2017 FEDERAL INCOME TAX LAW UPDATE

Fall 2017

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.

Carruthers & Roth Business Attorneys

J. Scott Dillon
jsd@crlaw.com

J. Stanley Atwell
jsa@crlaw.com

Gregory S. Williams
gsw@crlaw.com

Nicholas J. Bakatsias
njb@crlaw.com

J. Aaron Bennett
jab@crlaw.com

Christopher W. Genheimer
cwg@crlaw.com

PART ONE
IRS AUDIT STATISTICS

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

In early 2017, the IRS published its 2016 Internal Revenue Service Data Book (IR-2017-69) (March 30, 2017), which contained audit statistics for the Fiscal Year ending on September 30, 2016. Here are the audit statistics for returns filed in calendar year 2015 ("CY 2015"):

A. **Audit Rates for Individual Income Tax Returns**. Only .7% of individual income tax returns filed in CY 2015 were audited (down from .8% of returns audited in FYE 2015). Of these audited returns, only 23.6% of individual tax audits were conducted by Revenue Agents and the rest of the audits (about 76% of the audits) were correspondence audits.

Not surprisingly, the audit rates for Schedule C returns were higher than for individual returns. Schedule Cs filed in CY 2015, showing receipts of $100,000-$200,000, reported a 2.2% audit rate (down from 2.5% in FY 2015). Schedule C returns filed in CY 2015, showing income over $200,000, reported a 1.9% audit rate (down from 2.0% in FY 2015).

Total Individual Returns Audited		.7%
(1)	With Schedule C Income:	
	$100,000 to $200,000	2.2%
	Over $200,000	1.9%
(2)	Non-Business Income of:	
	$200,000 to $1 Million	1.0%
(3)	Positive Income Over $1 Million	5.8%

B. **Audit Rates For Partnerships and S Corporations:** For partnerships, the audit rate for returns filed in CY 2015 was .4% (down from .5% in FY 2015). For S Corporation returns, the audit rate for returns filed in CY 2015 was .3% (down from .4% in FY 2015).

C. **Audit Rates for C Corporations.** C Corporation returns filed in CY 2015 had an audit rate of 1.1%. However, for large corporations with assets over $10 Million, the audit rate was 9.5%.

Total C Corporation Returns Audited		1.1%
(1)	Assets less than $1 Million	1.0%
(2)	Assets $1,000,000 to $5 Million	1.0%
(3)	Assets $5 Million to $10 Million	1.6%
(4)	Assets $10 Million to $50 Million	4.7%

D. **Offers in Compromise.** The IRS received 63,000 offers in compromise, but only accepted 27,000 of them.

E. **Criminal Case Referrals.** According to the IRS statistics, the IRS initiated 3,395 criminal investigations for the fiscal year 2016 (down from 3,853 FYE 2015), and for 2016, the IRS referred 2,744 cases for criminal prosecutions (1,023 for legal source crimes, 1,037 for illegal source financial crimes and 684 for narcotics–related financial crimes) and obtained 2,672 convictions. For convictions, 2,156 were actually incarcerated.

PART TWO
SECTION 108 CANCELLATION OF DEBT INCOME

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

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

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

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

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

B. **The Bankruptcy Exception.**

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

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

C. The Insolvency Exception.

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

1. General Rules

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

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

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

2. Calculating the Amount of Insolvency.

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

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

ABC issued to its creditors were valued at $150, ABC would realize $25 of gross income, since the amount of forgiven debt ($50) exceeds the amount by which it was insolvent ($25) by $25.

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

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

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

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

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

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

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

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

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

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

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

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

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

II. Inventory Held by a Dealer Does Not Constitute "Real Property Used In A Trade Or Business" For Purposes Of The QRPBI Rules: Revenue Ruling 2016-15.

A. Background. Under Section 108(c)(3)(A), a taxpayer may elect to exclude, from cancellation of debt income, any relief of debt that constitutes "qualified real property business indebtedness" ("QRPBI"). Section 108(c)(3) defines QRPBI as debt secured by real property used in the taxpayer's trade or business, that is incurred to acquire or improve that real property, to which the taxpayer files an election to have these provisions apply.

Section 108(c)(3) defines QRPBI as indebtedness that is incurred by the taxpayer to acquire or improve real property used in connection with the taxpayer's "trade or business."

B. Revenue Ruling 2016-15 (June 10, 2016). In this Revenue Ruling, the IRS ruled that real property, that a taxpayer develops and holds for lease in its leasing business, constitutes "real property used in a trade or business" for purposes of Section 108(c)(3)(A). In the same Ruling, however, the IRS held that the QRPBI exclusion does not extend to real property that a taxpayer holds primarily for sale to customers in the ordinary course of its business (i.e., "inventory").

PART THREE
IRAs

I. Personal Guaranty Of Loan To A Corporation, Owned By An IRA, Results In A Deemed IRA Distribution.

In Thiessen v Commissioner, 146 TC No. 7 (March 29, 2016), Mr. and Mrs. Thiessen rolled over their retirement funds into a newly formed IRA. The IRA then acquired stock of a C corporation that then purchased assets of an existing business. The C corporation delivered a promissory note to the seller of the assets as part of the acquisition price, and the Thiessens personally guaranteed this loan.

The Tax Court agreed with the IRS that Mr. and Mrs. Thiessen had received a taxable distribution from their IRA by virtue of the loan guaranty. Pursuant to Section 4975(c)(1)(B), loan guarantees are "prohibited transactions" which cause the IRA to lose its status as an IRA, thus resulting in all of the assets of the IRA as being deemed to have been distributed to Mr. and Mrs. Thiessen in a taxable distribution.

The Court also disagreed with Mr. and Mrs. Thiessen's argument that the guarantees were given in connection with the acquisition of "a security" as permitted under Section 4975(d)(23), since the Thiessens' IRA acquired the seller's assets through C corporation stock which was owned by the IRA. According to the Court, the guarantee was given in connection with an asset acquisition, and not in connection with the acquisition of the C corporation stock.

II. IRA Funds Used To Purchase Land Are Deemed To Be An Early Withdrawal Where IRA Custodial Agreement Does Not Permit IRA Purchases of Real Estate.

In Dabney, TC Memo 2014-108 (June 5, 2014), Mr. Dabney wanted to use his self-directed Charles Schwab IRA funds to purchase undervalued real estate. However, Charles Schwab would not allow Mr. Dabney to purchase property directly through his IRA.

Accordingly, Mr. Dabney directed Charles Schwab to wire funds from his IRA account to the seller of real estate in Utah, and directed the title company to deed the property to the name of "Mr. Dabney Charles Schwab Company Custodial IRA Account." Mr. Dabney planned on selling the Utah property and then returning the sales proceeds to his IRA before the 60 day rollover period expired.

In 2009, when Charles Schwab wired the IRA funds to the seller of the Utah real estate, Charles Schwab showed this as a taxable distribution to Mr. Dabney. The title company deeded the Utah real estate directly into Mr. Dabney's name rather than into the name of "Mr. Dabney Charles Schwab Company Custodial IRA Account". Later, Mr. Dabney obtained a "scrivener's affidavit" from the title company in which the title company acknowledged responsibility for making an error in how the deed was transferred to Mr. Dabney, rather than into the name of his Charles Schwab IRA account.

In addition, when Mr. Dabney ultimately sold the Utah property in 2011, the funds were sent directly to Mr. Dabney's IRA. Mr. Dabney characterized the transfer as an IRA rollover contribution -- and that's how Charles Schwab recorded the deposit when it received the proceeds from the property sale in 2011.

Originally, when Charles Schwab sent its check to the seller of the Utah property, Charles Schwab issued a Form 1099 (Distributions from Pensions) showing that Mr. Dabney had taken a permanent withdrawal from his IRA. The IRS asserted that the 2009 distribution was taxable to Mr. Dabney and that the transfer of the sales proceeds in 2011 from the sale of the Utah property to Mr. Dabney's IRA at Charles Schwab was not a rollover contribution. Mr. Dabney argued that in 2009 he had taken title to the Utah property as agent for his self-directed IRA.

The IRS argued, and the Tax Court agreed, that although IRAs are not prohibited, under tax law, from owning real estate, the terms of any IRA Custodial Agreement (such as the Charles Schwab account agreement in this case) may serve to limit the type of rollover investments an IRA owner can make. Here, the Charles Schwab IRA Custodial Agreement prohibited investments in real estate.

Therefore, even though Mr. Dabney attempted to have the real estate retitled in the name of the custodial account, this did not accomplish a tax-free rollover of the IRA distribution into purchase funds used to purchase the Utah property. Here, the IRA did not purchase the Utah property and the IRA withdrawal was not a "trustee-to-trustee" rollover transfer.

Instead, in this case, the Court advised that Mr. Dabney should have undertaken a trustee-to-trustee rollover whereby Charles Schwab wired the purchase funds to another IRA Custodial trustee that would have permitted real estate investments and then allowed the new IRA trustee to purchase the real estate investment.

Ultimately, although Mr. Dabney was not subject to the accuracy related penalty, he had to pay tax on the failed rollover, plus a 10% early withdrawal penalty.

III. Self-Directed IRA Loses Asset Protective Status.

In the case of Kellerman, 115 AFTR 2d 2015-1944 (May 26, 2015), aff'd 116 AFTR 2d 2015-5247 (September 14, 2015), the U.S. Bankruptcy Court held that the assets of a self-directed IRA became subject to the claims of creditors of the IRA owner who engaged in a "prohibited transaction" under Section 4975. Therefore, the IRA was not a protected exempt asset in the bankruptcy proceeding, and thus the assets of the IRA could be used to satisfy judgment creditors of the IRA owner.

PART FOUR
DETERMINING TAXABLE INCOME

I. 9th Circuit Court Affirms That Stock Issued In A Demutualization Has A Tax Basis of Zero.

In Reuden v. U.S., 117 AFTR 2d 2016-313 (September 5, 2016), the 9th Circuit Court of Appeals affirmed the earlier decision of the District Court holding that stock received pursuant to a mutual insurance company "demutualization" has a zero tax basis to the stockholder.

> **Note:** The Federal Circuit, in Fisher v. U.S. ,105 AFTR 2d 2010-357 (October 9, 2009), previously held that a taxpayer has a cost basis in stock received in connection with the demutualization. So, there is a "circuit split" among the Circuit Courts as to this issue.

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

I. Background and Overview.

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

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

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

(i) Section 1031 nontaxable exchanges;

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

(iii) Section 453 installment sale reporting.

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

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

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

B. <u>Past Case Law</u>.

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 <u>Biedenharn Realty Company v. United States</u>, 526 F.2d 409 (5th Cir. 1976); <u>Suburban Realty Co. v. US</u>, 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 <u>Malat v. Riddell</u> (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 <u>Biedenharn Realty Co., Inc. v. U.S.</u> (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 <u>Kirschenmann v. Comr.</u> (24 T.C.M. 1759 (1965) held that frequent sales of lots undertaken by the taxpayer because the property was no longer suited for its intended purpose did not make the property investment property, while the court in Austin v. U.S. (116 F. Supp. 283 (1953) reached the opposite conclusion on similar facts. Similarly, capital gain treatment was allowed to the taxpayer in Brenneman v. Comr. (11 T.C.M. 628 (1952)), who sold his lots after an ordinance was enacted that barred the taxpayer's original plans, while the taxpayer in Shearer v. Smyth (116 F. Supp. 230 (1953)) was required to pay tax at ordinary rates under similar circumstances.

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

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

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

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

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

II. Husband and Wife Were Deemed Dealers Rather Than Investors In Real Property, So Gain On Sale of Land To A Developer Was Taxable As Ordinary Income And Not Capital Gain.

The case of *Boree v. Commissioner*, TC Memo 2014-85 (May 12, 2014), aff'd, 118 AFTR 2d 2016-5207 (September 12, 2016), involved the issue of whether Mr. and Mrs. Boree could treat gains on their sale of real property to a developer as capital gains, rather than as ordinary income.

A. Background of Facts. In 2002, Mr. Boree and Daniel Dukes formed Glen Forest, LLC and purchased almost 2,000 acres of land in Florida for a purchase price of approximately $3.2 Million. The purchase price was funded with almost $1.9 Million in loans from a local bank in addition to $250,000 of funds that they had borrowed from their parents.

Immediately after the closing of the purchase of the 2,000 acres, the LLC sold approximately 280 acres of the Glen Forest property to eight (8) purchasers.

In 2003, Glen Forest sold approximately 15 lots of the Glen Forest property and began building an unpaved road on the property. Glen Forest, LLC then began planning a residential development community on the Glen Forest property which would consist of over 100 lots.

Glen Forest, LLC then applied for, and received exemptions for, subdivision requirements that allowed Glen Forest to sell lots without completing the interior roads or submitting plats to the local governing board.

In 2003, Glen Forest executed a Declaration of Covenants and created a homeowners association to enforce the Declaration and to maintain the common area. The Declaration referred to "Glen Forest" as the developer.

During 2004, Glen Forest sold approximately six (6) lots of the Glen Forest property. During 2005, Glen Forest sold approximately 17 lots.

In March 2005, Mr. and Mrs. Boree purchased Mr. Duke's interest in the LLC and then became the sole owners of Glen Forest. In May 2005, Glen Forest submitted a proposal that the Glen Forest property be rezoned as a planned unit development (PUD). In September 2006, Glen Forest withdrew its PUD application and instead requested non-PUD zoning changes.

In February 2007, Glen Forest sold over 1,000 acres of the Glen Forest property to Adrian Development for $9.6 Million.

On their 2005, 2006 and 2007 tax returns, Mr. and Mrs. Boree reported on their Schedule C tax returns that their principal business was being "Land Investors." However, for 2005 and 2006, Mr. and Mrs. Boree reported income from Glen Forest sales of lots in 2005 and 2006 as ordinary income and they deducted (rather than capitalized) expenses relating to the Glen Forest property.

However, on their 2007 tax return, Mr. and Mrs. Boree indicated that Mr. Boree's occupation was that of a "Real Estate Professional" and for 2007 they reported a long-term capital gain of almost $8.6 Million relating to the Adrian transaction. The IRS challenged the Boree's characterization of the 2007 sale of their remaining Glen Forest property as long term capital gain and contended that the Borees should recognize ordinary income on the transaction.

B. Tax Court Decision. The Tax Court noted that, prior to the large sale in 2007, Mr. and Mrs. Boree subdivided the Glen Forest property, built a road and spent significant time and money in zoning activities in pursuing their continuing development activities. In addition, between 2002 and 2006, Mr. and Mrs. Boree sold approximately 60 lots which consisted of almost 600 acres of the Glen Forest property. The sales of these lots, up until 2007, reflected their intent to develop the Glen Forest property and sell sub-divided lots to customers.

In addition, after Mr. and Mrs. Boree purchased the interest of Mr. Duke, the Borees continued to engage in significant sales and development activities with respect to the Glen Forest property. For example, Mr. and Mrs. Boree reported their sales of lots in 2005 as ordinary income and they deducted (rather than capitalized) expenses related to their real estate activities.

Also, they did not "segregate" the property sold to Adrian Development from the rest of the Glen Forest property.

Accordingly, the sale of the remaining acreage in 2007 generated ordinary income and not capital gains to the Borees. The court also upheld the assessment of the substantial understatement penalty under Section 6662(a).

C. Court of Appeals Decision. Recently, the Court of Appeals for the 11th Circuit affirmed the prior Tax Court's decision in Boree v. Commissioner, TC Memo 2014-85 (May 12, 2014), confirming that the taxpayer's sale of a large tract of land should be taxed as ordinary income and not as capital gain. Boree, 118 AFTR 2d 2016-5207 (September 12, 2016).

The Borees had argued that their purpose in holding the Glen Forest property changed from development to investment as a result of certain land use restrictions placed upon the property in 2005 and 2006 which made further development so expensive so as to be practically impossible. The Court held, however, that the critical inquiry was to examine the taxpayer's primary holding purpose before the decision to make the sale arose. Here, before deciding to sell the Glen Forest tract in one sale, and during the years leading up to the sale, the Borees had indented to develop the property.

In addition, the Court did not agree with the Borees' argument that their gain resulted only from market appreciation. In the Tax Court proceeding, the Borees had argued that their $8 Million profit in 2007 was due to the property appreciating in value over a substantial period of time and was not attributable to any improvements made by the Borees to the Glen Forest property. The Court stated, however, that even though an increase in property value is attributable more to market appreciation than to improvements made to the property, this does not automatically entitle the taxpayer to capital gains tax treatment. Surburban Realty Co., 615 F 2d at 186. According to the Court, the Borees' sale arose from the Borees engaging in the ordinary course of their business of development; therefore, in light of the fact that the sale arose from their engaging in the ordinary course of business of developing real estate, the Borees were not entitled to capital gains tax treatment simply because the property had appreciated in value.

However, the Court of Appeals ruled that the Tax Court erred in imposing the accuracy related penalty finding that the Borees qualified for the reasonable cause and good faith exception to Section 6664.

PART SIX
REASONABLE COMPENSATION AND OTHER BONUS COMPENSATION CASES

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

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

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

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

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

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

5. Internal consistency in compensation through the ranks of company employees.

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

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

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

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

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

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

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

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

The compensation deduction was challenged by the IRS.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

PART SEVEN
HOBBY LOSS CASES

I. **Section 183 and Hobby Loss Rules.**

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

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

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

1. the manner in which the Taxpayer carries on the activity;

2. the expertise of the Taxpayer or his advisors;

3. the time and effort expended by the Taxpayer in carrying on the activity;

4. the expectation that the assets used in the activity may appreciate in value;

5. the success of the Taxpayer in carrying on other similar or dissimilar activities;

6. the Taxpayer's history of income or losses with respect to the activity;

7. the amount of occasional profits, if any, which are earned;

8. the financial status of the Taxpayer; and

9. the involvement of elements of personal pleasure or recreation.

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

Next, the expenses, related to the hobby activity, get moved to Schedule A, Itemized Deductions. The expenses are then broken down into two categories. The first category of expenses include items such as taxes and mortgage interest which are then deducted on Schedule A. Then, all of the other business expenses get moved to the "2% miscellaneous itemized deduction" line - which means that many of these expenses will not be deductible at all.

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

> **Note**: The bottom line here is that, when you have a client with a hobby loss that is disallowed, the client also often ends up with taxable income that greatly exceeds expenses. This could be a real lose/lose situation for taxpayers who attempt to deduct hobby losses.

II. Taxpayer "Whipsawed" By Renting Property to His S Corporation That Operated a "Hobby."

In Estate of Stuller, 117 AFTR 2d 2016-379 (7th Cir. January 26, 2016), the Court of Appeals for the 7th Circuit affirmed the earlier decision of the Tax Court which had previously held that activities conducted by the taxpayer's S Corporation was a "hobby" and not a "for profit" business. Here, Mr. and Mrs. Stuller owned several restaurant franchises and began breeding horses through their S corporation, called LSA, Inc. They also owned a horse farm in their individual names that they then rented to LSA, Inc.

The Court of Appeals confirmed the earlier decision of the District Court that determined that the Stullers could not prove that they operated their horse breeding activity with a "for profit" motive. The Court held that their lack of profit objective was demonstrated by numerous factors, including the fact that the taxpayers did not adequately track expenses or change operating methods or otherwise operate the activity in a business-like manner. And, although the taxpayers had significant business experience in running their franchise restaurants, they had no expertise in horse breeding activities. In light of the fact that the activity had losses for over fifteen (15) years and, in light of the fact that the taxpayers derived significant pleasure from the activity, the Court affirmed the District Court's previous finding that there was no "for profit" intent with respect to the horse operations. Thus, the Court of Appeals upheld the disallowance of any pass through losses attributable to LSA, Inc.

However, things then got worse for the Stullers. Previously, LSA, Inc. had paid rent to the Stullers.

The Stullers argued that, since the IRS disallowed their pass-through losses associated with LSA, the IRS should likewise be "estopped" from claiming that the rent payments from LSA constituted taxable income to the Stullers. However, the Court of Appeals held that the S corporation was a separate legal entity from the Stullers, and noted that the Stullers actually received rental funds from their S corporation. Therefore, even though the IRS could deny the S corporation's attempt to deduct the rental income under Section 183, the Stullers were nevertheless required to include the rental income in their taxable income for the years at issue.

III. Hobby Losses: Horse Breeder Was Able to Show "For Profit" Activity.

Recently, the 7th Circuit Court of Appeals reversed the Tax Court and held that Mr. Roberts engaged in his horse training activity "for profit." Roberts v. Commissioner, 117 AFTR 2d 2016-629 (7th Cir., April 10, 2016).

In Roberts v. Commissioner, the IRS disallowed certain horse breeding activity losses for 2005 through 2008. In reviewing all of the relevant facts, the Tax Court determined that, although Mr. Roberts did not engage in the activity "for profit" during the first two years of the activity, he was able to show that he was engaged in horse related activities "for profit" under Code Section 183 for the last two tax years at issue.

A. Background. Mr. Roberts owned a number of night clubs, restaurants and bars that he successfully operated. In 1987, Mr. Roberts purchased a 50 acre parcel of land that he rented to a farmer for about 10 years. In 1997, Mr. Roberts bought an additional 45 acre tract of land (the "Morris Street Property") directly north of the 50 acre tract. Mr. Roberts believed that, although he could only earn a small amount of income from this farm property, he could capitalize on the land investment by creating a 95 acre continuous plot through future appreciation.

In the late 1990s, Mr. Roberts became interested in breeding and training race horses. By 2005, Mr. Roberts decided to build his own horse training facility on the Morris Street Property, but ran into opposition from the local city government. The actions of the City discouraged Mr. Roberts from building on the Morris Street Property, and so he started looking for a new location to build a horse training facility.

In 2005, an unrelated party offered to buy the 95 acre tract (which included the Morris Street Property) for around $2.2 Million. In June 2006, Mr. Roberts closed on the sale and chose to recognize taxable gain on the 45 acre Morris Street Property parcel, but decided to reinvest the proceeds from the original 50 acre parcel through a Section 1031 exchange for other property that would be better suited for training horses. In 2006, Mr. Roberts purchased a 180-acre parcel of land near Mooresville, Indiana, for $1 Million and within the next six months, he invested between $500,000 and $600,000 in building improvements for a horse training facility.

In 2007 and 2008, Mr. Roberts became more heavily involved in his horse training activities.

B. **<u>Tax Court Decision</u>.** In the 2005 through 2008 tax years, Mr. Roberts was involved in multiple aspects of the race horse industry, including boarding, training and raising horses. Mr. Roberts had net losses from these activities for all four years at issue. Applying the nine (9) factor test under Reg. 1.183-2(b), the Tax Court found that Mr. Roberts was not engaged in the horse activity "for profit" during 2005 and 2006, but that he had established that he had engaged in these activities "for profit" in 2007 and 2008, notwithstanding continued losses in 2007 and 2008 as well.

Although Mr. Roberts employed a "rudimentary record keeping system," and even though Mr. Roberts had a history of losses in all of these years, other factors indicated his "for profit" objective in operating his business. For example, he sold his former unsuitable facility and moved his operations to a new property, expending substantial sums to build a premier training facility.

In addition, over time, he hired assistants and adopted accounting methods that allowed him to make informed business decisions. He also consulted with third-party experts as to how he could make his business more profitable and he also spent substantial time and effort in his horse breeding and training activities.

Mr. Roberts was also very active in various horse related trade associations and had risen through the ranks into leadership roles at two professional horse racing associations. And, Mr. Roberts had been successful in most of his prior business endeavors.

Based upon the facts, Mr. Roberts was able to show that he engaged in the horse related activities "for profit" in 2007 and 2008, but not for 2005 and 2006.

Mr. Roberts had argued that, notwithstanding his losses in 2005 and 2006, the Court should consider the fact that an overall profit was achieved in 2005 and 2006 by virtue of the sale of the Morris Street Property in 2006. The Court noted that, where land is purchased or held primarily with the intent to profit from its appreciation in value and where the taxpayer also engages in another activity on the land, then the activity **<u>and</u>** the holding of the land will ordinarily be considered a **single activity**, but **<u>only</u>** **<u>if</u>** the income derived from the activity exceeds the deductions attributable to that activity which are not directly attributable to holding land. In other words, when a taxpayer buys land mainly to profit from its appreciation, the potential appreciation of land is relevant in a Section 183 analysis <u>only</u> if the activity generates income in excess of deductions for the activity. On the other hand, when a taxpayer's primary intent is **not to profit** from the land, then the appreciation of the land **is considered** in a Section 183 profit analysis. <u>Perry v. Commissioner</u>, TC Memo 1997-4017.

Here, Mr. Roberts' primary intent in purchasing the Morris Street Property was to gain from its appreciation. Therefore, holding the Morris Street Property was an activity separate from his horse related activities and therefore any expectation of appreciation of that real estate would not contribute to finding that he was engaged in those activities for profit. Therefore, the fact that Mr. Roberts sold the Morris Street Property for gain would not help him establish a for profit motive for his horse activities for 2005 and 2006.

For 2007 and 2008, however, Mr. Roberts had purchased the Mooresville Property specifically to breed and train horses on that property. Therefore, the Mooresville Property's expected appreciation in value would be relevant to determining whether Mr. Roberts carried on his horse related activities with a "for profit" intent under Section 183 in 2007 and 2008.

And finally, for 2005 and 2006, Mr. Roberts' horse activities were primarily of a recreational and social nature. However, for 2007 and 2008, Mr. Roberts became more heavily involved in the horse-related activities with less emphasis on the recreational and social aspects of his horse related activities.

Based upon all of the facts, the Tax Court concluded that Mr. Roberts had established a "for profit" objective for 2007 and 2008, but not for 2005 and 2006. In essence, the Court somewhat "split the baby" and allowed the deductions for losses for two out of four years.

> **Note:** Also see, Annuzzi v. Comm'r, TC Memo 2014-233 (November 13, 2014), where the Tax Court concluded that the taxpayer had a "for profit motive" notwithstanding a 30 year history of losses.

C. Court of Appeals Reverses The Tax Court. On appeal, the 7th Circuit Court of Appeals held that Mr. Roberts had engaged in his horse training activity "for profit" for all four (4) years under audit. Roberts v. Commissioner, 117 AFTR 2d 2016-629 (7th Cir., April 10, 2016).

First, the Circuit Court took objection to the Tax Court's "split the baby" approach and stated that concluding -- that a business began as a hobby but then turns into a for profit business only after it becomes profitable -- would mean that essentially any start-up company would not be able to deduct its start-up costs. Moreover, the Court of appeals believed that, even in 2005 and 2006, Mr. Roberts operated his horse racing enterprise as a business.

And finally, the Court held that the Tax Court placed too much emphasis on the fact that Mr. Roberts enjoyed his activities, citing Jackson v. Commissioner, 59 TC 312, 317 (1972), in which the Jackson court stated that "success in business is largely obtained by pleasurable interest therein."

PART EIGHT
PASSIVE ACTIVITY LOSS CASES

I. Special Rules for Real Estate Professionals.

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

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

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

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

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

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

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

II. Mortgage Broker Fails to Qualify as Real Estate Professional Under the Passive Activity Loss Rules.

In Hickam, TC Summary Opinion 2017-66 (August 17, 2017), a mortgage broker failed to demonstrate that he was a "real estate professional" under the passive activity loss rules of Section 469.

Mr. Hickam was a mortgage broker who brokered and originated mortgage loans for his clients that were later used by the clients to buy real estate. During the tax years at issue, Mr. Hickam also owned several rental properties that reported net losses. Mr. Hickam took the position that he was a real estate professional and that the losses were therefore deductible under Section 469(c)(7)(C).

The Tax Court held that, although Mr. Hickam's mortgage brokerage business involved brokering and originating loans secured by real property, this business did not involve operating real properties. Therefore, hours he spent on his mortgage brokerage business could not be counted toward the 750 hour test. The Court implied, however, that the Court may have reached a different result if Mr. Hickam had brokered real estate, rather than simply brokering loans between buyers and financial institutions.

However, the Court did determine that Mr. Hickam's real estate activities with respect to the three (3) rental properties may constitute a real property trade or business. Unfortunately, Mr. Hickam did not keep contemporaneous records with respect to the hours that he spent on his three rental properties. During the audit, Mr. Hickam attempted to reconstruct a log of his hours and services with respect to these properties. However, because Mr. Hickam failed to keep contemporaneous records of the actual hours involved with his rental real estate activities, Mr. Hickam was not able to demonstrate that he qualified as a real estate professional.

> **Note**: The Court did **not** uphold assessment of the Section 6662(a) penalties.
>
> **Note**: In two other cases, the Tax Court was convinced by credible time logs and trial testimony. In Zarrinnegar v. Commissioner, TC Memo 2017-34 (February 13, 2017), based upon testimony and contemporary time logs, the Tax Court believed that a dentist worked fewer than 1,000 hours in his dental practice, but more than 1,000 hours in his real estate businesses. And, in Windham v. Commissioner, TC Memo 2017-68 (April 24, 2017), the Tax Court was convinced that a stockbroker devoted more hours to operating her real estate business than she did to her stockbroker work.

III. Taxpayer, Qualifying As A "Real Estate Professional," Still Must Prove Material Participation: Gragg vs. U.S. 118 AFTR 2d 2016-5091 (August 4, 2016).

In Gragg, the 9th Circuit Court of Appeals affirmed that merely qualifying as a real estate professional, under Code Section 469(c)(7), does not automatically make the taxpayer's rental losses deductible. The Court confirmed that even real estate professionals must prove their material participation and, material participation cannot be proven by offering only non-contemporaneous "ballpark guesstimates" of time spent on various activities.

IV. But, Another Real Estate Professional Was Able To Show Material Participation: Hailstock, TC Memo 2016-146 (August 8, 2016).

Ms. Hailstock quit her full-time job and began purchasing real estate. For the tax years at issue, she owned rental properties at over thirty (30) different locations. During the tax years at issue, Ms. Hailstock did not have a job outside of her real estate activities. Ms. Hailstock claimed that she spent over forty (40) hours per week on her real estate activities, which included purchasing supplies, supervising real estate repairs and meeting with prospective tenants.

However, Ms. Hailstock did not keep regular and contemporaneous records of time spent in her real estate activities. Likewise, Ms. Hailstock kept poor records of her income and expenses related to her real estate activities. So, during the Tax Court proceeding, the Tax Court allowed the IRS to use the "bank deposit analysis method" to reconstruct Ms. Hailstock's taxable income from her rental properties.

Here, notwithstanding her lack of contemporaneous time logs of her activities, the Court nevertheless found her testimony to be credible that she, in essence, was a "one man operation," and that she spent at least forty (40) hours per week on her real estate activities. The Court also noted that, by virtue of the IRS's bank deposit analysis reconstruction, it was clear that Ms. Hailstock had significant income and significant expenses associated with her real estate operations. Therefore, Ms. Hailstock met her burden of proving "material participation."

PART NINE
DEPRECIATION DEDUCTIONS

I. <u>Allocating Real Estate Purchase Price Between Buildings and Land; Neilsen v. Commissioner</u>.

A. <u>Background of General Allocation Rules.</u> Under Reg. 1.167(a)-5, when a single purchase price is paid to purchase both depreciable property (building) and non-depreciable property (land), the purchase price must be allocated between depreciable property and non-depreciable property based upon their relative fair market values at closing. Generally, the purchase price allocation is made based upon local county property tax values, as long as fair market values are not readily available. <u>Smith v. Commissioner,</u> TC Memo 2010-162. On the other hand, if better evidence of relative fair market values is available, then the allocation between depreciable property and non-depreciable property will be made based upon that better evidence, and not based upon local county property tax values. PLR 9110001.

B. <u>Neilsen v. Commissioner.</u> In <u>Neilsen v. Commissioner</u>, TC Summary Opinion 2017-31 (May 8, 2017), Mr. and Mrs. Neilsen acquired several different pieces of property over the span of about eight years from 2003 to 2011. For purposes of calculating depreciation on these rental properties, Mr. and Mrs. Neilsen included the cost of the land and improvements in their calculation of depreciable basis for their rental properties.

The IRS audited the Neilsen's 2012 tax return, and re-determined the appropriate depreciable basis of each rental property for that year, based upon county property tax records in effect during the years of purchase. The Neilsens argued that the county tax records allocated too much value to the land, and, at trial, they argued that a more accurate allocation should be made based upon other valuation methods. However, the Tax Court agreed with purchase price allocations based upon county tax records, partly because of the long passage of time since several of those properties were purchased.

PART TEN
CHARITABLE CONTRIBUTIONS

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

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

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

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

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

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

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

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

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

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

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

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

II. <u>A Charity's Faulty Letters of Acknowledgement Results in Denied Charitable Contribution Deductions</u>.

In <u>Durden</u>, 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.

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

In RERI Holdings I, LLC, 149 TC No. 1 (July 3, 2017), the Tax Court denied an LLC's charitable contribution deduction for the valuation of property donated to a University where the taxpayer failed to include its cost basis of the donated property on its Form 8283 submitted with its tax return. Here, the LLC purchased property for $3 Million in March 2002, and then donated a remainder interest in the real property to a university in August 2003. The LLC claimed a charitable contribution deduction of $33 Million for its assignment of its remainder interest to the University.

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

PART ELEVEN
S CORPORATIONS AND PARTNERSHIPS

I. Review of 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.

> **<u>Query</u>**: 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. <u>2006 Ruckriegel Case; Loans From Related Partnership Can Increase Basis Where Loans Made Directly to Shareholders</u>. In the case of <u>Ruckriegel v. Commissioner</u>, 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. <u>Direct Loans from the Partnership to the S Corporation</u>. 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.

II. <u>No Tax Basis Increase for Loan Guaranties Even After the Loan Is Called In Full.</u>

In Phillips v. U.S., TC Memo 2017-621 (April 10, 2017), Mrs. Phillips was a 50% owner of an S corporation. The S corporation developed and sold real estate. In 2007, after the S Corporation defaulted on significant real estate loans, the company's creditors sued Mrs. Phillips and were awarded judgments in excess of $100 Million. Mrs. Phillips took the position that once the loan obligations were reduced to judgments against Ms. Phillips, then she should be entitled to increase her tax basis in her S corporation stock by the guaranteed debt.

The Tax Court, however, ruled that, under the “economic outlay requirement,” Mrs. Phillips would not be entitled to any tax basis increase for her loan guaranties until she actually made payment to the corporation's lenders.

III. <u>S Corp Shareholder And Wife LLC Member Not Entitled to Tax Basis for Third Party Loans; Hargis v. Commissioner</u>.

In Hargis, TC Memo 2016-232 (December 21, 2016), Mr. Hargis owned 100% of several S corporations. The S corporation operated several nursing homes.

Mrs. Hargis owned 25% of several LLCs that owned real estate and equipment used in operating nursing homes, and these LLCs leased these assets to certain nursing home operators, including Mr. Hargis' operating companies.

Mr. Hargis was a co-guarantor of certain third party loans to his S corporations. Also, some of Mr. Hargis' profitable companies made certain inter-company loans to other unprofitable companies owned by Mr. Hargis. Not surprisingly, the Tax Court held that Mr. Hargis could not increase his tax basis in his S corporation stock by the amount of any co-guaranteed debt to the S corporations. The Court also held that Mr. Hargis could not increase his basis in S corporation stock by the amount of any inter-company loans.

What was more surprising, however, was the fact that the Tax Court did not allow Mrs. Hargis to claim tax basis for the LLC's debt borrowed from certain third parties. The Tax Court held that, although Mrs. Hargis was able to verify that the LLC incurred debts from third parties, Mrs. Hargis was not able to verify how those partnership liabilities were deemed to be allocated among the various LLC members for tax purposes.

Even though Mrs. Hargis presented Schedule Forms K-1 in trial, the Schedules K-1 did not report the total amount of partnership liabilities and did not report the amount of partnership liabilities that would be allocated to Mrs. Hargis. None of the Schedule Forms K-1 showed the amount of liabilities that had been specifically allocated to Mrs. Hargis. Therefore, Mrs. Hargis was not able to establish exactly how much of the partnership liabilities should be allocated to her for partnership tax basis purposes.

IV. **<u>Partnership's Allocation of Losses Failed The Substantial Economic Effect Test.</u>**

In Chief Counsel Memorandum 201741018, the IRS determined that a partnership's method of allocating losses to certain "equity partners" lacked economic effect, and therefore the losses had to be reallocated to other partners. Because these "equity partners" had no obligation under the Partnership Agreement to restore their negative capital accounts upon liquidation of the partnership, partnership losses could only be allocated to certain "equity partners" to the extent of their positive capital account balances.

V. **<u>S Corporation Payments of Owner's Personal Expenses Are Treated as Loan Repayments and Not As Taxable Compensation: Scott Singer Installations, Inc., TC Memo 2016-161 (August 24, 2016)</u>.**

Over the course of several years (from 2006 to 2008), Mr. Singer advanced over $600,000 to his S corporation to fund new business expansions. The S corporation incurred business difficulties from 2009 to 2011, and Mr. Singer personally borrowed over $500,000 that he then loaned to his S Corporation.

The S Corporation reported operating losses of over $100,000 for 2010 and over $250,000 for 2011. During these two years, the S Corporation paid over $182,000 of Mr. Singer's personal expenses -- by directly paying S corporation funds to Mr. Singer's personal creditors.

Upon audit, the IRS took the position that, when the S corporation paid these funds to Mr. Singer's creditors, the payments should be treated as wage payments to Mr. Singer, that would be subject to self-employment taxes, rather than as non-taxable repayments of Mr. Singer's loan to his S corporation.

The S Corporation consistently reported all of Mr. Singer's advnaces as shareholder loans on the S Corporation's general ledgers and tax returns. However, there were no promissory notes between Mr. Singer and his S Corporation. And, Mr. Singer never charged any interest to the S Corporation, and there were no maturity dates imposed on the loans.

However, the S Corporation did not claim any business deductions for the amounts paid to Mr. Singer's personal creditors and, instead, treated the payments as partial repayments of Mr. Singer's loans to the S Corporation.

Upon audit, the IRS took the position that Mr. Singer was an employee of the S Corporation for 2010 and 2011, and therefore contended that the payment of over $180,000 of personal expenses should have been treated as taxable wages to Mr. Singer that would be subject to employment taxes.

The Court, however, agreed with Mr. Singer notwithstanding the absence of any loan documentation between the parties. Here, the Court ruled that the principal factor to be reviewed, in evaluating the nature of transfers to closely-held corporations, was whether there was a genuine intention to create a debt with a reasonable expectation that the debt would be repaid to the S Corpoation shareholders.

The Court noted that there were several factors that indicated that Mr. Singer intended to establish a "debtor-creditor" relationship with his S corporation when some of the advances were made. For example, the S Corporation always reported Mr. Singer's advances as loans on its general ledgers and tax returns, and the S Corporation balance sheets showed the advances as loans. Also, the S corporation always treated its payment of Mr. Singer's personal debts as loan repayments and not as deductible business expenses.

Also, the amounts paid to Mr. Singer's personal creditors each year were consistent, regardless of the value of services he actually rendered to the corporation during those years. For example, many of the payments were for Mr. Singer's recurring and fixed monthly expenses, such as home mortgage payments and vehicle loan repayments. Because these payments were consistent in amount and were made on a regular basis, this indicated that the payments were more in the nature of debt repayments -- as opposed to compensation for services.

According to the Court, however, not all of Mr. Singer's advances to the corporation should be treated as loans. The Court noted that Mr. Singer had a "resonable expectation of repayment of loans" when he made advances during 2006 and 2008, because, at that time, the business was well known and was successful. However, the Court did not believe that Mr. Singer had a "reasonable expectation of repayment" for the advancess he made after 2008, because of the poor financial condition of the company at that time. Therefore, with respect to advances made after 2008, the Tax Court ruled that those advances were "capital contributions" and not loans.

PART TWELVE
NOL AND CREDIT CARRY FORWARDS

I. NOL Loss Carryover Deduction Not Allowed When Taxpayer Could Not Prove the Amount of the NOL From Closed Tax Years.

In Powers v. Commissioner, TC Memo 2016-157 (August 22, 2016), Mr. and Mrs. Powers had certain net operating losses for 1999 through 2002 that they sought to carryforward and use in 2007. When the 2007 tax return was audited, Mr. and Mrs. Powers admitted that they could not prove the exact amount of their NOL carryforwards but they were somewhat able to estimate their carryforwards.

According to the Court, under the “Cohan Rule”, the Court must have some information to estimate a proper deduction in those cases where the taxpayer is unable to substantiate the precise amount of any claimed deduction. Here, however, the Powers provided no testimony or other evidence to allow the Court to make any reasonable estimate of their reported NOL. Instead, the Powers were only able to provide copies of the 1999 through 2002 tax returns.

This case clearly reminds us that we must keep records of all transactions in NOL years for as long as we intend to use those NOL carryforwards.

II. **Taxpayer Not Entitled to Unsubstantiated NOL Carryforwards From Closed Years: Jasperson vs. Commissioner, 118 AFTR 2d 2016-5633 (11th Cir., August 31, 2016).**

Mr. Jasperson formed an S corporation in 1998, that engaged in the business of liquidating video stores. Mr. Jasperson claimed that his S corporation had losses in 2005 and 2006, that were passed-through to Mr. Jasperson, who then carried the NOLs forward on his individual tax returns for 2008, 2009, and 2010. Mr. Jasperson claimed that, rather than carry his NOLs back two years, he had elected, pursuant to Code Section 172(b)(3) to "waive" the two year period carry back option, and instead to carry the NOL losses forward.

Mr. Jasperson's 2008, 2009 and 2010 personal tax returns were selected by the IRS for examination, and in 2013, the IRS assessed additional tax for 2008 through 2010, on the basis that Mr. Jasperson could not document and verify the validity of his NOL carryforwards from 2005 and 2006.

Here, by the time the IRS assessed the tax deficiencies for 2008 to 2010, the statute of limitations were already closed with respect to Mr. Jasperson's 2005 and 2006 tax returns.

However, according to the 11th Circuit Court of Appeals, this did not preclude the IRS from disallowing his NOL carry forwards in the 2008 through 2010 years. Ultimately, Mr. Jasperson was not able to produce any records from 2005 to 2006 to verify the calculations of his NOLs for those years; therefore, the NOL carry forwards into 2008 through 2010 were disallowed.

> **Note**: The 11th Circuit Court of Appeals also affirmed the Tax Court's confirmation of the imposition of the Section 6662 accuracy-related penalties for these years.

> **Note**: This case stresses the importance of retaining NOL records through the 20-year carry-forward period.

III. IRS Permits Carry-Forward Of Increased Section 38 Credits From "Closed Years."

In PLR 201548006, the taxpayer was a partner of a partnership and a shareholder in an S corporation. For several years, the partnership and the S corporation understated the amount of their general business credit for several earlier years that were now "closed". Nevertheless, the IRS held that the taxpayer could use the "corrected" amount of the partnership's and S corporation's general business credit for the closed years to compute his general business carry-forward to an open tax year.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

V. IRS Gets Summary Judgment Against President For Trust Fund Recovery Penalties.

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

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

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

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

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

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

PART FIFTEEN
NOMINEE, TRANSFEREE AND SUCCESSOR TAX LIABILITY CASES

I. Transferee, Successor and Nominee Liability Rules.

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

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

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

3. Equitable transferee liability (also called the "trust fund" theory) - which is assessed for example when a corporation (owing taxes) distributes its assets to its

shareholders who are then jointly and severally liable for the unpaid taxes of the transferor corporation to the extent of assets received from the corporation.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

PART SIXTEEN
EMPLOYMENT TAXES

I. Tax Court Suggests That Some LLC Pass-Through Income May Be Exempt From Self-Employment Tax.

In Castigliola, TC Memo 2017-62 (April 12, 2017), Mr. Castigliola was a member of a law firm that operated as a professional limited liability company. The limited liability company was a "member-managed" LLC formed under the laws of Mississippi. The LLC had no written operating agreement.

Each year, the LLC paid its attorneys certain "guaranteed payments" which were commensurate with local legal salaries as determined by a survey of legal salaries in the area. Any profits of the LLC in excess of the guaranteed payments were distributed among the members based upon the members' agreement among themselves.

Mr. Castigliola and his partners paid self-employment tax on the guaranteed payments, but took the position that their distributive share profit payments were not subject to self-employment tax.

In determining whether the distributive share profit payments were "self-employment income" under the limited partner exclusion of Section 1402(a)(13), the Tax Court noted that in a limited partnership, general partners have both management power and unlimited personal liability, whereas limited partners lack management authority but also enjoy immunity from partnership debts.

Here, the Court noted that the PLLC was a member-managed LLC and therefore each of the members had the authority to participate in management decisions and, in fact, the members testified that all the members participated equally in all the decisions relating to the PLLC. The court concluded, therefore, that the members could not avail themselves of the limited partner exception of Section 1402(a)(13).

> **Note**: Interestingly, however, the Tax Court never stated that LLC members always are subject to self-employment tax on LLC income. Here, if the LLC had been a manager-managed LLC and if Mr. Castigliola had not been a manager, then one wonders if the Tax Court might have reached a different result.

II. Surgeon's Investment in Surgical Center Generates Non-Self-Employment Income.

In Hardy v. Commissioner, T.C. Memo 2017-16 (January 17, 2017), Dr. Hardy was a surgeon who purchased a minority interest in a surgical facility owned through an LLC. Mr.

Hardy claimed that his distributive share of the LLC income should not be subject to self-employment tax.

In Hardy, patients of the medical facility paid three (3) types of fees: (1) the fees of the surgeon, (2) the fees of the anesthesiologist, and (3) the fee to the surgical facility for use of the facility's equipment and staff.

The Tax Court agreed with Dr. Hardy on the basis that, as a minority investor in the surgical center, he was acting more as a limited partner/investor.

All the fees paid to the surgical center were paid by patients and Dr. Hardy's distributive share of the LLC income was not based upon the number of surgeries he performed at the surgical center. In addition, Dr. Hardy was not involved in the day-to-day business activities of the LLC.

The Tax Court distinguished its decision in Hardy from its earlier decision in Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. 137 (2011). Renkemeyer involved partners who were lawyers in a limited liability partnership. There, the Tax Court previously ruled that, because the revenue was derived from the legal services performed by the partners in their capacity as partners, they were not acting as "investors" in the law firm, and thus their distributive share of partnership income had to be subject to self-employment tax.

Here, in Hardy, however, Dr. Hardy received distributions that were based on fees paid by patients to use the surgical center facility, and thus the revenue generated by the surgical facility was simply for the patients' use of the facility.

III. Financial Planner Could Not Avoid Self-Employment Tax By Running Commissions Through His S Corporation.

In Fleischer v. Commissioner, U.S.T.C. Memo 2016-238 (December 29, 2016), Mr. Fleischer formed an S corporation called Fleischer Wealth Plan (“FWP”). Previously, Mr. Fleischer entered into a Representative Agreement with LPL Financial Services to serve as an independent sales contractor for LPL.

During the tax years at issue, Mr. Fleischer received commission income from LPL and LPL issued Mr. Fleischer a Form 1099 in his individual name. Mr. Fleischer, however, reported all the sales commissions from LPL on FWP's Form 1120S. As a result, Mr. Fleischer avoided self-employment income on the Form 1099 income issued by LPL.

The Tax Court ruled that, under the "who earned the income" test, the proper focus is who controls the earning of the income. Johnson v. Commissioner, 78 TC 882 (1982). Under this test, for a corporation, rather than its service provider-employee, to be the "controller of the income", two elements must be found: (1) the individual providing the services must be an employee of the corporation that in turn controls the employee and (2) there must exist between the corporation and the end user some type of contract or similar agreement recognizing the corporation as controlling the service provider.

Here, the agreement between Mr. Fleischer and LPL was clearly between LPL and Mr. Fleischer. Moreover, the contract between LPL and Mr. Fleischer never made any mention of FWP. Therefore, it was Mr. Fleischer, not his corporation, who earned the taxable income from LPL.

IV. <u>Chief Counsel Advises That LLC Manager Was Subject To Self-Employment Tax On All Of His "Distributable Share" Of LLC Profits: CCA 201640014</u>.

CCA 201640014 (June 15, 2016) involved a taxpayer-franchisee restaurant entrepreneur that operated a number of franchise restaurants through a limited liability company. According to the facts of this CCA, the taxpayer-franchisee originally purchased a number of franchise restaurants, and then contributed the restaurants to a limited liability company. The taxpayer-franchisee continued to be the "franchisee" for each of the franchised locations, and served as operating manager/president and chief executive officer of the LLC.

Here, the tax issue was whether the taxpayer would be subject to "self-employment" tax on his share of distributable profits attributable to his ownership interest in the LLC. The Operating Agreement for the LLC provided for only one class of unit ownership interest.

The taxpayer-franchisee held a majority ownership interest in the LLC, with the remaining membership interests in the LLC being owned by the franchisee-taxpayer's wife and her irrevocable trust. Because neither the franchisee-taxpayer's wife nor her trust were involved in the day-to-day affairs of the LLC, the IRS did not question their status as "limited partners" for purposes of Section 1402(a)(13) self employment tax issues. So, here the only question was whether the taxpayer-franchisee could likewise be treated as a "limited partner" of the LLC for self-employment tax purposes.

Under the terms of the franchisee's Franchise Agreements, the taxpayer was required to personally devote his full-time and best efforts to running the operation of the LLC. As the LLC's president and chief executive officer, the taxpayer, under the LLC's Operating Agreement, had full authority to run the day-to-day affairs of the LLC. And indeed, the taxpayer was very involved in the day-to-day business affairs of the LLC.

However, at the same time, the LLC employed a large number of individuals, some of whom had management and/or supervisory responsibilities. In fact, the LLC had appointed an executive team consisting of financial and operation executives that held no ownership interests in the LLC.

For the tax years under audit, the LLC made "guaranteed payments" to the taxpayer, but treated the taxpayer as a "limited partner" for self-employment tax purposes under Section 1402(a)(13), and thus only included the guaranteed payments into the taxpayer's "net earnings" for self-employment tax purposes. The LLC did not withhold or pay self-employment tax on the taxpayer's distributable share of LLC income/profits for those years.

The LLC took the position that the taxpayer's income from the partnership should be "bifurcated," for self-employment tax purposes, between the taxpayer's (1) distributive share of LLC income attributable to capital invested or the efforts of others, which is not subject to self-employment tax, and (2) compensation for services rendered which is subject to self-employment taxes. Here, the LLC had significant capital investments in buildings, equipment and working capital and employed many other employees.

According to the LLC, the taxpayer and the LLC had significant capital outlays to acquire and maintain its restaurants, and also argued that the LLC derived its income from the preparation and sale of food products by all of its numerous employees and not by virtue of the personal services of the taxpayer. Moreover, the LLC further argued that the taxpayer's "guaranteed payments" represented "reasonable compensation" for his services - and that the taxpayer's share of LLC profits - beyond his guaranteed payments - were basically of an investment nature.

In the CCA, the IRS noted that Section 1402(a)(13) provides an exclusion, from the definition of the term "net earnings from self-employment," with respect to the distributive share of any partnership items of income of a "limited partner," other than guaranteed payments. According to the CCA, individual partners, who are not "limited partners," are subject to self-employment tax regardless of their participation in the partnership's business and regardless of the capital intensive nature of the partnership's business.

The Service noted that, in a number of prior court cases, individuals, who owned working interests in oil and gas ventures, but who did not participate in those business operations, were nevertheless found to be liable for self-employment tax on their earnings from the joint venture, notwithstanding the individuals' lack of participation in the activity. *See* Cokes vs. Commissioner, 91 TC 222 (1988), Methvin vs. Commissioner TC Memo 2015-81, and Perry vs. Commissioner, TC Memo 1994-215.

Here, the Chief Counsel concluded that the taxpayer/LLC manager could not be a "limited partner" in the LLC for purposes of Section 1402(a)(13), because the legislative history to Section 1402(a)(13) was intended to apply **only** to those who "merely invested" in the LLC, rather than those who "actively participated" and "performed services for a partnership in their capacity as partners." *See*, Renkemeyer, 136 TC 137, at 150 (2011).

According to the CCA, only "passive investors" can qualify as limited partners, regardless of whether the partnership operates a capital intensive business. Instead, if an LLC owner participates in the business of the LLC, then the LLC owner is a "self-employed" individual for purposes of the SE tax rules. So, regardless of whether guaranteed payments represent a reasonable compensation for the services provided by the service partner, all of that service partner's distributive share of partnership income would be subject to self-employment tax and regardless of whether the partnership is engaged in a capital intensive business.

V. <u>**Sporadic Sale of Scrap Steel Did Not Amount to a Trade or Business: Ryther, TC Memo 2016-56 (March 28, 2016)**</u>.

Thomas Ryther owned a steel fabrication business that ultimately went through bankruptcy. At the conclusion of the bankruptcy proceeding, the bankruptcy trustee abandoned what it believed to be worthless property, including some scrap steel. Over the next several years, Mr. Ryther made sporadic sales of his scrap steel generating over $300,000 of revenue over a seven (7) year period.

Mr. Ryther reported the sales proceeds as "other income" on his tax return. Later, the IRS took the position that the scrap steel sales constituted a "trade or business" that should be subject to self-employment tax. Code Section 1402(a)(3) provides that any gain from the sale of a taxpayer's own property does not constitute self-employment income, unless (1) the property is inventory or (2) the property is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

Here, the Court determined that Mr. Ryther was not holding the scrap steel in the ordinary course of his business, based upon the following factors:

1. <u>Frequency or regularity of sales</u>. The sales of scrap steel were only made once or twice a month, so this factor favored Mr. Ryther.

2. <u>Substantiality of Sales</u>. Although sales were sporadic in number, the revenue generated constituted all of Mr. Ryther's income during the tax years. However, there was very little effort on Mr. Ryther's behalf to generate this revenue. The Court found this factor as neutral.

3. <u>Length of Time the Property is Held by the Taxpayer</u>. Mr. Ryther held the scrap metal for over seven (7) years so this factor favored Mr. Ryther.

4. <u>Segregation of Personal Property From Business Property</u>. Since Mr. Ryther did not have "personal" scrap metal and "business" scrap metal, this factor was neutral.

5. <u>Purpose of Acquisition</u>. The scrap metal was left after Mr. Ryther's business closed so this factor was neutral.

6. <u>Sales and Advertising Efforts</u>. Mr. Ryther did not make any attempt to advertise the property for sale. However, since there was a ready market for scrap steel, this factor was neutral.

7. <u>Time and Effort Devoted to the Activity</u>. Mr. Ryther contacted scrap wholesalers directly to arrange sales to third party buyers. However, the buyers did not approach Mr. Ryther as customers typically would. Thus, this factor was neutral.

8. <u>How the Sales Proceeds Were Used</u>. This was perhaps the most important factor viewed by the Court in Mr. Ryther's favor, as Mr. Ryther did not use any of the proceeds from

the sales to acquire more scrap metal. Instead, he was merely liquidating the scrap to pay normal living expenses.

Based upon the foregoing, the Court held that Mr. Ryther's scrap steel was not held for customers in the ordinary course of Mr. Ryther's trade or business, and therefore no self-employment tax would be owed on the gains.

PART SEVENTEEN
EMPLOYEE VS. INDEPENDENT CONTRACTOR

I. Home Care Provider Meets the Section 530 "Reasonable Basis" Test for Treating Workers as Independent Contractors For Employment Tax Purposes: Nelly Home Care, LLC v. U.S. 117 AFTR 2d 2016-1500 (May 10, 2016).

Nelly Home Care, Inc. ("NHC") was formed and managed by Helen Carney, as a successor in interest to Nelly, LLC ("Nelly"). NHC provided non-medical home care services.

Throughout its history, NHC would contract with workers to provide home care services to senior citizens. NHC represented itself as a "matchmaker" between elderly customers and workers who provided home care services. After a prospective customer contacted NHC requesting a home care worker, NHC would review workers in its work registry to determine if anyone was available. NHC took the position that it neither trained nor supervised workers in their performance of duties.

Prior to forming NHC, Ms. Carney actually worked as a provider of home care services. While working as a home care service provider, Ms. Carney met other providers of in-home health care services, and learned that they worked as independent contractors. Ms. Carney then learned that other home care service providers in her area also treated their workers as independent contractors. This was when Ms. Carney then decided to start her own company to provide home care services through independent contractors in the Bryn Mawr, Pennsylvania area.

In 2007, the IRS audited the personal tax returns of Ms. Carney and her husband for the 2004 and 2005 tax years. As part of the audit, the IRS requested information regarding Nelly, LLC (the predecessor to Nelly Home Care, Inc.). The requested information included information relating to Forms 1099, and copies of independent contractor agreements for Nelly, LLC and its independent contractors.

Ultimately, the IRS assessed additional taxes to Mr. and Ms. Carney after finding that Ms. Carney had charged 80% of her personal expenses through Nelly, LLC.

In 2011, the IRS conducted an employment tax audit of Nelly, LLC and Nelly Home Care, Inc. and determined that its workers were employees and not independent contractors. Ms. Carney took the position that she should be entitled to Section 530 "safe harbor" relief.

Section 530 of the Revenue Act of 1978, provides a "safe harbor" for taxpayers who are assessed back employment taxes after they erroneously failed to classify certain workers as employees, rather than independent contractors, provided that the taxpayer had a "reasonable basis" for not treating the workers as employees.

Generally, a taxpayer can show that it had a "statutory reasonable basis," to not classify its workers as employees, if the taxpayer based this classification on reasonable reliance upon one (1) of the following:

1. judicial precedent, published rulings or a letter ruling to the taxpayer (the "Judicial Precedent Defense");

2. a past Internal Revenue Service audit in which there was no assessment attributable to the treatment for employment tax purposes of the individuals as independent contractors (the "Prior Audit Defense"); or

3. a long-standing recognized practice of a significant segment of the industry in which such individuals engage (the "Long Standing Industry Practice Defense").

The Tax Court held that Ms. Carney did not satisfy any of the three (3) statutory safe harbor relief provisions.

Here, although there was a prior IRS audit of the Carneys' returns, the IRS reviewed Nelly's business records in a prior audit **only** to determine that certain deductions and expenses claimed by the LLC should be non-deductible personal expenses of Ms. Carney. Therefore, Ms. Carney could not rely upon the "Prior IRS Audit Defense" for relief under the second statutory safe harbor.

The Court also held that Ms. Carney could not meet the third statutory safe harbor test ("Long Standing Industry Practice Defense"), because Ms. Carney could not prove that a significant segment of her home health care industry likewise treated its workers as independent ccontractors. Here, although Ms. Carney testified that she had known other health care agencies that treated their workers as independent contractors, this did not establish a "significant segment of an industry" as a whole. Second, Ms. Carney had not been able to provide any evidence that this was a "long-standing" practice when entering into her industry.

Nevertheless, the Court held that, although NHC and Nelly had not shown that it was entitled to any "statutory safe harbor relief" under Section 530, the record demonstrated that NHC would be entitled to relief under the "common law other reasonable basis" safe harbor which is also known as the "common law" reasonable basis test of Section 530.

Here, prior to forming Nelly Home Care, Inc., Ms. Carney had indeed looked at other home health care agencies and found that most of them treated their workers as independent contractors. Also, the Court found it significant that the IRS had said nothing in its prior audit about independent contractor classification when the IRS audited Ms. Carney's personal tax returns for earlier years. The Court noted that, during the audit of Ms. Carney's personal tax returns, the IRS requested and reviewed numerous documents regarding Nelly, including copies of contracts with independent contractors.

According to the Court, given that the IRS undertook an indepth analysis of Nelly's business practices, it was reasonable for Ms. Carney to interpret the IRS' silence on the independent contractor classification issue as "acquiescence."

Based upon all of the facts and circumstances, the Court therefore held that the Carneys met the "common law reasonable basis" test under Section 530.

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

I. Sometimes, Reliance On A Non-Tax Professional Still Constitutes "Reasonable Cause" For Avoidance of Tax Penalties.

CNT Investors, LLC v. Commissioner, 144 T.C. No. 11 (March 23, 2015), involved a complicated series of transactions in a "Son of BOSS" tax shelter transaction. In this case, the Tax Court ruled that a taxpayer may be relieved of the Section 6662 negligence penalty for relying on the advice of a professional, **even if the professional is not a tax professional nor someone who holds himself out as being a tax professional.**

In this case, the Tax Court held that an entrepreneur, who had long relied on the trusted advice of his business lawyer, would not be subject to Section 6662 negligence penalty for relying on the advice of his long term business lawyer, who endorsed a highly complicated "Son of BOSS" transaction, even though the taxpayer's business lawyer lacked technical tax expertise.

Mr. Carroll was the tax matters partner for CNT Investors, LLC. In the Tax Court proceeding, Mr. Carroll conceded that the entire "Son of BOSS" transaction was a sham transaction having "no business purpose," but challenged the assessment of the Section 6662 penalty on the basis that Mr. Carroll "relied reasonably and in good faith on independent professional advice."

The Carroll Family had a number of advisors. First, there was Mr. Roger Myers who was their general business lawyer. Although Mr. Myers had taken some basic federal income tax courses, he did not hold himself out as being a tax expert.

Next, there was Frank Crowley, CPA. In addition to being a CPA, Mr. Crowley was also a Certified Financial Planner.

During the tax years at issue, Mr. Carroll owned a funeral home company that in turn owned highly appreciated real estate. Mr. Carroll believed that, if a national funeral home chain purchased his funeral home business, the buyer would not want to purchase the company's real property. So, Mr. Carroll sought advice from Mr. Myers and Mr. Crowley as to ways to transfer the funeral home real estate out of the company without incurring a significant tax liability. But, of course, neither Mr. Myers nor Mr. Crowley could conceive of any way to have the mortuary company divest itself of its appreciated real estate without triggering a significant tax liability.

Sometime later, however, Mr. Myers was describing Mr. Carroll's problem with a long time financial advisor, Ross Hoffman, and Mr. Hoffman advised that he had attended a seminar in Las Vegas, and had heard Erwin Mayer, an attorney with the law firm of Jenkins and Gilchrist, provide a presentation on the "Son of BOSS" transaction. Although Mr. Hoffman was a financial advisor, he was not a tax professional and did not hold himself out as being one.

Later, Mr. Hoffman and Mr. Myers held a conference call with Mr. Mayer to learn more about the "Son of BOSS" transaction. Later on, Mr. Myers and Mr. Hoffman met with the Carrolls and Mr. Crowley on two occasions to discuss a proposed "Son of BOSS" transaction involving Mr. Carroll's funeral home company. Mr. Hoffman also advised that Ted Turner had even successfully engineered a similar strategy.

Ultimately, the Carrolls decided to proceed with the "Son of BOSS" transaction. Mr. Crowley prepared and filed the tax return for the year at issue.

During the Tax Court proceeding, the Carrolls agreed that the transaction lacked "economic substance," and therefore resulted in a taxable transaction. However, the Carrolls contended that the Section 6662 accuracy penalty should not apply. Under Section 6664(c), the Section 6662 penalty will not apply to a tax underpayment where the taxpayer had reasonable cause and with respect to which the taxpayer acted in good faith.

Here, Mr. Carroll contended that he had reasonably relied on the advice of Mr. Myers and Mr. Crowley. Indeed, the regulations provide that reliance on "professional advice" will absolve the taxpayer of penalty liability if the reliance was reasonable and if the taxpayer acted in good faith. Reg. Section 1.6664-4(b)(1). In this case, Mr. Carroll would have to prove, by a preponderance of evidence, that Mr. Carroll met each of the following three (3) prong requirements:

1. The advisor was a competent professional who had sufficient expertise to justify reliance;

2. The taxpayer provided necessary and accurate information to the advisor; and

3. The taxpayer actually relied in good faith on the advisor's judgment.

See <u>Neonatology Associates, P.A. v. Commissioner</u>, 115 TC 43 (2000), aff'd, 299 F.3d 221 [90 AFTR 2d 2002-5442] (3rd Circuit 2002).

The Tax Court first ruled that, with respect to Mr. Crowley's advice, Mr. Carroll <u>did not meet</u> the three (3) prong test under the regulations. During testimony, Mr. Crowley testified that, in various meetings with Mr. Carroll, Mr. Crowley openly acknowledged that he did not fully understand how the "Son of BOSS" transaction would work. Therefore, according to the Tax

Court, Mr. Carroll's reliance on any endorsement of the transaction by Mr. Crowley could not have been "reasonable and in good faith," in light of Mr. Crowley's admitted confusion and lack of understanding of the structure of the Son of BOSS" transaction.

Mr. Myers, however, testified that he both understood the nature of the proposed "Son of BOSS" transaction and that he had endorsed it to Mr. Carroll. The more difficult question, however, was whether Mr. Myers had sufficient expertise to justify Mr. Carroll's reliance on his advice.

The Tax Court noted that Section 6664(c) does not require that the advisor possess a strong level of knowledge of federal tax law. Instead, the relevant regulations only provide that "reliance may not be reasonable or in good faith if the taxpayer knew or reasonably should have known that the advisor lacked such knowledge." Reg. Section 1.6664-4(c)(1).

Here, the Tax Court ruled that Mr. Myers possessed sufficient business expertise to justify reliance by Mr. Carroll. Mr. Myers had practiced law for thirty (30) years, and he had represented Mr. Carroll for almost twenty (20) of those years. Mr. Carroll had relied upon Mr. Myers' advice on a number of business transactions throughout the years, and Mr. Myers was Mr. Carroll's "go to attorney and trusted counselor." Also, Mr. Myers performed due diligence on the proposed "Son of BOSS" transaction through his conference calls with Mr. Mayer.

Therefore, the Tax Court ruled that when presented with the transaction proposed by Mr. Hoffman, Mr. Carroll naturally relied upon Mr. Myers, as he had in the past, for all forms of legal advice, including tax matters, and that when Mr. Myers advised Mr. Carroll that the transaction appeared to be a viable way to resolve the appreciated real property distribution issues, Mr. Carroll could justifiably rely on that advice.

Therefore, the Tax Court held that the Section 6662 penalty would not be applicable.

II. Dissolved Corporation Cannot File Tax Court Petition: Allied Transportation, Inc., TC Memo 2016-102 (May 25, 2016).

Allied Transport was formed in 2001 as a Maryland corporation. But in 2004, the Maryland Department of Revenue revoked Allied's corporate charter for failing to file a required tax return.

In August 2014, the IRS mailed Allied a Ninety (90) Day Statutory Notice of Deficiency and, within the 90-day Statutory Notice Of Deficiency Period, Allied filed a US Tax Court Petition to challenge the tax assessment. The Tax Court granted the IRS' motion to dismiss the Tax Court Petition for "lack of jurisdiction," on the basis that Allied's corporate charter had been revoked some ten (10) years earlier.

Under the Maryland law, a corporation, whose corporate charter has been revoked, may not initiate a law suit, unless the law suit was related to the "winding up" of the corporation's activities. Here, the Tax Court Petition was filed ten (10) years after the company's charter was revoked. The Tax Court, therefore, ruled that the US Tax Court Petition must be dismissed, since the Tax Court Petition could not have been initiated in connection with the "winding up" of the corporation's activities.

Also, see Urgent Care Nurses Registry, Inc., TC Memo 2016-198 (November 2, 2016).

III. Tax Court Dismisses Tax Court Petition Where Corporate Privileges Had Been Suspended.

In Medical Weight Control Specialists v. Commissioner, TC Memo 2015-52 (March 18, 2015), a corporation had its corporate privileges suspended by the State of California in 2004 for failing to pay state taxes. The IRS issued a statutory Notice of Deficiency to the corporation on May 22, 2013.

In order to avoid having to pay the tax deficiency and sue for refund, the corporation filed a U.S. Tax Court Petition on June 17, 2013, well within the ninety (90) day statutory Notice of Deficiency period. However, almost a year later, in April 2014, the IRS filed a Motion to Dismiss the U.S. Tax Court Petition on the basis that the corporation did not have the "corporate power" to file a U.S. Tax Court Petition. In May 2014, the company paid its delinquent California taxes and the State of California reinstated the company's corporate powers.

The Tax Court ruled that, even though the corporation had its corporate status reinstated, it was prohibited under California state law from maintaining any type of judicial action during the period in which its authority was suspended. Therefore, the corporation lacked the "corporate capacity" to file a valid Tax Court petition, such that the Tax Court did not have jurisdiction over the tax case.

The Tax Court noted that, under California law, a previously suspended corporation may continue prosecuting law suits filed at a time when the corporation's authority was suspended. However, here, because the ninety (90) day statutory notice of deficiency expired before the taxpayer's charter was revived, the statutory notice period served as a statute of limitations.

> **Note**: N.C.G.S. 55-14-22(c) states that, if a North Carolina corporation is administratively dissolved and its charter is later reinstated, then the reinstatement "relates back to," and takes effect as of, the date of the administrative dissolution, and the corporation resumes carrying on its business as if the administrative dissolution had never occurred. N.C.G.S. 57D-6-06(c) provides for a similar rule applicable to limited liability companies.
>
> **However, given the Tax Court decision in Medical Weight Loss Specialists, the practitioner should confirm that a corporate taxpayer's charter is "in good standing" prior to filing a U.S. Tax Court Petition.**

IV. Administrative Termination of a Corporation Did Not Affect Its Status As a Corporation for Federal Tax Purposes.

In Private Letter Ruling 201522001 (May 29, 2015), a corporation was administratively dissolved for failing to file an annual report and paying annual franchise taxes. The taxpayer corporation was not aware of the administrative dissolution and continued to file Form 1120 and pay all corporate taxes as they became due. Once the taxpayer corporation learned of its administrative dissolution in the following year, the taxpayer re-incorporated.

The IRS ruled that the taxpayer corporation status as a corporation for federal tax purposes did not terminate notwithstanding its administrative dissolution.

Note: The facts of this case were very favorable to the taxpayer-corporation.

V. A Single Member LLC Is Taxed As "A Disregarded Entity" - Even After It Files Form 1120: Heber E. Costello, LLC vs. Commissioner, TC Memo 2016-184 (September 29, 2016).

Mr. Costello inherited Heber E. Costello, Inc. from his father ("HECI"). In late 2003, Mr. Costello formed a single-member LLC (the 'LLC"). Mr. Costello then merged HECI into the LLC. Mr. Costello never filed a Form 8832, Entity Classification Election, for the LLC. However, after the merger, Mr. Costello reported all of the LLC income on Forms 1120, using HECI's employor identification number ("EIN").

Mr. Costello filed Forms 940 and 941 on behalf of the LLC for 2006, 2007 and 2008, but did not make sufficient tax deposits to satisfy its employment tax liabilities for 2007 and 2008.

The IRS contended that, under pre-2009 law, Mr. Costello was personally responsible for the unpaid employment taxes of the LLC. Under the former version of IRC Section 301.7701-2(c)(2)(iv), with respect to employment taxes owed for periods prior to January 2009, a "disregarded entity" was treated in the same manner as a sole proprietorship. Accordingly, the sole member of a single-member LLC, and the LLC itself, were deemed to be a "single taxpayer," who was personally liable for unpaid employment taxes on wages that were paid before January 1, 2009.

Here, since the unpaid employment taxes related to payroll periods prior to January 1, 2009, the IRS asserted that Mr. Costello was personally liable for employment taxes of his single-member LLC.

The IRS noted that a single-member LLC is disregarded as an entity separate from its owner, where the single-member LLC had never filed a Form 8832. Mr. Costello, however, argued that, because the IRS had accepted all of his Forms 1120, filed on behalf of his single-member LLC, that he had effectively "elected" to be taxed as a C corporation notwithstanding the fact that he never filed a Form 8832, electing to have this LLC taxed as a corporation. Mr. Costello also argued that the IRS should be "equitably estopped," and to be forced to treat the LLC as a C corporation for tax purposes, since the IRS had accepted the filed Forms 1120.

The Tax Court, however, sided with the IRS, and ruled that the LLC could <u>not</u> be taxed as anything but as a disregarded entity, and not as a C corporation, simply by virtue of the fact that Mr. Costello never filed a Form 8832 on behalf of the LLC.

> **<u>Note</u>:** This case involves an employment tax dispute, between the IRS on one hand and the taxpayer on the other hand, based upon pre-2009 tax law relating to unsatisfied employment tax liabilities of a single-member LLC. Nevertheless, this case may present a saving grace opportunity for LLCs and partnerships who mistakenly believe they have elected to be taxed as a corporation for tax purposes.

1395207-V5 KAW