<u>2022 FEDERAL INCOME TAX LAW UPDATE</u>

<u>AND REVIEW OF THE NEW NORTH CAROLINA</u>

<u>PASS-THROUGH ENTITY ("PTE") DEDUCTION</u>

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INTRODUCTION

Today's discussion will focus on some of the more interesting or important tax developments that have transpired over the last year or so. The new developments addressed in this presentation will include numerous tax court cases, decisions of various federal circuit courts, as well as IRS pronouncements, revenue rulings and regulatory changes.

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PART ONE
IRS AUDIT STATISTICS

I. Audit Statistics; What Are Your Chances of Being Audited?

In May 2022, the IRS published its 2021 Internal Revenue Service Data Book, which contained certain audit statistics for years 2011 through 2019, as of the Fiscal Year ending on September 30, 2021 (FY 2021). Note that for tax years 2017 and earlier, the statute of limitations for audits had expired as of September 30, 2021. However, for 2018 and 2019 returns, the Statute of Limitations has yet to expire, so more returns of those years still may be subject to audit.

Here are the audit statistics for 2019 tax returns:

A. Audit Rates for Individual Income Tax Returns. Only .2% of individual income tax returns filed in 2019 were audited (about the same for 2018 returns).

Total Individual Returns Audited:		.2%
(1)	With no positive Income	.8%
(2)	\$100,000 to \$500,000	.1%
(3)	\$500,000 to \$1 Million	.3%
(4)	\$1 Million to \$5 Million	.6%
(5)	\$5 Million to \$10 Million	1%
(6)	\$10 Million or More	2%

B. Audit Rates For Partnerships and S Corporations: For partnership and S Corporations, the audit rate for 2019 returns was .1%.

C. Audit Rates for C Corporations. C Corporation returns filed for 2019 had an audit rate of 2.9%.

Total C Corporation Returns Audited:		2.9%
(1)	Assets less than \$5 Million	.4%
(2)	Assets \$5 Million to \$10 Million	.5%
(4)	Assets \$10 Million to \$50 Million	1.1%

D. Note: The IRS has not published similar audit statistics for 2020 tax returns.

E. Schedule C Returns. Not surprisingly, the audit rates for Schedule C returns are much higher than for individual returns. According to audit statistics published in the 2019 Internal Revenue Service Data Book, Schedule C's filed for 2018, showing receipts of \$100,000-\$200,000, reported a 2.4% audit rate. Schedule C returns filed for 2018, showing income over \$200,000, reported a 1.9% audit rate.

II. <u>Offers in Compromise and Criminal Case Referrals.</u>

A. <u>Offers in Compromise</u>. For FY 2021, the IRS received around 49,000 offers in compromise, but only accepted around 15,000 of them.

B. <u>Criminal Case Referrals</u>. According to the IRS statistics, the IRS initiated 2,581 criminal investigations for the Fiscal Year 2021, and for Fiscal Year 2021, the IRS referred 1,982 cases for criminal prosecutions (575 for legal source tax crimes, 761 for illegal source financial crimes and 646 for narcotics–related financial crimes) and obtained 1,263 convictions. For convictions, 993 were actually incarcerated.

<u>PART TWO</u>

ORDINARY INCOME OR CAPITAL GAIN ON THE SALE OF REAL PROPERTY?

I. <u>Background and Overview</u>.

A. <u>Summary of Tax Differences</u>. When a taxpayer sells real estate, often the IRS and the taxpayers are at odds as to whether the sale should be treated as the sale of investment property or as the sale of ordinary income "inventory" property. The tax differences can be significant for both the taxpayer and the IRS.

If the transaction is treated as a sale of "investment" real property, then any gain on the sale will be taxed at the **capital gain tax rates**. And the gain recognized by the investor will not be subject to self-employment taxes.

In addition to the capital gain tax and self-employment tax benefits available to the real estate investor, such investors also can benefit from:

(i) Section 1031 nontaxable exchanges;

(ii) Section 1033(g) (relating to condemnation of real property held for productive use in a trade or business or for investment); and

(iii) Section 453 installment sale reporting.

These are tax benefits that are **<u>not</u>** available to ***dealers*** of real property.

On the other hand, investors in rental real estate must be cognizant of (i) the passive activity loss limitations of Section 469 and (ii) the capital loss limitations applicable to investment property (since, if the sale generates a loss, then the taxpayer's loss will be limited by the capital loss limitation rules - that is, the capital loss can only offset other capital gains income and another $3,000 of ordinary income for the year).

If the sale is treated as a sale of **inventory** by a **developer**, then any gain will be treated as **ordinary income**, and thus will be subject to the ordinary income tax rates as well as subject to **self-employment tax**. On the other hand, if the sale of the deemed **inventory** generates a tax loss, then the tax loss will be **fully deductable** against other ordinary income as well as capital gains.

B. Past Case Law.

The issue of whether the sale of real property should be treated as the sale of investment property versus inventory property has generated much litigation in the past. Throughout various court cases analyzing these issues, most courts cite the "investor versus dealer tests" analyzed under Biedenharn Realty Company v. United States, 526 F.2d 409 (5th Cir. 1976); Suburban Realty Co. v. US, 615 F.2d 171 (5th Cir. 1980). Under these cases, the courts have focused on the question of whether the property is held primarily for sale to customers in the ordinary course of the taxpayer's business versus whether the taxpayers held the property purely for investment purposes.

Because gain or loss from the disposition of real property is capital if it was held as an investment and ordinary if it was held "***primarily"*** for sale to customers, the identification of a particular parcel of real property as investment property or as property held primarily for sale to customers is critical.

According to the court in Malat v. Riddell (383 U.S. 569 (1966)), the term "primarily" means of "first importance" or "principally," so that the issue turns on the taxpayer's intent with respect to holding of the property, which is obviously a factual issue.

Accordingly, a taxpayer's position, that an investment in real estate is merely being disposed of in the most economically profitable manner is a sustainable argument, despite the taxpayer's engagement in activities traditionally conducted by a real estate dealer, provided that the taxpayer otherwise manages his property holdings in a manner substantially similar to that of an investor. Further, the taxpayer must be careful not to reinvest in substantially similar property shortly after the liquidation of the investment if he seeks to avoid ordinary income characterization.

Unfortunately, no definitive trend has arisen that identifies which factors will guarantee investor treatment. As the court in Biedenharn Realty Co., Inc. v. U.S. (526 F.2d 409 (1976)) noted, resolving this question is often a "vexing and ofttimes elusive" task. Obviously, however, the greater the degree of development and sales activities undertaken by the taxpayer, the more likely the taxpayer will be unsuccessful in sustaining its argument that the property is investor rather than dealer property.

Cases that have addressed the issue have emphasized various factors in different contexts, in a manner that makes it difficult to construct a pattern from which outcomes in other situations can be predicted with any degree of confidence. For example, the court in Kirschenmann v. Comr. (24 T.C.M. 1759 (1965) held that frequent sales of lots undertaken by the taxpayer because the property was no longer suited for its intended purpose did not make the property investment property, while the court in Austin v. U.S. (116 F. Supp. 283 (1953) reached the opposite conclusion on similar facts. Similarly, capital gain treatment was allowed to the taxpayer in Brenneman v. Comr. (11 T.C.M. 628 (1952)), who sold his lots after an ordinance was enacted that barred the taxpayer's original plans, while the taxpayer in Shearer v. Smyth (116 F. Supp. 230 (1953)) was required to pay tax at ordinary rates under similar circumstances.

C. Factors Reviewed By The Courts. The Court in Ada Belle Winthrop, (CA-5) 24 AFTR 2d 69-5760, rev'g (DC) 20 AFTR 2d 5477, (October 22, 1969) established a set of criteria which have been cited frequently by the courts addressing these dealer vs. investor arguments. In the order of frequency cited in other cases, these seven factors, known as the "seven pillars of capital gain," are as follows:

1. Nature and purpose of the acquisition and duration of ownership.
2. Extent and nature of the efforts of the owner to sell the property.
3. Number, extent, continuity and substantiality of the sales.
4. Extent of subdividing, developing and advertising to increase sales.
5. Time and effort devoted to sales.
6. Character and degree of supervision over sales representatives.
7. Use of a business office to sell the property.

Other courts have applied a nine (9) factor test as follows:

1. The taxpayer's purpose in acquiring the property;
2. The purpose for which the property was subsequently held;
3. The taxpayer's everyday business and the relationship of the income from the property to the total income of the taxpayers.
4. The frequency, continuity, and substantiality of sales of property;
5. The extent of developing and improving the property to increase sales revenue;
6. The extent to which the taxpayer used advertising, promotion, or other activities to increase sales;
7. The use of a business office for sale of the property;
8. The character and degree of supervision or control the taxpayer exercised over any representative selling the property; and
9. The time and effort the taxpayer habitually devoted to sales.

Moreover, the Court of Appeals for the 5th Circuit has noted that "frequency of sales" is especially important to review because "the presence of frequent sales ordinarily runs contrary to the taxpayer's position" for investment. Suburban Realty Company.

II. Musselwhite v. Commissioner, TC Memo 2022-57 (June 8, 2022); Capital Loss and Not Ordinary Loss Recognized on Property Sales.

Mr. Musselwhite received his undergraduate business degree from Wake Forest University and his law degree from Campbell University. After law school, Mr. Musselwhite became a personal injury lawyer in Lumberton, North Carolina.

Over the years, Mr. Musselwhite became involved in several different real estate ventures. He started his first real estate venture in 1986 when he, his father, his uncle and his brother purchased 100 acres of undeveloped land in Lumberton which was then developed into a 90-lot subdivision called Wycliffe East.

This development project lasted thirteen years and ultimately all 90 lots were sold from the development.

Mr. Musselwhite and his brother then had the opportunity to participate in another real estate venture, also in Lumberton, North Carolina. They formed Carolina Group Partnership ("CGP") which purchased 100 acres of undeveloped land which was later developed in phases into a residential subdivision, called Northwoods.

Later, Mr. Musselwhite became interested in real estate investment possibilities in the Wrightsville Beach/Wilmington, North Carolina, area.

Mr. Musselwhite became involved with David Stephenson, who was a successful businessman with a real estate development company in Lumberton.

In 2005, Mr. Musselwhite and Mr. Stephenson formed DS&EM Investments, LLC as a two-member limited liability company. DS&EM Investments filed an annual report in 2005 indicating that the nature of its business was "real estate investment". From 2006 to 2012, all NC Secretary of State LLC annual reports continued to reflect that the nature of the LLC's business was "real estate investment".

DS&EM Investments initially purchased five investment condominiums on Wrightsville Beach and immediately sold two of them. DS&EM Investments also acquired undeveloped lots in Lumberton and in the Brunswick County Sea Watch Subdivision, as well as a house in Wilmington. The undeveloped lots were purchased for investment purposes.

Mr. Musselwhite also owned portions of several mobile home parks.

In the summer of 2006, Adam Lisk, a North Carolina real estate developer, contacted DS&EM Investments proposing a possible business arrangement. Mr. Lisk offered to allow Mr. Musselwhite an opportunity to invest in a subdivision that Mr. Lisk was developing consisting of nine undeveloped wooded lots. Mr. Lisk would purchase the Wilmington house and DS&EM Investments would purchase four undeveloped wooded lots in the Cypress Lakes Subdivision in Brunswick County that Mr. Lisk owned.

In August of 2006, Mr. Lisk and DS&EM Investments entered into a written agreement memorializing their plans for the development of the nine wooded lots. DS&EM Investments purchased the four lots from Mr. Lisk for $1 million and Mr. Lisk purchased the Wilmington house from DS&EM Investments for over $2 million.

In 2007, the real estate market in Brunswick County began to deteriorate. Ultimately, a dispute between Mr. Lisk and DS&EM Investments arose, and to resolve their disputes, Mr. Lisk agreed to transfer his five lots to DS&EM Investments so that DS&EM Investments would then own all of the nine lots in the subdivision.

By the end of 2008, Mr. Lisk had made some improvements to the nine-lot subdivision, such as tree removal, creation of a road, grading for storm water drainage and securing some permitting for the subdivision.

However, after 2008, no more improvements were made to the lots held by DS&EM Investments.

From December 2008 until September 2011, the lots were offered for sale. Ultimately, Mr. Musselwhite and Mr. Stephenson decided to divide up the DS&EM Investments properties and, on July 27, 2012, DS&EM Investments distributed the four lots to Mr. Musselwhite.

Mr. Musselwhite immediately hired a local real estate broker to market the lots for sale. Ultimately, on November 14, 2012, Mr. Musselwhite was able to sell all four lots for a total sales price of $17,500, resulting in a loss of over $1 million on the project.

Mr. Musselwhite hired a CPA in Lumberton to prepare and file the DS&EM Investments tax returns for 2005 through 2012. The Forms 1065 reported (1) that DS&EM Investments' principal business activity was "investment", and (2) that its principal product or service was "property". The Forms 1065 reflected that DS&EM Investments had "no inventories" but instead held investment real estate.

For the first time in 2011, the Form 1065 reported that the four lots were held as "inventory". When the 2011 Form 1065 tax return was filed, Mr. Musselwhite and DS&EM Investments were well aware that the fair market value of the nine lots were less than DS&EM Investments' income tax basis in those lots.

Mr. Musselwhite's CPA testified at Tax Court that he always believed that the lots were always held by DS&EM as inventory. However, no one ever filed amended Forms 1065 tax returns for DS&EM Investments as to the prior taxable years reporting the lots' purported status as inventory.

And, during prior years, Mr. Musselwhite's personal income tax returns reflected some capital gains income, but mostly pass-through income from various partnerships and S corporations as well as from his law firm practice. However, none of his personal returns reported any meaningful income from the activities of DS&EM Investments.

After auditing Mr. Musselwhite's Form 1040 for 2012, the IRS disallowed Mr. Musselwhite's reported $1 million Schedule C loss from the sale of the four lots on the basis that the loss was a capital loss and not an ordinary loss.

Based upon decisions of prior courts, such as the court's decision in Graves v. Commissioner, 867 F.2d 199 (4th Circuit 1989), the Tax Court noted that the 4th Circuit Court of Appeals (which is where this case would be appealed) had held that several factors are relevant in resolving any dispute under Section 1221(a)(1) as to whether the losses should be treated as capital losses or as ordinary losses.

Among the factors to be considered are: (1) the purpose for which the property was acquired; (2) the purpose for which it was held; (3) improvements and their extent, made to the property by taxpayer; (4) frequency, number, and continuity of sales; (5) the extent and substantiality of the transaction; (6) the nature and extent of taxpayer's business; (7) the extent of advertising or lack thereof; and (8) listing of the property for sale directly or through a broker.

Mr. Musselwhite had acquired the four lots via a distribution from DS&EM Investments as part of an agreement with Mr. Stephenson to wind up their affairs. Mr. Musselwhite never had any intention of developing the lots when he acquired them from DS&EM Investments and in fact he never made any improvements to those lots at any time.

Also, DS&EM Investments purchased and held the lots for investment as it did with all of its real estate. Likewise, the North Carolina Secretary of State annual reports for DS&EM Investments and all of the tax returns filed from 2005 through 2012 reflected the lots as being held for real estate investment purposes.

Moreover, even if DS&EM Investments had originally acquired the four lots in 2006 for development purposes, all evidence indicated that the LLC had abandoned any development plans by the end of 2008.

And, for all years after between 2008 and 2012, DS&EM Investments did nothing to improve the lots or to market them for sale.

The Court noted that, while Mr. Musselwhite and his family members had been involved in various real estate development projects in the 1980s and the 1990s, DS&EM Investments had never reported any gross receipts from sales, but instead any property sales were reflected on the DS&EM tax returns as the sale of investment properties that resulted in capital gain or capital loss to the LLC. And in fact, Mr. Musselwhite's only involvement with the DS&EM Investments related to the sale of the four lots he acquired from DS&EM Investments.

Moreover, Mr. Musselwhite's every day business was not in the real estate development business, but instead was related to his successful personal injury law practice. From 2011 to 2013, Mr. Musselwhite's income from his law firm ranged from a low of $700,000 in 2011 and a high of almost $1.2 million in 2012.

According to the Court, Mr. Musselwhite and Mr. Stephenson formed and operated DS&EM Investments as a vehicle to invest in real estate and all their federal tax returns and North Carolina Secretary of State annual reports bore that out.

And, although Mr. Musselwhite made efforts to market and sell the four lots upon receiving the four lot distribution in 2012, this factor alone was insufficient to demonstrate that Mr. Musselwhite's overall relationship with the four lots held by DS&EM Investments was anything more than merely participating in the activities of DS&EM Investments' long-term real estate investment activities.

NOTE: Although the Court ultimately concluded that Mr. Musselwhite would be entitled to only a capital loss (and not an ordinary loss) on the sales of those four lots, no tax penalties were assessed against Mr. Musselwhite, as he and the IRS had already stipulated, before the Tax Court trial, that Mr. Musselwhite would not be liable for any accuracy-related penalties.

III. Custom Home Builder Not Entitled To Ordinary Loss On Deemed Sale Of Lots; Ferguson vs. Commissioner, TC Memo 2019-40 (April 23, 2019).

Mr. Ferguson was a custom home builder operating through an S corporation. Mr. Ferguson got into a dispute with some of his customers regarding a new development project. In settlement of the lawsuit, Mr. Ferguson's S corporation transferred lots out to the homeowners and the S corporation then claimed an ordinary loss deduction on the deemed sale of three of the lots by the S corporation.

The IRS disallowed the ordinary losses on the basis that Mr. Ferguson was unable to prove that the lots were not capital assets as defined in Section 1221(a). The main factor that probably worked against Mr. Ferguson was the fact that he claimed capital gain treatment on six other lots that were transferred to other plaintiffs.

IV. Rental Property Activities Did Not Rise to a "Trade or Business", Keefe v. Commissioner, 126 AFTR 2d 2020-5331 (2nd Cir. July 17, 2020).

Mr. and Mrs. Keefe purchased a historical mansion in Newport, Rhode Island for $1.35 million and then spent significant sums to renovate the mansion. Mrs. Keefe spent over 70 hours per week overseeing the renovation. While the restoration was in progress, Mr. and Mrs. Keefe met with a rental agent to discuss perhaps renting out the mansion once it was finished. Ultimately, the house was never rented, and between June 2005 and July 2009, the fair market value of the property dropped by almost $3 million.

Ultimately the property was sold for $6.15 million in July 2009.

On their original 2009 tax return, Mr. and Mrs. Keefe reported that they were treating the sale as the sale of a capital asset. They then amended their 2009 return and reported the sale of the mansion as the sale of a business property resulting in ordinary loss treatment.

The Tax Court ultimately held that Mr. and Mrs. Keefe could not establish that they operated their rental activity on a "continuous, regular and substantial" basis so the property would not qualify as real property used in a "trade or business". A number of courts had previously held that rental real estate is considered a "trade or business" only if the taxpayer-lessor engages in regular and continuous activities in relation to renting out the property. Alvary v. United States, 302 F.2d 790, 796 [9 AFTR 2d 1633] (2d Cir. 1962) (citing Gilford v. Commissioner, 201 F.2d 735, 736 [43 AFTR 221] (2d Cir. 1953); Pinchot v. Commissioner, 113 F.2d 718, 719 [25 AFTR 447] (2d Cir. 1940); Grier v. United States, 120 F. Supp. 395 [45 AFTR 1975] (D. Conn. 1954)).

Here, the court concluded that Mr. and Mrs. Keefe did not engage in "regular and continuous" rental activities because they never commenced any rental activity in a meaningful or substantial way. Also, they never advertised the mansion for rent and they never signed any lease with a potential tenant, nor did they furnish the property for rent after the renovations were completed. In fact, Mr. and Mrs. Keefe spent a significant amount of time from 2004 to 2009 trying to sell the property, rather than to rent it out.

In addition, the court also noted that Mr. and Mrs. Keefe were not already engaged in any type of rental trade or business before purchasing and renovating the Rhode Island mansion. Accordingly, the Court of Appeals affirmed the Tax Court's holding that the Rhode Island mansion was a capital asset.

Note also that the Court of Appeals upheld the IRS imposition of the Section 6662 "substantial understatement" penalty. Apparently, the only penalty defense that the Keefe's raised during the trial was the "substantial authority" defense, and evidently they did not try to raise the "good faith" or "reasonable basis" penalty defense either at the Tax Court or at the Court of Appeals.

PART THREE
SECTION 104 INCOME EXCLUSION FOR PHYSICAL INJURY AND PHYSICAL SICKNESS

I. Damages For Emotional Distress Not Excludable From Taxable Income Unless Directly Associated With Physical Injury.

Section 104(a)(2) provides an exclusion from gross income for settlement damages received by the taxpayer for personal physical injury or physical sickness. Generally, emotional distress is not considered a physical injury or physical sickness, and therefore taxpayers must report, as gross income, damages they receive for emotional distress unless the damages are reimbursements from medical care to treat the emotional distress. Section 104(a). Damages for emotional distress are excludable from gross income only when the emotional distress is attributable to a physical injury or a physical sickness.

II. No Section 104 Exclusion for Wrongful Termination Recovery; Dern v. Commissioner, TC Memo 2022-90 (August 30, 2022).

Mr. Dern was employed as a sale representative. In 2015, Mr. Dern was hospitalized for acute gastrointestinal bleeding and a resulting heart attack. His illness and hospitalization, however, was completely unrelated to his work for his employer.

In early 2016, Mr. Dern's employer notified him that his services were being terminated. A termination letter stated "your prolonged health conditions have unfortunately had a significant impact on your ability to effectively represent the Company and perform the duties of a sales representative."

Mr. Dern then sued his former employer under several theories, specifically including disability discrimination.

The parties settled all claims and executed a Settlement Agreement in which the employer would pay Mr. Dern $550,000 "to compensate Mr. Dern for alleged personal injuries, costs, penalties, and all other damages and claims."

The Settlement Agreement further provided that it was "for and on account of [Mr. Dern's] claims alleging compensatory damages, emotional injuries, penalties and punitive damages."

The Tax Count agreed with the IRS that, under the Settlement Agreement, the settlement payment was not "on account" of Mr. Dern's ***physical*** injuries or ***physical*** sickness. Here, the Settlement Agreement used the phrase "personal injuries" in stating that the settlement payment was to "compensate [Mr. Dern] for alleged personal injuries".

However, this language never specifically referred to ***physical*** injuries. Of course, Mr. Dern argued that Section 104(a)(2) was applicable, because it was Mr. Dern's ***physical illnesses*** that caused his employer to terminate him in the first place. The Court said, however, that Mr. Dern did not prove any "direct causal link" between his illness and the settlement payment.

According to Lindsey vs. Commissioner, 422 F3d 684 (Eighth Circuit Court of Appeals, 2005), there must be a "direct causal link" between an illness and a settlement payment. Here, Mr. Dern could easily prove that he was physically ill, but he couldn't provide any evidence that his employer ***caused or exasperated*** his illness. Since the employer did not compensate Mr. Dern for any ***physical*** injury or ***physical*** sickness, the settlement payments were not excludable under Section 104(a)(2).

III. Legal Malpractice Recovery is Taxable for Screwed Up Medical Malpractice Case; Blum vs Commissioner, 129 AFTR 2d 2022-1170, 2022 U.S. App. LEXIS 15282, (9th Circuit Court of Appeals, June 2, 2022).

In Blum, Ms. Blum sued her personal injury lawyer for malpractice relating to her personal injury medical malpractice lawsuit against a hospital. In effect, Ms. Blum was suing her lawyer for legal malpractice for failing to recover damages for her physical injuries caused by the hospital's negligence.

However, her legal malpractice recovery was held to be taxable, and not excludable under Section 104. In her case, the Settlement Agreement expressly stated that the settlement payment was not for her underlying physical injuries, but instead was payment in lieu of damages for legal malpractice of her former lawyer.

The Settlement Agreement went even further and stated that Mrs. Blum and her attorneys were stipulating that Mrs. Blum did not sustain any physical injuries as a result of her attorney's alleged negligence. And, the Settlement Agreement stated that the parties signed the Settlement Agreement "for the purpose of compromising and settling the [malpractice] dispute between" the parties.

IV. Tax Court Again Rules That Emotional Distress Is Not "Physical Illness"; *Rebecca A. Tressler v. Commissioner*, T.C. Summ. Op. 2021-33 (Sept. 13, 2021).

In Tressler, the Tax Court again held that emotional distress damages are not excludable from taxable income unless those emotional damages are attributable to a direct physical injury.

Ms. Tressler brought a lawsuit against her former employer for workplace harassment and retaliatory employment practices and for failing to prevent a physical assault by another employee. Ms. Tressler alleged that this assault caused her emotional distress which caused even more physical injuries.

The Tax Court agreed with the IRS and held that the emotional distress damages were not excludable from taxable income under Section 104(a)(2), because the language in Ms. Tressler's Settlement Agreement failed to state that the settlement payments she received were related to physical injuries rather than just related to her claims for emotional distress.

Under the Settlement Agreement, Ms. Tressler was paid $82,500, with $27,500 in wages reported on a Form W-2, and $55,000 reported on a Form 1099. In the Settlement Agreement, the $55,000 portion represented "settlement of Tressler's claim for emotional distress damages related to her allegations" in her lawsuit. The Settlement Agreement further stated that the payment was "inclusive of all claims by Tressler for any alleged damages against Amtrak, including, but not limited to, any alleged claims for physical injuries, emotional distress, attorneys' fees, and costs."

The court stated "we simply cannot accept petitioner's request to allocate the $55,000 payment among her claims for 'physical injuries, emotional distress, attorneys' fees, and costs,' when section 2.2 [of the Settlement Agreement] attributes the whole $55,000 to her claim for emotional distress damages related to her claims in the lawsuit."

Ms. Tressler had testified that she was the victim of a violent sexual assault that occurred while she was on duty at Amtrak and that Amtrak was aware of the assault. Although the court found her testimony credible, the absence from the payment provision of the Settlement Agreement of any reference to physical injuries represented a "conscious choice" by Tressler **and** Amtrak "to exclude physical injuries, including any physical injuries from the sexual assault, from the $55,000 settlement allocation."

V. Complaint And Settlement Agreement Dooms Tax Treatment of Emotional Distress Claims; Stassi, 2021 TC Summary Opinion 2021-5 (February 8, 2021).

Ms. Stassi sued and settled with her former employer for lost wages, wage and hour violations, constructive termination, retaliation for complaints she made against her employer and for emotional distress relating to shingles she contracted during her employment. Ms. Stassi's lawsuit Settlement Agreement allocated part of the settlement as payment for "emotional distress with physical manifestations."

However, her original Complaint never alleged her employer caused her shingles. Because Ms. Stassi did not file a Complaint based on physical injury or sickness, and because the Settlement Agreement did not state that the payment was in lieu of damages for physical injury or physical sickness, her settlement was taxable.

VI. Terminated Employee Can Exclude Portion of Lawsuit Recovery From Taxable Income Under Section 104; Beckett v. Commissioner, T.C. Summary Opinion, 2020-19, July 1, 2020.

Ms. Beckett was employed as a certified nursing assistant until her termination in January 2020. She suffered from epileptic seizures while at her workplace. Some seizures would be so severe that she would even hit her head hard enough to require stitches. Other times, she would bite her tongue, and at least once she was sent to the emergency room.

After her termination, Ms. Beckett sued her employer for employment discrimination under the Americans with Disabilities Act (the "ADA") claiming that she was wrongfully terminated because of her epilepsy and her employer's failure to make reasonable accommodations as required under the ADA. Ultimately the parties settled and Ms. Beckett received a payment of $28,000.

The Settlement Agreement provided that $19,000 of this amount was to compensate Ms. Beckett for her claims of emotional distress, pain and suffering, physical distress and damages. The court ruled that a portion of this $19,000 payment (one third) was exempt under Section 104(a)(2) because the Settlement Agreement stated that the compensatory damages were paid, in part, for "physical distress and damages" and by virtue of the fact that Ms. Beckett credibly testified, at her wrongful termination trial, that she suffered head and other physical injuries directly cause by her employer's refusal to make reasonable accommodations.

VII. No Section 104 Exclusion for Emotional Distress Damage Claims; Doyle, TC Memo 2019-8 (February 6, 2019).

Mr. Doyle was terminated from his employment after he raised concern with his employer's president that the company was involved with illegal anti-competition schemes. After he was terminated, Mr. Doyle began experiencing physical ailments such as nausea, vomiting, headaches, and backaches. Ultimately, after a confidential settlement with his employer, Mr. Doyle was paid $350,000 "as settlement for unpaid wages" and $200,000 "as settlement for alleged emotional distress and damages".

The Tax Court agreed with the IRS that the damages for the emotional distress were not excludable from gross income under Section 104(c)(2) because the underlying wrong committed by his former employer was based upon employment matters or contact matters and had nothing to do with any physical injury.

PART FOUR
ROYALTIES: CAPITAL GAINS OR ORDINARY INCOME

I. Ordinary Income, Not Capital Gain, on Transfer of Patent to Controlled Corporation; Filler v. Commissioner, 130 AFTR 2d 2022-5093, 2022 U.S. App. LEXIS 19356 (July 13, 2022).

In Filler, Dr. Filler was both a licensed attorney and a neurosurgeon. Over the years, Dr. Filler developed a number of patents, and over the years he brought more than 20 patent infringement lawsuits against certain third parties.

In 2014, Dr. Filler claimed an NOL of almost $2 million on his tax return alleging that the state of California had infringed on his patent thereby destroying the value of his stock of NeuroGrafix, Inc. ("NGI") that owned Dr. Filler's patent. Dr. Filler never sued the state of California for patent infringement but instead simply claimed that he had suffered an involuntary conversion NGI's patent. Since no court had ever made a finding of patent infringement by the State of California, the Tax Court couldn't allow his $2 million claimed ordinary loss. Instead, at most, he could only claim a capital loss.

Next, the court looked at the proper tax treatment of royalties paid by NGI to Dr. Filler. Dr. Filler had transferred his patent to NGI in exchange for a royalty arrangement, at a time when he owned 75% of stock of NGI. IRC Section 1235(a) treats, as capital gain, any consideration received for the transfer of substantially all of rights of the patent. Section 1235(a), Section 1222 and Section 1231.

However, Section 1235(a) does not apply to transfers between related persons, including a corporation and an individual that owns more than 25% of the outstanding stock of its shares. Clearly, NGI was a related party which converts all the royalty income to ordinary income.

PART FIVE
SECTION 108 CANCELLATION OF DEBT INCOME

I. Taxpayers' Interest in a Pension Plan Was Not An "Asset" For Purposes of the COD Insolvency Test.

A. Background. The general rule is that a debtor recognizes ordinary income equal to the amount of the debt discharged over the amount of cash and the fair market of any property paid to the creditor. However, there is an important exception to this rule where the debtor is bankrupt or insolvent.

Under Section 108(a)(1), if the debtor **is insolvent**, income **must** be recognized to the extent that the cancelled debt exceeds the amount by which the debtor was insolvent **before** the discharge. Section 108(a)(3).

> **Example:** Bob has assets worth $1 Million and debts of $1.3 Million. So, Bob is "insolvent" to the extent of $300,000. If Bob's creditors forgive $400,000 of debt, then Bob must recognize $100,000 of COD income. However, if Bob was in bankruptcy at the time of the debt forgiveness, Bob would not have any taxable COD income.

Note: The cost to the taxpayer of avoiding COD income by virtue of the bankruptcy or insolvency exclusion is the reduction in certain tax attributes of the taxpayer (such as loss carryforwards and asset basis). Section 108(b); Regs. 1.108-4(a).

B. The Bankruptcy Exception.

Under Section 108(a)(1)(A), a taxpayer in a title 11 case can exclude cancellation of debt income arising at the time the taxpayer is bankrupt. Section 108(d)(2) provides that the term "title 11 case" means a case under the Bankruptcy Code if: (i) the title 11 court as jurisdiction over the taxpayer; and (ii) the court approves a plan which discharges the cancelled debt income. Note that the foreclosure or debt cancellation must occur during bankruptcy to qualify for the exclusions. Thus, if the bankruptcy is filed too late or if the taxpayer has retirement funds or other assets available to satisfy the foreclosure, there can still be enormous and unexpected tax liability arising from the foreclosure.

Also, as mentioned above, Section 108(b) requires that the taxpayer must reduce certain tax attributes when taking advantage of the bankruptcy exception.

C. <u>The Insolvency Exception</u>.

<u>Section 108(a)(1)(B)</u> allows an insolvent taxpayer to exclude discharge of debt income if the discharge occurs at a time in which the taxpayer is insolvent. Section 108(a)(2)(A) provides that the insolvency exclusion is inapplicable in a discharge resulting from bankruptcy.

1. <u>General Rules</u>

Under the cancellation of debt rules, no amount is included in a debtor's gross income by reason of a discharge of indebtedness if the discharge occurs when the taxpayer is insolvent. Section 108(a)(1)(B). The amount excluded from income by reason of a debtor's insolvency can't exceed the amount by which the taxpayer is insolvent. Section 108(a)(3). The amount of COD income excluded as a result of the insolvency exception must be applied in the reduction of tax attributes under Section 108(b).

Under Section 108(d)(3), "insolvency" is defined as the excess of the taxpayer's liabilities over the fair market value of the taxpayer's assets, determined on the basis of asset values and liability balances immediately **<u>before</u>** the discharge. Accordingly, the discharged debt may count as a liability for purposes of determining the taxpayer's insolvency. <u>Miller, Timothy J.</u>, TC Memo 2006-125 (2006). As such, the taxpayer's financial status immediately after the discharge is irrelevant with respect to this exception to the COD rules. However, a taxpayer that becomes solvent by the cancellation of the debt will recognize income to the extent he's made solvent, i.e., to the extent the value of his assets (other than assets exempt from the claims of creditors) exceeds his liabilities immediately after the discharge.

Where a taxpayer-debtor is a partnership or LLC for tax purposes, the COD income is passed through to the partners or LLC members and the availability of the insolvency exception is determined at the partner/member level. Section 108(d)(6).

2. <u>Calculating the Amount of Insolvency.</u>

Section 108(a)(3) provides that the excluded amount is limited to the extent of the taxpayer's insolvency. Similar to the bankruptcy exclusion rules, the taxpayer must reduce certain tax attributes as a result of benefitting from the insolvency exception. Under Section 108(d)(3), "insolvency" is defined as the excess of the taxpayer's liabilities over the fair market value of its assets, as calculated immediately **<u>before</u>** the discharge.

> **<u>Example:</u>** ABC, a debtor corporation, has assets of $175 and liabilities of $200. ABC's creditors agree to cancel their indebtedness for ABC's stock worth $175. ABC has therefore satisfied $175 of its debt with stock and had $25 of debt cancelled for no consideration by its creditors. ABC does not realize discharge of indebtedness income because the amount of debt that has been forgiven ($25) does not exceed the amount by which ABC was insolvent ($25). If the stock that ABC issued to its creditors were valued at $150, ABC would realize $25 of gross income, since the amount of forgiven debt ($50) exceeds the amount by which it was insolvent ($25) by $25.

3. What Assets are included in the "Insolvency" Calculation?

Section 108(d)(3) does not identify which assets and which liabilities are included in the determination of a taxpayer's solvency. Prior to the promulgation of the Bankruptcy Tax Act, assets exempt from creditor claims were not included in the analysis of a taxpayer's solvency. Cole v. Comr., 42 B.T.A. 1110 (1940).

However, the Tax Court in Carlson v. Comr., 116 T.C. 87 (2001), held that, following the passage of the Bankruptcy Tax Act, **assets exempt from creditor claims are in fact included** in the determination of the taxpayer's solvency for purposes of the insolvency exception of Section 108(a)(1)(B).

Likewise, in TAM 199935002, the IRS Chief Counsel stated that exempt assets for bankruptcy purposes should be included as "assets" for insolvency calculation. Therefore, it is quite likely that the IRS will argue that certain assets of the taxpayer which are exempt from creditor claims (such as IRAs, tenants by the entirety real property and 401(k) plan balances) must be included as countable assets for purposes of determining the insolvency exception.

However, in PLR 8920019, the Internal Revenue Service found that, despite filing a joint return, the separate assets of a spouse are not factored into the insolvency calculation for the purpose of Section 108. Therefore, one issue is whether assets could be transferred from a debtor-taxpayer to his or her spouse prior to a debt discharge in order to increase such taxpayer's insolvency. Arguably, if the assets transferred by a taxpayer to his spouse prior to a debt cancellation are deemed to be separate assets of the spouse, this strategy arguably may work to reduce the solvency (or increase the insolvency) of the taxpayer for purposes of the insolvency exception.

However, at a minimum, the doctrines of economic substance and sham transaction will most likely be argued by the IRS in the event such a transfer of assets was made prior to an anticipated debt cancellation. Further, the IRS would likely argue that the spousal transfer was a fraudulent conveyance intended to defraud the IRS. On the other hand, we would argue that the transfer was a legitimate intra-marriage transfer with legitimate purposes other than tax savings.

C. Certain Pension Plan Benefits Are Not Countable For Purposes of Determining Insolvency; Schieber, TC Memo 2017-32.

As stated above, certain assets, such as IRAs and 401(k) balances and some pension plan assets, must be included as "assets" for purposes of determining whether taxpayer is insolvent for purposes of Section 108.

In Schieber, TC Memo 2017-32 (February 9, 2017), Mr. and Mrs. Schieber sought to exclude certain cancelled debt from taxable income based upon the insolvency test of IRC Section 108(d)(3). Mr. Schieber was the beneficiary of a monthly pension plan and took the position that the pension plan was not a countable asset for the purpose of insolvency test because Mr. Schieber had no immediate access to the pension plan assets.

Under the terms of the pension plan, Mr. Scheiber could not borrow from the plan or use the plan benefits as collateral for loans.

The Tax Court agreed with Mr. Schieber and held that the interest in the pension plan was not an "asset" for purposes of the Section 108 insolvency test because Mr. Schieber's only rights in the pension plan was to receive monthly pension benefits. Under the terms of the pension plan, he had no right to withdraw pension benefits in excess of the monthly pension benefit amount.

According to the Tax Court, under Carlson, an asset is included in the insolvency test only if the taxpayer gains immediate access to that asset. Under Carlson, an asset must be included in the insolvency calculation if the asset could be used to pay tax on the income tax from the cancelled debt. Carlson, 116 TC 87 (2001). Here, the Schiebers could not use their pension plan benefits to pay the tax on their COD income because their pension plan rights were limited to receipt of monthly benefits. Mr. and Mrs. Schieber could not borrow against their pension plan, nor could they sell it, assign it or convert periodic monthly payments into a lump sum payment in exchange for their interest in the plan.

> **Note:** In a previous case, the Tax Court reached a contrary decision where the taxpayer could borrow from his pension plan, and therefore the pension plan represented an "asset" for purposes of the insolvency test. Shepherd v. Commissioner, TC Memo 2012-212.

II. IRS Announces It's Refusal to Follow the Tax Court Decision in *Schieber's* Ruling That Pension Interest Is Not Part of the Insolvency Calculation Under Section 108.

Previously, in *Schieber*, TC Memo 2017-32 (February 9, 2017), the Tax Court stated that, as laid out in *Carlson v. Commissioner*, 116 TC 87 (2001), for purposes of determining whether something is an "asset" for Section 108(d)(3) purposes, the relevant test is whether the asset gives the taxpayer the ability to pay an immediate tax on income from the cancelled debt. Therefore, a pension plan asset balance should not be deemed as an "asset" of the taxpayer for purposes of applying the insolvency test, where the taxpayer cannot borrow against or assign the pension asset, nor convert the balance into a lump sum amount.

In its *Action on Decision*, IRB 2021-15 (April 12, 2021), the IRS advised that it would not follow *Schieber* in excluding pension plan assets from the definition of "assets" under Section 108(d)(3) merely on the grounds that the pension plan assets cannot be converted to a lump-sum cash amount or that they cannot be sold, assigned or borrowed against.

III. <u>Employer Provided Loan to Purchase Real Estate Was Ineligible for the Section 108 Cancellation of Principal Residence Debt Exclusion</u>.

In Weiderman v. Commissioner, TC Memo 2020-109 (July 15, 2020), Mrs. Widerman's employer provided her a $500,000 loan to purchase a home near her employer. The loan was evidenced by a promissory note, but was otherwise unsecured.

After Ms. Weiderman's employer terminated her employment, her employer made a demand for repayment of the promissory note. Ultimately, Ms. Weiderman and her employer reached a settlement and a portion of the loan was forgiven.

The Tax Court held that the forgiven debt did not qualify for the Section 108(a)(1)(E) exclusion from cancellation of debt income for qualified principal residence indebtedness that is discharged. The court noted that the term "Qualified Principal Residence Indebtedness" is defined as acquisition indebtedness within the meaning of Section 163(h)(3)(B). Under that section, "acquisition indebtedness" is defined as indebtedness which is used to acquire or improve a qualified residence of the taxpayer and that is secured by that residence.

Here, because the $500,000 loan was unsecured, Ms. Weiderman did not qualify for the principal residence debt exclusion.

The court also upheld the Section 6662 "substantial understatement penalty" because Ms. Weiderman did not have "reasonable cause" for her underpayments under Section 6664(c)(1). Ms. Weiderman contended that she relied upon her accountant in preparing her tax return and therefore that should excuse the 6662 penalty. The court noted that, while a taxpayer's reliance upon an accountant to prepare accurate returns may indicate an absence of fraud, the "reliance upon my accountant" defense will relieve penalties **<u>only</u>** if the accountant has been supplied with all the information necessary to prepare the returns. Here, Mr. and Mrs. Weiderman provided very little backup information to their accountant. Instead, the evidence indicated that the Weidermans did not rely upon the judgment of their accountant, but instead had decided on their own to exclude the cancelled debt from their gross income.

PART SIX
CAPITAL LOSSES OR SECTION 162 DEDUCTIONS

I. Payment of Merger Termination Fee Generates Capital Losses; CCA 202224010 (February 24, 2022).

In CCA 202224010, the taxpayer attempted to acquire a target company and after the taxpayer and the target agreed to terminate the merger agreement, the taxpayer paid a termination fee to the intended target to terminate the merger agreement.

The IRS Chief Counsel was asked to determine whether the termination fee should be treated as a capital loss under Section 1234A or whether the termination fee expense could be claimed as a deductible business expense under Section 162.

Section 1234A specifically provides that any gain or loss attributable to the cancellation, lapse, expiration or other termination of a right or obligation with respect to property which is (or an acquisition of which would be) a capital asset in the hands of the taxpayer, shall be treated as a gain or loss from the sale of the capital asset. Here, there was clearly an event that extinguished the taxpayer's contractual obligation to perform under the merger agreement.

So, the termination fee could only be deducted as a capital loss under Section 1234A and not as a Section 162 business expense.

PART SEVEN
HOBBY LOSS CASES

I. Section 183 and Hobby Loss Rules.

A. Background. Section 183 denies any deductibility of losses or expenses incurred in connection with a hobby rather than a trade or business. Section 183(a) provides that, if an individual or an S Corporation is engaged in an activity that is not engaged in for profit, no deduction attributable to the activity shall be allowed. Section 183(c) defines an activity "not engaged in for profit" as any activity other than one with respect to which deductions are allowable for the tax year under Section 162 or Section 212. Deductions are allowable under Section 162 or Section 212 **only** where the taxpayer is engaged in an activity with **an actual and honest objective of making a profit**.

B. "Three-out-of Five Year" Rule. Section 183(d) provides that an activity will be presumed to be an activity "engaged in for profit" if income exceeds deductions in **three out of five** consecutive taxable years.

C. Facts and Circumstances Test. Finally, Treas. Reg. 1.183-2(b) lists some of the factors to be considered in determining whether an activity is engaged in for profit. The factors listed include:

1. the manner in which the Taxpayer carries on the activity;
2. the expertise of the Taxpayer or his advisors;
3. the time and effort expended by the Taxpayer in carrying on the activity;
4. the expectation that the assets used in the activity may appreciate in value;
5. the success of the Taxpayer in carrying on other similar or dissimilar activities;
6. the Taxpayer's history of income or losses with respect to the activity;
7. the amount of occasional profits, if any, which are earned;
8. the financial status of the Taxpayer; and
9. the involvement of elements of personal pleasure or recreation.

D. <u>Income and Expenses Are Recharacterized When Hobby Losses Are Disallowed</u>. If a hobby loss is disallowed, then all of the income still has to be reported as taxable income, and all of this taxable income will be moved from Schedule C onto Line 21 of Page 1 of Form 1040 called "Other Income."

Next, the expenses, related to the hobby activity, get moved to Schedule A, Itemized Deductions. The expenses are then broken down into two categories. The first category of expenses include items such as taxes and mortgage interest which are then deducted on Schedule A. Then, all of the other business expenses (which would have been "2% miscellaneous itemized deductions" before 2018) will not be deductible at all.

> **<u>Note</u>**: The bottom line here is that, when you have a client with a hobby loss that is disallowed, the client also often ends up with taxable income that greatly exceeds expenses. This could be a real lose/lose situation for taxpayers who attempt to deduct hobby losses.
>
> **<u>Note</u>**: So, perhaps consider operating the "hobby business" through a C corporation, since C corporations are not subject to the Section 183 hobby loss rules. See <u>Potter</u>, TC Memo 2018-153 (September 17, 2018).

II. <u>Taxpayers Had "For Profit" Motive for Miniature Donkey Breeding Activities; William R. Huff v. Commissioner, TC Memo 2021- 140 (Dec. 21, 2021).</u>

In <u>Huff</u>, William Huff and Cathy Huff, were an extremely wealthy couple who wanted to supplement their income, by breeding and selling miniature donkeys. Mr. Huff was a successful asset manager and Mrs. Huff was a successful attorney.

Mr. and Mrs. Huff purchased 31.35 acres in New Jersey, subject to a conservation easement that permitted most equestrian and agricultural uses, for their donkey breeding activities.

In 2004, the Huffs formed Ecotone, an LLC owned by them as the sole members. According to its LLC operating agreement, Ecotone was organized for, among other things, "agricultural and equestrian or equine purposes including, without limitation, breeding and raising animals."

Although the Huff's had losses related to their activities, the Tax Court held that they had a "for profit" motive for their activities. The Tax Court noted that the Huffs had a business plan for their activity, kept separate books and records, and otherwise conducted the activity in businesslike manner. Also, they operated their business through an LLC.

Other key factors included that Mr. and Mrs. Huff enlisted the help of professionals who advised them about their industry; he spent significant time on their activity; and that they also engaged experts to assist them. The Court also pointed that that their losses were so far below their job income that this wasn't a situation of using activity losses to shelter their other income.

III. An Actress is Deemed to be Engaged in a "Trade or Business" and Not a "Hobby" *Gaston*, TC Memo 2021-107 (September 2, 2021).

After 45 years of working as a Mary Kay sales agent, Ms. Gaston retired from Mary Kay and decided to pursue her dream of becoming an actress. During several years, Mrs. Gaston racked up significant losses from pursuing her acting dreams. Nevertheless, the Tax Court determined that Mrs. Gaston's acting activities were not a hobby but instead constituted a "for profit" endeavor, and that she had engaged in her acting activities with the honest objective of earning a profit.

When analyzing whether certain taxpayers have proven that they entered into **acting** activities with an intent to profit, courts have considered such industry-specific factors such as whether they: (1) belong to an acting network or union, (2) take classes or otherwise formally develop their skills, (3) develop industry contacts, (4) seek or secure multiple auditions or roles, (5) advertise their services, (6) prepare headshots or a portfolio, (7) retain an agency or assistant to help secure roles, and (8) maintain their efforts over time, given the nature of the industry. See *Richards v. Commissioner*, T.C. Memo. 1999-163 (05/14/1999).

Here, Ms. Gaston secured roles in feature-length films; spent 35-45 hours per week researching, applying or auditioning for other roles; trained to enhance her skills through acting and voice lessons; retained an assistant and an agent to help her obtain new roles; and otherwise carried on her activities in a businesslike manner.

She also engaged various casting services, retained an agent and a business management company, secured professional headshots, advertised her skills, and took acting and voice lessons.

The Tax Court noted that, as a result of her efforts, Mrs. Gaston had actually landed some roles in movies and commercials.

IV. Team-Roping Activities Were Deemed To Be A Hobby; *Gallegos v. Commissioner*, TC Memo 2021-25 (March 2, 2021).

In *Gallegos v. Commissioner*, TC Memo 2021-25 (March 2, 2021), Mr. Gallegos and his wife built up an extremely successful insurance business. Later on, Mr. Gallegos decided to start competing in a sport called "team-roping". Over the course of three years, Mr. Gallegos lost over $150,000 in pursuing his dreams of being a team roping champion. The losses were reflected on a Schedule C. According to the Tax Court and the IRS, Mr. Gallegos' activities did not rise to a "trade or business" but instead were a hobby.

Several factors indicated that Mr. Gallegos operated his team-roping activities as a hobby. First of all, Mr. and Mrs. Gallegos kept very inaccurate records of their team-roping activities and expenses. They had no formal business plan and did not maintain a separate bank account or records for their team-roping activity. Also, Mr. and Mrs. Gallegos also had no formal budget plan for their team-roping activities.

PART EIGHT
OTHER DEDUCTIONS

I. The Tax Court Explains Deductions for Travel Expenses When Away From Home; Harwood, TC Memo 2028-8 (February 15, 2022).

Mr. Harwood worked on different construction projects in Washington state and Oregon. The court allowed Mr. Harwood to deduct travel expenses while he was away from home on temporary job assignments.

Under Section 162(a)(2), a taxpayer is allowed to deduct reasonable and necessary travel expenses, such as meals and lodging, incurred while "away from home". Courts have struggled with the definition of "away from home" for purposes of applying Section 162(a)(2). This requires a determination of the taxpayer's "tax home".

Normally, if a taxpayer is away on a temporary job assignment, the taxpayer is deemed to be "away from home" during the time the taxpayer is away from his or her primary place of work. That allows the taxpayer to deduct travel expenses while away from home.

If the taxpayer is on a job assignment that is expected to last for less than a year, then the job assignment is deemed to be "temporary", thereby allowing the taxpayer to deduct travel expenses.

However, when a job assignment has an indefinite period of time that the taxpayer must be away from home, then the location of the taxpayer's new job assignment becomes the taxpayer's new "tax home". In that situation, that taxpayer can't deduct travel expenses.

A taxpayer's residence may be treated as his tax home if his principal place of business is temporary rather than indefinite. See Geiman, T.C. Memo. 2021-80, at 11-15; see also Peurifoy v. Commissioner, 358 U.S. 59, 60, 79 S. Ct. 104, 3 L. Ed. 2d 30, 1958-2 C.B. 916 (1958); Yanke v. Commissioner, T.C. Memo. 2008-131, 2008 WL 2065068, at *3. Employment is "temporary" if it is the type that can be expected to last for only a short period, Albert v. Commissioner, 13 T.C. 129, 131 (1949), and is indefinite if "its termination cannot be foreseen within a fixed or reasonably short period of time," Stricker v. Commissioner, 54 T.C. 355, 361 (1970), aff'd, 438 F.2d 1216 (6th Cir. 1971).

The Court next determined whether Mr. Harwood had a tax home during tax years by referring to the three factors set forth in Revenue Ruling 73-529, 1973-2 C.B. 37. See, e.g., Geiman, T.C. Memo. 2021-80, at *13; Lyseng v. Commissioner, T.C. Memo. 2011-

226, 2011 WL 4389644, at *3; Minick v. Commissioner, T.C. Memo. 2010-12, 2010 WL 199954, at *4; see also Henderson v. Commissioner, 143 F.3d at 500.

Past courts have considered whether the taxpayer (1) incurs duplicate living expenses while traveling and maintaining the home, (2) has personal and historical connections to the home, and (3) has a business justification for maintaining the home. See Geiman, T.C. Memo. 2021-80, at *13-15; Lyseng v. Commissioner, T.C. Memo. 2011-226, 2011 WL 4389644, at *3; Yanke v. Commissioner, T.C. Memo. 2008-131, 2008 WL 2065068, at *3.

Based upon factors set forth in Revenue Ruling 73-529, and other court cases mentioned above, the court determined that Mr. Harwood's primary residence in Yakima, Washington was his "tax home".

Mr. Harwood was able to establish that he had significant personal and historical ties to Yakima that justified him retaining his tax home in Yakima, Washington. Mr. Harwood had a "business justification" for staying in Yakima, because Mr. Harwood was a member of the local union there in Yakima. By maintaining his residence in Yakima and staying close to his local union, Mr. Harwood could access jobs within the union's local territory.

II. Losses Disallowed On Demolition Of Home Destroyed By Fire; *Parker v. Commissioner*, TC Memo 2021-111 (September 23, 2021).

Mr. and Mrs. Parker claimed a Section 165 deduction for a loss on the demolition of their property that had been burned down by a prior year fire. The IRS and the Tax Court disallowed the loss deduction pursuant to Section 280B of the Internal Revenue Code. Section 280B of the Internal Revenue Code provides that, in the case of the demolition of any structure, no deductions shall be allowed to the owner for any expense incurred in connection with the demolition or any loss sustained on account of such demolition. Instead, these amounts shall be added to the taxpayer's tax basis with respect to the land on which the demolished structure was located.

III. The IRS Hates Schedule C's; Pilyavsky v. Commissioner, TC Summary Opinion 2020-20 (July 2, 2020).

Mr. Pilyavsky reported over $167,000 of Form W-2 income and a $40,000 Schedule C loss on his tax return. The IRS and Tax Court disallowed the Schedule C deductions on the basis that the taxpayer failed to substantiate almost $50,000 of alleged expenses relating to his Schedule C activity.

PART NINE
CHARITABLE CONTRIBUTIONS

I. Defective Contemporaneous Written Acknowledgment Dooms Attempted Charitable Contribution Deduction; Keefer vs. US, 130 AFTR 2d 2022-5406, 2022 U.S. Dist. LEXIS 142303 (US District Court for the Northern District of Texas, August 10, 2022).

Mr. and Mrs. Keefer attempted to donate an interest in a limited partnership to a donor advised fund. The District Court for Texas disallowed any charitable contribution deductions on the basis that the Contemporaneous Written Acknowledgment Letter (“CWA") that the Keefer’s received back from the donor-advised fund was defective.

In this case, one of the problems with the CWA was that it was actually issued **before** the donation itself took place. The CWA was issued to Mr. and Mrs. Keefer merely in ***anticipation*** of them making a donation, and not to acknowledge a donation that had already been made.

In addition, the court also considered whether the donation was subject to the “assignment of income" doctrine because, at the time the donation was made, the partnership, called “Burbank", had been in discussions with a REIT about the possible sale of Burbank’s hotel to the REIT. However, the transfer took place during a time when negotiations were ongoing but before Burbank signed a Letter of Intent with the REIT.

Under the “anticipatory assignment of income" doctrine, a charitable donation is recast as a sale by the taxpayer-donor, followed by a charitable contribution of the sales proceeds from the liquidated asset.

Here, the Court held that the donation didn’t necessarily violate the anticipatory assignment of income doctrine, because the partnership’s right to income from the hotel sale had not yet vested when Mr. and Mrs. Keefer assigned their interest to the donor advised fund - even though there was a 95% chance of the sale ultimately going through at the time of the donation.

However, when the Keefer’s gifted their partnership interest to the donor advised fund, the gift was subject to an “oral agreement” that he donor-partners were retaining certain rights to cash reserves held by the partnership at the time of the donation. Therefore, the donor-partners retained a ***partial interest*** in the donated asset, which meant that the assignment of income doctrine would apply to the entire donation, since the ***whole*** asset was not transferred to the donor advised fund before the sale. Dickinson v. Comm’r, 2020 WL 5239242 (Sept. 3, 2020).

II. Another Defective Contemporaneous Written Acknowledgment Dooms Charitable Contribution Deduction; Izen vs. Commissioner, 148 TC 71 (Fifth Circuit Court of Appeals) (June 29, 2022).

Mr. Izen allegedly donated a 50% interest in an aircraft to a charitable organization. The Fifth Circuit Court of Appeals upheld the earlier decision of the Tax Court denying any charitable contribution deduction, because the purported contemporaneous written acknowledgment ("CWA") letter failed the strict substantiation requirements of Section 170(f)(8)(B).

The tax rules provide specific substantiation requirements when the subject of the gift is a qualified vehicle or an airplane with a value in excess of $500. Under Section 170(f)(12)(B), the contemporaneous written acknowledgment ("CWA") letter from the donee organization must include the name and taxpayer identification number of the donor.

Here, when Mr. Izen donated his 50% interest in the aircraft to the charitable donee, the donee provided Mr. Izen with an acknowledgment letter. However, the letter was addressed to a Mr. Tangey, and not to Mr. Izen. Moreover, the letter never mentioned Mr. Izen by name and did not provide his taxpayer identification number.

Mr. Izen included, with his federal tax return, a copy of the Donation Agreement between Mr. Izen, Mr. Tangey and the charitable organization, but again the Donation Agreement failed to satisfy the substantiation requirements, since the donation agreement did not include Mr. Izen's name and taxpayer identification number.

Likewise, when Mr. Izen filed his tax return, he included a copy of Form 8283 signed by the charity with his tax return, but the Form 8283 did not include his Social Security number.

And finally, in a footnote, the Court the Court of Appeals noted that the Form 8283 also failed the "contemporaneous" requirement. Under Section 170(f)(12)(C) an acknowledgement of a donation of a vehicle or an aircraft is "contemporaneous" only if it is provided by the donee organization within thirty (30) days after the date of the contribution. Here, the Form 8283 wasn't signed until well after the donation date.

NOTE: For donations of vehicles (and aircraft), a special 30-day period applies to the definition of "contemporaneous".

III. <u>Another Failed CWA; Albrecht v. Commissioner, TC Memo 2022-53 (May 25, 2022).</u>

Under Section 170, no charitable contribution deduction is allowed, unless the done organization provides a Contemporaneous Written Acknowledgement ("CWA"). To meet the "substantiation" requirements, a CWA must state whether the charitable donee provided any goods or services in connection with the donation. Section 170(f)(8)(B)(ii).

In addition, the CWA must be "contemporaneous" (Section 170(f)(8)(C)), which means that the taxpayer must receive the CWA by the **<u>earlier</u>** of (1) the **<u>actual date</u>** the tax return is filed or (2) the due date (including extensions) for the tax year of the donation.

Martha Albrecht executed a "Deed of Gift" and donated a large collection of native American jewelry to a museum.

The problem here was that there was no CWA that specifically stated whether or not Mrs. Albrecht received any goods or services in exchange for her gift. Even though the Deed of Gift did not say that Mrs. Albrecht **did** receive something of value in exchange for her gift, the Deed of Gift simply did not recite **"<u>whether</u>"** the Museum gave her anything of value in exchange for her donation.

The silence in the CWA was fatal. The court ruled that a document that is "silent" about whether any goods or services were received by the taxpayer is by definition defective.

Furthermore, the Deed of Gift contained some rather strange language providing that Mrs. Albrecht had transferred "all rights, title and interest held by the donor included in the donation, unless otherwise stated in the Gift Agreement."

In this case, there actually was no other type of Gift Agreement and so the CWA erroneously and inaccurately referred to a document that simply didn't exist at all. Of course, Mrs. Albrecht couldn't prove that the Gift Agreement didn't exist; and indeed, if the Gift Agreement had existed, then it would have been possible that the Gift Agreement could have conveyed something back to Mrs. Albrecht from the museum.

IV. <u>No Charitable Deduction for Home Donated as Salvage; *Mann v. US* 127, AFTR2d 2021-447 (January 1, 2021)</u>.

In <u>*Mann*</u>, the Fourth Circuit Court denied a couple's charitable deduction for their donation of salvaged materials from their home's demolition. The Fourth Circuit affirmed that, without recording a deed of transfer of ownership of the home itself, the owners' interest in the structure was not severed from the underlying land. A Transfer Agreement with the charity receiving the items was ruled insufficient to support a transfer of an interest in the structure itself.

Mr. and Mrs. Mann decided to tear down their house and construct a new one on the property. The Manns entered into a Transfer Agreement with Second Chance, a charitable organization, which provided that the Manns would retain ownership of the underlying land but would donate the house to Second Chance.

However, under Maryland law, to transfer the house separately from the underlying land, the Manns were required to sever the house from the underlying land by recording the transfer of the house with the local county. (Sec. 170(f)(3)). However, the Manns did not record a deed of transfer for the house, so the house was not severed from the underlying land.

So, according to the Fourth Circuit Court of Appeal, since, under Maryland law, the Manns still retained record ownership of the house and were still liable for paying property taxes, the Manns had not conveyed their entire interest in the property.

V. <u>Charitable Contribution: No Charitable Contribution Deduction for Donation of Home to Fire Department For Training: Rolfs v. Commissioner, 135 TC No. 24 (November 4, 2010)</u>.

In the case of <u>Rolfs v. Commissioner</u>, 135 TC No. 24 (November 4, 2010), the taxpayers donated their lake front home to the local Volunteer Fire Department to be used for fire fighting and police training exercises and eventual demolition. Several days after donating the house to the Fire Department, the local Volunteer Fire Department conducted two training exercises at the house and burned it down.

Mr. and Mrs. Rolf claimed a $76,000 charitable deduction on their 1998 tax return, but later **amended the tax return** to claim a charitable deduction of $235,000 which was the reproduction cost of the house.

The Tax Court sided with the IRS and ruled that no charitable deduction was allowable because the Rolfs received, in exchange for the donated property, a benefit in the form of demolition services, the value of which exceeded the value of the donated property.

Originally, Mr. Rolf had the house appraised and the structure was valued at $76,000. At trial, the IRS introduced an expert who testified that it would cost $100,000 to "move" the house from one location to another. The IRS offered that, under the "quid pro quo argument," the value of any charitable donation should be reduced by the benefit conferred upon the donor. Mr. Rolf, however, provided testimony indicating that it would cost around $10,000 to demolish the house and remove the debris. Mr. Rolf relied upon the <u>Scharf v. Commissioner</u>, TC Memo 1973-265, case and argued that a small or incidental benefit received by a donor does not negate a finding of donated intent. The <u>Scharf</u> case had facts very similar to the Rolf's situation.

Ultimately, the Court considered whether the value of the lake house, as donated, exceeded the value of the demolition services that Mr. Rolf received.

The Court then applied a "willing buyer and willing seller" test to determine the value of the house without the land underneath it. Ultimately, the Court held that the lake house was virtually worthless, because no one would purchase it just to move it from the lake house location to another location. In other words, substantially all of the value of the lake house came from the fact that the lake house was just that – a house sitting on a lake shore.

The Court also reviewed the donation letter that the taxpayer provided to the local fire department and noted that, in the donation letter, Mr. Rolf stated that the house was to be used for firefighter training and for no other purpose. Since this was a restriction binding upon the donee, the donee could not liquidate its interest in the house by selling it to a third party. Thus, this restriction placed upon the donation would also serve to depress the value of the structure standing alone. In other words, in light of this restriction, no one would purchase the structure from the Fire Department -- since it could never be used for anything other than fire department training.

<u>Note</u>: No penalties were assessed against the taxpayers however.

<u>Note</u>: Here, the taxpayer should have provided more compelling testimony or evidence to indicate what a third party would pay to purchase just the structure and not the underlying land.

VI. <u>No Easement Donation Charitable Contribution Deduction Allowed Where Form 8283 Didn't Include Cost Basis Information.</u>

In yet another case of a failed charitable contribution donation deduction, in <u>Oakhill Woods, LLC v. Commission, TC Memo 2020-24 (Feb. 13, 2020)</u>, the IRS and Tax Court disallowed a contribution easement charitable contribution donation deduction because the taxpayer failed to include tax basis information on the IRS Form 8283. This resulted in a disallowed charitable deduction of almost $8 million.

On its filed tax return for the year of the donation, the taxpayer did not report its income tax basis for the donated easement but instead added an attachment to the Form 8283, citing that "the basis of the property is not taken into consideration when computing the amount of the deduction". The Tax Court ruled that, since the tax basis information was not included on the Form 8283 as originally filed for the year or the donation, the charitable deduction failed the "substantiation requirements" of Section 170.

The tax court also noted that the taxpayer may not qualify for the “reasonable cause” defense under Section 170(f)(11)(A)(ii)(II). Here, the LLC argued that it prepared and filed its Form 8283 in this manner based upon advice of their CPA, who prepared the return, as well as based upon advice of a consulting firm called “Forever Forests” which provided consulting advice in structuring the conservation easement donation. Here, because Forever Forests was involved with the conservation donation, another court would have to determine, at a later date, whether Forever Forests was a “competent and independent advisor unburdened with a conflict of interest” and whether the CPA was a “competent tax professional” who provided tax advice independent of the advice supplied by Forever Forests.

VII. Charitable Deduction Denied for Failure to Provide Tax Basis Information on Form 8283.

In Blau, 924 F.3d 1261, 123 AFTR2d 2019-1960 (CA DC, May 24, 2019) the Court of Appeals upheld the earlier decision of the Tax Court in RERI Holdings I, LLC, 149 TC No. 1 (July 3, 2017), denying an LLC's charitable contribution deduction for the valuation of property donated to a University where the taxpayer failed to include its cost basis of the donated property on its Form 8283 submitted with its tax return. Here, the LLC purchased property for $3 Million in March 2002, and then donated a remainder interest in the real property to a university in August 2003. The LLC claimed a charitable contribution deduction of $33 Million for its assignment of its remainder interest to the University.

However, the taxpayer failed to include its cost basis on the Form 8282 submitted with its 2002 return. The Court therefore ruled that the charitable contribution deduction should be denied, because the LLC failed to "substantially comply" with the substantiation requirements of Reg. Section 1.170A-13(c)(2). Here, the Court ruled that the taxpayer's failure to include its tax basis information on the Form 8283 failed to meet the substantial compliance rules. The Court noted that, if the taxpayer had shown its tax basis information on the Form 8283, then this would have alerted the IRS of the potential overvaluation of the contributed real property based upon the much lower amount paid for the property fairly soon before the charitable contribution.

VIII. Charitable Deduction Fails Where Tax Basis Not Shown on Form 8283.

Belair Woods, LLC vs. Commissioner, TC Memo 2018-159 (September 20, 2018), involved a taxpayer who tried to claim a conservation easement deduction under Section 170. Originally, Belair acquired an interest in certain real property with a carryover tax basis of approximately $2,605 per acre. A little more than a year later, Belair entered into a deed of conservation easement with the Georgia Land Trust. On the Belair’s tax return, it claimed a charitable contribution deduction of $33,707 per acre.

Belair’s tax return was accompanied by a Form 8283 containing all of the required information, except for the donor’s cost or adjusted basis in the donated property. Belair noted that the instructions to Form 8283 provide that, if the cost basis is not shown on the Form 8283, the taxpayer should attach an explanation to Form 8283 providing a reasonable cause for why it is not included. When Belair filed its Form 8283, it attached a statement to Form 8283 stating that the tax basis information was not being included on the return because "the basis of property is not taken into consideration when computing the amount of deduction."

In upholding the IRS's disallowance of the charitable deduction, the Court held that the requirement to disclose cost basis information, when that information is reasonably ascertainable, is necessary to help the IRS effectively identify overvalued property. Here, the question is not whether the cost basis information was readily ascertainable. Here, this was not an inadvertent omission, but a conscious election not to supply the required information. Therefore, Belair did not either, strictly or substantially, comply with the regulatory recording requirements of Section 170.

IX. Failed Charitable Contribution Donation Acknowledgement Letter Resulted in Disallowance of $65 Million Charitable Contribution.

A. Background. Section 170(f)(8)(A) provides that no deductions shall be allowed for any cash contributions of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution which also meets the requirements of Section 170(f)(8)(B). Under Section 170(f)(8)(B), the donee's written acknowledgement letter must indicate whether the donee organization provided any goods or services in consideration for the contribution.

B. West 17th Street, LLC. In 15 West 17th Street LLC, 147 TC No. 19 (December 22, 2016), a limited liability company (taxed as a partnership) made a charitable contribution of a Historic Preservation Deed of Easement to a charitable trust. In December 2007, West 17th Street LLC executed a Historic Preservation Deed of Easement in favor of the Trust for Architectural Easements (the "Trust").

In May 2008, the Trust sent the LLC a letter acknowledging receipt of the easement. However, the Trust's letter did not specifically say whether the Trust had provided any goods or services to the LLC, or whether the Trust had otherwise given the LLC anything of value, in exchange for the charitable contribution easement.

The LLC secured an appraisal that determined that the value of the charitable contribution easement was almost $65 Million.

In October 2008, the LLC filed its Partnership Tax Return, and included a copy of the Trust's letter of May 2008, along with the Form 8283, Non-Cash Charitable Contribution, executed by the appraiser and a representative of the Trust acknowledging the LLC's gift to the Trust.

The IRS disallowed the LLC's charitable contribution deduction on the basis that the May 2008 donee acknowledgement letter did not meet the "contemporaneous written acknowledgement" ("CWA") "substantiation requirements" of Section 170(f)(8)(A). The IRS argued that, in the done acknowledgement letter from May 2008, the Trust failed to confirm to the LLC that the Trust received nothing in exchange for the LLC's charitable contribution.

The Trust filed its Form 990 for 2007, but on the Form 990, the Trust failed to list the contribution of the easement on its informational return. However, after the LLC's tax return was selected for audit for 2007, the Trust prepared an amended Form 990 for the 2007 year, and showed, on its amended 2007 return, the receipt of the charitable donation from the LLC of $65 Million including all of the charitable information that met the substantiation requirements under Section 170.

During the Tax Court proceeding, the LLC argued that Section 170(f)(8)(D) specifically provides that a Donee Acknowledgement Letter does not need to be delivered to the donor if the donee charitable organization files an informational tax return which includes all of the done information that would have been included in the done acknowledgement letter "on such form and in accordance with such regulations as the Secretary may prescribe." The LLC thus argued that, by amending its Form 990 for 2007, the Trust effectively provided the IRS with the identical information that would have been included on the LLC's donee acknowledgement letter from May 2008.

Unfortunately for the LLC, however, the IRS has not issued any regulations that specify how a charitable organization's informational return Form 990 eliminates the necessity of the contemporaneous donee acknowledgment letter that must be provided from a charity to its donor. The LLC argued that, if the IRS had issued the Form 990 informational return regulations, as contemplated under Section 170(f)(8)(D), the IRS could not now disallow the charitable contributions merely by virtue of the IRS's failure to issue the regulations it was mandated to issue.

According to the Court, however, Section 170(f)(8)(D) does not require the IRS to issue such regulations, but instead simply states that the IRS "may" issue those regulations that would alleviate the need for charitable organizations to issue contemporaneous done acknowledgement letters provided that the organization's Form 990 discloses the same information that would have been disclosed on such a donee acknowledgment letter. According to the Tax Court, since Congress elected to use the word "may prescribe" rather than "shall prescribe" in Section 170(f)(8)(D), the charitable organization's informational return did not save the charitable deduction where the charitable organization's acknowledgement letter otherwise failed to meet the strict done acknowledgement requirements of Section 170(f)(8).

Note: But, in another case, a recorded deed accomplishes the contemporaneous acknowledgment requirement. 310 Retail, LLC v. Commissioner, TC Memo 2017-164 (August 24, 2017).

X. **Final Regulations Impose New Substantiation Reporting for Charitable Contributions**.

In July 2018, the IRS issued its final Section 170A regulations (TD 9836 July 27,2018). These regulations relate to substantiation and reporting requirements for cash and non-cash charitable contributions. Although the final regulations follow the 2008 proposed regulations, there are some startling differences between the final regulations and the proposed regulations.

For example, the final regulations state that a fully completed Form 8283, signed by the donee does not satisfy the contemporaneous donee acknowledgment requirements of Section 170(f)(8)(B), because the Form 8382 only contains some of the information that is required in a contemporaneous donee acknowledgement letter.

And further, the final regulations state that, if an appraisal is required to be attached to a tax return for the contribution year, then the same appraisal must be attached to the returns for all carryover years. Reg 1.170 A–16 (f) (3). An example of this would be where there is a large non-cash charitable contribution that exceeds 30% of the donor's AGI for the contribution year. This is a real foot fault for the unwary.

XI. **But In Another Case, "Substantial Compliance" Saved Unqualified Appraisal; Emanouil v. Commissioner, TC Memo 2020-120 (August 17, 2020)**.

In Emanouil, the Tax Court ruled that an appraisal met the "substantial compliance" requirement of Section 170 even though the appraisal (1) did not identify the date of the charitable contribution and (2) did not contain a statement that the appraisal was prepared for income tax purposes.

PART TEN
REASONABLE COMPENSATION
AND OTHER BONUS COMPENSATION CASES

I. Compensation Cases In General: The "Comparison Test" and The "Hypothetical Investor" Test.

A. Background. In connection with reasonable compensation cases, the courts have generally addressed compensation issues based upon a "reasonable compensation comparison test" which compares compensation paid by the taxpayer to the employee against the amount of compensation paid by other companies to other executive employees who possess similar qualities and provide similar services. This "comparison test" is of very limited benefit in closely-held corporations, since market data does not always exist to establish a fair comparison.

More recently, courts have also applied a "hypothetical investor" test as advanced by the courts in Exacto Spring Court vs. Commissioner, 196 F.3d 833 (1999) and in Dexsil 98-1 USTC 50,471 (2nd Cir. 1998), which evaluates reasonable compensation based upon the rate of return a hypothetical investor (such as shareholders) would deem reasonable in light of rate of returns they actually recognized on their stock investments.

The "hypothetical investor" test, therefore, looks not at the amount of compensation paid to the employee per se, but instead the "hypothetical investor" test looks at the rate of return generated on the "bottom line" after considering the compensation deduction. In many cases, the hypothetical investor test provides a pro-taxpayer benefit, since market data is more easily obtained to determine adequate investor rates returned by private versus public corporations.

B. The Elliott's "Comparison" Test. Under the holding of Elliott's, Inc. v. Commissioner, 83-2 USTC 9610 (9th Cir. 1983), five factors should be considered in establishing reasonable compensation paid to employees as follows:

1. The employee's role in the company such as the employee's position, hours worked, and duties performed;
2. A comparison of the employee's salary with salaries paid by similar companies for similar services;
3. The character and financial condition of the company;
4. Potential conflicts of interest (such as disguised dividends as salary); and
5. Internal consistency in compensation through the ranks of company employees.

C. The "Hypothetical Investor" Test. Dexsil Corporation v. Commissioner, 98-1 USTC 50,471 (2nd Cir. 1998) and Exacto Spring Court vs. Commissioner, 196 F.3d 833 (1999). More recently, courts have also applied a "hypothetical investor" test as advanced by the court in Exacto Spring Court vs. Commissioner, 196 F.3d 833 (1999) and Dexsil 98-1 USTC 50,471 (2nd Cir. 1998),which evaluates reasonable compensation based upon the rate of return a hypothetical investor (such as shareholders) would deem reasonable in light of rate of returns they actually recognized on their stock investments.

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In Dexsil, the 2nd Circuit Court of Appeals reversed the Tax Court's determination of reasonable compensation because the Tax Court had failed to adopt "the perspective of an independent investor" in determining the reasonable compensation issue. Thus, the Court of Appeals held that, in addition to reviewing the factors to be assessed in determining the reasonableness of compensation under Elliotts, the Tax Court is **also required** to apply a "hypothetical investor" analysis. This "hypothetical investor" test requires the Tax Court to consider whether:

> an inactive, independent investor would be willing to compensate the employee as he was compensated. The nature and quality of the services would be considered as well as the effect of those services on the return the investor is seeking on his investment.

In essence, if excessive compensation is being paid to the employee, so that corporate profits do not represent a reasonable return on the shareholder's investment, then an independent investor would probably disapprove of the compensation arrangement. Thus, in addition to applying other traditional compensation tests, the Tax Court must also consider:

1. The company's return on equity;
2. The amount of dividends paid to shareholders;
3. Increases in the company's net worth; and
4. Increases in market value of company stock.

In this case, although the Tax Court applied the five-factor test of Elliott's, Inc., the Tax Court failed to apply a hypothetical investor test. Therefore, the 2nd Circuit Court of Appeals remanded the opinion for further consideration based upon the hypothetical investor test.

D. Tax Court Concludes Compensation Is Reasonable Using the "Hypothetical Investor" Test: H. W. Johnson, Inc. v. Commissioner, TC Memo 2016-95 (May 11, 2016).

H. W. Johnson and Margaret Johnson formed their concrete contracting business, H. W. Johnson, Inc. ("HWJ"), in 1974. Bruce and Donald, the sons of Mr. and Mrs. Johnson, took over the operations of HWJ in 1993. Over time, Mr. and Mrs. Johnson made gifts of stock in HWJ to their sons. Due to the leadership of Bruce and Donald, revenues of HWJ increased dramatically over the years. During 2003 and 2004, HWJ paid bonuses of $4 Million and $7 Million to Bruce and Donald. These bonuses were based upon a formula bonus plan that had been adopted in the early 1990s.

In late 2002, Bruce and Donald became concerned that consolidation of the concrete supply industry could threaten their ongoing access to concrete. So, Bruce and Donald suggested to their mother that they form a concrete supply company. However, Mrs. Johnson thought that investing in a concrete supply company was too risky. Therefore, Bruce and Donald decided to form their own concrete supply company, called DBJ Enterprises, LLC. For 2004, HWJ paid a $500,000 bonus to DBJ for DBJ's agreement to provide a guaranteed supply of concrete at market prices for the year ending June 30, 2004.

During an IRS audit for the 2003 and 2004 tax years, the IRS disallowed the $500,000 guaranty supply bonus, as well as the compensation paid to Bruce and Donald for those years, taking the position that these amounts represented excessive compensation. Since this case would have been heard by the 9th Circuit Court of Appeals, the Tax Court applied the Elliotts, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983), five (5) factor test, including the hypothetical investor test.

During the Tax Court proceeding, the IRS effectively conceded four of the five Elliotts factors as being either taxpayer-favorable or neutral. However, the IRS took the position that the company failed the hypothetical investor test.

The Tax Court noted that, since no one (1) factor would be determinative of the reasonable compensation test, the Tax Court would have to review all five (5) factors under the Elliotts test, even though the IRS had conceded that at least four of the factors were either neutral or in favor of the company. Ultimately, the Tax Court ruled in favor of HWJ based upon the following analysis of the five (5) factors under Elliotts:

(1) Role in the Company. Bruce and Donald were clearly integral to the company's success during the tax years at issue, so this factor was clearly in favor of HWJ.

(2) External Comparison. As is the case with most closely-held businesses, there were no similar companies with published compensation that could be compared to HWJ, and so this factor was neutral.

(3) Character and Condition of the Company. During the years at issue, HWJ experienced significant revenue, profit margin and asset growth, and therefore this factor was clearly in favor of HWJ.

(4) Internal Consistency. Here, the annual bonuses were based upon a bonus formula that had been in place for a number of years, and therefore this factor was in favor of HWJ.

(5) Conflict of Interest. The "conflict of interest" test is analogous to the "independent investor" test. Here, the experts for HWJ and the IRS agreed that HWJ had pre-tax returns on equity of 10.2% and 9% for 2003 and 2004. However, the IRS and HWJ disagreed on what an expected return on equity should have been for HWJ for those years.

The IRS contended that an unexpected return of equity for a company like HWJ should have ranged from 13.8% to 18.3%. Using a different data service, however, the expert for HWJ concluded that, based upon similarly-situated companies, a more accurate projected industry pre-tax return on equity would have ranged from 10.5% to 10.9%, which admittedly was higher than the actual pre-tax rate of return that HWJ experienced in those years. The IRS, therefore, contended that, because HWJ's return on equity fell below the industry average for 2003 and 2004, the Tax Court should determine that all of the compensation paid to Donald and Bruce was unreasonable for those years.

The Court, however, held that the required actual return on equity, for purposes of the independent investor test, does not have to be shown to have significantly exceeded the industry average for companies who had been especially successful. Instead, in other court cases, courts have generally ruled that a return on equity of at least ten percent (10%) tends to indicate that the independent investor test has been met. See, e.g. Thousand Oaks Residential Care Home 1, Inc. v. Commissioner, T.C. Memo 2013-10; Multi-Pak Corp. v. Commissioner, T.C. Memo 2010-139.

According to the Court, therefore, HWJ's return on equity was close enough to this benchmark, so as to pass the independent investor test.

E. The *Menard* Court Proceedings Use Comparison Test And The Hypothetical Investor Test; Menard, Inc. vs. Commissioner, 560 F.3d 620 7th Cir., (March 10, 2009). Although the 7th Circuit Court of Appeals was the venue for the Exacto Spring case, other courts have been quick to adopt the "hypothetical investor" test under Exacto Spring. The 7th Circuit Court of Appeals again adopted the "hypothetical investor" test in the 2009 case of Menard, Inc. vs. Commissioner, 560 F.3d 620 7th Cir., (March 10, 2009).

In Menard, Inc., 103 AFTR 2d 1280 (7th Cir. Court of Appeals 2009), the 7th Circuit Court of Appeals found that John Menard's compensation of more than $20 Million was reasonable. In this case, John Menard was paid $20 Million of compensation from his C corporation in 1998.

In 1998, the tax year at issue, the Corporation was the third largest home improvement retailer in the US, just behind Home Depot and Lowes. Mr. Menard owned all of the company's voting shares and 56% of its non-voting shares. Mr. Menard was paid a bonus equivalent to 5% of the taxpayer's net tax income that amounted to over $17 Million.

Also Mr. Menard and the corporation had entered into a **reimbursement agreement** which provided that, should any portion of the compensation be found to be excessive, then Mr. Menard would refund the excess compensation back to the corporate taxpayer (presumably in an attempt to reverse any constructive dividend).

During the 1998 year, the company had revenues of approximately $3.4 Billion and its taxable income was $315 Million. The Company's return on equity during 1998 was about 18.8% which was higher than its two largest competitors.

In this case, Mr. Menard proved that he worked 12 to 16 hours each day. During the time he worked, sales and profits of his company had increased dramatically from 1991 to 1998.

Finally, under the compensation bonus arrangement, the $20 Million bonus consisted of more than $17 Million of bonus that had been awarded under a bonus compensation arrangement that the Board of Directors had adopted years before.

The $17 Million bonus paid to Mr. Menard was under a bonus program which was initially recommended by the company's accounting firm in 1973. Under the 1973 bonus program, the company paid a bonus of 5% of the company's net income before income taxes. In 1973, when the bonus plan was adopted, the Board of Directors included an outside director/shareholder who voted for the plan. In 1998, the Board of Directors included Mr. Menard's brother, as well as the company's treasurer.

The compensation deduction was challenged by the IRS.

The 7th Circuit Court of Appeals in Menard recalled that, in Exacto, the court created a ***presumption*** that:

> when investors . . . are obtaining a far higher return than they had any reason to expect, [the owner/employee's] salary is presumptively reasonable.

The IRS, of course, could rebut that presumption by presenting evidence that the company's success was the result of extraneous factors, such as an unexpected discovery of oil under the company's land, or that the company intended to pay the owner/employee a disguised dividend rather than salary. Here, of course, in Menard, the IRS presented no evidence that any of the Menard shareholders had complained about an 18.8% rate of return on their investment for 1998.

The 7th Circuit also was impressed by the risky nature of the bonus plan. In other words, Mr. Menard's compensation was likely to vary substantially from year to year since it was a pure income based bonus plan. The Court of Appeals noted that, under Mr. Menard's compensation agreement, if the company had lost money during the tax year, he would only have made a salary of around $157,000. However, since the company made profits in the tax year, he made a bonus of about $20 Million which was all "profit based".

II. Tax Court Decreases Deductible Compensation Under the Reasonable Compensation Test; Clary Hood, Inc. v. Commissioner, TC Memo 2022-15 (March 2, 2022).

Clary Hood, Inc., employed its founder and primary shareholder, Mr. Hood, as its chief executive officer. Hood, Inc. was a C corporation, and the Tax Court case involved establishing the amount of reasonable compensation that Hood, Inc. could deduct for the 2015 and 2016 tax year.

Mr. Hood ran Hood, Inc. starting in 1980 and had grown the company into a large and successful construction company operating out of South Carolina. By the end of 2016, the company had 150 employees with over $70 million in annual revenue. During

2015 and 2016, Mr. Hood received $168,000 and $196,000 in base salary, with $5 million bonuses for each of those years.

There was no written employment agreement between Mr. Hood and his company. Instead, the compensation was set directly by the Board of Directors, which was Mr. Hood and his wife.

However, the Hoods did solicit and accept the advice of their CPAs some years in setting Mr. Hood's compensation, although there was never any type of compensation formula used in either 2015 or 2016. The Hoods used an outside CPA firm, Elliott Davis, LLC who provided them with advice concerning the appropriate compensation to be paid to Mr. Hood. Specifically, in the Fall of 2014, Mr. Hood asked his accountants at Elliott Davis to consider whether he should be issued bonuses to account for the fact that he had been undercompensated in prior years. Mr. Hood also sought the advice of Elliott Davis to establish his future compensation going forward.

After its audit, the IRS substantially reduced Mr. Hood's deductible compensation for 2015 and 2016 and imposed the accuracy related penalties under Section 6662 and the substantial understatement penalty under Sec. 6662(a) and (b)(2).

The IRS assessed the accuracy related penalties and substantial understatement penalties under Section 6662.

In the Tax Court proceeding, the court noted that US 4th Circuit Court of Appeals (where South Carolina is located) has always applied the "multi-factor" approach when making the reasonable compensation test.

Unlike in other Circuits, the 4th Circuit Court of Appeals had never adopted any iteration of the "independent investor" test established by other courts such as in Exacto Spring Corp. v. Commissioner, 196 F.3d 833, 838 (7th Cir. 1999) (relying primarily on the independent investor test).

The "multi-factor" test looks at the following factors: the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with gross income and net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions and comparable concerns; and the salary policy of the taxpayer as to all employees.

Before applying the multi-factor test to determine Mr. Hood's reasonable compensation for 2015 and 2016, the court recognized that Mr. Hood was the "epitome of the American success story". In addition, according to the court, the IRS should never be able to substitute its own business judgment for that of the taxpayer as to setting the appropriate amount of a given employee's compensation. However, it would be up to the

Court to determine that amount of compensation that may be **deducted** for Federal income tax purposes.

The Court went on to find that the company had clearly met a number of the factors supporting the compensation paid to Mr. Hood, such as:

1. Mr. Hood's background and qualifications;
2. The nature and extent of Mr. Hood's work; and
3. The size and complexity of the company's business.

Compensation versus Net Income. The court went on to look at and compare Mr. Hood's compensation to the income earned by his company. The court noted that it is more important to consider compensation as a percentage of net income than merely a percentage of gross receipts, since net income is usually a more important comparison because it more accurately gauges whether a corporation is disguising the distribution of dividends as compensation.

The court noted that for 2015 and 2016, the company paid Mr. Hood 42% and 26% of its pre-tax net income as compensation, but that these percentages did not demonstrate an egregious pattern of disguised dividends.

Prevailing General Economic Conditions. The court also looked at the "prevailing economic conditions" of the company and the construction industry in general, as this factor helps to determine whether the success of a business may be attributable to the efforts and business acumen of the employee as opposed to general economic conditions. Between the 2013 and 2016, the company's revenue jumped from $16 million to over $68 million over this brief time, which of course was a trend that could not be credited only to economic conditions. Moreover, the company had down years with the construction industry, but continued to thrive and survive during those years. According to the Court, this demonstrated the importance of Mr. Hood's role in the company even during economically turbulent years.

Dividend History. The Court next looked at dividend history and noted that Hood, Inc. had never paid a cash dividend to its shareholders.

Expert Testimony About Compensation Comparables. Both the IRS and the company introduced experts' testimony at the Tax Court hearing.

The company offered the testimony of Mr. Kursh of BLDS, LLC which was an economic consulting firm. Unfortunately for the company, the Court held that the BLDS report lacked supporting calculations and failed to include underlying data that prevented the Court from being able to verify Mr. Kursh's findings and conclusions. The Court said it was going to give "little to no weight" to Mr. Kursh's testimony.

Next, Theodore Sharp, who was a senior partner at the management consulting firm of Korn Ferry, presented at trial an expert report prepared by Korn Ferry. Mr. Sharp testified that, although he reviewed and agreed with the Korn Ferry report, he had not written it himself. Apparently, the Korn Ferry report consisted of only a dozen or so Power Point slides in a bullet point format. The Tax Court was unimpressed.

On the other hand, David Fuller, who founded Value, Inc., testified for the IRS and the tax court was very impressed with the thoroughness of his testimony. The court determined that Mr. Fuller's report was the most credible and complete source of data, analysis and conclusions as to what similar companies might be willing to pay Mr. Hood for his services.

The Company's Compensation and Salary Policies. Next, the court noted that Hood, Inc. had no structured compensation system in place for establishing non-shareholder compensation and that the company did not have any compensation agreement with Mr. Hood at all. Instead, Mr. Hood's compensation was simply established by the Board of Directors.

As discussed further below, there were some instances in which Mr. Hood consulted with his outside accounting experts, but generally he had the final say so for what his compensation would be each year.

Catch-Up Compensation. The court next looked at the company's argument that its 2015 and 2016 bonuses were designed to provide Mr. Hood with catch-up compensation. The court noted that Mr. Hood's compensation increased over 300% in 2015 but there was no evidence that his duties or responsibilities increased correspondingly. The court acknowledged that, although Mr. Hood was likely undercompensated in past years, his undercompensation in past years did not allow the company complete latitude in deducting his back-pay bonus, since the company couldn't demonstrate, through reliable means, how the full amount of 2015 and 2016 compensation was proportionate in value to purported past services rendered by Mr. Hood.

Based upon the foregoing discussion, the court ultimately held that the company had not adequately established how the amounts paid to Mr. Hood during the tax years were both reasonable and paid solely as compensation for his services. While there were certain factors in the company's favor, the court wouldn't simply rule in favor of whichever side had the **most** factors in their favor, since all factors are not given equal weight.

Court Reduces Deductible Compensation. Ultimately, based upon Mr. Fuller's testimony on behalf of the IRS, the Tax Court reduced Mr. Hood's original compensation down to around $3.7 million for 2015 and just under $1.4 million for 2016.

Applicable Penalties. Next, the court determined whether it would apply the 20% substantial understatement penalty under Section 6662(a) and (b)(2). Since this was a C corporation, the understatements were deemed "substantial," because the understatement succeeded 10% of the tax required to be shown on the return. Section 6662(b)(1)(B).

Of course, the company asserted that it had "reasonable cause" and a good faith defense for the imposition of the penalties under Section 6664(c)(1).

Here, with respect to the 2015 tax year, the court stated that, since Mr. Hood had specifically sought out advice from its regular accounting firm and its outside accounting firm as to potential compensation and applicable tax consequences for 2015, Mr. Hood had "reasonable cause" for his position on his 2015 return.

However, for 2016, because the court believed that neither the testimony of Mr. Hood nor that of his expert witnesses could support the amount of compensation the company paid him in 2016, the Court also determined that the company failed to establish "reasonable basis" for its tax return positions during 2016.

According to the court, with respect to the 2016 compensation, Mr. Hood was able to provide virtually no evidence at trial with respect to any advice the company may have received from its accounting firm to determine the amount of compensation for 2016. Therefore, the court couldn't establish that the company had any "reasonable basis" for establishing the compensation as it did.

Next, the Company argued that it had "substantial authority" for its tax return position that would negate the substantial understatement penalty, pursuant to Section 6662(d)(2)(B)(i). The "substantial authority" test is met where there is about a 40% chance of success Canal Corp. vs. Commissioner, 135 TC 199 (2010).

The company argued that it had "substantial authority" for setting Mr. Hood's compensation based upon the "independent investor test" that had been adopted by the 7th Circuit Court of Appeals in Exacto Spring.

However, only the 7th Circuit had adopted the independent investor test as the "exclusive" test to be applied in the 7th Circuit. In the 4th Circuit, however, courts have applied the "multi-factor" approach without considering the "hypothetical investor" test at all. Since no 4th Circuit cases supported the independent investor test, no substantial authority existed for the company's position for 2016, as the 4th Circuit relies solely upon the multi-factor approach.

III. Another Disguised Dividend Case; Aspro, Inc. v. Commissioner, 8th Circuit Court of Appeals, 32 F.4th 673 (2022); 129 AFTR 2d 2022-1581; April 26, 2022.

Aspro was a paving company that claimed tax deductions for management fees paid to its shareholder employees. There were no written employment agreements between Aspro and its owners. Likewise, Aspro could produce no written management services agreements or other documentation of its relationship between Aspro and the stockholders, and there was no evidence as to how Aspro determined the amount of management fees to be paid to the owners.

Also, there was no evidence that either entity billed Aspro or sent invoices for services performed for Aspro.

The 8th Circuit Court of Appeals upheld the Tax Court's decision that the management fees were not purely for services rendered, but instead were disguised dividends. The Court noted that Aspro had never paid any dividends and that all management fees were paid roughly in proportion to the ownership interests of the stockholders themselves.

Finally, the Court of Appeals agreed with the earlier Tax Court's decision to **exclude** certain expert testimony submitted by Aspro. The Court held that the witnesses brought to testify could not provide admissible expert testimony, because the two experts did not have specialized knowledge as to how to determine the value of services rendered by the owners. Instead, the two experts merely testified as to the nature of the services provided by the owners and how important those services were to the success of Aspro.

According to the Court of Appeals, Aspro's experts did not "articulate" what principals and methods they used, if any, to conclude that "valuable services were provided" to Aspro for the management fees paid to the owners.

IV. Negligence Tax Penalties Upheld Where Bonuses Paid By A C Corporation (Law Firm) To Its Shareholder-Attorney/Employees Were Treated As Disguised Dividends: Brinks, Gilson & Lione, vs. Commissioner, TC Memo 2016-20 (February 10, 2016).

The Brinks, Gilson & Lione, PC law firm (the "Firm"), during the tax years at issue, employed about 150 attorneys, 65 of which were shareholders. The Firm also employed non-attorney staff of around 270 employees. The Firm was a C corporation for tax purposes.

Each year, each shareholder-attorney's proportionate ownership interests of stock shares were set to equal their proportionate share of projected compensation for the next year. Each year, the firm's Board of Directors would set yearly compensation to be paid to the shareholder/attorneys for the next year, and then would determine adjustments to their share of ownership percentages which would be necessary to reflect changes in proportionate compensation for the next tax year.

During the tax years at issue, the Board met to set compensation and share ownership percentages in late November or early December of the year preceding the compensation year. The Board would predetermine each attorney's expected compensation and share ownership percentage for the next year using a number of criteria - including hours billed, collections, business generated and other non-monetary contributions. The shareholder-employees would be paid a "draw" throughout the next year, with final bonuses coming through a bonus pool in the following year.

During each of the tax years at issue, the corporation had significant invested capital.

Upon audit, the IRS disallowed various business expense deductions, including year-end bonuses paid to each shareholder/attorney. During the audit, the IRS and the Firm reached a settlement, whereby the Firm agreed to pay an additional $1 Million of tax for each of the two tax years at issue. Thus, the only issue in this case was whether the Firm would be liable for the "accuracy related" penalty under Section 6662.

In determining whether the Firm should be responsible for the accuracy-related penalties, the Court considered both the <u>Pediatric Surgical Associates</u> case (TC Memo 2001-81) and the 7th Cir. Court of Appeals Decision in <u>Mulcahy vs. Commissioner</u>, 680 F.3d 867 (7th Cir. 2012).

Based upon those cases, the Court determined that, allowing a deduction of compensation to "zero out" corporate income would leave investors with no return on their investment. Therefore, based upon the hypothetical "independent investor test," and even when considering the significant amount of capital held by the Firm, the Court upheld the accuracy related penalty under Section 6662.

> **<u>Note</u>**: In determining that the Section 6662 accuracy-related penalty applied, the Court noted that the Firm had significant capital on its balance sheet, without even evaluating whether the Firm also held significant "off balance sheet" intangible assets (such as goodwill, going concern value, etc.) which further indicated that the shareholders in this case had failed the "independent investor" test. According to the Court, the firm's practice of "zeroing out" year-end bonuses to attorneys, that eliminated its book income, fails the "independent investor" test.

<u>PART ELEVEN</u>
S CORPORATIONS AND PARTNERSHIPS

I. <u>S Corporation Advances to a Shareholder Re-Characterized as Taxable Distributions; Kelly vs. Commissioner, TC Memo 2021-76 (June 28, 2021).</u>

<u>Kelly</u> involved a complicated series of inter-company transfers that Mr. Kelly effected over a number of years between various entities he controlled. These inter-company transfers were used to fund his investments in certain business purchases and sales and associated real estate transactions. Over a number of years, these inter-company transfers were treated and booked as loans from various companies directly to Mr. Kelly.

In the early years, Mr. Kelly took great care to adequately document these transfers as loans. In addition, in some years, Mr. Kelly actually had a habit of making re-payments of loan, principal and interest.

However, because of downturns in the economy starting in 2007, it became clear that Mr. Kelly had no realistic economic ability to re-pay any of those inter-company loans. Also, with each passing year beginning in 2007, loan formalities gradually faded over time.

Ultimately, the court held that in 2007, the inter-company transfers to Mr. Kelly were indeed bona fide loans, but for all transfers beginning in January 2008 and thereafter, the purported loans were recharacterized as taxable, capital gain distributions in excess of Mr. Kelly's income tax basis in his closely-held busines stock.

<u>NOTE:</u> The Court also upheld the Section 6662(a) accuracy-related penalty that would apply for any tax year in which there was a 25% omission from Mr. Kelly's gross income.

II. S Corporation Status is Not a Bankruptcy Property Interest, In Re: Gypc, Inc., DC OH, 129 AFTR 2d 2022-693, 2021 Bankr. LEXIS 2817 (SD OH, October 5, 2021).

The bankruptcy court again held that a prepetition conversion of a bankruptcy debtor from an S Corporation to a C Corporation could not be a voidable preferential or fraudulent transfer because the debtor's tax status was controlled by shareholders under federal law and therefore was not an asset of the bankruptcy estate.

III. 3rd Circuit Court of Appeals Overturns Bankruptcy Court in Majestic Star Casino; S Corporation's Tax Status is Not A Property Right of a Bankrupt Qualified Subchapter S Subsidiary; *Majestic Star Casino, LLC, 111 AFTR 2d 2013-742 (May 21, 2013).*

A parent S Corporation owned all of the stock of a QSSUB. The QSSUB filed bankruptcy, and during the bankruptcy proceeding, the parent's shareholders revoked the parent S corporation's status as an S Corporation. This caused the QSSUB to lose its status as an S corporation as well. As a result, a substantial part of the QSSUB's income during the bankruptcy proceeding would become taxable to the C corporation subsidiary (formerly a QSSUB), and would not be taxable to the shareholders of the parent corporation.

Earlier, the Bankruptcy Court found that maintaining status as an S Corporation was tantamount to a "property right" of the QSSUB. Thus, terminating the S Corporation status as a QSSUB was tantamount to a transfer of "property" by the bankrupt QSSUB - which was invalid since it was done without the permission of the Bankruptcy Court.

However, the Third Circuit Court of Appeals ruled that the QSSUB's tax status as an S corporation was not a "property interest" and so the QSSUB did not have a "property right" in its status as a QSSUB. Therefore, the subsidiary's status as an S corporation was never "property" of the bankruptcy estate.

Moreover, according to the Court of Appeals, even if the S corporation's tax status was a "property right," the ability to elect S corporation status ***for the parent*** would be a property right that belonged to the parent or the parent's shareholders and could never be a "property right" of the QSSUB.

Note: In another case, a pre-petition (by one week) revocation of S corporation status was not voidable as a fraudulent transfer because the S election is not a property right of the debtor, since the debtor doesn't have dominion and control over that right – only a majority of the shareholders can make the election or termination of S corporation treatment. In re Health Diagnostic Laboratory, Inc., 578 B.R. 552 (Bankr. E.D. Va. 2017).

IV. Bankruptcy Court Refuses to Allow Partnership to Convert to C Corporation Status.

In In Re Schroeder Brothers Farms of Camp Douglas LLP, 123 A.F.T.R. 2d 2019-2080, the U.S. Bankruptcy Court refused to allow the debtor, an entity taxed as a partnership for tax purposes, to convert to C corporation status by making the "check the box" election on Form 8832. The bankruptcy court held that allowing the partnership to convert to a C corporation was not in the "best interests" of the debtor, the estate, or its creditors.

V. IRS Continues to "Crack Down" on S Corporation Payments of Disguised Wages.

In *Ward & Ward Company v. Commissioner,* T.C. Memo. 2021-32 (Mar. 15, 2021) the Tax Court held that payments from the taxpayer's S corporation law firm to its owner/shareholder were wages subject to self-employment tax not Sub-S distributions of profit.

VI. Again this Year, the IRS issues Numerous Avenues for PLR Relief for S Corporation Screw Ups

As in past years, this year the IRS issued a number of Private Letter Rulings granting amnesty to taxpayers that failed to meet statutory and regulatory requirements under the S corporation tax rules.

The following is a list of some of the more interesting rulings:

1. Failure to File QSST Election After Shareholder's Death (PLR 202218004, 202218006 and 202218005);

2. Failure to File ESBT Election where Revocable "Grantor" Trust ceased to be qualifying shareholder two (2) years after grantor's death (PLR 202233001);

3. Failure to Timely File the QSST Election (PLR 202210001);

4. Failure to Timely File ESBT Election. PLR 202234003;

5. Beneficiary Failure to Consent to a QSST Election (PLR 202210002);

6. Second Class of Stock Problems For an LLC Making an S Election (PLR 202209001 and PLR 202219005); and

7. S Corp stock transferred to ineligible shareholder (a Section 501(a)(4) organization) but then transferred to an eligible S Corporation shareholder upon discovery that 501(c)(4) org. was not a "qualified shareholder". (PLR 202234004)

VII. Partnership Entitled To Ordinary Worthless Loss Deduction for Investment in Family Owned Real Estate Business; MCM Investment Management, LLC, TC Memo 2019-158 (December 10, 2019).

In MCM Investment Management, the Tax Court ruled that a partnership was entitled to an ordinary loss deduction under IRC Section 165(a) because its interest in a related family owned real estate development business became worthless during the tax year and was effectively abandoned by the owner.

MCM Investment Management, LLC was owned by four members of the same family. MCM owned a 20% interest in a real estate development and sales business. The four family members owned the other 80% interests.

The real estate development LLC (called "Companies") began experiencing financial difficulties and in 2008, the four family members created a new entity (called "Holdings") which purchased, at a discount, certain subordinated debt owed by Companies in an arms length transaction.

Later on, Holdings contributed the subordinated debt to Companies in exchange for preferred equity. By the end of 2009, the four family members concluded that, if Companies was liquidated, there would be nothing left over to pay any of the subordinated debt after senior debt was paid off.

The Tax Court held that the Holdings was entitled to an ordinary business loss deduction, on Form 4797, for the worthless interest in Companies.

In the earlier case of Forlizzo, Tax Court Memo 2018-137, the Tax Court had previously ruled that a partner could claim an ordinary loss from a worthless investment in a partnership, if the partnership interest becomes worthless during the year.

Under Section 165(a), a taxpayer may claim an ordinary loss deduction relating to his investment in a partnership if the investment becomes worthless and the partner abandons its interest in the partnership and if sale or exchange treatment of the partnership interest does not apply. See also Citron v. Commissioner, 97 T.C. 200 (1991).

PART TWELVE

SECTION 6672 RESPONSIBLE PERSON LIABILITY FOR TRUST FUND TAXES

I. Background and Introduction.

Section 6672 imposes personal responsibility for unpaid income and employment tax withholdings against certain "responsible persons." Under Section 6672, in order to hold a person liable as a "responsible person," the IRS must establish that the responsible person is one who (1) is responsible for collecting and paying over payroll taxes **and** who (2) wilfully failed to perform that responsibility. Code Section 6672(a).

II. Another Sad Case of the Boookkeeper Falling Victim to the Section 6672 Trust Fund Recovery Penalty; Kazmi, TC Memo 2022-13 (March 1, 2022).

In Kazmi, a bookkeeper, was found liable for the Section 6672 "trust fund" recovery penalty. The facts of this case are particularly sad.

First, the bookkeeper, Mr. Kazmi, was merely a part-time bookkeeper paid an hourly rate, who worked for an urgent care medical practice. Mr. Kazmi had no ownership interest in the urgent care practice, nor was he an officer or director. Mr. Kazmi was not even listed as an authorized signatory on any of his employer's bank accounts. Mr. Kazmi didn't have any check signing authority over the company's bank accounts, and he didn't have any authority to direct payments to the employer's creditors.

Unfortunately, Mr. Kazmi did handle all payroll functions for the urgent care. Because he transmitted payroll tax returns and made federal tax deposits on behalf of his employer, at a time when he was aware that withheld taxes had not been remitted to the IRS, he was held responsible for the trust fund recovery penalty.

III. Section 6672 Penalties Are Not Eligible For Section 6015 Equitable Relief; Chavis, 158 TC No. 8 (June 15, 2022).

In, Chavis, the Tax Court reminded us that the Section 6672 Trust Fund Penalty is just that, it is a penalty and it is not a tax. Therefore, a spouse cannot assert an Innocent Spouse Relief defense to assessment of the Section 6672 penalty.

In Chavis, the husband and wife were both owners of the same corporation that fell behind in paying the corporation's tax withholding. Here, the IRS determined that both the husband and wife were responsible persons who were personally liable for the withheld taxes under Section 6672.

However, the wife claimed that the husband was ***more at fault*** than she and contended that she should be eligible for Section 6015(f) "equitable innocent spouse" relief for purposes of the Section 6672 penalty. Again, however, the Court held that the

Section 6672 Trust Fund Tax is a penalty, and **<u>not</u>** an ***<u>income</u>*** tax to which the "Innocent Spouse" defense is available.

IV. <u>IRS Motion to Dismiss 6672 Refund Claim Denied Where There was a Question of Fact as to Whether the Responsible Person Acted Willfully; Preinesberger v. US, 126 AFTR2d 2020-5143 (DC CA) (August 5, 2020).</u>

Mr. Preinesberger owned less than 10% of the stock of Meridian Health Services Holdings ("Meridian") and operated five skilled nursing home facilities in California for Meridian.

Meridian got in financial trouble and stopped paying its payroll taxes, partly because of delays in reimbursement payments from Medicare and Medi-Cal. During its times of financial struggle, Meridian drew on a line of credit from Capital Finance, Inc. ("CFI"). Each time that Meridian drew on its line of credit with CFI, Meridian was required to use all of the borrowed funds strictly for payment of net wages; CFI refused to allow Meridian to use any of the funds for payment of withholding taxes.

In addition, unlike is the case with the atypical business, the facilities could not simply cease operations when they could no longer pay their employee's net wages and the necessary withholding taxes. Under state and federal regulations, nursing homes must follow a lengthy and detailed procedure for closure that includes notification to its residents and appropriate governmental agencies and transferring residents to other appropriate facilities. Accordingly, Mr. Preinesberger argued that it was not possible for the facilities to meet both the withholding obligations and the regulatory obligations to remain open and maintain well-being of their residents.

The IRS filed a motion to dismiss which was denied by the United States District Court for the Eastern District of California. The court held that it was possible that Mr. Preinesberger's failure to withhold were not "willful" and it would be up to a trier of fact to determine whether Mr. Preinesberger's actions were involuntary, and therefore not willful. According to the court, in this case, federal and state regulations required that CFI's loan be spent to maintain the standard of care which could arguably make the funds "encumbered".

V. <u>Another Court Rejects The "My Boss Told Me Not To Pay" Argument Against Assessment Of The Section 6672 Trust Fund Recovery Penalty; Myers v. U.S., 123 AFTR 2d 2019–1782 (923 F. 3d 935) May 6, 2019</u>.

Mr. Myers was the CFO and co-president of two companies that were in turn owned by another parent company. The parent company was licensed by the U.S. Small Business Administration as a Small Business Investment Company. The SBA had the power to place the parent company into receivership if it violated the terms of its license.

In 2008, the parent company violated the terms of its license and was then placed into receivership by the SBA. In 2009, the parent company got behind on its payroll tax filing obligation. The representatives of the SBA specifically told Mr. Myers to prioritize other vendors over the trust fund taxes.

The IRS assessed the trust fund recovery penalty against Mr. Myers. The District Court granted summary judgment in favor of the IRS and Mr. Myers appealed.

The 11th Circuit Court of Appeals noted a long line of precedent rejecting the "my boss told me not to pay" argument. See for example, Thosteson v. United States, 331 F3d 1294 (11th Cir. 2003). However, Mr. Myers argued that his case was different than those cases because the parent company's receiver was the SBA, a governmental agency. Mr. Myers argued that he should not be held liable because it was not an old boss telling him not to pay the taxes, it was a governmental agency. The 11th Circuit Court of Appeals ruled that Section 6672 liability attaches regardless of whether the boss is a private entity or a governmental agency.

VI. Section 6672 "Responsible Person" Gets No Trust Fund Tax Credit for Non-Designated Payment of Employment Taxes: Gann v. U.S., 119 AFTR 2d 2017-1220 (March 21, 2017).

Mr. Gann was the founder and CEO of Humanity Capital, Inc. ("HCI"). HCI had underpaid its payroll tax deposits for the fourth quarter of 2006 and the first and third quarters of 2007. However, HCI made payroll tax deposits for those quarters - that exceeded the amount of employee trust fund tax withholdings for those periods.

The Tax Court found that Mr. Gann was a "responsible person" within the meaning of Section 6672. Mr. Gann, however, argued that, since HCI paid payroll tax amounts -- above and beyond the trust fund portion of the payroll taxes -- in each of the quarters at issue, Mr. Gann should be given "trust fund recovery credit" for HCI's payroll tax deposits. The IRS, however, had applied all of HCI's payroll tax deposits first to the non-trust fund portion of the tax liability, which resulted in trust fund liabilities for those quarters.

The Court first noted, that back when HCI made its payroll tax deposits, HCI could have made an "express election" to apply any payments of taxes first against any trust fund liabilities first, by making an explicit instruction to the IRS with those payments. See Westerman v. U.S., 718 F3d 743 (8th Cir. 2013). However, absent such an election, the IRS is free to apply deposits as it sees fit.

VII. Section 6672 and the Reasonable Cause Exception and the "Unencumbered Funds" Trap; Spizz vs. U.S., 120 AFTR 2d. 2017-6719 (December 4, 2017).

Mr. Todtman initially formed the law firm that eventually became Todtman, Nachamie, Spizz and Johns, P.C. Todtman, Nachamie and Spizz were the primary owners of the law firm.

From 2009 through mid-September 2012, Todtman served as the president of the firm. In 2009, their outside accountant advised Mr. Todtman that he had discovered that the law firm was failing to pay its trust fund taxes. Mr. Todtman responded that the firm couldn't pay its taxes and its other bills, and so therefore Mr. Todtman had to make a "hard choice."

From 2009 through mid-September 2012, Mr. Spizz owned one-third (1/3) of the corporation stock and served as vice president. On or before June 2010, Mr. Spizz discovered that the firm had failed to pay its trust fund taxes that were being withheld. On this discovery, Mr. Spizz and Mr. Nachamie revoked Mr. Todtman's management authority going forward.

On April 2012, Mr. Spizz learned that the firm had not paid its trust fund taxes for the fourth quarter of 2011 and the first quarter of 2012. Finally, in December 2013, Mr. Spizz discovered that Mr. Nachamie had embezzled over $1 million from the firm's trust account.

The IRS assessed trust fund tax liability against Mr. Spizz and Mr. Todtman. The IRS assessed a trust fund tax penalty of $585,000 against Mr. Spizz and Mr. Todtman, jointly and severally, for periods beginning before June 2010, and assessed Mr. Spizz a trust fund penalty of $113,299 for the 2011 and 2012 periods.

In the Tax Court proceeding, the Court quickly concluded that, based upon their respective significant management roles for the firm, Mr. Spizz and Mr. Todtman met the definition of "responsible persons" under Section 6672.

Next, the court addressed whether Mr. Todtman and Mr. Spizz "willfully" failed to pay trust fund taxes. Since the Tax Court case was being decided in the District Court of New York, which is in the Second Circuit, the court noted that the Second Circuit recognizes a "reasonable cause" defense to Section 6672 where a responsible person reasonably believes that taxes were being paid. <u>Winter v. U.S.</u>, 196 F.3d 339, 345 (2d Cir. 1999). However, this reasonable cause exception will not be available if the taxpayer then fails to immediately use available unencumbered funds to pay to the IRS once the person ultimately becomes aware of the unpaid trust fund taxes.

Here, it was clear that Todtman willfully failed to remit trust fund taxes during 2009 and 2010 while he was controlling the firm. Next, the court then evaluated whether Mr. Spizz "willfully" failed to pay the trust fund taxes for pre-June 2010 tax periods and for post-June 2010 tax periods.

Spizz testified that, before June 2010, he was completely unaware of any unpaid trust fund taxes and, when he did become aware of these delinquencies in June 2010, the firm's bank had a lien against all of the assets of the firm and the firm's operating account carried a negative balance of $20,000. However, apparently the firm's bank account became negative only because the firm made disbursements on June 20, 2010 of over $80,000, the same day that Mr. Spizz learned of the tax delinquencies. Therefore, Mr. Spizz was liable for <u>all</u> of the trust fund taxes dating to periods before June 10, 2010.

The court further held that Mr. Spizz should be responsible for all the post-June 2010 tax periods as well. The court noted that, once Mr. Spizz became aware of past delinquencies, it was his responsibility to assure that taxes were remitted for future periods. And, failing to follow-up constitutes "reckless disregard" that meets the willfulness requirement.

So, Mr. Spizz and Mr. Todtman were found to be jointly and severally liable for the full amount of taxes for periods before June 2010. And, Mr. Spizz (but not Mr. Todtman) was held liable for all unpaid trust fund taxes for periods after June 2010.

> Also see Cherne v. U.S., 120 AFTR 2d 2017-6443 (November 1, 2017) where the Ninth Circuit Court of Appeals held that the taxpayer's funds were not "encumbered" where the taxpayer was under no legal obligation "to use the funds for a purpose other than satisfying the preexisting employment tax liability," since restrictions on assets imposed by a creditor do not qualify as legal obligations for purposes of this exception. Nakano v. United States, 742 F. 3d 1208, 1212 (9th Cir. 2014).

VIII. Davis vs U.S., 121 AFTR 2d. 2018–935 (March 6, 2018) More About the Unencumbered Funds Penalty.

In Davis, the Court of Appeals upheld the District Court of Colorado's grant of summary judgment in favor of the IRS on the "unencumbered funds" issue. This case provides an excellent discussion of the majority and minority opinions on the unencumbered funds test.

Mr. Davis, a resident of the 10th Circuit, had argued that he did not willfully pay his secured lender ahead of the IRS, because his secured lender had a contractually imposed security interest in all of his assets that was superior to any interest claimed by the IRS.

Previously, Mr. Davis had transferred $1.3 million of funds to his primary lender that had a security interest in all of its assets when he discovered the fact that his company had unpaid payroll tax obligations. The IRS assessed the trust fund recovery penalty against Mr. Davis for just under $1 million.

The Split of Authorization. The Court noted that there is a split of authority over the question as to whether contractually-imposed, voluntarily-assumed restrictions on a company's ability to direct funds constitutes an "encumbrance" that would preclude a finding of "willful" non-payment of payroll taxes. The Court noted that the **"majority rule"** recognizes that a company's voluntary decision to grant a security interest or other control over company funds to a lender does not create an encumbrance on those funds that thereafter excuses a failure to use those funds to pay tax delinquencies; it is only legally-imposed encumbrances (e.g. those created by statute or regulation) that excuse payment of tax obligations. See Honey v. U.S., 963 F.2d 1083 (8th Cir. 1992); U.S. v. Kim, 111 F.3d 1351 (7th Cir. 1997); Bell v. U.S., 355 F.3d 387 (6th Cir. 2004); Nakano v. U.S., 742 F.3d 1208 (9th Cir. 2014).

The Court noted that the **"minority rule"** is articulated in In re Premo, 116 B.R. 515 (Bankr. E.D. Mi. 1990). There, the court held that "where the taxpayer's discretion in the use of funds is subject to restrictions imposed by a creditor holding a security interest in the funds which is superior to any interest claimed by the IRS, the funds are regarded as encumbered if those restrictions preclude the taxpayer from using the funds to pay the trust fund taxes."

Having found that Mr. Davis was both a “responsible person” and that he acted willfully in failing to use his company’s funds in 2009 to pay the company's unpaid payroll taxes, the court held in favor of the Service. As stated in Honey, “it is no excuse that, as a matter of sound business judgment, the money was paid to suppliers and for wages in order to keep the corporation operating as a going concern — the government cannot be made an unwilling partner in a floundering business.” 963 F.2d at 1093, quoting Collins v. U.S., 848 F.2d 740, 741–42 [62 AFTR 2d 88-5038] (6th Cir. 1988).

IX. Doctor Assessed $4.3 Million Penalty Under Section 6672 For Making $100,000 Loan To His Medical Practice.

In McLendon, 118 AFTR 2d 2016-5464 (District Court of Texas November 17, 2016), Dr. McLendon was the owner of a family medical practice. Previously, in 1995, the medical practice had hired Richard Stephen as its CFO. In May 2009, Dr. McLendon learned that over $10 Million of unpaid payroll taxes were owed to the IRS. Ultimately, Mr. Stephen pled guilty to embezzling funds from the medical practice.

Upon learning of the unpaid payroll taxes, Dr. McLendon immediately closed the medical practice and turned over its remaining assets to the IRS to pay towards the outstanding tax liabilities. However, at that time, Dr. McLendon also made a $100,000 loan to the medical practice so it could meet its payroll for its payroll period ending May 15, 2009.

The IRS then assessed a $4.3 Million tax penalty against Dr. McLendon. The District Court of Texas held that, notwithstanding Dr. McLendon's good Samaritan acts, the fact that he used unencumbered funds to pay other creditors rather than the IRS made him liable for the full $4.3 Million tax penalty. According to the Court, notwithstanding Dr. McLendon's admirable motives, his use of loaned funds to pay payroll made him liable for the entire $4.3 Million tax penalty.

> **NOTE:** The Fifth Circuit recently vacated the earlier decision of the District Court that granted summary judgment in favor of the IRS for $4.3 million judgment against Dr. McLendon. According to the Fifth Circuit Court of Appeals, Dr. McClendon did present enough facts that could dispute whether the company had unencumbered funds to pay the taxes when he learned of the nonpayment. Therefore, this was not a case for summary judgment.
>
> Also, on appeal, Dr. McClendon argued that he should not have been held liable for more than $100,000 of funds he used to pay other creditors ahead of the IRS shortly before the practice was closed. The Fifth Circuit held that the $100,000 funds contributed to the company were unencumbered. However, the Fifth Circuit remanded the decision back to the lower court to determine whether the practice had retained $4.3 million of available funds as of the discovery date. McClendon vs. U.S., 121 AFTR 2d. 2018–2075 (June 14, 2018).

X. **Criminal Prosecution for Failure to Pay Employment Taxes.**

Background. Section 7202 provides that it is a felony to fail to truthfully account for and pay over trust fund taxes. A conviction under Section 7202 can carry a prison sentence of up to five years.

In United States vs. David Snyder (2018 WL 4335632) (September 11, 2018), the court upheld the defendant's criminal conviction for failing to pay withholding taxes under Section 7202. Mr. Snyder argued that his failure to pay was not willful but instead was caused by the great recession and existence of an IRS tax lien against the company's assets.

Here, however, witnesses testified that Mr. Snyder prioritized payments to his company's creditors over the payments to the IRS. Other employees testified that he would meet with certain employees each quarter to decide which payments would be made and which creditors would be paid. Finally, the record evidenced that there were other instances of failure to comply with tax obligations

XI. **No Trust Fund Designation Where Employment Tax Deposit Is Paid By Wire Transfer; Weder v. U.S., 120 AFTR 2d 2017-6211 (October 16, 2017).**

In Weder, Boom Drilling, LLC failed to timely pay its employment taxes for the first quarter of 2008. In April 2008, an Internal Revenue Service representative met with Ms. Weder, Boom's in-house CPA, and its attorney to discuss Boom's unpaid employment taxes.

After that meeting, Boom sent, via wire transfer, $300,000 to the IRS to be applied to the first quarter's employment tax delinquencies. However, when the wire transfer was made, Boom did not provide any written instructions to the IRS as to how to allocate any portion of the transfer between the trust fund and non-trust portions of the employment tax liability.

Ms. Weder, who attended the April 2008 meeting with the IRS representative, claimed that at the IRS meeting, the IRS representative told Ms. Weder that if Boom transferred $300,000 to the IRS in partial payment of outstanding tax liabilities, the IRS would apply that amount to trust fund tax liabilities.

At trial, the IRS took the position that the $300,000 payment was a "deposit" rather than a voluntary payment of employment taxes and that such a deposit cannot be designated toward trust fund tax liabilities.

The court stated that any oral statements made by the IRS representative would not be binding upon the IRS, since the IRS's published revenue procedures clearly provide that any voluntary employment tax payment designations must be made in writing (See Rev. Proc. 2002-26). In addition, the Court pointed out that Boom did not make a written designation that accompanied the electronic payment. Since there was no written designation that accompanied the payment, the IRS was free to apply the payments as it so desired. The Court granted summary judgment in favor of the IRS.

XII. <u>IRS Gets Summary Judgment Against President For Trust Fund Recovery Penalties</u>.

In <u>Arriondo vs. U.S.</u>, 118 AFTR 2d 2016-5205 (July 22, 2016), Mr. Arriondo was the President and Treasurer of American Steel Building Company, Inc. However, Mr. Arriondo was not an owner of the company.

The company's Finance Director ceased paying the company's payroll taxes, but deceived Mr. Arriondo as to the fact that payroll taxes had not been paid. When he learned that the former Finance Director had failed to pay the company's payroll taxes, Mr. Arriondo began shutting down the company and laying off employees.

Ultimately, the company hired a bankruptcy attorney and filed for bankruptcy protection eighteen (18) days after Mr. Arriondo learned of the unpaid payroll taxes. During this 18 day period however, Mr. Arriondo approved payments of other corporate expenses, including two payroll payments, and so the IRS assessed the trust fund recovery penalty against Mr. Arriondo.

Here, Mr. Arriondo was an authorized check signer and had access to all of the company's books and records. So, Mr. Arriondo was clearly a "responsible person."

Also, although the company's Finance Director deceived Mr. Arriondo about whether the company was making its payroll tax deposits, Mr. Arriondo knew that the company was in trouble, and that it had failed to pay other state taxes. And, Mr. Arriondo never took steps to make sure that IRS payroll taxes had been paid. The IRS contended this "willful disregard" constituted "willfull failure" by Mr. Arriondo to make sure payroll taxes had been paid.

Here, the court granted **<u>summary judgment</u>** in favor of the IRS, that Mr. Arriondo was personally responsible for over $350,000 of back payroll taxes. Mr. Arriondo was clearly a "responsible person" and his failure to inquire about the payroll tax situation, when he knew about the poor financial condition of the company, constituted "willful" failure to make sure payroll taxes had been paid. Also, after Mr. Arriondo knew of the unpaid payroll taxes, he still allowed unencumbered funds to be used to pay other creditors ahead of the IRS making Mr. Arriondo responsible for trust fund taxes for prior tax periods.

PART THIRTEEN
INNOCENT SPOUSE CASES

I. <u>Wife Entitled to Innocent Spouse Relief Even Though She Is Still Living With Her Ex-Husband; Pocock, TC Memo 2022-55 (June 6, 2022).</u>

Mr. and Mrs. Pocock had a tumultuous relationship, to say the least, including allegations of verbal and physical abuse by Mr. Pocock. From 1995 through 2005, Mr. and Mrs. Pocock filed joint tax returns which contained large tax refunds due to Mr. Pocock overstating his federal tax withholdings. In some cases, Mr. Pocock signed Mrs. Pocock's name to endorse the refund checks.

Mrs. Pocock filed an Innocent Spouse Relief Request which was denied by the IRS. Subsequently, Mrs. Pocock decided to file her own US Tax Court Petition and represent herself in the Tax Court proceedings.

Even though Mrs. Pocock divorced Mr. Pocock, she was still living with Mr. Pocock at the time she applied for innocent spouse relief because she needed a roommate to save expenses. Mrs. Pocock believed her living arrangement with Mr. Pocock was more reliable than a typical rental situation.

Judge Vasquez applied Revenue Procedures 2013-34 and 2013-43 to determine whether Mrs. Pocock qualified for "equitable" relief under Section 6015(f). The Tax Court held in favor of Ms. Pocock noting that:

(1) no assets were ever transferred by Mr. Pocock to Mrs. Pocock as part of any fraudulent scheme;

(2) Mrs. Pocock didn't knowingly participate in the filing of any fraudulent returns; and

(3) all of the tax shortcomings were solely attributable to the income tax withholding misstatements by Mr. Pocock.

The court also noted that Mrs. Pocock would suffer economic hardship if she was not granted equitable relief. And, although they were still living together when the joint returns were filed, abuse was clearly present at that time.

Next, the court found that, although Mrs. Pocock did not have actual knowledge of Mr. Pocock's fraudulent activities, Mrs. Pocock likely had "constructed knowledge" of the fraud and had reason to know of her husband's withholdings overstatements when the joint returns were filed. The court noted that there was credible testimony as to physical and verbal abusive behavior on the part of Mr. Pocock. Because of the presence of abuse, the court held that this constructive knowledge did not weigh against granting equitable relief.

And, Mrs. Pocock credibly testified that her economic situation necessitated that she have a roommate. So, the fact that Mrs. Pocock was still living with Mr. Pocock when she applied for innocent spouse relief did not contradict her allegations of earlier abuse during the period when the joint returns were actually being filed.

II. No Innocent Spouse Relief Even Though Husband Signed The Wife's Name to Tax Return; Jones vs. Commissioner, 129 AFTR 2d 2022-588; 2022 U.S. App. LEXIS 3095 (9th Circuit Court of Appeals, February 3, 2022).

In Jones, Mrs. Jones argued that she was entitled to Innocent Spouse Relief because she did not consent to her ex-husband signing her name to a joint tax return for 2010. The Court, however, refused to grant Innocent Spouse Relief finding that Mrs. Jones ***tacitly*** consented to allowing her husband to sign the joint return on her behalf.

The Court found the following factors determinative:

1. Mrs. Jones provided her ex-spouse with a copy of her Form W-2 and other tax information so that Mr. Jones could use this information presumably to file their 2010 joint tax return;

2. Mrs. Jones failed to file a separate tax return for 2010, even though she otherwise would have been required to file a separate return; and

3. In later years, Mrs. Jones allowed her **new** husband to sign tax returns on her behalf.

Once the Court determined that Mrs. Jones had reason to know that her ex-husband would not pay the tax liability reported on the 2010 return, it was easy to conclude that Mrs. Jones didn't qualify for innocent spouse relief because she had ***tacitly*** consented to allowing her husband to sign the joint return for her.

III. Spouse's Knowledge That Taxes Weren't Paid Didn't Preclude "Equitable" Innocent Spouse Relief; *Grady*, T.C. Summary Opinion 2021-29 (August 17, 2021).

In Grady, the Tax Court granted Mrs. Grady "equitable" innocent spouse relief even though she knew that joint return taxes weren't being paid by her husband at the time their joint returns were filed.

Here, Ms. Grady and her husband filed joint tax returns, and the returns reflected an unpaid balance owed. However, Ms. Grady's husband always assured her that he would secure an installment payment arrangement with the IRS to get their balances paid up.

Based upon applying "equitable" relief factors under Section 6015(f), the court held that Ms. Grady qualified for equitable innocent spouse relief even though she knew taxes weren't being paid when the joint returns were originally filed.

PART FOURTEEN
NOMINEE, TRANSFEREE AND SUCCESSOR TAX LIABILITY CASES

I. Transferee, Successor and Nominee Liability Rules.

A. Background of Section 6901 Transferee Liability Rules. Under the Code Section 6901 "transferee liability" rules, there are three (3) types of transferee liability that can arise when someone acquires assets from a taxpayer that owes taxes to the IRS:

1. Contractual transferee liability – which arises where the transferee assumes a tax paying obligation of the transferor;

2. Statutory transferee liability – which is usually imposed by federal or state law (often known as fraudulent conveyance statutes); or

3. Equitable transferee liability (also called the "trust fund" theory) - which is assessed for example when a corporation (owing taxes) distributes its assets to its shareholders who are then jointly and severally liable for the unpaid taxes of the transferor corporation to the extent of assets received from the corporation.

B. "Alter Ego" and "Successor Liability" Theories for Pursuing IRS Collection Actions Against a Transferee. IRS Internal Legal Memorandum 200847001 (released November 21, 2008) provides a thorough explanation of theories the IRS may advance in seeking to hold a transferee of assets liable for taxes owed by the transferor-taxpayer. In this ILM, the IRS National Office thoroughly examines the "alter ego" and "successor liability" theories for pursuing collection activities against a transferee who receives assets from a taxpayer-transferor.

1. Alter Ego Theory. As discussed in the ILM, the "alter ego theory" usually involves the "piercing of the corporate veil" to hold a shareholder liable for the debts of a corporation, or the "reverse piercing" to hold the corporation liable for the debts of a shareholder. The ILM cites a number of past court cases which have imposed "alter ego" liability against a transferee corporation - even without a formal stock ownership relationship between the transferee corporation and the taxpayer. In these cases, courts looked to control, and not the mere "paper ownership," to determine whether to apply the alter ego theory.

2. Successor Liability Theory. In addition, the ILM also discusses the "successor liability" theory for imposing liability on the transferee. Under the state law of most states, "successor liability" imposes liability upon a transferee in the following circumstances:

1. When a successor expressly assumes the liabilities of the transferor;
2. When the transaction amounts to a defacto merger;
3. When the successor is a "mere continuation" of the seller corporation; and
4. When the transaction is entered into fraudulently to escape liability.

The "defacto merger" and the "mere continuation" exceptions both generally look to whether the successor corporation shares common officers, directors and shareholders with the transferor corporation. Other factors to be considered include the continuity of business operations, management, assets, personnel and physical location. Also, courts will consider whether there was sufficient consideration paid by the buyer to the seller in exchange for the transferred assets.

3. <u>No New Assessment Required Against Transferee</u>. Finally, the Chief Counsel advised that the IRS is not required to make an additional assessment against the transferee where there was already a preexisting assessment against the transferor. Since the successor corporation steps into the shoes of the transferor corporation, a new assessment against the transferee corporation is not required.

II. <u>US District Court of Arizona Considers Fraudulent Conveyance, Alter Ego and Nominee Theories for Real Estate Liens; TBS Properties, LLC vs. United States 129 AFTR 2d 2022-1080, 2022 U.S. Dist. LEXIS 45835 March 15, 2022.</u>

In <u>TBS Properties</u>, various members of the Perry family owned a number of restaurant franchises. There were a total of thirteen restaurants, each of which was operated under a separate S corporation. The Perry family also owned the real property in which each restaurant was located, and the real properties were owned by thirteen separate LLCs.

In 1998, Mr. and Mrs. Perry transferred real property to one of the LLCs, called TBS Properties, LLC. Beginning in 2000, TBS began leasing its real property to RAEDON, Inc., via an unsigned lease arrangement. Then, in 2012, when Mr. and Mrs. Perry passed away, all of their closely-held business interests passed to certain trusts for the benefit of their heirs.

Between 2015 and 2017, RAEDON amassed over $150,000 in back tax liabilities. In 2019, the IRS filed a Notice of Federal tax Lien against the property held by TBS, LLC that was being leased to RAEDON. TBS then brought a "quiet title" action against the IRS requesting a "judicial determination and order" that "the United States has no lien interest or any other interest in or against" the TBS property.

The IRS then sought a declaratory judgment confirming that its lien was valid based upon three (3) "successor liability" theories:

1. The "fraudulent transfer" theory;
2. The "alter ego" theory; and
3. The "nominee" theory.

TBS then moved for summary judgment on all three IRS' theories. Here is where the Court came out.

First, on the "Fraudulent Transfer" argument, the District Court granted summary judgment in favor of TBS by virtue of the fact that RAEDON never transferred any of its real property to TBS. Instead, the transfer came directly from Mr. and Mrs. Perry.

The Court next looked at the "alter ego" claims. The Court noted that both the IRS and the taxpayer agreed that, in order for the IRS to be successful on the "alter ego" theory, regardless of whether the court applied federal law or state law, the United States would have to prove two (2) elements to establish "alter ego" liability:

1. Unity of Control; and
2. That observance of the corporate form would sanction fraud or promote injustice.

The Court noted that "unity of control" was clearly at play here, since the owners of the properties (the LLC's) and the S corporations had common ownership, common officers and directors. This fact, combined with the absence of an executed written lease between TBS and RAEDON, could lead the "trier of fact" to conclude that unity of control existed.

Second, the court held that a trier of fact likewise could determine that there was "fraud or injustice" arising here by virtue of the fact that RAEDON's tax liabilities had gone unpaid at a time when there were various cash transfers between RAEDON and TBS.

Finally, the Court held that the IRS also could pursue the "nominee" liability theory. According to the Court, since the nominee theory had never been expressly rejected by past Arizona courts, the Court could not grant summary judgment in favor of TBS on the nominee liability theory.

III. <u>IRS Is Successful in Pursuing Alter-Ego Theory on Successor Corporation: WRK Rareties, LLC v. US, 117 AFTR 2d 2016-856 (February 29, 2016).</u>

In WRK Rareties, Mr. Kimpel was the sole owner, president and managing officer of Kimpel's Jewelry and Gifts ("KJG"). KJG operated a jewelry store in Ohio. In 2005, KJG filed for bankruptcy protection and, during the bankruptcy proceeding, federal employment taxes went unpaid. KJG ceased operations in December 2010.

In September 2010, Mr. Kimpel formed a new company, called WRK Rareties, LLC doing business as "Kimpel's Fine Diamonds" ("WRK"). WRK operated in the same jewelry store location previously operated by KJG. In addition, Mr. Kimpel continued as the sole owner, president and manager of the day-to-day operations of WRK. In addition, WRK continued to use the same assets that were formerly owned and used by KJG, including signage, furniture, and fixtures, and WRK continued to operate in the same type of business formerly operated by KJG. WRK even used the same bank that KJG used.

Moreover, WRK continued to employ the same employees as KJG when it ceased its business operations in December 2010. These employees retained the same titles and salaries that they had when they worked for KJG.

The IRS sought to levy on the assets owned by WRK to satisfy the employment tax liabilities of KJG. Based upon the foregoing facts, the Court had little trouble concluding that WRK was an alter-ego of KJG and therefore, the IRS levy action was proper. The Court also noted that, under Ohio law, the fact that WRK paid no consideration to acquire the assets of KJG made the successor liable for the liabilities of the predecessor corporation under applicable Ohio law.

IV. Successor Liability Must be Determined by State Law, Rather Than By General Federal Common Law

In *TFT Galviston Portfolio, Ltd. vs. Commissioner*, 144 TC No.7 (February 26, 2015), the taxpayer was a Texas limited partnership that acquired a number of apartment projects from other Texas entities. Several of the selling entities had IRS tax liabilities for unpaid income and employment tax withholdings.

The IRS sought to hold TFT responsible for the income and employment tax liabilities of the prior owner entities on the basis that TFT was the "successor in interest" of the those other entities. The IRS contended that the Tax Court should apply broad federal common law in determining whether TFT was a "successor in interest" to the prior entities.

TFT, however, argued that, since the transactions all were based in Texas, the Tax Court should apply Texas state law to determine whether TFT, under Texas law, could be held liable for debts and obligations of the prior entities under Texas law.

The Tax Court ruled that specific Texas state law, rather than federal common law, should be applied to determine whether TFT was a "successor in interest" to the prior selling entities. Next, in applying Texas state law, the court noted that the Texas Business Organization Act specifically states that a person "acquiring property … may not be held responsible or liable for a liability obligation of the transferring domestic entity that is not expressly assumed by that person."

The Tax Court then noted that other states -- having state laws similar to Texas -- will occasionally apply three (3) narrow exceptions to the "non-liability" rule.

First, there is an exception where the transaction is tantamount to a "de facto merger." But, Texas law did not recognize the concept of a "de facto" merger doctrine.

The second exception is when the successor entity is a "mere continuation" of the seller. But again, this also was a doctrine that Texas courts had refused to apply.

And finally, the third exception is where the transaction was entered into fraudulently (i.e., under a fraudulent conveyance theory). Here, however there was no evidence of a fraudulent conveyance.

So, the court refused to hold TFT liable for the outstanding tax debts of its predecessors.

North Carolina Successor Liability Rule. The NC Court of Appeals case Joyce Farms vs. Van Vooren Holdings, Inc., 756 S.E. 2d 355 (March 4, 2014) sets forth the general rule in NC relating to "no successor liability" and the four (4) exceptions thereto.

Under the general "no successor liability rule," a corporation which purchases all or substantially all of the assets of another corporation is not liable" for the transferor's liabilities. Budd Tire, 90 N.C. App. At 687, 370 S.E. 2d at 269. However, the Court held that the general "no successor liability" rule does **not** apply where:

(1) there is an express or implied agreement by the purchasing corporation to assume the debt or liability;
(2) the transfer amounts to a de facto merger of the two corporations;
(3) the transfer of assets was done for the purpose of defrauding the corporation's creditors; or
(4) the purchasing corporation is a "mere continuation" of the selling corporation in that the purchasing corporation has some of the same shareholders, directors, and officers.

V. Again, State Law, and Not Federal Law, Determines Transferee Liability.

Also, in William Stewart v. Commissioner, 114 TC No. 12 (April 1, 2015) the Tax Court rejected the IRS' attempted use of the federal "substance over form" doctrine for purposes of applying Section 6901 transferee liability theory, and instead ruled that, to determine whether a transferee is liable under Section 6901, the Court must review the state law of the state in which the transfer occurred.

Nevertheless, the Tax Court held that under Nebraska law, since the transfer occurred in Nebraska, the transferee faced liability exposure under Section 6901 under Nebraska state law, and not under the federal common law concept of "substance over form."

The Court held that the disclaimer did not prevent Chris' interest in the condo from being attached by the federal tax lien. See Drye v. U.S., 528 US 49 (1999).

PART FIFTEEN

TAX PENALTIES, EFFECT OF ADMINISTRATIVE DISSOLUTION AND OTHER IRS TAX PROCEDURES

I. Tax Court Rules That Private Duty Notices are Employees for Employment Tax Purposes; Pediatric Impressions Home Health, TC Memo 2022-35 (April 12, 2022).

Pediatric Impressions provides a great overview of the application of the Section 530 "Safe Harbor Relief" rules, as well as a terrific overview of the twenty (20) factor "common law employee" test.

Pediatric Impressions provided at-home private duty nursing services to children with special needs. Prior to 2016, the company treated the nurses as employees for federal employment tax purposes, but starting in 2016, the company began treating many of their nurses as independent contractors. However, the jobs and services performed and provided by the nurses remained substantially the same even after the change from employee to independent contractor status.

During the tax years at issue, the company didn't make any federal employment tax deposits. The IRS assessed tax, interest and penalties for the company's failure to make employment tax deposits.

The Tax Court sided with the IRS and held that the nurses should have been properly characterized as common law employees during the tax years and that the company was not eligible for the Section 530 "Safe Harbor" relief.

In addition to being liable for the employment taxes and interest, the Court also held that the company was liable for penalties under Section 6651(a)(1) and for "failure to deposit" penalties under Section 6656, as well as the accuracy related penalties under Section 6662(a).

A. <u>Legal Classification of Nurses as Employees.</u> Based upon the twenty factor "common law employee" test, the Court ruled that the nurses were employees and not independent contractors.

Here, there were many factors that weighed heavily against the company. The company informed the nurses that they were "employed" on a "full time" basis with the company. The nurses were required to apply for jobs, undergo a background check and complete a nursing skills assessment.

Nurses were paid on an hourly rate basis based upon their own timesheets. Although the company didn't offer any employee benefits to the nurse, the nurses were reimbursed for certain transportation expenses and the nurses were not expected to provide their own supplies or equipment needed to perform their jobs.

All payments for the nurses' services were paid directly to the company, and the nurses had no contact with insurance companies or any other third-party reimbursement providers.

The company set the nurses' work schedules and most nurses were assured full-time work. If a nurse could not work her assigned shift, then she could not arrange for her own replacement. The third-party physicians for each of the company's clients prescribed the patient's "plan of care" and the company was ultimately responsible for ensuring that the nurses followed those plans of care.

The company had case managers on hand that would solicit feedback from clients, and it was the company that directed any type of counseling, discipline, reassignment or termination.

Based upon all these factors, it was easy for the court to conclude that the nurses should have been treated as employees and not as independent contractors.

B. The Court's Discussion of Section 530 Relief. Section 530 is the "get out of jail free card" which provides that an employer is automatically exempt from employment tax liabilities for worker misclassifications if all of the following four (4) requirements are met:

1. The employer never treated the same worker as an employee for any period (the "historic treatment" requirement);

2. The employer doesn't treat workers in similar positions as employees (the "substantive consistency" requirement);

3. All Federal tax returns (i.e., 1099s) were filed for the worker as an independent contractor (the "reporting test"); and

4. The employer had a "reasonable basis" for not treating the worker as an employee (based upon past court cases, revenue rulings, a long-standing industry practice, prior IRS audit or a strong opinion letter from a tax professional) (the "reasonable basis" test).

The Court quickly ruled that Section 530 relief was not available for the company. Here, the company treated the same nurses as employees in one period and as independent contractors in another. So, the company didn't meet the historical treatment requirement.

Also, similarly situated workers sometimes were treated as independent contractors and in other times as employees, so the company also failed to meet the "substantive consistency" requirement.

Because the company failed to satisfy both the historical treatment requirement and the substantive consistency requirement, Section 530 relief was not available.

C. <u>Court Upholds Penalties.</u> Finally, the Court also upheld the penalty assessments since the company failed to present any evidence to show that there was any reasonable cause to abate any of the penalties. Although the company's president and sole shareholder claimed that she was simply following the advice of her CPA, she failed to offer any evidence in trial to support her claims.

II. <u>Workers at a Cleaning Business Were Properly Treated as Independent Contractors and not Employees; Santos v. Commissioner, TC Memo 2020-88 (June 17, 2020)</u>.

Mrs. Santos owned a cleaning businesses called Campos Cleaning that had contracts with several apartment complexes to do "unit turnover cleaning", which is cleaning for recently vacated apartments before new tenants arrive.

The contracts with the apartment projects specified days and hours when common areas were to be cleaned. However, that was not the case with respect to cleaning recently vacated apartments. Instead, with respect to recently vacated apartments, the apartment project managers would contact Mrs. Santos directly to schedule the cleaning.

For cleaning common areas, the apartment complexes paid Campos Cleaning a weekly fixed amount ranging from $510 to $780. For cleaning recently vacated apartments, Campos Cleaning was paid monthly at a fixed rate of $90 to $120, depending upon the size of the apartments.

Mrs. Santos posted advertisements looking for workers. She only hired individuals with prior training in cleaning experience and she never provided any training to them. Mrs. Santos spoke English, but most of her workers did not. Mrs. Santos had no written employment contracts with any of her workers and, to that end, she did not guarantee them a minimum amount of work frequency. And, her workers could decline to do a cleaning job for whatever reason. Many of Mrs. Santos' workers cleaned for other individuals and businesses as well.

Mrs. Santos paid her employees weekly, but the pay rate was based upon a fixed rate of $50 to $70 per apartment cleaned, depending upon the size of the apartment. She did not provide any paid sick leave or vacation, and she did not offer any employee benefits. However, Campos Cleaning did maintain general liability insurance and workers compensation insurance as required by the apartments.

Once an apartment was recently vacated, the apartment manager would contact Mrs. Santos and she would then send one of her workers to do the cleaning by the deadline the property manager established. The workers used their own transportation and furnished and used their own cleaning supplies. They were also free to hire assistants.

Mrs. Santos did not supervise the cleaning, nor would she provide any post-cleaning inspections.

The Tax Court determined that Mrs. Santos was more of a “dispatcher” than an “employer”. So, based upon the foregoing facts, the court determined that the workers were properly characterized as independent contractors rather than employees.

III. Penalty for Failing to Report Form 1099 Income; Larochelle vs Commissioner, TC Summary Opinion 2022-12 (July 12, 2022).

During 2017, Mr. Larochelle was engaged in more than ten business partnerships which required filing of state income tax returns in more than five states. In 2017, Mr. Larochelle received an IRA distribution of $238,000 that never wound up on his personal tax return.

After the IRS sent a CP 2000 Notice to Mr. Larochelle, the IRS assessed the 20% substantial understatement penalty, under Section 6662(a) and (b)(2), equal to 20% of the amount of any tax underpayment that is attributable to any substantial understatement of income tax. An understatement is a “substantial understatement" if it exceeds the greater of $5000 or 10% of the tax required to be shown on the return. Section 6662(b)(1)(A).

Of course, the Section 6662 penalties can be avoided if the taxpayer can show that he acted with reasonable cause and in good faith. Section 6664(c)(1).

Here, Mr. Larochelle did not dispute that he received a Form 1099-R reporting the IRA distribution, but simply argued that he shouldn’t be subject to a penalty because he didn't remember having received the Form 1099R in the first place.

In past cases, courts have held that the nonreceipt of tax information, such as a Form W-2 or Form 1099, does not excuse the taxpayer from his or her duty to report that income. DuPoux vs. Commissioner, TC Memo 1994-448 (September 6, 1994) and Ashmore vs. Commissioner, TC Memo 2016-36 (March 2, 2016).

Next, Mr. Larochelle argued that he had reasonable reliance on the professional advice of a tax return preparer which should constitute reasonable cause for omission of the $238,000 IRA distribution on his tax return. Here, Mr. Larochelle basically claimed that he gave everything he had to his tax return preparer.

However, according to court, reliance on the professional advice of a tax return preparer does not constitute “reasonable cause” when the taxpayer did not provide the representative with all the information necessary to prepare an accurate income tax return. Enoch vs. Commissioner, 57 TC 781 (1972). Accordingly, the court upheld the penalty.

IV. Taxpayer's Burden of Establishing NOL Carryforward From Previous Tax Years.

A. Background. In numerous past cases, courts have allowed the IRS to go back and to disallow NOLs carried into the tax year at issue, where the taxpayer was unable to prove the exact amount of their NOL carryforwards into the relevant tax year. This was the case even if the original loss years were "closed" by virtue of the statute of limitations extension. See Powers v. Commissioner, TC Memo 2016-157 (August 22, 2016) and Jasperson vs. Commissioner, 118 AFTR 2d 2016-5633 (11^{th} Cir., August 31, 2016).

B. CPA Denied NOL Carryforwards and Hit with Negligence Penalties; Amos vs. Commissioner, TC Memo 2022-109 (November 10, 2022). Amos was a certified public accountant who owned multiple restaurant franchise businesses.

Amos claimed NOL carryforward deductions on her 2014 and 2015 tax returns. In agreeing with the IRS, the Tax Court disallowed the NOL carryforwards, into 2014 and 2015, on the basis that Amos was unable to establish the original amount of the original return NOLs and the NOL carryover amounts allowable in prior taxable years leading up to 2014 and 2015.

According to the court, any taxpayer that claims an NOL bears the ultimate burden of proof of establishing both the existence of the NOL and the amount that may be carried over to the tax year involved.

Here, Amos was unable to adequately establish the amount of NOLs incurred in previous years. And, she was unable to show that those NOL carryforwards had not been utilized in earlier tax years and thus were available for offset against taxable income for 2014 and 2015.

So, in order to claim an NOL deduction for the current year, the taxpayer must be able to (1) establish and verify the NOL deduction that occurred in the earlier year and (2) verify all of the taxpayer's taxable income for all subsequent years to confirm that the NOL had not been previously utilized in full.

The court also upheld the 20% accuracy related penalty under Section 6662(a) and (b)(1) on the basis that Amos had no "reasonable cause" for her tax understatements. Amos claimed that she relied upon her CPA for adequate advice in preparing her tax returns. However, Amos was able to establish only that her CPA gave her advice as to the underlying loss year tax return rather than the 2014 and 2015 tax years at issue. Moreover, because Amos was an experienced CPA, Amos certainly could not rely upon past years' practices nor could she reasonably assert that she did not know that each tax year stands on its own.

C. IRS Couldn't Re-Audit NOL Carryforward From Previously Audited Year; AA 2020501. In Field Attorney's Advice 20202501 F, the IRS Chief Counsel determined that the IRS cannot audit NOL carry forwards from previously audited years where the IRS had previously disallowed NOLs but, after the taxpayer requested an appeal, the IRS Office of Appeals allowed the NOLs.

Section 7605(b) prohibits the IRS from conducting "repetitive audits". This Section provides that a taxpayer will not be subject to unnecessary examination or investigation and that there shall be only one inspection of a taxpayer's books of account for a tax year unless the IRS, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

V. More on The One "Examination Rule"; *Kelly vs. U.S.*, 128 AFTR 2d 2021-5425 (August 5, 2021).

In Kelly vs. U.S., the U.S. District Court for the Southern District of California discussed the limited application of the "one examination rule" under Code Section 7605. Section 7605(b) provides that:

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

So, the statutory language of Section 7605(b) both (1) prohibits the IRS from conducting an "unnecessary examination or investigation" and (2) restricts the IRS to one "inspection of a taxpayer's books" unless the IRS, "after investigation," notifies the taxpayer that additional inspection is necessary.

In the past, various courts have narrowly construed Section 7605(b) to only apply if the IRS has completed a full audit of the taxpayer's return. See, for example, United States v. Giordano, 419 F.2d 564, 567 (8^{th} Cir. 1969).

VI. No "Reasonable Cause" Penalty Relief for Corporation's Late Filing, Late Deposit or Late Payment Penalties; *All Stacked Up Masonry*, (Ct Fed C1 10/22/20) 126 AFTR 2d –2020-5399.

In All Stacked Up Masonry, the Court of Federal Claims held that a corporation could not meet the "reasonable cause" relief from penalty assessments for failure to timely file returns and to timely deposit and pay payroll taxes.

A taxpayer seeking relief from penalty assessments for failure to timely file, pay or deposit taxes must show that its failure was not the result of carelessness, reckless indifference, or intentional failure. In numerous cases, courts have held that a taxpayer's duty to pay taxes or file returns can't be delegated. Therefore, the failure to timely file a tax return is not excused by a taxpayer's reliance on an agent, and such reliance is not reasonable cause for a late filing. Similarly, the duties to make deposits and payments also can't be delegated.

Also, using tax preparation software does not alleviate the taxpayer's duty to be aware of, and comply with, filing deadlines. (<u>In re Craddock</u>, 82 AFTR 2d 98-5439 (CA 10 1998).

VII. **<u>Taxpayer Was Still Liable For The Failure To Timely File Penalty Where Preparer Forgets To Hit "Send"</u>**.

In <u>Intress</u> vs. U.S., 124 AFTR 2d 2019-5420 (August 2, 2019), Christian Intress and Patrick Steffen hired a professional tax return preparer to file their 2014 income tax return. The preparer was in the process of submitting a Form 4868, Application For Automatic Extension Of Time To File U.S. Individual Income Tax Return, but the preparer failed to hit "send". The preparer did not discover the missed deadline until October 2015 resulting in a penalty assessment of over $120,000 under Section 6651(a). In upholding the penalty assessment, the court stated that the taxpayer's reliance upon their preparer to timely file the extension request was not "reasonable cause" for purposes of the penalty assessment. <u>United States vs. Boyle</u>, 469 U.S. 241 (1985).

VIII. <u>The Tax Court Petition Was Deemed Timely Filed Even Without the Postmark; Seely, TC Memo 2020-6 (January 13, 2020)</u>.

In <u>Seely</u>, the IRS issued Mr. and Mrs. Seely a Notice of Deficiency on March 28, 2017 for the 2013, 2014 and 2015 tax years. The last date for the Seelys to file a US Tax Court Petition, to challenge the deficiency, was June 26, 2017. The Seelys filed a Tax Court Petition which the IRS received July 17, 2017. Unfortunately for the Seelys, the envelope containing the Petition had no postmark. The IRS took the position therefore that the petition was untimely filed, and the IRS moved to dismiss the petition.

The Tax Court held that the tax petition was timely filed. The taxpayers submitted a declaration from their attorney, Mr. Boyce, stating that, under penalty of perjury, he deposited the Tax Court Petition in the United States postal service collection receptacle in Washington, DC on June 22, 2017. The court noted that under <u>Sylven v. Commissioner (65 TC 548 1975)</u> and <u>Mason v. Commissioner (68 TC 354 1977)</u> when the envelope bears no postmark, the court will permit the introduction of extrinsic evidence to ascertain the mailing date. The IRS argued that the petition actually arrived 21 days after its due date and therefore contended that Mr. Boyce's declaration was not credible since the petition actually arrived 25 business days after the alleged mailing date.

However, the court noted that because the 4th of July holiday fell between the date of the alleged mailing and the delivery date, there could have been a "plausible possible explanation" for the delay in delivery. In prior cases, holiday conditions at the post office (such as holiday closures, unusually large volumes of mail, or inefficiencies attributable to temporary staff) have been found to be a plausible explanation for short delays in delivery. <u>Rotenberry v. Commissioner, 847 F2d 229 (5th Circuit 1988)</u>.

IX. Program Manager Technical Advice 2020-001; "Failure to File" Penalty Exception for Certain Small Partnerships.

A. Background. A partnership, that fails to timely file a partnership return, is subject to a $200 per partner penalty under Code Section 6698, unless the failure to timely file is due to "reasonable cause." Under Code Section 6031(a), a partnership is required to file a return if it has any income or deductions allocable to its partners.

B. Program Manager Technical Advice 2020-001. The IRS issued Program Manager Technical Advice 2020-001 to remind us that, under Revenue Procedure 84-35, certain "small partnerships" will qualify for reasonable cause exception for the late filing penalties if certain requirements of the Revenue Procedure are met.

Revenue Procedure 84-35 provides that certain "small partnerships" can show "reasonable cause" for late filing of a return if the following criteria is met:

(1) A partnership with ten or fewer partners:

(2) Each partner is an individual, a C Corporation or the estate of a deceased partner;

(3) Each partner reports his share of income or expenses of the partnership on his or her timely filed income tax return.

X. Eighth Circuit Court of Appeals Narrows the "Reasonable Basis" Exception to the Negligence Penalty; Wells Fargo vs. United States, 957 F.3d 840 (April 24, 2020).

A. Background. Section 6662(b) provides for the assessment of certain penalties where there is negligence, substantial understatement of tax or certain valuation misstatements. These are referred to as the "accuracy related" penalties. The applicable penalty is 20% of any tax underpayment.

However, a defense to the negligence penalty exists under Reg. Section 1.6662-4(d) if the taxpayer's return position was "reasonably based on one or more of the certain authorities set forth in Reg. Section 1.6662-4(d)(3)(iii)". Reg. Section 1.6662-3(b)(3). This is called the "reasonable basis" defense. Reg. Section 1.6662-4(d)(3)(iii) sets forth authorities that the taxpayer can rely upon to meet the "reasonable basis" defense, such as case law, revenue rulings, etc. that meet the "substantial authority" test of Reg. Section 1.6662-4(d).

Likewise, under Section 6662(d)(2)(B), the substantial understatement penalty will not apply if there is or was "substantial authority" for the taxpayer's position under the criteria of Reg. Section 1.6662-4(d)(3).

The "substantial authority" standard is less stringent than the "more likely than not" standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the "reasonable basis" standard as defined in §1.6662-3(b)(3). Substantial authority exists only when the weight of the authorities supporting the treatment of the tax item is substantial in relation to the weight of the authorities supporting contrary treatment.

B. Wells Fargo. Wells Fargo involved the disallowance of certain foreign tax credits involving a structured trust arrangement entered into by Wells Fargo with Barclays Bank. The Eighth Circuit Court of Appeals upheld the disallowance of the claimed foreign tax credits.

However, more interesting was the Court's discussion of the application of the reasonable basis defense to the assessment of the negligence penalty.

In this case, the Eighth Circuit Court of Appeals ruled that Wells Fargo could not meet the "reasonable basis" defense to the negligence penalty because it failed to submit any evidence at trial to establish that it subjectively based its return position on legal authority at the time the return was filed. In other words, according to the Court, under the "reasonable basis" defense, the taxpayer cannot base its return position on relevant authorities without showing that it actually relied upon those authorities when filings its tax return.

XI. District Court Approves the Forced Sale of Real Property Owned by Taxpayer and His Non-Liable Sister; Dase, 125 AFTR 2d 2020-1079 (N.D. Ala. February 27, 2020).

Mr. Dase owed outstanding tax debts. When Mr. Dase's father passed away, Mr. Dase and his sister inherited real property located in Alabama, as tenants in common. The IRS sought to force the sale of the entire interest in the property, even though Mr. Dase's sister owned a one-half interest in the property and was not liable for Mr. Dase's tax debts.

Even though the IRS lien only attached to Mr. Dase's one-half interest in the property, the District Court allowed the IRS to issue a foreclosure sale of the **entire** property. Based upon Rodgers, the court concluded that ordering a foreclosure sale of the entire property was appropriate because (1) an attempt to sell only Mr. Dase's one-half interest would prejudice the interests of the government since no one would bid on a one-half tenant-in-common interest in the property, (2) the sister did not have expectation that the property would not be subject to a forced sale because, under Alabama law, either tenant could force a sale of a tenant-in-common interest in the property, (3) the sister did not live on the property and she would not be forcibly relocated by a sale, and (4) the sister would be adequately compensated for her interest in the property because of the fact that she would receive one-half of the sales proceeds.

XII. Court Rules That Taxpayers Adequately Notified the IRS of Address Change: Direct Communication of Address Change to IRS Agent was Sufficient Notice to IRS; *Gregory*, No. 19-2229 (3d Cir. 12/30/20).

The Third Circuit held that a couple's filing of two IRS tax forms, that used their new address, along with direct communication of the address change to an IRS agent, was sufficient notification to the IRS of the change of address. The Tax Court previously had held that the IRS had sent a valid 90-day Notice of Deficiency to the couple's last known address at their former residence and that the couple had not provided the IRS with clear and concise notification of the address change.

In June 2015, Mr. and Mrs. Gregory relocated but failed to file a Form 8822, *Change of Address*, to inform the IRS of their new address.

Based upon the Fifth Circuit Court's decision in *Terrell,* 625 F.3d 254 (5th Cir. 2010), the Third Circuit held that "in determining whether the IRS had clear and concise notice of an address change, the proper inquiry is what the IRS knew or should have known." The court held that the CPA's communication to the IRS provided the IRS with actual notice of the address change. Also, the IRS had received two tax forms with an updated address. According to the court, these two factors were sufficient notice to the IRS, such that the IRS knew, or should have known, of the address change.

XIII. Taxpayers Couldn't Challenge A Notice Of Deficiency Sent To Last Known Address. Gregory, 152 TC No. 7 (2019).

Mr. and Mrs. Gregory moved in the summer of 2015. However, the couple used their old mailing address when they filed their 2014 federal income tax return on October 15, 2015. A month later, in November 2015, the couple used their new address when they filed a Form 2848. The couple also used their new address in April 2016 when they filed an extension to extend the due date for filing their 2015 return.

On October 3, 2016, right before Mr. and Mrs. Gregory filed their 2015 tax return, the IRS mailed a Notice of Deficiency to their old address. Mr. and Mrs. Gregory did not find out about the notice of deficiency until after the 90 day statutory notice period had expired.

The Tax Court held that Mr. and Mrs. Gregory had not provided the IRS with "adequate notice" of their new address and therefore their deficiency notice sent to their old address was valid which meant that the Tax Court petition filed by Mr. and Mrs. Gregory was untimely.

Under the regulations, the last known address is the address that appears on the taxpayer's most recently filed tax return unless the IRS has been given clear and concise notification of a different address. In this case, in October 2016 when the IRS mailed the statutory Notice of Deficiency, the last tax return filed by Mr. and Mrs. Gregory was the 2014 return which reflected their old address. Mr. and Mrs. Gregory should have filed a Form 8822, Change of Address, to the IRS.

XIV. Consent To Extend The Statute Of Limitations Was Invalid And Unenforceable Where The IRS Failed To Sign The Form 872 Prior To Expiration; Chief Counsel CCA 201937017 (September 13, 2019).

In this CCA, the taxpayer signed a Form 872, Consent to Extend the Time To Assess Tax, before the statute of limitations on assessment expired. However, due to the government shutdown, an IRS representative failed to sign the Form 872 until the government shutdown ended.

According to the CCA, the IRS cannot enforce a Form 872, signed by it after the expiration of the statute of limitations, even if it was signed by the taxpayer prior to expiration of the statute of limitations. Treasury Reg. 301.6501(c)-1(d) specifically states that the period of limitations to assess the tax may only be extended by consent "prior to the expiration" of the time to assess, and consent to extend "shall become effective when the agreement has been executed by both parties." So, the IRS could not enforce the Form 872 against the taxpayer.

XV. U.S. Tax Court Petition Filed By Dissolved Corporation Was Invalid.

In Timbron Holdings Corporation v. Commissioner, TC Memo 2019–31 (April 8, 2019), a California corporation had its charter suspended for failing to file California tax returns. The IRS then mailed the taxpayer a Notice of Deficiency and the taxpayer timely filed a U.S. Tax Court Petition challenging the Notice of Deficiency. The problem, however, was that taxpayer's charter was suspended when it filed the U.S. Tax Court petition. Therefore, the court dismissed the petition as being untimely filed.

PART SIXTEEN

OVERVIEW OF NORTH CAROLINA PTE (PASS-THROUGH ENTITY) DEDUCTION RULES

I. Background: North Carolina Adopts the PTE Approach As a Work-Around to the SALT Cap Beginning in 2022.

SB 105 adopted the PTE SALT cap workaround approach beginning with the 2022 tax year.

Beginning with the 2022 tax year, an S-Corporation or partnership may elect to pay SALT (state and local tax) at the entity level, instead of at the personal level, to avoid the $10,000 federal cap on SALT deductions on 1040 schedule A. If such an election is made, the PTE will be subject to tax on its North Carolina taxable income at the individual income tax rate.

On November 18, 2021, North Carolina adopted Session Law 2021-180 that clarified how the new SALT workaround would work for North Carolina taxpayers. Of course, this is only a partial workaround on the SALT limits because this only applies to benefit taxpayers who are owners of LLCs and S corporations. In the new North Carolina SALT workaround, Partnerships and S Corporations may elect to pay the North Carolina income tax at the entity level on behalf of their owners.

II. North Carolina Publishes Its Important Notice.

Then, in April 2022, North Carolina issued "Important Notice Regarding North Carolina's Recently Enacted Pass-Through Entity Tax". The April 14, 2022 Important Notice was published in a "Question and Answer" format explanation of how the new PTE deduction in North Carolina will work.

The Important Notice acknowledges there are many unanswered questions as to how the PTE rules in North Carolina will work in different fact situations. In various places, the Important Notice says that more guidance will be provided once North Carolina issues its instructions to 2022 tax returns.

Interestingly, on November 15, 2022, the NCDOR "updated" its April 14, 2022 Important Notice. However, the November 15 "updated" Notice is virtually "identical" to the April 14 version, except that the updated Important Notice confirms that a North Carolina "rental real estate company" is eligible to make the PTE Election, but an "investment partnership" is not; whereas a rental real estate company is deemed to be engaged in business in NC and therefore is required to file a NC tax return, an "investment partnership" is not considered "doing business" in NC, and therefore is not required to file a NC tax return. 17 NCAC 06B .3505.

III. **Making the PTE Election.**

The Important Notice advised that the PTE election must be made on a timely filed tax return, **including** extensions. This means that every PTE needs to file a federal extension **and** a North Carolina extension request as a safeguard in case something gets screwed up with the federal extension election - we anticipate recommending that every PTE extend all of their tax returns for federal and North Carolina tax purposes even if the return is otherwise ready be filed by the normal date due date.

IV. **How to Make the PTE Election.**

The PTE election is made at the entity level and qualifying entities can switch back and forth each and every year. So, making the PTE election in one year doesn't obligate you to make this PTE election the next year.

Note that the PTE election must be made for **all** owners of the PTE. In other words, you can't make the PTE election for the benefit of some, but not all, of the owners.

V. **Payment of the PTE Tax.**

Under the PTE regime, the PTE pays North Carolina income tax on its taxable income at the flat individual income tax rate in North Carolina (currently at 4.99 percent). This is so regardless of whether the individual PTE owners may be subject to a lower effective North Carolina tax rate due to their own available credits, deductions, etc.

Note that payments of PTE tax for 2022 cannot be accrued, but instead the PTE will actually have to make the estimated tax payments in November and December of 2022 to generate a deduction in 2022, even if the taxpayer otherwise uses the accrual method of accounting for tax purposes.

VI. **Eligible Pass-Through Entities.**

Eligible pass-through entities include certain Partnerships and all S corporations. Partnerships are eligible to make the PTE election only if all of its partners are "qualifying owners". "Qualifying owners" are defined as:

(1) Individuals;
(2) Estates;
(3) Trusts "qualified" to hold S corporation stock; and
(4) Tax exempt entities.

Disregarded entities are **not** eligible to make the PTE election.

VII. Estimated Tax Payment Requirements.

For 2022, PTE's are not required to make estimated income tax payments throughout the 2022 tax year. In the future, a PTE that anticipates making the PTE election for a given tax year must only make estimated tax payments if the PTE had elected to be a PTE for the prior taxable year.

So, if the PTE makes a PTE election for 2022, then that PTE will have to make estimated tax payments for 2023 if the pass-through entity anticipates making the PTE election for 2023 as well.

Any overpayment by the PTE of its North Carolina estimated tax payments are refunded back to the PTE and not to the individual owners.

VIII. Specified Income Tax Payments.

In the IRS Notice 2020-75, you will see the phrase "specified income tax payment" (also referenced as "SITP") which generally refers to any amount of state income tax that a PTE pays directly to the state taxing authority.

The PTE will then deduct the SITP as a business expense on its federal income tax return.

The Notice goes on to state that the SITP will be reflected on a partner's or S corporation shareholder's K-1 as a distributive or pro rata share of non-separately stated income or loss.

IX. North Carolina Tax Treatment For the PTE.

The Important Notice outlines how the PTE calculates its North Carolina taxable income for purposes of paying the PTE tax.

The Notice states that the starting point would be the **sum** of:

(A) Each owner's share of the PTE's income or loss – subject to the decoupling adjustments under NCGS 105-153.6 - attributable North Carolina; **plus**

(B) Each resident owner's share of PTE income or loss – subject to the decoupling adjustments under NCGS 105-153.6 - not attributable to North Carolina.

The adjustments mentioned in Section 105-153.6 relate to the decoupling adjustments required under NCGS 105- 153.6.

The Important Notice further states that "separately stated" items of deduction are **not** included when calculating each owner's share of the PTE taxable income. Presumably, this means that a PTE could well overpay the PTE tax of its owners.

In addition, the adjustments required by Section 105-153.5(c3), dealing with the specific adjustments unique to PTEs, are not included in the calculation of the Taxed PTE's taxable income.

A. Net Income

Once the PTE makes the PTE election and pays the North Carolina tax, the owners do not get taxed a second time for North Carolina tax purposes on their share of PTE income. Instead, their share of PTE income is deducted on the state return to the extent it was included in the Taxed PTE's North Carolina taxable income and the owner's adjusted gross income.

B. Net Losses

Any losses by the electing PTE will not be deducted on the personal return and will not flow through. Instead, the loss will carry forward into future tax years of the PTE.

If the PTE has a net loss for the year, then each owner of the PTE must add back its share of the net loss to the owner's North Carolina tax return to the federal AGI on the North Carolina tax return.

If the pass-through entity expects to recognize a loss for 2022, then the loss would not be deductible to the owners of the PTE if the PTE election is made. So, in that case, if a loss is anticipated, the PTE may decide not to make the PTE election so that the losses can be available to be used by the owners (of course assuming they have sufficient tax basis to absorb the loss on their personal tax returns).

> **Note**: What about a PTE Partnership or S Corporation that undergoes an asset sale or a stock sale in 2022 which is either a loss year or a year in which the PTE overpays its North Carolina estimated tax? How will the owners of the selling S corporation or partnership get the benefit of the loss generated in 2022 or the excess North Carolina tax payments made in 2022?

X. Tax Treatment For PTE Owners.

The owner of the taxed PTE will deduct the amount of the owner's share of income from the taxed PTE to the extent it was included in the taxed PTE's North Carolina taxable income and the owner's federal AGI.

Note that even if the PTE makes the PTE election, the individual owners have to include on their North Carolina personal tax returns any "decoupling" add backs or subtractions set out in N.C.G.S. 105-153.6 that are otherwise included in the PTE's taxable income (such as bonus depreciation, deduction add backs, etc.) and thus included in the calculation of the North Carolina tax imposed on PTE's.

XI. North Carolina Non-Residents.

If a shareholder or partner in a North Carolina PTE is not a resident of North Carolina, then they will not be required to file a separate tax return in North Carolina because their North Carolina tax obligations will have been met by the PTE entity itself. Note this may be another advantage to making the PTE election.

XII. Treatment of Tax Credits.

There is some confusion as to how the credits themselves work. This is how we understand the rules to be:

A. Tax Credits in General.

The Important Notice also advises that a Taxed PTE cannot pass a North Carolina income tax credit to its owners (such as a tax credit for income taxes paid by the PTE to another state), and that a PTE cannot pass to its owners any carryforward of any unused portion of a tax credit that was claimed by the PTE on the PTE's North Carolina tax return.

B. Treatment of Tax Credits for Multi-State Taxpayers.

(1) A North Carolina PTE and a PTE in Other States. Here, the PTE can claim a credit for income tax paid to other states to the extent that the income is allocable to North Carolina resident owners. The PTE qualifies for the credit and the credit is not passed through to the individual owners of the PTE and the owners themselves do not claim the PTE credit.

(2) The PTE is a North Carolina PTE but it is not an electing PTE in the other state. Here, the owner of the North Carolina PTE claims a credit for taxes paid to another state.

(3) An S Corporation does not make the PTE election in North Carolina but does make the election in another state. Here, only the owner of the PTE gets the North Carolina credit for taxes paid to the other state by the S corporation.

(4) A partnership does not make the PTE election in North Carolina but does make the PTE election in another state. In the case of a partnership, however, an individual North Carolina partner cannot claim the credit for the out-of-state tax paid by the partnership.