DELAWARE TAX INSTITUTE

November 20, 2015

2015 INCOME TAX DEVELOPMENTS

NOTABLE CASES IN FEDERAL INCOME TAX

Charles J. Durante
Connolly Gallagher LLP
The Brandywine Building, Suite 1400
1000 West Street
Wilmington, Delaware 19801

(302) 888-6280

http://www.connollygallagher.com/attorneys/charles-durante/

NOTABLE CASES IN FEDERAL INCOME TAX

DEDUCTIONS, EXCLUSIONS AND INCLUSIONS

Business Expenses

Doctor's Deductions Limited for Use of Motor Home as Office

Cartwright, TC Memo 2015-212

An on-call surgeon who was required to work a 24-hour period three times a month was held not entitled to depreciation for the business use of a mobile home that he parked in the hospital parking lot, and his § 179 expense deductions were limited.

The taxpayer, a physician who had a practice and was also on call at a hospital 25 miles away, purchased a motor home that he parked near the emergency room, where he could rest when not needed in the hospital. He kept mileage logs for business and personal use. On Schedule C, he reported business expense deductions for depreciation and § 179 expenses relating to his business use percentages for the motor home in the amounts of 85% and 100%.

After examining mileage logs, odometer readings, and service invoices, IRS determined that Cartwright's actual business use percentages were 19.42% and 22.23%. The Tax Court agreed. He used the mobile home for business purposes when on call at the hospital, but the depreciation and § 179 expenses should be allocated between business use and personal use.

No Deduction for Expenses in German-trained Lawyer's U.S. Legal Education

O'Connor and Tracy, TC Memo 2015-155

A U.S. citizen who was licensed to practice law in Germany could not deduct the expenses associated with his legal education in the U.S.

The taxpayer attended University of Heidelberg for six years; after moving to the U.S., he became licensed to practice law in Germany. He then entered a U.S. law school, received his J.D., and passed the New York bar exam. He deducted his legal education costs as business expenses.

Tax Court disallowed, saying the deductions would stand only if the education were to maintain or improve skills required in his existing business. The taxpayer argued that since the New York bar allows foreign-trained lawyers to sit for the bar exam without completing a legal education program in the U.S., he wasn't entering a new trade, but the Court found that his German license didn't qualify him to be a legal professional in the U.S. Since the taxpayer had not "established himself" in the U.S. legal profession, his educational expenses weren't deductible business expenses but rather were incurred in association with entering a new trade or business.

Unreasonable Compensation for $2,000,000 Bonus Paid To Sole Shareholder

Midwest Eye Center, S.C., T.C. Memo 2015-53

The IRS disallowed half of the $2 million bonus as a disguised dividend rather than compensation to eye surgeon who was the sole shareholder. The Tax Court upheld the corporate tax deficiencies and an accuracy-related penalty.

The taxpayer was a C corporation with 50 employees. The surgeon took on additional responsibilities when another surgeon quit and another reduced his hours.

The Tax Court held that the corporation failed to produce comparable salary data or provide the methodology for computing the bonus payments in order to demonstrate that the amount was reasonable, and therefore, upheld the tax delinquencies and penalty.

Being Open for Business Isn't Required for a Building to Be "Placed in Service"

Stine, (DC LA 1/27/2015) 115 AFTR 2d ¶ 2015-381

A district court ruled that Reg. § 1.167(a)-11(e)(1)(i), which defines when property is "first placed in service," does not require, in the case of a building housing a retail store, that the store be open for business in order that the building be considered placed in service.

The taxpayer is a retail operation that built two new stores. As of the end of 2008, both stores were issued certificates of occupancy which allowed them to receive equipment, shelving, racks and merchandise as well as the appropriate personnel to install and/or stock them, but the stores were not open for business, and the certificates of occupancy did not allow customers to enter the buildings.

A depreciation period begins when an asset is placed in service. Reg. § 1.167(a)-11(e)(1)(I): "Property is first placed in service when first placed in a condition or state of readiness and availability for a specifically assigned function ... In the case of a building which is intended to house machinery and equipment and which is constructed ... for the taxpayer's use, the building will ordinarily be placed in service on the date such construction ... is substantially complete and the building is in a condition or state of readiness and availability. Thus, for example, in the case of a factory building, such readiness and availability shall be determined without regard to whether the machinery or equipment which the building houses, or is intended to house, has been placed in service."

IRS's position was that, because the two buildings were not open for business, the taxpayer did not place them in service during calendar year 2008. The Court disagreed. The court ruled that there is no "open for business" requirement.

Taxpayer Who Generally Lived at Casino Hotel Wasn't Professional Gambler

Boneparte, TC Memo 2015-128

The Tax Court has ruled that a taxpayer was not a professional gambler even though he gambled regularly, did not maintain a permanent residence, and generally stayed in Atlantic City, New Jersey casino hotels.

The taxpayer worked full time for the Port Authority, did not maintain a permanent residence, but kept his belongings in a storage locker. After work, he would drive to Atlantic City, check into a casino hotel and gamble. He did not keep a contemporaneous written log of his gambling activities. Rather, he would keep a running ledger in his head. Some of the casinos would also track his gambling activity, but would provide only averages rather than precise amounts. His return showed $25,000 of gambling losses and $90,000 of business expenses from his "gambling business."

The court ruled that he wasn't professional gambler, based on factors in Regs. § 1.183-2(b), which requires an actual profit objective shown by manner, expertise, the time and effort, success, history of income, and how any profits are used.

Store Inherited by Art Teacher from Her Father Was a Business, Not a Hobby

Savello, TC Memo 2015-24

The Tax Court held that a hobby store, that an art teacher inherited from her father and managed while continuing to teach, was operated as a trade or business, not a hobby.

Under the hobby loss rule, deductions attributable to a "not for profit" activity are allowed only to the extent of income from it, or to the extent deductions are allowable regardless of any profit-seeking motive, whichever is larger.

The taxpayer, an art teacher in Nevada, inherited from her father a model airplane business in Idaho near her second home. She retained her father's volunteer help to run the store. She would assist when in Idaho. The store had inventory, cash registers, telephone, display cases, offices, supplies, and workspace, and was open seven hours a day. In the tax years, business had gross receipts of $23,000 and $22,000, and net losses of $5,500 and $2,600.

Tax Court holds that she was in business. The Tax Court looked at seven of the nine factors in Reg. § 1.183-2(b) and concluded that she ran the business with an actual and honest objective of making a profit. Having a second job does not necessarily indicate a lack of profit motive because a taxpayer may engage in more than one trade or business simultaneously.

Marijuana Expenses – Even Loss from Seizure, Not Deductible

Olive v. Commissioner (9th Cir) 116 AFTR 2d ¶2015-5031

The Ninth Circuit affirmed the Tax Court's holding that a taxpayer was precluded from deducting expenses related to his legal medical marijuana dispensary business, relying on § 280E, which provides a taxpayer may not deduct any amount for a business that consists of trafficking in controlled substances that are prohibited by Federal law. The taxpayer operated a sole proprietorship medical marijuana dispensary in California, where the patrons can socialize, purchase medical marijuana, and consume it using the taxpayers' vaporizers. The taxpayer also provides complimentary food; discussion of illnesses; counseling on issues related to medical marijuana; and education on how to use the vaporizers and consume medical marijuana responsibly, all at no charge.

The taxpayer argued that § 280E applies only to illegal trafficking in a controlled substance and so didn't apply to the taxpayer's business, which was a legitimate operation under state law, and that, it was in two businesses, marijuana dispensing and caregiving, and that only the expenses related to dispensing marijuana should be disallowed. The Tax Court held that the taxpayer had a single business – the dispensing of medical marijuana – and provided the services and other activities as part of that business. Therefore, the Tax Court said, § 280E precluded the deduction of any Vapor Room expenses, including those incurred in providing the caregiving services.

The Ninth Circuit affirmed, agreeing that the taxpayer's only business was the sale of marijuana, because the other services were undertaken with the dominant hope of realizing a profit was the sale of medical marijuana. The taxpayer unsuccessfully argued that § 280E should not to apply to medical marijuana dispensaries because they did not exist when Congress enacted § 280E.

Beck v. Commissioner, TC Memo 2015-149

No deduction allowed when a medical marijuana dispensary's inventory and equipment were confiscated by the DEA. Medical marijuana dispensaries sold marijuana and marijuana edibles. The DEA seized cash, controlled substances, suspected edibles, and marijuana plants in 2007. The taxpayer argued for a deduction for cost of goods sold, or a loss deduction. The Tax Court held that the items could not be claimed as costs of goods sold, because they were confiscated, not sold, and § 280E bars deductions for costs incurred in connection with trafficking in a controlled substance.

Canna Care Inc. v. Commissioner, T. C. Memo 2015-206

A nonprofit medical marijuana dispensary was denied business deductions for salaries and other ordinary expenses. The court distinguished *Californians Helping to Alleviate Med. Problems, Inc. (CHAMP) v. Commissioner*, 128 T. C. 173 (2007), which permitted deductions for other businesses [like counseling], because the stipulation didn't provide evidence to determine what percentage of sales were due to marijuana compared to the sale of other merchandise.

Interest

Mortgage Interest Deduction Approved for Beneficial Owner

Van Phan, TC Summary Opinion 2015-1

A taxpayer could claim home mortgage interest deductions even though neither the residence nor mortgage were in his name. An oral agreement granting him an interest in the home in return for paying the mortgage and property expenses, coupled by the fact that his name ultimately was added to the legal title, bolstered by the fact that paid the mortgage, taxes, and insurance, established that he was an equitable owner of the property.

No Interest Deduction Where Claimed Substantiation Was Destroyed in Syria Conflict

Saad Al-Soufi, TC Memo 2015-68

A dual Syrian and U.S. citizen who claimed that relevant documentation was destroyed in the civil conflict in Syria, failed to prove that he met the requirements for deducting qualified residence interest on property that he purchased in Syria.

The taxpayer purchased a residence in Syria, intended for use as a summer home. He testified that a privately owned limited partnership issued him a mortgage and that he paid $73,619 in interest. The lender did not issue any contemporaneous document stating the amount of mortgage interest paid during 2010. He stated that his sister made the payments on his behalf, using gifts to him from extended family members, acting under a power of attorney.

While the Tax Court sympathized with the taxpayer's argument that he was unable to obtain verification of the relevant facts because of the civil war in Syria, it found that it was his own fault that he did not have copies of these documents in the U.S.

No Interest Deduction for Unpaid Interest Capitalized into Home Loan

Copeland, TC Memo 2014-226

A cash-basis taxpayer could not currently deduct unpaid residence interest that was capitalized into mortgage principal as part of a loan modification.

The taxpayers purchased in 1991, refinanced in 2007, and were granted a loan modification in 2010 under which past due interest was added to principal. The taxpayer argued that the arrangement was the equivalent of taking out another mortgage and using proceeds to pay off the old one. Tax Court said the mere delivery of a promissory note to satisfy an interest obligation, without an accompanying discharge of the note, is a mere promise to pay and not a cash equivalent.

No Investment Interest Deduction above Qualified Residence Interest Limit

Minchem International, Inc., TC Memo 2015-56

Parties purchased a residence in 2002, paying cash. In 2003, they borrowed $1.7 million and used their residence to secure the debt. They refinanced in 2006 for $2.5 million. They deducted $7,046 in 2008 as home mortgage interest and carried the remaining $166,297.49 forward as investment interest, which they deducted for 2009. In 2009, the Suns deducted $60,000 as home mortgage interest and the remaining $97,835.86 as an investment interest expense deduction.

The Tax Court held that the Suns failed to demonstrate that any deduction was allowable because they failed to show that the funds were used for investing. While noting that the qualified residence interest regulations permit debt exceeding the applicable limit to be allocated to an otherwise deductible category of interest, the Tax Court denied the deduction to the taxpayer who failed to shown that the funds, which were from a loan secured by a qualified residence, were actually used for investing.

Taxes

Law Partner Must Itemize His Share of State Nonresident Taxes

Cutler v. Commissioner, T.C. Memo 2015-73

State nonresident taxes imposed on a principal of law firm treated as partnership are deductible only above-the-line under §164(a)(3), rather than below-the-line under §62(a)(1).

The firm earned income sourced in five states, although the taxpayer only worked for clients in his home state. He paid state nonresident income taxes on income sourced in the other states. The state taxes were not entity-level taxes imposed directly on the law firm. They are not deductible from the partner's gross income, but instead are deductible only as itemized deductions under §164(a)(3).

Property Transferred for Services

Stock Wasn't Subject to Substantial Risk of Forfeiture

QinetiQ U.S. Holdings Inc., TC Memo 2015-123

Where a corporation issued 49.75% of its stock to an employee shortly after formation, its successor could not take a compensation deduction with respect to the stock many years later. There was some question as to whether the stock was issued in the connection with the performance of services, but no substantial risk of forfeiture at the time of the stock issuance was shown.

II. ALIMONY, JOINT RETURNS AND DOMESTIC RELATIONS

Payments Weren't Alimony – Delaware Case

Crabtree, TC Memo 2015-163

The Tax Court held that a series of payments received by a taxpayer from her ex-husband pursuant to a Delaware divorce agreement were not alimony and did not have to be included in income, finding that, although not expressly stated in the agreement, the payments, which were to be made for eight years, wouldn't terminate if the ex-wife were to die before the period ended.

The divorce agreement contained a provision stating that the husband "will continue to tender unallocated alimony/child support in the monthly sum of $5,232.00 for a continued eight year period with the provision as long as [the wife] should not remarry or cohabitate," but was silent as to whether the payment obligation would terminate if either were to die before eight years elapsed.

Siding with the taxpayer, the Court held that the payments were not alimony. Under 13 *Del. C.* § 1512(g), unless otherwise provided in writing, the obligation to pay future alimony terminates upon the death of either party – but the Court said that this provision only applies to judicially decreed alimony agreements, and although the Delaware Family Court did technically enter Ms. Crabtree and Dr. Girard's divorce agreement as an order, the overall facts showed that the agreement was in fact voluntary. Under 13 *Del. C.* § 1519(b), the obligation to make post-death payments ends "unless otherwise agreed by the parties in writing and expressly provided in the decree." The Court found this provision ambiguous as applied to the divorce agreement as the order didn't actually "provide" for anything (beyond giving the agreement legal effect). Accordingly, the Court held that the agreement was best interpreted as providing for the payments to be made for the entirety of the 8-year term, even though the parties' understanding as to this point was more implicit than express.

Abuse Mitigates Joint and Several Liability for Joint Return

Sapp v. Commissioner, T.C. Memo 2015-143

Taxpayer was the bookkeeper for husband's plumbing business. Their joint tax returns had significant understatements of income. She has initiated divorce proceedings.

The Tax Court held that equitable relief was available despite her knowledge and involvement in the financial aspects of Husband's business because of finding of physical and emotional abuse that prevented her from being in a position to independently question or determine what was on the tax returns. She failed one of the seven guidelines in Rev. Proc. 2013-34, §4.02, because of her involvement in the finances, but found her eligible based on an exception which allows relief based upon abuse of the spouse requesting relief. The court found she had been physically and emotionally abused, preventing her from being able to challenge or question the items on the joint returns. The court also noted that Husband had a history of alcohol and prescription drug abuse.

Joint Return Not Signed by Wife Was Not a Valid Return Despite Intent to File Jointly

Reifler, TC Memo TC Memo 2015-199

The Tax Court held that a joint return not signed by the wife was not a valid return and, as a result, imposed the failure-to-file penalty. The Court rejected the taxpayer's arguments that the return was valid either because it substantially complied with the valid return rules or because the wife intended to file a joint return and tacitly consented to the filing of a joint return.

Posthumous DRO's, Effective Before Participant's Death, Were Valid QDRO's

Yale-New Haven Hospital v. Claire M. Nicholls (2015, CA2) 2015 WL 3498771

The Second Circuit held that domestic relations orders, entered the day after the participant's death but made retroactively effective as of an earlier settlement agreement, were valid qualified domestic relations orders that effectively assigned plan benefits to the participant's first wife.

The decedent participated in four plans at Yale. He and his first wife divorced in 2008, entering into a settlement agreement that Harold's pension and retirement accounts were to be evenly divided between them. To accomplish this, the settlement agreement provided that her attorney was to prepare a QDRO, but it was not prepared. He remarried in 2009, and designated his second wife as sole beneficiary of each plan. In 2012, before having retired, he died.

The plan administrator interpleaded the competing claims. The Second Circuit majority affirmed the district court's grant of summary judgment to the first wife as to the three plans named in the nunc pro tunc DRO's, but with respect to the plan that wasn't named. The majority concluded that "the posthumous nature" of the two nunc pro tunc DROs did not affect their validity.

No Innocent Spouse Equitable Relief to Taxpayer Who Participated in Evasion

Williams v. Commissioner, T.C. Memo 2015-198

Taxpayer is not eligible for equitable relief under innocent spouse rules where taxpayer also participated in tax evading scheme.

Where the husband had actual knowledge of improper omissions of income and was also a significant contributing cause of the omissions, he was not eligible for equitable relief from joint and several liability.

“Separate Return” Only Refers to Married-Filing-Separate Return

Ibrahim, 115 AFTR 2d ¶ 2015-816

The Eighth Circuit, reversing the Tax Court, held that the term “separate return,” used in the rule allowing separate return filers to change to joint return filing status except under prescribed conditions, doesn’t apply where the original return is filed using head of household status. As a result, the Appeals Court held that the fact that one of the prescribed conditions existed didn’t prevent taxpayer from changing to a joint return.

The husband filed claiming head of household status, improperly because he was living with his wife. After receiving a notice of deficiency, he filed a petition with the Tax Court, seeking to change his status to married filing jointly in order to receive a credit and refund.

Tax Court held that Section 6013(b)(2)(B) bars a taxpayer, who has filed a return with single or head of household filing status, and in response to a notice of deficiency for that year, has filed a Tax Court petition, from changing his filing status to married filing jointly.

The Eighth Circuit reversed, holding that “separate return,” as used in § 6013(b)(1), refers only to returns with married filing separately status, and allowing the couple’s refund.

No Relief for Spouse Who Generated Most of the Couple’s Tax Liability

Johnson, Petitioner, and Hart, Intervenor, TC Memo 2014-240

The Tax Court denied a dental surgeon equitable innocent spouse relief from a joint tax liability with her ex-husband that resulted from her work as a dentist and sale of her practice.

She acquired a dental practice in 2002 and sold it in 2007. They were married in 2003, separated in 2008, and divorced in 2010. Their divorce agreement addressed their 2007 tax liability by making each responsible for half of it and the husband paying an up-front amount.

They filed a joint return for 2007 reporting tax due of $83,942, with his wage withholding of $28,213, resulting in $58,123 due. In 2011, she requested relief from joint and several liability.

No relief was granted. One of the conditions for relief under Rev. Proc. 2013-34 was lacking, in that the unpaid tax arose from her dental practice and none was attributable to his work.

III. LOSSES AND FORGIVENESS OF INDEBTEDNESS

No Safe Harbor for Losses from Services Provided to Partnership But Not Reported

Haff, T.C. Memo 2015-138

Taxpayer could not claim losses because he wasn't paid for services he provided as partner, but which he did not report as income.

The taxpayer invested $1 million in a real estate development venture, then advanced an additional $337,690 to cover its expenses. Acting on an SEC complaint that the promoter had created a Ponzi scheme, a court-appointed receiver determined that the project was not economically viable. The taxpayer concluded that his entire investment in LLC was lost. He claimed a bad debt deduction – for both his contribution to venture and the amount allegedly owed him as fees for services.

The Tax Court held that he could not claim a loss deduction for amounts owed him as fees for services he contributed, because he never reported the amounts as income. He could not rely on Rev. Proc. 2009-20, which allows Ponzi victims to treat investment losses as theft losses, because the §165 regulations generally limit loss to the adjusted basis of the property taken. "Basis does not include the value of services performed unless and until the value of those services has been subjected to tax."

Loan Agreement Trumps Form 1099, Cancellation of Debt Income Recognized

Dunnigan, TC Memo 2015-190

A taxpayer was found to have cancellation of debt income, where the loan agreement clearly imposed personal liability even though the lender indicated otherwise on its Form 1099-C.

A real estate appraiser borrowed $50,000 for his business. The line of credit agreement provided for personal liability. When he was unable to repay in full, he negotiated a partial payment in settlement of the debt. In reporting the transaction on Form 1099-C, Cancellation of Debt, the bank indicated on box 5 that the appraiser was not personally liable for repayment of the debt.

The Tax Court held he was liable for tax on the COD income resulting from the discharge.

The court noted that the credit agreement provided that he was and that, in any event, COD income may be realized even without a taxpayer's personal liability for a debt.

Corporate Executive Not Entitled to Deduction for Unpaid Loan

Cooper, TC Memo 2015-191

The Tax Court determined that a taxpayer couldn't deduct the amount of an unpaid loan that he made to a construction company owned by a friend that later filed for bankruptcy. The Court found that the taxpayer, who had a full time job and other side businesses, wasn't engaged in the trade or business of lending and thus couldn't claim a business bad debt deduction. The Court further concluded that the taxpayer wasn't entitled to a deduction for nonbusiness bad debt because he failed to establish that the loan was wholly worthless in the year claimed.

The taxpayer testified that he made sporadic loans to acquaintances referred to him by friends, typically on a short-term basis to people who might otherwise have difficulty obtaining cash and charged rates of up to 40 percent.

The Tax Court concluded the taxpayer was not in the business of lending. but the Tax Court didn't find his claim credible in light of his full time job, other business activity and lack of credit checks and other due diligence, the fact that he lent funds to friends and acquaintances, the lack of business formalities, the fact that he didn't hold himself out publicly as being in the lending business, and his inadequate recordkeeping. Accordingly, he couldn't deduct the loan as a business loan.

Forgiveness of Loan to Doctor for Staying in Underserved Community Caused Income

Wyatt, TC Summary Opinion 2015-31

The Tax Court held that guaranteed payments made from a hospital in an underserved community to a doctor as part of its efforts to recruit and retain physicians, which he wasn't required to repay because he stayed in the community, constituted bona fide loans, the forgiveness of which gave rise to cancellation of debt income. The Court rejected the doctor's argument that he wasn't personally liable for repayment and thus couldn't have received income from the loan's forgiveness.

A physician, recruited to a medically underserved community in Florida, entered an agreement that provided that he would practice medicine in Putnam County for a minimum of four years. The hospital would provide assistance to help him establish his practice, with an income guarantee with repayment forgiveness. The hospital would advance up to $33,000/month for a year to the extent his gross receipts fell short of that amount. Conversely, for any month that his gross receipts exceeded that amount, the excess would be repaid to the hospital to the extent of the guarantees previously paid to him. At the end of the period, his loan repayment would be due immediately, but if he continued practice in the community, the loan would be forgiven at a rate of 1/36 per month.

The absence of a promissory note isn't dispositive as to personal liability. Had the doctor breached the agreement, the hospital could have sued him.

No Discharge of Indebtedness Income as Loan Was Being Repaid

Johnston v. Commissioner, T.C. Memo 2015-91

When a $450,000 loan became due because of loan covenants in 2001, payments stopped. In 2011, the borrower made arrangements to resume payments, eventually at $1,000 per month. The IRS issued a deficiency notice for 2007 determining that the taxpayer failed to report COD income.

The IRS argued the loan was canceled in 2007 because the creditors failed to take collection action before the period of limitations for collection expired. The Tax Court held that the loan was not discharged in 2007 because it was still outstanding and being repaid and thus the taxpayers had no cancellation of indebtedness. The court found credible the testimony, from both creditor and debtor, that the debtor considered the loan outstanding and that the creditor was confident that the taxpayer would repay it, and the taxpayer repaid by payroll deductions of $1,000 per month.

The court explained that although a statute of limitations can be an identifiable event, it is not conclusive as to when a debt is discharged because the expiration of the period generally does not cancel an underlying obligation but simply provides an affirmative defense for the debtor.

Turning Debt over to Collection Agency Didn't Overcome Presumption of Uncollectibility

Clark, TC Memo 2015-175

The Tax Court held that the mere fact that a financial institution turned over a debt to a collection agency after the expiration of the nonpayment period was insufficient to overcome a rebuttable presumption in the regs that the debt had already been discharged.

The taxpayer defaulted on a retail installment agreement, and her car was repossessed in 2005. The creditor assigned the debt to five separate third-party debt collectors, without success over the next five years. The creditor reported her chargeoff balance on Form 1099-C in 2011.

Indebtedness is considered discharged only if one of eight identifiable events, described in Regs. § 1.6050P-1(b), has occurred. When a financial institution is the creditor, there is a rebuttable presumption that an identifiable event has occurred in a year if a creditor has not received a payment on a debt at any time during a period, generally 36 months ending at the close of the year. The presumption can be rebutted by the creditor if there has been significant bona fide collection activity.

The court found that the evidence did not show what collection activities the agencies undertook, so the IRS failed to rebut the presumption that an identifiable event discharging Clark's debt occurred in the 2008. It agreed with the taxpayer who pointed to the last payment date in 2005 and argued that the debt should have been reported as discharged on Dec. 31, 2008, and not in 2011.

IV. EXEMPT ORGANIZATIONS

California Disclosure Requirements Upheld in Ninth Circuit

Center for Competitive Politics v. Harris, No. 14-15978 (9th Cir)

A nonprofit group lost a case seeking to shield it from disclosing identifying information about its major donors.

The organization, exempt under § 501(c)(3), has a mission of challenging campaign finance and similar laws, petitioned a district court under 42 U.S.C. §1983 to enjoin California Attorney General from requiring it to disclose the names and contributions of O's major donors, as required by California for organizations that solicit tax deductible contributions. The district court denied the petition, holding that O had not shown any "actual burden" to itself or to its supporters.

On appeal, the organization argued that the disclosure requirement was "injurious" to it and its supporters' exercise of freedom of association, claiming a "chilling risk" from the requirement. The state argued there is a compelling law enforcement interest in disclosure of names of donors of more than $5,000 in a single year to the organization, that "such information is necessary to determine whether a charity is actually engaged in a charitable purpose, or is instead violating California law by engaging in self-dealing, improper loans, or other unfair business practices."

The Ninth Circuit held the organization did not show a likelihood of success on the merits, and the court affirmed the denial of O's motion for a preliminary injunction. The First Amendment argument was "a novel theory, but is not supported by our case law or Supreme Court precedent." The court found no produced evidence to suggest that its significant donors would experience threats, harassment or other potentially chilling conduct as a result of the disclosure requirement.

Donations of Profits Is Not an Exempt Purpose

Zagfly, Inc. v. Commissioner, No. 13-71566 (9th Cir.)

The Ninth Circuit affirmed Tax Court's nonexemption determination where the corporation's donations of business profits to charitable organizations is not exempt purpose.

The organization was established to engage in internet-based sale of flowers and offering a share of the profits to charitable organizations. After the IRS failed to respond within 270 days, it petitioned the Tax Court for a declaratory judgment under §7428(a)(2). The Tax Court held it was not eligible for tax-exempt status because its primary activity did not serve an exempt purpose.

The Ninth Circuit affirmed. The primary purpose of donating business profits to charitable organizations is not an exempt purpose. It is not "operated exclusively for exempt purposes." Its principal activity is sale of goods.

Tax Court Lacks Authority to Restrain Disclosure of Entire Revocation Letter

Anonymous v. Commissioner, 145 T.C. No. 10

The Tax Court reaffirmed its lack of authority to order the IRS to withhold properly redacted written determinations, including revocation letters, from public inspection under §6110.

After an examination of the activities of a §501(c)(3) organization, the IRS proposed to revoke its tax-exempt status, in part because of private inurement. After protest and consideration by the Appeals office, the IRS issued a final adverse determination and the original examination report revoking its exempt status and a notice of intention to disclose the determination. Litigation ensued. To resolve the dispute, there was a closing agreement under which the organization accepted revocation of its tax-exempt status for the years in question, the IRS withdrew the first determination and processed the organization's new Form 1023.

The IRS then issued a determination recognizing it as a §501(c)(3) organization and a second adverse determination revoking its exempt status for the years in dispute. The first determination remained subject to public inspection under §6110. The organization brought an action to restrain public disclosure of the first determination, which reported the details of the private inurement.

The Tax Court held that the first determination was subject to public inspection and that it lacked jurisdiction to restrain disclosure. The first determination was a written determination because it was a written statement that applied tax laws to a specific set of facts and was mailed from the National Office.

No Deduction for Undocumented Charitable Donations

Kunkel v. Commissioner, T.C. Memo 2015-71

Taxpayers could not deduct claimed values for clothing, furniture and other items donated to various charities, because they did not obtain receipts or keep records.

The Taxpayers claimed a charitable contribution deduction of $42,455, consisting of $5,140 in cash contributions, and $37,315 for noncash charitable contributions. They argued that they did not keep records because "they were careful to ensure that the items in each batch were worth less than $250," which they thought eliminated the need to get receipts. However, the court found that Taxpayers' "testimony that they intentionally made all other contributions in batches worth less than $250 requires the implausible assumption that they made these donations on 97 distinct occasions." In addition, the court noted that Taxpayers did not assign values to the items until they prepared their tax return. "That being so, it is hard to see how they could have ensured, at the time they contributed the property, that each individual batch was worth less than $250."

V. CAPITAL GAIN AND BASIS

Developer Who Sold Right to Purchase Land Had Capital Gain

Long, (11th Cir) 114 AFTR 2d ¶ 2014-5446

The Eleventh Circuit, reversing the Tax Court, held that a real estate developer who sued a party who backed out of a contract to sell land to the developer, and then sold his rights as a plaintiff to a third party, had capital gain from that sale

Looking to build luxury high-rise condos, the taxpayer contracted to buy the land. In the two years before the closing date, the taxpayer invested much in preparation, obtained zoning and received deposits for 20% of the units in the building. He then changed his mind and planned to sell the project to another builder, but the owner of the land breached the sales contract. While the taxpayer's trial court verdict was on appeal, he sold his position as plaintiff to the other builder. The IRS characterized the receipts as ordinary income.

The Eleventh Circuit ruled that the proceeds qualified for capital gain treatment, saying the Tax Court misconstrued the land as the "property" in question. But the taxpayer never actually owned the land. Instead, he sold a judgment. He didn't sell the land, but rather his right to buy it.

Properties Acquired in Tax Lien Purchase Business Were Held for Sale to Customers

Si Boo LLC, TC Memo 2015-19

The Tax Court held that partnerships whose primary business was buying property tax liens to earn income from the penalty paid by the owners when the liens were redeemed, but sometimes took possession of the underlying real property if the liens were not redeemed, held such property for sale to customers in the ordinary course of business. As a result, they had ordinary income, could not use the installment method, and the partners had self-employment income.

Under Illinois law, county tax collectors may sell tax liens at public auctions after judgment is rendered in favor of the county for nonpayment of taxes. The purchaser of the lien pays the back taxes plus costs and receives a certificate of purchase of tax lien (certificate) from the county clerk. If the statutory redemption period expires and the encumbered property has not been redeemed, the owner of the certificate may petition for a tax deed with respect to that property. The tax deed provides the owner of the certificate with merchantable title, free and clear from all previous titles.

The taxpayers were in the business of buying certificates at tax lien auctions. They hoped to make profit on the spread between the interest rates charged against their lines of credit and the penalty rates they received if the certificates were redeemed. At the end of one of the years at issue, the taxpayers owned approximately 6,500 certificates. The Tax Court held that the properties the taxpayers acquired via tax deed were held for sale to customers in the ordinary course of businesses.

Ordinary loss deduction allowed for company's voluntary surrender of securities

Pilgrim's Pride Corporation (5th Cir) 115 AFTR 2d ¶ 2015-477

The Fifth Circuit, reversing the Tax Court, held that a corporation's loss from abandonment of securities was an ordinary loss, not capital loss, concluding that § 1234A(1) only applies to the termination of contractual or derivative rights, and not to abandonment of capital assets.

The taxpayer purchased securities for $98 million. Five years later, the seller offered to redeem them for $20 million. The taxpayer decided to abandon the securities for no consideration because a $98 million ordinary loss would produce greater tax savings than the $20 million offer.

The Tax Court held that a company that voluntarily surrendered securities which had significant value was not entitled to claim an ordinary abandonment loss deduction in the amount of the purchase price, under Sec. 1234A, which considers losses to be capital losses if they are attributable to a lapse of a right if the property is a capital asset in the hands of the taxpayer.

The Fifth Circuit rejected the Tax Court's reasoning because abandonment of a capital asset involves the termination of certain rights and obligations "inherent in" those assets. Ownership of stock includes ownership of the capital asset and of rights in management, profits, and assets. Saying that Congress did not legislate in "logic puzzles," the court rejected the notion that Congress, rather than simply stating that the abandonment of a capital asset results in capital loss, chose to legislate that result by reference to the termination of rights and obligations "inherent in" capital assets.

No Like-kind Exchange Treatment in Related Party Transaction

North Central Rental & Leasing, (8th Cir) 115 AFTR 2d ¶ 2015-494

The Eighth Circuit affirmed that a taxpayer could not avoid the § 1031(f) like-kind exchange related-party rule by interposing unnecessary parties into the exchange transactions.

An equipment sales company formed a subsidiary to convey old low-basis equipment that it wanted to replace with new equipment to a qualified intermediary, which in turn would sell the equipment to a third party. The parent purchased replacement equipment from Caterpillar, worth about the same amount as the old equipment. The qualified intermediary used the sales proceeds to purchase the new equipment from the parent, then transferred the new equipment to the sub. The result: the sub held new equipment, a third-party customer owning the old equipment, and the parent having the sales proceeds from the old equipment. Under Caterpillar's dealer financing program, the parent had six months from the date of the invoice to pay for the new equipment.

The District Court agreed that nonrecognition was inapplicable because the transactions were structured to avoid the related-party exchange restrictions. The Eighth Circuit agreed, noting that the intermediaries were given significant financial benefits as part of the transactions.

No Stepped-up Basis for Gift of Shares to Nonresident Alien Spouse

Hughes, TC Memo 2015-89

The Tax Court has ruled that a taxpayer's purported gift of shares to his nonresident alien spouse didn't result in a stepped-up basis of the shares in her hands. The taxpayer, a retired partner of KPMG, was assessed a substantial valuation misstatement penalty on the general premise that "he should have known better" than to claim a stepped-up basis for the shares.

Taxpayers Never Abandoned Intent to Develop Property, So Gain from Sale Was Ordinary

Fargo and King, TC Memo 2015-96

Real estate was acquired with the intent to develop apartments and retail space. The taxpayer continued progress on development of the property. Its entities used the building as office space. An unrelated entity purchased the property.

Analyzing the relevant factors, the Tax Court found these factors favored ordinary income: the initial purpose for acquiring the property was development; the continuing search for financing; continuing efforts to plan and develop the property up until the purchase date; and the terms of the sale gave the taxpayers a chance to share in the profit from the property's development.

Favoring capital gain: the partners made only minor improvements ; the offer to purchase was unsolicited; the partnership had not performed substantial marketing.

The Tax Court concluded that the property was purchased for development, and this intent was never abandoned. Even though the property was used as rental property, the Court found that such use was not the primary purpose of holding it.

Reacquisition of Principal Residence Triggers Loss of Home Sale Exclusion

DeBough, (8th Cir) 106 AFTR 2d ¶2015-5192

The Eighth Circuit affirmed that a taxpayer who sold his principal residence and excluded gain under §121, then reacquired it after the buyers defaulted, had to recognize long-term capital gain on the reacquisition including amounts previously excluded under §121.

The taxpayer sold his principal residence on the installment basis. Three years later, the buyers defaulted. The taxpayer reacquired the property, and did not resell it. He reported gain, but applied the $500,000 exclusion. He treated the event as a reacquisition of property in full satisfaction of indebtedness under § 1038.

The Tax Court found that the taxpayer was not entitled to the § 121 exclusion because he had not resold the property within one year. Under §1038(e), if a seller doesn't recognize gain under the exclusion of §121, he repossesses the home and resells it within a year after repossession, the resale is treated as part of the original sale. As a result, the general rules applicable to reacquisitions of real property in §1038 overrode the principal-residence exclusion, and the prior status of the property as a principal residence was no longer relevant for tax purposes.

The Eighth Circuit affirmed, reading §1038(b) as acknowledging two types of gain upon reacquisition of real property: gain that was reported as income on a prior tax return, and gain that has not yet been returned as income. The Eighth Circuit said that having been excluded from income in 2006, the $500,000 protected by the principal-residence exclusion couldn't be considered gain that was "returned as income" on a prior tax return.

Assets Transferred to Newly Incorporated Former Proprietorship Were Capital Contributions

Bell, TC Memo 2015-111

The Tax Court held that a couple's transfer of the assets of their sole proprietorship real estate brokerage to a newly formed corporation of which they owned all of the stock was a capital contribution, not a sale of assets, to the corporation.

He was a real estate broker in a sole proprietorship, where she worked. They repaired and listed for sale properties that had been repossessed by lenders. They incorporated the business, then agreed to sell the proprietorship's assets to the new corporation for $225,000, with no appraisal. They reported the transaction as long-term capital gain.

Held that the transfer was a capital contribution subject to § 351, not a sale. The payments to the taxpayers were dividends, and the transferred assets could not be amortized or depreciated.

VI. EMPLOYMENT AND PAYROLL

Federal Circuit Upholds Reg Imposing FICA Liability on Full Deferred Compensation

Balestra v. U.S., (Fed. Cir.) 116 AFTR 2d ¶2015-5328

The Federal Circuit has affirmed a lower court decision denying a retiree's claim for a refund of FICA taxes paid on the full value of deferred compensation that he didn't and will never receive as a result of his employer's bankruptcy, upholding the regulation which imposed such liability.

Under a special timing rule, any amount deferred under a nonqualified deferred compensation plan must be taken into account as wages for FICA purposes at the later of (1) when the services are performed; or (2) when there is no substantial risk of forfeiture of the right to such amount. They are taxed at their present value, computed with actuarial projections, which disallow any discount for the unfunded status of the plan, investment risk, the risk that the payor will be unwilling or unable to pay, the possibility of future plan amendments, changes in the law or other risks.

The taxpayer retired from United Airlines, having earned unpaid NQDC in a nonaccount balance plan under Reg. § 1.409A-1(c)(2)(i)(C), with the present value of his deferred compensation included in the FICA tax base in the year of his retirement under § 3121(v)(2). United had entered bankruptcy proceedings two years before his retirement. As a result, its obligation to pay his deferred compensation was discharged, and most of the benefits were never paid.

Court of Federal Claims denied a refund of the FICA, finding the IRS's interpretation of the statute, including disallowance of discounts in situations like this, was neither arbitrary nor irrational. The Federal Circuit affirmed under the standard set by the Supreme Court in *Chevron v. NRDC*, 467 U.S. 837 (1984), instructing courts to defer to the reasonable interpretations of executive branch agencies charged by Congress to fill any implicit or explicit gap in the statutes they administer.

Partnership Owes Employment Taxes for Apartment Complex Staff, Penalties

TFT Galveston Portfolio, Ltd. v. Commissioner, 144 T.C. No. 7

A partnership that classified workers in apartment complex as independent contractors, instead of employees, was held to owe employment taxes for building staff, with penalties. The staff hired apartment managers, leasing agents, security personnel, a maintenance supervisor and general maintenance workers to maintain Ps' complexes. O did not require the workers he hired to fill out any applications before securing their positions, nor did the workers sign written agreements for the work they performed. Ps did not deposit any employment taxes for tax years 2000 to 2004.

The Tax Court cited the taxpayer's control of the work performed by the apartment workers. "Although some of the workers had some latitude in how they performed their duties, ultimately [it] was the boss and had final authority on all work performed at the properties."

Investment in Oil and Gas Ventures Resulted in Partnership & Self-employment Income

Methvin, TC 2015-81

An individual who acquired small working interests in several oil and gas ventures was a partner in a partnership for tax purposes. Despite his lack of active involvement in the operation of the wells and an election-out of the partnership rules, the working interest owners and well operator had created a pool or joint venture for the operation of the wells. As a result, the taxpayer's income from the working interests was income from a partnership, and he was liable for self-employment tax on the net income received from his working interests.

The taxpayer, who had no expertise in natural resources, acquired working interests in several such ventures, not in a business entity but by agreement with the operator of the interests. The taxpayer Egan was the operator of the interests during 2011. The taxpayer had no rights in the operation of the ventures. He received an annual accounting and check. The operator identified the revenues as nonemployee compensation and issued a Form 1099-MISC. The taxpayer reported the income as "other income" on line 21 on Form 1040, and paid no self-employment tax.

The Tax Court concluded that the well operator created a pool or joint venture, so the taxpayer's income was from a partnership of which he was a member under § 7701(a)(2), so he was liable for self-employment tax on the net income received from his working interests. The Court acknowledged that his personal involvement in the day-to-day operation of the wells was minimal, but a taxpayer who isn't personally active in the management of a business may be liable for self-employment tax if the business is carried out on his behalf through his agents.

Owner Who Agreed Not to Act Independently Was Still a Responsible Person

Waterhouse, (Ct Fed Cl) 116 AFTR 2d ¶ 2015-5080

The Court of Federal Claims held that the 40%-owner vice president of a corporation, who had agreed with the 40%-owner president not to exercise any independent authority over finances, was a responsible person for purposes of Sec. 6672. The Court found that the vice president willfully paid other creditors rather than IRS and thus found him liable for the § 6672 penalty.

The VP had authority to sign checks, but would do so only if the president was unavailable. The VP typically signed the field workers' payroll checks and signed the first quarter 2001 Form 941. He also purchased materials for projects. The two men would discuss capital expenditures and, to that extent, both controlled Skyline's financial policy. When the corporation became delinquent in its employment taxes, the VP signed an IRS form that stated that he was aware of the liability. Between then and when the business went into bankruptcy, vendors were paid.

No intentional disregard where taxpayer sent W-2s to employees but not to SSA

John C. Hom & Associates, Inc., TC Summary Opinion 2015-49

Where a corporation failed to file the corporation's Forms W-2 with the Social Security Administration, but sent Forms W-2 to its employees and believed they were sent to SSA, the corporation was liable for the failure-to-file penalty but not the intentional disregard penalty.

The taxpayer was an engineering company. Its owner decided to become a professional poker player, and spent less time on the business. For three years, the taxpayer issued W-2's to its employees but failed to file them with the SSA. Because the taxpayer kept copies, its president believed that he had completed the previous step of filing those forms with the SSA.

Audit, penalty assessments and a lien notice ensued. The taxpayer requested a collection due process hearing, at which the appeals officer determined that there was a pattern of conduct due to the taxpayer's history in filing employment tax returns late or not at all, and sustained the lien. It came to light that the revenue agent had engaged in prohibited communication with the appeals officer about the difficulty in dealing deal with the owner.

The Tax Court noted cases where such prohibited communication resulted in a remand to the Appeals Office for a new § 6330 hearing with an independent Appeals officer, but also noted that Congress did not provide a specific remedy for such prohibited communications, and concluded that, because it had already conducted a trial on the merits, it was in a better position to adjudicate the underlying liabilities than a different settlement officer. The Court found that the Taxpayer did not intentionally disregard the filing requirement.

Where IRS Properly Sends, but Taxpayer Doesn't Receive, Trust Fund Penalty Notice

Obiakor, TC Memo 2015-112

The Tax Court held that the fact that IRS properly sent a notice of intent to assess the trust fund penalty to taxpayer, but it was returned to IRS as undeliverable, didn't prevent IRS's assessment of the penalty from being valid. However, it did mean that the taxpayer didn't have a pre-collection due process (CDP) hearing opportunity to challenge the penalty. The Court also ruled on whether an IRS Appeals settlement officer (SO) abused her discretion when conducting that hearing.

The employer failed to pay employment taxes. The taxpayer conceded he was a responsible person for the trust fund portion. The IRS sent him a notice of intent to assess by certified mail at his last known address. Inexplicably, it was returned to IRS as "undeliverable." The IRS assessed trust fund penalties and sent him notice and demand for payment. He received later notices, and requested a collection due process hearing. Mailing a § 6672(b) notice to the taxpayer's last known address is sufficient to satisfy the notification requirements of § 6672(b)(1) even if such notice is not received by the taxpayer. Thus, the assessments were valid.

VII. ACCOUNTING

Lump-Sum Lease Payment Is Rental Income in Year of Receipt

Stough v. Commissioner, 144 T.C. No. 16

Payment by lessee of $1 million to reduce amount of project costs was payment for use of leased property, and was rental income to lessor in year of receipt.

The taxpayers developed a commercial building which they leased under an agreement that gave the lessee the option to make a one-time payment that would reduce the amount of rent it owed under the lease. The lessee elected to make a $1 million payment pursuant to those terms, and issued Form 1099-MISC, reporting both the monthly rent and the $1 million lump-sum payment.

The Tax Court held that the lump-sum payment was rental income to T in the year received, and that the proportional accrual method of §467 does not apply.

"When a lessee pays an expense or obligation incurred by the lessor in bringing the leased property into existence, there is a direct economic benefit to the lessor to the extent that the lessor is relieved of his or her financial obligations. ... There is no ambiguity regarding the financial benefit that the lessor received." Because the lease agreement did not specifically allocate fixed rent to any rental period pursuant to Reg. §1.467-1(c)(2)(ii)(A), the taxpayer must include the lump-sum payment in income for the year of receipt. The constant rental accrual method of §467(b)(2) does not apply, the §467 rental agreement does not have prepaid rent pursuant to Reg. §1.467-1(c)(3)(ii), and that the proportional rental accrual method does not apply.

Cash Method Corporation Can Deduct Packaging Materials in Year of Purchase

Agro-Jal Farming Enters., Inc v. Commissioner, 145 T.C. No. 5

A farming corporation that uses the cash method of accounting and accrual method for financial statements can deduct full price of field-packaging materials in year it purchases them.

The taxpayer has always used the cash method of accounting for the materials in which it packs its fruits and vegetables at harvest. Thus, it deducts the full amount it spends on the materials in the year they are purchased, even if it does not use them all or even receive them. The IRS argued that it may deduct the cost of only those field-packing materials that it actually uses each tax year.

The Tax Court held that it can deduct the materials for the year it purchased them. The materials that it purchases that are not "on hand" are governed by the general rules of cash-method accounting, which allow current deduction, and the materials that it purchases that are "on hand" are governed by Reg. §1.162-3, which does not require a cash-method taxpayer to defer its deductions until the materials are used or consumed, if the taxpayer deducted their costs for a prior tax year.

No Refunds Due to Car Dealership That Changed Accounting Method Without Consent

Hawse, TC Memo 2015-99

The Tax Court upheld IRS's denial of refunds to a car dealership that claimed them on the basis that its attempted accounting method change to a method that it then used consistently for the next seven years, was defective due to lack of IRS consent. While the Court agreed with the taxpayer that the requirements for obtaining automatic consent weren't satisfied, it concluded that the taxpayer nonetheless changed its method of accounting. Accordingly, the taxpayer's subsequent use of the prior method on amended returns constituted an accounting method change for which IRS consent was required but not received, and IRS was entitled to reject the amended returns and the refunds claimed thereon by the taxpayer.

In 1985, the taxpayer, a care dealer, elected to the LIFO method for its inventory. In 2001, it sought to terminate its LIFO election, attempting to follow the automatic consent procedure in Rev Proc 97-37 and filed with IRS an application to revoke its LIFO election in favor of the specific identification method, by attaching Form 3115 to its timely income tax return. In 2009, after becoming aware that its LIFO termination was potentially defective, it filed amended returns.

The Tax Court found that the conditions for automatic consent of the IRS to a changed accounting method were not satisfied, due to defects under Rev Proc 99-49, which requires strict compliance; that by filing its 2001 through 2007 tax returns in accordance with a new method, and it nonetheless changed its method of accounting without the required prior consent of the IRS.

New York Trader Could Not Use Mark-to-Market Accounting Method

Poppe v. Commissioner, T.C. Memo 2015-205

A full-time trader could not use mark-to-market accounting method to report securities and trading activity.

The taxpayer, a high school teacher, conducted stock trades during free periods. In 2003, he intended to file a §475(f) mark-to-market election, but did not retain a signed copy. His 2003 tax return stated that he made the election, but no copy of Form 3115 was attached. In 2006, he became a full-time trader. In 2007, he lost over $1 million. He did not file his 2007 return until 2013.

In 2012, the IRS filed a substitute 2007 tax return and a notice of deficiency. The taxpayer filed an amended 2007 tax return, with a statement that under §475(f) he is entitled to the mark-to-mark accounting method and plans to carry forward the losses incurred in 2007.

The Tax Court held that he did not make a valid election to use the mark-to-market accounting method and could not establish reasonable cause for his failure to pay taxes owed in 2007. His trading was sufficiently frequent, regular, and continuous enough to constitute a business, establishing him as a trader in securities in 2003, which would entitle him to make the §475(f) mark-to-market accounting method election, but with no evidence showing he had signed or mailed a Form 3115 in 2003, the court found that he did not make an effective election for the accounting method.

The court also held that his having organizational difficulties due to Asperger's Syndrome didn't excuse his failure to timely file his tax return or pay the tax due.

Tax Court strikes down regulation's requirement to share stock-based compensation costs

Altera Corporation and Subsidiaries 145 TC No. 3

The Tax Court held invalid the § 482 cost-sharing regs that require controlled entities entering into qualified cost-sharing agreements to share stock-based compensation costs.

Section 482 authorizes IRS to allocate income and expenses among related entities to ensure that taxpayers clearly reflect income. In 2003, IRS issued Reg. § 1.482-7(d)(2), requiring controlled parties entering into such agreements to share costs of restricted stock, nonstatutory stock options, statutory stock options, stock appreciation rights and phantom stock.

The consolidated group had a U.S. parent and a Cayman Islands subsidiary. The parent granted stock-based compensation to its employees, but did not share the costs with the subsidiary. The Tax Court held the reg was invalid because Treasury had no supporting evidence in the administrative record that unrelated parties would share such costs, did not articulate why all such arragments should be treated identically and failed to respond to significant comments.

VIII. RETIREMENT PLANS

Payment of Wages to Taxpayer by LLC Owned by His IRA Was a Prohibited Transaction

Ellis v. Comm., (8th Cir) 115 AFTR 2d ¶ 2015-805

The Eighth Circuit, affirming the Tax Court, ruled that where a taxpayer had his IRA own the shares of his business, the LLC's payment of compensation to him for his services was a prohibited transaction resulting in disqualification of the IRA and a deemed distribution of its assets.

The taxpayer formed an LLC, taxable as a corporation, whose operating agreement listed his IRA as 98% owner, to engage in the used car business. It paid him $9,754 for services, from its corporate checking account. The LLC deducted that amount on its corporation tax return.

While formation of the entity didn't involve a prohibited transaction, the compensation it paid to the taxpayer was a prohibited transaction. He exercised discretionary authority over his IRA, and was thus a fiduciary of his IRA and a disqualified person. The full amount that he transferred to his IRA from his 401(k) was deemed distributed under § 408(e)(2)(A), includible in gross income, and subject to the 10% additional tax under § 72(t).

The Eighth Circuit affirmed. He was a disqualified person because he was his IRA's fiduciary under § 4975(e)(3), by exercising discretionary control. The exception in § 4975(d)(10) applies only to compensation for services rendered in the performance of plan duties.

Participant Must Comply with Plan When Requesting a Change in Beneficiary

Mays-Williams v. Williams, TC 13-35069

After his divorce, the participant attempted to change his beneficiary designation from his former wife to his son from a previous marriage, via telephone conversations with the employer. After each, he received beneficiary designation forms to confirm the change in beneficiary, but he did not sign or return the forms. He died, both parties asserted claims and the employer interpleaded.

The district court granted a motion for summary judgment in favor of the ex-wife. On appeal, the Ninth Circuit held that a plan participant must substantially comply with governing plan documents when requesting a change in beneficiary designation. The governing plan documents required married participants to submit a written designation in order to change a beneficiary designation, but were silent as to whether unmarried participants could change a beneficiary designation by telephone. The panel found that Asa, Senior substantially complied with the requirement to change the designation, and, therefore, there was a triable issue of fact.

Action for Breach of Fiduciary Duty to Monitor 401(k) Investments Not Time-Barred

Tibble v. Edison International (S. Ct.) 2015 US No. 13-550

The Supreme Court held that §401(k) participants challenging high-cost investment options brought timely claims when they alleged that fiduciaries failed to monitor properly the investments during the preceding six years

Participants sued fiduciary for breach of fiduciary duties for adding three retail-class mutual funds to the plan in 1999 and three more in 2002. Participants stated that materially identical lower-priced institutional-class mutual funds were available, and fiduciary violated its duty of prudence by not selecting the lower-priced funds. The district court agreed with respect to funds added in 2002, but said the claim for funds added in 1999 was untimely because the disputed funds were included in the plan prior to the start of six-year statutory period of ERISA §413. The Ninth Circuit affirmed.

The Supreme Court ruled that the Ninth Circuit erred by applying the statute of limitations to a breach of fiduciary duty claim based on the initial selection of investments without considering the contours of the alleged breach of fiduciary duty. The Court stated that the Ninth Circuit incorrectly held that only a significant change in circumstances could constitute a new breach commencing a six-year limitations period.

The Supreme Court found that the Ninth Circuit had erred by applying the statutory bar to a fiduciary breach claim without having considered the nature of the fiduciary duty. More specifically, the Ninth Circuit did not take into account that under trust law, a fiduciary is required to conduct a regular review of its investments, with the nature and timing of the review contingent on circumstances, the Supreme Court said. Thus, a trustee has the continuing duty to monitor trust investments and remove imprudent investments within a reasonable time, the Court added. This continuing duty exists separate and apart from the duty to exercise prudence in selecting investments at the outset.

Where, as here, a plaintiff alleges that a fiduciary has breached the duty of prudence by failing to monitor investments and remove imprudent ones, as long as the alleged breach of the continuing duty occurred within six years of the suit, the claim is timely.

The Court stated that, under trust law principles, a fiduciary must conduct a regular review of its investments. The nature and timing of the review is contingent on the circumstances. This continuing duty to monitor trust investments and remove imprudent ones exists separate and apart from the trustee's duty to exercise prudence in selecting investments at the outset.

The Supreme Court expressed no view on the extent of the fiduciary responsibility or whether Edison had met its duty to monitor. The Supreme Court also left to the Ninth Circuit the question of whether the plaintiffs, in failing to assert during lower proceedings that respondents didn't meet their duty of monitoring the plan investments, had forfeited the right to raise this claim.

Retirement Plan Participant Couldn't Carry Forward Disallowed IRA Contribution Deduction

Dunn, TC Memo 2015-208

The Tax Court rejected arguments made by a taxpayer to carry forward an IRA contribution deduction that was disallowed because, in the year for which the contribution was made, he was an active participant in a retirement plan and had high earnings.

In 2008, when he was a participant in a retirement plan with earned income exceeding the threshold, he made IRA contributions. He tried to deduct the contribution in 2010, contending that the 2008 contribution was an excess contribution under § 4973(b), which became deductible in 2010. The Court rejected this argument because his allowable IRA contribution deduction for 2008 was zero. Because no contribution was allowed, his "excess contribution" for 2008 was zero.

Alternatively, he contended that, once IRS disallowed the 2008 contribution, each set of contributions should be "rolled forward" by one year. The Court held there is no provision that allows a cash basis taxpayer to claim a deduction for an IRA contribution made before the year for which the deduction is claimed.

Son Liable for Tax on Retirement Account Inherited, Then Shared with Siblings

Morris v. Commissioner, T.C. Memo 2015-82

Son held liable for tax on full amount of individual retirement account inherited from father that he later shared with two siblings.

Taxpayer was listed as sole beneficiary of his father's IRA. After receiving the distribution, he shared it equally with his siblings based on what he felt were his father's wishes.

The court held that he was taxable on the full amount. Although he "acted honorably in executing what he believed to be his father's wishes, his good conduct has no bearing on whether the IRA distributions were includible in his gross income," the court noted.

ESOP disqualified by stock allocation to officer who drew no salary

DNA Pro Ventures, Inc. Employee Stock Ownership Plan, TC Memo 2015-195

The Tax Court upheld the disqualification of an ESOP. The plan's allocation of stock to an officer's account exceeded contribution limits because he received no compensation that year.

A surgeon and his wife incorporated a business in November 2008, each receiving half the common stock. On December 31, the corporation issued 1,150 shares of class B common stock to the ESOP's trust, which allocated the shares to the doctor's ESOP account that day. The corporation paid no compensation in 2008. It did not file Forms 5500 for 2008, 2009, and 2010.

The Tax Court agreed with the IRS that, since neither party had any compensation in 2008, their contribution limits for the ESOP were zero. Because of the improper transfer of class B stock to the doctor's ESOP account in 2008, the ESOP was not a qualified plan for 2008. Because it proved to be a continuing failure, it also was not a qualified plan for all subsequent plan years.

The Tax Court further determined that because the ESOP failed to obtain any appraisals in 2008, 2009, and 2010, the ESOP did not qualify under § 401(a), and was not exempt from tax under § 501(a) for any year.

10% Penalty Applied to 401(k) Distribution Used to Prevent Employee's Eviction

Kott, TC Summary Opinion 2015-42

The Tax Court held that a taxpayer who was younger than 59½ was liable for the 10% early distribution penalty when he withdrew funds from a § 401(k) plan because he was delinquent in his mortgage payments and wanted to avoid foreclosure.

The taxpayer received distributions from his § 401(k) plan before he reached 59½. argued that the 10% tax should not be imposed on the distributions because they were made due to financial hardship.

Court finds taxpayer liable for 10% tax. The Tax Court noted under that Reg. § 1.401(k)-1(d)(3)(iii)(B)(4), his § 401(k) plan was only permitted to make the hardship distributions to him, but it did not exempt the distributions from the 10% additional tax under § 72(t). Because no statutory exemption applied, he was liable for the additional tax on the distributions.