2012 FEDERAL INCOME TAX UPDATE

December 5, 2012

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 2012, the IRS published its 2011 Internal Revenue Service Data Book (IR-2012-36), which contained audit statistics for the Fiscal Year ending on September 30, 2011. Here are the audit statistics:

A. Audit Rates for Individual Income Tax Returns. Only 1.1% of filed individual income tax returns were audited. Of these audited returns, only 25% of individual tax audits were conducted by Revenue Agents and the rest of the audits (about 75% 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 4.3% audit rate. For Schedule C returns, showing income over $200,000, around 3.8% of these returns were audited.

Total Individual Returns Audited 1.1%

(1) With Schedule C Income:
$100,000 to $200,000 4.3%
Over $200,000 3.8%

(2) Non-Business Income of:

$200,000 to $1 Million	3.2%
Positive Income Over $1 Million	12.5%

B. Audit Rates For Partnerships and S Corporations: For partnerships and S Corporation returns, the audit rate was only .4%.

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	1.6%
(2)	Assets $1,000,000 to $5 Million	1.9%
(3)	Assets $5 Million to $10 Million	2.6%
(4)	Assets Over $10 Million	17.6%

D. Offers in Compromise. The IRS received 59,000 offers in compromise, but only accepted 20,000 of them.

E. Criminal Case Referrals. According to the IRS statistics, the IRS initiated 4,720 criminal investigations for the fiscal year 2011, and of these, 3,410 ultimately resulted in prosecution, and of these, 2,350 resulted in convictions. For convictions, 81.5% were actually incarcerated.

PART TWO
SHAREHOLDER GOODWILL

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

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

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

Amounts Received for
Shareholder Goodwill: Capital gain and no employment taxes

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

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

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

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

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

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

Moreover, the purchase agreements also reflected that the shareholders were not "sellers" of the assets to the buyer, but instead were included in the sale documents only in their individual capacities as parties to the noncompete agreements. In addition, the shareholders (father and

son) were not required to enter into employment or consulting agreements which made it unlikely that the buyer was purchasing their personal goodwill.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> **Note:** What does this case teach us? In this case, Dr. Howard entered into a noncompete agreement with his C corporation (Howard Corporation) back in 1980, probably under the belief that the noncompete agreement would allow him to increase his deductible wages received from Howard Corp. However, when it came time to sell the corporation's assets, this noncompete agreement served to eliminate any argument that Dr. Howard owned shareholder goodwill.
>
> **Note**: So, whenever we have a professional practice that sells its assets, we need to make sure that there is no prior noncompete agreement in effect prior to the sale. If there is such a noncompete agreement, we will have a difficult time in proving that any payments to the shareholder constitute goodwill shareholder payments.

II. The "King Of Insurance," And Not His Corporation, Sold His Personal Shareholder Goodwill; H&M, Inc. v. Commissioner, TC Memo 2012-290 (October 15, 2012).

In H&M, Inc. v. Commissioner, TC Memo 2012-290 (October 15, 2012), Mr. Schmeets' C Corporation sold all of its assets in an asset sale. H&M, Inc. was an insurance agency.

Prior to the sale, Mr. Schmeets had acquired vast experience in operating all aspects of the insurance business, including accounting, management and employee training. He had also become an expert in all types of insurance lines.

Under the terms of the Asset Purchase Agreement, the buyer purchased all customer lists for $20,000. The Asset Purchase Agreement was contingent on Mr. Schmeets agreeing to a non-compete agreement and an Employment Agreement which would obligate Mr. Schmeets to work with the buyer for six years. The Employment Agreement provided for a modest annual base wage of around $39,000, but also possible "annual variable compensation" based upon the buyer's future profitability.

For the six years after the asset sale, Mr. Schmeets received over $600,000 of wage compensation under the terms of the Employment Agreement. The IRS sought to re-classify the wage income under the Employment Agreement as additional sales proceeds for the sale of H&M assets.

The Tax Court held that the payments paid by the buyer, under Mr. Schmeets' Employment Agreement, were not disguised payments to H&M for its customer lists and goodwill. The Court noted that, before the sales and while he worked for H&M, Mr. Schmeets had been called by some of his competitors the "King of Insurance." Also, when sales negotiations initially began, Mr. Schmeets was most concerned with obtaining guaranteed employment with the buyer after the sale transaction.

Also, after the sale, and during his six year employment term, Mr. Schmeets' employment went from a forty (40) hour work week before the sale to almost double that after the transaction. And, after the end of the six year employment term, Mr. Schmeets continued to manage the buyer's insurance agency business under year to year contracts.

PART THREE
DETERMINING TAXABLE INCOME

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

The case of Flood v. Commissioner, TC Memo 2012-243 (August 27, 2012) reviewed the age old issue of whether the taxpayers held real property for investment or as inventory in their capacity as dealers.

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

(i) Section 1031 nontaxable exchanges;

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

(iii) Section 453 installment sale reporting.

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

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

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

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

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

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

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

Accordingly, a taxpayer’s position, that an investment in real estate is merely being disposed of in the most economically profitable manner is a sustainable argument, despite the

taxpayer's engagement in activities traditionally conducted by a real estate dealer, provided that the taxpayer otherwise manages his property holdings in a manner substantially similar to that of an investor. Further, the taxpayer must be careful not to reinvest in substantially similar property shortly after the liquidation of the investment if he seeks to avoid ordinary income characterization.

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

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

B. Factors Reviewed By The Courts. The Court in Ada Belle Winthrop, (CA-5) 24 AFTR 2d 69-5760, rev'g (DC) 20 AFTR2d 5477, (October 22, 1969) established a set of criteria which have been cited frequently by the courts addressing these dealer vs. investor arguments. In the order of frequency cited in other cases, these seven factors, known as the "seven pillars of capital gain," are as follows:

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

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

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

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

C. Garrison vs. Commissioner, TC Memo 2010-261 (December 1, 2010); Sales of Real Property Produce Ordinary Income and Not Capital Gains, Since the Taxpayers Were Dealers and not Merely "Investors". The Tax Court held that proceeds of sales of real property that a mortgage banker and his spouse bought and sold in a relatively short period of time to support and supplement their other income would be taxable as ordinary income and not capital gains. This court case involved the **1998 and 1999** tax years. During these years, the taxpayers regularly purchased and sold real estate within short periods of time.

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

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

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

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

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

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

D. Gardner vs. Commissioner; Contractor Treated As An Investor (And Not As A Dealer); Gardner, TC Memo 2011-137 (June 20, 2011). In the case of Gardner, TC Memo 2011-137 (June 20, 2011), Mr. Gardner purchased a parcel of real estate with a plan that he would build multi-family projects on the land to generate future rental income. When Mr. Gardner purchased the tract in 2004, the tract had been approved for subdivision into five (5) lots. However, as a result of financial issues, Mr. Gardner decided to sell three lots from the subdivided tract, at a short term capital gain of over $370,000.

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

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

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

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

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

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

E. <u>Day Trader Was Also a Property Dealer; Flood v. Commissioner, TC Memo 2012-243 (August 27, 2012)</u>.

In <u>Flood v. Commissioner</u>, TC Memo 2012-243 (August 27, 2012), during the 2004 and 2005 tax years, Mr. Flood was a "day trader" in the stock market. Mr. and Mrs. Flood also operated a real estate venture which involved the purchase and sale of vacant lots. Mr. and Mrs. Flood did not subdivide the lots nor did they construct houses on the lots they purchased. From 2001 to 2008, Mr. and Mrs. Flood purchased at least 250 lots. During 2004, they sold two lots, and during 2005 they sold forty (40) lots.

The issue before the Tax Court was whether or not Mr. and Mrs. Flood held the lots "primarily for sales to customers in the ordinary course of business." If so, all of the gain would be ordinary income rather than capital gain income.

The Tax Court held that the Floods held the lots for inventory, and not for investment purposes, based upon the following factors:

(1) <u>The purpose of acquiring and holding the properties</u>. Mr. Flood claimed that he only sold lots to pay real estate taxes, and noted that he only sold a small number of lots in 2004 and 2005 when compared to the larger number of lots that they still held for resale. The Court noted, however, that even though they only sold a few lots during the years at issue (42 lots total), the Floods earned an enormous gain of over $1 Million on their sales. The Court also noted that the remaining lots not sold in 2004 and 2005 had relatively low value compared to the lots sold in 2004 and 2005.

(2) <u>The nature of the taxpayer's every day business</u>. The Floods argued that their everyday business was not being in the sale of real estate since Mr. Flood was a day trader. The Court noted, however, that the income from Mr. Flood's day trading activity was modest compared to the gains from their real estate ventures.

(3) <u>Frequency, continuity and substantiality of sales</u>. Again, the Floods only sold two lots in 2004 and forty lots in 2005. However, the two lots that they sold in 2004 had just been purchased in 2003. Of the forty lots that they sold in 2005, eleven lots had been purchased in 2001, fifteen lots had been purchased in 2002 and twelve lots had been purchased in 2003.

(4) <u>Development activities of the taxpayer</u>. Even though the Floods did not develop or improve the lots and did not use a business office for their activities, they put considerable time, effort and resources into their real estate ventures.

Accordingly, the Tax Court concluded that the Floods' real estate transactions were conducted in the ordinary course of a trade or business.

<u>Note</u>: However, the Tax Court did not uphold the assessment of accuracy-related penalties.

II. <u>When Does Cancellation of Debt Income Arise?</u>

In Kleber v. Commissioner, T.C. Memo 2011-233 (September 28, 2011), Ms. Kleber entered into an agricultural lease with the Department of the Navy. The lease was to run from January 1, 1997 to December 31, 2001. Under the lease, Ms. Kleber was obligated to pay over $190,000 of annual rent to the Department of the Navy. Ms. Kleber stopped the rental payments after August 1998, and in December 1998, Ms. Kleber advised the Navy that she would no longer be able to continue her farming operations on the leased property.

In January 1999, the Navy sent Ms. Kleber a letter advising her that it was terminating her lease and demanded that she pay past due rent of over $190,000. The Department of the Navy continued to send demand letters to Ms. Kleber up through April 1999.

No other debt collection activities took place, and on November 22, 2005, the Navy decided to write-off Ms. Kleber's debt. In 2006, the Navy issued Ms. Kleber a Form 1099-C, Cancellation of Debt, reflecting cancellation of debt income of over $260,000. The IRS assessed additional tax deficiencies on October 14, 2006 regarding the Kleber's 2005 tax return.

Ultimately, the Tax Court held that, under the "identifiable event test," the debt cancellation did not actually occur when the Department of the Navy decided to write off Ms. Kleber's debt in 2005. Instead, under the "36 month testing period" rule, there is a rebuttable presumption that an "identifiable event" has occurred during a calendar year if the creditor has not received a payment on an indebtedness at any time during the 36 month testing period ending on the close of that year. Reg. 1.6050P-1(b)(2)(iv). However, the 36 month testing period rule **does not apply** if the IRS can show that the creditor was engaged in significant bona fide collection activity at any time during the twelve month period ending at the close of the calendar year, or if the facts and circumstances existing as of January 1 of the calendar year following expiration of the 36 month period indicate that the indebtedness has not been discharged.

Here, the Navy stopped sending demand notices to Ms. Kleber in April 1999, and therefore there was a rebuttal of presumption that the "identifiable event" occurred in 2002 (under the "36 month testing period" rule) and thus that would be the year that the COD would have to be recognized.

The Court also noted that the term "significant bona fide collection activity" does not include ministerial collection actions, such as sending out an automated mailing. Reg. 1.6050P-1(b)(2)(iv)(A). Other facts and circumstances, indicating that the indebtedness has not been discharged, would include the filing of a lien or the sale of the indebtedness by the creditor. Reg. 1.6050P-1(b)(2)(iv)(B). Here, the IRS could not prove that the Navy had filed a lien against Ms. Kleber, or that it attempted to sell Ms. Kleber's debt, nor could the IRS point to any other collection activity on behalf of the Navy that would indicate that the Navy was pursuing collection actions against Mrs. Kleber.

So, under the "36 month testing period" rule, the "identifiable event" occurred in 2002 and, of course, by the time of trial, the statute of limitations on the IRS had already expired for the 2002 tax year.

Note: Also see Abarca v. Commissioner, TC Memo 2012-245 (August 27, 2012) where the Court determined that there was no cancellation of debt income for the year in question where, during the year in question the taxpayer received a letter from his lender stating that his loan had been "charged off," but that the Borrower "still remained obligated for payment of the debt."

Note: Also see Stewart, TC Summary Memo 2012-46 (May 21, 2012) where the taxpayer was able to rebut the presumption of correctness that attaches to a Form 1099 by presenting evidence that there had been no collection activity during the 36-month testing period.

III. A Terminated Life Insurance Policy Generated Gain On The Deemed Sale And Not Cancellation Of Debt Income; McGowen v. Commissioner, 108 AFTR 2d 2011-6063 (September 2, 2011).

McGowen v. Commissioner, 108 AFTR 2d 2011-6063 (September 2, 2011), involved a variable life insurance policy that terminated with significant outstanding policy loans.

In May 1986, Ms. McGowen purchased a "single premium" variable life insurance policy for a single premium of $500,000. The single premium funds were invested in the insurance policy, and investment gains were added to increase the life insurance policy's value over time.

Over time, Ms. McGowen borrowed against the policy, and by February 2004, the debt on the policy was over $1 Million - which exceeded the cash surrender value of the policy by $2,000.

The insurance company then sent a letter to Ms. McGowen advising her that the outstanding debt on the policy had exceeded its cash value and that Ms. McGowen would have thirty (30) days to make a minimum loan repayment of over $100,000 if she wished to keep the policy in force. Ms. McGowen decided not to make the required loan premium payment and the policy then lapsed.

The life insurance company then sent a termination notice to Ms. McGowen and advised that, as a result of the termination of the policy, Ms. McGowen had a taxable gain of $565,000, which was equal to the policy debt of $1,065,000 less Ms. McGowen's income tax basis in the policy ($500,000). The life insurance company then sent a Form 1099-R to Ms. McGowen reflecting the $565,000 taxable gain.

The McGowens then filed a 2004 joint tax return and claimed that the $565,000 gain was not attributable to the termination of a life insurance policy, but instead was "discharge of indebtedness" income (COD income) which they claimed was excludable from taxable gross income under the "insolvency exception" of Section 108. Under the Section 108 insolvency exception, cancellation of debt income is non-taxable if the taxpayer is insolvent as of the date of the debt forgiveness.

The Tax Court, however, applied the Section 72(e) rules, rather than the Section 108 rules. Under Section 72(e), taxpayers must include, as taxable gross income, any amount received under a life insurance contract. Here, the McGowens essentially used the cash value of the policy to pay off the debt, and thus they were taxed to the extent that the value of the policy exceeded their income tax basis in the policy, thus generating gain under Section 72(e).

> **Note**: By failing to make $100,000 loan repayment, the McGowens ended up paying over $175,000 in taxes on the surrender of the insurance policy.

Also see White, TC Summary Opinion 2012-108 (Oct. 31, 2012).

IV. Long Term Care Rider To An Annuity Contract Was "Insurance" Such That Long Term Care Benefits Will Be Non-Taxable.

In Private Letter Ruling 201213016 (March 30, 2012), the IRS considered whether a long-term care insurance rider, purchased as part of an annuity contract, would be excludable from taxable income. In this case, the taxpayer purchased an annuity that contained a long-term care benefit insurance rider that would pay long-term care benefits if the owner became chronically ill (the "LTC Rider"). In this Private Letter Ruling, the IRS ruled that the LTC Rider was indeed "insurance" and that any amounts payable under the long term care rider would be excludable from gross income under Section 104(a)(3).

V. IRS Provides Sample Language For Making A Code Section 83(b) Election.

A. Background. Section 83(a) provides the general rule that, a grant of stock or equity to an employee or independent contractor is current taxable income to the employee/independent contractor. However, if the stock/equity award is subject to a "substantial risk of forfeiture," then the employee/independent contractor will not recognize Section 83 taxable income until the substantial risk of forfeiture lapses. Nevertheless, where the stock/equity award is subject to a "substantial risk of forfeiture," the employee nevertheless may make an election (called a Section 83(b) election) to have the value of the stock/equity award currently taxed to the employee based upon the value of the stock/equity award at the date of grant.

The Section 83(b) election provides two potential tax advantages to the employee/independent contractor. First, the amount included in taxable income will be based upon the value of the stock/equity award at the date of grant, which may be substantially less than the value of the stock/equity value once the substantial risk of forfeiture lapses. Also, if the Section 83(b) election is made, then any future appreciation in the value of the stock/equity award will be taxed at capital gains rate, rather than at the ordinary income tax rates.

B. How To Make a Section 83(b) Election. In Revenue Procedure 2012-29 (June 26, 2012), the IRS has provided "sample" language that a taxpayer may use in making a Section 83(b) election for stock/equity awards that are subject to a "substantial risk of forfeiture." Under the Rev. Proc., the Section 83(b) election statement must include the following:

(1) a description of the property interest for which the election is made;

(2) the date of the transfer to the employee/independent contractor;

(3) the nature of restrictions to which the stock/equity award is subject; and

(4) the fair market value of the stock/equity award at the date of transfer.

Note: In order to make a valid Section 83(b) election, the employee/independent contractor must file the Section 83(b) election statement with the IRS within 30 days after the stock/equity grant is awarded.

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.

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.

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 recent case of Menard, Inc. vs. Commissioner, (March 10, 2009).

1. Facts of Menard. In the case of 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.

2. Tax Court Initially Rejects "Hypothetical Investor" Test In Favor of "Comparison Test." In Menard, the Tax Court disallowed a deduction of $13 million of the $20 million of compensation paid to John Menard, the CEO and owner of 89% of the taxpayer's stock. In that case, the Tax Court judge ignored the "hypothetical investor" test, but instead focused on language in Reg. 1.162-7(b)(3) which was not discussed in the Exacto Spring case. This regulation provides:

> In any event, the allowance for compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.

3. On Rehearing *Menard* Tax Court Insists on Using The Comparison Method While Referencing "Hypothetical Investor" Factors. On rehearing in Menard, T.C. Memo 2005-3 (January 6, 2005), the Tax Court refused to reconsider the earlier decision of the Tax Court in the Menard case. On rehearing, the Tax Court noted that the following factors indicated that the compensation amount was unreasonable:

1. No Dividends Ever Paid. The shareholders had never received **any** dividends;

2. The Existence of a Reimbursement Agreement. The corporation and the taxpayer had entered into a **reimbursement agreement** which provided that, should any portion of the compensation be found to be excessive, the employee would refund the excess compensation back to the corporate taxpayer (presumably in an attempt to reverse any constructive dividend); and

3. No Board of Director Evaluation. The Board of Directors never made any effort to evaluate whether the bonus would make Mr. Menard's total compensation excessive.

> **Note:** This case is a stark reminder that we cannot rely upon the "hypothetical investor" test to be the sole determination of whether compensation is reasonable. Instead, we must be prepared to fight the reasonable compensation test on the following two prongs: (1) does the compensation amount still provide the investors with a reasonable rate on their return, and (2) is the compensation "market" based upon all relevant factors.

4. 7th Circuit Court of Appeals. In the case of 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. Accounting Firm C Corporation's Consulting Fees Are Re-Characterized As Dividends Based Upon The "Reasonable Investor" Test; M*ulcahy v. Commissioner*, 109 AFTR 2d 2012-2140 (May 17, 2012).

In the case of M*ulcahy v. Commissioner*, 109 AFTR 2d 2012-2140 (May 17, 2012), the Mulcahy accounting firm operated as a C corporation. The accounting firm's tax return reflected

that, during the 2001 tax year, the three founding members of the CPA firm received salary compensation of over $230,000. The IRS did not challenge the salary deductions.

However, the IRS and the Tax Court disallowed more than $850,000 in "consulting fee" deductions that the CPA firm paid to three entities owned by the founding members, and recharacterized these "consulting fees" as dividends to the founding members. The accounting firm argued that the consulting fees should be treated as deductible compensation paid to the founding owners.

The 7th Circuit Court of Appeals upheld the decision of the Tax Court.

The Court ruled that, even though the accounting firm was a personal service corporation, that relied upon the talents of its owners, the corporation also had significant capital: the accounting firm had over 40 employees and multiple offices in different locations and therefore it needed a significant capital structure to support its large operation. Also, the corporation had significant capital in the form of client lists and other intangible assets.

According to the Court of Appeals, the large consulting fee deduction of $850,000 would practically "zero out" the accounting firm's income for the year, thus providing its shareholders with virtually no return on their investment for that year. Therefore, the consulting fees had to be recharacterized as non-deductible dividends under the "independent investor" test because there was no rate of return left over to provide the owners with a reasonable rate of return on their capital investment in the C corporation.

> **Note**: The Court of Appeals questioned what the C corporation received in exchange for the consulting fees and even at one time the court seemed to imply that it believed the consulting fees may have been paid to the related entities in order to disguise those payments from the accounting firm's other shareholders.

PART FIVE
DEDUCTIONS

I. A Charity's Faulty Letters of Acknowledgement Results in Denied Charitable Contribution Deductions.

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

B. Durden. In Durden, TC Memo 2012-140 (May 17, 2012), Mr. and Mrs. Durden were denied charitable contribution deductions for cash donations of $250 or more to their church, because the letters of acknowledgement from their church did not satisfy the substantiation requirements of Code Section 170(f)(8).

In 2007, the Durdens made various contributions to their church by check. At the Tax Court trial, the Durdens provided copies of the cancelled checks for 2007 together with two Letters of Acknowledgement from their church. The first acknowledgement letter, dated January 10, 2008, acknowledged their 2007 charitable contributions but did not indicate whether any goods or services were provided to the Durdens in exchange for their contributions. The second acknowledgement letter, dated June 21, 2009, contained a statement that no goods or services were provided to the Durdens in exchange for their contributions.

Here, the Court ruled that, while the first acknowledgement letter (dated January 8, 2008) was "contemporaneous" with their 2007 contributions, that letter was defective because that first letter failed to state whether the Durdens received any goods or services in exchange for their contribution. And, the second letter (dated June 21, 2009), which confirmed that the Durdens did not receive any goods or services in exchange for their contributions, nevertheless failed to meet the requirements of Section 170(f)(8) since that second letter was not sent contemporaneous with the timing of the 2007 contributions.

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

I. Background.

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 capital gain 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 not evidenced by a note, there is no sale or exchange when the debt is repaid, and therefore the S corporation shareholder-creditor recognizes ordinary income 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.

(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 "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. **[CITE]** 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

I. At- Risk and Passive Activity Loss Rules. Another Taxpayer Caught in the "Self-Rental" Passive Activity Loss Rules - And Cannot Offset Other Passive Rental Losses by Rental Income Generated From Rents To a Closely Held Corporation In Which Taxpayers Materially Participate.

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

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

B. Review of Self-Rental Rules. In connection therewith, Regulation 1.469-2(f)(6) provides that:

> An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity if the property . . . [i]s rented for use in a trade or business activity. . . in which the taxpayer materially participates . . . for the taxable year.

This regulation is known as the "self rental rule" and effectively characterizes, as **non-passive income**, any income generated from rentals to an activity in which the taxpayer materially participates.

C. <u>In Some Cases, Rental Activities May Be Aggregated And Treated as One Activity</u>. Section 469(d)(1) defines "passive activity loss" as the amount by which the aggregate <u>losses</u> from all passive "activities" exceed the aggregate <u>income</u> from all activities. Section 469, however, does not define the term "activity". However, Regulation 1.469-4(c) sets forth rules for grouping tax items together to determine what constitutes a "activity". That Regulation 1.469-4(c) provides:

> One or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of Section 469. Whether activities constituted "appropriate economic unit" depends on facts and circumstances.

However, as the <u>Carlos</u> and <u>Beecher</u> cases (discussed below) illustrate, the self-rental recharacterization rule will often serve to cause rental income to be recharacterized as non-passive income which cannot be used to offset other rental losses, even if the two activities otherwise could be "aggregated" and treated as one activity under Reg. 1.469-4(c).

D. <u>Non-Passive Income from Self Rental Activity Can't Offset Other Rental Property Passive Losses</u>. In <u>Beecher v. Commissioner</u>, 99 AFTR 2d 2007-1807 (March 23, 2007) Mr. and Mrs. Beecher were husband and wife. Mr. Beecher owned Cal Interiors, Inc., which was a C corporation that engaged in the business of repairing automobile interiors. Mrs. Beecher wholly owned S&C Dent Corp, also a C corporation, that engaged in the business of removing dents from automobiles.

Both Mr. and Mrs. Beecher worked full time for these two C corporations and thus materially participated in the activities of the C Corporations. Both C corporations' offices were located in the Beecher's home. Both C corporations paid Mr. and Mrs. Beecher rent for the corporations' use of this home office space in the Beechers' home.

In addition to renting this portion of their home to their two C corporations, Mr. and Mrs. Beecher also owned five (5) rental homes.

On their 1997, 1998 and 1999 tax returns, the Beechers reported net income from the leases of their home office space to their two C corporations. However, during these same years, Mr. and Mrs. Beecher also yielded net losses from their other five rental properties. In fact, their combined rental losses from the five rental properties exceeded the rental income derived from the leases of the home office space to Cal Interiors and to S&C Dent Corporation. As a result of this combination of income and losses, Mr. and Mrs. Beecher paid no income tax on the rental income paid to them by their C corporations.

The IRS audited the Beechers' returns and disallowed the net rental losses by taking the position that the Beechers could not offset their rental income from their C corporations against the rental losses from their rental properties. The Tax Court held that the rental income from the leases of the home office space was non-passive income pursuant to the **"self-rental rule" of Treasury Regulation 1.469-2(f)(6)**. This was based on the Tax Court's determination that the

Beechers materially participated in the business activities of their two C corporations, which were lessees from the Beechers.

Thus, the net income from the leases of the office in the home to their two C corporations could **not** be offset by the losses from the five other rental properties.

The 9th Circuit Court of Appeals upheld the decision of the Tax Court.

E. And Worse Yet, Self Rental Income Is Non-Passive, But Self Rental Loss Is Passive, and Thus The Two Cannot Offset Each Other. Carlos v. Commissioner, 123 T.C. No. 16 (September 20, 2004). In Carlos, Mr. Carlos owned 100% of the stock of two S corporations. One S corporation was a steel company and the other S corporation was a restaurant company. Mr. Carlos also owned two commercial pieces of property. One piece of property was rented to the steel company and one piece of property was rented to the restaurant.

During the 1999 and 2000 tax years at issue, Mr. Carlos earned net rental income from the rental of property to the steel company, but had a net loss from renting property to the restaurant. On his tax return, Mr. Carlos offset his rental losses from the restaurant leasing operation to offset and decrease his net rental income from the rental to his steel corporation.

Mr. Carlos argued that he could "group" the rental properties together to constitute a single "activity". The IRS, of course, disallowed the deductions. Notwithstanding that the two leasing activities constituted an "appropriate economic unit" under Section 1.469-4(c)(1), the IRS argued that Mr. Carlos improperly computed his passive activity loss within this "activity" grouping.

The Tax Court noted that, while the general rule of Section 469(c)(2) characterizes all rental activities as passive, Section 1.469-2(f)(6) requires that net rental income (but not rental loss) received by the taxpayer, for rental of the taxpayer's property to a business in which the taxpayer materially participates, shall be treated as non-passive income. This is often called the "self rental rule" or the "recharacterization" rule. According to the Tax Court, therefore, the net rental income arising from the rental of the steel company property should be recharacterized as "non-passive" since it was being leased to a business (the steel corporation) in which Mr. Carlos materially participated. After giving effect to the recharacterization or self-rental rule, Mr. Carlos was then left with no "passive" income which could be used to offset his passive losses from the rental to the restaurant.

F. Apply the "Self Rental" Recharacterization Rules Before You Apply the Aggregation/Grouping Rules. According to the Courts in Beecher and Carlos, the activity grouping rules do not bring into application the rules of Regulation 1.469-2(f)(6), since the Section 1.469-2(f)(6) regulations must first be applied to determine whether the rental activity is a passive or non-passive activity. Thus, this self-rental recharacterization test must **first** be applied to the determine the extent of any "non-passive income" or "passive loss" **before** applying the grouping activity rules. In other words, the activity grouping rules only apply **after** income or losses is determined to be passive or non-passive. Thus, no "netting" was allowed for the non-passive income against the passive loss.

G. More on Grouping and Aggregating Activities; Leasing Enterprise and Business It Rented To Are Treated as a Single Activity for PAL Rules: Candelaria vs. U.S. (October 5, 2007). The District Court for Texas in Candelaria held that the leasing enterprise and the business enterprise could be combined or "aggregated" for passive activity loss purposes since the leasing enterprise was "insubstantial" to the business enterprise. As a result, the losses incurred by the leasing enterprise were not "passive" losses for purposes of Section 469.

Reg. 1469-4(d) provides:

> (1) *Grouping rental activities with other trade or business activities* - (i) Rule. A rental activity may not be grouped with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit under paragraph (c) of this section and -
>
> (A) The rental activity is insubstantial in relation to the trade or business activity;
>
> (B) The trade or business activity is insubstantial in relation to the rental activity; or
>
> (C) Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.

Unfortunately, however, the regulations to Section 469 do not define what is meant by the term "insubstantial" in the context of comparing rental and other business activities. In Candelaria v. U.S. (100 AFTR 2d 2007-5378, October 5, 2007), the District Court concluded that the Equipment LLC and Medical Practice may be grouped as an appropriate economic unit because the Equipment LLC rental activity was "insubstantial" to the Medical Practice's business activities.

II. Tax Court Rules That Rental Income Should Be Re-Characterized As Non-Passive Income Under The "Self Rental" Rules; *Veriha*, 139 TC No. 3 (August 8, 2012).

In *Veriha,* 139 TC No. 3 (August 8, 2012), Mr. Veriha was the sole owner of John Veriha Trucking Inc. (JVT), a C corporation. JVT was a trucking company that employed Mr. Veriha and his wife. During the 2005 tax year, Mr. Veriha materially participated in the business of JVT.

JVT leased its trucking equipment from two different entities, Transportation Resources, Inc. (TRI) and JRV Leasing, LLC (JRV). TRI was an S corporation owned by Mr. Veriha and his father. JRV was a single member LLC owned solely by Mr. Veriha.

During the 2005 tax year, TRI generated net income which it reported to Mr. Veriha on a Schedule K-1 from the S corporation, and the Verihas treated this income as "passive income" on their tax return. During that same year, JRV generated a net loss, as reported on the Verihas Schedule C, and the Verihas treated the loss as a "passive loss" on their tax return.

The IRS took the position that the Verihas' TRI income should be re-characterized as "non-passive" income under the "Self Rental Rules" of Regulation 1.469-2(f)(6). This meant that the Verihas could not offset their income from TRI by their losses generated from JRV.

Reg. 1.469-2(f)(6) treats as "non-passive" the rental income from an "item of property" rented to another business in which the taxpayer materially participates. The Verihas argued that all of their tractors and trailers were a single "item of property" since Mr. Veriha owned 99% of TRI and all of JRV.

The Tax Court, however, ruled that each individual tractor or trailer was a "separate item of property" under Reg. 1.469-2(f)(6). The Court noted that the Verihas had decided to hold their fleet of tractors and trailers under two different entities and that each separate item of property was leased under a separate lease agreement.

> **Note:** The IRS did not challenge the Verihas's netting of gains and losses within TRI, but only treated the net income from TRI as non-passive income.
>
> **Note**: A different result might have arisen if all of the tractors and trailers were owned by a single entity (rather than by two entities) and if the Verihas has entered into one single lease agreement between the leasing company and their C corporation.

PART EIGHT
S CORPORATIONS AND PARTNERSHIPS

I. Tax Planning for S Corporations Who Might Be Heading Into Bankruptcy; Majestic Star Casino, LLC, 109 AFTR 2d 2012-698 (January 24, 2012).

Majestic Star Casino, LLC, 109 AFTR 2d 2012-698 (January 24, 2012) involved an S Corporation that filed an election with the IRS to revoke its S election after it filed for bankruptcy. By revoking the S election, the S Corporation shareholders would have been able to shift a $2.6 Million tax liability back to the corporation by virtue of the S election revocation, which would have been effective as of the end of the prior tax year. This meant that the corporation, rather than the S corporation shareholders, would have been liable for $2.6 Million of tax for the tax year.

The Bankruptcy Court, however, rejected the revocation of the S election on several grounds. First, the court noted that the S Corporation did not seek the prior authorization from the Bankruptcy Court to revoke its S election. Next, the Court held that the debtor's status as an S Corporation was "property of the bankruptcy estate" and therefore by revoking the S election, the S Corporation made a property interest transfer that could be voided by the Bankruptcy Court. Therefore, the Bankruptcy Court was able to undo the S status revocation because the revocation occurred after the bankruptcy filing and was not authorized by the Bankruptcy Court.

II. Stock and Loan Basis Limitations on Deducting S Corporation Losses.

A. Background and Introduction. An S Corporation shareholder may deduct his/her pro rata share of any losses sustained by the S Corporation, but these loss deductions will be limited to the sum of (1) the shareholder's adjusted tax basis in the stock **plus** (2) any corporate indebtedness actually owed to the shareholder. IRC Section 1366(d)(1). As many past Court cases have held, a loan made to an S Corporation by an outside lender will not increase the S Corporation shareholder's basis in the stock, even if the shareholder guarantees the bank loan or pledges personally-owned assets to secure the loan. In order to obtain tax basis, the S Corporation shareholder must make an "economic outlay" to the S Corporation.

B. The "Economic Outlay" Requirement. Hafiz v. Commissioner, TC Memo 1998-104 (March 16, 1998). In the case of Hafiz, Mr. Hafiz secured a loan from the bank to the S Corporation. The bank proceeds were used to purchase real property in the name of the S Corporation. The shareholder pledged all of his personally-owned assets to secure the bank loan. The shareholder also was a co-maker of the S Corporation's note issued back to the bank.

After the loan, the S Corporation suffered financial reversals and recognized significant operating losses. The taxpayer sought to deduct these losses on his personal income tax return on the basis that his tax basis in his S Corporation stock should increase as a result of the S Corporation indebtedness to the bank. The Tax Court, however, held that there was no "economic outlay" on the part of the shareholder, since he did not directly incur the bank indebtedness.

According to the Tax Court, no form of “indirect borrowing” will save the transaction, regardless of whether the shareholder is a guarantor or co-maker and regardless of whether or not the shareholder pledges individually-owned assets to secure the indebtedness. According to the Tax Court, the shareholder must make actual disbursements in the form of loans directly to the S Corporation.

C. Kerzner (2009); No S Corporation Stock Tax Basis Increase Allowed For Circular Loans - From Partnership to Shareholders to S Corporation and Back to the Partnership. In the case of Kerzner v. Commissioner, TC Memo 2009-76 (April 6, 2009), Mr. and Mrs. Kerzner were equal shareholders in an S Corporation, and were equal partners in a Partnership that leased partnership property to the S Corporation.

The Partnership borrowed money from a third party lender under a HUD loan. The Partnership obtained the HUD loan which was a **non-recourse loan** to acquire and construct real property on the Partnership's land, that was then leased to the S Corporation.

From 1986 to 2001, the Partnership loaned money to Mr. and Mrs. Kerzner, and Mr. and Mrs. Kerzner then in turn loaned money to their S Corporation. The S Corporation then paid rent to the Partnership. The Partnership then used the rental funds to pay back loan payments owed under the Partnership's HUD loan.

The issue in this case was whether or not Mr. and Mrs. Kerzner made an "economic outlay" on their yearly loans to the S Corporation. The IRS took the position that the loans from Mr. and Mrs. Kerzner to their S Corporation lacked "economic substance." According to the IRS, this was a circular flow of cash between the Partnership and the S Corporation, albeit through loans by the Partnership to Mr. and Mrs. Kerzner, and as loans from Mr. and Mrs. Kerzner to their S Corporation.

The Tax Court agreed with the IRS. According to the Tax Court, in the end, after the Partnership made loans to Mr. and Mrs. Kerzner, and then after Mr. and Mrs. Kerzner made a loan to their S Corporation, and then after the S Corporation paid rent to the Partnership, all of the cash ended up exactly where it had begun.

The Tax Court held that Mr. and Mrs. Kerzner never made any "economic outlay" for funds they advanced to their S Corporation since there was never any expectation by the Kerzners that they would have to repay the Partnership for the loans that the Partnership made to Mr. and Mrs. Kerzner. Indeed, Mr. and Mrs. Kerzner exercised complete control over both the Partnership and the S Corporation and so the Tax Court held that neither the Partnership nor the S Corporation would ever act in a manner that would be "adverse" to the interests of Mr. and Mrs. Kerzner.

Moreover, Mr. and Mrs. Kerzner only made one loan repayment back to the Partnership during the sixteen years from 1986 through 2001. Also, Mr. and Mrs. Kerzner never paid any interest back to their Partnership and their Partnership never reported any interest income from the Kerzners with respect to these Partnership loans to the Kerzners.

Perhaps more importantly, there was no significant risk that Mr. and Mrs. Kerzner would ever have to repay any part of the HUD loan, since this was a "non-recourse" loan from HUD to the Partnership, and thus Mr. and Mrs. Kerzner were never primarily liable on the HUD loan to the Partnership. Indeed, HUD would be able to collect from Mr. and Mrs. Kerzner under the non-recourse loan only if the Partnership filed for bankruptcy which was highly unlikely. Accordingly, Mr. and Mrs. Kerzner could never be deemed to have made an "economic outlay" with respect to amounts they borrowed from their Partnership and that they re-loaned to their S Corporation.

> **Query**: Would this result have been different if Mr. and Mrs. Kerzner had been personally liable under the HUD loan to the Partnership? If the HUD loan had not been non-recourse (and had been fully recourse to Mr. and Mrs. Kerzner), Mr. and Mrs. Kerzner would have had significant liability exposure to the Partnership's lender, and in that case, the loans to the S Corporation by Mr. and Mrs. Kerzner might have had "economic outlay" substance.

D. 2006 Ruckriegel Case; Loans From Related Partnership Can Increase Basis Where Loans Made Directly to Shareholders. In the case of Ruckriegel v. Commissioner, TC Memo 2006-78 (April 18, 2006), two brothers were 50/50 owners of an unprofitable S Corporation that operated fast food restaurants. At various times, the taxpayers used funds from their profitable real estate partnership to fund operating losses of the S Corporation. The two brothers argued that loans from the partnership should increase their tax basis in their S Corporation stock.

The partnership funding came from two different transactions:

a. Direct Loans from the Partnership to the S Corporation. In the first transaction, the partnership loaned money directly to the S Corporation. The sons argued that the "substance" of the loans from their partnership to the S Corporation were really "back to back" loans from the partnership to them individually, and from them individually to the partnership. Unfortunately, these loans did not involve funds going from the partnership to the taxpayers and then to their S Corporation. Moreover, S Corporation minutes purporting to authorize the S Corporation loans were not contemporaneous with those loans. There were no payments of interest from the S Corporation to the taxpayers individually. Thus, loans during the tax year directly from the partnership to the S Corporation did not increase the brothers' tax basis in their S Corporation stock.

b. Wire Transfers From Partnership to Shareholders to S Corporation. The second transaction involved wire transfers . The partnership made wire transfers to the S Corporation shareholders and the same funds were then wired by the sons to the S Corporation.

Thus, this fact was sufficient to establish that the shareholders could increase their basis by the wired transferred amounts.

E. How to Restructure Corporate Bank Debt in Order to Get Shareholder Basis;

1. S Corporation Basis Increase Is Allowed Where S Corporation Shareholder Replaces Corporation Notes for Shareholder Notes. In the case of Miller v. Commissioner, TC Memo 2006-125 (June 25, 2006), the S Corporation owed Notes to the Bank. In this case, Mr. Miller was a shareholder of the S Corporation which had borrowed money from the Bank to finance the S Corporation's operations. All loans were guaranteed by the shareholders, including Mr. Miller. Unfortunately, the Corporation's losses soon exceeded the shareholders' direct investment.

At the end of 1998, the S Corporation had substantial losses and the shareholders believed that the S Corporation would lose additional money in 1999. At that point, Mr. Miller restructured the bank debt by refinancing the bank debt and becoming the primary obligor of the obligations to the Bank, with the S Corporation becoming a guarantor of the Bank debts.

Mr. Miller had the S Corporation's Notes payable to the Bank cancelled and Mr. Miller substituted his own notes to the Bank followed by a Note from the S Corporation to Mr. Miller. Therefore, Mr. Miller became the primary obligor of the bank loans to him personally. Since the Bank's loan to Mr. Miller was fully recourse, and since the Bank could assert collection obligations against Mr. Miller, this strategy allowed Mr. Miller to increase his basis in his S Corporation by the amount of the substituted notes.

According to the Tax Court, this restructure arrangement met the "economic outlay" test under the Hafiz case. It is important to note that, in this case, the Bank's debt to Mr. Miller was fully recourse and therefore the Bank could pursue collection directly against Mr. Miller.

2. Form Over Substance Supports Tax Basis Increase Where S Corporation Shareholder Borrows Funds From a Bank and then Re-loans the Funds to His S Corporation. Gleason v. Commissioner, TC Memo 2006-191 (September 11, 2006). In this case, an S Corporation shareholder borrowed loans from a bank and then re-lent these funds to the S Corporation. The "borrower" on the loan documents was the shareholder himself rather than the S Corporation. Although the S Corporation guaranteed repayment of the loans to the Bank, and even though the S Corporation shareholder pledged his S corporation stock to the Bank to secure these loans, the Tax Court held that the form of the transaction overrode the substance of the transaction and therefore allowed Mr. Gleason to increase his basis in his S Corporation stock by the amount of the loans.

III. S Corporation Shareholders Are Allowed To Increase Stock Basis By Moving Receivables Between Related S Corporations; Maguire, TC Memo 2012-160 (June 6, 2012).

In Maguire, TC Memo 2012-160 (June 6, 2012), the Maguire family owned an automobile dealership (AA) and a finance company (CNAC). Both AA and CNAC were S corporations. AA held customer notes from the sale of automobiles to its customers. AA then sold the customer notes to CNAC which was a finance Company.

During the tax years at issue, CNAC showed a profit, but AA had losses each year. During each of those years, CNAC distributed -- to the shareholders of CNAC -- accounts receivable owed to CNAC by AA, and the shareholders of CNAC then contributed those accounts receivables back to AA, thereby allowing the shareholders of AA to increase their tax basis in their AA stock.

The IRS took the position that the AA shareholders should not be allowed to increase their income tax basis in their AA stock for the accounts receivable distributed from CNAC and then contributed to AA, since the shareholders had not made an actual "economic outlay" in favor of AA.

The Tax Court, however, concluded that the distributions of accounts receivable from CNAC, and the subsequent contributions of the accounts receivable to AA, had true "economic substance" since: (1) after the contributions, AA's net worth actually increased (since its liabilities to CNAC were reduced) and (2) the shareholders' net worth had actually decreased.

Also, the Tax Court noted that the accounts receivable distributions and contributions actually took place in the same year, were documented by corporate resolutions and were supported by journal entries that were recorded before the end of the tax year.

IV. But, No S Corporation Tax Basis Increase for Alleged "Back-to-Back Loans;" *Broz v. Commissioner*, 137 TC 46 (September 1, 2011).

In the *Broz* case, Mr. and Mrs. Broz did not get to increase their income tax basis in their S corporation stock by virtue of loans made from a bank to one S corporation, followed by a loan from the first S corporation to a second S corporation. Here, Mr. and Mrs. Broz couldn't prove that the first S corporation had loaned the funds to Mr. and Mrs. Broz and that Mr. and Mrs. Broz then loaned the funds over to the second S corporation.

V. IRS Issues New Proposed Regulations On S Corporation Tax Basis Increase For Shareholder Loans.

On June 11, 2012, the IRS issued new proposed regulations Section 1.1366-2 describing when an S corporation shareholder can increase his stock basis for loans made to the S corporation. The new regulations advise that, to increase a shareholder's stock basis in S corporation stock, there must be a "bona fide indebtedness" that is owed directly to the shareholder.

These new regulations also discuss the concept of the "incorporated pocketbook" argument under which the shareholder asserts that a loan from one S corporation to another related S corporation should be treated as a loan from the first S corporation to the shareholder followed by a loan from the shareholder to the second S corporation. The proposed regulations provide that the "incorporated pocketbook" argument is viable only where there is a true, bona fide debtor/creditor relationship between the S corporation and the shareholder. Therefore, as long as there is a bona fide debt, the S corporation shareholder doesn't have to otherwise make an economic outlay to the S corporation.

> **Note:** The "incorporated pocketbook" theory is based upon the case of *Culnen*, TC Memo 2000-139 (2000). In that case, the shareholder used S Corporation 1 to pay his personal expenses. Thereafter, S Corporation 1 made loans to S Corporation 2 that were recorded as distributions from S Corporation 1 to the shareholder and then as loans or contributions from the shareholder to the S Corporation 2. There, the Tax Court held that, even though the funds went directly from S Corporation 1 to S Corporation 2, the shareholder was still able to increase his basis in his stock of S Corporation 2.

> **Note:** The new proposed basis regulation rules do not change the IRS' previous position, in Revenue Ruling 81-187, that a shareholder of a S corporation does not get to increase his basis in his S corporation stock by contributing the shareholder's own unsecured demand promissory note to the corporation.

VI. Complete Liquidation of an S Corporation Can Generate A Current Loss.

CCA 201237017 (September 14, 2012), illustrates a clever technique that has become more widely used by S Corporations with debts that exceed the value of their assets, such as real estate development companies. According to this CCA, if an S Corporation distributes encumbered assets, in complete liquidation of the S Corporation stock, then the amount of the liabilities --assumed by the shareholder upon liquidation -- will reduce the "amount realized" by the shareholder in the liquidation. And, if the amount of the liabilities exceed the fair market value of the distributed property, then the S Corporation shareholder can recognize a loss on the liquidation.

> **Note**: The S Corporation will recognize taxable gain on liquidation just as if the property were sold for fair market value; and, for this purpose, the fair market value of the property will be deemed to be no less than the amount of the assumed debt.

> **Note:** Also see U.S. v. Williams, 110 AFTR 2d 2012-6199 (September 28, 2012) where the District Court of Indiana upheld the government's right to foreclose on "tenants-by-entirety" real property to satisfy husband's unpaid taxes.

VII. IRS Rules That A Valid Partnership Exists With A Two Person Partnership Consisting Of .01% And 99.99% Partners.

In Letter Ruling 201220012, the IRS stated that PT, a limited partnership - owned 99.99% by one limited partner and .01% owned by a general partner - was nevertheless a valid tax partnership.

VIII. Partner Subject to Tax On Disputed Partnership Income; Martignon v. Commissioner, TC Summary Opinion 2012-18 (March 1, 2012).

In Martignon v. Commissioner, TC Summary Opinion 2012-18 (March 1, 2012), Mr. Martignon was a 40% member of Café Savannah, LLC, which operated a restaurant. Mr. Vargas owned the other 60% interest.

Mr. Vargas controlled all of the LLC's finances, and shortly after the LLC began operations, Mr. Vargas shut Mr. Martignon out of the business. Mr. Vargas changed the locks, refused to communicate with Mr. Martignon and ignored his request for records.

The LLC filed its partnership tax return, Form 1065, and issued a Schedule K-1 to Mr. Martignon reflecting that his distributable share of partnership income at $22,544. Mr. Martignon did not believe that the partnership could have any taxable income (1) because the restaurant had reported a loss for every prior year, and (2) because Mr. Martignon did not receive any distributions from the LLC. Therefore, when Mr. Martignon filed his 2007 income tax return, Mr. Martignon reported that he had an interest in the LLC, but did not report on his Schedule E any of the $22,544 reported on his Schedule K-1.

The Tax Court upheld the IRS' determination that Mr. Martignon was responsible for paying tax on the K-1 income of $22,544. However, the Tax Court found that Mr. Martignon would not be liable for the accuracy related penalty under Section 6662(a) because he had made numerous attempts to contact Mr. Vargas after believing that the Schedule K-1 was incorrect and to access partnership records.

> **Note:** If Mr. Martignon 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 at all.

PART NINE
EMPLOYEES VS. INDEPENDENT CONTRACTORS

I. 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.

Note: Also see Chapman v. ASUI Healthcare, DC TX 2012, Civil Action H-11-3025, where the Court ruled that "direct care specialists," hired to work at employer's group residences, are employees and not independent contractors under the "economic reality" test, where:

(1) employer controlled meaningful aspects of its home health care business;
(2) workers' minimal investment (purchased uniforms);
(3) employer assigned hours worked and pay rate, such that workers had no opportunity to earn a profit;
(4) direct care specialists' services did not require specialized skills and workers had no discretion on how to perform their duties; and
(5) long-term relationship between workers and employer.

PART TEN

SECTION 6672 RESPONSIBLE PERSON LIABILITY FOR TRUST FUND TAXES

I. Background and Introduction.

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

II. IRS Forces Taxpayer's Credit Overpayments To Be Applied to Past Section 6672 Penalty; Weber, 138 TC No. 18 (May 7, 2012).

In Weber, 138 TC No. 18 (May 7, 2012), Mr. Weber unsuccessfully argued to the Tax Court that the IRS had abused its discretion in crediting certain income tax overpayments to an earlier Section 6672 penalty. Mr. Weber was assessed Section 6672 penalties of over $1 Million in July 2007. In October 2007, Mr. Weber filed his 2006 tax return reporting a $47,000 tax overpayment that Mr. Weber wanted to have applied to his 2007 and 2008 income tax returns. The IRS, however, applied the overpayment credits against the earlier Section 6672 penalty. Mr. Weber then requested that the Tax Court force the IRS to apply the refunds to future periods rather than against the prior Section 6672 penalty.

However, the Tax Court found that there was no regulatory authority that requires the IRS to apply overpayments against future estimated taxes as opposed to against prior Section 6672 penalty assessments. Section 6402(a) specifically provides that, in the case of any overpayment, the IRS "may credit the amount of such overpayment . . . against any liability" for unpaid tax owed by the person who made the tax overpayment.

> **Note**: This case reminds us that, whenever we have a client with an outstanding Section 6672 penalty, the taxpayer will need to "manage" future tax withholdings to make sure there is no tax refund coming back to the taxpayer on a subsequently filed income tax return.

III. Even Volunteers of Tax Exempt Entities Can Be Liable for the Section 6672 Penalty; Bunch vs. U.S., (DC TN March 8, 2012), 109 AFTR 2d 2012-572.

Don Bunch served as a volunteer Chairman of the Board and CFO of Perceptions, Inc., which was a non-profit corporation formed in 2004. Mr. Bunch served as Chairman of the Board of Directors from the date it was organized until it dissolved.

Although Mr. Bunch had no ownership interest in Perceptions, Mr. Bunch made a series of loans to Perceptions totaling almost $650,000. Mr. Bunch never received a pay check from Perceptions; he never hired or fired employees; and he never reviewed financial books and records of Perceptions, nor did he ever ask to see whether payroll taxes were being paid.

However, upon learning that Perceptions failed to pay its third quarter 2006 taxes, Mr. Bunch made a loan to Perceptions to pay those third quarter taxes.

In June 2007, Mr. Bunch became actively involved in the financial affairs of Perceptions and assumed check writing responsibility. In September 2009, the IRS advised Mr. Bunch that it was holding him liable for unpaid employment taxes for the second and fourth quarters of 2006 and for all four quarters of 2007.

At the court proceeding, Mr. Bunch acknowledged that he was a responsible person after June 2007, but disputed that he was a responsible person prior to that date. Here, the Court ruled that, even though Mr. Bunch did not hire or fire employees and had no check writing authority before June 2007, he had significant and substantial control over the financial affairs of Perceptions by acting as its line of credit lender. For example, Mr. Bunch could have forced Perceptions out of business simply by withholding periodic loans.

Also, Mr. Bunch at all times was Chairman of the Board of Directors and had the actual authority to supervise the Executive Director of Perceptions who reported directly to Mr. Bunch. Also, the Board of Directors had access to monthly financial reports.

Here, even though Mr. Bunch was unaware of unpaid employment taxes, his conduct constituted the requisite recklessness to meet the willfulness test, since Mr. Bunch should have known, and had reason to know, that taxes were not being paid - simply by virtue of the fact that he was having to loan so much money to Perceptions to keep it going. And, Mr. Bunch at all times had complete access to all books and financial records.

According to the Court, Mr. Bunch could not avoid liability simply by "wearing blinders" to avoid obtaining actual notice of tax delinquencies.

> **Note:** The Court also found it noteworthy that, during Perceptions' operations, Perceptions repaid Mr. Bunch a significant amount of his loans that would have been more than sufficient to pay the Company's outstanding withholding tax liabilities.

IV. Taxpayer "Willfully" Failed to Pay Withholding Taxes Where He Acted In Reckless Disregard; Kobus, 109 AFTR 2d 2012-520 (February 28, 2012).

In Kobus, 109 AFTR 2d 2012-520 (February 28, 2012), Mr. Kobus unsuccessfully argued that, although he was president and sole stockholder of his landscaping business, he should not be liable for the Section 6672 penalty where he delegated tax filing and payment obligations to other corporate officers.

V. The IRS Is Not Forced to Bring In Joint Parties Potentially Liable for Section 6672 Penalty; Gray v. U.S., 109 AFTR 2d 2012-1053 (February 16, 2012).

In Gray v. U.S., 109 AFTR 2d 2012-1053 (February 16, 2012), Mr. Gray had been assessed a Section 6672 trust fund recovery penalty for withholding taxes owed by Ace Roofing, Inc. The IRS seized Mr. Gray's income tax refunds, as well as funds from other financial accounts. Mr. Gray's business partner, Mr. Martinez, was also found to be a responsible person.

Mr. Gray filed an action in California District Court claiming that he was not a responsible person, and he also filed a motion to have Mr. Martinez's wife brought in as an additional third party defendant claiming that she was also a responsible person.

The Court denied Mr. Gray's motion to have Mrs. Martinez brought in as an additional third-party defendant. According to the Court, even if there were other responsible persons, this did not preclude the IRS from pursuing action directly against Mr. Gray. Although Mr. Gray could ultimately sue Mrs. Martinez for contribution, he would have to do so in a separate law suit.

VI. Titular Officer Was Not A Responsible Person Where He Had No Unilateral Authority To Sign Checks; Tarpoff v. U.S., District Court of Illinois, 109 AFTR 2d 2012-474 (February 15, 2012).

Mr. Tarpoff was an employee of Gateway Beef, LLC and was a signatory on both of Gateway's checking accounts. During the years at issue, Mr. Tarpoff signed over 1,800 checks. However, testimony at trial proved that Mr. Tarpoff could not unilaterally sign checks without the approval of the company's president. Therefore, even though Mr. Tarpoff had check signing authority, this still did not make him a responsible person since Mr. Tarpoff could not have paid the IRS ahead of other creditors, without the consent of the company's president.

Note: The Appeals Court awarded attorneys fees to Mr. Tarpoff. Tarpoff, 109 A.F.T.R. 2d 2012-2697 (June 20, 2012).

PART ELEVEN
IRS LIENS AND FORECLOSURES

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

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

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

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

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

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

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

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

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

B. The 6th Circuit Court Of Appeals Allows The IRS To Foreclose Upon "Tenants By The Entirety" Real Property To Satisfy The Tax Liabilities Of Only One Spouse; *US v. Barczyk*, 108 AFTR 2d 2011–5862 (August 17, 2011). In *US v. Barczyk*, 108 AFTR 2d 2011–5862 (August 17, 2011), the Court allowed the IRS to foreclose on "tenants by the entirety" real property to satisfy tax liabilities owed by only one spouse.

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

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

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

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

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

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

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

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

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

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

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

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

II. U.S. vs. Winsper. In Winsper, Mr. and Mrs. Winsper owned joint real property located in Kentucky. The IRS held a federal tax lien against Mr. Winsper for unpaid federal income taxes of over $900,000. The IRS sought to foreclose upon Mr. Winsper's one-half interest in the property pursuant to Section 7403 and sought permission of the District Court to force a foreclosure sale.

A. The Tax Court Trial; Winsper, 106 AFTR 2d 2010-6945 (November 3, 2010). The Tax Court refused to allow the IRS to foreclose on Mr. Winsper's interest in the property to satisfy his tax liens. Here is how the District Court applied § 7403 in light of the four (4) factor test set out in the U.S. Supreme Court case in Rogers:

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

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

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

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

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

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

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

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

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

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

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

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

B. Sixth Circuit Court of Appeals Overturns the Winsper Decision and Allows Foreclosure Sale of "Tenants by the Entirety" Marital Home and Found That The District Court Had Misapplied The Rodgers Equity Test; U.S. v. Winsper, 109 AFTR 2d 2012-2069 (May 10, 2012).

On appeal, the 6th Circuit Court of Appeals overturned the District Court on the basis that the District Court had misapplied the Rodgers' equity test. According to the 6th Circuit Court of Appeals, the District Court based its earlier decision on a mischaracterization and misapplication of the four (4) factor "balancing test" in Rogers as requiring that the Government must prove factors ***supporting*** the Government's discretion to force a foreclosure sale; instead, however, the proper test was to determine when the Court should **not** have discretion to force a foreclosure sale.

According to the Court of Appeals, under the Barr decision, the Rogers case "did not mandate application of the four factor balancing test before a District Court could order a sale under Section 7403." Barr, 617 F3d at 375-76.

The Court of Appeals also noted that, in looking at the underlying factors of Winsper, the District Court had wrongly focused on the fact that only a small percentage of Mr. Winsper's tax debt would be satisfied in determining that the Government would suffer little prejudice if limited to selling only Mr. Winsper's partial interest in the marital home. And indeed, such an analysis would favor a taxpayer who has significant tax debts.

Also, the Court of Appeals noted that, while the District Court properly found that Mrs. Winsper had a legally recognized expectation of no "forced sale" under state law, the Court record failed to show that Mrs. Winsper would actually suffer prejudice from a forced sale.

Ultimately, the Court of Appeals ordered the District Count to remand the case for further discussion to re-evaluate whether to exercise its limited discretion to **not order** a foreclosure sale based upon all the relevant factors.

Conclusion: What does this court case tell us?

We have a lot of clients out there who hold "jointly-owned" interests in real estate with other partners/investors. With respect to real estate owned by a husband and wife as "tenants-by-

the-entirety," the real estate arguably should be protected under North Carolina law from IRS liens filed against only one spouse (but see Barczyk and Winsper above). In those cases, we hope the IRS (or North Carolina Department of Revenue) will not attempt to foreclose upon the real estate, but instead will wait until the real estate is sold.

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

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

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

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

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

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

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

III. IRS Could Proceed With Foreclosure Actions Against A Married Couple For Delinquent Tax Liabilities Even Though Non-Liable Family Members Lived In The Home As Well.

In the case of *US v. Rivits*, 109 AFTR 2d 2012-2127 (May 15, 2012), the Rivits argued that the IRS should not be allowed to foreclose on real property under Sections 7403(a) where non-liable family members could be unduly harmed by the collection effort. The Rivits shared their home with a son, daughter, granddaughter and a niece, and Mr. Rivits' parents and sister lived near their home as well. The Rivits argued that, if the IRS was allowed to foreclose on the Rivits' home, then this would jeopardize the care that they gave to Mr. Rivits' father and sister. They also argued that the foreclosure would create an undue hardship on the non-liable family members that lived with them (the son, daughter, granddaughter and niece). The court, however, ruled that the inconveniences and dislocation cost that the Rivits would incur did not overweigh the government's interests in collecting delinquent taxes.

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

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

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

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

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

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

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

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

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

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

3. 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).

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

II. IRS Issues New Notice on Granting Section 6015(f) Equitable Relief; IRS Notice 2012-8 (January 5, 2012).

On January 5, 2012, the IRS issued Notice 2012-8, 2012-4 IRB 309, and issued a new proposed Revenue Procedure that will update Revenue Procedure 2003-61 for purposes of processing "equitable relief" requests under Section 6015(f).

The new Revenue Procedure provides more favorable treatment of requesting spouses, especially those who can show **abuse** or **financial control** by the non-requesting spouse. The new Revenue Procedure makes the following significant changes in how it will process "equitable" innocent spouse relief cases:

1. Streamlined Relief Procedure In Some Cases. The new Revenue Procedure provides for a streamlined case determination in some instances.

2. Spousal Abuse or Financial Control Will Be More Heavily Weighted Factors. The new Revenue Procedure now states that the IRS will place "greater weight" on the factors of (i) abuse and (ii) financial control by the non-requesting spouse in determining whether equitable relief should be granted. Specifically, the new Revenue Procedure provides that **actual knowledge** of an understatement or underpayment will **no**

longer be weighed more heavily than other factors. In addition, if the non-requesting spouse has maintained control over the household finances by restricting the requesting spouse's access to financial information, then that abuse or financial control will be a **factor weighing in favor of relief**, even if the requesting spouse had knowledge or reason to know of the understatement or tax underpayment.

3. Refund Claims. In addition, the new Revenue Procedure clarifies that a requesting spouse is eligible for a refund of separate payments made by the requesting spouse, where the requesting spouse can establish that the funds used to make the payment were provided by the requesting spouse. Also, a requesting spouse may be eligible for a refund of the requesting spouse's portion of joint tax overpayments of the requesting and non-requesting spouse for another tax year to the extent that the requesting spouse can establish that the requesting spouse provided the funds for the overpayment.

> **Note:** Previously, Revenue Procedure 2003-61 provided that a requesting spouse could seek a refund only of funds paid by the requesting spouse under an installment agreement.

III. Innocent Spouse Entitled to Funds Levied From A Joint Bank Account; Minihan v. Commissioner, 138 TC 1 (January 11, 2012).

In the case of Minihan v. Commissioner, 138 TC 1 (January 11, 2012), Mrs. Minihan filed for divorce against Mr. Minihan in September 2007. In 2008, the Minihans sold their jointly-owned home in Massachusetts and deposited the sales proceeds into jointly-owned Bank of America accounts.

In June 2008, Mrs. Minihan filed an innocent spouse relief request with the IRS. In August 2009, Mr. Minihan advised the IRS of the joint Bank of America accounts that held $230,000 in proceeds from the sale of their joint home.

Shortly thereafter, the IRS denied Mrs. Minihan's innocent spouse relief request, and in November 2009, Mrs. Minihan filed a Petition with the United States Tax Court to appeal the denial of her innocent spouse request. In February 2010, the IRS levied on the Minihan's joint Bank of America accounts.

In the Tax Court proceeding, the Tax Court ruled that, under Massachusetts law, Mrs. Minihan had a 50% interest in the joint account. Accordingly, Mrs. Minihan could pursue a refund action against the IRS to the extent she could establish that she would be entitled to relief under Section 6015(f).

PART THIRTEEN
OTHER IRS TAX PROCEDURES

I. <u>IRS Announces Changes To Its Offer In Compromise (OIC) Program</u>

In Internal Revenue Service News Release 2012-53 (May 21, 2012), the IRS announced that it was changing its offer in compromise process, as part of its Fresh Start Initiative, to help a greater number of struggling taxpayers make a "fresh start". The new changes alter the financial analysis used by the IRS to determine which taxpayers will qualify for an offer in compromise. The new announcement also allows some taxpayers to resolve their tax problems in as few as two years, as compared to four or five years in the past.

New **changes to the OIC process** include the following:

(1) In calculating the taxpayer's "reasonable collection potential," the IRS will now look at only one year of future income for those offers that will be paid in five or fewer months (down from 4 years); and two years of future income for offers paid in 6 to 24 months, down from five years.

(2) Also, the IRS has clarified when a "dissipated asset" would be included in the calculation of "reasonable collection potential."

(3) Also, equity and income producing assets generally will **<u>not</u>** be included in the calculation of reasonable collection potential for an on-going business.

(4) The IRS also may allow for repayment of student loans guaranteed by the federal government.

(5) And the IRS may allow some room for some payments of delinquent state and local sale taxes.

II. <u>IRS Offers New Streamlined Installment Payment Arrangements</u>.

The IRS is now offering new parameters for streamlined installment agreements. The IRS is now offering payment plans of up to 72 months (up from 60 months) for liabilities up to $50,000. However, the taxpayer only gets the new streamlined installment agreement if the taxpayer proves it can fully pay its liabilities within the 72 month extended period.

And, for installment payment agreements for liabilities less than $25,000, the taxpayer does not need to submit Form 433-A to qualify for the installment payment arrangement. For liabilities that exceed $25,000, the taxpayer must submit a Form 433-A to establish their ability to pay the liability over the 72 month payment period.

> **Note**: Of course, the IRS is going to want to review the taxpayer's financial condition every year or so to determine whether the taxpayer then has the ability to pay in shorter than 72 months. In that case, the Service will certainly void the long-term installment payment arrangement.

See, Small Business/Self-Employed Division 05-0112-013 (January 20, 2012). Also see Internal Revenue Manual Section 5.14.5 and Section 5.14.10.

III. Treasury Inspector General Reports That IRS Improperly Failed To Grant Penalty Abatement Relief For Millions Of Taxpayers.

The Treasury Inspector General for Tax Administration (TIGTA) recently reported that the IRS failed to inform almost 1.5 million taxpayers that they qualified for "First-Time Abate" relief that would have allowed them to receive abatement relief for almost $180 Million in penalties. Since 2001, the IRS has been granting penalty relief for failure to file and failure to pay penalties under an administrative waiver known as the "First-Time Abate." The purpose of the First Time Abate program was to encourage tax compliance. Under the First-Time Abate program, late filing and late payment penalties would be waived for taxpayers who were fully compliant in tax filings and tax payments for the three (3) prior tax years. See Internal Revenue Manual Section 20.1.1.3.6.1.

Unfortunately, the IRS does not widely publicize the First-Time Abate program and therefore many taxpayers are not aware that the program even exists. TIGTA has advised the IRS that it should more effectively publicize the existence of the First-Time Abate program.

IV. Revisiting the Mailbox Rule.

In Maine Medical Center vs. U.S., 109 AFTR 2d 2012-627 (March 30, 2012), Maine Medical was denied a FICA tax refund claim for failing to satisfy the common law and statutory "mail box" rules.

A. Fact Background. In Maine Medical, the corporate officers of Main Medical Center decided to file a FICA refund claim for 2001. The refund claim was due on April 15, 2005.

In the court proceeding, the officers of Maine Medical testified that on April 15, 2005, they assembled the refund claim for mailing. They testified that their standard practice would have been to drive to the local U.S. post office and mail the claim, via certified mail, return receipt requested. Unfortunately, no one could testify that they had specific memory of completing the mailing and no one could locate the certified mail receipt or the return receipt. And, the IRS testified that it had no record of ever having receiving the refund claim.

B. <u>No Relief Under the "Common Law" Mailbox Rule</u>. Here, the Court found that the common law "mailbox rule" would not do any good to Maine Medical. Since the refund claim was mailed on the date it was due, there was no way that the refund claim could have been received by the IRS on that same day. According to <u>Philadelphia Marine</u>, 523 F3d 140, (3rd Cir. 2008), a taxpayer cannot rely on the common law mailbox rule to prove timely filing where the filing was mailed on the day before the filing deadline because that was too late for the document to arrive at the IRS in the ordinary course of post office business.

C. <u>No Relief Under the Statutory Mailbox Rule</u>. The Court also held that Maine Medical did not satisfy the statutory mailbox rule of Section 7502, which provides that a registered or certified mail receipt provides "prima facia evidence of delivery" on the postmark date. Section 7502(c). Here, because Maine Medical did not have a certified mail return receipt, it could not avail itself of the Section 7502 mailbox rule.

D. <u>No Relief Under General Relief</u>. Therefore, Maine Medical's only other avenue for relief was the general rule of Section 7502(a) which provides a default rule that the date of the United States postmark stamped on the cover of the letter in which the refund claim is mailed shall be deemed to be the date of delivery.

Here, however, Maine Medical could not present testimony of any employees or U.S. postal employees who could testify that the refund claim was ever actually mailed.