proof of the address on the envelope, he failed the test of Treas. Reg. §301.7502-1(c)(1)(i), which requires taxpayers to address the envelope to the correct IRS office. In Mr. Zaimes' case, the proper address was an IRS post office box listed in the 2015 Instructions for Form 1040, *U.S. Individual Income Tax Return,* but he could not prove that he had properly addressed the envelope.

The regulations impose another requirement that the envelope must have sufficient postage. However, Mr. Zaimes could provide no evidence that he had affixed adequate postage, although he told the court that he had applied "a postage strip on it covering the necessary postage." Although postage from private postage meters is allowed, Mr. Zaimes provided no evidence that he applied the proper postage. Similarly, he did not provide evidence that a timely and legible postmark had been applied to his envelope.

After rejecting Mr. Zaimes' reasons for failing to file the return on time, the court turned to his reasons for failing to pay the tax due on time. The court found no basis for his claim that paying by the extended due date was evidence of his attempt to pay his tax on time, noting that the tax was due six months earlier in April on the unextended due date. The court quoted a 2004 case stating that reasonable cause for failure to pay is established on the unextended due date.[138]

> *The reasonable cause standard is a one-time test to be passed or failed at the payment due date.*

Thus, Mr. Zaimes was also found liable for the failure-to-pay penalty of §6651(a)(2).

Holding. The Tax Court found Mr. Zaimes liable for the failure to file addition to tax and the failure to pay addition to tax.

Practitioner Planning Tip

When sending physical documents to the IRS, using certified mail (or other USPS methods with tracked proof of delivery) can avoid many of the issues that Mr. Zaimes unsuccessfully faced.

137. Treas. Reg. §301.7502-1(e)(1).

138. *Estate of Hartsell v. Comm'r*, TC Memo 2004-221 (Sep. 21, 2004).

Multiple IRS Errors on Appeal

***Daniel and Christine Larkin v. Comm'r*, TC Memo 2023-106 (Aug. 16, 2023)**

IRC §§6211, 6651, 6662, and 7486

☞ Win, Lose, or Draw for UK Attorney and IRS

Facts. Previous Tax Court decisions found that Daniel Larkin, an attorney working in the United Kingdom, owed additional taxes and penalties for 2003–2006.[139] In his capacity as a partner in a large law firm, Mr. Larkin earned around $400,000 per year but paid no U.S. tax. Upon exam, the IRS determined he was liable for $524,140 of federal taxes, additions to tax under IRC §6651(a)(1), and penalties under IRC §6662(a) totaling $104,828.

On appeal, the U.S. Court of Appeals for the District of Columbia Circuit affirmed the Tax Court's opinion except for four errors acknowledged by the IRS. The court of appeals partly vacated the Tax Court's decision and remanded the cases to correct assessments involving the four years of tax returns. By this point, the IRS had twice revised its computations. The four errors involved the following matters.

1. Inclusion of self-employment tax in computing the tax liabilities for each year
2. A $27 increase in 2003 income
3. Inclusion of an excess $10,792 of §6662(a) penalty for 2004
4. An erroneous inclusion of $1,948 of income in 2006

Issue. The issue in this case is whether the IRS has corrected errors in assessing income tax, additions to tax, and penalties due from Mr. Larkin.

Analysis. On remand from the court of appeals, the Tax Court requested the IRS and Mr. Larkin revise their filings. The IRS obtained an extension of time to submit its filing and submitted a recalculation of the amounts due. Mr. Larkin, representing himself, did not respond to the Tax Court's request. Shortly after this, though, an attorney began representing the Larkins. This attorney requested additional time to comment on the IRS calculations. The Tax Court was unable to confirm the IRS calculation, finding discrepancies between the IRS amended calculation and the amounts that the Tax Court had previously determined.

The Larkins' attorney argued that the Tax Court could not find a deficiency in their tax liabilities if the IRS had made assessments that **had not been abated,** citing IRC §6211(a). Therefore, the Larkins' attorney requested that the Tax Court direct the IRS to prove that there were no existing assessments for 2003–2006.

In response, the Tax Court requested both sides do additional work. The court asked both parties to explain a "defaulted [automated underreporter] AUR notice" that caused assessments for tax related to 2004. In response, the Larkins told the Tax Court they never received the AUR notice. They also asserted the IRS should exclude the missing AUR notice amounts from its calculations. Further, the Larkins contended the IRS abated the Larkins' 2005 and 2006 tax liabilities. Finally, the Larkins argued, based on IRC §7486 and the *Estate of Smith* case, they should be able to apply their foreign tax credits to any tax liability they may have for 2004.

Because the IRS filed still more corrections, the Tax Court provided Mr. and Mrs. Larkin another opportunity to object to the agency's filings. The Larkins used this opportunity to remind the court that the IRS had abated their 2005 and 2006 tax liabilities. They claimed sufficient foreign tax credits to offset any remaining tax liability. Furthermore, they questioned whether the IRS had met the burden of proof that it had obtained a timely supervisory approval of the penalties it sought from the Larkins.

139. *Larkin v. Comm'r*, TC Memo 2017-54 (Apr. 3, 2017).

In response to the confusing volley of arguments, the Tax Court agreed with neither side. However, it found the IRS had provided enough information to allow the court to correct the four errors and comply with the court of appeals' instructions. However, the Tax Court could not reconsider issues raised in the initial trial that were accepted, yet not part of the court of appeals' remand. With this reasoning, the Tax Court refused to entertain the Larkins' arguments in response to the IRS's new calculations.

Examining the claims year-by-year, the Tax Court disagreed with the Larkins' claim that they did not receive the notice of deficiency. Instead, the Tax Court only corrected the penalty the IRS included twice. It took note of Mr. Larkin's experience as an attorney, noting that he should have been aware of the obligation to plead issues that he wanted the court to consider.

The Tax Court also rejected any notion that it should require the IRS to abate any assessments before entering revised decisions. The court clarified that §7486 is a "procedural device" irrelevant to the Larkins' case. Similarly, the court rejected the Larkins' claim that the IRS had abated the tax due for 2005 and 2006. This issue was not part of the remand instructions from the court of appeals. The Tax Court also refused to permit the Larkins to carry back any foreign tax credit to reduce their 2004 tax liability.

Citing the restricted scope of instructions from the appeals court, the Tax Court declined to pursue the Larkins' argument that the IRS personnel did not first obtain the appropriate supervisory approval under IRC §6751(b).

Holding. The Tax Court held that the IRS corrected errors in determining income tax, additions to tax, and penalties that Mr. and Mrs. Larkin owed the U.S. Treasury. The corrections reduced the Larkins' tax liability by more than $100,000, even though it found the Larkins' arguments to reduce it further without merit.

Reasonable Cause for Failure of Timely Filing

***Wayne Lee v. U. S.*, No. 8:21-cv-01579 (11th Cir. 2023)**

IRC §§6511 and 6651

☞ Reasonable Cause Argument for e-Filing Reaches Boyle-ing Point

Facts. Wayne Lee, a surgeon residing in Florida, engaged Kevin Walsh, a CPA, to prepare and file his individual income tax returns. For each tax year from 2014 through 2016, Dr. Lee reported over $1 million in gross receipts. In 2014, Dr. Lee had a significant overpayment that was applied to his 2015 tax return, which in turn resulted in an overpayment that was applied to the 2016 tax return. Dr. Lee reviewed the tax returns each year and signed Form 8879, *IRS e-file Signature Authorization*, to give Mr. Walsh authorization to electronically file his returns. However, while Mr. Walsh prepared the 2014, 2015, and 2016 income tax returns, he did not file them. Because the IRS had an incorrect address for him, Dr. Lee did not receive IRS notices advising him of the unfiled tax returns. It was not until an IRS agent visited Dr. Lee's office in December 2018 that Dr. Lee became aware of the issue. Shortly after, Dr. Lee filed his prepared 2014 through 2016 tax returns.

Because of the 3-year lookback period,[140] the IRS disallowed Dr. Lee's overpayment calculated on his 2014 tax return. Consequently, Dr. Lee owed income tax for the 2015 and 2016 tax years. Combined with failure-to-file and failure-to-pay penalties, Dr. Lee was liable for $289,183 owed to the IRS, which he paid in August 2019. Dr. Lee eventually filed a lawsuit against Mr. Walsh and his firm, and they settled in 2020. Dr. Lee subsequently filed a lawsuit against the United States for a refund of his taxes and fees, arguing that reliance on his CPA to file his tax returns was reasonable cause. The U.S. District Court for the Middle District of Florida did not rule in his favor, finding *U.S. v. Boyle*[141] was precedent for "reliance on an agent" alone being insufficient for "reasonable cause." In response, Dr. Lee appealed.

140. IRC §6511(b)(2)(A).

141. *U. S. v. Boyle*, 469 U.S. 241 (1985).

Issues. The issues in the case are the following.

- Whether *Boyle* applies to e-filed tax returns
- Whether Dr. Lee demonstrated reasonable cause under IRC §6651 for filing his returns late
- Whether the IRS incorrectly assessed the failure-to-pay penalties

Analysis. The court first tackled the issue of whether *Boyle*, which found that the sole reliance on an agent to file tax returns is an insufficient defense for reasonable cause, applies to e-filed tax returns. Dr. Lee argued that Form 8879 exempts e-filing from the bright line rule that *Boyle* establishes for paper filing. He stated that the form demonstrates that e-filing fundamentally differs from paper filing. Specifically, Dr. Lee explained that the issue in *Boyle* pertains to the taxpayer delegating the task of **preparing** the return, while in his situation, the issue at hand was his delegating the task of **filing** the return. Through this delegation, Mr. Walsh's failure to file his returns was beyond his control. The court disagreed, stating that Form 8879 is an authorization form allowing an agent to submit a tax return and does not constitute an action of a taxpayer filing a tax return. Consequently, signing Form 8879 does not absolve the taxpayer from exercising ordinary business care and prudence when filing a return or paying any tax due. Dr. Lee is still responsible for ensuring the tax return was prepared and submitted.

Further, circumstances beyond the taxpayer's control in the context of *Boyle* include only instances such as postal delays and taxpayer disabilities or illnesses. Dr. Lee's situation differed from these criteria, and signing Form 8879 did not alter his duty to exercise ordinary business care and prudence. While *Boyle* dealt with the paper filing of a tax return and Dr. Lee's situation involves the electronic filing of a return, the issue at hand of a taxpayer relying on an agent remains the same: taxes and penalties under §6651 apply equally to e-filed returns and paper-filed returns.

Dr. Lee also argued that e-filing is a task undertaken by tax preparers and not ordinary taxpayers, using the mandated e-filing requirement for specified tax return preparers[142] as a demonstration of Congress's intent. Essentially, Dr. Lee argued that once he signed Form 8879 after reviewing the tax returns and verifying they were indeed prepared, it was the responsibility of Mr. Walsh and the CPA firm to file his tax returns. The court also disagreed with this argument, stating that Dr. Lee was not forced to work with Mr. Walsh and retained full control over the engagement. While the court acknowledged Mr. Walsh may have failed to fulfill his contractual and ethical obligations to Dr. Lee and could theoretically reimburse him for damages resulting from such negligence, the court found that Mr. Walsh did not assume Dr. Lee's obligation to file a tax return on time and pay any tax due.

The court next assessed Dr. Lee's argument that he demonstrated reasonable cause for both filing his returns late and paying the tax due late under §6651. The court found Dr. Lee did not demonstrate reasonable cause regarding his late filings or late payments, regardless of the applicability of *Boyle*. As indicated in its earlier analysis, the court did not find that the filing medium, whether paper-filing or e-filing, alters the reasonable cause analysis under §6651. In assessing the exercise of ordinary business care and prudence, the court pointed out that Dr. Lee did not confirm whether Mr. Walsh filed his income tax returns. Instead, he assumed Mr. Walsh had filed them. As such, Dr. Lee's reliance on Mr. Walsh for filing the tax returns did not meet the reasonable cause standards under §6651(a)(1) for filing a tax return late.

The same fact patterns also pertain to Dr. Lee's late payment of taxes. While the disallowance of Dr. Lee's overpayment on his 2014 income tax return to 2015 and 2016 resulted in income tax due, had Dr. Lee verified that his 2014 income tax return was timely filed, he would have applied his overpayment to his 2015 and 2016 income tax returns. Dr. Lee's failure to pay his taxes on time did not result from financial hardship, unavailable records, or other events outside of his control,[143] but rather solely from his assumption that he would not have to pay 2015 and 2016 income tax because his 2014 income tax overpayment was applied to any tax due in those years.

142. TD 9518, 2011-17 IRB 710.

143. Treas. Reg. §301.6724-1(c).

Finally, the court assessed Dr. Lee's argument that the IRS incorrectly assessed the failure-to-pay penalties. The court identified that Dr. Lee did not make this argument before the district court, only presenting his arguments that *Boyle* did not apply to e-filed returns, and he was excused from failure to file and failure to pay penalties under reasonable cause. Because Dr. Lee first presented the argument of the IRS incorrectly assessing the failure-to-pay penalties on appeal, the court refused to consider the argument.

Holding. The district court held that *Boyle* applies to e-filed tax returns, and as such, Dr. Lee's reliance on his CPA to timely file his tax returns is not due to reasonable cause. Thus, the failure-to-file and failure-to-pay penalties under §§6651 and 6656 cannot be abated. The district court did not address whether the IRS assessed the failure-to-pay penalties incorrectly. The 11th Circuit Court of Appeals affirmed the decision made by the U.S. District Court for the Middle District of Florida.

> **Note.** This case specifically applies *Boyle* to e-filed returns. It establishes that by signing Form 8879, taxpayers have not fulfilled their responsibility to timely file tax returns and pay taxes due. While practitioners should exercise diligence in ensuring they are timely e-filing their clients' tax returns when authorized, taxpayers should be aware they are not personally relieved of their responsibilities when working with tax preparers.

PASSIVE ACTIVITIES

Net Investment Income Tax

***James and Catherine Senty v. Comm'r,* No. 22-cv-283-wmc (W.D.Wis. Dec. 15, 2023)**
IRC §§469 and 1411

☞ Let Sleeping NIIT Refunds Lie

Facts. James Senty holds leadership roles at multiple companies, manages apartment buildings, and owns farms in Wisconsin and Minnesota. Mr. Senty was the president of Deerfield Finance Corporation (DFC), Reconyx, Inc., Park Capital, LLC, and several other companies in 2014 and 2015. During those two years, Mr. Senty worked 65–70 hours per week but **did not keep any record of his time.** He estimated he worked more than 100 but less than 500 hours for Deerfield, Reconyx, and Park Capital during 2014 and 2015.

Both Mr. Senty and his son Paul worked for DFC in 2014 and 2015. Mr. Senty claimed that in 2014 and 2015, he worked more than 255 hours for DFC, and worked as a consultant, reviewed financial statements, monitored the performance of the directors, met with bank regulators, attended bank director conferences, attended director and compliance training, and monitored major issues in loan examinations, among other things. Mr. Senty said that he relied solely on his and Paul's memories to develop the list. However, he failed to provide any documentation of these hours other than an employment agreement he signed in 2017.

Mr. Senty worked on the board of directors for Reconyx in 2014 and 2015 and claimed he spent more than 276 hours working for Reconyx each year. Mr. Senty claimed he worked as a consultant, attended board meetings, field-tested cameras, developed cell phone camera lines, assisted with the opening of the Australian market, and provided international connections for the possible use of Reconyx's cameras at the Rio 2016 Olympics. Mr. Senty signed an employment agreement with Reconyx in 2016, which obligated him to provide at least 276 hours of service.

In 2014 and 2015, Mr. Senty was the sole manager of Park Capital, for which he claimed he did succession planning and held discussions with the successor manager, his son Paul. He also developed, financed, and leased a building in Verona, Wisconsin, to Park Capital. Mr. Senty said he spent more than 500 hours in 2014 and 2015 working for Park Capital but did not provide documentation to substantiate his claims.

Mr. Senty and his wife, Catherine, filed joint income tax returns for 2014 and 2015. The IRS audited the returns for both years and determined that the Sentys owed a 3.8% net investment income tax (NIIT) pursuant to IRC §1411. The Sentys paid the NIIT under protest in the amounts of $101,097 for 2014 and $105,354 in 2015. Then, in November 2021, the Sentys filed amended federal income tax returns for 2014 and 2015 to reduce the net investment income subject to NIIT for both years.

The IRS issued a $133,498 refund to the Sentys for the additional NIIT assessed and paid for 2014, plus interest. The IRS denied any refund for 2015. The Sentys filed suit over the 2015 return in May 2022, and the IRS counterclaimed for a return of their 2014 refund, putting at risk the money the Sentys were previously refunded. In July 2023, the Sentys filed a new set of amended federal tax returns for 2014 and 2015. The Sentys claimed the net investment income subject to NIIT should be further reduced as they argued that the rental income they received during 2014 and 2015 should not be subject to NIIT at all.

Issues. The issues in this case are the following.

- Whether Mr. Senty materially participated in the activities of DFC, Reconyx, and Park Capital
- Whether the Sentys can raise alternative theories a year after their initial lawsuit was filed

Analysis. Net investment income for purposes of determining NIIT is any excess sum of (1) gross income from interest, dividends, annuities, royalties, and rents, except as derived in the ordinary course of a trade or business and (2) other gross income derived from a trade or business through a passive activity.[144] A trade or business counts as a "passive activity" subject to NIIT if the taxpayer does not materially participate in the business.[145]

To show material participation, the Sentys relied on the significant participation test as defined by Treas. Reg. §1.469-5T(a)(4). Under this test, the taxpayer must prove that their significant participation activities exceed 100 hours but are less than 500 hours per year.[146] To prove participation, the taxpayer may show it by any reasonable means, such as daily time reports, logs, appointment books, calendars, or narrative summaries.[147]

The Sentys relied on four sources to show significant participation.

1. Post hoc employment agreements with Reconyx and DFC from 2016 and 2017
2. Board meeting minutes from a single 2014 DFC directors meeting, a 2015 Bank of Deerfield meeting, and a 2014 and 2015 Reconyx meeting
3. Mr. Senty's own deposition testimony
4. Deposition testimony from Mr. Senty's family and friends

The post-event employment agreements Mr. Senty signed in 2016 and 2017 requiring Mr. Senty to work hours of 276 and 255, respectively, consistent with "historical practice," do not prove hours worked from 2014 and 2015. The court found these agreements "self-serving." The headings, structure, and language of the agreements from two purportedly separate companies were also almost identical. The board meeting minutes from single meetings at each company also do not prove the number of hours worked throughout the year. Mr. Senty's testimony was too vague, as he did not give many details about how much time he spent doing any particular task, and he also conceded he had no documentation to substantiate his claimed hours. His other witnesses also failed to substantiate Mr. Senty's hours. His co-workers testified that Mr. Senty did a significant amount of work, but their testimony was vague, and they did not provide any documents substantiating the hours worked.

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144. IRC §1411(c)(1).

145. IRC §§469(c) and 1411(c)(2)(A).

146. *Brumbaugh v. Comm'r*, TC Memo 2018-40 (Apr. 3, 2018).

147. Treas. Reg. §1.469-5T(f)(4).

The Sentys also raised two alternative theories. First, the Sentys contended that because Park Capital's only income came from the rental of a building to Park Bank, its income was not subject to NIIT as it was "rented to a nonpassive activity."[148] Second, the Sentys contended the IRS should consider the Park Bank entities to be an "appropriate economic unit" for tax purposes. Because Mr. Senty worked more than 500 hours for all the entities combined, he should be exempt under Treas. Reg. §1.469-4(c)(1). This regulation imposes a requirement to "participat[e] in the activity for more than 500 hours during such year."[149] However, the Sentys cannot raise these arguments without first presenting them in a refund request.[150] The "substantial variance" doctrine limits a taxpayer to the grounds raised in the refund claim.[151] Here, the Sentys raised these two additional theories in their new amended returns a year after filing the lawsuit. The substantial variance theory thus precludes the Sentys from raising these alternate theories.

Finally, the Sentys contended that the IRS waived its substantial variance defense because the Sentys gave the government notice of the new theories in July 2023. However, the "waiver doctrine" only applies if the IRS considers the taxpayer's claim during administrative proceedings, despite the taxpayer not raising the specific claim.[152] That did not occur in this case.

Holding. The court held that the Sentys failed to meet their burden of proof establishing that Mr. Senty significantly participated in any of the three companies he worked for during 2014 and 2015. The Sentys also failed to present their alternative theories in their original suit. Therefore, the Sentys' net investment income is not excluded from the NIIT for 2014 or 2015.

RETIREMENT

Rollover IRA Contributions and Rollover Period

***Estate of James Caan v. Comm'r*, 161 TC 6 (Oct. 18, 2023)**
IRC §408(d)

☞ Actor's Distribution Caan't Qualify for Nontaxable Rollover

Facts. James Caan was a successful actor before his passing in 2022. In 2014, while a resident of California, Mr. Caan had two individual retirement arrangements (IRAs) with the global firm UBS. In addition to cash and mutual funds, and other securities, one of the IRAs also contained a partnership interest in P&A Multi-Sector Fund, L.P. (P&A Interest), which required Mr. Caan to provide UBS with the interest's appraised fair market value (FMV) at yearend per U.S. Department of the Treasury requirements. However, Mr. Caan did not provide this requested information, and after several notices that UBS sent to Mr. Caan requesting the information for which no response was received, UBS resigned as the P&A Interest's custodian on November 25, 2015. UBS distributed the ownership interest as an in-kind distribution. In January 2016, UBS issued Mr. Caan a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, using the 2013 FMV that Mr. Caan had provided a year earlier as the gross distribution of $1,910,903.

In October 2015, Mr. Caan transferred both IRA accounts from UBS to a single IRA at Merrill Lynch, apart from the P&A Interest, which still listed UBS as the custodian. In his timely filed 2015 individual tax return, Mr. Caan reported the P&A distribution but excluded the entire distribution from the taxable amount.

148. Treas. Reg. §1.469-2(f)(6).
149. Temp. Treas. Reg. §1.469-5T(a)(4).
150. *Blakely v. U.S.*, 593 F.3d 1337, 1342 (Fed.Cir. 2010).
151. Ibid.
152. *Brown v. U.S.*, 22 F.4th 1008, 1013 (Fed.Cir. 2022).

In 2017, Merrill Lynch liquidated the P&A Interest held by Mr. Caan from January through June, with the distributions totaling $1,532,605. In November of that year, the IRS issued a notice to Mr. Caan, proposing to change his 2015 tax return to include the $1,910,903 distribution of P&A Interest as taxable income. In April 2018, the IRS followed with a notice of deficiency, claiming a balance of $779,915 in unpaid tax for the taxable distribution of the P&A Interest. A $155,983 accuracy-related penalty was also assessed. In response, Mr. Caan requested a private letter ruling, in which he sought an IRS waiver of the 60-day rollover requirement for a distribution to be deemed rolled over, and thus nontaxable. The IRS denied this request in November 2018, stating that the liquidation of the P&A Interest and subsequent cash contribution to the Merrill Lynch IRA did not meet the "same property" requirements under IRC §§408(d)(3)(A)(i) and (D), and therefore they could not grant a waiver of the 60-day rollover period.

Issues. The issues in the case are the following.

- Whether UBS distributed the P&A Interest to Mr. Caan in tax year 2015
- Whether the UBS distribution is nontaxable under the 60-day rollover period
- Whether the reported value of the UBS distribution was correct
- Whether the court may review the IRS's refusal to issue a private letter ruling to waive the 60-day rollover period under §408(d)(3)(I)
- Whether the IRS abused its discretion in declining to waive the 60-day rollover period under §408(d)(3)(I)

Analysis. The court first looked at the issue of whether UBS distributed the P&A Interest to Mr. Caan, noting that UBS was within its rights to resign as custodian and distribute the P&A Interest in-kind. Mr. Caan's estate argued that the distribution was a "phantom distribution," where UBS resigned as custodian but did not notify Mr. Caan or other responsible parties, thereby leaving them to believe UBS was still the custodian of the P&A Interest. The court pointed out that even if the submitted communication from UBS was not received by Mr. Caan, there appeared to be no follow-up to UBS by Mr. Caan regarding the issued Form 1099-R or the subsequent cessation of mailed account statements.

Mr. Caan's estate also argued the lack of distribution due to Mr. Caan not having actual or constructive receipt of the P&A Interest. The court disagreed with this argument, noting that Mr. Caan had unfettered command of the P&A Interest as documented by his ability to re-register the P&A Interest in his name without the involvement of UBS. Finally, the estate argued that there was no distribution under California trust law. The court dismissed the argument on the grounds that the relationship between Mr. Caan and UBS was custodial and the stated agreement between the two parties was governed by New York law, not California law.

The court next assessed whether the UBS distribution was nontaxable under the 60-day rollover period. Looking at the facts, the court noted UBS distributed the P&A Interest on November 25, 2015. As 60 days from that date fell on a Sunday, the 60-day period ended on Monday, January 25, 2016. Merrill Lynch requested the liquidation of the P&A Interest in December 2016, where the court found three issues with how the distribution was handled. First, the character of the property was changed when liquidated to cash, where §408(d)(3)(A)(i) requires the character to be unchanged when contributed to preserve its tax-deferred status. Second, the actual distribution was made after January 25, 2016. Finally, the distribution was made in three separate transactions, whereas §408(d)(3)(B) allows only one rollover contribution in a 1-year period. Therefore, even if the other two issues were not present, only the first rollover contribution would have qualified as a tax-free rollover.

The court further assessed whether the reported value of the distribution of $1,910,903 on the Form 1099-R that UBS issued Mr. Caan was correct. The IRS agreed with Mr. Caan's estate that the reported value was erroneous, being based on FMV as of 2013. Therefore, the IRS requested that the value be assessed at $1,548,010, which was the ending capital balance per the P&A Fund's issued Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.* The estate did not argue against this value and did not propose a different one. Therefore, the court held that the value of the P&A Interest was $1,548,010.

Finally, the court reviewed whether it had jurisdiction in reviewing denials of waivers under §408(d)(3)(I), and if so, whether the IRS abused its discretion in declining to waive the 60-day rollover period. The court looked to a case with similar fact patterns, *Trimmer v. Comm'r,*[153] to provide guidance. Just as with that case, the court found that it does have jurisdiction to review the IRS's denial of a waiver under §408(d)(3)(I) and that it can review said denial for abuse of discretion. Because the IRS identified the noncompliant issue of changing the contributing property's character under §408(d)(3)(A)(i) as prohibiting the IRS from issuing a waiver of the 60-day rollover period, the court found that the IRS did not abuse its discretion in declining the waiver.

Holding. The Tax Court held that UBS did distribute the P&A interest to Mr. Caan in tax year 2015 and that the distribution was not nontaxable under the 60-day rollover period. The court also held that the reported value of the P&A interest was incorrect and the corrected value is $1,548,010. Finally, the court held that it had jurisdiction to review the IRS's refusal to issue a private letter ruling to waive the 60-day rollover period under §408(d)(3)(I), and in doing so, found that the IRS did not abuse its discretion in declining the waiver.

S CORPORATION

S Corporation Debt versus Equity

***Estate of Thomas Fry v. Comm'r*, TC Memo 2024-8 (Jan. 23, 2024)**
IRC §§385, 1366, 6651, and 6662

☞ Debt, and Equity, and Basis, Oh Fry!

Facts. Thomas H. Fry, the sole shareholder of two S corporations, Crown Disposal, Inc. and CR Maintenance Services, Inc., managed both companies in a highly integrated operation despite their organizational distinctions. Crown, which is engaged in waste collection, and CR Maintenance, which is focused on processing waste into saleable commodities, shared a facility in Sun Valley, California. They operated under a shared infrastructure, including personnel, maintenance, and accounting services.

From 2008 to 2015, Mr. Fry received compensation and rent from both corporations. Despite their collaborative operations, financial transactions between the two entities did not involve direct payment for services or shared revenues. Instead, Crown supported CR Maintenance financially, especially as the latter faced unprofitability from 2010 onwards. A significant contract loss with the City of Los Angeles in 2011, triggered by a tragic accident, led to continued financial losses for CR Maintenance. The losses necessitated substantial financial interventions from Crown to sustain operations.

This support was manifested through direct financial transfers and payments for CR Maintenance's operational expenses by Crown ("the transfers and payments"), totaling $36,255,141 by the end of 2013. These transactions were not formalized through promissory notes or interest payments. Both entities accounted for these transactions as liabilities, with the intent of repayment subject to CR Maintenance's profitability.

Mr. Fry and his wife did not report any distributions from Crown on their tax returns from 2008 to 2019. However, Crown reported significant shareholder distributions and loan repayments on Mr. Fry's behalf, especially following a lucrative asset sale in 2015, which netted about $70 million. This sale marked the culmination of Crown's financial distributions to Mr. Fry, with subsequent distributions being mere accounting adjustments rather than actual cash transactions.

153. *Trimmer v. Comm'r*, 148 TC 334, and 345–49 (2017).

Notably, on November 10, 2014, Mr. and Mrs. Fry untimely filed their joint tax return for the 2013 tax year, which was due on October 15, 2014. CR Maintenance reported a loss of $5,650,651 for the same year, and Mr. and Mrs. Fry claimed a flowthrough loss deduction of $4,733,675 from CR Maintenance on their individual return. The IRS's scrutiny for the 2013 tax year led to a notice of deficiency, determining a deficiency in income tax, an addition to tax pursuant to IRC §6651(a)(1), and an accuracy-related penalty pursuant to IRC §6662(a). The IRS also disallowed flowthrough loss deductions from CR Maintenance due to insufficient basis.

Issues. The issues in this case are the following.

- Whether the transfers and payments from Crown to CR Maintenance are bona fide debt or equity
- Whether Mr. Fry had an adequate basis in order to claim the disallowed flowthrough loss from CR Maintenance of $3,455,006
- Whether the IRS is harmed by a finding that the transfers and payments are equity
- Whether Mr. and Mrs. Fry are liable for the late filing addition to tax pursuant to §6651(a)(1)
- Whether Mr. and Mrs. Fry are liable for the accuracy-related penalty pursuant to §§6662(a) and (b)(2) for a substantial understatement of income tax

Analysis. In determining whether a particular interest is characterized as debt or equity, the court considers various factors that indicate the economic substance of a transaction. IRC §385 allows for the reclassification of corporate interests based on their substance, aiming to discern whether transactions were genuinely debt-based, with expectations of repayment, or equity contributions, lacking formal obligations of return. The court found no formal issuance of debt or equity instruments, rendering §385 inapplicable based on a strict interpretation.

Case law factors prioritize the substance over the form of transactions. The Ninth Circuit has identified 11 factors that may be relevant in determining whether a transfer to a corporation by a shareholder is debt or a contribution of capital.[154]

1. The names given to the certificates evidencing the debt
2. The presence or absence of a fixed maturity date
3. The source of the payments
4. The right to enforce payments of principal and interest
5. Whether the advances increase participation in management
6. Whether the "lender" has a status equal or inferior to that of regular creditors
7. Objective indicators of the parties' intent
8. Whether the capital structure of the "borrower" is thin or adequate
9. The extent to which the funds advanced are proportional to the shareholder's capital interest
10. The extent to which interest payments come from "dividend" money
11. The ability of the "borrower" to obtain loans from outside lending institutions

Of the 11 factors, the court found that four are neutral, six favor equity, and one favors debt.[155] After weighing the factors, the court concluded that the transfers and payments did not constitute true indebtedness and should be viewed as equity.

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154. See *Hardman v. U.S.*, 827 F.2d 1409, 1412 (9th Cir. 1987).

155. The six factors that the court found favoring equity are: (2) presence or absence of a maturity date; (3) source of payments; (4) right to enforce payment of principal and interest; (6) status equal to or inferior to that of regular corporate creditors; (9) identity of interest between creditor and stockholder; (10) extent to which interest payments come from "dividend" money. The only factor that the court found favoring debt is (7) the intent of the parties. The court found the remaining factors neutral.

The court next examined whether the transactions can be recharacterized as constructive distributions from Crown to its shareholder, Mr. Fry, followed by contributions of capital to CR Maintenance. According to Ninth Circuit caselaw, a constructive dividend occurs where a 2-part test is met.[156]

1. The expenditures do not give rise to a deduction on behalf of the distributing corporation.
2. The expenditures create **economic gain, benefit, or income** to the shareholder.

The court found both prongs are satisfied as the constructive distributions were made primarily for Mr. Fry's benefit. There was no discernable business reason for Crown to make the transfers and payments, which is in accordance with the finding of no true expectation of interest or timely repayment. Accordingly, the court concluded that the transfers and payments constituted constructive distributions from Crown to Mr. Fry, followed by constructive contributions from Mr. Fry to CR Maintenance.

Then, the court examined Mr. Fry's ability to deduct losses based on his basis in the corporations. IRC §1366(d)(1) limits the amount of losses and deductions a shareholder may deduct to the sum of their adjusted basis in their stock and in any indebtedness they have in the S corporation. The court found that there was insufficient information to recalculate Mr. Fry's adjusted bases in CR Maintenance and Crown. Consequently, the court directed the parties to recalculate Mr. Fry's bases in the companies from 2013 to 2020, as this calculation can determine the allowable loss amount for 2013.

The IRS contended that recharacterizing the transfers and payments as equity would unfairly harm the IRS. Despite claims of potential harm, including incorrect basis calculations leading to unmerited loss claims, the court found the IRS's argument unsubstantiated. Notably, the assertion that distributions exceeded Mr. Fry's basis, potentially leading to tax avoidance, was challenged. Testimony revealed these "distributions" were merely accounting adjustments, not actual economic transactions. The court dismissed concerns over inconsistency, whipsaw, and election doctrine applicability, emphasizing that the transfers and payments were interests in equity, ensuring Mr. and Mrs. Fry's entitlement to claimed losses.

Finally, the court found Mr. and Mrs. Fry liable for an addition to tax under §6651(a)(1) due to the late filing of their 2013 return and an accuracy-related penalty under §6662(a) for a substantial understatement of income tax. The IRS met its burden of proof, including obtaining necessary supervisory approval for the penalty, as mandated by §6751(b)(1). Although Mr. and Mrs. Fry conceded late filing, their attempt to invoke a reasonable cause defense based on reliance on professional advice for the penalty was rejected due to late assertion, causing potential prejudice to the IRS. Therefore, liability for the penalty depends on the outcome of Rule 155 computations to ascertain if there was a substantial understatement of tax.

Holding. The court held that the transfers and payments between the corporations did not constitute true indebtedness, but instead, they constituted constructive distributions from Crown to Mr. Fry, followed by constructive contributions from Mr. Fry to CR Maintenance. The court also held that Mr. Fry's bases from 2013 to 2020 should be recalculated to determine the allowable loss amount for 2013. Additionally, the IRS is not harmed by a finding that the transfers and payments are equity. Lastly, the court held that the Frys are liable for an addition to tax due to the late filing of their return and an accuracy-related penalty.

[156] See *P.R. Farms, Inc. v. Comm'r*, 820 F.2d 1084, 1088 (9th Cir. 1987).

Business Expenses

***Gary and Melissa Sinopoli v. Comm'r*, TC Memo 2023-105 (Aug. 14, 2023)**

IRC §162

☞ Business Expense Deductions Don't "Work Out"

Facts. This case arose from the consolidation of three separate cases. The petitioners for the first case were Dr. Gary Sinopoli and Melissa Sinopoli; Dr. Robert Siragusa was the petitioner for the second case; and Michael and Angela Hurring were the petitioners for the third case. Dr. Sinopoli, Dr. Siragusa, and Mr. Hurring were members who owned a limited liability company (LLC) called Planet LA, LLC (Planet), which elected to be taxed as an S corporation. Planet owned five Planet Fitness franchise locations, which it sold in mid-2017. Each of the three LLC members reported their income on their individual tax returns using Schedule E, *Supplemental Income and Loss*. In 2020, the IRS sent notices of deficiency to Drs. Sinopoli and Siragusa, and in 2021 to Mr. Hurring.

Prior to 2015, the members held business meetings at either the hospital where they worked or Planet's fitness center in Gretna, LA. The Gretna location was far from where the petitioners lived, however, and they started meeting at their homes in 2015. For this, Planet started to pay them rent for the use of their homes in 2015. However, they did not obtain an appraisal for the rental value of their residences as meeting space. Dr. Sinopoli researched how much rental rates were in that area, which he claimed was $1.83 per square foot. Using this calculation, the petitioners charged over $30,000 in rent to the business for the years 2015–2017.

The IRS revenue agent assigned to examine Planet's S corporation returns and the LLC members' personal returns, determined that the rate should have been $500 per day after some research. After calculating $500 per day for each meeting that the members were able to substantiate with notes, the IRS disallowed the rent deduction for 2015 entirely and allowed rent expense deductions for 2016 and 2017 of only $6,000 and $4,500, respectively. The LLC members had no records of what business they conducted at their meetings, but they presented some evidence that they actually held meetings in 2016 and 2017.

Planet also engaged in advertising. When it first started advertising, it paid local advertisers directly. In 2014, Dr. Sinopoli, Dr. Siragusa, and Mr. Hurring each incorporated their own marketing companies, which they controlled. Planet paid the marketing companies, which then paid the local advertisers. The IRS examined the marketing companies' returns and found the fees far exceeded the amounts paid to local advertisers and accordingly disallowed the deduction for marketing fees in excess of the amount paid to local advertisers.

Issue. The issue in this case is whether Planet's expense deductions for rent and marketing are reasonable and necessary and, therefore, deductible.

Analysis. The petitioners bear the burden of proof to substantiate their claimed corporate expenses. IRC §162(a) allows a deduction for a business's ordinary and necessary expenses paid or incurred during the year. The expenses are deductible only to the extent the amount is reasonable.[157]

The petitioners failed to present any record of what business was discussed at their meetings during the years at issue. Nevertheless, the court allowed a $500 deduction for rent for 2015 based on the members' testimony, even though it found their testimony about the meetings vague and inconsistent. The court allowed rent deductions of $500 for each of 12 meetings for 2015, 2016, and nine for 2017.

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157. *Audano v. U.S.*, 428 F.2d 251, 256–57 (5th Cir. 1970).

The court found the marketing fees that Planet paid the three LLC members' marketing companies excessive considering the much smaller amounts that were paid to the local advertisers. The members failed to present evidence substantiating the business purpose of the excess marketing fees. The court noted the marketing companies undertook no activities other than paying the local advertisers. Accordingly, the court limited Planet's marketing deductions to the amounts the marketing companies actually paid the advertising companies. The court's opinion noted that the members' marketing companies ceased their operations when Planet was sold. The judge did not dispute the IRS's argument that the excessive marketing fees were a mechanism to direct Planet's earnings to its members for personal use. In light of this, the excess marketing fees did not qualify as an ordinary and necessary business expense.

Holding. The court reduced the Planet's rent deductions to $500 per meeting. The amounts that Planet paid for marketing fees in excess of the amounts paid to local advertisers were disallowed.