# DELAWARE TAX INSTITUTE

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# 2017 INCOME TAX DEVELOPMENTS

# NOTABLE CASES IN FEDERAL INCOME TAX

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## NOTABLE CASES IN FEDERAL INCOME TAX


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# I. DEDUCTIONS, EXCLUSIONS AND INCLUSIONS

## Medical Expenses

### Morrissey, 11th Cir., 871 F.3d 1260 (2017)

The taxpayer was held not entitled to a deduction for *in vitro* fertilization expenses because they were incurred for the medical care of an unrelated egg donor and potential surrogate. Section 213 limits deductible medical expenses to amounts paid for the medical care of the taxpayer, spouse or dependents. Expenses paid for medical procedures performed on others, such as egg donors and surrogates do not qualify. The taxpayer argued that as a homosexual man, he is effectively infertile and the amounts he paid for egg donors and surrogates affected his reproductive function.

## Clergy Housing Exclusion

### Gaylor v. Mnuchin, W.D. Wis., 2017-2 U.S.T.C. ¶50,372, (Oct. 6, 2017)

A district court has again held that the exemption for housing allowances provided to ministers under § 107(2) violates the Establishment Clause because its purpose and effect were to provide financial assistance to ministers without any consideration for similar secular employees. Therefore, the statute has no secular purpose and could not be justified on secular grounds.

## Legal Fees

### Dulik, No. 16642-15S., T.C. Summary Opinion 2017-51

Legal fees paid by a CPA to renegotiate his severance agreement with his former employers (which had prevented him from consulting in the pharmaceutical industry) were held not ordinary and necessary expenses of his consulting business, but rather miscellaneous itemized deductions. The taxpayer argued the fees were rooted in his desire to work in the pharmaceutical industry, but the court held they arose from his status as a former employee, and not from his consulting business.

## Qualification for New Business

### Czarnecki, Fed. Cl., 2017 BL 367750 (Oct. 13, 2017)

An engineer could not deduct expenses related to his doctoral thesis in engineering as ordinary and necessary business expenses. A licensed engineer employed by the Navy, the taxpayer did not need to pursue continuing education to maintain his license. Rather, the studies qualified him for a new trade as a university professor.

**Captive Insurance**

**Avrahami, No. 17594-13, 149 T.C. No. 7 (Aug. 21, 2017)**

Payments made by married taxpayers' companies to a captive insurance company, owned by the wife, did not qualify as insurance premiums. The foreign captive elected to be treated as a domestic corporation and to be taxed as a small insurance company. The taxpayers' three jewelry companies continued to buy insurance from third-party commercial carriers, with no change to coverage. Three-fourths of their $1 million insurance deduction on their tax returns was paid to the captive. Because no claims were filed, the captive accumulated a surplus, which it transferred to the wife and to an LLC that was owned by the taxpayers' three children, which owned 27 acres in Arizona, as a loan. Deductions were denied because there was no risk-shifting.

**De Minimis Fringe Benefits**

**Jacobs, 148 T.C. ____, No. 24, 2017 BL 220189 (June 26, 2017)**

The Boston Bruins were entitled to deduct the entire cost of pregame meals for players and personnel at away games as *de minimis* fringe benefits under § 274, which requires that the employer-operated eating facility be owned or leased by the employer, and were not subject to the 50-percent limit on business meals. Although the contracts between the Bruins and their road-game hotels were not titled "leases," and the team did not pay separately for the rental of the meal rooms, where player attendance was mandatory, those rooms were essential to the team's operations, and used to conduct team business. The meals were held to be provided to the traveling employees for substantial non-compensatory business reasons, including for nutritional and performance reasons, and were provided before, during or after the employees workday.

**Interest**

**Wells Fargo & Co., D. Minn., 2017-1 USTC ¶50,235 (May 24, 2017)**

The taxpayer could deduct interest it paid on a loan that had economic substance, even though the loan lacked any business purpose outside of the tax considerations that were part of a related Structured Trust Advantaged Repackaged Securities (STARS) arrangement. While the loan's only purpose was to disguise the sham nature of the STARS arrangement, the loan was not an integral part of the trust structure that generated sham foreign tax credits, and the loan proceeds were available for the taxpayer to use throughout the STARS transaction.

## Losses

### Adkins, Federal Cir., 2017-1 U.S.T.C. ¶50,218, (May 8, 2017)

The taxpayers learned in 2002 that they were victims of securities fraud. An indictment was issued in 2004, and arbitration was stayed, ultimately withdrawn in 2008. The taxpayers took a theft loss deduction on their 2004 return, when they stopped paying their lawyer for the arbitration. The Claims Court held that the taxpayers did not meet their burden of establishing that they abandoned their claim in, and therefore sustained their theft loss, in 2004.

The Federal Circuit held that the Claims Court misinterpreted Reg. § 1.165-1(d)(3)'s test for determining the year when a taxpayer can deduct a theft loss. The Regulation doesn't require taxpayers to make a stronger evidentiary showing when attempting to claim a theft loss in any year after the discovery year. This aligns with common sense incentives for theft victims; good-faith efforts to recover losses tend to push the claim year beyond the year of discovery. To the extent that it is rendered more difficult to succeed on a loss claim in years subsequent to discovery, taxpayers will be dissuaded from making such good-faith efforts. The Claims Court further erred by treating the abandonment of the taxpayers' arbitration claim as a prerequisite to a reasonable certainty of no recovery. Generally, a taxpayer's maintenance of an active arbitration or lawsuit is at least probative evidence of the taxpayer's belief in the potential for recovery, but where it appears that the associated maintenance costs are almost zero, the taxpayer's decision to keep the proceeding open tells little about the chances for recovery. Accordingly, the taxpayers' ongoing arbitration was only one factor to be considered among many, and a broader analysis should be conducted on remand. There was evidence that the taxpayers had reason to believe that there was a reasonable certainty of no recovery, including a criminal investigation, subsequent indictments and plea agreements that would leave no assets from which to recover any losses.

## Profit Motive

### Vest, 5th Cir., 119 AFTR 2d 2017-813 (June 2, 2017)

A taxpayer cannot deduct the costs of investigating his father's death because the investigation wasn't motivated by profit.

## II. ALIMONY, JOINT RETURNS AND DOMESTIC RELATIONS

### Child's Income and Expenses

**T.P. Lopez., T.C. Memo. 2017-171, 114 T.C.M. 270, (Aug. 30, 2017)**

Parents were not entitled to claim their child's beauty pageant income and expenses as their own. The taxpayers reported the child's pageant winnings and expenses on Schedule C. Held, expenses attributable to a child's gross income are treated as paid or incurred by the child even if a parent actually paid the expenses. § 73(b). Accuracy-related penalties not imposed because the taxpayers reasonably relied on the advice of a seasoned return preparer.

### Child Care Credit

**Polsky, 3rd Cir., 2016-2 U.S.T.C. ¶50,506, (Dec. 15, 2016)**

The Taxpayers were not entitled to a child tax credit under § 24 for their disabled daughter because she had attained the age of 17. They had argued that the exception in § 152(c)(3), which permits a dependency exemption regardless of age if the child is permanently and totally disabled, supplants the age limitation of 17 in § 24(c)(1), but the exception doesn't extend to the § 24 credit.

### Alimony

**Quintal, T.C. Summary Opinion 2017-3 (Feb. 2, 2017)**

Where a poorly-drafted separation agreement contained conflicting clauses about the tax treatment of payments to the wife, the clause which disqualified the payments from being considered alimony was more definitive and prevailed, so the husband got no alimony deduction.

One exhibit to the agreement stated that payments would terminate on the death of a party or the wife's remarriage, and that the parties acknowledged "the above payment is deductible to him and includable to Wife." Another exhibit stated, "In accordance with § 71(b)(1)(B) of the Code, the Husband and Wife expressly agree to designate and hereby do designate all payments required in this Exhibit as excludable and non-deductible payments for purposes of Sections 71 and 215 of the Code, respectively." This more definitive statement, in the portion that specified payments, controlled.

## Joint Returns

### Okorogu, TC Memo 2017-53, 113 T.C.M. 1233, (Mar. 30, 2017)

A taxpayer's wife was entitled to equitable innocent spouse relief, where her testimony and supporting documentation established that she suffered from near constant emotional and physical abuse during the time that she lived with the taxpayer. He strictly, secretively controlled the family's finances and she reasonably feared his retaliation for any attempt to question his decisions. He continued to instill fear in and exercise control over her after he moved and she remained fearful of retaliation. Abuse and restricting access to necessary financial information are factors that strongly favor granting equitable relief under Sec. 6015(f). Although he claimed that the returns were invalid because she did not sign them (they bore her electronic signature), she at least acquiesced in the taxpayer's filing of the joint returns.

### Taft, T.C. Memo. 2017-66, 113 T.C.M. 1312 (Apr. 18, 2017)

Wronged ex-wife was entitled to relief from joint and several liability. She credibly testified that they maintained independence in their family's financial affairs, with separate bank accounts unaccessible to the other and didn't read each other's mail. He directed the accountant to file the return electronically without her signature or review. She had no accounting, business or tax background. She didn't gain any benefit from her ex-husband's concealment of wasteful spending and stock sales (to support his extramarital affair), so she met all the requirement for Sec. 6015(b)(1) relief and was entitled to a refund of the amount used to offset her former spouse's tax deficiency.

### Knez, T.C. Memo. 2017-205, T.C. Memo. 114 TCM 444 (Oct. 18, 2017)

A couple was not barred from filing a joint return, even though they filed after the IRS issued a notice of deficiency to the wife, who had erroneously filed as a head of household. Generally, when a married individual files separately, a joint return may not be filed after a notice of deficiency has been mailed to either spouse. Held here, that she didn't effectively elect to file as a head of household because that filing status was not legally available to her. Since that status was legally impermissible, her erroneously-filed original return was held not to be a separate return.

## III. EXEMPT ORGANIZATIONS AND THE CHARITABLE DEDUCTION

### Donee Acknowledgment

### 15 West 17th Street LLC, (12/22/2016) 147 TC No. 19

Where a charitable donee's letter of acknowledgment for a contribution of an easement did not include the required statements whether the donee had provided any goods or services, or had otherwise given anything of value for the easement, the donor took a deduction. After the case reached Tax Court, the donee organization submitted an amended Form 990 that included the information specified in Sec. 170(f)(8)(B), which, the taxpayer contended, eliminated the need for a contemporary acknowledgment to substantiate the gift due to Sec. 170(f)(8)(D), which waives the requirement that a charitable donor obtain and keep contemporaneous written acknowledgment from the donee if the donee files a return with that information "on such form and in accordance with such regulations as the Secretary may prescribe." The Tax Court held that this exception doesn't apply because IRS has not yet issued those regulations.

### Operation for Charitable Purposes

### Community Education Foundation, TC Memo 2016-223

The IRS properly revoked an organization's tax-exempt status because it did not engage in any activity that accomplished one or more of the specified exempt purposes. Granted exempt status in 2001, the organization did not meaningfully organize or allocate resources to any of the activities enumerated on its application for tax-exempt charitable status. The organization admitted that it was inactive from 2001 through December of 2008, but it asserted that it tried, but failed, to host various events in 2009 and 2010.

### Church Plans

### Advocate Health Care Network, Supreme Court, 2017-1 U.S.T.C. ¶50,237 (June 5, 2017)

The Supreme Court held that pension plans administered by church-affiliated hospitals qualify as "church plans" that are exempt from ERISA. Section 414(e) defined "church plan" as "a plan established and maintained ... for its employees (or their beneficiaries) by a church or by a convention or association of churches." In 1980, Congress expanded that definition by adding, at § 414(e)(3)(A), "A plan established and maintained for its employees ... by a church ... includes a plan maintained by an organization ... the principal purpose ... of which is the administration or funding of [such] plan ... for the employees of a church ... if such organization is controlled by or associated with a church." The Third, Seventh and Ninth Circuits agreed with employees that the hospitals' pension plans did not fall within ERISA's church-plan exemption because they were not established by a church.

## Church Examinations

### Bible Study Time Inc., S.C. Dist., 119 AFTR 2d ¶ 2017-514 (March 7, 2017)

A nonprofit unsuccessfully argued that the rules governing church examinations precluded a summons for its bank records. The entity, which produced faith-based mental health talk and interview broadcasts with biblical teachings, had not indicated that it was a church on Form 990. When selected for audit, the entity took the position that it was a church. The IRS began procedures to determine whether to authorize a church tax inquiry. When the entity didn't respond, the IRS sent a Notice of Church Tax Examination. When the entity did not respond, the IRS issued summonses to the entity's banks. The entity petitioned to quash the summonses.

The court held that third-party summonses are governed solely by § 7609, and not by 7611, which governs examinations of a church's own records, and whose legislative history states, "Records held by third parties (e.g., cancelled checks or other records in the possession of a bank) are not considered church records."

## Interest on Refunds

### Med. Coll. of Wisc. Aff'd Hospitals, Inc., 7th Cir., 119 AFTR 2d ¶2017-698 (04/25/2017)

The Seventh Circuit joined the Second and Sixth Circuits in holding that the interest rate that the IRS is required to pay on overpayments by corporations, which is lower than the rate for other taxpayers, applies to overpayments by nonprofit corporations.

## Bargain Sale to Charity

### Rutkoske, 149 T.C. No. 6, (Aug. 7, 2017)

Farmers who conveyed a conservation easement to a public charity were not "qualified farmers" entitled to an enhanced charitable contribution deduction. A "qualified farmer" is an individual whose gross income from the trade or business of farming exceeds 50 percent of his gross income, and can deduct up to 100 percent of their basis for the year of a conservation easement contribution. The taxpayers argued that the sale of real estate used in the business of farming generated income from the business of farming, but the court held that selling property does not constitute cultivating the soil, raising agricultural or horticultural commodities, handling the commodities or tree farming. Therefore, selling the rights to develop the land did not generate income from the trade or business of farming. Moreover, the LLC that sold the property was not in the business of farming; it was in the business of leasing real estate to farmers. Thus, for federal income tax purposes, the income from the sale was characterized as income from the sale of real estate and that characterization flowed through to the taxpayers.

## IV. PARTNERSHIPS

### Status as Partner

**Derringer Trading LLC, T.C. Docket 20872-07 (Aug. 11, 2017)**

In a pretrial order, the Tax Court ruled that where a taxpayer held herself out as a partner in a partnership, on her tax returns and elsewhere, she was precluded by the duty of consistency from arguing in the pending case that she was not a partner in the partnership. The partnership's 2003 and 2004 returns showed that the taxpayer had a 99 percent interest, with her share of losses exceeding $3 million. In subsequent years she testified that she was a partner. Subsequently, she said she was "intimidated and coerced" by her husband into signing joint tax returns that showed her as a partner.

### TEFRA Audit Procedures

**Seaview Trading LLC, 9th Cir., 119 AFTR 2d ¶ 2017-827 (June 7, 2017)**

The Ninth Circuit, affirming the Tax Court, has held that a disregarded entity that is a partner in a partnership is treated as a passthrough partner, which precludes the partnership from qualifying for the small partnership exception to the TEFRA audit rules, and can be the partnership's tax matters partner. TEFRA audit rules do not apply to any partnership having 10 or fewer partners, each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner, unless the partnership elects to have them apply. § 6231(a)(1)(B). The exception does not apply if any partner is a "pass-thru partner" – a partnership, estate, trust, S corporation, nominee or similar person through whom other persons hold an interest. § 6231(a)(9).

### Partnership Not Recognized

**New Millennium Trading, LLC, TC Memo 2017-9**

The Tax Court held that because a partnership was created exclusively for tax avoidance purposes, it would not be recognized as an entity for Federal tax purposes, and sustained IRS's partnership-item adjustments and partnership-level determinations.

An investor who expected to recognize income of $110 million from the sale of a business joined a tax shelter in which he contributed offsetting options to an LLC to obtain an artificially high basis in a partnership interest, receive euro and stock in disposition of that interest, and then claim a significant tax loss from the disposition of the euro and stock, offsetting millions of dollars of gain realized on the sale of an unrelated business interest. Following the D.C. Circuit's holding in *ASA Investerings Partnership* (2000) that a partnership requires that "the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance," the Court found the evidence overwhelming that the partnership was created exclusively for tax avoidance purposes.

# V. CORPORATIONS

## S Corporation Basis

### Hargis, T.C. Memo. 2016-232, 112 T.C.M. 681 (Dec. 21, 2016)

The debt represented by loans to S corporations did not increase the basis of a shareholder who co-signed or guaranteed the loans. No loan proceeds were advanced to the shareholder himself. The Court found this distinction was critical. None of the promissory notes were collateralized by the shareholder's own property. Finally, the taxpayer provided no convincing evidence that any of the lenders looked to him as the primary obligor on the loans received by the companies.

### Phillips, TC Memo. 2017-61 (April 10, 2017)

A shareholder's guarantee of a loan to her S corporation didn't give her basis in the entity even where the lenders sued her on her guarantee and recovered deficiency judgments against her, resulting in liens against her real and personal property.

## Corporate Status

### Urgent Care Nurses Registry T.C. Memo. 2016-198, 112 TCM 480, (Nov. 2, 2016)

A corporation's petition seeking review of a determination notice sustaining a proposed levy was dismissed for lack of jurisdiction because its corporate charter was suspended and, therefore, the corporation lacked legal capacity to prosecute the case.

### Eriem Surgical, Inc., 7th Cir., 843 F.3d 1160, 2017-1 U.S.T.C. ¶50,125, (Dec. 16, 2016)

A company's wrongful levy claim failed because it was the successor of a tax debtor. The debtor company went out of business owing taxes and a new company was incorporated on the same day, purchased all the defunct business's inventory, took over its office space, website and phone number, hired its employees and pursued the same line of business. That the stockholder's wife was the ostensible owner of the new company did not prevent treating the firm as the defunct company's successor. Only a complete change in ownership would prevents a finding of succession.

## Liquidating Distributions

### W.S. Stuart, Jr. 8th Circuit, 2016-2 USTC ¶50,468 (Nov. 14, 2016)

The Eighth Circuit held that the Tax Court erred by failing to consider whether a stock sale should have been recharacterized as a liquidating distribution under state law. The Tax Court ruled that the IRS's recovery depended on the shareholders' status as transfer beneficiaries, and they were only liable for the amount by which they benefitted from the corporation's transfer of cash to the purchaser of the stock. The underlying rationale would not apply if the Tax Court had concluded that the stock sale was really a liquidating distribution made directly to the former shareholders. Thus, if the transaction was recharacterized under state law, the IRS could be entitled to collect the full amount of its claim from the former shareholders.

## Sale of Stock

### Makric Enterprises, 5th Cir., 119 AFTR 2d ¶ 2017-580 (March 27, 2017)

The Fifth Circuit upheld the Tax Court's conclusion that the structure of a transaction, signed and executed by the taxpayer, could not be recast due to alleged mutual mistake. Generally, a taxpayer generally can't use the substance-over-form doctrine to challenge the tax consequences of his own agreement unless the agreement was unenforceable on account of mistake, fraud, duress, or undue influence. *Danielson* (3rd Cir. 1967).

# VI. CAPITAL GAIN AND BASIS

## Basis

### Mileham, T.C. Memo. 2017-168, 114 T.C.M. 249, (Aug. 28, 2017)

A coin and metals dealer who maintained inadequate records was held entitled to a higher cost of goods sold than determined by the IRS. The IRS reconstructed his cost of goods using a bank accounts disbursement analysis that did not use invoices. This had the effect of omitting exchange transactions that didn't result in a net purchase. The court found sufficient evidence from expert testimony to estimate costs of goods sold using markup over cost, which it found to be 2.1 percent.

### Tseytin, 3rd Cir., 120 AFTR 2d ¶2017-5160 (August 18, 2017)

The Third Circuit affirmed a Tax Court decision that a primary shareholder who bought out the minority shareholder, then sold all of the shares, should be taxed on the gain attributable to all shares, including those purchased from the minority shareholder, rejecting the taxpayer's claim that he was merely an agent for the minority shareholder. He also could not net his short-term loss on the minority shareholder's shares against the long-term gains from the shares he had held.

### Washington Mutual, 9th Cir., 119 AFTR 2d ¶2017-757 (May 12, 2017)

The Ninth Circuit affirmed that a bank failed to establish a reliable cost basis in rights it obtained in its acquisition of failed savings and loan associations in the 1970's and 1980's, so its amortization deductions were not allowed. The bank had to establish the excess of the failed thrifts' liabilities over the value of their assets, then establish what portion of that excess was allocated to their branching rights. The district court agreed with the bank that an estimate would suffice for valuation purposes – but held that the flaws underlying the bank's economic model rendered it incapable of producing a reliable value for the branching rights.

## Abandonment

### Watts, T.C. Memo. 2017-114, 113 T.C.M. 1507, (Jun. 14, 2017)

The Tax Court held that taxpayers' losses on the disposal of partnership interests were not ordinary abandonment losses, but rather were capital losses. A loss due to abandonment of worthless property is generally deductible under Sec. 165(a) as an ordinary loss if it was incurred in a transaction entered into for profit. The taxpayer must demonstrate that the transaction wasn't a sale or exchange, and that the taxpayer abandoned the asset, intentionally by overt act. Here, the partnership was sold to a private equity firm, for $87 million, but the taxpayers received none of the cash.

## Capitalization of Expenses

### Wasco Real Properties I, LLC, T.C. Memo. 2016-224, 112 T.C.M. 640, (Dec. 13, 2016)

The Tax Court held that farming partnerships were required to capitalize interest on the debt allocable to the land where they grew almond trees. One partnership was also required to capitalize property taxes. Two partnerships were required to capitalize the interest on funds they borrowed from a third party and contemporaneously lent to the third partnership because it was a related-party loan to avoid interest capitalization rules and did not carry out the purposes of § 263A(f).

The property taxes had to be capitalized because the taxes directly benefitted the almond trees and were allocable to property that produced future income. Allowing a current deduction of property taxes would distort the taxpayer's actual income for subsequent years and would otherwise allow the taxpayer to offset unrelated income causing a mismatch of expenses and revenues that § 263A was enacted to prevent. The interest allocable to the land where the almond trees grew had to be capitalized because the land was indispensable to growing the trees. Thus, the cost of the land was an indirect cost to the extent the land was used to grow the trees. The interest paid on financing that portion of the land was directly attributable to production expenditures with respect to property. However, the interest allocable the portion of land that was used to grow row crops was currently deductible because that portion of the land was currently producing income.

## Capital Asset

### T.G. Hurford Estate, TC Memo. 2008-278 (Apr. 27, 2017)

A partnership, created to hold phantom stock in an oil company, could treat the income it received on termination of the phantom-stock plan as long-term capital gain. A widow received the phantom stock, representing deferred compensation, when her husband died. She transferred the stock to the partnership. The phantom stock was a capital asset in the hands of the partnership after the transfer. The partnership could not do anything to affect the stock's value, but rather simply held the phantom stock and hoped it would appreciate in value. This distinguishing characteristic was enough to show that the stock was a capital asset of the partnership, whose basis in the phantom stock equaled its fair market value at the time of the spouse's death.

## Franchises

### Greenteam Materials Recovery Facility, TCM (Jun. 22, 2017)

Taxpayers recognized capital gain when they sold service contracts to a third party because the contracts (to provide landfill, waste-disposal and recycling services in specified areas) were franchises, which are capital assets. The taxpayers retained no interest in the contracts after the transfer and received no contingent payments. Thus, the contracts met the definition of a franchise.

## VII. REAL ESTATE

### Distressed Property

### Tucker, 11th Cir., 118 AFTR 2d ¶2016-5521 (Nov. 21, 2016)

The Eleventh Circuit affirmed disallowance of net operating loss carry-backs claimed for real estate the taxpayer said was abandoned or rendered worthless by the 2008 housing crisis. The business reported a loss of $10.8 million on its 2008 return, of which $8.9 million was attributable to a write-down of its real estate inventory to market value as of December 31, 2008. Its owner claimed a flow-through loss of roughly $6.8, and elected to carry back the NOL to the previous five years. The record showed, though, that (1) the owner continued to develop and sell the properties throughout 2009 and 2010, (2) its principal invested over $800,000 to facilitate construction in that time; (3) the owner settled foreclosure suits rather than re-conveying the properties to the lenders, which was inconsistent with any claims of abandonment.

### Bobo, T.C. Summary Opinion 2016-74, (Nov. 8, 2016)

A couple was required to include an amount designated by the payor as payment for a deed in lieu of foreclosure as ordinary income. The taxpayers received the amount as part of the "cash for keys" program by fulfilling conditions at the time of foreclosure of their second home. The taxpayers had two agreements with the mortgage company stemming from the exchange of property, the deed in lieu of foreclosure agreement and the cash for keys agreement. They were found to be inseparable, since the mortgage company would not have issued the cash-for-keys payment if the taxpayers did not agree to sign over the deed to the property. Therefore, the cash for keys payment was treated as part of the deed in lieu of foreclosure transaction and was included in the amount realized on the house. The mortgage company paid the taxpayers to avoid the lengthy and expensive legal process of foreclosure. Therefore, the payment was an incentive payment and was considered ordinary income since it was not part of the amount realized on the exchange.

# VIII. EMPLOYMENT AND PAYROLL

## FICA

### University of Utah, D. Utah, 2017-2 U.S.T.C. ¶50,355, (Sept. 21, 2017)

A medical school's claim, that medical residents were exempt from Federal Insurance Contributions Act taxes because they are state employees, was rejected.

The state-employee exemption, Sec. 3121(b)(7)(E), provides that services performed for a state entity do not constitute employment for FICA purposes unless that service is included under a Section 218 agreement. The student exclusion in the state's 218 agreement provides that services performed in the employ of a university are excluded from FICA if the service is performed by a student who is enrolled and regularly attending classes. Thus, if the medical residents were not students, they were subject to FICA taxation. However, the Social Security Administration (SSA) had made it clear that it did not interpret the term "student" to include medical residents before the state modified its 218 agreements to remove the qualifier "full-time." Moreover, even if the state understood the term student to include medical residents, there was no evidence that this understanding was ever communicated to the SSA. Further, the state was, or should have been, aware of the SSA's position that medical residents are not students. Therefore, the university failed to show that the term student in its 218 agreement included medical residents.

## Responsible Person Liability

### Fitzpatrick, T.C. Memo. 2016-199, T.C. Memo. 112 TCM 481 (Aug. 3, 2017)

The owner's wife was held not to be a responsible person. She "lacked the authority to control the financial affairs of the business or exercise any significant authority over the disbursement of [corporate] funds. Notwithstanding petitioner's signatory authority and her spousal relationship to one of the corporation's owners, the substance of petitioner's position was largely ministerial and she lacked actual authority ... Petitioner has a high school education. She has never completed or even enrolled in any college-level courses. While petitioner developed strengths in sales and marketing during the course of operating her rental real estate business, she does not have experience in accounting, finance, tax, or management ... It is clear from the testimony and other evidence that petitioner was not an officer, director, owner, or employee of the corporation at any time. With the exception of a few weeks during the pre-opening phase, petitioner had no involvement in the day-to-day affairs of the corporation. In fact, she spent most of her time taking care of her disabled son ... She had no responsibility to oversee or ensure the payment of payroll taxes on its behalf."

**Commander, N.J. Dist., 119 AFTR 2d ¶2017-620 (April 3, 2017)**

A 50% owner of a member-managed company, who was required to sign off on all significant decisions and actions relating to the company, was liable for the trust fund penalty. His role in the company established that he was a responsible person, regardless of whether the other owner had primary responsibility for the company's taxes. Responsibility is a matter of "status, duty or authority, not knowledge." *Quattrone* (3rd Cir. 1990).

**McClendon, S.D. Texas, 2017-1 U.S.T.C. ¶50,170, (Mar. 6, 2017)**

A district court upheld its decision that a physician who lent his business $100,000 to pay its next payroll, after learning that an employee embezzled millions of withheld taxes, was liable for the full $4.3 million responsible person penalty for unpaid employment taxes. When he learned of a $10 million delinquency in withholding taxes, when his CFO pleaded guilty to embezzlement from his practice, the business stopped operating and remitted its remaining receivables to IRS. The physician made a $100,000 personal loan to the practice "for the restricted purpose of...using the funds to pay the May 15, 2009 payroll." The practice used the funds to pay its employees. IRS assessed a $4.3 million responsible person penalty on Dr. McClendon. The district court rejected the argument that the funds were "encumbered" and that willfulness is shown only if a responsible person directed "unencumbered" funds to a creditor other than the government. On reargument, the court rejected the taxpayer's request that his liability be limited to the $100,000 preferential payment, because the issue wasn't raised in the first trial.

**Byrne, 6th Cir., 2017-1 USTC ¶50,228 (May 17, 2017)**

Reversing a district court, the Sixth Circuit held that the CEO and president of a defunct manufacturer did not willfully fail to pay over trust fund taxes. They took reasonable steps to ensure the timely payment of the trust-fund taxes and reasonably believed the taxes were being paid. They were not reckless because they did not independently verify their auditor's reports or the controller's account of the business's tax status. The officers hired an assistant controller and a CFO who oversaw the controller's work after they discovered that the controller had made late trust-fund deposits. They also hired an independent, professional CPA firm to assist in tax matters and to conduct full-scope audits, which also demonstrated that they took reasonable steps to comply with all of the business's tax obligations, including the timely payment of trust-fund taxes. The officers did not have any indication of inaccuracies in the audit reports until after they became aware of the nonpayment. The CPA firm did not detect the controller's suspect financial accounting after having performed a full-scope audit and it took several months for a crisis management firm to determine the exact amount of the tax liability.

**Gann, Ct. Cl. 119 AFTR 2d ¶ 2017-562, March 21, 2017**

A corporate officer failed to establish that he didn't willfully fail to pay trust fund taxes, where the employer remitted payroll taxes in an amount that exceeded the amount it withheld from its employees, but that was less than the sum of that amount and the employer's portion of the payroll taxes; and did not designate how its payment should be applied to its tax liabilities. A taxpayer may make an express election to pay trust fund liabilities first by making an explicit instruction to IRS. That he made no election was not a defense.

**Independent Contractor vs. Employee**

**Mescalero Apache Tribe, (2017) 148 TC No. 11**

The Tax Court rejected IRS's argument that Sec. 6103's confidentiality rule prohibited it from providing an employer that it was auditing with the amounts of federal income tax that were paid by workers that the employer had misclassified as independent contractors. The employer was attempting to apply § 3402(d)'s rule that allowed it to offset its liability for withheld tax by the income tax paid by those workers. The Court held that § 6103(h)(4) permitted the disclosure. That section permits return information to be disclosed in a judicial or administrative proceeding pertaining to tax administration, to the extent that "an item reflected on such return is directly related to the resolution of an issue in the proceeding; [or] ... directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding."

**Disputed 1099's**

**Shiner v. Turnoy, 7th Cir., 119 AFTR 2d ¶ 2017-542 (March 16, 2017)**

A payor and a payee disagreed about the amount owed. The payor wrote a check for the amount he believed he owed, which the payee disputed. The check stated that cashing it would release the payor of any future obligation. The payee declined to cash it. The payor submitted a Form 1099 for the amount of the check. Reversing a district court, the Seventh Circuit held that the payor did not willfully file a fraudulent information return.

Normalcy, creditors are in constructive receipt once they receive the check. If there is a dispute over the underlying debt, and a restrictive endorsement on the check imposes a condition upon its acceptance, there is no constructive receipt. When the payor included the restrictive endorsement, he transformed it from a payment into an offer of payment subject to a condition. The district court concluded that the payor exhibited willfulness in filing the fraudulent Form 1099. The Circuit Court reversed, reasoning that Turnoy had filed the Form 1099 more than a month after sending the check, during which the payee had neither asked for a new check without a restrictive endorsement nor otherwise communicated a rejection of the check. This inaction gave the payor a basis for believing that the check was accepted.

**Derolof v. Risinger Bros. Transfer, Inc., DC Ill., 2017-1 USTC ¶50,207 (Apr. 27, 2017)**

Truck drivers' claims that their employer purposefully misclassified them as independent contractors, and was willfully filing fraudulent information returns, were rejected. Under § 7434, a person is prohibited from willfully filing a fraudulent information return with respect to payments purported to be made to any other person. A Form 1099 that identifies a worker as an independent contractor when he is really an employee is a false information return with respect to the worker's employment status, but so long as the Form 1099 accurately reported the amounts paid to the worker the return is not fraudulent with respect to the payments made. Therefore, the individuals failed to state a claim under § 7434 because they did not claim that the amounts on the Forms 1099 were incorrect.

**Tran v. Tran, M.D. Florida, 2017-1 U.S.T.C. ¶50,208, (March 7, 2017)**

In an employee's claim that his employer misclassified him as an independent contractor instead of as an employee by issuing a false Form 1099, the Court held that Congress' intent was to bar attempts to inflate another person's tax liability by reporting more income than actually received. Section 7434 does not permit recovery for the mere misclassification of an employee with the filing of Form 1099, instead of Form W-2, because a judgment for the employee would require the court to find the employer liable for tax fraud while acknowledging that the employer accurately reported the employee's income. Finally, the defining characteristic of an information return is the reporting of a payee's income. Whether innocent or deliberate, the payor's filing of the wrong form does not establish liability under § 7434, unless the form willfully misstates income.

**ESOP Deduction**

**Petersen, (2017) 148 TC No. 22 (Jun. 13, 2017)**

The Tax Court held that the entity holding S corporation stock for participants in the corporation's employee stock ownership plan was a trust, so the stock was deemed to be held by the trust's beneficiaries, the ESOP participants. Therefore, the ESOP participants and S corporation were related under § 267(b), so the S corporation was required to defer its deductions, for certain accrued but unpaid payroll expenses, until the compensation was received by the ESOP participants and includible in their gross income.

# IX. ACCOUNTING

## Transfer Pricing

### Amazon.com, Inc. and Subsidiaries, (2017) 148 TC No. 8

The Tax Court upheld the taxpayer's method of transfer pricing involving its foreign subsidiary, and rejected the IRS's adjustments as arbitrary and unreasonable, holding that the taxpayer's uncontrolled transaction method, with appropriate upward adjustments, was the best method to determine the buy-in payment, and that its cost-allocation method, with certain adjustments, supplied a reasonable basis for allocating costs to intangible development costs, following *Veritas Software Corp.*, (2009), which upheld a comparable transfer pricing method.

## Completed Contract Method

### Basic Engineering, Inc., TC Memo 2017-26

The Tax Court held that a taxpayer that disassembled, transported and assembled oil refineries under two long-term contracts couldn't use the completed contract accounting method because the taxpayer failed to reasonably estimate that the contract would be completed within two years of the contract commencement date as required under § 460(e)(1)(B)(i).

## Mitigation Relief

### Robb Evans & Associates, 1st Cir., 119 AFTR 2d ¶ 2017-500 (March 3, 2017)

Reversing a district court, the First Circuit held that mitigation relief under § 1341 was not available to taxpayers with respect to funds that were derived from fraudulent activity. Since they received the funds fraudulently, the taxpayers could not have claimed an "unrestricted right" to them within the meaning of § 1341(a), which applies if a taxpayer establishes that (1) an item was included in gross income for a prior tax year because it appeared that the taxpayer had an unrestricted right to such item; and (2) a deduction exceeding $3,000 is allowable for the current year because it was established after the close of such prior tax year that the taxpayer did not have an unrestricted right to the item.

A court-appointed receiver acting on behalf of a class of defrauded persons, sought to collect a $259 million judgment from operators of a debt counseling business. The Receiver was only able to recoup $2.5 million. Seeking to increase the recovery, the Receiver filed a refund claim for $9,387,235 on behalf of the fraudulent defendants it was chasing, asserting that they had reported as income funds that they had fraudulently obtained from their clients, and were now obliged to restore these funds to those whom the Receiver represented. Because the defendants could deduct these repayments, and the deductions would exceed the defendants' tax liability for the year of repayment, refunds should be paid to the Receiver. The court rejected the claim.

# X. RETIREMENT PLANS

## Taxation of Distributions

### Ozimkoski T.C. Memo. 2016-228, 112 T.C.M. 666, (Dec. 19, 2016)

Where the trustee of taxpayer's late husband's IRA incorrectly rolled over his IRA to the taxpayer's IRA, and then she made distributions from her IRA, including a payment to her stepson in settlement of his Will contest, the distributions were subject to tax and to various penalties including the § 72(t) tax on early IRA distributions.

She received all property under his Will, but not named as a beneficiary of his IRA. The stepson challenged his Will in court. The IRA trustee froze the IRA pending the outcome. The contest was settled for $110,000 as a "net payment free of tax."

The IRA transferred $235,495 from husband's IRA to her traditional IRA. She received distributions totaling $142,000 from her IRA, then wrote the $110,000 settlement check.

Held: under Florida law, the trustee should have distributed the IRA to husband's estate. Although the trustee incorrectly rolled over his IRA to her IRA, the Court had no jurisdiction to unwind the transaction. The distributions she received were from her own IRA were taxable income. Since she was under 59½, the early distribution penalty also applied.

## Rollovers

### Trimmer, 148 T.C. No. 14 (April 20, 2017)

A taxpayer, who failed to timely roll over two IRA distributions while suffering from a major depressive episode, was entitled to a hardship waiver of the 60-day rollover deadline. Because he was entitled to a hardship waiver, he was also relieved of the early distribution penalty. Held that neither Rev. Proc. 2003-16, as modified by Rev. Proc. 2016-47, nor § 402(c)(3)(B) constrains an examiner's ability to consider a hardship waiver during an examination. Although the taxpayer did not expressly cite § 402(c)(3)(B), his letter clearly requested a hardship waiver.

# XI. PROCEDURE

## Execution

### Cardaci, 3rd Cir., 2017-1 U.S.T.C. ¶50,220, (May 8, 2017)

The Third Circuit vacated a district court's decision not to order the sale of a delinquent taxpayer's marital home, holding that the district court had jurisdiction to order the sale of property even though it was held as tenants by the entirety. A district court must order a sale of the sale of entireties property to satisfy a tax lien unless, in light of common sense or special circumstances, it determines that a sale would be inequitable using the factors set out by the Supreme Court in *Rodgers* (1983). The district court had found "equities" that against a sale, and instead imputed a monthly rental of $1,500 and ordered the husband to pay half that value to the IRS each month. To determine adequate compensation to the innocent spouse, the appeals court said her interest in the property was worth 86% of the property's market value, the sum of her 50 percent survivorship rights, plus half of her 72 percent life interest.

### Davis, La. Dist., 119 AFTR 2d ¶ 2017-309 (Jan. 5, 2017)

A district court approved a foreclosure sale of property partially owned by an innocent party. A law firm owed taxes, and its partners owned two-thirds of the parcel. The Court found that the IRS met the standards set by the Supreme Court in *Rodgers* with respect to the innocent third owner's interest, and a purchase of tax sale title on the property by a third party had no effect on IRS's lien. The property had been sold at a public tax sale because local taxes had been unpaid, but notice of the sale was not provided to the IRS in the manner required by § 7425(c).

## Transferee Liability

### Kardash, 11th Cir., 2017-2 U.S.T.C. ¶50,300, (Aug. 4, 2017)

A shareholder of a construction company, which was defrauded by two other shareholders, was held liable as a transferee for the business's unpaid taxes, on the dividends he received from the corporation. The government was not required to exhaust all reasonable collection efforts against the transferor because state law did not require exhaustion for there to be liability; instead, state law permits a creditor to collect against a transferee of a debtor under a theory of constructive fraud when the claim arose before the transfer, the debtor made the transfer without receiving equivalent value in exchange, and the transferor was insolvent or became insolvent as a result of the transfer. The taxpayer, who was also a senior employee, could not prove the funds were compensation.

## Whistleblower

### Whistleblower 12568-16W, 148 T.C. No. 7, (Mar. 22, 2017)

A whistleblower was permitted to proceed anonymously. He presented a sufficient showing of harm that outweighed societal interests in knowing his identity. Previously employed by an entity related to the taxpayer, he claimed knowledge of significant unlawful tax violations by the taxpayer that he acquired in the normal course of his employment.

The possibility of retaliation, ostracism, economic loss, professional embarrassment and physical harm was buttressed by extensive testimony and exhibits. The grant of anonymity is provisional, as factors can shift as the balance between the alleged harm to the whistleblower and the societal interest in knowing his identity may shift and that anonymity may no longer be justified.

### Whistleblower 16158-14W 148 T.C. No. 12, (Apr. 17, 2017)

A whistleblower was not eligible to receive an award because there were no "collected proceeds" for the three years examined and the IRS did not take any action on the other years. Based on the whistleblower's information that the taxpayer failed to withhold taxes on interest and dividend payments it made to foreign persons, the IRS expanded an ongoing examination to include the whistleblower's issue, but took no administrative or judicial action with respect to the subsequent years for which the whistleblower sought an award. The whistleblower argued that the amounts collected for the later years were "collected proceeds" and should relate back to the earlier examination. But the court held that "collected proceeds" did not include self-reported amounts collected when the taxpayer changed its reporting for years that were not a part of the action the IRS took based on the whistleblower's information.

### Ian Smith, 148 T.C. No. 21, (Jun. 7, 2017)

In a case of first impression, the Tax Court has determined that the "amount in dispute" for purposes of a whistleblower award was the total liability the IRS proposed with respect to an examination commenced using the whistleblower's information, not just the "collected proceeds" attributable to the whistleblower's information or specific allegations. The IRS used the whistleblower's information and the examination resulted in nearly $20 million of tax in dispute (of which almost $2 million was directly or indirectly attributable to the whistleblower's information). The IRS determined that the "amounts in dispute" did not meet the $2 million threshold and, therefore, the whistleblower was only entitled to a discretionary award equal to 10 percent of the amount directly attributable to his information. However, the "amount in dispute" for purposes of § 7623(b)(5)(B) was in excess of $2 million and, therefore, the IRS's use of the discretionary provisions of § 7623(a) to determine the amount of the whistleblower award was in error.

## Collection Due Process Hearings

### McNeill, 148 TC —, No. 23, Dec. 60,938 (Jun. 20, 2017)

In a case of first impression, the Tax Court determined that it has jurisdiction to review a Collection Due Process hearing determination when the underlying tax liability consisted solely of an accuracy-related penalty related to a partnership adjustment that was excluded from the deficiency procedures. The accuracy-related penalty was another example of an item not subject to the court's deficiency jurisdiction, but was nonetheless reviewable by the court.

## Return after Deficiency Notice Issued

### R. Borenstein, 149 T.C. No. 10, (Aug. 30, 2017)

In a case of first impression, The Tax Court held that a taxpayer who did not file her return before the notice of deficiency was issued and did not pay her tax liability within two years of the mailing of the notice of deficiency was not entitled to a refund of the overpayment of taxes. The taxpayer was limited to the look back period under § 6511(b). Therefore, the Tax Court lacked jurisdiction to issue the refund.

### Riggins, T.C. Memo. 2017-106, 113 T.C.M. 1477, (Jun. 8, 2017)

The Tax Court has held that even if the IRS processes a taxpayer's return, after it issued a notice of deficiency based on an IRS-prepared substitute for return and after the taxpayer filed her petition seeking the Court's redetermination of her tax liability, the Service had authority to rely upon that notice of deficiency.

After the IRS issued the notice of deficiency, the taxpayer filed her 1040, then filed her Tax Court petition. The IRS processed her 1040 and offset her claimed refund against a non-tax debt. At trial, taxpayer argued that IRS had voluntarily redetermined her liability by accepting the 1040 she filed after the notice of deficiency was issued. Therefore, she argued, IRS should be precluded from offering any evidence inconsistent with the redetermined tax liability and no longer could rely upon the original notice of deficiency. The court rejected this argument, saying that taxpayer had invoked the Court's jurisdiction by filing her petition for redetermination, which had the effect of restricting IRS's ability to assess or collect taxes until the Court's decision became final. The Court said that she was seeking to "end-run" the statute that gave the Court jurisdiction once she filed her petition.

## Summons

**Fridman, 2nd Cir., 2017-1 U.S.T.C. ¶50,110, (Dec. 13, 2016)**

An order enforcing IRS summonses seeking records related to an individual's foreign financial accounts was reversed because the record was insufficient to review the Fifth Amendment privilege claim. The IRS agent's affidavit was sufficient to show that the requested documents were relevant, but there was no transcript of the proceeding during which the individual asserted his privilege, and the district court failed to identify which exceptions to the privilege applied, and to which documents.

## Levy

**Dent, CA-9, 2016-2 USTC ¶50,456.**

An LLC manager who failed to honor an IRS levy on two members was personally liable for the outstanding tax liability. The IRS sent the manager a notice of levy instructing him to turn over "wages, salaries and other income that you have now or for which you are obligated." He argued the levy did not encompass membership distributions and licensing fees that the LLC was required to pay to the two members each month. However, the members' rights to the distributions and licensing fees were fixed and determinable "income" and, therefore, the levies attached to those rights.

**Lindsay Manor Nursing Home, Inc., 148 TC 9148, TC Memo. 2017-50 (March 22, 2017)**

The economic hardship exception, under which a levy proceeding can be halted, applies only to individual taxpayers and cannot be invoked by a corporation. The Court found § 6343(a)(1)(D) was silent or ambiguous on the issue of whether "taxpayer" includes entities and that either interpretation was possible. Legislative history did not resolve the ambiguity. Applying the deference to agency interpretation authorized by the Supreme Court in *Chevron* (1984), the court determined that the IRS interpretation in Reg. §301.6343-1(b)(4)(i), which limits this kind of relief to situations where satisfaction of the levy "would cause an individual taxpayer to be unable to pay his reasonable basic living expenses," was reasonable.

## Evidence at Trial

**Worth, CA-9, 2017-1 USTC ¶50,126**

An IRS agent was properly allowed to testify to the taxpayers' net worth. She used the net worth method and the dash method to reconstruct their income. The taxpayers did not dispute that the agent was qualified to apply the net worth method, nor did they show that her methodology was unreliable, identify any flaws in her calculations that were overlooked at trial or otherwise demonstrate that disclosing her as an expert would have changed the outcome of their case.

## Unauthorized Disclosure

**Minda, 2nd Cir., 119 AFTR 2d ¶ 2017-571, 2017-1 U.S.T.C. ¶50,185, (Mar. 24, 2017)**

The Second Circuit, affirming the district court, concluded that a taxpayer was entitled to statutory damages from IRS only for its single act of disclosing a report of proposed changes, and not separately for the disclosure of each item of information contained in that report.

**Welborn, DC D.C., 2016-2 USTC ¶50,459 (Nov. 2, 2016)**

Claims that the IRS disclosed return information when its "Get Transcript" online application was hacked were dismissed for failure to state a claim. The claimants argued that the IRS negligently failed to properly secure the Get Transcript application, which proximately caused the disclosure of their personal identifying information. The court held, however, that § 6103 does not authorize a suit based on a failure to protect, but only for improper disclosure of, such information.

## Prevailing Party

**Nelly Home Care, Inc., E. D. Pa., 119 AFTR 2d ¶ 2017-665 (May 10, 2016)**

A district court has held that the fact that a taxpayer wins a case against IRS on summary judgment is not dispositive on the question of whether the taxpayer may be awarded litigation costs. Under § 7430(a), a prevailing party may recover reasonable administrative and litigation costs incurred in a tax matter if it "substantially prevailed" with respect to the amount in controversy or the most significant issues presented – but not if IRS establishes that its position was substantially justified. Here, the court found IRS's position was substantially justified, despite its loss on summary judgment, because there had been no precedent involving the issue in question.

## Refunds

**Pfizer, S.D. N.Y., 2017-1 U.S.T.C. ¶50,230, 118 AFTR 2d ¶ 2016-5407 (May 12, 2017)**

A district court held that district courts have jurisdiction to hear cases in which the only issue is interest owed to a taxpayer on overpaid taxes. The taxpayer overpaid its taxes and sought a refund, but, due to an internal error, IRS made a late refund of the overpaid taxes and no interest. When the taxpayer brought suit in district court to obtain overpayment interest the court held it had jurisdiction under 28 U.S.C. § 1346(a)(1), which states "The district courts shall have original jurisdiction of any civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws."

## Statute of Limitations

### Giaimo, 8th Cir., 119 AFTR 2d ¶ 2017-679 (Apr. 17, 2017)

The Eighth Circuit affirmed the rejection of a taxpayer's arguments that her Tax Court appeal of IRS's collection due process hearing determination did not toll the statute of limitations on collection. Collection may be begun within 10 years after an assessment. Section 6502(a)(1). The IRS must give a taxpayer written notice if a lien is filed on the taxpayer's property or IRS intends to levy, and inform the taxpayer of the right to request a CDP hearing in the IRS Appeals Office. If a person requests a CDP hearing regarding a levy, the levy actions and the limitations periods are suspended while the hearing, and any appeals from the hearing, are pending.

## Nominee

### Holland, E.D. Michigan, 2017-2 U.S.T.C. ¶50,348, (Sept. 12, 2017)

A bank's lien was valid and superior to the government's claims to a first-priority distribution from interpleaded funds. The taxpayer, one of Motown's leading songwriters, owned the rights to his works, and created an LLC to receive his future royalty payments. He then securitized his future royalties to borrow $15 million from a bank. The IRS argued that its lien was superior to the bank's lien because the songwriter fraudulently transferred his royalty rights to a nominee. The IRS, however, was unable to show that the transfer of future royalties to the LLC was fraudulent. There was no evidence that the transfer significantly hindered the songwriter's creditors; that consideration for the transfer was inadequate; or that the transfer rendered the taxpayer insolvent. Therefore, the government had no right to the assets held by the LLC

## XII. PRACTICE

### Registration Fees

**Steele, D.C. Dist., 120 AFTR 2d ¶ 2017-5041 (July 10, 2017)**

A district court permanently enjoined IRS from charging fees for Preparer Tax Identification Numbers and ordered IRS to make a full refund of all PTIN fees paid from Sept. 1, 2010 to present.

IRS requires that tax return preparers obtain and exclusively use the PTIN in forms, instructions, or other guidance, rather than a Social Security Number, as the identifying number to be included with the preparer's signature on a tax return or refund claim. Regs. § 300.13 imposes a user fee requirement for obtaining a PTIN. As authority for requiring these fees, IRS relied on 31 U.S.C. 9701(b), which authorizes agencies to prescribe regulations "establishing the charge for a service or thing of value provided by the agency."

Attempting to regulate tax return preparers, the IRS promulgated regulations in 2010 to establish a "registered tax return preparer" designation, requiring individuals other than attorneys and CPA's to pass a one-time competency exam, pass a suitability check, obtain a PTIN and pay a user fee. Reg. § 301.7701-15. As statutory authority, IRS relied on 31 U.S.C. § 330(a), which states that IRS may regulate the practice of representatives of persons before the Department of the Treasury; and before admitting a representative to practice, require that the representative demonstrate good character, good reputation, qualifications; and competency.

In 2014, a panel of the D.C. Circuit held that IRS lacked statutory authority to promulgate or enforce those final regulations, saying that tax return preparers are not representatives tax return preparation does not involve practice before IRS because it is not an adversarial proceeding. *Loving*, 113 AFTR 2d 2014-867. Thus, after Loving, the only part of the new regulatory scheme that remains is the PTIN requirement and the attendant PTIN fee requirement.

Here, the Court upheld the IRS's authority to require the exclusive use of PTIN's, but following *Loving*, held it was not authorized to charge a fee to obtain a PTIN.

### Business Expenses

**Engstrom, Lipscomb & Lack, 9th Cir., 2017-1 USTC ¶50,124 (Jan. 13, 2017)**

A law firm could not deduct as travel expenses all payments it made for standby airplane use. The firm argued that it had agreed to for 24-hour standby use of aircraft, but failed to produce any written record of such an agreement; testimony did not clearly establish the alleged agreement's existence; and evidence did not clearly show that all flights had a business purpose; where flights had a substantiated business purpose, there was no evidence of their individualized cost. Thus, the firm's evidence was adequate to substantiate some, but not all, of his deduction.

## Tax Promoter Penalty

### P.G. Groves, N.D. Illinois, 2017-1 U.S.T.C. ¶50,232, (May 5, 2017)

A tax shelter promoter penalty, imposed a decade after alleged tax shelter violations, was not barred by the three-year statute of limitations. Section 6501 depends on filing a return to begin the running of the limitations period, but § 6700 penalty assessments do not depend on filing a return; rather, they occur when the IRS discovers an individual's activities are prohibited by § 6700. The conduct prohibited by § 6700 is not the client's filing of an inaccurate return, but a tax shelter promoter's making a statement that falsely touts the shelter's tax benefits: a tax shelter promoter can violate § 6700 even if the client does not file a return.

## Investigations

### Sexton, Nev. Dist., 2017-1 USTC ¶50,181 (March 23, 2017)

The IRS was permanently enjoined from exercising its authority over a disbarred attorney, who was suspended from practicing before the IRS, or his tax preparation business. The individual's tax preparation activities were insufficient to grant the IRS authority to investigate or regulate him and there was no evidence that the individual or his business "practiced" before the IRS or represented taxpayers before the IRS.

The IRS argued that 31 U.S.C. 330 applies to tax professionals who offer services within the scope of the statute and implementing regulations but who are not authorized to practice before the IRS because they are suspended from practice due to misconduct. However, while the IRS has the authority to regulate representatives or practitioners before it, that authority did not extend to tax preparers or suspended former practitioners who are tax preparers. The IRS's claim that it has inherent authority to regulate tax preparation was rejected because it would dramatically expand the scope of the IRS's regulatory authority to include hundreds of thousands of individuals in the multi-billion dollar tax-preparation industry. Moreover, nothing in the statute's text or legislative record contemplated that vast expansion of the IRS's authority. The fact that an individual was formerly a practitioner before the IRS could not give the IRS jurisdiction where no jurisdiction previously existed. Thus, the IRS's authority and jurisdiction did not extend to tax professionals who were not authorized to practice before the IRS because they were suspended from practice due to misconduct. The IRS also argued that section 330 applies to tax professionals who offer written tax advice regardless of whether they represent clients in a typical tax controversy before the IRS. The IRS conceded that the individual was permitted to prepare taxes while he was suspended, but claimed he could not offer written advice regardless of whether there was a typical tax controversy before the IRS under section 330(e). However, the government did not present any authority to support its argument that the written advice did not need to be given in the context of an actual proceeding or investigation before the IRS. Further, the individual merely offered to send written advice to the client; he did not in fact rendered any advice since he was fired by his client after she found out about his disbarment.

## Attorney-Client Privilege

### Micro Cap KY Insurance Co., E.D. Ky., 119 AFTR 2d ¶ 2017-583 (March 27, 2017)

A rejected an IRS argument that the taxpayers waived their attorney-client privilege by claiming a reasonable cause defense in a parallel Tax Court proceeding, because the mere assertion of a reasonable cause defense in a pleading did not lead to the automatic disclosure of privileged documents.

A taxpayer claiming reliance on a tax professional must prove that the adviser was a competent professional who had sufficient expertise to justify reliance, the taxpayer provided necessary and accurate information to the adviser; and the taxpayer relied in good faith on the adviser's judgment.

In New Phoenix Sunrise, (CA 6 2010) 106 AFTR 2d 2010-7116106 AFTR 2d 2010-7116 (see Weekly Alert ¶ 25 12/02/2010), the Sixth Circuit found that the Tax Court correctly held that the taxpayer had voluntarily waived its attorney-client privilege by raising a reasonable cause defense premised on a claim of reasonable reliance on the law firm's tax opinion.

In Ad Investment 2000 Fund, LLC, (2014) 142 TC 248142 TC 248 (see Weekly Alert ¶ 20 04/24/2014), the Tax Court granted IRS's motion to compel production of legal opinion letters because a partnership's attempt to establish a reasonable cause and good faith

## Tax Preparer's Client Lists and Client Data

### Salgado, Wash. Dist., 119 AFTR 2d ¶ 2017-576 (March 24, 2017)

A district court held that a tax preparer's client lists and client identifying data weren't trade secrets under Washington law but that, because the preparer's clients had reasonable expectations that their personal identifying information would not become publicly available, IRS could not put the lists and data, in full detail, into the public record. Rather, the court instructed the parties to confer and submit a joint statement to the court as to what should be redacted.

The IRS brought an action alleging that the preparer filed hundreds of false or fraudulent federal tax returns, and seeking to bar her from acting as a tax return preparer. The preparer sought a protective order to limit the IRS's ability to file her unredacted client lists and client personal identifying information into the public record. The court said that it expected that the parties' agreement would result in public filings with all personal identifying information redacted such that a specific client could not be recognized.

## Appraisers

### Clower, 11th Cir., 2017-1 USTC ¶50,107 (December 22, 2016)

The enforcement of an IRS summons against a real estate appraiser who specialized in conservation easements was upheld. The IRS was investigating whether the individual might owe penalties for preparing conservation easement appraisals that improperly valued the property. The summons was limited to documents concerning the individual's appraisals of conservation easements, including where the client was obtaining the appraisal of an easement for purposes of a tax return or charitable deduction. Given that limitation, the IRS established a *prima facie* case for enforcement of the summons under the standards set by the Supreme Court in *Powell* (1964), The individual's argument that the IRS had no legitimate purpose in requesting land appraisals that were not ultimately used by a taxpayer and filed with the IRS was rejected. The IRS was investigating the appraiser, not his clients. The IRS is not required to limit its investigations to filed tax returns.

## Collection Due Process Hearing

### Abdiwali Suldan Mohamed, TC Summary Opinion 2017-69 (Aug. 29, 2017)

The Tax Court ruled that a CPA who had full opportunity at Appeals to challenge § 6695(g) penalties (for not complying with earned income tax credit due diligence requirements), was precluded from raising that issue at a collection due process hearing.

## XIII. INTERNATIONAL

### FBAR

**Bussell, 9th Cir., 2017-2 USTC ¶50,384, (Nov. 1, 2017)**

A $1.2 million penalty on a taxpayer who admitted that she willfully failed to disclose her financial interests in an overseas account, did not violate the Eighth Amendment's Excessive Fines Clause because it was not grossly disproportionate to the harm the taxpayer caused.

**Bohanec, Calif. Dist. Ct., 2016-2 USTC ¶50,498, 2016-2 U.S.T.C. ¶50,498, (Dec. 8, 2016)**

Taxpayers were held liable for a penalty for willful failure to report their interests in foreign bank accounts. They never provided their Swiss bank with their home address, never told their tax professional about their offshore accounts, did not keep proper records, made several misrepresentations on their application for participation in the IRS's Voluntary Disclosure Program, including that the funds in the Swiss account were after-tax proceeds from their business. Not only intentional violations of a known legal duty but also reckless disregard of such a duty were shown.

**Bedrosian, E.D. Pa., 2017-2 U.S.T.C. ¶50,349, (Sept. 20, 2017)**

A pharmaceutical company's CEO was not liable for the penalty for failing to file an accurate FBAR, because wilfulness was not shown. He had two Swiss bank accounts, but only reported one for the tax year at issue. The only issue was whether his failure to file an FBAR for the second account was willful. The court found that he was only negligent (rather than knowing or reckless) in his failure to file). It noted that the taxpayer filed amended returns and rectified the issue before he learned the government was investigating him and before he knew the bank turned his information over to the IRS.

### Foreign Corporations

**Good Fortune Shipping SA, 148 TC —, No. 10, Dec. 60,860 (Mar. 29, 2017)**

Regulations that preclude a foreign corporation with bearer shares from using those shares to establish exemption of certain income from U.S. taxation were valid under *Chevron*. Section 887(a) imposes a tax of 4 percent of a foreign corporation's U.S. source gross transportation income. Section 883(a)(1) excludes gross income from the international operation of ships derived by the foreign corporation if the foreign country in which the corporation is organized grants an equivalent exemption to U.S. corporations. Section 883(c)(1) provides that the exclusion does not apply if 50 percent or more of its stock is owned, directly or indirectly, by individuals who are not residents of a foreign country that grants an equivalent exemption to U.S. corporations. Because the statute did not directly address how a foreign corporation could establish ownership by qualified individuals, Treasury was authorized to promulgate regulations to do so.

## Earned Income Exclusion

### Redfield, TC Memo. 2017-71 (Apr. 27, 2017)

A veteran of the Afghanistan conflict was not entitled to exclude his foreign earned income because he failed to make a timely election under Reg. §1.911-7(a)(2). Three years after he failed to file his return, the IRS prepared a substitute return and sent him a deficiency notice. The taxpayer then filed a late return and attached Form 2555, claiming the foreign earned income exclusion, which the IRS disallowed. By preparing a substitute for return that treated all of the individual's wages as gross income, the IRS evidenced its "discovery" that he had failed to elect the exclusion.

### Qunell, T.C. Summary Opinion 2016-86, (Dec. 19, 2016)

Wages earned by an ex-army member working as an atmospheric manager in Afghanistan under a Defense Department contract were not excludable. The taxpayer failed to establish that his "tax home was in a foreign country." His ties to Afghanistan were transitory; other than the location of his employment, he had no economic, family, or personal ties to Afghanistan. He owned a home in Illinois where his wife and children lived and he maintained bank accounts in the United States. The taxpayer's economic, family, and personal ties to the United States were sufficiently strong for the United States to be considered the location of his abode at all relevant times.

## Residence

### McManus, Ct. Cl., 119 AFTR 2d ¶ 2017-485 2017-1 U.S.T.C. ¶50,166, (Mar. 3, 2017)

The Court of Federal Claims rejected a taxpayer's claim that because he was liable for Ireland's "domicile levy," he was an Irish resident for purposes of the U.S.-Ireland treaty and thus exempt from U.S. tax on his winnings at a U.S. backgammon tournament.

Ireland does not tax gambling winnings. Article 22(1) of the Tax Treaty provides that if income is not dealt with in the Tax Treaty, as is the case for gambling, it is taxable only in the country of residence. The domicile levy applies to Irish-domiciled individuals who own property in Ireland valued over €5 million, whose worldwide income exceeds €1 million, and whose liability for Irish income tax in the relevant tax year was less than €200,000. The maximum domicile levy is €200,000. The Tax Treaty defines "resident of a Contracting State" as "any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature." The court held that this provision must be read in context, "consistent with the shared expectations" and intent of the treaty parties. OECD Commentary states that to be "liable to tax," a person must be subject to comprehensive or full taxation, such as an income tax on the full amount of the person's worldwide earnings – not just Ireland's domicile levy. The court also noted that Ireland Revenue has reached the same conclusion.