2024 FEDERAL INCOME TAX LAW UPDATE

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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?

The 2023 Internal Revenue Service Data Book released in April 2024 contains audit statistics for years 2013 through 2021, as of the fiscal year ended September 30, 2023 (FY 2023). For tax years 2019 and earlier, the statute of limitations for audits had generally expired as of September 30, 2023. However, for 2020 and later returns, the statute of limitations has yet to expire, so additional returns of those years may be audited.

For 2013 through 2021, audit rates dropped significantly. For example, individual tax returns had an audit rate of 0.6% for 2013 returns versus 0.2% for 2021. In addition, for individuals with income between $1 million and $5 million, the audit rate dropped from 3% for 2013 returns to .5% for 2021 returns.

The overall audit rate for C corporations dropped from 1.2% for 2013 returns to .3% for 2021 returns. For partnerships and S corporations, the audit rate for 2013 returns was 0.3% and 0.3%, respectively, compared to 0.1% and 0.1% for 2021 returns.

In FY 2023, 22.7% of audits were field audits. The others were correspondence audits.

Below are the FY 2023 audit statistics for 2021 tax returns:

A. Audit Rates for Individual Tax Returns. During FY 2023, only 0.2% of individual income tax returns filed for 2021 were audited (same as for 2020 returns).

Total 2021 Individual Returns Audited in FY 2023: 0.2%

(1)	No positive income	0.3%
(2)	$100,000 to $200,000	0.1%
(3)	$500,000 to $1 million	0.3%
(4)	$1 million to $5 million	0.5%
(5)	$5 million to $10 million	1.4%
(6)	$10 million or more	2.9%

B. Audit Rates For Partnerships and S Corporations: For partnership and S corporations, the FY 2023 audit rate for 2021 returns was .1% (same as for 2020 returns).

C. Audit Rates for C Corporations. C corporation returns filed for 2021 had an audit rate of 0.3% during FY 2023 (down from .6% for 2020 returns).

Total 2021 C Corporation Returns Audited in Fiscal Year 2023: 0.3%

(1)	Assets $1 million to $5 million	.4%
(2)	Assets $5 million to $20 million	6.5%
(3)	Assets $20 million or more	15.8%

D. Schedule C Returns. Not surprisingly, the audit rates for Schedule C returns are much higher than for other individual returns. According to Internal Revenue Service Data Book 2019, Schedule Cs filed for 2018 with receipts of $100,000-$200,000 had a 1.6% audit rate. Schedule C returns filed for 2018 with income over $200,000 had a 1.4% audit rate. Since 2019, the IRS has not published similar Schedule C audit statistics for tax returns after 2018.

II. Offers in Compromise and Criminal Case Referrals.

A. Offers in Compromise. For FY 2023, the IRS received around 30,000 offers in compromise but accepted only about 12,700.

B. Criminal Case Referrals. The IRS initiated 2,676 criminal investigations for FY 2023 and completed 2,584 cases. The IRS referred 1,838 cases for criminal prosecutions (484 for legal source tax crimes, 874 for illegal source financial crimes, and 480 for narcotics–related financial crimes) and obtained 1,508 convictions. For convictions, 1,167 were incarcerated.

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

I. Background and Overview.

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

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

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

(i) Section 1031 nontaxable exchanges;

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

(iii) Section 453 installment sale reporting.

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

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

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

B. Past Case Law.

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

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

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

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

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

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

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

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

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

1. The taxpayer's purpose in acquiring the property;
2. The purpose for which the property was subsequently held;
3. The taxpayer's everyday business and the relationship of the income from the property to the total income of the taxpayers.
4. The frequency, continuity, and substantiality of sales of property;

5. The extent of developing and improving the property to increase sales revenue;
6. The extent to which the taxpayer used advertising, promotion, or other activities to increase sales;
7. The use of a business office for sale of the property;
8. The character and degree of supervision or control the taxpayer exercised over any representative selling the property; and
9. The time and effort the taxpayer habitually devoted to sales.

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

II. Conservation Easement Charitable Deduction Limited To Taxpayer's Adjusted Basis In Ordinary Income Property and Further Reduced to Zero When the Taxpayer Couldn't Prove Current Basis Figures. Also, Informal Understanding Between the Appraiser and Taxpayer Disqualified the Appraiser From Being a "Qualified Appraiser" Under Section 170; Oconee Landing Property vs. Commissioner, TC Memo 2024-25 (February 21, 2024).

Oconee Landing Property, LLC claimed a charitable contribution deduction of almost $21 Million on its partnership tax return for the 2015 tax year for its donation of a conservation easement over property it owned in Georgia. The IRS disallowed the entire charitable contribution deduction.

In siding with the IRS, the Tax Court held that the charitable contribution failed in its entirety for two distinct reasons. First, the real estate appraisers, assisting Ocenee, were not "qualified appraisers", which meant that Oconee had failed to attach a "qualified appraisal" to its 2015 tax return. Second, because the property on which the easement was granted was "ordinary income" property, the amount of the charitable contribution was limited to Oconee's tax basis in the donated property. And, because Oconee could not prove that its tax basis in the donated property exceed zero, its charitable contribution was limited to zero.

In 2015, Oconee donated a conservation easement over a tract of land it owned in Georgia (the "Easement Tract"), which was located near Lake Oconee. Oconee acquired the Easement Tract through a capital contribution from one of its partners, known as Carey Station, LLC.

The principals of Carey Station, LLC were members of the Reynolds family and were real estate developers. The Reynolds family held the Easement Tract as part of a much larger tract acquired in 2003 by the Reynolds family (the "Carey Tract"). The Reynolds family had hoped to develop the Carey Tract.

Originally, the Reynolds family had held the Carey Tract and the surrounding acreage and made extensive efforts to either develop the Carey Tract themselves or, when they eventually ran out of cash, they attempted unsuccessfully to find a joint venture partner that would provide the capital to assist them in developing a “master infrastructure” for the Carey Tract, including roads and sewer facilities.

During these intervening years (between 2007 and 2014), the Reynolds family approached different venture capital groups with no success. At times, the Reynolds family sold small tracts from the larger Carey Tract, usually to buyers who would acquire adjoining tracts with a view to facilitating amenities that would be synergistic with the Reynolds' larger development ideas. For example, the Reynolds family sold portions of the Carey Tract for the construction of a fire station, a church, a school, a skilled nursing/assisted-living facility and a residential community. In all these cases, the Reynolds reported their profits from the sales as ordinary income on their own tax returns.

In 2014, the Reynolds family formed Carey Station, LLC and contributed to it 980 acres of the Carey Tract. They then unsuccessfully attempted to sell the Carey Station property at prices between $6.7 Million and $7.9 Million.

After the Reynolds family became frustrated with their attempts to find a joint venture partner or to sell the Carey Tract, they decided to form a syndicated conservation easement joint venture for the Cary Tract. The idea was for the Reynolds family to sell units in a newly-formed syndicated joint venture partnership that would provide the buyers with a $1.00 charitable contribution deduction for every $4.35 paid by the buyers.

The Reynolds family wanted to generate almost $7 Million in proceeds from the sale of partnership units. This required that the Oconee joint venture secure a valuation of over $60 million for the Carey Station property. However, the Reynolds family had been unsuccessful in finding potential buyers willing to pay more than $7 million for the entire easement tract. Ultimately, Oconee secured a valuation of the Carey Tract at almost $60 Million.

The Reynolds family decided to “carve out” 82 acres from the Carey Tract and retain ownership of that acreage in Carey Station, LLC. This reduced the Carey Tract to 874 acres. The Reynolds family ultimately caused Carey Station to contribute only 355 acres to the Oconee,,LLC, the new syndicated easement venture, and Carey Station kept the remaining acres. The appraisers valued the contributed property at around $60,000 per acre.

After contributing the 355 acres to Oconee, LLC, Carey Station, LLC received 95% of the Oconee units which it then sold to investors for $3.7 Million, a valuation far less than at $60,000 per acre.

The Tax Court struck down the charitable contribution deduction on numerous grounds.

First, the Tax Court held that the Easement Tract (the 355 acres) had been “inventory” in the hands of Carey Station, LLC that had contributed the Easement Tract to the Oconee, LLC syndicated easement joint venture, which meant that Oconee’s charitable deduction would be limited to Oconee's adjusted tax basis in the Easement Tract.

The history of the Reynolds family's and Carey Station's efforts to develop the Easement Tract clearly showed that the Reynoldses held their interests in the Easement Tract for sale to customers in the ordinary course of their real estate business. Also, when the Reynolds family sold different portions from the Carey Tract, they reported those gains as ordinary income on their own tax returns. Similarly, when the contributing partner (Carey Station, LLC) sold tracts of the Carey Tract property it retained, Carey Station reported those sales in 2015 as ordinary income.

Therefore, when Carey Station conveyed the Easement Tract to Oconee, the nature and character of the property carried forward as ordinary income inventory pursuant to Section 724 of the Internal Revenue Code to the extent there were any dispositions of that property over the next five years. Since this property would continue as "ordinary income property" over the next five years, the Easement Tract retained its character as ordinary income property after the conservation easement.

Further, the Tax Court ruled that the charitable deduction would be reduced to zero on the grounds that the syndicated partnership, Oconee, LLC, had failed to establish its income tax basis in the syndicated Easement Tract. The only evidence presented at trial was carryover tax basis information from an earlier tax return that the joint venture partner (Carey Station, LLC) had filed in earlier years. Carey Station's Form 1065 for 2014 showed a cost basis of $9 Million for the Easement Tract. However, as the court stated, "an entry on a tax return simply states the taxpayer's position as to an item; it does not constitute evidence." Without anything more to substantiate the Carey Station's cost basis in the Easement Tract, the charitable contribution deduction was reduced to zero.

Next, the court ruled that the appraisal, submitted with the Form 8283, did not meet the standards of a "qualified appraisal." The Tax Court found that the two appraisers, who provided the $21 Million valuation report, failed to meet the "qualified appraiser" requirement with respect to the donation. This meant that the final appraisal report, which was attached to the Oconee's tax return Form 8283, was not a "qualified appraisal" as required by Section 170(f)(11)(E)(i).

Under the charitable contribution regulations, even if appraisers have the qualifications and standards required to qualify as "qualified appraisers", they may lose that qualification by virtue of the "exception" set forth in Treasury Regulation 1.170A-13(c)(5)(ii). That exception in the regulations provides that an individual is not a "qualified appraiser" with respect to a particular donation if the appraiser and the donor already had an understanding as to the amount that the property would be valued and "if the donor had knowledge of facts that would cause a reasonable person to expect the appraiser to falsely overstate the value of the donated property."

Here, the appraisers, who appraised the Carey Tract at almost $21 Million, already knew that this was the number that the Reynolds family needed to secure in order to make the syndicated conservation transaction meet the Reynolds family's economic requirements. So, there was already a meeting of the minds between the appraiser and the taxpayer as to the valuation that would ultimately be placed on the donated Easement Tract.

Also, the Reynolds family knew that the tract was worth less than $10 million and therefore they "had knowledge of the facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property." Treasury Regulation 1.170A-13(c)(5)(ii).

III. Investment Property vs. Dealer Inventory: Charitable Deduction for Easement Property Donation Limited to Donor's Tax Basis Where Contributing Partner and Predeessor Held Property as Inventory; Glade Creek Partners, LLC v. Commissioner, T.C. Memo 2023-82 (June 29, 2023).

In 2012, Glade Creek Partners, LLC ("Glade Creek") donated a conservation easement on undeveloped real estate that was part of a failed residential development and claimed a $17.5 million charitable contribution deduction based upon the asserted fair market value of the easement. *Glade Creek,* T.C. Memo. 2020-148. In an earlier decision, the tax court found that, on the easement date, the unencumbered easement property had a fair market value of $9,354,171, and that the easement had a fair market value of $8,877,771. *Id.* at *53, *55.

On remand, the Tax Court determined that the easement property was inventory, and not investment property, in the hands of the partner that contributed the property to Glade Creek. Therefore, the easement contribution was a donation of "inventory", such that the charitable deduction was limited to Glade Creek's adjusted tax basis in the donated easement property.

In January 2006, International Land Consultants, Inc. ("ILC") purchased 2,000 acres of undeveloped land in Tennessee ("ILC Property") for over $9 million to develop into a residential vacation community. The development plans for the property contemplated phase development of Tracts I, II and III of the ILC Property.

All but three acres of Tracts II and III ultimately were the subject of the conservation easement donation (the "Easement Property").

Before it purchased the ILC Property, ILC hired James Vincent, a local businessman and real estate investor and developer, to help with the vacation community development project. Mr. Vincent did not have an ownership interest in ILC and was to be compensated through a profit-sharing arrangement. Mr. Vincent also assisted with obtaining financing for the infrastructure construction and personally guaranteed infrastructure loans.

In March 2007, ILC recorded the lots in Tract I and began sales efforts. However, ILC never recorded any platted lots for Tracts II and III. ILC sold approximately 30% of the Tract I lots in less than two years. By 2009, sales had slowed down significantly due to the 2008 economic recession. ILC only sold 9 lots in 2009, and at some point in 2009, ILC ran out of funds and was forced to halt marketing the vacation community.

Sometime in late 2009 or early 2010, one of ILC's three owners withdrew from the project, leaving Mr. Vincent and the remaining two ILC owners, James Tague and Rocco

Toscano, solely responsible for ILC's seller-financed mortgage and for its outstanding infrastructure loans.

In April 2010, facing pressure from their lenders, Mr. Tague, Mr. Toscano and Mr. Vincent formed Hawks Bluff Investment Group, Inc. (“Hawks Bluff”), an S corporation. On April 20, 2010, ILC transferred the unsold lots of Tract I and the Easement Property (Tracts I and II) to Hawks Bluff in exchange for Hawks Bluff’s assumption of ILC's debt. The purpose of the land transfer was to help reassure the bank that financed the infrastructure loans.

After a mortgage modification, Hawks Bluff owed approximately $1.8 million on the mortgage and had total debt of approximately $3.3 million. Hawks Bluff sold only a couple of lots during 2010 and 2011, and no lots in 2012.

In the face of mounting financial debt pressures, in August 2012, Mr. Vincent decided to pursue a syndicated conservation easement transaction to pay off part of Hawks Bluff's debt.
Two newly organized entities were formed to affect the easement transaction, one to hold the Easement Property, Glade Creek, and the second, Sequatchie, to promote the easement transaction to investors. Under the easement donation plan, Hawks Bluff would contribute the Easement Property to Glade Creek in exchange for a 98% membership interest, and after raising funds through a private placement, Sequatchie would purchase a 90% to 95% interest in Glade Creek. Then, as the controlling member of Glade Creek, Sequatchie would cause Glade Creek to grant the easement.

Initially Glade Creek was owned 98% by Hawks Bluff and 1% each by Mr. Tague and Mr. Vincent. On September 18, 2012, Hawks Bluff deeded the Easement Property to Glade Creek subject to the $1.8 Million mortgage in exchange for a 98% membership interest. Glade Creek acquired a $3.8 Million carryover tax basis in the Easement Property. Hawks Bluff decreased the value of its inventory on its books by almost $3 Million to account for its capital contribution to Glade Creek.

Sequatchie prepared a private placement memorandum (PPM) to present to potential investors to raise funds it needed to purchase membership interests in Glade Creek. The PPM described the tax consequences of a conservation easement transaction and included a discussion relating to whether the easement deduction would be limited to Glade Creek's adjusted tax basis in the Easement Property pursuant to Section 170(e)(1)(A).

The PPM stated that that the Easement Property constituted a “capital asset” in Glade Creek's hands, and therefore an easement deduction would equal the easement's fair market value. The PPM stated that Sequatchie believed that the property had not been associated with any development or dealer activities, and that neither Glade Creek nor Hawks Bluff had sold any part of the easement property or undertaken marketing or development activities. The PPM stated that Sequatchie did not believe that the property could be characterized as property held “primarily for sale to customers in the ordinary course of a trade or business” in Glade Creek's hands and did not anticipate that the easement deduction would be limited to Glade Creek's adjusted tax basis in the Easement Property.

On November 29, 2012, Sequatchie acquired a 91% membership interest in Glade Creek for $3.2 million and then voted to grant the conservation easement. By deed dated December 29, 2012 Glade Creek granted the easement.

Glade Creek's partnership return for 2012 reflected the easement deduction and did not report that Glade Creek held any inventory.

However, Hawks Bluff's 2012 S corporation return reported that it was a "real estate dealer" and reported the easement property (prior to is capital contribution to lade Creek) as inventory. Hawks Bluff reported an ordinary loss of $194,262 on the sale of its Glade Creek's membership interest to Sequatchie.

In general, the sale of a partnership interest is treated as a sale of a capital asset that generates a capital gain or loss. Section 741. However, Section 751 provides an exception to this general rule and requires taxpayers to report the sale of a partnership interest as resulting in some ordinary income or loss, if the partnership holds inventory. Section 751(a)(2); Treas. Reg. § 1.751-1(a)(2). Likewise, ordinarily the character of partnership property as a capital asset, a Section 1231 asset, or as inventory is a partnership item. Treas. Reg. § 301.6231(a)(3)-1. However, Section 751 requires that "we look through the partnership to the underlying assets and deem such a sale as the sale of separate interests in each asset." *Grecian Magnesite Mining, Indus. & Shipping Co. v. Commissioner,* 149 T.C. 63, 79 (2017), *aff'd,* 926 F.3d 819 (D.C. Cir. 2019).

On remand, the Tax Court had to determine whether the charitable contributions deduction would be determined based upon its fair market value at the date of the easement grant versus Glade Creek's carryover income tax basis in the Easement Property.

Generally, a charitable deduction is equal to the donated property's fair market value at the time of the donation. Treas. Reg. § 1.170A-1(c)(1). However, if a sale of donated property would have generated ordinary income or short-term capital gain, the amount of the deduction is limited to the taxpayer's adjusted tax basis in the property.

Moreover, Section 724(b) provides that, if a partner contributes property to a partnership that is an "inventory item" in the partner's hands immediately before the contribution, any gain or loss recognized by the partnership on the subsequent disposition is treated as ordinary income or loss if the contributed property is sold during the next five years after the property was contributed to the partnership. This provision was enacted to prevent conversion of a partner's ordinary income property into capital gain property by contributing it to a partnership that has a different purpose for owning the property.

So, according to the Tax Court, if the Easement Property was inventory in Hawks Bluff's hands, Section 724(b) would require Glade Creek to carry over Hawks Bluff's characterization of the Easement Property as inventory for five years after Hawks Bluff's contribution, and the easement deduction would be limited to Glade Creek's adjusted tax basis in the Easement Property under Section 170(e)(1)(A).

Accordingly, the Tax Court would be tasked with determining whether the Easement Property was inventory or investment property in Hawks Bluff's hands.

Glade Creek argued that the Easement Property was investment property in Hawks Bluff's hands, and that ILC's activities also were relevant to determine the character of the Easement Property. Glade Creek contended that ILC acquired and held all three tracts as investment property, and that only Tract I constituted inventory. Alternatively, even if the Court found that ILC initially acquired the Easement Property as inventory, Glade Creek argued that ILC ***converted*** the Easement Property to investment property in 2009 when ILC abandoned its intent to develop the ILC Property on account of the 2008 economic recession and ILC's lack of funding.

It further argued that Hawks Bluff was organized to hold the Easement Property as investment property and always had held it that way.

The Court pointed out that the term "inventory item" for purposes of Section 724(b) is defined in Section 751(d) by reference to the definition of a "capital asset" in Section 1221(a)(1). Section 1221(a)(1) defines a capital asset as "property held by the taxpayer (whether or not connected with his trade or business), but does not include" property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Section 1221(a)(1).

In the Eleventh Circuit (where Glade Creek would be appealed to), the question of whether an asset is a capital asset or an inventory item involves three separate inquiries: (1) whether the taxpayer was engaged in a trade or business, and if so, what business; (2) whether the taxpayer was holding the property primarily for sale in that business; and (3) whether the sales contemplated by the taxpayer were "ordinary" in the course of that business. *Sanders v. United States,* 740 F.2d 886, 888-89 (11th Cir. 1984) (citing *Suburban Realty Co. v. United States,* 615 F.2d 171, 178 (5th Cir. 1980)).

In past cases, the Eleventh Circuit had identified the following factors as relevant to answer those three questions: (1) the nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity, and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales. *Boree v. Commissioner,* 837 F.3d at 1100 (citing *United States v. Winthrop,* 417 F.2d 905, 909-10 (5th Cir. 1969)); *see Sanders,* 740 F.2d at 889 (applying the *Winthrop* factors).

The Court recognized that most of those seven factors (in number) related to sales and marketing efforts. In Glade Creek's case, those factors would support Glade Creek's argument that the Easement Property was a capital asset, since there had been no lot sales on the Easement Property. However, the Court stated that no factor or combination of factors is controlling, and each case must be decided on its particular facts. *Biedenharn Realty Co. v. United States,* 526

F.2d 409, 415 (5th Cir. 1976) (quoting *Thompson v. Commissioner,* 322 F.2d 122, 127 (5th Cir. 1963), *aff'g in part, rev'g in part* 38 T.C. 153 (1962)).

And in this case, the Court pointed out that, on its 2012 return, Hawks Bluff reported that it was a real estate dealer, it reported the Easement Property as "inventory", and it decreased the amount of its inventory on its tax returns upon the capital contribution of the Easement Property to Glade Creek. The Court noted that statements on tax returns may generally be treated as admissions by that taxpayer. *Mendes v. Commissioner,* 121 T.C. 308, 312 (2003).

Glade Creek argued that it should not be bound by Hawks Bluff's reporting. However, according to the Court, the very purpose of Section 724(b) is to determine the character of the property in the hands of the contributing partner (Hawks Bluff) because Congress enacted Section 724 to prevent taxpayers from attempting to recharacterize ordinary income property as a capital asset by contributing the property to a newly organized partnership before the property is sold for a gain.

The Tax Court then applied decisions of other Courts in the Eleventh Circuit to determine the character of the Easement Property in Hawks Bluff's hands.

The court noted that the Eleventh Circuit has recognized that a taxpayer's purpose for holding property can change over time and has indicated that the purpose at the ***time of sale*** is not determinative. *Boree v. Commissioner,* 837 F.3d at 1101 ("[T]he Fifth Circuit rejected the notion that `the decisive question is the purpose for which (the property) "primarily" was held *when* sold.'" (quoting *Suburban Realty,* 615 F.2d at 182)).

It has been held that "a proper analysis of a taxpayer's primary purpose in holding property should take into account a reasonable period of time prior to the sale." *Id.*; *see Sanders,* 740 F.2d at 889 (considering years leading up to the sale and holding that the sale profit was ordinary income); *Suburban Realty,* 615 F.2d at 183-84 (stating that the inquiry may consider "purpose over the entire course of his ownership . . . [and] should start at the time the property is acquired").

Other courts likewise have stated that, generally, the purpose **at the time of sale** is determinative, but the court should consider earlier events to decide the tasxpayer's purpose at the time of sale. *Cottle v. Commissioner,* 89 T.C. 467, (1987). In *Boree v. Commissioner,* 837 F.3d at 1101, the Eleventh Circuit found that, consistent with *Suburban Realty*, "[t]he *Sanders* court also analyzed the taxpayer's activities over multiple years" leading up to the sale.

Therefore, according to the Eleventh Circuit in *Boree*, the first question for the tax court was whether Hawks Bluff was in a trade or business as a real estate dealer. Although Glade Creek asserted that Hawks Bluff was organized to hold the ILC Property for investment purposes, its 2012 tax returns reported that it was a "real estate dealer" and no one gave any testimony that Hawks Bluff held the Easement Property for investment. Also, Hawks Bluff continued its efforts to sell lots on Tract I after the easement transaction.

The court also noted that "The taxpayer's claim to capital gain treatment is likely to be weaker if he can point to no other business activities . . . ." *Suburban Realty,* 615 F.2d at 179 n.24; *see Boree v. Commissioner,* 837 F.3d at 1105 (finding that taxpayer engaged in no other income-producing activity although it had no sales during years at issue).

Glade Creek further argued that a real estate dealer also may hold real estate for investment purposes. According to the Court, however, when a real estate dealer holds both inventory and investment property, it must segregate investment property from its inventory. *Pritchett,* 63 T.C. at 163.

And indeed, caselaw in the Eleventh Circuit considers whether the taxpayer treated the property at issue differently from its other property. *Pritchett,* 63 T.C. at 164-68; *Wray,* T.C. Memo. 1978-488. For example, holding title to real property in a different name or entity does not conclusively establish segregation, but is a factor for courts to consider. *Pritchett,* 63 T.C. at 164; *Paullus v. Commissioner,* T.C. Memo. 1996-419.

Based upon all relevant evidence, the Court determined that Hawks Bluff was organized to take over ILC's failing real estate development, to find a solution for the ongoing financial problems surrounding the ILC Property, and to continue to sell the lots from the ILC Property to is customers in the ordinary course of business. Hawks Bluff did not passively hold he Easement Property in the hopes that it could sell it for the highest price to a third party.

Likewise, ILC was in the real estate business and acquired the ILC Property because it was suitable for development. No witness testified that ILC treated any part of the ILC Property as an investment on its books and records when it acquired it or at any time thereafter.

Finally, the court gave little weight to Hawks Bluff's lack of sales of lots on the Easement Property. Although the Eleventh Circuit has stated that frequency and substantiality of sales is the "most important" factor in determining the character of property (*Boree v. Commissioner,* 837 F.3d at 1100 (quoting *Biedenharn Realty,* 526 F.2d at 416)), the lack of sales on the Easement Property did not conclusively establish that the Easement Property was investment property based upon all other facts.

And, even though Hawks Bluff did not undertake any additional development, ILC had already completed the necessary infrastructure to sell lots on Tract I, so no further development by Hawks Bluff with respect to those lots was necessary.

Based upon the totality of the facts and circumstances, the court concluded that ILC and Hawks Bluff did not segregate the Easement Property from Tract I in a manner sufficient to meet Glade Creek's burden to show that the Easement Property was investment property. Glade Creek presented no evidence to substantiate its argument that Hawks Bluff was organized to hold the easement property or to dispute Hawks Bluff's reporting that it held the property as inventory. ILC held the easement property as inventory and did not segregate it from Tract I. Accordingly, Glade Creek's easement deduction was limited to its adjusted tax basis pursuant to Sections 724(b) and 170(e).

IV. Musselwhite v. Commissioner, TC Memo 2022-57 (June 8, 2022); Capital Loss and Not Ordinary Loss Recognized on Property Sales.

Mr. Musselwhite received his undergraduate business degree from Wake Forest University and his law degree from Campbell University. After law school, Mr. Musselwhite became a personal injury lawyer in Lumberton, North Carolina.

Over the years, Mr. Musselwhite became involved in several different real estate ventures. He started his first real estate venture in 1986 when he, his father, his uncle and his brother purchased 100 acres of undeveloped land in Lumberton which was then developed into a 90-lot subdivision called Wycliffe East.

This development project lasted thirteen years and ultimately all 90 lots were sold from the development.

Mr. Musselwhite and his brother then had the opportunity to participate in another real estate venture, also in Lumberton, North Carolina. They formed Carolina Group Partnership ("CGP") which purchased 100 acres of undeveloped land which was later developed in phases into a residential subdivision, called Northwoods.

Later, Mr. Musselwhite became interested in real estate investment possibilities in the Wrightsville Beach/Wilmington, North Carolina, area.

Mr. Musselwhite became involved with David Stephenson, who was a successful businessman with a real estate development company in Lumberton.

In 2005, Mr. Musselwhite and Mr. Stephenson formed DS&EM Investments, LLC as a two-member limited liability company. DS&EM Investments filed an annual report in 2005 indicating that the nature of its business was "real estate investment". From 2006 to 2012, all NC Secretary of State LLC annual reports continued to reflect that the nature of the LLC's business was "real estate investment".

DS&EM Investments initially purchased five investment condominiums on Wrightsville Beach and immediately sold two of them. DS&EM Investments also acquired undeveloped lots in Lumberton and in the Brunswick County Sea Watch Subdivision, as well as a house in Wilmington. The undeveloped lots were purchased for investment purposes.

Mr. Musselwhite also owned portions of several mobile home parks.

In the summer of 2006, Adam Lisk, a North Carolina real estate developer, contacted DS&EM Investments proposing a possible business arrangement. Mr. Lisk offered to allow Mr. Musselwhite an opportunity to invest in a subdivision that Mr. Lisk was developing consisting of nine undeveloped wooded lots. Mr. Lisk would purchase the Wilmington house and DS&EM Investments would purchase four undeveloped wooded lots in the Cypress Lakes Subdivision in Brunswick County that Mr. Lisk owned.

In August of 2006, Mr. Lisk and DS&EM Investments entered into a written agreement memorializing their plans for the development of the nine wooded lots. DS&EM Investments purchased the four lots from Mr. Lisk for $1 million and Mr. Lisk purchased the Wilmington house from DS&EM Investments for over $2 million.

In 2007, the real estate market in Brunswick County began to deteriorate. Ultimately, a dispute between Mr. Lisk and DS&EM Investments arose, and to resolve their disputes, Mr. Lisk agreed to transfer his five lots to DS&EM Investments so that DS&EM Investments would then own all of the nine lots in the subdivision.

By the end of 2008, Mr. Lisk had made some improvements to the nine-lot subdivision, such as tree removal, creation of a road, grading for storm water drainage and securing some permitting for the subdivision.

However, after 2008, no more improvements were made to the lots held by DS&EM Investments.

From December 2008 until September 2011, the lots were offered for sale. Ultimately, Mr. Musselwhite and Mr. Stephenson decided to divide up the DS&EM Investments properties and, on July 27, 2012, DS&EM Investments distributed the four lots to Mr. Musselwhite.

Mr. Musselwhite immediately hired a local real estate broker to market the lots for sale. Ultimately, on November 14, 2012, Mr. Musselwhite was able to sell all four lots for a total sales price of $17,500, resulting in a loss of over $1 million on the project.

Mr. Musselwhite hired a CPA in Lumberton to prepare and file the DS&EM Investments tax returns for 2005 through 2012. The Forms 1065 reported (1) that DS&EM Investments' principal business activity was "investment", and (2) that its principal product or service was "property". The Forms 1065 reflected that DS&EM Investments had "no inventories" but instead held investment real estate.

For the first time in 2011, the Form 1065 reported that the four lots were held as "inventory". When the 2011 Form 1065 tax return was filed, Mr. Musselwhite and DS&EM Investments were well aware that the fair market value of the nine lots were less than DS&EM Investments' income tax basis in those lots.

Mr. Musselwhite's CPA testified at Tax Court that he always believed that the lots were always held by DS&EM as inventory. However, no one ever filed amended Forms 1065 tax returns for DS&EM Investments as to the prior taxable years reporting the lots' purported status as inventory.

And, during prior years, Mr. Musselwhite's personal income tax returns reflected some capital gains income, but mostly pass-through income from various partnerships and S corporations as well as from his law firm practice. However, none of his personal returns reported any meaningful income from the activities of DS&EM Investments.

After auditing Mr. Musselwhite's Form 1040 for 2012, the IRS disallowed Mr. Musselwhite's reported $1 million Schedule C loss from the sale of the four lots on the basis that the loss was a capital loss and not an ordinary loss.

Based upon decisions of prior courts, such as the court's decision in Graves v. Commissioner, 867 F.2d 199 (4th Circuit 1989), the Tax Court noted that the 4th Circuit Court of Appeals (which is where this case would be appealed) had held that several factors are relevant in resolving any dispute under Section 1221(a)(1) as to whether the losses should be treated as capital losses or as ordinary losses.

Among the factors to be considered are: (1) the purpose for which the property was acquired; (2) the purpose for which it was held; (3) improvements and their extent, made to the property by taxpayer; (4) frequency, number, and continuity of sales; (5) the extent and substantiality of the transaction; (6) the nature and extent of taxpayer's business; (7) the extent of advertising or lack thereof; and (8) listing of the property for sale directly or through a broker.

Mr. Musselwhite had acquired the four lots via a distribution from DS&EM Investments as part of an agreement with Mr. Stephenson to wind up their affairs. Mr. Musselwhite never had any intention of developing the lots when he acquired them from DS&EM Investments and in fact he never made any improvements to those lots at any time.

Also, DS&EM Investments purchased and held the lots for investment as it did with all of its real estate. Likewise, the North Carolina Secretary of State annual reports for DS&EM Investments and all of the tax returns filed from 2005 through 2012 reflected the lots as being held for real estate investment purposes.

Moreover, even if DS&EM Investments had originally acquired the four lots in 2006 for development purposes, all evidence indicated that the LLC had abandoned any development plans by the end of 2008.

And, for all years after between 2008 and 2012, DS&EM Investments did nothing to improve the lots or to market them for sale.

The Court noted that, while Mr. Musselwhite and his family members had been involved in various real estate development projects in the 1980s and the 1990s, DS&EM Investments had never reported any gross receipts from sales, but instead any property sales were reflected on the DS&EM tax returns as the sale of investment properties that resulted in capital gain or capital loss to the LLC. And in fact, Mr. Musselwhite's only involvement with the DS&EM Investments related to the sale of the four lots he acquired from DS&EM Investments.

Moreover, Mr. Musselwhite's every day business was not in the real estate development business, but instead was related to his successful personal injury law practice. From 2011 to 2013, Mr. Musselwhite's income from his law firm ranged from a low of $700,000 in 2011 and a high of almost $1.2 million in 2012.

According to the Court, Mr. Musselwhite and Mr. Stephenson formed and operated DS&EM Investments as a vehicle to invest in real estate and all their federal tax returns and North Carolina Secretary of State annual reports bore that out.

And, although Mr. Musselwhite made efforts to market and sell the four lots upon receiving the four lot distribution in 2012, this factor alone was insufficient to demonstrate that Mr. Musselwhite's overall relationship with the four lots held by DS&EM Investments was anything more than merely participating in the activities of DS&EM Investments' long-term real estate investment activities.

NOTE: Although the Court ultimately concluded that Mr. Musselwhite would be entitled to only a capital loss (and not an ordinary loss) on the sales of those four lots, no tax penalties were assessed against Mr. Musselwhite, as he and the IRS had already stipulated, before the Tax Court trial, that Mr. Musselwhite would not be liable for any accuracy-related penalties.

PART THREE

SECTION 1031 TAX FREE EXCHANGES

I. Like-Kind Exchange Treatment Not Available for Certain Section 1245 Depreciation Recapture; Gerhardt vs. Commissioner, 160 TC No. 9 (April 20, 2023).

A. Beware of special rules regarding depreciation recapture. Depreciation recapture under Sections 1245 and 1250 is not eligible for Section 1031 tax-free exchange treatment. Complicated rules apply in determining the amount of depreciation recapture not eligible for Section 1031 treatment depending upon the nature of the real property involved and the year the property was placed in service. For example, for non-residential real property placed in service after 1980 and before 1987, all accelerated ACRS depreciation is subject to Section 1250 recapture. On the other hand, for residential real property, only the excess of ACRS depreciation over straight-line depreciation is subject to Section 1250 recapture.

B. Gerhardt v. Commissioner. In Gerhardt, Jack and Shelley Gerhardt sold rental property located in Armstrong, Iowa in an attempted Section 1031 exchange. The rental property consisted of hog buildings and equipment, as well as land. Jack and Shelley treated the sale of the property as a Section 1031 exchange for replacement property located in Cape Coral.

The IRS did not challenge the exchange's meeting the requirements of Section 1031. Instead, the IRS took the position a portion of the relinquished property consisted of Section 1245 property. Section 1245 property includes "property which is or has been property of a character subject to the allowance for depreciation provided in section 167" that is either (1) personal property or (2) a single-purpose agriculture or horticultural structure. Section 1245(a)(3)(A), (D). Under the Section 1245 regulations, if Section 1245 property is disposed of in a Section 1031 exchange, any gain from the disposition of the relinquished property may have to be recognized as ordinary income. Section 1245(a)(1) and (b)(4); Treas. Reg. § 1.1245-6(b). Moreover, if both Section 1245 property and non-Section 1245 property are disposed of in the same transaction, gain is allocated between the Section 1245 property and non-Section 1245 property in proportion to their respective fair market values. Treas. Reg. § 1.1245-1(a)(5).

The court found the hog buildings and equipment were Section 1245 property. Therefore, the gain on the sale of those assets did not qualify for Section 1031 exchange treatment. Moreover, Jack and Shelley did not present evidence of the fair market values of the non-Section 1245 property and the Section 1245 property. Since they did not establish how much of the gain from the sale of the Armstrong site could be allocable to non-Section 1245 assets, the court allocated all the gain to Section 1245 property, so none of the assets exchanged qualified for tax-free recognition under Section 1031.

PART FOUR

SECTION 104 INCOME EXCLUSION FOR PHYSICAL INJURY AND PHYSICAL SICKNESS

I. Overview of General Section 104 Gross Income Exclusion for Personal Physical Injury or Personal Physical Sickness Damages.

Section 104(a)(2) provides an exclusion from gross income for settlement damages received by the taxpayer for personal physical 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.

II. No Section 108(a)(2) Personal Physical Injury Damage Exclusion For PTSD Where Damage Payments Were Received In Settlement Of Constitutional Claims And Not For Physical Injuries Or Sickness; Estate of Finnigan vs. Commissioner TC Memo 2024-42 (May 14, 2024).

A group of plaintiffs brought constitutional action claims against the Pulaski County Department of Child Services in Indiana claiming violations of plaintiffs' constitutional rights under the First, Fourth, Sixth and Fourteenth Amendments to United States Constitution. Ultimately, a jury awarded $31.5 million in compensatory (and not punitive) damages to the plaintiffs but, after the defendants appealed to the Seventh Circuit Court of Appeals, the plaintiffs and defendants entered into a $25 million settlement.

The plaintiff-taxpayers argued that they suffered from post-traumatic stress disorder (PTSD) as a result of the defendant's actions and thereby excluded the $25 million settlement amount from their gross income under the Section 104(a)(2) exclusion for personal physical injury recoveries.

The Tax Court ruled that, for the damage award be excludable under Section 104(a)(2), there had to be a "direct causal link between the action giving rise to the damages and the physical injury or physical illness." Here, in all of the lawsuit proceedings prior to the settlement agreement, there had been very little mention of PTSD by the plaintiffs. For example, PTSD was not even mentioned in the plaintiffs' complaint or in the form jury instructions. And, the jury verdict, awarding the plaintiffs $31.5 million in compensatory damages, did not indicate that any portion of the damages were being awarded for PTSD or for any physical injury or sickness.

And finally, the $25 million settlement agreement itself made no mention of PTSD or physical injury, and even contained a clause in which the plaintiffs agreed to report the income and pay tax on the full settlement amount.

III. No Section 104(a)(2) Personal Injury Exclusion Even Where Alleged Physical Altercation Took Place; Tillman-Kelly vs. Commissioner, TC Memo 2022-111 (November 21, 2022).

In Tillman-Kelly, the taxpayer brought a wrongful termination action against his employer claiming the employer retaliated against him for reporting the employer's misuse of funds. After being fired, Mr. Tillman-Kelly sued his former employer alleging his termination violated protections for whistleblowers. The complaint filed by Mr. Tillman-Kelly requested "damages included but not limited to emotional distress and humiliation and lost income and benefits." The complaint, however, did not allege Mr. Tillman-Kelly suffered any physical harm.

After the lawsuit settled, Mr. Tillman-Kelly received a payment of over $230,000. The agreement stated the payment was made for "alleged non-wage injuries as non-economic emotional distress damages". Mr. Tillman-Kelly took the position the settlement was nontaxable under Section 104(a)(2).

Mr. Tillman-Kelly alleged he suffered emotional trauma as a result of physical injuries he suffered. He alleged his retaliation lawsuit led to a heated altercation with his employer that resulted in physical injury to him from the slamming of a door. However, because neither the complaint nor the settlement agreement mentioned any type of physical injury, the settlement payment was fully taxable.

IV. No Section 104 Exclusion for Wrongful Termination Recovery; Dern v. Commissioner, TC Memo 2022-90 (August 30, 2022).

Mr. Dern was employed as a sale representative. In 2015, Mr. Dern was hospitalized for acute gastrointestinal bleeding and a resulting heart attack. His illness and hospitalization, however, was completely unrelated to his work for his employer.

In early 2016, Mr. Dern's employer notified him that his services were being terminated. A termination letter stated "your prolonged health conditions have unfortunately had a significant impact on your ability to effectively represent the Company and perform the duties of a sales representative."

Mr. Dern then sued his former employer under several theories, specifically including disability discrimination.

The parties settled all claims and executed a Settlement Agreement in which the employer would pay Mr. Dern $550,000 "to compensate Mr. Dern for alleged personal injuries, costs, penalties, and all other damages and claims."

The Settlement Agreement further provided that it was "for and on account of [Mr. Dern's] claims alleging compensatory damages, emotional injuries, penalties and punitive damages."

The Tax Count agreed with the IRS that, under the Settlement Agreement, the settlement payment was not "on account" of Mr. Dern's ***physical*** injuries or ***physical*** sickness. Here, the Settlement Agreement used the phrase "personal injuries" in stating that the settlement payment was to "compensate [Mr. Dern] for alleged personal injuries".

However, this language never specifically referred to ***physical*** injuries. Of course, Mr. Dern argued that Section 104(a)(2) was applicable, because it was Mr. Dern's ***physical illnesses*** that caused his employer to terminate him in the first place. The Court said, however, that Mr. Dern did not prove any "direct causal link" between his illness and the settlement payment.

According to Lindsey vs. Commissioner, 422 F3d 684 (Eighth Circuit Court of Appeals, 2005), there must be a "direct causal link" between an illness and a settlement payment. Here, Mr. Dern could easily prove that he was physically ill, but he couldn't provide any evidence that his employer ***caused or exasperated*** his illness. Since the employer did not compensate Mr. Dern for any ***physical*** injury or ***physical*** sickness, the settlement payments were not excludable under Section 104(a)(2).

V. Legal Malpractice Recovery is Taxable for Screwed Up Medical Malpractice Case; Blum vs Commissioner, 129 AFTR 2d 2022-1170, 2022 U.S. App. LEXIS 15282, (9th Circuit Court of Appeals, June 2, 2022).

In Blum, Ms. Blum sued her personal injury lawyer for malpractice relating to her personal injury medical malpractice lawsuit against a hospital. In effect, Ms. Blum was suing her lawyer for legal malpractice for failing to recover damages for her physical injuries caused by the hospital's negligence.

However, her legal malpractice recovery was held to be taxable, and not excludable under Section 104. In her case, the Settlement Agreement expressly stated that the settlement payment was not for her underlying physical injuries, but instead was payment in lieu of damages for legal malpractice of her former lawyer.

The Settlement Agreement went even further and stated that Mrs. Blum and her attorneys were stipulating that Mrs. Blum did not sustain any physical injuries as a result of her attorney's alleged negligence. And, the Settlement Agreement stated that the parties signed the Settlement Agreement "for the purpose of compromising and settling the [malpractice] dispute between" the parties.

PART FIVE

SECTION 108 CANCELLATION OF DEBT INCOME

I. Overview of Insolvency and Bankruptcy Exceptions to Taxable COD Income.

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

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

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

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

B. The Bankruptcy Exception.

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

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

C. <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. What Assets are included in the "Insolvency" Calculation?

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

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

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

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

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

D. Certain Pension Plan Benefits Are Not Countable For Purposes of Determining Insolvency; Schieber, TC Memo 2017-32. In Schieber, TC Memo 2017-32 (February 9, 2017), the Tax Court agreed with Mr. Schieber and held that Mr. Scheiber's interest in a 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. Under the terms of the pension plan, Mr. Scheiber could not borrow from the plan or use the plan benefits as collateral for loans.

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. Unpaid Lease Obligations are Bona Fide Debt for Purposes of the Section 108 Insolvency Test; White vs. Commissioner, TC Memo 2023-77 (June 21, 2023).

Mrs. White's LLC secured a $15,000 small business loan from her local bank to fund her new business. After her business failed, the local lender cancelled her debt and sent a Form 1099C to Ms. White advising her that she had $14,433 of cancellation of debt income.

Mrs. White agreed that the forgiven small business loan constituted cancellation of debt income, but contended the debt was non-taxable under the Section 108(a)(I)(B) insolvency exception on the basis that all of her business debts exceeded the fair market value of her assets. The most significant business debts were the small business loan of $14,433 and an unpaid lease obligation of $21,700 that she included in her insolvency calculation.

Mrs. White's lease had an "acceleration clause" providing that, upon default, the entire remaining amounts due for the remainder of the lease term ($21,700) would become immediately due and payable. However, because the landlord never sought to collect the future unpaid rent from Mrs. White, the IRS contended that the unpaid rent obligations for the breached lease were not true, bona fide indebtedness.

The Tax Court agreed with Mrs. White and ruled that the unpaid lease obligations constituted a legally enforceable debt, regardless of whether the landlord ever intended to pursue collection against Ms. White. Since the $21,700 unpaid lease obligations was bona fide indebtedness, Ms. White could include the lease debt in her insolvency calculations.

> **Note:** The facts of this case don't explain why the landlord had not pursued collection from Ms. White. We do not know whether the lessor repossessed the business premises or whether the landlord was able to, or obligated under the lease to, mitigate or cover its damages by locating a new tenant. These factors may have played a role in determining whether the lease breach debts were truly bona fide debts or not.

PART SIX

SECTION 453 AND SECTION 1042 DEFERRAL PROVISIONS AND SECTION 1202 STOCK GAIN EXCLUSION

I. Section 453 and Section 1042 Deferral Provisions Can Apply to the Same ESOP Transaction; Berman vs. Commissioner, 163 TC No. 1 (July 16, 2024).

In 2002, Mr. and Mrs. Berman sold their closely-held C corporation stock to an ESOP in in exchange for installment sale promissory notes. Mr. and Mrs. Berman did not receive any proceeds from the ESOP sale in 2002.

Mr. and Mrs. Berman also purchased “qualified replacement property” (“QRP”) in an amount equal to or exceeding the gain on the sale of their C corporation stock to the ESOP, but some of the QRP purchases did not fully occur until the end of the twelve-month QRP replacement period which extended into the 2003 tax year.

The Bermans filed a Section 1042 election with their 2002 tax return, in which they elected to defer recognition of the entire gain on the ESOP sale. For 2002, the Bermans reported zero taxable income from the stock sale to the ESOP.

In 2003, each of Mr. and Mrs. Berman received approximately $450,000 under the ESOP promissory notes. Also, in 2003, the Bermans used their QRP as collateral for a 90% loan, allowing the lender to keep the remaining 10% as a loan fee. Later, the Bermans conceded that the cash-out loan they collateralized with their QRP was a de facto disguised sale of the QRP.

On audit, the IRS took the position that the collateralized cash out loan in 2003 caused the Section 1042 deferred gain to be fully recognized in 2003 under the deferred gain recapture rules of Section 1042(e). The Bermans took the position that their 2003 gain should be limited to the $450,000 note payments under the installment sale.

The Tax Court agreed with the Bermans. The Tax Court stated that Section 453 and Section 1042(a) are not mutually exclusive and that Section 1042 acts to defer the gain that otherwise would be recognized under the installment method. Here, there was no gain that could be recognized in 2002. By not reporting any of the gain in 2002, the Berman’s had not “elected out” of Section 453, thus causing the automatic deferral of gain recognition until future note payments were received.

II. <u>Sale of Stock Did Not Qualify for Section 1202 Qualified Small Business Stock Exclusion Because the Company Didn't Meet the Qualified Trade or Business Requirement of Section 1202(e); Private Letter Ruling 202319013.</u>

Taxpayer founded a C Corporation that was a software company. The company's employees possessed technical skill and knowledge. At the same time, the company did have certain proprietary service delivery processes and methodologies that were unique to the company and that could not be utilized by any of its employees for any other employer.

The IRS ruled that, to qualify for as a Section 1202 qualified small business, the C Corporation must be engaged in a "qualified trade or business" which is defined as a trade or business ***other than*** a trade or business involving the performance of "services" or where the principal asset of that trade or business is the reputation or skill of one or more of its employees. Section 1202(e)(3)(A).

Here, the company's principal asset was the reputation or skill of its key employees, notwithstanding the fact that the company may have possessed proprietary processes and methodologies.

<u>PART SEVEN</u>

SECTION 162 DEDUCTIONS

I. <u>Payment of Attorney's Fees in Wire Fraud and Money Laundering Criminal Investigation Qualify as Section 162 Ordinary and Necessary Business Expenses; Chang vs. Commissioner, TC Summary Opinion 2024-18 (September 16, 2024).</u>

Mr. Chang was involved with several religious organizations, including one called "HOC Associates, Inc." HOCA Associates, Inc. was a Section 501(c)(3) organization, and Mr. Chang was a member of its Board of Directors.

Mr. Chang also served as a member of the Board of Directors of S3 Graphics, Inc. and for IA Technologies, Inc. Mr. Chang was a close personal friend of the owner of these two companies.

In 2004, Mr. Chang formed HOCA Associates, LLC as a for-profit limited liability company engaged in the business of acquiring and leasing out rental property. Mr. Chang was the sole owner of HOCA, LLC.

In 2016, Mr. Chang was indicted and charged with multiple counts of conspiracy to commit wire fraud and money laundering. These criminal charges involved transactions to and from HOCA, Inc., HOCA, LLC and Mr. Chang's personal bank accounts. In September 2019, a jury convicted Mr. Chang of four counts of wire fraud and three counts of money laundering.

During the 2016 tax year, Mr. Chang incurred over $365,000 of attorney's fees that he deducted on HOCA, LLC's Schedule C. The IRS took the position that these legal expenses were nondeductible personal expenses.

The Tax Court, however, agreed with Mr. Chang. Citing the United States Supreme Court in US vs. Gilmore, 372 US 39 (1963), the court stated that the deductibility of legal fees depends on the "origin and character" of the claim for which the expenses were incurred **and** whether the claim bears a "sufficient nexus" to the taxpayer's business or income producing activities.

Here, the criminal case involved HOCA, Inc. and HOCA, LLC and their activities, and the underlying criminal charges involved transactions that were made between the HOCA entities and Mr. Chang. The court concluded that the court "origin" of Mr. Chang's legal fees stemmed from Mr. Chang's business activities as the director of the HOCA entities. Therefore, the legal fees related to his criminal activities could be deducted as a Section 162 ordinary and necessary business expense.

II. No Deduction For "Start-Up Costs" for a Company That Never "Started Up"; Eason vs. Commissioner, 2024 Tax Court Summary Opinion 2024-17 (August 13, 2024).

In 2016, Mr. Eason and a friend formed an S Corporation to provide advice and guidance to real estate owners and investors. In 2016, Mr. Eason and his friend paid over $40,000 to enroll in educational courses being produced by Advanced Real Estate Education ("Advanced") which offered courses on business opportunities available through real estate ownership and investment.

Advanced soon went out of business and Mr. Eason and his friend lost their $40,000 investment. The S corporation deducted the $40,000 in fees paid to Advanced as a business expense.

The Tax Court agreed with the IRS that the $40,000 lost investment was not a deductible Section 162(a) business expenses, because the educational expenses were not incurred in connection with the "carrying on any trade or business" during 2016. According to the court, Mr. Eason and his friend simply had never engaged in any business through their S corporation during 2016. Whatever business activities the S corporation had hoped to engage in, it had not done so by the end of 2016 tax year. The corporation earned no income in 2016, and Mr. Eason could not show that the S corporation had provided, or had even-offered to provide, any services to clients or customers during 2016. The Court, however, refused to sustain the substantial understatement penalty on the basis that "reasonable minds could differ over the point in time, and\or the specific actions that establish when a business" begins.

III. Race Car Driving Attorney Cannot Deduct Advertising Expenses for Promoting His Law Practice on the Side of His Race Car; Avery v. Commissioner, TC Memo 2023-18 (February 21, 2023).

Mr. Avery was a practicing attorney who raced cars on the side. Mr. Avery bought a Dodge Viper and placed a decal above the driver's window showing Avery Law Firm as "sponsor" for the driver of the race car. Mr. Avery testified that he thought that being involved in car racing might enable him to meet lawyers, doctors and other professionals who could help his legal career. Mr. Avery had Schedule C advertising expenses of almost $15,000 for advertising his law practice on his race car.

The Tax Court concluded that the advertising expenses were related to a racing "hobby" and that these expenses were neither ordinary nor necessary for a law firm practice under the meaning of Section 162(a). As the court noted, in discerning what constitutes an "ordinary and necessary" business expense under Section 162(a), the courts have focused on the taxpayer's primary motive for incurring the expenses and whether there was a reasonably proximate relationship between the expense and the taxpayer's occupation. If the expenditure was primarily motivated by personal considerations, then no deduction is allowable.

Interestingly, during the tax years at issue, most of Mr. Avery's litigation practice was conducted in Colorado, but his racing activities occurred in Indiana. The court said, however, that even if Mr. Avery had raced in his relevant business market in and around Denver, the court still would not have found his advertising expenses to be legitimate advertising expenses for his law firm.

Note: Since the court never discussed application of the Section 6662 "negligence penalty", we have to assume that the negligence penalty wasn't asserted during the IRS audit.

PART EIGHT

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.

II. Section 183 Deductions are "Below the Line" Miscellaneous Itemized Deductions; Gregory v. Comm'r 69 F.4th 762 (11th Cir. 2023).

A. 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).

B. Gregory v. Comm'r, 69 F.4th 762 (11th Cir. 2023). Mr. and Mrs. Gregory reported substantial revenues and expenses from their yacht charter activities on their Schedule C for 2014 and 2015. After the Gregorys conceded they lacked a "for profit" motive in their yacht activities, the IRS moved their Schedule C revenues to the "Other Income" line on the Gregorys' return and then moved all of their yacht activity expenses as miscellaneous itemized deductions subject to the 2% AGI floor. The Gregorys reported incomes of $20 Million and $80 Million for 2014 and 2015, so the recharacterization of expenses from "above the line" to "below the line" 2% miscellaneous itemized deductions generated a $300,000 tax assessment against the Gregorys.

The Ninth Circuit Court of Appeals upheld the Tax Court's decision in favor of the IRS. The courts agreed that Section 183(b)(2) merely sets forth the ***"amount"*** of allowable deductions for hobby deductions, which is capped at the hobby's gross income. Section 183(b) however, does not specify ***"where"*** those deductions belong on a taxpayer's return: above the line (reducing gross income) or below the line as miscellaneous itemized deductions (reducing adjusted gross income). For that determination, the Court focused on Sections 62, 63 and 67.

Section 62 specifies the above-the-line trade and business expense deductions that reduce the taxpayer's gross income and therefore belong above the line. Section 62(a)(1). These deductions include trade and business expenses under Section 62(a)(1), "losses from the sale or exchange of property" under Section 62(a)(3), and certain attorney's fees per Section 62(a)(21). The list of above-the-line deductions in Section 62(a) is exhaustive, and Section 62 never mentions Section 183 or hobby expenses within its comprehensive list of above-the-line deductions.

Then, we move to Section 63. Section 63(d) defines "itemized deductions" as all deductions except (1) the above-the-line deductions listed in Section 62 and (2) "any deduction referred to in any paragraph of" Section 63(b). For its part, Section 63(b) lists four deductions: the standard deduction, the personal exemption deduction under Section 151, the qualified business income deduction under Section 199A, and the charitable contribution deduction under Section 170(p). Since Section 183 is not listed under Section 63(b), the Section 183 deduction must therefore be an "itemized deduction."

And, finally, Section 67(a), which imposes the two-percent floor on "miscellaneous itemized deductions", defines "miscellaneous itemized deductions" as all "itemized deductions" other than twelve specific listed deductions, none of which mentions hobby expenses or Section 183. Section 67(a)-(b). Thus, Section 183 expenses are miscellaneous itemized deductions and deductible "only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." Section 67(a).

III. <u>Ecotourism Activity Deemed to be a Hobby Following Fifteen Years of Repeated Losses; Schwarz vs. Commissioner, TC Memo 2024-55 (May 13, 2024).</u>

Mr. Schwarz was an avid hunter who attempted to engage in an ecotourism business on his property in Texas. He offered hunting, fishing and other recreational events as part of his ecotourism business.

In addition to his ecotourism business, Mr. Schwarz also has significant farming operations on the properties that he was using for his ecotourism business activities.

The IRS audited Mr. Schwarz's 2015, 2016 and 2017, where Mr. Schwarz's claimed losses for each year on a Schedule F ("Profit or Loss from Farming Operations"). In addition to losing money in each of the three audit years, Mr. Schwarz had previous losses in each of the prior 12 years, leaving Mr. Schwarz with 15 straight years of losses from his ecotourism activity.

After analyzing the 13 factor test set forth in the Section 183 regulations, the Tax Court concluded that the presence of personal recreation that Mr. Schwarz derived from his activities, coupled with the fact the he had 15 straight years of losses and that he did not carry on his activity in a businesslike manner, demonstrated that Mr. Schwarz's farming\ecotourism activities were nothing more than a hobby.

Notably, however, the court ultimately struck down the 20% Section 6662 penalty by virtue of the testimony of Mr. Schwarz's CPA, who credibly testified that he genuinely believed that Mr. Schwartz's activities met the honest and objective profit intent standard.

Future Appreciation in Real Estate Values and Aggregating Activities

Although the Schwarz decision is not particularly interesting in its conclusion, the case does deserve interest by virtue of the court's detailed analysis of Regulation Section 1.183-1(d)(1) which set forth the rules for determining whether Mr. Schwarz could "aggregate" his farming operations with his profitable real estate activities in order to support Mr. Schwarz's contention that his projected gains from the appreciation in the value of his farm real estate could become a for-profit activity. Under Regulation Section 1.183-1(d)(1), a farming activity and the holding of land on which the farm operates can be treated as one activity for purposes of Section 183, but if and only if the farming activity reduces the net cost of carrying the land for its appreciation in value. Thus, in order to treat farming and holding of the land as a single activity, the taxpayer must show that the income derived from the farming exceeds the deductions attributable to the farming activity which are not directly attributable to holding of the land itself.

After providing an extensive analysis of this test, the court concluded that Mr. Schwarz could not "aggregate" the farming activities with the activity of holding the land for future value increases.

IV. Fishing Charter Activities Couldn't Meet the "For-Profit" Test; Swanson vs. Commissioner, TC Memo 2023-81 (June 29, 2023).

After retiring from two separate jobs, Mr. Swanson decided to start "Happy Jack Charters" to provide private charters for halibut fishing. Mr. Swanson had been an avid fisherman in Alaska for more than 30 years. Mr. Swanson bought a boat to provide charters during the Alaskan halibut fishing season, which runs from May to September.

Mr. Swanson filed a Schedule C on his tax return claiming losses from the Happy Jack Charters during 2014, 2015 and 2016. Mr. Swanson's Schedule C claimed extensive expenses for his charter boat and for his airplane.

Mr. Swanson was not very successful in his charter business. Because he didn't obtain a commercial fishing permit for halibut fishing in 2014, he had no charters for that year. He rented a fishing permit for 2015, but only booked five trips in 2015 and six trips in 2016.

Based upon the nine-factor test in the Section 183 regulations, the Court ruled that Happy Jack Charters wasn't a "for profit" business. The Tax Court found the following factors indicated that Mr. Swanson's activities did not have a "for-profit" motive:

1. Mr. Swanson did not have a separate bank account, or any accounting or record-keeping systems;

2. He did not keep records of income and expenses, but instead merely kept expense receipts for tax reporting purposes.

3. Mr. Swanson did not have any type of business plan;

4. Mr. Swanson made no changes over the course of the years to reduce expenses or increase revenue;

5. His business experienced significant losses from the time it began in 2010 and through the three audit years;

6. Mr. Swanson did not need to rely on income from his charters notwithstanding his losses in those years, because he had income from other sources, such as from Social Security, pension and rental income from two rental properties;

7. Mr. Swanson could not demonstrate that he had any expertise in running a business, much less a charter fishing business; and

8. Mr. Swanson could not demonstrate how he prepared for running a fishing charter business or whether he consulted with experts or received any other advice about operating a fishing charter business.

It was also clear that Mr. Swanson gained personal pleasure from his activities. For example, the court stated that Mr. Swanson "could not adequately explain the number of times he had to refuel the boat that had no corresponding charter booking." Mr. Swanson even testified that his retirement plan had always been to retire and fish.

Perhaps one of the most significant factors was that Mr. Swanson did not keep adequate records of his activities. The court stated that, "for Section 183 purposes, the key question is not whether the taxpayer keeps records, but whether the taxpayer uses his records to improve profitability and take steps to control expenses and increase income." See Golanty, 72 TC 411, at 430 (1979). Here, Mr. Swanson merely explained that he kept various tax receipts for tax preparation purposes and that he would let his accountant figure everything out at the end of the year.

> **Note:** In Swanson, before trial, the IRS conceded that no penalty should be assessed against Mr. Swanson.

V. Emergency Room Physician Can't Claim Business Deductions for Music-Film Production Activities; Sherman v. Commissioner, TC Memo 2023-63 (May 17, 2023).

Dr. Sherman was a medical emergency room physician with a passion for music. During college, he took music classes and learned to play the guitar. He even helped pay for some of his medical expenses during the 1970's and 1980's playing for pay.

Although Dr. Sherman did keep records of how much cash he earned, he admitted he never made large sums of money playing music.

At some point, Dr. Sherman decided to launch a film company, called "Songswell". Songswell was a film production company that also did music composition, scriptwriting, filming, etc. Dr. Sherman claimed that he had hoped that, by combining music and film, he could one day earn a large profit. Of course, Dr. Sherman's activities produced a loss. The IRS disallowed the loss as a "hobby loss" under Section 183.

Dr. Sherman claimed that he spent around 200 to 300 hours per month on Songswell activities in addition to working as a physician. But, he never registered Songswell as a licensed business in any state. In addition, he had no business plan for Songswell and there was never any evidence that Songswell ever earned a profit.

The Tax Court said that this was not a "difficult case," primarily because of the poor manner in which the activity was conducted. Dr. Sherman had no business plan and there was no evidence that the business was licensed. Dr. Sherman failed to keep complete and accurate books and records relating to Songswell activities and its purported business expenses. There was no evidence that Dr. Sherman ever engaged in extensive studies regarding operating a film production company, nor was there any evidence that he ever consulted with experts regarding a film production company.

Also, Dr. Sherman provided no evidence that he ever decreased his physician work to focus on his music and film activities, and there was no evidence that he employed others to continue operating Songswell while he was working as a physician.

Interestingly, there was no record as to whether the IRS ever attempted to assert the "negligence penalty" or the substantial understatement penalty against Dr. Sherman.

VI. Cattle Ranching Was "For-Profit" Activity; Paul Wondries vs. Commissioner, TC Memo 2023-5 (January 9, 2023).

Wondries is a taxpayer victory illustrating how one should document a case and build a defense to an IRS hobby loss attack. Mr. Wondries was a successful car dealer entrepreneur. He had operated around twenty-three car dealerships, many of which he turned from losing ventures to profitable ones. In 2004, Mr. Wondries diversified his business interests by acquiring a 1,100-acre cattle ranch in California. It included a main house, a guest house, a foreman's house and wells and natural springs. The ranch contained 30 miles of road access.

As Mr. Wondries had no prior experience in ranching, he hired Robert Palm, an experienced ranch foreman. Mr. Palm had profitably managed two other ranches, both of which were over 1,000 acres. He had almost 20 years of ranching experience in California, Nevada, Oregon, Idaho, Texas and Nebraska. Mr. Palm took care of all aspects of running the ranch.

Soon after Mr. Wondries purchased the ranch, severe drought hit California. To curb his losses, Mr. Wondries sold all of his cattle within a few months of purchasing the ranch. Mr. Wondries considered leasing the ranch for hunting purposes but determined the ranch was too small to sustain a sufficient population of wild animals, and the liability risks outweighed any potential revenue. Mr. Wondries ultimately determined he could not turn a profit by raising cattle. He decided to turn from an operating ranch focus to an investment focus that would someday allow him to sell his investment at a gain.

Although Mr. Wondries relied on his ranch foreman and independent contractors for most of the ranch tasks, Mr. and Mrs. Wondries often personally performed tasks while visiting. Mr. and Mrs. Wondries never used the ranch for vacation purposes; instead, the Wondries used one of their other vacation properties for leisure. Mr. and Mrs. Wondries performed accounting and payroll functions for the ranch. They kept detailed records of expenses, including copies of cancelled checks and receipts. Mr. Wondries used the CPA for his car dealerships to review his ranch accounting work. Notwithstanding these efforts, Mr. and Mrs. Wondries never earned a profit at their ranch.

The IRS challenged the Wondries attempts to use their ranch losses to offset their other taxable income. The court upheld the deductibility of the Wondries' ranch losses based on the multi-factor test under the Section 183 regulations.

1. **Manner in which the Taxpayer Undertakes the Activity.**

The Wondries hired Mr. Palm to oversee the day-to-day operations of the ranch and maintained complete and accurate books and records of all ranch activities. The Wondries had a business plan that initially included guided hunting expeditions. Those plans were later abandoned, and the Wondries adopted a long-term investment strategy.

2. **Expertise of the Taxpayers and their Advisors.**

Although the Wondries had no prior ranching experience, Mr. Palm had extensive experience in successfully operating cattle ranches.

3. **Time and Effort Expended by the Taxpayer in Carrying on the Activity.**

Mr. and Mrs. Wondries admitted they spent little personal time on the ranch. The court, however, stated that did not necessarily indicate a lack of for-profit motive where the taxpayer hires competent and qualified persons to carry on the activity.

4. **Expectation Assets Used in the Activity May Appreciate in Value.**

The Wondries credibly testified they had two plans when they initially purchased the ranch: an operational one and investment one. The operational plan was to raise cattle and provide guided hunting expeditions. The Wondries' backup plan was to improve the ranch and hold it as a long-term investment. Once the Wondries realized they could not earn a profit from raising cattle or providing guided hunting expeditions, they began making improvements to ranch structures and landscape to increase the ranch's investment value.

The court noted a for-profit objective may be inferred where expected appreciation in the activities' assets may exceed operating expenses sufficient to recoup accumulated losses. Previous cases have not required the taxpayer to recoup all past losses. Instead, the question is whether the taxpayer would recoup the losses between the years at issue and the hoped for profitable future. Robison v. Commissioner, TC Memo 2018-88 and Helmick v. Commissioner, TC Memo 2009-220. An overall profit motive is present if net earnings and appreciation are sufficient to recoup losses sustained in intervening years.

The Wondries initially purchased the ranch for $2 million. They believed the ranch was worth between $5.5 and $6 million in 2015 through 2017. Although the ranch was losing about $300,000 each year, the Wondries would make an overall profit on the ranch based on the estimated value.

5. Success of the Taxpayer in Carrying on Similar Activities.

Mr. Wondries had a track history of turning unprofitable businesses into profitable ones. Mr. and Mrs. Wondries, however, never earned a profit on the ranch since they purchased it in 2004. There were unforeseen circumstances, such as a drought early during farm operations. Even though droughts are common in California, they are beyond the taxpayer's control. Under the Section 183 regulations, if losses are sustained because of unforeseen or fortuitous circumstances that are beyond the control of the taxpayer (such as drought, disease, fire, theft water damages or other involuntary conversions or a depressed market), losses are not an indication the activity is not engaged in for profit. See Treas. Reg. 1.183-2(b)(6). Because Mr. Wondries could not prove his losses were caused by the early drought, this factor was in favor of the IRS.

6. Amount of Occasional Profits.

This factor clearly weighed against Mr. and Mrs. Wondries because they never earned a profit during any year.

7. Financial Status of the Taxpayer.

In each of the three audit years, the Wondries reported over $9 million of total income from other sources. Thus, the ranch losses created substantial tax benefits to the Wondries, which was a factor weighing against them.

8. Elements of Personal Pleasure or Recreation.

The Wondries had numerous properties in desirable locations where they often vacationed. This factor, therefore, weighed in favor of Mr. and Mrs. Wondries.

The court concluded this was a close case, but after weighing all the facts and circumstances, concluded Mr. and Mrs. Wondries engaged in their ranching activities for profit.

VI. Poor Record Keeping and Following Poor Business Practices Result in Denial of Deductions; Skolnick v. Commission (3rd Cir. 2023).

Mr. Skolnick and several of his family members formed Bluestone Farms, LLC to operate a horse farm in New Jersey. Bluestone Farms bought, sold, bred and raced Standardbred horses. During the years at issue (2010 through 2013), the family kept between and 15 and 25 horses at Bluestone Farms. Bluestone Farms employed between 7 and 10 employees During 2010 through 2013, Bluestone lost more than $3.5 million. The entire Skolnick family lost more than $11.4 million between 1998 and 2013.

The Third Circuit upheld the decision of the Tax Court (Skolnick v. Commission, TC Memo 2021-139) ruling that the Skolnicks could not deduct losses from Bluestone Farms, LLC. The court held because the Skolnicks failed to operate the horse farm in a business-like manner, their horse breeding activity was not engaged in for profit under Section 183. In addition, the court refused to allow Mr. and Mrs. Skolnick to carry over NOL losses arising from their horse activities in years prior to 2010 because they failed to substantiate them. The court, however, held the Skolnicks were not liable for accuracy-related penalties under Section 6662 because they had relied on the advice of their CPA advisors.

The court applied the nine-factor test in the Section 183 regulations and agreed with the Tax Court, which found five factors favored the IRS, three factors were neutral, and only one factor favored the Skolnicks

Factor 6, History of Losses. This factor was by far the most important to the Tax Court and the Court of Appeals.

Factor 1, Manner of Conducting Business Activity. The Court of Appeals and the Tax Court found the lack of a business plan and the absence of employee budgets, as well as payment of personal expenses out of the Bluestone Farms operating account, were evidence of failure to operate the activities in a business-like manner.

Factor 8, Financial Status of the Taxpayers. The court noted the taxpayers eliminated substantially all of their taxable income from other sources by offsetting losses from the horse breeding activities.

Other Factors. The Skolnicks failed to keep adequate records. They did not demonstrate they anticipated profits in the future, or future property value increases would be sufficient to offset their substantial losses in the past. The court noted the Skolnicks derived personal pleasure from horse breeding activities. Although the Skolnicks consulted experts and made some operational changes over time and had some previous experience in horse breeding activities, those factors alone failed to support an overall for-profit motive.

NOL Carryforwards. The court upheld the Tax Court determination that the Skolnicks did not prove the existence of NOL carryforwards generated from their horse activities in earlier years. The Skolnicks did not produce any meaningful evidence to support their loss calculations. Simply providing copies of their income tax returns for prior years was insufficient. Roberts vs. Commissioner, 62 TC 834 (1974).

The Skolnicks also attempted to use as evidence an IRS no change letter they received in 2010 after the IRS audited their 2008 tax return. During the 2008 audit the IRS never challenged the hobby status of Bluestone Farms. The no change letter simply said the IRS was proposing no changes to their 2008 tax return. Since the prior audit made no finding whether the horse activities were a for-profit endeavor, the Skolnicks could not use the no-change letter to support their NOL carryforwards.

PART NINE

PASSIVE ACTIVITY LOSSES AND THE NET INVESTMENT INCOME TAX

I. Court of Appeals Imposes Material Participation Standard Onto the Taxpayer, So Non-Passive Losses Cannot Offset Passive Income; Also, Yacht Rental Activity Was Per Se Passive Because Zero Rental Days Don't Establish Average Period of Customer Use; Rogerson vs. Commissioner, 2023 U.S. App. Lexis 31644, 2023 WL 8271976 (November 30, 2023).

The Ninth Circuit Court of Appeals recently upheld the earlier decision of the tax court, TC Memo 2022-49 (May 12, 2022), and ruled that a taxpayer's activities were non-passive and thus generated non-passive income that could not be offset by losses from his passive activities.

During 2014 to 2016, Mr. Rogerson owned several S corporations that were engaged in various aspects of the aerospace industry. Between 2005 and 2013, all of the separate S corporations were wholly-owned subsidiaries of an S corporation holding company. From 2005 through 2013, Mr. Rogerson filed his income tax returns treating the holding company's activities as "nonpassive".

In 2014, Mr. Rogerson restructured ownership of the holding company such that he then directly owned the former subsidiaries of the old holding company structure. One of the S corporations (which we will call "RAEG") earned substantial profits in 2014, 2015 and 2016.

In addition to owning his S corporations, Mr. Rogerson also owned two yachts that he planned to charter. However, neither yacht was charted out during 2014, 2015 and 2016 which generated substantial losses for the yacht charter business.

On his 2014, 2015 and 2016 tax returns, Mr. Rogerson reported his yacht losses as "nonpassive losses" and treated his income from RAEG as "passive income". That way, Mr. Rogerson assumed, even if the IRS were to recharacterize the yacht activities from nonpassive to passive, he would be able to use the passive losses from the yacht activity to offset his passive income from RAEG.

On audit, however, the IRS determined that Mr. Rogerson's activities with respect RAEG were nonpassive, and that the yacht charter activities were passive.

The Tax Court agreed with the IRS that Mr. Rogerson's activities for RAEG were "regular, continuous and substantial" as contemplated under Section 469(h). For purposes of Section 469(h)(1), a taxpayer is treated as "materially participating" in an activity if he materially participated in the activity for any five out of the ten years immediately preceding the taxable year. Treas. Reg. Section 1.469-5T(5).

The Tax Court decided that the activities of RAEG satisfied the “five of the last ten years” material participation test, in part because of Mr. Rogerson’s prior tax treatment of the combined S corporation holding company structure as “nonpassive” in tax years before 2014.

The Tax Court found that there was no question that, before 2014, Mr. Rogerson's involvement in the aerospace business as a whole was nonpassive. Likewise, there was no dispute that Mr. Rogerson reported his involvement in the aerospace business as a whole, including the activities that became part of RAEG, as nonpassive.

Next, the Tax Court determined that yachting activities were “per se” passive rental activities. Of the six exceptions to the definition of a per se “passive rental activity", only two exceptions could be relevant to the court's analysis: the “seven days or less test” or the “thirty days or less test” combined with the provision of significant personal services provided by the taxpayer. Reg. 1.469-1T(e)(3)(ii)(8)(A) and (B).

Mr. Rogerson claimed that he qualified under both of these two (2) exceptions described in Treas. Reg 1.469-1T(e)(3)(ii).

The Tax Court, however, ruled that Mr. Rogerson couldn’t meet either test because there was no customer use in any of those tax years. Mr. Rogerson could not provide any evidence to the court as to the average period of customer use during the audit years since no customers charted the yachts during any of those years.

Mr. Rogerson testified that none of the charters were available for more than seven-day charters and that no one would have rented a charter for more than thirty days in one given time. Notwithstanding his testimony, however, the absence of any actual customer use of the yachts precluded the Tax Court from determining the actual average period of customer use.

As the Tax Court said, without any customers use, it is impossible to establish, as required by the regulations, the average period of customer use for the yachts. Since Mr. Rogerson couldn’t meet any of the two exceptions, the yacht charter activities were per se passive rental activities.

Finally, although the IRS had assessed the Section 6666(a)(2) 20% negligence penalty, the Tax Court refused to uphold the IRS assessment of the Section 6666(a)(2) 20% negligence penalty because Mr. Rogerson’s CPA, Mr. Chang, credibly testified at trial that he provided Mr. Rogerson with advice regarding the proper reporting of his activities under the passive loss rules for all three tax years.

In upholding the decision of the Tax Court, the Ninth Circuit Court of Appeals found that the Tax Court had sufficient evidence before it to conclude that Mr. Rogerson materially participated in RAEG during the tax years as defined under Section 469(h)(1) even though Mr. Rogerson argued that his activities for RAEG “did not require much of his time”. According to the Ninth Circuit, Section 469(h) does not impose a minimal hours' requirement to find that the taxpayer has materially participated in an activity, but only that the participation is "regular, continuous and substantial".

Finally, with respect to the yacht charter activity, the Ninth Circuit held that the Tax Court applied the correct standard and that "actual activity, not intention, is relevant to the applicability" of the "seven days or less" and the "thirty days or less" tests.

II. Taxpayer Must Prove Material Participation to Avoid the Net Income Tax; Senty v. United States, No. 22-CV-283-WMC, 2023 U.S. Dist. LEXIS 223973 (W.D. Wis. Dec. 15, 2023).

Mr. Senty was involved in several businesses, including gas companies, banks and a surveillance camera company. For 2014 and 2015, Mr. and Mrs. Senty filed joint tax returns showing taxable profits from some of these companies. The IRS audited the Senty's tax returns and determined that they owed net investment income tax on the companies' profits.

Mr. Senty contended that he met one of the material participation tests (the more than 100 hour test) for these activities thus exempting them from the net investment income tax. Mr. Senty claimed that he spent more than 100 hours, but less than 500 hours, working for each of these three companies in both 2014 and 2015.

However, Mr. Senty did not maintain a work calendar, appointment book, log journal, timesheet register or any other document to keep track of the hours or what type of work he performed for any particular activity. Also, Mr. Senty rarely used email or text messages for work.

The District Court concluded that Mr. Senty failed to meet his burden of establishing the number of hours actually devoted to these different activities, and therefore failed to satisfy Section 469 "material participation test". The court stated that, although taxpayers may use narrative summaries to demonstrate the amount of hours spent on a given activity, the taxpayers must identify the specific number of hours spent on specific tasks by providing contemporaneous evidence, such as phone records, flight and travel records, or credit card receipts.

III. Special Rules for Real Estate Professionals.

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

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

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

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

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

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

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

C. Married Couple Failed to Qualify as Real Estate Professionals Because they Couldn't Meet the "More than One-Half" Proportionality Test; Drocella vs. Commissioner, TC Summary Opinion 2023-12 (April 3, 2023). Mr. and Mrs. Drocella worked full time for their regular employers during 2018. In addition, during 2018 the Drocellas owned and managed six rental properties. Their real estate activities included renting and renovating the properties and handling issues with guests and tenants.

The Drocellas kept time logs of hours that each of them individually spent working on their real estate activities. Mr. Drocella's time log showed that he worked over 750 hours on the rental properties during 2018, but Mrs. Drocella's time log showed that she spent less than 750 hours on the real estate activities.

The Drocellas filed a Schedule E with their 2018 tax return showing a "loss from real estate activities" of $62,983. The Drocellas claimed that their loss was not limited by the Section 469 "passive activity" loss limitation rules on the basis that they qualified as "real estate professionals" ("REP"s) who materially participated in their real estate activities.

The Tax Court noted that, in the case of a joint tax return, married taxpayers meet the REP requirements of Section 460(c)(7)(B) if **either** spouse separately satisfies all three (3) of the REP requirements. However, to meet the "750 hours worked test", married taxpayers may not combine their hours. Instead, at least one of the spouses must meet the 750-hour test.

The court noted that, for purposes of applying the "proportionality test", a "trade or business" includes a taxpayer's status as an employee. See Ostrom vs. Commissioner, TC Memo 2017-118 and Fowler vs. Commissioner, TC Memo 2022-223.

Here, both Mr. and Mrs. Drocella stated that they worked full-time for their regular employers. However, neither of them could provide an indication of the number of hours they actually worked for their full-time employers. Since neither Mr. Drocella nor Mrs. Drocella could prove that more than one-half of their total personal services performed in their trades and businesses were performed on their rental real estate activities during the year, neither of them could qualify as a "real estate professional".

According to court, it's not enough that taxpayers prove the actual hours spent on their real estate activities. They must also prove that the hours that at least one of them worked for their regular employer did not exceed the hours that they worked on their real estate activities.

The court noted that, in order for either of Mr. Drocella or Mrs. Drocella to qualify as a real estate professional, then not only would one of them have to establish the number of hours actually worked on the rental real estate activities, but that spouse would also have to establish that he/she did not work more hours for their regular employer than he or she worked on the real estate activities.

Note: If Mr. and Mrs. Drocella were employed on a full-time basis during 2018, then we must assume that each of them worked at least 2,000 hours a year for their regular employers. This means that, in order to satisfy the "proportionality" test under the real estate professional rules, either Mr. Drocella or Mrs. Drocella would have to prove that they spent more than 2,000 hours actually working on their real estate activities.

Also Note: In addition to the "proportionality test", and the "750-hour" test, the taxpayer must also meet the "material participation" test. Presumably, if a taxpayer meets the 750-hour requirement, the taxpayer should be deemed to have "materially participated" in the real estate activities during that year. However, this is not always the case. For example, a taxpayer could count some hours toward participation in a real estate trade or business, but those same hours would not be treated as "material participation". Examples that come to mind would be "investor type" activities, such as reviewing financial statements, engaging in cash flow projections, etc.

<u>Also Note</u>: The “material participation” test is applied on a property-by-property basis, unless the taxpayers make an election for the applicable tax year to “aggregate” their real estate activities as one (1) single activity for purposes of the material participation test.

D. <u>Another Real Estate Investor Can’t Qualify as a Real Estate Professional if He Can’t Prove His Hours Working on Real Estate Activities; Teague vs. Commissioner, TC Summary Opinion 2023-16 (April 19, 2023).</u> Mr. and Mrs. Teague owned four properties in Maine: a duplex and three (3) cabins, called the “Maine Cabins”. For the 2017 tax year, Mr. Teague worked full-time for Comcast. The Teagues claimed a $24,000 Schedule E loss on their rental real estate activities relating to all four of the Maine properties.

The IRS agreed that the Maine Cabins were a real estate activity in which the Teagues “actively participated". However, because of the AGI phase-out limitations for “active participation” real estate activities, the Teagues were limited to deducting $1,500 of their $24,000 loss on their cabin rental activities.

The Teagues, however, contended that Mr. Teague qualified as a “real estate professional”, such that the Teagues would be entitled to the entire $24,000 rental loss. To determine whether Mr. Teague qualified as a “real estate professional”, the court had to establish: (1) the number of hours Mr. Teague worked at Comcast during 2017, and (2) the number of hours that Mr. Teague worked on the rental properties during 2017.

Evidence before the Court showed that Mr. Teague worked as a full-time employee for Comcast. At different times, Mr. Teague gave inconsistent testimonial estimates of the amount of time he actually worked for Comcast. Since his testimony was not entirely credible, the Court assumed that Mr. Teague had to have worked at least 1,840 hours in 2017 for Comcast (40 hours per week x 46 weeks).

Therefore, the Court was left to determine whether Mr. Teague could prove that he worked at least 1,840 hours on his real estate activities.

Unfortunately, Mr. and Mrs. Teague failed to keep records showing the actual time that Mr. Teague spent working on the Maine cabins. Although Mr. Teague did not keep any specific logs of hours spent working on the Maine Cabins, Mr. Teague claimed that he spent 1,993 hours in 2017 working on the Maine cabins.

And, the Court pointed out that the Teagues failed to “group" all four of the Maine properties as a “single” real estate activity on their 2017 tax return. Therefore, the time the Teagues spent working on the Maine duplex would not count for purposes of determining whether Mr. Teague qualified as a REP.

Mr. and Mrs. Teague also tried to contend that the hours spent by both Mr. and Mrs. Teague should be aggregated for determining whether one of the Teagues qualified as a “real estate professional”. The Court quickly noted that the requirements for a real estate professional are satisfied only if **<u>either spouse separately</u>** meets the REP requirements. Section 469(c)(7)(B).

Since Mr. Teague did not keep any records of the amount of time spent working on the Maine cabins, the Court was simply left to come up with its own estimates based upon the Mr. Teague's testimony. Ultimately, the Court accepted Mr. Teague's testimony that he was physically located at the cabins for 102 days during 2017. However, the Court could not accept Mr. Teague's claim that he worked 12 hours per day in each of those 102 days (which would have accounted for only 1,224 total hours anyway).

In fact, Mr. Teague's testimony provided details only for around 300 of the total 1,224 hours that he claimed to have worked physically on site at the cabins. Based upon the lack of Mr. Teague's own records as to the hours he spent working on the Maine Cabins, the Court concluded that Mr. Teague could not meet his burden of proving that he worked more than 1,840 hours at the Maine Cabins during 2017.

PART TEN

CHARITABLE CONTRIBUTIONS

I. Conservation Easement Charitable Deduction Limited To Taxpayer's Adjusted Basis In Ordinary Income Property and Further Reduced to Zero When the Taxpayer Couldn't Prove Current Basis Figures. Also, Informal Understanding Between the Appraiser and Taxpayer Disqualified the Appraiser From Being a "Qualified Appraiser" Under Section 170; Oconee Landing Property vs. Commissioner, TC Memo 2024-25 (February 21, 2024).

Oconee Landing Property, LLC claimed a charitable contribution deduction of almost $21 Million on its partnership tax return for the 2015 tax year for its donation of a conservation easement over property it owned in Georgia. The IRS disallowed the entire charitable contribution deduction.

In siding with the IRS, the Tax Court held that the charitable contribution failed in its entirety for two distinct reasons. First, the real estate appraisers, assisting Ocenee, were not "qualified appraisers", which meant that Oconee had failed to attach a "qualified appraisal" to its 2015 tax return. Second, because the property on which the easement was granted was "ordinary income" property, the amount of the charitable contribution was limited to Oconee's tax basis in the donated property. And, because Oconee could not prove that its tax basis in the donated property exceed zero, its charitable contribution was limited to zero.

II. Investment Property vs. Dealer Inventory: Charitable Deduction for Easement Property Donation Limited to Donor's Tax Basis Where Contributing Partner and Predecessor Held Property as Inventory; Glade Creek Partners, LLC v. Commissioner, T.C. Memo 2023-82 (June 29, 2023).

In 2012, Glade Creek Partners, LLC ("Glade Creek") donated a conservation easement on undeveloped real estate that was part of a failed residential development and claimed a $17.5 million charitable contribution deduction based upon the asserted fair market value of the easement. *Glade Creek,* T.C. Memo. 2020-148. In an earlier decision, the tax court found that, on the easement date, the unencumbered easement property had a fair market value of $9,354,171, and that the easement had a fair market value of $8,877,771. *Id.* at *53, *55.

On remand, the Tax Court determined that the easement property was inventory, and not investment property, in the hands of the partner that contributed the property to Glade Creek. Therefore, the easement contribution was a donation of "inventory", such that the charitable deduction was limited to Glade Creek's adjusted tax basis in the donated easement property.

III. Assignment of Income Doctrine and a Defective Appraisal Doom Charitable Contributions Deduction; Hoensheid vs. Commissioner, TC Memo 2023-24 (March 4, 2023).

Mr. and Mrs. Hoensheid made a generous gift of stock in their closely held business, Commercial Steel Treating Corp. ("CSTC), to Fidelity Charitable Gift Fund ("Fidelity Charitable"). Fidelity Charitable is a Section 501(c)(3) organization that administers donor advised funds. Almost immediately after the charitable gift, Fidelity Charitable sold the CSTC stock.

The Tax Court held, under the assignment of income doctrine, the Hoensheids had to recognize all of the capital gain on the gifted stock because the effective transfer of the stock to the charitable organization did not occur until all of the deal points had been reached on a stock sale. That was so even though the sales contract was not executed, and closing did not occur, until two days after the Hoensheids transferred the CSTC stock to the charitable organization. The court also disallowed the Hoensheids' charitable contribution deduction because their appraisal report failed to meet the requirements of a qualified appraisal under Section 170. The claimed charitable contribution deduction was over $3 million.

On April 23, 2015, the Hoensheids and one of their suitors, HCI Equity Partners ("HCI"), executed a nonbinding letter of intent for the purchase of CSTC stock for $107 million. Between April 23rd and July 13, the parties negotiated the terms of a potential stock purchase agreement. During the same period, Mr. and Mrs. Hoensheid and their advisors worked on a gift of CSTC stock to Fidelity Charitable. The Hoensheids' long-time tax and estate planning advisor, Andrea Kanski, advised Mr. and Mrs. Hoensheid their stock gifts should take place before there was any definitive agreement for the sale of CSTC stock. Mr. and Mrs. Hoensheid were reluctant to pull the trigger on their stock gift until they were virtually certain the stock sale to HCI would ultimately take place. From April 23 until July 15, negotiations between CSTC and HCI continued. During that period, Mr. and Mrs. Hoensheid continued to prepare the paperwork to complete the stock gift to Fidelity Charitable.

July 13, 2015 was a very busy day for everyone involved. At 4:38 a.m. the purchase agreement underwent a final redline comparison that confirmed the parties had finally agreed on the remaining open deal points. However, as of 9:13 a.m. on that same day, Fidelity Charitable had not yet received the physical stock certificate evidencing the shares' transfer to Fidelity Charitable.

The Court considered whether the assignment of income doctrine caused the Hoensheids to recognize all the gain on the sale of the gifted CSTC shares. The court analyzed past cases addressing the elements that make a valid stock gift, such as (1) donative intent, (2) delivery of the gift and (3) acceptance of the gift.

The court held Mr. and Mrs. Hoensheid did not relinquish dominion and control over the gifted shares until around 3:24 p.m. on the afternoon of July 13 when a PDF copy of the gifted stock certificate was emailed to Fidelity Charitable. The court concluded the delivery of the CSTC shares did not occur before July 13, and Fidelity Charitable likewise did not accept delivery of the gifted shares until later that day. That means July 13 was the date Mr. and Mrs. Hoensheid relinquished title to the CSTC shares.

The court determined Mr. and Mrs. Hoensheid would never have made the gift but for the impending stock sale. The court noted when Fidelity Charitable received the shares, it had no legal obligation to sell them to HCI. On the other hand, when the Hoensheids transferred the stock to Fidelity Charitable, the sale was a virtual certainty.

Most important was no material unresolved sale contingencies remained when the shares were transferred to Fidelity Charitable on July 13. The email exchange between the parties at 4:38 a.m. included a redline comparison of the stock purchase agreement confirming all significant deal points had been resolved. Since there was no risk the sale would not occur when the contribution was made, the right to the income from the sale was fixed prior to the gift. Therefore, the Hoensheids were taxable on the sale proceeds received by Fidelity Charitable.

The court then disallowed the entire charitable contribution deduction because the stock appraisal was not a qualified appraisal meeting the requirements of Section 170(f)(11). There were several factors indicating the appraisal failed to meet the requirements of Treas. Reg. § 1.170A-13 (c)(3)), including it:

(1) did not include the statement that it was prepared for federal income tax purposes;
(2) included the incorrect date of June 11 as the date of gift;
(3) included a premature date of appraisal;
(4) did not sufficiently describe the method for the valuation;
(5) was not signed by the appraiser;
(6) did not include the appraiser's qualifications as an appraiser;
(7) did not describe the gifted property in sufficient detail; and
(8) did not include an explanation of the specific basis for the valuation.

Mr. and Mrs. Hoensheid argued the appraisal report substantially complied with the Section 170 regulations. The court, however, found it did not. The appraiser's biography in the report did not include the appraiser's qualifications. The court found that fatal because the requirement that the appraisal be prepared by a qualified appraiser is one of the most substantive requirements in the regulations. See <u>Mohamed vs. Commissioner</u>, TC Memo 2012-152. Furthermore, the report contained an incorrect date of the contribution.

This was not a case, therefore, “where a taxpayer does all that is reasonably possible, but nonetheless fails to comply with the specific requirements of a provision." Instead, the report was defective in that it failed to satisfy several substantive requirements, in addition to a number of minor defects, precluding a finding of substantial compliance.

The Hoensheids argued even though they were unable to establish substantial compliance, they should be allowed the charitable contribution deduction because they had reasonable cause for defective appraisal. Under the Section 170 regulations, taxpayers who fail to comply with the appraisal requirements may be entitled to a charitable contribution deduction if they show that their noncompliance is due to reasonable cause and not willful neglect. Section 170(f)(11)(A).

Mr. and Mrs. Hoensheid argued they should be able to rely on their appraiser to perform an appraisal that met all of the substantiation requirements. They clearly established their long-term tax and estate planning advisor, Ms. Kanski, was an expert in her field.

However, the IRS took the position it was Mr. and Mrs. Hoensheid, and not Ms. Kanski, who selected the appraiser, even though Ms. Kanski reviewed the appraisal, met with Mr. Dragon and advised Mr. and Mrs. Hoensheid about the Section 170 requirements of a qualified appraisal. Mr. and Mrs. Hoensheid should have known the appraisal report was defective on its face because the report showed a contribution date of June 11 rather than July 13. Because Mr. and Mrs. Hoensheid should have known the date of contribution, and thus the date of valuation, was incorrect, they could not rely on Ms. Kanski's or Mr. Dragon's judgment that the appraisal report contained the required information. Thus, Mr. and Mrs. Hoensheid did not have reasonable cause for their failure to procure a qualified appraisal.

In the penalty phase, the IRS conceded Mr. and Mrs. Hoensheid were not liable for the Section 6662(a) negligence penalty and the substantial understatement penalty relating to the disallowed charitable contribution deduction. Instead, the IRS argued there should be a **new** Section 6662(a) penalty assessed as to the underreported capital gains.

The court ruled the IRS failed to meet its burden of establishing Mr. and Mrs. Hoensheid did not have reasonable cause for the underpayment of tax. Generally, the IRS bears the initial burden of production. It must produce sufficient evidence to establish a taxpayer is liable for negligence or understatement penalties. However, if a **new penalty is asserted in an answer**, the IRS carries the entire burden of proof to the new penalty assessment. The IRS would have to establish (1) Ms. Kanski was not a competent professional advisor; (2) Mr. and Mrs. Hoensheid failed to provide her with necessary and accurate information, or (3) that Mr. and Mrs. Hoensheid did not actually rely in good faith on her judgment. The court determined the IRS did not meet its initial burden of production since the court did not “consider the anticipatory assignment of income issue to be so clear-cut that Petitioners should have known it was unreasonable to rely on Ms. Kanski's advice." Therefore, no penalties were imposed.

IV. Tax Court Permits Charitable Contribution Deduction Even Though the Taxpayer Failed to Meet the Strict Substantiation Requirements of Section 170; Murfam Enterprises, LLC vs. Commissioner, TC Memo 2023-73 (June 15, 2023) and Murphy vs. Commissioner, TC Memo 2023-72 (June 15, 2023).

Murfam v. Commissioner:

In 2010, Murfam Enterprises, LLC granted a conservation easement in favor of North American Land Trust, and Murfam claimed a charitable contribution deduction of over $5.7 million on its 2010 tax return.

Portions of the Form 8283, attached to the Murfam tax return for 2010, were either totally missing or incomplete. For example, Form 8283 failed to report the date that the donor acquired the property or the donor's adjusted tax basis in the donated property.

After the IRS audited Murfam's tax return, the IRS issued an FPAA and on the Form 886-A, "Explanation of Adjustments", the FPAA, merely stated:

> it has not been established that the value of the non-cash charitable contribution of a qualified conservation easement deducted on a return was $5,744,600. It is determined that the value of the charitable contribution attributable to the qualifying conservation easement is $446,000; therefore, the charitable contribution is decreased by $5,298,600.

The FPAA issued to Murfam did not assert any liability for any penalty, nor did it determine to deny the charitable contribution deduction based upon Murfam's failure to attach a fully completed Form 8283 to its tax return as required to satisfy the substantiation and reporting requirements of Section 170(f)(11).

After Murfam submitted its Petition to the Tax Court, the IRS filed its Answer and, in the Answer, for the first time the IRS asserted imposition of the gross valuation misstatement penalty or, in the alternative, an accuracy related penalty under Section 6662(a).

However, even in its Amended Answer, the IRS did not assert that the underlying contribution deduction failed due to Murfam's failure to comply with the substantiation requirements of Section 170(f)(11). Instead, the IRS only first made this contention in its pretrial memorandum.

The Tax Court ruled that, since the IRS failed to raise any penalty issues or Murfam's failure to comply with the substantiation requirements of Section 170 in its initial FPAA, the "burden of proof" then shifted to the IRS to establish that Murfam had no reasonable cause defense to the imposition of the penalties or for its failure to meet the substantiation requirements of Section 170(f)(11).

The Tax Court determined that Murfam failed to strictly or substantially comply with the Section 170(f)(11) substantiation requirements which mandate that the taxpayer attach a fully completed appraisal summary of its tax return, since the appraisal summary (on the Form 8283) failed to provide the donor's cost basis information. However, this did not mean that the Tax Court would disallow the contribution deduction.

Under Section 170(f)(11)(A)(ii)(I), the taxpayer's deduction will not be disallowed if it shows that the failure to meet the substantiation requirements was due to reasonable cause and not due to willful neglect. Similarly, under the tax penalty provisions, Section 6664(c)(1) likewise provides there is no penalty under Section 6662 if it is shown that there was reasonable cause for the tax underpayment.

Since the IRS did not raise the penalty issue or challenge to charitable contribution deduction allowance until it filed its Amended Answer and Pretrial Memorandum, these were deemed to be “new matters" for which the IRS then bears the overall burden of proof. And, that burden of proof includes the burden to prove the absence of “reasonable cause" under Section 6664 and under Section 170(f)(11).

According to the Court, the IRS thus had to prove that Murfam did not rely on professional advice in filling out its Form 8283. At trial, Murfam's outside CPA firm credibly testified that Murfam provided the CPA firm with all the information needed to file a fully and accurate tax return, and that the CPA received all the information that it had requested from Murfam.

So, the IRS could not show that Murfam itself declined to provide the cost basis information to its CPA when it prepared the tax returns. It was possible that the CPA firm failed to request this information from Murfam. Because the burden of proving the absence of “reasonable cause" fell on the IRS, the IRS could not prove that it was Murfam's fault (rather than the fault of the outside CPA firm) that the Form 8283 did not contain the required income tax basis information. Therefore, although the ***amount*** of the charitable contribution was slightly reduced, the deduction was otherwise allowable and without the imposition of any tax penalties.

> **Note:** Interestingly, Murfam argued that, even though it did not include its cost basis information on its Form 8283, Murfam should be deemed to have “substantially complied” with that requirement, because the cost basis information was provided in other parts of Murfam's partnership tax return for the contribution year. For example, by merely reviewing the Schedule L “Balance Sheet", one could easily deduce how the purported tax basis in the "Land" category decreased from the beginning of the year through to the end of the year. This same information also could be gleaned from reviewing the “Schedule M-1 Adjustment” section of the partnership tax return. The court ruled, however, that Murfam still failed the “substantial compliance" test because Section 170(f)(11)(C) and Treasury Regulation 1.170A-13(c)(4)(i)(A) and (II)(E) require that the donor's cost basis be actually reported on the Form 8283 itself.

<u>Murphy vs. Commissioner</u>:

In a related case, the Murphys were shareholders of Duplin Land Company. In 2010, Duplin Land Development, Inc. made an easement donation to the North American Land Trust. The Murphys were issued Notices of the Deficiency to reduce the amounts of their charitable contribution deductions claimed on their 2010 Forms 1040 that were passed through to them from Duplin Land Company's Form 1120S.

As in the <u>Murfam</u> case discussed above, the Notices of Deficiency issued to the Murphys did not assert any liability for penalties nor did the Notices of Deficiency determine to deny their charitable contribution deductions by virtue of their failure to satisfy substantiation reporting requirements of Section 170(f)(11). As in the <u>Murfam</u> case, the Form 8283 attached to the company's 2010 tax return failed to include cost basis information. However, in the Notices of Deficiency, the IRS did not directly attack whether the Murphy's appraisal summaries on Form 8283 were defective.

So again, since the IRS did not raise these issues in the Notices of Deficiency or in its Answer, the IRS bore the burden of proving that the blank basis boxes on Forms 8283 were the result of the Murphy's willful neglect rather than the result of CPA's advice. Although it was possible that the Murphy's may not have been able to prove "reasonable cause", here the burden of proof was on the IRS to prove the ***absence*** of reasonable cause. And because the IRS failed establish that a reasonable cause defense did not exist for Murphy's failure to comply with the substantiation reporting requirements of Section 170(f)(11), the charitable contribution deduction was allowed.

V. <u>Qualified Appraisal Required for Multiple Gifts to Goodwill and the Salvation Army; Bass v. Commissioner, TC Memo 2023-41 (March 26, 2023).</u>

During 2017, Mr. Bass donated significant amounts of clothing and other household items to Goodwill and the Salvation Army. Mr. Bass claimed he donated almost $14,000 of clothing to Goodwill and another $11,594 of clothing to the Salvation Army. Mr. Bass made regular trips to the Salvation Army and Goodwill, and sometimes made more than one trip a day. During 2017, Mr. Bass made 173 separate trips to Goodwill and the Salvation Army. Mr. Bass admitted he made numerous separate trips to avoid the requirement of having the donated items actually appraised. For each trip, Mr. Bass received from the Salvation Army or Goodwill worker a donation acknowledgment receipt he filled out listing the donated items and their estimated fair market values. Mr. Bass' receipts showed he donated a total of $13,852 of clothing items to Goodwill and $11,594 of clothing items to the Salvation Army during 2017.

Mr. Bass claimed all of the donated clothing items as a Schedule A charitable contribution itemized deduction. However, he did not attach any qualified appraisal reports to his IRS Form 8283. Under the Section 170 regulations, for any non-cash charitable contributions exceeding $5,000, the donor is required to obtain a qualified appraisal for the contributed property

Mr. Bass testified for each separate donation trip, the fair market value of his donated items was less than $250. He assumed, since each receipt for donated clothing showed a fair market value less than $250, he would not need to have any of the items appraised. However, under the Section 170 regulations, for purposes of determining whether donations for the year exceed the relevant $5,000 threshold, all similar items of property donated to one or more charitable organizations are treated as one property. Section 170(f)(11)(F) and Treas. Reg. § 1.170 A-13(c)(1)(i). The phrase "similar items of property" is defined as "property of the same generic category or type such as … clothing…." Treas. Reg. § 1.170 A-13(c)(7)(iii). Therefore, the court concluded, since Mr. Bass did not obtain a qualified appraisal for his clothing donations, he could not claim any charitable contribution deductions.

VI. <u>Another Failed CWA; Albrecht v. Commissioner, TC Memo 2022-53 (May 25, 2022).</u>

Under Section 170, no charitable contribution deduction is allowed, unless the done organization provides a Contemporaneous Written Acknowledgement ("CWA"). To meet the "substantiation" requirements, a CWA must state whether the charitable donee provided any goods or services in connection with the donation. Section 170(f)(8)(B)(ii).

In addition, the CWA must be "contemporaneous" (Section 170(f)(8)(C)), which means that the taxpayer must receive the CWA by the **<u>earlier</u>** of (1) the **<u>actual date</u>** the tax return is filed or (2) the due date (including extensions) for the tax year of the donation.

Martha Albrecht executed a "Deed of Gift" and donated a large collection of native American jewelry to a museum.

The problem here was that there was no CWA that specifically stated whether or not Mrs. Albrecht received any goods or services in exchange for her gift. Even though the Deed of Gift did not say that Mrs. Albrecht **did** receive something of value in exchange for her gift, the Deed of Gift simply did not recite **"<u>whether</u>"** the Museum gave her anything of value in exchange for her donation.

The silence in the CWA was fatal. The court ruled that a document that is "silent" about whether any goods or services were received by the taxpayer is by definition defective.

Furthermore, the Deed of Gift contained some rather strange language providing that Mrs. Albrecht had transferred "all rights, title and interest held by the donor included in the donation, unless otherwise stated in the Gift Agreement."

In this case, there actually was no other type of Gift Agreement and so the CWA erroneously and inaccurately referred to a document that simply didn't exist at all. Of course, Mrs. Albrecht couldn't prove that the Gift Agreement didn't exist; and indeed, if the Gift Agreement had existed, then it would have been possible that the Gift Agreement could have conveyed something back to Mrs. Albrecht from the museum.

PART ELEVEN

REASONABLE COMPENSATION AND OTHER BONUS COMPENSATION CASES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The compensation deduction was challenged by the IRS.

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

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

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

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

II. Fourth Circuit Court of Appeals Confirms Tax Court's Decrease of Deductible Compensation Under the Reasonable Compensation Test; Clary Hood, Inc. v. Commissioner, 131 A.F.T.R. 2d 2023-1875 (4th Cir. 2023).

The 4th Circuit Court of Appeals recently affirmed the Tax Court's earlier decision in Clary Hood, Inc. to reduce the amount of deductible compensation paid to the founder and primary shareholder of a construction company, but vacated the Tax Court's earlier imposition of the "substantial understatement" penalty.

Clary Hood, Inc., employed its founder and primary shareholder, Mr. Hood, as its chief executive officer. Hood, Inc. was a South Carolina C corporation, and the Tax Court case involved establishing the amount of reasonable and deductible compensation paid to Mr. Hood in 2015 and 2016.

During 2015 and 2016, Mr. Hood received $168,000 and $196,000 in base salary, with $5 million bonuses for each of those years.

Upon audit, the IRS substantially reduced Mr. Hood's deductible compensation for 2015 and 2016 and imposed the accuracy related penalties and the substantial understatement penalty under Sec. 6662(a) and (b)(2).

Hood, Inc. argued that Mr. Hood's compensation was reasonable based upon the "independent investor" test established by other courts such as in Exacto Spring Corp. v. Commissioner, 196 F.3d 833, 838 (7th Cir. 1999).

In the Tax Court proceeding, Hood, Inc. vs. Commissioner, TC Memo 2022-15 (March 2, 2022), the court noted that, unlike in other Circuits, the 4th Circuit (where South Carolina is located) had never adopted any iteration of the "independent investor" test and had always applied the "multi-factor" approach when making the reasonable compensation test.

The tax court went on to find that the company had clearly met a number of the factors supporting the compensation paid to Mr. Hood.

However, the tax court ultimately held that the company had not adequately established how the amounts paid to Mr. Hood during the tax years were both reasonable and paid solely as compensation for his services. While there were certain factors in the company's favor, the court couldn't simply rule in favor of whichever side had the **most** factors in their favor, since all factors are not given equal weight.

Based upon expert testimony on behalf of the IRS, the Tax Court reduced Mr. Hood's original compensation down to around $3.7 million for 2015 and just under $1.4 million for 2016.

Next, the tax court determined whether it would uphold the 20% substantial understatement penalty under Section 6662(a) and (b)(2).

The company asserted that it had “reasonable cause” and a good faith defense for the imposition of the penalties under Section 6664(c)(1), both based upon its reliance upon the advice of their outside CPA firm and based upon prior courts’ application of the “independent investor” test when making the reasonable compensation determination.

With respect to the 2015 tax year, the court stated that, since Mr. Hood had specifically sought out advice from its regular accounting firm and its outside accounting firm as to potential compensation for 2015, Mr. Hood had “reasonable cause” for his position on his 2015 return.

However, for 2016, because the court believed that neither the testimony of Mr. Hood nor that of his expert witnesses could support the amount of compensation the company paid him in 2016, the Court also determined that the company failed to establish “reasonable basis” for its tax return positions during 2016.

Also, since no 4th Circuit cases supported the independent investor test, no substantial authority existed for the company’s position for 2016, as the 4th Circuit relies solely upon the multi-factor approach.

Upon appeal to the Fourth Circuit, the Court of Appeals concluded that the “multifactor” test is the appropriate test to apply in making the reasonable compensation determination. The Court stated that, while it may be reasonable to consider the independent investor test along with other factors, the multifactor test takes more relevant factors into consideration, and therefore the multifactor test is the more reasonable test to use.

Next, the Court of Appeals upheld the Tax Court’s decision to reduce the amount of deductible compensation paid to Mr. Hood in 2015 and 2016. Because the Tax Court fully explained its position for rejecting Hood, Inc.’s experts and for relying on the IRS’s expert, the company failed to prove that the Tax Court’s factual findings were clearly erroneous or that its reliance on the IRS expert was inappropriate.

However, the Court of Appeals vacated the Tax Court’s imposition of the substantial understatement penalty for the 2016 tax year, because the Court of Appeals determined that Mr. Hood and his CPAs had followed the same process to determine bonus amounts in 2016 as they did in 2015. Since the tax advisors approved the bonus plan for both 2015 and 2016, the company’s reliance upon the advice of a professional tax advisor, to establish the reasonable-cause defense for the 2015 tax year, also should apply to the 2016 tax year.

PART TWELVE

S CORPORATIONS AND PARTNERSHIPS

I. Even Embezzlement and Cheating Your Partner Won't Terminate The S Corporation Election, So S Corporation Shareholder Must Pay Tax on Income He Never Received; Maggard vs. Commissioner, TC Memo 2024-77 (August 7, 2024).

Mr. Maggard established a California S corporation to operate his engineering firm. The engineering firm elected S corporation status in its first year of operation. The company's articles of incorporation provided that the company was authorized to issue 10,000 shares, all of which would be common shares. And, the company's bylaws never made any mention of the firm having more than one class of stock, nor was there a provision allowing for disproportionate distributions to its shareholders.

Soon after forming his new company, Mr. Maggard brought in two new partners, we will call them Mr. L and Mr. J. Mr. L served as the firm's CEO and CFO, while Mr. J served as secretary. Mr. Maggard, Mr. L and Mr. J all were members of the Board of Directors.

Maggard continued to own a 40% minority interest in the company, with Mr. L and Mr. J owning 40% and 20% of the outstanding shares. The three men never changed the firm's articles of organization or its bylaws to allow for disproportionate distributions.

Almost immediately, Mr. L began misappropriating funds, and Mr. L and Mr. J began making disproportionate distributions to themselves at the expense of Mr. Maggard.

As soon as he became CFO, Mr. L stopped filing federal S corporation tax returns and stopped sending Schedules K-1 to the shareholders. Litigation ensued after Mr. Maggard found out about the disproportionate distributions. Mr. Maggard also learned that the company had failed to pay him his share of the company's profits. Mr. Maggard even accused Mr. L and Mr. J of embezzling more than $1 Million from the firm. At that point, Mr. L and Mr. J completely froze Mr. Maggard out of all business operations and cut him off from the books and records of the company.

In April 2018, the company filed its Forms 1120S for the years 2011 through 2016. Mr. Maggard understood that he had to file his own income tax returns, so he had his attorney contact Mr. L to secure profit and loss information so that Mr. Maggard could file his personal tax returns.

Mr. L came back with a single number "$300,000" written on a napkin and Mr. L represented that this was Mr. Maggard's pro rata portion of the firm's losses for 2014. Mr. Maggard filed his 2014 return and claimed these losses on his return.

For 2015, Mr. L again provided a single number to Mr. Maggard, a $50,000 loss, which Mr. Maggard claimed on his tax return for 2015. For 2016, Mr. Maggard reported no income or loss from the S corporation.

After litigation, Mr. L agreed to purchase Mr. Maggard's shares for $1.2 million and the parties signed a settlement agreement in October 2018. The settlement agreement included a covenant that the company wouldn't make any changes to its Forms K-1 that it finally issued to Mr. Maggard in late 2018 for the 2012 through 2017 tax years.

Finally, in November 2018, the company issued its Schedules K-1 to the shareholders for the 2011 through 2016 tax years. These K-1s, however, showed that Mr. Maggard had a proportionate share of the firm's profits, and not losses.

Not surprisingly, the IRS audited Mr. Maggard's return due to the discrepancies between the Forms K-1 issued to Maggard and the IRS, and the amounts claimed on Mr. Maggard's returns.

Mr. Maggard argued to the Tax Court that he shouldn't have to pay tax on S corporation profits taken by his two partners. Mr. Maggard also contended that the firm's S election terminated when it began making disproportionate distributions to Mr. L and Mr. J at the expense of Mr. Maggard in years well before the 2014 through 2016 tax years at issue. Since the company's S election terminated, it converted to a C corporation, which meant that none of the C corporation profits would be taxed to Mr. Maggard.

The Tax Court, however, ruled that the S election never terminated, notwithstanding the bad acts of Mr. L and Mr. J. The S corporation regulations clearly provide that, in determining whether the S corporation has violated the "one class of stock rules", we must look at the corporation's governing documents and not what the shareholders actually do. Treasury Regulation 1.1361-1(l)(2) provides that uneven S corporation distributions do not mean that the corporation has more than one class of stock where the underlying governing documents (such as articles of incorporation and bylaws) themselves do not authorize unequal distributions to its shareholders. Rev. Proc. 2022-19.

The Tax Court cited its earlier decision in Mowry vs. Commissioner, No. 21407-16, 2018 Tax Ct. Memo LEXIS 107 (T.C. July 5, 2018) where a taxpayer previously argued that unauthorized withdrawals from the S corporation bank account effectively changed the company's articles of incorporation and bylaws by virtue of the actions of the majority shareholder (the taxpayer's brother) who owned more than 50% of the stock of the S corporation. In that earlier case, the Tax Court had ruled that the disproportionate distributions do not terminate the company's S election in the absence of a formal change to the articles of incorporation and bylaws.

Likewise, in Minton vs. Commissioner, T.C. Memo 2007-372, aff'd, 562 F.3d 730 (Fifth Circuit 2009), the court held that, in the absence of a binding agreement, the S corporation shareholders, who in fact actually received unequal distributions, do not have enforceable rights to disproportionate distributions, even though the majority shareholders had made an oral agreement between themselves to make fixed distributions to the exclusion of the taxpayer-S corporation shareholder.

Relying upon <u>Minton</u> and <u>Mowry</u>, the Tax Court concluded that the misdeeds of Mr. J and Mr. L never constituted formal corporate action that changed the governing corporate governing documents, the articles of incorporation and bylaws.

> **<u>Note:</u>** The court's decision never makes any mention of the IRS assessment of penalties, so we must assume that at least the IRS didn't try to assert any penalties against Mr. Maggard.
>
> **<u>Note:</u>** Should Mr. Maggard have filed an IRS Form 8082, "Notice of Inconsistent Treatment or Administrative Adjustment Request AAR" with his 2014 to 2016 tax returns? Maybe Mr. Maggard made the wrong arguments here. Rather than contending that S corporation election terminated by reason of the disproportionate distributions, perhaps Mr. Maggard could have argued that disproportionate dividend distributions should be recast by the IRS as deductible wage compensation paid to the majority shareholders. Again, Mr. L and Mr. J both were executive officers of the company. Since the firm's organizational documents did not permit these disproportionate distributions, why didn't Mr. Maggard argue that the disproportionate distributions were actually tax-deductible wages or losses in the form of disguised wages or embezzlement losses?
>
> By filing Form 8082, Notice of Inconsistent Treatment, maybe the IRS would have audited the firm's tax return and would have assessed additional wage compensation or embezzlement income to Mr. L and Mr. J.

II. <u>Tax Court Treats Inter-Company Loans as Shareholder Debt Basis And Allows S Corporation Shareholder Income Tax Basis for Brother/Sister Inter Company Loans; Notwithstanding Inconsistent Balance Sheet and Tax Return Reporting; Estate of Fry, TC Memo 2024-8 (January 23, 2024)</u>.

Mr. Fry was the sole shareholder of two S corporations, called "Crown" and "CR Maintenance". Crown was profitable, but CR Maintenance wasn't.

From 2010 to 2013, Crown provided financial support to CR Maintenance to allow it to continue operating. Mr. Fry would instruct Crown to transfer funds, via check or bank transfers, directly to CR Maintenance (the "Transfers"). In addition, Crown, on behalf of CR Maintenance, also made payments directly to CR Maintenance's creditors for operating business expenses (called the "Payments").

Over time, the Transfers and Payments exceeded $36 million, but CR Maintenance never issued any type of promissory notes evidencing the Transfers. Also, there was no security granted by CR Maintenance in favor of Crown and there was no evidence that CR Maintenance made any promises to repay interest or debt payments relating to the Transfers or Payments.

Nevertheless, in its books, records and tax returns from 2010 through 2017, CR Maintenance accounted for each of the Transfers and Payments from Crown as either a "Loan Payable" to Crown or as a "Due to Crown", thus, characterizing the Payments and Transfers as debts owed by CR Maintenance to Crown. In addition, CR Maintenance never treated Crown's Transfers and the Payments as additional capital contributions from Mr. Fry to CR Maintenance.

Likewise, Crown recorded the Transfers and the Payments as a "Receivable Due From CR Maintenance" on its tax returns and characterized these transactions as indebtedness.

For the 2013 tax year, CR Maintenance reported ordinary losses in excess of $5.6 Million and Mr. & Mrs. Fry claimed flow through loss deductions of over $4.7 Million from CR Maintenance on their individual 1040 tax return.

The IRS disallowed Mr. Fry's flow through losses from CR Maintenance on the basis that Mr. Fry was bound by the form of the transaction he had chosen. Mr. Fry had clearly indicated in all of the books and records of Crown and CR Maintenance that all of the capital infusions into CR Maintenance had come directly from Crown, and not from Mr. Fry in the form of capital contributions or personal loans to CR Maintenance.

Mr. Fry, however, contended that the Payments and Transfers from Crown should be treated as (1) distributions from Crown to Mr. Fry and as (2) subsequent capital contributions by Mr. Fry to CR Maintenance.

Mr. Fry argued that, regardless of the tax return and financial statement reporting, the "substance" of the Transfers and Payments from Crown to CR Maintenance were not bona fide debts, but instead were constructive equity distributions from Crown to Mr. Fry followed by equity contributions by Mr. Fry to CR Maintenance.

This "recharacterization" allowed Mr. Fry to have sufficient stock basis in his CR Maintenance stock to deduct over $3.4 million of flow through losses from CR Maintenance on his 2013 tax return.

In Tax Court, the IRS asserted various grounds in support of its position that, because Mr. Fry had consistently characterized the Transfers and Payments between Crown and CR Maintenance as debt between the two S corporations, Mr. Fry was prohibited from re-characterizing them as equity contributions. The IRS asserted that Section 385(c), the "duty of consistency" and the "doctrine of election" all prohibited the re-characterization of the Transfers and Payments from debt to equity, as their original characterization was that of indebtedness.

The Tax Court, however, sided with Mr. & Mrs. Fry. Since the Ninth Circuit was the Circuit to which the Tax Court's opinion would be appealed, the Court discussed the Ninth Circuit's view of the application of Section 385 to the "debt or equity" question in the context of S corporations, as well as the 9th Circuit's view of the "duty of consistency doctrine" and the "doctrine of election".

Section 285.

Generally, under Section 1371, the provisions of Subchapter C of the Tax Code apply to S corporations as well as to C corporations. Section 385(b) sets forth five (5) factors that may be included in regulations prescribed by the IRS to make the debt versus equity determination.

Also, Section 385(c) states that the characterization "by the issuer" as to whether an interest in a corporation is stock or indebtedness shall "be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary)."

The Court first noted that Section 385 had never been applied to S corporations and that the regulations issued under Section 385 in 2016 specifically exclude S corporations entirely from being affected by Section 385. Second, Section 385(c) only applies where there is a formal issuance of a promissory evidencing a debtor/creditor relationship, Therefore, regardless of whether Section 385 could even apply to Crown and CR Maintenance, as S corporations, the Court reasoned that, based upon the plain reading of Section 385(c), that Section could not apply here since CR Maintenance never issued any promissory notes to Crown.

Debt versus Equity Factors.

The court then looked at the facts and circumstances factors considered by the 9th Circuit as relevant in determining whether a transfer to a corporation by a shareholder is debt or a contribution of capital. Citing Hardman vs. US, 827 F.2d 1409 (9th Circuit 1987), the court noted that the 9th Circuit has identified the following eleven (11) factors to consider as potentially relevant to the debt vs. equity inquiry: (1) the names given to the certificates evidencing the debt; (2) the presence or absence of a fixed maturity date; (3) the source of the payments; (4) the right to enforce payments of principal and interest; (5) whether the advances increase participation in management; (6) whether the "lender" has a status equal or inferior to that of regular creditors; (7) objective indicators of the parties' intent; (8) whether the capital structure of the "borrower" is thin or adequate; (9) the extent to which the funds advanced are proportional to the shareholder's capital interest; (10) the extent to which interest payments come from "dividend" money; and (11) the ability of the "borrower" to obtain loans from outside lending institutions. *See Hardman*, 827 F.2d at 1412; *NA Gen. P'ship & Subs. v. Commissioner*, T.C. Memo. 2012-172, 2012 WL 2344719.

The court then analyzed the Hardman eleven factors, and concluded that of the eleven factors, four were neutral, six favored equity treatment and one favored debt. After weighing all the various factors, the court concluded that it was more likely than not that the Transfers and the Payments did not constitute true indebtedness. The Court stated that, even though the evidence of the transaction reflected a debt from CR Maintenance to Crown, this was not a definitive factor in this determination. Instead, it was the true intent of the parties that was relevant.

The court seemed compelled by the fact that CR Maintenance's ability to satisfy its "indebtedness" to Crown had been completely dependent on the future profitability of CR Maintenance. Likewise, there were no documents evidencing true indebtedness, and there was no specific maturity date for maturity of any loans from Crown to CR Maintenance. Also, Mr.

Fry never made a written demand on CR Maintenance on behalf of Crown for repayment of any debt.

In addition, for all practical purposes, the debt owed by CR Maintenance to Crown was effectively subordinate to the claims of its general creditors and no other third parties would extend credit to CR Maintenance. Finally, Mr. Fry was in charge of both corporations.

So, under the eleven-factor test of Hardman, the treatment of Mr. Fry on the corporate tax returns and financial statements was not fatal to Mr. Fry's "debt versus equity" argument.

Once the court concluded that infusions of cash from Crown to CR Maintenance should be recharacterized as capital contributions from Mr. Fry to CR Maintenance, the court then had to determine whether the Transfers from Crown should be recharacterized as a constructive distributions from Crown to Mr. Fry.

Under Ninth Circuit case law, a constructive dividend occurs when a two-part test is met: (1) the expenditures do not give rise to a deduction on behalf of the distributing corporation and (2) the expenditures create "economic gain, benefit, or income" to the recipient shareholder. P.R. Farms vs. Commissioner, 828 F.2d 1084 (9th Circuit 1987).

In this case, the Transfers and the Payments primarily benefited Mr. Fry as there was no business reason for Crown to make the Transfers and Payments on behalf CR Maintenance. Instead, the Transfers and the Payments directly benefited Mr. Fry since it allowed his other business entity, CR Maintenance, to continue operations. For this reason, the court found that the substance of the Transfers and Payments were constructive distributions by Crown to Mr. Fry.

Next, the court then addressed whether Mr. Fry was bound by his prior tax return and financial statement treatment under the "duty of consistency" doctrine and under the "doctrine of election".

Duty of Consistency.

The Court concluded that the "doctrine of inconsistent treatment" should not preclude Mr. Fry from claiming the intercompany transfers as constructive distributions from Crown to Mr. Fry followed by constructive contributions from Mr. Fry to CR Maintenance. The court described the "doctrine of inconsistent treatment" as akin to the concept of "Whipsaw"" which occurs when both parties to a taxable event avoid taxation by taking inconsistent tax reporting positions for the same transaction.

Here, there was no "whipsaw." CR Maintenance never promised to pay interest on the Transfers and the Payments, and Crown never requested that interest be paid. There was no evidence that Crown or CR Maintenance ever deducted any interest and Mr. Fry, as an individual, would not have been able eligible to claim the Section 243 dividend received deduction on any deemed distributions from Crown to Mr. Fry.

Next, with respect to the "duty of consistency", the 9th Circuit had held that, in order for the "duty of consistency" to apply, there usually has to be some type of demonstrated harm to the IRS as a result of the inconsistent position taken by the taxpayers. See Estate of Ashman vs. Commissioner, 231 F.3d 541. Here, the Service could not allege any such harm over Mr. Fry's recharacterization of the Transfers and Payments on his 2013 tax return.

Doctrine of Election.

The Court then reviewed the IRS' argument that the "doctrine of election" precluded the Frys from recharacterizing the debts as equity. According to the Court, the "doctrine of election" is an equitable principle that generally precludes a taxpayer, who makes a conscious election, from revoking or amending that election without the consent of the IRS. That doctrine requires a showing of the following two elements: (1) there must be a free choice between two or more alternatives and (2) there must be an overt act by the taxpayer communicating that choice to the IRS. Often, the "doctrine of election" would be applied when a taxpayer files an amended return to change the treatment of some item inconsistently with the treatment of the item on the original return.

Here, however, that doctrine could not have applied, since Mr. Fry never had a "free choice" or election to deem the Transfers or the Payments as either debt or equity. Rather, the proper characterization of the Transfers and the Payments is to be based on various factors that indicate the true economic substance of the transaction.

And, this was not a case where a taxpayer had filed an amended return or a refund suit treating contested items inconsistently with how the taxpayer previously treated them on the originally filed return.

III. IRS Allows S Corporation Status to Continue, Even After Trust Fails to Meet the QSST Income Distribution Requirement; PLR 202405003 (February 2, 2024).

An S corporation shareholder transferred S corporation stock to two trusts that qualified as electing small business trusts (ESBTs). Later, the trustees and beneficiaries of the ESBTs elected to convert the trusts from ESBTs to Qualified Subchapter S Trusts (QSSTs).

Under the terms of the trusts, distributions of income or principal could be made only to the income beneficiary during the beneficiary's lifetime. However, the trusts did not mandate that all trust income actually be distributed to the income beneficiary each year.

Even though the trust terms did not mandate that all income be distributed each year, the trusts qualified as QSSTs, assuming that the trusts actually in fact distributed all income to the income beneficiary each year.

After the new QSST elections were made, the trustees failed to distribute all trust income out to the trust beneficiaries as required by Section 1361(d)(3)(B) for QSST's that otherwise do not require annual distributions of all trust income. Nevertheless, pursuant to Section 1362(f), the IRS concluded the S election termination was inadvertent and allowed the S corporation to continue its existence as an S corporation.

IV. Bankruptcy Court Rules that Sub S Status is a Corporate Asset That Shareholders Can't Terminate While S Corporation in Bankruptcy; In Re Vital Pharmaceuticals, 22-178424 (Bankr. S.D. FLA October 6, 2023).

Vital Pharmaceuticals was a Subchapter S Corporation that sought Chapter 11 Bankruptcy protection. Mr. John Owoc was the sole shareholder of Vital.

Vital entered into an asset sale agreement to sell its assets for $370 million which would have generated a substantial tax liability to Mr. Owoc. Mr. Owoc desired to revoke Vital's sub S election status prior to the closing of the sale transaction.

Three weeks before the asset sale was scheduled to close, Mr. Owoc filed his Motion asking the Court to confirm that Vital's S election was not property of the estate bankruptcy and that the bankruptcy court's automatic stay did not bar him from revoking Vital's S election. Mr. Owoc requested that the bankruptcy court lift its "automatic stay" so he could cause the S corporation to terminate its S corporation status by transferring his stock in Vital in a way that would cause Vital to become ineligible to be an S corporation.

Mr. Owoc contended that the Vital's S election was not property of the estate and therefore the automatic stay should not apply to acts he may take that would result in its termination.

The Bankruptcy court, however, refused to lift the automatic stay. Rejecting the Third Circuit's Court of Appeals reasoning in Majestic Star Casino, 111 AFTR 2d 2013-742 (May 21, 2013), the Court ruled that the S corporation status is the "property" of the S corporation-debtor's bankruptcy estate which was protected by the automatic stay. In Majestic Star, the Third Circuit Court of Appeals concluded that a debtor corporation's status as a qualified subchapter S status was not "property" of the bankruptcy estate.

But in Vital's case, the bankruptcy court came to a different conclusion. Of importance was the fact that the subchapter S status provided a benefit to the debtor-corporation by allowing the debtor-corporation to avoid corporate level income tax on its earnings.

The Court also determined that the power to terminate a subchapter S election rests with the corporation, and not with its shareholder. The fact that a shareholder can take action that results in the termination of a corporation's S status is irrelevant to whether the S election is property of the estate. The court noted that, while owners of an S corporation can take action that will result in the termination of the S election (such as by selling shares to an ineligible shareholder), it is "only the corporation that can revoke its S election", even though it cannot do so without the consent of its shareholders. An S election therefore is, indeed, property of the estate.

The court also reasoned that, although a corporation's right to its S election is contingent on a shareholder not taking action that could cause the termination of the S election, the S Corporation status gives a corporation the right to avoid paying taxes. Therefore, lifting the automatic stay would allow the officers and directors of Vital to breach their fiduciary duties to Vital by revoking its S election.

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

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

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

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

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

B. And, Revocation of S Corporation Status was Not Voidable as a Fraudulent Transfer; In re Health Diagnostic Laboratory, Inc., 578 B.R. 552 (Bankr. E.D. Va. 2017). In another case, a pre-petition (by one week) revocation of S corporation status was not voidable as a fraudulent transfer because the S election is not a property right of the debtor, since the debtor doesn’t have dominion and control over that right – only a majority of the shareholders can make the election or termination of S corporation treatment.

C. S Corporation Status is Not a Bankruptcy Property Interest, In Re: Gypc, Inc., DC OH, 129 AFTR 2d 2022-693, 2021 Bankr. LEXIS 2817 (SD OH, October 5, 2021).

The bankruptcy court again held that a prepetition conversion of a bankruptcy debtor from an S Corporation to a C Corporation could not be a voidable preferential or fraudulent transfer because the debtor's tax status was controlled by shareholders under federal law and therefore was not an asset of the bankruptcy estate.

D. But in Another Case, the Bankruptcy Court Refuses to Allow Partnership to Convert to C Corporation Status; In Re Schroeder Brothers Farms of Camp Douglas LL, 123 A.F.T.R. 2d 2019-2080, In Schroeder Brothers, the U.S. Bankruptcy Court in Wisconsin refused to allow the debtor, an entity taxed as a partnership for tax purposes, to convert to C corporation status by making the "check the box" election on Form 8832. The bankruptcy court held that allowing the partnership to convert to a C corporation was not in the "best interests" of the debtor, the estate, or its creditors.

V. New Revenue Procedure Provides S Corporation Termination Relief Without a Private Letter Ruling; Revenue Procedure 2022-19, Internal Revenue Bulletin Number 2022-41 (October 11, 2022).

On October 11, 2022, the IRS issued Rev. Proc 2002-19 (October 11, 2022) which allows S corporations and their shareholders to resolve frequently encountered issues with certainty and often without requesting a Private Letter Ruling.

This Rev. Proc. provides taxpayers with procedures to address issues that the IRS has historically identified as not affecting the validity or continuation of a corporation's S Election or the validity of an election by an S corporation parent to treat its corporate subsidiary as a qualified subchapter S subsidiary. In addition, the Revenue Procedure provides **retroactive corrective relief procedures** in certain circumstances to allow taxpayers to retroactively preserve S elections that are invalid or terminated solely as a result of one or more non-identical distribution provisions in the corporation's governing documents.

Disproportionate Distributions. Section 2.03 of the Revenue Procedure (pages 284 thru 286) addresses six (6) areas for which issues are now resolvable without having to receive a Private Letter Ruling, such as the following:

For example, Section 2.03(2) of the new Revenue Procedure provides for certain automatic relief where S corporation disproportionate distributions exist which otherwise would violate the one class of stock rule, as long as the corporation's governing documents provide for identical distributions and liquidation rights.

Filing the Wrong Tax Return. The Revenue Procedure also addresses situations where an S corporation files an income tax return that is inconsistent with the corporation's status as an S corporation or a QSSUB, such as where the S corporation or its QSSUB files a partnership tax return (Form 1065) or a C corporation return (Form 1120).

Section 2.03(5) (page 285) of the Rev. Proc. makes it clear that simply filing a tax return inconsistent with S corporation treatment does not affect the validity of corporation's S status. Section 3.05 of the Rev. Proc. describes how the taxpayers may correct inconsistent treatment.

Non-identical Governing Provisions. Section 2.03(6) (Pages 285 and 286) addresses a common situation where there is a question as to whether an S corporation should be deemed to have more than one class of stock because there are non-identical distribution provisions in the governing documents for the S corporation. (Presumably, a common scenario would be a limited liability company with typical LLC distribution and liquidation provisions in place preceding the date that the LLC elects to be taxed as an S Corporation.)

Section 3 of the new Revenue Procedure explains how to qualify for the Rev. Proc. amnesty without having to secure a PLR.

For example, Section 3.05 (page 287) provides procedures for addressing a federal tax return filing that is inconsistent with an S election or a QSSUB election. This part of the Rev. Proc. directs the taxpayer to file federal income tax returns for open taxable years consistent with its status as an S corporation or its status as the parent of a QSSUB, or to reflect the status of the subsidiary as a QSSUB.

Likewise, Section 3.06 of the Revenue Procedure (page 287 and 288) addresses how an S corporation can retroactively correct one or more non-identical distribution provisions in its governing documents. However, there are certain limitations on an S corporation's eligibility to rectify non-identical distribution provisions: (1) an S corporation may not have made any disproportionate distributions; (2) the S corporation must have timely filed all of its S corporation returns for each of the years where there exists nonidentical distribution provisions; and (3) the taxpayer must comply with all of the reporting requirements before the IRS discovers existence of non-identical distribution provisions in the S corporation's governing documents.

If these requirements are met, however, then the taxpayer can correct the problem by completing a corporate Governing Provision Statement in accordance with Section 3.06 (2)(c)(ii) of the Revenue Procedure, and a Shareholder Statement signed by each applicable shareholder in accordance with section 3.06(2)(c)(iii) of the Revenue Procedure. These statements are called "Corrective Relief Statements" and must be completed and retained in the permanent corporate tax records for future IRS inspection.

Note that there is no requirement that the corrective action statements be sent to the IRS; instead, they merely must be retained in the permanent internal records of the S corporation. Furthermore, Appendix A and Appendix B of the Revenue Procedure provides sample Corporate Governing Provision Statements and sample Shareholder Statements to use for this purpose.

Finally, Section 3.06(2)(e) of the Revenue Procedure (page 289) clarifies that an S corporation that does not qualify for corrective relief under Section 3.06 may still seek corrective relief through a PLR.

VI. **<u>The IRS Determines That Termination of S Corporation Status Was Inadvertent Where S Corporation Shares are Owned by an IRA.</u>**

In Private Letter Ruling 202319003, the IRS again demonstrated its willingness to grant amnesty to inadvertent S corporation terminations. Here, a corporation elected to be taxed as an S corporation, but the election was invalid because one of its shareholders at that time was an IRA. The IRA had been established for the benefit of its owner. According to the facts of the PLR, when the S election was filed, the officers of the S corporation and the owner of the IRA did not know that an IRA was not an eligible S corporation shareholder.

Soon after the corporation learned that the IRA was an ineligible shareholder, the S corporation stock was transferred from the IRA to its owner. In the PLR, the S corporation represented that it had filed all tax returns consistent with the corporation's status as an S Corporation. The PLR ruled that the circumstances resulting in the termination of the S election were "inadvertent and were not motivated by tax avoidance or retroactive tax planning." Therefore, the IRS waived the inadvertent termination and permitted the S corporation's status as of its original incorporation date.

However, as a condition for the favorable Private Letter Ruling, for all open years for which the S corporation showed positive income, the individual IRA owner would have to be treated as the actual shareholder for all purposes. And, for any open years that showed a net loss, the IRA had to be treated as the owner of the stock.

VII. IRS Waives Other Ineffective Elections and Inadvertent Termination.

In addition to PLR 202319003 noted above, the IRS has also recently issued a number of favorable Private Letter Rulings forgiving ineffective elections and waiving inadverdent S corporation terminations.

The following is a list of some of the more recent rulings:

1. Failure to File QSST Election Where Revocable "Grantor" Trust Ceased To Be Qualifying Shareholder Two (2) Years After Shareholder's Death. (PLR 202305004);

2. Failure To File ESBT Election Where Revocable "Grantor" Trust Ceased To Be Qualifying Shareholder Two (2) Years After Grantor's Death. (PLR 202233001);

3. Failure to File QSST Election. (PLR 202303002; PLR 202315004);

4. Failure to File ESBT Election. (PLR 202308006; PLR 202307004; PLR 202310003; PLR 202315001);

5. Beneficiary Failure to Consent to a QSST Election. (PLR 202315002);

6. Late QSSUB Election. (PLR 202325001; PLR 202325006).

7. Second Class of Stock Problems For an LLC Making an S Election. (PLR 202302004) (Also see PLR 202305002 where S Election terminated when LLC filed S Corp. election and then adopted new LLC Operating Agreement); and

8. S Corp. Stock Transferred to Ineligible Shareholder. (PLR 202234004: S Corp. stock transferred to a Section 501(a)(4) organization, but then transferred to an eligible S Corporation shareholder upon discovery that Section 501(c)(4) org. was not a "qualified shareholder"); (PLR 202307005: S corporation stock held by ineligible S corporation shareholder transferred to a permissible shareholder).

VIII. Shareholders of Bankrupt S Corporation Failed to Abandon Their Stock; Yaguda v. Commissioner, TC Summary Opinion 2022-21 (October 2022).

Mr. and Mrs. Yaguda owned stock of EFI, Inc., an S Corporation. In 2008, a creditor forced EFI into involuntary bankruptcy. Later that year, EFI's case was converted to a voluntary Chapter 11 bankruptcy proceeding. In addition, during 2008 Mr. Yaguda's ownership interest in EFI was transferred to a receivership created by the California Superior Court as a result of criminal proceedings initiated by California against Mr. Yaguda.

During 2015, EFI began selling its assets to raise funds for payment to its creditors. EFI issued a Form K-1 for 2015 reporting Mr. and Mrs. Yaguda had over $97,000 of distributive pass-through income. However, when Mr. and Mrs. Yaguda filed their income tax return, they failed to include any pass-through amounts from EFI on the basis they did not derive any personal benefit from the business activities of EFI during the year, since all of the liquidating sales proceeds went to the payment of EFI's creditors.

During the Tax Court proceedings, Mr. Yaguda contended he should not be taxable on any income attributable to EFI since all of his stock was transferred to a receivership. However, the receivership never exercised its authority to claim the EFI shares as property of the receivership. Instead, the receiver abandoned the shares, thus leaving them still owned by Mr. Yaguda.

Mr. and Mrs. Yaguda alternatively contended they had effectively abandoned their EFI stock before the liquidating sales took place. Past courts have held a partner can abandon partnership interests for federal tax purposes. Citron v. Commissioner, 97 TC 200 (1991). However, courts have required an affirmative action by the taxpayer to abandon the interest. The mere intention to abandon a partnership interest is insufficient to accomplish abandonment. See, Beus v. Commissioner, 261 F. 2d 176, 180 (9th Cir. 1958); United Cal. Bank v. Commissioner, 41 T.C. 437, 451 (1964), aff'd per curiam, 340 F. 2d 320 (9th Cir. 1965).

Mr. and Mrs. Yaguda, however, did not establish they had taken affirmative actions to transfer or abandon their stock in EFI. Therefore, Mr. and Mrs. Yaguda were taxable on their distributive share of pass-through income of EFI.

The court concluded the 20% negligence penalty under 6662(a) should not be assessed based on the reasonable, good faith defense. The court noted the appropriate tax treatment was not entirely clear from the proceedings in the California Superior Court and the bankruptcy court.

IX. Tax Court Rejects NOL Carryovers, Explains Partnership Tax Rules and At Risk Limitation Rules in the Case of Tiered Partnerships and Advises that Partners Do Not Increase Their Partnership Interest Tax Basis by Delivering Their Own Promissory Notes; Bryan v. Commissioner, TC Memo 2023-74 (June 20, 2023).

Mr. Bryan and his wife owned all of the membership interest in LLC One. In September 2007, Mr. Bryan issued a $2.7 million promissory note payable to LLC One. Then, LLC One acquired a 20% interest in LLC Two in exchange for issuance of a $2.7 million promissory note payable by LLC One to LLC Two.

Both $2.7 million promissory notes accrued annual interest of 4.75% and both notes were payable in full in 23 years. Neither note was secured with any collateral and neither note contained any repayment schedule.

LLC Two secured third-party financing that was guaranteed by another member of LLC Two. Neither of Mr. and Mrs. Bryan nor LLC One were personally liable for the third-party financing owed by LLC Two.

The operating agreements for both LLC One and LLC Two provided that members were not personally liable for debts and obligations of the LLC, and neither operating agreement contained deficit restoration obligations or any mandatory capital call provisions.

The IRS audited the Bryans' tax returns for 2010, 2011 and 2012. For those tax years, the Bryans had NOL carryovers from 2007, 2008 and 2009. The IRS challenged the NOL carryovers taking the position the Bryans had insufficient tax basis in their direct and indirect LLC interests and insufficient at-risk amounts in 2007, 2008 and 2009 to generate losses in those years that could be carried forward into 2010, 2011 and 2012.

The Tax Court ruled that neither Mr. and Mrs. Bryan nor LLC One acquired any tax basis in the LLC interests on account of the $2.7 million promissory notes delivered to the LLCs. Citing Vision Monitor Software LLC, TC Memo 2014-182 (Sept. 3, 2014), the court stated that a partner's contribution of its own promissory note to a partnership does not increase the partner's outside tax basis in its partnership interest.

In addition, the court ruled that LLC Two's debt owed to a third party did not increase LLC One's income tax basis in LLC Two. The Section 752 regulations provide that, in cases of tiered partnerships with recourse liabilities, the amount of liabilities of a lower-tier partnership (LLC Two) that can be allocated to the upper-tier partnership (LLC One) are equal to the amount of economic risk of loss the upper-tier partnership bears with respect to those liabilities. Treasury regulation 1.752-2(i). Here, neither the Bryans nor LLC One had any personal liability for the third-party debt owed by LLC Two, since that third-party debt was guaranteed by another member of LLC Two.

Once the court determined that the Bryans had insufficient tax basis in LLC One to generate losses in 2007, 2008 in 2009, the court further held that the Bryans also failed the "at risk" test under Section 465. First of all, the court found that the $2.7 Million promissory notes did not represent "bona fide indebtedness", because the court did not believe that the Bryans had any intention of ever satisfying those notes. And second, neither the Bryans nor LLC One were personally liable for any debts that LLC Two owed to third parties, and the operating agreements of LLC One and LLC Two did not require additional capital contributions of the members.

X. Special Income Allocation Fails the Substantial Economic Effects Test and Must be Reallocated in Accordance with the Partners Interests in the Partnership; Clark Raymond & Co. PLLC vs. Commissioner, TC Memo 2022-105 (October 13, 2022).

In Clark Raymond & Company, the Tax Court rejected the IRS's attempt to reallocate income away from LLC members withdrawing from the LLC. The court found the LLC's attempt to specially allocate income to its withdrawing partners failed the substantial economic effect test and therefore had to be reallocated in accordance with their partnership interests pursuant to Section 704(b) and the 704(b) Regs. Nevertheless, because the LLC operating agreement contained a qualified income offset provision and because the withdrawing partners had negative capital accounts at the end of the year, ordinary income would have allocated to the withdrawing partners in an amount necessary to bring their negative capital accounts back to zero.

CRC was an accounting firm operating as an LLC. There were three single-member entities that were member/partners of CRC during 2013. For short, we will call the three members C, N and T. During 2013, the three members were in the process of negotiating the buyout of C. They executed a restated operating agreement that contained a qualified income offset ("QIO") provision. The restated operating agreement contemplated certain withdrawing partners would receive a distribution of clients from the LLC.

After the restated operating agreement was executed, N and T withdrew from CRC and took a number of CRC clients. C, as the sole remaining partner, filed a 2013 tax return reporting that T and N had received deemed distributions from CRC equal to the value of the clients they took with them (at such values as determined under the operating agreement). C therefore decreased N's and T's capital accounts by the value of those client distributions, which caused N's and T's capital accounts to drop below zero. To restore their capital accounts to zero, C allocated all of CRC's ordinary income to N and T pursuant to the QIO provision. As a result, C was allocated no income for 2013.

N and T filed a Form 8082 "Notice of Inconsistent Treatment or Administrative Adjustment Request" protesting the 2013 income allocations. The IRS audited CRC's 2013 tax return and determined CRC's purported client distributions to N and T had not been substantiated, and therefore CRC's corresponding allocations of income to N and T lacked substantial economic effect.

The Tax Court concluded CRC failed to maintain capital accounts in accordance with the Section 704 regulations. Therefore, CRC's purported special allocations of income to N and T lacked substantial economic effect and had to be reallocated in accordance with the partners' interests in the partnership under Section 704(b) and Reg. 1.704-1(b)(3). However, the court agreed with the IRS that, because N and T had negative capital accounts at the end of 2013, they had to receive special allocations of ordinary income to bring their capital accounts up to zero.

The court scrutinized the capital account maintenance provisions in the operating agreement and concluded the agreement itself mandated that capital accounts be maintained in accordance with Reg. § 1.704-1(b)(2)(iv). The court found, however, the LLC failed to maintain the members' capital accounts in accordance with the provisions of Section 704(b) throughout the life of the partnership.

For example, under the operating agreement and Section 704(b), when the LLC made deemed distributions of its clients to its withdrawing members, the capital accounts of N and T should have been grossed-up to reflect any unrealized appreciation in the value of the client accounts distributed to them. That gross-up should have been reflected as a positive adjustment to their capital accounts before the corresponding reduction in their capital accounts to reflect the fair market value of the deemed distribution of the client relationships to N and T.

In 2013 when the client relationships were distributed to N and T, the Forms K-1 reflected the fair market value of those distributions. However, the capital accounts of N and T were not grossed-up to reflect unrealized appreciation in the values of the client relationships. Since the LLC failed to adhere to the capital account maintenance provisions in the operating agreement and the Section 704(b) Regulations, any special income allocations arising from the QIO provision would necessary fail all three of the substantial economic effect tests.

The court described the substantial economic effect test that determines whether the special allocations of income to N and T would be respected. The court reviewed the three tests for economic effect: the basic test, alternate test and economic equivalence test. Under all three of those tests, the partnership must follow the capital account maintenance rules in Section 704(b) and the 704(b) Regulations. Because the LLC did not strictly follow the capital account maintenance rules, the special allocations did not meet any of the substantial economic effect tests.

The court determined the LLC's income held to be allocated among the partners in accordance with their interests in the partnership as required under Section 704(b). To accomplish that, the partners' capital accounts had to be redetermined by first increasing N's and T's capital accounts to reflect how unrealized gain in the property distributed to them (the client relationships) would otherwise have been allocated among the partners if there were a taxable disposition of those client relationships for their fair market values. Reg. § 1.704-1(b)(2)(iv)(e)(1).

PART THIRTEEN

SECTION 6672 RESPONSIBLE PERSON LIABILITY FOR TRUST FUND TAXES

I. Background and Introduction.

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

II. Another Sad Case of the Boookkeeper Falling Victim to the Section 6672 Trust Fund Recovery Penalty; Kazmi, TC Memo 2022-13 (March 1, 2022).

In Kazmi, a bookkeeper, was found liable for the Section 6672 "trust fund" recovery penalty. The facts of this case are particularly sad.

First, the bookkeeper, Mr. Kazmi, was merely a part-time bookkeeper paid an hourly rate, who worked for an urgent care medical practice. Mr. Kazmi had no ownership interest in the urgent care practice, nor was he an officer or director. Mr. Kazmi was not even listed as an authorized signatory on any of his employer's bank accounts. Mr. Kazmi didn't have any check signing authority over the company's bank accounts, and he didn't have any authority to direct payments to the employer's creditors.

Unfortunately, Mr. Kazmi did handle all payroll functions for the urgent care. Because he transmitted payroll tax returns and made federal tax deposits on behalf of his employer, at a time when he was aware that withheld taxes had not been remitted to the IRS, he was held responsible for the trust fund recovery penalty.

III. Section 6672 Penalties Are Not Eligible For Section 6015 Equitable Relief; Chavis, 158 TC No. 8 (June 15, 2022).

In, Chavis, the Tax Court reminded us that the Section 6672 Trust Fund Penalty is just that, it is a penalty and it is not a tax. Therefore, a spouse cannot assert an Innocent Spouse Relief defense to assessment of the Section 6672 penalty.

In Chavis, the husband and wife were both owners of the same corporation that fell behind in paying the corporation's tax withholding. Here, the IRS determined that both the husband and wife were responsible persons who were personally liable for the withheld taxes under Section 6672.

However, the wife claimed that the husband was ***more at fault*** than she and contended that she should be eligible for Section 6015(f) "equitable innocent spouse" relief for purposes of the Section 6672 penalty. Again, however, the Court held that the Section 6672 Trust Fund Tax is a penalty, and **not** an ***income*** tax to which the "Innocent Spouse" defense is available.

PART FOURTEEN

INNOCENT SPOUSE CASES

I. Wife Entitled to Innocent Spouse Relief Even Though She Is Still Living With Her Ex-Husband; Pocock, TC Memo 2022-55 (June 6, 2022).

Mr. and Mrs. Pocock had a tumultuous relationship, to say the least, including allegations of verbal and physical abuse by Mr. Pocock. From 1995 through 2005, Mr. and Mrs. Pocock filed joint tax returns which contained large tax refunds due to Mr. Pocock overstating his federal tax withholdings. In some cases, Mr. Pocock signed Mrs. Pocock's name to endorse the refund checks.

Mrs. Pocock filed an Innocent Spouse Relief Request which was denied by the IRS. Subsequently, Mrs. Pocock decided to file her own US Tax Court Petition and represent herself in the Tax Court proceedings.

Even though Mrs. Pocock divorced Mr. Pocock, she was still living with Mr. Pocock at the time she applied for innocent spouse relief because she needed a roommate to save expenses. Mrs. Pocock believed her living arrangement with Mr. Pocock was more reliable than a typical rental situation.

Judge Vasquez applied Revenue Procedures 2013-34 and 2013-43 to determine whether Mrs. Pocock qualified for "equitable" relief under Section 6015(f). The Tax Court held in favor of Ms. Pocock noting that:

(1) no assets were ever transferred by Mr. Pocock to Mrs. Pocock as part of any fraudulent scheme;

(2) Mrs. Pocock didn't knowingly participate in the filing of any fraudulent returns; and

(3) all of the tax shortcomings were solely attributable to the income tax withholding misstatements by Mr. Pocock.

The court also noted that Mrs. Pocock would suffer economic hardship if she was not granted equitable relief. And, although they were still living together when the joint returns were filed, abuse was clearly present at that time.

Next, the court found that, although Mrs. Pocock did not have actual knowledge of Mr. Pocock's fraudulent activities, Mrs. Pocock likely had "constructed knowledge" of the fraud and had reason to know of her husband's withholdings overstatements when the joint returns were filed. The court noted that there was credible testimony as to physical and verbal abusive behavior on the part of Mr. Pocock. Because of the presence of abuse, the court held that this constructive knowledge did not weigh against granting equitable relief.

And, Mrs. Pocock credibly testified that her economic situation necessitated that she have a roommate. So, the fact that Mrs. Pocock was still living with Mr. Pocock when she applied for innocent spouse relief did not contradict her allegations of earlier abuse during the period when the joint returns were actually being filed.

II. No Innocent Spouse Relief Even Though Husband Signed The Wife's Name to Tax Return; Jones vs. Commissioner, 129 AFTR 2d 2022-588; 2022 U.S. App. LEXIS 3095 (9th Circuit Court of Appeals, February 3, 2022).

In Jones, Mrs. Jones argued that she was entitled to Innocent Spouse Relief because she did not consent to her ex-husband signing her name to a joint tax return for 2010. The Court, however, refused to grant Innocent Spouse Relief finding that Mrs. Jones ***tacitly*** consented to allowing her husband to sign the joint return on her behalf.

The Court found the following factors determinative:

1. Mrs. Jones provided her ex-spouse with a copy of her Form W-2 and other tax information so that Mr. Jones could use this information presumably to file their 2010

joint tax return;

2. Mrs. Jones failed to file a separate tax return for 2010, even though she otherwise would have been required to file a separate return; and

3. In later years, Mrs. Jones allowed her **new** husband to sign tax returns on her behalf.

Once the Court determined that Mrs. Jones had reason to know that her ex-husband would not pay the tax liability reported on the 2010 return, it was easy to conclude that Mrs. Jones didn't qualify for innocent spouse relief because she had ***tacitly*** consented to allowing her husband to sign the joint return for her.

III. 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.

PART FIFTEEN

NOMINEE, TRANSFEREE AND SUCCESSOR TAX LIABILITY CASES

I. Transferee, Successor and Nominee Liability Rules.

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

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

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

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

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

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

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

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

4. When the transaction is entered into fraudulently to escape liability.

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

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

II. <u>US District Court of Utah Allows Assessment of Successor in Interest Liability; ACI Construction, LLC vs. US, 13 AFTR 2d 2024-1418 (March 28, 2024).</u>

Sid Crookston, LLC operated a construction business for many years. After Sid Construction failed to pay Federal 941 taxes of over $2 Million, the principals of Sid Construction decided to form ACI Construction to take over the construction activities of Sid Construction. ACI Construction was formed by the Crookston family to take over Sid Construction's activities.

Various members of the Crookston family formed ACI Construction. Although Mr. Crookston, the patriarch of the Crookston family and primary stockholder of Sid Construction, owned no stock in ACI, the new owners of ACI (Sid's children) ensured everyone that Mr. Crookston would be in charge of ACI's operations. Likewise, Mr. Crookston himself met with some of Sid Construction's customers and advised that, although he would not have any stock in the new company, he would be helping his sons and stepson with ACI and that he would play a major role and remain heavily involved with its operations.

Soon after ACI was formed, Sid Construction went out of business, ceased operations but ACI picked up all of Sid Construction's employees, equipment and continued its to perform its construction contracts and its general business operations. ACI even paid off some of the creditors of Sid Construction, even though ACI never entered into any formal arrangements that required it to do so.

The District Court in Utah ruled in favor of the IRS and allowed the IRS to pursue federal tax liens against ACI, as a successor in interest of Sid Construction.

The Court based its decision upon four separate doctrines established under Utah state law: (1) the successor liability doctrine; and (2) the theory of a "de facto merger" between Sid Construction and ACI; (3) the theory that ACI had "implicitly agreed" to assume all debts and obligations of its predecessor; and (4) the fraudulent transfer doctrine.

The court also held that a separate tax assessment against ACI was not required because Section 6901 conveys transferee liability upon ACI, not as a new tax liability, but simply as an enforcement mechanism to allow the IRS to proceed to enforce an existing liability against ACI, as the successor in interest of Sid Construction.

The Court further concluded that the IRS was not required to issue a notice or demand for payment to ACI. Instead, the IRS was only required to send a payment demand to Sid Construction. According to the court, ACI "inherited" the demand for payment made to Sid Construction years earlier.

Finally, the court determined that ACI Construction was not even entitled to a CDP Notice or Hearing under Section 6320.

III. North Carolina District Court Examines NC Fraudulent Conveyance Statutes to Pursue Tax Claims Against Transferee Spouse; Boykin vs. US, 131 AFTR 2d 2023-1718 (DC NC May 15, 2023).

On May 15, 2023, the Federal District Court for the Middle District of North Carolina issued a decision in a case regarding the application of the North Carolina Fraudulent Conveyance Statutes to transfers made by a taxpayer to his spouse, at a time when the taxpayer had substantial tax debts.

In Boykin vs. US, 131 AFTR 2d 2023-1718 (DC NC May 15, 2023), the IRS asserted nominee liens against the spouse of Dr. James Balvich. Dr. Balvich was an emergency room physician that failed to pay his income taxes for a number of years. The IRS also assessed civil fraud penalties against Dr. Balvich.

Dr. Balvich's tax liability arose during the 1999 through 2006 tax years. In 2009, Dr. Balvich entered into an installment agreement with the IRS to satisfy his outstanding tax liabilities. Dr. Balvich subsequently defaulted under every IRS installment agreement. In 2019, the IRS brought a civil action against Dr. Balvich to reduce to judgment Dr. Balvich's tax liability. By the time everything was added up, as of January 2023, Dr. Balvich's tax liabilities to the IRS totaled almost $5 million.

In early 2010, Dr. Balvich began a romantic relationship with Ms. Boykin and Ms. Boykin began assisting Dr. Balvich with his medical practice. Soon after they married in June 2015, Dr. Balvich transferred a 50% membership interest in K.B. Management Services, LLC to Ms. Boykin. K.B. Management Services, LLC was an LLC through which emergency rooms paid Dr. Balvich for his work. Ms. Boykin did not pay Dr. Balvich any monetary consideration in exchange for Dr. Balvich's transfer to Ms. Boykin of a 50% membership interest K.B. Management Services, LLC.

At the time Dr. Balvich transferred the 50% LLC interest to Ms. Boykin, K.B. Management, LLC had no tangible assets, but did have a regular source of income from Dr. Balvich's work as an emergency room physician. From 2015 through 2019, Ms. Boykin actually received over $340,000 in guaranteed payments or in cash distributions from K.B. Management, LLC by virtue of her 50% ownership in the LLC.

Ms. Boykin filed an action to seek a declaratory judgment that certain IRS nominee tax liens asserted against her primary residence were invalid.

The IRS sought to enforce its nominee liens against Ms. Boykin's residence. The IRS asserted that Ms. Boykin received fraudulent transfers from Dr. Balvich in the form of (i) excessive compensation and (2) transfer of 50% ownership interest in K.B. Management Service, LLC, without adequate consideration.

Both the IRS and Ms. Boykin filed motions for summary judgment as to whether the transfers from Dr. Balvich to Ms. Boykin violated North Carolina Uniform Voidable Transaction Act under N.C.G.S. 39-23.4(a) and/or N.C.G.S. 39-23.5.

N.C.G.S. 39-23.4(a) "Future" Creditor Remedy Under the North Carolina Uniform Voidable Transaction Act.

N.C.G.S. 39-23.4(a) provides present and future creditors a potential remedy to void certain transfers by the debtor under the North Carolina Uniform Avoidable Transactions Act. N.C.G.S. 39-23.4 can be asserted by future creditors that did not even exist at the time of the original alleged fraudulent transfer.

N.C.G.S. 39-23.4(a) provides that certain transfers made by a debtor is fraudulent as to **an existing creditor, or a future creditor,** and regardless of whether a creditor's claim arose **before or after** the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

(1) With the "intent" to defraud "any creditor" of the debtor; or

(2) Without receiving equivalent consideration if the debtor was insolvent, or would be rendered insolvent, at the time of the transfers.

Specifically, N.C.G.S. 39-23.4(a) provides:

(a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

(1) With intent to hinder, delay, or defraud any creditor of the debtor; or

(2) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

a. Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

b. Intended to incur, or believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.

<u>N.C.G.S. 39-23.5 "Present Creditor" Remedy under North Carolina Uniform Affordable Transactions Act.</u>

N.C.G.S. 39-23.5 provides for potential fraudulent conveyance remedies where a transfer is determined to be fraudulent as to a **present creditor**, whose claim arose **before** the transfer was made.

Specifically, N.C.G.S. 39-23.5(a) provides:

> (a) A transfer made or obligation incurred by a debtor is voidable as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.

<u>Summary Judgment Claims Under N.C.G.S. 39-23.4</u>

The court noted that both tests under 39.23.4(a) require a determination of Dr. Balvich's intent. The IRS argued that Dr. Balvich transferred a 50% ownership interest in K.B. Management to Ms. Boykin in exchange for nothing **<u>and</u>** to avoid collection of his outstanding liability. Ms. Boykin, on the other hand, contended that Dr. Balvich had legitimately transferred a 50% ownership interest to her to recognize her work as his administrative assistant and the life-long commitment they had made through marriage.

Ultimately, the court held that the merits of the parties' arguments under N.C.G.S. 23.4(a) depended upon a determination of Dr. Balvich's intent, and that therefore his intent was the essence of a material factual dispute. Therefore, summary judgment could not be rendered in favor of either party with respect to the fraudulent conveyance claims under N.C.G.S. 39-23.4(a).

<u>Summary Judgment Claims Under N.C.G.S. 39-23.5.</u>

On the second claim under the North Carolina Uniform Avoidable Transactions Act, the court granted summary judgment in favor of the IRS stating that the IRS was entitled to a judgment as a matter of law under N.C.G.S. 39-23.5(a), since the transfer met **all three (3) elements** of the fraudulent conveyance statute pertaining to present creditors as of the date of the transfer.

First, the transfer of K.B. Management interests occurred in 2015, which was **long after** the IRS made its tax assessments against Dr. Balvich in 2010.

Second, the court concluded that Dr. Balvich received **nothing in exchange** for his transfer. Ms. Boykin argued that there existed a factual dispute as to whether she received anything in return for Dr. Balvich's transfers, since the LLC "had no assets" at the time of the transfer. The Court stated, however, that regardless of its balance sheet, K.B. Management had (and was expected to have) significant sources of income at the time of the ownership change by virtue of Dr. Balvich' ongoing 36-year career as a physician. That reality was clearly demonstrated by the fact that Ms. Boykin received over $340,000 in future distributions due to her 50% ownership interest in K.B. Management, LLC.

The court also determined that Ms. Boykin provided **no equivalent value** for the transfer, even though Ms. Boykin contended that she provided Dr. Balvich with "love, affection and companionship for the entirety of their marriage". North Carolina courts have held in the past that "love, affection and companionship" is not valid consideration in the context of the North Carolina Uniform Avoidable Transactions Act. Specifically, D.W.C. 3 vs. Kissel, 246 NC App 361 (2016) held that a transfer motivated by love and affection does not constitute "reasonably equivalent value" under North Carolina fraudulent transfer statute.

And third, it was clear that Dr. Balvich was **insolvent** at the time of the transfer since the outstanding tax liabilities dwarfed the amount of his assets.

Therefore, the court issued summary judgment in favor of the IRS and permitted the US to recover a monetary judgment against Ms. Boykin.

IV. Bankruptcy Court Allowed to Pursue Fraudulent Conveyance Claims Under IRC Section 6502 Ten-Year Collection Period and is Allowed to "Reverse Pierce" the Debtor's LLC Corporate Veil; In Re: Palmieri, Bankruptcy Court IL, 131 AFTR 2d; 2023-1705 (May 15, 2023).

After Mr. Palmieri was facing millions of dollars in outstanding tax liabilities, Mr. Palmieri made a series of transfers of his residence, called the "Byron Property", to a number of Trusts, for the benefit of family and friends, and to his own revocable living trust. The Byron Property was Mr. Palmieri's personal residence where he continued to live up to the date of the bankruptcy trial.

Mr. Palmieri created Specialty Industries, LLC ("Specialty Industries"), which was a Delaware Series limited liability company owned 90% by Mr. Palmieri's revocable trust. The remaining 10% of Specialty Industries was owned by Specialty Industries II, LLC (a Colorado LLC) which was owned by Mr. Palmieri's revocable trust and by Mr. Macchitelli, who was one of Mr. Palmieri's closest friends. The revocable trust and Mr. Macchitelli each owned 50% of Specialty Industries II.

Specialty Industries was divided into two (2) Delaware "Series" LLC's under the Delaware Limited Liability Company Act, called Series Rosemont and Series Rosemontto.

Mr. Palmieri transferred title to the Byron Property to Series Rosemont on September 14, 2005.

In April 2010, a Federal Grand Jury indicted Mr. Palmieri on twenty-one (21) counts of tax fraud. Sometime after April 29, 2010, Mr. Palmieri pled guilty, and as part of his plea bargain, he agreed to pay restitution of almost $673,000.

On January 2, 2011, eleven (11) days before his sentencing, Mr. Palmieri and Mr. Macchitelli transferred 100% of their interests in Specialty Industries II to Mr. Palmieri's girlfriend, Karen Witt.

Ms. Witt was also the beneficiary of the assets of the Byron Street Land Trust which was an Illinois Trust created to own the Byron Property.

In July 2014, the Byron Property was transferred to Series Rosemontto and then over to Specialty Industries II (for no consideration), and on October 19, 2015, Specialty Industries II conveyed the Byron Property to Ms. Witt (again, for no consideration).

Finally, in August of 2019, as the IRS was continuing to investigate Mr. Palmieri and the Byron Property, Ms. Witt conveyed the Byron Property to the Byron Trust.

The bankruptcy trustee sought to unwind the transfers of the Byron Property under the Delaware Uniform Fraudulent Conveyance Act (the "UFCA"). Mr. Palmieri argued that any claim under the UFCA must be brought within four (4) years after the transfer was made and thus were time barred. The Bankruptcy Trustee argued, however, that Section 544(b) of the Federal Bankruptcy Code allows the Bankruptcy Trustee to pursue fraudulent conveyance claims under the ten (10) year collections statute of limitations available to the IRS in collection actions under IRC Section 6502(a)(1).

The Bankruptcy Court noted that there was a "split authority" as to whether a Bankruptcy Trustee can "step into" the shoes of the IRS under Section 544(b) of the Bankruptcy Act and use the ten (10) year statute of limitations window available to the IRS for collection of assessed taxes under IRC Section 6502.

The Seventh Circuit, where the Palmieri case would be appealed to, had not addressed this issue, but a majority of other courts had concluded that Section 544(b) of the Bankruptcy Code indeed allows a Bankruptcy Trustee to take advantage of the longer ten (10) year collections period, as long as the IRS is a creditor in the Bankruptcy case. See e.g. Bledsoe v. Flamingo Props, LLC (In Re Musselwhite, 128 AFTR 2d 2021-6064 (Bankr. E.D.N.C. September 23, 2021)).

Ultimately, the Illinois Bankruptcy Court decided to adopt the majority rule, and allow the Bankruptcy Trustee to proceed under the ten (10) year collection statute otherwise available to the IRS, since the IRS was clearly a creditor in Mr. Palmieri's bankruptcy proceedings.

Next, the Trustee then moved to pursue a claim "for reverse veil piercing" to reach the Byron Property.

Mr. Palmieri argued that, when the Byron Property was transferred to Specialty Industry II on July 21, 2014, Mr. Palmieri did not own the Byron Property on that date, and therefore the Trustee's attempts to pursue the Byron Property under the "reverse veil piercing" theory should fail.

Mr. Palmieri claimed that he transferred his interest in the Byron Property to Series Rosemont on September 14, 2005, and therefore the transfer of the Byron Property in July 2014 was made by Series Rosemont and not by Mr. Palmieri himself.

The Court quickly dismissed with this argument, on the basis that Series Rosemont was Mr. Palmieri's "alter ego" and therefore the Byron Property never left the Bankruptcy estate when it was transferred from Mr. Palmieri to Series Rosemont in 2005. Therefore, the sole issue for the Bankruptcy Court was whether the Bankruptcy Trustee had alleged sufficient facts to state a "reverse veil piercing" cause of action. And, since Special Industries was a Delaware Series LLC, Delaware Law would govern whether "reverse veil piercing" is appropriate.

The Court noted that, when considering a claim for "reverse veil piercing", Delaware Courts look to the same factors reviewed by Delaware Courts when analyzing a "traditional veil-piercing claim." These factors would include alter ego factors, insolvency of the debtor, undercapitalization, commingling of corporate and personal funds, any absence of corporate formalities and whether the property owner was merely a facade for the equitable owner. Manichaen Cap. LLC v. Exela Techs, Inc., 251 A.3d 695 (Del. Ch. 2021).

If these facts are present, then the court would then ask whether the owner of the asset is utilizing the corporate form to perpetuate fraud or an injustice.

Here, it was clear that Mr. Palmieri had complete control over Series Rosemont and that he had failed to comply with corporate formalities, that he had conveyed Byron Property to Series Rosemont without receiving any consideration in return, and that Mr. Palmieri continued to use it as his primary residence throughout the entire history of various transfers.

Also, Mr. Palmieri's Revocable Trust and Specialty Property II were the members of Series Rosemont. Mr. Palmieri was Series Rosemont's sole manager who had complete control over virtually all matters regarding Series Rosemont. In addition, under the Series Rosemont Operating Agreement, the manager could be changed only with a majority vote of non-manager members, and here the only non-managing member was Specialty Industries II which was owned 50% by Mr. Palmieri. Since Mr. Palmieri held a 50% veto vote over Specialty Industries II, he could not be removed as manager of Series Rosemont without his consent.

The Court concluded these facts were sufficient to justify a "reverse veil piercing" remedy.

V. <u>IRS Allowed to Foreclose on Property Held by a Nominee Even Though the Taxpayer Never Owned the Property; US vs. Hovnanian, 130 AFTR 2d. 2022-6796 (December 27, 2022).</u>

In <u>Hovnanian</u>, the District Court allowed the IRS to foreclose on real property under the nominee theory even though the taxpayer never held a direct ownership interest in it. Mr. Shant was subject to extensive tax liens for engaging in tax shelters. He had more than $16 million in unpaid federal taxes related to those illegal tax shelters.

Mr. Shant's mother-in-law transferred a personal residence located in Red Bank, New Jersey (the "Red Bank residence") to a trust created by Mr. Shant for the benefit of his children. The trust paid $1 to purchase the Red Bank residence from Mr. Shant's mother-in-law. She made the transfer after the tax assessments against Mr. Shant. Mr. Shant's sister-in-law, Nina Hovnanian, was the trustee of the trust. Mr. Shant and his wife lived in the Red Bank residence and were responsible for paying all expenses associated with the home. Mr. Shant never paid any rent to the trust.

The IRS sought a determination that the trust was Mr. Shant's "nominee" so the tax liens assessed against Mr. Shant consequently attached to the Red Bank home. The District Court agreed with the IRS. The court held the trust merely held legal title to the Red Bank home. In reality, Mr. Shant had total control over the property as "evidenced by him paying the property's bills, living on the property, and being the decision maker for anything that had to do with the property". Case law confirms the government can enforce its liens against the taxpayer's property, including property held by a nominee or alter ego. <u>United States vs. Wunder</u>, 124 AFTR 2d. 2019-5069, aff'd, 829 App'x 589, (3d. Cir. 2020).

The court relied primarily on <u>United States vs. Patras</u>, 544 F. App'x 137, 113 (3rd Circuit 2013), which held when "there is a tax lien on a taxpayer's property, the Government may seek to satisfy by levying upon property the taxpayer controls". In other words, if property is under the control of the third party but the third party is the nominee or alter ego of the delinquent taxpayer, the property can be subject to the taxpayer's tax lien. Under <u>Patras</u>, the test for a nominee relationship, under both federal and New Jersey law, generally is based on the following six factors:

1. Whether the nominee paid adequate consideration for the property;
2. Whether the property was placed in the nominee's name in anticipation of a suit or other liabilities while the taxpayer continued to control the property;
3. The relationship between the taxpayer and the nominee;
4. The failure to record the conveyance;
5. Whether the property remained in the taxpayer's possession; and
6. The taxpayer's continued enjoyment of the benefits of the property.

Mr. Shant argued the first and second tests of <u>Patras</u> could not be met because Mr. Shant never held legal title to the Red Bank residence. He argued the government should be barred from pursuing a nominee lien against the property since he was never in the chain of title to the home.

The court, however, ruled the focus in the first and second tests is not on the taxpayer, but instead is on the nominee. The question is not whether the taxpayer paid adequate consideration for the transfer, nor whether the taxpayer was ever in the chain of title. Instead, the sole focus is whether the nominee paid adequate consideration for the property transfer. The trust only paid $1 for the property. Mr. Shant exerted total control and dominion over the home after it was transferred to the trust. Thus, the tests of Patras were met. Interestingly, the court noted Mr. Shant was actually the settlor of the trust. The decision, however, does not offer any insight whether the court would have reached a different decision had someone else (such as Mr. Shant's mother-in-law) been the settlor of the trust.

VI. US District Court of Arizona Considers Fraudulent Conveyance, Alter Ego and Nominee Theories for Real Estate Liens; TBS Properties, LLC vs. United States 129 AFTR 2d 2022-1080, 2022 U.S. Dist. LEXIS 45835 March 15, 2022.

In TBS Properties, various members of the Perry family owned a number of restaurant franchises. There were a total of thirteen restaurants, each of which was operated under a separate S corporation. The Perry family also owned the real property in which each restaurant was located, and the real properties were owned by thirteen separate LLCs.

In 1998, Mr. and Mrs. Perry transferred real property to one of the LLCs, called TBS Properties, LLC. Beginning in 2000, TBS began leasing its real property to RAEDON, Inc., via an unsigned lease arrangement. Then, in 2012, when Mr. and Mrs. Perry passed away, all of their closely-held business interests passed to certain trusts for the benefit of their heirs.

Between 2015 and 2017, RAEDON amassed over $150,000 in back tax liabilities. In 2019, the IRS filed a Notice of Federal tax Lien against the property held by TBS, LLC that was being leased to RAEDON. TBS then brought a "quiet title" action against the IRS requesting a "judicial determination and order" that "the United States has no lien interest or any other interest in or against" the TBS property.

The IRS then sought a declaratory judgment confirming that its lien was valid based upon three (3) "successor liability" theories:

1. The "fraudulent transfer" theory;

2. The "alter ego" theory; and

3. The "nominee" theory.

TBS then moved for summary judgment on all three IRS' theories. Here is where the Court came out.

First, on the "Fraudulent Transfer" argument, the District Court granted summary judgment in favor of TBS by virtue of the fact that RAEDON never transferred any of its real property to TBS. Instead, the transfer came directly from Mr. and Mrs. Perry.

The Court next looked at the "alter ego" claims. The Court noted that both the IRS and the taxpayer agreed that, in order for the IRS to be successful on the "alter ego" theory, regardless of whether the court applied federal law or state law, the United States would have to prove two (2) elements to establish "alter ego" liability:

1. Unity of Control; and
2. That observance of the corporate form would sanction fraud or promote injustice.

The Court noted that "unity of control" was clearly at play here, since the owners of the properties (the LLC's) and the S corporations had common ownership, common officers and directors. This fact, combined with the absence of an executed written lease between TBS and RAEDON, could lead the "trier of fact" to conclude that unity of control existed.

Second, the court held that a trier of fact likewise could determine that there was "fraud or injustice" arising here by virtue of the fact that RAEDON's tax liabilities had gone unpaid at a time when there were various cash transfers between RAEDON and TBS.

Finally, the Court held that the IRS also could pursue the "nominee" liability theory. According to the Court, since the nominee theory had never been expressly rejected by past Arizona courts, the Court could not grant summary judgment in favor of TBS on the nominee liability theory.

PART SIXTEEN

OTHER TAX COLLECTION MATTERS; JOINTLY-OWNED PROPERTIES

I. Tenancy by the Entirety Property Can't Escape the IRS Tax Lien in Bankruptcy; Morgan v. Bruton, No. 22-1964, 2024 U.S. App. LEXIS 9266 (4th Cir. Apr. 17, 2024).

Ronald Morgan owned "tenants by the entirety" real property with his wife located here in North Carolina. In July 2021, Mr. Morgan filed for Chapter 7 bankruptcy and listed his tenants by the entirety single family home on his asset list schedule. Mr. Morgan also showed that he owed a debt to the IRS that was strictly a debt of Mr. Morgan, as Mrs. Morgan did not owe any of that tax debt to the IRS.

At the time Mr. Morgan filed for Chapter 7 bankruptcy protection, the IRS had not yet filed a federal tax lien to perfect its lien against Mr. Morgan's interest in the tenants by the entirety real property.

In his bankruptcy filing, Mr. Morgan took the position that the single family home, held as tenants by the entirety, was exempt from the bankruptcy estate under 11 U.S.C. 522(b)(3)(B) which allows the debtor to keep his entirety's interest outside the bankruptcy estate, thus protecting the tenants by the entirety real property from creditors, but only "to the extent that such interest … is exempt from process under applicable non-bankruptcy law." 11 U.S.C. 522(b)(3)(B).

Generally, under North Carolina law, tenants by the entirety real property is exempt from claims of creditors. Dealer Supply Co. v. Greene, 422 S.E.2d 350, 352 (N.C. App. 1992) ("In North Carolina, it is well established that an individual creditor of either a husband or a wife has no right to levy upon property held by the couple as tenants by the entirety."); accord L & M Gas Co. v. Leggett, 161 S.E.2d 23, 26 (N.C. 1968); Grabenhofer v. Garrett, 131 S.E.2d 675, 677 (N.C. 1963).

The Bankruptcy Trustee, however, asserted that the single-family tenants by the entirety home was not exempt, notwithstanding the fact that, under normal North Carolina law, tenants by the entirety's property is exempt from creditors.

According to the Trustee, that North Carolina exemption does not apply to tax obligations owed to the United States, under the Supreme Court decision in Craft vs. US, 535 US 274 (2002). In the United States Supreme Case of U.S. vs. Craft, the United States Supreme Court ruled that a federal tax lien under IRC Section 6321 could attach to a husband's entirety interest even though only the husband owed tax debts to the IRS. The Craft court found that each tenant in the tenants by the entirety arrangement possesses individual rights in the tenants by the entirety real property that constitutes "rights to property" for purposes of a federal tax lien.

Mr. Morgan, however, raised two alternative arguments for his position that his home was "exempt from process".

First, Mr. Morgan argued that the IRS would have had to have actually obtained a tax lien prior to the bankruptcy filing, and that simply having the right to obtain the lien was insufficient to prevent the tenants by the entirety property from being exempt from creditor's claims. The bankruptcy judge dismissed this argument based upon the court's decision in Sumy vs. Schlossberg, 777 F.2d 921 (4th Circuit 1985), where the court stated that the absence of a judgment or lien has no bearing on the hypothetical issue of whether the debtor's interest would be "exempt from process" under 11 USC 522(b)(3)(B). Although Sumy involved both spouses, the Court found no reason to impose a different rule in Mr. Morgan's case.

Next, Mr. Morgan argued that Craft requires the IRS to perfect its tax lien against his property before he actually filed for bankruptcy. The Bankruptcy Court ruled that nothing in Craft suggested that providing notice of the lien was necessary for the IRS to obtain an interest in the property. Therefore, the Craft decision is not limited to only those instances where the IRS has perfected a tax lien against the property prior to the bankruptcy filing. Craft merely addressed whether a tax lien could attach to the interest of the spouse who owed the tax debt and not whether the lien could attach to the spouse who did not owe the tax debt. There was nothing in Craft that suggested that providing notice of the lien was necessary for the IRS to obtain an interest in the specific property.

II. 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).

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 Rodgers, 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.

PART SEVENTEEN

INCOME SUBJECT TO SELF-EMPLOYEMNT TAXES

I. The Tax Court Rules that Limited Partners in State Law Limited Partnership Are Not "Automatically Exempt" From Self-employment Tax; Instead, the "Functional Test" Determines Whether a Limited Partner Is Exempt From SE Tax, Soroban Capital Partners, LP, 161 TC No. 12, November 28, 2023.

A. Background.

Section 1402(a)(13) contains the well-known "limited partner" exception that excludes, from net earnings from self-employment tax, the limited partner's distributive share of partnership income other than guaranteed payments. Of course, the historical problem is that Section 1402(a)(13) does not define the term "limited partner" for these purposes.

In 1997, the IRS issued proposed regulations to define the scope of the limited partner exception to Section 1402(a), but by July 1998, after professional public outcry, Congress issued a moratorium prohibiting the IRS from issuing any temporary or final regulations with respect to the limited partner definition under section 1402(a)(13). Since that moratorium, Congress has declined to take further action as to the appropriate definition of "limited partner" for purposes of Section 1402(a)(13).

Several years ago, in Renkemeyer, L.L.P., 136 TC 137 (2011), the Tax Court held that limited partners in a law firm operated as a limited liability partnership (an LLP), rather than as a traditional state law limited partnership, would be subject to a "functional analysis" test to determine whether the limited partner exception to Section 1402(a)(13) applied to the limited partner lawyers of that law firm. However, that court did not address whether a limited partner in a state law limited partnership must also satisfy a "functional analyses" test to be entitled to the limited partner exception. And, other cases in the context of a limited liability company have found that certain professional LLC members were not "limited partners" for purposes of Section 1402(a)(13). Castigliola v. Commissioner, TC Memo 2017-62 (April 12, 2017).

B. Soroban Capital Partners, LP, 161 TC No. 12, (November 28, 2023).

Soroban Capital Partners was a state law limited partnership owned by three limited partners and its general partner. During the tax years at issue, the limited partnership reported guaranteed payments to its limited partners plus the general partner's share of ordinary business income as income from self-employment earnings. The IRS took the position that Soroban's net earnings from self-employment should also include the share of ordinary business income allocated to the limited partners by taking the position that those individuals were "limited partners in name only."

Soroban Capital Partners then filed a Motion for Summary Judgment asking the court to conclude that the ordinary business income component allocated to the limited partners would be exempt from self-employment tax by virtue of the fact that the partners were designated as limited partners. Soroban argued that limited partners of a state law limited partnership are automatically excluded from application of the self-employment tax on their distributive share of partnership income.

The Tax Court, however, held that a limited partner's distributive share of partnership income would not automatically be excluded from potential imposition of self-employment tax merely by virtue of their status as limited partners. The court stated that, in enacting Section 1402(a)(13), Congress had intended for the limited partner exception to apply to earnings that were of an investment nature and, determining whether earnings allocated to limited partners are of an "investment nature" necessarily requires an inquiry into the functions and roles those limited partners provide to the limited partnership as a whole.

Therefore, in denying the taxpayer's motion for summary judgment, the court held that the distributive shares of income of limited partners in state law limited partnerships would not automatically be exempt from self-employment income and instead the court would be required to apply a functional analysis test to determine whether the limited partnership exception under Section 1402(a)(13) would apply to those limited partners in that specific case.

PART EIGHTEEN

EMPLOYEES VS. INDEPENDENT CONTRACTORS

I. Medical Office Workers Did Not Qualify as Independent Contractors and Employer Didn't Qualify for Section 530 Safe Harbor Relief; Cardiovascular Center, LLC v. Commissioner, TC Memo 2023-64 (May 18, 2023).

In Cardiovascular Center LLC, the IRS issued a Notice of Employment Tax Determination of Worker Classification to Cardiovascular Center LLC and determined that the LLC failed to classify some of its workers as employees during the applicable tax periods. The Notice of Determination further stated that the LLC was not eligible for Section 530 Safe Harbor Relief. Thus, the LLC owed significant federal employment taxes in addition to late filing and late payment penalties.

Dr. Frank Kresock owned 100% of Cardiovascular Center LLC which was an Arizona limited liability company.

The workers at issue included Jeanine Smith, who worked as an office manager, and four other medical assistants that assisted Dr. Kresock in his practice.

Applying the twenty (20) factor common law test, the court quickly determined that the workers qualified as employees rather than as independent contractors. For example, the workers were paid a set hourly rate; they were subject to Dr. Kresock's direct supervision; they were expected to follow certain office procedures set by Dr. Kresock; none of the workers could realize a profit or loss from their services; there were no formal employment contracts in place;

the workers received previous training from Dr. Kresock and he supplied their work supplies and tools.

In addition, all the workers worked almost every day at the medical practice, had worked there for years and did not freely work for other employers.

The court noted that the most significant element of the twenty (20) factor test was the degree of control over the worker, and that Dr. Kresock controlled every aspect of the workers' services. In addition, the work performed by the workers were a central aspect of the LLC's regular business as a medical office. Also, after the workers received their practical training at the LLC’s facility, they had all expressed an interest in working for the practice after their formal training.

The Court also noted that, under Ewens v. Miller, Inc., 117 TC 263 (2001), a transitory relationship tends to point toward independent contractor status. Here, however, all of the workers had stayed with the practice for a number of years following their practical training at the center.

Based upon all these factors, these workers were employees, and not independent contractors, under the common law twenty (20) factor test.

Next, the court found that the LLC could not qualify for Section 530 relief because it failed two of the four Section 530 “safe harbor” requirements. First, the practice failed to issue Forms 1099 or Forms W-2 to the workers, thereby failing the second of the four Section 530 “safe harbor” requirements, known as the reporting requirement.

Second, under the third Section 530 test (called the "reasonable basis" test), the taxpayer has to prove that it relied upon at least one of the following: (1) judicial precedent or published rulings; (2) a past IRS audit upholding independent contractor treatment; or (3) long-standing recognized practice industry practice.

Here, there was no evidence that the center relied upon any of these factors when making its decision to classify its workers as independent contractors, rather than as employees.

II. Tax Court Rules That Private Duty Nurses are Employees for Employment Tax Purposes; Pediatric Impressions Home Health, TC Memo 2022-35 (April 12, 2022).

Pediatric Impressions provides a great overview of the application of the Section 530 “Safe Harbor Relief” rules, as well as a terrific overview of the twenty (20) factor “common law employee” test.

Pediatric Impressions provided at-home private duty nursing services to children with special needs. Prior to 2016, the company treated the nurses as employees for federal employment tax purposes, but starting in 2016, the company began treating many of their nurses as independent contractors. However, the jobs and services performed and provided by the nurses remained substantially the same even after the change from employee to independent contractor status.

During the tax years at issue, the company didn't make any federal employment tax deposits. The IRS assessed tax, interest and penalties for the company's failure to make employment tax deposits.

The Tax Court sided with the IRS and held that the nurses should have been properly characterized as common law employees during the tax years and that the company was not eligible for the Section 530 "Safe Harbor" relief.

In addition to being liable for the employment taxes and interest, the Court also held that the company was liable for penalties under Section 6651(a)(1) and for "failure to deposit" penalties under Section 6656, as well as the accuracy related penalties under Section 6662(a).

A. <u>Legal Classification of Nurses as Employees.</u> Based upon the twenty factor "common law employee" test, the Court ruled that the nurses were employees and not independent contractors.

Here, there were many factors that weighed heavily against the company. The company informed the nurses that they were "employed" on a "full time" basis with the company. The nurses were required to apply for jobs, undergo a background check and complete a nursing skills assessment.

Nurses were paid on an hourly rate basis based upon their own timesheets. Although the company didn't offer any employee benefits to the nurse, the nurses were reimbursed for certain transportation expenses and the nurses were not expected to provide their own supplies or equipment needed to perform their jobs.

All payments for the nurses' services were paid directly to the company, and the nurses had no contact with insurance companies or any other third-party reimbursement providers.

The company set the nurses' work schedules and most nurses were assured full-time work. If a nurse could not work her assigned shift, then she could not arrange for her own replacement. The third-party physicians for each of the company's clients prescribed the patient's "plan of care" and the company was ultimately responsible for ensuring that the nurses followed those plans of care.

The company had case managers on hand that would solicit feedback from clients, and it was the company that directed any type of counseling, discipline, reassignment or termination.

Based upon all these factors, it was easy for the court to conclude that the nurses should have been treated as employees and not as independent contractors.

B. **The Court's Discussion of Section 530 Relief.** Section 530 is the "get out of jail free card" which provides that an employer is automatically exempt from employment tax liabilities for worker misclassifications if all of the following four (4) requirements are met:

1. The employer never treated the same worker as an employee for any period (the "historic treatment" requirement);

2. The employer doesn't treat workers in similar positions as employees (the "substantive consistency" requirement);

3. All Federal tax returns (i.e., 1099s) were filed for the worker as an independent contractor (the "reporting test"); and

4. The employer had a "reasonable basis" for not treating the worker as an employee (based upon past court cases, revenue rulings, a long-standing industry practice, prior IRS audit or a strong opinion letter from a tax professional) (the "reasonable basis" test).

The Court quickly ruled that Section 530 relief was not available for the company. Here, the company treated the same nurses as employees in one period and as independent contractors in another. So, the company didn't meet the historical treatment requirement.

Also, similarly situated workers sometimes were treated as independent contractors and in other times as employees, so the company also failed to meet the "substantive consistency" requirement.

Because the company failed to satisfy both the historical treatment requirement and the substantive consistency requirement, Section 530 relief was not available.

C. **Court Upholds Penalties.** Finally, the Court also upheld the penalty assessments since the company failed to present any evidence to show that there was any reasonable cause to abate any of the penalties. Although the company's president and sole shareholder claimed that she was simply following the advice of her CPA, she failed to offer any evidence in trial to support her claims.

PART NINETEEN

THE "MAILBOX" RULE AND LATE FILED TAX COURT PETITIONS

I. The Common Law and The Statutory Mailbox Rules. Under the old common law mailbox rule, if a document was placed in the US Mail, then there was a presumption that mailed documents were physically received by the IRS in the time that such a mailing would normally take to arrive. This common law mailbox rule created all kinds of problems for taxpayers because the rule necessitated testimonial circumstantial evidence to establish proof of timely filing of a tax document.

Then, Section 7502 was enacted to provide a statutory "safe harbor" mailbox rule.

Section 7502(a) creates a presumption of the timeliness of the "filing" of a document. Under Section 7502(a), a document is deemed timely filed if it is: (1) deposited in the US mail in a properly addressed envelope with adequate postage; (2) postmarked on or before the prescribed filing date; and (3) actually delivered by the US Mail to the IRS, even after its due date. Of course, Section 7502(a) only provides relief to taxpayers when the document is actually delivered, albeit late, to the IRS. In other words, Section 7502(a) is of no benefit to the taxpayer if the document is never actually delivered to the IRS at all.

However, Section 7502(c) creates a presumption of "delivery," and provides that a document sent by registered or certified mail is prima facie evidence of "delivery" and that the date of registration shall be deemed the postmark date. Likewise, the Section 7502 regulations provide that using certified mail or registered mail is prima facie evidence that the item was actually **delivered** to the IRS. Reg. Section 301.7502-1(e)(2).

Thus, under this regulation, the only way to establish prima facie evidence of delivery of a document to the IRS is by one of the following: (1) direct proof of actual delivery; (2) proof of proper use of registered or certified mail; or (3) proof of proper use of a designated private delivery service (such as FedEx, DLH or UPS).

This Regulation goes on to say that "no other evidence of a postmark or of mailing will be prima facie evidence of delivery or raise a presumption that the document was delivered."

Presumably, therefore, the Section 7502 Regulations completely replace the common law mailbox rule. However, in the past, some Circuit Courts have disagreed as to whether Section 7502 supplemented or completely replaced the common law mailbox rule. The Second and Sixth Circuits both say that the statute has "replaced" the common law rule, while the Eighth and Tenth Circuits have stated that Section 7502 merely "supplemented" the common law rule.

As discussed further below, the Fourth Circuit Court of Appeals in Pond vs. US, made it clear that, in the Fourth Circuit (where we are in North Carolina), the statutory mailbox rule of Section 7502 has completely replaced the common law mailbox rule.

II. <u>No Presumption of Delivery or Filing by Regular Mail; Pond vs. U.S., 131 A.F.T.R. 2d 2023-1844 (4th Cir. May 26, 2023).</u>

October 26 was Mr. Pond's last day to file a refund request with the IRS. Mr. Pond mailed the IRS his refund claim by regular mail, rather than by registered or certified mail. But, his first-class mail was postmarked July 18, which allowed plenty of time for Mr. Pond's refund request to arrive at the IRS by the October 26 deadline.

The IRS denied Pond's refund request and claimed it had no record of having received it. Mr. Pond filed suit in court. But, since Mr. Pond didn't use certified or registered mail, the IRS moved for Summary Judgment in Mr. Pond's refund lawsuit. Mr. Pond argued that, since his letter was postmarked so far in advance of his refund request due date, he should be entitled to the presumption of timely delivery under the common law mailbox rule

Our Fourth Circuit Court of Appeals agreed with the IRS that Section 7502 completely replaced the common law mailbox rule. So, taxpayers like Mr. Pond can no longer rely upon the common law presumption of delivery. Also, since Mr. Pond failed to send in his refund claim by certified or registered mail, Mr. Pond could not rely upon ***any*** presumption of delivery under Section 7502(c) to show timely filing.

However, since Mr. Pond alleged that his refund request was physically delivered to the IRS, the IRS was denied its summary judgment motion to dismiss. Instead, the Appeals Court sent the case back down to the lower court to determine whether Mr. Pond could prove that the document ultimately arrived at its destination, whether before or after the refund claim due date.

III. <u>The Statutory Mailbox Rule Can't Save An E-Filed Tax Court Petition; Nutt, 160 TC No. 10 (May 2, 2023).</u>

Mr. and Mrs. Nutt were residents of Alabama and needed to file a US Tax Court Petition with the Tax Court's Clerk's Office in Washington, DC by July 18, 2022, in order to protest a Notice of Deficiency sent to Mr. and Mrs. Nutt on April 18, 2022. Mr. and Mrs. Nutt decided to e-file their petition at 11:05 p.m. on July 18, 2022.

The problem was that Mr. and Mrs. Nutt lived in Alabama, and so 11:05 Alabama (Central) time was 12:05 a.m. Eastern time on July 19, 2022. According to the Tax Court, the Nutt's untimely Petition had to be dismissed, since the timely mailing rule does not apply to an electronically filed US Tax Court Petition. Section 7502(a) is clear in that its terms only apply to a document that is "mailed" to the IRS.

IV. <u>Tax Court Petition E-filed Eleven Seconds Late – Due to Operator Error - Gets Dismissed; Antawn Sanders, 160 T.C. No. 16 (June 20, 2023)</u>.

The IRS mailed a Statutory Notice of Deficiency (a "90-day Letter") to Mr. Sanders at his North Carolina residence on September 8, 2022. The Notice advised Mr. Sanders that his last day to file a Tax Court Petition was December 12, 2022.

Mr. Sanders prepared to file his Petition electronically, and before December 12, 2022, Mr. Sanders set up an account to electronically file his Petition through "DAWSON," which is the Tax Court's electronic filing system.

Shortly after 11 p.m. on December 12, 2022, Mr. Sanders tried to file his Petition from his phone. Mr. Sanders claimed that he attempted to upload documents, but DAWSON "would not even allow [him] to click the button to upload the documents from [his] android device even after several times of login in and logging out."

After unsuccessful attempts to file his Petition from his phone, Mr. Sanders finally tried using his Windows computer shortly before midnight. But, for some reason, Mr. Sanders still could not log in to DAWSON. However, within one second, another Windows user successfully logged into DAWSON. Likewise, at 11:57 p.m., Mr. Sanders finally successfully logged in as well. According to Tax Court logs, during the entire evening of December 12, DAWSON was fully operational.

Mr. Sanders ultimately filed the Petition from his computer eleven (11) seconds after midnight on December 12, 2022, and at the time of filing, DAWSON automatically applied a cover sheet to the Petition stating that the Petition was electronically filed and received at "12/13/22 12:00 am."

The IRS filed a Motion to Dismiss for Lack of Jurisdiction on January 25, 2023, contending that the period for timely filing ended at 11:59 p.m. on December 12, 2022. The IRS pointed out that DAWSON logs showed that DAWSON was accessible throughout the day on December 12, 2022, such that DAWSON, "as a filing location, cannot be considered as having been inaccessible or unavailable to the general public for purposes of section 7451(b)."

Under Section 6213(a), a Tax Court Petition must be filed within 90 days after the Notice of Deficiency is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day). *See* I.R.C. § 7503.

Also, a Petition is ordinarily considered to have been filed when it is received by the Tax Court. *See, e.g., Leventis v. Commissioner,* 49 T.C. 353, 354 (1968). Under Tax Court Rule 22(d), an electronically filed petition "will be considered timely filed if it is electronically filed at or before 11:59 p.m., eastern time, on the last day of the applicable period for filing."

The court stated that electronic filing is not accomplished merely by logging into the system or beginning the filing process. Also, in Nutt, the Tax Court had previously held that the Section 7502 timely mailing mailbox rule does not apply to an electronically filed Tax Court Petition.

The Court also pointed out that, in circumstances where the Clerk's office or a filing location is inaccessible or otherwise unavailable to the general public, a taxpayer may have additional time to file a petition. *See* I.R.C. § 7451(b); *Guralnik,* 146 T.C. at 247.

In *Guralnik,* the Tax Court held that, if the Tax Court Clerk's office is inaccessible on the last day for filing a Petition, then the time for filing is extended to the next accessible business day. In Guralink, the Tax Court was closed because of a winter storm on the taxpayer's last day to file a petition. And because the Clerk's office was inaccessible to the general public, the Petition was timely. *Guralnik,* 146 T.C. at 232-33.

Likewise, Section 7451(b) provides an additional remedy to taxpayers for situations such as a snow day (as in *Guralnik*), or where an electronic filing system outage might interfere with timely filing a US Tax Court Petition. *See* I.R.C. § 7451(b). But, for this purpose "inaccessibility" does not include user error or technical difficulties on the user's side. *See, e.g., In re Beal,* 616 B.R. 140.

Sanders reminds us that, with electronic filing, "user problems, such as entering an incorrect password, a Wi-Fi outage, or problems with the user's device, are the same as traffic jams or car problems that occur on the way to an open courthouse; they do not render the system inaccessible or otherwise unavailable to the general public."

Note: The Court maintains a log of any DAWSON outages, and that log is publicly available at United States Tax Court, https://status.ustaxcourt.gov/uptime/726t4kw06kfh. The log identifies both full and partial outages and describes the nature and duration of any outages.

V. Thanksgiving Holiday Extends the Due Date for Filing US Tax Court Petition; Sall vs. Commissioner, 161 T.C. No. 13 (November 30, 2023).

Mr. Sall received a Notice of Deficiency from the IRS dated August 25, 2022, which was sent to Mr. Sall certified mail on August 26. The 90th day after August 26 was Thursday November 24, Thanksgiving Day. The face of the Notice of Deficiency stated that "the last day to file a petition with the US Tax Court" was Friday November 25, 2022.

Although the Tax Court's electronic filing system through "Dawson" was operational and accessible throughout the entire Thanksgiving week, the US Tax Court was closed for business from Thanksgiving Day until the following Monday, November 28, 2022. Mr. Sall mailed his petition to the Tax Court on Monday, November 28, 2022, and the Tax Court received Mr. Sall's Petition on Thursday, December 1, 2022, and filed it that same day.

The IRS filed a motion to dismiss on the basis that the Petition was filed late, since according to the IRS, the filing deadline was November 25, 2022.

The Tax Court, however, concluded that the Petitioner's due date would be no ***earlier*** than Monday, December 12, 2022, which was long after the Tax Court received Mr. Sall's petition on December 1, 2022.

Here is how the Court navigated the rules of Section 7451 to conclude that the filing deadline was extended from Friday, November 25 through Monday December 12, 2022.

First, even though the electronic Dawson filing system was operational throughout the whole entire Thanksgiving week, the Tax Court was officially "closed" on Thursday, November 24 and Friday, November 25, the day after Thanksgiving. Under Section 7451(b), the statute of limitations period for filing a Tax Court petition is "tolled" by "the number of days within the period of inaccessibility, plus an additional fourteen days". IRC Section 7451(b)(1).

In addition, other rules may operate to extend the deadline to file a Tax Court Petition. For example, if the filing deadline falls on a Saturday, Sunday or legal holiday, the deadline is extended to the next day that is not a Saturday, Sunday or legal holiday. IRC Section 7503. Also, if the face of the Notice of Deficiency provides for a "last day to file a petition" date that is later than the 90th day, then the due date is extended to that later date. IRC Section 6213(a).

Adding fourteen days to Friday, November 25, meant that the initial due date would extend for fifteen days from the original due date, which would shift the Petition due date to no earlier than December 10. However, since December 10 was a Saturday, the Petition deadline shifted further to Monday December 12, 2022.

VI. <u>Tax Court Petition Dismissed for Being Filed One Day Late Even Though Sent by Federal Express; Nguyen, TC Memo 2023-151 (December 23, 2023)</u>.

Mr. Nguyen received an IRS 90-day Statutory Notice of Deficiency on October 13, 2022, advising him that January 11, 2023, would be his last day to file a Petition with the US Tax Court to challenge the Notice of Deficiency. On January 10, 2023, Mr. Nguyen sent his Petition to the US Tax Court, via Federal Express, and the Tax Court received it on January 12, 2023.

Unfortunately, Mr. Nguyen, elected to use "Fedex Ground". Although "Federal Express Overnight" delivery is on the list of approved "designated private delivery services", FedEx Ground <u>***is not***</u> on that list. As a result, the Tax Court dismissed Mr. Nguyen's untimely petition for lack of jurisdiction.

VII. <u>Third Circuit Court of Appeals Holds That The Time Limit under Section 6213 Deadline for Filing a US Tax Court Petition is "Procedural" Rather than "Jurisdictional" so Equitable Tolling Can Save a Late Filed Tax Court Petition; Culp vs. Commissioner, 2023 U.S. App. LEXIS 18287 July 19, 2023.</u>

Mr. and Mrs. Culp were late in filing their US Tax Court Petition, and so the Tax Court dismissed their Tax Court Petition on the basis that the Tax Court lacked jurisdiction to review their Petition based upon the time deadlines set forth in Section 6213(a). The Third Circuit Court of Appeals determined that the Section 6213(a) deadline is not "jurisdictional" but instead is a statutory deadline that is "claims processing" in nature. This means that the principles of equity can serve to "toll" the deadline for filing a US Tax Court Petition. The Court of Appeals then remanded the case back to the Tax Court to determine whether the Culps qualified for equitable tolling relief to excuse their late filed US Tax Court Petition.

VIII. In Another Case, Tax Court found that Section 7436(b)(2)'s Deadline to File a Petition to Redetermine Employment Status is Not Jurisdictional; Belagio Fine Jewelry, Inc. v. Commissioner, U.S. Tax Ct. LEXIS 1634, *1 (June 25, 2024).

In Belagio, the Tax Court sitting in Florida decided that the deadline for filing a Tax Court Petition to determine employment tax status was not jurisdictional. The Tax Court stated, "To create a jurisdictional requirement, Congress 'need not use magic words.' Henderson v. Shinseki, 562 U.S. 428, 436 (2011)…[T]he focus of the analysis is whether the statute expressly refers to the Court's authority to hear a case rather than merely the consequences to the petitioner." Further, the Belagio court noted, "…jurisdictional statutes speak to the 'power of the court' whereas claim-processing rules speak 'to the rights or obligations of the parties.'"

Belagio concluded that Section 7436(b)(2)'s use of the word "initiated" focuses on consequences to the taxpayer, not the Court's ability to "hear the case, to consider the pleadings, or to act upon motions." In concluding that Section 7436(b)(2) did not clearly indicate the deadline was jurisdictional, the court added "[Section 7436(b)(2)]'s use of prescriptive text---'no proceeding may be initiated'---likewise does not make the deadline jurisdictional. The Supreme Court has rejected the notion that mandatory or emphatic text is sufficient to signal that a deadline is jurisdictional."

IX. Tax Court in the Fourth Circuit Rules That Deadline to File a Tax Court Petition to Dispute a Notice of Deficiency is Jurisdictional; Sanders v. Comm'r, 161 T.C. No. 8 (Nov. 2, 2023).

After the Culp decision was issued by the Third Circuit Court of Appeals, the Tax Court located in the Fourth Circuit declined to follow Culp and ruled that Section 6213(a) 90-day deadline for filing a US Tax Court petition is jurisdictional. In Sanders, Tuesday June 21, 2022 was Ms. Sanders' deadline for filing a US Tax Court Petition. Her USPS Priority Mail envelope was dated June 23, 2023. Relying on the Tax Court's decision in California, Hallmark Research Collective v. Comm'r, 159 T.C. 126 (2022), the Sanders court held that the 90-day deadline in 6213(e) is indeed jurisdictional and upheld the IRS' motion to dismiss.

X. 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).

PART TWENTY

AUDITS AND APPEALS

I. Existence of Prior IRS Audits Don't Save NOL Carryforwards; Amos vs. Commissioner, 11th Circuit Court of Appeals, AFTR 2d 2024 – 1267 (April 2, 2024).

A. Background: Taxpayer's Burden of Establishing NOL Carryforward From Previous Tax Years.

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. Amos vs. Commissioner (11th Circuit April 2024).

Betty Amos was a certified public accountant and restaurateur.

The IRS assessed additional tax against Ms. Amos for 2014 and 2015 by disallowing NOL carryforwards that were generated beginning in 1999 and 2000. The IRS asserted that Ms. Amos had not established that she had sustained losses in the earlier 1999 and 2000 NOL years or that those losses were still available to be carried over into the 2014 and 2015 tax years.

Even before the 2014 and 2015 IRS audits, Ms. Amos had a long history of IRS audits.

The NOL carryforwards at issue originally arose in 1999 and 2000. For 1999, Ms. Amos' joint return claimed NOL loss carryforwards of almost $1.5 Million, and she reported an additional NOL for the year 2000 of over $370,000. With the 1999 and 2000 NOL carryforwards combined, Ms. Amos' 2000 return showed an NOL carryforward of $1,870,175 going into 2001.

The IRS audited Ms. Amos' 2000 return, but agreed there was no deficiency.

Later, the IRS audited Ms. Amos' 2009 tax return, and the parties settled with a small tax deficiency of $11,545 for that year. However, when the IRS and the Amoses settled their dispute for 2009, the parties stipulated that the 2009 deficiency amount did not take into account NOLs from prior years. The parties agreed that Mr. and Mrs. Amos reserved the right to claim NOLs in future years, and that the IRS reserved the right to challenge any future claimed NOLs as well.

For the 2014 at 2015 tax years, the Tax Court determined that Ms. Amos had been unable to establish the existence of her NOLs carryforwards from 1999 and 2000. The Tax Court also determined that Ms. Amos and not shown sufficient details with respect to those NOL carryforwards into intervening years between 2000 and 2014 to prove that any NOLs from 1999 and 2000 had not been absorbed in tax years before 2014.

The Amoses then appealed to the 11th Circuit Court of Appeals. In agreeing with the Tax Court, the 11th Circuit Court of Appeals affirmed that a taxpayer is required to maintain permanent books of records to establish deductions allowable in the current year, including NOLs from prior years, which includes a detailed schedule showing the computation of any net operating loss deduction for the current year. IRC Regulation Section 1.172-1(c).

It wasn't sufficient for Ms. Amos to provide nothing more than a schedule of her past NOLs. Instead, Ms. Amos was required to establish how the NOLs actually arose in 1999 and 2000, and that her taxable income for years between 2000 and 2014 were insufficient to absorb those NOLs carryforwards during those intervening years.

In the prior Tax Court proceeding, Ms. Amos failed to introduce a complete set of her tax returns from 2001 to 2013, but instead introduced mere portions of those returns for those years. But, those portions of her introduced returns were insufficient to determine how much of the 1999/2000 NOL carryforwards might have been absorbed before 2014.

The Court of Appeals also confirmed that previous audits do not bind the IRS, and that a deduction condoned or agreed to in a former year does not bind the IRS with respect to other years, which leaves the IRS free to challenge those same deductions in future tax years.

Finally, the 11th Circuit Court also confirmed the Tax Court's decision to uphold the Section 6662 20% accuracy related penalty against Mrs. Amos. Since Ms. Amos was a certified public accountant, she was surely aware that "each tax year stands alone and that it was her responsibility to demonstrate her entitlement to the deductions she claimed."

C. <u>CPA Denied NOL Carryforwards and Hit with Negligence Penalties; Amos vs. Commissioner, TC Memo 2022-109 (November 10, 2022).</u> Amos was a certified public accountant who owned multiple restaurant franchise businesses.

Amos claimed NOL carryforward deductions on her 2014 and 2015 tax returns. In agreeing with the IRS, the Tax Court disallowed the NOL carryforwards, into 2014 and 2015, on the basis that Amos was unable to establish the original amount of the original return NOLs and the NOL carryover amounts allowable in prior taxable years leading up to 2014 and 2015.

According to the court, any taxpayer that claims an NOL bears the ultimate burden of proof of establishing both the existence of the NOL and the amount that may be carried over to the tax year involved.

Here, Amos was unable to adequately establish the amount of NOLs incurred in previous years. And, she was unable to show that those NOL carryforwards had not been utilized in earlier tax years and thus were available for offset against taxable income for 2014 and 2015.

So, in order to claim an NOL deduction for the current year, the taxpayer must be able to (1) establish and verify the NOL deduction that occurred in the earlier year and (2) verify all of the taxpayer's taxable income for all subsequent years to confirm that the NOL had not been previously utilized in full.

The court also upheld the 20% accuracy related penalty under Section 6662(a) and (b)(1) on the basis that Amos had no "reasonable cause" for her tax understatements. Amos claimed that she relied upon her CPA for adequate advice in preparing her tax returns. However, Amos was able to establish only that her CPA gave her advice as to the underlying loss year tax return rather than the 2014 and 2015 tax years at issue. Moreover, because Amos was an experienced CPA, Amos certainly could not rely upon past years' practices nor could she reasonably assert that she did not know that each tax year stands on its own.

D. IRS Couldn't Re-Audit NOL Carryforward From Previously Audited Year; AA 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.

II. 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 (8^{th} Cir. 1969).

III. 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.

IV. 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.

V. <u>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)</u>.

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.

<u>PART TWENTY-ONE</u>

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

I. <u>No "Reliance Upon the Professional" Reasonable Cause Penalty Defense Where a CPA Didn't Give Specific Advice About Erroneous Tax Return Items; Johnson v. Commissioner, TC Memo 2023-116 (September 13, 2023).</u>

Mr. and Mrs. Johnson hired a professional CPA to prepare their tax returns for the 2015, 2016, 2017, and 2018 tax years. From 2006 to 2013, Mr. and Mrs. Johnson improperly claimed depreciation deductions on certain commercial buildings by using a seven-year depreciation life on their commercial buildings, rather than the 39-year depreciation life applicable to commercial property. As a result, the Johnsons overstated their depreciation deductions between 2006 and 2013 by $1.5 million.

The Johnsons then sold their commercial property in 2016 for $5 million. Because of their improper depreciation deductions claimed between 2006 and 2013, upon audit the IRS made a Section 481 accounting method adjustment of almost $2 million for 2015. In addition, for 2015, the Johnsons claimed a charitable contribution deduction, but with their return, they attached an incomplete Form 8283, Non-cash Charitable Contributions, that was fatally defective in numerous respects.

In the audit, the IRS assessed the 20% accuracy related negligence penalty under Section 6662(a).

During the Tax Court proceeding, the Johnsons didn't dispute the additional tax assessments, but instead challenged the validity of the 20% negligence penalty asserting that they had a “reasonable cause defense" for the penalty.

However, the Johnsons presented no evidence that their CPA actually told them that a seven-year depreciation schedule was applicable to commercial buildings. Likewise, the Johnsons never testified that their CPA advised them that a County property tax valuation would suffice for charitable contribution purposes instead of a qualified appraisal. When asked to testify on behalf of the Johnsons, their CPA testified that she had “never had that discussion with Mr. Johnson" about the charitable contribution deduction requirements.

The Johnsons then asserted that they were entitled to the “reasonable cause and good faith exception” merely because their CPA prepared their tax returns. However, past courts have held that the mere fact that a certified public accountant has prepared a tax return does not mean that he or she has opined on any or all of the items reported in that return. <u>Neonatology Associates, PA,</u> 115 T.C. 43 (2000). Indeed, taxpayers have a nondelegable duty to review the return for accuracy before it’s filed.

II. <u>Penalty for Failing to Report Form 1099 Income; Larochelle vs Commissioner, TC Summary Opinion 2022-12 (July 12, 2022).</u>

During 2017, Mr. Larochelle was engaged in more than ten business partnerships which required filing of state income tax returns in more than five states. In 2017, Mr. Larochelle received an IRA distribution of $238,000 that never wound up on his personal tax return.

After the IRS sent a CP 2000 Notice to Mr. Larochelle, the IRS assessed the 20% substantial understatement penalty, under Section 6662(a) and (b)(2), equal to 20% of the amount of any tax underpayment that is attributable to any substantial understatement of income tax. An understatement is a “substantial understatement" if it exceeds the greater of $5000 or 10% of the tax required to be shown on the return. Section 6662(b)(1)(A).

Of course, the Section 6662 penalties can be avoided if the taxpayer can show that he acted with reasonable cause and in good faith. Section 6664(c)(1).

Here, Mr. Larochelle did not dispute that he received a Form 1099-R reporting the IRA distribution, but simply argued that he shouldn’t be subject to a penalty because he didn't remember having received the Form 1099R in the first place.

In past cases, courts have held that the nonreceipt of tax information, such as a Form W-2 or Form 1099, does not excuse the taxpayer from his or her duty to report that income. <u>DuPoux vs. Commissioner, TC Memo 1994-448 (September 6, 1994) and Ashmore vs. Commissioner, TC Memo 2016-36 (March 2, 2016).</u>

Next, Mr. Larochelle argued that he had reasonable reliance on the professional advice of a tax return preparer which should constitute reasonable cause for omission of the $238,000 IRA distribution on his tax return. Here, Mr. Larochelle basically claimed that he gave everything he had to his tax return preparer.

However, according to court, reliance on the professional advice of a tax return preparer does not constitute "reasonable cause" when the taxpayer did not provide the representative with all the information necessary to prepare an accurate income tax return. Enoch vs. Commissioner, 57 TC 781 (1972). Accordingly, the court upheld the penalty.

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. (In re Craddock, 82 AFTR 2d 98-5439 (CA 10 1998).

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

In Intress 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. United States vs. Boyle, 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 all of the following criteria are 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; and

(4) The partnership has **<u>NOT</u>** elected out of the centralized partnership audit regime for the penalty tax year (ie, the partnership must have checked the "no" box on Question 31 of Form 1065, Schedule B).

VI. <u>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)</u>.

A. <u>Background</u>. 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.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.

4884-9893-8568, v. 1