<u>WINTER 2022 FEDERAL INCOME TAX LAW UPDATE</u>

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INTRODUCTION

Today's discussion will focus on some of the more interesting or important tax developments that have transpired over the last year or so. The new developments addressed in this presentation will include numerous tax court cases, decisions of various federal circuit courts, as well as IRS pronouncements, revenue rulings and regulatory changes.

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PART ONE
IRS AUDIT STATISTICS

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

In early 2020, the IRS published its 2019 Internal Revenue Service Data Book, which contained audit statistics for the Fiscal Year ending on September 30, 2019. Here are the audit statistics for tax returns filed in calendar year 2018 ("CY 2018"):

A. Audit Rates for Individual Income Tax Returns. Only .6% of individual income tax returns filed in CY 2018 were audited (about the same for CY 2017). Of these audited returns, only 25% of individual tax audits were conducted by Revenue Agents (down from 29%) and the rest of the audits (about 75% of the audits) were correspondence audits.

Not surprisingly, the audit rates for Schedule C returns were higher than for individual returns. Schedule Cs filed in CY 2018, showing receipts of $100,000-$200,000, reported a 2.4% audit rate (up from 2.1% in CY 2018). Schedule C returns filed in CY 2018, showing income over $200,000, reported a 1.9% audit rate (same as for CY 2018).

Total Individual Returns Audited		.6%
(1)	With Schedule C Income:	
	$100,000 to $200,000	2.4%
	Over $200,000	1.9%
(2)	Non-Business Income of:	
	$200,000 to $1 Million	.6%
(3)	Positive Income Over $1 Million	3.2%

B. Audit Rates For Partnerships and S Corporations: For partnerships, the audit rate for returns filed in CY 2018 was .2% (down from .4% in CY 2017). For S Corporation returns, the audit rate for returns filed in CY 2018 was .2% (down from CY 2017).

C. Audit Rates for C Corporations. C Corporation returns filed in CY 2018 had an audit rate of 1.0%.

Total C Corporation Returns Audited		.9%
(1)	Assets less than $1 Million	.9%
(2)	Assets $1,000,000 to $5 Million	.8%
(3)	Assets $5 Million to $10 Million	1.1%
(4)	Assets $10 Million to $50 Million	4.6%

D. Note: The IRS has not published similar audit statistics for FY 2020.

II. **<u>Offers in Compromise and Criminal Case Referrals.</u>**

A. <u>Offers in Compromise</u>. For FY 2020, the IRS received around 45,000 offers in compromise, but only accepted 14,000 of them.

B. <u>Criminal Case Referrals</u>. According to the IRS statistics, the IRS initiated 2,596 criminal investigations for the fiscal year 2020, and for 2020, the IRS referred 1,859 cases for criminal prosecutions (669 for legal source crimes, 677 for illegal source financial crimes and 513 for narcotics–related financial crimes) and obtained 1,187 convictions. For convictions, 978 were actually incarcerated.

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

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

A. <u>Summary of Tax Differences</u>. 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 **<u>not</u>** 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. Custom Home Builder Not Entitled To Ordinary Loss On Deemed Sale Of Lots; Ferguson vs. Commissioner, TC Memo 2019-40 (April 23, 2019).

Mr. Ferguson was a custom home builder operating through an S corporation. Mr. Ferguson got into a dispute with some of his customers regarding a new development project. In settlement of the lawsuit, Mr. Ferguson's S corporation transferred lots out to the homeowners and the S corporation then claimed an ordinary loss deduction on the deemed sale of three of the lots by the S corporation.

The IRS disallowed the ordinary losses on the basis that Mr. Ferguson was unable to prove that the lots were not capital assets as defined in Section 1221(a). The main factor that probably worked against Mr. Ferguson was the fact that he claimed capital gain treatment on six other lots that were transferred to other plaintiffs.

III. Rental Property Activities Did Not Rise to a "Trade or Business", Keefe v. Commissioner, 126 AFTR 2d 2020-5331 (2nd Cir. July 17, 2020).

Mr. and Mrs. Keefe purchased a historical mansion in Newport, Rhode Island for $1.35 million and then spent significant sums to renovate the mansion. Mrs. Keefe spent over 70 hours per week overseeing the renovation. While the restoration was in progress, Mr. and Mrs. Keefe met with a rental agent to discuss perhaps renting out the mansion once it was finished. Ultimately, the house was never rented, and between June 2005 and July 2009, the fair market value of the property dropped by almost $3 million.

Ultimately the property was sold for $6.15 million in July 2009.

On their original 2009 tax return, Mr. and Mrs. Keefe reported that they were treating the sale as the sale of a capital asset. They then amended their 2009 return and reported the sale of the mansion as the sale of a business property resulting in ordinary loss treatment.

The Tax Court ultimately held that Mr. and Mrs. Keefe could not establish that they operated their rental activity on a "continuous, regular and substantial" basis so the property would not qualify as real property used in a "trade or business". A number of courts had previously held that rental real estate is considered a "trade or business" only if the taxpayer-lessor engages in regular and continuous activities in relation to renting out the property. Alvary v. United States, 302 F.2d 790, 796 [9 AFTR 2d 1633] (2d Cir. 1962) (citing Gilford v. Commissioner, 201 F.2d 735, 736 [43 AFTR 221] (2d Cir. 1953); Pinchot v. Commissioner, 113 F.2d 718, 719 [25 AFTR 447] (2d Cir. 1940); Grier v. United States, 120 F. Supp. 395 [45 AFTR 1975] (D. Conn. 1954)).

Here, the court concluded that Mr. and Mrs. Keefe did not engage in "regular and continuous" rental activities because they never commenced any rental activity in a meaningful or substantial way. Also, they never advertised the mansion for rent and they never signed any lease with a potential tenant, nor did they furnish the property for rent after the renovations were completed. In fact, Mr. and Mrs. Keefe spent a significant amount of time from 2004 to 2009 trying to sell the property, rather than to rent it out.

In addition, the court also noted that Mr. and Mrs. Keefe were not already engaged in any type of rental trade or business before purchasing and renovating the Rhode Island mansion. Accordingly, the Court of Appeals affirmed the Tax Court's holding that the Rhode Island mansion was a capital asset.

Note also that the Court of Appeals upheld the IRS imposition of the Section 6662 "substantial understatement" penalty. Apparently, the only penalty defense that the Keefe's raised during the trial was the "substantial authority" defense, and evidently they did not try to raise the "good faith" or "reasonable basis" penalty defense either at the Tax Court or at the Court of Appeals.

PART THREE
OTHER INCOME

I. Damages For Emotional Distress Not Excludable From Taxable Income Unless Directly Associated With Physical Injury.

A. Background. Section 104(a)(2) provides an exclusion from gross income for settlement damages received by the taxpayer for personal injury or physical sickness. Generally, emotional distress is not considered a physical injury or physical sickness, and therefore taxpayers must report, as gross income, damages they receive for emotional distress unless the damages are reimbursements from medical care to treat the emotional distress. Section 104(a). Damages for emotional distress are excludable from gross income only when the emotional distress is attributable to a physical injury or a physical sickness.

B. Tax Court Again Rules That Emotional Distress Is Not "Physical Illness"; *Rebecca A. Tressler v. Commissioner*, T.C. Summ. Op. 2021-33 (Sept. 13, 2021).

In Tressler, the Tax Court again held that emotional distress damages are not excludable from taxable income unless those emotional damages are attributable to a direct physical injury.

Ms. Tressler brought a lawsuit against her former employer for failing to prevent a physical assault by another employee. Ms. Tressler alleged that this assault caused her emotional distress which caused even more physical injuries.

The Tax Court agreed with the IRS and held that the emotional distress damages were not excludable from taxable income under Section 104(a)(2), because the language in Ms. Tressler's Settlement Agreement failed to state that the settlement payments she received were related to physical injuries rather than just related to her claims for emotional distress.

C. Terminated Employee Can Exclude Portion of Lawsuit Recovery From Taxable Income Under Section 104; Beckett v. Commissioner, T.C. Summary Opinion, 2020-19, July 1, 2020. Ms. Beckett was employed as a certified nursing assistant until her termination in January 2020. She suffered from epileptic seizures while at her workplace. Some seizures would be so severe that she would even hit her head hard enough to require stitches. Other times, she would bite her tongue, and at least once she was sent to the emergency room.

After her termination, Ms. Beckett sued her employer for employment discrimination under the Americans with Disabilities Act (the "ADA") claiming that she was wrongfully terminated because of her epilepsy and her employer's failure to make reasonable accommodations as required under the ADA. Ultimately the parties settled and Ms. Beckett received a payment of $28,000.

The Settlement Agreement provided that $19,000 of this amount was to compensate Ms. Beckett for her claims of emotional distress, pain and suffering, physical distress and damages. The court ruled that a portion of this $19,000 payment (one third) was exempt under Section 104(a)(2) because the Settlement Agreement stated that the compensatory damages were paid, in part, for "physical distress and damages" and by virtue of the fact that Ms. Beckett credibly testified, at her wrongful termination trial, that she suffered head and other physical injuries directly cause by her employer's refusal to make reasonable accommodations.

D. <u>Doyle, TC Memo 2019-8 (February 6, 2019)</u>. Mr. Doyle was terminated from his employment after he raised concern with his employer's president that the company was involved with illegal anti-competition schemes. After he was terminated, Mr. Doyle began experiencing physical ailments such as nausea, vomiting, headaches, and backaches. Ultimately, after a confidential settlement with his employer, Mr. Doyle was paid $350,000 "as settlement for unpaid wages" and $200,000 "as settlement for alleged emotional distress and damages".

The Tax Court agreed with the IRS that the damages for the emotional distress were not excludable from gross income under Section 104(c)(2) because the underlying wrong committed by his former employer was based upon employment matters or contact matters and had nothing to do with any physical injury.

<u>PART FOUR</u>
SECTION 108 CANCELLATION OF DEBT INCOME

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

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

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

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

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

B. <u>The Bankruptcy Exception</u>.

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

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

C. <u>The Insolvency Exception</u>.

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

1. <u>General Rules</u>

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

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

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

2. <u>Calculating the Amount of Insolvency.</u>

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

> **<u>Example:</u>** ABC, a debtor corporation, has assets of $175 and liabilities of $200. ABC's creditors agree to cancel their indebtedness for ABC's stock worth $175. ABC has therefore satisfied $175 of its debt with stock and had $25 of debt cancelled for no consideration by its creditors. ABC does not realize discharge of indebtedness income because the amount of debt that has been forgiven ($25) does not exceed the amount by which ABC was insolvent ($25). If the stock that ABC issued to its creditors were valued at $150, ABC would realize $25 of gross income, since the amount of forgiven debt ($50) exceeds the amount by which it was insolvent ($25) by $25.

3. <u>What Assets are included in the "Insolvency" Calculation?</u>

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

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

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

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

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

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

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

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

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

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

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

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

II. <u>IRS Announces It's Refusal to Follow the Tax Court Decision in *Schieber's* Ruling That Pension Interest Is Not Part of the Insolvency Calculation Under Section 108.</u>

Previously, in <u>*Schieber*</u>, TC Memo 2017-32 (February 9, 2017), the Tax Court stated that, as laid out in <u>*Carlson v. Commissioner*</u>, 116 TC 87 (2001), for purposes of determining whether something is an "asset" for Section 108(d)(3) purposes, the relevant test is whether the asset gives the taxpayer the ability to pay an immediate tax on income from the cancelled debt. Therefore, a pension plan asset balance should not be deemed as an "asset" of the taxpayer for purposes of applying the insolvency test, where the taxpayer cannot borrow against or assign the pension asset, nor convert the balance into a lump sum amount.

In its <u>*Action on Decision*</u>, IRB 2021-15 (April 12, 2021), the IRS advised that it would not follow <u>*Schieber*</u> in excluding pension plan assets from the definition of "assets" under Section 108(d)(3) merely on the grounds that the pension plan assets cannot be converted to a lump-sum cash amount or that they cannot be sold, assigned or borrowed against.

III. <u>Employer Provided Loan to Purchase Real Estate Was Ineligible for the Section 108 Cancellation of Principal Residence Debt Exclusion</u>.

In <u>Weiderman v. Commissioner, TC Memo 2020-109 (July 15, 2020)</u>, Mrs. Widerman's employer provided her a $500,000 loan to purchase a home near her employer. The loan was evidenced by a promissory note, but was otherwise unsecured.

After Ms. Weiderman's employer terminated her employment, her employer made a demand for repayment of the promissory note. Ultimately, Ms. Weiderman and her employer reached a settlement and a portion of the loan was forgiven.

The Tax Court held that the forgiven debt did not qualify for the Section 108(a)(1)(E) exclusion from cancellation of debt income for qualified principal residence indebtedness that is discharged. The court noted that the term "Qualified Principal Residence Indebtedness" is defined as acquisition indebtedness within the meaning of Section 163(h)(3)(B). Under that section, "acquisition indebtedness" is defined as indebtedness which is used to acquire or improve a qualified residence of the taxpayer and that is secured by that residence.

Here, because the $500,000 loan was unsecured, Ms. Weiderman did not qualify for the principal residence debt exclusion.

The court also upheld the Section 6662 "substantial understatement penalty" because Ms. Weiderman did not have "reasonable cause" for her underpayments under Section 6664(c)(1). Ms. Weiderman contended that she relied upon her accountant in preparing her tax return and therefore that should excuse the 6662 penalty. The court noted that, while a taxpayer's reliance upon an accountant to prepare accurate returns may indicate an absence of fraud, the "reliance upon my accountant" defense will relieve penalties <u>**only**</u> if the accountant has been supplied with all the information necessary to prepare the returns. Here, Mr. and Mrs. Weiderman provided very little backup information to their accountant. Instead, the evidence indicated that the

Weidermans did not rely upon the judgment of their accountant, but instead had decided on their own to exclude the cancelled debt from their gross income.

PART FIVE
HOBBY LOSS CASES

I. Section 183 and Hobby Loss Rules.

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

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

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

1. the manner in which the Taxpayer carries on the activity;
2. the expertise of the Taxpayer or his advisors;
3. the time and effort expended by the Taxpayer in carrying on the activity;
4. the expectation that the assets used in the activity may appreciate in value;
5. the success of the Taxpayer in carrying on other similar or dissimilar activities;
6. the Taxpayer's history of income or losses with respect to the activity;
7. the amount of occasional profits, if any, which are earned;
8. the financial status of the Taxpayer; and
9. the involvement of elements of personal pleasure or recreation.

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

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

> **Note**: The bottom line here is that, when you have a client with a hobby loss that is disallowed, the client also often ends up with taxable income that greatly exceeds expenses. This could be a real lose/lose situation for taxpayers who attempt to deduct hobby losses.
>
> **Note**: 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 Potter, TC Memo 2018-153 (September 17, 2018).

II. Team-Roping Activities Were Deemed To Be A Hobby; *Gallegos v. Commissioner*, TC Memo 2021-25 (March 2, 2021).

In *Gallegos v. Commissioner*, TC Memo 2021-25 (March 2, 2021), Mr. Gallegos and his wife built up an extremely successful insurance business. Later on, Mr. Gallegos decided to start competing in a sport called "team-roping". Over the course of three years, Mr. Gallegos lost over $150,000 in pursuing his dreams of being a team roping champion. The losses were reflected on a Schedule C. According to the Tax Court and the IRS, Mr. Gallegos' activities did not rise to a "trade or business" but instead were a hobby.

Several factors indicated that Mr. Gallegos operated his team-roping activities as a hobby. First of all, Mr. and Mrs. Gallegos kept very inaccurate records of their team-roping activities and expenses. They had no formal business plan and did not maintain a separate bank account or records for their team-roping activity. Also, Mr. and Mrs. Gallegos also had no formal budget plan for their team-roping activities.

III. But In Another Case an Actress is Deemed to be Engaged in a "Trade or Business" and Not a "Hobby" *Gaston*, TC Memo 2021-107 (September 2, 2021).

After 45 years of working as a Mary Kay sales agent, Ms. Gaston retired from Mary Kay and decided to pursue her dream of becoming an actress. During several years, Mrs. Gaston racked up significant losses from pursuing her acting dreams. Nevertheless, the Tax Court determined that Mrs. Gaston's acting activities were not a hobby but instead constituted a "for profit" endeavor, and that she had engaged in her acting activities with the honest objective of earning a profit.

When analyzing whether certain taxpayers have proven that they entered into **acting** activities with an intent to profit, courts have considered such industry-specific factors such as whether they: (1) belong to an acting network or union, (2) take classes or otherwise formally develop their skills, (3) develop industry contacts, (4) seek or secure multiple auditions or roles, (5) advertise their services, (6) prepare headshots or a portfolio, (7) retain an agency or assistant to help secure roles, and (8) maintain their efforts over time, given the nature of the industry. See *Richards v. Commissioner*, T.C. Memo. 1999-163 (05/14/1999).

Here, Ms. Gaston secured roles in feature-length films; spent 35-45 hours per week researching, applying or auditioning for other roles; trained to enhance her skills through acting and voice lessons; retained an assistant and an agent to help her obtain new roles; and otherwise carried on her activities in a businesslike manner.

She also engaged various casting services, retained an agent and a business management company, secured professional headshots, advertised her skills, and took acting and voice lessons.

The Tax Court noted that, as a result of her efforts, Mrs. Gaston had actually landed some roles in movies and commercials.

IV. Taxpayers Had "For Profit" Motive for Miniature Donkey Breeding Activities; William R. Huff v. Commissioner, TC Memo 2021- 140 (Dec. 21, 2021).

In Huff, William Huff and Cathy Huff, were an extremely wealthy couple who wanted to supplement their income, by breeding and selling miniature donkeys. Mr. Huff was a successful asset manager and Mrs. Huff was a successful attorney.

Mr. and Mrs. Huff purchased 31.35 acres in New Jersey, subject to a conservation easement that permitted most equestrian and agricultural uses, for their donkey breeding activities.

In 2004, the Huffs formed Ecotone, an LLC owned by them as the sole members. According to its LLC operating agreement, Ecotone was organized for, among other things, "agricultural and equestrian or equine purposes including, without limitation, breeding and raising animals."

Although the Huff's had losses related to their activities, the Tax Court held that they had a "for profit" motive for their activities. The Tax Court noted that the Huffs had a business plan for their activity, kept separate books and records, and otherwise conducted the activity in businesslike manner. Also, they operated their business through an LLC.

Other key factors included that Mr. and Mrs. Huff enlisted the help of professionals who advised them about their industry; he spent significant time on their activity; and that they also engaged experts to assist them. The Court also pointed that that their losses were so far below their job income that this wasn't a situation of using activity losses to shelter their other income.

PART SIX
OTHER DEDUCTIONS

I. Losses Disallowed On Demolition Of Home Destroyed By Fire; *Parker v. Commissioner*, TC Memo 2021-111 (September 23, 2021).

Mr. and Mrs. Parker claimed a Section 165 deduction for a loss on the demolition of their property that had been burned down by a prior year fire. The IRS and the Tax Court disallowed the loss deduction pursuant to Section 280B of the Internal Revenue Code. Section 280B of the Internal Revenue Code provides that, in the case of the demolition of any structure, no deductions shall be allowed to the owner for any expense incurred in connection with the demolition or any loss sustained on account of such demolition. Instead, these amounts shall be added to the taxpayer's tax basis with respect to the land on which the demolished structure was located.

II. The IRS Hates Schedule C's; Pilyavsky v. Commissioner, TC Summary Opinion 2020-20 (July 2, 2020).

Mr. Pilyavsky reported over $167,000 of Form W-2 income and a $40,000 Schedule C loss on his tax return. The IRS and Tax Court disallowed the Schedule C deductions on the basis that the taxpayer failed to substantiate almost $50,000 of alleged expenses relating to his Schedule C activity.

PART SEVEN
CHARITABLE CONTRIBUTIONS

I. No Charitable Deduction for Home Donated as Salvage; *Mann v. US* 127, AFTR2d 2021-447 (January 1, 2021).

In *Mann*, the Fourth Circuit Court denied a couple's charitable deduction for their donation of salvaged materials from their home's demolition. The Fourth Circuit affirmed that, without recording a deed of transfer of ownership of the home itself, the owners' interest in the structure was not severed from the underlying land. A Transfer Agreement with the charity receiving the items was ruled insufficient to support a transfer of an interest in the structure itself.

Mr. and Mrs. Mann decided to tear down their house and construct a new one on the property. The Manns entered into a Transfer Agreement with Second Chance, a charitable organization, which provided that the Manns would retain ownership of the underlying land but would donate the house to Second Chance.

However, under Maryland law, to transfer the house separately from the underlying land, the Manns were required to sever the house from the underlying land by recording the transfer of the house with the local county. (Sec. 170(f)(3)). However, the Manns did not record a deed of transfer for the house, so the house was not severed from the underlying land.

So, according to the Fourth Circuit Court of Appeal, since, under Maryland law, the Manns still retained record ownership of the house and were still liable for paying property taxes, the Manns had not conveyed their entire interest in the property.

II. Charitable Contribution: No Charitable Contribution Deduction for Donation of Home to Fire Department For Training: Rolfs v. Commissioner, 135 TC No. 24 (November 4, 2010).

In the case of Rolfs v. Commissioner, 135 TC No. 24 (November 4, 2010), the taxpayers donated their lake front home to the local Volunteer Fire Department to be used for fire fighting and police training exercises and eventual demolition. Several days after donating the house to the Fire Department, the local Volunteer Fire Department conducted two training exercises at the house and burned it down.

Mr. and Mrs. Rolf claimed a $76,000 charitable deduction on their 1998 tax return, but later **amended the tax return** to claim a charitable deduction of $235,000 which was the reproduction cost of the house.

The Tax Court sided with the IRS and ruled that no charitable deduction was allowable because the Rolfs received, in exchange for the donated property, a benefit in the form of demolition services, the value of which exceeded the value of the donated property.

Originally, Mr. Rolf had the house appraised and the structure was valued at $76,000. At trial, the IRS introduced an expert who testified that it would cost $100,000 to "move" the house from one location to another. The IRS offered that, under the "quid pro quo argument," the value of any charitable donation should be reduced by the benefit conferred upon the donor. Mr. Rolf, however, provided testimony indicating that it would cost around $10,000 to demolish the house and remove the debris. Mr. Rolf relied upon the Scharf v. Commissioner, TC Memo 1973-265, case and argued that a small or incidental benefit received by a donor does not negate a finding of donated intent. The Scharf case had facts very similar to the Rolf's situation.

Ultimately, the Court considered whether the value of the lake house, as donated, exceeded the value of the demolition services that Mr. Rolf received.

The Court then applied a "willing buyer and willing seller" test to determine the value of the house without the land underneath it. Ultimately, the Court held that the lake house was virtually worthless, because no one would purchase it just to move it from the lake house location to another location. In other words, substantially all of the value of the lake house came from the fact that the lake house was just that – a house sitting on a lake shore.

The Court also reviewed the donation letter that the taxpayer provided to the local fire department and noted that, in the donation letter, Mr. Rolf stated that the house was to be used for firefighter training and for no other purpose. Since this was a restriction binding upon the donee, the donee could not liquidate its interest in the house by selling it to a third party. Thus, this restriction placed upon the donation would also serve to depress the value of the structure standing alone. In other words, in light of this restriction, no one would purchase the structure from the Fire Department -- since it could never be used for anything other than fire department training.

Note: No penalties were assessed against the taxpayers however.

Note: Here, the taxpayer should have provided more compelling testimony or evidence to indicate what a third party would pay to purchase just the structure and not the underlying land.

III. No Easement Donation Charitable Contribution Deduction Allowed Where Form 8283 Didn't Include Cost Basis Information.

In yet another case of a failed charitable contribution donation deduction, in Oakhill Woods, LLC v. Commission, TC Memo 2020-24 (Feb. 13, 2020), the IRS and Tax Court disallowed a contribution easement charitable contribution donation deduction because the taxpayer failed to include tax basis information on the IRS Form 8283. This resulted in a disallowed charitable deduction of almost $8 million.

On its filed tax return for the year of the donation, the taxpayer did not report its income tax basis for the donated easement but instead added an attachment to the Form 8283, citing that "the basis of the property is not taken into consideration when computing the amount of the deduction". The Tax Court ruled that, since the tax basis information was not included on the Form 8283 as originally filed for the year or the donation, the charitable deduction failed the "substantiation requirements" of Section 170.

The tax court also noted that the taxpayer may not qualify for the "reasonable cause" defense under Section 170(f)(11)(A)(ii)(II). Here, the LLC argued that it prepared and filed its Form 8283 in this manner based upon advice of their CPA, who prepared the return, as well as based upon advice of a consulting firm called "Forever Forests" which provided consulting advice in structuring the conservation easement donation. Here, because Forever Forests was involved with the conservation donation, another court would have to determine, at a later date, whether Forever Forests was a "competent and independent advisor unburdened with a conflict of interest" and whether the CPA was a "competent tax professional" who provided tax advice independent of the advice supplied by Forever Forests.

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

In Blau, 924 F.3d 1261, 123 AFTR2d 2019-1960 (CA DC, May 24, 2019) the Court of Appeals upheld the earlier decision of the Tax Court in RERI Holdings I, LLC, 149 TC No. 1 (July 3, 2017), denying 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 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 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.

V. Charitable Deduction Fails Where Tax Basis Not Shown on Form 8283.

Belair Woods, LLC vs. Commissioner, 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.

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

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

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

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

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

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

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

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

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

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

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

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

VII. <u>Final Regulations Impose New Substantiation Reporting for Charitable Contributions</u>.

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.

VIII. <u>But In Another Case, "Substantial Compliance" Saved Unqualified Appraisal; Emanouil v. Commissioner, TC Memo 2020-120 (August 17, 2020)</u>.

In <u>Emanouil</u>, the Tax Court ruled that an appraisal met the "substantial compliance" requirement of Section 170 even though the appraisal (1) did not identify the date of the charitable contribution and (2) did not contain a statement that the appraisal was prepared for income tax purposes.

<u>PART EIGHT</u>
S CORPORATIONS AND PARTNERSHIPS

I. <u>IRS Continues to "Crack Down" on S Corporation Payments of Disguised Wages</u>.

In *<u>Ward & Ward Company v. Commissioner</u>,* T.C. Memo. 2021-32 (Mar. 15, 2021) the Tax Court held that payments from the taxpayer's S corporation law firm to its owner/shareholder were wages subject to self-employment tax not Sub-S distributions of profit.

II. <u>PLR Grants Inadvertent Invalid Election and Termination Relief With Numerous Qualification Problems</u>

In PLR 201936005, an S Corporation was actually a limited partnership that had, as an owner, another partnership. The limited partnership elected to be taxed as an S Corporation. The IRS granted "inadvertent termination of S Election" relief for the partnership taxed as an S Corporation even though the (1) S Corporation had an ineligible partnership as a shareholder, (2) the partnership failed to sign the Form 2553, and (3) the S Corporation's governing documents provided that distributions were made in accordance with capital account balances rather than based upon percentage ownership interests.

III. <u>Partnership Entitled To Ordinary Worthless Loss Deduction for Investment in Family Owned Real Estate Business; MCM Investment Management, LLC, TC Memo 2019-158 (December 10, 2019)</u>.

In <u>MCM Investment Management</u>, the Tax Court ruled that a partnership was entitled to an ordinary loss deduction under IRC Section 165(a) because its interest in a related family owned real estate development business became worthless during the tax year.

MCM Investment Management, LLC was owned by four members of the same family. MCM owned a 20% interest in a real estate development and sales business. The four family members owned the other 80% interests.

The real estate development LLC (called "Companies") began experiencing financial difficulties and in 2008, the four family members created a new entity (called "Holdings") which purchased, at a discount, certain subordinated debt owed by Companies in an arms length transaction.

Later on, Holdings contributed the subordinated debt to Companies in exchange for preferred equity. By the end of 2009, the four family members concluded that, if Companies was liquidated, there would be nothing left over to pay any of the subordinated debt after senior debt was paid off.

The Tax Court held that the Holdings was entitled to an ordinary business loss deduction, on Form 4797, for the worthless interest in Companies.

In the earlier case of Forlizzo, Tax Court Memo 2018-137, the Tax Court had previously ruled that a partner could claim an ordinary loss from a worthless investment in a partnership, if the partnership interest becomes worthless during the year. Under Section 165(a), a taxpayer may claim an ordinary loss deduction relating to his investment in a partnership if the investment becomes worthless and sale or exchange treatment does not apply. See also Citron v. Commissioner, 97 T.C. 200 (1991).

PART NINE
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. **Another Court Rejects The "My Boss Told Me Not To Pay" Argument Against Assessment Of The Section 6672 Trust Fund Recovery Penalty; Myers v. U.S., 123 AFTR 2d 2019–1782 (923 F. 3d 935) May 6, 2019.**

Mr. Myers was the CFO and co-president of two companies that were in turn owned by another parent company. The parent company was licensed by the U.S. Small Business Administration as a Small Business Investment Company. The SBA had the power to place the parent company into receivership if it violated the terms of its license.

In 2008, the parent company violated the terms of its license and was then placed into receivership by the SBA. In 2009, the parent company got behind on its payroll tax filing obligation. The representatives of the SBA specifically told Mr. Myers to prioritize other vendors over the trust fund taxes.

The IRS assessed the trust fund recovery penalty against Mr. Myers. The District Court granted summary judgment in favor of the IRS and Mr. Myers appealed.

The 11th Circuit Court of Appeals noted a long line of precedent rejecting the "my boss told me not to pay" argument. See for example, Thosteson v. United States, 331 F3d 1294 (11th Cir. 2003). However, Mr. Myers argued that his case was different than those cases because the parent company's receiver was the SBA, a governmental agency. Mr. Myers argued that he should not be held liable because it was not an old boss telling him not to pay the taxes, it was a governmental agency. The 11th Circuit Court of Appeals ruled that Section 6672 liability attaches regardless of whether the boss is a private entity or a governmental agency.

III. IRS Motion to Dismiss 6672 Refund Claim Denied Where There was a Question of Fact as to Whether the Responsible Person Acted Willfully; Preinesberger v. US, 126 AFTR2d 2020-5143 (DC CA) (August 5, 2020).

Mr. Preinesberger owned less than 10% of the stock of Meridian Health Services Holdings ("Meridian") and operated five skilled nursing home facilities in California for Meridian.

Meridian got in financial trouble and stopped paying its payroll taxes, partly because of delays in reimbursement payments from Medicare and Medi-Cal. During its times of financial struggle, Meridian drew on a line of credit from Capital Finance, Inc. ("CFI"). Each time that Meridian drew on its line of credit with CFI, Meridian was required to use all of the borrowed funds strictly for payment of net wages; CFI refused to allow Meridian to use any of the funds for payment of withholding taxes.

In addition, unlike is the case with the atypical business, the facilities could not simply cease operations when they could no longer pay their employee's net wages and the necessary withholding taxes. Under state and federal regulations, nursing homes must follow a lengthy and detailed procedure for closure that includes notification to its residents and appropriate governmental agencies and transferring residents to other appropriate facilities. Accordingly, Mr. Preinesberger argued that it was not possible for the facilities to meet both the withholding obligations and the regulatory obligations to remain open and maintain well-being of their residents.

The IRS filed a motion to dismiss which was denied by the United States District Court for the Eastern District of California. The court held that it was possible that Mr. Preinesberger's failure to withhold were not "willful" and it would be up to a trier of fact to determine whether Mr. Preinesberger's actions were involuntary, and therefore not willful. According to the court, in this case, federal and state regulations required that CFI's loan be spent to maintain the standard of care which could arguably make the funds "encumbered".

IV. <u>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)</u>.

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 <u>Westerman v. U.S.</u>, 718 F3d 743 (8th Cir. 2013). However, absent such an election, the IRS is free to apply deposits as it sees fit.

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

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).

VI. 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).

VII. 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).

VIII. 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

IX. 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.

X. 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 TEN
TAX PENALTIES, EFFECT OF ADMINISTRATIVE DISSOLUTION AND OTHER IRS TAX PROCEDURES

I. More on The One "Examination Rule"; *Kelly vs. U.S.*, 128 AFTR 2d 2021-5425 (August 5, 2021.

In *Kelly vs. U.S.*, the U.S. District Court for the Southern District of California discussed the limited application of the "one examination rule" under Code Section 7605. Section 7605(b) provides that:

> No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

So, the statutory language of Section 7605(b) both (1) prohibits the IRS from conducting an "unnecessary examination or investigation" and (2) restricts the IRS to one "inspection of a taxpayer's books" unless the IRS, "after investigation," notifies the taxpayer that additional inspection is necessary.

In the past, various courts have narrowly construed Section 7605(b) to only apply if the IRS has completed a full audit of the taxpayer's return. See, for example, *United States v. Giordano*, 419 F.2d 564, 567 (8th Cir. 1969).

II. IRS Couldn't Re-Audit NOL Carryforward From Previously Audited Year; FAA 20202501F.

A. Background. In numerous past cases, courts have allowed the IRS to go back and to disallow NOLs carried into the tax year at issue, where the taxpayer was unable to prove the exact amount of their NOL carryforwards into the relevant tax year. This was the case even if the original loss years were "closed" by virtue of the statute of limitations extension. See Powers v. Commissioner, TC Memo 2016-157 (August 22, 2016) and Jasperson vs. Commissioner, 118 AFTR 2d 2016-5633 (11th Cir., August 31, 2016).

B. FAA 2020501. In Field Attorney's Advice 20202501 F, the IRS Chief Counsel determined that the IRS cannot audit NOL carry forwards from previously audited years where the IRS had previously disallowed NOLs but, after the taxpayer requested an appeal, the IRS Office of Appeals allowed the NOLs.

Section 7605(b) prohibits the IRS from conducting "repetitive audits". This Section provides that a taxpayer will not be subject to unnecessary examination or investigation and that there shall be only one inspection of a taxpayer's books of account for a tax year unless the IRS, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

III. No "Reasonable Cause" Penalty Relief for Corporation's Late Filing, Late Deposit or Late Payment Penalties; *All Stacked Up Masonry*, (Ct Fed C1 10/22/20) 126 AFTR 2d ¶2020-5399.

In *All Stacked Up* Masonry, the Court of Federal Claims held that a corporation could not meet the "reasonable cause" relief from penalty assessments for failure to timely file returns and to timely deposit and pay payroll taxes.

A taxpayer seeking relief from penalty assessments for failure to timely file, pay or deposit taxes must show that its failure was not the result of carelessness, reckless indifference, or intentional failure. In numerous cases, courts have held that a taxpayer's duty to pay taxes or file returns can't be delegated. Therefore, the failure to timely file a tax return is not excused by a taxpayer's reliance on an agent, and such reliance is not reasonable cause for a late filing. Similarly, the duties to make deposits and payments also can't be delegated.

Also, using tax preparation software does not alleviate the taxpayer's duty to be aware of, and comply with, filing deadlines. (<u>In re Craddock</u>, 82 AFTR 2d 98-5439 (CA 10 1998).

IV. <u>Taxpayer Was Still Liable For The Failure To Timely File Penalty Where Preparer Forgets To Hit "Send"</u>.

In <u>Intress</u> vs. U.S., 124 AFTR 2d 2019-5420 (August 2, 2019), Christian Intress and Patrick Steffen hired a professional tax return preparer to file their 2014 income tax return. The preparer was in the process of submitting a Form 4868, Application For Automatic Extension Of Time To File U.S. Individual Income Tax Return, but the preparer failed to hit "send". The preparer did not discover the missed deadline until October 2015 resulting in a penalty assessment of over $120,000 under Section 6651(a). In upholding the penalty assessment, the court stated that the taxpayer's reliance upon their preparer to timely file the extension request was not "reasonable cause" for purposes of the penalty assessment. <u>United States vs. Boyle</u>, 469 U.S. 241 (1985).

V. <u>Program Manager Technical Advice 2020-001; "Failure to File" Penalty Exception for Certain Small Partnerships</u>.

A. <u>Background</u>. A partnership, that fails to timely file a partnership return, is subject to a $200 per partner penalty under Code Section 6698, unless the failure to timely file is due to "reasonable cause." Under Code Section 6031(a), a partnership is required to file a return if it has any income or deductions allocable to its partners.

B. <u>Program Manager Technical Advice 2020-001</u>. The IRS issued Program Manager Technical Advice 2020-001 to remind us that, under Revenue Procedure 84-35, certain "small partnerships" will qualify for reasonable cause exception for the late filing penalties if certain requirements of the Revenue Procedure are met.

Revenue Procedure 84-35 provides that certain "small partnerships" can show "reasonable cause" for late filing of a return if the following criteria is met:

(1) A partnership with ten or fewer partners:

(2) Each partner is an individual, a C Corporation or the estate of a deceased partner;

(3) Each partner reports his share of income or expenses of the partnership on his or her timely filed income tax return.

VI. Eighth Circuit Court of Appeals Narrows the "Reasonable Basis" Exception to the Negligence Penalty; Wells Fargo vs. United States, 957 F.3d 840 (April 24, 2020).

A. Background. Section 6662(b) provides for the assessment of certain penalties where there is negligence, substantial understatement of tax or certain valuation misstatements. These are referred to as the "accuracy related" penalties. The applicable penalty is 20% of any tax underpayment.

However, a defense to the negligence penalty exists under Reg. Section 1.6662-4(d) if the taxpayer's return position was "reasonably based on one or more of the certain authorities set forth in Reg. Section 1.6662-4(d)(3)(iii)". Reg. Section 1.6662-3(b)(3). This is called the "reasonable basis" defense. Reg. Section 1.6662-4(d)(3)(iii) sets forth authorities that the taxpayer can rely upon to meet the "reasonable basis" defense, such as case law, revenue rulings, etc. that meet the "substantial authority" test of Reg. Section 1.6662-4(d).

Likewise, under Section 6662(d)(2)(B), the substantial understatement penalty will not apply if there is or was "substantial authority" for the taxpayer's position under the criteria of Reg. Section 1.6662-4(d)(3).

The "substantial authority" standard is less stringent than the "more likely than not" standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the "reasonable basis" standard as defined in §1.6662-3(b)(3). Substantial authority exists only when the weight of the authorities supporting the treatment of the tax item is substantial in relation to the weight of the authorities supporting contrary treatment.

B. Wells Fargo. Wells Fargo involved the disallowance of certain foreign tax credits involving a structured trust arrangement entered into by Wells Fargo with Barclays Bank. The Eighth Circuit Court of Appeals upheld the disallowance of the claimed foreign tax credits.

However, more interesting was the Court's discussion of the application of the reasonable basis defense to the assessment of the negligence penalty.

In this case, the Eighth Circuit Court of Appeals ruled that Wells Fargo could not meet the "reasonable basis" defense to the negligence penalty because it failed to submit any evidence at trial to establish that it subjectively based its return position on legal authority at the time the return was filed. In other words, according to the Court, under the "reasonable basis" defense, the taxpayer cannot base its return position on relevant authorities without showing that it actually relied upon those authorities when filings its tax return.

VII. <u>District Court Approves the Forced Sale of Real Property Owned by Taxpayer and His Non-Liable Sister; Dase, 125 AFTR 2d 2020-1079 (N.D. Ala. February 27, 2020)</u>.

Mr. Dase owed outstanding tax debts. When Mr. Dase's father passed away, Mr. Dase and his sister inherited real property located in Alabama, as tenants in common. The IRS sought to force the sale of the entire interest in the property, even though Mr. Dase's sister owned a one-half interest in the property and was not liable for Mr. Dase's tax debts.

Even though the IRS lien only attached to Mr. Dase's one-half interest in the property, the District Court allowed the IRS to issue a foreclosure sale of the **entire** property. Based upon <u>Rodgers</u>, the court concluded that ordering a foreclosure sale of the entire property was appropriate because (1) an attempt to sell only Mr. Dase's one-half interest would prejudice the interests of the government since no one would bid on a one-half tenant-in-common interest in the property, (2) the sister did not have expectation that the property would not be subject to a forced sale because, under Alabama law, either tenant could force a sale of a tenant-in-common interest in the property, (3) the sister did not live on the property and she would not be forcibly relocated by a sale, and (4) the sister would be adequately compensated for her interest in the property because of the fact that she would receive one-half of the sales proceeds.

VIII. <u>Workers at a Cleaning Business Were Properly Treated as Independent Contractors and not Employees; Santos v. Commissioner, TC Memo 2020-88 (June 17, 2020)</u>.

Mrs. Santos owned a cleaning businesses called Campos Cleaning that had contracts with several apartment complexes to do "unit turnover cleaning", which is cleaning for recently vacated apartments before new tenants arrive.

The contracts with the apartment projects specified days and hours when common areas were to be cleaned. However, that was not the case with respect to cleaning recently vacated apartments. Instead, with respect to recently vacated apartments, the apartment project managers would contact Mrs. Santos directly to schedule the cleaning.

For cleaning common areas, the apartment complexes paid Campos Cleaning a weekly fixed amount ranging from \$510 to \$780. For cleaning recently vacated apartments, Campos Cleaning was paid monthly at a fixed rate of \$90 to \$120, depending upon the size of the apartments.

Mrs. Santos posted advertisements looking for workers. She only hired individuals with prior training in cleaning experience and she never provided any training to them. Mrs. Santos spoke English, but most of her workers did not. Mrs. Santos had no written employment contracts with any of her workers and, to that end, she did not guarantee them a minimum amount of work frequency. And, her workers could decline to do a cleaning job for whatever reason. Many of Mrs. Santos' workers cleaned for other individuals and businesses as well.

Mrs. Santos paid her employees weekly, but the pay rate was based upon a fixed rate of $50 to $70 per apartment cleaned, depending upon the size of the apartment. She did not provide any paid sick leave or vacation, and she did not offer any employee benefits. However, Campos Cleaning did maintain general liability insurance and workers compensation insurance as required by the apartments.

Once an apartment was recently vacated, the apartment manager would contact Mrs. Santos and she would then send one of her workers to do the cleaning by the deadline the property manager established. The workers used their own transportation and furnished and used their own cleaning supplies. They were also free to hire assistants.

Mrs. Santos did not supervise the cleaning, nor would she provide any post-cleaning inspections.

The Tax Court determined that Mrs. Santos was more of a "dispatcher" than an "employer". So, based upon the foregoing facts, the court determined that the workers were properly characterized as independent contractors rather than employees.

IX. Taxpayers Couldn't Challenge A Notice Of Deficiency Sent To Last Known Address. Gregory, 152 TC No. 7 (2019).

Mr. and Mrs. Gregory moved in the summer of 2015. However, the couple used their old mailing address when they filed their 2014 federal income tax return on October 15, 2015. A month later, in November 2015, the couple used their new address when they filed a Form 2848. The couple also used their new address in April 2016 when they filed an extension to extend the due date for filing their 2015 return.

On October 3, 2016, right before Mr. and Mrs. Gregory filed their 2015 tax return, the IRS mailed a Notice of Deficiency to their old address. Mr. and Mrs. Gregory did not find out about the notice of deficiency until after the 90 day statutory notice period had expired.

The Tax Court held that Mr. and Mrs. Gregory had not provided the IRS with "adequate notice" of their new address and therefore their deficiency notice sent to their old address was valid which meant that the Tax Court petition filed by Mr. and Mrs. Gregory was untimely.

Under the regulations, the last known address is the address that appears on the taxpayer's most recently filed tax return unless the IRS has been given clear and concise notification of a different address. In this case, in October 2016 when the IRS mailed the statutory Notice of Deficiency, the last tax return filed by Mr. and Mrs. Gregory was the 2014 return which reflected their old address. Mr. and Mrs. Gregory should have filed a Form 8822, Change of Address, to the IRS.

X. Court Rules That Taxpayers Adequately Notified the IRS of Address Change: Direct Communication of Address Change to IRS Agent was Sufficient Notice to IRS; *Gregory*, No. 19-2229 (3d Cir. 12/30/20).

The Third Circuit held that a couple's filing of two IRS tax forms, that used their new address, along with direct communication of the address change to an IRS agent, was sufficient notification to the IRS of the change of address. The Tax Court previously had held that the IRS had sent a valid 90-day Notice of Deficiency to the couple's last known address at their former residence and that the couple had not provided the IRS with clear and concise notification of the address change.

In June 2015, Mr. and Mrs. Gregory relocated but failed to file a Form 8822, *Change of Address*, to inform the IRS of their new address.

Based upon the Fifth Circuit Court's decision in *Terrell,* 625 F.3d 254 (5th Cir. 2010), the Third Circuit held that "in determining whether the IRS had clear and concise notice of an address change, the proper inquiry is what the IRS knew or should have known." The court held that the CPA's communication to the IRS provided the IRS with actual notice of the address change. Also, the IRS had received two tax forms with an updated address. According to the court, these two factors were sufficient notice to the IRS, such that the IRS knew, or should have known, of the address change.

XI. The Tax Court Petition Was Deemed Timely Filed Even Without the Postmark; Seely, TC Memo 2020-6 (January 13, 2020).

In Seely, the IRS issued Mr. and Mrs. Seely a Notice of Deficiency on March 28, 2017 for the 2013, 2014 and 2015 tax years. The last date for the Seelys to file a US Tax Court Petition, to challenge the deficiency, was June 26, 2017. The Seelys filed a Tax Court Petition which the IRS received July 17, 2017. Unfortunately for the Seelys, the envelope containing the Petition had no postmark. The IRS took the position therefore that the petition was untimely filed, and the IRS moved to dismiss the petition.

The Tax Court held that the tax petition was timely filed. The taxpayers submitted a declaration from their attorney, Mr. Boyce, stating that, under penalty of perjury, he deposited the Tax Court Petition in the United States postal service collection receptacle in Washington, DC on June 22, 2017. The court noted that under Sylven v. Commissioner (65 TC 548 1975) and Mason v. Commissioner (68 TC 354 1977) when the envelope bears no postmark, the court will permit the introduction of extrinsic evidence to ascertain the mailing date. The IRS argued that the petition actually arrived 21 days after its due date and therefore contended that Mr. Boyce's declaration was not credible since the petition actually arrived 25 business days after the alleged mailing date.

However, the court noted that because the 4th of July holiday fell between the date of the alleged mailing and the delivery date, there could have been a "plausible possible explanation" for the delay in delivery. In prior cases, holiday conditions at the post office (such as holiday closures, unusually large volumes of mail, or inefficiencies attributable to temporary staff) have been found to be a plausible explanation for short delays in delivery. Rotenberry v. Commissioner, 847 F2d 229 (5th Circuit 1988).

XII. **Consent To Extend The Statute Of Limitations Was Invalid And Unenforceable Where The IRS Failed To Sign The Form 872 Prior To Expiration; Chief Counsel CCA 201937017 (September 13, 2019).**

In this CCA, the taxpayer signed a Form 872, Consent to Extend the Time To Assess Tax, before the statute of limitations on assessment expired. However, due to the government shutdown, an IRS representative failed to sign the Form 872 until the government shutdown ended.

According to the CCA, the IRS cannot enforce a Form 872, signed by it after the expiration of the statute of limitations, even if it was signed by the taxpayer prior to expiration of the statute of limitations. Treasury Reg. 301.6501(c)-1(d) specifically states that the period of limitations to assess the tax may only be extended by consent “prior to the expiration" of the time to assess, and consent to extend “shall become effective when the agreement has been executed by both parties." So, the IRS could not enforce the Form 872 against the taxpayer.

XIII. **U.S. Tax Court Petition Filed By Dissolved Corporation Was Invalid.**

In Timbron Holdings Corporation v. Commissioner, TC Memo 2019–31 (April 8, 2019), a California corporation had its charter suspended for failing to file California tax returns. The IRS then mailed the taxpayer a Notice of Deficiency and the taxpayer timely filed a U.S. Tax Court Petition challenging the Notice of Deficiency. The problem, however, was that taxpayer's charter was suspended when it filed the U.S. Tax Court petition. Therefore, the court dismissed the petition as being untimely filed.

XIV. **Spouse’s Knowledge That Taxes Weren’t Paid Didn’t Preclude “Equitable” Innocent Spouse Relief; *Grady*, T.C. Summary Opinion 2021-29 (August 17, 2021).**

In Grady, the Tax Court granted Mrs. Grady “equitable” innocent spouse relief even though she knew that joint return taxes weren’t being paid by her husband at the time their joint returns were filed.

Here, Ms. Grady and her husband filed joint tax returns, and the returns reflected an unpaid balance owed. However, Ms. Grady’s husband always assured her that he would secure an installment payment arrangement with the IRS to get their balances paid up.

Based upon applying “equitable” relief factors under Section 6015(f), the court held that Ms. Grady qualified for equitable innocent spouse relief even though she knew taxes weren’t being paid when the joint returns were originally filed.