2018 FEDERAL INCOME TAX LAW UPDATE

Fall 2018

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

Keith Wood, CPA, JD, an attorney with Carruthers & Roth, PA, in Greensboro, NC, is a Board Certified Specialist in estate planning and probate law. Keith's practice areas include tax planning and representation of clients before the Internal Revenue Service, corporate law and business transactions, and estate planning. Keith is a Certified Public Accountant and is an active member of the North Carolina Association of Certified Public Accountants. Keith received his undergraduate degree in business administration and his law degree, with honors, from the University of North Carolina.

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

Gregory S. Williams
gsw@crlaw.com

Craig A. Taylor
cat@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 2018, the IRS published its 2017 Internal Revenue Service Data Book (Publication 558) (March 30, 2018), which contained audit statistics for the Fiscal Year ending on September 30, 2017. Here are the audit statistics for returns filed in calendar year 2016 ("CY 2016"):

A. Audit Rates for Individual Income Tax Returns. Only .6% of individual income tax returns filed in CY 2016 were audited (down from .7% of returns audited in FYE 2015). Of these audited returns, only 29% of individual tax audits were conducted by Revenue Agents and the rest of the audits (about 71% 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 2016, showing receipts of $100,000-$200,000, reported a 2.1% audit rate (down from 2.2% in FY 2016). Schedule C returns filed in CY 2016, showing income over $200,000, reported a 1.9% audit rate (same as for FY 2016).

Total Individual Returns Audited		.6%
(1)	With Schedule C Income:	
	$100,000 to $200,000	2.1%
	Over $200,000	1.9%
(2)	Non-Business Income of:	
	$200,000 to $1 Million	.8%
(3)	Positive Income Over $1 Million	4.4%

B. Audit Rates For Partnerships and S Corporations: For partnerships, the audit rate for returns filed in CY 2016 was .4% (no change from FY 2015). For S Corporation returns, the audit rate for returns filed in CY 2016 was .3% (no change from FY 2015).

C. Audit Rates for C Corporations. C Corporation returns filed in CY 2016 had an audit rate of 1.0%.

Total C Corporation Returns Audited		1.0%
(1)	Assets less than $1 Million	1.1%
(2)	Assets $1,000,000 to $5 Million	.9%
(3)	Assets $5 Million to $10 Million	1.3%
(4)	Assets $10 Million to $50 Million	4.0%

D. **<u>Offers in Compromise</u>.** The IRS received 62,000 offers in compromise, but only accepted 25,000 of them.

E. **<u>Criminal Case Referrals</u>.** According to the IRS statistics, the IRS initiated 3,019 criminal investigations for the fiscal year 2017 (down from 3,395 FYE 2016), and for 2017, the IRS referred 2,251 cases for criminal prosecutions (795 for legal source crimes, 875 for illegal source financial crimes and 581 for narcotics–related financial crimes) and obtained 2,300 convictions. For convictions, 2,043 were actually incarcerated.

PART TWO
SHAREHOLDER GOODWILL

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

payment was deemed to have been paid to Howard Corp., followed by a dividend payment to Dr. Howard.

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

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

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

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

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

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

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

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

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

II. Shareholder Goodwill Was Owned by Father and Not By His Corporation -- So No Deemed Distribution or Gift of Corporate Goodwill Where Father Lets Sons Open a New Trucking Business.

In Bross Trucking, Inc. v. Commissioner, TC Memo 2014-107 (June 5, 2014), the issue before the Court was whether Mr. Bross made a gift of certain goodwill, relating to his trucking business, to his sons when Mr. Bross ceased operations of his trucking business and then allowed his sons to start up a new trucking business. Because the tax court held that Mr. Bross, and not his company, owned all related goodwill of his business, there was no distribution from Bross Trucking to Mr. Bross and no gift by Mr. Bross to his sons. So, Bross Trucking was not liable for any income tax on a deemed distribution of goodwill to Mr. Bross, and Mr. Bross was not liable for gift tax liabilities for any purported gift of the Bross Trucking goodwill to his sons.

A. Facts. In 1972, Chester Bross ("Mr. Bross") organized Bross Construction to engage in various road construction projects. In the early 1980, Mr. Bross formed Bross Trucking, Inc., of which he was the 100% shareholder. Bross Trucking, Inc. leased most of its equipment from CB Equipment, which was owned by members of the Bross family.

The principal customers of Bross Trucking were Bross Construction and other Bross family businesses.

Mr. Bross personally developed relationships with customers in the road construction industry and was responsible for fostering and maintaining relationships among all the Bross family businesses to ensure that certain road construction projects were successfully completed. Mr. Bross did not have an employment contract or a noncompete agreement with Bross Trucking, Inc. which would prohibit him from competing against Bross Trucking, Inc. if he ever left the company.

In the late 1990s, Bross Trucking, Inc. became the subject of safety investigations by state and federal regulatory agencies involving safety issues at Bross Trucking. Ultimately, Mr. Bross decided to cease operating Bross Trucking.

In 2003, Mr. Bross' three sons, who were not previously involved with Bross Trucking, started their own trucking company, called LWK Trucking. The sons claimed that, because

Bross Trucking ceased operations, they needed to form a new trucking company to support their construction business.

By 2004, almost 50% of LWK employees were former employees of Bross Trucking. LWK also executed a new vehicle lease agreement with CB Equipment after Bross Trucking's equipment lease had terminated. The new lease allowed LWK Trucking to use the same equipment that had previously been leased to Bross Trucking.

LWK even had some of the old Bross Trucking logos on its trucks, but the sons tried to cover the old Bross Trucking logos with their new business name out of concerns about negative publicity surrounding Bross Trucking's safety investigations by state and federal agencies.

B. Decision of Tax Court. The IRS took the position that, when Bross Trucking shut down operations and when LWK started operations, that Bross Trucking effectively distributed appreciated intangible assets (goodwill) to its sole shareholder (Mr. Bross), and that Mr. Bross then made a gift of these intangible assets to his sons. The IRS assessed income tax against Bross Trucking and asserted gift tax assessments against Mr. Bross on the deemed gift of the intangible assets to his sons.

The Tax Court ultimately ruled that Bross Trucking's goodwill was personally owned by Mr. Bross. Therefore, Bross Trucking did not transfer any corporate goodwill to Mr. Bross, and since there was no taxable distribution to Mr. Bross, there was no gift by Mr. Bross to his sons.

In part, the court was moved by the fact that the regulatory investigation had caused Bross Trucking to lose much of its reputation in the business community. Indeed, Bross Trucking faced being shut down by federal and state regulators and therefore its workforce was in jeopardy. Faced with a potential shutdown of Bross Trucking operations, its customers had to re-evaluate whether to continue to do business with Bross Trucking.

The court ultimately concluded that all the goodwill used by Bross Trucking, Inc. was Mr. Bross' personal assets. The company's established revenue stream, its developed customer base and its continued business operations were all created by Mr. Bross' past work in the road construction industry as a result of his personal efforts and relationships.

Negative Safety Ratings. The court held that any corporate goodwill that Bross Trucking previously owned was lost due to negative attention from unsatisfactory safety ratings, as demonstrated by the fact that his sons tried to hide the Bross Trucking logo on their trucks.

The question then was whether Mr. Bross transferred an element of goodwill to his children by virtue of a continued workforce from Bross Trucking. The court determined that Bross Trucking did not transfer an established workforce to Mr. Bross, since only 50% of the LWK employees had previously been employed by Bross Trucking.

The court noted that Mr. Bross did not have an employment contract or a noncompete agreement with Bross Trucking. The court also found it important that there was no indication that LWK Trucking received goodwill from Mr. Bross' prior relationships but instead the court believed that these similarity of customers between Bross Trucking and LWK Trucking may simply mean that the Bross sons cultivated and profited from continued relationships that the sons independently created.

III. <u>Termination Payments Paid to The Owner Of An Insurance Agency Generated Ordinary Income And Not Capital Gain, Pexa vs. U.S., 121 AFTR 2d. 2018–1686 (DC CA) (May 8, 2018</u>).

Mr. Pexa worked as an insurance agent for Farmers Insurance Group. In 1998, Mr. Pexa was promoted to the position of District Manager. As District Manager, he was not an insurance agent and served in a completely different role than that of an insurance agent. As a District Manager, Mr. Pexa recruited, trained and supervised insurance agents, but was forbidden from selling insurance himself. Over the years, Mr. Pexa receive compensation from Farmers in the form of commissions on policies sold by the insurance agents that worked under him.

Farmers ultimately terminated its relationship with Mr. Pexa and, pursuant to his District Managers Appointment Agreement, Farmers paid Mr. Pexa the “contract value" of his Farmers Agency contract. This “contract value" was based upon the number of years Mr. Pexa worked as the District Manager and the commissions he received during the six months before his termination.

Farmers reported the “contract value” payments of almost $1 million on a Form 1099-MISC. Mr. Pexa, however, treated these payments as capital gains on his tax return.

Here, the court ruled that, in order for Mr. Pexa to be entitled to capital gain treatment for the contract payments, he would have had to have a capital asset to sell back to Farmers. Mr. Pexa essentially argued that he was transferring goodwill relating to his well-developed smooth operating business that he built up over 11 years.

The court noted however, that Mr. Pexa's District Manager’s contract with Farmers could be terminated by Farmers at any time. And, the contract prohibited Mr. Pexa from selling insurance. Accordingly, Mr. Pexa did not own any assets related to his business and thus could not transfer goodwill to the Farmer's assignee. Here, the only “interest" that Mr. Pexa retained was a contractual right to perform services for Farmers as long as the agreement remained in place. However, a contract right to perform services is not a capital asset. Therefore, Mr. Pexa was required to recognize ordinary income treatment on all the contract value payments.

> **<u>Note</u>**: The court upheld assessment of the 20% accuracy related penalty under 6662(a). Although Mr. Pexa consulted with an accountant to help him prepare his tax returns, Mr. Pexa did not provide his accountant with a copy of the Form 1099–MISC or a copy of the Farmers agreement, and therefore Mr. Pexa could not “reasonably rely” on any recommended advice given by the accountant.

PART THREE
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. Past Case Law.

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

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

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

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

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

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

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

1. Nature and purpose of the acquisition and duration of ownership.

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

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

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

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

II. **Lawyer Unable to Prove Regular Conduct of Real Estate Activities.**

In Levitz, USTC 2018-10 (March 8, 2018), the court held that Mr. Levitz could not prove that he was in the "trade or business" of real property development and sales, and therefore his losses on certain investment properties were limited to the $3,000 annual capital loss limitation.

Here, Mr. Levitz could not prove that he engaged in real estate activities with continuity and regularity. Mr. Levitz was a practicing lawyer while he held the properties for sale and was unable to prove how many hours he devoted to his real estate activities versus his law practice.

In addition, Mr. Levitz failed to keep books and records in a business-like manner. Mr. Levitz also failed to file a Schedule C reporting his real estate activities which indicated that he was not conducting his activity as a trade or business. Finally, Mr. Levitz did not hire employees for his real estate activities, nor did he maintain an office. The court concluded that Mr. Levitz engaged in "sporadic, and not regular, sales of property over a period of several years."

III. <u>Changed Circumstances Allows Developer to Claim Capital Gain Treatment; Sugar Land Ranch Development, LLC, TC Memo 2018-21 (Feb. 22, 2018)</u>.

Sugar Land Ranch Development Company, LLC ("SLRD") was formed in 1998 to acquire contiguous tracts of land in Sugar Land, Texas

SLRD intended to develop the tracts into single-family residential lots and commercial tracts. SLRD bought the first tract of 883 acres in March 1998 and purchased an additional 59 acres in November 1998.

The property had previously been an oil well field. So, from 1998 until 2008, SLRD capped oil wells, removed oil lines and did some environmental cleanup work to prepare the property for development. SLRD sold a very small portion of the property between 1998 and 2008. In 2011 and 2012, SLRD sold approximately 580 acres to a major homebuilder, named Taylor Morrison.

Late in 2008, the managers of SLRD concluded that SLRD would not be able to develop, subdivide and sell residential lots because of the effects of the subprime mortgage crisis on the local housing market and the difficulty in obtaining financing for housing projects because of the financial crisis.

The managers of SLRD signed a "Unanimous Consent" document dated December 16, 2008, in which they acknowledged that they would hold the property as an investment until the market recovered enough to sell it off. Between 2008 and 2012, the SLRD property just sat there. SLRD sold one parcel to Mr. Morrison in 2011 and the final two parcels in 2012.

The Tax Court case involved the issue of whether SLRD was entitled to recognize capital gain from the 2012 sales. The court stated there was no question SLRD originally intended to be in the business of selling residential and commercial lots to customers. However, that intent changed in 2008 when SLRD ceased holding its property primarily for sales to customers, but instead began to hold it only for investment purposes.

The Court noted the earlier decision of <u>Suburban Realty</u> in which the Court of Appeals for the Fifth Circuit held that a taxpayer is “entitled to show that its primary purpose changed to, or back to, for investment.” <u>Suburban Realty</u>, 615 F2d at 184. By virtue of its Unanimous Consent dated December 2008, SRLD was able to establish its “Change in Circumstance” and that its primary purpose for holding the property had changed as well.

Interestingly, the IRS also argued that the court should impute, to SLRD, certain development activities which were performed by related parties. However, the court noted that past cases had rejected the argument - that development efforts by a related party should be imputed to the taxpayer. See <u>Bramlett vs. Commissioner</u>, 960 F2d at 533–534, and <u>Phelan vs. Commissioner</u>, TC memo 2004–2006.

IV. <u>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</u>.

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 FOUR
HOBBY LOSS CASES

I. Section 183 and Hobby Loss Rules.

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

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

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

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

2. the expertise of the Taxpayer or his advisors;

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

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

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

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

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

8. the financial status of the Taxpayer; and

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

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

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

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

II. <u>Section 183 and Hobby Loss Rules: Expansive Ranching Activity Found To Be "For Profit" and Not a Hobby</u>.

In <u>Welch vs. Commissioner</u>, TC Memo 2017-229 (November 20, 2017), the Tax Court held that Mr. Welch engaged in his ranching activities with a "for profit" motive and not as a hobby. Although Mr. Welch did not have any type of written business plan, there were other factors indicating that the activity was not a hobby. For example, Mr. Welch kept detailed books and records for his activities, he operated the ranching activity through a separate bank account, he routinely hired experts to assist with his ranching operations, and he often made alterations to his business operations to improve changes of profitability.

III. <u>But Another Rancher Is Not Allowed to Deduct His Hobby Loss; David Williams et al., TC Memo 2018–48 (April 9, 2018)</u>.

Mr. Williams grew up on a family ranch in Texas. From junior high on up, Mr. Williams worked with his father on the farm raising hogs and cattle. Mr. Williams was never involved in the financial aspects of the family ranch.

After high school, Mr. Williams went on to become a chiropractor. After closing his chiropractic practice, Mr. Williams became very interested in researching and writing on the topic of alternative health remedies and he began publishing a newspaper called "Alternatives." From 2003 to 2014, Mr. Williams operated his research and publishing business through a single member LLC, called “Global Search, LLC.” From 2003 to 2014, Mr. Williams earned over $3 million in profit operating his publishing business.

Mr. Williams also had a firearm business. Over a twelve year period, the firearm business showed a net loss of $2,300.

Mr. Williams also operated a ranch. The ranch sat on over a thousand acres. From 2000 to 2015, Mr. Williams lost almost $1.7 million in his ranch operations and never earned a profit in any year of operation.

The Tax Court agreed with the IRS that, even though Mr. Williams had grown up on a farm, his ranch operations constituted a hobby. Although Mr. Williams kept track of income and expenses, there was no evidence that Mr. Williams ever changed operations or business tactics in order to stem losses or improve profitability.

Also, Mr. Williams never had any formal education in farming and never consulted with experts on the operation of this ranch activities. And, although Mr. Williams hired a bookkeeper to keep track of farm expenses and income, he never used those records to evaluate overall performance of ranching activities.

The court also noted that, although Mr. Williams had been successful in running his health and wellness business, his work as a researcher and writer was not sufficiently similar to ranching activities so as to indicate that he could do so successfully. The only factor in the Section 183 nine factor test that Mr. Williams met was establishing that there was no element of personal pleasure or recreation.

The court also upheld the Section 6662(a) accuracy related penalty.

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

In Estate of Stuller, 117 AFTR 2d 2016-379 (7^{th} Cir. January 26, 2016), the Court of Appeals for the 7^{th} 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.

V. 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."

<u>PART FIVE</u>
PASSIVE ACTIVITY LOSS CASES

I. <u>Special Rules for Real Estate Professionals</u>.

A. <u>Background of Real Estate Professional Rules</u>. 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;" **<u>and</u>**

(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), **<u>unless</u>** 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 **<u>each</u>** **<u>interest</u>** in rental real estate **<u>unless</u>** 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 **<u>all</u>** 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. <u>How to Make The Grouping Election for a Real Estate Professional</u>. 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 **<u>original</u>** 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 SIX
OTHER DEDUCTIONS

I. No Deduction for Expenses Related to Boat Rental Activity Where the Boat was not Rented Out; De Sylva vs. Commissioner, TC Memo 2018 – 165 (September 27, 2018).

A. Background. Section 162 allows for current deductions for ordinary and necessary business expenses incurred in “carrying on any trade or business.” Therefore, in order for a taxpayer to be able to deduct business expenses, the taxpayer actually has to be carrying on an active trade or business. If the taxpayer incurs business expenses before commencing active operations, Section 195 allows for up to $5,000 of deductions for start-up expenses, and the rest can be amortized over 60 months.

B. **<u>De Sylva</u>**. In 2004, Mr. De Sylva purchased a boat with the idea that he would rent it out to third parties as a way to supplement his income

When Mr. De Sylva purchased the boat, it was in no condition to be rented out and indeed was in dire need of repair. So, from 2004 to 2012, Mr. De Sylva spent considerable time and effort in getting the boat in shape to be rented out. However, Mr. De Sylva began experiencing financial difficulties and could never afford to pay to have the necessary repairs completed.

During 2012, Mr. Sylva incurred significant expenses related to his boat rental business, such as repairs, maintenance, and boat slip fees paid to dock the boat. However, by the time 2012 rolled around, Mr. De Sylva still had not rented the boat to anyone.

The Tax Court agreed with the IRS that the expenses related to the boat rental business were not deductible based upon the fact that Mr. De Sylva had never rented the boat out nor had he ever marketed the boat as being available for rent. Therefore, there was no “trade or business" activity related to the boat rental business. Instead, these expenses had to be capitalized under Section 195, since these were merely start-up expenses that pre-dated the start of an active trade or business.

<u>PART SEVEN</u>
CHARITABLE CONTRIBUTIONS

I. <u>Charitable Deduction Fails Where Tax Basis Not Shown on Form 8283</u>.

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

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

In upholding the IRS’s disallowance of the charitable deduction, the Court held that the requirement to disclose cost basis information, when that information is reasonably ascertainable, is necessary to help the IRS effectively identify overvalued property. Here, the question is not whether the cost basis information was readily ascertainable. Here, this was not an inadvertent omission, but a conscious election not to supply the required information.

Therefore, Belair did not either, strictly or substantially, comply with the regulatory recording requirements of Section 170.

II. 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.

III. 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).

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

IV. Final Regulations Impose New Substantiation Reporting for Charitable Contributions.

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

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

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

V. Charitable Contribution Fails the Substantiation Test, Davis vs. Commissioner, TC Memo 2018 -56 (April 24, 2018).

Mr. Davis was the president and senior minister of a small church. Mr. Davis claimed charitable contribution deductions for certain non-cash contributions to the church. A donee acknowledgement letter was signed by Mr. Davis as senior minister and president. However, the letter was not issued contemporaneously with the date of his non-cash charitable contributions to the church. Also, the letter failed to report the date and location of the contribution and a description of the property donated.

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

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

In 2007, the Durdens made various contributions to their church by check. At the Tax Court trial, the Durdens provided copies of the cancelled checks for 2007 together with two

Letters of Acknowledgement from their church. The first acknowledgement letter, dated January 10, 2008, acknowledged their 2007 charitable contributions but did not indicate whether any goods or services were provided to the Durdens in exchange for their contributions. The second acknowledgement letter, dated June 21, 2009, contained a statement that no goods or services were provided to the Durdens in exchange for their contributions.

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

PART EIGHT
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.

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

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

The partnership funding came from two different transactions:

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

b. Wire Transfers From Partnership to Shareholders to S Corporation. The second transaction involved wire transfers. The partnership made wire transfers to the S Corporation shareholders and the same funds were then wired by the sons to the S Corporation. Thus, this fact was sufficient to establish that the shareholders could increase their basis by the wired transferred amounts.

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

1. S Corporation Basis Increase Is Allowed Where S Corporation Shareholder Replaces Corporation Notes for Shareholder Notes. In the case of Miller v. Commissioner, TC Memo 2006-125 (June 25, 2006), the S Corporation owed Notes to the Bank.

In this case, Mr. Miller was a shareholder of the S Corporation which had borrowed money from the Bank to finance the S Corporation's operations. All loans were guaranteed by the shareholders, including Mr. Miller. Unfortunately, the Corporation's losses soon exceeded the shareholders' direct investment.

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

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

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

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

II. No S Corporation Basis Increase for Intercompany Loans; Meruelo vs. Commissioner, TC Memo 2018–16 (February 5, 2018).

Mr. Meruelo owned 49% of an S corporation, called Merco. In 2008, Merco incurred a loss of over $26 million, 49% of which was allocated to Mr. Meruelo on his Schedule K-1.

The IRS disallowed a substantial portion of the deduction on the position that Mr. Meruelo did not have sufficient tax basis in his S corporation stock to absorb the full loss. Mr. Meruelo contended that he should get income tax basis credit, for inter-company loans made between the various affiliated entities under the “back to back" loan theory or under the “incorporated pocketbook” theory.

According to the court, however, in order for the back-to-back loan theory to prevail, the indebtedness of the S corporation must run directly to the shareholder. Therefore, any loans between the affiliates to Merco could not be recast as loans to the shareholders followed by loans from the shareholders to Merco. Here there was no promissory notes or other evidence of indebtedness of Merco to the shareholders nor was there any evidence that Merco and the affiliates intended to create loans to or from Mr. Meruelo.

Finally, the court agreed with the IRS that the incorporated pocketbook theory did not apply because, although Mr. Meruelo was a shareholder of Merco and Merco's affiliates, there were other shareholders of those entities. In the past, courts have applied the incorporated pocketbook theory only in those instances in which the taxpayer had a "habitual practice of having his wholly owned corporation pay money to third parties on his behalf" and where the S Corporation shareholder was the sole shareholder of the corporations involved.

III. Court of Appeals Upholds Tax Court Decision That No Tax Basis Increase for Loan Guarantees, Even After A Loan Is Called in Full; Phillips vs. Commissioner, 121 AFTR 2d. 2018–1776 (11th Circuit Court of Appeals May 17, 2018).

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.

IV. Eighth Circuit Court of Appeals Confirms That S Corp Shareholder And Wife LLC Member Not Entitled to Tax Basis for Third Party Loans; Hargis v. Commissioner, 121 AFTR 2d 2018 – 2206 (8th Cir. 2018).

In Hargis, 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.

V. S Corporation Shareholder Satisfies the "Inconsistent Treatment" Test.

A. Background. S Corporation shareholders are required to report, on their personal income tax returns, in a manner that is consistent with the separately stated items reflected on the K-1 from the Form 1120-S. Under Section 6037, if a tax return filed by a shareholder of an S corporation is inconsistent with the S corporation's return, then the shareholder must file a "statement identifying the inconsistency" with his tax return.

B. Rubin vs. U.S., U.S. Court of Appeals for the Ninth Circuit (September 24, 2018). Mr. Rubin owned 100% of an S corporation, called Focus. By 2000, Focus was in serious financial difficulty and was placed in involuntary bankruptcy. The bankruptcy trustee filed Focus' 2000 tax return.

Mr. Rubin believed that the trustee incorrectly reported almost $67 million of cancellation of debt income and failed to write off $23 million of bad debt expenses.

Mr. Rubin initially filed his personal tax return in a manner consistent with that of the S corporation. However, he later filed an amended personal income tax return, and in the amended return, he included a statement that described how his income flowed from Focus and how he disagreed with the tax return filed for Focus by the bankruptcy trustee.

Mr. Rubin even attached a pro forma amended tax return for Focus for the 2000 year which reflected the different treatment of bad debt expenses and the cancellation of debt income. And, he also attached a pro forma Schedule K-1 showing the income that he believed should have been reported to him based upon the revised numbers in the pro forma tax return for Focus.

The IRS rejected Mr. Rubin's amended returns because, in the attachments to Mr. Rubin's amended tax returns, he only identified how his amended returns were different from his original returns, and not how his amended returns were different from the corporate returns. Also, the IRS argued in the District Court proceeding that Mr. Rubin's amended returns should be rejected because he failed to file Form 8082, "Notice of Inconsistent Treatment."

According to the Court of Appeals, however, though Mr. Rubin failed to attach the preferred IRS Form 8082 to his returns, all information submitted by Mr. Rubin, with his amended returns, were sufficient to apprise the IRS of how and why his amended returns differed from the S corporation returns filed by the bankruptcy trustee. Thus, the Court of Appeals held that Mr. Rubin met the requirements Section 6037(c).

VI. <u>Severity of Shareholder Dispute Did Not Deprive the Other Shareholder of His Economic Interest in the S Corporation</u>.

In <u>Enis</u> TC Memo 2017–222 (November 15, 2017), Mrs. Enis was a shareholder of an S corporation, called NLS. Mr. Enis also was a partner in a consulting firm that agreed to provide consulting services for NLS. In exchange for the consulting services, NLS agreed to pay a monthly consulting fee and issue shares of NLS stock to the owners of the consulting firm.

When NLS and the consulting firm initially begin discussions, NLS provided the consulting firm with copies of its financial statements. Those financial statements of NLS showed a liability on its balance sheet owed to Dr. Ginsburg of almost $7 million arising from an initial loan made by Dr. Ginsberg to NLS.

Over time, the relationship between Dr. Ginsburg and the consulting firm shareholders began to deteriorate. Dr. Ginsburg refused to allow the NLS shareholders from entering the NLS premises and began withholding financial information from the NLS shareholders. Ultimately, NLS stopped paying the consulting fees to the consulting firm.

On their 2010 tax return, the Enises did not include their pro rata share of S Corporation income. In addition, the Enises claimed a theft loss deduction based on Dr. Ginsberg's actions.

The Tax Court agreed with the IRS that Dr. Ginsberg's actions did not deprive the Enises of the "economic benefit" of their NLS shares. According to the court, under the Tax Court's previous decision in <u>Kumar</u>, TC Memo 2013–184, unless there is an express agreement between shareholders to transfer economic interest rights from one shoulder to another, mere disagreements between the shareholders or a deterioration in their relationship does not deprive one stockholder of his economic interest in the S corporation. Thus, the Enises were required to include their pro rata share of the S Corporation income on their return regardless of Dr. Ginsberg's actions.

Likewise, the Tax Court ruled that the Enises were not entitled to any theft loss deduction on their tax return. The Enises had claimed that Dr. Ginsburg committed a theft under Florida law by using corporate funds to pay his personal expenses without the consent of other shareholders. Over time, the corporation had paid down Dr. Ginsburg's loan by the corporation paying personal expenses of Dr. Ginsberg. The books and records of NLS showed a decreasing loan balance as these personal expenses were paid over time.

Here, the court concluded that the Enises did not prove that Dr. Ginsberg had committed a crime under Florida law. Dr. Ginsberg's loan to the company was clearly shown on the financial statements and all payments against the loan were clearly recorded in the company's books and records.

According to the court, even if Mr. Dr. Ginsberg's actions violated the terms of any shareholder agreement with other parties, those actions did not amount to a theft for the purposes of Section 165.

VII. **Husband and Wife Unable to Claim Single-Member LLC Status for an LLC Owned by the Husband and Wife.**

A. Argosy Technologies LLC, TC Memo 2018-35 (March 22, 2018). In Argosy, the IRS asserted late filing penalties under Section 6698 for the late filing of Forms 1065, Partnership Tax Return, against Argosy Technologies for 2010 and 2011.

Mr. and Mrs. Petito each owned 50% of the LLC. In response to the penalty assertions, Argosy claimed that it was a single-member limited liability company and thus a single member LLC cannot be subject to partnership penalties. The court ruled, however, that here there was no question that this was a multimember LLC since, by their own admission, the LLC was owned by Mr. and Mrs. Petito. Moreover, the fact that the Petitos filed the late Forms 1065 also indicated their admission that this was a multimember LLC. The court also noted that there was no evidence of any Code Section 761(f) election in place to treat the married owners as a single partner.

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

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

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

Please note, however, that a business owned and operated by spouses through a limited liability company does not qualify for the 761(f) election.

PART NINE
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 TEN
SECTION 6672 RESPONSIBLE PERSON LIABILITY FOR TRUST FUND TAXES

I. Background and Introduction.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

IV. Davis vs U.S., 121 AFTR 2d. 2018–935 (March 6, 2018) More About the Unencumbered Funds Penalty. In Davis, the Court of Appeals upheld the District Court of Colorado's grant of summary judgment in favor of the IRS on the "unencumbered funds" issue. This case provides an excellent discussion of the majority and minority opinions on the unencumbered funds test.

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

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

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

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

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

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

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

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

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

> **NOTE:** The Fifth Circuit recently vacated the earlier decision of the District Court that granted summary judgment in favor of the IRS for $4.3 million judgment against Dr. McLendon. According to the Fifth Circuit Court of Appeals,

Dr. McClendon did present enough facts that could dispute whether the company had unencumbered funds to pay the taxes when he learned of the nonpayment. Therefore, this was not a case for summary judgment.

Also, on appeal, Dr. McClendon argued that he should not have been held liable for more than $100,000 of funds he used to pay other creditors ahead of the IRS shortly before the practice was closed. The Fifth Circuit held that the $100,000 funds contributed to the company were unencumbered. However, the Fifth Circuit remanded the decision back to the lower court to determine whether the practice had retained $4.3 million of available funds as of the discovery date. McClendon vs. U.S., 121 AFTR 2d. 2018–2075 (June 14, 2018).

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

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

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

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

VII. **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.

VIII. 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 ELEVEN
INNOCENT SPOUSE

I. <u>No Innocent Spouse Relief Allowed Where Spouse Knew Of Husband's Form 1099 Income</u>.

In <u>Lessard</u>, TC Summary Opinion 2017–95 (December 27, 2017), Mindy and her husband filed a joint tax return for 2013. They later divorced in 2014. The IRS assessed additional taxes for the 2013 return arising from (1) cancellation of debt income of Mindy's husband, Mr. Tomko, (2) cancellation of debt income of Mindy and (3) $20,000 of withdrawals from Mr. Tomko's retirement plan.

The court determined that Mindy was not eligible for innocent spouse relief under Section 6015(b) or Section 6015(c) because she had knowledge of the source of her husband's unreported income.

The court further found that Mindy was not entitled to "equitable relief" under Code Section 6015(f). Although there were several factors in favor of granting equitable relief (such as the facts that Mindy and Mr. Tomko were no longer married, the fact that Mindy had complied with federal tax laws going forward and the fact that Mindy received no significant benefit from the unreported income), the other factors weighed against granting equitable relief.

The primary factor that weighed against Mindy was the fact that she was aware of the canceled debts and was aware of the withdrawals from Mr. Tomko's retirement plan when she signed the 2013 returns. The fact that she didn't understand that those withdrawal amounts were fully taxable to her did not negate the fact that she was aware of the underlying nature of the unreported items.

<u>PART TWELVE</u>
NOMINEE, TRANSFEREE AND SUCCESSOR TAX LIABILITY CASES

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

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

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

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

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

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

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

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

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

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

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

2. Substantiality of Sales. 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. Length of Time the Property is Held by the Taxpayer. Mr. Ryther held the scrap metal for over seven (7) years so this factor favored Mr. Ryther.

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

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

6. Sales and Advertising Efforts. 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. Time and Effort Devoted to the Activity. 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. How the Sales Proceeds Were Used. 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 FOURTEEN
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 FIFTEEN
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. Six-Year Statute of Limitations Applied to Assessment of Tax on S Corp. Shareholders Tax Return for Omitted Income of The S Corporation.

A. Background. Generally, the IRs must assess any tax deficiency within 3 years after a tax return is filed. However, if the tax return omits gross income that exceeds 25% of the amount of gross income reported on the return, then the IRS has 6 years to assess tax. Section 6501(e)(1)(A).

However, under Section 6501, in determining whether a return omits its gross income, you do not take into account any amount which is omitted from gross income reported on the return, if the amount is disclosed (1) on the return or (2) in a statement attached the return or (3) in a manner adequate to apprise the IRS of the nature and amount of such item.

B. Manashi v. Commissioner, TC Memo 2018–106 (July 5, 2018). Mr. Manashi owned 100% of an S corporation, called Flight Vehicles Consulting, Inc. (“FVC”). FVC filed Forms 1120-S for 2006, 2007, 2008 and 2009.

During those same years, Mr. Manashi reported the ordinary income of the corporation on Schedule E of each his tax returns and identified the source of the income as coming from his S corporation. Mr. Manashi also provided the employer identification number on Schedule E.

Upon audit of Mr. Manashi's returns, the IRS determined that FVC had substantial omissions of gross income. The IRS issued a Notice of Deficiency to Mr. Manashi more than three years, but less than six years, after the original personal tax returns were filed.

In the past, courts have ruled that, when an individual return includes a reference to an S corporation return, then to determine whether the three year or six-year statute of limitations applies to the audit of the individual return, then the corporate information return of Form 1120-S must be considered, along with the taxpayer's individual return, to determine whether there has been adequate disclosure. Benderoff vs. United States, 398 F.2d 132 (8th Cir. 1968) and CNT Investors, LLC vs. Commissioner, 144 TC 161 (2015).

Here, however, the court ruled that there was nothing on the face of the Forms 1120-S that would alert any "reasonable person" that FVC had omitted over $800,000 of gross receipts on each of its 2006, 2007, and 2008 tax returns. Therefore, the six-year statute of limitations applied to Manashi's personal tax returns.

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.

> **Note:** 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.