2013 FEDERAL INCOME TAX UPDATE

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Keith A. Wood, Attorney, CPA
Carruthers & Roth, P.A.
235 N. Edgeworth Street
Post Office Box 540
Greensboro, North Carolina 27402
Phone: (336) 478-1185
Fax: (336) 478-1184
E-mail: kaw@crlaw.com

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
IRS AUDIT STATISTICS

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

In early 2013, the IRS published its 2012 Internal Revenue Service Data Book (IR-2013-32), which contained audit statistics for the Fiscal Year ending on September 30, 2012. Here are the audit statistics:

A. **Audit Rates for Individual Income Tax Returns**. Only 1.0% of filed individual income tax returns were audited. Of these audited returns, only 24% of individual tax audits were conducted by Revenue Agents and the rest of the audits (about 76% of the audits) were correspondence audits.

Not surprisingly, the audit rates for Schedule C returns were higher than for individual returns. Schedule Cs, showing receipts of $100,000-$200,000, reported a 3.6% audit rate. Schedule C returns, showing income over $200,000, reported a 3.4% audit rate.

Total Individual Returns Audited 1.0%

(1)	With Schedule C Income:	
	$100,000 to $200,000	3.6%
	Over $200,000	3.4%
(2)	Non-Business Income of:	
	$200,000 to $1 Million	2.8%
	Positive Income Over $1 Million	12.1%

B. Audit Rates For Partnerships and S Corporations: For partnerships and S Corporation returns, the audit rate was only .5%.

C. Audit Rates for Corporations. C Corporation returns had an audit rate of 1.5%. However, for large corporations with assets over $10 Million, the audit rate was 17.6%.

Total C Corporation Returns Audited 1.5%

(1)	Assets less than $1 Million	1.7%
(2)	Assets $1,000,000 to $5 Million	2.1%
(3)	Assets $5 Million to $10 Million	2.6%
(4)	Assets Over $10 Million	17.8%

D. Offers in Compromise. The IRS received 64,000 offers in compromise, but only accepted 24,000 of them.

E. Criminal Case Referrals. According to the IRS statistics, the IRS initiated 5,125 criminal investigations for the fiscal year 2012, and of these, 3,701 ultimately resulted in prosecution, and of these, 2,634 resulted in convictions. For convictions, 81.5% were actually incarcerated.

PART TWO
SECTION 1031 LIKE KIND EXCHANGES

I. Tax Court Affirms A Valid 1031 Exchange, Even Though Rental Property Was Soon Converted to a Primary Residence; *Reesink v. Commissioner, TC Memo 2012-118 (April 26, 2012).*

Mr. Reesink owned an apartment building with his brother. The building was sold in 2005, and Mr. Reesink structured his share of the sale as a Section 1031 tax-free exchange. Mr. Reesink used his share of the sales proceeds to purchase a residence on Laurel Hill Lane in a neighboring city using his share of the Section 1031 sales proceeds, as well as funds from a bank loan. On the bank loan application, Mr. Reesink stated that the property was being acquired "for investment purposes."

For the next seven months, Mr. Reesink unsuccessfully attempted to rent the property. Although they never advertised in any local newspapers, the Reesinks posted flyers throughout the town that the Laurel Hill Lane property was available for rent.

The Reesinks owned another primary residence and a trailer that was close to Mr. Reesink's job. Due to financial difficulties, the Reesinks sold their primary residence and moved into the Laurel Hill Lane property about seven months after the sale of the apartment building.

The IRS sought to disallow the Section 1031 exchange on the basis that the Reesink's primary purpose of acquiring the Laurel Hill Lane property was to use it as a primary residence.

Ultimately, Mr. Reesink was able to prevail at trial primarily based upon the testimony of his brother, who testified that the Reesinks had stated that they intended to move to the Laurel Hill Lane area once their children were out of his school. But at that time, Mr. Reesink's son was only fifteen years old and a long way from high school graduation. According to the Court, therefore, at the time the Reesinks acquired the replacement property, they intended to hold it for investment purposes.

PART THREE
DETERMINING TAXABLE INCOME

I. Medical Practice Owes Employment Taxes on Advances to New Doctors Which Were Recharacterized as Compensation; *Vancouver Clinic, Inc. v. U.S., 111 AFTR 2d 2013-1571 (April 9, 2013).*

Vancouver Clinic was a medical practice which offered a loan program to new doctors. Under the loan program, new physician doctors would be provided with an advance at the beginning of their employment. The "loans" would also accrue interest. However, as long as the physician remained employed for five full years, the loans would be forgiven at the end of five years. If a physician quit during that five year period, then the entire loan amount had to be repaid.

The IRS took the position that the loan advances were compensation in the first year and that the employer owed substantial employment taxes on the "advanced" amounts. The Court agreed with the IRS that the early advances were not true loans, but were designed as compensation for the new physicians. According to the Court, the advances were "incentive inducements" for the physicians to be employed for the next five years and that the loan repayment obligation was more in the nature of a penalty if the physician left during the first five years.

The Court found that the parties never intended for the advances to be loans because both parties (the employer and the employed physicians) fully expected that the physicians would work the full five year employment term. The Court also noted that, when the loan agreements were signed, the borrowers (the physicians) did not have a reasonable prospect of repaying the loan amounts at that time.

II. Ordinary Income or Capital Gain on the Sale of Real Property?

The case of Long v. Commissioner, TC Memo 2013 – 233 (October 21, 2013), reviewed the age old issue of whether the taxpayer held real property for investment or as inventory in its capacity as a dealer.

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

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

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

(i) Section 1031 nontaxable exchanges;

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

(iii) Section 453 installment sale reporting.

These are tax benefits that are **not** available to ***dealers*** of real property.

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

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

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.

B. Past Case Law.

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

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

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

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

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

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

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

III. <u>Sale of Lawsuit Rights by Real Estate Developer Generate Ordinary Income and Not Capital Gain; *Long v. Commissioner*, TC Memo 2013 – 233 (October 21, 2013)</u>.

Mr. Long was involved in several real estate development activities in Florida. In 2002, Mr. Long entered into a Contract (the "Contract") to purchase real estate located on Las Olas Boulevard (the "Property") from Las Olas Riverside Hotel ("LOR") in 2002.

When the Contract was executed, Mr. Long intended to build a condominium building on the Property and then sell off the condominium units.

The closing on the Property sale was scheduled to occur on December 31, 2004, but before the closing date, the president of LOR died and his heirs decided that they did not wish to go through with the Contract sale.

In March 2004, Mr. Long sued LOR for "specific performance" and for monetary damages.

By the time the lawsuit rolled around, Mr. Long decided that he no longer wished to construct the condominium project on the Property, but instead decided to sell the Property, which was ready for construction, to another party. The State Court ordered that LOR perform its obligations under the Purchase Contract. During the appeal of that court case in September 2006, Mr. Louis Ferris offered to purchase Mr. Long's position in his lawsuit against LOR for a purchase price of $5.75 Million.

In his 2006 tax return, Mr. Long filed a Schedule C reporting that he was a "real estate developer".

In the Tax Court preceding, Mr. Long argued that he should be entitled to capital gains tax treatment on the sale of his lawsuit claim to Mr. Ferris on the basis that, at the time of filing his original lawsuit, he had decided to forego development of the condominium project but instead had decided to sell the Property to one single purchaser.

The Tax Court noted that the proper analysis focuses on Mr. Long's intention at the time the property was disposed of in determining whether the Property was held for investment purposes or as inventory for sale in the ordinary course of the taxpayer's business. See, for example, <u>*Rice v. Commissioner*, TC 2009 – 142; Raymond v. Commissioner, TC Memo 2001-96</u>.

The Court noted that the purpose of Section 1221(a)(1) - which excludes inventory from the definition of a "capital asset" - is to "differentiate between gain arrived from the everyday operation of a business and gain derived from assets that have appreciated in value over a substantial period of time." <u>*McManus vs. Commissioner*</u>, 65 TC 197 (1975); and <u>*Malat*</u>, 383 U.S. 569 at 572 (9^{th} Cir.). The Court noted that, in determining whether or not property is "a capital asset" or "stock in trade" under Section 1221(a), courts often apply the nine factor test set forth in <u>*Biedenharn*</u>, <u>*Winthrop*</u> and <u>*Suburban Realty Co.*</u>

So, according to the Court, the key analysis was whether, at the time that Mr. Long decided to sell the Property to another developer, was he intending to sell the Property to customers in the ordinary course of his business? Here, even though Mr. Long decided to sell the Property in one transaction, the Court nevertheless held that the Property was "inventory," and not a capital asset, based upon the following factors:

1. The intent of Mr. Long at the time he acquired the Property. At the time of the lawsuit, Mr. Long's intentions were to acquire the Property, design a condominium building, secure zoning approval, and then sell the undeveloped Property to another purchaser.

2. The Nature of the Taxpayer's Business. Mr. Long's fulltime business activity was developing real estate, and, at the time that he attempted to acquire the LOR Property, his fulltime activity was working on developing that Property for the condominium building.

3. Frequency, Continuity and Substantiality of Property Sales. Mr. Long had already received deposits from 20% of condominium purchasers and therefore the court ruled that, although Mr. Long had changed his plans and decided to sell the Property ready for construction, this did not alter the court's view that Mr. Long held the Property primary for sale to customers in the ordinary course of his business. The sale of the Property would have generated a large profit which would have been the result of Mr. Long's effort to develop the Property and not the result of the mere passage of time.

4. Extent to which the Taxpayer Developed and Approved the Property. Here, Mr. Long hired architects, obtained zoning permit and printed promotion materials and negotiated contracts with Unit customers.

5. The Extent to which the Taxpayer Used Advertising. Through Mr. Long's own sales efforts, he had already received deposits on 20% of the Units.

6. Use of A Business Office. Mr. Long used a business office to sell the condominium units.

7. Character and Degree of Supervision or Control Exercised by the Taxpayer over any Representatives on the Property. The court said that, if Mr. Long had not sold his rights under the lawsuit to Mr. Ferris, then he would have been primarily responsible for selling the Property.

8. Time and Effort the Taxpayer Devotes to Sales of Property. Here, Mr. Long was a professional real estate developer, and his full time business was developing and selling condominium properties.

Based upon the foregoing, the Court held that the gain from the sale of Mr. Long's rights under the Purchase Contract should be ordinary income, as he would have earned ordinary income on the sale of the Property.

IV. <u>No Section 104(a)(2) Income Exclusion for Payments to Settle Employment Discrimination Claims; *Molina v. Commissioner*, TC Memo 2013–226 (September 23, 2013)</u>.

Mr. Molina worked for Clearinghouse Payments Co., LLC from 1980 until 2007. Mr. Molina alleged that, during 2004 and 2005, he began to suffer from peptic ulcers, gastric problems, intestinal problems and stomach pains as a result of being overworked and being racially discriminated against by his supervisors at Clearinghouse. However, medical tests were inconclusive as to whether Mr. Molina actually had any peptic ulcers.

In 2005, Mr. Molina notified his supervisors of insufficient staffing in his department and its potential detrimental effect on employee morale and health. However, Mr. Molina never filed any disability claims with Clearinghouse or with its disability insurance carriers.

In 2007, Mr. Molina filed a lawsuit against Clearinghouse alleging that Clearinghouse created a hostile work environment and discriminated against Mr. Molina because of his race and nationality. In his Complaint, Mr. Molina alleged that he was the victim of "serious and significant emotional and physical distress".

The case was settled and Clearinghouse agreed to pay Mr. Molina $700,000, less applicable employment withholdings. The Settlement Agreement did not attribute any of the settlement payment to physical injuries, physical illness or emotional distress. And, the Settlement Agreement contained a complete release by which Mr. Molina agreed to release Clearinghouse from any other causes of actions or liabilities.

Clearinghouse sent Mr. Molina a Form W-2 for 2007, reporting that he had received wage compensation during 2007. However, Mr. Molina attached a statement to his 2007 tax return claiming that the amounts he received under the Settlement Agreement should be excluded from gross income as non-taxable compensation for damages received on account of a physical injury or sickness under Section 104(a)(2).

The Tax Court agreed with the IRS that none of the settlement payments were excludable from gross income under Section 104(a)(2). Mr. Molina had argued that his physical problems were the result of being overworked and being racially discriminated against by supervisors at Clearinghouse. Citing the case of <u>*Domeny v. Commissioner*</u>, TC Memo 2010-9 (2010), Mr. Molina argued that payments may be excluded from gross income if the payments are in satisfaction of a "claim of stress induced physical sickness".

The Court held that, because none of the terms of the Settlement Agreement allocated any of the settlement payments to compensation for physical injuries or sickness, no portion of the settlement payment was excludable under Section 104.

Also, the Tax Court noted that Mr. Molina did not offer any evidence at trial establishing either that he was physically ill or that he had informed his Clearinghouse supervisors of his illness or that the alleged discrimination caused these injuries. Moreover, the Settlement Agreement never allocated any portion of the settlement payments to compensation for physical injuries or sickness, and indeed Mr. Molina's own lawsuit Complaint only mentioned a claim for "serious and significant emotional and physical distress," without elaborating specific physical injuries or sickness. The Complaint never connected Mr. Molina's alleged health problems with his employment discrimination claim.

> **Note:** A plaintiff will be able to exclude damages for employment related illnesses from gross income under Section 104(a)(2) only where the plaintiff can demonstrate that the physical sickness was directly caused (or exacerbated) by the conduct of superiors. Moreover, in those events where the employee can prove that the physical injuries were caused or exacerbated by stress at work, the employee must overcome the additional burden of showing that the judgment award or settlement agreement properly allocated a portion of the award to physical injuries. Unless the Complaint and Settlement Agreement/judgment provides evidence that the settlement/judgment was designed to compensate the employee for that physical injury or sickness, none of the damages will be excludable under Section 104(a)(2).

PART FOUR
REASONABLE COMPENSATION ISSUES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In this case, Mr. Menard proved that he worked 12 to 16 hours each day. During the time he worked, sales and profits of his company had increased dramatically from 1991 to 1998. Finally, under the compensation bonus arrangement, the $20 Million bonus consisted of more than $17 Million of bonus that had been awarded under a bonus compensation arrangement that the Board of Directors had adopted years before.

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

The compensation deduction was challenged by the IRS.

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

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

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

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

II. Catch-Up Compensation Payments for Under-Compensated Shareholder-Employee Were Deemed Excessive Compensation; *Thousand Oaks Residential Care Home I, Inc., TC Memo 2013-10 (January 14, 2013).*

Dr. Fletcher and his wife purchased a corporation that owned a residential care facility in 1973. They paid $25,000 for their investment and assumed substantial debts in order to finance their purchase. From 1973 to 1983, neither Dr. Fletcher nor Mrs. Fletcher received any compensation from the company. From 1984 to 2001, their compensation ranged from nothing up to $36,000. In 2002, the corporation paid Dr. and Mrs. Fletcher $130,000 each as wage compensation.

In October 2002, the corporation sold its assisted living facility for $3.4 Million in an installment sale transaction. In 2003, 2004 and 2005, the corporation paid each of Dr. and Mrs. Fletcher $200,000 in 2003, $200,000 in 2004 and $30,000 in 2005. During the years 2003-2005, the company also made significant retirement plan contributions on behalf of Dr. and Mrs. Fletcher. At the time of the sale of the assisted living facility, the company only had about $160,000 of retained earnings at that time. Later, the new owner paid herself approximately $240,000 per year as compensation.

The IRS took the position that the Fletchers' compensation for 2003 through 2005 was excessive, but the Fletchers took the position that this compensation was designed to compensate them for the inadequate compensation they received over the last thirty years and that this compensation was merely designed to be "catch-up compensation" for their prior years services.

During the Tax Court trial, the Tax Court agreed that the Fletchers had been under-compensated for their prior years' services and that, in some of those earlier years, the corporation simply did not have the funds to pay adequate compensation in those years.

Since this was a case for which the 9th Circuit would hear any appeals, the Court noted that the 9th Circuit generally applies the five factor Elliotts test as well as the "independent investor test." The Court applied the "five factors" test in Elliotts, as well as the "independent investor" test, to determine whether the compensation paid to the Fletchers was reasonable for those tax years.

The IRS' expert testified that the compensation paid in the 2003-2005 tax years was substantially higher than market average based upon Bureau of Labor statistics, even considering the prior under-compensation. However, the Court found that some of the other five factors under Elliotts weighed in favor of determining that the compensation was reasonable.

The Court then looked at the independent investor test and noted that, in the past, courts have found a return on investment of between 10% and 20% tends to indicate that compensation was reasonable. See for example L&B Pipe & Supply Company, Inc., TC Memo 1994-187.

Here, the Fletchers had invested $25,000 to purchase the business. Assuming a ten percent rate of return over the thirty years that the Fletchers owned the business, the Court found that the company would need to have at least $500,000 to distribute to hypothetical shareholder-investors after the sale. Here, however, because the compensation package paid to the Fletchers did not leave enough assets to satisfy a hypothetical investor, this factor weighed against finding that the compensation was reasonable.

So, based upon all of the factors of Elliotts, as well as the independent investors test, the Court determined that the "catch-up" compensation was unreasonable.

> **Note:** Based upon court cases we have seen over the last handful of years, such as Menard, Multi-Pak, Mulcahy and Thousand Oaks, it appears that the courts are placing more and more weight on the "independent investor" test in determining whether compensation is reasonable.

III. In Another Case, Catch-Up Payments Are Deemed To Be Reasonable Compensation, At Least In Part; *Aries Communications, Inc., TC Memo 2013-97 (April 10, 2013).*

Mr. Astor was chief financial officer and sole shareholder of a radio broadcasting company. In 2004, the company sold some of its major assets resulting in a large taxable gain in that year. During the 2004 tax year at issue, the company paid Mr. Astor almost $7 Million (which included a bonus of $2 Million), in part for "catch-up" compensation for prior years.

As this Tax Court was within the jurisdiction of the 9th Circuit Court of Appeals, the Tax Court applied the five factor test in Elliotts, as well as the reasonable investor test, and found as follows:

1. <u>Employee's role in the company</u>. Mr. Astor's role in the company was significant and so this factor was in favor of Mr. Astor.

2. <u>Comparison with similar companies</u>. Here, the Court found that the fixed compensation component for the current and past years was less than compensation paid by similar companies. However, the Court rejected both the taxpayer's and the IRS' experts as to whether the $2 Million bonus was reasonable.

3. <u>Character and Condition of the Company</u>. Here, the company had a bleak financial picture going forward and therefore this factor favored the IRS.

4. <u>Potential Conflicts of Interest</u>. Since Mr. Astor was the shareholder and primary officer of the company, there was a clear conflict of interest.

5. <u>Internal Consistency</u>. The Court found that this factor was neutral. Here, Mr. Astor's compensation was not based upon any type of structured formula or any type of compensation program operated from year-to-year. Also, there were no other employees within the company with similar management roles, and therefore there was no way to test Mr. Astor's compensation against compensation paid to other employees.

6. <u>Independent Investor Test</u>. The Court found that the company had sufficient retained earnings to satisfy a "hypothetical investor" to justify the compensation paid to Mr. Astor, and so this factor favored the company.

Ultimately, the Court deemed the $2 Million bonus to be reasonable, but allowed only around $700,000 for current year compensation and for catch-up compensation for prior years. The Court also upheld the accuracy-related penalty.

<u>PART FIVE</u>
OTHER DEDUCTIONS

I. <u>You Cannot Deduct Management Fees Unless the Management Company Actually Does Something; Elick, *TC Memo 2013-139 (June 3, 2013).*</u>

Dr. Elick owned a dental practice and also owned SDG Management Group, Inc. ("SDG"). SDG entered into a Management Agreement, whereby SDG would manage the business operations of the dental practice, and the dental practice paid management fees to SDG under the Management Agreement.

The IRS disallowed the management fee deductions, finding that SDG did not provide any management services for the dental practice. Neither the dental practice nor SDG were able to provide any contemporaneous records corroborating services that SDG allegedly provided for the dental practice.

<u>Note</u>: In addition to disallowing the management fee deductions, the Tax Court also upheld the assessment of the Section 6662(a) negligence penalty.

<u>PART SIX</u>
BAD DEBT DEDUCTION RULES FOR SHAREHOLDER LOANS/ADVANCES AND CAPITAL CONTRIBUTIONS

I. <u>Background</u>.

We often have many clients who have had to infuse their businesses with operating capital. Oftentimes, a taxpayer will make advances to a closely-held corporation. In many cases, a desperate taxpayer continues to loan money to an entity that is not credit worthy. The tax question at issue is often whether or not the capital infusion is truly a loan or instead a capital contribution.

Oftentimes, however, shareholder-creditors fail to carefully document whether these transfers are **(i) bona fide loans or (ii) capital contributions**. In these cases, the following problems may arise:

(1) Subsequent repayment of these "advances", or payment of "interest", may be treated as C Corporation **dividends** to the C Corporation shareholder creditor;

(2) In the S Corporation context, the S Corporation repayment may be treated as a **bonus** which is subject to payroll taxes;

(3) In the S corporation context, where the shareholder has no basis in the S corporation's note to the shareholder (because the S shareholder used its basis in the note to absorb S corporation operating losses), any repayment of the debt by the S corporation will be **taxable income** to the S Corporation shareholder. The **character of taxable income** will depend upon whether or not the debt is evidenced by a promissory note. Generally, the debt repayment will be treated as <u>capital gain</u> to the S corporation shareholder-creditor, as long as the debt is evidenced by a note. Rev. Rul. 64-162. However, if the debt is <u>not</u> evidenced by a note, there is no sale or exchange when the debt is repaid, and therefore the S corporation shareholder-creditor recognizes <u>ordinary income</u> to the extent of the amount paid over the shareholder-creditor's basis in the debt. Rev. Rul. 68-537;

(4) Loans by a family member to the corporation may be recharacterized as gifts to the shareholder-children; and

(5) The tax treatment to the shareholder upon the subsequent insolvency of the company will differ depending upon whether the capital infusion is treated as a loan or as a capital contribution.

II. **<u>Review of Section 165 Capital Loss Rules and Section 166 Bad Debt Deduction Rules</u>**.

A. <u>Advance Treated As a Capital Contribution</u>. If the corporation fails to repay an advance that is properly characterized as a capital contribution rather than as a loan, the Shareholder will not be able to claim a Section **166(a) business bad debt deduction** <u>or</u> a Section **166(b) non-business bad debt deduction** for the worthless debt. Instead, there will be no allowable deduction at all - if the advance is treated as a capital contribution to the corporation - until the underlying stock becomes worthless. (See Section 165 and Section 1244 for worthless stock rules). Generally, Section 165 ensures that any such worthless stock loss will be treated as a capital loss, rather than as an ordinary loss, unless the stock qualifies as Section 1244 stock.

B. <u>Advance Treated As a Loan</u>. If the corporation fails to repay an advance that is properly characterized as a loan rather than as a capital contribution, the lending Shareholder will be able to claim a Section **166(a) business bad debt deduction** or a Section **166(b) non-business bad debt deduction** for the worthless debt. "Business" bad debt losses are treated as ordinary loses, but "non-business" bad debt losses are treated as capital losses, and, to claim a business bad debt loss, one must show that the loan was made in connection with the taxpayer's trade or business.

1. <u>Business Bad Debts: Debts Incurred to Protect Shareholder's Employment</u>. Section 166 defines a business bad debt as a debt incurred in connection with the taxpayer's trade or business. The "trade or business" test can include the shareholder's trade or business of being an employee. Thus, an employee's loan to the corporation will be deemed to have been made in connection with the employee's "trade or business" of being an employee if the advance to the employer corporation was necessary to insure the employee's continued employment. <u>Trent v. Commissioner</u>, 291 F.2d 660 (2d Cir. 1961).

2. <u>Nonbusiness Bad Debts: Debts Incurred to Protect Shareholder's Investment Rather Than Employment</u>. If the loss loan was not made in connection with the taxpayer's trade or business (such as where the shareholder was not employed by the corporation), the loss is deemed to be a Section 166(b) nonbusiness bad debt which is only deductible as a capital loss. Section 165(c) and Section 165(d).

3. <u>Summary Comparison of Tax Results of Section 165 Capital Loss versus Section 166(d) Bad Debt Loss Treatment</u>. Since bad debt deductions attributable to one's services as an employee are 2% miscellaneous itemized deductions under Section 63(d) and 62(a)(1), you may be better off claiming a non-business bad debt capital loss rather than a business bad debt attributable to the provision of services as an employee so as to avoid (i) the 2% miscellaneous itemized deduction threshold; (ii) the Section 68 overall limitation on itemized deductions; and (iii) the disallowance of the itemized deduction for AMT purposes.

4. <u>Section 1244 Stock Loss Rules</u>. Under IRC § 1244(a), an individual may claim an ordinary loss deduction of up to $50,000 per year ($100,000 for joint returns) for worthless §1244 stock. Section 1244 stock is defined as original issue stock of $1,000,000 or less. Ordinary losses, however, will not arise where the taxpayer makes subsequent additional capital contributions, even if the taxpayer's stock is already 1244 stock. Reg. 1.1244(c)-1(b). **Thus, the additional §1244 capital infusions would have to be structured as new purchases of newly issued stock.**

C. Loans vs. Capital Contributions. In the past, courts have set forth a 13 point test or a 16 point test to determine whether a capital infusion is a loan versus a contribution to capital. The Tedford case, TC Summary Opinion 2004-132, and the Warning case, 2001-2 U.S.T.C. 50,729 (2001), provide excellent restatements of the 13 point and 16 point tests. Also see Indmar, 444 F3d 771 (2006).

III. No Bad Debt Deduction for Loans Made to a Family-Owned Business; *Shaw, TC Memo 2013-170 (July 24, 2013).*

Ms. Shaw, her mother and her siblings owned SRG Corp. ("SRG"). Ms. Shaw also worked for SRG as an officer from 2002 through 2009.

SRG desired to develop a shopping center. Initially, an unrelated third-party agreed to provide part of the financing for the project, but later changed her mind. So, in January 2009, Ms. Shaw agreed to loan $1 Million, in the form of a revolving line of credit, to finance the development project. SRG issued a promissory note in favor of Ms. Shaw providing for a 10% annual interest payment, with the principal balance being due in two years. However, the line of credit was unsecured.

Throughout 2009, SRG encountered continued financial difficulties, but nevertheless, Ms. Shaw continued to fund advances under the line of credit. By the end of 2009, the balance owed on the line of credit was $800,000. Soon thereafter, the project was abandoned.

SRG never paid any principal or interest under the note. At the end of 2009, SRG still owned a number of other real estate projects and SRG continued to operate for several years thereafter.

Ms. Shaw claimed a worthless bad debt deduction for 2009 for the entire $800,000 loan. The Tax Court upheld the IRS's disallowance of the bad debt deduction on two grounds.

First, the Court held that Ms. Shaw could not prove that the initial advance was a true loan, rather than merely a capital contribution to SRG or a gift to her family members. The Court noted that advances made to an insolvent debtor by a shareholder are almost always treated as capital contributions or gifts and not true loans.

The Court noted that, at the time Ms. Shaw initially made the loans she could not prove that SRG had any ability to repay the debt at that time. The Court noted that the taxpayer bears the burden of proving that, at the time she advanced the funds, she had a real expectation of repayment and had an actual intent to enforce collection of the debt. See Davis v. Commissioner, 69 TC 814 (1978). Here, Ms. Shaw was not able to provide any evidence at trial showing the company's credit worthiness in January 2009 when the loans were made.

Also, Ms. Shaw provided no evidence that a third party lender, in January 2009, would have extended credit to SRG on comparable terms. Indeed, one potential financer had just de-committed. The Court also noted that Ms. Shaw continued to advance funds, even as the company's credit worthiness deteriorated throughout 2009. Also, Ms. Shaw never made any attempts to enforce collection of the debt.

Second, Ms. Shaw could not prove that, at the end of 2009, the debt was uncollectible. Indeed, at the end of 2009, SRG still had assets and still had some ongoing business activities. Also, Ms. Shaw could not provide any third party opinions that the debt had become worthless in that year. And finally, there was never any evidence that SRG ever recognized "cancellation of debt income" in 2009.

IV. No "Business Bad Debt" Deduction Allowed For Shareholder/Employee Who Made Loans To Protect His Investment Rather Than To Protect His Salary; *Haury v. Commissioner*, TC Memo 2012-215 (July 30, 2012).

In *Haury v. Commissioner*, TC Memo 2012-215 (July 30, 2012), Mr. Haury was a software engineer who designed computer software used by two corporations that employed Mr. Haury. Mr. Haury owned less than 50% of the stock of both corporations.

In 2005 and 2006, one corporation paid Mr. Haury just over $147,000 in compensation, but the other corporation paid him no compensation for either tax years.

In 2007, the two corporations employing Mr. Haury entered into a software license agreement with the Department of Homeland Security. To perform the contracts, the corporations needed additional funds and Mr. Haury allowed his IRA to loan funds to the corporations in 2007.

By the end of 2007, Mr. Haury's loans to the corporations had become worthless. Mr. Haury filed his 2007 return and claimed a business bad debt deduction on his Schedule C, taking the position that he had incurred a "business bad debt" for his worthless loans.

The Tax Court agreed with the IRS that Mr. Haury had made a loan to his corporations in order to protect his investment as a stockholder -- rather than to protect his status as an employee of the two corporations. The Tax Court noted that Mr. Haury did not receive any employment compensation for 2007 or thereafter, and that Mr. Haury had only received modest compensation from the corporations in 2005 and 2006. In addition, Mr. Haury had substantial investments in both corporations, both in terms of his actual stock ownership as well as in terms of his personal time in developing the computer software used by the corporations.

The Tax Court noted that, in past cases, in determining whether a worthless loan is deductible as a "business bad debt" versus a "non-business bad debt," the key issue is the taxpayer's "dominant motive" in making the loan to the corporation. That is, was the dominant motive in making the loan to protect the taxpayer's investment or to protect the taxpayer's salary? For example, in *Dagres v. Commissioner*, 136 TC 263 (2011), the Tax Court held that a loss is a non-business bad-debt where the taxpayer's "dominant motive" is to protect his investment in the corporation even if the taxpayer was also an employee of the corporation.

Here, in light of Mr. Haury's modest salary from the corporations in 2005 and 2006, and in light of the fact that he was paid no employee compensation in 2007 and thereafter, and in light of his substantial investment in his corporations through his stock ownership, Mr. Haury's dominant motive in making the loans must have been to protect his investment as a shareholder and not as an employee.

> **Note**: In the past, courts have held that a taxpayer's investment in a corporation does not constitute a "trade or business". Section 166(d); *Whipple v. Commissioner*, 373 US 193 (1963). On the other hand, being an employee is a trade or business. Trent vs. Commissioner, 291 F.2d 6609 (1961). Therefore, when a taxpayer is both an employee and an investor in a corporation, the business bad debt deduction treatment will be allowed only where the employee can prove that the dominant motive of his loan was to protect his employment rather than merely his investment.

PART SEVEN
PASSIVE LOSS CASES AND "AT RISK" RULES

I. Special Rules for Real Estate Professionals.

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 materially 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.

II. Taxpayer Could Not Provide Adequate Documentation To Substantiate Status as a Real Estate Professional; *Merino v. Commissioner, TC Memo 2013-167 (July 16, 2013).*

Mr. Merino was the President and sole shareholder of One Stop Home Loans, Inc., an S Corporation. In addition, during 2007 Mr. Merino operated a business known as Mona Vie, Inc., which involved the sale and distribution of a berry drink.

Mr. Merino also operated a real estate rental activity in 2007 involving seven (7) rental properties. One property was located out of state and Mr. Merino used a management company to manage that property. With respect to the other properties, Mr. Merino paid an assistant an hourly rate to handle property management services.

The rental activity generated a loss for 2007 and Mr. Merino took the position that the losses were deductible under Section 469(c)(7) on the basis that Mr. Merino qualified as a real estate professional. The Tax Court determined that Mr. Merino could not meet either (1) the "one-half of services" test or (2) the "750 hour" test.

The problem here was that Mr. Merino did not present any evidence at trial as to how many hours he spent working at One Stop and at Mona Vie. Since Mr. Merino could not meet the "one-half-of-services" test of Section 469(c)(7), the rental activity was deemed passive.

The Court went further on to say that Mr. Merino also failed to substantiate the "750 hour requirement." The Court noted that a taxpayer may substantiate that he meets the "750 hour test" by "any reasonable means," and "any reasonable means" does not require that the taxpayer have contemporaneous records compiled on a daily basis. Reg. Section 1.469-5T(f)(4). Instead, the taxpayer may use any reasonable method, such as identifying specific services performed over a period of time by using appointment books, calendars or narrative summaries and then estimating the approximate number of hours spent on these activities. Reg. Section 1.469-5T(f)(4). However, the IRS regulations do not allow the taxpayer to use a post event "ball park guesstimate." Moss v. Commissioner, 135 TC 365 (2010).

Here, the Court found that Mr. Merino's time summary relied upon his estimates and memory as to how much time he spent on certain tasks, and that his summary was less of an approximation and more of a "ball park guesstimate." The Court also upheld assessment of negligence penalties.

III. <u>Taxpayer Fails to Provide Evidence That He Met the "Material Participation" Test for His Side Business as a Bull Breeder, *Bartlett, TC Memo 2013-182 (August 8, 2013)*</u>.

Here, Mr. Bartlett kept no contemporaneous records for his activities performed in connection with his bull breeding business. Instead, during the IRS audit, he used credit card statements to recreate a schedule which showed what days he made purchases relating to his bull breeding business. Mr. Bartlett then tried to extrapolate from his credit card statements based upon an estimate of how much time he likely spent on activities on those various days. The Court ultimately determined that this was not sufficient documentation.

IV. <u>Trusts and the Section 469 Material Participation Standards; *PLR 201317010*</u>.

In PLR 201317010, two trusts held stock in an S Corporation. The Trustee of the trusts was also an employee and officer of the two S corporations.

The IRS ruled that the personal activities of the trustees could not be imputed to the trust for purposes of applying the Section 469(h) material participation test. According to the IRS, although no regulations have been issued under Section 469, to address the material participation requirement for trusts and estates, legislative history indicates that "an estate or trust is treated as materially participating in activity…if the executor fiduciary, in his capacity as such, is so participating." According to the IRS, therefore, only the trustee's services, in its fiduciary capacity as trustee, may be counted for determining whether the trust materially participates in the activity. So, the trustee cannot count other services he performs in the activity, even as an officer or employee of the business.

V. <u>The "At Risk" Rules and Guarantees of LLC Debt.</u>

Internal Revenue Legal Memorandum 201308028 discusses when an LLC member will be "at risk" with respect to guaranteed LLC debt. This ILM reminds us that, if a member of an LLC personally guarantees debt of the LLC, but has rights of subrogation or contribution or indemnity from other third parties, then the LLC member will not be "at risk" under Section 465 unless and until the rights of subrogation, contribution or indemnity are waived or until the co-guarantors and indemnitors become insolvent.

PART EIGHT
S CORPORATIONS AND PARTNERSHIPS

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

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

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

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

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

II. Taxpayer's Basis in S Corporation Stock Must Be Reduced for Losses Not Claimed in Earlier Years; *Barnes v. Commissioner, 111 AFTR 2d 2013-1529 (712 F3d 581) (April 5, 2013).*

Mr. and Mrs. Barnes operated a restaurant business through their S Corporation. The Barnes' claimed a loss on their 2003 tax return for their share of the S Corporation's losses for 2003. The IRS determined, however, that the Barnes' had insufficient basis in their S corporation stock to claim the full amount of the losses in 2003. Accordingly, the IRS disallowed a portion of the deduction for that year.

The problem here was that, previously in 1997, the Barnes' had taxable pass-through income from their S corporation. However, the Barnes' failed to claim a deduction in 1997 for a suspended loss from prior years, even though they had adequate basis in their S corporation stock in 1997 to utilize the loss by virtue of the S corporation income for 1997.

According to the Tax Court, a shareholder's tax basis in S corporation stock is decreased "for any period" by the amount of that shareholder's pro rata share of the corporation's losses and suspended losses **in the first year** the shareholder has adequate tax basis to do so. Of course, by the time the 2003 tax year rolled around, it was too late for the Barnes' to amend their 1997 tax return to claim the loss for that year. The Tax Court ruled that, even though the Barnes' would lose the tax benefit of their prior 1997 losses, they still had to reduce their stock basis by the amount of unclaimed losses for 1997.

III. Keeping Track of S Corporation Stock Basis; Watch for Closed Year Losses That May Come Back to Haunt You; 2002 IRS FSA Extends the IRS Statute of Limitations on Certain S Corporation Operating Losses. The IRS announced, in Field Service Advisory 200230030, that the tax basis of S Corporation stock in an open year must be reduced by losses deducted in excess of available tax basis for closed years. Field Service Advisory 200230030. Here are the facts presented in that Field Service Advisory:

> A is the 100% shareholder of an S Corporation. In Year One, the Corporation had \$50,000 in losses at a time when A had an adjusted basis in his stock of \$20,000. However, on his return, A deducted the entire \$50,000 loss and reduced his basis in his corporate stock to zero. In Year Two, the Corporation had a loss of \$30,000, all of which was deducted by A who then again claimed that he had an adjusted basis of zero in his stock at the end of Year Two.
>
> In Year Three, the Corporation had \$90,000 of ordinary income which A recognized on his return. However, at the end of Year Three, A claimed that his ending tax basis in the stock was \$90,000. The question presented in the FSA was: What was A's tax basis in the S corporation stock in Year 4?
>
> In the Field Service Advisory, it is assumed that Years 1, 2, and 3 are closed under the three-year statute of limitation for assessment, and that Year 4 is open and is currently under examination.

Here, the Field Service Advisory advised that, although the IRS is barred by the statute of limitation from disallowing any of the losses for Years 1 and 2, the tax basis of the stock for Year 4 would be recalculated based upon what A's stock basis would have been if it had been correctly determined in earlier years. This means that, in the above example, A’s basis in the corporate stock would be \$30,000 at the beginning of Year 4, which takes into account his \$90,000 of income from Year 3, reduced by the amount of excess losses of \$60,000 claimed in Years 1 and 2.

This means that, although the statute of limitations has expired for Years 1 and 2, A still has substantial risk of unexpected tax consequences in Year 4 and beyond. For example, if A received a Sub-S distribution of \$90,000 in Year 4, A would have a \$60,000 capital gain, since he would not have sufficient Accumulative Adjustment Account (AAA) to absorb the full amount of the distribution (\$90,000 distribution minus \$30,000 stock basis). Moreover, if the S Corporation had a \$40,000 loss in Year 4, A’s loss would be limited to \$30,000 (his basis in the stock) notwithstanding his contention that his tax basis would have been much higher if the IRS were not able to recalculate his stock basis to take into account excess losses deducted during closed years.

> **Note:** S Corporation shareholders don't always limit their loss deductions to their S Corporation stock basis. Many of us have been under the mistaken impression that, once the statute of limitation expires for these tax years, we no longer have to worry about the basis limitation rules. As the Field Service Advisory advises us, we can no longer live in "blissful ignorance" as to how our clients may or may not understand the S Corporation tax basis limitation rules. Indeed, miscalculation of tax basis in closed years may generate substantial tax, penalty and interest exposure in subsequent open years.

IV. Payments to S Corporation Shareholder Were Wages, and Not Loan Repayments or Dividends; *Glass Blocks Unlimited v. Commissioner, TC Memo 2013-180 (August 7, 2013).*

Mr. Block was the President, sole shareholder and a full time employee of his S corporation. Before the tax year at issue, Mr. Block transferred funds from personal accounts to the corporation. Unfortunately, the corporation never issued any promissory notes to evidence Mr. Block's "loans" to the corporation.

In 2007 and 2008, the S corporation paid no wages to Mr. Block. However, in each of those years, the company distributed more than $30,000 to Mr. Block. Mr. Block reported these transfers as loan repayments.

The IRS took the position that these payments were wages, and thus subject to employment tax assessments. Unfortunately, Mr. Block could not demonstrate that his earlier advances were loans, and not merely capital contributions. Again, there was no documentation evidencing the loans (such as promissory notes) and even the corporate tax returns for 2007 and 2008 failed to evidence the existence of shareholder loans as liabilities on the corporation's balance sheet. Therefore, the distributions could not be treated as loan repayments.

Next, the Court applied the "reasonableness of compensation" test to determine if the payments could be characterized as dividends. Mr. Block contended that, if the distributions were recharacterized as wages, then those wages would be excessive and unreasonable compensation under the Elliotts case. The Court found, however, that in light of Mr. Block's significant activities on behalf of the corporation, that amount of compensation clearly would not be deemed excessive or unreasonable under Elliott's. Therefore, the entire amounts were properly characterized as wages and not as dividends.

V. Dealing With S Corporation Phantom Income; *Kumar, TC Memo 2013-184 (August 13, 2013).*

Dr. Kumar was a minority shareholder of an S corporation medical practice. The majority shareholder excluded Dr. Kumar from participation in management of the medical practice. For 2005, the S Corporation made no distributions to its shareholders and paid no wages to Dr. Kumar. Nevertheless, the S Corporation issued Dr. Kumar a Schedule K-1 reporting $216,000 as his share of pass-through income from the S Corporation.

Dr. Kumar, however, did not report any of the Schedule K-1 income on his Form 1040 for 2005. Dr. Kumar took the position that, since the majority shareholder had excluded him from participation in management, and since the company paid no distributions to him, he should not be deemed to be the "beneficial" owner of the S Corporation stock during 2005.

The court noted that, in the past, courts have held that one taxpayer is the "beneficial owner" of property of another, if the taxpayer (i) controls the property or (ii) has the economic benefit of ownership of the property. Anderson v. Commissioner, 164 F. 2d 870 (7th Circuit 1947). However, cases applying the "beneficial ownership test" have involved some type of voluntary arrangement between the parties who had some specific agreement or understanding regarding their relationship with each other, such as the relationship of creditor/debtor, donor/donee, etc. See, for example, Hightower v. Commission, TC Memo 2005-274.

Accordingly, the Tax Court, held that even though the majority shareholder excluded him from participation, Dr. Kumar still had the ***"economic benefit"*** of ownership of his shares. Although the majority shareholder may have interfered with Dr. Kumar's participation in the S Corporation's activities, that interference did not amount to a deprivation of this economic benefit.

> **Note:** If Dr. Kumar had filed a Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request, he still would have owed the tax, but he might not have had to argue about the accuracy related penalty.

VI. QSST Will Be Taxed on Gain Upon the Actual Sale, or Deemed Sale, of S Corporation Assets; *PLR 2012 32003 (August 10, 2012).*

A. Background. Under the QSST rules, if a QSST owns stock in an S corporation, all of the trust's beneficiaries are treated as owners of the S corporation stock for tax purposes. Therefore, all of the pass-through K-1 income from the S corporation (including gain from the sale of S corporation assets) will be taxed to the trust beneficiaries. But, if the QSST sells its S corporation stock, then the QSST status is terminated, such that any gain from the stock sale will be taxed to the trust rather than to the individual trust beneficiaries (unless the sales proceeds are distributed from the trust and then to the trust beneficiaries).

B. Section 338(h)(10) Deemed Asset Sales. PLR 201232003 reminds us that the same result can occur when a QSST sells its stock in an S corporation, and where the stock sale is treated as a "deemed asset sale" under Section 338(h)(10).

If a QSST sells its stock in an S corporation, and if the trust and the buyer agree to make a Section 338(h)(10) election with respect to the stock sale, then the stock sale is treated as an asset sale for all tax purposes, but the QSST tax status is terminated. This means that any capital gain, ordinary income or depreciation recapture from the deemed sale of the S corporation assets will be taxed to the trust on its Form 1041, unless the sales proceeds are paid out to the trust beneficiaries.

VII. New Simplified Procedure for Requesting Relief for Late S Elections.

On August 14, 2013, the IRS issued Rev. Proc. 2013-30 providing new automatic relief for:

(i) late S elections;
(ii) late ESBT elections;
(iii) late QSST elections; and
(iv) late Q-Sub elections.

This new Revenue Procedure modifies and supersedes all of the other Revenue Procedures that relate to late S election relief. And, user fees do not apply for requests submitted under the new Rev. Proc. 2013-30.

Under Rev. Proc. 2013-30, automatic late election relief will be available if all of the following requirements are met:

1. The requesting entity intended to be an S corporation, ESBT, QSST or Q-Sub as of the date the election is intended to be effective (the "Effective Date");

2. The relief request is made within three (3) years and seventy-five (75) days after the Effective Date (except as otherwise provided below);

3. The failure to qualify as an S corporation, ESBT, QSST or Q-Sub was solely because the S election was not timely filed by the original due date of the election; and

4. In the case of request for relief for a late S Corporation election or Q-sub election,

(i) the requesting entity must have "reasonable cause" for its failure to make the timely election; and

(ii) the requesting entity must have acted diligently to correct the mistake upon its discovery.

In the case of a request for relief for an inadvertent invalid S corporation election or an inadvertent termination of an S corporation election ***due to the failure to make the timely ESBT or QSST election***, (i) the failure to file the timely election was inadvertent **<u>and</u>** (ii) the S corporation seeking relief acted diligently to correct the mistake upon discovery.

The Revenue Procedure also explains how to make the late relief election. The election can be made by attaching an election form (the "Election Form") to the **current year Form 1120-S**. Or, in the case of an S corporation that has not filed any Forms 1120-S for the tax year including the Effective Date **or** any year following the Effective Date, then the election form may be attached to the Form 1120-S for the year that included the Effective Date, as long as the Form 1120-S is filed within **three (3) years and seventy-five (75) days** after the Effective Date, and as long as all other delinquent Forms 1120-S are filed simultaneously and consistently with the relief request.

> **<u>Note:</u>** Previously, an S corporation could not avail itself of the simplified relief procedures (and instead it had to pursue a private letter ruling request) in those cases where the S corporation had failed to timely file all of its Forms 1120-S for the election year and for all years after the late election.

<u>Special Relief Rules Where All Returns Were Filed As An S Corporation</u>. In addition, under the new Revenue Procedure, relief does not have to be sought within the three (3) year and seventy-five (75) day deadline, in those cases where the following conditions are met:

1. The corporation failed to qualify as an S corporation solely because the Form 2553 was not timely filed;

2. The corporation and all of its shareholders reported their income consistent with S corporation status; and

3. At least six (6) months have lapsed since the date on which the corporation timely filed its tax return for the first year the corporation intended to be an S corporation and neither the corporation or any of its shareholders were notified by the IRS of a problem regarding the S corporation status within six (6) months after the date on which the Form 1120-S for the first year was timely filed.

VIII. <u>When Are Spouses Treated as Partners or Co-Owners</u>?

ECC 201235015 (issued by the IRS on August 31, 2012) reminds us that spouses, who co-own a business venture, can be treated either as partners of a partnership or as co-owners of a "qualified joint venture."

This distinction is important because if spouses owning a business together are treated as partners in a partnership, then they must file a Form 1065 to report all their business activities. The IRS will assess significant failure to file penalties (of $195 per partner per month) for which the Form 1065 goes unfiled (Section 6698). Also, the partnership will be subject to all the complex partnership tax rules.

On the other hand, in some cases, spouses who co-own a business, and who both materially participate in the business, can make a "qualified joint venture" election under Section 761(f) ("QJV Election") and can elect to **<u>not</u>** be treated as a partnership. To make the Section 761(f) QJV election, the spouses must file separate Schedule Cs (and file separate Schedules SE) to report their pro rata shares of income and expenses, based upon their percentage ownership in the qualified joint venture.

PART NINE
EMPLOYEES VS. INDEPENDENT CONTRACTORS

I. According to the IRS, A Worker Can Be an Employee in One Capacity and An Independent Contractor in Another Capacity.

In Information Letter 2012-0069, the IRS has advised that, where a professional consultant provides services for a company on two separate consulting projects in different capacities, it may be possible for that person to be both an employee with respect to one project and an independent contractor with respect to the other project. Of course, the "twenty factor" test would be applied separately to test the services being provided by the worker in each capacity.

II. Tax Court Finds That Construction Workers Are Employees And Not Independent Contractors; *Kurek*, TC Memo 2013-64 (February 28, 2013).

Mr. Kurek owned KMA Construction and KMA Construction hired construction workers, on a project-by-project basis, to perform various construction services. Mr. Kurek treated the workers as independent contractors, but the IRS took the position that the workers were employees.

The Tax Court agreed with the IRS. Although the workers could establish their own work hours and work schedules, and even though Mr. Kurek didn't specifically tell the workers how to perform their jobs, the Court held that based upon all of the following underlying factors, the workers were true employees and not independent contractors:

1. Employer Control. Here, Mr. Kurek monitored the quality of work and set deadlines for the work to be accomplished. Although Mr. Kurek did not tell the employees how to do their job, he had the right to right to fire them if he was dissatisfied with their work quality. This factor heavily favored employee status.

2. Supplying Materials and Tools. Although the workers provided their own small tools, Mr. Kurek provided all of the heavy construction equipment used by the workers. This factor favored employee status.

3. Opportunity for Profit or Risk of Loss. The workers were paid a flat fee for their work product and therefore the workers had no opportunity to realize a profit or suffer a loss from the venture. This factor favored employee status.

4. Ability to Discharge Workers. Although the workers were hired only on a "project-by-project basis," Mr. Kurek could fire any worker he was dissatisfied with. This factor favored employee status.

5. Whether the Workers' Services Were "Integral" With the Employer's Business. As this was a construction company, the projects could not have been completed without the services of the workers. Thus, they were integral to Mr. Kurek's business. This factor heavily favored employee status.

6. Whether The Relationship Was Temporary Or Long-Term. Here, the workers worked on a project-by-project basis and the workers were free to work for other construction companies. And indeed, many of the workers did work for other construction companies. The court held that this factor favored independent contractor status.

7. Intent of the Parties. Mr. Kurek and one of the workers testified that they honestly believed that their relationship was that of an independent contractor and thus this factor favored independent contractor status.

Based upon all of the foregoing, the court held that a majority of the factors favored employee treatment status.

III. **Masonry Workers Were Employees And Not Independent Contractors; *Atlantic Coast Masonry, Inc*. TC Memo 2012-233 (August 13, 2012).**

Atlantic Coast Masonry, Inc. was a masonry subcontractor that hired masonry workers to provide masonry services. The workers provided and used their own tools and were free to work for other competing masonry subcontractors.

However, the Tax Court ruled that a strong majority of the "20 factor common law test" supported treating the workers as employees and not independent contractors as follows:

(1) the masonry workers received their work instructions from the owners prior to starting the job;

(2) many workers only worked for Atlantic Coast;

(3) Atlantic Coast had the right to approve or disapprove of the masons' work;

(4) Atlantic Coast required eight hour work shifts and the workers were paid based upon their productivity;

(5) the masonry workers could be fired at any time;

(6) the workers had no opportunity to earn a profit or loss, regardless of whether the overall job was profitable or not;

(7) and perhaps most importantly, the masonry workers were an integral part of the business of Atlantic Coast.

<u>**PART TEN**</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>IRS's Power to Allocate Undesignated Payments to Non-Trust Fund Liabilities; *Westerman v. U.S., 112 AFTR 2d. 2013-50 (718 F. 3d 743) (June 27, 2013)*</u>.

Mr. Westerman was the owner and key officer of WestCorp., which failed to fully pay its employment taxes for the 1st and 4th quarters of 2000 or for the 1st, 3rd and 4th quarters of 2001.

Mr. Westerman was clearly liable for the trust fund tax obligations of WestCorp. under Section 6672. However, Mr. Westerman argued that the company had already satisfied much of the trust fund portion of its tax obligations for which Mr. Westerman otherwise would be personally liable. During the quarters in question, WestCorp. made the following five (5) payments:

1. $5,508.14 on February 24, 2000. WestCorp.'s Form 941 for the 1st quarter of 2000 listed a monthly tax liability of $5,508.14 for January 2000.

2. $4,704.94 on April 3, 2000. Again, WestCorp.'s Form 941 for the 1st quarter of 2000 listed a tax liability of $4,704.94 for February 2000.

3. $5,166.88 on December 11, 2000 which Mr. Westerman claimed was intended to satisfy WestCorp.'s November 2000 tax liabilities. However, WestCorp.'s 941 for the 4th quarter of 2000 listed a tax liability of $5,166.88 for October 2000.

4. $5,811.66 on April 19, 2001. WestCorp.'s 941 for the 1st quarter of 2001 listed a tax liability of $5,811.66 for March 2001.

5. $1,165.95 on December 27, 2001 which approximately equaled WestCorp.'s total employment tax liability for the month of November 2001.

Mr. Westerman contended that he had intended that each of those payments would cover the full trust fund and non-trust fund employment tax liability for those particular months within the corresponding quarters. Unfortunately, when Mr. Westerman submitted these five (5) payments to the IRS, he did not specifically instruct the IRS – either by writing on the check, enclosing a payment coupon with the check, or in a contemporaneous letter – to apply the payments in any particular manner. As a result, the IRS applied the tax payments toward

WestCorp.'s non-trust fund tax obligations for the quarter in which the payments were made, which increased the unpaid trust fund portion of each quarter's tax liability for which Mr. Westerman was liable.

The 8th Circuit Court of Appeals noted that the IRS's long standing policy is to apply any tax payment first toward non-trust fund tax liabilities unless the payor otherwise designates that the specific payment is to be applied only to trust fund tax liabilities. IRS Policy Statement P-5-14, reprinted in Internal Revenue Manual (IRM) Section 1.2.14.1.3. And indeed, there is a long standing judicial precedence confirming that, where a debtor has multiple debts owed to the same creditor, the debtor can specify that certain payments are intended to be submitted in satisfaction of certain specific debts. However, in those cases where the debtor fails to designate that a specific payment is intended to be applied toward a specific debt, the creditor is free to allocate that payment as the creditor so desires.

Mr. Westerman, however, argued that, although he did not ***affirmatively*** designate how the five payments were to be applied toward specific periods, in each instance the payment amount corresponded to the most recent tax liability for the preceding month. Therefore, Mr. Westerman argued that he had ***"impliedly"*** designated his payments to be credited to certain months.

The problem with Mr. Westerman's "implied" argument, however, was the fact that the checks were not submitted with any filed Forms 941, since the Forms 941 were filed separately. So, when it received payments from Mr. Westerman, the IRS could not have known that Mr. Westerman intended for those payments to be applied to specific liabilities shown on the separately filed Forms 941. And, the IRS could not have easily checked the Forms 941 to compare the liabilities for the various relevant months against the check deposits. So, the IRS was free to apply the payments as it so desired.

> **Observation.** This case reminds us that, when employment tax liabilities are accruing due to shortfall payments, the client should specifically note on the check, on a payment coupon, or in the accompanying letter that the client desires to apply the payments to specific periods or specific trust fund liabilities.

III. Even Outside Accountants Can Be Liable for the Section 6672 Penalty; *Erwin v. Commissioner, 111 AFTR 2d 2013-748 (February 5, 2013).*

This case reminds us that even an outside accounting firm can be liable for the Section 6672 penalty if the accounting firm handles the financial dealings of the taxpayer.

Buddy Light Accounting & Tax Services (the "Accounting Firm") managed the payroll and accounts payable functions for one of its clients, GC Affordable Dining ("GCAD"). The Accounting Firm learned that GCAD was delinquent in its payroll tax obligations. The Accounting Firm repeatedly warned GCAD that GCAD did not have sufficient funds to pay payroll and other creditors, as well as the IRS. However, the Accounting Firm continued to follow GCAD's instructions to issue payroll checks and pay certain other creditors.

Here, the Court held that, since the accounting firm had access to the GCAD operating accounts and had authority to draw from that account from time to time, the owners of the Accounting Firm should be held jointly and severally liable for the unpaid trust fund tax obligations. Here, there was no evidence that anyone at GCAD **prevented** the Accounting Firm partners from issuing checks to the IRS rather than to employees and other creditors.

IV. No Section 6672 Responsible Person Liability For Healthcare LLC's Financial Officer; *Comeaux v. U.S., 111 AFTR 2013-1029 (March 1, 2013)*.

Mark Comeaux worked for several healthcare companies. His primary function was handling billing matters for the medical practices. The Court granted Mr. Comeaux's summary judgment motion that he was not a responsible person based upon the following:

(1) he had no authority to make decisions regarding purchases, contracts or loans;

(2) he wasn't responsible for managing the day-to-day affairs of the business;

(3) he wasn't responsible for preparing or filing tax returns;

(4) he signed and issued payroll checks only infrequently, and only upon the express directive of other officers;

(5) he was not an officer or director of any of the related companies,

(6) he had no control over employees and had no authority to control distributions of payroll to employees;

(7) he had no authority or ability to pay payroll taxes relating to employees;

(8) when Mr. Comeaux issued payroll checks, it was only in emergency situations, and Mr. Comeaux had no authorization to use the electronic federal tax payment system to make federal tax deposits; and

(9) Mr. Comeaux had no authority to sign or issue tax forms or to prepare tax returns.

Clearly, therefore, Mr. Comeaux could not be a responsible person as defined in Section 6672.

V. <u>Construction Company Project Manager Held Liable For The Section 6672 Penalty Period, *Graham v. U.S*., 111 AFTR 2d 2013-1016 (February 28, 2013)</u>.

Mr. Graham was a construction manager and Vice President of a bankrupt construction company's successor called Underground Ventures (UV).

Mr. Graham served as vice president of UV, and often held himself out to third parties to be "co-owner and president" of UV. Mr. Graham was not an office guy, but instead spent most of his time working out in the field managing construction projects. However, during various business administrative meetings, where the officers discussed projects and payments of bills, Mr. Graham often offered his opinions as to which creditors should be paid.

Mr. Graham also had signature authority over the company's bank accounts and there was even a signature stamp which bore Mr. Graham's signature so that checks could be signed in his absence.

Indeed, Mr. Graham signed many checks on behalf of UV including payroll checks and expense reimbursement checks. One check, dated July 30, 2001, was made out to Whitney National Bank for $10,000 for "federal tax deposit" on behalf of UV. The check showed UV's federal employment identification number and stated "Trust Fund Portion Only 6/30/01".

After UV failed to satisfy some employment obligations, the IRS asserted Section 6672 liability against Mr. Graham. The Tax Court found that Mr. Graham was clearly a "responsible person" under Section 6672 in light of his significant authority within the corporation. Mr. Graham was vice president and held himself out to be co-owner and/or president to third parties.

Also, even though Mr. Graham did not manage the operations of UV's home office, he exercised significant decision-making authority over offsite operations as the company's construction manager. In addition, Mr. Graham had signature authority over the bank account and had at least some power to decide which creditors to pay and when. Mr. Graham also had authority to hire and fire employees.

Based upon all these factors, the court found that Mr. Graham clearly was a "responsible person" under Section 6672.

Next, the court considered whether or not Mr. Graham "willfully" failed to cause taxes to be paid. Here, the court noted that, although Mr. Graham knew that UV's predecessor had filed for bankruptcy prior to the formation of UV, it was not clear as to whether or not Mr. Graham knew that there were unpaid withholding taxes.

Nonetheless, the court held that Mr. Graham had acted with "reckless disregard" in ignoring the company's payroll tax delinquencies. Most importantly was the fact that Mr. Graham signed the July 30, 2001 check for "federal tax deposits" which showed that the check was to be made for the "trust fund portion only". Indeed, Mr. Graham had been in the construction business before and understood that payroll tax payments had to be made.

Therefore, the court found that Graham had constructive, if not actual, knowledge that the company was not complying with its payroll tax obligations.

VI. <u>IRS Reminds Employers, Who Outsource Payroll Functions, That They Are Still Responsible for Unpaid Payroll Taxes</u>.

In FS-2013-9 (July 2013), the IRS issued a Notice warning employers who outsource payroll functions. The Notice acknowledged that many employers choose to use third party payroll companies to handle payroll functions and that many of these third party payors have absconded with funds belonging to the employer. As a result, a number of employers have found themselves faced with substantial payroll tax debts owed to the IRS. The IRS warns employers, however, that it is the responsibility of the employer to take steps to insure that the third party payors satisfy tax payment obligations, since the employer is ultimately responsible for any payroll tax non-payments.

<u>PART ELEVEN</u>
IRS LIENS AND FORECLOSURES

I. <u>Nominee and Transferee Liability Rules</u>.

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

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

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

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

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

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

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

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

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

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

C. Nominee Liability: Taxpayer Could Not Escape Tax Lien by Transferring Property to a "Nominee;" U.S. vs. Jones, 109 AFTR 2d 2012-1072 (February 17, 2012).

In U.S. vs. Jones, 109 AFTR 2d 2012-1072 (February 17, 2012), Mr. and Mrs. Jones owed millions of dollars of tax debts. The IRS ultimately filed tax liens against the Jones' property. At various times, Mr. and Mrs. Jones transferred various properties to certain trusts and to other nominees.

The IRS then filed federal "nominee" tax liens and the IRS then sought to foreclose on the properties. In allowing the foreclosure sale to proceed against the nominees, the Court noted that, notwithstanding the Jones' transfer of the properties:

(i) the Joneses still acted and operated as the owners of those properties;

(ii) many of the transfers happened after the tax liens were already filed; and

(iii) worse, many of the transfers were made for no adequate consideration and the transfers were made to family members or to entities controlled by family members.

This case is notable in that it articulates a six (6) factor test often applied by the courts to review whether the IRS can assert **nominee liability**:

(1) No consideration paid by the nominee;
(2) Debtor continues to exercise control over transferred property;
(3) Close relationship between transferor and nominee;
(4) Failure to record conveyance;
(5) Retention of possession by debtor; and
(6) Continued enjoyment of property by debtor.

Note: Also, the transferee-nominees could not qualify as Code Section 6323(a) "protected" purchasers. Section 6323(a) protects a "purchaser" who pays full and adequate consideration for a taxpayer's property prior to the IRS filing a Notice of Federal Tax Lien. For this purpose, the term "adequate and full consideration" means consideration that has a "reasonable relationship to the true value of the interest in the property acquired." Section 301.6323(h)-1(f)(3); U.S. vs. McCombs 30 F3d 310 (2nd Cir. 1994).

II. IRS Asserts Nominee Tax Lien on Assets of a Single Member LLC; *Berkshire Bank v. Town of Ludlow, 111 AFTR 2d 2013-498, 708 F3d 249 (January 11, 2013).*

Mr. Livermore owned 15 acres of undeveloped land that he wanted to develop as a residential subdivision.

Ultimately, Mr. Livermore formed a single-member LLC, called WAL Development, LLC ("WAL"), and transferred the property to the new LLC. Later, Mr. Livermore racked up huge tax deficiencies, due in part from income generated from WAL.

In 2009, the IRS assessed a "nominee tax lien" against the assets of WAL, and in 2010, the City of Ludlow recorded a judgment lien against the assets of WAL. The Court concluded that the nominee tax lien was valid and thus had priority over the judgment lien in favor of the City of Ludlow.

The Court looked at the following factors, often applied by the Courts, to determine whether the owner of the property (WAL) could be treated as the "nominee" of the taxpayer as follows:

(1) The lack of consideration paid by the titleholder;

(2) A close relationship between the taxpayer and the title holder;

(3) The control exercised over the property by the taxpayer while title is held by another;

(4) The use and enjoyment by the taxpayer of the property titled to another;

(5) Lack of interference in taxpayer's use of property by titleholder;

(6) The use of property or funds titled to another to pay the taxpayer's personal expenses;

(7) Whether the taxpayer exercises dominion and control over the property, or treats it as if it belongs to him; and

(8) Whether title was placed in the record owner's name as a result of or in anticipation of the taxpayer's liability.

Here, the Court noted that Mr. Livermore had properly recorded a deed transferring the property to WAL, that WAL had always been maintained as a valid Massachusetts LLC, that Mr. Livermore had kept records of WAL's transactions and that he kept these records separate from his personal records. Also, Mr. Livermore's attorney kept a "corporate book" for the LLC and Mr. Livermore had maintained a separate bank account for WAL.

The problem here was that many of the other factors favored the IRS. For example, Mr. Livermore kept the WAL bank account titled in Mr. Livermore's name, and he frequently transferred funds from this account to his personal bank account. The Court stated:

> We do not wish to suggest, as Ludlow fears, that a single-member, single-purpose LLC can never escape nominee status for purposes of a federal tax lien. But under the circumstances presented here, there was simply too much intermingling of funds and too close of a relationship between Livermore and WAL for us to conclude that WAL was anything other than "a legal fiction."
>
> **Note:** This case reminds us of how critically important it is that we meticulously maintain the separate existence and observe corporate formalities.

PART TWELVE
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).

1. 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.

2. <u>May Apply Even Where Requesting Spouse Knew or Should Have Known of Tax Underpayment or Tax Understatement</u>. 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.

II. <u>New IRS Revenue Procedure Provides New Guidance For Equitable Innocent Spouse Relief Requests; Rev. Proc. 2013-34</u>.

A. <u>New Revenue Procedure 2013-34</u>. The IRS recently issued Rev. Proc. 2013-34 which was designed to replace all earlier revenue procedures outlining how the Service is to approach equitable innocent spouse relief requests. The new revenue procedure makes significant changes to the earlier equitable spouse relief revenue procedures. The new revenue procedure places a tremendous amount of weight to the presence of spousal abuse, whether that be physical abuse or emotional abuse.

In addition, applying the knowledge factor has also changed. Now, under the new Revenue Procedure, the actual knowledge of an item giving rise to a "understatement or deficiency" will no longer be weighed more heavily than other factors, and this is especially true in cases where there is abuse involved. Also, the fact that the requesting spouse financially benefited from an understatement amount will not weigh against relief if the requesting spouse can show that abuse was present.

Moreover, if the non-requesting spouse significantly benefited from the underpaid amount and if the requesting spouse received little or no benefit from the underpayment, then this factor will weigh in favor of relief. And finally, a requesting spouse's subsequent compliance with the federal tax laws will also weigh in favor of relief (previously this factor was merely neutral).

B. <u>General Conditions for Relief</u>. In order to seek equitable relief under Code Section 6015(f), the following must be satisfied:

(1) The requesting spouse filed a joint return for the taxable year for which he or she seeks relief;

(2) Relief is not available to the requesting spouse under Code Sec. 6015(b) or Code Sec. 6015(c);

(3) The claim for relief is timely filed;

(4) No assets were transferred between the spouses as part of a fraudulent scheme by the spouses;

(5) The nonrequesting spouse did not transfer disqualified assets (under Code Sec. 6015(c)(4)(B)) to the requesting spouse;

(6) The requesting spouse did not knowingly participate in the filing of a fraudulent joint return; and

(7) The income tax liability from which the requesting spouse seeks relief is attributable (either in full or in part) to an item of the nonrequesting spouse or an underpayment resulting from the nonrequesting spouse's income. If the liability is partially attributable to the requesting spouse, then relief can only be considered for the portion attributable to the nonrequesting spouse. However, the IRS will consider granting relief regardless of whether the understatement, deficiency, or underpayment is attributable (in full or in part) to the requesting spouse if an exception (such as abuse) applies. (Rev. Proc. 2013-34, Sec. 4.01)

C. Streamlined Determinations. If the requesting spouse meets the seven (7) tests above, he or she will be eligible for "streamlined determination" where the requesting spouse also can establish that he/she (1) is no longer married to the non-requesting spouse, (2) would suffer economic hardship if relief is not granted, and (3) did not know or did not have reason to know the deficiency wouldn't be paid (although the third requirement doesn't have to be met where abuse or financial control is present).

And, if the requesting spouse is not eligible for the streamlined determination procedure, then the requesting spouse can still apply for innocent spouse relief under the "equitable relief factor test" of the Revenue Procedure.

PART THIRTEEN
OTHER IRS TAX PROCEDURES

I. You No Longer Need To Get A New EIN When Converting From A Multi-Member LLC To A Single-Member LLC. In the "Help - EIN Assistant" section of the IRS website, you can find valuable information as to when certain taxpayers (including corporations, partnerships, estates, trusts or limited liability companies) will be required to secure a new federal employer identification number as a result of some structural change. In the section dealing with limited liability companies, the IRS has advised that you do not need to secure a new federal EIN (1) where an LLC converts from a single-ember LLC to a multi-member LLC or (2) where a multi-member LLC converts to a single member LLC. You can access this section of the IRS website at https://sa1.www4.irs.gov/modiein/individual/help/help-toc.jsp.