58TH ANNUAL GREAT PLAINS TAX INSTITUTE OMAHA, NEBRASKA Important Developments in Federal Income Taxation

Preprint · December 2020

DOI: 10.13140/RG.2.2.12741.68322

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Version
113020

58TH ANNUAL GREAT PLAINS TAX INSTITUTE
OMAHA, NEBRASKA
DECEMBER 3, 2020

Important Developments in Federal Income Taxation

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This outline covers significant developments in federal income taxation arising during the past year. It offers a selective treatment focusing on items likely to interest practitioners and advisors within a broad range of professional practices. Tax Court decisions (regular and memorandum) and appellate cases receive greater attention on account of their legal significance; Tax Court summary opinions and unreported appellate cases are omitted. Other trial decisions in the district court and claims court receive only limited attention due to their comparatively limited impact on tax law development. A few noteworthy administrative developments are also included, but such discussion is not comprehensive. Some employment tax cases are also noted in part VIII, and part IX concludes with a high-level summary of tax provisions in the CARES act and other recent tax legislation. This version includes updates through November 30, 2020.

Contents

I. Gross Income.

A. Timing.

1. Section 481 adjustment applies to recomputation of depreciation deductions on rental real estate, Pinkston v. Commissioner, TC Memo 2020-44.

Taxpayers acquired rental property in Hawaii in 2003 and 2010, and they claimed depreciation deductions on the property over applicable MACRS recovery periods, including future tax years. The Service audited their return for the 2012 tax year. This audit focused on deductions claimed in 2012 for the property acquired in 2003. The Service increased the share of the purchase price reallocated to the underlying land, thereby reducing the depreciable basis of the property. It also recharacterized what Taxpayer had claimed as five-year property into the 39-year classification.

In computing audit adjustments, the Service computed a section 481 adjustment that brought back into income the excess deductions claimed on the property since its purchase – including those tax years prior to 2012 that were otherwise closed by the statute of limitations. This adjustment totaled over $1.1 million. Taxpayers challenged this adjustment in the Tax Court, arguing that the recalculation of depreciation was not a change in method of accounting.

The Tax Court agreed with the Service. Noting that section 481 has been described as "codified confusion", the Court pointed to authorities that permit the section to reach back into closed years. That ability to reach back into the past, thereby disrupting the repose of the Taxpayer, merits judicial scrutiny when the Commissioner invokes section 481. Here, the Tax Court was careful to examine whether a method of accounting was involved. This was no mere mathematical or positing error, it was material, and there was consistent treatment through application of depreciation deductions over a period of years. The treatment affected the time when those items would be considered, rather than a permanent change. In this sense, the shift from basis recoverable through depreciation to basis attributed to land would affect the timing of income, whether in the year the depreciation was taken or in the year the asset was sold. In this sense, the Commissioner's determination was unlike one that might deny a claimed deduction because it is properly characterized as nondeductible personal expenditure.

Regulations under section 446 of the Code also contemplate that changes such as these are changes in methods of accounting to which section 481 becomes applicable. A "change in the depreciation or amortization method, period of recovery, or convention of a depreciable or amortizable asset" constitutes a change in method of accounting. Treas. Reg. § 1.446-1(e)(2)(ii)(d). An enumerated exception for "an adjustment in the useful life" does not refer, as here, to Taxpayers using MACRS, but instead specifically applies only to assets where the Taxpayer determines the recovery period under section 167. Regulations promulgated in 2003 clarified this result, and those regulations were made applicable to taxable years ending in 2003 and beyond – covering the assets in this case.

Comment: This case involves settled law, but it illustrates the potential reach of section 481 into the past, including closed years. But there is good news, too: section 481 may also reach into the past to bring back depreciation deductions that should have been taken when the Taxpayer's method was improper. Taxpayers generally require permission first, though.

2. Accrued expenses not included in COGS where "all events test" was not satisfied, Morning Star Packing Co. v. Commissioner, TC Memo 2020-142

Taxpayers operated production facilities that take in fresh tomatoes and convert them into tomato paste for human consumption. These facilities operate continuously during the tomato production season, after which production equipment not otherwise needed to store tomato paste for later delivery to customers is shut down.

Before the end of the taxable year, Taxpayers accrued production costs consisting of amounts that will be paid for goods and services needed to restore, rebuild, and retest the manufacturing facilities for next year's production cycle. These amounts, which included items such as boiler fuel, production wages, repairs and maintenance, electricity, and waste disposal, were recurring items. Because of the need to do the restoration and rebuilding work as close to the time of the production so as to preserve the hygienic conditions in the production line, most of these costs were accrued in the current year but not actually incurred and paid until the following year.

Taxpayers used the full absorption method to account for inventory costs. They included these accrued production costs in the cost pool and allocated a portion to COGS and the balance to ending inventory. On audit, the Service disallowed these advance accruals of restoration and rebuilding costs, which had been included in the current-year computation of COGS. Although the Service conceded that economic performance would otherwise have been satisfied, the Service challenged the satisfaction of the all-events test in the year of accrual on the ground that these goods and services subject to this advance accrual were the product of separate bilateral contracts, thus preventing liabilities from becoming fixed during the current tax year.

Taxpayers argued that their credit agreements, which generally required them to maintain material licenses, permits, and government approvals and to keep their business in good working order required them to continue purchasing these goods and services oriented toward restoration and rebuilding. They also argued that their long-term production contracts with customers required continuous operations. The court rejected both arguments. The credit arrangements were not specific enough to require the purchase of particular goods and services and the production contracts had imposed obligations that were specific to each year's production run. After failing the all events test, there was no reason to address further any matters involving economic performance.

Comment: This case is a good example of the importance of meeting the all-events test before getting to the matter of economic performance. Taxpayer faces a quandary: In order to accelerate a deduction, there must be a binding contract in the current year and economic performance must be satisfied within the applicable constraints of section 461(h). A multi-year contract with suppliers might suffice, but that might also subject Taxpayer to damages in the event their operations change. Here, tax treatment follows the legal risk of incurring costs.

B. Exclusions/Deferral.

1. Settlement proceeds deposited in account under lawyer's name triggered unreported contingent fee income, Isaacson v. Commissioner, TC Memo 2020-17.

Taxpayer was a trial attorney for 38 years specializing in tax fraud litigation. In 2013, he was disbarred in California for commingling client funds with his own. Prior to disbarment, he had represented four individuals who had been sexually abused by clergy. Taxpayer knew these clients personally, and two of them were brothers. The terms of the retainer agreement provided he would receive 50 percent of the "present value of all amounts recovered" if the case settles prior to 120 days before the first trial date, and 60 percent thereafter. He would also be reimbursed at 110 percent of costs and be allowed to deposit any funds in a "non-IOLTA" account that allowed him to retain the interest earned thereon.

Three of the four clients made it clear that Taxpayer was not to deposit their funds at the Union Bank of Switzerland (UBS) because they did not want him to manage the funds on their behalf. Nevertheless, Taxpayer opened an account at UBS in December 2006, listing himself as the principal officer and beneficial owner. He hand-wrote the word "Trustee" on the account form, but he also indicated that the source of funds would be "income from the business/organization." He also stated a preference for "capital appreciation" and an "aggressive/speculative" risk profile. There was no indication that the account was for client funds.

He made an initial deposit of $800K and directed UBS to invest in "auction-rate securities". In November 2007, he told the UBS account manager he expected to receive a large sum of money from the clergy lawsuit. The UBS manager advised investing in Treasury securities with low risk, but Taxpayer directed investment in the higher-yielding auction securities.

The clergy settlement had been announced in July 2007, which allocated $12.75 million to Taxpayer's four clients. The clients ultimately agreed to the 60 percent attorney fee, although two of them found this amount to be excessive. The clients brought no legal challenges, which the fee agreement would have referred to arbitration. However, the entire settlement was apparently deposited into Taxpayer's UBS account. Taxpayer made personal payments from the account, including a gift to personal trainer and a $600K payment to his law firm's account at Bank of America. He continued to manage and use funds from the account. It was not until January 2008 that Taxpayer paid one of the clients his portion of the settlement.

In February 2008 the market for auction rate securities froze on account of the pending financial crisis. UBS grew concerned about its accounts and retained counsel to advise them. Counsel for UBS imposed a legal hold on Taxpayer's account due to concerns that it may hold client funds. Taxpayer submitted affidavits from the clients that they were satisfied with his representation and based on those affidavits UBS ultimately lifted the hold.

However, in June 2008 Taxpayer and his clients retained another firm (Crotchett) to sue UBS over the investments made from these funds, alleging investment in the auction securities occurred without their authorization. That retainer agreement would pay from 15 to 17 percent of the recovery obtained as a contingent fee to Crotchett. At the same time, the SEC was pursuing an investigation of UBS relating to the auction rate securities market.

UBS ultimately settled the SEC claim by agreeing to repurchase the securities from Taxpayer at par, which it did on January 9, 2009. Taxpayer directed UBS to issue checks to the clients. UBS claimed it could not issue checks because the Crotchett firm had a lien on the account. UBS interpleaded the funds to the LA County Superior Court for determination of ownership. Taxpayer negotiated a stipulation that would allow a partial disbursement to the clients. Eventually, the Crotchett firm got its fees and the balance was distributed.

However, arbitration proceedings continued based on claims raised by the Crotchett firm against UBS, which required FINRA arbitration. UBS agreed to settle these claims for $950,000. But FINRA arbitration can leave an undesirable mark on financial industry professionals. Some UBS personnel who were defendants in the lawsuit sought to expunge the result from their FINRA records, and they eventually obtained an order from the LA County Superior Court to the effect that Taxpayer's allegation that they invested funds without his authorization as both "false" and "clearly erroneous".

All of this is prelude for Taxpayer's 2007 return problem. He filed that return late on November 17, 2008, and he reported no income from the clergy settlement. Although he claimed that the settlement did not constitute gross income because UBS had invested the funds without his authorization, litigation resolved that claim adversely. He also claimed that UBS had "stolen" his funds and invested them without authorization. He even had a legal assistant in his law firm prepare a memorandum on constructive receipt.

In 2014, the Commissioner issued a notice of deficiency that included a civil fraud penalty. However, Taxpayer argued that because his clients – known as the Brothers – disputed his fee, he could not ethically access funds from the account. The Tax Court rejected this defense on several grounds. First, it concluded that Taxpayer was judicially estopped from asserting this argument based on his prior representations in LA County Superior Court interpleader proceedings that no such dispute existed. Taxpayer would not be allowed to now change his story when a dispute suited his interest. The court declined this invitation to reward his "cynical gamesmanship", finding that he had at least earned the 60 percent contingency fee during 2007.

At a minimum, he was in constructive receipt of those amounts. Even if there was a fee dispute with the Brothers, the other clients did not dispute the fees. Thus, it would be clear that all events which fixed his right to the fee from that recovery had occurred in 2007, when the funds were deposited. Moreover, he held those fees under a claim of right, which required Taxpayer to report them as taxable income, even if they might have to be returned at a later time.

Whatever claims Taxpayer may have had to the constraints imposed by ethical rules were offset by his actual behavior in taking dominion over those fees in the account. Unlike the Tax Court's prior decision in Miele v. Commissioner, 72 T.C. 284 (1979), where the taxpayer obeyed the relevant ethical rules and segregated funds until their fees were considered earned, this Taxpayer did not obey ethical constraints in forming the UBS account.

The Tax Court also upheld a 75 percent civil fraud penalty based upon finding badges of fraud supported by Taxpayer's prior history as a lawyer specializing in tax fraud defense. Not only did Taxpayer understate his income in 2007, but the Service also showed a consistent pattern of understating his income in prior tax years. Taxpayer offered implausible and inconsistent explanations for his failure to report the fee income in 2007, including an attempt to rely on a memorandum on constructive receipt that was prepared by a legal assistant who did not even pass the bar. That memorandum did not grapple with the real facts, but instead was based on false and unreasonable assumptions that Taxpayer provided. Moreover, Taxpayer filed a false document in the FINRA arbitration, including a false 2009 tax return that did not match his actual 2009 return. He also conceded filing a false tax return in 2008. Together, these indicate badges of fraudulent intent for the 2007 return.

Comment: When a seasoned tax professional goes awry, consequences soon follow. Since when does a true "friend of the family" charge a 60 percent contingent fee with 110 percent of expenses coming off the top? And then invest the proceeds in risky investments? Yikes. An appeal has been filed in the Ninth Circuit.

2. "Litigation support" payments received by attorney are includable in gross income, Novoselsky v. Commissioner, TC Memo 2020-68.

Taxpayer was an attorney practicing in the Chicago area with a focus on class action litigation. To fund this litigation, he engaged in "litigation support" agreements with counterparties who would advance funds to support the cost of the litigation. The agreements characterize these amounts as loans made on a nonrecourse basis bearing interest, sometimes at 18 percent or sometimes simply doubling the amount advanced.

If the litigation was successful, Taxpayer would be required to return the initial amounts plus a premium from the proceeds collected. If the litigation did not result in collection, Taxpayer was not obligated to repay these amounts. Counterparties included the clients being represented in litigation, persons whose interests were economically aligned with those clients, lawyers with fee-sharing arrangements, and other individuals seeking a high return on their investment. Taxpayer received over $1.4 million from these agreements during the years at issue.

Taxpayer did not report these payments on Schedule C. The Service audited returns for 2009 and 2011 and determined substantial underreporting of income based on part on the failure to report these payments. As statute of limitations for the 2009 year was about to expire and Taxpayer refused to extend the limitations period, a notice of deficiency was issued, triggering this litigation.

In the interim, Taxpayer filed for bankruptcy, which initiated a stay in the tax proceedings. The Government filed a claim for the 2009 and 2011 taxes and penalties, and it also took the position that Taxpayer should not be eligible for discharge because of false statements – including his failure to list the counterparties to the litigation support agreements as creditors in his petition. The bankruptcy court agreed with the Government that it was not estopped from making this claim based on the pending tax case, as the standards for tax debt may not be the same as the standard for filing claims in connection with a bankruptcy case. The bankruptcy stay was lifted, and the tax case proceeded.

On the substantive matter of the loans, the Tax Court pointed to case law that holds where the obligation to repay arises only on the occurrence of a future event, a valid debt does not exist for Federal tax purposes. In contrast, true loans require an unconditional obligation to repay and an unconditional intention on behalf of the party advancing funds to secure repayment from the obligor. This treatment also extends to funds advanced when repayment is contingent on the outcome of litigation. A similar outcome could also be based on multi-factor approaches for analyzing whether a loan was contemplated, including those in the Seventh Circuit to which an appeal would be taken. The court also rejected claims that these were "gifts" or the corpus of a trust, noting that neither argument "passes the straight-face test". Accuracy penalties applied.

Comment: As the court noted, these arrangements may present professional responsibility concerns, as Illinois rules prevent fee-splitting with non-lawyers. The Tax Court also noted that this situation is distinct from that of the lawyer who advances fees, which presents a different question about whether those expenditures are currently deductible. See note 9. An appeal to the Seventh Circuit has been filed in this case.

3. $25 million in payments from business partner were not gifts, Kroner v. Commissioner, TC Memo 2020-73.

Taxpayer, who resided in Florida, had a longstanding business relationship with a UK businessman, Mr. Haring. During the 2005-2007 tax years, Haring wired nearly $25 million in payments, with some made directly to Taxpayer and others to offshore trusts for his benefit or to a company that Taxpayer controlled. Taxpayer did not report any of these transfers as income during the years at issue.

An audit ensued, and in August 2012 the Revenue Agent delivered Letter 915, which transmitted his examination report, and Form 4549, which stated the Income Tax Examination Changes with an expectation for agreement by the Taxpayer, during a closing conference. The Agent proposed to treat these amounts as income, proposed accuracy penalties, and offered the opportunity for Taxpayer to protest proposed changes. Over two months later, the Agent's supervisor approved penalties and the Agent issued Letter 950, the so-called 30-day letter, and Form 4549-A, which contained the Agent's adjustments. A notice of deficiency was submitted in 2014, and a Tax Court petition followed.

The Tax Court first considered the substantive issue of whether Taxpayer had received an excludable gift. Taxpayer had the burden of proof on this issue, and unfortunately, he could not meet that burden. Significantly, he did not choose to call Mr. Haring to testify. Although he won a motion *in limine* to prevent the IRS from making an adverse inference based on his failure to testify, the failure of other proof proved fatal to Taxpayer's case. Essentially, Taxpayer was required to rely on his own testimony and the testimony of a lawyer that represented both Haring and Taxpayer – hardly disinterested testimony. The Tax Court did not find this testimony credible as to the required showing of detached and disinterested generosity necessary for a gift exclusion under section 102. A letter purportedly signed by Haring but drafted by his lawyer had indeed professed friendship, but the Court viewed this as insufficient. Experience with the "mainsprings of human conduct" could not support a gift in this context, where other facts suggested a more plausible narrative involving an investment by Haring to be held by Taxpayer in a nominee relationship.

However, Taxpayer did eke out a small victory in the form of penalty relief. Here, following its regular decisions in Clay and Belair Woods (see discussion below), the Tax Court determined that the letter submitted in August 2012 was the initial determination of the penalty, rejecting the IRS argument that the later 30-day letter reflected that determination. The substance of the communication, not the label, governs the outcome. Even though the Agent may have subjectively intended the letter to merely invite a response from the Taxpayer, it did include a penalty and it provided the Taxpayer's right to file a protest with Appeals. That was sufficient to trigger the supervisory approval requirement.

Comment: This case was pending during the Graev and Clay decisions. You can bet that supervisory approval will receive greater attention in future audit contexts. This case shows that the approval requirement can indeed attach prior to the 30-day letter or notice of deficiency, based on the substance of the communication. As for the gift determination, this case highlights the difference between a common law gift and an excludable gift under section 102, which requires the additional proof of the motivation for the gift. This taxpayer took a risk in not calling Mr. Haring – or maybe based on what he knew about Haring's testimony he took the best shot he had. If Taxpayer was being repaid for a prior investment, he lost the opportunity to claim a return of capital or capital gain. "You pays your money, you takes your choice."

4. Funds deposited in son's account counted in computing insolvency under section 108, Hamilton v. Commissioner, 955 F.3d 1169 (10th Cir. 2020).

Taxpayer sought to exclude $160,000 in debts forgiven in the aftermath of a disabling injury on the ground that he was insolvent. See IRC § 108(a). However, in the same taxable year, Taxpayer received over $300,00 in a non-taxable distribution from a partnership. He transferred those funds into a savings account held by their adult son, who was in medical school. There were no other funds in that account. Using login credentials provided by Son, Wife transferred $120,000 back to their joint checking account to cover living expenses.

The Tax Court found that Taxpayers retained effective control over these funds, and that if such funds were included in the assets owned by Taxpayers, they would not be insolvent. The Tenth circuit agreed. This was not a gift. Son provided credentials for access, and he did not use the funds as his own. Even if Utah law considered the son as the legal owner, substance over form principles could be applied to treat this asset as belonging to Taxpayers for purposes of making the insolvency determination. Neither could these funds be treated as separate property of one of the spouses – even though Husband received the distribution and Wife made the transfer, she did so as his agent. Moreover, the funds supported the couple's living expenses.

Comment: This is a common-sense outcome. State law is important in determining ownership, but ownership is not always defined based on formal title. Benefits of ownership accrued to Taxpayers in this case.

5. Tribal treaty did not exempt income from gravel mining, Perkins v. Commissioner, 979 F.3d 148 (2d Cir. 2020), affirming 150 T.C. No. 6 (2018)

Taxpayers sought to exclude income derived from a gravel mining operation on Seneca land based on their interpretation of the 1794 Treaty of Canandaigua, 7 Stat. 44 (Nov. 11, 1794) and a subsequent 1842 Treaty with the Seneca. The Tax Court disagreed, ruling that the income was taxable. The Second Circuit affirmed the Tax Court ruling, finding that the relevant treaty language was constrained by historical contexts that would not permit a tax exemption for these individuals.

Comment: For further analysis of this case at the Tax Court level, see my 2018 Great Plains Tax Institute materials.

6. Failure to prove cancelled debt was nonrecourse means COD income, Wienke v. Commissioner, TC Memo 2020-143.

Taxpayer lived in California, a community property state. At issue were several items of taxable income excluded from her separate return. California state law determines the scope of community property, but Federal tax law requires half of community income to be reported on the separate return of a married taxpayer who does not file jointly.

Taxpayer had excluded cancellation of indebtedness income in connection with certain real property investments held by the couple on the ground that the debts were nonrecourse. However, Taxpayer received Form 1099-C that indicated that borrowers were personally liable. Here, Taxpayer failed to prove that the debts were actually nonrecourse.

Comment: It is not clear whether Taxpayer sought to report the debt as part of the proceeds from the disposition of property, which would have been consistent with her claim for exclusion. The case shows the importance of the presumptions favoring the Commissioner in tax litigation.

7. Taxable distributions from IRA occurred, Ball v. Commissioner, TC Memo 2020-152

Taxpayer had a SEP-IRA. In 2012, when he was younger than 59 ½, he caused distributions of nearly $190,000 to be made to an LLC that he owned and controlled. The LLC then loaned these funds to help other entities acquire real estate. The loans were repaid by 2013, and Taxpayer sought to treat these as rollover contributions or current year contributions.

Taxpayer did not report these distributions as gross income. The IRS automatic matching program noted inconsistency with this program, which generated an audit. Taxpayer received a notice of deficiency based on treating these amounts as taxable distributions, including substantial income understatement penalties as well as penalties for early distributions.

The Tax Court upheld the deficiency, finding that Taxpayer had control over the funds as the sole owner and manager of the LLC that received the distributions. These funds were not loaned on behalf of the custodian, but they were instead invested at Taxpayer's direction. Both accuracy penalties and early withdrawal penalties applied in this case.

8. Final regulations implementing definition of like-kind real property, TD 9935 (to be published in the Federal Register).

These regulations generally follow proposed regulations published earlier this year, but they depart by further embracing state law considerations as the standard for determining the scope of real property. The retain prior exceptions from the legislative history that include certain LLC interests in drainage and irrigation companies that otherwise accompany real estate.

Comment: These regulations likely deserve their own CLE program. Taxpayers contemplating like-kind exchanges will want to study these carefully to evaluate whether improvements and equipment associated with land may qualify as real property under these regulations. State and local law expertise of the property lawyer will prove helpful.

C. Characterization.

1. Proceeds from litigation over disputed partnership interest generated capital gains, NCA Argyle LP v. Commissioner, TC Memo 2020-56.

This consolidated case addressed the tax treatment of a settlement to break up a joint venture involving real estate development. Taxpayer (NCA) and its related entities allegedly engaged in joint venture activities with Commonfund and its related entities. However, Commonfund resisted this characterization, alleging that the parties had no definitive agreement. Commonfund sought declaratory relief that NCA had no interest in any of its ventures and damages for conversion of property.

NCA filed a cross-complaint alleging breach of fiduciary duties based on Commonfund's acts in repudiating NCA's valid interest in the joint venture. Under California law, this permitted NCA to pursue a conversion measure of damages, which values the loss based on what was taken at the date the venture was repudiated. NCA hired an expert to determine the value of the repudiated joint venture interest, and his report produced values that ranged from $16 to $24 million depending on the discount rate applied to the expected future revenues from the business.

A jury found that a joint venture existed and that Commonfund breached fiduciary duties owed to NCA. The jury awarded damages of $16.3 million, which matched the lowest valuation figure produced by the expert. The jury also awarded punitive damages of $33.9 million because Commonfund acted with malice, oppression, or fraud. Commonfund moved to set aside the verdict and requested a new trial based on the excessive punitive damage award. The judge conditionally granted a motion for a new trial. In order to avoid a new trial, NCA agreed to reduce the punitive damages to an amount equal to the actual damages, making the total judgment $32.7 million. This successfully avoided a new trial, but Commonfund nevertheless filed an appeal.

While the appeal was pending, NCA obtained tax advice on the result of any settlement. Their CPA advised that if they could structure a settlement in which they would be paid for their joint venture interest, a capital gain would result. After negotiations, the parties agreed to a payment of $23 million for "a transfer by NCA of its joint venture interest in these projects with Commonfund…." The proceeds were paid and distributed out to the NCA entities, which reported them as long-term capital gains.

The Service audited the NCA entities, recharacterizing the payments as ordinary income and imposing accuracy penalties. A Tax Court petition ensued. The Service offered a fallback position that $5 million of the proceeds were capital gains under section 741, but the additional $18 million was ordinary income, either based on lost profits or punitive damages.

The Tax Court focused on the express allocation of damages reached by the parties in their settlement, which treated all of the proceeds as being in exchange for their joint venture interest. It found that these parties were adversarial and negotiated at arm's length. Tax-wise, Commonfund would get a deductible payment if it compensated NCA for providing services. However, Commonfund would have had to capitalize amounts paid for the joint venture interests. See IRC §§ 742, 1012(a).

The Tax Court also focused on the underlying claim, which was based on the breach of fiduciary duty associated with repudiation of NCA's joint venture interest. Damages awarded at trial were based on the value of that interest, which is consistent with this settlement approach. The fact that Taxpayer's experts used future income to value the interests did not change the fact that the payment was for the value of the interest; future economic benefits are a common, acceptable way to value an asset.

The Service argued that the parties were not adverse with regard to punitive damage characterization. However, the Tax Court disagreed, noting that Commonfund would have been able to deduct punitive damages, while it could not deduct the payment for the joint venture interest. Likewise, NCA would have had to treat punitive damages as ordinary income. Here, the parties chose to allocate nothing to punitive damages. That allocation would be respected.

Comments: This is a helpful case for taxpayers with settlement proceeds. It should also be noted that $23 million was within the upper range of values determined by Taxpayer's expert at trial. This may have helped support the court's willingness to agree to the absence of any punitive damages. Notably, the absence of punitive damages ended up costing Commonfund a *current deduction, which would have been offset by ordinary income from NCA. The Treasury would thus be net neutral. If Commonfund had to capitalize those costs, NCA still paid its share of capital gains taxes – effectively a double-tax on the future income Commonfund would now earn (and be taxed upon). By losing, the Government gets to reap a current-year tax windfall. Maybe the Government should have conceded this case at the start!*

Also note that NCA may have gotten a better deal on the settlement because of the current-year tax benefits foregone by Commonfund (bounded, perhaps, but the current-year tax savings it would realize). These settlement environments are wonderfully complex and might even cause one to reread R.H. Coase, The Problem of Social Cost, 3 J. Law & Econ. 1 (October 1960).

2. Loss was capital, not ordinary, where rental activity did not begin, Keefe v. Commissioner, 966 F.3d 107 (2nd Cir. 2020).

In January 2000, Taxpayers paid $1.35 million for an historic mansion in Newport, Rhode Island, with the intent of restoring it. Husband was a fertility doctor, Wife had degrees in art history, education, and journalism. Neither was an architect or contractor.

In 2002, Taxpayers divided the property into two condominiums, selling one of them and retaining the other. The retained property remained uninhabitable, and they obtained loans to finance restoration costs estimated at $2 million. Taxpayers listed the property for sale continuously from May 2004 until its ultimate sale in 2009.

Wife spent considerable time overseeing renovations, traveling back to Newport from their home in Tampa, where Taxpayers had moved in 2005. In 2007, they received temporary certificates of use and occupancy followed by a final certificate in 2008. During this time, Taxpayers spoke with a real estate firm about renting out the property.

The agent contacted some potential rental clients, but she did not advertise the property for rental due to ongoing renovations. She represented to Taxpayers that the house could bring $75K/month during the summer. One of her clients expressed interest, but this did not lead to an actual rental. In May 2008, when the restoration was completed, the house was pulled from the rental market and efforts to sell continued in earnest.

Bank of America, which held the second mortgage used to finance renovations, raised Taxpayers' monthly mortgage payment from $25K to $39K. In the meantime, the property value began to decline from $12 million in 2005 to $9.6 million in 2009. Taxpayers contacted three auctioneers, but ultimately chose not to auction the property. They eventually sold the property for $6.51 million on July 31, 2009.

Taxpayers hired a professional accounting firm to prepare their taxes. Problematically, they had not timely filed their 2006-2008 returns and they had unpaid taxes from 2004-07. For 2009, they originally treated the sale as involving a capital asset, which produced a capital loss. However, upon advice from an estate planner, they had another accounting firm file an amended return that treated this as a sale of a business, which would allow ordinary loss as real property used in a trade or business. See IRC § 1221(2). An audit ensued, eventually leading Taxpayers to the Tax Court. That court upheld the IRS position that this was a sale of a capital asset that did not involve an ongoing trade or business.

The Second Circuit affirmed. According to the court, the matter of whether Taxpayers had entered into a trade or business here turned on "whether the rental activity in question was sufficiently regular and continuous as to lead to the conclusion that the taxpayer was engaged in a real estate rental trade or business." Id. at n. 22. Factors regularly considered include whether the taxpayer or an agent perform maintenance and repairs, manage the property or provide tenant services, or purchase materials, collect rent, and pay expenses.

Here, efforts to rent property are also relevant. Those efforts were not sufficiently continuous and regular to constitute a trade or business. The effort to sell the property continued throughout their period of ownership. Efforts to renovate the property were equally conducive to their goal of selling the property as it was to the putative rental goal. Moreover, when they did get an inquiry about rental, they doubled down on their efforts to sell the property.

The Second Circuit distinguished cases involving taxpayers who "failed to carry out a business goal and yet were held to be engaged in a trade or business". The taxpayers in those cases had already been engaged in a trade or business; these taxpayers had not. The Second Circuit also upheld penalties, including late-filing and accuracy penalties.

Comment: The matter of when a trade or business begins is important not only for deductibility, but also for the characterization of losses. Another issue lurking here involves a timing question. Was this property acquired for the purpose of holding it for rent? When property is acquired as a personal asset and it is converted to an investment or business asset, basis at the time of conversion is limited to prevent conversion of nondeductible losses into deductible ones. See Treas. Reg. § 1.165-9. How would conversion to a rental property – assuming that this did occur – impact the amount of a section 1221(2) exception from capital losses for real estate used in a trade or business?

3. Danielson Rule restricts Taxpayer efforts to depart from written agreement in recharacterizing income from transaction, Watts v. Commissioner, TC Memo 2020-144.

This case comes on remand from the Eleventh Circuit, which had vacated the Tax Court's prior decision adverse to the Taxpayers in Watts I, TC Memo 2017-144. On Appeal, both parties agreed that the Tax Court decision relied upon an unfounded assumption. Accordingly, the Eleventh Circuit remanded for consideration without this assumption. The Tax Court continued to rule against the Taxpayer, based in part on the so-called Danielson rule.

Taxpayers had argued that certain losses otherwise characterized as capital could be treated as ordinary based on a different approach to a transaction involving the disposition of a partnership interest. However, this characterization departed from the written agreement between the parties as to the locus of sale proceeds. According to Commissioner v. Danielson, 378 F.2d 772 (3d Cir. 1967), "[A] party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." Essentially, Taxpayers in this context cannot invoke substance over form in their favor when doing so contradicts the terms of the underlying agreement.

Comment: Substance over form appropriately remains a one-way ratchet that favors the IRS. Exceptions are rare. Taxpayers must therefore structure deals knowing that the objective terms likely provide the foundation for tax treatment. Such a rule reduces the incidence of litigation with the Government and also permits counterparties to rely on the terms they negotiated, thereby escaping whipsaw positions in subsequent tax litigation.

II. Deductions.

A. Charitable.

1. Conservation easement regulations requiring donee interest to be protected in perpetuity are valid, Oakbrook Land Holdings, LLC v. Commissioner, 154 T.C. No. 10 (2020).

In 2007, Taxpayer bought 143 acres near Chattanooga, TN for $1.7 million. In December 2008, slightly more than one year later, it donated a conservation easement to a qualified organization and claimed a charitable deduction for $9.545 million. As the court noted, Taxpayer "took the position that the land covered by the easement had appreciated in value by about 700% in a single year during the worst real estate crisis to hit the United States since the Great Depression."

From that inauspicious beginning, one expects a negative outcome for Taxpayer. But this case did not turn on valuation. Instead, it turned on the application of the "protected in perpetuity" requirement imposed by section 170(h)(5)(A) the applicable regulations, Treas. Reg. § 1.170A-14(g)(6).

In a separate memorandum decision, *Oakbrook Land Holdings, LLC v. Commissioner*, TC Memo 2020-54, the court disallowed the deduction by finding that the easement deed did not adequately protect the interest of the donee. If the easement were ever terminated, the deed did not entitle the charitable donee to a proportionate share of the proceeds from a sale, and it also reduced the proceeds payable to the donee based on the value of improvements made by the donor. This outcome reflected the application of the regulations to the facts and was in accord with other Tax Court decisions.

This regular Tax Court decision addressed Taxpayer's challenge to the validity of those regulations, a topic that had not previously been addressed head on by the Tax Court. The Tax Court upheld those regulations, albeit not without disagreement from some of its judges, including Judge Holmes who wrote the memorandum decision issued on the same day.

Comments: This case, as well as the memorandum decision in TC Memo 2020-54, contains useful history of this controversy for those interested in digging deeper into the matter of conservation easement deductions. The Tax Court judges disagreed over the validity of the regulation, but apparently not over the application of the regulation to the facts provided in this case. Judge Holmes filed a vigorous dissent, in which he recognized that upholding the *regulation would invalidate hundreds or thousands of conservation easement deductions and lead to further appellate controversies. He also predicted that the decision here would lead, "at best, to a circuit conflict that the Supreme Court will have to resolve."*

Other recent cases involving disallowed charitable deductions for noncompliance with the perpetuity provisions in these regulations include Railroad Holdings, LLC v. Commissioner, TC Memo 2020-22; Carter v. Commissioner, TC Memo 2020-21; Hoffman Properties II, LP v. Commissioner, 956 F.3d 832 (6th Cir. 2020) (affirming Tax Court determination on perpetuity issue); Woodland Property Holdings v. Commissioner, TC Memo 2020-55; Hewitt v. Commissioner, TC Memo 2020-89; Plateau Holdings v. Commissioner, TC Memo 2020-93; Lumpkin One Five Six, LLC v. Commissioner, T.C. Memo 2020-94 and Lumpkin HC, LLC v. Commissioner, TC Memo 2020-95; Village at Effingham, LLC v. Commissioner, TC Memo 2020-102; Riverside Place, LLC v. Commissioner, T.C. Memo 2020-103; Maple Landing, LLC v. Commissioner, TC Memo 2020-104; Englewood Place, LLC v. Commissioner, TC Memo 2020-105; Smith Lake, LLC v. Commissioner, TC Memo 2020-107; Belaire Woods, LLC v. Commissioner, TC Memo 2020-112; Cottonwood Place, LLC v. Commissioner, TC Memo 2020-115; Red Oak Estates, LLC v. Commissioner, TC Memo 2020-116.

Those interested in researching charitable contribution cases can find a helpful list and summary of 121 cases in IRS Chief Counsel Advisory 202020002 (May 15, 2020). Commentary on these matters in the secondary literature is extensive. For some good insights, see Nancy Ortmeyer Kuhn, Charitable Conservation Easements – IRS and Tax Court Act to Shut them Down, Bloomberg Daily Tax Report, July 22, 2020. Ms. Kuhn also points to another important case in the Eleventh Circuit, Champions Retreat Golf Founders, LLC v. Commissioner 959 F.3d 1033 (11th Cir. 2020), which produced a Taxpayer-friendly outcome in a conservation easement adjoining a golf course. The Eleventh Circuit upheld the easement deduction against a challenge by the Service that the easement served no public purpose. Some of the cases cited above have been appealed – and there is likely more to come on this topic. The Commissioner filed a notice of appeal on Oakbrook Land Holdings, LLC in the Sixth Circuit on November 12, 2020. However, the basis for that appeal is not clear as the Government won the challenge to the validity of the easement regulations but lost on the penalty issue. See number 2, below, for a late-breaking appeal decision in which the Eleventh Circuit rules for the Taxpayer.

2. Eleventh Circuit spanks Tax Court by ruling conservation easement satisfies perpetuity requirement, Pine Mountain Preserve, LLP v. Commissioner, __ F.3d__, 2020 WL 6193897 (11th Cir., 10/22/20), affirming in part and reversing in part, 151 T.C. 247 (2018).

Taxpayer granted the North American Land Trust conservation easements valued at over $33 million. These easements, which were granted in 2005-2007, restricted development of some 1,282 acres out of 6,224 acres it owned near Birmingham, AL. In the 2005 and 2006 easement, presumptive areas in which building would be allowed were clearly defined, but the easement allows the parties to modify the location so long as the total acres remain unchanged and the conservation purposes are not adversely affected. The 2007 easement provided that the parties "shall mutually have the right, in their sole discretion, to agree to amendments to this Conservation Easement, which are not inconsistent with the Conservation Purposes."

The Service denied tax deductions for these easements, and the Tax Court determined: (1) easements from 2005 and 2006 were not “granted in perpetuity”, as required in section 170(h)(2)(C), because the grantor had reserved to itself a limited development right within the conservation areas; (2) the easement granted in 2007 satisfied the perpetuity requirement; and (3) the value for the easement allowed was overstated and should be reduced to the numerical mean between the Taxpayer’s claimed value and zero. Taxpayer appealed and the Service cross appealed. Thus, no one was happy with this outcome.

The Eleventh Circuit delivered a Taxpayer victory. First, it held that the “plain language of section 170(b)(2)(C), the statutory structure more generally, and relevant precedent all demonstrate that the 2005 and 2006 easements satisfy the “granted in perpetuity requirement”. It rejected the Tax Court’s determination, based on a “Swiss-cheese metaphor” that building sites were “holes” in the conservation area that meant the restrictions did not attach to a defined parcel, accurately reflected the bundle of rights associated with the property. Rights were indeed restricted for perpetuity in the sense that the owners, heirs, and assigns would be subject to them. Instead, the Circuit found that the donee got a slice of “pepper jack” cheese. There were no holes, but only restrictions that affected the entire property. Reserved rights were like flakes of pepper, not holes. In effect, the Circuit was focusing on the substance of the restrictions, rather than legal formalities that would require a particular square inch of the property to be definitely and permanently covered.

Second, as for the 2007 easement, the Service position was based on the fact that the amendment provision was so broad that the parties might undermine the conservation purposes that were required to be held in perpetuity. The Tax Court had rejected that provision, and the Circuit Court agreed. Perpetuity does not mean ”inalienability, unreleasability, or unamendability.” Instead, it means that the property “won’t automatically revert to the grantor, his heirs, or assigns.” A conservation easement is a bilateral contract, and parties to a bilateral contract can always agree to amend their agreement. A conservation organization can be expected to enforce their interests in the property.

Finally, Taxpayer had pushed a deduction value in the Tax Court to a total of $97 million, when it had initially claimed a value of $33 million on its return. Keep in mind, the entire property was purchased for $37 million. At trial, a battle of experts produced what the Tax Court deemed “offsetting errors”, which allowed them to weight them equally and find the arithmetic mean as the value. The Circuit Court rejected this approach, which it characterized as a “pox on both your houses” methodology. It remanded for a proper valuation analysis.

Comments: Judge Holmes’ dissenting prediction in the Tax Court (see comments from Oakbrook Land Holdings, supra) may be starting to unfold before our eyes. This case will likely produce still more litigation and more appellate decisions to discuss next year. Large valuation issues here remain unresolved; that likely should have been the focus of these cases. One can understand how this tax administration problem drove the Service to take a more aggressive position on interpretation. The Tax Court bought their arguments; the Eleventh Circuit did not. Generalist judges may indeed have different frames of reference.

3. $17.5 million conservation easement deduction disallowed based on failure of perpetuity requirement, Glade Creek Partners, LLC v. Commissioner, TC Memo 2020-148.

The Tax Court upheld the disallowance of a conservation easement based on the failure to satisfy the perpetuity requirement in Treas. Reg.1.170A-14(g)(6)(ii), which requires that, upon extinguishment, the conservation easement owner must be entitled to "a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction." Earlier this year, the court upheld the validity of this regulation in *Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. No. 10 (2020).

In this case, the easement required the parties to subtract the value attributable to post-easement improvements before determining the share attributed to the conservation easement owner. Other cases have ruled that similar provisions failed to protect the charitable interest in perpetuity. See *Oakbrook Land Holdings LLC v. Commissioner*, TC Memo 2020-54 and *PBBM-Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193, 208 (5th Cir. 2018).

The case also provides an extensive analysis and critique of valuation expert reports and discussion of penalty considerations in that context. These taxpayers escaped gross valuation misstatement penalties, but the Court upheld an accuracy penalty for claiming a deduction in excess of the fair market value of only $8.8 million as determined, not $17.5 million as claimed by Taxpayers.

4. Façade easement value mostly upheld, avoiding valuation penalties, Kissling v. Commissioner, TC Memo 2020-153.

This case involved the valuation of façade easements granted on buildings located in Buffalo, NY. The IRS claimed that since these buildings were already located in an historic preservation district, they grant of a façade easement did not reduce their value. The Service sought to disallow the deduction claimed and imposed substantial valuation penalties. A battle of experts ensued, with Taxpayer largely winning the battle by proving a change in value associated with the easement and avoiding the substantial valuations penalties. The fact that the city was quite lax in enforcing the historical preservation rules, but the private donee of the easement was diligent in inspecting and restricting changes, played well for the Taxpayer's case.

Comment: This opinion by Judge Holmes, who can really tell a story, is instructive on many levels. He recounts an interesting history of the rise and fall of Buffalo, as well as a careful assessment of expert reports that may prove helpful for those with valuation issues. Note that Taxpayer might have lost this case based on a deed provision that made the easement vulnerable under Palmolive Bldg. Inv'rs. LLC v. Commissioner, 149 T.C. 389 (2017). However, the Service stipulated away this issue.

5. Taxpayers vindicated in claimed conservation easement deduction, Kumar v. Commissioner, TC Memo 2020-159

Following the Eleventh Circuit ruling in *Pine Mountain LLLP v. Commissioner*, 2020 WL 6193897 (11th Cir. Oct. 22, 2020), the Tax Court rejected the IRS arguments based on a failure to satisfy the perpetuity requirement in this context. Thus, the case turned on valuation. The Tax Court ruled that the factual context presented here supported the valuation claimed by the Taxpayer. While the court did not find the actual value, it determined that such value was at least sufficiently great to show there was no deficiency for these taxpayers.

Comment: These taxpayers drew the lucky straw of getting Judge Holmes to hear their case. True to form, the opinion is fun to read and enlightening on the matter of valuation.

6. Failure to comply with appraisal regulations dooms charitable deduction for house donated for "deconstruction", Loube v. Commissioner, TC Memo 2020-3.

Taxpayers purchased real property in Maryland, consisting of .38 acres of land on which a single-family home was constructed. Taxpayers initially planned to demolish the home and build another one on the lot. However, they chose to use a charitable organization, Second Chance, to "deconstruct" the house. Second Chance assists persons facing barriers to employment by providing job training during the "deconstruction" process. It also sells salvaged materials, including fixtures and lumber, to fund its efforts. This effort lessens the burden on local landfills, although demolition is still required when Second Chance is done with its salvage efforts.

Homeowners who contract with Second Chance generally make a cash charitable contribution to Second Chance to fund their work. Their agreement allows Second Chance to take usable materials from the property, but it leaves the real estate owner responsible for demolition and removal of the remainder. In this case, deconstruction efforts "did not appreciably reduce" demolition costs.

Taxpayers' agreement with Second Chance included a "charitable pledge" of a cash contribution on or before December 31, 2013, plus an in-kind donation of the improvements (i.e., the existing home). The agreement was not recorded in the real estate records, and it did not state the specific items conveyed. Taxpayers hired an appraiser to determine the value of the home on a "current cost to reproduce" basis, which was then reduced for various factors to a rounded value of $297,000. The appraiser also provided a list of the value of special items, including appliances and other fixtures, totaling $182,718. On December 23, 2013, Taxpayers contributed $15,000 to Second Chance, and On January 10, 2014, they contracted for the construction of a new home, which included demolition of what was left of the existing home at a cost of $14,500.

Taxpayers included a Form 8283, Noncash Charitable Contributions, in support of the claimed $297,000 noncash contribution, with their 2013 return. They attached their appraisal. However, on the form itself, they left several boxes blank, including the cost or adjusted basis of the property as well as the signature of the appraiser and the donee that are required on the form.

The Service disallowed the deduction, and the Tax Court upheld this determination based on the Taxpayer's noncompliance with the applicable Treasury Regulations, including § 1.170A-13. Taxpayers alleged substantial compliance, but that position was rejected. Here, Taxpayer failed to provide the cost or adjusted basis, which was deemed essential by the Tax Court in its prior decision in RERI Holdings I, LLC, 149 T.C. 1. This failure to provide cost basis data impedes the Service's work in identifying inflated appraisals. Although clues about value could have been obtained from other information provided in the attached appraisal, the court did not believe Congress intended to require the Service to sift through returns to obtain that data.

Comment: Taxpayers seeking to donate a home that will be demolished face a formidable challenge in securing a charitable deduction. In this case, the record did not disclose whether Taxpayers successfully claimed a cash charitable deduction. Arguably such a deduction would be proper, as they got no appreciable benefit in exchange for their payments, which were designed to fund an exempt, benevolent purpose. If the facts had shown otherwise, Taxpayers would be reaping a personal benefit from the contribution – a form of capital cost reduction associated with deconstruction in the course of building their new home.

Those trying to obtain a noncash charitable deduction should look at this case, as well as the others cited herein, as stern warnings about the importance of compliance in submitting their returns. See also Oakhill Woods, LLC v. Commissioner, TC Memo 2020-24 (conservation easement; failure to report basis). For a better outcome, compare Emanouil v. Commissioner, TC Memo 2020-120, in which a taxpayer who made an actual donation of property adjoining an affordable housing project was permitted a charitable deduction based on substantial compliance with the applicable regulations, thereby upholding claimed deductions against IRS challenges.

7. Charitable deduction for prescription eyeglass program denied for faulty appraisal and nonconformity with regulations, Campbell v. Commissioner, TC Memo 2020-41.

Taxpayers received a notice of deficiency for their 2008 tax year. The IRS disallowed a carryover charitable deduction from 2007 that related to an in-kind contribution of 3,432 new designer eyeglass frames to Lions in Sight, a charitable organization connected with Lions International. The Service also imposed an accuracy penalty.

Taxpayer learned of a charitable contribution program through his CPA. ZD Products, Inc. had consolidated over 170,000 eyeglass frames it owned into units of 3,432 frames each (286 dozen). ZD Products sold them to 50 buyers for $50,000 per unit. The program required the purchaser to hold the frames for one year, followed by an in-kind donation to a charitable organization (here, an affiliate of the Lions Club International, which provides no-cost eye-care assistance to needy and low-income individuals). The offering material for the program included an appraisal from Marshall & Stevens that supported a charitable contribution value of $225,322 for each unit of the glasses. ZD Products agreed to take care of the logistics, including storage and drop-shipment to the charity and completion of IRS Form 8283. ZD Products also contracted with Marshall & Steven to conduct a follow-up appraisal at the time the donation was made to confirm the reported value.

As of November 27, 2006, the Marshall & Steven appraisal shows a breakdown of each brand of designer glasses, along with models and wholesale prices. Using a market approach, Marshall & Stevens marked up the glasses 35 percent from wholesale and valued the entire lot at $11.2 million. Sometime in 2007, Lions in Sight received these eyeglass frames, as well as some others that ZD Products had acquired. A follow-up appraisal was performed and dated December 26, 2007, listing the property on hand in the prior year plus additional glasses from other designer brands. Based on that new appraisal, Marshall & Stevens sent Taxpayer a letter stating that the eyewear products donated were valued at $225,596 – about the same value determined in the 2006 program materials.

Taxpayers' 2007 return included Form 8283 showing the eyeglasses at their appraised value, along with the letter from Marshall & Stevens and their appraisal from 2007. Taxpayers showed a loss for 2007, so they carried forward the value of the eyeglasses and other charitable contributions to their 2008 return. In 2012, another appraiser evaluated the eyeglasses donated through the program on a retrospective basis going back to 2007, which also supported the value determined by Marshall & Stevens.

The Service challenged the donation on the basis that Taxpayers failed to satisfy the regulatory requirements for in-kind donations. First, it challenged the 2007 Marshall & Stevens appraisal on the ground that it failed to provide "A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed." See Treas. Reg. § 1.170-13(c)(3)(i)(A). The Tax Court agreed, but it also found a more fundamental problem: the appraisal did not cover the actual glasses acquired by these Taxpayers. Instead, the appraisal covered the entire lot. This was analogous to valuing fractional interests of property by using an appraisal for the entire property, which was rejected in Smith v. Commissioner, TC Memo 2007-368, or using an appraisal of corporate assets when the Taxpayer donated shares in the corporation, as rejected in Estate of Evenchik, TC Memo 20013-34.

The eyeglasses in the large lot ranged from $37-80 each, but no records confirm that the lot donated by Taxpayers contained the same mix of frames as the whole. Although Taxpayers argued that they donated a "fractional interest" in the entire lot, that was not what they stipulated to in the Tax Court.

Taxpayer's deduction was also compromised by the fact that the letter from the donee, Lions for Sight, only thanked Taxpayers for their generous donation and did not include the mandatory language that they did not provide any other consideration in return. This language cannot be omitted. Substantial compliance is not permitted when essential requirements such as those identified here are not satisfied.

Further, Taxpayer could not rely on the advice of their accountants as a basis for reasonable cause in failing to satisfy the requirements of section 170. Here, the accountants were also promoters and participants in the charitable program, and thus they were not independent.

Taxpayer did get a break, however, in that the Service failed to satisfy the supervisory approval requirement for accuracy penalties.

Comment: This case shows that extra caution is required for in-kind contributions, and particularly ones promoted by one's tax preparer. Also, stipulations matter. Taxpayers stipulated to giving a specific lot of eyeglasses, not a fractional interest in the whole. This distinction became important when the court focused on what had been appraised. The charity itself also let them down by not including boilerplate language regarding quid pro quo in their letter. Even if this deal had been papered more effectively, I suspect valuation issues could also *be lurking here. $11 million seems a pretty big markup from $2.5 million (50 participants paying $50,000 each). Query whether a close examination might lead to an assessment that more of these frames were out of style and thus not worth the marked-up retail price. For another case involving a failure based on noncompliance with these regulations and a failure to prove value based on proper expert testimony, see Brannan Sand & Gravel Co. v. Commissioner, TC Memo 2020-76 (involving donation of water storage rights). For a case where a deduction is reduced based on a valuation challenge, see Johnson v. Commissioner, TC Memo 2020-79 (reducing conservation easement on ranch based on competing expert testimony as to before and after value).*

Finally, allow me to note that Lions for Sight is a fine charity. My late father-in-law and mother-in-law were both terrific boosters of this worthy cause. May they rest in peace. And "Go Lions. Roar."

8. Charitable deduction of appreciated stock respected instead of recharacterized as redemption followed by donation of cash proceeds, Dickinson v. Commissioner, TC Memo 2020-128.

Taxpayer was the CFO and a shareholder in GCI, a privately held company. The GCI board authorized shareholders to donate GCI stock to Fidelity Investments Charitable Gift Fund, a tax-exempt organization operated as a donor-advised fund. The Fidelity fund included procedures that require immediate liquidation of nonpublic stock donated in-kind by tendering it to the issuer for cash. After GCI board authorization, Taxpayer donated appreciated GCI shares to Fidelity. GCI confirmed that Fidelity became the owner of the shares. Fidelity executed a letter of understanding with Taxpayer that it owned the shares and maintained full discretion over all conditions of any subsequent sale. Then, pursuant to its policy, Fidelity tendered the stock to GCI for redemption shortly after each donation.

Taxpayers claimed a charitable donation deduction based on the appreciated value of the stock. The Service issued a notice of deficiency based on recharacterizing the transaction as a redemption by Taxpayer followed by a cash donation to Fidelity. Taxpayer petitioned the Tax Court and filed a motion for summary judgment.

The Tax Court ruled for Taxpayer. Following *Humacid Co. v. Commissioner*, 42 T.C. 894 (1964), the court respects the form of transaction when the Taxpayer gives away the property and parts with the title thereto before the property gives rise to income. Both elements were satisfied in this case.

Comment: Taxpayers considering gifts of appreciated stock in a closely held corporation which will likely be followed by a redemption transaction will want to review this case and related authorities cited herein carefully. This taxpayer did it all right. Care should also be taken that the Ninth Circuit approach in Ferguson (1999) – see note 2 – does not apply. In that case, proceeds were taxable to the donor when a tender offer and merger are "practically certain to proceed". Would that standard have helped the Service here, when redemption is otherwise followed under the policy of the donor advised fund? The Tax Court was willing to overlook this as long as there was no proof that the donor had a fixed right to redeem at the time the donation *was made. As a practical matter, an in-kind donation may not be possible if these policies are in place without an understanding that the stock can be redeemed.*

B. Business/Investment.

1. No reasonable prospect of recovery permits fraud loss deduction, Adkins v. United States, 960 F.3d 1352 (Fed. Cir. 2020), reversing 140 Fed.Cl. 297 (2018).

On their second trip to the Federal Circuit, Taxpayers finally obtained a victory in their refund claim based on a 2004 fraud loss. The Federal Circuit had to correct the Claims Court once again for expecting too much from taxpayers in proving their loss.

In Adkins v. United States, 856 F.3d 914, 918-20 (Fed. Cir. 2017) ("*Adkins I* "), the Federal Circuit explained:

> [W]hat a taxpayer must prove by reasonable certainty is that, as of the time the loss was claimed, there was no reasonable "prospect of recovery"; she is not required to prove that it was certain no recovery could be had. We also explained that, while one could establish the absence of any reasonable prospect of recovery by abandonment of a claim, abandonment is not a prerequisite to such a showing. In short, we explained that the Claims Court had required too much from the taxpayers—both with regard to what they must prove and with regard to what evidence is needed to satisfy that burden of proof.

After remand, the Claims Court persisted in ruling against Taxpayers, who had racked up over $2 million in losses from dealing with a brokerage firm that had defrauded them in 2002. They filed a claim for refund in 2004, which the IRS initially approved but then later contested. The Claims Court determined that Taxpayers had three possible avenues for recovery: (1) arbitration claims against the investment firm and its principals; (2) legal claims against certain of the principals of the firm; and (3) restitution claims in conjunction with criminal cases against the principals. Based on the evidence in the record, the Claims Court concluded that “a reasonable taxpayer in plaintiff’s position *could not have known* in 2004 whether he had a reasonable prospect of recovering *at least some* of his losses.” Stated differently, the Claims Court characterized the status of their claims as “simply unknowable”. This ruling suggests that the taxpayer could not claim a refund until the taxpayer exhausts all avenues for recovery, regardless of the likelihood of success or cost associated with the claim.

In this appeal, the Federal Circuit clarified the standard required for proving a theft or fraud loss. It traced the “unknowable” standard to Jeppsen v. Commissioner, 128 F.3d 1410 (10th Cir. 1997), in which the majority ruled against the taxpayer seeking a deduction for a theft loss, which he ultimately recovered years later from the perpetrator. The Federal Circuit noted several factual distinctions in Jeppsen, but more importantly, it characterized the majority’s use of “unknowable” as mere dicta. A dissenting opinion in Jeppsen also called out the majority for invoking this standard as one which would “always doom a loss claim as an implicit requirement of affirmative proof that the loss will never be recovered.” 128 F.3d at 1419-20 (Kelly, J., dissenting). The Federal Circuit agreed with the dissent, finding that neither the statute nor the regulations, which focus on whether a “reasonable prospect of recovery” is present, require this level of proof, stating in part:

> Notably, the Claims Court pointed to possible avenues of recovery but did not calculate either the cost of pursuing that recovery or attempt to balance those costs against the

> likelihood of victory. While a taxpayer is not free to put her head in the sand and ignore meaningful avenues of recovery, it would be a tremendous waste of resources and time for the taxpayer to pursue every option, regardless of the likelihood of success or degree of difficulty.

Here, the question of a reasonable prospect of recovery "is a question of foresight and of fact, to be determined upon an examination of all facts and circumstances." A preponderance of the evidence is required. Even a pending case that might reasonably be decided in Taxpayer's favor does not necessarily doom Taxpayer's claim, as the prospects for recovery must be considered. Taxpayer had much room for doubt as to the viability of any of these avenues for recovery. Their arbitration claim was stagnant, not proceeding due to the pending criminal indictment. Moreover, there was reason to believe the targets may be judgment-proof. At most, their prospects for recovery were remote, not reasonable.

Comment: This fact pattern will continue to present future litigation controversies given the challenges of predicting the future. Given the time and expense of litigation, coupled with the inherent delay in ultimately pursuing justice in such a case, a strong case can be made for an immediate deduction rule, followed by taxing the recipient in the year of recovery to the extent of any recovery of a prior tax benefit. Legislation is needed to prevent these protracted controversies that require prognostication skills that most of us lack. As discussed below in Giambrone v. Commissioner, TC Memo 2020-145, safe harbors granted in Revenue Procedures present one avenue for greater certainty and predictability – but these may not bind the IRS.

2. Lack of business records results in higher reconstructed income from failed business, Hommel v. Commissioner, TC Memo 2020-4.

Taxpayer was engaged in a coin and bullion business in 2009. He was very successful, making over $1 million in profits that year. But by 2010, his business was in shambles. This case tells the sad tale of this emerging disorder.

During 2009, Taxpayer prepared a bill of sale transferring his coin shop to a business associate, purportedly to keep his name out of the public eye. The bill of sale covered many of the business assets, but not the inventory. Pursuant to an oral agreement, Taxpayer thought he had effectively negated an actual sale of the business; he kept the inventory and would receive profits from the business, less a salary paid to his business associate.

At this point, the Tax Court states: "We are careful to note, at this point in our factfinding, that we also believe Mr. Hommel when he says that he did not consult with a lawyer, broker, or anyone else when he crafted this transaction." (So, this approach just sprang from his own mind – thank heavens. But the story continues.)

Taxpayer began to think his putative business associate was stealing from him. Proceeds from the coin shop business were not being deposited into Taxpayer's bank account as expected. Instead, the business associate had opened his own bank account for those funds.

Taxpayer also separately opened a mint and coin shop, seeking to vertically integrate the production of silver coins and their sale through a retail outlet. He committed 200,000 ounces of silver to the venture, along with some equipment he purchased. But here, too, he relied on a business associate to run the operation. That business associated likewise opened his own bank account, and the contents of Taxpayer's silver inventory evaporated.

Taxpayer became upset, going first to the local police station to drop off what he called "an indictment" of his associates. He then went to make a "citizen's arrest" carrying a gun, padlock, and chain. But this private justice effort backfired, as the police arrested him for false imprisonment, and he was convicted. The business associates claimed they owned the businesses, and one had the bill of sale to prove it. Taxpayer sued them for theft and conversion, but the cases settled in 2012 with no one getting any money. A restraining order keeps Taxpayer away from these businesses for good.

Meanwhile the 2009 return remained unfiled. Eventually, after filing, an audit ensued and a Revenue Agent tried to reconstruct his income from bank records. Taxpayer had no records of inventory and related transactions, as they were all part of the businesses that were taken over by his business associates. Initially, the Agent determined he failed to report $8.1 million in income. But a second look showed cost of goods sold of over $6 million along with additional expenses. The report settled at an adjustment of $1.2 million. A deficiency was assessed in 2014, along with a late filing penalty and an accuracy penalty.

This Tax Court petition followed, with Taxpayer representing himself. Among other things, Taxpayer argued that he could not have had that much income because he has so few assets now. As the Tax Court explained, it does not quite work that way. He also alleged that the COGS determination failed to take into account cash payments made to customers to purchase silver goods for his mint operation. However, Taxpayer failed to keep any records and thus was stuck with the IRS effort to reconstruct from bank accounts. Taxpayer also argued for theft losses, but here there was a timing question – losses, if they did indeed occur, accrued after the 2009 tax year.

Taxpayer was successful in challenging the accuracy penalty here on the basis that the Service did not meet its burden of proof. Although the Service introduced evidence of a penalty assessment form, it was not tied to the supervisor of the agent who proposed the deficiency. The Service tried to explain this away as an "autopopulation problem" involving the form they used, but the Court did not find this persuasive. It also refused to reopen the record for additional evidence on the matter of the penalty form, which would be prejudicial to Taxpayer and would be necessary because of a lack of diligence by the Commissioner in proving its case.

Comment: One can sympathize with a taxpayer who cannot get access to business records because they are in the hands of business associates who may have stolen from you and which you are restrained from accessing on account of prior self-help efforts that went a little too far. Taxpayer apparently did not try to get around the restraining orders to access to those records, if indeed they had existed at all. There is some consolation here for our people: at least a professional advisor did not get him into this mess.

3. S-Corporation did not realize loss on transfer of property to "liquidating trust", Sage v. Commissioner, 154 T.C. No. 12 (2020).

Taxpayer, a real estate developer, owned three parcels of property through IDG, an S corporation. The 2008 recession hurt his business, causing him to lay off staff and generating efforts to restructure debt. After negotiations with creditors, Taxpayer caused IDG to form three SMLLCs, each of which would receive one of the parcels of property. In 2009, these LLCs (treated as disregarded entities) transferred title to the property to liquidating trusts, which were classified as grantor trusts. IDG continued to operate the properties as before. During 2010-2012, those trusts ultimately disposed of the properties and applied the net proceeds for the benefit of the mortgage creditors. By doing so, it reduced the outstanding liabilities of IDG and its LLCs.

IDG reported losses on the 2009 transfers, which passed through to Taxpayer. Taxpayer used the resulting NOL as a carry back to the 2006 tax year and a carry forward to the 2012 tax year. The Service audited both IDG and Taxpayer returns for 2009. It disallowed those losses, also affecting Taxpayer's 2006 and 2012 tax years for which Taxpayer received refunds due to NOLs. The Service argued that the transfers to the trusts did not reflect "closed and completed transactions" upon which losses under section 165 may be claimed. The Tax Court agreed.

The Tax Court ruled that these "liquidating trusts" were governed by the grantor trust provisions found in section 671-79 of the Code. Those rules essentially look through the trust form and tax the true owner of the property. In this case, IDG was the grantor. It received the benefit of any trust income, which would be applied to discharge its legal obligations on the mortgages. Thus, the trusts were not separate taxable entities benefitting creditors. As a result, there was no disposition of the properties reflecting a closed and completed transaction necessary to establish a loss in 2009. The court also rejected arguments by Taxpayer that the transfers to the trust should be treated as dispositions, based in part on certain revenue rulings. But those rulings were distinguishable – the trusts here were established without involvement of the creditors. The fact that the creditors chose not to file suit did not constitute a ratification to this scheme. Indeed, the creditors stated that they did not view the trusts as having any practical effect on their debt liability. (See id. at n. 20).

Comment: The application of the grantor trust rules in this context prevents a transfer in this context from creating a closed and completed transaction. Let's hope that Taxpayer kept open the 2010 and 2011 tax years, as those later years will generate deductions that might apply salve to take away the sting of the loss here. However, note 20 and the surrounding text suggests that there may be room for a different outcome if the transaction could have been reengineered to deprive the transferor of ownership status, such as by an accord and satisfaction transaction involving the creditor or a simple foreclosure. Form remains important in this context. For another case rejecting a loss based on no closed and completed transaction, see also Cuthbertson v. Commissioner, TC Memo 2020-9.

4. No deduction for unreimbursed employee business expenses, Near v. Commissioner, TC Memo 2020-10.

Taxpayer was an attorney employed by the State of California Department of Transportation (Caltrans), who also had his own law firm. In 2015, Taxpayer worked on a civil case for his employer, which required him to be in Solano County, California from October 26 to December 23, 2015. During that time, he rented a hotel room near the courthouse. His employment agreement, negotiated by the public employee union, required the state to reimburse these travel costs.

On Taxpayer's 2015 return, he claimed deductions for travel, including his hotel and airline trips connected to the civil trial he conducted on behalf of Caltrans. Taxpayer claimed that during the trial, he needed to communicate with other clients and do related client work. But the Tax Court found that he could have received reimbursement from Caltrans for these expenses. As a result, there are not considered "necessary". Moreover, they could not be converted into trade or business expenses by failing to seek reimbursement.

Comment: The outcome in this case is unremarkable, but it provides clear authority for rejecting deductions claimed by taxpayers in dual-role situations (employee and independent contractor).

5. Personal guarantees of loans to disregarded LLCs put Taxpayer at risk and eligible to deduct suspended losses, Bordelon v. Commissioner, TC Memo 2020-26.

Taxpayer owned a medical services company that provided management services to hospitals and other providers. Beginning in 2008, he also formed a single member LLC for the purpose of acquiring and operating a hospital in Many, Louisiana. Using his medical services company and the LLC, he obtained funding from an agricultural development loan through Union Bank in Many to allow these entities to purchase the hospital for $9.9 million. However, he was required to execute a personal guarantee for the loan. That guarantee allowed the creditor to go directly to Taxpayer to obtain payment, without first seeking payments from the other borrower entities.

Taxpayer also owned a majority interest in another LLC operating a hospital in Kilgore, Texas. That LLC borrowed $550,000 in 2011, secured by the LLC's collateral as well as Taxpayer's personal residence. Taxpayer was also required to execute a personal guarantee, which was absolute and unconditional.

During the 2008 Tax year, Taxpayer reported losses of $1.6 million for the Many LLC and $2.7 million for the Kilgore LLC. After audit, the Service disallowed about $1 million of the Many LLC loss deduction on the ground that he was not "at risk" for such amounts. It also disallowed the Kilgore losses on the ground that Taxpayer lacked sufficient basis to claim the loss deduction.

As for the Many loss, Taxpayer was able to show that he was at risk for purposes of section 465. Although Taxpayer was not the obligor on the loan, he was "personally liable" on account of the guarantee that he signed. Guarantees do not generally establish personal liability for purposes of section 465(b)(2)(A), but not all guarantees are created equal. This guarantee put Taxpayer in a position of personal liability without any meaningful right to contribution from other debtors. The co-debtors in this case were his own companies. Moreover, the bank could pursue him directly without any action against the obligors on the note. Although Louisiana law, like the law of other states, precludes a member's personal liability for debts of the LLC, the guarantee circumvents this state law protection. Further, the fact that Louisiana law provides for a right of reimbursement would not shift his status as being at risk: the court applies a "worst case" scenario that the entities are worthless, and even if that were not the case, as the single owner Taxpayer would bear the economic cost.

Taxpayer was also not protected against loss in a manner that prevents him from being at risk under IRC 465(b)(4). While this factor considers the prospect for reimbursement, the fact that any reimbursement here would be obtained from limited liability entities that he owned. Although the court applied a "realistic possibility" standard for incurring economic loss, that was not much different from the "worst case scenario" used in determining personal liability. Either way, this Taxpayer is fine.

As for the basis in Kilgore, Taxpayer conceded that he had a zero basis in Kilgore during 2008, so that the loss should be disallowed. But Taxpayer claimed that his basis increased by $550,000 on account of the debt incurred in 2011, which would allow those losses suspended and carried forward from 2008 to be used in 2011. Here, the Tax Court applied a constructive liquidation approach to allocate the risk of loss for the debt. In that analysis, Taxpayer was deemed to be economically at risk for the full amount. In effect, Taxpayer's unconditional guarantee made this loan his recourse obligation, with a corresponding increase in his partnership basis. The Tax Court also extended this analysis for purposes of section 465, noting that "there might be a scenario in which a partner's basis could increase on account of a guarantee but in which the guarantee would not result in his being considered at risk under section 465, but this is not such a case."

Comment: This case may prove helpful to those who choose to use entities for acquisitions. Personal guarantees are commonly used as tools to avoid the limited liability feature of those entities. When, as here, the borrower is the only guarantor, the at-risk proposition can be clearly stated. But presumably the principles for analysis used in this context could also extend to other contexts involving more than one investor – with due attention to all relevant facts.

6. Company formed to pursue insurance company acquisitions and support brokerage firm must capitalize startup expenses, Williams v. Commissioner, TC Memo 2020-48.

Taxpayer was previously employed by Washington Mutual Insurance from 2003-10. He left the firm in June 2010, after it was merged into JP Morgan Chase. In 2007, he had formed GSE Financial (GSE) as a sole proprietorship. He intended to use it as a holding company to acquire other insurance businesses. In 2010-12, he engaged law firms to provide legal advice and counsel on licensing matters and similar issues affecting proposed acquisitions. He acquired his first insurance brokerage in 2010 (known as "BJW"), and beginning in 2011 he provided business development, marketing, and other support to BJW through GSE. In 2010 and following years, GSE incurred expenses for legal fees, travel, office rent, and other related expenses. The total for 2010 was approximately $40,000, and slightly less in 2011.

The Service challenged these deductions on behalf of GSE as nondeductible startup expenses. Section 195 precludes a current deduction for startup expenses, requiring instead that those expenses must be capitalized. However, section 195 generally allows amortization over

180 months beginning in the taxable year in which the active trade or business begins. Alternatively, a taxpayer may elect to forego this deemed amortization election by an affirmative election on a timely filed return for the taxable year in which the business begins.

At issue here was whether GSE began its business in 2010 when its only activities consisted of pursuing target companies that it did not actually purchase. According to the Schedule C for GSE, it reported no income until 2013 when it shifted its business activities from acquiring targets to providing support to BJW.

Based on the record, the Tax Court concluded that the activities of pursuing other targets, which included meeting with lawyers and other business peoples, were paid in "investigating the creation or acquisition of an active trade or business" and therefore start-up expenditures under section 195(c)(1). No deductions were allowed for the 2010 tax year. However, in 2011, the court determined that GSE began an active trade or business when it began to provide services. Having failed to make an affirmative election not to amortize, a deduction of $5000 plus amortization deductions are proper beginning in 2011 for the startup expenses substantiated by Taxpayer.

Comment: Startup expense cases are rare. It is potentially significant that the sole proprietorship, GSE, was deemed to be carrying on a trade or business before it earned any revenue.

7. Self-employed taxpayer claws back from PPA tax credit cliff based on self-employed medical deduction, Abrego v. Commissioner, TC Memo 2020-87.

Taxpayers, although eligible for Medicare, purchased private insurance. They relied upon the advance payment of premium tax credits under the Patient Protection and Affordable Care Act to cover approximately $900 of the $1000 monthly premium. Credits for the 2015 tax year totaled $9,210, as they were covered only ten months of the year. Taxpayers had $662 in schedule C income from a tax preparation business, along with wage and social security income. Their reported AGI was $61,478. They failed to provide Form 8962 regarding their premium tax credits, and they did not report any premium tax credits in line 69 of their return.

When their untaxed social security income is added to their AGI, their total household income for purposes of assessing eligibility for the premium tax credit was $63,332. Unfortunately for Taxpayers, that was higher than 400% of the federal poverty rate for a family of two in California ($62,920), making them ineligible for the credits. Taxpayers filed their 2015 return late because they thought they were getting a refund. But they were in for a big surprise.

The Service issued a notice of deficiency that included a late filing penalty based on disallowing their entitlement to the premium credits. Prior to trial in the Tax Court, the Commissioner conceded that Taxpayers should be entitled to a self-employed health insurance deduction of $662 – the amount of their health premiums paid out of pocket that corresponded to their reported schedule C income from self-employment. This reduced their taxable income and, more importantly, their household income to an amount that was only 398% of the federal poverty level. According to the court, this meant that they were entitled a credit that would be reduced by a larger contribution amount – in this case $583.12 per month, or $5831.20 for the ten-month period in 2015.

But this still left Taxpayers owing an excess credit of $3,378.81. Fortunately, they were under the 400 percent of federal poverty guideline, where the Code imposes a maximum repayment obligation of $2500, which also established the base for their late filing penalty.

Comment: This case reflects the steep "cliff" effects imposed on those taxpayers who earn above the 400 percent of federal poverty level. Taxpayers were over this "cliff" by only $412. The potential tax cost (omitting penalties) would have been $9,210 – full loss of premium credits. The self-employment income deduction of $692 took them back from this cliff, effectively saving $6,710 in taxes – almost a tenfold return on the deduction. If these older Taxpayers had saved their capital and generated interest income instead of using it to generate self-employment income, they would not been eligible for the health insurance deduction. Not only would their taxable income increase, but that same amount of marginal investment income would generate $9,210 in taxes from credit repayments. These taxpayers may have (mostly) escaped disaster in this year, but what about 2016 and later years? The delayed time period for discovering their problem was partly their own doing, as they had deliberately filed late. Hardworking taxpayers who earned near the cliff level will likely find themselves in a financial crisis with the unexpected loss of these health insurance tax benefits they thought they deserved. Here, the Abregos had the option of choosing Medicare, but many others will not. Can we chalk this up to unintended consequences? Or did the members of Congress who voted for the PPA anticipate this result when writing the rules? Results like these show that sometimes tax law can be an ass.

8. Loss on sale of converted vacation home disallowed where Taxpayers failed to prove basis at the time of conversion, Duffy v. Commissioner, TC Memo 2020-18.

Taxpayers bought a property in Oregon for $2 million in 2006, paying $430,500 and financing the balance with the sellers. They defaulted on their debt in July 2008. In September 2008, they borrowed $1.4 million from JPMorgan to make a partial payment to sellers on this property. On their loan documents, they represented the property as a second residence, but they instead regularly rented the property to family and acquaintances in 2009 and 2010.

In March 2011, Taxpayers sold the property for $800,000. JPMorgan accepted $750,841 of the proceeds from the sale in full satisfaction of the mortgage on the property. Testimony from Taxpayers indicates that they were insolvent in March 2011. Husband had lost his job during the financial crisis and he liquidated the proceeds of his retirement account to invest in a company that manufactured medical equipment. In 2013, Wells Fargo also cancelled almost $400K of debt on their principal residence. They were also insolvent at that time.

In 2011, Taxpayers reported a loss of $971,988 from the sale of the Oregon property on Form 4797. They also reported cancellation of indebtedness income of $626,046 regarding the JPMorgan loan on that property. With the disposition of the property, Taxpayers also claimed a deduction of previously suspended passive losses on the property, which totaled $199,875. Consequently, this activity generated an NOL of $274K that was carried back to obtain refunds in the 2009 and 2010 tax years. Those carrybacks reduced their 2009 and 2010 income below

$150,000, thereby allowing them to claim additional amounts of previously suspended passive losses.

The Service audited Taxpayers' returns for 2009-14, raising issues related to the Oregon property as well as to matters connected with the medical equipment company in which Taxpayer was an investor. Taxpayers petitioned the Tax Court. The property issues are discussed below.

First, the Service challenged whether the property was operated as a trade or business. The Service noted that the loan documents in September 2008 treated that property as a second residence, for which a loss would be disallowed. However, Taxpayers claimed that they started renting the property in 2009 after obtaining the loan. The Tax Court upheld the denial of the loss deduction on a more fundamental ground: Taxpayers never proved that the basis at the time of sale exceeded the amount realized. Having converted the property, its basis would be limited to the FMV at the time of conversion for purposes of computing a loss. See Treas. Reg. § 1.165-9.

As for the JPMorgan loan discharge, Taxpayers took a different position at trial than they took on their 2011 return, claiming that they were insolvent in 2011 so that this discharge amount could be excluded from their gross income. However, an exclusion only applies if the loan is a recourse loan. The Service conceded that if the loan had been nonrecourse, the proceeds would have been included in the amount realized, and no taxable income would result in these circumstances, only a reduction of the disallowed loss.

The Tax Court looked to the underlying state law in Oregon governing secured lending for residential real estate. According to the Court, Oregon law does not permit the lender to collect a deficiency in an administrative foreclosure, which does not involve a court. Under that rule, it would not matter whether the loan had been secured by a "residential trust deed", which the IRS disputed. Thus, the loan discharge becomes part of the amount realized, which would not trigger additional taxable income in this context. Instead, it would offset their original basis.

Finally, Taxpayers also claimed an exclusion under IRC § 108(a)(1)(E) for the cancellation of indebtedness on their principal residence. However, the mortgage debt discharged by Wells Fargo was not acquisition indebtedness or indebtedness used to improve the property, but instead financed living expenses for the couple. This made them ineligible for the principal residence exclusion. However, Taxpayer alleged that they were eligible for an exclusion based on the insolvency exception. Although the Service challenged the evidence, which involved primarily Taxpayers' own testimony without the benefit of documentary support, as being insufficient, the Tax Court allowed Taxpayers to exclude some of the income based on the available evidence, including Taxpayer's own assessment of the value of their home. It specifically rejected a requirement for documentary evidence in this context. Based on the evidence before the court, Taxpayers could exclude $274K based on the insolvency exception, leaving $117K in cancellation of indebtedness income.

The balance of the opinion addressed partnership issues, and it also held that penalties could not be imposed due to the failure to obtained supervisory approval.

Comment: This case illustrates some of the income tax issues that occur when leveraged taxpayers face a financial crisis. Here, state law helped to convert what might have been a recourse mortgage into nonrecourse debt, which turned out to have significant tax advantages where property has declined in value below the original cost basis. These taxpayers could have done better at trial on the matter of insolvency proof, but the Tax Court generously considered all available evidence, which is good to know if you cannot afford expert testimony.

This case also touches upon the special exclusion for qualified principal residence indebtedness, which seems to expire and then get revived with some regularity. For another case in which a failure to secure the debt by the property (this time located in California) provides a basis to deny the exclusion, see Weiderman v. Commissioner, TC Memo 2020-109.

9. Corporate loss for bad debt denied, VHC, Inc. v. Commissioner, 968 F.3d 839 (7th Cir. 2020), affirming TC Memo 2017-220.

Taxpayer, a closely held corporation controlled by a family, had made cash advances to a son of the founder totaling $111 million. Son spent these on his business ventures and for other personal matters; he did not repay the corporation. Taxpayer claimed bad debt deductions and, in the alternative, claimed that payments were ordinary and necessary business expenses. The Tax Court held for the Service, and Taxpayer appealed.

The Seventh Circuit affirmed, finding that the Tax Court's determination that these advances did not amount to bona fide indebtedness was a fact finding reviewable under a clear error standard. Taxpayer failed to show clear error here.

As for the claimed deduction, Taxpayer's theory was based on payment of expenses for another allowed in *Lohrke v. Commissioner*, 48 T.C. 679 (1967). However, Taxpayer failed to substantiate these expenses. Even if they had been substantiated, Taxpayer failed to prove that such expenses would have been ordinary and necessary in its industry.

Finally, Taxpayer sought to exclude from income interest payments that Son had made to Taxpayer before the putative debts were declared worthless. Although the Tax Court correctly upheld exclusions for accrued but unpaid interest, Taxpayers had not asked the Tax Court to exclude amounts actually paid. Taxpayers' tactical error did not constitute an error by the Tax Court.

Comment: This appellate determination follows a solidly reasoned Tax Court decision. Family corporations need to be sure that loans are documented – especially when they get into the 9-figure range.

10. Seismic engineering firm eligible for partial section 199 deduction, TGS-Nopec Geophysical Co. v. Commissioner, 155 T.C. No. 3 (2020).

Taxpayer acquires, processes, and licenses marine seismic data, primarily to customers in the oil and gas industry. They collect the data, process it into images of subsurface geophysical structures, and then sell or license those images to others that use it to produce oil and gas.

Data collection is achieved by independent contractors, who use an acoustic sound source to broadcast sound waves into the ocean floor and hydrophones to detect the reflected seismic energy. The surveyed areas can span thousands of square kilometers, which can take more than three months to complete. The response is recorded on a magnetic tape. Tapes are accumulated on the recording ships every few weeks and shipped by helicopter to a data processing center in Houston, Texas. Taxpayer's imaging teams manipulate the data based on sophisticated algorithms and process them into images of subsurface geology. Considerable skill and computing power are required to do this processing, as Taxpayer employs fifteen for the purpose of improving the images produced by these processes, including reprocessing prior data to improve the quality.

After processing, the data was copied and licensed to clients using master agreements, which granted a nonexclusive right for clients to use the data. Taxpayer retained ownership over the data and the tapes from which the processed data was derived. Taxpayer received revenues from licensing, as well as from "reproduction revenue" obtained by processing data provided from its corporate parent, a Netherlands corporation, which it processed and licensed to customers.

Taxpayer treated these activities as eligible for the domestic production activities deduction under former section 199, claiming $1.9 million in deductions on DPGR of $74 million. The Service disallowed the deduction, resulting in this Tax Court petition.

The Tax Court ruled for the Taxpayer, subject to some constraints. Taxpayer had claimed that these were eligible activities because the produced "qualified production property" (here, a sound recording) within the United States or, alternatively, because they provided an engineering service in the United States with respect to construction of real property. The first argument failed, but the second was mostly successful.

First, the product here was data. It was not tangible personal property, which is "corporeal" in nature. According to the statute, even computer programs are not tangible personal property even when they are affixed to a tangible medium. The data being licensed lacks corporeal form. Although Taxpayer argued that the tapes should be considered tangible property based on authorities applying the ITC rules in section 38, the Tax Court distinguished these authorities on the ground that the section 38 cases involved the original copies of the tapes, not a transaction involving the data itself. Nor could this data be treated as a sound recording, as defined in section 199 and in provisions under section 168. Here, the data licensed was not a sound recording, but a visual image generated through analysis of recorded seismic energy. Rather than a "work" that could be protected by copyright, the data reflects something more akin to a "useful article" that is not eligible for copyright protection.

Second, the Tax Court agreed with Taxpayer that engineering services were ultimately connected to the construction of oil and gas wells, which are structures affixed or connected to real property. The Service argued that the data could not be connected because it could be used for other purposes, including valuing leases on the associated undersea territories. However, the Court ruled there was a sufficient connection with the ultimate construction of wells in properties that are part of the United States to permit the deduction. The Court also clarified that the engineering services did not have to be provided contemporaneously with construction. However, some restrictions on deductibility were appropriate with respect to revenues earned from data processed for its corporate parent in the Netherlands, which was deemed too attenuated from real property construction in the United States.

Comment: This is a creative position -- a long stretch on the connection to real property, but the Taxpayer apparently had those long rubbery arms this time. Others may find a basis to criticize the court's intellectual property findings, but the real property construction prong ensured a taxpayer victory in any event. Section 199 is now history – and good riddance from a tax policy perspective in my view – but controversies will continue to work their way through the courts.

11. Business deduction disallowed for fees in accounting malpractice case affecting individual taxes; recovery not excludable from gross income, McKenney v. United States, 973 F.3d 1291 (11th Cir. 2020).

Taxpayers had sued their accounting firm alleging that its negligence caused them to pay over $2 million in federal income taxes. The firm settled by paying Taxpayers $800,000. This refund litigation addressed the tax treatment of the recovery as well as the deductibility of related litigation expenses.

Between 2000 and 2005, the accounting firm had advised Taxpayers to follow a dubious tax strategy that involved using an S corporation owned by an ESOP. The Service audited their returns, and in 2007 Taxpayers conceded all claimed tax benefits from the ESOP transactions, ultimately paying over $2.2 million in taxes, interest, and penalties. In 2008, they sued their accountants in state court, alleging malpractice. In 2009, the firm settled this lawsuit with a payment of $800K.

Taxpayers filed their 2009 return claiming: (1) a deduction of $419K of legal fees to litigate the malpractice suit; (2) an unreimbursed loss of $1.4 million based on the difference between the taxes they had to pay in 2007 and the cash payment from the firm of $800K; and (3) excluding the $800K settlement payment from gross income. The combination of these deductions and the exclusion produced an NOL, which they carried forward to 2010 and 2011.

In 2013, the Service issued a notice of deficiency rejecting all deductions and exclusions. As for the legal fees, the Service treated these as miscellaneous itemized deductions subject to a 2 percent floor (applicable in those years). It rejected any loss deduction and characterized the settlement payment as taxable income.

Taxpayers paid the tax and sued for a refund. The district court issued a summary judgment order denying business expense deductions for the legal fees, which were incurred on behalf of Taxpayers personally rather than on behalf of a business. The court also upheld the loss disallowance on the ground that their settlement with the IRS precluded any further deductions related to the ESOP. However, the court ruled that the $800K settlement was excludable as a return of capital. Both parties appealed this compromise result.

The Eleventh Circuit, applying *de novo* review, upheld the disallowance of the deduction for legal fees in the malpractice case. These fees did relate to advice given to Taxpayer's business operations, but that relationship did not transform the fees into a deductible business expense. Applying the Supreme Court's guidance in *United States v. Gilmore* (372 U.S. 39 (1963)), the Eleventh Circuit focused on the origin and character of the claim. In this case, their personal tax liability was at issue – and the suit arose from advice given by the firm to them personally, not to their businesses. Efforts to address one's personal tax liability are personal, rather than business, expenses. However, the Service allowed these as a miscellaneous itemized deduction. (As discussed below, this follows from a decision to treat the $800,000 recovery as taxable income. But if it was not taxable income, then why allow a deduction at all? See IRC § 212.)

As for the $1.4 million loss, the Eleventh Circuit agreed that the settlement agreement with the IRS barred a deduction. While the settlement agreement involved a payment of tax, the lost recovery of those taxes from the accounting firm in a malpractice action could not turn that into a deductible payment.

Finally, as to the $800,000 recovery, the Eleventh Circuit first focused on the question posted by *Raytheon Products* (1st Cir. 1944), "in lieu of what were the damages awarded?" Taxpayers relied on *Clark v. Commissioner*, 40 BTA 333 (1939), which treated a payment from negligent tax counsel as a return of capital, not taxable income. Although the Tax Court and the Court of Federal Claims has followed Clark, the Eleventh Circuit pointed out that no Article I court had applied *Clark* in the 80 years since it was decided. The Eleventh Circuit refused to take up the validity of *Clark*, as it instead focused on alternative ground of the Taxpayer's failure to satisfy the burden of proof in refund litigation.

Taxpayers failed to prove that they would have been entitled to the ESOP benefits if they had not been badly advised by the firm. The Government argued that their claim of economic harm from the advice was entirely speculative, as they had failed to designate an expert witness who could testify that "they would have received tax benefits had [the firm] performed differently." Even if the ESOP strategy had been legal at the time the firm proposed it, taxpayers seeking a refund have a burden to prove that they overpaid taxes they would not have incurred if they had been correctly advised. They failed to prove this, which was fatal to their claim that the recovery was a return of their capital excludable from gross income.

Comment: This case merits careful reading by taxpayers seeking a malpractice recovery for tax advice gone awry. The failure to procure expert testimony on the tax benefits that could have been obtained seems fatal to the Taxpayer's case, as it prevented Taxpayers from establishing a necessary fact to show that their capital had been impaired in the first place. It should also be noted that assertions by attorneys for Taxpayers in a memorandum of law did not rise to the requisite level of factual evidence for purposes of evaluating whether summary judgment could be granted in the taxpayer's favor. This case thus provides additional support for the proposition that tax consequences are a proper and perhaps indispensable subject for expert testimony, despite the connection to substantive law that some courts find to be within the ken of judges. Recall that even Einstein recognized the specialized knowledge required to render tax advice was beyond his capability!

12. Theft loss disallowed due to noncompliance with Revenue Procedure safe harbor, Giambrone v. Commissioner, TC Memo 2020-145.

Taxpayers founded a bank in 1999. That bank was unprofitable, and they raised new capital by selling a controlling interest to a Florida corporation (TBW) in 2007. Farkas, TBW's majority shareholder and CEO, effectively looted the company, using trust funds belonging to others for the purpose of covering property taxes and insurance premiums on home mortgages to purchase additional mortgage loans. When the bank could not sell those loans, it was placed into receivership in 2009. On June 15, 2010, a federal grand jury indicted Farkas on federal charges, including bank, wire, and securities fraud. He was convicted in 2011 and sentenced to 30 years in prison.

Taxpayers claimed a theft loss of 95 percent of their investments in the bank on their 2012 federal income tax returns. This loss was based on a safe harbor in Rev. Proc. 2009-20, which allows taxpayer who experienced losses in certain investment arrangements discovered to be criminally fraudulent to deduct 95 percent of their investments in the year the loss was discovered. The Service disallowed the deduction, resulting in this tax court proceeding in which the Service moved for summary judgment against the taxpayer on the ground that they were not eligible for the safe harbor deduction.

The Tax Court agreed with the Service, granting summary judgment. While Revenue Procedures are not binding on the court and generally do not confer substantive rights on taxpayers, these taxpayers failed to comply with the terms of the Revenue Procedure, which required a deduction in the "discovery year". This is a defined term which includes the year an indictment, information, or criminal complaint was filed against the lead figure. Here, 2010, not 2012, would have been the discovery year.

The Tax Court also rejected Taxpayer's argument that the terms of the Revenue Procedure conflict with the statute and regulations. This was a "fundamental misconception", as the IRS may exercise administrative discretion that benefits a taxpayer that does not comply with provisions of the Code or Regulations.

Comment: Revenue Procedures have low precedential value. There may be a basis to assert an abuse of discretion if the IRS does not follow the terms of a Revenue Procedure, but even this is not a sure path to victory. If these taxpayers are allowed to claim a deduction, they are left to proving it based on the Code and Regulations rather than effectively rewriting the Revenue Procedure with which they did not otherwise comply. Let's hope that the 2010 tax year is still open, or that they can otherwise prove that a closed and completed transaction occurred in a later year when they determined no recovery would be available to them from the fraudster. On this standard, consider the Adkins case, discussed above. Also compare Littlejohn, TC Memo 2020-42, infra, which denied proof of theft under state law when only civil fraud had been proven.

13. Marijuana dispensary loses effort to enhance COGS offset, Richmond Patients Group v. Commissioner, TC Memo 2020-52.

Taxpayer was a California mutual benefit corporation that is taxed as a C corporation, which operates as a marijuana dispensary. Only members may purchase, and members must have a valid physician's recommendation. The dispensary had 22 employees and it rented space to carry on its activities. The firm bought in bulk and broke down the products into smaller packaging. Some of the products had to be dried before final packaging. An inventory tracking system was used to maintain control over the products in stock.

On its returns, Taxpayer used a FIFO method. For 2014, Taxpayer had about $4.9 million in gross receipts and COGS of $3.2 million. The COGS amounts included costs for inventory security, packaging, testing, permit fees, and certain other items. The firm also claimed business expense deductions of more than $1.6 million.

On examination for the 2014 tax year, the firm received a notice of deficiency adjusting COGS and disallowing business expense deductions under section 280E. Taxpayer petitioned the Tax Court for review.

The Tax Court upheld the 280E disallowance, relying on other marijuana dispensary cases. With regard to adjustments to COGS, in this case, the court found that the Taxpayer was a reseller, not a producer. Accordingly, it could not deduct additional indirect costs included in COGS, including damage and shrinking, depreciation, inventory security, and permit fees.

On March 15, 2016, Taxpayer filed Form 3115 with its 2015 Form 1120, which requested a change in accounting method from the FIFO method for resellers, which it had used since its inception, to that of a producer under Treas. Reg. § 1.471-3(c). However, the Service rejected the proposed change. The Tax Court upheld this as a proper exercise of discretion.

Accuracy penalties were upheld. It was noted that the supervisory approval requirements do not apply in the case of an accuracy penalty applied to a corporation and included in the notice of deficiency. A reasonable cause defense was rejected based on existing authorities limiting deductions in the context.

Comment: Dispensaries continue to face considerable federal tax burdens, albeit lesser burdens beginning in 2018 under the rate reductions enacted as part of the Tax Cuts and Jobs Act. AB 37, signed into law last year, gives a state tax deduction to sole proprietorships and partnerships operating in California. See Laura Mahoney, Pot Businesses in California Will Get Tax Deductions, Bloomberg Law: Tax (October 13, 2019). The new law becomes effective in 2020 and sunsets January 1, 2025. The bill indicates that its purpose includes aligning personal income tax law with corporate tax law regarding IRC § 280E. See also this statement by the Franchise Tax Board at https://www.ftb.ca.gov/about-ftb/newsroom/tax-news/november-2019/new-law-will-help-california-cannabis-businesses.html.

14. Computation of $100,000 phaseout threshold for $25,000 passive loss offset exemption, Sharma v. Commissioner, TC Memo 2020-147.

These pro se taxpayers challenged the disallowance of rental real estate losses on their 2014 return. Apparently retired, they reported AGI of $122,948, but this included taxable IRA distributions and pension and annuity distributions totaling over $108K, along with taxable social security benefits of about $13K. It also included a deductible loss of $26,877 from rental real estate activities. They filed Form 8582, Passive Activity Loss Limitations, and reported the full loss as deductible. The Service disallowed $20,913 of the loss and imposed an accuracy penalty, which was later conceded.

At issue here is the computation of the $25,000 offset exemption from the passive activity loss limits, as provided in section 469(i). If a Taxpayer actively participates in rental real estate but cannot otherwise satisfy the material participation requirements for a real property trade or business or other exemptions to avoid restrictions on deductibility of losses, up to $25,000 of rental real estate losses may be deductible under section 469(i). However, that deduction phases out as AGI exceeds $100,000. AGI is also modified as provided in IRC § 469(i)(3)(E) ("MAGI") to remove taxable social security benefits, as well as certain other adjustments, including removal of the real estate loss.

The Service determined MAGI to be $138K, which would have restricted the allowable deductible loss to $5,964, resulting in the disallowance on their return. This included the removal of the loss and the taxable portion of social security benefits as required in section 469(i)(E). However, Taxpayers pointed to Form 8582, which instructs them to calculate their AGI without regard to, among other things, deductible *contributions* to IRAs and pension plans. Taxpayers interpreted this to exclude taxable IRA and pension *distributions*, but this is plainly not the case.

Comment: Tax law is hard. These Taxpayers tried to figure it out, but got it wrong. That may explain the removal of an accuracy penalty. And good for the Tax Court for patiently explaining the error. Those curious about how the phaseout works will find some instruction from this case.

15. Meals and Entertainment Expenses under Section 274, T.D. 9925, 85 Fed. Reg. 64026 (Oct. 9, 2020).

The Tax Cuts and Jobs Act eliminated the deduction for entertainment expenses. Many thought business meals could be viewed as a form of entertainment, but ambiguity was presented by the fact that some Code provisions still retained references to business meals. Notice 2018-75, issued October 14, 2018, provided the transitional guidance and proposed regulations followed in February of 2020. These final regulations generally follow the proposed regulations, albeit adding some examples to illustrate the rules involving what constitutes entertainment and what constitutes a business meal.

Comment: In light of the significant hit taken by the food, beverage, and entertainment industry by Covid-19, one wonders whether a loosening of these restrictions will be part of future tax legislation. While deductibility by business taxpayers injects concerns about horizontal equity, it also certainly boosts the income of workers in this area, many of whom are not high-income earners.

C. Personal

1. Alimony denied based on payment reduction correlation to child's age, Biddle v. Commissioner, TC Memo 2020-39.

Taxpayer and his former spouse divorced in 2010 after a fourteen-year marriage that produced four children. The divorce decree contained provisions for child support and alimony, but both payments were stipulated to end based on the occurrence of several events, one of which was the youngest child's 18th birthday. The decree was modified the following year to reflect Taxpayer's custody of one of the children, which reduced child support but not alimony. The Service challenged Taxpayer's alimony deductions of $28,000 on his 2015 return because they failed the definition of alimony. Here, the Service alleged that the payments were subject to "contingencies involving a child", which include the child reaching a certain age, thereby depriving Taxpayer of alimony status under IRC § 71(c)(2).

The Tax Court agreed. Taxpayer argued unsuccessfully that their intention was to create alimony, but the Court recognized no authority that such intention (even when reflected in separate payments) sustains a deduction when the payments terminate on a date contingent on an event connected to the child. The deficiency was upheld, but the accuracy penalty was denied.

Comment: The accuracy penalty waiver was an act of mercy here, as the law is clear. But this shows how family law practitioners who fail to grasp tax law do a great disservice to their clients. Assuming similar payments continued until the current year, not only is Taxpayer paying $8,500/year for taxes (more than $40K over 5 years), but his former spouse is likely paying taxes on those amounts unnecessarily. Family law practitioners who draft agreements like this should be calling their malpractice carriers, in my view.

2. No deductible loss allowable for reduction in FERS disability annuity by amount of SSDI benefits, Staples v. Commissioner, TC Memo 2020-34.

Taxpayer was a federal employee, who was employed as a patent examiner until a disability forced him into retirement in 2012. He was covered by the Federal Employees Retirement System, and in 2013 he obtained an award for disability payments. The Federal Office of Personnel Management instructed Taxpayer to also apply for SSDI benefits, which Taxpayer did. However, the receipt of those SSDI benefits caused a reduction in the FERS benefits. This rankled Taxpayer, who apparently chose to report the benefits he received but to omit other taxable income from his 2015 return. When the omitted items were identified through third-party reporting, the IRS sent a notice proposing changes to that return. Taxpayer paid the balance requested, but the Agent treated this as a deposit and Taxpayer contested the additional liability based on a theory that he had a "deductible loss" in the amount of the reduction in his federal benefits.

Taxpayer filed an amended return to advance his loss theory, but the Service did not process that return. (It was, after all, filed during the pending review of his original return.) Taxpayer continued to protest the additional tax claimed by the Service, arguing that he earned the SSDI benefit through employment in the private sector and yet receiving it cut his federal pension that was earned while working in the public sector. He also indicated that the loss he received was akin to gambling, casualties, disasters, thefts, and business losses, which otherwise were allowed.

A notice of deficiency and petition to the Tax Court followed. After a lengthy rehearsal of the background on disputes over this reduction in federal disability pension, including references to the legislative history reflecting the intentional nature of this reduction, the Tax Court declined Taxpayer's invitation to decide the employee benefit entitlement issues he had raised. However, on the matter of the claimed deduction, it ruled that no deduction is allowed for a loss of unrealized income by a cash method taxpayer.

Comment: This is a straightforward matter in terms of tax law – no deduction without prior realization. For anyone with a client receiving a FERS annuity, the other legal history may prove useful. This is also another example of the Tax Court performing civic instruction functions for pro se taxpayers.

3. No theft loss proven based on concealed defects in property, Littlejohn v. Commissioner, TC Memo 2020-42.

Taxpayers are a married couple filing a joint return. In 2008, Wife acquired a home in California, which she intended to use as a rental property. After closing on the home, they discovered defects that had not been disclosed by sellers. Wife sued both the sellers, the home inspector, and the real estate agent, claiming that they conspired to defraud them by intentionally deceiving them about defects in the property in order to induce them to purchase it for an inflated value.

Wife exacted settlements and payments from two of the three defendants, but a default judgment for $150,000 against a third defendant remained uncollected. Taxpayers claimed a $150,000 theft loss deduction occurred in 2010, when they received the default judgment but determined it would be uncollectible. At trial, they upped the claim for this deduction to $266,000, the amount which the trial court determined to be the amount of damages caused by the defendant, although Wife had limited her claim to $150,000.

The Tax Court rejected this deduction on the basis that Taxpayers had not established that a theft occurred. The default judgment did indicate that the defendant was part of a conspiracy to defraud. However, a civil judgment of fraud is not admissible to prove the crime of theft under California law. The failure to pay a civil judgment is not theft. Moreover, the amount of the loss was also in doubt, as the civil finding did not have any preclusive effect on the Service, which was not a party to that litigation. Finally, to the extent that any such theft involved the actions of others, there was no showing that the loss was not recoverable at that point in time.

On their 2013 return, Taxpayers also claimed at $1.196 million deduction as a theft loss, which they upped in the litigation to claim $1.775 million based on the total amount Wife overpaid for the property. Here, too, Taxpayers failed to prove theft under California law. The court found no case holding a crime of theft based on a failure to disclose defects in commercial real estate. Under California law, theft requires proof of something more than nonperformance or actual falsity – it also requires fraudulent intent. The record here showed that some of the defects were disclosed, and others failed to provide concrete evidence of defects known to the defendants. Nothing in the $200,000 settlement from these defendants supported the theft claim. The property had been appraised for $3.6 million prior to the sale, and the seller's accepted an offer of only $2.5 million – which the court suggested meant that any defects were reflected in the purchase price, rather than concealed for the purpose of obtaining more than the property was worth. Finally, the court also found proof of loss from a valuation expert to be an insufficient foundation for proving any such loss. Accuracy penalties followed.

Comment: Theft loss is easier to prove with the benefit of a criminal prosecution. This case shows the importance of attention to state law on such matters. These taxpayers failed to do their homework on the elements of theft as well as the substantiation of the losses they claimed.

4. Failure to attach Form 8332 to return fatal to dependency exemption and child credit claims by noncustodial parent, Bethune v. Commissioner, TC Memo 2020-96.

Taxpayer was the noncustodial parent of two minor children. Her former husband had custody. In her 2014 tax return, Taxpayer claimed head of household filing status and claimed dependent exemptions and child credits for the children. She did not attach Form 8332 to her return, or any other facsimile declaration that her former husband would not claim them as dependents. Unbeknownst to Taxpayer, her former husband had also claimed the children on his return.

In 2015, after the 2014 return was filed, state court in Maine issued an order modifying parental rights regarding the children. That order did not specifically address the 2014 tax year, but it stated that the parties agreed the minor children would continue to be claimed by their mother "as prior to the 2014 tax year".

In 2016, the 2014 return was under examination. Taxpayer provided the state court order from 2015 to the examination team. However, an IRS employee told Taxpayer that she needed a Form 8332, which she had not heard of. Taxpayer got her former husband to sign one for the 2014 tax year, dated April 12, 2017, and provided it to the Service. The former husband did not file an amended return.

Prior to receiving the signed Form 8332, the Service issued a statutory notice of deficiency to Taxpayer. She later mailed the Form 8332 to the IRS on the same date she filed her Tax Court petition.

The Tax Court ruled against Taxpayer. The applicable regulations require that Taxpayer file either Form 8332 or an alternative statement that conforms to its substance when the return is filed. Taxpayer could not show that the 2015 district court order conformed to the substance of a Form 8332, as it did not specifically address the 2014 tax year. Moreover, that court order presumably suffered from the same defect as the Form 8332 she provided – it was not filed with the return. Although in 2017, the Government proposed regulations to allow submission during an examination, instead of attaching it with a return, the regulations only allow this to be effective if the custodial parent had not already claimed the children on his/her return and had not also filed an amended return removing that claim.

Accordingly, Taxpayer loses both child credits and dependency deductions for each of the children, and she is also ineligible for head of household status.

Comment: These rules have been extant for years, but case law continues to reflect noncompliance by taxpayers. For a similar outcome, see also Bidzimou v. Commissioner, TC Memo 2020-85. Family law practitioners also need to pay attention in this area.

5. Mortgage interest deductions disallowed on multiple grounds, McCarthy v. Commissioner, TC Memo 2020-74.

From 1999-2003, Taxpayer lived in a beach house in Hermosa Beach, California, which was owned by his friend Mr. Rogers, a fellow CPA and tax return preparer. In 2005, Taxpayer moved to New York. He eventually bought a co-op apartment unit there, and lived in that unit until 2014, when his job ended and he moved to Minnesota. He chose to rent out the New York property while he lived and worked in Minnesota. He spent no timing living in New York in 2015. Mr. Rogers prepared Taxpayer's 2015 return, which listed his home address in Minnesota and claimed as itemized deductions a total of $48,514, which consisted of $18,712 paid on his New York apartment and $29,802 which was paid to Mr. Rogers in connection with the Hermosa Beach Property. He also included a schedule E for the rental property, on which he claimed rent less depreciation and related expenses, but no interest. Taxpayer was married, but he filed separately from his wife.

The Service audited the 2015 return and disallowed the itemized deductions, while causing the $18,712 interest on the New York apartment to be transferred to schedule E. A tax court petition followed.

Before the Tax Court, Taxpayer claimed his principal residence was in New York and that the Hermosa Beach property was his second home. First, the Tax Court identified a threshold problem with this approach: as a married taxpayer filing separately, a taxpayer may only choose one home. See IRC § 163(h)(4)(A)(iii). He did not choose which one should be reported on his return. However, since the Tax Court concluded neither property was eligible for a mortgage interest deduction, this point was moot.

First, regarding the New York property claimed as a principal residence, it is possible to have a property serve as one's principal residence even though one no longer resides there and the property is rented to another. For example, market conditions may not permit an immediate sale. However, Taxpayer must show, based on all facts and circumstances, that this was his principal residence. He could not do so. Although he tried to assert that market conditions delayed the sale – and he did indeed sell in 2016 – Taxpayer failed to offer any evidence to substantiate this claim. Moreover, Taxpayer spent no time in New York, but instead lived and worked in Minnesota and reported that address on his tax returns. Taxpayer offered no other evidence to show that familial or other ties remained in New York. Nor could the New York property serve as a "second residence" because he rented it out for the entire year.

As for the Hermosa beach property, Taxpayer alleged that he bought a 32.5 percent interest in the property from Mr. Rogers in 2010, modifying it to include his own separate entrance and his own bedroom, but sharing common areas. The purchase was acquired with a "seller-financed note" from Mr. Rogers, and that the principal and interest payments were not actually made in cash but were handled as notional adjustments against a $150,000 debt that Rogers had to Taxpayer. Documentary evidence introduced to show the transaction included a deed of trust signed by Rogers and Taxpayer in 2010, but it was notarized in 2004 by a notary whose stamp indicated that the notary commission expired in 2007. Curious indeed!

The Court excluded these documents, but noted that even if they had been included, a mortgage interest deduction would not be allowed because the debt was not secured by the property. Moreover, in order to be a second residence, it has to be used as such by Taxpayer for more than 14 days during 2015. See IRC § 280A(d)(1)(A). Taxpayer did not show any such use. In fact, Mr. Rogers reported $96,000 in annual rental receipts from renting out a portion of the property to his niece. The court presumed that, based on the size of the house, she must have been renting more than one room – presumably the space allegedly owned by Taxpayer.

Even if all these issues had been conceded, Taxpayer failed to prove that interest payments were made in cash or cash equivalents. Regarding a debt between Mr. Rogers and Taxpayer, Taxpayer could not produce evidence of the obligation. A paper copy he introduced was not recognized by Mr. Rogers at trial. Rogers and Taxpayer were friends, traveling together and sometimes sharing expenses. But their relationship did not reflect any formal schedule or practice that reflected the reality of repaying debt.

Comment: Taxpayer loses the mortgage interest deduction on multiple grounds, but he was successful in resisting the accuracy penalty based on failure to provide supervisory approval. The positions taken here, including documents the court treated as specious, cast doubt on professionalism of these actors.

6. Owner occupation of rental property to conduct repair and maintenance did not count toward personal use days under § 280A, Lucero v. Commissioner, TC Memo 2020-136.

Taxpayers claimed real estate losses on Schedule E relating to a rental property they maintained in Sea Ranch, California, which was several hours from their home in Sacramento. Using a property management company to handle day-to-day rental operations, they rented the property on 146 days in 2014 and 152 days in 2015. This included daily cleaning, routine maintenance, and finding subcontractors for more substantial repairs. However, to save money Taxpayers drove to the property approximately six to nine times a year to do landscaping, clean and inventory, make or oversee repairs, and to decorate it for tenants. During those trips, Taxpayers stayed in the property.

The Service disallowed the losses as related to passive activities, and the court eventually ruled in favor of the Service on this basis. However, this property involved short-term rentals, which potentially allowed proof of material participation apart from qualification as a real estate professional. Taxpayers failed to maintain contemporaneous logs of their activities and the proof they offered based on later reconstructions did not show they were active on a regular, continuous, and substantial basis.

At trial, the Service also raised another basis for disallowance: Section 280A precludes deductions for a personal residence used as a vacation rental when the taxpayer's use for personal purposes exceeds the greater of 14 days or ten percent of the days the unit is rented at a fair rental value in a taxable year. "Days spent primarily repairing and maintaining the unit will not count toward personal use merely because other individuals on the premises are engaged in some other activity." While the court did not accept the testimony about the number of days spent on repairs, it did agree that the trips were primarily for maintenance, thereby avoiding the 280A restriction.

Comment: Those trying to count activities for material participation may find some helpful guidance in this case. Travel time to the rental, time spent on investor activities, and time shopping for personal items along with business items for the rental, cannot be counted.

7. Gambling losses established in part through expert testimony, Coleman v. Commissioner, TC Memo 2020-146.

Taxpayer, admittedly a compulsive gambler, failed to file a return for 2014. Based on Forms 1099-R and W-2G, the Service reconstructed income and assessed a deficiency based on unreported income of more than $350,000. Taxpayer obtained pro bono counsel and filed an actual return for the year, but this was not accepted by the Service. A tax court proceeding ensued, which centered primarily on the deductibility of gambling losses to offset his unreported gambling winnings.

Taxpayer gambled 8-10 hours per day playing slot machines. Casinos tracked his wagering habits. In one casino, he averaged $10/spin but occasionally reached $100/spin. Often, he would play ten spins per minute. Sometimes he used a player card to track his play, but sometimes he did not because he believed it might change his luck. His bank accounts did not show any significant increases over the taxable year, and he had no other assets where gambling winnings could have been deposited. On the contrary, he had significant bank records showing withdrawals that he alleged were wagered in casinos. His property taxes have gone unpaid, his cell phone has been cut off, and he has received notices for utility cutoff. He is now getting treatment for his gambling compulsion.

At trial, the Service challenged his claimed deductions that would match or exceed the roughly $350,000 in winnings reported on Form W-2G. Expert testimony from an expert who had been qualified in other gambling cases showed that, "if a player gambles long enough and does not win any prizes that are exceptionally large relative to the size of the wager, it would be virtually impossible for that player to have annual net gambling winnings." The expert opined that the odds against even $1 of net gambling profit during 2014 were "140 million to 1."

When combined with other evidence, including bank records, other assets, lifestyle choices, and other concerns, the Tax Court upheld the loss deduction.

Comment: One wonders why the Service chose to litigate this in light of the substantial weight of evidence showing that this taxpayer had no accession to wealth at day's end. Taxpayers do indeed bear the burden of proof to establish deductions, but this situation required indirect methods of proof given the lack of a consistent diary or log of the transactions. Presumably the expert testimony helped seal the deal. The laws of nature are hard – particularly when you are on the wrong side of mathematical probabilities. Time always favors the casino over the player. But you might win – as it turns out, 1 time in 140 million. I'm no gambler, but that does not seem like a good bet to me.

8. SALT relief for business interests may be on its way, Notice 2020-75.

The Treasury recently announced its intention to issue proposed regulations that will clarify that state and local income taxes imposed at the entity level on passthrough entities, including S corporations and partnerships, will be allowed as a deduction and not restricted by the SALT cap in IRC § 164(b)(6).

Comment: State attempts to convert taxes into charitable contributions were thwarted last year, but this Notice sends a friendly signal to states that are contemplating entity-level taxes as a means of providing relief to investors in pass-through entities. Query whether these efforts will become moot if, instead, a newly constituted Congress embraces SALT relief in its legislative agenda.

9. Theft loss disallowed in post-marital property distribution controversy, Bruno v. Commissioner, TC Memo 2020-156.

Taxpayer was divorced from Husband in 2008. The divorce decree awarded her substantial assets, most of which Husband failed to transfer to her despite repeated contempt citations from state courts. A 2011 appellate decision confirmed that she was entitled to assets totaling nearly $2.5 million, which were held by Husband. Taxpayer apparently engaged in some self-help in 2010 by retaining proceeds from a residential property sold for $1.9 million in defiance of a court order. She was held in contempt in 2015 by the divorce court for this action. Moreover, Husband filed a Chapter 7 bankruptcy petition in 2015, seeking discharge of her claims against his estate and also seeking recovery of half the proceeds from the residential property.

Taxpayer then began other recovery efforts against Husband and his then-wife, Christina. She sued Christina alleging that she conspired with Husband and several LLCs to conceal and convert Husband's property in order to defeat her claims to marital property awarded in their divorce. She obtained a lien against one of the properties owned by an LLC controlled by Christina. She also filed a proof of claim with the bankruptcy court totaling more than $3.5 million, including alimony in arrears. Further, the bankruptcy trustee commenced adversary proceedings in 2017 against Husband, Christina, Husband's mother, and various LLCs alleging fraudulent transfers. The claim was eventually settled. In 2020, the bankruptcy trustee sent her a check for $450,000, representing her share of property. But the settlement did not resolve past claims against Husband for the marital property.

Taxpayer sought theft loss deductions over multiple tax years beginning in 2008 stemming from the activities of Husband and others. The Service disallowed these deductions and related NOL carryforwards. At issue here was whether a theft loss could be claimed in 2015.

The Tax Court ruled that no theft loss had been proven in this context, and therefore no NOL deductions could be applied in subsequent tax years. Theft requires proof by a preponderance of evidence, which Taxpayer could not meet. Although Taxpayer claimed that felony embezzlement occurred under Connecticut law, the Tax Court rejected her theory based on the elements of the crime in this context. First, a marital property award creates a debt of the party required to pay the judgment. Failing to transfer marital property is a common occurrence and does not necessarily create a crime; if it did, her failure to transfer proceeds of the residential share pursuant to a court order might likewise constitute embezzlement.

But even if Connecticut law would have allowed embezzlement to be proven, Taxpayer has not established that this occurred in 2015 or any other year at issue. Taxpayer had claims against Husband and others in his family that were pending at this time. Although she relied on his bankruptcy petition, which asserted he had only $2500, the Tax Court stated that "We do not think a reasonable person in petitioner's position would have believed that assertion." It found that Husband had earnings of over $2 million per year and likely had other assets. Accordingly, while these claims were pending, they represented bona fide claims for recoupment that prevented a deduction in the years at issue.

Comment: This is a sad tale in which legal fees likely substantially eroded the value of any claims recovered. The concept of "theft" depends on state law, and this case shows how hard that can be to prove in the marital context. You may have a cheatin' spouse (in many respects), but that does not translate into a crime for state law – or federal income tax -- purposes.

III. Tax Administration.

A. Penalties.

In the past year, the matter of supervisory approval prior to penalty assessment was a common issue. Several important cases are discussed below, including regular opinions of the Tax Court. Several other memorandum decisions are noted in my italicized comments. As penalties are a regular feature of tax litigation, you will also find other cases with penalty issues also interspersed within other substantive issue classifications elsewhere in the outline.

1. Supervisory approval requirements of section 6751(b)(1) satisfied in partnership case, Belair Woods, LLC v. Commissioner, 154 T.C. No. 1 (2020).

Belair Woods was a partnership formed in 2008. During the 2009 tax year, it claimed a charitable contribution of $4.7 million for a conservation easement donated to the Georgia Land Trust. In October 2012, the Service mailed a notice informing the partnership that an audit was beginning. The revenue agent, with the help of an IRS engineer, determined that the conservation easement deduction was significantly overstated. The revenue agent prepared a summary report which was transmitted to the taxpayer with an invitation to attend a closing conference to discuss proposed adjustments and various related penalties.

The closing conference was held in February 2013. Taxpayer agreed to extend the limitations period and the IRS engineer agreed to revise his report. A second conference occurred in May 2014, but no agreement was reached.

At some unstated time during the audit of the partnership, the Revenue Agent prepared a civil penalty approval form and submitted it to supervisory personnel. That form stated that penalties were justified because of the overstated value claimed for the conservation easement and the lack of justification for that value. However, the penalties discussed did not include the section 6662(e) substantial valuation misstatement penalty. On September 2, 2014, the Revenue

Agent's new supervisor signed the penalty approval form. There was no proof that her supervisor at the time of the audit had ever signed the form.

On March 9, 2015, the IRS issued a 60-day letter formally communicating its decision to assert tax adjustments and penalties. Taxpayers sought review by Appeals, but that effort was unsuccessful. A final partnership administrative adjustment was issued on June 19, 2017, including the penalties approved in 2014 plus a new attempt to assert the substantial valuation misstatement penalty.

Before the Tax Court, the Service conceded that the substantial valuation misstatement penalty that was mentioned for the first time in the 60-day letter did not satisfy the supervisory approval requirement of section 6751(b). However, taxpayers asserted that the other penalties also failed the supervisory approval requirement because there was no evidence of approval prior to submission of the initial memorandum with the proposed adjustments and related penalties.

The Tax Court pointed out that the penalty approval requirement attaches at the "initial determination of … [an] assessment", terminology which appears nowhere else in the tax code. Looking to legislative history, courts have determined that this time coincides to the point when a supervisor no longer has discretion to give or withhold permission. In most cases, that means the time a notice of deficiency is sent. In a partnership case, it means the time when a FPAA is sent to the partnership. However, in Clay v. Commissioner, 152 T.C. 223 (2019), the Tax Court determined that supervisory approval could occur at an earlier date if the IRS formally communicates a determination to assert a penalty and notifies the taxpayer of his right to appeal that determination.

Here, the Tax Court concluded that there was no formal determination prior to the 60-day letter. By that time, supervisory approval had been obtained for all penalties except the conceded substantial valuation misstatement penalty. The summary report issued in 2012 did not notify taxpayers of a definite decision to assert penalties, but only invited taxpayers to a conference to discuss them. According to the court, the term "determination" entails a sense of "definiteness and formality". This taxpayer had not been informed that the examination division had completed its work and that a penalty had been definitively proposed. Instead, the Revenue Agent sought additional input from taxpayers on the penalty issue. That initial conference occurred only two months into the audit. A determination is not the subjective decision of the Revenue Agent, but instead entails additional formal communication that did not happen here.

Comment: This result is taxpayer-friendly in the sense that it allows the IRS some latitude in working through a case during the examination phase before coming to a final conclusion about penalty assertion. Rather than locking in the service to a penalty position, this will permit revenue agents to gather information before proposing penalties. This outcome also provides some evidentiary clarity about timing that will help both taxpayers and the government in assessing compliance with the supervisory approval requirement. Compare Tribune Media Co. v. Commissioner, TC Memo 2020-2 (applying <u>Belaire Woods</u> in related partnership penalty matter); Carter v. Commissioner, TC Memo 2020-21 (disallowing gross valuation penalty in conservation easement case where Service communicated penalties via RAR issued to Taxpayer in advance of supervisory approval; the fact that the RAR did not include a right to Appeal due *to the imminent statute of limitations deadline did not change its character as a form of communication under* <u>*Belaire Woods*</u>*); Patel v. Commissioner, TC Memo 2020-133 (viewing letter 5153 as determination despite no 30-day letter).*

2. Burdens of production and proof in penalty matters, Frost v. Commissioner, 154 T.C. No. 2 (2020).

Taxpayer was a self-employed insurance salesman and consultant with extensive travel between Oregon and Texas to serve his clients. He claimed extensive deductions for business and travel expenses, which he was unable to substantiate. He also owned an 80% membership interest in an LLC for which she reported pass-through losses. However, he was unable to prove that he had sufficient basis in his partnership interest to support the deduction. Taxpayer also had prior experience as an enrolled agent preparing returns for others.

The IRS audited taxpayers' 2010 through 2012 tax years, challenging deductions and partnership losses. Taxpayer took his case to Appeals, which issued notices of deficiency for these years, including accuracy penalties. However, the IRS was only able to show a civil penalty approval form for the 2012 tax year, not for prior tax years.

Taxpayer sought review in the Tax Court challenging both the substance of the IRS adjustments as well as the validity of the notices of deficiency and IRS compliance with the supervisory approval requirements associated with assessing penalties. The Tax Court made short work of his substantive challenges, as he failed to substantiate deductions and the basis in his partnership interest that was required to allow pass-through losses. It also rejected challenges to the validity of the notices, which centered on procedures by which the IRS selected his returns for examination. Long-standing precedents do not allow challenges based on the procedures for selection as a defense to underlying tax liability.

However, Taxpayer successfully challenged penalties. The IRS has the burden of proof to show compliance with the supervisory approval requirements of section 6751(b). Following its decision in *Bel Air Woods*, the Tax Court required supervisory approval to be obtained before the time when the examination division formally notifies the taxpayer that it has completed its work and made an unequivocal decision to assert penalties. The IRS is required to satisfy the initial burden of production showing the application of penalties. Moreover, if the taxpayer challenges penalty determinations, the Commissioner must also come forward with evidence of penalty approval as part of the initial burden of production. One the IRS satisfies this requirement, the taxpayer is required to produce contrary evidence.

Here, the IRS failed to produce evidence of written supervisory approval for the 2010 and 2011 tax years, but it had evidence of approval for the 2012 tax year. The examining agent's manager signed a penalty approval form over a year before the notice of deficiency was issued. According to the court, the IRS was not required to show that it had approved the penalty before any formal communication with the taxpayer. Instead, the taxpayer had the burden to rebut its evidence of timely approval. This approach avoids the burden of proving a negative. It also relies upon the Taxpayer to produce evidence of prior communications, which he or she would be expected to have in his possession.

Comment: This is an efficient allocation of burdens. Rather than forcing the IRS to prove a negative, it appropriately puts the burden on the Taxpayer to show that the IRS made a determination – as defined in Belaire Woods – at an earlier time. Note that this ruling continues to require taxpayers to challenge a penalty before the IRS is required to produce evidence of supervisory approval as a part of its prima facie case. Nevertheless, it would seem appropriate for IRS attorneys to make that record in each case, rather than waiting for a Taxpayer challenge.

3. Supervisory approval required for Trust Fund Recovery Penalty, Chadwick v. Commissioner, 154 T.C. No. 5 (2020).

Petitioner in this case was a sole member of limited liability companies that failed to pay employment taxes. After investigation, Revenue Officers determined that petitioner was a responsible party who failed to pay over these taxes. The Revenue Officers completed form 4183 and submitted it to their supervisors, who electronically signed the form approving trust fund recovery penalties. The same day, the Revenue Officers sent petitioners Letter 1153, Trust Fund Recovery Penalty Letter, asserting penalties. Petitioner failed to appeal the penalty determination and these amounts were put into collections.

The IRS sent a notice of intent to levy to petitioner, who responded that he was unable to pay these amounts. A collection due process hearing was scheduled, but petitioner did not submit any information by the applicable deadline. The levy was sustained, and petitioner sought review by the Tax Court. The IRS moved for summary judgment, and petitioner failed to respond.

Here, summary judgment could have been granted solely based on the petitioner's failure to respond to the IRS motion. See Tax Court Rule 121(d). However, the Tax Court raised the penalty approval issue *sua sponte*, noting that its prior rulings had not yet determined whether section 6751(b) applied to the trust fund recovery penalty under section 6672. Based on a review of the plain text of section 6672 and its location in the Code among other provisions that are captioned "Assessable Penalties", the Tax Court concluded that the trust fund penalties were subject to supervisory approval. In reaching this conclusion, it rejected district court authorities offered by the Service which treated the trust fund penalties outside the scope of supervisory approval. In this case, that approval was obtained in advance of mailing the letters.

Comment: It is odd to have a court raise a significant issue sua sponte when a simple summary judgment order would have been sufficient. But this situation did include arguments by the Service that trust fund penalties were outside the scope of the approval requirement. Although an electronic signature is sufficient, one might wonder: did that signature precede the actual mailing of the letter? No one raised a specific challenge here, although the Court cited the Internal Revenue Manual for the proposition that determination should occur before mailing.

See also Lambert v. Commissioner, TC Memo 2020-53, for another trust fund penalty case in which the court invoked the penalty approval process sua sponte in a case involving a taxpayer's failure to respond to the IRS motion for summary judgment. The court also followed Chadwick, finding that approval had been granted.

4. Reportable transaction penalty under section 6707A subject to supervisory approval requirement, nixing assessment, Laidlaw's Harley Davidson Sales, Inc. v. Commissioner, 154 T.C. No. 4 (2020).

On audit, the IRS determined that Taxpayer, a C Corporation, failed to timely disclose its participation in a listed transaction when it filed Form 1120 for its tax year ending May 31, 2008. The Revenue Agent issued a 30-day letter proposing a penalty under IRC § 6707A for failure to disclose the reportable transaction. However, at the time the letter was issued, no supervisory approval had been obtained. Taxpayer requested an Appeals conference but Appeals sustained the penalty and the IRS assessed the penalty. After a notice of levy, Taxpayer sought a collection due process hearing, after which Appeals sustained the levy.

Further litigation ensued, along with another supplemental CDP hearing, in which Appeals refused relief. Taxpayer then filed a petition in the Tax Court seeking summary judgment based on failure to comply with the supervisory approval requirements of section 6751(b).

The Tax Court ruled in Taxpayer's favor, finding that the supervisory approval requirement applied to the section 6707A penalty for failure to disclose reportable transaction information. Further, it determined that the 30-day letter constituted the initial determination of the penalty, which required supervisory approval. Such approval was not obtained until months after the 30-day letter was sent. Here, the court rejected the IRS position that it was free to seek supervisory approval at any time before a deficiency is formally assessed. According to the court, such a position would contradict the statutory purpose for approval, which was to prevent agents from aggressively using penalties to extract taxpayer settlements.

5. Section 72(t) penalties for premature distributions pass muster under Due Process and Equal Protection claims, Conard v. Commissioner, 154 T.C. No. 6 (2020).

In 2008, taxpayer received nine distributions totaling over $61,000 from a qualified retirement plan. She reported the distributions on her return, but neither reported nor pay the 10% tax imposed by section 72(t). At the time the distributions were received, taxpayer was not yet 59 ½ years old, neither was she disabled or eligible for any exceptions to the penalty. On her return, she included a statement that the additional tax was "arbitrary and capricious" and she also sought refunds for section 72(t) amounts paid on distributions in prior years.

A notice of deficiency followed, and Taxpayer sought review in the Tax Court alleging that the exceptions to the tax violates constitutional right to equal treatment under the law. The Tax Court construed this claim as invoking both the Due Process clause of the Fifth Amendment and the Equal Protection clause of the Fourteenth Amendment. Applying a rational basis framework, the court concluded that there was a foundation for the exemptions for age and disability reflected in the statute. Since this taxpayer was unable to carry her heavy burden of negating every conceivable basis which might support the legislative arrangement under section 72(t), the tax was upheld.

Comment: Mere belief that legislation is "inequitable or unwise" is not sufficient for finding it unconstitutional. Elections do matter, apparently; if a majority chooses unwise representatives, *we live with their unwise enactments. But of course, the rest of us must suffer along, even if we chose someone else.*

6. Tax protestor gets frivolous return penalty, but not frivolous litigation penalty, Jaxtheimer v. Commissioner, TC Memo 2019-164 (2019).

Taxpayer failed to file returns for 2006-08, and he received statutory notices of deficiency for each of these years based on returns reconstructed by the IRS. In 2013, he filed a "zero" return, which reported zero wages and zero tax, along with documents that purported to "correct" third-party information. He also filed two other zero returns later in 2013, although it remains unclear whether these were duplicates of the original.

The Revenue Agent in charge of these returns completed three Forms 8278 to assess frivolous return penalties of $5000 for each of the returns. Her supervisor approved the penalties on October 1, 2014, and on October 27, 2014, the Service assessed $15,000 in aggregate penalties for 2013. On June 14, 2016, the Service filed a notice of federal tax lien for the 2006-2008 tax years (no returns) and for the 2013 penalties. Taxpayer sought a hearing, and after exchanging letters during the rest of the year, Taxpayer agreed to a face-to-face hearing on March 22, 2017. He did not show up for that hearing, but they had a telephonic one.

The Service provided copies of the substitute returns for 2006-08 and advised Taxpayer to file his own returns if he disagreed. Taxpayer did not provide any information. He objected to the notice of deficiency sent to him, which were sent to an old address, but such mailings satisfied the requirement for mailing to the "last known address" of the taxpayer. On April 13, 2017, the Service issued a notice of determination sustaining the tax lien. Taxpayer filed a petition for review in the Tax Court.

Taxpayer filed a motion to dismiss for lack of jurisdiction, but the Tax Court upheld its jurisdiction, rejecting frivolous legal arguments and proceeding to review the determination for an abuse of discretion. As for the 2006-08 tax years, the Tax Court concluded that there was no basis to challenge the deficiencies determined for those years, as Taxpayer failed to contest them at the administrative hearing. As for the frivolous return penalty under section 6702(a), the Taxpayer had challenged this at the administrative hearing, which was appropriate as there was no opportunity to challenge them prior to assessment. However, the Tax Court upheld only one penalty, as it was unclear from the record whether there were three returns or only one return with two copies. The actual returns were not admitted into the record, but the court agreed that at least one return was filed based on the Form 8278 and Taxpayer's own admissions in his motion to dismiss.

The Tax Court declined to impose a section 6673 penalty for frivolous litigation, which the Service had requested. This was Taxpayer's first case; he got off with a warning.

Comment: This litigation did prevent the assessment of $10,000 in 6702(a) penalties. In Kersten (2019), the Tax Court had previously ruled that each time a copy was filed did not justify an additional penalty. A $5000 penalty should suffice to deter this behavior, and the Service likely bears minimal costs to evaluate an additional return that is essentially a duplicate of others. When additional returns are substantially different, separate penalties may be *appropriate on account of the costs of reviewing them. However, it is surprising that the Service did not introduce the actual returns into evidence as a matter of course.*

One also wonders whether the Tax Court's policy of leniency on a taxpayer's first trip to the court is appropriate. Frivolous arguments still require judicial resources. But many tax protestors proceed pro se – as this one did – and thus may not have the benefit of legal advice. On the other hand, if they are clever enough to find the protestor arguments in the first place, shouldn't that mean they should be able to determine whether "that dog will hunt" and, if not, what consequences attend their hunting efforts?

Sometimes the Tax Court will not impose frivolous litigation penalties even after a previous warning. See Schwager v. Commissioner, TC Memo 2020-83 (pro se Taxpayer raising frivolous arguments in collection action, including denial of federal tax jurisdiction over him as a citizen of Michigan). Likewise, the Federal Circuit refused to impose frivolous litigation penalties where a pro se taxpayer was involved. See Walby v. United States, 957 F.3d 1295, 1303 (Fed. Cir. 2020) (despite agreement that claims of non-citizen status are "patently frivolous", Circuit Court "decline[s] to impose sanctions… because her filing of this frivolous appeal may be attributable to her ignorance of the law." Mercy is nice, when you can afford it. But uncertain enforcement is not conducive to deterrence. A "free pass" approach for pro se litigants allows them to continue to burden the courts (and the government attorneys who must respond) through the pursuit of appeals on frivolous issues.

7. Frivolous return penalties upheld, but not frivolous litigation penalties, Sun River Financial Trust v. Commissioner, TC Memo 2020-30.

Taxpayer filed returns for trusts in which he was the trustee. He reported taxable income, but zero taxes. He also filed documentation (various Form1099s) with his returns that the Service determined to be false. The Service determined that these returns were frivolous and warned him that, unless he withdrew these returns and filed nonfrivolous ones within 30 days, he could face penalties. Taxpayer responded with still more frivolous arguments (including an assertion that IRS agents lack capacity to determine if a return is frivolous because they are not lawyers) and no amended returns. The Service imposed $5000 penalties under section 6702 for each of the frivolous returns and provided notice in writing of assessment.

No payment was forthcoming, so the Service filed a Notice of Intent to Levy and a Notice of Federal Tax Lien. A CDP hearing request followed, in which Taxpayer challenged the penalties on the ground that GAO reports had found that IRS computers are "unreliable, inaccurate, untrustworthy and lack property security." He also stated he was reluctant to pay penalties without "proof that mathematical calculations … [were] correct." The Settlement Officer rejected these arguments and, using IRS computers (the TSMODA transcript), confirmed that the penalties were properly assessed. Appeal to the Tax Court followed.

The Tax Court noted that the section 6702 frivolous return penalty is not subject to deficiency procedures, which might otherwise trigger Tax Court jurisdiction. However, liability for such penalties can be reviewed in CDP determinations if the Taxpayer exercised his opportunity to contest the underlying liability at a prior hearing. A "meaningful challenge to the penalty itself" is required. Here, Taxpayer did not present evidence or arguments affecting the merits of liability. A demand for proof of mathematical correctness does not equate to a meaningful challenge. General allegations about unreliability of computer systems likewise fail to meet the standard.

Accordingly, only an abuse of discretion standard applies to the penalty assessment; no such abuse was found here. It was not an abuse of discretion to rely on TSMODA computer transcripts, despite the GAO problems, as there was no showing of any irregularities applicable in this case.

Comment: One might sympathize with the epistemological position of this Taxpayer – you are relying on unreliable computers to penalize me – if only it was only a matter of computing. This Taxpayer got an offer of mercy on his first returns, and yet he chose to persist. He paid the price. (Be thankful you are not the beneficiary of this trust.) However, the Tax Court refused to impose a $25K penalty under IRC § 6672(a)(1), instead warning Taxpayer against future frivolous arguments. Was this another case of a first-time offender getting a free pass? Or was there just enough truth in the computer allegations to make judicial review appropriate?

8. Frivolous litigation penalty of $25,000 upheld, Calpino v. Commissioner, 819 Fed. Appx 860 (11th Cir. 2020).

In response to an IRS notice of levy, Taxpayers requested a collection due process (CDP) hearing. They argued, among other things, that the IRS could not levy against their property for unpaid taxes because Taxpayers were immune from the tax laws and the IRS levy powers. Taxpayers based their immunity on a sentence in IRC § 6331(a) that authorizes levies against "the accrued salary or wages of any officer, employee, or elected official, of the United States, the District of Columbia, or any agency or instrumentality". They argued that since they were not officials of the United States or the District of Columbia, they could not be levied against. But this argument ignores preceding language that casts a much broader levy net. The first sentence of section 6331(a) states: "If any person liable to pay any tax neglects or refuses to pay the same within 10 days after notice and demand, it shall be lawful for the Secretary to collect such tax ... by levy[.]"

They lost on this argument at the hearing, but they chose to renew it in the Tax Court. The Tax Court rejected their argument, and it also would have otherwise lacked jurisdiction to consider it as it involves the matter of challenging the underlying tax liability. That was not permitted here, as its review of CDP determinations do not extend to the underlying liability when, as here, Taxpayers had received a notice of deficiency. See IRC § 6330(c)(2)(B). The Tax Court also imposed a $25K penalty under section 6673(a)(1). Taxpayers appealed.

The Eleventh Circuit affirmed, providing additional legislative history to address the sentence in section 6331(a) on which Taxpayers relied. According to the court, this sentence was added after a 1918 Supreme Court decision to clarify that federal government officials were subject to the same levy rules as other taxpayers. The Eleventh Circuit found no abuse of discretion in imposing a penalty here, as these Taxpayers raised frivolous arguments rejected by multiple courts and they were repeatedly warned.

Comment: While perseverance may be considered a virtue in some contexts (perhaps as a subcategory of "fortitude" or "justice"), virtuous perseverance requires a noble end. In contrast, positions lacking "an arguable basis either in law or in fact" are frivolous. This decision is unpublished, but it should be added to the pantheon of tax protestor cases to warn others of the cost of persistent adherence to a bad idea. But as noted above, some repeat offenders get the penalty, some do not.

9. Tax shelter promotion penalties under section 6700 upheld in "tool plan" promotion, Davison v. Commissioner, TC Memo 2020-58 and Lemay v. Commissioner, TC Memo 2020-59.

In these collection due process cases, promoters associated with "tool plan" tax shelter programs challenged the basis for assessing promoter penalties under section 6700. Such penalties apply when a Taxpayer has organized, assisted, or participated in the sale of an interest in an investment plan or arrangements and made material statements concerning the tax benefits to be derived from the plan that the party knew or had reason to know were false. See IRC § 6700(a). The penalty reaches half the income earned from such promotion.

Although the issue has not been resolved in all circuits, the Tax Court followed a preponderance of evidence standard in finding the elements of these penalties. It provided de novo review of the application of the underlying penalty.

Taxpayers in each case were deemed to satisfy the elements for imposing these penalties. Among other things, they were aware of tax opinions from multiple accounting firms and one major law firm that challenged the proposition that their tool plan programs satisfied the accountable plan rules and other relevant provisions in the Code. Advice provided to taxpayers adopting the plan, at various points, plainly conflicted with existing tax law. Moreover, the promoters also failed to qualify their assertions about tax benefits and notify clients about potential tax scrutiny, which has qualified as a false statement in other cases. Here, the Service had announced that it was scrutinizing similar tool reimbursement plans, and the promoters said nothing about these risks.

Moreover, the backgrounds of these promoters made it reasonable to conclude they had reason to know of the falsity of these statements (and omissions). One was a CPA and tax attorney, and while the other was not trained in taxes, he was thoroughly familiar with adverse guidance, including the adverse professional advice of others. His attempt to rely on his CPA/tax lawyer colleague were unavailing, as that colleague was not independent on the matter but shared his goals of marketing the program and profiting from it.

Comment: This is a sad tale of citizens gone bad. By promoting these programs, one of them lost his professional credentials and both lost social capital likely valued at more than the penalties imposed on the fees they earned. In fact, the RA in this case was likely being conservative in applying the penalty to a more limited fee base than might have been defensible.

10. An initial penalty determination may be raised by IRS attorneys in an answer at trial, Koh v. Commissioner, TC Memo 2020-77.

Taxpayer sought judgment on the pleadings for a penalty determination that was made for the first time by IRS counsel in an answer to his complaint. The Tax Court denied Taxpayer's motion, noting that it was not the first time this claim that the IRS counsel lacked authority to assert penalties had been rejected. According to the Tax Court, the Commissioner's authority to assert penalties an answer to a petition is "well established" (citing numerous cases), and it follows that his representative in Court also possesses this authority.

11. STARS transaction ruled a partial sham; accuracy penalty based on failure to prove actual reliance on authority, Wells Fargo & Co. v. United States, 957 F.3d 840 (8th Cir. 2020).

In the continuing saga of the tax treatment of this STARS transaction, the Eighth Circuit affirms a district court ruling rejecting Taxpayer's refund claims and finding that the STARS transaction, which was broken down into two components, a "trust" portion and a "loan" portion, was a sham with regard to the "trust" portion. The district court also imposed a

As to the sham determination, the Eighth Circuit concluded that Taxpayer failed to prove either a reasonable expectation of profit or a valid business purpose apart from tax considerations. In doing so, the court continued to dodge the question of whether these two parts of the economic substance test apply conjunctively, disjunctively, or as factors in a flexible analysis. All three judges approved this outcome.

Dissent emerged in part III of the opinion, which addresses the matter of the accuracy penalty. The district court relied upon Taxpayer's stipulation that it would not try to prove actual reliance on authority for its position. See 260 F.Supp. 3d at 1147. Instead, Taxpayer sought to rely on the objective determination of authorities supporting its position. Unfortunately for Taxpayer, the district court ruled that the regulations (Treas. Reg. 1.6662-3(b)) underlying the reasonable basis defense to a negligence penalty were ambiguous, and that *Auer* deference required that ambiguity to be resolved in favor the agency's own interpretation. Since the agency chose to require proof of actual reliance by the taxpayer, the penalty would be upheld.

The Eighth Circuit majority affirmed the district court in requiring that actual reliance on authority must be proven in order to satisfy the reasonable basis defense to the penalty. It noted that the regulation did not merely require the taxpayer to show that its position was simply "consistent with" or "supported by" authority, but that the taxpayer "based" its position on such authority. This is also in line with the concept of "negligence", which suggests reference to actual conduct. This approach rejected Taxpayer's policy arguments, including a concern that showing actual reliance would jeopardize attorney-client privilege. This approach also means that a taxpayer may have reached a reasonable position – perhaps even by sheer luck – but cannot avoid a penalty, while a taxpayer that carefully studies authorities but reaches the wrong conclusion may avoid a penalty.

In dissent, Judge Grasz challenged the district court's application of Auer deference in this case by questioning whether the agency has particular expertise on the applicable legal standard. In his view, judges rather than agencies should get to make the call. Although the majority may have reached a similar outcome based on de novo review of the regulation, rather than *Auer* deference, Judge Grasz disagreed that subjective reliance by the taxpayer should be the standard. Here, either the agency or the courts assess whether there is a reasonable basis for the taxpayer's position after the return is filed, rather than a taxpayer determination beforehand.

Judge Grasz used an analogy adopted by the district court. Three friends try to decide where to go to dinner. A and B disagree over which restaurant is best. C is tasked with resolving the dispute. C consults Zagat and agrees with A that her restaurant is the "best". Z relied upon Zagat, but A did not. Judge Grasz views the court as in the position of C, and he would allow an objective analysis to prevail.

Finally, the court rejected Taxpayer's claims about supervisory approval of the negligence penalty. This was not a challenge to an "assessment", but instead it was an offset asserted in refund litigation. Supervisory approval is not required in that situation.

Comment: Taxpayers who bought into the STARS deal surely have buyer's remorse. The economic substance test just cannot be satisfied. Taxpayer stipulated away an actual reliance defense, which in retrospect turned out to be their downfall in resisting the accuracy penalty. But in my view, Judge Grasz has this right. Negligence does not require action, but sometimes is based on inaction. The tax laws should not turn on subjective reliance as a predicate to others assessing whether that reliance is reasonable. A lucky but ignorant taxpayer should not pay a penalty if there is reasonable basis for his position that turns out to be wrong. A careful taxpayer still has to run through the assessment as to whether the exercise of care was reasonable in light of all the extant authority. Skipping the subjective analysis will be more efficient, saving time at trial. But in many cases, penalty avoidance will still depend on whether taxpayers were advised by independent outside counsel.

12. Lawyer could not escape accuracy penalty, Babu v. Commissioner, TC Memo 2020-121.

Taxpayer had a BA in finance and a law degree. He took courses in tax law, participated in a low-income tax clinic, and finished law school with "a pretty good understanding of tax." During law school, he was employed by a tax return preparation firm, ITS. He was admitted to the bar in three jurisdictions and later was employed as general counsel for ITS, which used a franchise business model to provide tax return preparation services. Taxpayer owned franchises for 19 separate location, which generated significant profits, aggregating over $800K during the period 2008-2010.

In 2012, the Justice Department filed a civil complaint against ITS and related entities seeking to enjoin them from activities related to tax fraud. After trial, and injunction was issued. Although Taxpayer was not a defendant in this litigation, he was named as facilitating fraudulent activities. As a result, he was not permitted to continue in the tax return preparation business, which was taken over by another firm, GTX. Franchisees signed up with GTX.

After the injunction, Taxpayer formed a new company, Refunds Plus ("RP"), an S corporation, which acquired the tax processing software previously licensed to former ITS franchisees. RP continued this licensing arrangement with GTX franchisees, for which it was to be paid $100.95 for each return processed that claimed a refund. These fees were deposited automatically into accounts over which RP had access, generating several million dollars in fees during 2014. Taxpayer withdrew significant funds by wire transfers from these accounts. Taxpayer failed to report these fees for 2014, in fact telling his return preparer that RP had no gross income. A deficiency with accuracy penalties resulted from an audit of that year.

Taxpayer challenged only the accuracy penalties in this litigation. Taxpayer proffered evidence from another lawyer, Rebeck, who claimed that she advised Taxpayer that RP had no gross receipts under these account arrangements. However, the Tax Court did not find this credible, as no advice was produced and Rebeck also had mutual business interests with Taxpayer, including franchises that used RP software. She also received unexplained transfers from Taxpayer in starting her own law firm, and she was later named as a codefendant in a lawsuit involving misappropriated funds. Rebeck also offered theories for excluding these amounts that the court found "implausible", including treating them as repayment of loans.

Taxpayer also argued that he believed that, because he diverted the funds from RP to his own account, he was somehow not taxable on them. The Tax Court did not believe he actually misunderstood the tax law in this matter, but even if he did, such a misunderstanding was not reasonable given his "experience, education, and knowledge of tax law".

Comment: This taxpayer apparently admitted he had a "pretty good understanding of tax" when he finished law school. But it seems that seven years later, he was not thinking too clearly about what gross income meant. I don't think even a nonlawyer could have gotten to reasonable cause and good faith in these circumstances.

13. Settlement offer by Revenue Agent was not an initial determination of a penalty, Thompson v. Commissioner, 155 T.C. No. 5 (2020).

Taxpayers were under audit. The Revenue Agent handling their case sent them letters offering to settle tax liabilities related to an abusive transaction known as a "distressed asset trust" transaction. Pursuant to a settlement initiative under Announcement 2005-80, the settlement offer sent in 2007 included accuracy penalties at a reduced rate of ten percent based on a deficiency that would be calculated later. Taxpayers did not accept the offer. The Revenue Agent sent another letter in 2009, which offered less generous terms of 15 percent. However, it also explained that if the offer was not accepted, the audit would continue, they would develop the case, and applicable penalties would apply. Taxpayers likewise did not accept this offer.

Later in 2009, the Revenue Agent completed his examination and determined deficiencies for 2003-07, which included penalties at the full statutory rates. Supervisory approval was obtained on December 18, 2009, before the notice of deficiency was sent. However, Taxpayer claimed that these penalties failed to satisfy the supervisory approval requirement of section 6751(b)(1).

The Tax Court denied Taxpayer's motion for summary judgment on the penalties, finding that the supervisory approval requirement had indeed been met. Relying on its prior decision in *Belaire Woods*, the court determined that the time for required supervisory approval does not pass before the Service "formally notifies the taxpayer in writing that it has completed its work and made an unequivocal decision to assert penalties." Here, the offer letters sent to Taxpayers did not reflect an initial determination because they did not indicate that the examination process had been completed. Although the legislative history suggests that the provision was designed to prevent penalties from becoming a bargaining chip, the Tax Court refused to let this legislative history argument "animate our decision." The court also rejected arguments calling for substantive content to the review process and seeking to apply the rule of lenity in this context.

Comment: The rule that emerged here leaves room for these offers of settlement to tax shelter participants to come in from the cold and avoid some penalties. Those offers only work if there is an even bigger penalty waiting later – as was the case here.

14. Supervisory approval following Letter 5153 was not timely; substantial valuation penalty was an enhancement of earlier penalties, not a separate penalty, Oropeza v. Commissioner, 155 T.C. No. 9 (2020).

Taxpayer was the sole shareholder of a "micro-captive" insurance company organized as an S Corporation. Taxpayer's 2011 tax year was under examination. In order to avoid the expiration of the statute of limitations, the Service issued Letter 5153 and attached the revenue agent's report (RAR). The Letter proposed a $1.25 million increase to the distributive share of the S corporation income passing through to Taxpayer, as well as an increase in the amount of capital gains income. It also proposed "accuracy-related penalties" of 20 percent under section 6662(a), but it offered several bases for such penalties without identifying any single one. The letter also left blank the space where a 40 percent penalty for gross valuation misstatement or transactions lacking economic substance could be imposed under section 6662(h), (i), and (j). The RAR did not suggest that a 40 percent penalty was being asserted as an alternative to the 20 percent penalty. Significantly, the request for supervisory approval went out the same day as the letter, and no approval was obtained before sending it.

The letter gave the Taxpayer a choice: agree to the adjustments, agree to extend the statute and seek review in Appeals, or receive a notice of deficiency. Taxpayer did not agree to the adjustment or agree to extend the statute, so the agent closed the case. The agent submitted a memo to Chief Counsel indicating that a 40 percent penalty should be applied because the micro-captive arrangement had not been disclosed. Supervisory approval was given on May 1, 2015, and the notice of deficiency imposing the 40 percent penalty was issued on May 6, 2015.

Taxpayer filed a motion for partial summary judgment on the matter of the penalty. The Service conceded that supervisory approval had not been obtained prior to the Letter 5153, which had imposed a negligence penalty. However, it argued that the letter was not a final determination. The Service also argued that it had obtained proper approval for the 40 percent penalty.

The Tax Court, following *Belair Woods* (154 T.C. 1 (2020)), ruled that the Letter 5153 and RAR did constitute the initial determination of a negligence penalty. This letter made it clear that the Examination Division had concluded its work and that it intended to assert a penalty against Taxpayer. Whether a taxpayer receives a 30-day letter (as here) or a 60-day letter (as in Belair Woods), the taxpayer has notice that a penalty determination had been made. Supervisory approval had not been obtained until after the letter was sent, so the penalties could not be imposed. See also Oropeza, TC Memo 2020-111 (involving the same taxpayer but the 2012 tax year) and Carter, TC Memo 2020-21 (discussed above).

As for the Service's argument that the 40 percent penalty for nondisclosure of a transaction that lacked economic substance was a separate penalty for which supervisory approval had been obtained in a timely manner, the Tax Court disagreed. Section 6662(i) imposes this penalty as an addition to the 20 percent negligence penalty. It is not a distinct penalty, but an enhancement of the 20 percent penalty already referred to in the RAR. According to the court,

> boilerplate text in an IRS communication, determining liability for an accuracy-related penalty "attributable to one or more of" specified grounds, will be interpreted to assert all of the specified grounds as alternative bases for the penalty, unless other portions of the communication explicitly limit the penalty determination to a subset of those grounds.

Comment: The rush to beat the statute here deprived the Service of a penalty that it might well have won if supervisory approval had been obtained.

15. Seventh Circuit announces penalty for frivolous tax appeals at $5K, Veal-Hill v. Commissioner, __F.3d__, 2020 WL 6055418 (7th Cir. Oct. 14, 2020).

Inflation affects the cost of government attorneys' wasted time to address frivolous tax appeals. In 1986, the Seventh Circuit set that value at $1500. Since then, it has gradually increased. As of this case, the price of a frivolous appeal is now $5,000.

Comment: Be wary of frivolity in the Seventh Circuit! Given the amount of time required, I am surprised it is not more.

16. Late filing penalty not excused by reliance upon CPA to file extension, Baer v. United States, No. 19-01439 (Fed. Cl. Nov. 5, 2020)

Taxpayer, a lawyer engaged in corporate and business litigation, filed his 2011 individual income tax return on August 24, 2012, after the April 15, 2012 deadline. The IRS assessed a late filing penalty, which Taxpayer paid. Refund litigation followed. Taxpayer alleged that the late filing was due to a "miscommunication" with his CPA, whom Taxpayer believed had filed an extension for the 2011 tax year. Unfortunately, the CPA did not file an extension based on the erroneous belief that full payment of taxes due would be required at that time. The Government moved to dismiss the claim, alleging that the Taxpayer could not prove reasonable cause and good faith in this context as a defense to the penalty.

Taxpayer's CPA had prepared prior year returns for Taxpayer. In April 2011, the CPA had provided a draft Form 4868 to extend Taxpayer's filing deadline. Unfortunately, the Form was never filed. Taxpayer filed late and was assessed penalties associated with a large underpayment of taxes due. However, due to Taxpayer's otherwise consistent record of filing and payment, the late filing penalties were abated.

In 2012, Taxpayer was in a similar situation with a large underpayment and without liquid assets to pay at the usual deadline. In Taxpayer's CPA provided him with a completed but unsent Form 4868. The CPA erroneously believed that the form could not be submitted without paying the balance due, and the CPA assumed that Taxpayer would make the payment and submit the form. However, Taxpayer did not receive any actual advice. Instead, he believed the document was only a "courtesy copy" so he did nothing.

The Court of Federal Claims ruled for the Government, dismissing the claim. Here, the court found that Taxpayer had a nondelegable duty to comply with the filing requirement; employing an agent did not absolve him of noncompliance. Although some authorities allow taxpayers to rely upon the advice of professionals, the court ruled that the conduct of the CPA – providing him with a form without filing it – did not constitute "advice". Even if it did, such "advice" must be reasonable to support Taxpayer's good faith reliance as a defense to the imposition of a penalty. Instructions associated with Form 4868 explicitly stated that taxpayers are "not required to make a payment of the tax you estimate as due" when the form is filed.

Comment: Relief based on professional advice is hard to come by in the context of late filing. In this case, it was hard to find "advice" apart from a course of past dealing, which was very limited. While a taxpayer who is not a tax professional may find it difficult and/or impractical to access legal sources that might uncover faulty tax advice, this case points to the instructions to the form as a source that should have indicated that something was awry. For other recent cases rejecting penalty relief on the basis of failure by Taxpayer's agents, see Padda v. Commissioner, TC Memo 2020-154 (reliance on an accounting firm that regularly filed late did not provide reasonable cause); All Stacked Up Masonry, Inc. v. United States, __ Fed. Cl. __, 2020 WL 6194599 (Oct. 22, 2020) (bookkeeping errors by agents and unspecified problems with QuickBooks software did not provide reasonable cause).

B. FBAR Penalties.

FBAR penalties are now being collected following initiatives to obtain disclosures from foreign banks and voluntary compliance from Taxpayers who are coming in from the cold. Some notable cases at the district court level are include below. The recent Fourth Circuit decision in *Horowitz* (No. 19-1280, 10/20/2020), clarifies that willful civil penalties can be assessed based on reckless behavior – a precedent that, if followed in other circuits, might produce a worse outcome for some of these taxpayers who were able to avoid willful penalties. Readers should be cautioned: some of these penalties are harsh indeed. "Lawyer guidance is suggested."

1. FBAR penalty is remedial and survives Taxpayer's death, United States v. Green, 2020 WL 198059, _ F.Supp.3d _ (S.D. Florida April 27, 2020).

Government's case against children of decedent, co-trustees of a revocable trust she created during her life, survives a motion to dismiss for failure to state a claim. With analysis, court concludes that the penalty survives decedent's death as it is remedial in nature, rather than penal, and that Government pleading contained sufficient particularity to lead to a finding of willfulness, thus also surviving a motion to dismiss on this ground.

Comment: See also United States v. Wolin, No. 17-CV-2927 (RRM)(CLP) (E.D. NY Sept. 28, 2020) (following Green and related authorities in concluding that FBAR willfulness penalty survived death of account holder).

2. Non-willful civil penalty for FBAR violation limited to each FBAR form, not each account, United States v. Bittner, 2020 WL 3498082, 126 AFTR2d 2020-5051 (E.D. Texas, June 29, 2020)

Taxpayer was a Romanian-American dual citizen. He moved to the U.S. and became a naturalized citizen in 1987 or 1988. He moved back to Romania and lived there until 2011, when he returned to the United States. He did not renounce his U.S. citizenship. While in Romania, he generated over $70 million from foreign businesses and investments. He had numerous foreign bank accounts, each of which held more than $10,000 per year. Taxpayer failed to file FBAR s until May 2012. In June 2017, the Service assessed a total of $2.7 million in penalties on the basis of $10,000 fines for each foreign account.

At issue in this case: Does the civil penalty provided by 31 U.S.C. § 5321(a)(5)(A) and (B)(i) for non-willful violation(s) of the regulations implementing 31 U.S.C. § 5314 apply per foreign financial account maintained per year but not properly or timely reported on an annual FBAR, or per annual FBAR report not properly or timely filed? This was an issue of first impression in the Fifth Circuit, where an appeal would lie.

The district court ruled that the penalty applies for each form, not for each account. This is true to the statute, which focuses on the failure to file as the act for which a penalty is imposed. It also avoids an absurd result in which a taxpayer with multiple accounts holding the same balance as a taxpayer with a single account is penalized more, or a willful violator who fails to file over a single account potentially gets a lower penalty than a non-willful violator who holds multiple accounts.

The district court recognized contrary authority in United States v. Boyd (C.D. Cal., April 23, 2019), but that court's decision is not binding on a sister federal district court. The court also granted summary judgment in the Government's favor on the issue of reasonable cause, finding no excuse for a taxpayer making millions of dollars not to inquire about FBAR reporting.

Comment: This is a big win for Taxpayer, who owes $10K per year and not 40-50 times that amount due to the total number of accounts he maintained. The Government is unlikely to give up on this issue; look for more cases. For one involving a Nebraska couple, see United States v. Hidy, __ F. Supp. 3d __, 2020 WL 4516357 (D. Neb. July 7, 2020) (non-willful penalties of $112,543 against H and $50,000 against W for unreported foreign accounts during 2009-13).

3. Willful violations supported by evidence other than signing return, United States v. Schwarzbaum, __ F.Supp.3d __, 2020 WL 1316232 (S.D. Florida March 20, 2020).

Government imposed $13.7 million in willful FBAR penalties. Although the district court rejected the Government's theory of willful avoidance based only on the fact that he signed the tax return without disclosure or that he knowingly violated FBAR requirements, it upheld the penalty for willfulness based on recklessness or willful blindness for at least some of the tax years. However, the Government erred in assessing the penalties based on the highest balance in the account, rather than the balance at the time of the violation.

Comment: Penalties are recalculated in 125 AFTR2d 2020-2109 (May 18, 2020). Taxpayer appealed to the Eleventh Circuit. This more restrictive approach to the "constructive knowledge" basis for finding willfulness grounded in signing a false return has been used by other taxpayers to challenge willfulness. See, e.g., Jones v. United States, 2020 WL 22803353 (C.D. Cal. May 11, 2020). However, in Jones, the constructive knowledge was prima facie evidence of willfulness that could be rebutted. A genuine dispute existed in that case, which included reliance on tax professionals. That case also followed Schwarzbaum in rejecting penalty computations based on the highest balance.

4. Constructive knowledge, recklessness, and concealment support willful penalty, United States v. Ott, 441 F.Supp. 3d 521 (E.D. Mich. 2020).

Taxpayer was a carpenter with a small business in Michigan. He maintained Canadian brokerage accounts, from which he directed investments beginning in 1993. Various accounts were opened over time as his investment advisor changed firms. Taxpayer used his sister's home address in Canada as the address for the accounts. The highest aggregate balance of the accounts in 2007 was $1.9 million, with varying amounts in 2008-09. Taxpayer had a U.S. accountant for many years who prepared his returns based on information Taxpayer provided. For 2007, Taxpayer's return disclosed income of $21,381. Per the accountant's software, Schedule B questions re: foreign bank accounts defaulted to no. Taxpayer did not file FBAR forms in any of the years at issue.

After transferring accounts again in 2010, Taxpayer informed his accountant, who referred Taxpayer to a tax attorney. The attorney recommended disclosure as part of the voluntary disclosure initiative. Taxpayer prepared amended returns and paid additional taxes on his Canadian income. However, in 2011, Taxpayer opted out of the voluntary disclosure initiative based on the prospect of lower penalties for non-willful nonfilers. After withdrawal, the IRS audited Taxpayer for the 2003-2009 tax years, imposing civil fraud penalties for 2007-09. Taxpayer petitioned the tax court, and a settlement was reached. Taxpayer paid all applicable penalties related to his tax deficiency in June 2019.

However, the Government separately assessed FBAR penalties of $988,245 against Taxpayer for willful failure to report the Canadian accounts. Here, Taxpayer challenged willfulness. The District Court upheld the willfulness determination. Here, signing the return was evidence of constructive knowledge of its false contents. Moreover, Taxpayer acted recklessly by failing to disclose the foreign accounts to his accountant. Erroneous advice he had received as a young adult about the nontaxability of foreign income was no excuse – he should have known to consult his current professional preparer. Using his sister's address was deemed an act of concealment, and moreover this taxpayer regularly directed investments from these accounts, reflecting continuous knowledge of their existence.

Comment: This taxpayer with comparatively modest income has faced not only civil fraud but also FBAR penalties that will likely eclipse the value of his foreign accounts. The decision to opt-out likely looks not so good in hindsight.

5. Fraudulent transfer theory applied against transferees of Taxpayer facing FBAR penalties, United States v. Weatherly, 125 AFTR 2d 2020-2180, 2020 WL 2543091 (M.D. Florida, May 19, 2020).

Taxpayer had a willful FBAR penalty assessed for over $1.9 million for maintaining undisclosed foreign bank accounts and failing to report taxable income from those accounts. Taxpayer allegedly transferred $3 million to her children, attempting to defeat the Government claims. The Government sued Taxpayer and her children to collect its tax debt, asserting that Florida's fraudulent transfer act allowed it to recoup the funds transferred to the children without reasonably equivalent value.

Children sought to dismiss the claim against their mother, but they had no standing to do so. They also alleged that the transfers were made before the four-year statute of limitations applicable under Florida law. However, the court recognized that the Government is not barred by the statute of limitations imposed by state law in pursuing this claim. Arguments that the transfer predated the time when the tax liabilities were assessed were also unavailing.

6. Reckless behavior supporting willful FBAR penalty do not support enhanced fraud penalty for failure to file return, United States v. DeMauro, __ F.Supp. 3d __, 2020 WL 575466 (D. N.H. August 28, 2020).

Taxpayer, an 82-year old divorced woman, had significant money deposited in foreign bank accounts from a prior marriage, as well as additional funds transferred there from property sales in the United States. She also transferred funds from one foreign bank to another, and from the foreign accounts back to the United States. Taxpayer was noncompliant when it came to taxes on the income earned from these accounts. She had a CPA file a return in 2002 when she had a significant gain from a property sale, but the CPA prepared only extensions for subsequent years and did not file returns. After an IRS investigation began in 2010, delinquent returns were eventually filed. In addition to willful FBAR penalties, the Service also imposed enhanced penalties under section 6651(f) for fraudulent failure to file returns.

The Government assessed willful FBAR penalties of $274K for each of the 2007-2009 tax years. The district court upheld these penalties based on "reckless" behavior by Taxpayer. It also sought to assess enhanced penalties against Taxpayer under section 6651(f) on the basis that the failure to file returns in those years was fraudulent. Taxpayer challenged that penalty in a counterclaim against the Government.

The district court ruled for the Taxpayer on the counterclaim. While the proof adduced to show willful behavior, which was based on recklessness, satisfied the preponderance of evidence requirement for the FBAR penalty, it was not sufficient to show, by clear and convincing evidence, that she had a specific fraudulent intent to evade tax.

Comment: The more rigorous standard of proof for fraud provided a small victory for this taxpayer – but the fraud penalty is modest indeed compared to the mighty willful FBAR penalty.

7. Fifth Amendment privilege against self-incrimination not a defense to willful FBAR penalty, United States v. Bernstein, __ F.Supp.3d __, 2020 WL 5517315 (E.D. NY September 14, 2020).

Noncompliant taxpayers with foreign accounts sought the advice of an attorney who specialized in white collar criminal cases. The attorney advised them to file an FBAR for the 2010 tax year in which they would invoke their Fifth Amendment privilege against self-incrimination, while including an addendum offering additional information if they were granted immunited from criminal prosecution. They also invoked the Fifth Amendment on their Schedule B return.

That tactic apparently worked, as there was no criminal prosecution. But the Government did assess willful civil FBAR penalties. The district court found sufficient evidence for willfulness to grant summary judgment to the Government. It also rejected the Taxpayer's claim that, by filing the FBAR with a Fifth Amendment reservation, they were subjectively not "willfully violating" the Bank Secrecy Act. Their authority, Cheek v. United States, 498 U.S. 192 (1991), involved a criminal prosecution for tax evasion. But this is a civil matter, and the court rejected this approach out of hand. On the matter of the Fifth Amendment claims, these paragraphs of the opinion are instructive:

> It is often useful on summary judgment motions to envision what would happen if the motion was denied and the case went to trial. Here, the jury would receive evidence of all of the Bernsteins' dubious conduct between 2002 and 2009 described above. <u>See</u> Fed. R. Evid. 401, 404(b). It would then be apprised of their 2010 FBAR and the invocation of their privilege. If I went the Bernsteins' preferred direction (instead of instructing the jury that it could draw an adverse inference against the Bernsteins by reason of their invocation of the privilege, which I might or might not do), I would then instruct the jury, in substance, that "you may not consider the Bernsteins' invocation of their Fifth Amendment privilege in determining whether they acted willfully. That is not a bad act. They had a right to assert their privilege. You must only determine whether they willfully failed to disclose information that is required by law." Based on the definition of "willfulness" set forth above, I only see one answer to that question.
>
> This is not semantics. It is the difference between using the privilege as a shield against criminal liability as opposed to a sword to cut off civil liability, in effect, a tax-planning device. It would be all too easy for tax cheats, once caught or on the verge of getting caught, to invoke their Fifth Amendment and avoid civil tax penalties. That result would be unacceptable and there is no precedent for it.

Comment: As in DeMauro, above, different proof standards are in play here. Recklessness is enough to show willfulness for purposes of a civil penalty. A subjective belief that one acted properly by invoking a privilege against self-incrimination is not a penalty defense. If you choose not to disclose – for whatever reason – the civil penalty for that choice still follows.

8. `Willful civil penalties applied despite claims of subjective ignorance of law, United States v. Horowitz, __ F.3d__ , 2020 WL 6140674 (No 19-1280, 4th Cir., 10/20/2020)

Taxpayers received assessments of penalties and interests totaling nearly $1 million for willful failure to file FBARs in 2007 and 2008 based on undisclosed accounts that held over $2 million in Swiss banks. These funds had been accumulated while Taxpayers lived and worked abroad over many years. They had moved back to the U.S. in 2001, but they decided to maintain the accounts, never reporting interest earned upon them and requesting that no mail be sent to them. They merely checked on the accounts by phone periodically. A professional prepared their returns but they never disclosed the accounts and professed never to have looked at them in any detail.

In 2008, Taxpayers began to become concerned about reports involving UBS, one of the banks at which they held accounts. Husband traveled to Switzerland to close the account and to transfer it to another Swiss bank, maintaining it as a "numbered" account with "hold mail service". However, the new bank would not add Wife to the account without her being present. One year later, they both travelled there to add her name to the account. At this time, they learned more about voluntary disclosures and IRS concerns about undisclosed accounts. They also received a letter from UBS indicating that they were going to disclose information to the IRS. They promptly sought advice from a tax attorney. In 2010, they submitted a letter disclosing their foreign accounts and requested acceptance into the Offshore Voluntary Disclosure Program. They filed late FBARS and amended tax returns for 2003-08, reporting additional income and paying back taxes. But for unexplained reasons, they opted out of the program in 2012.

The Service proposed FBAR penalties in 2014 proposing willful FBAR penalties. Settlement negotiations proved unsuccessful, and the Government commenced suit to collect the penalties. The district court granted summary judgment favoring the government, although providing relief for penalties assessed against Wife during the year she was not on the account. This appeal followed.

Taxpayers contested the application of willful penalties, contending the mere fact that they signed tax returns that disclosed no foreign accounts could not legally support a finding of willfulness, and that they were entitled to a trial on the matter. The Fourth Circuit affirmed the trial court, rejecting this argument. While a criminal penalty requires a higher standard, civil penalties for willful conduct entail both knowing and reckless behavior. "Willfully" is a "word of many meanings…" But in the civil context, it can include recklessness. Moreover, Taxpayers' conduct here permitted the court to find recklessness – and thus willfulness – as a matter of law. Here, these Taxpayers should have known that there was a grave risk that an accurate FBAR was not being filed and they were in a position to ascertain this easily. They knew that a significant portion of their savings was in foreign accounts, and they knowingly failed to report income on those accounts that they should have known was taxable. They nevertheless failed to inquire about this or disclose the accounts to their tax preparer. The account was also designed to impede government discovery of its existence. The fact that they claimed not to read the returns or understand the jurat under which they signed was not accepted.

Comment: This approach is consistent with other appellate courts, including the Federal Circuit and the Third Circuit. As other circuits follow, the Service will perhaps become bolder in proposing willful civil penalties, which can take up to half the account.

C. Whistleblowers.

1. Whistleblower challenge to inadequate award upheld, Lewis v. Commissioner, 154 T.C. No. 8 (2020).

Whistleblower submitted Form 211 to the IRS Whistleblower Office in 2011, alleging that a closely held corporation and its two married shareholders underpaid income tax for 2010 and prior tax years. Whistleblower had been employed as a financial manager at the corporation until April 2011, when his employment was terminated.

Whistleblower's principal allegations supporting his award involved payments by the corporation to the shareholder's sons that the corporation had characterized as deductible expenses. Whistleblower claimed that these payments are properly treated as dividends to the shareholders followed by taxable gifts to the sons.

The IRS audited the corporation for its 2010 tax year and the shareholders for their 2010 and 2011 tax years. At the time of the audit, the corporate 2011 tax return had not yet been filed, so it was not under examination. During the audit of the 2010 tax year, the corporation learned that the IRS had raised issues about the deductibility of these payments, so it chose not to claim deductions on its 2011 tax return. At the conclusion of the audit, the corporation and the shareholders executed a closing agreement in which the parties agree that no deduction would be allowed for the $500,000 payment to their son. However, since Son reported the payment as income on his return, the payment would neither be treated as a dividend nor as a gift from the shareholders. The parties agreed to apply accuracy penalties for the 2010 tax year.

Despite the closing agreement, the shareholders filed gift tax returns for 2010 and 2011, using their unified credits to cover the gift tax due. Shareholder husband died in 2014 and pursuant to his estate plan the estate claimed his remaining unified credit and provided a marital deduction for other properties. No estate tax was due. During 2015, shareholder wife made gifts of over $11 million, using the balance of her remaining unified credit and paying over $4.6 million in gift tax.

After Husband's estate audit was completed, the audit team completed Form 11369 for the purpose of evaluating the whistleblower award based on the information provided. The revenue agent concluded that the total collected proceeds resulting from the whistleblower information, including both corporate and shareholder level effects, would exceed $1 million. The WBO recommended payment of about $206,000, which was based on a 22 percent level for reward.

However, the revenue agent's report also indicated that because of the audit triggered by Whistleblower's information, the corporation would have computed wage deductions for payments to the son in 2011, thereby reducing its corporate taxes by $180,000. The WBO did not take these enhanced collections into account when computing the whistleblower award.

Whistleblower disputed the sufficiency of the reward, arguing that the collected proceeds should include the taxes paid in 2011 after the corporation changed its reporting position on the deductibility of the payments to the son. He also claimed that an additional amount was due because his efforts caused the Husband to use up his unified credit regarding gifts in 2010 and

2011, thereby increasing the taxable estate of his spouse (and increasing future Treasury collections thereon).

The WBO agreed to modify its award to permit Whistleblower to obtain 22 percent of any additional estate taxes that might be collected on Wife's estate, but it refused to enhance the current payment amount. Whistleblower appealed to the Tax Court.

The Tax Court ruled that the WBO did not abuse its discretion in refusing to compute an award based on the corporation's change of its reporting position in 2011. Prior precedent had ruled that the WBO is not required to monitor the target for a change in future reporting based on information reported. Information about changes in future reporting can be considered in determining the percentage of the award, but not in determining the collected proceeds. Moreover, collected proceeds do not include "reported, paid tax when the target changes its reporting for a year after the year of an audit."

The Tax Court also ruled that there could be no award based on the husband's use of his unified credit. The husband's estate filed a return and no taxes were due; there could be no collection from him. There was no further discussion of future collections from Wife.

Finally, the Tax Court also ruled that it had jurisdiction to consider the effects of the sequestration, and it ruled that sequestration had a sound basis in law.

Comment: According to the WBO's acknowledgement in this case, Whistleblower could obtain an award based on future estate taxes collected from Wife. (See text preceding note 3 of the opinion.) However, Wife paid gift taxes in 2015. So doesn't that mean the IRS already collected from her? (See note 3). But more importantly, aren't future estate tax collections taxes coming from a different taxpayer (an estate), and aren't those taxes regularly paid in after the audit, thereby excluding them from an award? The change in a future estate is a dicey proposition, given the many slips that can happen "between the cup and the lip". This merits further examination.

2. Whistleblower claims denied despite IRS refusal to examine returns based on disputed application of statute of limitations to Target behavior, Cline v. Commissioner, TC Memo 2020-35.

Whistleblower (W), a retired veteran now employed as an accountant, filed two whistleblower claims. The first involved an alleged failure to report $650,000 in proceeds from the sale of stock in 2013. W supported this claim with copies of cancelled checks. The second claim involved a failure to report owner's draws totaling $635,352 in the 2012 tax year. Target had previously been convicted of criminal tax offenses, and W had previously been employed by Target.

The WBO reviewed both claims and determined that the statute of limitations had run on these items. Accordingly, they recommended that the claims be denied and they did not forward the information for Examination of Target's returns. The final determination letter sent to W stated in part: "[T]he information you provided did not result in the collection of any proceeds. Therefore, you are not eligible for an award."

W also submitted claims about Target 2, which employed him as an accountant to reconstruct the books of one of the Target's companies. W submitted a claim indicating he believed that Target had run income from separate entities through company accounts, when they should have been separately reported. He was also "uncertain" about whether Target accurately reported profit and losses, as well as owner draws.

The WBO rejected this claim as speculative and did not forward it to Examination. A determination letter was sent to W stating the speculative nature of his claim as the basis for summarily rejecting it.

W appealed to the Tax Court, which granted summary judgment to the Commissioner. Here, the Tax Court followed its precedent in Lacey v. Commissioner, 153 T.C. No. 8 (2019). Here, there was a denial of claims after a substantive review. The Tax Court has jurisdiction to review the administrative record and to evaluate the denial based on an abuse of discretion standard. However, it does not review a decision whether to audit a target and it has no authority to require the IRS to explain a decision not to audit.

As for the first claim, the decision to deny the claim was based on the statute of limitations. This goes beyond the administrative record and any indications of the credibility of the whistleblower or the reliability of information provided. W alleged that the statute of limitations could be extended for fraud, so that the determination underlying the rejection of his claim may indeed be faulty. But this claim goes to the matter of whether the IRS would choose to audit, which is not within the purview of Tax Court review. Here, the determination letter correctly stated that no proceeds were collected, and this was a proper basis for deny the claim.

As for the second claim, there was ample basis in the record to support the WBO's decision to reject the claim as speculative, lacking basis or support for allegations. There was no abuse of discretion.

Comments: The Service continues to hold and exercise considerable discretion over whether to proceed with examination after a whistleblower claim. As the Tax Court previously stated in Lacey, "[S]ection 7623(b) does not convert the Tax Court into an overseer of the IRS's audit and collection activity." Other authorities support this view. In fact, a vigorous dissent in Lacey asserted that summary judgment should be granted to the Commissioner whenever no proceeds are collected – which was exactly the basis for denying the first claim discussed above in the Cline case.

According to the Tax Court in Cline, the WBO reorganized the claim evaluation function after the Lacey case to include an initial claim evaluation team headquartered in the Small Business/Self-Employed division of the IRS. Presumably, this puts more substantive expertise behind the evaluation of most claims involving Targets in this category. It also provides an additional source for an administrative record, which was lacking in Lacey but needed for Tax Court reviews of WBO determinations.

This case also illustrates the need for taxpayers to be concerned about potential whistleblower claims coming from employees and contractors. Your sins may find you out, with a little help from incentivized tattling.

Finally, this whistleblower did not avail himself of anonymizing features available in Tax Court litigation – query the impact of that decision on his future accounting business.

3. No collection, no award, Pulcine v. Commissioner, TC Memo 2020-29.

Whistleblower submitted a claim for a nondiscretionary award based on information that Taxpayer had erroneously deducted, instead of capitalized, a $4 million payment. Taxpayer was under examination, and the information submitted by W was considered. However, Examination determined that the expenditures were properly deductible, resulting in no additional tax collection. The WBO issued a determination that denied his claim, stating that "the information you provided did not result in any additional tax, penalties, interest or additional amounts related to the tax issue you raised."

W appealed this determination to the Tax Court, which treated his petition as a motion for summary judgment. The Service responded with its own motion for summary judgment. The Tax Court ruled for the Service and against W, holding that there was no abuse of discretion here. It also specifically rejected W's claims based on the IRS failure to pursue the matter, noting that "we cannot order respondent to reexamine the taxpayer's returns for additional deficiencies or conduct our own examination." With no collected proceeds, there was no reward.

Comment: This case provides further validation that Whistleblowers will have a hard time (read: impossible?) resisting summary judgment in favor of the IRS when there is no collection from the Target. Note that W here proceeded pro se – and did not anonymize his claim.

4. Whistleblower alleging illegal action by German court system summarily denied, Alber v. Commissioner, TC Memo 2020-20.

Whistleblower, a non-U.S. citizen residing in Germany, filed Whistleblower claim alleging that the "fake 'Federal Republic of Germany' banana republic has been treating …[him] badly and in illegal, unconstitutional ways …." This mistreatment included violation of German tax laws and a failure to protect his property rights. He also alleged, among other things, a "highly criminal psychological assessment" by a German doctor (contradicting Taxpayer's own claim that he is "totally healthy"). No nexus to the United States was cited. The WBO summarily dismissed his claim. Whistleblower appealed to the Tax Court.

The Tax Court found no abuse of discretion in this case.

Comment: Did you realize that our WBO and that Tax Court have to deal patiently with claims like this one? And there are others, too. Complaints about one's government cannot always find a friendly domestic ear. This case reminds me of an old story about the former Soviet Union. An American told his Russian friend that he could stand outside the White House and denounce the American Government. His comrade agreed: "I can also stand outside the Kremlin and denounce the American Government any time I wish."

5. Whistleblower claims based on misclassified independent contractors rejected, Kansky v. Commissioner, TC Memo 2020-43.

Whistleblower alleged that a corporation providing temporary workers to medical offices, along with the president of that corporation, misclassified employees as independent contractors.

W obtained some of this information from his girlfriend, who ran a competing staffing agency. Proof for this claim consisted of a letter with these allegations, along with information from the company's website.

The WBO referred these claims to a classifier in the Small Business/Self-Employed Operating Division, who specialized in employment tax. She found no employment tax issues for the company president, who did not even file a Schedule C or other form indicated that he might carry on a trade or business using any employees. As to the target corporation, that company did not file Form 1099-Misc, as W had claimed.

On the basis of this analysis, the WBO dismissed the claims as speculative. W appealed to the Tax Court, which found no abuse of discretion. Although W appealed to Lacey, supra, as precedent, the Tax Court distinguished the facts presented here, which showed a careful review of the underlying basis for the claim.

Comment: Nothing to see here, folks. A no collection, no reward theory could also apply in this context. A similar outcome distinguishable from Lacey can be found in Waszczuk v. Commissioner, TC Memo 2020-75.

6. Whistleblower claims on W's own Chapter 7 bankruptcy estate denied, Frantz v. Commissioner, TC Memo 2020-64.

Whistleblowers, Mr. and Mrs. Frantz, had filed a Chapter 7 petition in bankruptcy in 2013. In 2018, they filed two whistleblower claims alleging that the bankruptcy trustee had understated the estate's taxes by approximately $2.25 million during the 2014-17 tax year. They included with their claim form a letter from a CPA who calculated the shortfall and provided an amended return based on information the Frantzes provided, along with some returns from the estate. A third claim also targeted the trustee, but no specific information was provided. That claim was rejected as speculative without further investigation.

Classifiers reviewed the claims against the bankruptcy estate, and one noted that the Frantzes might also have received unreported income. The estate issues were referred for further review, and reviewer determined that there was little or no audit potential here because any potential adjustments would be very small. The WBO informed the Frantzes that the information did not result in collection of proceeds, so they were not eligible for reward.

The court found no abuse of discretion here.

Comment: This posits an odd scenario, as the bankruptcy estate is a separate taxpayer, even though assets and the ability to generate income may come from the whistleblowers in this situation. However, once again, the failure to collect proceeds ultimately seems to dictate the outcome; there is no authority for the court to direct the Service to conduct further investigations.

7. Whistleblower denied award based on supplemented administrative record, Van Bemmelen v. Commissioner, 155 T.C. No. 4 (2020).

Whistleblower (W) filed an original Form 211 with the Whistleblower Office (WBO) before 2012. He and his attorney supplemented that original form with other information from time to time during the intervening period, including a letter from his attorney submitted in 2018. The claims include allegations of oral information involving the target being shared with the IRS as early as 2004. The claims indicate that the target evaded taxes on some $858 million through deducting interest used to finance secondary market life insurance investments, contravening section 264(a) of the Code, allegedly between 2001-15.

The 2018 letter was assigned a claim number, and it was forwarded to a classifier for investigation. The classifier failed to find the prior year claim. Taxpayer's counsel, who had neglected to include a power of attorney in the earlier claim, later provided it along with another supplemental claim. The WBO informed her that the claim was "still open". Another classifier reviewed the claim and recommended rejection as the claims advanced were not "specific, credible, or are speculative…." A final notice of rejection was sent to W through his counsel.

W petitioned the Tax Court for review. He also filed a copy of a 2012 letter to the WBO, with accompanying attachments that included identification of fifteen other Taxpayers besides the named target that had engaged in similar allegedly abusive tax practices. He also filed a 2019 claim, which was sent to the WBO. The Service opposed this attempt to supplement the record.

The Tax Court reviewed the denial of W's claim based on an arbitrary and capricious standard. Here, the court allowed W to supplement the record. "An administrative record may be "supplemented" in one of two ways, 'either by (1) including evidence that should have been properly a part of the administrative record but was excluded by the agency, or (2) adding extrajudicial evidence that was not initially before the agency but the party believes should nonetheless be included in the administrative record.'" (Citation omitted).

As for the 2012 letter, the mere fact that WBO possessed it did not mean it should be part of the administrative record. That letter had been received years before the 2018 letter on which a determination was made. However, the fact that the 2018 letter referenced it made it appropriate to include this as part of the administrative record. The court supplemented the record accordingly.

But the additional evidence from 2019 could not have been considered as part of the decision on the 2018 claim, as it was not properly before the WBO at that time. Absent factors such as a deliberate or negligent exclusion of documents that might have been adverse to its decision, supplementation would not be permitted. W's efforts to suggest bias in WBO determinations would not carry the day.

However, despite granting a partial victory to W on supplementing the record, the court granted summary judgment in favor of the WBO. There was no abuse of discretion in rejecting this claim. Although there were also no proceeds from which an award could be collected, the WBO did not rely on that fact, so the abuse of discretion analysis was limited to the record of the kind of claim raised. The Tax Court found no abuse of discretion here.

Comment: Supplementing the record is a limited remedy, as illustrated here. WBO personnel should take note: also let the rejection letter rely on a failure to collect any proceeds to buttress the decision to reject weak and speculative claims.

8. Tax Court has authority to enforce its prior decisions on awards, Whistleblower 21276-13W v. Commissioner, 155 T.C. No. 2 (2020).

This is the third case by the same Whistleblower (W) to settle a dispute over payment of an award. W claimed that he and a fellow whistleblower were entitled to a share of $74 million in tax proceeds collected from a target. In the earlier decisions, the Tax Court approved W's claims to a portion of the proceeds and the amount of such proceeds were later determined. Settlements were reached that allowed partial payments, but amounts were reduced according to sequester orders. Taxes were also withheld.

In this case, W challenged the reduction of his awards due to the sequester reduction. The WBO asserts that all payments due have been made. The only issue for decision involves whether the sequester reductions could be applied.

The Tax Court ruled that it had jurisdiction to consider the claim. Whereas the usual remedy is remand where an abuse of discretion has occurred, there is no need for remand when the result is clear. Here a remand is futile. The amount of the award was clearly stipulated by the parties. The only dispute involves the application of the sequester. The Tax Court also determined that it had jurisdiction to enforce its judgments. Unlike a judgment finding an overpayment, where an order to refund may require other determinations, such as whether it may be applied as an offset against other tax due, the whistleblower award is much more straightforward.

On the merits, the court found that the payments ordered were clearly subject to an agreement concerning the sequester effects. Thus, the payments could be reduced. W must abide by the bargain he struck with the Service, as interpreted by the court.

Comment: The court describes this case as a cautionary tale for W's who reach partial settlements. Be clear about your deal, and back it up with proof. On the merits, a concurrence also questioned whether the same result could have been reached under a different rationale: clarification of a prior order rather than jurisdiction to enforce that order.

9. Whistleblower wins summary judgment motion when record failed to support determination that IRS took no action, Doyle v. Commissioner, TC Memo 2020-139.

Whistleblowers initially submitted a Form 211 to the WBO on behalf of an LLC. Both of their names were submitted as part of the claim. They included significant information about a nonprofit that allegedly served as a foreign agent. The WBO found that "specific credible documentation" had been provided and referred the matter of the Tax Exempt and Government Entities Division (TEGE). However, it responded to the LLC that only individual claims may be submitted; both individuals responded with separate Forms 211 including similar attachments.

TEGE referred the matter to the Criminal Investigations Division (CI), which declined to investigate the target on the basis that they did not find potential criminal activity. At this point, TGE again reviewed the claim. It issued a preliminary determination denying the claim as speculative and it did not take further action against the tax-exempt organization targeted by the claim.

Whistleblowers responded with a sharply-worded letter, expressing disbelief that the claims were not being investigated despite words of appreciation for their work from IRS and FBI agents. They also asserted that news reports indicated that investigations remained ongoing.

The WBO reviewed the IRS Integrated Data Retrieval System to confirm no open IRS examinations involved the target. It also asked CI to confirmed that no one from the IRS was working with the FBI on any criminal investigation. CI responded: “The claim was appropriately declined by criminal investigation.” Taking that to mean “no”, the WBO issued a final determination stating that the information provided did not change the decision in the preliminary determination to deny an award.

Whistleblowers filed suit in the Tax Court to review this determination. The Service filed a motion for summary judgment, arguing that it reviewed the claims and failed to investigate and did not collect any proceeds from which an award could be given.

The Tax Court rejected summary judgment to the Commissioner on the basis that the final determination did not expressly rely on the absence of collected proceeds. Tax Court review is based on the administrative record and there was insufficient evidence to show that no proceeds were collected. While a failure to investigate could be expected not to produce collected proceeds, the WBO did not rely upon this basis denying the claim and did not develop an administrative record on the point.

As for denial based on failure to take any action against the target, the court reiterated that it had no authority to order the IRS to investigate any target. However, the court also refused to grant summary judgment to the Commissioner on the basis of declining further investigation. The court considered the CI response to be a “deliberate evasion” that was not a sufficient basis for the WBO determination that no further investigation was pursued.

Comment: Lesson 1 for WBO: include “no collected proceeds” as part of the denial of every claim. Compare Neal v. Commissioner, TC Memo 2020-138 (no collected proceeds deemed sufficient basis for denial). Lesson 2: be sure that the record shows a failure to pursue the target. The absence of any Tax Court power to require the IRS to act against a target effectively means that political rather than legal constraints are operative.

10. Whistleblower wins partial victory where WBO determination did not adequately distinguish between rejection and denial of claim, Worthington v. Commissioner, TC Memo 2020-141.

Whistleblower filed Form 211 alleging that a group of law enforcement agencies illegally collected millions of dollars of “tax free illegal monies.” The classifier assigned to the claim initially thought that the matter might be referred for criminal investigation, but after being directed to reconsider the matter, she determined that it was speculative, failed to address a legitimate tax issue, and that it should be rejected. A final determination letter followed stating that “The claim has been rejected because the IRS decided not to pursue the information you provided.” W petitioned the Tax Court, and motions for summary judgment followed from both W and the WBO.

The Tax Court ruled against both parties, and in doing so, it clarified the difference between rejecting and denying a claim. A claim may be rejected if it fails to satisfy threshold criteria for eligibility, including specific, credible information that is substantive and not speculative. See generally Lacey v. Commissioner, 153 T.C. 146, 169 (2019).

A denial differs from a rejection because the WBO indicates that the IRS either chose not to proceed based on the information provided or did not collect proceeds after proceeding. Denials occur after some substantive consideration of the claim.

As for W, the Court rejected his motion because the record did not support a failure to consider his claim. The Court reiterated that it could not compel an examination, and that the standard for rejection is an abuse of discretion.

As for the WBO motion, the Court also rejected summary judgment in their favor on the ground that the record did not clearly distinguish whether the outcome was rejection or denial. The letter suggests “rejection” but it also states that the “IRS decided not to pursue the information”. While the Court cannot compel an audit, it must determine whether the basis for a rejection is an abuse of discretion. The record did not provide the reasons for such a rejection.

Comment: I doubt that this ultimately provides a good outcome for the Whistleblower, but this interim victory may clarify future determination letters and assist those seeking judicial review of an adverse determination.

D. Innocent Spouse.

1. Debtor-wife could discharge past joint tax liability in bankruptcy, United States v. Eaton, No. 2:17-v-01220 (S.D. W.Va. May 28, 2020).

Taxpayer (Wife) filed joint returns with Husband prior to their divorce. During their marriage, the couple had substantial unpaid taxes. Husband took care of the finances and often signed his wife’s name to tax documents. During 2005 and 2006, the couple’s income went up substantially. Their 2006 return, which was prepared by an accounting firm, reported over $2 million in taxable income. The couple bought two expensive homes and boats in that year, but the bulk of their reported tax liability remained unpaid.

The Government sought to collect the tax due by enforcing liens against their property, including one of the homes given to a son. However, Husband concealed these activities from Wife. The couple later divorced, and the Government began to pursue lien collections against the wife. She filed for Chapter 7 bankruptcy and the bankruptcy court discharged her debts, including the balance of her joint return liability.

At issue in this case was whether the Taxpayer’s debt was excepted from the discharge under 11 U.S.C. § 523(a)(1)(C), which requires the Government to show that the debtor willfully sought to evade or defeat his tax liability. That requirement must be met for each spouse, and it is not met through mere failure to pay the taxes due. Instead, the Government must show that the debtor had a duty to file returns and pay taxes, knew of such duty, and voluntarily and intentionally violated that duty.

Here, Taxpayer did not discover that the couple's 2006 tax liability until several years after filing the return. Taxpayer let her husband handle the finances. Even though she signed the 2006 return showing a balance due, she was not aware that Husband had not paid those taxes when the couple purchased the homes and boats. Later tax problems that emerged from their amended 2005 tax return, for which they had paid their full liability (albeit late), was not proof that she intentionally violated her duty to pay the 2006 taxes or that she knew those taxes were due and owing. Moreover, many of the documents the Government proffered to show intentional behavior were signed by Husband without her knowledge.

Comment: Bankruptcy is a more extreme route for pursuing relief from a tax debt, as compared with innocent spouse relief. Here, innocent spouse relief would likely not have been granted, as Taxpayer signed a joint return knowing that taxes were unpaid. She would have had to show that she had reason to believe that payment would be made by her husband. However, she got relief in this bankruptcy proceeding, which instead shifted the burden of proof to the Government.

2. Partial innocent spouse relief from embezzlement income, Jacobsen v. Commissioner, 950 F.3d 414 (7th Cir. 2020).

Taxpayer's former wife embezzled over $400K from her employer, which she omitted from their joint returns for the 2010 and 2011 tax years. The Service imposed deficiencies and accuracy penalties, and Taxpayer sought innocent spouse relief. The Tax Court granted relief for 2010 but denied it for 2011. The Seventh Circuit affirmed, finding no abuse of discretion.

Taxpayer worked as a machine operator at a factory, plus he had a side job doing home inspections for banks and insurance companies. His wife was an accountant who worked for a blood bank. Taxpayer deposited his wages into an account at Evergreen Credit Union, but the home inspection earnings and Wife's income (along with the embezzled funds) were deposited into a joint account at Community First Credit Union. Wife was arrested for her embezzlement in June 2011. Prior to her arrest, Taxpayer did not know of her crimes.

Taxpayer was uninvolved with the couple's finances, and the couple did not live extravagantly. The couple gambled during this time, but Taxpayer thought those funds were coming from legitimate income they had earned.

Wife was sentenced for her crimes in 2012 and incarcerated. The couple divorced in 2015. The divorce decree saddled Taxpayer with half of their unpaid liabilities for 2010 and 2011, which were also under audit. Both of them signed the Form 4549, reflecting their consent to assessed adjustments and penalties. But in January 2014, Taxpayer requested innocent spouse relief. Appeals denied all relief, but the Tax Court granted relief for 2010 but not 2011. Although Taxpayer was unaware of the unreported income in 2010, by 2011 he learned of her crimes, making equitable relief inappropriate.

The Seventh Circuit first addressed the standard of review, noting that statutory amendments to section 6015(e) require the Tax Court to engage in de novo review of innocent spouse determinations, but that change does not impact appellate review. Although an issue could be raised about whether "abuse of discretion" or "clear error" should apply, the Court found that the decision below could be upheld under either standard. Taxpayer did not have to know the particular amount of the embezzled income, only that embezzlement had occurred in 2011. Knowledge is one of the seven factors in Re. Proc. 2013-34 that the Tax Court balanced in its decision not to accord relief.

Comment: This case could have gone the other way, as the court noted: "We are sympathetic to [Taxpayer's] situation, and recognize that the Tax Court could have easily decided on this record that [he] was entitled to equitable relief …." Taxpayer would have been well advised to file a separate return for 2011 in light of the uncertain situation involving the embezzled income. Joint and several liability presents risks for an innocent spouse whenever a breach of trust has occurred, and this case illustrates that discretionary relief may not be available when you need it.

3. De novo review by the Tax Court permitted for innocent spouse claim filed before effective date of the Taxpayer First Act (Pub. L. No 116-25), Sutherland v. Commissioner, 155 T.C. No. 6 (2020).

Taxpayer's husband was convicted of tax crimes. The couple filed delinquent joint tax returns for prior years immediately before sentencing. Taxpayer believed she had to file these joint returns with her husband, when in fact she had no independent obligation to file returns in those years based on her personal income.

Later, she sought innocent spouse relief based on filing returns during a "confusing and emotional" period in her life. She did not check the box on Form 8857 indicating that she had any mental or physical health problems at that time, as she believed this required a medical diagnosis.

The Service considered her application and denied her request, which was then sent to Appeals. Believing that the Appeals Officer was not applying the proper factors affecting her relief, Taxpayer's counsel opted to stop providing evidence and to seek de novo review in the Tax Court. On November 15, 2017, Appeals issued an adverse determination. Taxpayer then petitioned the Tax Court for review.

In the meantime, Congress passed the Taxpayer First Act (Act), Pub. L. No. 116-25, sec. 1203, 133 Stat. at 988 (2019), which added section 6015(e)(7) and (f)(2) to the Code. According to the Tax Court, "Subsection (e)(7) addresses the scope and standard of our review in stand-alone innocent spouse cases. Subsection (f)(2) sets forth a limitation on the Secretary's authority to grant requests for equitable relief." The (e)(7) review requires de novo review based on the administrative record at the time of the determination plus "any additional newly discovered or previously unavailable evidence". These changes were effective for "petitions or requests filed or pending" on or after July 1, 2019.

Taxpayer filed a motion to remand the case back to Appeals in order to expand on the administrative record. However, the Tax Court rejected this motion as unnecessary, as she would have the ability to introduce evidence unrestricted by the legislative change to subsection (e)(7). The statutory language presented an issue of "structural (also called syntactic) ambiguity". An ordinance applying to "cars or boats parked or docked" would likely be interpreted to cars parked and boats docked, which accords with common usage. Alternatively, a sales tax "effective for cars or trucks sold or leased" would likely apply to "cars sold or leased or trucks sold or leased", so that these similar vehicles receive the same tax treatment.

In this context, the court considered the "petitions or requests filed or pending" to mean "Petitions filed [in the Tax Court] and requests pending [with the IRS]" on or after the effective date. As a result, the legislative change restricting review to the administrative record did not affect this taxpayer, who had filed her Tax Court petition before the effective date. The statutory canon of interpretation against superfluity also supports this result, as a request "filed or pending" would be superfluous, as all pending requests have been filed. Such a result also avoids a "gotcha" situation in which a taxpayer who filed believing the scope of review was de novo would later be constrained to the record established below.

Comment: This reviewed decision gets the right outcome. However, future litigants should recognize the constraint of de novo review limited to the evidence established in the record, plus any new evidence unavailable at that time. The Tax Court followed Sutherland in applying de novo review in Robinson v. Commissioner, TC Memo 2020-134 (granting innocent spouse relief); Leith v. Commissioner, TC Memo 2020-149 (also granting equitable relief).

E. Other.

1. Chapter 13 debtor can continue to make 401(k) contributions that reduce "disposable income" available to pay her creditors, In re Davis, 960 F.3d 346 (6th Cir. 2020).

This appellate bankruptcy case addresses the concept of "projected disposable income" under 11 U.S.C. § 1325(b)(1) and the troublesome exclusion addressed in 11 U.S.C. § 541(b)(7), which permits "any amount … withheld by an employer from the wages of employees for payment as contributions [to a 401(k) retirement plan]." A hanging paragraph following this language states: "[E]xcept that such amount under this subparagraph shall not constitute disposable income as defined in section 1325(b)(2)".

At issue here was the interpretation of that language in the Sixth Circuit. A majority ruled that the language permitted a debtor in a Chapter 13 proceeding to continue making 401(k) contributions, even though this had the effect of reducing disposable income and thereby depriving creditors of future payments. A vigorous dissent disagreed both on statutory interpretation and policy grounds.

Comment: Although this is a bankruptcy case, tax practitioners may find the quotation of various rules of statutory interpretation to be helpful in crafting arguments in tax cases. This case presents poorly crafted language that must nevertheless be interpreted and applied, as well as dubious policy outcomes that courts are hesitant to address, which Congress should fix *instead. Sadly, our Congress often disappoints; but this is no surprise, as it is made up of people like us. Uncertainty that Congress created in 2006 continues to this day.*

2. Audit adjustment based on third party records does constitute a second examination of taxpayer books and records under 7605(b), Essner v. Commissioner, TC Memo 2020-23.

Taxpayer, a cancer surgeon, inherited IRA accounts from his mother. He took distributions of about $360K in 2014 and $148K in 2015. Pursuant to his own research on the internet, Taxpayer determined that he would not be taxable on the distributions. He failed to report these amounts or to tell his professional return preparer. But of course, he got a 1099-R reporting them -- and so did the IRS.

On March 21, 2016, the Commissioner's Automated Underreporting program generated a notice to Taxpayer that it had detected a discrepancy in his 2014 return involving the IRA proceeds. On May 31, 2016, he got a similar notice for his 2015 return. Taxpayer responded to both notices that he did not agree with proposed adjustments, and the automated program generated a notice of deficiency for 2014. Complicating matters somewhat, Taxpayer also received notice of an audit for his 2014-15 tax years. A Revenue Agent was assigned to his case, and that agent proposed adjustments for the 2014 tax year but his report did not mention the IRA proceeds. While the examination and negotiation with the Revenue Agent was ongoing, Taxpayer filed a timely petition in the Tax Court involving the notice of deficiency generated by the automatic program. This petition mentioned the ongoing examination. On October 23, 2017, the Service sent a notice of deficiency for the 2015 tax year, but apparently, no additional adjustments for 2014. Taxpayer also petitioned the Tax Court over the 2015 notice.

On the substance of the distributions, Taxpayer alleged that he believed some portion of the inherited IRA reflected nondeductible contributions made by his late father. However, he was unable to obtain records to substantiate any such contributions. The Tax Court sympathized with his dilemma, but nevertheless upheld the Commissioner's determination of an underpayment.

Taxpayer also made a second claim to resist the notice for 2014. Section 7605(b) provides: "No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary." According to the Tax Court, this restriction is read narrowly. It does not limit the Commissioner's ability to assemble and consult third-party records. Here, the Tax Court agreed with the Service that the 2014 notice was not the product of an examination of his books and records, but instead was generated from third party records. Accordingly, there was no violation of this provision.

Taxpayer was assessed an accuracy penalty for the 2015 tax year. His failure to inform his return preparer was not deemed reasonable given the substantial size of the distribution.

Comment: This case illustrates the parameters of section 7605(b), as well as the need to be candid with one's return preparer. The Tax Court treated Taxpayer's claims about *nondeductible contributions as credible, but it nevertheless imposed an accuracy penalty rather than finding reasonable cause. Note that penalties for 2014 were apparently not imposed, possibly because supervisory approval requirements were not met for that year, although they were met for 2015. Finally, note that automated system operated successfully here, albeit not regularly and predictably in relationship to the time when returns are filed.*

3. Corporate tax liability accrues on the last day of its taxable year creating post-petition administration expense, In re Affirmative Insurance Holdings, No. 15-12136-CSS, 2020 WL 4287375 (D. Delaware July 27, 2020).

The federal district court addressed this appeal from the bankruptcy court on the question of how a "straddle year" is to be treated for federal income tax purposes. A "straddle year" is one in which a corporation files a bankruptcy petition during the taxable year. The bankruptcy court treated the tax liability as accruing ratably all year, thereby allocating the total between the pre-petition and post-petition periods. See 607 B.R. 175 (Bankr. D. Del. 2019). However, the United States appealed this order, as moving more of the tax liability into a post-petition period would potentially increase the Government's recovery as an administrative expense.

The district court ruled that the corporate tax liability accrues on the last day of the tax year, thereby making the "straddle year" tax a liability that arises after the bankruptcy petition has been filed. Relying in part on the Supreme Court decision in Hall v. United States (2012), the Supreme Court determined that "incurred by the estate" in section 503(b) of the Bankruptcy Code meant "to become liable" for the tax. A federal income tax cannot be computed before the end of the tax period, and in this sense it differs from a tax on a particular transaction. "Until midnight on December 31, a corporation can still, for example, incur operating expenses or make charitable donations that will eliminate any liability that would otherwise arise from income earned during the preceding twelve months." The entire year's tax thus becomes an administrative expense chargeable against the assets of the estate.

The district court agreed with the bankruptcy court that there was nothing in BAPCPA amendments to provide for this outcome, but the outcome was dictated by the underlying substantive federal tax law on when a liability accrues.

Comment: This is a potentially significant issue for creditors, who might lose a share of assets to the Government for current-year taxes and penalties that effectively become priority claims under this analysis. An appeal is pending in the Third Circuit.

4. Who gets a tax refund in bankruptcy affecting a member of an affiliated group? State law, not federal common law, decides, Rodriguez v. FDIC, No. 18-1269, 529 U.S. __ (2020).

Bank encountered hard times and entered a receivership with the FDIC. Bank Holding Company, parent of Bank, filed bankruptcy. Bank and its parent had filed consolidated income tax returns. On the basis of a consolidated return, the Service agreed to issue a $4 million tax refund. But to whom? The consolidated return regulations state only that the Service will pay a designated agent and that this will discharge the Government's refund liability. But the regulations say nothing about division of the funds among the members of the group. Private ordering through a tax allocation agreement ordinarily governs that distribution, but no such agreement is present here. So what is the rule of decision? State law? Or federal common law?

The Ninth Circuit crafted a rule some years back that essentially said the party responsible for the losses that led to a tax refund gets to keep the refund if a tax allocation agreement did not resolve the matter. This was known as the "Bob Richards rule", but it was not uniformly followed by other circuit courts. The Supreme Court thus took this case to announce the fate of the Bob Richards rule. Alas (for some), that rule is dead.

Federal common law has a modest role to play in our system, which vests legislative powers in the Congress and reserves other regulatory authority to the States. Rules of decision can be crafted in narrow areas, including where common lawmaking is required to protect uniquely federal interests. No such interest exists here. The Government's interest involves regulating how it receives taxes and in the delivery of a tax refund, but it does not extend to distributing a refund among the members of a consolidated group. Property rights in a refund must be determined by state law. Accordingly, the matter is remanded to the Tenth Circuit for a determination on that basis.

Comment: "There is no federal general common law" is an important rule to remember, and this case ensures that we go deeper in restricting the scope of even more limited incursions into state powers.

IV. Tax Litigation & Procedure

A. Jurisdiction.

Many of the cases discussed below involve the physical act of filing a petition by mail. This is quite important in the Tax Court, which currently provides on its web site: "Initial filings, such as the petition, may be filed only in paper form." See https://www.ustaxcourt.gov/electronic_access.html (visited October 27, 2020); see also Petitioners' Guide to Electronic Case Access and Filing (August 6, 2020), https://www.ustaxcourt.gov/resources/eaccess/Petitioners_Guide_to_eAccess_and_eFiling.pdf (visited October 27, 2020) ("Initial filings, such as the petition, must be filed in paper form." Page 1). But times, they are changing. The Tax Court recently announced that it would be launching an electronic case management system. Transition will begin November 20, 2020, and become active by December 28, 2020. See Press Release (October 7, 2020), available at https://www.ustaxcourt.gov/resources/press/10072020.pdf. Mail or private delivery services continue to be the vehicle for filing during this period. As of October 30, 2020, the Service will not accept hand delivery. See Press Release (October 29, 2020), available at https://www.ustaxcourt.gov/resources/press/10292020.pdf. But hand delivery was resumed as of November 16, 2020. (Press release, November 12, 2020). News sources indicate that the new system will permit electronic filing to extend to petitions. Thus, much of the law here will become less significant. The "mailbox" may go the route of the phonograph.

1. Mailing a day late deprives taxpayer of Tax Court jurisdiction for CDP hearing, Chang v. Commissioner, TC Memo 2020-19.

Taxpayer sought collection due process review for various tax years between 1999 and 2014. The Service moved to dismiss for lack of jurisdiction. The Tax Court held for the Service.

The Service mailed a levy notice (Letter 1058) on January 12, 2016, which indicated that he had 30 days to request a CDP hearing. That 30-day period expired on February 11, 2016. Here, Taxpayer and his advisor both mailed letters requesting CDP hearings. They bore no postmarks. However, the letters were not received until Tuesday, February 16, 206. Mail was not delivered on Sunday, February 14 or Monday, February 15 (President's Day). Taxpayer offered testimony that he mailed his letter on February 11. However, that testimony was contradictory and inconclusive. His advisor mailed a letter on February 12, which tended to corroborate the possibility that Taxpayer likewise mailed his letter on the same day. Expert testimony from a postal service employee indicated that a barcode stamp on the letter indicated that it had been received in the main post office after 12:00 a.m. on Saturday, which likely indicated a Friday mailing.

The Service offered Taxpayer a so-called "equivalent hearing", even though he failed to timely request a hearing. At that hearing, they had extensive discussion of the merits of his case, and a decision letter was sent on November 30, 2017, explaining their interaction and restating that Taxpayer had not timely requested hearings from the lien notices he had received. According to the Tax Court, this decision letter does not provide a basis for jurisdiction. (Compare Craig v. Commissioner, 119 T.C. 252 (2002), in which the Commissioner had erroneously issued a determination after an equivalent hearing when, in fact, Taxpayer had timely requested a hearing.) Although Taxpayer was only a day late in requesting a hearing, that did not provide the basis for relief.

Comment: Deadlines matter. Query whether Taxpayer received any professional advice on filing. Note that if an equivalent hearing is provided, there is no basis for judicial review in the Tax Court.

2. Mailing using unapproved delivery service deprives Taxpayer of "mailbox rule", Organic Cannabis Foundation, LLC v. Commissioner, 962 F.3d 1082 (9th Cir. 2020).

"This unhappy case presents a cautionary tale about the need for lawyers to ensure that they have done exactly what is statutorily required to invoke a court's jurisdiction." Taxpayer operated marijuana dispensaries. On January 22, 2015, the Service issued notices of deficiency disallowing expenses based on section 280E, assessing taxes and penalties totaling over $1.3 million. Taxpayer retrieved the notices on February 3, 2015. The cover page on the notices stated that the last day to file a Tax Court petition was April 22, 2015.

Taxpayer's law firm prepared petitions. On the afternoon of April 21, one of the firm's attorneys asked a secretary to prepare a FedEx shipping envelope for overnight delivery of the petition to the Tax Court. The secretary duly prepared the envelope for shipping, but knowing of the urgency of delivery, she chose "FedEx 'First Overnight'" as the delivery option. The label showed the shipping date of 21APR15 and that it was to be delivered by 22 APR 8:30A by "First

Overnight". However, FedEx prepared a new label bearing a notation that it was created 04/22 and designated the package for delivery on Thu-23 APR 8:30A. This label was affixed over the label prepared by the secretary. The package was in fact delivered on April 23 – one day late.

The attorney asked the secretary to check on the package on Wednesday. She called the clerk's office, who told her it had not been received. She called FedEx to check, and they responded that "the driver's delivery notes stated the driver had tried to deliver but could not because … he or she could not get to the door for some plausible reason like construction, or some sort of police action…." She got an email showing delivery on Thursday at 7:35 a.m.

The Commissioner moved to dismiss for lack of jurisdiction, and the Tax Court granted their motion based on the pleadings. Taxpayers argued that the filing date should be extended based on the inaccessibility of the clerk's office. Although federal civil procedure Rule 6(a)(3)(A) extends the due date to the first accessible day thereafter, those rules do not apply of their own force to the Tax Court, which instead has its own rules that permit federal rules to be applied when its own rules are silent. Prior decisions had ruled that inaccessibility applied to inclement weather, government closings, or other reasons, but these facts did not fit the definition of "inaccessibility". A temporary difficulty early in the day does not prevent delivery by the end of the day.

Taxpayers also argued that the "mailbox rule" of section 7502(a) should apply. The statute requires the U.S. Mail or a "designated delivery service" in order to invoke the rule. At the time of delivery in this case, Notice 2004-83 designated those services that could be used, which included FedEx, DHL, and UPS. However, FedEx services included "Priority Overnight", "Standard Overnight", but not "First Overnight". "First Overnight" was added to an updated list in Notice 2015-38 (later superseded by Notice 2016-30) only two weeks after this package was sent, but that did not make it a proper designated service when filed.

Finally, the Ninth Circuit rejected equitable tolling in this context, finding that the statutory deadline was intended as a jurisdictional limit.

Comment: A sad lesson indeed. The Secretary did everything one could have expected of her – and I would say her initiative made good sense at the time. But this shows the importance of reading the rules if you choose to use a service other than the U.S. Mail. Query what liability limit terms are baked into the FedEx boilerplate user agreement?

3. Limiting CDP review petition to 30 days after mailing upheld against due process challenge, Boechler, P.C. v. Commissioner, 967 F.3d 760 (8th Cir. 2020).

Taxpayer, a law firm, filed a petition in the Tax Court to review an adverse determination one day after the filing deadline passed. The Tax Court dismissed the petition for lack of jurisdiction. Taxpayer appealed, arguing that the 30-day time limit in section 6330(d)(1) is not jurisdictional, that equitable tolling was permitted, and that calculating this limit based on issuance rather than receipt violates due process or equal protection.

The Eighth Circuit affirmed the Tax Court. As to jurisdiction, the court looked at the text, context and history of section 6330 to determine if Congress intended the 30-day period to be jurisdictional, or merely a processing guideline that could be tolled. In this case, it found that the statutory text of section 6330 "is a rare instance where Congress clearly expressed its intent to make the filing deadline jurisdictional". In doing so, it rejected the D.C. Circuit's approach with regard to another statute that used similar language, choosing instead to embrace precedent from the Ninth Circuit that was in accord with its views. When, as here, there is a jurisdictional bar, no equitable tolling theory allows the court to decide the matter.

The Eighth Circuit also refused to grant relief based on due process or equal protection grounds. It noted that if the IRS were required to wait thirty-days until after the determination was received, as opposed to mailed, it would not be able to administer the levy in a uniform manner. The focus on the date of mailing permits the Service to address taxpayers who refuse deliver and promotes efficient tax administration.

Comment: A concurring opinion recognized a claim made by an amicus in this case, the Harvard Low Income Tax Clinic, that the impact of this rule may disproportionately affect low-income taxpayers. However, the concurring judge thought that prior precedents dictated this outcome, even though the majority found them to involve dicta or an unpublished decision. It should be noted that this claim involved a law firm, not low-income taxpayers. Neither group gets a reprieve from these clear rules, which makes judicial review in other legal fora harder to obtain based on the full payment rule of Flora.

4. Tax Court lacked jurisdiction in CDP hearing based on prior Appeals conference after tax had been assessed, Lander v. Commissioner, 154 T.C. No. 7 (2020).

Married taxpayers failed to timely file their 2005 tax return. On April 2, 2009, they filed a delinquent return for 2009. Shortly thereafter, the IRS opened an audit. Taxpayer's filed an amended return, showing their current address in Florida. During 2009, Husband, an attorney, was convicted of mail fraud and money laundering charges. He began a term of incarceration in federal prison beginning in early 2010 and remained incarcerated during the audit.

The Service issued a Revenue Agent's Report on July 29, 2011. Pursuant to a power of attorney, Wife responded to the RAR with a packet of documents labeled "Formal Protest" on August 26, 2011. That package included direction to contact her husband at his prison mailing address if further information was needed. However, the Service did not treat the packet as a protest, and since the statute was about to expire, it prepared a statutory notice of deficiency.

Two copies of the notice were prepared, with one mailed to the couple's Florida address and the other mailed to Husband's prison address in Morgantown, WV. Unfortunately, Husband was in the process of being transferred from Morgantown to a prison in Florida after the notice was mailed to him. That notice was returned unclaimed; and so was the notice mailed to the Florida address, which was admittedly the last known address of the couple. The Service retained the envelopes and other evidence showing the notices were unclaimed. It then entered assessments against the Taxpayers on July 2, 2012, followed by a Notice of Intent to Levy. Taxpayers responded with a letter to the Taxpayer Advocate Service on July 26, 2020, stating they had never received a notice of deficiency or a response to their letter styled as a protest.

The Service objected to the letter being considered a protest. But it treated it as a request to reopen the audit, and the Service offered a rebuttal based on evidence in the file. Taxpayers sent another protest on July 1, 2013, in response to this rebuttal, which was followed by further exchanges. All this time, Husband was still in prison until September 17, 2013. An Appeals Officer was assigned to the case, and the Taxpayers' position was that assessments are invalid because notices of deficiency were not sent. This was not legally accurate – they were sent, but just not delivered. The Appeals Officer eventually agreed to adjust the amount subject to levy by abating the accuracy penalty and a portion of other tax and interest. But this did not stop the levy process from continuing on the balance due.

On January 13, 2015, the Service mailed a Notice of Tax Lien filing. Taxpayers made a timely request for a CDP hearing. At the hearing, Taxpayers continued to raise claims about the failure to receive a notice of deficiency. Appeals sustained the determination, and Taxpayers filed a petition for Tax Court review. After a supplemental remand to confirm that the notice had been sent, the Tax Court took up the question of whether the assessment of the lien was valid.

First, the Court found that there was evidence the notice of deficiency was sent to their last known address. The Commissioner only had to prove mailing, not delivery. It was able to do so through testimony combined with documentary evidence including the copy of the envelope and notice of deficiency contained therein.

Second, the Court determined that Taxpayers were not eligible to challenge the underlying tax liability in this proceeding. In order to make such a challenge, they would have to prove that they "did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability." (*quoting* IRC 6330(c)(2)(B)). On this point, the Service argued that Taxpayers did have a chance to dispute the underlying liability based on the audit reconsideration process outlined above. The Tax Court agreed. Here, the two alternatives are stated disjunctively. Even though they did not actually receive the notice of deficiency, Taxpayers actually got relief from Appeals after the deficiency was assessed. Taxpayers may not have found this opportunity to their liking, as they chose to focus on the fact that they did not receive a notice of deficiency. But the record shows that the underlying liability was indeed discussed. This conference satisfied the definition for an opportunity to dispute the underlying liability. The Tax Court thus had no jurisdiction to review a later challenge to the underlying liability.

Comment: This case confirms that your opportunities for judicial review of the underlying tax lien in the Tax Court are limited. These taxpayers missed the opportunity to petition the Tax Court because they did not get the notice of deficiency on a timely basis. But then, after an initial assessment of the tax, they got an opportunity to dispute the underlying tax through a meeting with Appeals. This court found that such an opportunity was all the due process you are entitled to based on section 6330: the later assessment and CDP request did not provide another opportunity to review a substantive challenge. These taxpayers will have to pay the tax and file a refund claim to get judicial review of their tax due. (See note 10).

This case also illustrates the importance of monitoring one's last known address. It may seem unfair that H's notice was not delivered, as his absence from Morgantown prison may not have *been something he planned. After all, the prison system is run by the same Government that is trying to take away his stuff! But the fault of not getting the mail through to him was on the prison, and this was not attributed to the IRS, which had properly mailed the notice. Moreover, W still had access to the copy sent to their home address and she had previously acted on the couple's behalf in tax matters. Query why she did not pick up those notices.*

5. Tax Court lacked jurisdiction over passport "seriously delinquent debt" controversy, Ruesch v. Commissioner, 154 T.C. No. 13 (2020), affirmed, 805 Fed. Appx. 12 (2nd Cir. 2020).

In 2018, the Service assessed $160K of penalties under section 6038 for failing to file information returns for foreign corporations during the 2005-10 tax years. Section 6038 provides for penalties of $10K/period/failed reporting period, which allows these penalties to dollar up fairly quickly. On April 16, 2018, the Service issued a notice of intent to levy. Taxpayer responded with a request for a hearing.

Meanwhile, on December 17, 2018, the Service sent notice to Taxpayer that it was certifying a "seriously delinquent" tax debt to the State Department. This leads to revocation of Taxpayer's passport under IRC § 7345. A "seriously delinquent" debt does not include debt that is subject to a CDP hearing. However, there was some confusion here about whether the hearing requested was one under the "Collection Appeals Program" or CDP hearing. The Service stipulated that it would revise the certification if it determined a CDP hearing was requested. In September 2019, it determined that a CDP hearing had been requested, thereby vacating the certification of "seriously delinquent" debt. The Service then moved to dismiss on the grounds of mootness – Taxpayer had gotten what she had requested in the form of reinstatement of her passport.

The Tax Court agreed with the Service. Under section 7345, the Tax Court's jurisdiction is limited to determining whether that certification is "erroneous", and the only relief is to notify the Secretary of State. Taxpayer already got that relief here. As for Taxpayer's desire to challenge the underlying penalty, section 7345 does not confer additional jurisdiction to redetermine penalty liability. In this case, section 7345 penalties are also outside the court's deficiency jurisdiction. Tax Court review of the liability may also proceed after an adverse determination in a CDP hearing, where neither a notice of deficiency nor a prior opportunity to review has been afforded to the taxpayer. No such determination has been made here, making this claim premature. And while IRS could change its mind and put a hold on Taxpayer's passport again, Taxpayer could not show that this was a reasonable possibility. Instead, the first hold was apparently based on a computer coding error, and it was soon reversed. There was no indication in the record that the IRS would "return to its old ways". Taxpayer also argued that the category of "seriously delinquent tax debt" could only be certified once, but the court found no basis for such a restriction.

Comment: This case exemplifies the process constraints for a tax where a notice of deficiency would not be available. A challenge in a CDP hearing might provide the ticket to Tax Court review. Otherwise, payment and refund litigation would be the only viable path for judicial review of the underlying liability.

6. Taxpayer successfully proves mailing of Tax Court petition, thereby preserving jurisdiction, Seely v. Commissioner, TC Memo 2020-6.

The Service mailed a notice of deficiency to Taxpayers on March 28, 2017, which stated the due date for filing a petition in the Tax Court would be June 26, 2017. Taxpayers hired an attorney who prepared a petition and mailed it on June 22, 2017, in an envelope properly addressed to the Tax Court. The envelope had proper postage, and it was eventually delivered on July 17, 2017, 111 days after the notice of deficiency was mailed. However, there was no discernable postmark to show the date of mailing.

The Service moved to dismiss the petition for lack of jurisdiction. However, Taxpayers objected and introduced an affidavit from their attorney stating that he mailed the petition on June 22, 2017, before the 90-day deadline.

The parties thus did not dispute delivery, but only disputed proof of mailing when no postmark was present. In these circumstances, extrinsic evidence can be admitted, and the party seeking to prove mailing must present "convincing evidence" of timely mailing. Testimony is permitted evidence. The Service also introduced evidence showing that the normal delivery period ranged from 8 to 15 business days from any location in the United States. Using the maximum period, if the Taxpayer's attorney had mailed the petition on June 22 as he claimed, delivery would have been on July 14, 2017. But that was a Friday – and the petition was delivered on the following Monday. This was not enough to "unconvince" the court. After all, it was only one day outside the window and the Fourth of July holiday occurred during the intervening period.

Comment: The Tax Court distinguished this case from Baldwin v. United States (9th Cir. 2019), in which the court ruled that Taxpayer could not rely on the common law mailbox rule to prove delivery where delivery was contested. Here, delivery was undisputed. But the bigger lesson: use certified mail or an accepted delivery service (see Notice 2016-30) to avoid uncertainty. If this petition had been "lost in the mail" Taxpayer would be out of luck. Plus, I do not think the costs of resisting this motion were less than the cost of certified mail or a Federal Express envelope. Compare Moukhitdinov v. Commissioner, TC Memo 2020-86 (error in zip code due to appending additional numbers did not prevent proof of mailing to last known address).

7. USPS postmark controls over private postmark in mailing petition, Thomas v. Commissioner, TC Memo 2020-33.

Taxpayers, a married couple, received a notice of deficiency dated December 4, 2017. On March 5, the date their Tax Court petition had to be mailed, Wife got a postage-paid envelope from her employer and took it home with her. Husband prepared the petition, put it in the envelope, and on either March 5 or March 6, deposited the envelope in a mailbox, in which the collection time was ordinarily 5:00 p.m. The Tax Court received the petition eight days later, but 98 days after the date of the statutory notice of deficiency. The letter showed the private postmark from the employer's system as well as a second postmark dated March 6.

Did the Tax Court have jurisdiction? It did not. Regulations provide that when an envelope has two postmarks, one of which is made by the USPS and another which is not, the USPS mark governs. Taxpayer testified that he placed the mail in the post box before 5:00 p.m.

on March 5. But even if the court found that testimony credible, it could not permit the petition to be considered timely filed when the postmark bears a date after March 5.

Comment: This case provides another example of the perils of failing to use certified mail or an approved private delivery service. Apparently, even if the post office picked up the mail early, before the 5:00 p.m. sign on the box, that would not change the outcome. The postmark becomes conclusive proof – if there is a mark. (See above). See also Rivas v. Commissioner, TC Memo 2020-124, which held that the USPS postmark date, not the date Taxpayer's attorney allegedly deposited the petition in a mailbox, controlled for purposes of determining timely filing. This reminds me of the old joke about the umpire, who was asked if he had ever missed a call. His response: "They ain't nothing until I call 'em." Before instant replay, we still had our doubts, but all we had was futile argument.

8. Tax Court has no jurisdiction over interest dispute in deficiency proceeding, Liu v. Commissioner, TC Memo 2020-31.

Taxpayers, a married couple, each owned half of an S corporation. They erroneously reported their S corporation income as a qualified dividend in the 2012 and 2013 tax years. After audit and a notice of deficiency, they petitioned the Tax Court. The Tax Court ruled that they indeed owed additional taxes on the ordinary income passed through from their S corporation, which could not qualify as a qualified dividend.

Perhaps reading the writing on the wall about their chances at trial, Taxpayers paid the tax due in 2018, before their deficiency case had been decided. This amount was duly applied to their account. However, Taxpayers also raised a challenge to the interest assessed against their account. Here, the Tax Court declined to rule on the ground that it lacked jurisdiction to determine interest in a deficiency proceeding. That claim must be raised after assessment in a collection action, which had not occurred. In fact, a tax lien that had been recorded erroneously despite the Tax Court deficiency proceeding had since been released by the Service, so there was no pending collection action.

Comment: The interest claim would have to wait until a separate proceeding. Or maybe these taxpayers will also read the writing on the wall and pay it.

9. Erroneous denial of challenge to underlying tax liability at earlier CDP hearing deprives Taxpayer of later Tax Court review, McNamee v. Commissioner, TC Memo 2020-37.

Taxpayer was a CPA who engaged in tax return preparation for clients. On March 5, 2013, the Service sent numerous Letters 1125 to Taxpayer explaining a proposed assessment of preparer penalties for returns of 18 of his clients in 2009. These penalties included $1000 amounts for "unreasonable positions" under section 6694(a) and $4000 amounts under section 6694(b) for "willful or reckless conduct". The latter penalties were eventually abated.

The Letters 1125 advised Taxpayer that if he did not protest by April 4, 2013, the Service would assess the penalties and begin collection actions. Taxpayer got an extension to submit his protest until April 19, 2013, but Taxpayer refused to extend the statute of limitations. The

Service proceeded to assess the penalties for 2009 along with additional penalties for some other taxable years.

Taxpayer filed his protest by the due date, but the Appeals Office sent the matter back to examination for additional factfinding. Examination never returned the case to Appeals, so there was no final determination at this point.

In February 2014, the Service issued a Notice of Federal Tax Lien covering the 2009 penalty assessment. A Settlement Officer was assigned to the case, and Taxpayer timely requested a CDP hearing. At that hearing, the Settlement Officer informed Taxpayer that liability challenges to return preparer penalties were not permitted in a CDP hearing. (At trial, the Service conceded that this was erroneous.) A notice of determination followed. Taxpayer filed a petition in the Tax Court four months after the due date, and that case was dismissed for lack of jurisdiction.

Taxpayer then received a second tax lien notice from the Service, and he timely requested a CDP hearing. Taxpayer again challenged the assessment of the penalties, but the Settlement Officer determined that Taxpayer had a prior opportunity to challenge the underlying liabilities, and so no challenge would be entertained in that hearing. This petition to the Tax Court followed that determination.

The Tax Court declined jurisdiction over the Taxpayer's challenge to the underlying penalty assessments. After first disposing of the issue of whether a timely petition had been filed (Taxpayer had filed the petition during a Government shutdown, requiring Federal Express to return his package as undeliverable), the Tax Court ruled that it had no jurisdiction because Taxpayer had a prior opportunity to dispute the penalties. Although he was erroneously advised he could not dispute the penalties in the first hearing, he had an opportunity to file a petition in the Tax Court to challenge that determination. He failed to do so on a timely basis.

Accordingly, the Tax Court could only review the assessment for an abuse of discretion. Taxpayer claimed that a failure to issue a final administrative determination on his initial protest of the penalties was an abuse of discretion, but the Tax Court ruled that this did not adversely impact the assessment process in this case. Unlike an appeal of a trust fund recovery penalty, where section 6672(b)(3) extends the statute of limitations for assessment pending a final administrative determination on the protest, there is no similar suspension for preparer penalties. It was appropriate to assess the tax where the Taxpayer would not extend the limitations period.

Comment: According to the Tax Court, the current Internal Revenue Manual indicates the IRS will not submit a preparer penalty case to Appeals unless a full year remains on the limitation period. So, prepare to extend the statute or deal with the matter through CDP processes. Also note a big lesson here: if the IRS tells you the wrong thing, your remedy is in the Tax Court. Failure to avail yourself of that remedy can result in losing the ability to obtain Tax Court review.

10. Taxpayer lost opportunity to challenge underlying TFRP based on $1 OIC, Shepherd v. Commissioner, TC Memo 2020-45.

Taxpayer was the CEO of an LLC that filed Form 941 but failed to pay over the employment tax amounts. The Service assessed a trust fund recovery penalty (TFRP) against him as a responsible person. Payment was not forthcoming. In October 2013, the Service mailed a notice of intent to levy against him. Taxpayer requested a CDP hearing. Taxpayer requested a hardship waiver, and the Service placed his account in "currently not collectible" status. In March 2016, Taxpayer submitted an OIC offering $1 in full satisfaction of the TFRPs on the basis that his liability was in doubt. The Service rejected his OIC, and Taxpayer requested review by Appeals. Appeals affirmed the rejection of the OIC, stating that they could discuss reducing the amount only if he would withdraw the OIC. Taxpayer did not withdraw the OIC, and he did not file any petition for further review in the Tax Court.

In February 2018, the Service took Taxpayer's account out of "currently not collectible" status based on its determination that Taxpayer's financial standing had improved. It sent a new notice of tax lien and sought to collect the balance of the TFRP. Taxpayer sought review by Appeals, but it rejected any challenge to the underlying liability because Taxpayer had a prior opportunity to challenge but did not do so. Tax Court review followed.

Before the Tax Court, the Service argued that Taxpayer had two opportunities to contest his liability (i.e., in 2013 and 2016), but he failed to do so. The Tax Court agreed. Summary judgment was appropriate for the Service in this case.

Comment: This is yet another example of the importance of using CDP hearings effectively. You snooze, you lose. See also Lambert v. Commissioner, TC Memo 2020-53.

11. Tax Court lacked jurisdiction over notice of deficiency that imposed no tax, but only reduced withholding credits, Pope v. Commissioner, TC Memo 2020-62.

Taxpayer filed his 2017 tax return, which reported wages of over $42K and a tentative tax of $1,698. He claimed childcare and child tax credits for $1,698, thereby reducing his tax liability to zero. However, he also claimed tax withholding of $8,929 and an additional refundable child credit, thereby requesting a refund of over $9,000 based on this alleged overpayment.

The Service examined the return and determined that his wages were only $2,448, from which his employers had withheld $1,073. It apparently disallowed child credits and ultimately sent a contact letter for the "automated questionable credit program" showing that $7,856 of the credits claimed on his return had been disallowed (i.e., the difference in withholding claimed and actually determined on audit). Taxpayer did not respond.

On November 20, 2018, the Service issued a notice of deficiency showing that it had been unable to verify reported wages and withholding, and that the amount of his deficiency was $0. The notice explained a downward adjustment to his AGI and the $7,856 reduction in withholding credits. The notice also falsely stated that he had improperly tried to claim an earned income credit for income earned as an inmate, which was ineligible for that credit. However, Taxpayer did not claim an EIC; he only claimed childcare and child tax credits. On

March 15, the Service issued a refund check for $1,215, representing his overpayment plus the additional child credit of $142 and interest of $58.

Taxpayer filed a timely petition in the Tax Court after the notice of deficiency. He alleged he was not an "inmate" and had not been incarcerated during 2017. The Service filed a motion to dismiss based on a lack of prosecution, but Taxpayer appeared for the calendar call in January 2020. The Service substituted a motion for lack of jurisdiction.

The Tax Court agreed. First, section 6213 confers jurisdiction to make a "redetermination of the deficiency" determined by the IRS. A deficiency is the amount by which the correct amount of tax exceeds the amount of tax shown on the return. The tax imposed on the return does not include credits for withholding. Therefore, withholding credit adjustments fall outside the deficiency jurisdiction of the Tax Court.

Here, there was no deficiency created by the IRS adjustment of withholding credits. Taxpayer's reliance on Dees, 148 T.C. 1 (2017), which addressed a refundable credit disallowed by the Service, was determined to be misguided. Unlike in Dees, the notice of deficiency in this case was unambiguous. Even if it had been ambiguous, the Taxpayer must still show that the Commissioner determined a deficiency. A reduction in a refundable credit is akin to a tax increase, but there was no similar tax increase here, as no refundable credits were disallowed; only withholding credits were affected, and these are outside of deficiency jurisdiction. If there was a deficiency, the Tax Court could determine whether an overpayment exists. See IRC § 6512(b)(1). But without a deficiency, the Tax Court is powerless to adjudicate.

Comment: Apparently, a Taxpayer with no deficiency and who claims only withholding credits is relegated to the district court or the claims court to pursue judicial review. In effect, this becomes a refund claim rather than a claim for the Tax Court. But apart from the money, I can understand why this Taxpayer might want a court to tell the IRS that it was wrong about treating him as an "inmate" when that was not true.

12. Taxpayer's payment was a deposit that did not extinguish the deficiency and thereby prevent Tax Court jurisdiction, Peacock v. Commissioner, TC Memo 2020-63.

Taxpayers received a 30-day letter proposing adjustments to their Schedule C expenses, which resulted in a proposed deficiency of about $8500. Taxpayers met with the Revenue Agent, who then removed the accuracy penalty and reduced the tax and interest due to $7,192.43, issuing a corrected Form 4549-A on April 7, 2016. On April 8, 2016, Taxpayers delivered a check for $7,192.43, payable to the U.S. Treasury, which was accompanied by a cover letter that included allegations of fraud against a stock exchange that related to these claimed deductions, along with a request for a follow-up meeting to discuss amending their return to more accurately reflect fraud expenses. The letter also stated: "I do, however, respectfully disagree completely with your determination." Taxpayer also indicated that he would be requesting review by Appeals.

Taxpayer also communicated with Appeals, indicating that "I made it crystal clear that this payment was made in protest, and that I completely disagreed with the IRS determination."

Appeals issued a notice of deficiency on March 27, 2017, showing a deficiency of $6544. Taxpayers filed a petition on May 24, 2017. The Service moved to dismiss the case for lack of jurisdiction on the basis that the deficiency had been extinguished before the notice had been issued.

The Tax Court wrestled with the distinction between a payment and a deposit. Rev. Proc. 2005-18 provides guidance on the matter of submitting a deposit. A taxpayer may designate a payment as a deposit. Taxpayers argued that their statements clearly stated this intention, and that the Service effectively treated the payment as a deposit by issuing the notice of deficiency after receiving the payment, as well as by continuing to trial. However, the Service pointed to the memo line on the check, which stated "payment". Moreover, an undesignated remittance will be treated as a payment.

Reading the letter along with the check, however, the Tax Court found that Taxpayer had expressed a desire to dispute the deficiency and did not merely disagree with the adjustment. This was similar to a "stop interest" order that Rev. Proc. 2005-18 recognizes as language creating a deposit.

The Tax Court also examined how the Service treated the remittance. The IRM indicates that an undesignated remittance will be treated as a payment; in that case, a notice of deficiency would not be issued. IRS examination personnel are instructed by the IRM to "look for a statement that this constitutes an advance payment or evidence that the taxpayer intends to file a protest." Issuing the notice of deficiency thus provided evidence that the IRS treated the payment as a deposit.

Comment: Taxpayers get their day in Tax Court, instead of a refund claim. But if the notice of deficiency is evidence that the IRS treated the remittance as a deposit, shouldn't we have a broader rule allowing deposit as a default in such matters, up and until a Tax Court petition is filed?

13. Tax Court believes Taxpayer testimony in determining whether he received notice of deficiency, Nguyen v. Commissioner, TC Memo 2020-97.

Taxpayer received a notice of determination concerning collections actions regarding a lien filed to secure unpaid tax liabilities for 2006-09. Taxpayer petitioned the Tax Court, challenging the underlying liabilities as well as alleging an abuse of discretion in sustaining the lien filing.

The Tax Court engages in de novo review of a determination of underlying tax liability but reviews other administrative matters only for abuse of discretion. In the Ninth Circuit, administrative matters are reviewed based on the administrative record, including material available to review. However, de novo review may contemplate additional evidence introduced at trial, which goes beyond the record. Here, that involved Taxpayer testimony.

A Taxpayer may challenge the underlying liability in a CDP hearing only if he did not have an opportunity to otherwise dispute the liability. If a notice of deficiency is properly mailed to Taxpayer's last known address, the notice may be valid even if Taxpayer did not actually receive it. Settlement Officers must verify this mailing in making their determination. However, Taxpayers may also be eligible to establish that even if properly mailed, the notice was not received. In this case, Taxpayer was permitted to testify on this point, even though he conceded that the notice had been mailed to his last known address and that he received other notices. He had not refused delivery either. The Tax Court found he credibly testified he did not receive any notice, and it agreed to treat him as though he did not receive one.

However, Taxpayer failed to challenge the liabilities at his administrative hearing. Merely raising the issue without presenting any evidence is not sufficient for this purpose. Moreover, amended returns are not evidence for this purpose.

Comment: This case may provide hope for taxpayers who presented evidence to support their claims at their CDP hearing, but had their claim rejected on the basis that they had a prior opportunity to challenge the underlying liability by responding to a notice of deficiency.

14. Failure to sign amended return deprived Claims Court of jurisdiction, Clark v. United States, No. 19-713T (Ct. Fed. Cl., July 27, 2020)

Taxpayers hired Castro to prepare their 2016 returns. In the process, Castro discovered errors in the 2014 and 2015 returns. On October 16, 2017, Castro filed amended returns for those tax years. Taxpayers did not sign these returns, however. Castro signed both the Taxpayer signature line and his own line as “paid preparer”. No power of attorney (Form 2848) was attached. These amended returns claimed refunds of about $19K for 2014 and $24K for 2015.

In 2018, Taxpayers received a letter that their amended returns were selected for examination. In July 2018, they appointed Castro as their representative in dealing with the examination. The examination proceeded with IDRs to the Taxpayers, to which they responded with documents. But no resolution was forthcoming.

Taxpayers filed a refund claim in the Claims Court on May 15, 2019. The Government moved to dismiss on the ground that their refund claim failed to comply with Treas. Reg. § 301.6402-2(b)(1), in that the claim was not “duly filed” because it was not “verified by a written declaration it was made under penalties of perjury”. If they had signed the return, that requirement would have been met. Taxpayers countered by arguing that the IRS waived that regulation by examining the return.

The Court of Federal Claims dismissed the suit for lack of jurisdiction. Although waiver by the IRS can potentially apply, Taxpayers failed to meet the “extremely heavy burden” of doing so here. The Government’s action in this case – commencing an examination of the disputed returns – did not involve a determination on the merits. Although the court noted that an action short of a determination on the merits could, in a proper case, support a waiver, Taxpayers would have to show that the IRS intentionally relinquished or abandoned a known right or privilege. In other words, the IRS must have either known, or should have known, that the signature was not their own. The court noted that the signatures on the amended returns were illegible. Taxpayers submitted Form 2848 with their signatures several months later. The IRS was under no obligation to compare those at that time, and the court did not see evidence that they did so.

Comment: Not signing the amended return is likely a fatal defect. Query whether the statute was kept open as a result of the pending audit so that those defects could be cured with a later filing.

B. Statutes of Limitations.

1. Financial disability potentially tolls refund statute for over 15 years for inmate committed for psychiatric treatment, Wattleton v. Mnuchin, No. 19-1893 (BAH), 2020 WL 4365487 (D.D.C. July 30, 2020).

Taxpayer was indicted in 1999 for telephonic threats involving fire or explosives. He entered a plea of not guilty by reason of insanity, and a jury so found. He was committed to federal custody, where he remains "currently [and] indefinitely committed" for psychiatric treatment. Taxpayer filed a refund claim for the 1993-99 taxable years, and in May 2019 this claim was denied. This complaint followed, in which he claimed he suffered from a financial disability on account of mental health conditions, including a delusional disorder.

The Government successfully moved to dismiss claims against Secretary Mnuchin, which were barred by the doctrine of sovereign immunity. However, the refund claim against the United States, which was added as a party to the complaint, was sustained. Section 6511 of the Code ordinarily imposes a statute of limitations for refund claims where, as here, Taxpayer did not file returns, to extend two years from the year of payment. However, section 6511(h) suspends the limitation period while the individual is "financially disabled".

The Government conceded that a disability existed during the 1993-99 period, but it then claimed the period ended and the statute has now run. However, Taxpayer alleged that his disability continued and that mental health issues are ongoing. He also alleged that there was no other person authorized to act on his behalf. Revenue Procedure 99-21 provides guidance for proving disability, and it was unclear from the record whether Taxpayer included adequate proof. However, it was enough to resist the Government's motion for summary judgment.

Finally, venue remained at issue. In the D.C. Circuit, venue in the federal district court is improper for a refund claim by a nonresident. The Government sought to transfer venue to the district court in Minnesota, where Taxpayer was incarcerated. This would be proper under D.C. Circuit rules, which permit venue if a litigant is incarcerated there. However, Eighth Circuit precedent does not treat long-term incarceration as residency for this purpose, as it is involuntary. Thus, the Minnesota court would likely resist transfer on that basis. Accordingly, the D.C. district court ordered the case transferred to the Northern District of Georgia, where Taxpayer had residency prior to his incarceration.

Comment: Often tolling on the basis of disability is tough to prove because someone else has authority to act on Taxpayer's behalf. (Recall our discussion last year of POAs – even unused ones – potentially triggering legal problems for elderly taxpayers who seek to handle their own affairs but fail to prosecute refund claims.) Taxpayer has an uphill battle, but he may yet succeed. Note also the venue issue presented here where a taxpayer is incarcerated.

2. Statute of limitations triggered by filing return that was rejected for failing to include IP PIN, Fowler v. Commissioner, 155 T.C. No. 7 (2020).

Taxpayer filed Form 4868 on or before April 15, 2014, to extend the time to file his 2013 return. Taxpayer then electronically submitted his 2013 return on October 15, 2014, October 28, 2014, and April 30, 2015. Only the final submission was accepted.

When the October 15, 2014 submission was made, Taxpayer's CPA received a "Submission ID", which is a 20-digit number assigned to electronically filed returns. The Service nevertheless rejected the return, citing code "IND-181" which indicates a failure to provide a valid Identity Protection Personal Identification Number (IP PIN) with that return. An IP PIN is issued to validate the identity of one whose identity had been compromised in the past tax year. The Service contended – and the court accepted as true – that such a number had been provided to Taxpayer at the end of 2013 based on a compromised identity.

Taxpayer then submitted a paper return, signed by Taxpayer using DocuSign, and submitted it on October 28, 2014. A return receipt was signed by an IRS employee. However, in December 2014 Taxpayer received a notice that the IRS had not received his return. This triggered the third submission on April 30, 2014. This one included the IP PIN and the IRS software reviewed and accepted it.

On April 5, 2018, the Service issued a notice of deficiency. Taxpayer filed a petition in the Tax Court, which alleged that the deficiency was barred by the statute of limitations.

The Tax Court ruled in favor of the Taxpayer, finding that the October 15 submission was a "required return" that was "properly filed", thereby triggering the limitations period to begin. Applying the *Beard* factors, the court had no trouble finding that his was an honest return filed with proper information and signed by the taxpayer. The Service argued that the signature requirement had not been satisfied in this case on account of the failure to include the IP PIN. However, they could point to no legal authority for this requirement. Moreover, the instructions for filing required only the PIN to permit electronic filing, for which Taxpayer was compliant. The Service sought refuge in the Internal Revenue Manual, but the court rejected that argument: just because the IRM instructs that software will reject the return does not make an IP PIN part of the legal requirement for a signature. The Tax Court noted that where an ERO, such as Taxpayer's CPA, prepares a return, the ERO is required to authenticate the individual, which should make the IP PIN superfluous. Moreover, nothing in the Code requires a more onerous burden for signing by a taxpayer who has suffered identity theft.

Moreover, the return was also properly filed, as required in the *Beard* factors. The record shows that the IRS received the electronic return in October 15, 2014. Here, the mode of filing, not what the IRS received and understood, governs whether proper filing occurred.

Comment: This is a good outcome for this taxpayer. But consider one who has a refund claim. The fact that the IRS rejects the original filing, and a subsequent filing is not approved until much later, may in fact trigger the limitations period on a refund under similar logic. I can sympathize with this taxpayer as I had to prove my identity before the Service would accept my *return – which by the way, included a check for taxes due and owing, not a refund claim. Is it plausible that a return with a tax payment would not be the real deal?*

C. Remedies.

1. IRS abused discretion by requiring Taxpayer to sell property prior to entering installment agreement, Kirkley v. Commissioner, TC Memo 2020-57.

Taxpayers owed nearly $4 million in taxes, interest, and penalties for the 2013 and 2014 tax years. They did not dispute their liability, but sought to enter into an installment agreement, stating that they were attempting to borrow against their home equity. Moreover, Taxpayers were already making installment payments of almost $50,000 per month on delinquent state and local taxes, which would be satisfied after one more payment. Taxpayers proposed to pay $50,000 per month toward their federal tax burdens, plus a lump sum from their equity in real estate after it had been sold.

The Settlement Officer (SO) rejected their proposal on the basis that the IRM did not permit an installment agreement before Taxpayers liquidated their assets and paid the proceeds to the Service. She also found that Taxpayers had only about $3,438 per month in disposable income, which would be unable to support the $50,000 per month payments. Her determination letter stated that all assets, except two vehicles, would have to be sold and paid over to the Service before entering any installment agreement.

The Tax Court ruled that this determination was an abuse of discretion. It found that the IRM did not automatically mandate the sale of all of a taxpayer's property as a precondition of entering into an installment agreement. Among other things, the record did not show that the Settlement Office considered whether properties were "assets necessary for the production of income or the health and welfare of the family". Moreover, the IRM requires some flexibility in dealing with home equity. It states in part:

> If the taxpayer does not attempt to borrow on the home he must be notified that, though the installment agreement request is pending, it will be recommended for rejection. If the taxpayer is able to get a home equity loan and the monies are used to pay taxes, the amount of the payment on the loan will be considered an allowable expense. However, if the taxpayer applies for a loan but the loan is not approved, every effort should be made to preserve the installment agreement. It would promote voluntary compliance and be in interest of the government.

The Tax Court remanded the case for further consideration, noting that the record did not show that the Settlement Officer "balanced the need to collect tax with the legitimate concern that the collection action be no more intrusive than necessary."

Comment: This case illustrates the Tax Court's role as an important safeguard over what appears to be overreaching by Settlement Officers. Collection zeal might benefit the Treasury in the short run, but it may also undermine long-run support for the tax system. But that zeal is sometimes needed to prevent abuse by taxpayers. Compare Strashny v. Commissioner, TC Memo 2020-82, in which Taxpayers were refused an installment agreement on the basis that they had cryptocurrency accounts totaling more than $7 million which they refused to liquidate to pay off over $1.1 million in tax debt. Those taxpayers showed no hardship or other basis for relief, *other than an apparent desire to pay their tax debt over time. Depending on the times, cryptocurrency may have a ROR higher than the AFR!*

2. Government shutdown during CDP review did not create grounds for disputing assessment, Nesbitt v. Commissioner, TC Memo 2020-61.

Taxpayers filed a delinquent return for 2014 that reported additional tax due, which they did not pay. The IRS assessed the tax and penalties, which remained unpaid. A notice of intent to levy followed. Taxpayers requested a CDP hearing, but they did not challenge the underlying liability, only their ability to pay.

Appeals scheduled a telephone CDP hearing for January 15, 2019. The Settlement Officer requested financial information along with tax returns for 2015 and 2016, which the IRS records indicated had not been filed. However, due to a government shutdown, the hearing could not be held. The Settlement Officer (SO) called Taxpayers and left messages for them, but they did not respond. She sent another letter rescheduling the hearing for March 5, 2019, and Taxpayers submitted incomplete financial information before that hearing. Taxpayers did not answer the phone on the scheduled hearing date, so SO left a message. Eventually, she sent a "last chance" letter that required Taxpayers to send her complete information or she would close their case. Receiving no response and noting that no 2015 and 2016 returns had been filed, the SO verified that the assessment was proper.

Taxpayers sought review in the Tax Court, which granted summary judgment to the Commissioner. The shutdown and related telephone problems had no impact on the determinations made here. Taxpayers did not provide documents. Failing to file tax returns in subsequent years is an independent ground for rejecting relief from collections. See Chadwick v. Commissioner, 154 T.C. No. 5 (2020).

Comment: The Tax Court notes that Taxpayers remain free to submit, at any time, a collection alternative. Query why pursuing pro se Tax Court review took priority over completing basic financial documents, including 2015 and 2016 tax returns.

3. Married taxpayers who file joint returns, divorce, then "up and die", create a tangled web of tax payments and remedies, Richlin v. Commissioner, TC Memo 2020-60.

Abigail and Milton married in 1993. They executed a prenuptial agreement that required Milton to be liable for all taxes incurred during the marriage, and to hold Abigail harmless from any such liability other than that which attended to Abigail's separate property or earned income.

The couple filed a joint return for 2005, which showed an overpayment. This was applied to their estimated tax for 2006. Milton made other estimated payments for 2006 from a trust account, using vouchers that identified the tax payments with the couple. On April 16, 2007, Milton sent in another check on the trust account to accompany Form 4868, which extended the due date for their 2006 return.

On January 24, 2007, a decree of divorce was issued by a Nevada court. Milton had filed for divorce in April 2006. In May 2007, Milton petitioned the divorce court to mandate that Abigail pay her share of the couple's 2006 taxes, which included a gain of about $1.5 million derived from Abigail's separate property. This tax liability was supposedly covered by estimated payments drawn on Milton's trust account. However, while this suit was pending, Milton died. In March 2008, the divorce court ordered Abigail to pay any obligation related to her own property. (However, it did not require her to reimburse Milton for any payments made.)

Abigail filed her own return for 2006, in which she claimed a filing status of married filing separately. On that return, she claimed as credits half of all the following: (1) the overpayment shown on the 2005 joint return she had filed with Milton; (2) estimated payments made by Milton for 2006; and (3) the extension payment Milton made in April 2007. The credits exceeded the tax shown as due.

However, in 2010, Abigail received a Notice of Federal Tax Lien for unpaid taxes in the 2006 tax year. She requested a CDP hearing, and in that request she stated that she did not owe the tax because the IRS failed to credit her with tax payments made by her late husband, and alternatively, she could not pay and collection should be delayed to address "less intrusive alternatives". Following the hearing, Abigail and the Service executed Form 12257, which states the determination that credits were erroneously transferred back to her deceased husband, and that the "correct resolution" is to credit the taxpayer, which would eliminate her tax liability and cause the lien to be released.

In the intervening period, Milton's estate had claimed entitlement to those credits, and IRS counsel had agreed that the estate, not Abigail, was entitled to them. In 2013, the Service decided to renew collection activity against Abigail for the 2006 tax year. A second Form 12257 was executed in August 2014, indicating that "a collection alternative has been reached" and continuing the CDP hearing. Upon continuation, Abigail rejected discussion of collection alternatives and rested her case on the credits being applied to her account, not Milton's. Finally, a notice of determination was issued to Abigail upholding the determination of her tax liability, based on advice from IRS counsel that, based on the interpretation of the prenuptial agreement, tax liability for Abigail in 2006 related to her separate property, and thus Milton deserves the entire credit for payments he made for that year.

Tax Court review ensued, including de novo review of the underlying liability and abuse of discretion review based on other matters. In this case, such review was based on the administrative record, although the court noted that some questions exist about this issue.

Taxpayer alleged that Appeals abused its discretion by sustaining the levy action, citing four reasons. First, she argued that the summary notices executed in Form 12257 in 2012 and later in 2014 created a binding promise for the Service not to execute the lien. The Tax Court rejected this position. Outside of a closing agreement, an installment agreement, or an offer-in-compromise, the Service is not bound by determinations of Appeals following CDP hearings. Those documents only reflect the disposition reached at a given time, on the basis of information then available. They do not prohibit a final decision to rescind the summary notice and issue a notice of determination that is contrary to the taxpayer, which may then become a basis for judicial review in the Tax Court. That is what happened here. The IRM provides that even a notice of determination can be amended prior to a tax court petition, thus confirming that discretion exists in this context. Although equitable estoppel principles can sometimes apply against the Government, Taxpayer failed to show that estoppel against the Government was proper here under relevant authorities.

Moving to the substance of the payments, the Tax Court found that the 2007 payment accompanying the extension for the couple's return was made after the divorce was final, so it should be applied to Milton, who made the payment. As for other payments while the couple remained married, the regulations require allocation as the parties may agree.

In discerning this agreement, the court looked to the premarital agreement. The parties see the mechanics of that agreement somewhat differently. Abigail viewed this as recognizing that Milton would pay taxes for the couple and then he would seek reimbursement from Abigail for amounts attributable to her. Respondent disagreed with these mechanics, but the court found that mechanics did not matter – economic burden did. On that basis, it found that all the other payments while they were married should be applied to Milton. If the rule were otherwise, then Abigail would be relieved of the economic burden of her taxes. She did not refund any estimated payments to Milton, nor did she have any interest in the trust account. This approach ensures that Milton's payments pay Milton's taxes, not Abigail's, and this implements the purpose behind the agreement.

According to the court, in an organization as large as the IRS, "the right hand may not always know what the left is doing." This situation was not ideal, but the ruling reflects the proper legal outcome. There was no showing of a prejudicial impact as a result of changing the IRS position at the Appeals level.

Comment: This decision should be carefully considered by family law practitioners. First, prenuptial and divorce agreements should take this scenario into account. Second, the matter of applying overpayments from a prior year presents complexity that deserves attention. A cash refund may become the clearest way to resolve the matter.

4. Taxpayer could not invoke equitable estoppel to prevent assessment of tax, Howe v. Commissioner, TC Memo 2020-78.

Taxpayer and his wife, represented separately in this case, had filed a joint return for the 2008 tax year in which they claimed deductions from losses attributed to pass-through entities. Taxpayer had invested funds in these entities, which he had obtained from another company in which he served as CEO and held a majority of its shares. After audit, the Service proposed a deficiency of over $8 million from disallowing loss deductions because it determined that Taxpayer was not at risk.

Taxpayer filed a protest, sending the matter to Appeals. On February 14, 2014, Taxpayers signed Form 870-AD, which was countersigned by an appropriate representative from the IRS. This form reduced the proposed deficiency from more than $8 million to $1.5 million and it reduced accuracy penalties to zero. The form also stated that the case would not be reopened unless there was "fraud, malfeasance, concealment, or misrepresentation of a material fact."

The Appeals Officer finalized his case memorandum in March 2014. His analysis supported Taxpayer's position. He found that the advances were not funded by loans from Taxpayer's company, but instead were funded by dividends paid to Taxpayer. This treatment differed from the treatment reported by Taxpayer's company, and it also differed from the position of the Revenue Agent. The Revenue Agent and her supervisor filed a dissent to this memorandum, alleging that Taxpayer had changed his position and that this constituted a misrepresentation of material facts. That dissent prodded the Appeals Director to approve reopening the case.

On September 17, 2014, the Service issued a notice of deficiency that once again returned to the position that loss deductions claimed from these entities were disallowed. This litigation ensued.

The Tax Court bifurcated the case for trial, addressing first Taxpayer's claim that the Government was estopped from pursuing a deficiency claim in excess of the amount stated on the Form 870-AD completed in 2014. Taxpayer argued that the Government was bound by contract law to honor their agreement. However, the Tax Court ruled that Form 870-AD is not a binding settlement agreement under section 7121. Thus, it does not function as a contract to bind the Government.

Taxpayer then argued that equitable estoppel principles bind the Government in this case, as their actions in agreeing to Form 870-AD caused Taxpayer to rely to his detriment. However, equitable estoppel does not apply against the Government in the same way it might apply to a private litigant. Instead, it must be applied with "utmost caution and restraint". In the tax context, it must "outweigh the policy consideration" that favors efficient revenue collection. Traditional elements for equitable estoppel include Government knowledge of the facts, an intention for Government conduct to be relied upon, a lack of taxpayer knowledge of the true facts, and reliance on that conduct to the injury of another. However, Taxpayer must also show (1) affirmative misconduct by the Government that goes beyond negligence, (2) serious injustice results from the misconduct, and (3) the absence of undue damage to the public interest if estoppel is provided.

Taxpayer was not able to satisfy these formidable requirements. The parties disputed whether there was concealment or misrepresentation, but that made no difference to the outcome. Even if the court concluded there was no concealment and the Service failed to follow procedures in the IRM, that would not rise to the level of affirmative misconduct by the Government. Furthermore, even if Government misconduct was shown, Taxpayer could not prove that he did not have knowledge of the true facts and that he relied to his detriment on the Government's action.

Regarding knowledge of the true facts, Taxpayer is charged with knowledge of the law, which includes the fact that Form 870-AD is not a binding settlement agreement under IRC §§ 7121-22. Regarding detrimental reliance, Taxpayer's only claim was based on paying interested against the proposed deficiency. But payments alone do not constitute detrimental reliance. Accordingly, the case will proceed to trial on the substantive issue of the deficiency.

Comment: This case shows that equitable estoppel is extremely tough to prove. And a valuable lesson can be found here for Taxpayers wrangling with Appeals – Form 870-AD is not a binding contract. A closing agreement is necessary to bind the Government; until that time, or until the statute runs, Appeals can change its mind.

5. Service could deny OIC based on determination that it was "not in the best interest of the Government", Elkins v. Commissioner, TC Memo 2020-110.

Taxpayer was a physician and former CEO of Integrated Health Services, one of the largest nursing home chains in the country during the late 1990s. He left that position but remained in the healthcare field. He also had substantial underlying liabilities that stemmed from losses disallowed in a trading partnership during 1998, 2000, and 2001 tax years. The Service determined that the trading transactions engaged in by the partnership lacked economic substance. However, the partnership filed suit in the Tax Court, which ultimately entered a stipulated decision reflecting a settlement with the IRS, which became final in 2012.

The Service then imposed a computational adjustment against Taxpayer's returns and assessed over $10 million in tax, penalties, and interest against Taxpayer in 2013. Taxpayer initially submitted an offer in compromise (OIC) for $17,500. He alleged: "I am 71 years old. My wife has filed for divorce. I am unemployed and do not have substantial assets or income." He asserted that his reasonable collection potential was only $15,500, based on the value of an art collection and wine he owned. He enclosed a check for $3500 with his OIC. He also filed Form 433-A, showing only income from personal assets, a new lease on an Audi A6 for $630/month, and the art collection and wine. He disclosed a stock transfer to his wife valued at $240,000, some of which would be returned in the form of an "equitable distribution" after their divorce.

The OIC specialist assigned to the case scrutinized Taxpayer's ongoing relationship with his former spouse. They had agreed to keep their own assets and liabilities separate, and Taxpayer maintained an ongoing relationship with a holding company his ex-wife owned. He received no compensation, but his wife "provided for all his needs". He also addressed a promissory note for $240k from his former wife, on which she had repaid $219K.

After this investigation, Taxpayer increased his OIC offer to $33,000 in January 2015, but he did not revise Form 433-A. The OIC specialist did further research on Taxpayer, uncovering news articles that included a Wall Street Journal report that his former partnership had issued loans of nearly $60 million – mostly to Taxpayer – which were not required to be repaid. The loans were reportedly used to fund retirement accounts and other assets, including art worth more than $8 million.

In April 2015, the OIC specialist rejected Taxpayer's OIC, noting his likely future income and assets supported a collection potential of $71,192. Taxpayer offered to increase his OIC to $71,500, and the OIC specialist explained that Taxpayer showed no evidence of substantial hardship, he drove a luxury car acquired in 2014, ate out regularly, and traveled. Moreover, he seemed to be getting funds from his former spouse and his willingness to increase his offers indicated that he had more funds beyond what the RCP had indicated.

Taxpayer appealed this denial of his OIC, and the Service initiated collection activities. Taxpayer initiated a CDP hearing, and Taxpayer continued to press for settlement. However, the Appeals officer sustained the rejection of the OIC based on the ground that it was "not in the best interest of the Government." This determination was rooted in the information laid out above by the OIC specialist.

Taxpayer sought review in the Tax Court, which upheld the determination, finding no abuse of discretion. According to the IRM, the Service may consider public policy and tax administration concerns when determining to accept an OIC. Rejections "should not be routine", but they may be appropriate when a taxpayer has an "egregious history of noncompliance". Here, there was evidence in the record to support the Appeals determination that Taxpayer lacked good faith, failed to make any payments toward his liabilities for over 3 years while his OIC was pending, and his "negative history" in escaping a $10 million tax debt. The Wall Street Journal article played into the "negative history" finding.

Comment: Note that the ability to raise one's offer after reporting minimal assets was used against this taxpayer. Also, formal rules of evidence do not apply in these hearings, which allowed the IRS to rely on news reports included in the administrative record. The IRS was suspicious here where these taxpayers divorced and kept separate assets, and yet the former spouse continued to support Taxpayer. That former spouse was not tagged with this tax debt, apparently because she did not file a joint return with him. For a somewhat similar situation in which innocent spouse relief was denied to a joint return filer whose husband racked up partnership tax debt, compare Rogers v. Commissioner, TC Memo 2020-91.

6. Past settlements in Tax Court did not bind Service in other tax years, Audio Technica U.S. v. United States, 963 F.3d 569 (6th Cir. 2020).

In this refund litigation, Taxpayer asserts that it was entitled to an increased R&D credit based on increasing its research expenditures from a fixed base determined during 1984-88 tax years. The Government challenged Taxpayer's fixed base percentage, and before trial, Taxpayer made a motion *in limine* seeking to prevent the challenge on the basis that the government was judicially estopped from denying the fixed base percentage Taxpayer claimed in this case. Taxpayer pointed to two prior stipulated settlements in the Tax Court that adopted this percentage to compute credits for other tax years.

The district court ruled that the Government was judicially estopped from challenging the percentage determined by prior settlements in the Tax Court, and thus could not introduce evidence showing another percentage. The jury ruled in favor of Taxpayer and the court ordered Taxpayer to submit a proposed judgment, which gave Taxpayer a refund and court costs.

The Sixth Circuit reversed. First, although a ruling on a motion *in limine* might otherwise be reviewed on an abuse of discretion standard, the application of judicial estoppel is reviewed *de novo*. Further, the court noted that it was improper for the court to apply judicial estoppel in a motion *in limine*. Instead of addressing admissibility of evidence, the district court's order essentially gave a judgment as a matter of law on the issue of the relevant percentage. This would entitle the government to de novo review.

On the matter of judicial estoppel, the Sixth Circuit found it was not applicable in this context. Settlements do not constitute judicial acceptance of whatever terms they contain. Tax Court proceedings ended with a settlement, which did not require judicial acceptance of litigating positions. Judicial estoppel cannot attach in that context. Moreover, the Tax Court only approved dollar amounts in that settlement, not the details including the fixed-base percentage.

Comment: Judicial estoppel remains a difficult doctrine to invoke successfully against the Government. Efforts to bind the Government in other years would apparently require some kind of formal closing agreement.

7. Work-product protection not waived by memo of in-house counsel disclosed to valuation expert, United States v. Sanmina Corp, 968 F.3d 1107 (9th Cir. 2020).

Taxpayer claimed a worthless stock deduction of $503 million on its 2008 federal tax return, wiping out all income for the year and resulting in a carryforward of the excess loss. An audit ensued, which resulted in Taxpayer providing a valuation report prepared by DLA Piper. That report referred to two internal memos authored by Taxpayer's in-house counsel. The Service issued a summons for those memos, but Taxpayer declined citing attorney-client privilege and attorney work product protections. It offered instead to produce non-privileged documents on which those memoranda relied.

This litigation ensued over access to those memos, which involved the exclusion of certain inter-company debt in determining the valuation of the affected stock. In the first trip through the courts, the district court concluded that while the memos were indeed protected by attorney-client privilege and work product (as they were prepared in anticipation of litigation with the Government over the propriety of this deduction), the protections were waived because the memos were voluntarily disclosed to DLA Piper for the purpose of determining the value of common stock. Since the DLA Piper valuation relied on the contents of the memoranda and based conclusions, in part, on them, they should be available for Government review.

In this appeal, the Ninth Circuit considered whether waiver had occurred. This was a mixed question of law and fact reviewed de novo. According to the court, the waiver question turned on whether disclosure of the memos to DLA Piper was for the purpose of obtaining legal advice, in which case no waiver had occurred. On one hand, DLA Piper was retained to provide a valuation report. On the other hand, it was also retained as outside tax counsel for purposes of evaluating the propriety of the claimed deduction. Although the Ninth Circuit identified the possibility that both non-legal and legal purposes may be at stake, it chose to affirm the district court's finding of waiver because there was no "clear error" in the district court's conclusion concerning attorney-client privilege.

On the work product question, the court distinguished the context of disclosure to a third party from a waiver of privilege. Attorney-client privilege can be waived through disclosure to a third party, but work-product waiver requires disclosure to an adversary. The doctrine is designed to prevent an adversary from exploiting a party's effort in preparing for litigation. Accordingly, work product protections are not as easily waived. A disclosure to a third party waives the protection only when, under the circumstances, it is inconsistent with maintaining secrecy over the mental processes of its attorneys. As in United States v. Deloitte, LLP, 610

F.3d 129 (D.C. Cir. 201), a Taxpayer disclosure of legal memoranda to its auditor was not a disclosure to an adversary when the party had reason to believe the documents would remain confidential. That was also true here, where DLA Piper was not in a position of an adversary or even a "conduit to an adversary" in fulfilling its role in providing a valuation. Thus, there was no waiver when Taxpayer provided the memos to DLA Piper.

However, when Taxpayer provided the DLA Piper report to the IRS, a separate disclosure occurred. There was no express waiver here, since the DLA Piper report did not itself disclose the content of the memo. In contrast, the court left open the possibility that an implied waiver might occur in other contexts. In this case, however, the conduct seemed inconsistent with the purported goals of secrecy, undermining Taxpayer's claim to protection. But implicit waiver is tailored to the needs of the opposing party, and at this stage of the proceedings, it is not clear that Taxpayer obtained any unfair advantage by maintaining confidentiality. As this dispute involved the audit stage, the Service could disavow the report entirely. It was not bound to consider or accept it. At most, waiver occurred over any factual discussions from those memos, but not other analysis. Fairness does not allow the IRS to litigate based on "wits borrowed from the adversary" in these circumstances.

Comments: If you give documents to a valuation expert, you should probably not expect that those documents will be maintained in confidence. If the document is cited in the valuation report, then there is a greater chance of waiver at least as to factual matters. If the document is not cited in the valuation report, there is still a problem to the extent that discovery about expert materials might require subsequent disclosure by the expert of the document.

D. Attorney fees, costs, and damages.

1. No section 7430 award in CDP proceeding, Dennis v. Commissioner, TC Memo 2020-98.

Taxpayers executed an installment agreement for unpaid taxes in the 2015 tax year. Subsequent disputes emerged, with the Service issuing a Notice of Federal Tax lien regarding unpaid balances. Those disputes were eventually resolved with a determination that Taxpayers had not violated their installment agreement, thereby resulting in the Tax Court ruling that the NTFL filed against them was not sustained.

Taxpayers then filed a motion before the Tax Court to seek litigation costs under section 7430(a). As the court noted, "To recover costs, the taxpayers must establish that (1) they are the prevailing party, (2) they did not unreasonably protract the proceedings, (3) the amount of the costs requested is reasonable, and (4) they exhausted the administrative remedies available." The Service concedes that Taxpayers did not protract the proceedings, they prevailed, and it did not assert that the position of the United States was correct or substantially justified. However, it challenged the reasonableness of the costs and it also contended that the administrative hearings and litigation involved here did not involve the underlying liability for tax, and therefore are plainly not eligible for recovery under applicable regulations. Moreover, recoverable litigation costs are not allowed for time spent by pro se taxpayers representing themselves.

On the matter of challenges to the underlying tax liability, Taxpayers argued that they presented evidence about whether a $7500 payment had been credited to their account, which affected the total tax yet due from past deficiencies. However, whether a check is properly credited has been previously held not to constitute a challenge to the underlying liability. Accordingly, the administrative proceedings here involved only the matter of collection, for which no cost recovery would be allowed under section 7430.

Moreover, litigation costs claimed here were not actually incurred for services from outsiders, but instead only represented the value of their own time. Section 7430 allows recovery only of actual costs, not opportunity costs. Those opportunity costs included the lost legal fees that one of the Taxpayers may have incurred in representing the couple in this matter.

Comment: This decision leaves open the possibility that litigation costs could extend to a CDP hearing if the tax liability is being challenged, albeit limited to out-of-pocket costs.

2. Taxpayers ineligible for litigation costs where Service position was substantially justified, Johnson v. Commissioner, 972 F.3d 655 (5th Cir. 2020).

Taxpayers received a notice of deficiency assessing $51K in taxes, penalties, and interest related to certain distributions from individual retirement accounts. Taxpayers correctly claimed that a significant amount of the distributions were non-taxable rollovers. Unfortunately, the documentation from various fiduciaries sent confusing signals. Moreover, they had no documentation to prove that an alleged distribution had never occurred.

After a series of 24 letters and phone calls, Taxpayers were unable to satisfy the Service. A notice of deficiency was issued, and Taxpayers filed a petition in the Tax Court. Eventually, the Service admitted no tax was due; the Tax Court issued a stipulated decision showing no deficiency for 2015. It also asked Taxpayers to move for fees and costs within three weeks.

Taxpayers responded with a request for thousands of dollars, despite representing themselves and incurring only 71 dollars in out-of-pocket costs (filing fees and postage). The Service opposed their motion on three grounds: (1) costs were not reasonable; (2) failure to exhaust administrative remedies; and (3) the Service position was substantially justified. In particular, the Service was allowed to seek clarification as to the taxability of the distributions reported by fiduciaries. The Tax Court denied the Taxpayer's requests for costs, and Taxpayers appealed.

The Fifth Circuit affirmed, applying an abuse of discretion standard. Here, there was a discrepancy between third party information and the returns. The Service was not required to concede adjustments until it received information to substantiate them. Since Taxpayers failed to prove this point, there was no reason to address the exhaustion of administrative remedies (a matter also not analyzed by the Tax Court.)

Comment: Frustration does not justify costs under section 7430. I suspect that the appellate process resulted in still more frustration for these pro se taxpayers.

3. No litigation costs where IRS concedes in answer, Dang v. Commissioner, TC Memo 2020-150.

Taxpayers entered into a stipulated settlement of deficiencies for the 2008 and 2009 tax years. Taxpayers requested that the IRS levy against an IRA account, which would have allowed an exception from the early distribution penalty under section 72(t). The IRS rejected this alternative, choosing instead to pursue other assets. A collection due process hearing followed, eventually generating a Tax Court petition. In the answer to that petition, the Service conceded that Appeals was wrong in rejecting the levy against the IRA account. The case went back to Appeals, which then levied against the IRA and satisfied the deficiency.

Taxpayers then sought to recover litigation and administrative costs under section 7430 based on the IRS concessions. The Tax Court rejected this claim, finding that the administrative costs were not allowable prior to assessment, which had not occurred here. Moreover, litigation costs could not be recovered when, as here, the IRS responded promptly in its answer by conceding to the Taxpayer. In this situation, the "position of the United States" was "substantially justified", despite the fact that the IRS position was not in accord with applicable regulations.

Comment: This may seem counterintuitive to the extent that the IRS position at Appeals was not consistent with its own regulations. However, litigation costs were not magnified because of the Government's change in position, which was promptly reflected in the answer to Taxpayer's petition.

E. Tax Crimes/Civil Fraud.

1. Taxpayer avoids civil fraud penalty based on prior termination assessment that prevented underpayment, Onyeani v. Commissioner, TC Memo 2020-15.

Taxpayer, who was born in Nigeria, moved to the U.S. and became a permanent U.S. resident in 2012. He was born in Nigeria and practiced medicine for a time in the U.K., where in 2009 he lost his medical license due to some accusations of misconduct, including falsification of medical records. He obtained an MBA from DeVry University in 2015. At that time, he had no experience in the oil and gas business.

In January 2015, Taxpayer formed a corporation, AHPE. It had no assets or employees. However, Taxpayer formed a website describing AHPE as an "independent crude oil purchasing and selling broker" headquartered in Chicago, with a "term of experts" interested in purchasing crude oil. According to the court, the website included false representations. AHPE had no discernable business activity. It possessed three bank accounts opened in its name at Bank of America (BoA) in January 2015.

Taxpayer entered into a transaction he alleged involved petroleum owned by the Nigerian National Petroleum Corporation (NNPC), in which he purportedly was authorized to sell 5 million barrels of oil – worth over $250 million at the time – which was then on vessels off the Nigerian coast. The NNPC had issued "scam alerts" involving schemes by "unsavory characters" purporting to be its contractors. Taxpayer produced documents involving a Chinese entity and a U.S. company as buyers of crude oil, which was to be delivered in Shanghai. Both buyers were required to pay advance fees, which were wired to Taxpayer's corporate bank accounts at BoA. As of March 2015, the accounts nominally held $806,985, of which $744,985 constituted advances from these two prospective buyers. The rest came from Taxpayer's own funds.

Taxpayer then ordered BoA to wire $300,000 to an account in London. BoA's fraud department flagged the transaction, froze the AHPE accounts, and informed Taxpayer that he was under investigation for money laundering or other illegal activity. Taxpayer responded by opening other bank accounts in his name and under AHPE's name. He used funds from AHPE's accounts to pay personal expenses, including travel and entertainment. BoA determined that these transactions involved "excessive risk", closed AHPE's accounts, and issued cashier's checks to AHPE for the balance. Taxpayer deposited these funds at Harris bank.

Soon, Secret Service informed Harris that it was investigating Taxpayer. So was the Chicago Police Department. Harris froze the accounts. Meanwhile, the Secret Service informed the IRS. The IRS immediately reconstructed Taxpayer's income using a bank deposits analysis, determining that he had earned gross income of $802K, which included the amount he received from the two putative buyers. It terminated Taxpayer's year and assessed the tax due on this amount, allowing only a standard deduction. It then sent a notice of levy to Harris bank, which put this amount of tax due into escrow. Harris then allowed Taxpayer to withdraw the balance of the funds.

Taxpayer challenged the levy in District Court, which approved the levy. Accordingly, Harris released the escrow funds to the IRS. In June 2015, he deposited the balance of the funds from Harris into another bank in AHPE's name. He made various personal expense payments using a check card from that account.

In July 2015, one of the putative oil buyers informed the Justice Department that Taxpayer had defrauded them. Taxpayer reached a private settlement with the disaffected buyer, wiring him $400K from the AHPE account.

Taxpayer then filed his 2015 tax return, jointly with his spouse, claiming taxable income of $42K earned by his spouse, taxable income of $21,383, and total tax of $2,271. He did not report income subject to the termination assessment.

The Service determined that Taxpayer had failed to report the $802K of income that had been the subject of the termination assessment, and it recommended a civil fraud penalty against the taxpayer. The penalty was approved and a notice of deficiency was issued, including a deficiency of $273K, a civil fraud penalty of $205K, and alternatively, an accuracy penalty. Taxpayer sought review in the Tax Court.

First, the Tax Court addressed the question of whether Taxpayer, an individual, was indeed the proper taxpayer to report the income. The Service bore the burden of proof to establish this, as it raised the lack of a separate entity for the first time at trial. However, the Service was able to establish that AHPE was Taxpayer's alter ego, which should not be respected. Even though Taxpayer deposited funds in accounts bearing AHPE's name, he used those funds as his own and the corporation did not carry on any normal business operations. Moreover, even if AHPE was treated as a real business entity, Taxpayer effectively exercised dominion over the accounts, diverting funds for his own purposes.

Second, the Tax Court agreed that the IRS could use the bank deposits method to reconstruct his income here, and that such income included the advances from putative oil buyers.

However, the Tax Court found a significant legal barrier to fraud penalties – and accuracy penalties – in this case because it determined that there was no showing that the Taxpayer underpaid his taxes. In this case, the termination assessment more than covered the balance of taxes that would have been due in this case, which in fact involved an overpayment because Taxpayer had to repay $400,000 to one of the putative buyers. According to the court, a deduction should be allowed for this cash payment made in the year the funds where received.

Moreover, even if there was an underpayment, the Tax Court also concluded that the Service failed to prove fraud by clear and convincing evidence. By 2016, when Taxpayer and his spouse signed their 2015 tax return, the IRS was well aware of and had assessed the tax upon the additional income it claimed he had earned in 2015. Indeed, Harris bank had already released payment of the taxes. The Court did not see how he would have intentionally avoided any tax – particularly when he appears to be due a refund.

Comment: While the transactions here presented reason for suspicion that eventually led the IRS to think they had gotten this fellow for tax fraud, the Tax Court appropriately concluded that he had done no such thing. He might have ill-gotten gains (to the extent of deposits from the other putative oil buyer – an issue not addressed herein), but at least he paid the taxes on them. If he committed fraud, it was not fraud against the Treasury. This case shows the importance of Tax Court review. The system works, even for those who might be operating outside the boundaries of the law. Compare Purvis v. Commissioner, TC Memo 2020-13 (upholding fraud penalties where traditional "badges of fraud" were present); Collins v. Commissioner, TC Memo 2020-50 (upholding civil fraud penalties against professional return preparer where "badges of fraud" present).

2. Prior criminal restitution order did not collaterally estop Service from assessing civil tax liability, Tran v. Commissioner, TC Memo 2020-27.

A civil audit of Taxpayer's joint returns for 2004-2006 began in 2007. This audit generated evidence of significant underreporting of income, as well as falsifying records. A criminal referral resulted, and Taxpayer Husband plead guilty to tax evasion for the 2006 tax year. In his plea agreement, he agreed to pay restitution of $33,332 to the IRS based on the underreporting of income due to business checks deposited into the couple's personal account. However, the restitution order did not include cash deposited into the couple's personal accounts, which involved considerable amounts generated in their nail salon business. In exchange for the plea on 2006, the Government agreed to drop similar charges from 2004 and 2005.

After the guilty plea, the civil audit concluded. Fraud penalties were approved by supervisors for Taxpayer Husband and accuracy penalties for Taxpayer Wife. A notice of deficiency proposing additional taxes and penalties was timely issued to Taxpayers.

Taxpayer argued that the doctrine of collateral estoppel bars the Commissioner from relitigating his 2006 tax liability, as the amount was determined in the criminal restitution order.

However, the Tax Court rejected that argument. An order of restitution is not an element of a crime that results in conviction but is instead a matter of judicial discretion. Neither an order of restitution, nor a failure to order restitution, establishes the taxpayer's correct civil tax liability. Thus, that issue has not previously been litigated and there is no preclusive effect from such an order.

Taxpayers' deficiencies and Husband's fraud penalties were upheld, but no accuracy penalty could be assessed against Wife as this would involve an improper stacking of penalties.

Comment: Criminal tax counsel should coordinate with civil tax counsel in working through the matter of prior payments. Presumably these restitution payments should be credited against the civil tax liability for that year.

3. Taxpayer subject to collection action on criminal restitution penalty, Engle v. Commissioner, TC Memo 2020-69.

In 2004, Taxpayer pleaded guilty to tax evasion for the 1998 tax year. The criminal information filed against him indicated tax evasion for 16 years between 1984 and 2002 involving more than $600,000 in unpaid tax. In 2006, he was initially sentenced to probation and confinement in a community corrections center. But this sentence was vacated and resentencing occurred in 2008. That sentence also involved four years of probation with 18 months home detention, with no finding of the exact amount of tax loss. The sentencing court required him to pay $25,000 to the IRS and a further $100,000 within 90 days, with a further amount "to be determined by the IRS."

The Government appealed this sentence, and the Fourth Circuit remanded for resentencing, including the order of restitution, to be considered in light of sentencing guidelines and Taxpayer's failure to make any payments on the prior restitution order. In 2011, the district court resentenced Taxpayer for 60 months incarceration followed by 14 months of supervised release, and further ordered restitution of $620,549 payable immediately.

In 2014, the Service made Restitution Based Assessments (RBAs) against Taxpayer for various tax years, with the amount of tax due equaling the 2011 restitution order. It would later send a NTFL for $2.7 million, reflecting the addition of interest and penalties. However, in the interim, *Klein v. Commissioner*, 149 T.C. 341 (2017), which held that the Commissioner may not assess and collect interest and penalties on a restitution obligation, even though it may otherwise collect such obligations in the same manner as if it was a tax. Accordingly, the Service conceded that issue at trial.

At the CDP hearing, Taxpayer was prohibited by law from challenging the existence or amount of an underlying tax liability. However, Taxpayer in this case challenged the authority to collect the restitution order, as this authority was provided through amendments to section 6201(a)(4)(A) that applies only to restitution ordered after August 16, 2010. Taxpayer here claimed that the 2011 order related back to his prior sentence in 2008, thereby predating collection authority. Appeals rejected this claim, and Tax Court review followed.

The Tax Court, after recognizing the Service's concession under *Klein* as noted above, rejected the Taxpayer's claim that an abuse of discretion had occurred. According to the Tax Court, the Fourth Circuit vacated the prior sentence, resulting in a new sentence and a new restitution order, which the IRS could proceed to collect because it was made after August 16, 2010.

Comment: This case illustrates that criminal restitution orders can be collected in the same manner as other taxes, and that such collections can occur many years after the tax year in question. Note that this taxpayer was still wrestling with consequences from his bad behavior more than two decades ago. However, the Klein restrictions on interest and penalties do at least prevent compounding, which in this case would have increased the debt more than four-fold.

4. Taxpayer who signed Form 4549 in prison, but later withdrew it, avoids fraud penalties based on supervisory approval, Minemyer v. Commissioner, TC Memo 2020-99.

In 2009, Taxpayer pleaded guilty to tax evasion for the 2000 tax year. The Government dismissed a second indictment for the 2001 tax year. Taxpayer paid restitution totaling $200K according to his plea agreement, and he began a prison sentence. In 2010, while he was in prison, a Revenue Agent visited taxpayer and provided him with Form 4549, Income Tax Examination Changes, for 2000-2001 tax years. Taxpayers signed the form, which agreed to both deficiencies and penalties. However, he requested that this agreement be withdrawn as he claimed to sign under duress. The Service agreed and withdrew this Form on March 4, 2010. On May 17, 2010, it sent a 30-day letter to petitioner that included fraud penalties. The new Form 4549-A attached thereto included the words "corrected report", and it was signed by the Revenue Agent on May 7, 2010, along with a statement: "This Report supersedes the report issued 3/4/2010." A notice of deficiency followed, which also included fraud penalties.

Taxpayer petitioned the Tax Court, challenging the fraud penalty for 2001 on the basis that the Service failed to prove supervisory approval. Here, the Service had a burden of production regarding supervisory approval. Based on *Belair Woods*, supra, notification of the Taxpayer involves the first time an unequivocal decision to assert penalties had been made. Here, the Service visited Taxpayer in prison and provided Form 4549. During the opening statement, counsel for the Service referred to this document and alleged that Taxpayer signed it, agreeing to the fraud penalty for 2001. However, the Service did not introduce this document into evidence. According to the Tax Court, this meant the Service did not satisfy its burden of production because the court could not determine if it clearly reflected the Revenue Agent's determination that it would be imposing a penalty. If it had, then there was no advance supervisory approval, and no penalty could be assessed.

Comment: It is unclear why only the 2001 penalty was contested and not the 2000 penalty as well. Civil penalties presumably require supervisory approval in either case. This was a trial error by IRS counsel – one likely did not need to refer to the prior document, which he withdrew in any event, in order to prove the matter of fraud, but if he did, he should have included it in evidence.

5. Civil fraud penalties apply to Taxpayer convicted of "corruptly endeavor[ing] to obstruct and impede the due administration of the internal revenue laws" under section 7212(a), Belanger v. Commissioner, TC Memo 2020-130 (2020).

Taxpayer ran a construction business using the name Number One Foundations. Beginning in 1985 or 1986, his son Stephen began working for him. Stephen opened two bank accounts for Number One Foundations at a local bank. He had sole signatory authority over the accounts, and he used them to pay bills and expenses, including payroll. Number One Foundations paid him $600-$800 per week for his work. Taxpayer had his own method for bookkeeping, which included the use of stairs inside his home. Paid invoices were kept on one stair, and during the years at issue, he had his then-girlfriend take the paid invoices, add them up, and this became the gross receipts figure reported on his tax return.

Many of his customers paid by check issued to either Number One Foundations, to Stephen, or to Taxpayer. Taxpayer instructed Stephen how to treat all the checks, and this included going to banks and either cashing the check, negotiating them for treasurer's checks issued on the bank and payable to him, or depositing them. Stephen ensured that treasurer's checks did not exceed $10,000. Taxpayer also kept the treasurer checks rather than depositing them. He paid his employees, which included undocumented workers, in cash. No employment tax returns were filed.

After uncashed treasurer's checks piled up at one of the banks, a branch manager contacted Taxpayer, telling him that the checks needed to be reissued or the bank would consider them abandoned property. This triggered a criminal tax investigation for underreporting gross receipts for the business. Taxpayer was convicted. A fraud penalty was then asserted and civil proceedings followed to address the penalty.

The Tax Court approved the imposition of the penalty under the traditional "badges of fraud" analysis. It also found that the statute of limitations did not protect this taxpayer on account of the fraud associated with returns.

Comment: This scheme was bound to unravel at some point. But one wonders how it took so long for this matter to come to trial – the tax years at issue were 1999-2001 and the notice of deficiency was sent in 2014.

F. Transferee/Fiduciary Liability.

1. Transferee liability of over $50 million in tax and penalties upheld, Alta V Limited Partnership v. Commissioner, TC Memo 2020-8.

Petitioners, including partnerships and individual taxpayers, owned interests in a closely held Wisconsin corporation (SCC) that invested in television and radio stations in the Upper Midwest. In 1995, the shareholders entered an agreement that provided a right of redemption or put option, which required corporate purchase of their shares. Such a right would commence more than six years later, and it was subject to numerous detailed provisions affecting both valuation and rights.

In 1999, prior to the time that the put option in their shareholder agreement came into effect, the principal shareholders began exploring strategic alternatives for selling the company.

While the shareholders preferred a stock sale, broadcast industry preferences favored asset sales. Moreover, investors interested in radio were not interested in television, and vice versa. Unfortunately, their tax advisor, a managing director and tax partner with a major accounting firm, introduced them to Integrated Capital Associates ("ICA"), a firm that was engaged in so-called Midco transactions. ICA was integrated into existing deals under negotiation for selling some of the assets, and it executed a stock purchase agreement with Taxpayers that closed on May 31, 2001.

Predictably (for a Midco transaction), ICA formed subsidiaries, eventually liquidated SCC, selling off its assets. Distributions of over $64 million were made to Taxpayers over a period beginning Macy 31, 2001 and ending on October 29, 2003, apparently funded by the proceeds of those asset sales. SCC did not pay any corporate taxes, and ICA and its subsidiaries were nowhere to be found. The Service audited SCC and issued a notice of deficiency for its short taxable year ended May 31, 2001 of over $41 million, plus penalties totaling over $10 million. Thereafter, the Service pursue transferee liability examinations of eight of the largest shareholders of SCC, sending them notices of transferee liability on August 21, 2008, for the deficiency and penalties owed by the corporation, plus accrued interest.

Significant litigation ensued, including multiple trips through the tax court and to the Seventh Circuit. In this case, the final issue was litigated: whether under applicable Wisconsin law, including Wisconsin's Uniform Fraudulent Conveyance Act, these shareholders received transfers from SCC "without receiving reasonably equivalent value in exchange". Under Wisconsin law, the shareholder's subjective good faith is not a barrier to imposing liability under a constructive fraud theory, and in this case, the Service was able to prove that no contemporaneous value was given to SCC in exchange for the payments. Although Taxpayers argued that they surrendered their valuable put option rights, such rights were not even in existence when the Corporation terminated. Moreover, the put option rights were never discussed as part of the bargained-for exchange, but instead were merely incidental to the transfer. In that situation, no consideration can be accorded to those putative rights. Moreover, substance over form principles were applied to make the Taxpayer transferees, which implicated their liability under section 6901.

Comment: This is yet another sad tale of taxpayers led astray by an advisor from a presumptively reputable firm, which unfortunately put them into a legion with scoundrels. The taxpayers paid a hefty price for this arrangement. Let us hope they invested the proceeds at a rate of return that exceeded the applicable federal rate during this lengthy period.

V. Corporations.

1. New Jersey economic relocation incentives are taxable income, not contribution to capital under section 118, Commissioner v. Brokertec Holdings, Inc., 967 F.3d 317 (3d Cir. 2020), reversing TC Memo 2019-32.

Taxpayer and its subsidiaries received over $170 million in economic relocation incentives from the State of New Jersey to move its securities trading operation from New York following the destruction of the World Trade Center in 2001. There were no restrictions on how the cash could be used; much of it purchased the stock of another company. The Tax Court held that those payments were excluded from gross income under section 118 as it read prior to amendment in 2017 to excise government contributions from this exclusion. The Commissioner appealed.

The Third Circuit reversed, holding that the Tax Court's finding that the State was motivated by a desire to make a contribution to capital, a fact finding ordinarily subject to clear error review, was not determinative because it rested upon a misunderstanding of section 118 as a matter of law. The Commissioner argued that in order to qualify as a contribution to capital, the contribution must be restricted to supporting the capital of the enterprise rather than allowing the payment of operational expenses or dividends. Taxpayer argued that this unnecessarily restricts the use of state-contributed cash to the purchase of fixed assets.

The Third Circuit sided with the Commissioner. It concluded that relevant authorities supporting an exclusion all involved restrictions on the use of government payments. Decisions in the Fifth and Eleventh Circuits regarding government payments to telephone companies for the purpose of providing services to certain high-cost and low-income customers were in accord, as these were treated as nonexcludable payments to enhance the income of the taxpayers.

Comment: Circuit courts do not often tell the Tax Court that it completely misunderstands the law, but that is what happened here. This case has a limited impact going forward due to the 2017 amendments to section 118 that restrict exclusions in this context. While this ruling effectively restricts the efficacy of past state efforts to support crony capitalism, there are other reasons to believe that crony capitalism remains alive and well.

2. Attempt to avoid S corporation income through "surrender" of shares treated as sham, Estate of Kechijian v. Commissioner, 962 F.3d 800 (4th Cir. 2020).

Taxpayers held interests in several LLCs that they used to channel investments in distressed debt instruments. Taxpayers reorganized the business in 1998 by transferring their ownership interests into a single S corporation (UMLIC), which became the holding company used to manage and administer all taxes for these entities. Each received 47,500 shares in UMLIC stock. Each also signed a "restricted stock agreement" and an "employment agreement" that, taken together, required each to continue working for the company for a five-year period (until 2004) or suffer the pain of forfeiting half the value of his shares. In December 1998, Taxpayers formed an ESOP for UMLIC, which purchased 5,000 shares in the company. They transferred some of their shares to irrevocable trusts for the benefit of their families, but those shares continued to be subject to restrictions.

Taxpayers used these structures to construct an elaborate tax avoidance scheme. First, they treated their shares (including the shares they transferred to their trusts) as shares received in connection with the performance of services that are subject to a substantial risk of forfeiture under section 83. Pursuant to rules under subchapter S, restricted stock is not treated as outstanding stock for tax purposes. See Treas. Reg. § 1.1361-1(b)(3). Accordingly, the pass-through income of the S corporation would not pass through to those shareholders. Since the ESOP is a tax-exempt entity, that meant no shareholder was taxable on the S corporation income. The S corporation did indeed make profits – more than $90 million during the period 2000-03 – but none of this was reported as taxable income.

Congress later closed the "loophole" that permitted this kind of tax avoidance, so that the structure ceased to provide these benefits after January 1, 2005. In anticipation of this change, Taxpayers again sought to do some restructuring in late 2003. The formed a new LLC (Holdings), which purchased UMLIC's operating assets in exchange for a $190 million note plus the assumption of all liabilities. UMLIC realized capital gains of $174.6 million and allocated the gain to the ESOP, the only outstanding shareholder.

When the restrictions on Taxpayer's stock lapsed in 2004, the fair market value of shares controlled by each Taxpayer was $45.9 million. But Taxpayers did not hold them for long – they purported to "surrender" these shares back to the corporation and then issue notes for $41.5 million each to "repurchase" new shares from the S corporation. Each reported $4.5 million in compensation income, which represented the difference between the value of the new shares and the promissory notes they issued to obtain them. Subsequently, they had UMLIC redeem the ESOP shares, so that Taxpayers became the sole shareholders. UMLIC kept operating until the financial crisis, when it failed.

The Service challenged the entire scheme, but the Tax Court upheld much of Taxpayers' plan. However, the Tax Court also concluded that the 2004 transactions designed to "surrender" and then "purchase" shares in the S corporation in exchange for a note was a sham and would be disregarded. Consequently, the Tax Court concluded that the restrictions on their S corporation stock were lifted in 2004, causing each of the Taxpayers to receive compensation income in that year totaling more than $45 million. It also applied accuracy penalties.

The Fourth Circuit affirmed. It rejected Taxpayers' rescission theory, noting that Taxpayers could not take back their services for which the stock had been issued. Moreover, it agreed that these transactions in 2004 lacked economic substance. The Taxpayers' own argument shows tax avoidance purposes, in that they sought to avoid employment taxes for the corporation on the amounts that would be deemed to be compensation. Tax avoidance by their wholly owned corporation, and not just by themselves in an individual capacity, was relevant to considering whether the transaction had economic substance. The court also found that the notes they issued to "purchase" the stock lacked substance, but even if that were not so, any increase in basis would affect the "new" shares they acquired, not the old ones they had surrendered.

In other parts of the decision, the Fourth Circuit affirmed the application of accuracy penalties as well as the Tax Court's refusal to take up a computational issue based on carrying back NOLs from 2008 to offset liabilities associated with the deficiency in this case.

Comment: This tangled plan provided some deferral benefits before it was shut down by Congress. Economic substance proved to be a useful tool to combat tax avoidance in this case. The rejection of a rescission theory here might also prove relevant to other taxpayers seeking to turn back the clock on a transaction.

3. S Corporation strategy unsuccessful at eliminating gains, Daichman v. Commissioner, TC Memo 2020-126.

Taxpayer (H) was an engineer who was an executive in a closely held company. His tax advisor pitched a strategy to eliminate tax from substantial income from his employment and pass-through items from his company. The strategy involved contributing cash and securities to an S corporation, which would then transfer 98 percent of the ownership over these assets to a family limited partnership. A family management trust would hold the other two percent. Upon dissolving the S corporation, Taxpayers would then own the 98 percent interest in the family limited partnership and book a tax loss on the disposition of their S corporation stock, presumably based on a valuation discount. Before liquidation, the S corporation engaged in trivial amounts of trading in stock and securities it had retained.

Taxpayers paid $20,000 in fees for this structure. Neither H nor W was financially sophisticated and neither investigated the proposed transaction. They engaged a CPA unrelated to the transaction to prepare their 2009 return, and they provided graphs and illustrations from the promoter showing how the tax strategy worked. In calculating the S corporation income, the CPA used unorthodox [incorrect] methods, following the direction of the author of this tax scheme. He reported gross receipts equal to the FMV of the cash and securities received from Taxpayers, less a 40 percent discount for lack of "control and marketability". The discount included both cash and securities, some of which were "marketable". He then reported COGS as the value of the assets on the date they were transferred to the FLP, except for Limited partnership interests, for which he used the basis computed by Taxpayer. This generated a $2 million loss reported for the S corporation, which flowed through to Taxpayers, netting out other reported income from wages, salaries, dividends, and flow through income from his business.

The audit did not go well for the Taxpayers (and this is no surprise). The Service disallowed the claimed loss deduction and imposed an accuracy penalty, which was approved by a supervisor in advance of sending the RAR to Taxpayers. By these calculations, the deficiency was approximately $448K and the penalty was approximately $90K. Taxpayers could have settled here and gone home with more treasure, but they chose to appeal. Appeals increase the final notice of deficiency balance to $1.1 million based on errors in computation by the Revenue Agent. As a result, the accuracy penalty more than doubled to $232K. A Tax Court petition followed.

The Tax Court upheld the deficiency, applying economic substance doctrine to disallow all claimed loss deductions associated with the S corporation. It also upheld penalties, examining both supervisory approval and the failure to have reasonable cause and good faith in taking these reporting positions. Taxpayer (H) was a sophisticated businessman who should have known that he was forming a corporation for no business purpose other than the putative tax losses he might claim on the deal.

Comment: This provides a sad example of clearly wrong tax advice from two licensed professionals. And who was advising them in their administrative appeal decision? The claimed losses were wrong on so many levels – I wonder how you could get it that wrong without just being plain dishonest. In my grade book, they earn an F. And let's hope that there is no curve imaginable that could save them based on being no worse than the rest.

4. Passthrough losses disallowed to putative shareholder of S corporation with untimely S election, Deckard v. Commissioner, 155 T.C. No. 8 (2020).

Waterfront Fashion Week, Inc., was organized in 2012 as a nonprofit corporation under Kentucky law. However, Taxpayer never filed for tax exempt status with the IRS. Waterfront held "fashion week" events from October 17 to 19, 2012. The event was supposed to generate profits that would be donated to a nonprofit that maintained the Louisville Waterfront Park. However, the event instead lost money.

Taxpayer, the president and CEO, sought to file an S election in 2014 that would be retroactively effective to the date of Waterfront's incorporation. The election was filed under Rev. Proc. 2013-30, which enables a taxpayer to make a retroactive election if properly completed within three years and 75 days after the initial due date. Along with the election, Taxpayer also signed the shareholder's consent statement, which indicated that he was the 100 percent owner as of May 8, 2012.

Waterfront filed late returns for 2012 and 2013 that reported passthrough losses on K-1s showing Taxpayer as the sole shareholder. Taxpayer then filed returns for 2012 and 2013 claiming deductions based on passthrough losses from Waterfront. The Service disallowed the losses and Taxpayer sought review in the Tax Court. The Service moved for partial summary judgment on the ground that Taxpayer was not a shareholder of the S corporation, even if a valid election had been made.

The Tax Court agreed with the Service. The test for whether one is considered a shareholder depends on the concept of beneficial ownership: would this person otherwise be required to report as personal income profits earned by the corporation? Beneficial ownership also entails the right to demand from the nominal owner any dividends or other distributions of earnings on the shares. State law governs these determinations. No case law shows a nonprofit corporation with beneficial owners. Nonprofits lack owners because they cannot distribute profits to insiders, thereby precluding any analogy to for-profit corporations who may do this. Kentucky law respects this distinction, also prohibiting nonprofit corporations from issuing stock. Taxpayer also lacked dissolution rights in Waterfront, which would otherwise be held by a shareholder. As with other nonprofits, upon dissolution the assets must be distributed for exempt charitable or public purposes.

Taxpayer alleged that despite these formalities, he should be treated as the shareholder because he exercised dominion and control over the corporation. Perhaps so – but this argument ignores the fact that other directors had fiduciary obligations that could have restricted his discretionary use of corporate assets. Taxpayer also tried to argue substance over form as a basis for rejecting nonprofit status, but Taxpayer was bound by the form of the business he chose. The failure to obtain tax-exempt status from the IRS, while relevant for other purposes, had nothing to do with the state-law constraints on nonprofit corporations that prevented him from taking these pass-through losses into account.

Comment: The court did not reach the matter of the validity of the retroactive election. There is some question over whether the Tax Court would have jurisdiction for that determination, *although the court cited several cases in which it had such jurisdiction to make determinations at the shareholder level. See note 12 in the opinion.*

VI. Partnerships.

1. NOL from prior tax year could be examined in CDP hearing and subject to Tax Court review, Amanda Iris Gluck Irrevocable Trust v. Commissioner, 154 T.C. No. 11 (2020).

This case presents a procedural tangle involving a TEFRA audit of partnerships in which the Taxpayer held an ownership interest in a first-tier partnership, which in turn owned an interest in a second-tier downstream partnership, which jointly owned an interest in a third-tier downstream partnership. In the 2012 tax year, the third-tier downstream partnership sold property jointly owned by the second-tier partnership, realizing a capital gain of more than $88 million. The upstream partnership allegedly reported its total distributive share of $79 million on Form 1065. However, the K-1 issued to Taxpayer allegedly understated her distributive share of the gain. Taxpayer now alleges that losses offset the balance of the gain, so that the net amount reported to Taxpayer and reported on Form 1041 for the 2012 tax year is correct. But the IRS treated this as a computational error that was not disclosed through filing Form 8082, and which allowed it to assess the tax due without issuing a notice permitting a pre-assessment challenge. See IRC §§ 6222(c), 6230(a)(1). 6231(a)(6).

The Notice of Computation Adjustment affected Taxpayer's 2012 tax year increased taxable income, thereby eliminating an NOL reported for that year and creating a tax liability for 2012. This, in turn, affected NOL carryforwards for 2013-2015, thereby creating liabilities in those years. Taxpayer failed to pay those liabilities, and the IRS issued Letter 1058, a final levy notice, which affected the 2013-2015 tax years. The levy did not affect the 2012 tax year. Taxpayer then filed a request for a CDP hearing, but no relief was granted, resulting in this Tax Court petition.

First, the Court determined that it had no jurisdiction over either the 2012 or 2013 tax years. The levy did not address the 2012 liability, and all liability for 2013 had been satisfied in the interim through the application of credits from other years. Thus, there was no possible collection action that could be adjudicated for that tax year.

However, for the 2014-15 tax years, the Tax Court agreed that it had jurisdiction. The Service sought summary judgment on the grounds that the taxpayer could not properly challenge the underlying tax liability and did not submit any request for a collection alternative. According to the Service, the adjustments for 2014-15 flowed from the computational adjustment to 2012, which meant the only way for the taxpayer to challenge the underlying liability was to pay the tax and file a claim for refund. Since it did not do this, Taxpayer could not now challenge the deficiencies in this hearing. Of course, this would leave the Taxpayer with no prepayment remedy at all.

The Tax Court refused summary judgment in this case. First, it determined that the Taxpayer had in fact asserted a defense to the underlying liabilities presented in this case for the 2014-15 years – that defense was based on its carryforward of an NOL from 2012. Although the

Tax Court would not be able to review the computational adjustment applied to 2012 in a deficiency proceeding, its jurisdiction was not similarly restricted in the collection context. However, the 2012 tax year was not before the court in this case – and neither was it the subject of the CDP hearing. Nevertheless, the Tax Court viewed this matter as a challenge to the IRS determination that NOL carryforwards from 2012 should be disallowed in 2014 and 2015. That determination was a matter that could be disputed in the CDP hearing and a matter that the Tax Court could adjudicate. In other words, since the NOL was carried forward, the Taxpayer could prove entitlement to the NOL in the earlier tax year. That means the determination of whether the computation adjustment was correct is a matter for proof. The Tax Court remanded for further factfinding by Appeals.

Comment: This result effectively creates a means to challenge a computational assessment without prepaying the tax. Generally, a Taxpayer may challenge the underlying tax liability in a CDP proceeding only when the Taxpayer did not receive a statutory notice of deficiency or otherwise have an opportunity to dispute the liability. Moreover, the Taxpayer must raise the challenge at the CDP hearing to preserve the issue for the Tax Court. Compare Bishop v. Commissioner, TC Memo 2020-36 (claims of financial hardship do not constitute a challenge of the underling tax liability that preserve the matter for judicial review). This case also illustrates that a prior tax year with an NOL can still effectively be "open" to the extent that the NOL has been carried forward to a future tax year. It remains to be seen whether Taxpayer will get relief, but at least the claim goes forward.

2. Commissioner's reasonable belief in non-TEFRA partnership permits Tax Court jurisdiction over individual partnership adjustments, Bridges v. Commissioner, TC Memo 2020-51.

In a partnership matter involving a Missouri LLC, the Service determined that normal deficiency procedures applied rather than the TEFRA partnership procedures. Accordingly, it proposed a deficiency based on flow-through adjustments from the LLC directly against each of the 50-percent owners based on the belief that it was a small partnership eligible for an exclusion from TEFRA procedures. That determination was based in part on the tax returns filed for the partnership, which reported that the owners were individuals. This included information on Schedule B of Form 1065 as well as the K-1s issued to the partners. The Tax Court characterized this information as "overwhelming".

However, attachments to the Schedules K-1 indicated that other disregarded entities owned the Missouri LLC. In fact, the opposite was true – the Missouri LLC owned these other entities. This relationship was also reflected on a chart prepared by Revenue Agents auditing the LLC. However, the chart also shows that the members of the LLCs were trusts, not the individual taxpayers.

When the notice of deficiency was issued, the Service had concluded that individual taxpayers were the partners, that the small partnership exception applied, and that TEFRA was inapplicable. However, before the Tax Court, the Service conceded that the true owners were trusts, not individuals, thus making it ineligible for the small partnership exception to TEFRA. Although a small partnership can elect out of TEFRA, no such election was made here.

Accordingly, the issue before the Tax Court was whether it would have jurisdiction over this notice of deficiency.

The small partnership exception was added to TEFRA procedures because of their complexity, but this complexity also extends to determining to whether a partnership is subject to TEFRA. Former section 6231(g) was added in 1997 to alleviate this problem for the Service by permitting the IRS to rely on the partnership return in making its determination of which set of procedures should apply. Here, the IRS made a reasonable determination on the basis of the return. Although conflicting information was produced during the audit, including the organization chart showing the trusts as owners, that information was disputed. Moreover, the Tax Court agreed that it did not prevent the IRS from relying on the return information for making that determination. In doing so, it rejected a Chief Counsel Memo that indicated reliance on the return was not proper if the Service was aware of contrary facts. According to the court, relying on disputed information would eviscerate section 6231(g) and contradict its plain language. Mere inconsistencies in the return, including the erroneous statements buried in the K-1s, did not make the reliance on other plain indicators of individual ownership unreasonable.

Comment: This is another case about epistemology. Here, Taxpayer seeks to benefit from his own erroneous statements in the return, when he was in possession of the truth. The IRS umpire may have called a true ball a strike, but in this case, the Taxpayer should still be out.

3. Tax Court could determine penalty, but not TEFRA partnership adjustment, in taxpayer-initiated proceeding over failed like-kind exchange, Gluck v. Commissioner, TC Memo 2020-66.

Taxpayers sold a condominium in 2012 in a transaction that they sought to qualify as a like-kind exchange. The proceeds of over $10 million were deposited in a qualified escrow account. They designated a Manhattan apartment building as a possible replacement property. He formed a SMLLC, Gluck LLC. On November 29, 2012, Gluck LLC executed two contracts that each purported to acquire a 12.5 percent interest in the property from holders of tenancy in common interests. On December 7, Gluck LLC assigned the rights under these purchase contracts to the escrow agent, which delivered proceeds to the sellers from the escrow account. Earlier in 2012, Gluck LLC had acquired another 25 percent interest in the property, but this was not at issue in this case.

On their 2012 return, Taxpayers reported the sale as a like-kind exchange that deferred over $10 million in gain. However, that is not the way the owner of the rest of the apartment building characterized this deal. A partnership, Greenberg & Portnoy (G&P), reported on its 2012 return that it owned the apartment building and that Gluck LLC had acquired partnership interests, rather than a direct ownership interest in the building. G&P had owned the apartment building for many years, and its interests had descended among numerous family members. According to G&P, both of the sellers who traded their interests with Gluck LLC held partnership interests, not tenancy in common interests in the real estate.

G&P thus showed Gluck LLC as a new partner at year end, which owed a 50 percent partnership interest. It also provided a K-1 showing that Gluck LLC had a distributive share of the net rental real estate income associated with the building. Taxpayers did not report this income, or file Form 8082 to provide notice of inconsistent treatment. G&P was also a TEFRA partnership on account of the fact that other entities held partnership interest, and its tax matters partner was Carolyn Grant.

Section 1031(a)(2)(D) disallows like-kind exchange treatment for transactions involving partnership interests. The Service examined Taxpayer's 2012 return and disallowed the section 1031 deferral of gain. However, the Service did not propose an adjustment for failing to report their share of K-1 income from G&P. Taxpayers petitioned the Tax Court for redetermination.

The Service filed a motion to dismiss for lack of jurisdiction, arguing that the deficiency in this case is the product of a "computational adjustment" associated with a TEFRA partnership. Such adjustments can be assessed without following the usual deficiency procedures. Whether a person is a partner in a partnership is generally a "partnership item" that is subject to determination at the partnership level; so is the existence of a valid partnership. Here, G&P was a TEFRA partnership that was not eligible for the small-partnership exception on account of entities holding partnership interests – Gluck LLC was itself a disregarded entity that would put G&P outside the small partnership category. TEFRA provisions generally apply when an entity files a partnership return, even if the entity is ultimately determined not to be a partnership.

Thus, whether Taxpayers are members of a partnership and whether the partnership owned the apartment building are partnership items; the legal and factual determinations that underlie the amount, timing, and characterization of income are likewise partnership items. If G&P had not owned the building, it would not be proper for G&P to report the income and expenses from it on its partnership return. "Because Gluck LLC's interest in G&P was a partnership item, the IRS' disallowance of deferral under section 1031 was a change in petitioners' tax liability that properly reflected G&P's treatment of a partnership item." Here, no partner-level determination needed to be made. The result was a computational matter, rather than one in which partner-level determinations had to be made, as in the case of a "factual affected item" (e.g., determining whether partner was "at-risk").

Although computational adjustments often take the form of mathematical operations, such as correcting the distributive share of partnership income, section 6231(a)(6) includes any "change in the tax liability of a partner which properly reflects treatment … of a partnership item." Taxpayers correctly pointed out that the section 1031 deferral they sought was not part of the partnership tax return but was only claimed on their personal return. However, the Tax Court pointed out that other computational adjustments – such as impacts on the partner's return to adjust itemized deductions for medical expenses flowing from a corrected share of partnership income – also appear only on the partner's tax return.

Thus, the Tax court lacked jurisdiction over this "computational adjustment". Taxpayers complained bitterly that this issue had not been raised during consideration by Appeals. However, the Tax Court pointed out that jurisdictional arguments can be argued at any stage of the case. The Service also noted that a notice of deficiency can be used as a protective matter in such cases given the "gray area" that exists between computational affected items and factual affected items. The Tax Court did have jurisdiction to determine the accuracy penalty associated with this "computational adjustment", but it made no determination in this decision.

Comments: This case provides an unexpected and counterintuitive result, but one that can be reached by following the court's logic. The court observed that Taxpayers could have avoided this result by immediately responding to the K-1 they received, which could have triggered an audit of G&P. But G&P would have had no interest in advocating that it was not a partnership – that would not have produced an adversarial determination. Finally, this case shows the need for due diligence about the true nature of the property interest conveyed in a case involving a like-kind exchange. At least in this case, Gluck LLC was recognized as the owner of something! The nemo dat rule would not have given them this much if, indeed, the sellers had no tenancy in common interest to transfer.

4. Six-month limitation period to challenge computational item for corporate partner barred refund claim, General Mills, Inc. v. United States, 957 F.3d 1275 (Fed. Cir. 2020).

Taxpayer sued in the Claims Court to seek refunds of interest erroneously collected at the enhanced rates for "large corporate underpayments" under section 6621(c) for taxes assessed during the 2002-06 tax years. Taxpayer is the parent corporation of several partners of General Mills Cereals, LLC, which is a partnership for tax purposes. The partnership was audited during 2002-06, and it settled proposed deficiencies with the IRS. Computational adjustments from that settlement thus flowed through to its corporate partners.

Taxpayer paid the tax and interest from those computational adjustments on behalf of its entity partners in 2011. It then filed refund claims in 2013, which alleged that the Service erred in computing these interest amounts. The Service denied the claims, triggering its refund litigation. The Claims Court denied the claims as untimely, and Taxpayer appealed.

At issue in this case is whether the ordinary rule of I.R.C. § 6511(a), which allows a two-year period for the claim, or the more limited six-month rule of I.R.C. § 6230(c)(2)(A), which applies to a claim for refund that is based on an erroneous computational adjustment. The Court of Federal Claims applied the six-month period, which it determined had preempted the longer, general rule of section 6511(a). As a result, it ruled that it lacked jurisdiction to consider the substance of this claim.

The Federal Circuit affirmed. The Court agreed that the IRS used incorrect "applicable dates" to calculate the interest due, but it treated that error as a computational adjustment for purposes of applying this statute of limitations. It rejected Taxpayer's claim to distinguish mathematical errors from "legal" errors for purposes of determining whether the taxpayer is challenging whether the Service "erroneously computed any computational adjustment." Further, it agreed with the Government that proper notice was given in this case to permit Taxpayer to challenge the computational adjustment. Accordingly, the untimely petition deprived the court of jurisdiction to consider the refund claim.

Comment: This is a tough outcome that turns on a broader reading of a computational adjustment than a reasonable lawyer might have recognized. Judge Newman's dissent supports that alternative reasonable view. He also questions the fairness of such a ruling. Unfortunately, tax law is very hard, and outcomes in cases like these reflect its unforgiving character.

5. Distressed debt scheme is still a sham, Sugarloaf Fund, LLC v. Commissioner, 953 F.3d 439 (7th Cir. 2020).

A promoter of distressed debt investment schemes returned to continue litigating their validity after being rebuffed in previous attempts. This time, he argued, a restructuring of the business made it completely different. The Tax Court disagreed in TC Memo 2018-181, finding that the changes lacked economic significance. The Seventh Circuit affirmed, concluding: "The Internal Revenue Service, Tax Court, and now our court have devoted substantial resources over multiple proceedings to deciphering foreign and domestic transactions, understanding complex tax structures, and separating the fair from the fraud. None of this has gone well for Rogers or his partnership, the Sugarloaf Fund. While we cannot control any party's litigation choices, we can sound caution to those who persist in pressing claims lacking any merit. The time has come to do so here …."

Comment: The case provides a helpful overview of distressed debt tax strategies. If you have a client intrigued with a similar idea, send them off to read this case first. And note the recent announcement by the Seventh Circuit discussed above that frivolous appeal penalties of up to $5,000 may be applied in a proper case.

6. No partnership basis from payments to former spouse connected to divorce, Matzkin v. Commissioner, TC Memo 2020-117.

Taxpayer (Steve), a dentist, owned 70 percent of a very successful dental support organization business operated through an LLC. In January 2008, he transferred his 70 percent membership interest to SRM, an S Corporation. He owned 100 percent of the S corporation, which continued to own his 70 percent membership interest in the LLC.

In May 2008, Steve filed for divorce from his wife, Georgeann. The indirect interest in the LLC was considered a marital asset, and the coupled valued it at $21 million. Since Georgeann was not a dentist, she could not be realistically be given an interest in the LLC due to requirements for consent to be admitted to the LLC as a member. Accordingly, while other assets were divided equally between the couple, the LLC would go to Steve and he would pay Georgeann the value of her share in a structured settlement, which included a cash down payment, followed by an interest-bearing promissory note and the assumption of Georgeann's share of the couple's liabilities.

That deal was formalized through a document that specified that Georgeann would receive no alimony apart from payment on the promissory note, which would be deemed "non-taxable alimony". A later agreement characterized this as "non-modifiable alimony for …[Georgeann's] support and maintenance". The obligations to pay were not terminable on either party's death or Georgeann's remarriage. They were not deductible to Steve nor taxable to Georgeann. The deal further prescribed that if Steve sold the interest in the LLC within 18 months for more than $30 million, the couple would share the excess. A sale would also accelerate the due date of any payments on the note.

A final judgment of divorce was entered in January 2009. In the ensuing years, Steve paid Georgeann cash plus principal and interest on the note, plus he paid her share of their joint liabilities. On May 24, 2012, he sold the indirect interest in the LLC held through his S corporation for $93.7 million. Gains on the sale passed through to him. He paid the note balance pursuant to the couple's agreement. He reported gains of $85 million on the sale, which was from pass-through income reported by his S corporation. The IRS adjusted this figure upward after audit. Taxpayer asserted that he was entitled to adjust the basis upward based on payments he made to Georgeann and to his attorney in connection with the settlement.

The Tax Court first looked to Florida law to characterize the payments to Georgeann, and it concluded that these should be treated as "lump-sum alimony", which is essentially a form of property settlement. No one claimed that the payments should be deductible alimony payments. Although the payments were made over time, lump-sum alimony contemplates this possibility.

However, Steve claimed that these payments were essentially payments to purchase her interest in the LLC, and thus they should be treated as increasing Steve's basis. But this was factually inaccurate: neither Steve nor his S corporation acquired any interest in the LLC from Georgeann or anyone else. Nor did any of these payments constitute a contribution to the partnership. According to the Tax Court, this was much like a situation where a key marital asset consisted of common stock. If Steve had owned $21 million of common stock and he agreed to give half of it to Georgeann, he would have the same pro-rata basis he had before the division of the stock. The same result obtains if Steve decided to keep the stock and pay for the interest in cash – the cash payment would not increase his pre-transfer basis in the stock. Likewise, the same result would obtain if Steve gave his wife a promissory note for her share of the stock.

Steve also argued that Georgeann's claims were like a cloud hanging over his title to the LLC interest, and thus the payments to his lawyer and to Georgeann were designed to clear the cloud, thereby requiring capitalization. The Tax Court did not buy it. Steve made the payments, not his S corporation (which actually owned the LLC interest). If it was a payment requiring capitalization, it should affect his basis in the S corporation, not the LLC interest. More importantly, the claims of his former spouse did not cloud the title to any particular asset, but instead served as an equitable claim to half of the couple's assets. Florida law makes that claim attach to the value of assets, not any particular asset. Steve's S corporation had, and continued to have, title to the membership interest, so there was no theory about capitalization of costs to defend or protect title available to Steve.

Comment: Family law practitioners, take note. Be sure both sides understand the tax consequences of these marital settlements.

7. Carried interests: proposed regulations are here, REG-107213-18, __ Fed. Reg. ___ (August 3, 2013).

The Tax Cuts and Jobs Act added section 1061 to Subchapter K, which recharacterizes certain capital gain income of affected partners as short-term capital gain by extending the applicable holding period from section 1222 to require a three-year holding period. Although there was some controversy over whether a partnership interest held by an S Corporation could escape these rules, the Proposed Regulations follow earlier IRS guidance that does not permit this to occur.

8. Other notable administrative developments.

Draft instructions for partnership tax basis capital reporting have been issued. IR-2020-240 (October 22, 2020), https://www.irs.gov/newsroom/irs-releases-draft-form-1065-instructions-on-partner-tax-basis-capital-reporting. The Treasury will be looking at comments to improve the matter of capital account reporting, which has produced variable and often confusing outcomes.

Also, proposed regulations issued for the partnership audit regime provide new guidance on the partnership entities that may be eligible to opt-out of the entity regime created under the Bipartisan Budget Act of 2015. See REG-123652-18 Among other things, the proposed regulations ensure that a partnership with a QSSS as a partner are ineligible to opt-out, a change from earlier IRS positions.

VII. International.

Reforms in the international tax regime following the Tax Cuts and Jobs Act, as well as those addressing OECD attempts to address tax reporting regimes, have generated significant administrative developments and news stories over the past year. Those matters could provide grist for a separate outline that perhaps equals or exceeds the length of this one. Below I am highlighting several case law developments that touch on broader and perhaps more durable issues. But of course, predictions on durability are hazardous, and particularly so when tax is involved.

1. Time-chartered ship decommissioning wells on OCS had effectively connected income despite lacking a permanent establishment, Adams Challenge (UK) Ltd. v. Commissioner, 154 T.C. No. 3 (2020).

Taxpayer was a private limited liability company under UK law, which owned a vessel equipped with equipment and systems that could be used in decommissioning oil and gas wells Taxpayer chartered the ship to another firm, EPIC, in 2009 for the purpose of undertaking decommissioning work. Taxpayer provided the vessel and a marine crew of 28 persons, while EPIC provided about sixty other workers to undertake salvage and decommissioning operations in the located on the outer continental shelf (OCS). The vessel moved from Gibraltar to the Gulf of Mexico (for which it was paid $750K, which the Service admits is not taxable), but then began work on various contracts between EPIC and oil and gas companies. Many of these wells had not been producing for some time, as they had been damaged in hurricanes. Thus, there was no connection between work being done and oil or gas production.

Taxpayer did not file a corporate tax return in the U.S. for either 2009 or 2010. In 2013 Taxpayer filed a delinquent return for 2011 showing taxable income of $369K, with $2.7M of effectively connected income offset by about $2.4 million of deductions. In 2014, the Service prepared substitute returns for the 2009 and 2010 years, and it issued a notice of deficiency covering these three years that reflected more than $40 million in unreported taxable income. A Tax Court petition followed by motions and cross-motions for summary judgment followed, which turned on the interpretation of section 882 and the inclusion of taxable income "effectively connected with the conduct of a trade or business within the United States."

This question turned on the meaning of "within the United States", as Taxpayer conceded it was carrying on a trade or business. Although section 7701(a)(9) provides that the term "United States" includes only the states and the District of Columbia, section 638 expands this to include "the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources …." The Outer Continental Shelf in the Gulf of Mexico falls within the scope of this definition. Section 638 applies for purposes of applying sections 1 through 1400u-3 of the Code, but only for activities "with respect to mines, oil and gas wells, and other natural deposits."

The Tax Court found that Taxpayer's activities fell within the scope of these provisions, thus presenting effectively connected income that would be subject to tax by the United States. First, time charters like this one are specifically included in an example in the regulations. Second, the regulations under section 638 include activities "related to" exploration for or exploitation of oil and gas. This did not require a direct or immediate relationship, and it was reasonable to conclude that decommissioning activities had a sufficient relationship, particularly when Interior Department regulations require decommissioning activities for all producers, which is merely a part of the production cycle. After all, even medical doctors and cooks who are providing services in such context are treated as generating effectively connected income in examples provided in those regulations.

Further, Taxpayer was not entitled to protection under the UK/US tax treaty. Although the treaty otherwise requires a permanent establishment as a prerequisite for taxation in the U.S., a special rule deems activities connected with the exploitation of natural resources to be a permanent establishment for these purposes. Here, looking to section 638 for guidance in interpreting that connection, the Tax Court found that the treaty did not preclude taxation.

Finally, the Tax Court also rejected Taxpayer's arguments that some of its revenues should be attributed to activities, such as idling at sea or moving between job sites, which were not connected to oil and gas. These were found to be inseparable from other charter activities.

Comment: This is an important case for Taxpayers engaged in similar activities on the U.S. continental shelf, and likely also for U.S. Taxpayers active in the territorial waters of other nations. The case is well-researched and provides good insights on the history of section 638 and the development of related treaty exceptions for natural resource exploration and exploitation. It should also be noted that this Taxpayer apparently did not think it was subject to tax in the U.S., so it did not file a return. And it is also interesting that a delinquent return was filed just before the IRS filed substitute returns on its behalf. There is likely a back story here about discovery and enforcement. This taxpayer also took the step of filing its own returns for 2009 and 2010 to preserve its right to claim deductions associated with any effectively connected income.

2. Research grant exempt from US taxation based on the Russian treaty, Baturin v. Commissioner, 153 T.C. No. 10 (2019).

Taxpayer is a Russian citizen with background in physics. He was invited to work at a lab connected with the US department of energy, which was engaged in researching the structure of the matter in the universe. Taxpayer had skills relating to the operation of particle accelerators and other complex equipment. He obtained a temporary visa and received annual compensation of $75,000. The arrangement continued for 2 years, after which taxpayer was offered a three-year extension of his position, which would extend through the 2012 tax year. He then received another extension and a H-1B Temporary Worker visa, which extended through 2015.

During the 2010 and 2011 tax years, taxpayer received a W-2 reporting amounts paid and federal income tax withheld. Taxpayer timely filed form 1040NR, the tax return for nonresident aliens, claiming an exemption from US taxes under the US – Russia treaty. In 2014, the service issued a notice of deficiency for the 2010 and 2011 tax years, claiming that taxpayer received taxable wages that were not exempt from US income tax.

The Tax Court determined that Article 18 of the US-Russia treaty exempted payments that taxpayer received as a nonresident researcher in the United States. This provision exempts payments "for the purpose of his maintenance" connected to a "grant, allowance, or other similar payments" in support of studying or doing research that was in the public interest. The technical explanation to the treaty provides that article 18 exemption applies even if the individual becomes a resident of the United States under the substantial presence test of IRC § 7701(b).

The treaty provides a broader exemption than the exclusion for scholarships under section 117 of the code. This was consistent with the terms of the treaty, which placed great emphasis on facilitating the exchange of scientific research. The court was willing to look to the technical explanation of the treaty to supplement the actual terms, finding that characterizing payments as wages reportable on form W-2 did not prevent them from being treated as a "grant allowance or similar payment". Significantly, the court distinguished between a grant awarded to an individual and an individual being paid from a grant awarded to another. Only the former is eligible for an exclusion under section 18. However, "[i]f the institution issuing a Form W-2 is the conduit for payment and the individual otherwise meets the requirements of Article 18, indirect payment of a 'grant, allowance for some other similar payment' is exempt from taxation.

Here, it was significant that the payments and 2010 and 2011 occurred when taxpayer had a J – one visa, which reflects temporary presence in the United States. In contrast, is H – 1B visa effective in 2012 reflected a different kind of arrangement, in which he would be receiving payments as a worker that were subject to tax withholding.

Comment: This pro se taxpayer obtained a significant victory by avoiding US taxes on income earned during these tax years. This decision may provide helpful precedent for other nonresident alien researchers who received grants to support their work. It conserves grant resources to allow tax-exempt earnings. Query the extent that similar provisions exist in other bilateral tax treaties.

3. Structure produced foreign base company sales income includable in Subpart F income based on "branch or similar establishment" provision, Whirlpool Financial Corp. v. Commissioner, 154 T.C. No. 9 (2020).

Whirlpool Corporation manufactured household appliances, including Maytag which it acquired in 2006. Beginning in 2007, Whirlpool restructured its operations to take advantage of some special tax opportunities rooted in Mexican laws. Ownership in subsidiaries operating in Mexico, including a corporation engaged in manufacturing in Mexico, was transferred to two Luxembourg holding companies. The transferred Mexican subsidiaries had been considered CFCs under US tax law. The Luxembourg holding companies had no operations, except one of them had a single part-time employee who performed modest administrative functions.

Whirlpool also formed a new corporation, WIN, under Mexican law. It, too, was transferred to a Luxembourg holding company, but it maintained a separate corporate existence under applicable foreign laws. WIN made a "check the box" election to be treated as a disregarded entity for Federal Income Tax purposes.

Other Mexican subsidiaries continued to own land and manufacture products in Mexico, but they leased all their operational assets and sold all their inventory to WIN. WIN likewise had no employees of its own, and it used "seconded" employees from the other Mexican firms and "subcontracted" employees at the rank-and-file level to carry out its operations. However, agreements provided that all such employees remained employees of the original Mexican firms, which retained employment responsibility over them.

WIN executed bailment agreements with the Mexican companies, allowing them to use the leased equipment to carry out their obligations to manufacture refrigerators and washing machines. At the completion of the manufacturing process, the finished goods were sold primarily to WIN, from which Whirlpool derived gross receipts of more than $800M.

The Mexican tax rules were based on the so-called maquiladora program, which was designed to incentivize manufacturing in Mexico. Although a foreign principal engaged in manufacturing operations would ordinarily acquire a PE in Mexico and subject itself to a 28 percent tax rate, these foreign firms could take advantage of lower Mexican tax rates by satisfying certain transfer-pricing requirements. WIN qualified, allowing it to pay a lower 17 percent tax rate. Whirlpool Luxembourg took the position that it had no PE in Mexico (as all those activities were conducted through WIN) and it was exempt therefore exempted from Mexican taxes on all income earned under supply agreements that WIN had with the Mexican corporations.

Tax rules in Luxembourg sweetened the deal. A Mexico-Luxembourg tax treaty allowed income attributable to a PE in Mexico to be exempt from Luxembourg tax. Thus, Whirlpool Luxembourg took the position that it had a PE in Mexico through the ownership and use of the plants in Mexico to manufacture goods, as well as from the sale of its products in Mexico. So, Whirlpool Luxembourg has the enviable position of neither being taxed in Mexico nor in Luxembourg.

The potential fly in the ointment would be a tax emanating from the United States. In particular, the IRS took the position that Whirlpool Luxembourg's sale of products to Whirlpool Corporation and to its Mexican subsidiary (for resale in Mexico) gave rise to foreign base company sales income (FBCSI) taxable to Whirlpool Corporation under Subpart F. This dispute over some $49 million in income lead to a summary judgment motion in the Tax Court.

The Tax Court granted summary judgment in favor of the IRS. After rehearsing the history of Subpart F, which was designed to capture income from "the purchase and sale of property, without any appreciable value being added to the product by the selling corporation" (quoting the legislative history), the court proceeded to address the scope of FBSCI taxable as Subpart F income under section 954(d). In this case, the applicable regulations date to 2002, as new regulations proposed in 2008 were not adopted until 2011. Taxpayer did not elect to apply these new regulations retroactively.

The 2008 regulations would have made the IRS case easier to win. However, the Service was able to prevail because of the "branch or similar establishment" rule found in IRC § 954(d)(2). Taxpayer was able to demonstrate that its structure – which was very clever – did not technically come under the scope of section 954(d)(1), which encompassed four different categories of property transactions: (i) "the purchase of personal property from a related person and its sale to any person," (ii) "the sale of personal property to any person on behalf of a related person," (iii) "the purchase of personal property from any person and its sale to a related person," and (iv) "the purchase of personal property from any person on behalf of a related person."

Here, Whirlpool Luxembourg did not purchase personal property from a related person under category (i), as it purchased raw materials and components from unrelated suppliers for use in the manufacturing operations located in Mexico.

Neither did Whirlpool Luxembourg sell personal property on behalf of a related person. WIN, its subsidiary, was disregarded. Therefore, it was treated as a "branch". And a "branch" is not a related person as defined in section 954(d)(3), which requires a separate corporation. A disregarded entity does not conform to this definition.

Whirlpool Luxembourg also did not sell property purchased from any person to a related person, as in category (iii), as the raw materials and components were transformed by manufacturing before they were sold. Thus, although Whirlpool Corporation and its Mexican subsidiary were indeed related persons, this category was not satisfied because of the manufacturing processes applied to the products (refrigerators and washing machines) that they bought. Although the Service did not challenge this transformation, it challenged the locus of the firm providing it. Indeed, Whirlpool Luxembourg and WIN had only one part-time employee. The manufacturing processes after the 2007 changes remained pretty much the same as before. But here, the statute does not define what it takes to be a manufacturer. The 2002 regulations left room for the Taxpayer position, but the 2008 regulations clarified in their preamble that manufacturer status should not apply where "the CFC itself performs little or no part of the manufacture of th[e] property". (quoting 73 Fed. Reg. 10718 (Feb. 28, 2008). Those regulations would require manufacturing using the CFC's employees, which did not occur here.

Sensing a potential loss on the MSJ, the Service argued that existing precedent, Electric Arts, Inc., 118 TC 226 (2002), left open some important questions of fact in this case. While the Tax Court agreed, it chose not to decide on this basis. Instead, it looked to section 954(d)(2) to rule for the Service.

Section 954(d)(2) reaches out to include in FBCSI that income derived using a "branch or similar establishment" outside the CFC's country of establishment that has "substantially the same effect" as using a controlled subsidiary. Here, the Tax Court concluded that Whirlpool Luxembourg indeed had the equivalent of a branch operation in Mexico. After all, it had represented to Luxembourg authorities that it had a PE in Mexico – which is consistent with operating a branch. According to the Tax Court, this provision was designed to reach those circumstances where the CFC chose a structure that generated substantially the same effect as if it had operated through a subsidiary. In that case, the subsidiary income would be taxable under Subpart F.

Comment: While the opinion contains numerous additional details concerning the computation of taxable income under the applicable regulations, this decision is a big win for the Service. It also merits careful study by those who wish to understand the enormous complexity and opportunities for gamesmanship under the international tax regime. The cat may catch up with new regulations – a better mouse trap – but mice are notoriously crafty.

4. Coca-Cola loses $3.4 Billion Transfer Pricing Case, The Coca-Cola Company v. Commissioner, 155 T.C. No. 10 (2020).

In a massive 244-page opinion, the Tax Court deals a blow to the transfer-pricing plans implemented by Coca-Cola to shift income to its foreign subsidiaries. The key role of intangibles owned and developed in the U.S. provided the foundation for the Service to find the allocation to foreign subsidiaries did not clearly reflect income.

Comments: Other commentators suggest that this IRS victory does not bode well for other multinationals that rely significantly on IP to generate profits abroad.

5. Taxpayer ineligible for foreign earned income exclusion, Cutting v. Commissioner, TC Memo 2020-158.

Taxpayer was a long-haul pilot who flew international routes for his U.S.-based employer. He married a resident of Thailand, and he spent most of his time off there with his family. However, he did not become a resident of Thailand and used temporary visa status that extended for 30 days and was renewed each time he left and re-entered the country after completing flight duties for his employer from his duty base in San Jose, CA.

Taxpayer sought to exclude from his taxable income amounts of "foreign-earned income" under section 911 of the Code. Section 911 requires one to have a tax home in a foreign country and either status as a bona fide resident of a foreign country or physical presence abroad for certain periods. Here, Taxpayer failed these requirements. First, he failed to satisfy the "tax home" component. His principal place of business was in San Jose, California, the location of his "duty station' for his employer. Despite flying international routes, his employment agreement identified San Jose as his home base. Although it did not need to reach other components of the section 911 exclusion, the Tax Court also analyzed the bona fide residence and physical presence tests otherwise applicable in this context. It ruled that Taxpayer also failed to satisfy either of these requirements.

Comment: Taxpayers in this situation face higher tax burdens than those who are eligible to establish a business (tax) home and residence abroad. The case provides helpful guidance for those who have clients that work abroad in transportation industries. Notably, the IRS conceded penalties for this taxpayer, likely reflecting the complex factual determinations at play in this area.

VIII. Employment Taxes.

1. Dissolved corporation could litigate in Tax Court for a reasonable time after dissolution, Patrick's Payroll Services, Inc. v. Commissioner, TC Memo 2020-47.

Taxpayer was a Michigan corporation that engaged in employee leasing and provided payroll services. It treated the employees it leased out as its own, withheld payroll taxes, and issued W-2s to them. However, it failed to pay over the employment taxes and to file the applicable employment tax returns. The corporation was defunct and had no assets as of October 2011, and it dissolved in 2013.

In 2015, an examination commenced into the 2010 and 2011 tax years, which produced a 30-day letter proposing more than $985K in payroll taxes and penalties. The company passed on any opportunity to request an Appeals conference, and the tax was assessed.

After assessment, Taxpayer filed a request for a CDP hearing, in which it requested that the account be treated as "currently not collectible" (CNC). It disputed the calculation of liabilities based on the date the company started, but not the underlying liability. Eventually, a CDP hearing was held by telephone. Taxpayer admitted that it owed "some taxes", and it advised the IRS that the corporation was defunct and had no assets. The Settlement Officer asked for detailed financial information and proposed settlement alternatives, but none was forthcoming. The Service proceeded toward collection. This appeal to the Tax Court followed.

The Tax Court first inquired as to whether it had jurisdiction to hear the case based on the prior dissolution of the corporation. Looking to Michigan law (see Tax Court Rule 60(c)), the court determined that a dissolved corporation may litigate over its debts for a reasonable period required to wind up its affairs. Accordingly, since this litigation arose out of the examination commencing in 2015, it was deemed to be within that reasonable period.

However, on the substantive matter of challenging the underlying liability, Taxpayer was precluded based on the failure to challenge the underlying liability after the tax was assessed. (Numerous precedents support this view.) Moreover, there was no abuse of discretion in assessing the tax and related penalties.

Comment: Defunct corporations do come up with some regularity. One wonders why a TFRP was not asserted here. Query whether the Service is chasing this defunct corporation because it has reason to believe that assets distributed from it are in the hands of someone from whom they might collect under section 6901.

2. Taxpayer successfully established independent contractor status for workers connected to her cleaning business, Santos v. Commissioner, TC Memo 2020-88.

Taxpayer received notice that she was liable for employment taxes of $125,799 for the 2008-10 tax years in connection with her failure to legally classify workers in her cleaning business as employees. Taxpayer petitioned the Tax Court for a redetermination of employment status pursuant to section 7436.

Taxpayer's business, which she reported on Schedule C, provided cleaning services for vacated apartments prior to future tenant occupation. These were scheduled on an as-needed basis, while contracts to clean common areas of those apartment buildings was scheduled regularly. Charges for common areas were determined on a weekly fixed cost basis, but apartment cleaning generated variable charges based on the size.

As an immigrant from Brazil fluent in Portuguese and English, Taxpayer tapped into the network of her countrymen and hired only individuals with previous experience in cleaning. No training was required. Many of these workers cleaned for other businesses in addition to cleaning for Taxpayer. They were paid a fixed rate for each apartment, provided their own transportation and cleaning supplies. They could hire their own assistants. She rarely ever visited the properties for inspection, as any deficiency in outcome would be noted by the apartment manager.

Applying common law principles, the Tax Court agreed with Taxpayer that these workers were not her employees. Here, the right to control the work was determinative – Taxpayer did not exercise such a right but instead delegated the methods, means, and details of achieving the desired result to her workers. Taxpayer instead functioned as a "dispatcher" who also helped bridge any language gaps between workers and clients. Although Taxpayer maintained workers compensation coverage as required by contracts with apartment complexes, this was not determinative, as these contracts governed only their relationships inter se, and did not affect government classification. Based on the history of Taxpayer's relationship with workers, the court also found the relationship to be "transitory".

Comment: This taxpayer did not claim relief under section 530(a) of the Revenue Act of 1978, so this decision was based entirely on the common law basis for employer/employee relationships.

3. Taxpayer gets chance to dispute underlying TFRP liability by alleging he did not get notice of Appeals hearing, Barnhill v. Commissioner, 155 T.C. No. 1 (2020).

Taxpayer was a director of a corporation that withheld but failed to pay over employment taxes. It also failed to pay the employer share, and it filed no returns as required. The Service assessed employment taxes for ten calendar quarters, along with civil penalties (TFRP) totaling about $160,000 against Taxpayer. Taxpayer disputes that he is a responsible party for purposes of this penalty.

The Service sent Letter 1153 to Taxpayer on November 16, 2016, proposing to assess the penalties against him. The letter states in part: "You may still appeal without additional information, but including it at this stage will help us to process your request promptly." In response, Taxpayer did not submit anything to the Service employee who sent the letter, but instead he filed a protest with Appeals on January 13, 2017.

The Appeals officer sent Letter 5157 by regular mail, which scheduled the appeals conference. However, Taxpayer alleges he did not receive that letter. As a result, he did not attend the appeals conference and have an opportunity to provide additional information in support of his position that he was not a responsible party.

Two days after the scheduled conference, Appeals sent a letter 1536 to Taxpayer that stated it was returning the case to the Collection function for assessment. The Service assessed the penalties and made notice and demand, and when payment did not follow, it filed a Notice of Federal Tax Lien. Taxpayer requested a CDP hearing, and he sought to dispute the underlying liability. However, the Appeals officer rejected evidence on the matter of the underlying liability on the ground that Taxpayer had a prior opportunity to dispute but did not exercise it. It sent a notice of determination sustaining the NFTL filing.

Taxpayer appealed to the Tax Court, and the Service moved for summary judgment. The Tax Court refused summary judgment to the Commissioner, holding that there was a genuine issue of material fact as to whether Taxpayer in fact had an opportunity to dispute the underlying liability. Taxpayer declared under penalty of perjury that he did not receive Letter 5157, even though the Appeals officer testified that he mailed the letter to the same address as the previous Letter 1153, which was received by the Taxpayer.

Here, the legal issue addressed involved whether a taxpayer who files a protest after receiving Letter 1153 but fails to pursue an Appeals conference has had an “opportunity” to challenge the underlying liability that is sufficient to preclude him from further disputing the underlying liability in a CDP hearing. Clarifying prior statements on the matter, the Tax Court explained that receiving Letter 1153 does not constitute the opportunity, but instead gives rise to the opportunity through an Appeals hearing. Someone who received Letter 1153, filed a protest, and then still waits for a scheduled hearing has not yet gotten an opportunity to dispute the underlying liability.

None of the cases holding that receipt of Letter 1153 constituted an opportunity to challenge the underlying liability involved a Taxpayer like this one, who timely submitted a protest but, through no fault of his own, was not informed of the schedule and thus missed the opportunity to submit additional information to support his claim. Here, unlike other tax disputes in which the Appeals office sends a “last chance” letter, the Appeals office simply closed the case and sent it to Collection. That may be efficient, but it does not afford Taxpayer and opportunity. Finally, the failure to allow Taxpayer to submit additional information was not a harmless error – the Letter 1153 indicates that Taxpayer would have an opportunity to do so and he was deprived of it.

Comment: This should cause Appeals to communicate by certified mail or by some other channel that will ensure Taxpayer receives communication. In note 7 of this case, the Tax Court observes that employment tax disputes like this one offer some relief if a Taxpayer is unable to obtain Tax Court review. Since the liability is divisible, a Taxpayer may avoid the full-payment *rule by paying the tax associated with one employee and then pursuing refund litigation if the refund claim is denied. Presumably, there would be an opportunity to use a favorable judgment to prevent collection of tax associated with the other employees subject to the TFRP.*

4. Memorandum on Deferring Payroll Tax Obligations in Light of the Ongoing COVID-19 Disaster (August 8, 2020).

President Trump issued an executive order directing the Secretary of the Treasury to defer collection and deposits of payroll taxes on those employees whose income payable during any bi-weekly pay period is less than $4,000. The Secretary is also directed to "explore avenues, including legislation, to eliminate the obligations to pay the taxes deferred…."

Comment: It is doubtful this will generate significant buy-in from Taxpayers, other than those who have no choice.

5. Updated Social Security wage base for 2021, Press Release (October 13, 2020) available at (https://www.ssa.gov/news/press/releases/2020/#10-2020-1

The wage base will increase to $142,800 from $137,700, a healthy increase of 3.7 percent, reflecting improved labor conditions that some may find better than their own situation. Social Security recipients will receive a 1.3 percent COLA beginning next year. Social Security earnings tax exemption amounts increase from $18,240 in 2020 to $18,960 in 2021.

IX. Legislation Highlights.

A. Consolidated Appropriations Act, 2020, Pub. L. No. 116-94, 113 Stat 2534 (December 20, 2019).

This act extended certain expiring provisions in Division Q, with a short title "Taxpayer Certainty and Disaster Tax Relief Act of 2019". It included these popular individual tax provisions:

- IRC § 108(a)(1)(e) principal residence cancelled debt exclusion (to January 1, 2021).
- IRC § 163(h)(3)(E)(iv)(l) mortgage insurance premiums as residence interest (to December 31, 2020).
- IRC § 213(f) medical expense AGI floor reduced to 7.5 percent (to January 1, 2021).
- IRC § 222(e) deduction for qualified tuition and related expenses (to December 31, 2020).

Other notable provisions included cost recovery periods for racehorses, motorsports complexes, and property on Indian reservations; empowerment zones (extended to year-end 2020); several extensions of energy-related provisions; and some disaster-area relief provisions.

Division O of this act included the so-called SECURE Act of 2019 (Setting Every Community Up for Retirement Enhancement), which made significant changes to retirement plans. These include:

- Raising the required age for minimum distribution from 70.5 to 72;
- Allow contributions to traditional IRAs after age 70.5;
- Eliminating deferral opportunities associated with inherited IRAs, causing them to be distributed within ten years.
- Increasing certain failure to file penalties.

The SECURE Act also repealed what turned out to be an unpopular and arguably unjust restriction enacted in the TCJA of 2017 relating to the so-called "Kiddie Tax", allowing affected taxpayers to elect revised treatment retroactively back to 2018. For further analysis, see Mantzke, Cripe, and Youngberg, "Former kiddie tax rules restored", J of Accountancy, July 1, 2020, available at https://www.journalofaccountancy.com/issues/2020/jul/kiddie-tax-rules-restored.html

B. Families First Coronavirus Response Act, Pub. L. No. 116-127, 134 Stat. 177 (March 18, 2020).

- Expands payroll credits for family, medical, and sick leave, including provisions for self-employed workers.

C. Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. No. 116-136 (March 27, 2020).

The CARES Act was passed with massive bipartisan support. Its provisions are far-reaching and effectuates large government stimulus and safety net provisions through the Economic Impact provisions to individuals and paycheck protection loan provisions benefiting businesses. Alternatively, employers may benefit from special employment credits and/or payroll tax deferrals. This outline will not cover these provisions in detail, as they are likely the target of other more detailed programs. Some of the other significant tax provisions with far-reaching effects include:

- IRC § 172: NOLs arising after 2017 and before 2021, previously restricted by TCJA, can now be carried back five years.
- IRC § 163: Restrictions on business expense deductions from TCJA, with increased limitation from 30% to 50% of EBITDA. Note final regulations promulgated in IR-2020-171 (July 28, 2020); see also Notice 2020-22.
- IRC § 56: Unused corporate AMT credits could be recovered in form of refund or credit (previously deferred until 2021).
- IRC § 461(l): Excess business loss limitations are retroactively eliminated for 2018-19, effectively deferring this provision introduced by TCJA until 2021.
- IRC § 72(t) (and others): Certain taxpayers affected by corona virus may withdraw up to $100K from retirement plans before December 31, 2020, if allowed by their plans, without the 10 percent penalty tax on premature distributions. These withdrawals may be taken into income in the current year or over a three-year period, or they may be repaid within three years and defer income taxes. (For more information, see IR-2020-172 (July 29,2020).
- IRC § 401(a)(9) (and others): RMDs are also temporarily suspended and rollover transactions expanded.
- IRC § 168: "Glitch" related to qualified improvements to nonresidential property fixed so that bonus depreciation is now applicable. See also Rev. Proc. 2020-25.

- IRC § 170 (and others): Corporate charitable contribution limits increased from 10 percent to 25 percent for tax years ending after December 31, 2019. Individuals get a $300 "above the line" deduction, rather than itemized deduction.
- IRC § 127: exclusion for certain employer payments of principal and interest on qualified education loans extended to payments before January 1, 2021.

IRS extensions of due dates for filing returns and other related payment obligations also affected filing this year. See generally Notice 2020-35. Cafeteria plans were also allowed additional flexibility for mid-year elections by employees. See Notice 2020-29.

D. Pub. L. No. 116-147, 134 Stat. 660 (July 4, 2020)

- Extends payroll protection program loans and appropriates additional funds.

E. Selected Administrative Guidance.

PPP Loan Forgiveness Guidance, Rev. Rul. 2020-27, 2020-50 IRB amplifying Notice 2020-32, 2020-21 IRB 837; Announcement 2020-12, 2020-41 IRB 893; Rev. Proc. 2020-51, 2020-50 IRB __ (forthcoming December 7, 2020).

Notice 2020-32, issued in May soon after the PPP loan program was rolled out, clarified that section 265, which disallows otherwise deductible expenses connected with tax-exempt income, applies to deductions financed by PPP loans. To the extent PPP loans are expended for covered purposes (e.g., payroll costs, rent, utilities) and the Taxpayer otherwise does not trigger restrictions in loan forgiveness (e.g. significant reductions in employment or salary), the loan may be forgiven. Significantly, such forgiveness "shall be excluded from gross income". See Section 1106(i) of the CARES Act.

Taxpayers faced questions about how to treat expenses this year. Given that forgiveness for many PPP loan recipients may not occur until the 2021 tax year, a final determination about exclusion from gross income may not have been made in 2020. Moreover, Congress has discussed the possibility of a legislative fix, including S. 3612 and H.R. 6821, the Small Business Expense Protection Acts of 2020 and H.R.6754, the Protecting the Paycheck Protection Program Act.

On November 18, the IRS issued Rev. Rul. 2020-27, which reaffirmed and amplified its guidance in Notice 2020-32. In addition to relying upon section 265, the Service also relied on case law in which a "reasonable expectation of reimbursement" prevented current-year deductions. It also issued Rev. Proc. 2020-51, which provides safe harbor treatment for taxpayers who incurred deductible expenses and either was denied loan forgiveness or irrevocably chose not to seek forgiveness in 2021. Eligible taxpayers can file an amended return, seek an administrative adjustment, or claim the deduction in the following tax year.

Some good news for lenders in Announcement 2020-12: no information reporting on Form 1099-C is required for PPP loans. Apparently loan recipients weren't the only ones facing uncertainty about the implications of a future event.

Finally, the IRS also posted some Q/A that deal with PPP and other virus relief programs in an acquisition context. See https://www.irs.gov/newsroom/covid-19-related-employee-retention-credits-interaction-with-other-credit-and-relief-provisions-faqs

Comment: Section 265 prevents a double tax benefit that would otherwise occur when a taxpayer eligible for an exclusion from taxable income takes a related deduction that reduces taxable income. The extra tax burden from losing deductions financed by the loan in 2020 potentially reduces the impact of relief that the program was designed to provide, causing the loan to resemble a taxable transfer payment affecting 2020 income. But isn't the transfer payment model most consistent with helping businesses that are likely to continue as profitable entities? The AICPA is nevertheless lobbying for additional relief for affected taxpayers, who would undoubtedly prefer more rather than less. Some experts also believe that the expenses should be deductible under existing tax doctrine. See, e.g., Deborah Walker & Barry M. Weins, Expenses Used for PPP loan forgiveness: Deductible or not?, The Tax Adviser, December 3, 2020. But remember, someone eventually has to pay for these benefits, don't they?