2011 FEDERAL INCOME TAX UPDATE

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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.

PART ONE
DETERMINING TAXABLE INCOME

I. 9th Circuit Court of Appeals Affirms the Earlier Holding of the District Court Case of Howard versus Commissioner and Rules that Goodwill From Sale of a Professional Practice is a Corporate Asset.

A. Background of Cases Involving The Sale of Personal Goodwill.

In many asset sale transactions, shareholders of the seller will try to allocate the purchase price between payments going to the corporation (for the asset purchase) and payments going to the shareholders for various goodwill payments, noncompete payments and/or consulting agreements. The following is a chart of the tax treatment of these shareholder payments:

Type of Payment	Tax Treatment
Amounts Received for Consulting Agreements:	Ordinary income and self employment tax
Amounts Received Under Noncompete Agreements:	Ordinary income, but no self employment tax
Amounts Received for Shareholder Goodwill:	Capital gain and no employment taxes

These shareholder payment allocations can be even more helpful in cases where the assets are sold by a C Corporation that would otherwise be subject to the C Corporation double tax.

B. Martin Ice Cream and Norwalk. In both the Martin Ice Cream, 110 TC 189 (March 17, 1998), and the Norwalk, (TC Memo 1998-279) cases, the Courts held that the presence of shareholder goodwill prevented the taxpayer-corporations from recognizing gain from the exchange of the shareholder-based intangible assets - in the context of a failed Section 355 spin-off in the Martin Ice Cream case and in the case of a corporate liquidation in the Norwalk case. In the aftermath of the Norwalk and Martin Ice Cream decisions issued in 1998, many tax practitioners have been lulled into a safe sense of security that it may be relatively easy to attribute a corporation's goodwill to intangible assets and goodwill owned by the taxpayer-corporation's shareholders.

C. Sale of Shareholder Goodwill Is More Difficult Where A Manufacturing Business Was Involved. In the case of Solomon v. Commissioner, TC Memo 2008-102 (April 16, 2008), a corporation was owned by father and son and sold one of its lines of business to a competitor. In connection with the sale, the shareholder-employees (father and son) entered into covenants not to compete with the buyer.

However, there were conflicting provisions in the Asset Purchase Agreement and Covenant Not to Compete Agreements which made it unclear as to whether payments received by the father and son (as shareholders) were payments for a customer list **or** were payments under the Noncompete Agreements.

At the Tax Court proceeding, the IRS took the position that the corporation had distributed an undivided interest in the customer list to each of the shareholders as a dividend immediately prior to the sale - which would have resulted in corporate level gain under Section 311(a), as well as dividend income being taxed at ordinary income rates to the shareholders.
The Tax Court disagreed with the IRS, but also rejected the shareholders' arguments that the payments were consideration for the sale of personal goodwill owned by the shareholders (which would have been taxed at capital gains tax rates).

In this case, the Tax Court ruled that, because the Corporation's business was processing, manufacturing and sale of product (rather than the provision of services), the assets of the sold corporation's business did not depend entirely on the goodwill of its employee-shareholders for its success.

Moreover, the purchase agreements also reflected that the shareholders were not "sellers" of the assets to the buyer, but instead were included in the sale documents only in their individual capacities as parties to the noncompete agreements. In addition, the shareholders (father and son) were not required to enter into employment or consulting agreements which made it unlikely that the buyer was purchasing their personal goodwill.

Accordingly, the Tax Court held that the payments to the father and son were entirely consideration for their covenants not to compete (taxed at ordinary income rates rather than capital gains tax rates).

NOTE: What does this case tell us? First, this case indicates that it will be much harder for a shareholder to sell personal goodwill when the company is in the business of manufacturing or processing since that is not a service-related business (such as the distribution business under the Martin Ice Cream case or a CPA practice under the Norwalk case). Also, the form and content of the transaction documents will be critically important to review - especially where the shareholders are not listed as sellers of corporate assets, but instead are merely subject to a noncompete agreement.

D. And, the Muskat Case Reminds Us: You Can't Sell Your Shareholder Goodwill Unless The Transaction Documents Say You Are. In the case of Irwin Muskat, 103 AFTR 2d 2009-419 (1st Circuit Court of Appeals January 29, 2009), Mr. Muskat was the shareholder of a corporation that sold its assets in 1998.

The corporation was originally formed by Mr. Muskat's grandfather. Mr. Muskat took control of the company in 1987. In this case, the corporation was a meat packing company.

In 1997, Mr. Muskat began to consider a sale of the company. An Asset Purchase Agreement was signed in March 1998 allocating almost $16 Million to the Company's goodwill. Mr. Muskat received $1 Million under a noncompete agreement in connection with the asset purchase transaction.

Mr. Muskat reported the $1 Million noncompete payment as ordinary income and even paid self-employment taxes on his 1998 tax return on the noncompete payment. Subsequently, Mr. Muskat filed an amended tax return for 1998 reclassifying the $1 Million noncompete payments as capital gain for the sale of "personal goodwill." Mr. Muskat took the position that, due to his advanced age, the buyer was really not gaining anything of value by virtue of payments under a noncompete agreement. Therefore, Mr. Muskat took the position that the payments under the noncompete agreement were simply payments for the sale of personal goodwill.

Unfortunately for Mr. Muskat, however, none of the purchase documents nor the noncompete agreement ever mentioned any sale by Mr. Muskat of any personal goodwill, and instead all of the agreements referenced the fact that Mr. Muskat would receive $1 Million for his covenant not to compete with the buyer. Therefore, there was never any evidence that the buyer paid Mr. Muskat $1 Million for his personal goodwill rather than for his agreement not to compete. In fact, the sale of personal goodwill was never mentioned in any of the purchase documents or in any negotiations.

> **NOTE:** Here, the substance of the transaction documents probably were fatal to Mr. Muskat's arguments. In this case, the corporation was a meat packing company. Mr. Muskat exercised operational control over the company, maintained involvement with key customer accounts and had personal relationships with the seller's customers and suppliers. Presumably, therefore, Mr. Muskat had some personal goodwill that he could have sold in terms of his relationships with customers. However, the purchase documents never mentioned any sale of personal goodwill by Mr. Muskat and therefore he could not prove that the buyer paid any portion of the $1 Million noncompete agreement in exchange for the personal goodwill of Mr. Muskat.

E. Also, the Existence of A Preexisting Noncompete Agreement Invalidates Attempted Sale of Personal Shareholder Goodwill; Howard, 106 AFTR 2d 2010-5533 (August 29, 2011).

Recently, the 9th Circuit Court of Appeals has held that the earlier District Court's decision, confirming that the existence of a pre-existing non-compete agreement, invalidates attempted sale of personal shareholder goodwill. U.S. v. Howard, 106 A.F.T.R. 2d 2010-5533 (August 29, 2011).

The case of Larry Howard, 106 AFTR 2d 2010-5140 (D.C. Wash. July 30, 2010), involved a dentist (Dr. Howard) who was employed by his solely-owned C corporation. In 2002, Dr. Howard sold his dental practice (in an asset sale transaction) through his C Corporation.

Originally, Dr. Howard incorporated his dental practice in 1980 as Howard Corporation, and named himself as its sole shareholder, director and officer. Dr. Howard also signed an employment contract with his corporation, Howard Corporation, that included a three (3) year noncompete agreement. Under the three year noncompete agreement, Dr. Howard agreed not to compete with his C Corporation (Howard Corporation) within a fifteen (15) mile radius of his dental practice for three (3) years after he ceased to be a shareholder of his dental practice.

In 2002, Howard Corp. sold its dental practice to a purchaser under an asset purchase arrangement and, under the terms of the Asset Purchase Agreement, Dr. Howard received almost $550,000 for his personal goodwill. Howard Corp. received $47,000 for its assets.

Dr. Howard reported a substantial long term capital gain of over $320,000 on the sale of his personal goodwill. However, upon audit, the IRS recharacterized the sale of the personal goodwill as the sale of a corporate asset and treated the $320,000 capital gain as a dividend to Dr. Howard from the dental practice. Since the sale occurred in 2002, the deemed dividend to Dr. Howard was taxed at ordinary income tax rates in effect in 2002, which generated a substantial deficiency assessment against Dr. Howard.

Dr. Howard argued in the District Court proceeding that he had sold his personal goodwill to the purchaser, since the Asset Purchase Agreement classified a substantial portion of the purchase price payment as a payment for the purchase of Dr. Howard's shareholder goodwill. In addition, Dr. Howard argued that the Howard Corp. noncompete agreement between Howard Corp. and Dr. Howard was terminated upon the asset sale to the third party purchaser.

Nevertheless, the District Court held that, since Dr. Howard had a noncompete agreement in favor of Howard Corp., any goodwill created during the periods from 1980-2002 effectively belonged to the Howard Corp., and therefore no portion of the goodwill payments would be treated as having been received by Dr. Howard. **Thus, the entire amount of the goodwill payment was deemed to have been paid to Howard Corp., followed by a dividend payment to Dr. Howard.**

On appeal to the Ninth Circuit United States Court of Appeals, Dr. Howard argued that his earlier non-compete and employment agreements terminated upon the asset sale. The 9th Circuit Court dismissed this argument but noted that, even if the sale did terminate these two agreements, then the terminations of these two very valuable agreements would be treated as a deemed dividend distribution to Dr. Howard anyway.

> **Note:** What does this case teach us? In this case, Dr. Howard entered into a noncompete agreement with his C corporation (Howard Corporation) back in 1980, probably under the belief that the noncompete agreement would allow him to increase his deductible wages received from Howard Corp. However, when it came time to sell the corporation's assets, this noncompete agreement served to eliminate any argument that Dr. Howard owned shareholder goodwill.

> **Note**: So, whenever we have a professional practice that sells its assets, we need to make sure that there is no prior noncompete agreement in effect prior to the sale. If there is such a noncompete agreement, we will have a difficult time in proving that any payments to the shareholder constitute goodwill shareholder payments.

II. When Do Sales of Real Property Produce Ordinary Income Versus Capital Gains? Were the Taxpayers "Dealers" and not Merely "Investors".

The cases of Garrison v. Commissioner, TC Memo 2010-261 (December 1, 2010) and Gardner, TC Memo 2011-137 (June 20, 2011), reviewed the age old issue of whether the taxpayers held real property for investment or as inventory in their capacity as dealers.

A. Background and Introduction.

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. 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 **not** available to ***dealers*** of real property.

On the other hand, investors in rental real estate must be cognizant of the passive activity loss limitations of Section 469 and the capital loss limitations applicable to investment property.

Likewise, 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.

In this day and age, as compared with past years, we are much more inclined to argue that our clients are holding properties as inventory as opposed to for investment purposes. Since property values have diminished substantially over the last four years or so, many of our clients will seek to take the position that their loss property was held as inventory as opposed to property for investment purposes.

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.

B. Factors Reviewed By The Courts. The Court in Ada Belle Winthrop, (CA-5) 24 AFTR 2d 69-5760, rev'g (DC) 20 AFTR2d 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.

C. <u>Garrison vs. Commissioner; Sales of Real Property Produce Ordinary Income and Not Capital Gains, Since the Taxpayers Were Dealers and not Merely "Investors".</u> The Tax Court held that proceeds of sales of real property that a mortgage banker and his spouse bought and sold in a relatively short period of time to support and supplement their other income would be taxable as ordinary income and not capital gains. This court case involved the **1998 and 1999** tax years. During these years, the taxpayers regularly purchased and sold real estate within short periods of time.

Mr. Garrison earned less than $40,000 a year as a mortgage banker and the court found that their gains from their real estate transactions substantially contributed to their income.

Mr. and Mrs. Garrison regularly purchased property through foreclosure. In 1998, they purchased parcels of real property and sold all of these properties within two months of purchase. Mr. and Mrs. Garrison did not claim any expenses for repairs for any of these properties. In 1999 and 2000, Mr. and Mrs. Garrison sold four parcels of real estate each year. These properties were sold within ten (10) weeks of acquisition. During the 1998, 1999 and 2000 years, Mr. and Mrs. Garrison did not rent any of the properties before selling them.

During the tax court proceedings, Mr. Garrison testified that "I am in the business of buying material, fixing houses, and reselling them." Based upon all this evidence, the court quickly determined that the sales were sales of inventory and not sales of capital assets. The Court was most persuaded by the following facts:

1. The income from the sales substantially contributed to the Garrisons income when considering his relatively low wages from his mortgage brokerage business;

2. The frequency and continuity of sales (including the fact that they had sold fifteen (15) properties over three years); and

3. Mr. Garrison's own testimony that he was in the business of buying, fixing and reselling properties.

D. <u>Gardner vs. Commissioner; Contractor Treated As An Investor (And Not As A Dealer)</u>.

In the case of <u>Gardner</u>, TC Memo 2011-137 (June 20, 2011), Mr. Gardner purchased a parcel of real estate with a plan that he would build multi-family projects on the land to generate future rental income. When Mr. Gardner purchased the tract in 2004, the tract had been approved for subdivision into five (5) lots. However, as a result of financial issues, Mr. Gardner decided to sell three lots from the subdivided tract, at a short term capital gain of over $370,000.

The IRS contended that, by virtue of Mr. Gardner's past development activities, that Mr. Gardner should be treated as a "dealer" with respect to the three lots, and so the IRS assessed **self-employment taxes on the short term capital gain.**

Over a 26 year period, Mr. Gardner bought and sold 16 parcels of real estate. Sometimes, Mr. Gardner would purchase unimproved land, build multi-family housing on the land and would hold it for long term investment. In other cases, Mr. Gardner would buy unimproved land and then sell it later.

The IRS argued that Mr. Gardner's past history showed that he was a developer and also argued that, when Mr. Gardner purchased the 2004 tract, his intent was to sell off previously approved subdivided lots.

Mr. Gardner admitted that, in the past, he had been both the dealer and investor. Mr. Gardner pointed to the fact that his past practice of holding multi-family properties, for long terms, proved that he was an investor with respect to those types of properties. In addition, in the past when Mr. Gardner had sold multi-family properties, he usually had held them for at least several years before selling them.

At trial, the Tax Court agreed that Mr. Gardner had demonstrated a long term practice of holding multi-family investments for long term investment purposes.

Note: This case seem to critically "hinge" on the fact that Mr. Gardner was a credible witness at trial in testifying as to his original purchase purpose in acquiring the 2004 tract - that is, to build multi-family properties and hold them for long term rental potential.

III. Purported Loans from a Corporation to Its Shareholder Were Recharacterized As Dividend Distributions.

In the case of Knutsen-Rowell, Inc., TC Memo 2011-65 (March 16, 2011), the Tax Court held that distributions, from a closely-held C corporation to its shareholders, were constructive dividends and not true loans.

A. Background. In past cases, in determining whether distributions to a shareholder should be treated as a non-taxable loan or as a taxable dividend, the Courts have analyzed various factors to determine whether the facts indicated the true intent of the parties to treat a distribution as a loan to the shareholder. Among the following factors considered by the courts are as follows:

1. whether there is a promissory note evidencing the loan;
2. whether the corporation charged interest (and whether the shareholder actually paid interest back to the corporation);
3. whether there was a fixed repayment schedule for the loan;
4. whether the loan was secured by some type of collateral;
5. whether the shareholders ever made repayments on the loan;
6. whether the borrower (shareholder) actually had the financial ability to repay the loan and whether the lender (the corporation) had adequate capital to make the -loan.

B. Facts of Knutsen. In the Knutsen case, the shareholders used withdrawn amounts to pay personal living expenses, including expenses for their children. However, the shareholders never executed a promissory note in favor of the corporation and the "loans" were not collateralized or secured in any way. Also, there was no repayment schedule and the shareholders could not provide any other evidence that the distributions were intended to be loans when the distributions were made. Perhaps, most importantly, the distributions were not even booked as loans on the corporation's books and records and in other financial statements.

IV. Settlement Payments For Trade Secret Misappropriation Treated as Ordinary Income, and Not Capital Gain; Freda v. Commissioner, 108 AFTR 2d 2011-5985 (7th Cir. Ct. of Appeals August 26, 2011).

In this case, C&F Packing Company sued Pizza Hut, Inc. for "trade secret misappropriation." Ultimately, C&F agreed to dismiss all of its claims against Pizza Hut in exchange for payment of $15.3 Million. C&F reported the entire payment as proceeds from the sale of a capital asset, generating capital gain. Since C&F was an S corporation, the reported capital gain was passed-through, and taxed to, the individual S corporation shareholders of C&F.

Later, the IRS contended that the settlement payments should be treated as ordinary income, since the lawsuit Complaint, originally filed by C&F against Pizza Hut, alleged that trade secret misappropriation, by Pizza Hut, had caused C&F to incur substantial losses of potential profits.

A. Fact Summary. C&F was a sausage producer. Years earlier, Pizza Hut had approached C&F about allowing Pizza Hut to use C&F's meat processing procedures in connection with Pizza Hut's business. In 1985, Pizza Hut agreed to sign a Confidentiality Agreement under which Pizza Hut agreed that it would not disclose C&F's confidential information about its sausage processing procedures.

Later, C&F sued Pizza Hut for "trade secret misappropriation" and contended that Pizza Hut violated the terms of the Confidentiality Agreement. In the original lawsuit Complaint, C&F requested a damage award, claiming in its Complaint that "C&F has been damaged, and has suffered, among other things, lost profits, lost opportunities, operating losses and expenditures."

Ultimately, Pizza Hut and C&F entered into a Settlement Agreement, and in exchange for a $15 Million settlement payment, C&F agreed to release all of its claims against Pizza Hut. The Settlement Agreement provided for "a lump sum payment in full and complete discharge and settlement of the Lawsuit and other past, present and future claims that could be asserted now or in the future by C&F". C&F characterized $6.12 Million from the settlement as gain from a "trade secret sale" and reported the entire amount as long-term capital gain on its 2002 federal income tax return. Since C&F was an S corporation, the reported capital gain was passed-through, and taxed to, the individual S corporation shareholders of C&F.

B. The Tax Court Proceedings. During the Tax Court proceedings, the IRS argued that, in its very own Complaint, C&F had never argued that it had suffered damages to a capital gain asset. Instead, the Complaint only alleged damages for lost profits. And, in the Settlement Agreement, the terms of the Settlement Agreement never purported that C&F was exchanging its trade secrets information in exchange for a lump sum settlement payment.

C&F, however, presented three arguments in support of its position that the settlement proceeds should be taxed as long term capital gain:

1. Relying on Inco Electroenergy Corp vs. Commissioner, TCM 1987-437, which held that funds received for damages to a capital asset are taxable as capital gain, the shareholders of C&F argued that the settlement payments by Pizza Hut were payments for damage to C&F trade secrets, which were capital assets.

2. Second, the C&F shareholders argued that since long-term capital gain is defined in terms of the "sale or exchange" of capital assets, the settlement payment represented the culmination of a "sale or exchange" of the trade secrets relating to the C&F process.

3. Third, since Section 1234A treats, as capital gain, income attributable to the termination of certain rights or obligations, the shareholders contended that Pizza Hut made the settlement payment to terminate C&F's rights under the Confidentiality Agreement the parties had signed in 1985.

The Tax Court rejected all three arguments and held that all the settlement payment proceeds should be taxed as ordinary income. The Tax Court held that, based upon the "origin of the claim" doctrine, since C&F had never alleged that it received payments as compensation for a lost or transferred capital asset, but instead had simply alleged that it suffered "loss of profits", the language in the original Complaint and in the Settlement Agreement bound C&F to recognize the entire amount as ordinary income, and not as capital gain.

C. The 7th Circuit Court of Appeals. The C&F shareholders then appealed to the 7th Circuit Court of Appeals. In agreement with the Tax Court, the Appeals Court noted that, in the earlier case of Sager Glove, 36 TC 1173 (September 29, 1961), aff'd 11 A.F.T.R. 2d 325 (7th Cir. 1962), the Seventh Circuit Court of Appeals had held that, under the "origin of the claim" doctrine where:

> "the recovery represents damages for lost profits, it is taxable as ordinary income. However, if it represents a replacement of capital destroyed or injured, the money received … is a return of capital and not taxable."

Here in Freda, in the original Complaint, C&F sought damages for loss of profits and in nowhere in the Complaint did C&F focus on any type of damage to or destruction of its capital asset. In addition, the Settlement Agreement gave no indication that Pizza Hut believed that it was compensating C&F for the sale or the use of its trade secrets. Instead, the Settlement Agreement only stated that $15.3 Million was tendered "in consideration of the dismissal with prejudice of the lawsuit." And, nowhere did the Settlement Agreement mention anything about the settlement payment being in exchange for any type of transfer of a capital asset that Pizza Hut previously received, or was receiving, by virtue of the Settlement Agreement.

Thus, based upon a direct and plain reading of the original Complaint and Settlement Agreement, the Court of Appeals ruled that C&F was bound by its prior demand for judicial award for "lost profits."

Note: This case is the classic case where C&F's litigation attorneys drafted an initial Complaint, and even the Settlement Agreement, without considering the possible tax consequences of the judicial award or settlement. Perhaps C&F's litigation attorneys believed that they would have an easier time in proving lost profits, as opposed to being able to prove diminishing value of C&F's capital assets, *i.e.*, its trade secrets or proprietary meat processing process.

Presumably, with even a small amount of foresight or tax planning, C&F's litigation attorneys easily could have alleged alternative damages to its capital asset in the original Complaint. Likewise, in the Settlement Agreement, the litigation attorneys easily could have "couched" the Settlement Agreement in terms of payment for damages to, or transfer of, a capital asset from C&F to Pizza Hut.

Also Note: One judge dissented with the 7th Circuit Court of Appeals' decision, and indeed the end result seems particularly harsh in light of the fact that C&F never would have incurred lost profits without the corresponding loss or destruction of its capital asset. Indeed, if Pizza Hut had negligently or intentionally destroyed a building belonging to C&F, then it is obvious that C&F's damages would have related to the loss of the building itself (a capital asset), rather than the mere loss of potential rental income (ordinary income) the building could have generated.

V. Two Recent IRS Email Announcements Remind Us To Consider the FICA Tax Reporting Requirements for Non-Qualified Deferred Compensation Arrangements.

In CCA 201025053 (June 25, 2010), the IRS reminds us that, if a taxpayer has nonqualified deferred compensation benefits, that are not taken into W-2 wages when the income is earned, then those amounts - and all the subsequent income attributable to them -- will be subject to the 7.65% FICA tax when these amounts are distributed from the non-qualified deferred compensation plan.

CCA 201025056 (June 25, 2010) reminds us that you might be better off claiming all the deferred compensation as income in the year when earned – rather than in the deferral year of receipt – since you might otherwise be able to avoid the 6.2% social security tax component of the FICA tax on the deferred income, as well as all the FICA tax on the earnings in the account.

EXAMPLE: Employee retires in 2011 and enters into a deferred compensation arrangement which obligates the Employer to pay $150,000 of deferred compensation in future years. Assume the employee earns $125,000 in 2011 as regular Form W-2 wages, but defers the $150,000 of deferred compensation income until a future year under the employer's deferred compensation arrangement.

In this case, the employee defers federal income tax and FICA tax on the $150,000 of deferred compensation award until it is fully vested down the road. However, if the employee had taken the full $275,000 into Form W-2 wage income in 2011, the employee would not have paid the 6.2% Social Security tax on the extra $150,000 of deferred compensation (since the employee was already over the $106,800 wage base for 2011). And, the employee would have avoided all the FICA tax on the earnings in the account.

However, if the employee does not take the deferred compensation into income in the year ear earned, then once the deferred amounts ultimately are distributed (or are no longer subject to risk of forfeiture), then all of the deferred compensation amounts (including all earnings in the deferred compensation account) will be subject to FICA tax, except to the extent the retired employee might have other Form W-2 wage compensation in the year that the deferred compensation is received.

So, you have to do the math. Is the employee better off accelerating the federal income tax in the year the deferred compensation is earned in order to avoid FICA tax on the deferred compensation amount and future earnings when those amounts are ultimately distributed out?

PART TWO
DEDUCTIONS

I. Tax Court Allows Medical Deduction for "In Home" Personal Care That Was Tantamount to "Long Term Care Services."

A. Background. Under Section 213, a taxpayer is allowed a deduction for medical care expenses, to the extent that the medical care expenses exceed 7.5% of AGI. The term "medical care" for these purposes is defined to include long-term services as defined in Section 7702B(c)(1) as long as those services are:

1. required by a chronically ill individual; and
2. provided pursuant to a plan of care prescribed by a licensed health care practitioner.

Usually, clients claim "medical care" itemized deduction expenses for amounts paid to a nursing home for long term care. However, as the case of Lillian Baral v. Commissioner, 137 TC Memo No. 1 (July 5, 2011) below illustrates, individuals may be entitled to a long term medical care expense deduction even if the medical care is provided "at home."

B. Facts of Estate of Lillian Baral. In the Estate of Lillian Baral v. Commissioner, Mrs. Baral's executors challenged the IRS's refusal to allow Mrs. Baral to claim medical care expenses before her death for amounts paid for at home care. In this case, Mrs. Baral was diagnosed with dementia by her physician in 2004 and needed repeated hospitalization. Mrs. Baral's physician determined that she needed around the clock care if she were to live independently. Based upon her physician's recommendations, Mrs. Baral's attorney-in-fact (her brother) hired two around the clock care givers to assist her with daily needs (such as bathing, dressing, trips to the doctors, medications, etc.).

The issue in this case was whether the expenses paid for Mrs. Baral's care qualified as "long-term" care service expenses pursuant to Section 7702B(c)(1). Ultimately, the Tax Court agreed with Mrs. Baral's estate that the amounts paid to the caregivers for their services were deductible as qualified long term care services under Section 7702B(c)(1). In this case, the Court noted that the doctor advised that Mrs. Baral was chronically ill and that the at home care was medically necessary to insure her protected health and safety based upon her physician's recommendations. So, Mrs. Baral was permitted medical care deductions under Section 213 for "long term care" services, even though she was allowed to remain in her home.

PART THREE
PASSIVE LOSS CASES

I. Passive Losses: General Overview

A. Background of Passive Activity Loss's Rules. Section 469 denies passive activity losses to an individual, an estate or trust, a C corporation or a personal service corporation. Under Section 469(a), a "passive activity" is defined as any activity involving the conduct of a trade or business in which the taxpayer does not materially participate. The term "passive activity" however, generally includes any rental activity, regardless of material participation. Section 469(d)(2). The Code defines "rental property" as "any activity where payments where payments are principally for the use of tangible property".

Congress enacted Section 469 to prevent taxpayers from applying losses from rental properties and other passive business activities to offset and shelter non-passive income such as wages, dividends or profits from non-passive activities. See S. Rep. No. 99-313, at 716-18 (1986).

B. The Seven "Material Participation" Tests. Under Temporary Regulation 1.469-5T(a), seven tests are created for determining whether an individual "materially participates" in an activity. A taxpayer must satisfy only one of these tests. These seven "material participation tests" are as follows:

1. individual participation for more than 500 hours during the year;

2. an individual's participation constitutes substantially all of the participation in that activity for the year;

3. an individual participates more than 100 hours and that participation is as much as any other individual's participation;

4. "significant participation activity";

5. material participation is presumed if existed in five of preceding ten years;

6. material participation is presumed if a personal service activity is present and Taxpayer was a material participant in any three years prior to the year in issue (consecutive years not required);

7. facts and circumstances test.

II. <u>Passive Activity Loss Rules: Short Term Rentals For One Activity Preclude Loss Deductions From Other Rental Activities</u>.

In the case of <u>Bailey v. Commissioner</u>, TC Summary Opinion 2011-22 (March 3, 2011), Mr. and Mrs. Bailey owned three rental properties. Two of the rental properties were offered for long term year-to-year rentals, and for the tax years at issue, the Baileys deducted their losses for those two rental activities on their Schedule E.

The third property was an Inn that offered short term rentals (less than eight (8) days at a time). The Baileys' deducted their losses from the Inn activities on their Schedule C.

During the 2004 tax year, the Baileys spent 382 hours on the two long-term rental properties listed on their Schedule E. The Baileys also spent 192 hours researching other potential acquisitions and spent 105 hours in activities related to acquiring a fourth property.

The Baileys spent 324 hours relating to the Inn property (with reported losses on their Schedule C).

Thus, all totaled, including time spent on acquiring the fourth property, the Baileys spent 1,003 hours of time on all of their real estate activities for 2004 (as reported on their Schedules C and E).

Since the Inn activity was a short-term rental activity and the Baileys clearly "materially participated" in the Inn activity, the IRS did not challenge the Schedule C losses for the Inn.

However, the IRS disallowed all of the Schedule E losses for the other two properties because rental activities usually are per-se passive activities. Also, because the Baileys had combined AGI of over $150,000, the Baileys were not entitled to the $25,000 loss deduction on their Schedule E under Section 469(i)(2) because of the $150,000 AGI "phase-out" rule.

The Baileys, however, argued that they were "real estate professionals" under Section 469(c)(7), and therefore their real estate activities should not be treated, per-se, as "passive activities."

Under the special "real estate professional" rule, the taxpayers' rental activities will not be treated as a "passive activity" if:

(1) more than one-half (1/2) of the personal services performed in trades or businesses by the taxpayer during the year are performed in real property trades or businesses in which the taxpayer materially participates; **and**

(2) the taxpayer performs more than 750 hours of services during the year in real property trades or businesses in which the taxpayer materially participates.

The Baileys argued that, since they were real estate professionals, all of their Schedule E losses should be deductible, and not subject to the passive loss limitation rules.

In this case, Mrs. Bailey performed all of the hours of services in the real property trades or businesses and she had no other employment during the year. Thus, the Baileys clearly satisfied the first test of Section 469(c)(7).

The problem was, however, that the time spent on the Inn activity could not be included in meeting the 750 hour test. Under Reg. 1.469-1T(e)(3)(ii)(A), short term rentals of less than eight (8) days are specifically excluded from the definition of a "rental activity," and therefore the rental of the Inn did not count as a "real property trade or business." Therefore, once the 324 hours were subtracted from the total $1,003 hours, this left only 679 hours actually devoted to real property trades or businesses. So, those hours did not count toward the 750 hour test of Section 469(c)(7).

Thus, the Tax Court ruled that, since the Baileys did not qualify as real estate professionals, all of their reported Schedule E losses would be disallowed under the passive loss limitation rule of Section 469.

III. <u>Absence Of Contemporaneous Record Keeping, and Overall Lack of Credibility During Testimony, Prevented Two Taxpayers from Qualifying As "Real Estate Professionals" For Passive Loss Purposes</u>.

Two tax court cases from 2011 reemphasized the fact that, in order to meet the rigorous "real estate professional" exception to the passive loss rules under Section 469, a heavy burden is on the taxpayer to prove and establish actual hours spent on their real estate activities.

A. <u>Anyika</u>. In the case of <u>Anyika</u>, TC Memo 2011-69 (March 24, 2011), Mr. Anyika was an engineer who worked full-time over 40 hours per week in his engineering services. Mrs. Anyika was a nurse who worked at least 24 hours a week. During 2005 and 2006, Mr. and Mrs. Anyika had losses from rental activities and they claimed deductions for the real estate losses under the "real estate professional exception" of Section 469(c)(7).

Initially, during the tax court trial, Mr. Anyika, testified that he spent 800 hours a year maintaining the rental properties. This would have allowed Mr. Anyika to satisfy the 750 hour test of § 469(c)(7). However, at some point during the trial court proceeding, Mr. Anyika evidently also discovered the second test of § 469(c)(7) - which requires that the taxpayer prove that more than one-half (½) of his professional time was spent in real property trades or businesses.

Mr. Anyika then changed his testimony claiming that he actually spent 1,920 hours per year on his rental activities. The Tax Court was so unimpressed with Mr. Anyika's credibility, that the Tax Court also assessed the negligence penalty.

B. <u>Mango</u>. In the case of <u>Mango</u>, TC Summary Opinion 2011-43 (April 6, 2011), the Tax Court likewise held that Mr. Mango did not provide credible evidence that he spent more than one-half (1/2) of his professional time in real estate activities. The Court noted that Mr. Mango provided no calendars, narrative summaries, mileage logs, receipts or any other documentation to prove his actual hours of service.

IV. Real Estate Professionals Must Keep Adequate Records to Avoid Passive Activity Loss Rules.

A. Background Rules for Real Estate Professionals.

A real estate professional must work **more than 750 hours** in a real estate trade or business in which he or she materially participates. **In addition**, this activity must be more than one-half (1/2) of the professional's services that the real estate professional performs in a tax year. Section 469(c)(7)(B).

B. The Importance of Keeping Contemporaneous Time Records.

In the case of Carolyn Fenderson vs. Commissioner, TC Summary Opinion 2007-191 (November 13, 2007), Ms. Fenderson was an account manager for a computer security software company. As an account manager, Ms. Fenderson frequently traveled to customers and potential customers in the Cleveland, Ohio and Pittsburgh, Pennsylvania area. She spent at least 50 hours a week doing so.

During the same tax year, Ms. Fenderson also owned several parcels of residential estate that she held out for rent. Ms. Fenderson was responsible for renting and managing the rental units. In addition to the rental activities, Ms. Fenderson also attended real estate auctions and reviewed the listing of real estate for sale by the U.S. government and private sellers in foreclosure auctions.

For the tax year at issue, Ms. Fenderson claimed tax losses on her rental real estate activities and she sought to offset the rental losses against her other employment income from her employer. The IRS sought to disallow the activity losses on the basis that Ms. Fenderson could **not prove** that she worked more hours in the real estate activities than she did for her regular employment.

At issue in this case was a calendar log that Ms. Fenderson kept to detail her real estate activities. On the calendar, Ms. Fenderson provided some details showing where she worked, such as attending auctions and for managing her real estate. The problem here was that Ms. Fenderson's calendar **was not specific enough**. On the calendar, she did not **detail the specific hours** she spent on her real estate activities. This was fatal for Ms. Fenderson.

NOTE: This case proves how important contemporaneous documentation is in order to establish the number of hours spent on real estate activities. In this case, Ms. Fenderson could only prove that she worked 759 hours for her real estate activities, yet her testimony indicated that she worked 780 hours for her regular employer. Thus, she failed by a **mere 21 hours**, since her calendar was not specific enough to detail the activity she provided for her real estate activities.

V. **New Revenue Procedure Provides For Simplified Retroactive Late Relief for Real Estate Professionals Who Fail to Timely Elect to Aggregate All Real Estate Activities As A Single Rental Activity For Purposes Of The Passive Loss Rules**

A. Background of Real Estate Professional Rules. A "rental activity" is generally treated as a passive activity regardless of whether the taxpayer materially participates in that rental activity. Section 469(c)(2). However, pursuant to Section 469(c)(7)(B), the rental activities of a "real estate professional" are not per se "passive activities" under Section 469(c)(2), but instead are treated as a trade or business subject to the "material participation" requirements of Section 469(c)(1). Reg. Section 1.469-9(e)(1).

Under Section 469(c)(7)(B), a taxpayer qualifies as a "real estate professional," and thus is not engaged in a passive activity under Section 469(c)(2), if:

(1) more than half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real estate property trades or businesses in which the taxpayer "materially participates;" **and**

(2) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer participates.

However, even if the requirements of Section 469(c)(7)(B) are met, and even if the taxpayer qualifies as a real estate professional, a taxpayer's rental activity will be treated as a "passive activity" under Section 469(c)(1), **unless** the real estate professional taxpayer materially participates in the activity.

Moreover, in determining whether a taxpayer materially participates in a trade or business, the participation requirements must be met with respect to **each interest** in rental real estate **unless** the taxpayer makes an election to treat **all** interests in rental real estate as a single real estate activity (the "aggregation/grouping election"). Section 469(c)(7)(A). Thus, a qualifying taxpayer may elect to aggregate or group **all** of his activities and treat them as one activity for purposes of applying the material participation tests. Sec. 469(c)(7)(A). However, once the election is made, it applies for that tax year and for all future tax years. Reg. 1.469-9(g).

B. How to Make The Grouping Election for a Real Estate Professional. Reg. Section 1.469-9(g)(3) provides that a qualifying taxpayer (a real estate professional) makes the election to treat all interest in rental real estate as a single rental activity – for purposes of determining if they have materially participated in the activity - by filing a statement with the taxpayer's **original** income tax return for the taxable year (the "grouping election"). IRC Reg. §1.469-9(g)(3) describes the information that must be contained in the grouping election statement. Pursuant to Reg. Sec. 1.469-9(g)(3), the statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to Section 469(c)(7)(A).

C. **Rev. Proc. 2011-34 (May 26, 2011).** Until recently, once the due date for filing the original return had expired, the taxpayer would have to apply for a Private Letter Ruling request under Reg. Sec. 301.9100-1(c) (and pay a use fee) in order to request an extension of time to make a late aggregation election for that tax year. Now, under the new Revenue Procedure, real estate professionals may make a late grouping election by filing an Election Statement with an amended return for the most recent tax year. The Election Statement must **identify the tax year** for which the taxpayer seeks to make the aggregation election effective, and the Election Statement must state at the top that is "Filed Pursuant to Rev. Proc. 2011-34".

In this Election Statement, the taxpayer must make the following representations under penalties of perjury:

1. The taxpayer failed to make the election solely because the taxpayer failed to timely meet the requirements of Section 1.469-9(g);

2. The taxpayer filed consistently with having made an election under Reg. 1.469-9(g) on any return that would have been affected if the taxpayer had timely made the election. The taxpayer must have filed all required federal income tax returns consistent with the requested aggregation for all of the years including and following the year the taxpayer intends for the requested aggregation to be effective and no tax returns contain positions inconsistent with the requested aggregation have been filed with respect to any of those tax years;

3. The taxpayer **timely filed each tax return** that would have been affected by the election if it had been timely made; and

4. The taxpayer has "reasonable cause" for its failure to meet the requirements of Reg. 1.469-9(g).

Note: So, as indicated above, not only can the aggregation election be made with respect to the most recent tax year, but the aggregation election will be effective as of the first tax year in which the taxpayer seeks to have the election apply.

PART FOUR
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. Income and Expenses Are Recharacterized When Hobby Losses Are Disallowed. 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 get moved to the "2% miscellaneous itemized deduction" line - which means that many of these expenses will not be deductible at all.

Things get much worse for taxpayers who are subject to the itemized deduction phase-out or the AMT. First, for any married taxpayers with AGIs over $166,800, the itemized deductions are phased out as AGI exceeds $166,800. Moreover, for those taxpayers subject to the AMT, many expenses are not allowed for AMT purposes, such as property taxes and 2% miscellaneous itemized deductions.

> **Note**: 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.

II. Time Share Rental Activity Was Determined To Be A Hobby Activity; Rundlett v. Commissioner, TC Memo 2011-229 (September 26, 2011).

In the case of Rundlett, Mr. and Mrs. Rundlett were denied Schedule C losses claimed on their 2005 and 2006 tax returns relating to their rental time share activity.

Mrs. Rundlett was an insurance agent in California and spent about 35-40 hours per week in connection with her insurance business. Mr. Rundlett worked 35-40 hours each week in his construction business.

While on vacation in 2005, Mr. and Mrs. Rundlett became interested in purchasing a time share for subsequent rental. Mrs. Rundlett determined that the investment return on the time share activity would be higher than the interest they would otherwise be earning on their bank accounts.

During 2005 and 2006, Mr. and Mrs. Rundlett purchased ten (10) time share units. Mrs. Rundlett testified that her ultimate goal was to own fifty-two (52) units and to use the time share rental income to supplement their retirement income. By the time the case was before the Tax Court, the time share activity had never been profitable.

During the tax years at issue, in order to rent the time shares out to third parties, Mrs. Rundlett would reserve one week each year for each time share and then she would advertise the time shares for rental. Most of the advertising was done by word of mouth and by posting fliers at the time share resort.

Mrs. Rundlett testified that it normally took her six (6) to eight (8) hours per unit per year on average to reserve the unit, market it and rent it out. At trial, Mrs. Rundlett was not able to testify as to how other time share owners used their time shares at their time share resorts and whether the other owners used the units or attempted to rent them out.

During the tax years at issue, Mr. and Mrs. Rundlett had substantial income from their other business activities (Mrs. Rundlett's insurance agency and Mr. Rundlett's construction business).

In the Tax Court proceeding, the Tax Court reviewed the eight (8) factor test set out in Treas. Reg. 1.183-2(b). This is how the Tax Court analyzed the eight (8) factor test:

1. **The Manner In Which The Taxpayer Carries On The Activity.** The Tax Court ruled that Mr. and Mrs. Rundlett did not carry on their time share rental activity in a "business-like" manner. Mrs. Rundlett claimed that she had a business plan that she had been updating each year, and Mrs. Rundlett claimed that she maintained a spreadsheet -- showing rental activities and rental costs for each time share unit. However, Mrs. Rundlett was not able to produce either the business plan or the income/cost spreadsheet at trial.

In addition, the Tax Court noted that Mr. and Mrs. Rundlett did not have any written documents showing their estimated profit calculations **prior** to purchasing the time shares. In addition, the Rundletts could not identify how they conducted their activity in a manner similar to other comparable business activities, nor could they show how they had ever changed or adopted new techniques to make their business more profitable. **So, this factor was in favor of the IRS.**

2. **The Expertise Of The Taxpayer And His Advisors.** The Tax Court quickly noted that Mr. and Mrs. Rundlett were not able to produce any evidence that they ever studied the business of renting time share units or that they had ever consulted with experts. Also, the Rundletts never consulted with any experts about how to make their business more profitable, nor could they provide any evidence that they consulted with other time share owners about the time share rental business prior to making their purchase of the time share units. **So, this factor was also in favor of the IRS.**

3. **The Time And Effort Expended By The Taxpayer In Carrying On The Activity.** Again, Mrs. Rundlett testified that she only spent six to eight hours each year on each time share unit and they both also worked full time jobs. **So, this factor was also in favor of the IRS.**

4. **The Expectation That Assets Used In the Activity May Appreciate In Value.** At trial, the Rundletts did not produce any evidence that the value of their time shares would increase over time. **Nevertheless, the Court ruled that this factor was merely neutral.**

5. **The Success of the Taxpayer in Carrying On Similar Or Dissimilar Activities.** The Rundletts were not able to provide any testimony or evidence that they conducted other similar business activities in the past in a profitable manner. **Nevertheless, the Court ruled that this factor was merely neutral.**

6. **The Taxpayer's History of Income or Loss.** Again, the Rundletts never made a profit and instead showed losses for all of the years at issue. However, the Court also noted that the two tax years at issue were the first years of the time share rental activity and that losses had been decreasing each year since the time share activities began. Because the time share activity had never made a profit, but was still in the "start-up" stage during the tax years at issue, **the Tax Court found that this factor was neutral.**

7. <u>The Amount of Occasional Profits From the Activity</u>. The Rundletts had never made any profit from their time share rental activity since inception, but **the Tax court held that this factor was merely neutral.**

8. <u>The Financial Status of the Taxpayer</u>. Since Mr. and Mrs. Rundlett made over $170,000 in combined compensation for the tax years at issue from other sources, this factor was clearly **in favor of the IRS.**

9. <u>Elements of Personal Recreation or Pleasure</u>. Mrs. Rundlett testified that, while making trips to review time shares for purchase, she was mixing both business and pleasure. Mrs. Rundlett stated that she hated attending the time share sales and marketing presentations, but admitted that she and her daughter would stay at expensive resorts while they were there so they could go to the beach the next day and make the trip enjoyable. The Court noted that Mrs. Rundlett did spend time working on renting and reserving units that the Court would not classify as pleasurable or recreational. **This factor ended up being neutral.**

<u>Conclusion</u>. So, based upon all of these factors, the Tax Court concluded that of all of the eight (8) factor tests, four (4) factors were in favor of the IRS and four (4) factors were neutral. None of the factors favored Mr. and Mrs. Rundlett.

Accordingly, the Court ruled that the time share activity was a hobby and not a "for profit" business.

III. <u>Horse Breeding Activity Is Found to be a "For Profit" Activity, Even After Ten Straight Years of Losses</u>. Under Section 183(d), if an activity earns a profit in three (3) of five (5) years, then the activity is presumed to be a for profit activity and not a hobby. And, if the activity involves a horse breeding activity, then the activity is presumed to be a for profit activity (and not a hobby) if the activity earns a profit two (2) of seven (7) years. Section 183(d).

A. <u>Background of Facts</u>. In the case of <u>Frimml</u>, TC Summary Opinion 2010 – 176 (December 28, 2010), Mr. and Mrs. Frimml operated a horse breeding activity that failed to generate a profit for ten (10) consecutive years, including the 2005 and 2006 tax years at issue.

Mr. and Mrs. Frimml both grew up on farms. Soon after they married, they purchased their first two horses in 1988 and, over the next ten years, they spent significant time learning about horse breeding activities and developing a business plan. Their business plan eventually focused on American Paint horses. At trial, Mr. and Mrs. Frimml were able to testify as to their extensive knowledge of the mechanics and financial aspects of horse breeding.

In 1998, the Frimmls purchased a six acre property for their horse breeding business. Over the next 7 to 8 years, they substantially improved the property. By the time of the trial in 2010, the six acre property had substantially appreciated in value – in part because of the Frimml's work in improving the property. Initially, Mr. Frimml maintained a very small stable of Paint breeding mares and sought to earn income by showing and selling the young foals. They consulted with experts on various aspects of the horse activities, including showing, breeding and selling the horses.

Mr. and Mrs. Frimml made many difficult business decisions regarding the purchase, care and sale of a number of paint horses for the horse breeding activity. They paid extensive amounts to take care of some of the mares when they were injured. On another occasion, Mr. and Mrs. Frimml decided to euthanize an injured two year old foal, because the cost to heal the foal exceeded the projected price that they would receive if they were able to sell her.

Mr. and Mrs. Frimml advertised their breeding activity primarily by showing their horses at various events. Mr. and Mrs. Frimml testified that they thought that showing their horses would be the best advertisement possible.

During the tax years at issue, Mr. and Mrs. Frimml both had full time jobs. Mr. Frimml worked for a local railroad, but his work allowed him flexibility to spend time off working on his horse breeding activities. On days off from his full time job, Mr. Frimml spent six to ten hours each day working and caring for his horses. Mrs. Frimml spent approximately one and one-half hours each day attending to horse activity even though she was employed full time as an office worker.

Mr. and Mrs. Frimml spent substantial personal time attending horse shows, learning about regional horses and otherwise advancing their activities. Indeed, the Frimmls rarely spent free time away from the horse activity. According to their testimony, one of them usually stayed back from family events so that the Paint horses would not be unattended. Also, Mr. and Mrs. Frimml and their family and friends did not ride the horses.

Mr. and Mrs. Frimml testified that their Paint horse activity was to provide a means for saving for their retirement. They did not believe that their savings would be sufficient to cover their retirement needs. The Frimmls had no sizeable investments or source of retirement income and only had a small 401(k) plan. Their total wages and salaries did not exceed more than $90,000 for each of the tax years at issue. Their total expenses for the horse activities were around $26,000 for each of the tax years at issue. They kept track of their business income and expenses by means of a check register.

B. <u>Tax Court Proceeding</u>. During the Tax Court proceeding, the Tax court applied the nine (9) factor test under Reg. Section 1.183-2(b). Here is how the Court applied the nine (9) factor test:

1. <u>The Manner In Which The Taxpayers Carried On The Business Activity</u>. The Court believed that the Frimmls carried on the horse breeding activity somewhat in a "business-like" manner. The Court noted that, **before** the Frimmls began their horse breeding activity, they spent a decade in formulating their business plan. The Court noted that, even though the Frimmls did not keep a written business plan, this was not fatal. <u>Rinehart v. Commissioner</u>, TC Memo 2002-9. They purchased their six acre tract and spent a great deal of time and money improving the tract. They also continuously engaged in methods of altering their business plan to make their horse breeding activity more successful. In some cases, they would spend funds to provide medical care for their horses, but other times they made difficult decisions, such as the decision to euthanize a young foal that had been hurt.

The Court also noted, however, that the check register they used to keep track of income and expenses was kept in an "unprofessional and imprecise" manner. The Court also noted that the taxpayers' advertising was not extensive and that they had not even developed a website by the time of the trial. Accordingly, with respect to the "business-like" factor, the Court held that this factor **was neutral**.

2. **<u>The Taxpayers' Expertise, Research And Study Of An Activity</u>.** Again here, the taxpayers studied the horse breeding activity for a full decade before they began their horse breeding activity. They also sought the advice of experts. Since the Frimmls had become well educated on horse breeding activities and had hired experts to help them learn more, the Tax Court concluded that this factor was in **favor of the Frimmls**.

3. **<u>The Time And Effort Expended By The Taxpayers In Carrying On The Activity</u>.** The Tax Court noted that Mr. Frimml worked on the horse activity virtually every day when he was not on his regular job. Also, Mrs. Frimml spent time every day on the horse activity, even when she was working full time at her office job. Also, during their free times, the taxpayers spent substantial time attending horse shows, learning about horses and otherwise advancing their activity. They rarely spent free time away from their horse activity and usually, one of them stayed back from family events so that the horses would not be unattended. This factor was in **favor of the taxpayers**.

4. **<u>The Taxpayer's Expectation That Assets Used In The Activity May Appreciate In Value</u>.** The Court noted that the six acre property used to house the horse activity had more than doubled in value by the time of trial, at least in part because of improvements the Frimmls made to their property. This factor favored Mr. and Mrs. Frimml as it **indicated a profit motive**.

5. **<u>The Taxpayer's Success In Carrying On Similar Or Dissimilar Activities.</u>** Although Mr. and Mrs. Frimml both grew up on farms, they produced no evidence at trial that they had ever undertaken similar horse activities in the past and so, this factor **favored the IRS**.

Factors 6 and 7: **<u>The Taxpayer's History Of Income Or Loss On The Horse Breeding Activity And The Amount Of Occasional Profits, If Any, Which Were Ever Earned</u>.** Here, Frimmls had never earned a profit operating their horse breeding activity. However, the Frimmls were able to provide evidence indicating that a paint horse breeding activity typically had a "start-up phase" of five to ten years. Based upon prior court cases, the Tax Court held that a five to ten year start-up phase for breeding certain types of horses was not unreasonable. <u>Engdahl v. Commissioner</u>, 72 TC 666, at 669 (1979); <u>Phillips v. Commissioner</u>, TC Memo 1997-128. Here, the 2005 and 2006 tax years are well within the five to ten year start-up window. The Court held that these factors **<u>were</u> <u>neutral</u>** because their losses were incurred during the start-up phase of their activities. <u>Strickland v. Commissioner</u>, TC Memo 2000-309.

8. **<u>The Financial Success Of The Taxpayer</u>.** The Court noted that Mr. and Mrs. Frimml both had full time jobs and made over $90,000 a year in other business activities. However, the Court did not believe that they were using their salaries from their regular jobs to support their horse breeding activities as a hobby. The Court noted that the Frimmls did not have any other savings to support their retirement and that they had testified that they had planned on operating their horse breeding activity in order to supplement their retirement income. The Court ultimately believed that it was highly unlikely that the Frimmls would embark on a hobby that would consume so much of their income and time unless they had a true profit motive. Engdahl v. Commissioner; Mary v. Commissioner, TC Memo 1989-118. This factor was in **favor of the taxpayers**.

9. Whether There Were Elements Of Personal Pleasure Or Recreation. The Court quickly noted that Mr. and Mrs. Frimml spent substantial funds in maintaining their horse breeding activity and that they did not ride their horses nor did they allow family or friends to ride them either. This factor indicated a **profit objective**.

C. Tax Court's Conclusion. Based upon all of the foregoing, the Tax Court concluded that the horse breeding activities were not a "hobby."

IV. Another Horse Breeding Case Was Determined to be A For Profit Activity and Not a Hobby.

A. Background and Introduction. The case of Blackwell v. Commissioner, TC Memo 2011–188 (August 8, 2011) involved another married couple engaged in a horse breeding activity. The Blackwell case involved a horse breeding activity that had losses for 2005 and 2006 of $46,504 and $34,500.

Before they began their horse breeding activities, Mr. and Mrs. Blackwell had very different backgrounds. Mr. Blackwell did not grow up around farm animals or horses but Mrs. Blackwell grew up around farm animals and horses and had always dreamed of owning and raising horses.

Mr. Blackwell held an MBA and had 30 years of business experience in different business areas. Mr. Blackwell had succeeded in virtually every endeavor in which he became involved.

Mrs. Blackwell had a college degree in nursing. During 2001 and 2002, Mrs. Blackwell did not work outside of her involvement in the horse breeding activity. Beginning in 2003, Mrs. Blackwell worked part-time for 3 hours a week as a rehabilitation nurse. From 2003 to 2009, the Blackwells' salaries from their activities ranged from a high of $1.2 Million in 2003, to a low of $371,000 in 2009. In each of these years, from 2003 until 2009, their combined salaries showed a downward trend except during 2007.

In 1993, the Blackwells purchased their first horse, and between 1993 and 2003, they purchased a number of additional horses. They also read books and magazines and watched videos about horse management and breeding activities. They also attended a number of national horse shows during these years.

In the mid-1990s, the Blackwells developed an interest in starting a horse breeding activity. In 1996, Mrs. Blackwell enrolled in a Equine Management Degree Program at the University of Minnesota. By the late 1990s, as a result of their reading and research, and by virtue of their conversations with experts, Mr. and Mrs. Blackwell became a lot more interested in starting a horse breeding activity. In 1999, they prepared a detailed business plan relating to the purchase, breeding, and training of Reining Horses.

The business plan included sections entitled "Executive Summary", "Market Overview", "Advertising and Promotion" and "Proforma Income Statement". The business plan indicated that Mrs. Blackwell would run the day-to-day activities of the horse breeding activity and that Mr. Blackwell would be responsible for the business and marketing sides of the horse activity. The business plan estimated small losses for 2000 and 2001, but estimated profits for 2002 through 2005 that would increase over those years.

The Blackwells began their horse breeding activity in 2000 on a farm in Minnesota in which they lived. During the years at issue, Mrs. Blackwell spent 15 to 20 hours per week taking care of the horses and Mr. Blackwell spent 2 to 5 hours per week in marketing and advertising activities. During these years, the Blackwells also joined a number of horse organizations in order to improve their expertise in breeding horses.

In 2002 and in later years, Mr. and Mrs. Blackwell sought and received advice from nationally recognized experts on horse training. They also substantially advertised their horses on their own website and in video and magazine articles. From time to time, Mr. and Mrs. Blackwell would hire professional horse trainers to work the horses or to show or ride their horses in horse shows.

In 2006, Mr. and Mrs. Blackwell shifted their horse breeding and training activity from "Reining Horses" to "Cutting Horses" because, by 2006, "Cutting Horses" were in greater demand in the horse industry. At one point, they began selling some of their horses at early ages to avoid horse training expenses that they would incur as the horses got older.

From 1998 to 2008, Mr. and Mrs. Blackwell purchased 14 horses. Ten of the horses were subsequently sold for a loss. Three horses were sold for a small profit and a fourth died yielding an insurance settlement.

During these years, the Blackwells also sold 21 additional horses that they acquired by breeding their mares with outside stud horses. Furthermore, during these years, the Blackwells also showed some of their horses in show competitions and they were able to generate funds by winning some of the competitions.

Nevertheless, in spite of their activities, from 2003 until 2009, the Blackwells had a net operating loss on their Schedule C for all those years.

Accordingly, the IRS sought to disallow their losses for 2005 and 2006 audit years on the basis that their horse breeding activities were a hobby and not a for profit activity.

B. <u>Tax Court Proceeding</u>. The tax court applied the nine (9) factor test under Reg. Section 1.183-2(b). Under Section 183(d), if an activity earns a profit in three of five years, then the activity is presumed to be a for profit activity and not a hobby. And, if the activity involves a horse breeding activity, then the activity is presumed to be a for profit activity (and not a hobby) if the activity earns a profit two of seven years. Section 183(d).

1. Manner In Which the Activity Is Carried On. Here, before starting their business, the Blackwells took educational courses and developed a rather comprehensive written business plan. They actually spent six or seven years learning about horse breeding activities and management before actually beginning their activities. At trial, the Blackwells testified that they were "pretty cautious so we didn't hop into it, we just kept trying to learn and figure out is this a business that we could . . . be in and be successful, and it took us some time to make the final decision to get in".

Also, once they began their horse activity in 2000, they both became substantially involved in the activity on a personal, and not absentee basis. They also hired and consulted experts, they advertised and showed their horses, and they paid significant stud fees to have their mares bred with stallions that they determined to have good blood lines.

Also, through all those years, they made adjustments to their business plan from time to time and they always maintained good books and records of income and expenses relating to their activities. Also, and perhaps most importantly, by the time the trial court date had arrived in 2011, Mr. and Mrs. Blackwell had terminated their activity in 2009 in light of the accumulated losses they had realized up until then.

2. Expertise of the Taxpayers. Although Mr. and Mrs. Blackwell had never been in a horse breeding activity, Mark had been very successful in other business activities. Thus, even in light of their lack of experience in horse breeding activities, Mr. Blackwell's prior business activities indicated that he had significant business expertise that well could have translated over into success in the horse breeding activity world.

3. History of Income Or Losses. As indicated above, the Blackwells always lost money on the horse breeding activities. However, as in past court cases, the tax court noted that a series of losses during the start up period of an activity is not necessarily an indication that the activity is a hobby where they believed they would be able to earn a profit in the long run and that they could use future net earnings to recoup losses from earlier years. Bessenyey v. Commissioner, 45 TC 261 (1965), affd 379 F.2d 252 (2nd Cir. 1967); Emerson v. Commissioner, TC Memo 2000-137.

Also, the court noted that in 2006, 2007, and 2008 the Blackwells did receive significant gross income from their horse activities. Although the tax court issue involved the 2005, 2006 tax years, the court looked at their gross income recognition for 2007 and 2009 and noted that they were still merely in the startup years of the activity. Also, the Blackwells terminated their activity in 2009 when they realized that their likelihood of profitability was remote.

4. Amount of Occasional Profits. Here, even though the Blackwells were never able to earn a profit from business venture, the court noted that, under the Regulations, an "opportunity" to earn a substantial profit in a highly speculative venture may be sufficient to indicate that an activity is engaged in for profit. Reg. Section 1.183-2(b)(7). Indeed, the court noted that horse breeding activities are an inherently speculative venture, but that the Blackwells had convinced the tax court that they had an "opportunity or potential" to earn a profit in their risky horse breeding activity.

5. Financial Status Of the Taxpayer. The court noted that Mr. and Mrs. Blackwell had significant wealth and financial resources from other means (such as accumulated wealth and their salaries) during the tax years. However, in light of their minimal recreational activities, the Tax Court believed that their wealth would not be indicative of a nonprofit objective for their horse breeding activity.

6. Elements of Personal Pleasure. Although Mrs. Blackwell had always dreamed of owning a horse breeding activity, the court stated that the facts did not indicate that the Blackwells were motivated or driven by personal pleasure alone but instead were driven by actual hopes that they could sell their horses for a profit.

C. Conclusion. Based upon the foregoing, the court ultimately ruled that the Blackwells were engaged in a for-profit, and not a hobby, activity.

<u>PART FIVE</u>
S CORPORATIONS

I. <u>Grant of Stock Purchase Warrants to a Non-Permitted S Corporation Shareholder Will Not Terminate the S Corporation Election – Until The Warrants Are Exercised</u>.

In PLR 201043015, an S Corporation owed money to a creditor. As part of the S Corporation's debt restructure, the S Corporation granted warrants to the creditor which would allow the creditor to purchase non-voting stock later on. The stock purchase warrant would allow the creditor to participate in future increases in value of the S Corporation stock between the date of the stock warrant grant up until the date the warrant was actually exercised.

The problem was that the creditor was not an eligible S Corporation shareholder. So, the S Corporation asked for an IRS private letter ruling as to whether or not the mere grant of a stock warrant right, to purchase stock of the S Corporation down the road, would terminate the S election. The IRS ruled that, even though the creditor would not participate in earnings or in pro rata liquidating distributions, the mere grant of a stock purchase warrant to the creditor would not terminate the S election.

Here, the warrant grant did not create a second class of stock because the warrant holder would not be a stockholder until the exercise date. And, since the warrant holder was not a stockholder until the exercise date, the warrant holder would not become an ineligible shareholder until the exercise date.

Of course, if the creditor ultimately exercised the warrant and became a direct stockholder of the corporation, the S election would then terminate. However, if the creditor instead sold the stock warrant purchase rights to an eligible S corporation shareholder, then the S corporation election would not terminate when the stock purchaser, not the creditor, ultimately exercised the warrant purchase rights.

PART SIX
EMPLOYEES VS. INDEPENDENT CONTRACTORS

I. IRS Presents New Voluntary Compliance Program for Workers Misclassified as Independent Contractors.

A. Introduction. The IRS has always had the worker classification settlement program ("CSP") for taxpayers under an IRS audit. Under the CSP, if a taxpayer is under an audit and the IRS determines that the taxpayer is not entitled to Section 530 relief, then the CSP program provides different settlement options depending upon whether or not the taxpayer has met the Section 530 "reasonable basis" requirement and the "reporting consistency" requirement. The CSP settlement offer is either (1) one year of full employment taxes under Section 3509 or (2) 25% of the Section 3509 tax assessment for one year.

B. New Voluntary Compliance Program; Announcement 2011-64 (September 21, 2011). On September 21, 2011, the IRS issued Announcement 2011-64 and announced that it was initiating a new voluntary compliance program which would allow employers the opportunity to reclassify, on a prospective basis, workers previously misclassified as independent contractors. The new voluntary disclosure program provides favorable payment terms, penalty relief and audit protection for prior years.

C. Benefits of New Voluntary Compliance Program. Under the new voluntary compliance settlement program ("VCSP"), a taxpayer — who is not under audit — can come forward and agree to treat workers as employees on a prospective basis. If the taxpayer qualifies for participation in the new VCSP Program, and agrees to prospectively treat workers as employees going forward, then the employer gets the following benefits:

1. Will only pay **10% of the employment tax liability** that would have been due on compensation paid to the workers for the **most recent tax year**, determined under the **reduced rates of Section 3509**;

2. No interest **or** penalties on the assessed tax amount; and

3. Will **not** be subject to a worker classification audit for **prior years**.

D. Qualification for New VCSP Program. To qualify for participation in the new VCSP Program, the taxpayer must meet the following requirements:

1. The taxpayer must have consistently treated the workers as independent contractors for all periods in which the workers previously provided services;

2. The taxpayer must have filed all Forms 1099 for the previous three (3) years; and

3. The taxpayer cannot currently be under any audit by the IRS, the Department of Labor or by a state government agency.

E. VCSP Application Process. To apply for the new VCSP program, a taxpayer has to file Form 8952.

II. **<u>IRS Announces That The IRS and Department of Labor Will Begin To Share Information on Workers Misclassified as Independent Contractors</u>.**

Recently, the IRS and the Department of Labor announced that the Department of Labor would begin sharing, with the IRS, information that the DOL obtains during the course of an investigation which indicates that an employer may have misclassified a worker as an independent contractor, rather than as an employee. While we always **suspected** that the DOL ***could*** share this information with the IRS, now we know that the DOL ***will*** share this information with the IRS.

III. **<u>Massage Therapists and Cosmetologists of a Spa Were Not Employees, But Instead Were Independent Contractors</u>.**

In <u>*Mayfield Therapy Center*</u>, TC Memo 2010 - 239 (Oct. 28, 2010), a spa offered the services of massage therapists and cosmetologists who paid "booth rent" to the spa. The massage therapists and cosmetologists paid for their own supplies and paid booth rent back to the spa on a weekly basis. Therefore, the massage therapists and cosmetologists had "entrepreneurial risk" in that they could either earn a profit or lose money for some weeks. In addition, the cosmetologists and massage therapists were free to work as many hours as they chose and they were free to establish their own prices for their services.

Based upon this "economic independence" test, the Tax Court ruled that these massage therapists and cosmetologists were independent contractors and not employees.

<u>PART SEVEN</u>
SECTION 6672 RESPONSIBLE PERSON LIABILITY FOR TRUST FUND TAXES

I. **<u>Background and Introduction</u>.**

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 **<u>and</u>** who (2) wilfully failed to perform that responsibility. Code Section 6672(a).

II. **<u>4th Circuit Court of Appeals Holds That The President and Majority Stockholder of a Construction Company Is Subject to Section 6672 Penalty - Even Though A Third Party Lender Had Seized The Company's Bank Account.</u>** <u>Newbill, 108 A.F.T.R. 2d 2011-5477 (4th Circuit Court of Appeals, July 29, 2011)</u>.

In this case, it was clear that a construction company's President was a "responsible person" since he had signature authority over the company's bank account. The question, however, for the Court was whether the failure to pay was "willful."

In 2003, New Construction, Inc. ("NCI") got into financial trouble and NCI's main creditor seized NCI's bank account. Another creditor then took over control of NCI's business operations and continued to employ Mr. Newbill and allowed Mr. Newbill to remain a signatory over the bank account. Under the terms of a Joint Control Trust Agreement, signed between NCI and the creditor in November 2003, checks required the signatures of both the creditor and Mr. Newbill.

Shortly thereafter, NCI fell behind in payment of employment taxes and Mr. Newbill signed over $100,000 worth of checks to various creditors and vendors.

Mr. Newbill argued that he lacked control over NCI's bank account after it had been seized by the creditors, and therefore his failure to pay was not "willful" since he could not authorize payment to the IRS without the lender's consent.

The 4th Circuit Court of Appeals, however, rejected this argument, and held that a taxpayer cannot avoid a Section 6672 penalty by giving control over the company's bank account to a third party lender.

Here, even though the tax liabilities arose after the creditor seized the bank account, Mr. Newbill couldn't avoid Section 6672 liability, since any checks required the signature of Mr. Newbill. Although Mr. Newbill could not have unilaterally used NCI funds to pay the employment taxes without the creditor's consent, the creditor likewise could not have diverted N CI funds without Mr. Newbill's consent.

III. <u>Section 6672 Responsible Person Penalty Applied Even Though the Company Had No Funds At The Time Embezzlement Was Discovered</u>.

In the case of <u>Oppliger v. U.</u>S.,107 AFTR 2d 2011-631 (8th Circuit Court of Appeals, March 29, 2011), Mr. and Mrs. Oppliger owned a trucking business and a livestock feed company. In 1996, the Oppligers hired Mrs. Kerkman to perform accounting and bookkeeping services for the two businesses. Mr. and Mrs. Oppliger assigned to Mrs. Kerkman the duties of filing employment tax returns and paying payroll taxes. In 2002, Mrs. Kerkman committed suicide and the Oppligers then learned that she had embezzled funds from the companies.

Soon after Mrs. Kerkman's death, an IRS Revenue Officer informed the Oppligers that there were substantial employment tax delinquencies. In September 2002, the Oppligers sold the assets of the two companies and, between April 2002 and September 2002, they paid over $2 Million to their employees and $3.2 Million to third party creditors. The IRS assessed trust fund recovery penalties against the Oppligers of over $2.4 Million for unpaid payroll taxes.

The Oppligers argued that, when they discovered the embezzlement, there was less than $10,000 in the Company's bank accounts at the time. The Oppligers argued that, previously, the U.S. Supreme Court ruled that, if a person first becomes a responsible party <u>**after**</u> the withholding tax liability generates, then the responsible person is only required to use unencumbered funds, <u>existing at the date he becomes a responsible person</u>, to satisfy past withholding obligations. <u>Slodov v. U.S.</u>, 436 U.S. 238 (1978).

The Oppliger Court noted, however, that under Olsen v. United States, 952 F 2d 360 (8^{th} Circuit Court of Appeals 1981), where a person is a responsible person **before and after** the withholding tax liability accrued, the taxpayer must use unencumbered funds collected **after** the withholding obligations become payable to satisfy that withholding obligation. Here, the 8^{th} Circuit Court of Appeals held that, during all of the tax years at issue, the Oppligers were "responsible persons." In addition, by paying employees and other creditors ahead of the IRS, the Oppligers "willfully failed" to pay trust fund taxes.

PART EIGHT
INNOCENT SPOUSE RELIEF

I. Innocent Spouse Relief Rules in General.

Spouses, who file joint tax returns, each are "jointly and severally" liable for the accuracy of their return and they are jointly and severally liable for the entire tax due for that tax year. Section 6013(d)(3). A spouse may, however, seek relief from joint and several liability by following the "innocent spouse" relief procedures established in Section 6015. Section 6015 provides for three (3) forms of innocent spouse relief:

A. Traditional Relief Under Section 6015(b). First, Section 6015(b) allows the **traditional relief** from joint and several liability for a tax **understatement** (rather than a mere tax underpayment) where (a) the spouse did not know, and had no reason to know of the tax deficiency and (b) where taking into account all fact and circumstances, it would be unfair to hold the requesting spouse liable for the deficiency resulting from an understatement of tax attributable to erroneous items of one spouse.

Note that Section 6015(b) relief is **only** available (1) where there is a tax liability **understatement** (rather than merely a tax liability underpayment) and **only** (2) where the requesting spouse did not know, and had no reason to know, of the tax understatement.

B. Allocation of Liability - Separate Return Treatment - Relief Under Section 6015(c). Second, Section 6015(c) provides for an **allocation of liability** for a deficiency resulting from an **understatement of tax** attributable to erroneous items of one spouse as if the spouses had filed separate returns. However, Section 6015(c) relief is **only** available if (1) the requesting spouse is no longer married to or living with the spouse; and (2) the requesting spouse had **no actual knowledge** of the tax underpayment, unless the return was signed by the requesting spouse under duress. **Also, Section 6015(c) relief is only available where there is a tax understatement (rather than a tax underpayment).**

Therefore, separate return treatment relief may be available even where a spouse "should have known" of an understatement or where a spouse knew of the understatement but signed the return under duress.

C. Equitable Relief Under Section 6015(f). Finally, Section 6015(f) confers **discretion upon the IRS** to grant "equitable relief" in situations where relief is unavailable under Section 6015(b) or (c).

II. More About the Section 6015(f) "Equitable Relief" Rules.

IRC § 6015(f) allows the IRS to grant "equitable" innocent spouse relief to an innocent spouse in situations where relief is unavailable under Section 6015(b) or (c).

A. May Apply To Tax Underpayments. Since Section 6015(b) and (c) relief is not available for tax underpayments, Section 6015(f) provides the only potential avenue for relief for tax underpayments where there is no tax understatement (such as where a non-requesting spouse has unreported income or disallowed deductions or losses). Thus, Section 6015(f) relief usually often is requested where there is a tax underpayment, rather than an understatement of a tax liability, since Section 6015(f) provides the only potential avenue of liability relief for a tax underpayment.

B. May Apply Even Where Requesting Spouse Knew or Should Have Known of Tax Underpayment or Tax Understatement. Moreover, since no relief is available under 6015(b) or (c) for spouses who were aware (or should have been aware) of the tax understatement, many requesting spouses have requested innocent spouse relief under Section 6015(f) where they were aware of the potential tax understatement or the tax underpayment.

C. Section 6015(f) "Equitable Relief" Guidelines Under Rev. Proc. 2000-15. Rev. Procedure 2000-15 contains guidelines that will be considered in determining whether an individual qualifies for equitable relief under Section 6015(f). Section 4.01 of the Revenue Procedure lists seven threshold conditions that must be satisfied before the IRS will consider a request for equitable relief under Section 6015(f). Section 4.02 of the Revenue Procedure provides that, in cases where a liability reported on a joint return is unpaid, relief under Section 6015(f) will ordinarily be granted if all of the following three requirements are satisfied:

1. At the time the relief is requested, the requesting spouse is no longer married or is legally separated from the non-requesting spouse or has not been a member of the same household as the non-requesting spouse at any time during the twelve month period ending on the date relief was requested;

2. At the time the return was signed, the requesting spouse had no knowledge or reason to know that the tax would not be paid; and

3. The requesting spouse will suffer economic hardship if relief is not granted. Relief under Section 4.02 of the Revenue Procedure is available only to the extent that the unpaid liability is allocable to the nonrequesting spouse.

If relief is not available under Section 4.02 of the Revenue Procedure, then Section 4.03 of Revenue Procedure 2000-15 provides other factors that the IRS **may** consider in deciding whether to grant relief under Section 6015(f). Section 4.03 lists the following six (6) factors weighing **in favor** of granting relief for an unpaid liability:

1. The requesting spouse is separated or divorced from the non-requesting spouse;

2. The requesting spouse would suffer economic hardship if relief is denied;

3. The requesting spouse was abused by the non-requesting spouse;

4. The requesting spouse did not know or have reason to know that the reported liability would not be paid;

5. The non-requesting spouse has a legal obligation pursuant to a divorce decree or agreement to pay the unpaid liability; and

6. The unpaid liability is attributable to the non-requesting spouse.

Section 4.03(1).

Section 4.03(2) of the Revenue Procedure lists the following six factors weighing **against** granting relief for unpaid tax liability:

1. The unpaid liability is attributable to the requesting spouse.

2. The requesting spouse knew or had reason to know that the unreported liability would be unpaid at the time the return was signed.

3. The requesting spouse significantly benefitted (beyond normal support) from the unpaid liability.

4. The requesting spouse will not suffer economic hardship if relief is denied.

5. The requesting spouse has not made a good faith effort to comply with the tax laws in the tax years following the tax year to which the request for relief states.

6. The requesting spouse has a legal obligation pursuant to a divorce decree or agreement to pay the unpaid liability.

Section 4.03 of the Revenue Procedure further provides that these factors, however, are not exhaustive, no single factor is determinative, and all factors should be considered and weighed appropriately. Also, under the "abuse of discretion" test, the Tax Court will overrule the decisions of the IRS only where the Tax Court determines the IRS has abused its discretion in not granting relief. Washington v. Commissioner, 120 TC 137 (2003).

III. IRS Changes Its Position on "Two-Year Limit" for Equitable Innocent Spouse Relief Requests.

A. Background and Introduction.

Previously, the IRS issued regulations which stated that, in order to request innocent spouse relief under § 6015(f), the declaring innocent spouse must request relief within two years from the date of the first IRS collection activity against the innocent spouse. Reg. 1.6015-5(b)(1).

In the Tax Court case of Cathy Lantz, 132 TC No. 8 (April 7, 2009), the Tax Court ruled that the IRS regulations under 6015(f) were invalid, because there was no authority in the Tax Code or the Congressional Committee Reports that explained the relevant reason for imposing a two year limitation upon an "innocent spouse" who desires to request innocent spouse relief under the equitable relief rules of Section 6015(f).

After the Lantz case, the IRS Chief Counsel issued **Notice CC-2009-012** and asked IRS attorneys and auditors to develop a governmental response to the Lantz case and to resist equitable relief requests that are past the two year time limit.

On June 8, 2010, the 7th Circuit Court of Appeals overruled the Tax Court in the Lantz decision and, in that case, the 7th Circuit Court of Appeals concluded that the two year statute of limitations in Code Section 6015(b) and (c) supported the use of the two year standard in Code Section 6015(f), and thus ruled that the IRS has the authority to issue Regs. to carry out the Code Section 6015(f) equitable relief provisions -- including the two year limitation. Lantz, 607 F.3d 479 (7th Cir. 2010), 2010-1 USTC 50,446 (June 2010).

B. Recent Court Cases. In various cases, the Tax Court has sometimes ruled that the "two year" limitation Regulation Section 1.6015-5(b)(1) was invalid, on the basis that the IRS did not have regulatory authority to impose a two year limitation rule, without specific authority from Congress. Other courts, however, have sided with the IRS.

Most recently, the 3rd Circuit, 4th Circuit and 7th Circuit Courts all have upheld the IRS' authority to promulgate the two year regulation limit under Regulation Section 1.6015-5(b)(1). Lantz v. Commissioner, 607 F.3d 479 (2010); Mannella v. Commissioner, 631 F.3d 115 (2011); and Jones v. Commissioner, 642 F.3d 459 (2011).

C. IRS Notice 2011-70 (July 25, 20211). In an "about face," the IRS issued Notice 2011-70 on July 25, 2011 and advised that it will now consider equitable innocent spouse relief requests at any time, as long as the ten (10) year collection period under Section 6502 has not expired. However, if the taxpayer is also making a **refund claim,** as part of the equitable innocent spouse relief request, then the IRS will consider the refund request - only if the three (3) year refund statute has not expired.

D. Requesting Innocent Spouse Relief After Notice 2011-70 For Pending and Previously Filed Requests. In the Notice, the IRS provided guidance on how to deal with pending and previously filed equitable innocent spouse relief requests.

1. Requests Currently Pending with the IRS. If the taxpayer has already submitted a Form 8857, Request for Innocent Spouse Relief, but the IRS has not yet ruled on that relief request, the taxpayer does not need to re-apply, and Notice 2011-70 advises that the IRS will consider the request even if the request was submitted more than two (2) years after the first collection activity, if the innocent spouse relief request was filed within the ten (10) year and three (3) year limitation periods discussed above.

2. Requests Previously Denied by the IRS Solely For Untimeliness. If you have a client who previously applied for equitable innocent spouse relief, but was denied **solely** because the taxpayer failed to make the request within two (2) years after the first collection action, the taxpayer may **re-apply** for innocent spouse relief. In that case, the IRS will use the **date of the original relief request** for purposes of determining whether the refund request came within the applicable ten (10) year and three (3) year limitation periods discussed above.

3. <u>Equitable Relief Requests That Are Currently The Subject of IRS Litigation</u>. In those cases where the taxpayer has a current case pending in litigation, Notice 2011-70 advises that the IRS will "take appropriate action consistent with the position" announced in Notice 2011-70.

4. <u>Requests Made After Final Litigation</u>. If you have an equitable innocent spouse relief request, that has already been litigated and a final court case has been determined that the taxpayer did not meet the two year request rule, the IRS has advised that it will take no further collection activity after July 25, 2011. However, for finally adjudicated cases, no refund or credit is allowed for amounts previously collected by the IRS.

5. <u>Future Equitable Innocent Spouse Relief Requests Filed After July 25, 2011</u>. For future equitable innocent spouse relief requests filed after July 25, 2011, the IRS will not impose the two year collection action rule, but instead will consider the equitable innocent spouse relief request in a manner that is consistent with the other applicable limitation periods discussed above irrespective of when collection actions first began.

IV. <u>No Equitable Innocent Spouse Relief For Ex-Wife Who Knew Her Husband Would Never Pay The Taxes Anyway</u>.

In the case of <u>Pugsley</u>, TC Memo 2010-155 (November 18, 2010), the Tax Court denied equitable innocent spouse relief for liabilities arising out of an ex-husband's dental practice for the 2003 and 2004 tax years where:

1. the wife knew the husband would not pay the tax liabilities when she signed the joint return;
2. the ex-wife benefitted from the unpaid tax income;
3. the requesting spouse had subsequent tax delinquencies; and
4. where the ex-spouse would not suffer substantial financial hardship if forced to pay the outstanding tax liabilities.

In this case, Dr. Pugsley was a dentist, and he and his wife were in constant financial difficulty. In the early 1990s, Dr. and Mrs. Pugsley got behind on their income tax obligations and ultimately had tax liens filed against their house. The tax liens ultimately were paid off when the house was sold.

Dr. Pugsley suffered from depression and alcoholism, and eventually was forced to close his dental practice. Mrs. Pugsley would regularly discover creditor notices lying around the house, but Dr. Pugsley would assure her that their finances were all in good order. However, the Pugsleys had to rely substantially on gifts from their parents to support their standard of living.

In 1999, Dr. Pugsley hired a CPA to prepare their tax returns. However, from 1999 to 2002, neither Dr. Pugsley nor Mrs. Pugsley signed any of the tax returns that their CPA prepared. Instead, Dr. Pugsley simply stuck the unsigned tax returns in his office desk drawer. Presumably, Mrs. Pugsley knew that these returns had not been filed, since she knew that she had not signed them. And, Mrs. Pugsley never checked with her husband to see whether the tax returns had been filed from 1999 to 2002.

In 2005, the Pugsleys hired a new accountant to prepare their 2003 and 2004 tax returns. The next year, they filed a joint tax return for 2005, but failed to pay the tax due on that return.

Dr. Pugsley's dental practice was shut down by the Ohio State Dental Board in March 2007. In late 2007, Mrs. Pugsley contacted her CPA regarding the unfiled 2003 and 2004 tax returns. The CPA advised her to execute the unfiled returns and send them to the IRS. Before filing the returns, however, Mrs. Pugsley filed an equitable innocent spouse relief request with the IRS in October 2007 with respect to their 2003 and 2004 income tax returns. The IRS, however, denied her claim because she had not yet filed those unfiled returns.

Ultimately, the Pugsleys executed the unfiled 2003 and 2004 tax returns in January 2008, and Mr. and Mrs. Pugsley continued to live together until their home ultimately was foreclosed upon in May 2008. The Pugsleys then separated later in 2008 and, under a Separation Agreement signed in September 2009, Dr. Pugsley agreed to satisfy and pay off all of the unfiled tax obligations. Mrs. Pugsley filed new equitable innocent spouse relief claims in the spring of 2008 regarding the 2003 and 2004 tax years at issue.

The IRS denied her innocent spouse relief request. During the Tax Court proceeding, the Tax Court first noted that Mrs. Pugsley was not eligible for the "safe harbor" relief under Section 6015(f). This safe harbor relief is only available where the requesting spouse was no longer married to, or was legally separated from, her former spouse at the time she filed the request for innocent spouse relief.

Here, Mrs. Pugsley filed the innocent spouse relief request in April 2008 and, at that time, she and Dr. Pugsley were still married and living together. In fact, they did not enter into a Separation Agreement until September 2009 and they did not get divorced until February 2010. Since Mrs. Pugsley did not qualify for the equitable relief safe harbor test (since she wasn't separated from Dr. Pugsley when she filed for innocent spouse relief in the spring of 2008), the Tax Court then reviewed the eight (8) factor "facts and circumstances test" under Rev. Proc. 2003-61.

1. **Marital Status of the Taxpayers**. Even though Mrs. Pugsley was married to Dr. Pugsley when she applied for innocent spouse relief, the two were separated at the time of trial. So, this factor favored Mrs. Pugsley.

2. **Did the Requesting Spouse Know or Have Reason to Know the Non-Requesting Spouse Would Not Pay the Tax Liability?** The Court quickly noted that past court cases have consistently found the requesting spouse's knowledge of the couple's financial difficulties deprives the requesting spouse of reason to believe that his or her ex-spouse will pay the tax liability. Stolkin v. Commissioner, TC Memo 2008-211; Gonce v. Commissioner, TC Memo 2007-328; Butner v. Commissioner, TC Memo 2007-136.

Mrs. Pugsley knew that she and her husband suffered extreme financial difficulties throughout their married life. Dr. Pugsley filed for bankruptcy in 2007 and the family constantly had to rely upon family gifts to support themselves. Therefore when she signed the 2003 and 2004 joint returns in 2008, Mrs. Pugsley knew their financial situation was dire and she knew (or should have known) that the taxes would not be paid.

In addition, Dr. Pugsley had a long history of lying and deceit with Mrs. Pugsley and so the Court simply found that Mrs. Pugsley could not have relied upon any of Dr. Pugsley's assurances.

3. Economic Hardship. The Court found that Mrs. Pugsley had sufficient income and assets of her own to pay the outstanding tax liabilities, albeit over time. Therefore, forcing Mrs. Pugsley to pay the outstanding tax liabilities would not put her under undue hardship since she would be able to meet her reasonable living expenses and still pay the tax liabilities off over time pursuant to an installment payment agreement.

4. Subsequent Compliance With Tax Laws. Even after Dr. and Mrs. Pugsley got divorced, Mrs. Pugsley filed a tax return and failed to report spousal alimony as taxable income. She also claimed a $5,000 tax deduction for an IRA contribution that she never actually made. The Court presumably was then unimpressed with Mrs. Pugsley's poor compliance history after the divorce.

5. Economic Benefit From Items Giving Rise to Tax Liability. Even though Dr. and Mrs. Pugsley were in dire financial difficulties in 2003 and 2004, Dr. and Mrs. Pugsley were living in an expensive home (at a cost of over $500,000). Mrs. Pugsley was a member of an exclusive athletic club and they also sent their children to expensive private colleges. Clearly, Mrs. Pugsley benefitted from their non-payment of their tax liabilities.

6. Abuse By Non-Requesting Spouse. There was no evidence of physical or mental abuse here.

Based upon all of the balancing factors, the Tax Court concluded that Mrs. Pugsley did not qualify for equitable relief under Rev. Proc. 2003-61.

V. Equitable Innocent Spouse Relief Available For Psychologically Abused Spouse, Even Though She Signed the Return and Knew Taxes Would Not Be Paid. In Joan Thomassen, TC Memo 2011-88 (April 21, 2011), the wife of a bipolar husband was entitled to equitable innocence spouse relief. Here, even though the spouse signed returns, knowing that taxes would not be paid, the spouse qualified for equitable relief due to the extreme psychological abuse of her husband.

PART NINE
IRS LIENS AND FORECLOSURES

I. When Can The IRS Foreclose on Jointly Owned Property To Satisfy Liens of One Property Owner?

A. Background. IRC Section 7403 allows the IRS to apply to the court for permission for a foreclosure sale in order to sell jointly owned property partially owned by an IRS tax debtor. Once the IRS secures a federal tax lien against the taxpayer's real property, the IRS generally has ten (10) years to foreclose upon its federal tax lien. If the taxpayer attempts to sell his real property during the ten (10) year lien period, the IRS will collect some or all of what it is owed at the time the sale occurs. However, the IRS does not have to wait for a sale to enforce its tax lien. Indeed, under § 7403, the IRS can file a civil action in district court to enforce the tax lien.

Once the IRS has commenced its civil action in District Court under § 7403, it can then proceed to foreclose on the subject property. However, once the case is filed, the District Court is not ***required*** to allow the IRS to proceed with the foreclosure sale. Instead, under § 7403(c), the district court is required to "finally determine the merits of all claims" and after doing so the court "may decree" a sale. In other words, the District Court has **some discretion** in deciding whether or not to allow a foreclosure sale to proceed.

Also, the IRS is limited to the extent to which it can exercise its foreclosure powers to foreclose on property that is **jointly owned by a taxpayer and another third party**. In the case of United States vs. Rogers, 461 US 677 (1983), the US Supreme Court placed limitations on the IRS' ability to foreclose on **jointly owned property** subject to a tax lien.

In the Rogers case, the U.S. Supreme Court discussed four (4) factors that govern whether the U.S. may use its limited discretion to foreclose on property that is also jointly owned by an "innocent third party." The Rogers Supreme Court articulated four (4) factors that the Tax Court should consider when deciding whether to foreclose on property that is jointly owned with an innocent third party:

1. The extent to which the IRS would be prejudiced if it were relegated to make a forced sale of the partial interest actually liable for the delinquent taxes;

2. Whether the innocent third party joint owner had a legally recognized expectation that the separate property would not be subject to forced sale by the taxpayer or by a creditor to satisfy the legal obligations owed by the taxpayer;

3. The potential prejudice to the third party, both in terms of personal dislocation costs and under compensation; and

4. The relative character and value of the non-liable and liable interests held in the property.

B. <u>The 6th Circuit Court Of Appeals Allows The IRS To Foreclose Upon "Tenants By The Entirety" Real Property To Satisfy The Tax Liabilities Of Only One Spouse</u>.

The case <u>*US v. Barczyk*</u>, 108 AFTR 2d 2011–5862 (August 17, 2011), may be the first case in which the Court has allowed the IRS to foreclose on "tenants by the entirety" real property to satisfy tax liabilities owed by only one spouse.

In this case, the husband and wife owned Michigan real property (their personal residence) as tenants by the entirety. The husband and wife had filed for all tax years as "married filing separately". Mrs. Barczyk paid her taxes but Mr. Barczyk did not. The IRS secured significant federal tax liens on Mr. Barczyk, including a lien on his one-half (½) interest in the tenants by the entirety home.

Then, the IRS filed a District Court action to force the property to be sold through a foreclosure sale pursuant to IRC Section 7403. Mrs. Barczyk protested against the foreclosure sale based upon the fact that, under Michigan state law, a creditor of one spouse cannot foreclose on tenants by the entirety real property to satisfy debts owed by the liable owner.

The District Court ruled in favor of the IRS and Mrs. Barczyk appealed to the 6th Circuit Court of Appeals.

In her appeal, Mrs. Barczyk argued that, under Michigan law, "tenancy by the entirety" real property is protected from claims of creditors of only one spouse. Mrs. Barczyk argued that, since Mr. Barczyk could not encumber or sell his one-half (½) interest in the house without Mrs. Barczyk's consent under Michigan state law, the IRS should not be able to foreclose on its tax lien.

In addition, Mrs. Barczyk also argued that, in the alternative, since she was much younger than Mr. Barczyk, her actuarial interest in the home (<u>*i.e*</u>., her survivorship interest) was worth significantly more than 50% of the value of the home. So, even if the IRS could foreclose on the home, the IRS should have to pay more than 50% of the net sales proceeds to Mrs. Barczyk.

The 6th Circuit Court of Appeals ruled against Mrs. Barczyk under both arguments. First, the Court stated that federal law always trumps state law. And in enacting IRC Section 7403, US Congress intended to provide the IRS with a preemptive tool for enforcing tax liens against property interests, even though other creditors of the taxpayer would be bound by state law.

The Court noted that, in the <u>*Craft*</u> case, 535 US, 274 (2002), the US Supreme Court previously held that a federal tax lien could attach to one-half (½) tenancy by the entirety interest in real property. However, the <u>*Craft*</u> case did not specifically address whether the IRS could then move forward with a foreclosure and forced sale of the property pursuant to IRS Section 7403.

Mrs. Barczyk argued that allowing the foreclosure sale would effectively substitute federal law for Michigan state law. The Court of Appeals, however, held that under the federal tax code, courts initially look to state law to determine what rights the taxpayer has in the property that the IRS is seeking to attach but the courts then look to federal law to determine whether the taxpayer's state delineated rights qualify as "property". *Craft*, 535 US at 278. Therefore, the District Court was not bound by Michigan state law in applying Section 7403. In other words, Section 7403 trumps any contrary state law.

Next, the 6th Circuit Court of Appeals quickly dispatched with Mrs. Barczyk's argument that she should be entitled to more than one half of the sales proceeds from the sale, even though her survivorship interest might have a higher actuarial value than the survivorship interest of Mr. Barczyk.

The court noted that, under Michigan law, tenants by the entireties have equal interests in their home and therefore Section 7403 normally presents an equal division of sales proceeds when there has been a foreclosure sale. However, under the *Barr* case, 617 F 3d 370 (2010), the *Barr* court left open a narrow opportunity for the non-liable spouse to avoid the presumption of the equal division of the foreclosure sales proceeds by presenting compelling evidence that an equal division would be unfair to the non-liable spouse. Here, Mrs. Barczyk was only 5 years younger than Mr. Barczyk and therefore there was no compelling reason to vary from the equal division presumption.

Here, the court noted that a District Court could consider differences in ages in determining how to divide the sales proceeds. But, in this case, Mrs. Barczyk and Mr. Barczyk were of similar ages and Mrs. Barczyk was only 5 years younger than Mr. Barczyk. This slight difference in age did not give the court reason to avoid the otherwise presumption of equal division of the foreclosure sales proceeds under Section 7403.

> **Note: Would the court perhaps have reached a different result if Mr. Barczyk was a lot older than Mrs. Barczyk? What if Mr. Barczyk was nearing the end of his life at the time of the foreclosure sale?**

C. IRS Not Allowed to Foreclose on Jointly Owned Property To Satisfy Liens of One Property Owner; U.S. vs. Winsper, 106 AFTR 2d 2010-6945 (November 3, 2010). In Winsper, Mr. and Mrs. Winsper owned joint real property located in Kentucky. The IRS held a federal tax lien against Mr. Winsper for unpaid federal income taxes of over $900,000. The IRS sought to foreclose upon Mr. Winsper's one-half interest in the property pursuant to Section 7403 and sought permission of the District Court to force a foreclosure sale.

Ultimately, the Tax Court refused to allow the IRS to foreclose on Mr. Winsper's interest in the property to satisfy his tax liens. Here is how the District Court applied § 7403 in light of the four (4) factor test set out in the U.S. Supreme Court case in Rogers:

First Factor: The extent to which the IRS would be prejudiced if it were relegated to make a forced sale of the partial interest actually liable for the delinquent taxes.

The *Winsper* Court noted that there was significant disagreement as to the value of the property. The higher the value of the property, then there would be a greater prejudice against the IRS if it was not allowed to foreclose. The IRS argued the property was worth $300,000 (but offered no appraisal) while the taxpayer presented an appraisal of the property at $136,000. Both the taxpayer and the IRS agreed that a foreclosure sale would only bring about 80% of the appraised value.

The Court determined that the actual value of the property was closer to $200K and that, if it had allowed a foreclosure sale, the foreclosure sale would only bring in around $160,000 upon a foreclosure sale. And, after prior first mortgages were satisfied, only around $145,000 would be left. After other foreclosure expenses, this would leave only around $71,500 of funds to pay Mr. Winsper's tax liabilities (since he only owed half (½) of the property) which only represented about 8% of his total tax liability at the time.

The Court also noted that, if the foreclosure sale was further delayed, then this would work against the interest of the IRS. On the other hand, Mr. Winsper had owed taxes for almost ten (10) years before the potential foreclosure sale and the foreclosure sale would only render a small portion of funds that could be used to pay against Mr. Winsper's tax liability. Thus, the Tax Court viewed that, by forestalling the foreclosure sale until some later time, this would not prejudice the interest of the IRS.

Second Factor: Did the Other Joint Owner Have An Expectation That The Jointly Owned Property Would Not Be Foreclosed Upon?

Next, the Court reviewed Kentucky law to determine whether a spouse would have a reasonable expectation that jointly-owned property would not be foreclosed upon to pay the tax debts of a spouse. In reviewing Kentucky law, the Court determined that the Kentucky courts had previously held that a spouse would not have a reasonable expectation that her property interest could be foreclosed upon to pay the debts of a spouse.

> **Note:** This is very similar to North Carolina law which provides that tenancy-by-the-entirety real estate, owned between a husband and wife, cannot be used to pay off debts of one spouse. On the other hand, under North Carolina law, "tenants in common" ownership interests are subject to debts of either co-owner. Likewise, under North Carolina law, if co-owners own real estate, even with rights of survivorship, North Carolina law does not protect non-spouses from creditor foreclosure.

Third Factor: The Likely Prejudice to the Third Party Co-Owner.

The Court next determined that, if the IRS foreclosed on the real property, then Mrs. Winsper would only receive around $71,500 from her sale of the one-half interest in the property. This amount was so small that Mrs. Winsper would not be able to relocate her principal residence to another property or even to other reasonable housing. So, this factor favored against foreclosure of the property.

Fourth Factor: The Relative Character and Value of the Non-Liable and Liable Interests in the Property.

The Court determined that Mr. and Mrs. Winsper appeared to own a 50/50 interest in the home and the Court concluded that this was a substantial ownership interest by Mrs. Winsper. So, if the IRS foreclosed on this property, then the IRS's foreclosure would detrimentally affect Mrs. Winsper since she owned a full 50% ownership interest in the home.

Based upon all these facts, the Court refused to allow the IRS to foreclose upon the home owned by Mr. and Mrs. Winsper.

Conclusion: What does this court case tell us?

We have a lot of clients out there who hold "jointly-owned" interests in real estate with other partners/investors. With respect to real estate owned by a husband and wife as "tenants-by-the-entirety," the real estate arguably should be protected under North Carolina law from IRS liens filed against only one spouse (but see Barczyk above). In those cases, we hope the IRS (or North Carolina Department of Revenue) will not attempt to foreclose upon the real estate, but instead will wait until the real estate is sold.

In other cases, we have clients who own investment real estate (beach real estate, mountain home vacation real estate, etc.) owned by investors as tenants in common. And in some cases, we even have spouses who own real property as "tenants in common" and not as "tenants-by-the-entirety." These property interests are not protected by North Carolina state law. Instead, any such tenants in common real property will be subject to creditors' claims owed by either of the tenants in common.

So, we should not be surprised when IRS liens arise against the interests of a one-half tenants in common owner. In those cases, we need to be prepared to fight off IRS attempts to foreclose on this real property under the foreclosure powers under § 7403.

In these cases, we need to be prepared to assert that, under the Rogers case, the IRS should not be permitted to foreclose upon these partial interests under the following arguments:

1. Real Estate Property Values Are At an "All-Time" Low. So, the IRS would be much better served if it would forestall foreclosure sales until a later year after property values have increased.

2. The innocent third party would be substantially prejudiced by a foreclosure against the tax liable partner, since

   (a) a foreclosure sale rarely brings in the full value of the property; and

   (b) the ownership interests of the non-liable co-tenant usually are significant in terms of character and value.

PART TEN
IRS AUDITS

I. What Are Your Chances of Being Audited By the IRS?

In early 2011, the IRS published its 2010 Internal Revenue Service Data Book, which contained audit statistics for the Fiscal Year ending on September 30, 2010. Here are the audit statistics:

A.	Total Individual Returns Audited		1.1%
	(1)	No Schedule C, E or F:	.5%
	(2)	With Schedule C Income:	
		Under $100,000	2.5%
		$100,000 to $200,000	4.7%
		Over $200,000	3.3%
	(3)	With Schedule E Only	1.2%
	(4)	Non-Business Income of $200,000 to $1 Million	2.5%
	(5)	Positive Income Over $1 Million	8.4%
B.	Partnerships and S Corporations		.4%
C.	Total C Corporation Returns Audited		1.4%
	(1)	Assets $1,000,000 to $5 Million	1.4%
	(2)	Assets $5 Million to $10 Million	3.0%
	(3)	Assets Over $10 Million	16.6%
D.	Employment Tax Returns		.2%
E.	Fiduciary Income Tax Returns		.2%
F.	Gift Tax Returns*		.7%
G.	Estate Tax Returns		
	(1)	Under $5 Million	6.5%
	(2)	$5 Million to $10 Million	20.8%
	(3)	Over $10 Million	30.8%

*Note: We expect these audit rates will increase substantially by virtue of extensive transfer tax planning gifts to take place in 2011 and 2012.

II. <u>Does Overstatement of Income Tax Basis Trigger the Six Year Statute of Limitation Period</u>?

A. <u>Background</u>. Code Section 6229(c)(2) and 6501(e)(1)(A) provide that the IRS has an extended six (6) year statute of limitations period to assess tax if the taxpayer omits reporting in its gross income an amount that is over 25% of the amount of gross income stated. If the understatement is not due to an omission from gross income, then a three (3) year statute of limitation applies. Section 6501(a).

B. <u>Supreme Court's Interpretation of "Omission of Gross Income" in the 1958 Case of Colony, Inc.</u> In the 1958 case of <u>Colony, Inc.</u>, the U.S. Supreme Court held that the extended six year statute of limitation period was applicable **<u>only</u>** where a taxpayer actually omitted some income receipt or accrual in its computation of gross income. 1 A.F.T.R. 2d 1894, 357 U.S. 28 (1958). <u>Colony</u>, however, did not interpret Code Section 6501(e)(1)(A). Instead, since <u>Colony</u> was decided in 1958, <u>Colony</u> only addressed Code Section 275(c) of the 1939 Tax Code, which was the predecessor of Code Section 6501(e)(1)(A) of the 1954 Code.

C. <u>2009 Court of Appeals Cases: Income Tax Basis Overstatement Is Not An "Omission of Gross Income</u>." In the case of <u>Bakersfield Energy</u>, 2009-1 USTC 50,448 (9th Circuit Ct. Of Appeals), the 9th Circuit Court of Appeals found that, when Congress reenacted Code Section 275(c), as new Code Section 6501(e)(1)(A), it did not materially alter Code Section 275(c) under the 1939 Act. Therefore, the six year statute of limitations would not apply where the omission was due to an income tax basis overstatement.

In the 2009 case of <u>Salman Ranch</u>, the Court of Appeals for the Federal Circuit agreed with the 9th Circuit in <u>Bakersfield</u> and held that an overstatement of tax basis is not an omission from gross income for purposes of the extended six year statute of limitations. <u>Salman Ranch, Ltd. v. U.S.</u> 104 A.F.T.R. 2d 2009-5190 (July 30, 2009). Also, the Tax Court recently held that the basis overstatement does not trigger the six year statute of limitation. <u>Beard,</u> TC Memo 2009-184.

> **<u>NOTE</u>:** However, other courts have agreed with the IRS that the six year statute of limitation can be triggered by a basis of overstatement. For example, see <u>Brandon Ridge Partners v. U.S.</u> (DC Florida July 30, 2007) 100 AFTR 2d 2007-5347.

D. <u>In 2009, the IRS Issues New Temporary and Proposed Regulations</u>. On September 24, 2009, the IRS issued new temporary and proposed regulations, which state that any tax basis overstatement, outside of a trade or business, which leads to an understatement of gross income under Section 61(a), is an "omission from gross income" for purposes of the extended six year assessment periods under Section 6229(c)(2) and 6501(e)(1)(A). T.D. 9466 (Sept. 24, 2009); Reg. 301.6229(c)(2)-1T; Reg. 301.6501(e)-1T.

> **<u>Query</u>:** How can the IRS issue proposed regulations which are directly contrary to Court of Appeals Decisions?

E. 2011 Cases: Does The Three Year or Six Year Statute of Limitations Apply to Substantial Basis Overstatements?

The Court of Appeals for the DC District Court upheld the IRS determination that the six year statute of limitations applies to an overstatement of basis. Intermountain Insurance Services (DC Court of Appeals DC, June 21, 2011).

In another case, however, the 5^{th} Circuit Court of Appeals ruled that the IRS is not permitted to use the six year statute of limitations for a basis overstatement case. Equipment Holding Co., LLC vs. Commissioner, Docket No. 0960866 (unpublished opinion). Likewise, the 5^{th} Circuit Court of Appeals earlier held in Burks v. U.S., 633 F.3d 347 (February 9, 2011) that the three year statute of limitations applies to basis overstatements. Also see Carpenter Family Investments, LLC, 136 TC No. 17 (2011).

III. Does An IRS Audit Bind the IRS As To Subsequent Audits? The Answer Here is "No."

The case of Rooney v. Commissioner, TC Memo 2011-14 (January 18, 2011) involved a film director who claimed business depreciation deductions on certain equipment. 1999 was the first year that he deducted depreciation on these equipment items. The IRS audited the 1999 return and allowed the depreciation deductions.

Later on, in 2003, the IRS again audited Mr. Rooney and disallowed the depreciation deductions. Mr. Rooney claimed that the prior IRS audit (in which the IRS permitted the audit deductions) precluded the IRS from disallowing deductions in future years. Mr. Rooney asserted, in the Tax Court proceedings, that the IRS was estopped (or precluded) from denying the deductions for 2003, since the IRS had already allowed the deductions for 1999. The Tax Court, however, ruled that the IRS was free to disallow the 2003 depreciation deductions, even though the IRS had earlier determined that the 1999 depreciation deductions were appropriate.

This case reminds us that prior IRS audit determinations do not bind the IRS as to future audit determinations. Indeed, each IRS audit is a brand new audit and the IRS is never precluded from taking contrary positions to a prior audit, unless a Closing Agreement was signed between the IRS and the taxpayer with respect to the tax item at issue. Indeed, a Closing Agreement is a legally enforceable contract between the taxpayer and the IRS. In this case, Mr. Rooney ignorantly assumed that the prior audit was a Closing Agreement.

IV. IRS Issues New Audit Technique Guide For Attorney Audits.

On July 13, 2011, the IRS published its new Audit Technique Guide to be used by IRS Auditors when performing audits on attorneys. The Audit Guide advises IRS Auditors to look at the following potential tax issues involving attorneys:

1. Whether upfront fee payments by clients should be taken into taxable income by the attorneys;
2. Whether attorneys properly report cash receipts for criminal and immigration matters as taxable income;
3. "Personal Service Corporation" tax issues for C corporations;

4. Constructive dividend issues for C corporations that pay personal expenses of the attorneys;
5. Loans to shareholders or the personal use of corporate assets;
6. Inadequate compensation issues for S corporations; and
7. Whether attorneys are claiming non-deductible deductions for client advances.

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