Important Developments in Federal Income Taxation

Edward A. Morse
PROFESSOR OF LAW
MCGRATH NORTH MULLIN & KRATZ ENDOWED CHAIR IN BUSINESS LAW
CREIGHTON UNIVERSITY SCHOOL OF LAW
MORSE@CREIGHTON.EDU

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 generally 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 their discussion is not comprehensive. Some employment tax cases are covered in part IX and part X concludes with a high-level summary of tax provisions in recent tax legislation passed in 2020 and 2021. This outline reflects developments reported through November 30, 2021.

Table of Contents
I. Gross Income. .................................................................................................................. 10
   A. Timing ................................................................................................................................ 10
      1. COGS offset could not occur without sales, BRC Operating Co. LLC v. Commissioner, TC Memo 2021-59. .......................................................... 10
      2. Final regulations under section 451(b), (c), T.D. 9941 (Dec. 21, 2020) ......................... 10
   B. Inclusion/Exclusion/Deferral. ............................................................................................. 11
      1. AmEx reward dollars earned from debit card purchases constituted taxable income, not purchase price reductions, Anikeev v. Commissioner, TC Memo 2021-23 .......................................................... 11
      2. Settlement proceeds from legal malpractice claim were taxable income, Holliday v. Commissioner, TC Memo 2021-69. ......................................................... 12
      3. Basis reductions required in year of sale connected to QRPBI, Hussey v. Commissioner, 156 T.C. No. 12 (2021) ................................................................. 13
4. FSC payments routed into Roth IRA were not subject to recharacterization by IRS, Mazzei v. Commissioner, 998 F.3d 1041 (9th Cir. 2021), reversing 150 T.C. 138 (2018)...

5. Self-directed IRA deemed to distribute gold coins held directly by Taxpayers, McNulty v. Commissioner, 157 T.C. No. 10 (2021) .................................................. 16

6. Tribal per capita payments were taxable income, Clay v. Commissioner, 990 F.3d 1296 (11th Cir. 2021), affirming 152 T.C. No. 13 (2019) .................................................. 17

7. UBER business failed to report substantial income, Nurumbi v. Commissioner, TC Memo 2021-79 ............................................................................................................ 18

8. Pre-2018 crypto exchanges are not like-kind, CCA 2021-24-008 (June 18, 2021) .................................................................................................................. 18

C. Characterization. ........................................................................................................... 19

1. Transfer of patent rights generated ordinary income not capital gain, Filler v. Commissioner, TC Memo 2021-6 ........................................................................ 19

2. Excess rent paid to shareholders was dividend, not deductible expense, but corporation avoids penalties, Plentywood Drug, Inc. v. Commissioner, TC Memo 2021-45 .................................................................................................................. 21

3. Interest on judgment was ordinary income; underpayment interest cannot accrue when Taxpayer elects to allow Government to retain overpayment balances, Goldring v. United States, 15 F.4th 639 (5th Cir. 2021) ....................................................................... 22

4. Compensatory split-dollar life insurance benefits resulted in taxable income from employment of shareholder-employee, De Los Santos v. Commissioner, 156 T.C. No. 9 (2021) .................................................................................................................. 23

5. AMT obligation imposed on 2016 adjustment for attorney fees claimed as miscellaneous itemized deduction, Colton v. Commissioner, TC Memo 2021-44 .................................................................................................. 25

D. Section 280E (Cannabis Businesses). ........................................................................ 25

1. Section 280E does not violate Eighth or Sixteenth Amendments, Today’s Health Care II, LLC v. Commissioner, TC Memo 2021-96 .................................................................. 25

2. Depreciation and charitable deductions disallowed under section 280E, San Jose Wellness v. Commissioner, 156 T.C. No. 4 (2021) ........................................................................ 25

3. Expert testimony on average COGS rejected in cannabis dispensary case where Taxpayer destroyed accounting records, Purple Heart Patient Center, Inc. v. Commissioner, TC Memo 2021-38 .................................................................................................. 26

II. Deductions. .................................................................................................................... 27

A. Charitable. ..................................................................................................................... 27

1. Charitable contribution deductions denied for lack of qualified appraisal, Pankratz v. Commissioner, TC Memo 2021-26 ........................................................................ 27

2. State law certification not needed, Montgomery-Alabama River, LLC v. Commissioner, TC Memo 2021-62 .................................................................................. 28
3. Some partners escape penalties for conservation easement deductions, Sells v. Commissioner, TC Memo 2021-12. ................................................. 28
4. Savings clause did not cure defect in conservation easement, TOT Property Holdings, LLC v. Commissioner, 1 F.4th 1354 (11th Cir. 2021). ........................................... 29
5. Façade easement fails based on defective language in easement deed, 901 South Broadway Limited Partnership v. Commissioner, TC Memo 2021-132. ...................... 30

B. Business/Investment........................................................................................................ 30
1. Taxpayer fails to prove ongoing trade or business, Estate of Morgan v. Commissioner, TC Memo 2021-104. ................................................................. 30
2. Taxpayer engaged in the trade or business of acting despite losses, Gaston v. Commissioner, TC Memo 2021-107. ................................................................. 31
3. Taxpayer was away from home for purposes of deducting per diem living expenses, Geiman v. Commissioner, TC Memo 2021-80 ................................................. 32
5. Capital loss results from abandonment of interest in LLC by passive investor, Swartz v. United States, No. 17-cv-5914 (E.D. N.Y. July 20, 2021) ........................................... 33
6. Failure to begin trade or business of farming justifies denial of deductions, Costello v. Commissioner, TC Memo 2021–9 ......................................................... 34
8. Taxpayer is not a bank eligible for loss deductions, MoneyGram Int’l, Inc. v. Commissioner, 999 F.3d 269 (5th Cir. 2021). ................................................................. 36
9. NOL carryforwards fail to cross the finish line, Martin v. Commissioner, TC Memo 2021-35. ......................................................................................... 36
10. NOL Guidance for Farm Businesses, Rev. Proc. 2021-14 ................................................ 37
11. Taxpayers who use a per diem rates for meals can fully deduct the meal portion, Notice 2021-63, 2021 WL 5371500 (Nov. 16, 2021) ................................................... 37

C. Personal ......................................................................................................................... 38
1. Race car expenses were not connected to a construction trade or business, Berry v. Commissioner, TC Memo 2021-42. ................................................................. 38
2. Deductible alimony paid through cafeteria plan payments upheld, Leyh v. Commissioner, 157 T.C. No. 7 (2021) ................................................................. 38

III. Credits ......................................................................................................................... 39
1. No research credit for fashion designer, Max v. Commissioner, TC Memo 2021-37. ................................................................. 39
2. Deductions and credits for solar power tax shelter scheme disallowed, Olsen v. Commissioner, TC Memo 2021-41. ................................................................. 40
4. Taxable social security benefits create deficiency from excess APTC, Knox v.
Commissioner, TC Memo 2021-126. ................................................................. 40

IV. Tax Administration. .......................................................................................... 41

A. Penalties. .............................................................................................................. 41

1. Taxpayer avoids fraud penalties due to lack of administrative approval, Beland v.
Commissioner, 156 T.C. No. 5 (2021). ................................................................. 41

2. Passport revocation for delinquent tax debt is constitutional, Maehr v. Department of
State, 5 F.4th 1100 (10th Cir. 2021). ................................................................. 42

3. Tax Court holds that section 7345 did not unconstitutionally infringe right to travel,
Rowen v. Commissioner, 156 T.C. No. 8 (2021). ................................................................. 43

4. Tax Court rejects frivolous protestor claim but does not impose penalties, Delgado v.
Commissioner, TC Memo 2021-84. ......................................................... 43

5. Taxpayer precluded from denying notices of deficiencies underlying seriously
delinquent tax debt under section 7345, Kaebel v. Commissioner, TC Memo 2021-109. 44

6. Early distribution “exaction” under section 72(t) is not a penalty requiring
supervisory approval, Grajales v. Commissioner, 156 T.C. No. 3 (2021)................. 45

7. Penalty on omitted income not excused for reasonable cause based on return preparer,
Walton v. Commissioner, TC Memo 2021-40. ......................................................... 45

8. Owner and beneficiary of foreign trust pays 35 percent penalty for failing to file
returns, Wilson v. United States, 6 F.4th 432 (2nd Cir. 2021). ....................... 46

9. Timely supervisory approval was obtained before initial determination of penalty,
Excelsior Aggregates, LLC v. Commissioner, TC Memo 2021-125. .................. 46

10. Penalty approval by “immediate supervisor” satisfied despite promotion of RA, Sand

11. Incarceration is not reasonable cause for failing to file returns, Lindsay v. United
States, 4 F.4th 292 (5th Cir. 2021). ................................................................. 48

B. FBAR Penalties. ................................................................................................ 49

1. Willful FBAR penalty takes half the account balances of decedent’s estate, United
States v. Kahn, 5 F.4th 167 (2d Cir. 2021). ................................................................. 49

2. Only one non-willful civil penalty can be imposed for late filing of FBAR with
multiple accounts, United States v. Boyd, 991 F.3d 1077 (9th Cir. 2021). .............. 49

3. Willful FBAR penalties upheld based on reckless disregard, Kimble v. United States,
991 F.3d 1238 (Fed. Cir. 2021), cert denied, No. 20-1697 (Oct. 4, 2021). ............ 50

C. Whistleblowers. .................................................................................................. 51

1. Decision on administrative record supports denial of whistleblower claim,
Whistleblower 10084-16W v. Commissioner, TC Memo 2021-73. ....................... 51

2. Whistleblower did not receive determination, McCrory v. Commissioner 156 T.C.
No. 6 (2021). ................................................................. 52


5. Whistleblower denied award where administrative action did not produce collections from the issue disclosed, Lissack v. Commissioner, 157 T.C. No. 5 (2021).


8. WBO did not abuse discretion in rejecting WB claim without remand to WBO over deficient record, Marino v. Commissioner, TC Memo 2021-130.


D. Innocent Spouse.

1. Innocent spouse relief denied based on knowledge, Sutherland v. Commissioner, TC Memo 2021-110.


5. Tax Court jurisdiction to review innocent spouse relief based on denial for one taxable year, Vera v. Commissioner, 157 T.C. No. 6 (2021).

E. Other.

1. IRS did not abuse its discretion in rejecting OIC by estate, Estate of Kwang Lee v. Commissioner, TC Memo 2021-92.


3. SO abused discretion by refusing to review OIC and pursuing collection action, Mason v. Commissioner, TC Memo 2021-64.


5. No right to new CDP hearing based on notes of meeting with Taxpayer’s counsel, Stewart v. Commissioner, 999 F.3d 1150 (8th Cir. 2021).

6. Taxpayer was ineligible for an “equivalent hearing” when he filed a timely request for a CDP hearing, Ruhaak v. Commissioner, 157 T.C. No. 9 (2021).
7. Updated Tax Information for 2022, Rev. Proc. 2021-45 .................................................. 68

V. Tax Litigation & Procedure .......................................................................................... 68

A. Jurisdiction ................................ .............................................................................. 68

1. Chapter 13 Bankruptcy Petition did not preclude IRS from pursuing deficiency against Taxpayer, Wathen v. Commissioner, TC Memo 2021-100 .................................................. 68

2. Second notice of deficiency not required following audit reconsideration, Pazden v. Commissioner, TC Memo 2021-108 ................................................................. 69

3. Married couple may petition Tax Court jointly in passport revocation case, Garcia v. Commissioner, 157 T.C. No. 1 (2021) ........................................................................... 69

4. Taxpayers with adjustment for mathematical error allowed to dispute underlying tax liability in CDP case, Garcia v. Commissioner, TC Memo 2021-72 .................................. 70

5. Notice of determination issued to a sole proprietorship, rather than the individual taxpayer, was a harmless error that did not deprive the Tax Court of jurisdiction, BM Construction v. Commissioner, TC Memo 2021-13 .................................................. 70

6. Taxpayer may withdraw Tax Court petition to review interest abatement, Mainstay Business Solutions v. Commissioner, 156 T.C. No. 7 (2021) ........................................... 71

7. Taxpayer barred from challenging underlying liability, Jeffers v. Commissioner, 992 F.3d 649 (7th Cir. 2021) ........................................................................................................... 72

8. Abuse of discretion based on administrative record applies in CDP review without challenge to underlying liability, Belair v. Commissioner, 157 T.C. No. 2 (2021) ............ 72

9. Tax Court lacks jurisdiction to order refund without a notice of deficiency, Brown v. Commissioner, TC Memo 2021-112 ................................................................. 73

10. Form 1040X creates a claim for abatement, not a claim for refund, where tax was due at the time it was filed, Carr v. United States, No. 20-cv-00744-WHO, 2021 WL 5449072 (N.D. Cal., Nov. 22, 2021) ................................................................. 73

B. Statutes of Limitations ................................ ................................................................. 75

1. Notice of intent to levy sent to taxpayer’s last known address by certified mail starts 30-day period for Tax Court petition, Ramey v. Commissioner, 156 T.C. No. 1 (2021) .... 75

2. Taxpayers were nonfilers because they filed only in the Virgin Islands, Coffey v. Commissioner, 987 F.3d 808 (8th Cir. 2021) ................................................................. 75

3. Seizure of taxpayer records does not shift the burden of proof, Lufkin v. Commissioner, TC Memo 2021-71 ................................................................................................. 75

4. Untimely petition with no proof of mailing results in dismissal, Spain v. Commissioner, TC Memo 2021-58 ................................................................. 76

5. Supreme Court to decide if 30-day rule for filing CDP review petition creates jurisdictional bar, Boechler P.C. v. Commissioner, 967 F.3d 760 (8th Cir. 2020), cert. granted, No. 20-1472, 2021 WL 4464219 (Sept. 30, 2021) ........................................... 77

6. Penalty under section 6700(a) for promoting abusive tax shelters was timely assessed, Crim v. Commissioner, TC Memo 2021-117 .................................................. 77
7. POA consents extended statute for living spouse but not for deceased spouse, FAB Holdings, LLC v. Commissioner, TC Memo 2021-135. ................................................................. 78
8. Tacit consent to filing joint return and implied authority of attorney extended statute of limitations, Soni v. Commissioner, TC Memo 2021-137................................. 79
C. Remedies ........................................................................................................ 81
1. Sovereign immunity protects conversion of collectible coins, Willis v. Boyd, 993 F.3d 545 (8th Cir. 2021) ................................................................. 81
2. Interest abatement claims denied, Verghese v. Commissioner, TC Memo 2021-70. 81
3. Corporate taxpayer is estopped from changing position established in prior litigation, New Capital Fire, Inc. v. Commissioner, TC Memo 2021-67................................. 82
4. Alter ego theory based on state law applied to selected corporate transactions, Jenkins v. Commissioner, TC Memo 2021-54........................................ 84
5. A Notice CP12 is not a settlement agreement, Peak v. Commissioner, TC Memo 2021-128 ................................................................. 85
D. Attorney fees, costs, and damages ................................................................. 86
1. Taxpayer successfully claims litigation cost award under section 7430, Morreale v. Commissioner, TC Memo 2021-90 ................................................................. 86
2. Litigation cost award under 7430 denied because IRS position substantially justified, Jacobs v. Commissioner, TC Memo 2021-51................................................................ 87
E. Tax Crimes/Civil Fraud ................................................................................ 89
1. Deficiency proceeding dismissed for lack of prosecution on account of death, Catlett v. Commissioner, TC Memo 2021-102. ................................................................. 89
2. Restitution payments by convicted taxpayer did not affect additions to tax for penalties that accrued before sentencing, Ervin v. Commissioner, TC Memo 2021-75. ..... 90
3. Fraudulent underreporting of offshore income supports assessment beyond otherwise applicable statute of limitations, Harrington v. Commissioner, TC Memo 2021-95. .......... 90
F. Transferee/Fiduciary Liability ........................................................................ 92
1. Transferee liability is not required to be separately assessed, United States v. Henco Holding Corp., 985 F.3d 1290 (11th Cir. 2021) ................................................................. 92
2. Alter ego theory applied to Taxpayer’s corporation, causing him to be liable for unpaid corporate taxes, United States v. Lothringer, No. 20-50823, 2021 WL 4714609 (5th Cir. 2021). ................................................................. 93
3. Hospital administrator stung by trust fund penalties as responsible party, Cashaw v. Commissioner, TC Memo 2021-123 ................................................................. 93
G. Other

1. Partial summary judgment order in Tax Court not final appealable order, Minemeyer v. Commissioner, 995 F.3d 781 (10th Cir. 2021). ............................................................ 94

VI. Corporations

1. Shareholders who served as officers are statutory employees for FICA purposes, upending their compensation scheme, Blossom Day Care Centers, Inc. v. Commissioner, TC Memo 2021-86................................................................. 96
2. Theft loss from Ponzi scheme disallowed, Vennes v. Commissioner, TC Memo 2021-93........................................................................................................ 96
3. Related party loans were distributions after financial crisis removed reasonable prospects for repayment, Kelly v. Commissioner, TC Memo 2021-76................................. 97
4. S-Corporation law practice delivers tax lessons sole shareholder apparently did not learn in law school, Ward v. Commissioner, TC Memo 2021-32................................. 101
5. Payments for management fees were disguised dividends, not deductible expenditures, Aspro, Inc. v. Commissioner, T.C. Memo 2021–8. ........................................ 101
6. Business losses from former business partner’s withdrawals disallowed, Torres v. Commissioner, TC Memo 2021-66. .................................................................................. 102
7. No tax-exempt status for corporation engaged in research activities intended for public works projects, New World Infrastructure Org. v. Commissioner, TC Memo 2021-91................................................................. 102
8. Corporate taxpayer allowed to reap tax benefits from recharacterizing transaction, Complex Media, Inc. v. Commissioner, TC Memo 2021-14. .............................................. 103

VII. Partnerships

1. Notable administrative developments on basis reporting........................................ 105
2. Omission and nondisclosure extended statute of limitations for timely notice of deficiency, Pragias v. Commissioner, TC Memo 2021-82............................................................. 106
3. Gross income from receipt of a partnership interest for future services is a partnership item for the recipient, ES NPA Holding, LLC v. Commissioner, TC Memo 2021-68. ................................................................. 106
4. Partnership that engaged in Son of Boss transactions was not bona fide, BCP Trading and Investments, LLC v. Commissioner, 991 F.3d 1253 (D.C. Cir. 2021), affirming TC Memo 2017-151................................................................. 107
5. Son of Boss deficiencies affirmed for TEFRA partnership, Greenberg v. Commissioner, No. 20-13001 2021 WL 3700294 (11th Cir. 8/20/21)................................. 108
6. Taxpayer could not sustain challenge to underlying liability for distributive share of partnership income, Dodd v. Commissioner, TC Memo 2021-118.................... 109
7. Partner made loans, not capital contribution, triggering COD income upon termination, Hohl v. Commissioner, TC Memo 2021-5................................. 110
8. Recharacterization of subordinated debt into equity results in gross income for partners in Chicago Cubs, Tribune Media Co. v. Commissioner, TC Memo 2021-122. ... 111
9. Supervisory approval of penalty is a partnership-level defense barred in refund litigation by partner, Ginsburg v. United States, 17 F.4th 78 (11th Cir. 2021)......................... 114
10. Carried interest FAQs and Worksheets, IR-2021-215 (11/3/2021).......................... 115

VIII. International. ........................................................................................................... 115

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)......................................................... 115
2. Returns filed after audit did not prevent disallowance of associated deductions, Adams Challenge (UK) Ltd. v. Commissioner, 156 T.C. No. 2 (2021).............................. 116
3. Military contract payments excluded from gross income under section 911, Wood v. Commissioner, TC Memo 2021-103. ................................................................. 117
4. Tax treaties with France and Italy do not allow foreign tax credits to offset NII tax under section 1411, Toulouse v. Commissioner, 157 T.C. No. 4 (2021).............................. 118
5. FIRPTA withholding by real estate purchaser not subject to declaratory judgment, Gilbert v. United States, 997 F.3d 410 (9th Cir. 2021)........................................... 119

IX. Employment Taxes. ................................................................................................. 120

1. Updated Social Security wage base for 2022 ............................................................. 120
2. Economic hardship exception does not apply to corporate taxpayer, Seminole Nursing Home, Inc. v. Commissioner, 12 F.4th 1150 (10th Cir. 2021), affirming TC Memo 2017-102. ................................................................. 121

X. Legislation Highlights............................................................................................... 122

G. Infrastructure Investment and Jobs Act, Pub. L. No. 117-56 (November 15, 2021) ... 125

I. Gross Income.

A. Timing.

1. COGS offset could not occur without sales, BRC Operating Co. LLC v. Commissioner, TC Memo 2021-59.

Taxpayers organized as LLCs invested $180 million in 2008 to acquire mineral and lease interests for the purpose of producing natural gas. However, it did not actually drill or receive drilling services for third parties during 2008 or 2009. Nevertheless, Taxpayers included COGS on their partnership tax returns totaling $100M in 2008 and $60M in 2009, representing accrued drilling costs. Taxpayers and the IRS stipulated to these amounts, and there was no question about the propriety of the costs. The only question involved whether the costs could be taking into account during the tax years claimed by the Taxpayers.

The Service argued that the costs failed the all-events test associated with the economic performance requirement in section 461(h)(1). Taxpayers argued that the regulations under section 461 were not applicable to COGS, which are not deductions but instead are offsets to the selling price. Although the Taxpayer’s characterization of COGS is correct and supported by considerable authority outlined in this case, not the least of which is the Sixteenth Amendment, which requires the income tax to apply to income and not on capital, the Tax Court identified another issue: could COGS be taken into account when there were no sales?

The Tax Court concluded that it was not proper to report COGS when there were no goods “sold” in this case. Accordingly, it did not reach the matter of the application of section 461(h).

Comment: The better view is probably that section 461(h) also applies to items affecting COGS, but this court did not need to reach the issue. (For further analysis, See Gertzman, Federal Tax Accounting, ¶ 4.04, n. 319.) COGS is not a deduction, but it is an offset against the selling price used to compute gross income (i.e., gross profit on sales). This explains the proliferation of cases involving marijuana dispensaries, which are allowed to use inventory accounting methods to compute gross income but are precluded from taking other deductions under IRC § 280E. For a recent circuit case on point, see Patients Mutual Assistance Collective Corp. v. Commissioner, 995 F.3d 671 (9th Cir. 2021) (upholding the constitutionality of 280E and requiring merchandiser to follow inventory accounting regulations in determining COGS).

2. Final regulations under section 451(b), (c), T.D. 9941 (Dec. 21, 2020)

Tax accounting mavens will be interested in these final regulations, which implement amendments to sections 451(b) and (c) that were part of the Tax Cuts and Jobs Act of 2017. These regulations are generally effective after January 1, 2021, but taxpayers may also elect to apply them retroactively for tax years beginning after December 31, 2017. The regulations affect the timing of income for firms that have an applicable financial statement, which could include statements prepared according to GAAP, such as a Form 10-K, an audited financial statement
used for credit or reporting to owners, or a statement filed with a federal agency other than for federal tax purposes. For such taxpayers, income inclusion occurs under the “all events test” no later than when the item is taken into account on the applicable financial statement, except for certain other special methods of accounting (such as under section 453, 460, 467). These regulations also include provisions that govern the treatment of advance payments and associated costs for income recognition purposes.

B. Inclusion/Exclusion/Deferral.

1. AmEx reward dollars earned from debit card purchases constituted taxable income, not purchase price reductions, Anikeev v. Commissioner, TC Memo 2021-23.

During 2013 and 2014, Taxpayers (H and W) participated in the Blue Cash Awards program sponsored by American Express. This program gave reward dollars ranging from 0.5% to up to 5% of eligible purchases, which could either be applied toward a statement balance or redeemed for Amazon gift cards. There was no limit to the amount of reward dollars that could be earned.

    During 2013, Taxpayers racked up over $1 million on their cards. During 2014, the total exceeded $5 million. Almost all of these transactions involved the purchase of VISA gift cards, reloadable debit cards, and money orders. In 2013 and 2014, over $4 million of the money orders were deposited into Taxpayers’ bank accounts.

    These transactions generated reward dollars totaling $36,200 in 2013 and $277,275 in 2014. Taxpayers failed to report any of the reward dollar transactions on their tax returns.

    The Service asserted a deficiency for the entire amount of the reward points that were not earned in connection with the purchase of goods or services other than debit cards, gift cards, and money orders. Although a payment received as an inducement to purchase property may be properly characterized as a nontaxable purchase price adjustment accounted for as a basis adjustment affecting the property acquired, the Service alleged that payments from the purchase of cash equivalents constitute gross income under section 61.

    The Tax Court found this cash equivalent argument to be a poor fit. Instead, it fashioned a remedy based on the application of longstanding policy rooted in Rev. Rul. 76-96, which determined that a rebate issued by an automobile manufacturer was not gross income but a purchase price adjustment. Rather than an accession to wealth consistent with the definition of gross income, the rebate reflects a reduction in consumption. This policy is also reflected in IRS Publication 17, which specifically addresses car and public utility rebates.

    The AmEx reward dollars earned here were converted to Visa gift cards, which Taxpayers then used to acquire money orders that could be deposited into their bank accounts and used to pay their American Express bills. In this sense, the reward dollars were not the same as the “Thank You Points” received by Taxpayers from their bank for maintaining an account, which were treated as in the nature of interest income when used to purchase an airline ticket. Shankar v. Commissioner, 143 T.C. 140 (2014).
However, the Service takes the position that the acquisition of the Visa gift cards is a cash equivalent, when in fact they are not. They cannot be deposited into a bank account. The gift card entails a convenience service, which Taxpayers paid for upon acquisition. The Service did not argue that the conversion of the gift cards to money orders constituted a taxable event, although the court suggests that would have been a viable theory, noting that it would be akin to an automobile purchaser reselling the car after receiving the cash rebate and realizing gain upon that disposition.

The Tax Court also noted that the “cash equivalency doctrine” had been used to determine the proper timing of income recognition when a taxpayer receives a contractual right to a future payment, as in cases like Cowden (5th Cir. 1961) and its progeny. But those cases did not address the matter of whether a purchase price adjustment was involved.

Accordingly, the Tax Court held that that use of reward dollars to acquire Visa gift cards did not constitute gross income. Those cards could be treated as a product embodying convenience features for the consumers, and they could not be deposited into a bank account. However, when reward dollars were used to acquire money orders or reloadable debit cards, which could be deposited into the customer’s bank account and used for cash infusions, not merely to pay transfer fees, the court upheld the determination that the Taxpayer realized gross income.

Comment: The Tax Court expressly limited its holdings to the unique circumstances of this case, and it expressed hope that the Treasury would clarify its policy rather than rely on litigation to develop the law further in this area. The theoretical possibility raised here – defer the realization event to the disposition of the Visa gift card for a money order – may prove more difficult to administer on account of the diffused information sources for those exchanges compared to the single source of the card issuer. Could gift cards in volume trigger a SAR? Do those rules need to be modified? One wonders how these Taxpayers were selected for audit. Husband had a PhD in physics and the couple reported wages and other income well under $200K each year. Million-dollar bank deposits would seem suspicious, but perhaps without cash no reporting would occur. Perhaps this case provides an example where additional information reporting by banks could prove helpful for tax enforcement. But broader issues of financial privacy and burdens on financial intermediaries deserve a careful weighing in crafting more information sharing rules.

2. Settlement proceeds from legal malpractice claim were taxable income, Holliday v. Commissioner, TC Memo 2021-69.

Taxpayer was represented by counsel in a divorce proceeding. Mediation ensued over the property settlement, which Taxpayer alleged resulted in her executing a settlement against her will. Her counsel said he would appeal the judgment of the trial court granting the divorce decree, which awarded Taxpayer too little in terms of marital property. However, he failed to do so.

Taxpayer later brought a malpractice case against her former counsel in the divorce proceeding, alleging that he was negligent in causing her to settle against her will. She sought damages for pecuniary and compensatory losses, including damages for mental anguish,
suffering, and stress. The parties ended up settling this suit for $175,000, with no admission of fault. In 2014, Taxpayer received $101,500, and her counsel in the malpractice case retained $73,500 for his fee.

Taxpayer reported the proceeds as follows. She acknowledged receipt of the $101,500, but she then subtracted this amount with the description, “Misclassification of Lawsuit recovery of marital assets.” The Service issued a notice of deficiency that initially treated only $101,500 as taxable income. However, an amended answer treated all $175,000 as gross income and allowed the attorney’s fee as a miscellaneous itemized deduction, resulting in a proposed deficiency of $44,939.

Before the Tax Court, Taxpayer was required to prove that the settlement proceeds reflected what she claimed – a nontaxable recovery of capital. Typically this involves the simple question: “in lieu of what was the settlement awarded?” The dominant reason for making the payment is important in this determination, and such reason can be adduced from the settlement agreement and the surrounding circumstances. Here, the settlement agreement focused on the malpractice claim, not on the failure to obtain marital property rights in the property settlement accompanying her divorce.

As the court noted, a similar result was obtained in Blum v. Commissioner, TC Memo 2021-18, in which a malpractice settlement award against a lawyer arising out of a personal injury matter was not eligible for exclusion under section 104, as the Taxpayer failed to prove that attorneys had compensated her for physical injuries and could not prove that the payment was a return of capital, as might be possible in a tax-related case where the tax could have been avoided with proper advice.

The Tax Court also sustained the treatment accorded to the settlement under the authority of Banks v. Commissioner, which treats the entire amounts as gross income and subjects the attorney fee portion to applicable rules regarding deductions, which of course are now quite unfavorable after miscellaneous itemized deduction provision was repealed from 2018-25.

Comments: This raises the bar for malpractice attorneys. Query, can the malpractice settlement be revised to make the payment nontaxable (i.e., I am compensating you for the marital property or personal injury that you did not receive from the defendant)? Should the parties negotiate specific payments for specific claims? Will that be effective? If a settlement could be converted into a nontaxable amount, will that affect the amount of the payment the plaintiff would accept? Should the plaintiff demand a higher payment if tax exemption is not possible, making the additional tax a component of damages? There is much to think about in this area. Blum, referenced herein, is on appeal to the Ninth Circuit.


Taxpayer acquired 27 investment properties in 2009. He assumed loans totaling $1.7 million in connection with these acquisitions. He struggled to make the loan payments, and in 2012 he sold 16 of the properties at a loss. The lender issued Forms 1099-C showing $754K in cancellation of indebtedness associated with notes on these properties. In 2013, he sold seven of
the remaining properties, also at a loss. The bank did not issue Forms 1099-C for 2013, as it refinanced the balance of a note secured by the remaining properties.

Taxpayer suspected that the return his accounting professional prepared for 2012 was erroneous, as it claimed a gain on the disposition of these properties. He consulted a tax attorney and then filed an amended return on January 14, 2015, which showed a loss of more than $613K. That return included Form 982, Reduction of Tax Attributes, in which he reported excludable income of $685K associated with qualified real property business indebtedness (QRPBI) which was applied to reduce the basis of depreciable real property. The same firm also prepared his 2013 return, which also showed a loss from investment property but no discharge of indebtedness income. His 2014 return showed a NOL carryforward from 2013.

The Service audited 2013 and 2014, and it proposed deficiencies based on its determination to disallow loss deductions from the 2013 taxable year and to disallow loss carryover deductions from 2013 claimed in the 2014 tax year. Those determinations were based on its position that the basis of remaining investment property owned by Taxpayer were required to be reduced on account of the QRPBI exclusion in 2012.

Although 2012 is not before the Court, the tax consequences of reporting in that year affected the proper 2013 and 2014 reporting. The parties stipulated that the QRPBI exclusion from taxable income in that year was proper. At issue was whether the basis adjustments provided in sections 108 and 1017 had to be made in 2012 or 2013.

The Tax Court ruled that the Code requires the basis adjustments associated with the exclusion of QRPBI to occur first in 2012 for the property being sold, as section 1017(b)(3)(F)(iii) requires such property to be reduced immediately before the sale of such property. Legislative history supported that interpretation. The parties agreed that the amount of the basis reduction associated with the property sold in 2012 was less than the amount of the exclusion from gross income in 2012, so that the balance was therefore carried over until 2013.

Further, although the tax attorney Taxpayer consulted here had errors in the returns because he failed to reduce the basis of property in 2012, thereby allowing a loss carryforward and an exclusion of gross income, there was no accuracy penalty imposed. Taxpayer consulted an expert and was not expected to recognize this error, despite the Service’s claim that the result should have been noted as “too good to be true”.

Comment: My tax students struggle with the interrelationships between section 108 and 1017, and with good reason. The provisions are intricate and require careful attention. The Tax Court clarified some of those provisions with this decision. It should also be noted that this taxpayer likely got some “get out of penalty” points by recognizing the error in his first return and seeking out an expert in this area, even if the expert’s advice proved deficient.
4. FSC payments routed into Roth IRA were not subject to recharacterization by IRS, Mazzei v. Commissioner, 998 F.3d 1041 (9th Cir. 2021), reversing 150 T.C. 138 (2018).

Joining the First, Second, and Sixth Circuits, the Ninth Circuit reversed the Tax Court and delivered victories to Taxpayers utilizing Roth IRAs in connection with tax structures designed to incentivize export sales.

Taxpayers utilized a Foreign Sales Corporation (FSC) under now-repealed provisions of the Code that were designed to incentivize export sales by reducing the tax rates on connected income. Taxpayers established a FSC, which was essentially a shell corporation. Their related export corporation would pay tax-deductible “commissions” to the FSC, which essentially provided no services. The FSC was allowed to treat a portion of those commissions as tax-exempt income, and dividends paid by the FSC (or deemed paid under a formula) were potentially taxed at reduced rates for non-exempt shareholders. This regime replaced the DISC regime, which provided similar tax incentives by effectively reducing the tax rates on otherwise taxable export income.

Taxpayers upped the game, however, by choosing to own their FSC shares in a Roth IRA. As a result, the good deal offered from reduced taxes on this income became a great deal indeed. Through owning the stock in a Roth IRA, (1) the export corporation got a tax-deductible commission, paying no taxes on that income; (2) the FSC got its partial tax exemption, thereby reducing the corporate tax rate on the income; and (3) the dividends paid out by the FSC were never taxed because they were held in the Roth IRA, which could in turn distribute them tax-free to the beneficiary. Moreover, since the “commissions” are a percentage of export sales, this structure ensured a large stream of income and growth within the Roth IRA, ensuring a significant amount of future tax-exempt income for the beneficiary. While Roth IRAs at this time were subject to strict contribution limits of $2000 per year, a small investment in a FSC could generate many multiples of the original investment in the form of commissions. For example, these Taxpayers invested $500 in FSC stock and the FSC received over $500K in commissions between 1998 and 2002.

The Service thought this was too good to be true, and it attacked the plan though using substance over form principles to make the individual taxpayers the owners of the FSC, followed by contributions to the IRA. But this generated excise taxes on excess contributions, as well as dividend taxes to the owners. In a reviewed decision, the Tax Court agreed with the Service’s view of the economic substance of the transaction. However, a vigorous dissent authored by Judge Holmes, who was joined by three other judges, concluded that this analysis was flawed because it ignored the special rules that Congress enacted in the FSC regime that permitted exactly this kind of transaction.

The Ninth Circuit effectively adopted Judge Holmes’ approach and reversed the Tax Court. Here, substance over form was viewed as an interpretive approach that should generally be followed in applying the tax laws, but which must give way when Congress designs a specific statutory structure like the FSC regime. Here, Congress specifically contemplated that the FSC would be a shell corporation, but unlike other shell corporations that might be ignored for tax purposes, it would be respected to achieve other tax policy goals. For similar reasons,
anticipatory assignment of income principles would also be inapplicable in this context. The FSC regime allowed commissions to be shifted from the export corporation to another taxpayer, so it would be improper to invoke this doctrine to change the locus of taxation to another earner. This position was also buttressed by special provisions relating to IRAs – traditional IRAs paid an unrelated business income tax on dividends from a FSC, but no similar provision applied to Roth IRAs.

Although other circuits had not addressed the precise question of a FSC, having instead focused on DISC transactions, the Ninth Circuit nevertheless found them persuasive on the matter of rejecting substance over form.

Comment: This is a victory for textualism that will notch a narrow exception for the application of substance over form. Congress probably did not think about this clever approach, but that is not a new problem. With thousands of pages of tax legislation coming down all at once, often in the midst of other voluminous legislation, it is impossible to know what they really intended apart from the text of what they enacted. In this case, it is quite clear that Congress intended to incentivize export sales and retirement savings. Doubt as to the intention regarding the combination of these two features may be fair, but here it gets resolved in Taxpayer’s favor.

5. **Self-directed IRA deemed to distribute gold coins held directly by Taxpayers, McNulty v. Commissioner, 157 T.C. No. 10 (2021).**

The Service proposed deficiencies of $250K for 2015 and $18K for 2016 attributed to unreported taxable distributions from self-directed IRAs received by these married taxpayers. They settled the husband’s distribution issues, leaving only the wife’s transactions for litigation in this case, along with related penalty issues.

Taxpayers purchased services from Check Book IRA, LLC, which included assistance to establish a self-directed IRA and forming an LLC to which she would transfer IRA funds through the purchase of membership interests. The LLC would then, in turn, use the funds to purchase American Eagle gold coins. Check Book advised that they could keep the gold coins at their home as long as the coins were “titled” in the name of the LLC. (However, gold coins do not have certificates of title, per se.)

Wife followed this plan, which she obtained from Check Book. First, she established a self-directed IRA that named Kingdom Trust Co. as the custodian. Second, she formed a single-member LLC, Greenwood, which was supposed to be a disregarded entity for federal tax purposes. She obtained a TIN for the LLC, opened a bank account in Greenwood’s name (over which she and her husband had signatory authority), and then funded the IRA by transferring funds from qualified retirement accounts. Thus, her IRA became the sole member of Greenwood, but she and her husband were managers of Greenwood. She then instructed Kingdom Trust (her IRA custodian) to purchase interests in Green Hill by transferring cash to its bank account. Green Hill used those funds to buy gold coins, which Taxpayers kept in a safe at their home. Wife updated Kingdom Trust with a year-end statement concerning the value of the coins held by Green Hill.
The Service proposed a deficiency based on the theory that the Taxpayer received a distribution when she took possession of the coins. The Tax Court upheld the Service’s position, finding that Taxpayer was in constructive receipt of the coins. The current structure violates the fundamental framework established for an IRA, which requires that assets be held and managed by a custodian or trustee. According to the court,

The presence of such a fiduciary is fundamentally important to the statutory scheme of IRAs, which is intended to encourage retirement savings and to protect those savings for retirement. Independent oversight by a third-party fiduciary to track and monitor investment activities is one of the key aspects of the statutory scheme. When coins or bullion are in the physical possession of the IRA owner (in whatever capacity the owner may be acting), there is no independent oversight that could prevent the owner from invading her retirement funds. This lack of oversight is clearly inconsistent with the statutory scheme. Personal control over the IRA assets by the IRA owner is against the very nature of an IRA.

Taxpayers also argued that section 408(m)(3) creates an exception to this framework by authorizing direct ownership of gold coins. Section 408(m)(3) carves out an exception from the prohibition of IRA investments in “collectibles” for investments in certain coins and bullion, which ends with this flush language: “if such bullion is in the physical possession of a trustee….” Taxpayers thus argued that coins need not be held by a trustee or custodian.

The Tax Court rejected this interpretation, finding instead that the broader context of the statute requires custodial or trustee possession in all cases, not just in the case of bullion. The Service also argued that Taxpayers violated “comingling” prohibitions by putting these coins in a safe with other assets. However, the Tax Court did not decide that issue as physical possession was enough to trigger a distribution.

The Tax Court upheld these penalties, rejecting reasonable cause defenses. Check Book was not a professional on which these taxpayers could rely. Moreover, Taxpayers failed to obtain advice from their CPA about these transactions, which involved substantial sums.

Comments: Gold is frequently touted as an IRA investment. But marketing pitches are not reliable tax advice. If you want to own gold in an IRA, you must have a fiduciary or custodian take physical possession. The IRS theory here did not attack the single-member LLC structure, but query whether such a structure also presents questions of constructive receipt when, as here, Taxpayers had signatory authority over the LLC bank account.

6. Tribal per capita payments were taxable income, Clay v. Commissioner, 990 F.3d 1296 (11th Cir. 2021), affirming 152 T.C. No. 13 (2019).

During the 1980s, the Miccosukee Tribe contracted with a third party to build a casino on their land in Florida. It imposed a gross receipts tax on the amounts received by the casino, including admission fees, wagers, and even revenue from the gift shop. The Tribe’s chairman held the proceeds in a separate account, and then it used those funds to make per capita payments to tribal members, which ranged from $100K to nearly $160K per year. The Tribe’s leadership urged members not to report these amounts on their tax returns. In order to prevent discovery,
the leadership also advised members not to list these amounts on credit applications or otherwise disclose them in applications for food stamps, Medicare, or Medicaid.

But the IRS found out anyway. Dozens of audits ensued, followed by notices of deficiency. Taxpayers litigated before the Tax Court, which upheld notices of deficiency but rejected accuracy penalties. This appeal to the Eleventh Circuit followed.

The Eleventh Circuit affirmed, rejecting Taxpayer’s arguments that the payments from the casinos were tax exempt based on their connection to tribal lands.

Comment: Certiorari was denied in this case (October 12, 2021). In my view, the law and facts strongly supported the IRS. On October 4, the Supreme Court denied cert in another tribal case, Perkins v. Commissioner, 970 F.3d 148 (2d Cir. 2020), which also involved a treaty claim. See programs in 2019 and 2020 for more discussion.


Taxpayer had an UBER account in his name, which he connected with a Bank of America account that was owned by an LLC that he controlled. He convinced several friends and associates to drive his vehicles under the UBER account, and UBER deposited all fares less its fees in the Bank of America account. From this account, Taxpayer made payments to the drivers, although some payments were supposedly made from cash. From these payments, he routinely withheld a rental fee on his vehicles. Recordkeeping was very loose, as no records for gas, vehicle maintenance, or related expenses were separately kept.

The Service determined that Taxpayer failed to report over $542K in gross receipts from UBER, which was reflected on Form 1099-K, Payment Card and Third-Party Network Transactions. The Tax Court sustained this determination and further held that Taxpayer failed to show that other determinations about allowable expenses used to compute his taxable income were erroneous.

Comment: This is a triumph for the 1099-K reporting system. Sadly, there are probably other UBER drivers out there who have trouble substantiating their expenses, particularly when they must bear the heightened requirements of section 274(d). Generally, a logbook or similar record is required. The revenue stream here is unusually high due to multiple drivers sharing the same account, but those with UBER driving clients may want to read this case.

8. Pre-2018 crypto exchanges are not like-kind, CCA 2021-24-008 (June 18, 2021).

This chief counsel advice concludes that certain pre-2018 exchanges involving cryptocurrencies do not qualify as a like-kind exchange. The advice addressed exchanges of Bitcoin or Ether for Litecoin or Bitcoin for Ether. However, it also noted that on one popular cryptocurrency exchange, there were more than 1000 different cryptocurrencies that could be acquired, but only in exchange for Bitcoin, Ether, or fiat currency.

Chief Counsel analogized these cryptocurrencies to other property, such as gold and silver, that have been held to differ as to “kind or class” based on their role in the marketplace.
For example, silver is primarily an industrial commodity while gold is primarily an investment. Even gold investors who choose a coin with numismatic value will acquire a different kind of gold when the value is derived from its metal content, not collectability.

Chief Counsel noted that Bitcoin and Ether (albeit to a lesser extent) occupied a special position in the cryptocurrency environment during 2016 and 2017 because of their role as a pathway toward acquiring other cryptocurrencies. Litecoin’s role was much more limited. However, Bitcoin and Ether were also treated as different from one another to the extent that they differ in design, intended use, and actual use. Bitcoin was designed as a unit of payment within a payment network, while the Ethereum blockchain was intended to act not only as a payment network but also as a platform for operating smart contracts and other applications.

Comment: These distinctions are contestable and subject to judicial challenge if a taxpayer with transactions from these pre-2018 tax years is willing to take up this issue. The advice is limited to the trades listed in the analysis— and numerous other possibilities are not covered.

Cryptocurrencies are being targeted by the IRS as a source of additional tax revenues. Look for more developments on this front.

C. Characterization.

1. Transfer of patent rights generated ordinary income not capital gain, Filler v. Commissioner, TC Memo 2021-6.

   Taxpayer was an accomplished physician and inventor. He was a neurosurgeon who also held academic and research positions involving neuroimaging, neurological surgery, and neuroscience at both the University of Washington (UW) and UCLA. As of December 2014, he was listed as an inventor on eleven patents, with two more pending. Taxpayer later obtained a law degree from Concord Law School, Kaplan University, and he was admitted to the California Bar in 2015. He practiced law through a separate PC, and he also had several sole proprietorships and interests in other entities, all apparently related to his medical technological expertise.

   Taxpayer was one of the inventors of MRI technologies applicable to neurological practices. In 1993, he and the other inventors transferred their interests in a pending patent application for the technology to UW, which in turn licensed the MRI technology to the Washington Research Foundation (WRF) in exchange for 60% of proceeds received from sublicensing the technology. The patent was granted in October 1996, after which Taxpayer formed a separate corporation, NeuroGrafix, Inc. (NGF) for the apparent purpose of acquiring the rights from WRF to sublicense the MRI technology.

   However, instead of having WLF sublicense technology directly to NGF, Taxpayer convinced WLF to make an interim assignment of the patent rights to him personally, which he agreed would follow by a transfer to WLF within 14 days. Pursuant to a pre-incorporation agreement, Taxpayer would own 75 percent of NGF, and some others who would be involved in the business together owned the remaining 25 percent. Taxpayer paid no consideration to WLF for the patent rights.
The transfer of the patent to NGF was completed in late 1998. NGF’s preformation agreement included terms that other officers in NGF would each receive compensation of up to $100K per year, capped at five percent of NG’s gross income. Taxpayer would receive a “royalty” of 20 percent of NG’s gross income, capped at $100K per year, in exchange for the patent and in lieu of any compensation for managerial or professional services he might provide.

NG compensated WRF for the patent by paying an up-front fee of 4,000 NG shares, plus an ongoing royalty of 1.5% of the first $2.5M in sales and 2.5% of sales above $2.5M. NG then proceeded to license the technology to others, as well as to sue alleged infringers in numerous patent infringement suits. However, several of these suits were dismissed on the ground that NG lacked standing based on questions about the chain of title it had in the patent, including a suit against the federal government in the Court of Federal Claims.

Notably, a suit by NG against General Electric (GE), which had manufactured equipment using the patent technology, settled in 2012, with GE paying $2.5 million to NG in exchange for dismissing all claims. There was no admission of infringement of any patent, as NG had alleged. Despite these adverse rulings for NG, it continued to litigate patent infringement claims and obtained settlements totaling $10.3 million through late 2014, when the patent expired and a license to use the technology was no longer necessary.

Taxpayer and his wife prepared their own returns from 2010-13, but in 2014 it hired a CPA firm to prepare their 2014 return, which provides the grist for this litigation. Taxpayers claimed the $100,000 “royalty” payment from NG was a long-term capital gain under section 1235, as then-applicable. They also claimed a NOL carryover of $1.9 million rooted in a loss reported in 2012 in connection with the GE litigation. An audit and penalty assessments followed.

The Tax Court first considered the characterization of the payment from NG for 2014. Section 1235(a) provides that a transfer of substantial rights by a holder of patent are treated as a long-term capital gain, regardless of whether the payments are characterized as a royalty. As such, section 1235(a) does not require a one-year holding period, otherwise necessary for long-term capital gain treatment.

However, section 1235 also provides that a transfer by one other than a holder does not qualify; neither does a transfer by a holder to a related person. Those exceptions applied here. Since Taxpayer owned 75 percent of NG, it is a related person. Without section 1235, Taxpayer had to prove that other provisions of the Code allowed long-term capital gain treatment. He could not meet this burden. First, he could not establish a holding period of more than 14 days under the agreements outlined above, assuming they were respected. Second, an intermediary in an “accommodation transfer” like the one he arranged from WF is unable to prove that he made a “sale or exchange” under several authorities which treat the conduit as lacking a sufficient interest in the property.

Taxpayer thus had ordinary income. The Tax Court also found him liable for self-employment tax on these payments, as the issue was treated as conceded absent any arguments in the briefs.
The Tax Court then turned to the matter of the NOL Taxpayer claimed. His theory seemed to be rooted in treating the settlement by GE as an “inverse taking” of his rights in NG stock, making it valueless. But this position was contradicted by the fact that NG continued to litigate patent infringement suits after 2012, which the settlement was reached. A mere diminution in value could not support a loss. (Notably, the 2012 tax year was treated as open for this purpose, as the NOL from that year was being carried forward to 2014.) Taxpayer also challenged penalties, but the Service showed that they were administratively and substantively proper.

Comment: Litigating tax cases involving capital gains and NOLs proves a lot more difficult for this Taxpayer than inventing neurological imaging technology.

2. Excess rent paid to shareholders was dividend, not deductible expense, but corporation avoids penalties, Plentywood Drug, Inc. v. Commissioner, TC Memo 2021-45.

Taxpayer is a corporation that operates a pharmacy in Plentywood, Montana, at town of 1700 in northeast Montana. (Since this is an opinion by Judge Holmes, we get to learn that the town got its name from a cowboy, Dutch Henry, who suggested to a poor chuckwagon cook trying to start a fire with damp buffalo chips that he could find “plenty [of] wood” just up the creek. Hence, a future town would be formed.) The pharmacy was operated from a building having some 8K square feet on the main level and 5K square feet in the basement, which was owned by its four shareholders – two married couples. Taxpayer paid rent pursuant to an oral agreement totaling $83,584 in 2011 and $192,000 in 2012 and 2013, which the shareholder couples dutifully reported on their personal tax returns.

An audit ensued, which also extended to the shareholders. The Service proposed an adjustment based on the theory that the rent paid her was not reasonable in amount, and therefore not deductible to the corporation. Before the Tax Court, a battle of experts emerged. Taxpayer’s expert got extra credibility points because he did not know the rent paid until after he did his report. Their expert also surveyed rents from surrounding areas, including Williston, which had been influenced by the oil boom in Montana differently from Plentywood. The government also criticized Taxpayer’s expert for failing to follow Uniform Standards of Professional Appraisal Practice (USPAP) in his survey.

The government’s expert, in contrast, focused only on local properties, which due to the small size of the town provided room for criticism concerning comparability. For example, an apartment building is not comparable to retail space. Moreover, the government’s expert excluded basement space in the building, which was used in the business.

Judge Holmes recognized the failure to follow USPAP as a legitimate criticism, but he viewed that as going to weight, not admissibility. He also accepted the criticism that there were differences in the Williston market. But he found that the government’s expert did not properly evaluate comparable properties. The court concluded that the most comparable property was a post office. Although a post office may enjoy lower rents on account of the lower risk associated with the government as a tenant, no premium was added in this case. His ultimate conclusion:
reasonable rent was $171,187.50. That meant no deficiency for 2011, and a small adjustment for 2012-13.

On the matter of penalties, Taxpayers escaped on substance. The court found that they acted reasonably, based in part on the difficulty of determining the fair rent in this case as demonstrated by the expert opinions. But it is interesting to note that in the matter of penalties imposed on the corporation, the corporation bears the burden of production. In this case, they would have to prove a negative if they were going to hide behind administrative approval in section 6751 – which the court suggested could have been done via a FOIA request or discovery request on the matter of administrative approval.

Comment: Judge Holmes seems to do justice in this tangled case. The penalty phase illustrates important differences between corporations and individuals re: the burden of production of evidence on the matter of supervisory approval.

3. Interest on judgment was ordinary income; underpayment interest cannot accrue when Taxpayer elects to allow Government to retain overpayment balances, Goldring v. United States, 15 F.4th 639 (5th Cir. 2021).

Taxpayer held stock in a privately held Delaware corporation that was the subject of a cash-out merger in 1999. Litigation over the value of those shares ensued, ultimately resulting in a judgment in Taxpayer’s favor totaling $13M for the value of the shares, $26M in pre-judgment interest, additional costs and fees, plus post-judgment interest of $185K. Taxpayer had sought a remedy of recission, but the court rejected this remedy in favor of money damages, finding recission too difficult following changes in the surviving company. The judgment was paid on April 6, 2010, and Taxpayer reported the entire proceeds – over $40.7M, as a long-term capital gain on her joint return with her husband. However, recognizing that the Service might seeks to recharacterize the interest award as ordinary income, Taxpayers chose to overpay their 2010 taxes by an amount sufficient to cover any deficiency that might arise. They elected to apply the overpayment as a credit against estimated 2011 liabilities, and they continued this practice of rolling the overpayment forward through the 2016 tax year.

In 2015, the Service completed its audit of the 2010 tax year and it determined that the interest component of the settlement was ordinary income rather than capital gain. It issued a notice of deficiency showing a $5.2 million underpayment for 2010. Taxpayers consented to an immediate assessment but reserved a right to file a refund claim. On August 17, the Service assessed tax of $5.2 million but also included underpayment interest of $603 thousand. Taxpayers filed a refund claim for the entire amount.

The district court upheld the Government’s position on the characterization of interest as ordinary income. On the matter of the underpayment interest, the district court also upheld the Government’s position on the ground that the credit balance from 2010 had been applied to estimated taxes for 2011, and thus was not available to satisfy the additional 2010 liability. This appeal followed.

Although recognizing that merely characterizing an award as interest does not always produce ordinary income, the Fifth Circuit upheld the Government’s position that the interest
awarded in this case was ordinary income. Taxpayers here were compensated for the inability to use the fair value of the shares during the thirteen-year time period in which litigation was pending. The court rejected Taxpayers’ argument that the “origin of the claim” doctrine required the interest to be treated as capital gain because it was part of a judgment to compensate for the loss of a capital asset.

Regarding the underpayment interest, the Fifth Circuit reversed. The “use-of-money” principle, which holds that a taxpayer is liable for interest only when the government does not have the use of money it is lawfully due, see Manning v. Seeley Tube & Box, 338 U.S. 561 (1950), supported the Taxpayers’ claim that the IRS should not charge underpayment interest because it had the continuous use of their funds during the ensuing period. Although a majority of the Federal Circuit in FleetBoston Fin. Corp v. United States, 483 F.3d 1345 (Fed. Cir. 2007) had rejected a similar argument, the Fifth Circuit agreed with the dissent and concluded that the simple and straightforward approach of the “use-of-money” principle applied in light of the lack of clear statutory authority for the IRS position.

Comment: This taxpayer-friendly outcome on interest remains in doubt in other circuits. Paying the tax and filing an immediate refund claim would appear to be the only surefire way to avoid underpayment interest. But of course, that puts the tax issue squarely before the IRS, rather than leaving it for discretionary review under audit. On the characterization of interest, query whether the fact that this taxpayer retained her shares throughout the period of litigation and was denied a recission remedy should have received greater weight, particularly in light of the desired remedy of continued ownership, which was denied. If the judgment had been to surrender the shares with a current value of $40M, rather than valuing them 13 years ago, the full amount would have been capital gain. Query whether tax counsel was involved in negotiating the settlement. But after 13 years of wrangling, Taxpayers were likely glad to have their victory, even if it came with a tax bill.


Taxpayer was a shareholder-employee in an S corporation that adopted an employee welfare benefit plan for himself and four other employees. He was the sole shareholder of the corporation, through which he practiced medicine. The Tax Court previously ruled that this arrangement was a compensatory “split-dollar” life insurance arrangement under Treas. Reg. § 1.61-22(b), which generated current taxable income. See T.C. Memo 2018-155. Taxpayer then asserted that whatever economic benefits received as taxable income should be treated as a distribution under section 301 on account of his status as a shareholder of the corporation, rather than compensation to him in his status as an employee. This issue comes before the Tax Court on Taxpayer’s motion for summary judgment.

The split dollar arrangement in this case involved payments by the S corporation to a trust that purchased life insurance on the lives of the covered employees. Taxpayer and his spouse, both employees, were entitled to a $12.5 million death benefit. Four other rank and file employees were entitled to $10K death benefits as well as certain flexible benefits. The S corporation paid $1.8 million during 2006-2010 to fund the premiums, and it treated these
amounts as deductible expenses. Through 2012, the trust paid out a total of $884 in premiums on the life insurance policies, which accumulated cash values aggregating $640K at the end of 2011 and $744K at the end of 2012.

In their 2011 and 2012 tax returns, Taxpayers failed to report any income from their participation in the plan. They concede, following their prior litigation, that the economic benefits they obtained as employees and “non-owners” of the policies are part of a compensatory arrangement. The split-dollar regulations distinguish between a “compensatory arrangement” and a “shareholder arrangement”. For either arrangement, “economic benefits are treated as being provided to the non-owner of the life insurance contract” and that such benefits must be taken into account based on their full value less any consideration paid. The regulations allow those benefits to be taken into account, “[depending on the relationship between the owner and non-owner”, as either a payment of compensation or a distribution under section 301.

The Tax Court determined that this was a “compensatory arrangement” because it was entered into in connection with the performance of services. Accordingly, it should not be treated as an arrangement between a corporation and a shareholder, which would be essential to categorizing the economic benefit as a distribution. Taxpayers relied upon the Sixth Circuit’s decision in Machacek v. Commissioner, 906 F.3d 429 (6th Cir. 2018), which had reversed a similar decision in the Tax Court holding that a split-dollar arrangement was compensatory and therefore not to be treated as a distribution. The Sixth Circuit relied upon Treas. Reg. § 1.301-1(q)(1)(i), which treats a split dollar benefit provided by a corporation to its shareholder as a “distribution of property”, ruling that this regulation governs both compensatory and shareholder agreements. But the Tax Court persisted in rejecting this rationale. Since appeal does not lie to the Sixth Circuit, they are free to reject this authority.

Additionally, the Tax Court pointed to another ground not considered by the Sixth Circuit: Section 1372 requires that employee benefits to a 2 percent shareholder of an S corporation must be treated in the same manner as a partnership. Partnerships cannot make distributions governed by section 301. Instead, those benefits would be treated as compensatory guaranteed payments under section 707(c). According to the court, this not only points to the error of the Sixth Circuit’s analysis, but it also confirms their own approach.

Comment: This reviewed decision, joined by all members of the court, signals continued commitment to this approach, which is both sensible and consistent with the statutory scheme for split-dollar arrangements. Look for more circuits to take up this issue which agree with the Tax Court. Machacek v. Commissioner, 906 F.3d 429 (6th Cir. 2018), rev’g TC Memo 2016-55, was the subject of an AOD (IRB 2021-21, May 24, 2021) that states the Service will respect this position in the Sixth Circuit, but not where appeal would lie elsewhere. It also pointed out that if a taxpayer treats a split-dollar benefit as a distribution, it will terminate the S election if the arrangement provides some shareholders with superior distribution rights in violation of IRC § 1361(b)(1)(D).
5. AMT obligation imposed on 2016 adjustment for attorney fees claimed as miscellaneous itemized deduction, Colton v. Commissioner, TC Memo 2021-44.

Taxpayer filed a joint return for 2016, on which they claimed the standard deduction. However, in 2018, the Service sent a letter asserting unreported income associated with a legal settlement and $20 in interest. Taxpayers filed an amended return reporting $62,500 in settlement proceeds and including $80,075 of itemized deductions, which included attorney’s fees in connection with the litigation and settlement.

The IRS allowed the attorney fee deduction, but it still imposed a deficiency because Taxpayers owed AMT on the settlement. Miscellaneous itemized deductions were tax preferences during 2016. Taxpayers petitioned for review, but the court upheld the assessment as correct. Taxpayer had AMTI of $101,111 – which was the sum of their regular taxable income of $14,958, personal exemptions of $8100, and the miscellaneous itemized deduction (net of the 2% floor) of $78,053. After subtracting their exemption of $83,800, the taxable amount of $17,311 times a 26 percent tax rate yielded tentative tax of $4501 – some $3K more than the regular tax they had paid.

Comment: This outcome shows how a Taxpayer could be a “winner” in litigation but a “loser” when taxes and attorney fees are considered.

D. Section 280E (Cannabis Businesses).

1. Section 280E does not violate Eighth or Sixteenth Amendments, Today’s Health Care II, LLC v. Commissioner, TC Memo 2021-96.

In this memorandum decision, the Tax Court announced that it would continue to follow its prior ruling in N. Cal. Small Bus. Assistants Inc. v. Commissioner, 153 T.C. 65 (2019), which rejected these constitutional claims over the objections of one dissenting judge.


Taxpayer, a C corporation, was engaged in the business of operating a marijuana dispensary. The Service disallowed all of its deductions, including those for depreciation and charitable contribution, under section 280E, which provides in part: “No deduction … shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances ….”

In Patients Mutual Assistance Collective Corp. v. Commissioner, 151 T.C. 176 (2018), aff’d, 995 F.3d 671 (9th Cir. 2021), the Tax Court had previously held that a business that involved more than the sale of cannabis items nevertheless “consist[ed]” of one that involved trafficking in controlled substances. Further, in Northern California Small Business Assistants Inc. v. Commissioner, 153 T.C. 65 (2019), the court had previously rejected claims for exceptions to section 280E based on sections 164 and 167.

Taxpayer here argued that 280E did not foreclose deductions under section 167 and 170 because depreciation was not “paid or incurred during the taxable year” and that charitable contributions were not made in “carrying on” its trade or business. Although the Northern
California case had previously rejected an exception for depreciation, the Tax Court addressed their argument because of their more nuanced statutory argument. Here, Taxpayer claimed that depreciation was not a “business expenditure” that was “paid or incurred during the taxable year”. However, The Tax Court turned to section 7701(a)(25), which provides that “paid or incurred” is construed based on the method of accounting adopted. Taxpayer here used the accrual method. According to the Supreme Court’s decision in Idaho Power, depreciation is a cost that is incurred. Section 168 also treats depreciation as an item incurred during the taxable year.

As for the charitable contributions, Taxpayer argued that those were not incurred “in carrying on” its trade or business. California corporations are authorized to make charitable contributions, and this decision is permitted with discretion to consider its operational and financial goals. However, there was no showing here that the contributions did not involve business advantages, which are permitted in the corporate context. For purposes of section 280E, it was sufficient that these expenses gave rise to a deduction while the trade or business was operating. The court also rejected a policy argument based on section 170, as Congress announced a contrary policy in section 280E.

Comment: Nice try on the statutory language. The court presumably made this a regular decision to ensure that others would not clog the dockets with these kinds of arguments. Oddly enough, the Commissioner did not raise the Northern California case in its brief, which the Tax Court noted with some surprise (and no doubt, consternation).


Taxpayer was a public benefit corporation taxed as a C corporation. It operated a marijuana dispensary selling products grown by others. Only about three percent of sales involved non-cannabis product. It also purported to engage in medical counseling with patients, which it characterized as “free services”. No licensed medical professionals or therapists were involved in the putative counseling. The business was entirely cash-based. Moreover, after sales tax returns and federal income tax returns were filed each year, Taxpayer destroyed all of its financial records, supposedly to avoid having evidence on hand that could support criminal prosecution.

Taxpayer’s returns for the 2010 to 2012 taxable years were under audit. Without financial records, the Service resorted to examining bank deposits and cash expenditures. Since Taxpayer did not deposit all of its cash, the RA looked at expenditures reported on Form 1120 to adjust cash flows. Although Taxpayer argued that all expenses claimed on Form 1120 related to medical counseling and not cannabis, thereby avoiding disallowance under section 280E, the RA did not buy it. He disallowed all the COGS and other deductions and proposed deficiencies.

Taxpayer attempted to bolster his COGS deductions by offering expert testimony, which was supposedly based on examining 99 tax returns filed by other dispensaries during the relevant years and estimating the average COGS reported. However, the Tax Court rejected this
testimony as unreliable. The expert would not share the underlying returns, he could not testify that the returns accurately reflected the books of the taxpayers.

Although COGS is an offset used to determine gross income, Taxpayers had no records from which it could show the amount. An estimate under the Cohan rule could suffice, but Taxpayers could point to no case granting a taxpayer leniency under a Cohan analysis because there was a reasonable explanation for the lack of substantiation. The tax returns here are not evidence, only self-serving declarations. However, the court was willing to look at testimony by employees of Taxpayer concerning the markup they applied to cannabis products, which suggested that COGS was about 50 percent of the selling price of cannabis – far lower than the 75 percent figures determined by Taxpayer’s expert.

Finally, Taxpayer could not escape penalties. Although the return disclosed that section 280E issues present here, it did not disclose the lack of substantiation. Those practices made underpayments here attributable to negligence.

Comment: As the court also noted, intentional destruction of records in this case would have had a dubious value in the criminal realm, as sufficient other evidence exists to tie the owner to illicit activities. This case offers some good lessons about expert reports and the importance of recordkeeping. See also Desert Organic Solutions v. Commissioner, TC Memo 2021-22 (finding a single trade or business related to trafficking in controlled substances when very little income was generated from non-cannabis sources, such as rolling papers and pipes).

II. Deductions.

A. Charitable.


   Taxpayer was an entrepreneur from South Dakota who had acquired a number of successful small businesses after selling out a laboratory that produced animal vaccines, which he had invented. Taxpayer relied on Horning, a longtime employee who was not a CPA or attorney, to prepare his tax returns, with the help of Meier, an outside CPA. But Horning’s methods, coupled with Taxpayer’s frequent absence around tax time, had led to problems with past returns. Taxpayer knew this.

   In 2008 and 2009, Taxpayer made multi-million-dollar donations of real property to charitable causes. His return included Form 8283, NonCash Charitable Contributions. But the second page of the form, which contains repeated instructions for attached appraisals, was left blank. When Meier reviewed the returns, he noticed the lack of appraisals. He conferred with Horning, but not with Taxpayer. They filed the returns on Taxpayer’s behalf, and Taxpayer did not review them because he was not around when they were filed.

   The Service disallowed these deductions, and Taxpayer sought to establish that he had reasonable cause to fail to attach the appraisal on account of relying upon professional return preparers. This position required three showings: (1) competent tax advisers, (2) provided with necessary and accurate information, and (3) good faith reliance on their advice.
While Horning did not rise to the level of a competent tax adviser, Meier clearly did. Taxpayer also provided all relevant information to the preparers about the donated property, except of course for a qualified appraisal. But according to the court, this was not required because Taxpayer did not know about the requirement in advance of filing the return. However, Taxpayer had issues with the third requirement of good faith reliance.

Taxpayer never received actual advice telling him he needed or didn’t need an appraisal. But this cuts against Taxpayer’s claim of good faith reliance. Further, he never reviewed his return. While in some cases a diligent review might not reveal a subtle problem, this problem was not of such a subtle nature. Finally, while Taxpayer sought to present himself as a “lowly farm hand” (who had indeed grown up on a farm without indoor plumbing), the court found him to be a sophisticated businessman with a college degree and a doctorate. Even without tax training, he should have been able to spot the blank form.

For reasons similar to those underlying the denial of reasonable cause for failing to attach appraisals, the court also upheld penalties.

Comment: Judge Holmes writes a wonderful story here, chronicling this very human story of errors and omissions. Others should take note: the good faith reliance prong requires one to receive advice and rely upon it. Failing to review a return that contains glaring omissions is not going to allow good faith reliance.

   In this conservation easement case, the Tax Court declined to certify a state law property question to the Supreme Court of Alabama, finding that there was adequate guidance under existing Alabama law.

   While losing on the substance of their claims on the authority of Oakbrook Land Holdings LLC v. Commissioner, 154 T.C. 180 (2020) and its progeny, these taxpayers escaped penalties based in part on the lack of advance administrative approval and based in part on “reasonable cause and good faith”.

Comment: This was another masterful opinion by Judge Holmes. See also Montgomery Ala. River, LLC v. Commissioner, TC Memo 2021-62 (following Sells in rejecting conservation easement claims based on Alabama law). It appears that the frenetic pace of filing conservation easement cases in the Tax Court, witnessed last year, is now subsiding. So far, only one appellate case has been decided. See TOT Property Holdings, LLC v. Commissioner, 1 F.4th 1354 (11th Cir. 2021) (affirming Tax Court bench opinion denying easement for failure to satisfy perpetuity requirement, discussed below). In Plateau Holdings, LLC v. Commissioner, TC Memo 2021-133, the Taxpayers suffered a gross valuation misstatement penalty for overstating a $2.6 million deduction as being $25.4 million. However, they avoided a negligence penalty on claiming the $2.6 million deduction, which was also disallowed, on the basis of reasonable
reliance. *That case turned on the failure of judicial extinguishment clauses to protect the easement in perpetuity.*

4. **Savings clause did not cure defect in conservation easement, TOT Property Holdings, LLC v. Commissioner, 1 F.4th 1354 (11th Cir. 2021).**

In 2005, George Dixon purchased 2,602 acres of land in Tennessee. He transferred 652 acres of this land, representing $486K of the original purchase price, to TOT Property Holdings, LLC (TOT). In 2013, PES Fund purchased 98.99% of TOT for total consideration of about $1 million. At that time, TOT’s assets consisted solely of the property plus $100 in cash.

A few weeks later, TOT executed a deed to Foothills Land Conservancy transmitting a conservation easement over nearly all the property. The deed included language that the Tax Court held to violate the perpetuity requirement in the regulations governing charitable deductions of this nature. Moreover, TOT valued the easement at more than three times the amount it paid for the property.

However, it also included language that the parties stipulated should be called the “Treasury Regulation Override”. Section 9.1, dealing with future extinguishment of the easement, stated in part: “The amount of the proceeds to which Grantee shall be entitled from any sale, exchange, or involuntary conversion of all or any portion of the Property subsequent to such termination or extinguishment, shall be the stipulated fair market value of this Easement, or proportionate part thereof, as determined in accordance with Section 9.2 or 26 C.F.R. Section 1.170A-14, if different.” Section 9.2, which determines the valuation of the extinguished interest, states in part: “It is intended that this Section 9.2 be interpreted to adhere to and be consistent with 26 C.F.R. Section 1.170A-14(g)(6)(ii).”

At issue in this appeal was whether the Tax Court erred in upholding the deficiency against TOT, which included denial of the deduction for failure to satisfy the “protected in perpetuity requirement”, the imposition of penalties (including the gross valuation penalty), and satisfaction of the supervisory approval requirements prior to determination of penalties.

The Eleventh Circuit upheld the Tax Court’s decision. The legal deficiency in the deed is similar to those reached in the Fifth Circuit in *PBBM-Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018) and *Coal Property Holdings LLC v. Commissioner*, 153 T.C. 126 (2019). However, the Taxpayer alleged that the Tax Court erred in rejecting the Treasury Override as an interpretive provision rather than an invalid and unenforceable savings clause.

According to the Eleventh Circuit, “courts and the IRS have refused to enforce a clause that purports to save an instrument from being out of compliance with the tax laws if the clause is operative by way of a condition subsequent.” On the other hand, a clause that serves as an interpretive tool is valid when it is not dependent on subsequent, adverse action by the IRS. In rejecting the latter classification, the Eleventh Circuit relied on two decisions in the Fourth Circuit – *Belk v. Commissioner* and *Commissioner v. Procter*, which rejected clauses that would purport to change the terms of a conveyance if adverse tax consequences were imposed. Such clauses were rejected in part on the basis of their adverse effects on ability to enforce the tax laws.
Here, the Treasury Override depends on a condition subsequent – an adverse tax determination – instead of serving as an interpretive aid. As in Belk, “there is no open interpretive question for the savings clause to ‘help’ clarify.” The Treasury Regulation Override simply nullifies the formula provided in the deed.

The court also upheld the Tax Court’s determination of penalties based on expert valuations of the property and satisfaction of the supervisory approval requirement.

Comment: Planners interested in “savings clauses” in this and other contexts will want to consider this case, along with the authorities it discusses, in evaluating their potential effectiveness.

5. Façade easement fails based on defective language in easement deed, 901 South Broadway Limited Partnership v. Commissioner, TC Memo 2021-132.

This façade easement, which was based on the Model Historical Preservation and Conservation Easement published by the National Trust for Historic preservation, departed from the model language by granting a priority claim to creditors for the proceeds of insurance or condemnation. Based on the Tax Court’s prior decision in Palmolive Building Investors v. Commissioner, 149 T.C. 380 (2017), such a provision does not satisfy the perpetuity requirement imposed by section 170(h)(5)(A). The Tax Court directed petitioners to show cause why it should not enter a decision in favor of the Service on the matter of disallowing the deduction, which in this case totaled more than $20 million. The Tax Court ruled that, in accordance with the show cause order, it would enter a decision in favor of the Service.

Comment: Those with conservation easements will want to study this case and the authorities mentioned therein.

B. Business/Investment.
1. Taxpayer fails to prove ongoing trade or business, Estate of Morgan v. Commissioner, TC Memo 2021-104.

Taxpayer worked for years in the homebuilding business. However, the financial crisis drove his companies into receivership after defaulting on $75 million in debt. The receivership continued from 2009 until it concluded in 2013. During that time, the receiver took control of all Taxpayer’s entities and he was prohibited from incurring expenses on their behalf or otherwise using them to conduct business.

But Taxpayer was interested in continuing his career. He formed Legacy, a single-member LLC that he used as a vehicle for searching for other companies to acquire. He hired former employees of his company to assist in these efforts, and he spent his time on business search activities. However, these activities consisted solely of looking at opportunities. He did not make an offer to purchase or otherwise acquire another business. He did, however, make a loan of $180K to a former business associate, which was repaid in full.

Taxpayer also maintained an LLC, Falcon, which he used to own and maintain aircraft. He had previously used these aircraft to support his homebuilding business, but after the
receivership he used them only to search for new businesses. He listed their business as "consulting" on the partnership return filed for 2010 and 2011, after which Falcon became a disregarded entity which he reported on Schedule C.

Falcon reported losses during the tax years at issue, with revenues coming entirely from personal use of the aircraft and for consulting fees paid by Legacy, and expenses consisting of aircraft use and maintenance. Legacy also reported losses attributed to expenses, which included business investigation expenses and other expenses reported on Schedule E. The Service issued notices of deficiencies, and Tax Court litigation followed.

The Tax Court determined that Taxpayer had failed to carry on a trade or business through either of the entities. During the receivership, business activities in connection with other entities had been discontinued. He was not continuing homebuilding activity – which was limited at best to making a single loan to a former business associate.

Regarding Legacy, the expenses he incurred were at most associated with investigating a new trade or business, which would fall under section 195. Short of taking any step toward performing the functions for which a business is organized, the taxpayer is not permitted to deduct expenses. Simply looking for a new business is not the foundation for engaging in a trade or business. As for Falcon, there was no "consulting" business conducted; these activities were limited to transporting Taxpayer in his business search activities. There was not an ongoing business. As a consequence of having no trade or business, Taxpayer could not claim NOL deductions based on claiming expenses associated with searching for business. However, based on good faith reliance on competent tax advisors, Taxpayer was held not liable for accuracy penalties associated with these deficiencies.

Comment: The case includes some helpful discussion of section 195 and related authorities involving the time when a trade or business begins. Taxpayer seems to have gotten a gift in avoiding accuracy penalties given the factual context presented for these activities.


Taxpayer was a former national sales director for Mary Kay. She was highly successful in the business, which generated substantial income. After mandatory retirement was imposed on her in 2010, Taxpayer took an interest in selling jewelry to her former Mary Kay associates through a wholly owned S corporation. However, Mary Kay banned marketing by persons like Taxpayer to members of their former sales force, cutting off a valuable customer base. She devoted little time to selling jewelry to the general public and eventually abandoned the activity.

Taxpayer also took up acting. She had family connections and some past experience, so she decided to devote significant time to this activity. She took lessons and hired an assistant who helped identify opportunities. (Undisclosed in the case, Taxpayer’s daughter is actress Robin Wright – Claire Underwood in the series “House of Cards”). By 2011 she had her first film credit and by 2013 she had appeared in a feature-length film. By 2019 she had ten film credits and several roles in commercials.
In 2013 and 2014, Taxpayer respectively reported $83K and $98K of schedule C expenses, which the IRS disallowed as not being connected to an activity with the “predominant, primary or principal objective of making a profit.

Based on all the facts and circumstances, the Tax Court upheld these deductions. It found that Taxpayer did indeed show an intent to profit from her acting activities, noting that an objectively reasonable expectation was not required. In this case, she hired an assistant, took acting classes, and made significant efforts to advertise their services and network to obtain roles. She spent 35-45 hours per week researching, applying for, and auditioning for roles. She trained to enhance her skills and took a businesslike approach to marketing and realizing success in an admittedly difficult industry. The fact that those efforts did not generate profits during the years at issue was not determinative. However, not all expenses were sufficiently documented to be connected with her acting career, which resulted in some adjustments being upheld.

The Tax court also considered her jewelry sales efforts. As the activity was conducted through an S corporation, the assessment of whether she intended to conduct them in a profit-seeking venture was based on her intentions, as she was the sole shareholder. Unlike the acting business, her efforts here were not sustained and were intermittent at best. The court would not uphold passthrough losses claimed on Schedule E connected to these activities.

Finally, Taxpayer also claimed deductions for contributions to deferred compensation plans. During the 2013 and 2014 tax years, she received over $500K each year from a sole proprietorship profit sharing plan that she had established prior to her retirement from Mary Kay. Because these amounts were subject to self-employment taxes under section 1402, Taxpayer argued that they were also “earned income” that allowed her to make a tax-deductible deferred compensation contribution for a self-employed person under section 404.

However, the Code requires not only “earned income”, but it also requires that such income be derived from the trade or business with respect to which the deferred compensation plan is established. Here, Taxpayer failed to prove that the plan was connected to a trade or business that generated earned income. The only business during those years was acting, which did not generate taxable income.

Comment: Aspiring actors will want to follow Ms. Gaston’s path to establish deductible expenses in connecting with the pursuit of their careers.

3. Taxpayer was away from home for purposes of deducting per diem living expenses, Geiman v. Commissioner, TC Memo 2021-80

Taxpayer was a journeyman electrician who sought to deduct living expenses associated with work on temporary jobs in Wyoming and Colorado. Taxpayer was able to prove that his tax home was in Clifton, Colorado, where he maintained a personal residence and where he was a member of the local electrician’s union, which provided job referrals to him. This aspect of union membership was considered a business justification for continuing to maintain his tax home away from locales where he held temporary jobs. Union records also assisted Taxpayer in substantiating some of the days away from home at these jobs, which allowed him to claim per
diem rates for business expenses. Other claimed expenses generally suffered from a lack of substantiation.


The Caylors were entrepreneurs who started with a construction business that grew into many different subsidiaries and affiliates. The entities had previously paid about $60K per year for insurance coverage. However, in 2007, they began paying a micro-captive insurer about $1.2 million per year. At the same time, so-called “consulting” payments between related entities also increased to about $1.2 million. The Service audited the companies for 2009 and 2010, challenging both deductions for consulting payments and for insurance costs.

The Tax Court upheld the adjustments. As Judge Holmes observed, the case broke no new ground, but simply applied existing precedents that held that microcaptive arrangements failed to distribute risk and thus did not constitute insurance. And as for consulting payments, they seem to involve conversations between father and son. “For a father and son to have a warm and loving relationship that helps sustain and grow the family business is admirable. But it’s not deductible.”

Comment: Those who want a primer on microcaptive insurance will find a good explanation by Judge Holmes in this case. For even more detail, consider the excellent article by David Slenn, Micro-Captive Insurance at the Tax Court, ABA Tax Times, June 2021.

5. Capital loss results from abandonment of interest in LLC by passive investor, Swartz v. United States, No. 17-cv-5914 (E.D. N.Y. July 20, 2021)

Taxpayer invested a total of $4.5 million in two LLCs designed to finance and distribute films. He was warned in advance that these investments were speculative and risky. The purchase agreements characterized the interests as “investments” and gave him no rights to participate in the business. However, he did have a consulting contract with one of the entities, which required him to be available to work one day per month, for which he would be paid $60K per year. There was no mention in the case of any actual consulting work or the nature of that work.

Taxpayer was informed that one of the LLCs was involved in an involuntary bankruptcy proceeding in 2010, but he did not participate. Another of the LLCs informed him in 2010 that it was winding up its operations and that his investment was worthless. Taxpayer claimed that worthlessness of these investments created a NOL for the 2010 tax year, which he attempted to carry back to 2008 and 2009, when he had substantial income. The Service disallowed the claim, and refund litigation followed.

The district court granted summary judgment to the government. Even assuming that Taxpayer could prove a closed and completed transaction of abandonment in 2010, the court ruled that the investment in this case would produce a capital loss, not an ordinary loss eligible for NOL treatment. In doing so, it rejected the application of Rev. Rul. 9380 and the Fifth Circuit’s decision in Pilgrim’s Pride, 770 F.3d 311 (5th Cir. 2015), which permitted the abandonment of a partnership interest to be treated as generating an ordinary loss in some cases.
Here, the court indicated that the entire scope of facts and circumstances indicated that this was not a partnership, but instead reflected a passive equity investment. Moreover, the Taxpayer was not engaged in a trade or business in connection with these investments, which might otherwise support an ordinary loss.

Comment: There are many missing links here, including the effects of any losses on the basis of this investment. However, those authorities permitting ordinary losses for abandonment of a partnership interest, where no consideration is obtained for the interest, deserve careful study when a taxpayer owns a partnership interest in a failed or failing venture.


In this case Taxpayers were engaged in experimental activities to grow crops raised poultry and raise cattle on a farm in Mexico. The farming activities in each case never reached any level of commercial success and in some cases did not even involve any sales of farm products. Taxpayers claimed losses from these activities, which the Commissioner disallowed. The Tax Court agreed, finding that the expenditures at issue here were nondeductible startup expenditures governed by section 195(a). Farming activities never moved beyond initial experimentation and investigation. Planting only research crops, failing to sell chickens for meat despite raising meat chickens, and efforts to produce commercial eggs that were abandoned, could not be characterized as a current trade or business.

Comment: For another failure to start-up case, see Whatley v. Commissioner, TC Memo 2021–11 (no deductions for cattle farm with no cattle and tree farm that would not yield timber profits for years into the future).


Taxpayer is a major drug manufacturer. Before marketing a drug, Taxpayer is required to obtain FDA approval. The precise path to approval varies depending on whether the drug is new or whether it is a generic drug permitted to be distributed after a drug patent has expired. An expedited approval process applies for generic drugs, and that application requires disclosure of patents that were either invalid or which would not be infringed in the manufacturing process for the generic drug. Taxpayer knew that those disclosures would produce litigation, but they chose to move ahead because it would expedite their opportunity to bring generic drugs to market.

After filing their generic drug applications, Taxpayer prepared notices to those holding patents referenced in their application, which set forth Taxpayer’s position as to why their manufacture and sale of a generic drug would not infringe their patents. Lawsuits regularly arose in response to these notices, and FDA consideration continued without regard to those lawsuits. However, Taxpayer would provide the FDA with outcomes, including settlements, while the approval process continued.

Taxpayer deducted from $38–46 million in legal fees during the 2012-14 tax years, which the IRS challenged on audit. The outcome in this case depends on the application of regulations under section 263(a), which were issued following the INDOPCO decision to clarify the
“substantial future benefits” standard previously applied to determine whether capitalization was appropriate. Admittedly, prior law was murky. As the Tax Court observed, “An expenditure, no matter its type, may be deductible in one setting but nevertheless required to be capitalized in another.”

The regulations involving capitalization of intangibles implements general principles that require capitalization when an expenditure either “(1) creates or enhances a separate or distinct asset, or (2) otherwise generates significant benefits for the taxpayer extending beyond the current taxable year.” The Tax Court broke down the legal expenditures into separate categories based on the regulations. Expenditures incurred to obtain rights from a government agency are capitalized as creating a new intangible right. These include not only direct costs, but also “facilitative costs” that include “ancillary expenditures incurred in acquiring, creating, or enhancing the intangible asset.”

Capitalization also extends to amounts paid to “defend or perfect title to intangible property”. However, patent law distinguishes suits for the defense of title to intellectual property (for which expenditures must be capitalized) from patent infringement litigation. Patent infringement litigation can be analogized to tort litigation, as the purpose is not to remove a cloud on the title or defend ownership, but instead an award of damages to compensate the patent owner for gains or profits to which he is due from exploitation of the property. Those damages are viewed as compensation, not a return of capital. Moreover, those who prosecute or defend patent infringement cases (and tort cases alike) are generally allowed to treat litigation costs as a normal part of carrying on a trade or business.

This case involves the intersection of these principles. The Service argued that the intangible right pursued here – FDA authorization to manufacture and distribute a generic drug – would not be acquired by Taxpayer until that right became “effective”. Proceeding from this view, the Service argued that costs to give notice to patent holders as part of the application process were direct costs that must be capitalized, not costs to facilitate patent litigation that might be deductible. As for the litigation costs associated with resolving any patent disputes – thereby clearing the way for Taxpayer’s right to proceed with manufacture and sale of a generic drug – the Service argued that these costs facilitated the acquisition of an intangible right, thereby requiring capitalization rather than deduction.

The Tax Court agreed with the Service’s view about the acquisition of the intangible right occurring when the right became effective, but it took a more nuanced approach to capitalization. On the matter of the legal costs of preparing notices and explanations for competing patent holders, the court agreed that those costs should be capitalized as part of the costs to acquire the intangible right. However, it rejected capitalization for the litigation costs. Examining the legislative history to the Hatch-Waxman Act and the notice requirement in the generic drug approval process, the court found that the notice requirement was designed to protect the rights of existing patent holders, thereby facilitating litigation to protect their rights. Such litigation was not a normal step in the FDA approval process, but merely a vehicle to protect third party rights. Litigation over those rights should not be treated differently from other ordinary and necessary business expenses. Established precedents allow the defendant in a patent
infringement suit to deduct those expenses currently. Examples in regulations under section 263(a) also support this outcome in the analogous area of tort litigation.

Taxpayer thus got a partial victory in the capitalization determination. It would be allowed amortization deductions under section 197 for the remainder of the costs that must be capitalized.

Comment: This is a thorough opinion that may prove helpful to others facing issues involving capitalization of legal costs. The matter of litigation costs was a close case, but it does appear that the Tax Court got this one right. The analogy between patent infringement and tort, rather than patent infringement and defense of title, was critical to the outcome.

8. Taxpayer is not a bank eligible for loss deductions, MoneyGram Int’l, Inc. v. Commissioner, 999 F.3d 269 (5th Cir. 2021).

The “38 million dollar question” litigated in this case involves the question of whether this taxpayer can be treated as a bank, which is thereby eligible for special loss deduction provision of the Code which are available only to banks. During the years leading up to the Great Recession, Taxpayer had invested over $4 billion in mortgage-backed securities. In 2007 and 2008, Taxpayer claimed deductions against its ordinary income from losses on these investments under section 582 of the Code. The Service disallowed those losses to the extent that they exceeded capital gains, which Taxpayer did not have during the relevant years.

Status as a “bank” depends on a key aspect of the customer relationship: does a customer deposit funds for safekeeping. This taxpayer sold money orders to customers, which the court determined was not a deposit for safekeeping but instead resembled the purchase of a gift card.

When a customer buys a money order, that customer acquires a contractual obligation from Taxpayer to pay over the stated amount to the third-party listed as the payee on the money order. According to the court, this is not a deposit for safekeeping. The financial institutions that subsequently process the money orders are likewise not depositing funds. Without a deposit relationship, there could be no banking function and therefore no access to deductions that are specific to banks.

9. NOL carryforwards fail to cross the finish line, Martin v. Commissioner, TC Memo 2021-35.

Taxpayer was a mechanical engineer and a veteran race car driver, whose career began in the mid-1960s. During the 1990s, Taxpayer had his own racing team. However, a sponsorship fell through, leaving a loss of over $1.7 million in connection with the business. Taxpayer filed for bankruptcy in 1997, but he continued to claim the NOL as his own and to carry it forward into future tax years. NOLs arising during this period could be carried back three years and forward 15 years. And ordinarily, bankruptcy wipes out an NOL to the extent discharged debt is excluded from taxable income. See IRC § 108(b)(3).

A taxpayer who claimed an NOL during the 2008 tax year, which was applicable here, would have had to prove these elements: (1) existence of an NOL for a prior year; (2) an election to waive the carryback applicable to that year, or alternatively, that the NOL could not
be fully applied to the income in prior years; (3) the NOL could not have been applied to subsequent, intervening years before 2009; and (4) that 2009 would be no more than fifteen years after the NOLs were generated.

Taxpayer’s proof was thin indeed, as it relied on an argument that prior audits left the NOLs intact. The Tax Court rejected that argument. Each tax year stands on its own, being the origin of new liability that presents a separate claim. Neither res judicata nor collateral estoppel applies to prior audit determinations. The failure to challenge an item in the past is irrelevant to future treatment. So, the long and short of it – this argument cannot cross the finish line.

Comment: The case also involved other routine substantiation issues and matters involving tracing of expenses to business or investment activities.

10. NOL Guidance for Farm Businesses, Rev. Proc. 2021-14

The Tax Cuts and Jobs Act restricted NOL deductions arising after 2017 to 80 percent of the taxable income computed without regard to the NOL deduction for most taxpayers. It also generally eliminated NOL carrybacks, instead requiring them to be carried forward for most taxpayers. However, farming losses were allowed a two-year carryback period. A taxpayer with a farming loss was required to make an irrevocable election to waive that carryback period.

The CARES Act provided a temporary suspension of the 80 percent limitation for NOLs and allowed a five-year carryback period for an NOL arising in taxable years beginning after December 31, 2017 and before January 1, 2021. This five-year carryback applies in lieu of the two-year carryback for farming NOLs. Thus, a taxpayer with farm losses would presumably have to waive a carryback altogether or go back five years, not two.

The COVID-Related Tax Relief Act of 2020 (“CTRA”) further amended the NOL rules to allow a taxpayer with a farming NOL to disregard the CARES act changes. This would mean the following:

- Applying the 80 percent limitation for NOL amounts arising in 2018-2020 tax years;
- Carrying back the farming loss two years (and only that portion of the NOL that constitutes a farming loss)

The revenue procedure allows a taxpayer to affirmatively elect to follow the CTRA provision by filing a statement (see 3.01(2)(b)) with their return by the due date (with extensions) for their return. Alternatively, a “deemed election” applies if the taxpayer files a return disregarding the CARES ACT restrictions on a farming loss.

11. Taxpayers who use a per diem rates for meals can fully deduct the meal portion, Notice 2021-63, 2021 WL 5371500 (Nov. 16, 2021).

Taxpayers who used per diem approaches for traveling expenses were previously required to substantiate the amounts for meals and treat them as subject to the 50 percent deduction limitation under IRC § 274(n). Rev. Proc. 2019-48 provided methods for compliance with those substantiation requirements. In this notice, the Service has adopted a liberal position that the amounts attributable to meals are eligible to be treated as food or beverages provided by a restaurant, thereby allowing 100 percent deductibility for the 2021 and 2022 tax years.
C. Personal

1. Race car expenses were not connected to a construction trade or business, Berry v. Commissioner, TC Memo 2021-42.

Taxpayers were family members and shareholders in an S corporation, Phoenix Construction, which engaged in building houses and developing real estate. The S corporation’s 2013 return was under audit, with numerous adjustments, including a challenge to $121,903 deductions claimed in connection with the racing activity, including the acquisition of a 1968 Camaro.

Photographs of the race car did not show any branding or logo on the car that related to the business. The racing activities were conducted under the name Berry Racing, not under the name of Phoenix Construction. The company did not claim the car expenses as advertising expenses, but simply buried them with other construction-related expenses. Thus, taxpayers failed to prove these were ordinary and necessary expenses of their construction business. Taxpayer alternatively argued that the car racing venture was a separate business, but that argument failed because the actual racing did not begin until 2014. At most, these expenditures could be considered as startup expenditures under section 195, or as nondeductible capital expenditures under section 263(a) in the case of the acquisition costs.

Comments: Professional return preparers did not catch these issues, presumably because the Taxpayers buried these expenses in their other construction-related expenses. Query if some deductions could be properly taken in future years with some business-model adjustments.

2. Deductible alimony paid through cafeteria plan payments upheld, Leyh v. Commissioner, 157 T.C. No. 7 (2021)

In 2012, Taxpayer filed for divorce from his wife Cynthia. In 2014, while the petition for divorce was still pending, they entered into a written separation agreement in which Taxpayer agreed to pay for Cynthia’s health and vision insurance. Taxpayer used pretax payroll reductions from his wages through his employer’s cafeteria plan to make these payments, which totaled $10,683 during the 2015 tax year. Taxpayer thus benefitted from the exclusion from gross income accomplished through using the cafeteria plan, but he also claimed an alimony deduction for the payments on his 2015 tax return.

On audit, the Service disallowed the alimony deduction and imposed an accuracy penalty, which was later conceded. At issue before the Tax Court was the availability of the alimony deduction in these circumstances, as the Service conceded that Taxpayer was allowed to exclude these amounts paid for insurance for his then-separated spouse under sections 106 and 125. Moreover, Cynthia had included the payments in her gross income in accord with section 71. According to the Tax Court, the case presented the question of whether Taxpayer would obtain an impermissible “double deduction” as a result of allowing the alimony deduction.

After rehearsing numerous authorities on the matter of allowing a “double deduction”, which the court concluded was permitted only when there was specific intent, the court found that such intent was presented here. Alimony is a means of allocating taxable income among the two members of the former couple. If this couple had continued to file a joint return – as they
were eligible to do – they would have benefitted from the exclusion in the cafeteria plan and also had no alimony deduction. In filing separate returns, the couple had to allocate the income, and they did so by giving Taxpayer a deduction and including that amount in Cynthia’s income. The matching event here is the alimony income in the hands of his former spouse, and not the excluded wage income that he obtained by using the cafeteria plan. Congress, not the Tax Court, must formulate an exception. The Tax Court also considered the Service’s arguments under section 265, but it found section 265 inapplicable. The alimony payments did not create wholly tax-exempt income, but instead required the payment to be included in Cynthia’s income.

Comment: Of course, Congress did change the alimony regime by eliminating the deduction beginning in 2019. However, grandfather provisions affecting prior payments might still permit this kind of “double benefit” situation for couples with long-term separation agreements.

III. Credits.

1. No research credit for fashion designer, Max v. Commissioner, TC Memo 2021-37. Taxpayer conducted a business as a clothing designer through an S corporation, and the corporation claimed research tax credits in connection with fashion-related activities, which included fabric selection, tailoring, testing the outfits using models, and testing the fabrics for dye performance and seam strength. The government’s expert testified that these activities are normal in the fashion industry.

The Tax Court agreed that the research credits were not available in this context. First, the activities failed the section 174 test, which requires that the expenditures serve an investigative purpose that are not related to the actual construction of the product. The Court found that fitting a garment on a model is hardly investigatory, as it did not involve development of new knowledge but instead reflected common knowledge applied to common problems, often using trial and error.

Neither was this activity designed to discover technological information. According to the court, the fact that formulas may be applied to ascertain where a spherical projectile will land does not make a center fielder a mathematician. In the fashion examples, science works in the background, but the Taxpayer did not engage in hard sciences to do its work. Unlike a material scientist trying to identify the DNA sequence for cashmere, the Taxpayer’s activities fail the technological test.

Nor was there a sufficient process of experimentation that might qualify as research. Finding clothing that fits well and appeals to aesthetic preferences is important, but neither hard sciences nor a formalized scientific method are involved in the Taxpayer’s processes.

Comment: Those tempted to stretch the research credit may find this case helpful in fleshing out the various tests and parameters for cabining creditable activities. See also Little Sandy Coal Co v. Commissioner, TC Memo 2021-15 (rejecting research credit for shipbuilding and drydock production).

This is a test case for more than 200 pending disputes involving a tax shelter scheme involving solar power. The promoters sold light-concentrating lenses that were supposed to be used as components of solar power generation systems. However, the project never got past the R&D stage, and the lenses were never placed in service. The Justice Department eventually enjoyed the promotion of the tax shelter, but in the meantime, the tax consequences had to work through the system.

Taxpayers attempted to claim deductions and credits associated with their investments, making purchases that were designed to “zero out” their taxes (or nearly so) in 2009-14, offsetting substantial wage income. Only the 2010-14 years are at issue in this case.

The Tax Court made short work of Taxpayer’s deduction and credit claims. Taxpayer was not carrying on a trade or business, and he could not claim the lenses he bought were property held for production of income. He generated no income from the lenses and failed to demonstrate a profit motive in holding them. In fact, the lenses he purchased in 2009 included an agreement for a refund of the purchase price in the event that the seller failed to install and start-up the lenses by year end. That did not occur, and yet Taxpayer continued to make the lens purchases each year in order to obtain tax benefits.

Even if Taxpayer could have proven a profit-seeking motivation, depreciation deductions and energy credits both require assets placed in service during the taxable year. No such showing was possible here, as the lenses were incapable of functioning apart from a larger system that was never assembled, let alone proven functional.

Comment: If your clients were taken in by this shelter, this predictable outcome should induce them to settle their claims and move on. This taxpayer benefitted from the avoidance of penalties because the supervisory approval requirement was not met. He should have known better – he was a partner in a large law firm.


As also noted below in the legislation discussion, enhanced child and childcare credits that are part of the American Rescue Plan provide substantial and refundable tax benefits this year. For more detailed analysis, see reports by the Congressional Research Service available at https://crsreports.congress.gov/product/pdf/IN/IN11613 (May 12, 2021) and at https://crsreports.congress.gov/product/pdf/IN/IN11645 (May 10, 2021).

4. Taxable social security benefits create deficiency from excess APTC, Knox v. Commissioner, TC Memo 2021-126.

Taxpayers obtained advance premium tax credits (APTCs) under the Affordable Care Act to assist in procuring health insurance during the 2015 tax year. During that year, they reported AGI of $18,631, which they thought put them well within the range of eligibility for the APTCs they received (i.e., between 100% and 400% of the Federal poverty line for their family of two.) However, they treated $53,813 of social security benefits received during 2015, as nontaxable income. This amount included lump sum payments from 2013 and 2014. These taxpayers also
made an election under section 83(e) to limit the amount of the prior-year benefit that was included in their taxable income.

According to the Court, the election to include a portion of those benefits made no difference in this case, as eligibility for APTCs depends on the computation of MAGI, which includes Social Security benefits that were “not included in gross income under section 86”.

In Johnson v. Commissioner, 151 T.C. 121 (2019), the Tax Court had also ruled that Social Security benefits were included in the APTC eligibility determination. With the social security benefits included in MAGA, Taxpayers had income in excess of 400% of the federal poverty guidelines and thus lost their eligibility for premium credits. Thus, the Court upheld the deficiency issued against them for excess premium amounts.

Comment: This is a tough result, as going over 400% means a “cliff” where no benefits are payable in these years. As the court noted, “While we are sympathetic to their plight, we cannot ignore the law to achieve an equitable end.” A legislative fix for 2021 eliminates that cliff by providing an 8.5 percent of income limit for health insurance costs. For a similar case in which excess APTC credits also generated a deficiency, see Amburgey v. Commissioner, TC Memo 2021-124 (dealing with the 2018 tax year).

IV. Tax Administration.

A. Penalties.

In the past two years, 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. Taxpayer avoids fraud penalties due to lack of administrative approval, Beland v. Commissioner, 156 T.C. No. 5 (2021)

Married taxpayers had their joint return under examination. The RA summoned Taxpayers to an in-person closing conference just before the statute of limitations would expire. At that conference, he produced a Form 4549, Income Tax Examination Changes, which reflected a civil fraud penalty. No 30-day letter accompanied this report, as the limitations period would soon expire. Taxpayers declined to consent to the penalty or to sign Form 872 to extend the limitations period. Thereafter, the RA sought supervisory approval for the penalty and submitted a notice of deficiency.

Taxpayers moved for summary judgment on the penalty on the grounds that there was no supervisory approval preceding the initial determination of the penalty, which they alleged occurred when the Form 4549 was presented. The Tax Court agreed, ruling that the context of the Form 4549, which presented Taxpayers with an opportunity, if not expectation, to legally bind them to the assessment of a penalty was a determination for this purpose. At the closing agreement, they had three options: (1) agree to the fraud penalty (which would waive appeal rights); (2) execute Form 872 to extend the limitations period and then have Appeals review the case; or (3) decline these options and receive a notice of deficiency. There was no reason to believe that the RA would remove the penalty from that notice. This case was thus
distinguishable from other communications that suggested contingent or proposed penalties that were held not to constitute determinations for purposes of supervisory approval.

Comment: This case makes it clear that an in-person presentation of a document indicating that penalties would be assessed is sufficient to trigger the requirement of prior supervisory approval. The summons added to the formality of the situation, which was not merely a meeting where the mere possibility of assessing penalties might be discussed.

2. Passport revocation for delinquent tax debt is constitutional, Maehr v. Department of State, 5 F.4th 1100 (10th Cir. 2021).

This is the first Circuit-level case to address the constitutionality of section 7345 and its scheme of certification of a delinquent federal tax debt of $50,000 or more which authorizes the Secretary of State to revoke a taxpayer’s passport. Taxpayer argued that this provision (1) violates substantive due process rights under the Fifth Amendment in depriving him of a fundamental right to travel; (2) deprives him of rights under the Privileges and Immunities Clause; and (3) violated the common law principle of ne exeat republica (i.e., “let him not leave the republic”).

The Court rejected the Fifth Amendment claim on the basis that international travel did not constitute a fundamental right. Accordingly, the constraint on travel only had to survive rational basis review. Similar review has been applied to passport restrictions imposed for failure to pay child support. The court distinguished international travel from interstate travel, which it found had a stronger constitutional provenance. This statute survives rational basis scrutiny as it furthers the governments legitimate interest in raising tax revenues. A concurring judge disagreed on this point, but his view did not carry the day.

The Privileges and Immunities claims, rooted in Article IV, section 2 and the Fourteenth Amendment, were summarily rejected. Those provisions apply to the states, not to the Federal government.

Finally, the court also rejected common law constraints on “ne exeat” writ from application in this context. The “ne exeat” writ was essentially a form of civil arrest used to confine a person to a particular jurisdiction, or even to his house. It can be applied in the context of tax enforcement. Although the Tenth Circuit had not articulated a framework for evaluating these writs, the court recognized a four-factor test applied in other jurisdictions. However, the Tenth Circuit ultimately rejected a common law test here, choosing instead to distinguish the writ from the statutory powers in section 7435, which were much narrower than the writ and contained built-in due process protections that include challenge in the tax court.

Comment: According to a report by the Taxpayer Advocate, 436,400 taxpayers qualified for passport revocation in 2018. The concurring judge would take a more generous approach to the right to international travel, which he asserted should be protected by intermediate scrutiny, but he acquiesced in the judgment as that issue was not briefed adequately. Note that First Amendment concerns affected the scope of travel rights in older cases. Query how Internet access affects those claims – is virtual presence sufficient? I hope not, particularly in a world
where censorship and cancellation possibilities abound. Those interested in the history of the travel right will find some interesting authorities here, including academic treatments.

3. Tax Court holds that section 7345 did not unconstitutionally infringe right to travel, Rowen v. Commissioner, 156 T.C. No. 8 (2021).

Following two decades of chasing after Taxpayer to collect past-due tax debt, the Service invoked section 7345 in 2018. The Commissioner certified a “seriously delinquent tax debt” to the Secretary of the Treasury, who in turn transmitted that certification to the Secretary of State for “action with respect to denial, revocation, or limitation of a passport…” The Commissioner and Secretary of the Treasury did their part, but the Secretary of State has not yet acted.

Taxpayer sought review in the Tax Court, moving for summary judgment to determine that the certification was invalid because it deprived him of the right to travel internationally in violation of the Due Process Clause of the Fifth Amendment. The Tax Court rejected this claim, finding that section 7345 itself has no impact on his right to travel, as it only gives the Commissioner the power to certify. The power to revoke is exercised by the Secretary of State, not the Commissioner, and that power is not an issue before the Tax Court. The court also rejected a similar claim based on the Universal Declaration of Human Rights, noting that even if this declaration bound the Government, there was no proof that the Commissioner’s actions restricted his right to travel. The court also found no procedural or factual errors involving certification of delinquent tax debt here.

Comment: If you want to challenge the FAST Act that permits revocation, then apparently joinder of the Secretary of State is required in a different federal court. Actual revocation would also be helpful, although threatened revocation might produce sufficient harm to allow for injunctive relief. This case also suggests that this new collection tool probably works: it certainly got the attention of this delinquent taxpayer!

4. Tax Court rejects frivolous protestor claim but does not impose penalties, Delgado v. Commissioner, TC Memo 2021-84.

Taxpayer received Form 1099-MISC totaling over $123K in 2017 for services performed as an independent contractor. His Form 1040EZ showed zero income. A notice of deficiency followed.

Taxpayer argued that he was not engaged in a “trade or business” as that term is defined in section 7701(a)(26), which provides that “[t]he term ‘trade or business’ includes the performance of the functions of a public office.” However, Section 7701(c) also provides that the term “includes” should not be interpreted to “exclude other things within the meaning of the term defined.” The Tax Court rejected Taxpayer’s argument that he could not have income from a trade or business because he did not hold a public office, noting that other authorities treat this claim as frivolous. Both income tax and employment tax assessments were upheld.

Comment: The court is very patient in addressing this claim, which might otherwise have been a candidate for penalties. Compare Muhammad v. Commissioner, TC Memo 2021-77 (imposing a $250 penalty for frivolous denial of taxability of wages); Smith v. Commissioner, TC Memo 2021-29 (imposing $2500 for frivolous arguments based on denial of taxable income from
services); Llanos v. Commissioner, TC Memo 2021-21 (declining IRS invitation to sanction Taxpayer but issuing warning about future frivolous arguments where present case included legitimate issues); Silver v. Commissioner, TC Memo 2021-98 (finding frivolous omission of income but declining penalty when IRS waited until trial to advance penalty). See also Swanson v. Commissioner, No. 21-11576 (11th Cir. Oct. 5, 2021) (unpublished) (recognizing Tax Court forbearance but imposing $8K sanction against Taxpayer-Appellant raising frivolous issue that income tax was an unconstitutional direct tax).

5. Taxpayer precluded from denying notices of deficiencies underlying seriously delinquent tax debt under section 7345, Kaebel v. Commissioner, TC Memo 2021-109.

Taxpayer was on his third trip to the Tax Court associated with a challenge to deficiencies from the 2005-2010 tax years totaling more than $210,000. In 2018, the Service notified Taxpayer that it had certified him to the Secretary of State as an individual with a seriously delinquent tax debt.

Attempts to collect the debt through levy were mostly unsuccessful. In 2014, Taxpayer filed a petition in the Tax Court to challenge a determination to levy to collect taxes for 2010. In that proceeding, Taxpayer alleged that no notice of deficiency had been issued for the 2010 tax year. The Tax Court ruled that a notice had indeed been seen to his last known address.

In 2018, Taxpayer filed another petition disputing levies for all the delinquency years on the ground that the Service was trying to proceed without issuing notices of deficiency. The Service sought to dismiss on the basis that the Tax Court lacked jurisdiction over those years, and in support of that motion it offered as evidence copies of deficiency notices for the delinquency years, which showed they were mailed to his last known address. The notices proved that any petition to challenge them was untimely, thereby depriving the court of jurisdiction. Taxpayer challenged the notices as “hearsay”, but the Tax Court rejected his motion to strike and dismissed the petition for lack of jurisdiction. That ruling was affirmed by the Fifth Circuit.

In the current proceeding, Taxpayer persisted in his claim that no notices of deficiency had been issued to him. The Service argued that he was collaterally estopped from denying the notices. The Tax Court agreed with the Service, finding that all five elements required for collateral estoppel were present here: “(1) the issue in the second suit must be identical in all respects with the one decided in the first suit; (2) there must be a final judgment rendered by a court of competent jurisdiction; (3) the party against whom collateral estoppel is asserted must have been a party to the first suit or a privy to a party; (4) the parties must have actually litigated the issues and the resolution of these issues must have been essential to the prior decision; and (5) the controlling facts and applicable legal rules must remain unchanged from those in the prior litigation.” There was no basis to challenge the certification, as there was seriously delinquent tax debt present here.

Taxpayer was ordered to show cause why he should not be subject to penalties under section 6673 for a frivolous litigation position.
Comment: One wonders how such a fundamental fact issue could be the source of a litigation position -- even by a pro se taxpayer! This taxpayer also tried to challenge section 7345 based on infringement of his right to travel, an approach that is rejected because section 7345 merely provides for certification of certain tax-related facts and did not, of itself, have an impact on his travel rights.

6. Early distribution “exaction” under section 72(t) is not a penalty requiring supervisory approval, Grajales v. Commissioner, 156 T.C. No. 3 (2021).

Taxpayer turned 42 in 2015. She took loans in connection with her retirement plan, which the fiduciary reported as taxable distributions. On her 2015 return, she failed to report the distributions as taxable income. The Service issued a notice of deficiency proposing regular tax and the additional 10% tax under section 72(t) for an early distribution prior to age 59 and a half. Prior to trial, the parties stipulated that only $908.62 was taxable and that section 72(t) tax was $90.86. However, Taxpayer asserted that the section 72(t) tax was a penalty for which no supervisory approval had been obtained, thereby negating the penalty.

The Tax Court noted that the section 72(t) “exaction” had been determined to be a tax and not a penalty, addition to tax, or additional amount in other contexts involving the assignment of the burden of production between the Commissioner and taxpayers. The Tax Court followed this characterization, which it also noted was consistent with the Supreme Court’s analysis of a tax in National Federation of Independent Business (2012). Accordingly, Taxpayer could not invoke the protection of section 6751(b) or (c) in this case.

Comment: I have often called the section 72(t) “tax” as a “penalty”, haven’t you? I think “exaction” should include both taxes and penalties, as none are paid voluntarily. This case is on appeal to the Ninth Circuit.

7. Penalty on omitted income not excused for reasonable cause based on return preparer, Walton v. Commissioner, TC Memo 2021-40.

Taxpayer sent a spreadsheet to her longtime CPA showing income received during 2015 totaling about $525,000. Later that year, she transmitted Forms 1099 and W-2 to her CPA to aid in preparation of her 2015 return, but these totaled only $351K. The CPA emailed her to ask about the discrepancy, but Taxpayer responded with missing 1099s involving investment income, not omitted compensation. After seeking an extension, the CPA filed her return that omitted some $169K of compensation reflected on the spreadsheet. The firm had a practice of following the documentation when there was a discrepancy. Taxpayer did not review the return prior to filing.

The IRS AUR program caught the mismatch between the 1099-MISC that should have been reported and the amount of the return and sent her a notice that she would owe another $62K in tax and a substantial understatement penalty of $12K. Taxpayer did not dispute that she owed the tax, but she contested the penalty based on reasonable cause in relying upon her longstanding professional preparer.

The Tax Court upheld the penalty, rejecting Taxpayer’s reasonable cause argument. Unconditional reliance on a professional does not satisfy reasonable cause; diligence and
prudence are also required. Here, she failed to review the return. Even a cursory review would have shown reported income far below what she had given her CPA—some 32 percent less. While a taxpayer need not duplicate professional effort, a bare minimum of an attempt to review and the application of reasonable effort in the circumstances should have detected the problem. Accordingly, she could not satisfy her burden.

Comment: Failing to review a return falls below the minimum standard. If the amount had been smaller, the outcome might have been different. Note that there was no supervisory approval requirement in this case, as the penalty was generated automatically by the AUR computer program.


Taxpayer was the settlor and sole beneficiary of a foreign trust, which he established in 2003 with approximately $9 million in assets. In 2007, he liquidated the trust and received approximately $9.2 million in distributions. Section 6048 requires that U.S. owners of a foreign trust must ensure that the trust files an annual information return, and it also imposes a requirement on beneficiaries to file returns reporting any distributions they received. Section 6677 imposes penalties for filing these returns after the due date: 35 percent on beneficiaries and 5 percent on owners. Taxpayer filed both returns for 2007 late. The Service assessed a penalty of 35 percent, totaling more than $3.2 million. Taxpayer paid the tax and filed a refund claim, arguing that only the 5 percent penalty could be imposed on him in the status of an owner of the trust.

The district court upheld the Taxpayer’s claim, ruling that the language of the penalty provisions precluded the IRS from imposing the higher penalty. The government appealed, and the Second Circuit reversed. Based on its textual analysis, the disclosure provisions in section 6048 and the related penalty provisions in section 6677 impose a penalty of 35 percent in this context. There is no exception for a beneficiary who is also an owner; neither may both penalties be applied.

Comment: Owners of foreign assets have many disclosure and reporting requirements. Expert advice may be required in this context. A petition for certiorari was filed on October 29, 2021.

9. Timely supervisory approval was obtained before initial determination of penalty, Excelsior Aggregates, LLC v. Commissioner, TC Memo 2021-125.

Taxpayers challenged penalties imposed in connection with a conservation easement deduction claimed by their partnership. The Service claimed that the “initial determination” of the penalty came in the FPAA, and that supervisory approval was obtained prior to that time. However, Taxpayers claimed that the initial determination predated the FPAA and supervisory approval, occurring either when the Service discussed penalties during a phone call with the partnership’s representative or when it assessed penalties against the partnership’s appraiser under section 6695A(a), which penalizes the appraiser for a valuation that the appraiser knows will produce a substantial valuation misstatement in connection with the taxpayer’s return connected with such an appraisal.
The Tax Court granted summary judgment in favor of the Service on this issue. First, it found that the Service obtained supervisory approval two days before issuing the FPAA that included penalties for the partnership. It rejected the claim that a telephone call nine months before that date included any determination regarding penalties. The agenda for that call indicated that the examination was “substantially completed” but the results could change “before the examination officially concludes”. According to the court, this was not an initial determination. These circumstances were distinguishable from Beland v. Commissioner, 156 TC 80 (2021), where the taxpayers were presented with an RAR that included fraud penalties and were told to sign it or a notice of deficiency would be issues. In that case, Taxpayer had nothing more to do to close the examination file and proceed to the notice of deficiency. Here, the agenda presented left open a possibility for discussion and change. Moreover, the audit remained open and incomplete. Finally, there was no determination of the amount of any penalties, only the possibility that penalties might be applicable without even identifying whether those involved 20 percent or 40 percent of any deficiency.

As for the penalty notice to the partnership’s appraiser, the Tax Court also found this argument to be unavailing. Each penalty stands on its own for purposes of the approval requirement. A penalty against an appraiser does not necessarily mean a penalty is also being assessed against the taxpayer relying upon that appraisal. Supervisory approval is required before a determination is made for each taxpayer; the appraiser is a different taxpayer.

Comment: This case provides helpful additional parameters for the supervisory approval requirement.


Sand Investment Co. (“Sand”), an LLC, took a large charitable deduction for a conservation easement. The Service issued a FPAA disallowing the deduction and imposing accuracy penalties. Sand challenged the penalties based on compliance with the supervisory approval requirement in section 6751(b)(1), moving for partial summary judgment on that issue.

Revenue Agent Cooper, who was in charge of the case, was supervised by Supervisory Revenue Agent Gregory Burris, who served as both “case manager” and “issue manager” for Sand’s return. On September 2, 2018, the Service promoted Cooper to “Senior Revenue Agent” and transferred her to a different audit team, in which Wilson became her new supervisor. However, the Service authorized Cooper to continue her work on the Sands audit. Wilson managed administrative matters, such as timesheets and leave requests, but Burris remained in charge of oversight for work on the Sands examination.

On September 27, 2018, Agent Cooper decided to assert penalties against Sand. Burris signed documents approving those penalties on November 20, 2018, in his capacity as the “case/issue manager” and/or “case & issue supervisor”. On November 23, 2018, Agent Cooper’s new supervisor, Wilson, also signed penalty approval documents. The FPAA was not issued to Sands until February 8, 2019, which was long after approval was obtained.
Sands’ argument proceeded in two steps: First, that a packet of documents communicated to Sand on November 21, 2018, included the penalties, thereby constituting a penalty determination. Second, this packet delivery occurred before a signature from her new supervisor was obtained, thus depriving the IRS of penalty approval by her immediate supervisor in advance of a penalty determination.

The Tax Court rejected the significance of the second step of this argument, making it unnecessary to consider the first step. According to the court, approval from Burris, which preceded Sands’ alleged determination, satisfied the statutory requirement of approval from her “immediate supervisor.” While recognizing that section 6751(b) is “not a paragon of statutory draftsmanship”, Burris was her “immediate supervisor” as he was not separated from Agent Cooper by any intermediary supervisors and he remained in charge of the Sands audit after Cooper’s promotion.

This determination was also in line with the legislative purpose of supervisory approval, which presumably draws upon the expertise of a person who is most familiar with the facts and legal issues presented in the case. Accordingly, Sands’ summary judgment motion was denied.

Comment: This case clarifies and eliminates confusion about the identity of the supervisor.

11. Incarceration is not reasonable cause for failing to file returns, Lindsay v. United States, 4 F.4th 292 (5th Cir. 2021).

Taxpayer was incarcerated. He executed a power of attorney to Bertelson, who had control of his bank accounts and was in charge of managing Taxpayer’s affairs, including filing his tax returns for 2012-2015. But Bertelson failed to file those returns or make any tax payments. In fact, Bertelson embezzled from Taxpayer until he discovered the malfeasance in 2014. He sued Bertelson and was awarded $705K in actual damages and $1 million in punitive damages.

After being released from prison, Taxpayer filed delinquent returns and paid all taxes, including $425K in penalties. He sought a refund for the penalties, claiming that his incarceration provided reasonable cause for his failure to file, rather than being a product of willful neglect. Taxpayer sought a jury trial. However, the district court granted the Government’s motion to dismiss on the ground that he failed to state a claim on which relief can be granted. Despite sympathy for his circumstances, the court ruled that Boyle (SCT 1985) and its progeny, which treated filing obligations as nondelegable duties.

The Fifth Circuit affirmed. Taxpayer’s incarceration did not provide a basis for finding reasonable cause, as he was able to employ a CPA and otherwise conduct business while incarcerated. Ordinary business care and prudence should have told him that the returns had not been filed. Thus, no penalty relief.

Comment: This taxpayer could not show an “unavoidable absence” that is sometimes allowed as a basis for reasonable cause due to the fact that he was able to retain others to carry on his business. Query whether that ability makes “unavoidable absence” a virtual nullity as long as the taxpayer has the means and mental capacity to retain competent professional assistance.
When that assistance is not competent (or even corrupt, as in this case), this would mean the remedy lies in litigation against the professional. Hopefully the $1 million punitive damage award (if collected) will provide a sufficient pool of assets to pay the tax penalties. (But after income taxes and attorney fees, I doubt it.)

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 included 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. Willful FBAR penalty takes half the account balances of decedent’s estate, United States v. Kahn, 5 F.4th 167 (2d Cir. 2021).

Taxpayer’s estate appealed from a district court judgment imposing a penalty of $4.2 million for willful failure to file FBAR reports on decedent’s two foreign bank accounts, which had balances totaling $8.5 million. The Government imposed the maximum penalty allowed under 31 U.S.C. § 5321, which as amended in 2004, permitted a penalty of 50 percent of the aggregate balance of the accounts at the time of the failure to report. However, the Taxpayer argued that a 1987 Treasury regulation, which had not been amended following the statutory change in 2004, capped the penalty at $100,000 per account. The district court ruled for the Government, and Taxpayer appealed.

A majority of the Second Circuit upheld the judgment on the basis that the subsequent statute governs when in conflict with a prior inconsistent regulation. Other circuit courts took a similar position. See also Norman v. United States, 942 F.3d 1111 (Fed. Cir. 2019); United States v. Horowitz, 978 F.3d 80 (4th Cir. 2020); United States v. Rum, 995 F.3d 882 (11th Cir. 2021). However, a dissenting judge would have required the Treasury to follow its own regulations on the ground that the statute only permits a higher penalty, which the Treasury chose not to implement.

Comment: The penalty regime enacted in 2004 enhances compliance incentives – if $100K is not big enough to get your attention, half the balance will probably do the trick. Flouting the FBAR reporting rules can be detrimental to your financial health. This decision reinforces principles of statutory primacy over regulations that are often not updated to reflect the current state of the law.

2. Only one non-willful civil penalty can be imposed for late filing of FBAR with multiple accounts, United States v. Boyd, 991 F.3d 1077 (9th Cir. 2021).

Taxpayer failed to file an FBAR for multiple accounts in the UK until after she entered the Offshore Voluntary Disclosure Program (OVDP). In 2012, she filed an FBAR disclosing fourteen accounts held in 2010 and she amended her 2010 tax return to include interest and
dividends from such accounts that she had not reported. Taxpayer then received permission to opt out of the OVDP in 2014. An examination of her return produced a penalty of $47,279.

The Government sued Taxpayer for $47,279 plus additional penalties and interest, but Taxpayer defended on the ground that she committed only one non-willful violation for which $10K would be the maximum penalty. The Government alleged that the statute allowed a penalty for each account, and the district court agreed. This appeal followed.

The Ninth Circuit addressed this issue of first impression, holding that the civil penalty for non-willful violation of the reporting and disclosure requirements in 31 U.S.C. 5314 is limited to one penalty per account. The relevant statute, 31 U.S.C. 5321, delineates two types of civil penalties. The maximum penalty for a non-willful violation “shall not exceed $10,000.” 31 U.S.C. § 5321(a)(5) (B)(i). But a willful violation allows a penalty up to the greater of 50 percent of the account balance or $100,000. According to the court, the statute does not impose a cap on penalties for willful violations or restrict them to a single account.

The court followed the applicable statutory and regulatory scheme, finding only a single violation – filing one FBAR form for 2010. Thus, a single maximum penalty. It rejected the Government’s arguments that Congress intended a more expansive penalty regime for non-willful violations as unsupported by the text. Congress could have provided that the non-willful penalty “shall not exceed $10,000 for each failure to timely report the existence of an account or any identifying information.” But it omitted the text after $10,000. Moreover, in the Ninth Circuit, a rule of lenity applies not only to interpreting criminal statutes, but also to tax penalty provisions. Even if the Taxpayer’s interpretation is not “compelled” by the statutes, it is a reasonable one, which should prevail if the statute is construed strictly against the government.

Comment: A dissenting judge criticized the majority’s analysis as contrary to the natural reading of the statute. She also rejected the majority’s view of the rule of lenity. Admittedly, this outcome does not provide the same reinforcement for compliance as in the willful scheme, but isn’t that appropriate if the penalty is based on non-willful behavior? And query whether the emerging “reckless” standard for a finding of willful violation will make these cases rarer. (See below.) The favorable result here seems to be the rare case in which a taxpayer who exited the OVDP does not make her situation worse. Note: In a late-breaking development, the Fifth Circuit just rejected Boyd, creating a circuit split on this issue. See United States v. Bittner, No. 20-40597, 2021 WL 5570729 (5th Cir. 11/30/2021).


Taxpayer’s parents established a foreign account with UBS in 1980, designating her as a joint owner. Her father, whose family had been killed in the Holocaust, established the account and maintained its secrecy based on his fear of persecution in the United States and the possible need to flee, as his parents had fled the Nazis years before. Taxpayer married in 1983 and disclosed the account to her husband, a financial analyst, who advised her about the account. After her father’s death in 1997, she maintained the account as a “numbered account” rather than a named account.
The couple divorced in 2000 and she hired a CPA to prepare her income tax returns. The CPA did not ask about foreign accounts, and she did not volunteer that information. Her returns stated that she did not have a foreign bank account, but she testified that she did not review their accuracy before signing them. In 2008, she learned about U.S. government investigation of UBS for abetting tax fraud. She retained counsel, and in 2009 she entered into the Offshore Voluntary Disclosure Program (OVDP). In 2012, she negotiated an agreement with the IRS to pay a penalty of $377,309. However, in 2013 she withdrew from the OVDP and she declined to pay the penalty. After completion of its examination, the Service determined a willful failure to file and sought penalties of $697,299, representing 50 percent of the UBS account. Taxpayer paid the penalty and then sued for a refund.

The Court of Federal Claims granted summary judgment in favor of the Government, and Taxpayer appealed. The Federal Circuit reviewed that determination de novo under a “clear error” standard. The Federal Circuit affirmed the decision, ruling that it was not clear error to find willfulness here despite the absence of “actual knowledge of the obligation to file an FBAR”. Here, Taxpayer had constructive knowledge of the requirement to file because she was reckless in failing to review her returns for accuracy. Further, the 50 percent penalty was within the range of discretion for the IRS.

Comment: Other courts have also recently embraced a recklessness standard. See also United States v. Rum, 995 F.3d 882 (11th Cir. 2021) (reckless disregard of known or obvious risk constitutes willfulness). The court in Rum also noted: “A taxpayer can be ‘willful’ even if her violation has good reason.” Further, “there is no ‘reasonable cause’ exception for willful violations.” See also United States v. Gentges, 531 F.Supp.3d 731 (S.D. N.Y. 2021) (finding willful violation based on reckless Taxpayer conduct in matter of first impression); Landa v. United States, 153 Fed. Cl. 585 (2021) (reckless behavior supports willful violation); United States v. Hughes, No. 18-cv-05931-JCS, 2021 WL 4768683 (N.D. Cal. Oct. 13, 2021) (checking box for foreign bank account in tax software supported willful violation).

C. Whistleblowers.

1. Decision on administrative record supports denial of whistleblower claim,
Whistleblower 10084-16W v. Commissioner, TC Memo 2021-73.

Whistleblower (W) sought review of an adverse determination of a reward claim based on information provided about a taxpayer. However, the record shows that the information was already known to the Service and had been used during pending audits. While those audits were pending, the target taxpayer had also disclosed in SEC filings that it had made a $170 million settlement with taxing authorities, without specifying anything about which authorities were involved.

W challenged the adverse determination, but the Tax Court upheld the IRS, finding no abuse of discretion. While the Service sought summary judgment, the court noted that summary judgment was “not generally apt” in a whistleblower review, as such a review is restricted to the administrative record. Thus, there is no trial on the merits to avoid. See generally Van Bemmelen v. Commissioner, 155 T.C. No. 4 (2020). However, nuances in the standard made no difference, as the record shows no collection of additional tax based on information provided.
Comment: See also O’Donnell v. Commissioner, TC Memo 2021-134, where the Tax Court follows Van Bemmelen in reviewing a CDP case based solely on the administrative record.


Whistleblower (W) submitted 21 Forms 211 claiming that individual taxpayers who were parties to a litigation settlement underreported their tax obligations. The information provided was contained in public records, and this was the ninth series of claims submitted by W.

Based on information provided, the WBO issued a “preliminary award recommendation” under section 7623(a), which indicated a preliminary amount of $962.92 for her award. The letter contained two boxes, which allowed her to either agree or disagree with the preliminary reward and to return a signed copy. W chose to create a third box, which stated she neither agreed nor disagreed, and she transmitted a letter explaining that she would need to review the IRS files to ascertain if the award was appropriate. The WBO denied that request, as the file included confidential taxpayer information. It did not issue a subsequent decision letter, award check, or any other notice about her claim.

W filed a petition in the Tax Court requesting disclosure of the information. The WBO filed a motion to dismiss for lack of jurisdiction because the preliminary award recommendation was not a determination for purposes of invoking judicial review under IRC 7623(b)(4). The Tax Court held for the WBO, ruling that it had no authority to intervene in the administrative process until a final determination had been made.


Whistleblower (W) submitted information to the IRS in 2009. The WBO denied his claim, and he appealed to the Tax Court, alleging that the IRS abused its discretion by failing to investigate or take administrative or judicial action against the targets named in the information. The Tax Court ruled for the IRS on the ground that it lacked jurisdiction to require the IRS to investigate or conduct an administrative proceeding or initiate judicial action against a target. The D.C. Circuit affirmed the Tax Court’s judgment.

W then tried again in 2018 with another claim, which also did not lead to IRS action and thus produced no collectable proceeds that would entitle him to an award. The DC Circuit affirmed. In his appeal, W also alleged that his claim coupled with interactions with the IRS created an implied-in-fact contract that the IRS had breached. The DC Circuit stated that a contract claim had to be filed in the Court of Federal Claims, not the Tax Court.

W duly filed in the Court of Federal Claims, which denied the claim. W appealed, and the Federal Circuit affirmed. W argued that section 7623(b)(1) is an offer of payment for information about tax evaders, which he accepted by filing Form 211 and providing that information. However, relying on other Federal Circuit precedent, the court ruled that no enforceable contract emerges until the government negotiate a specific amount as the reward. No such negotiation and determination occurred here.
Comment: W also argued that the DC Circuit sent him to the Claims Court, but in doing so it did not find that a contract was present. If there was any doubt, the WBO maintains considerable discretion in the matter of investigating and pursuing claims presented to them.


Witnessblower (W) filed nine Forms 211 seeking rewards for information from the IRS Whistleblower Office (WBO). These forms identified individuals— all extended family members or personal acquaintances— who were alleged to have conspired to commit “grand theft through conversion” of his mother’s assets. W also attached his own investigative report, which showed how funds were transferred through various entities to divest his mother of her ownership. W had a power of attorney exercised by his mother, and following her death, he was the executor of her estate.

WBO sent the claim to a classifier from the Small Business Self-Employed operating division, which recommended that the claim be rejected and which stated: “Allegations are not specific, credible, or are speculative…” The classifier indicated that the amount may be “more than $2 million, but the claim lacks specific/credible information, is purely speculative in nature, or does not allege a tax issue.”

A Tax Examining Technician then prepared an “Award Recommendation Memorandum” (ARM) which recommended that the WBO “reject” the claim. It recited reasons offered by the classifier. A letter was then prepared for W, which stated that the WBO had “made a final decision to reject your claim for an award” and that the claim “has been rejected because the IRS decided not to pursue the information you provided.”

W sought review in the Tax Court. The Service filed a motion for summary judgment. Pursuant to its prior decision in Van Bemmelen (2020), the Tax Court treated this motion as a mechanism for deciding, as a matter of law, whether the administration record supports the agency determination and whether such action is not arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law. Notably, the motion for summary judgment did not include an answer that asserted an affirmative defense to substantive review based on the fact that the whistleblower information involved a tax loss exceeding $2 million or involved individuals with taxable income of more than $200K. See IRC § 7623(b)(5).

Here, the record supported W’s position that summary judgment was not proper. The statutory and regulatory scheme provide for two determinations that result in no reward: rejection and denial. In the case of rejection, regulations provide guidance for whether a claim will satisfy threshold requirements, including a requirement for specific and credible evidence. A claim may be rejected on its face, or it may be rejected after further consideration and investigation. If a claim is rejected, the WBO may choose to allow the W to perfect the claim by providing additional information.
If a claim is eligible for consideration under section 7623(b), which involves claims that exceed the threshold amounts noted above, then an administrative proceeding is opened. W is notified through a preliminary rejection letter, in which case W is allowed to respond.

A denial, on the other hand, is a determination that implicates taxpayer information, rather than purely the information contained in the application. It is based on a determination not to proceed against the target, or on the finding that no proceeds were collected. That determination occurs after substantive consideration beyond the face of the claim. If the threshold amounts are not involved, a denial does not open an administrative proceeding. However, if the threshold amounts are involved, the denial letter must state the basis for denial and invite comments from W, after which a final determination is given. Because denial is based on factors beyond the claim itself, there is no right to perfect a deficient filing.

Here, the Tax Court first found deficiencies in the letter issued by the WBO. The WBO stated that it was “rejecting” the claim “because the IRS decided not to pursue the information you provided.” The Tax Court pointed out that this rationale matches denial, not rejection. Of course, any rejection means that the IRS will not pursue the target on the basis of the information provided, but a reason is required. In effect, the WBO has said “we reject your claim because we are denying the claim”, which is not consistent with its obligations under the regulations.

The Tax Court also found that the administrative record did not clarify the reasoning stated in the letter. In a proper case, the Tax Court is permitted to look beyond the four corners of the WBO letter to evaluate whether the WBO’s action was proper. Here, the record indicates that reviewers found reasons to reject the claim for failing to provide substantive information that was sufficiently specific and credible. Although one reviewer went beyond the information in the claim to investigate information for some of the targeted taxpayers, which could be viewed as supporting denial, the Tax Court found that limited inquiry was nevertheless consistent with rejection.

But given the inconsistency in the WBO letter, the Tax Court was not able to determine the basis for the agency’s determination. This was not a case where the administrative record could clear up a muddled letter. If W’s claim was rejected, he would have had the right to perfect and resubmit his claim (assuming it met the financial thresholds, which the IRS did not contest in its answer). Although the WBO may ultimately decide not to pursue the claim and W may get no reward, the WBO’s current decision was an abuse of discretion that merits remand to the WBO for further consideration.

Comment: This case provides a helpful tour of the procedural requirements for review of whistleblower claims. I doubt that this legal victory by the whistleblower will yield any practical benefit, but it will help the WBO write clearer determinations. And the Tax Court also reminds us that sometimes “turning square corners” can involve a two-way street. “If men must turn square corners when they deal with the government, it cannot be too much to expect the government to turn square corners when it deals with them.” Niz-Chavez v. Garland, 593 U.S. ___, ___, 141 S. Ct. 1474, 1486 (2021).
5. Whistleblower denied award where administrative action did not produce collections from the issue disclosed, Lissack v. Commissioner, 157 T.C. No. 5 (2021).

Whistleblower (W) filed a claim that entities engaged in developing condominiums and offering golf and beach club memberships failed to include millions of dollars in membership fees in their gross income. The WBO processed the claim and referred it for investigation. However, after reviewing the returns filed by these entities, the revenue agent determined that these amounts characterized as membership fees were instead nontaxable deposits, thereby resulting in no adjustment. The revenue agent informed the WBO that no change resulted from the information provided in the claim. But the revenue agent apparently continued his investigation over the next few months, and eventually he identified another issue, a $60 million deduction for intercompany bad debt that he determined was unrelated to the whistleblower’s claims. An examination of the target was completed, which eventually generated adjustments in excess of $60 million, including the bad debt issue and other smaller adjustments. All of these were unrelated to the information provided by W.

After review of the entire case file, the WBO determined not to pay an award to W, stating that the “IRS took no action on the issues you raised.” It also stated that the IRS assessed additional tax against the targets, but “the information you provided was not relevant to those issues.” W petitioned the Tax Court for review.

The Tax Court granted summary judgment in favor of the Service. Section 7623(b)(1) entitles a whistleblower to an award only if the IRS collects proceeds “based on” the information provided and “as a result of the action.” As further expounded in regulations, including examples, the court found that the portion of the examination unrelated to the facts and issues provided by W was a separate administrative action that could not be linked to an award. It also rejected W’s claims about the validity of the regulations, finding them valid and entitled to Chevron deference.

Comment: This decision provides some clarity for whistleblowers and the IRS in matters relating to awards. While expanding the audit to another tax year for the same issue will generate an award, other issues disclosed do not generate collections when they are unrelated to the information provided. Merely triggering an audit (which here did not occur at the outset, but only after the investigation of target returns), does not connect a collection to an award.


Whistleblower (W) and his wife had filed several claims with the WBO. Previous targets included an apparent mobster and the governor of their state. W claimed to come from the “tax, accounting, and finance professional community”, but his only business activity for the past several years was devoted exclusively to developing whistleblower claims based on scouring public information about taxpayers. Wife managed a registered investment advisory firm, and she was also a candidate for appointment to the state board that oversees assets held in pension funds.

W and his wife requested anonymity in Tax Court proceedings under Tax Court Rule 345(a). The Tax Court initially denied the motion. W appealed to the D.C. Circuit, which ruled
that the court abused its discretion in denying the motion on the basis that this W relied only on public information. It remanded for further consideration, after which the Tax Court again denied his motion.

The ability to proceed anonymously compromises societal interests in knowing who is using the courts. However, where sufficient fact-based conditions for anonymity are present, the court permits anonymous proceedings. In the original decision, the Tax Court concluded that W had failed to make a sufficient showing. W did not claim an employment relationship would be at risk, any credible threat of physical harm, or any other plausible claim beyond the usual embarrassment or annoyance associated with litigation. However, the Tax Court also went on to state that the people’s interest in knowing W’s identity was enhanced on account of his serial whistleblower status which was based solely on information available to the public, including published financial reports.

The DC Circuit rejected the public interest premise, as it found that purpose could also be served by giving each W a unique pseudonym. It returned the case, but the Tax Court reached the same conclusion based on its analysis of other facts. Even without an enhanced public interest in knowing the identity of a serial claimant, W could not satisfy the court that he had a need to proceed anonymously based on potential harm from disclosing his identity. The court recognized that public interest may be weaker in an earlier stage of litigation, where only purely legal issues are presented, but that was not the case here where specific issues would be discussed affecting the claim.

Comment: Those interested in the matter of anonymous proceedings will find this case to be interesting and important.


Whistleblower (W) submitted 19 claims in total based on public information that Targets received legal settlements and failed to report them. The Whistleblower Office assigned the cases for investigation, and after reviewing return information determined that either the amounts were reported and/or further examination was not warranted as the claimed lacked specific or credible information about tax underpayments.

W appealed to the Tax Court, which upheld the WBO rejections as being “not arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law.” The Tax Court rejected W’s arguments that her claims were summarily dismissed because they were based on public information. In each case, the reviewer compared allegations to IRS records, including returns filed by the Targets. There was no reference to the public information or connection to that determination in the recommendation to reject her claims. It also rejected a technical claim that the WBO improperly “rejected” her claims when it should have “denied” them. According to the court, the substance of the WBO actions governs. Here, the regulations permit rejection when a claim is speculative; the fact that they also reviewed return information did not require a different assessment. Finally, any inaccuracies in classifying these claims based on the amount of the claimed underpayment (i.e., over or under $2 million under sections 7623(a) and (b)) did
not constitute an abuse of discretion when, as here, the basis for rejection is the content of the claim.

Comment: This case also discusses various databases maintained by the IRS and used to evaluate whistleblower claims. Those interested in whistleblower cases may gain some insights from those resources available. But this case also shows that just because you have a hunch based on public information, that does not turn into a requirement for the IRS to audit or otherwise investigate the Target.

8. WBO did not abuse discretion in rejecting WB claim without remand to WBO over deficient record, Marino v. Commissioner, TC Memo 2021-130.

W submitted information about target taxpayers. The Service responded by auditing the targets. The Service acted on the information by conducting audits, which generated adjustments but not additional tax liability due to the fact that taxpayers had losses in each of the relevant years that they carried forward to other loss years. The agent’s report on Form 11369, Confidential Evaluation Report on Claim for Award, thus indicated that adjustments were made that reduced the losses, but there was no current change in tax liability. Eventually, one of the target taxpayers died and the reduced NOL benefits carried forward expired with him. Other issues raised by W either did not generate adjustments or if an adjustment was warranted, did not result in further collections from the targets.

The WBO thus denied any reward to W, who then petitioned the Tax Court. The Tax Court found no abuse of discretion in this context. Although some of the determinations, such as the reports in Form 11369 may have technically constituted hearsay, the court recognized its ability to evaluate and rely upon such information in reviewing the administrative record. Furthermore, while that administrative record may not have definitively answered all of the possible ways that the adjustment could have affected a target’s tax liabilities in a future tax year, the Service submitted certification that the IRS in fact collected no proceeds for the future tax years. The failure to collect is a proper basis for denying a reward, and it also provides a basis to determine that no abuse of discretion occurred. The inadequacy of the administrative record does not require a remand when doing so “would be an idle and useless formality.”

The Tax Court also rejected W’s claims that a 2018 amendment to section 7623(b)(1), which made an award available for collections “determined without regard to whether such proceeds are available to the Secretary”, somehow entitled him to an award in this context. The court explained the legislative history to that change, which allows an award for a civil forfeiture, for example, but even this requires the government to bring a claim and collect something. Without collection, the argument for an award becomes “nonsensical”. Moreover, the court continued to reject any claims based on the adequacy of investigation.

Comment: Although the case treads familiar ground on the basis for obtaining a reward, it does illustrate a situation in which the administrative record may in fact be supplemented, albeit informally, to show a failure to collect proceeds from a target, thereby confirming the appropriateness of denying an award. The case also raises an interesting point – an audit adjustment that decreases an NOL may not produce a notice of deficiency for that tax year if there is, in fact, no tax owing and due as a result of the adjustment. Presumably, such
adjustments are still open to challenge in a future carryforward year – assuming you don’t reach room temperature first as the NOL tax attribute dies with the taxpayer.


W filed a claim for an award with the WBO, which denied the claim. W petitioned the Tax Court for review. While that claim was still pending, W died. Counsel for W filed a petition to substitute W’s estate as the party to continue to prosecute W’s claim. The Commissioner did not oppose the motion, and the Tax Court granted the petition.

Comment: This case reaches a common-sense result that has not yet been ruled upon by the Tax Court, thus producing this regular opinion.

D. Innocent Spouse.

1. Innocent spouse relief denied based on knowledge, Sutherland v. Commissioner, TC Memo 2021-110.

Taxpayer (Wife) married her husband in 1990, and they continue to be married at the time the petition was filed. Husband ran a business that installed and maintained draft beer systems at bars and restaurants. The business had about ten employees. Wife assisted the business in various ways, including dispatching crews to venues for installation work. She also had substantial bookkeeping responsibilities, including writing checks for payroll and other business expenses.

During 2004, Wife’s responsibilities at the business were reduced as she devoted time to a sports bar business. However, she continued to sign checks for Husband’s business. She sold the sports bar in 2009, and then returned to her former duties at Husband’s business.

In 2005, the couple’s returns for 2003 and 2004 were under examination. The Revenue Agent discovered that payroll taxes withheld in Husband’s business had not been deposited, and he referred the case for criminal investigation. In 2010, the special agent in charge of the criminal investigation referred Husband and Wife for prosecution. However, only Husband was indicted. He pleaded guilty. On the day of Husband’s sentencing, the couple signed delinquent returns for 2005 and 2006 which showed unpaid tax liabilities totaling about $40K. Husband was sentenced to six months plus probation and to restitution of $254,351, representing the tax loss from the failure to deposit payroll taxes.

Wife believed that the restitution was Husband’s responsibility, since it was his business. And She also believed that the 2005 and 2006 liabilities were also attributable to his business. She sought innocent spouse relief, representing that their finances were kept separate and that she had no knowledge of their financial shortcomings. On her request for relief, she did not claim any health issues regarding the 2005 and 2006 returns. However, she testified at trial that she “was a mess” due to stress from her mother’s death from cancer and demands from her estranged brother over her mother’s estate.

The Tax Court considered equitable relief under section 6015(f), but it agreed with the IRS that relief was not proper. In applying the seven factors from Rev. Proc. 2013-34, the court did not find Wife’s testimony to be credible that she was unaware of their financial situation,
including unpaid federal taxes from 2005 and 2006. It also found she had reason to know of the payroll tax deficiencies, given her responsibilities within the business. The criminal order of restitution affected employment taxes, not the delinquent income taxes due for those years. She was aware that taxes were unpaid and that Husband would not be able to pay them on his own. The court also rejected stress as a basis for granting relief based on health problems. Wife could not show that the stress impacted her ability to meet her tax obligations, even though she did wish that Husband would take care of them.

Comment: A little knowledge is a dangerous thing if you are trying to avoid joint and several liability.


James was married to Bailey from 2003-2006. After their divorce, they continued to cohabit, with Bailey caring for James and her children during a period of her illness. Bailey filed a joint return with James for 2010, which claimed an overpayment of over $11,000, which the Service refunded. Later, the Service audited the 2010 tax year, determining additional tax and penalties. It also applied James’ 2014 and 2016 tax overpayments against the assessment for 2010.

In 2017, James submitted Form 8857, requesting innocent spouse relief under section 6015(e)(1). However, the IRS examiner denied such relief, finding that she had not filed a valid joint return in 2010 as she was not married to Bailey. The examiner removed her name from the liability, but also took steps that benefitted James, including removing her name from the 2010 joint liability and allowing a refund of her 2016 overpayment. As for the 2014 overpayment, the examiner denied the refund as the refund request was untimely.

James petitioned the Tax Court for relief, but the Tax Court upheld the Commissioner’s position and denied her claim. Innocent spouse relief depends upon the status of a spouse who filed a valid joint income tax return. After determining that this status was not present, as James and her ex-husband were not married in 2010, the Tax Court lacks jurisdiction to consider her refund claim.

Comment: Oddly enough, the 2010 return resulted in a deficiency in part because of the omission of James’ unemployment compensation. However, it is unclear whether James would have owed any tax in 2010 if she had properly filed a return in that year. Given that the failure to file a return leaves the limitations period open, the Service could have pursued a deficiency against her if one was justified. Query what effect this determination has on her ex-husband, Bailey, who got assessed additional tax in part due to James’ unreported income?


Taxpayer and her former husband, who was an intervenor in this case, operated a rental business (Capital City Tent) in the 2010-2011 tax years, which involved rental of tents, tables, and chairs. Taxpayer had some background in banking, and she did the books, made payments, and worked with an accountant to file various tax documents on behalf of the business. Husband
took care of operations and assisted with bookkeeping. Taxpayer also separately owned other rental businesses involving “bounce houses” and pony rides. The same accountant prepared returns for these businesses.

Taxpayer and her husband filed untimely returns for 2010 and 2011. Audits ensued, resulting in adjustments. On January 7, 2014, they signed Forms 4549 consenting to assessment of deficiencies, which remain unpaid. On July 1, 2014, a decree of divorce was issued. On August 23, 2014, a marital property settlement was incorporated into the divorce judgment, in which Husband was awarded “business or professional interests” in Capital City Tent. However, the settlement stipulated that both spouses remained liable for assessed tax liabilities for the years at issue.

In 2016, Taxpayer filed a request for innocent spouse relief. The Service denied relief, and the Tax Court upheld the denial. Taxpayer sought streamlined relief under Rev. Proc. 2013-34. She met only two of the prerequisite conditions (i.e., no longer married and economic hardship would result from enforcement), but she could not meet the third condition because she had actual or constructive knowledge of the items giving rise to the deficiency. Although she alleged that abuse occurred, which can negate the third condition, she failed to provide specific evidence of such abuse, which the court found to be self-serving and not credible. As for equitable considerations under 6013(f), the Tax Court found that under the totality of circumstances, relief was not appropriate. Taxpayer was involved in the business, knew or had reason to know of the items giving rise to the deficiencies, and failed to make a good faith effort to comply with tax filing obligations.

Comment: It is tough to argue for innocent spouse relief when you are the bookkeeper and you have access to the family bank account. Divorcing a spouse that may have been abusive appears unlikely to lead to relief from past tax debt without specific evidence of abuse that creates a colorable claim that the abuse affected the spouse’s ability to comply with the tax laws. Mere acrimony and name calling appears to be insufficient.


Lori and David Sleeth filed joint returns for the 2008-2010 tax years, but they did not pay the associated liabilities. David was a lawyer when they wed in 1988, but he went to medical school in 1993 and began practicing medicine following the completion of his residency training. The couple’s income increased and their lifestyle expanded, but their ability to keep up with tax obligations did not grow at a corresponding rate. They fell behind on their taxes beginning in 2005 and they apparently could not catch up. In the meantime, David made significant purchases and put them in Lori’s name.

Eventually, their tax bill grew and they had problems keeping up with other creditors. The couple divorced in 2015, and David accepted full responsibility for all outstanding tax liabilities, which by this time were considerable. Lorie sought innocent spouse relief, stating that she had “no idea” that payments toward their liabilities were not being made. The IRS denied relief on the ground that Lori did not have a reasonable expectation that David would or could
pay the tax at the time she signed the joint returns, and she failed to show economic hardship absent relief. Lori petitioned the Tax Court, which upheld the denial. Among other things, the Tax Court determined that she had knowledge or reason to know of the underpayment when she filed the return, which weighed heavily against relief. She also failed to show economic hardship, which the court viewed as a neutral factor. Lori appealed.

The Eleventh Circuit upheld the Tax Court’s determination, finding no abuse of discretion. On the matter of the failure to show economic hardship, the court agreed with the Tax Court’s determination that mere employment in a low-wage job did not satisfy economic hardship where the taxpayer had other assets available to make payments on the taxes due. On the equitable assessment of her knowledge, the court likewise found no error. There is no formula for weighing the factors listed – even one factor can weigh sufficiently for a court to appropriately deny relief.

Comment: This approach affirms significant discretion. When a spouse knows of deficiencies at the time returns are filed, it is tough to avoid joint and several liability without showing some kind of abusive situation or other factors that support relief. A collection due process hearing becomes the next venue for litigating the appropriate payment.

5. Tax Court jurisdiction to review innocent spouse relief based on denial for one taxable year, Vera v. Commissioner, 157 T.C. No. 6 (2021).

Wife filed joint returns with Husband for the 2010 and 2013 tax years. In 2010, the Service determined a deficiency. In 2013, the return showed an underpayment of tax, resulting in an assessment of liability and penalties.

In 2015, W filed request for innocent spouse relief for the 2013 underpayment. The Service denied relief, and because W filed her Tax Court petition late, the court denied jurisdiction.

In 2016, W filed another relief request, which included the 2010 tax year. But she also included documents related to 2013. The Service denied the request, and the heading of the letter conveying that denial listed only the 2010 tax year. But the substance of the letter addressed both 2010 and 2013. This time, W filed a timely petition for review, using a preprinted form provided by the Tax Court (TC Form 2, revised November 2018). That form allowed her to state that the petition covered both 2010 and 2103 tax years.

The Service moved to dismiss the 2013 year because there was not a new determination for that year. However, the Tax Court determined that applicable regulations under section 6015 did not preclude the issuance of more than one final determination on the matter of innocent spouse relief. Even if the Service issued the second letter in error, the references to the 2013 tax year unambiguously include denial of relief. This was a final determination, which could be subject to review in the tax court. The validity of the notice provided is determined from the face of the notice, and the court had jurisdiction to review both years.
Comment:  W may still lose on the merits – which the case does not reach – but at least she gets her day in court after being thrown out of court in 2013 because she missed the filing deadline for her petition by one day.

E. Other.
1. IRS did not abuse its discretion in rejecting OIC by estate, Estate of Kwang Lee v. Commissioner, TC Memo 2021-92.

Taxpayer’s estate seeks review of the rejection of an OIC that proffered $183K – the only remaining asset of the estate, which consisted of a checking account balance – to satisfy a $536K deficiency assessed against the estate in 2010 following an adverse ruling in the Tax Court. The Settlement Officer determined that the IRS could seek collection against the executor under 31 U.S.C. § 3713, or from the beneficiaries under IRC § 6324(a)(2), and thus rejected the OIC.

The Tax Court agreed that there was no abuse of discretion in rejecting the OIC in this context. In 2007, the executor (who was an attorney and a municipal court judge) had distributed sufficient assets to have paid the estate tax due after the estate had received a notice of deficiency and the estate had filed a Tax Court petition in 2006. The estate failed to provide evidence that the executor had legal advice that no tax was due.

Comment: Although this case involved an estate tax liability, the same principles may apply to other federal tax liabilities assessed against an estate. Fiduciaries need to be cautious about distributions that would render the estate unable to satisfy these liabilities. Moreover, long limitations periods can apply in this context.


Although this case involves the estate tax marital deduction, the matter of who is one’s lawful spouse is important for many income tax issues. This was a fascinating case about a Jewish decedent, Semone, who survived internment in concentration camps during World War II, eventually moved to New York, and married Hilda, who was also Jewish, in 1955. They had two children. In 1965, they moved apart and entered into a separation agreement consistent with their religious community. Semone made regular payments to Hilda, and they never reconciled or cohabited thereafter. But they did not go through a civil divorce in New York or elsewhere in the U.S. at that time.

In 1967, Semone commenced a new relationship with Katia, who was not Jewish. Semone traveled to Mexico, obtained a divorce from Hilda, and then married Katia in a civil ceremony conducted in New Jersey. They also had two children. However, the relationship with Katia ended in 1974. However, Hilda filed a declaratory judgment action against Semone and Katia, seeking to establish that the Mexican divorce Semone obtained from Hilda was null and void and that Hilda remained his wife. After a trial, the court found in Hilda’s favor and ruled that they were still married. However, they did not cohabit after this decision.

By 1986, Semone became engaged to Ziona without addressing the matter of the putative marriage to Hilda. Ziona was a dual citizen of the US and Israel, and she traveled frequently to
Israel to visit family and friends. Semone and Ziona decided to marry in Israel. After going through rabbinical approval, they were issued an official marriage contract allowing them to marry in Israel. They were married in 1987 in a traditional Orthodox ceremony. The marriage certificate issued by the state treated Ziona as single and Semone as divorced. The couple returned to New York and lived together until Semone’s death in 2014.

Hilda would see Ziona and Semone socially from time to time. She continued to file her tax returns as “single”, despite the declaratory judgment she obtained. After Semone’s death, she made no statutory claim against his estate as surviving spouse, which under New York law would have allowed her to elect to take up to one-third of the estate. Semone left an estate valued at $79 million, which was left entirely to Ziona.

At issue here was the estate tax marital deduction, which the Commissioner challenged. However, the Tax Court held that Ziona was the surviving spouse. The Commissioner claimed that New York law should determine the matter of the validity of the marriage between Semone and Ziona. Taxpayer claimed, however, that the “place of celebration” determines the validity of the marriage for Federal tax purposes. Alternatively, it argued that a Second Circuit decision should be followed, which held that if there was no court in the state of New York, where the parties resided and the estate was administered, that ruled the marriage invalid, the marriage would be respected.

After rehearsing the Israeli law on marriage, which supports the validity of the marriage between Semone and Ziona, the Tax Court turned to assess the law of New York. New York recognizes the law of the place of contract as relevant to assess the validity of a marriage. That rule is subject to certain narrow exceptions, including “incest or polygamy coming within the prohibitions of natural law” and other prohibitions by “positive law”. Here, neither of the exceptions applied. The Commissioner’s claims of bigamy failed, as New York courts will not recognize bigamy as a crime when the putative second marriage is contracted outside the state. Moreover, New York courts also examine the law of the place of contract for the validity of the marriage. Such a marriage was not one which falls within the realm of natural law prohibitions, which would otherwise offend the public sense of morality, such as contemporaneous cohabitation in a bigamous relationship. The court also rejected the Commissioner’s claims based on the New York Constitution, which it ruled did not consider extraterritorial acts such as occurred here.

Here, the Commissioner had to overcome a presumption of validity associated with this marriage, which he could not do. Thus, the marital deduction was proper.

Comment: This is a rich case with a considerable variety of legal and policy options for decision. Those having clients with multiple relationships may benefit from these considerations. But as in many other areas, you know what they say about an “ounce of prevention”.

63
3. SO abused discretion by refusing to review OIC and pursuing collection action, Mason v. Commissioner, TC Memo 2021-64.

“We’ve had some similar cases, but never one quite like this.” Judge Holmes rules in favor of the Taxpayers in this CDP case, finding an abuse of discretion in returning an OIC offer to the Taxpayers without reading it.

Taxpayers got behind on their taxes, including trust fund tax obligations. They did not contest the liabilities, but they could not pay them. They attempted an installment agreement, but they defaulted. An IRS agent visited their home, suggesting that they sell it to pay off their debt. (Judge Holmes described this meeting as “this nice-little-home-you-got-here-shame-if-something-happened-to-it field call.”) On that same day, the IRS also sent a notice of intent to levy. Within two weeks, Taxpayers submitted an OIC. Apart from being behind on their past tax debts, Taxpayers were current in all intervening tax years.

After submitting the OIC, which was processed through the IRS Centralized OIC Unit, Taxpayers also requested a CDP hearing. In their hearing request, they asked for an OIC or an installment agreement. Upon learning that the Taxpayers had sent an OIC, the RO drafted a report that concluded that Taxpayers submitted the offer to delay collection and sent it to the Centralized Unit. The Unit responded by returning the offer to the Taxpayers with a statement that it was submitted “solely to hinder or delay our collection actions which are expected to collect significantly more than the amount you have offered.”

A SO was assigned for Taxpayer’s CDP hearing, and Taxpayers asked her to review their OIC on the merits, but she refused. She cited the IRM and told them their circumstances had been considered. In the meantime, collection efforts continued. A CDP hearing was eventually held, and Taxpayers again sought review of their OIC on the merits. The SO did not do so and she sustained the collection action against Taxpayers. Final notices of determination were issued in March 2016, and Taxpayers petitioned the Tax Court.

In a CDP hearing, the SO is supposed to be independent and should not engage in ex parte discussions of the case that would weaken that independence. An OIC can be rejected, or it can be returned, as happened in this case. Returns can occur because the IRS determines that the offer was made “solely to delay collection” or the OIC is otherwise not processable or incomplete. Such decisions are not considered a rejection of the OIC, and thus those decisions may not be appealed.

So, if a taxpayer is entitled to a hearing that includes consideration of alternatives collection efforts that necessarily delays those efforts, what does not mean for an OIC to be returned on the ground that it was submitted “solely to delay collection”? Judge Holmes concluded that, although a return is not appealable, it should put a higher burden on the IRS to show that there is no other conceivable motive behind submitting the offer before returning it.

While the Tax Court lacks jurisdiction to review a return of an OIC, it can review determinations made during CDP hearings. Here, the SO was required to consider relevant issues raised by the Taxpayer, including collection alternatives. See IRC § 6330(c)(2). The SO only considered whether it was appropriate for the Centralized Unit to return the OIC, but she
did not consider the merits herself. However, there was another legal question presented here: was the OIC actually before Appeals?

In a previous case, Galloway v. Commissioner, TC Memo 2021-24, the court held that the IRS did not abuse its discretion in refusing to reconsider a prior OIC that had been rejected some years ago. The taxpayer had been given an opportunity to submit a new OIC, but he refused. But this case is different. There was not rejection, but a return, and this happened months before the CDP hearing. The SO here should have considered the offer. Taxpayers deserve to have their offer and current circumstances considered, which did not occur here. That was an abuse of discretion.

Comment: Those representing Taxpayers in CDP hearings will want to study this case. Judge Holmes does a nice job in laying out the practical and legal issues presented. Why not make this a regular decision instead of a memorandum decision? Are these circumstances unlikely to be repeated?


Taxpayer wife was a dual citizen of the United States and Italy who received a foreign pension sourced in Italy. The couple underreported their taxable income during 2003-2010 by omitting those foreign pensions, on which taxes had been paid to Italy. They retained counsel to facilitate their participation in the Offshore Voluntary Disclosure Program. In 2012, they filed a written submission disclosing their underreporting for 2003-2011, which included amended tax returns for each year and a check for the computed underpayments totaling about $47K. With regard to the 2011 return, their original return had disclosed their foreign pension and claimed a foreign tax credit. The amended return for that year made only small adjustments to their original return.

The Service examined the amended returns and did not accept them as filed. On May 1, 2015, the Service sent a RAR which showed tax deficiencies for each year, based on part on the disallowance of portions of the foreign tax credits they had claimed. For 2011, the RAR slightly reduced the foreign tax credit claimed, but it also inadvertently allowed a $6K AMT credit, reducing the tax due.

Taxpayers settled by paying the IRS $111,276, which together with the initial payment satisfied the balance due. They executed a closing agreement, which purported to cover 2003-2010. However, paragraph 4 of the agreement also stated: “During tax years 2003 through 2011, Taxpayer was entitled to foreign tax credit under section 901 of the Internal Revenue Code for foreign income taxes paid or accrued to a foreign country or U.S. possession.” The closing agreement allowed audit of the 2003-2011 tax years, but only allowed adjustments “unrelated to offshore financial arrangements” or related to other offshore arrangements not disclosed by Taxpayers.

After the closing agreement was executed, the Service assessed additional tax of $11K and an accuracy penalty for the 2011 tax year. This assessment exceeded the proposed adjustment on the RAR by $6,661, which was the amount of a prior year minimum tax credit that
the RA had allowed in error. However, in August 2016, the IRS abated that tax. Then, in February 2017, Taxpayers received another notice of deficiency for the same amount. There was some discrepancy as to the basis for this adjustment, as in one place it referred to the minimum tax credit error and in another it referred to a foreign tax credit adjustment. Taxpayers paid a cash deposit and filed suit to challenge the deficiency on the basis that it was barred by the closing agreement.

The Tax Court rehearsed the rules applicable to closing agreements, to which federal common law applies in matters of interpretation. Reading the agreement as a whole, the court determined that the parties intended only to grant a foreign tax credit for 2011 in an unstated amount. However, there was ambiguity in the matter of whether an adjustment to that amount was proper. If, as Taxpayers argued, the agreement was intended to settle the amounts related to the offshore disclosures, then the amount would be fixed and not subject to adjustment. If no agreement on amount had been reached, an adjustment might still be effective.

The Tax Court agreed with the Taxpayer’s view, and therefore ruled that the closing agreement precluded the adjustment. Instead of a deficiency, and overpayment resulted from the deposit.

Comment: This case is helpful for those who have executed closing agreements. The matters of contract interpretation presented here left room for doubt, which might have been avoided with clarification.

5. No right to new CDP hearing based on notes of meeting with Taxpayer’s counsel, Stewart v. Commissioner, 999 F.3d 1150 (8th Cir. 2021).

Taxpayers requested a CDP hearing challenging a tax lien imposed on their assets. They claimed that the lien should be discharged because they could not afford to pay the outstanding balance. The Revenue Officer assigned to their case showed up unannounced to speak with Taxpayers’ attorney at his officer. That meeting did not go so well, and the Revenue Officer put notes in the administrative file describing the attorney as “uncooperative” based in part on his refusal to provide financial information associated with the Taxpayers. That information would have been relevant to the collectability of their tax debt. After that meeting, the Revenue Officer provided financial analysis of the Taxpayer’s status and determined that they were not eligible for relief by placing their account on non-collectible status.

Taxpayers then petitioned the Tax Court, arguing that they were entitled to a new hearing because the notes in the file prejudiced the Revenue Officer against them. The Tax Court rejected this claim, and this appeal followed.

The Eighth Circuit upheld the denial of a new hearing. Although there is generally a separation between investigative and adjudicative functions when it comes to collection activities, the separation is not absolute. Here, the Revenue Officer’s statements about being uncooperative was a contemporaneous statement he recorded that would be pertinent to the assessment of whether the account was collectable. The Revenue Officer would face difficulties in getting the information, and that would prove relevant to the later hearing. While it is true that the Revenue Officer should not have shown up as he had done, the mere fact that a CDP hearing
request has been made does not suspect the investigatory function. This past conflict with the Revenue Officer did not support requiring a new hearing on the matter.

6. Taxpayer was ineligible for an “equivalent hearing” when he filed a timely request for a CDP hearing, Ruhaak v. Commissioner, 157 T.C. No. 9 (2021). Taxpayer received a Notice of Intent to Levy regarding unpaid income taxes for 2013 and 2014. Within the prescribed period of 30 days after the date of the Notice, Taxpayer submitted Form 12153 to request a CDP hearing. However, he also checked a box on the Form that he would like an equivalent hearing “if my request for a CDP hearing does not meet the requirements for a timely CDP hearing.” Appeals treated the CDP hearing request as timely, and a SO contacted Taxpayer to set up a conference.

Taxpayer rejected a CDP hearing conference, and instead told the SO that he only wanted an equivalent hearing for the 2013 tax year—not for the 2014 tax year. Taxpayer also demanded that the SO reschedule the date and time when she accepted his request for an equivalent hearing.

The SO agreed with Taxpayer that he may request only a hearing for the 2013 tax year if he so desired, but she told Taxpayer his request would be treated as connected to a CDP hearing, as his Form 12153 was timely. The SO also requested additional information from Taxpayer to allow her to evaluate his CDP claim, but Taxpayer failed to provide any information.

Taxpayer sought an equivalent hearing because he wanted to present conscientious objections to the morality of paying federal income taxes. If he presented those arguments in a CDP hearing, he would potentially face a fine of up to $5,000 under IRC § 6702(b) for making a “specified frivolous submission”. The IRM indicates that the IRS will not impose such a fine in an equivalent hearing. An equivalent hearing, unlike a CDP hearing, is not subject to Tax Court review. Taxpayer also had no desire to appeal any CDP hearing outcome to the Tax Court, as doing so in the past had led to frivolous litigation penalties under section 6673(a)(1). Based on the arguments he intended to make, a penalty would have been likely.

The Tax Court determined that Taxpayer was in error in claiming that he was eligible for an equivalent hearing after filing a timely request for a CDP hearing. Although Taxpayer’s literal approach to the governing regulation could have supported his position, the Tax Court read the regulations in context and with the purpose of the rules in mind—equivalent hearings are a substitute for a CDP hearing only when a CDP hearing is not timely.

Here, Taxpayer only wanted the equivalent hearing so he could present his arguments about moral objections to paying taxes. The Tax Court noted that the IRM provides that a Taxpayer is not entitled to either a CDP hearing or an equivalent hearing if the entire request is frivolous (meaning that only frivolous arguments are to be presented). Appeals may summarily deny such a request.

The Service requested a frivolous litigation penalty under section 6673, but the Tax Court rejected that outcome. Taxpayer’s position in this litigation was not frivolous, as he had a colorable claim.
Comment: It appears Taxpayer should have waited more than 30 days before filing his equivalent hearing request, as this would have made his CDP request untimely. This case helps explain the differences between equivalent hearings and regular CDP hearings, and it also provides guidance in counting the 30-day period for timely filing a CDP request. The case also illustrates that tax protestors are clever enough to learn complicated procedural rules, but apparently unwilling to grasp the idea that the legal process is not the proper forum for political objections. The Tax Court treated this pro se taxpayer with due respect, as is its custom. See also Holland v. Commissioner, TC Memo 2021-129, declining frivolous penalty for cooperative pro se taxpayer, even though argument was on the IRS site, The Truth About Frivolous Tax Arguments (March 2018). The Holland court noted: “Although petitioner has no legal training, he evidently had no difficulty cutting and pasting material downloaded from tax-protester websites. Had he made even a modest inquiry using an internet search engine, he would have found the copious authorities refuting his stance.”


The latest in tax brackets, phase-out amounts, standard deductions, and the like are presented in this Revenue Procedure issued on November 10. As expected, these amounts are creeping upward, reflecting inflationary pressures during the past year.

V. Tax Litigation & Procedure

A. Jurisdiction.

1. Chapter 13 Bankruptcy Petition did not preclude IRS from pursuing deficiency against Taxpayer, Wathen v. Commissioner, TC Memo 2021-100.

Taxpayer, a bankruptcy practitioner, filed his own chapter 13 bankruptcy petition on August 6, 2012. The Service filed a proof of claim for the 2010 and 2011 tax years, which it later amended in 2013 after Taxpayer untimely filed his returns for those years. The bankruptcy plan was confirmed in August 2014, but nothing in the court’s order involved a determination of taxes.

While the bankruptcy case was pending, the Service issued notices of deficiency for the 2010 and 2011 tax years. Taxpayer filed a petition in the Tax Court to challenge these notices, which included a motion to dismiss the Government’s case on the ground of res judicata. However, the Tax Court pointed to its decision in Brelend v. Commissioner, 152 T.C. 156 (2019), which held that res judicata did not apply to the redetermination of federal tax liability governed by a notice of deficiency, which provides a separate cause of action than a proceeding to object to the confirmation of a bankruptcy plan. A deficiency proceeding involves the proof of the taxpayer’s income, deductions and credits, while bankruptcy plan confirmation depends on the viability of reorganization and the disposition of the debtor’s assets. Here, there was no evidence that any proceeding before the bankruptcy court involved a determination of the taxes due for these years at issue. Nor was there any indication that tax debts were being discharged.

Comment: Bankruptcy proceedings that do not address underlying tax liabilities will not prevent the assertion of deficiencies and the creation of new tax debts that may affect claims on the assets of the bankruptcy estate. As a practical matter, collection due process proceedings are likely to become the venue for resolving those claims.

Taxpayer received a notice of intent to levy associated with her 2010 tax liability. She timely requested a CDP hearing, in which she also challenged her underlying liability and requested audit reconsideration.

The Service assigned her case to a revenue agent, which offered Taxpayer an opportunity to discuss the case and provide information to substantiate her position. The examination concluded with a letter that explained no changes were made to previous adjustments that provided that basis for her original notice of deficiency.

Meanwhile, Taxpayer persisted in challenging her underlying liability in CDP proceedings, which the Service rejected because she had an opportunity to challenge the underlying notice of deficiency and chose not to do so. It would only discuss collection alternatives with her, which she rejected.

Before the Tax Court, Taxpayer argued that she should have received a second notice of deficiency following her examination, which would give rise to a right to challenge the underlying liability. The Tax Court rejected this position, as there was no additional deficiency determined and thus no requirement to issue a second notice.

Taxpayer also challenged the CDP determination on the ground that it was issued before her audit reconsideration was completed. However, an audit reconsideration is conducted outside of the CDP process, and the settlement officer has discretion to issue a determination before it is completed. There is no jurisdiction in the Tax Court to review the results of an audit reconsideration when, as here, there is no change.

Comment: Audit reconsideration that changed the result might have produced a different outcome. But when, as here, no change results, the fact that discretionary review was given did not enhance any rights of the taxpayer to challenge the underlying liability.


Taxpayers, husband (now deceased) and wife, petitioned the Tax Court in early 2020 to challenge separate but nearly identical certifications by the Commissioner that each had a “seriously delinquent tax debt” which allowed passport revocation under IRC § 7345. H died after the petition had been filed. After the couple filed an offer in compromise to address the debt, the IRS reversed its certification in November 2020. The Service moved to dismiss the Tax Court petition on the ground of mootness. The Tax Court agreed with the Service and dismissed the case. But in doing so, it first addressed the threshold question whether a married couple can file a joint petition to challenge a certification under section 7345. The court found that although Rule 34(a) of the Tax Court addresses joint petitions in deficiency and liability actions, equity and common sense supports extending that permission by analogy to cases like this one. Both certifications present similar questions about the same tax liability. Similar issues are presented in collection due process
cases, where separate notices are often given but litigation involves common issues for the couple.

As for the matter of mootness, the Court also noted that the case involving H would appear to be moot, as there was no evident continuing interest in his passport status after his death. However, it also cited Ninth Circuit precedent in which a continuing interest was found to be present, which permitted the litigation to continue. However, the rest of the case was moot in any event, as the IRS had already revoked its certification and thus there was no further relief the court could offer them. Taxpayers argued that the IRS had not yet accepted their offer-in-compromise, leaving them with potential uncertainty. However, such acceptance is discretionary and it is outside the scope of any resolution within a passport certification case.

Comment: Common sense and equity may be in short supply elsewhere, but it can be found in the Tax Court. See also Shitrit v. Commissioner, TC Memo 2021-63, finding mootness after IRS reversed its certification.

4. Taxpayers with adjustment for mathematical error allowed to dispute underlying tax liability in CDP case, Garcia v. Commissioner, TC Memo 2021-72.

In 2014, Taxpayers reported taxable compensation for services performed in Puerto Rico for the U.S. Air Force totaling $74K along with taxable pension income. However, Taxpayer’s omitted $14K of Social Security benefits, believing them to be nontaxable. Their return showed $3,904 of tax liability, all of which was offset by a foreign tax credit claimed based on taxes paid to Puerto Rico.

The Service determined that $12K of the Social Security benefits should have been taxable, which they treated as a mathematical error. Accordingly, Taxpayers did not get a notice of deficiency. When Taxpayers did not respond, they sent a Notice CP90, Intent to Seize Your Assets. Taxpayers timely requested a CDP hearing at which they disputed their underlying liability. The SO granted partial relief, which was based on the determination of the applicable limitation of the foreign tax credit under section 904. Taxpayers petitioned the Tax Court for review.

The Tax Court agreed that it had jurisdiction to consider the underlying liability, as this was a case in which the taxpayer had not had a prior opportunity to contest the underlying liability. However, it upheld the SO’s determination. Social Security income is U.S.-sourced income, and this affected the fraction used to compute the applicable foreign tax credit.

Comment: This case provides an example where a challenge of the underlying liability is permitted in a CDP case because a notice of deficiency was never issued. Much litigation occurs because taxpayers fail to grasp this limitation.

5. Notice of determination issued to a sole proprietorship, rather than the individual taxpayer, was a harmless error that did not deprive the Tax Court of jurisdiction, BM Construction v. Commissioner, TC Memo 2021-13.

Taxpayer brought a petition to the Tax Court for review of a CDP determination. Taxpayer sought to challenge the underlying tax liabilities involving backup withholding, for
which a notice of deficiency is not applicable. His ability to challenge the liability thus turned on whether Taxpayer had received Letter 950-D, which would have given him 30 days to request an Appeals conference. The examining agent sent the letter on June 13, 2014, addressed to Taxpayer at the business’s address. One day after the 30-day period expired, Taxpayer’s CPA contacted the examining agent and provided information about the backup withholding issues. However, no protest was received. The Service sent a Notice of Intent to Levy and Taxpayer timely requested a CDP Hearing, indicating that it wished to dispute the underlying liability.

The SO assigned to the case informed Taxpayer that it would not be allowed to dispute the underlying liability, as there had been no protest filed within the 30-day period in Letter 950-D. The SO further determined that there was no alternative to collection available. A notice of determination was also sent to Taxpayer at the construction business address. A Tax Court petition followed.

The Tax Court first addressed a jurisdictional issue: whether the notice of determination mailed to the entity at its address made the notice of determination invalid. The court had not previously addressed this issue, but it looked to the analogous situation of a single-member LLC to conclude that the failure to treat the entity as disregarded does not render the notice invalid. There was no prejudice to Taxpayer here, who was adequately notified.

Taxpayer also sought to prove that he never received the Letter 950-D, but the court rejected those efforts. Testimony from the examining agent supported her practice of mailing, even though those letters are not mailed using certified mail. The fact that the parties engaged in conversations about the issues following the issuance of the letter further indicated that it had been received, despite testimony from Taxpayer that he did not receive the letter and the CPA that she did not receive a copy from Taxpayer.

Comment: This case shows that Taxpayers need to be very careful about correspondence received from the IRS. The failure to submit a protest here proved fatal to efforts to engage in pre-levy proceedings in the Tax Court that addressed the substance of the underlying tax claims. When Taxpayers have the burden to prove mailing, testimony like that accepted from the examining agent in this case is often dismissed as self-serving.

6. Taxpayer may withdraw Tax Court petition to review interest abatement, Mainstay Business Solutions v. Commissioner, 156 T.C. No. 7 (2021).

In deficiency proceedings, a decision by the Tax Court permitting the Taxpayer to withdraw his petition is required by section 7459(d) to be considered as determining that the deficiency determined by the Service is correct. However, over time Tax Court jurisdiction has expanded beyond deficiency proceedings, including innocent spouse relief and whistleblower determinations. In these areas, the court has permitted petitioners to withdraw their petitions without consequences where there is no prejudice to the other party. Such rulings follow decisions under Federal Rules of Civil Procedure by analogy.

In this case, the court determined that interest abatement should be treated similarly.
Comment: See also Stein v. Commissioner, 156 T.C. No. 11 (2021) (allowing withdrawal of petition contesting denial of award of administrative costs under section 7430 on similar grounds to those outlined in Mainstay Business Solutions).

7. Taxpayer barred from challenging underlying liability, Jeffers v. Commissioner, 992 F.3d 649 (7th Cir. 2021).

In 2012, Taxpayer received a notice of federal tax lien in connection with his 2008 and 2009 tax years. Taxpayer did not request a collection due process (CDP) hearing. On February 23, 2017, the IRS notified Taxpayer of its intent to levy on his property. This time, Taxpayer timely requested a CDP hearing. At the hearing, he contested the underlying liabilities for 2008 and 2009. He submitted amended returns claiming rental real estate losses for those years. The hearing officer rejected these claims, finding that a challenge to the underlying liability was precluded because Taxpayer had an opportunity to contest it when the notice of federal tax lien had been filed, and he failed to exercise the opportunity.

Taxpayer sought review in the Tax Court, which granted summary judgment to the Commissioner. This appeal followed. The Seventh Circuit upheld the application of regulations under section 6330, which state in part: “If the taxpayer previously received a CDP Notice under section 6320 [the provision for notice of a federal lien] with respect to the same tax and tax period and did not request a CDP hearing with respect to that earlier CDP Notice, the taxpayer had a prior opportunity to dispute the existence or amount of underlying tax liability.” According to the Seventh Circuit, the regulation was reasonable and part of a system which appropriately incorporates concepts of claim and issue preclusion into the CDP context. There was no abuse of discretion in refusing to address the underlying liability in this case or otherwise addressing substantive claims associated with amended returns submitted by the Taxpayer.

8. Abuse of discretion based on administrative record applies in CDP review without challenge to underlying liability, Belair v. Commissioner, 157 T.C. No. 2 (2021)

Taxpayer requested CDP hearing following a notice of federal tax lien. She had requested an installment agreement. She did not contest the underlying tax liability. Her claim for an installment agreement was based in part on a $20 million lawsuit pending against the U.S. Attorney, from which she hoped to recover damages. Appeals declined to investigate this claim. Based on Taxpayer’s failure to resolve delinquent returns for other tax years, Appeals determined she was not eligible for an installment agreement and upheld the lien. Taxpayer sought review in the Tax Court, and the Service filed a motion for summary judgment. Appeal in this case would lie in the Ninth Circuit.

The Tax Court determined that traditional summary judgment rules are not appropriate in this context, as judicial review is limited to evaluating whether the administrative record supports the determination made by the Service and that such determination is not arbitrary, capricious, or without sound basis in fact or law. Although the Tax Court had previously ruled that its jurisdiction to review CDP cases is not limited to the administrative record, it followed the Ninth Circuit’s restriction of its jurisdiction under the Golsen rule.
Comment: This analytical approach was also adopted in Van Bemmelen v. Commissioner, 155 T.C. 64 (2020), where analysis of whistleblower claims is also limited to the administrative record.

9. Tax Court lacks jurisdiction to order refund without a notice of deficiency, Brown v. Commissioner, TC Memo 2021-112. The Ninth Circuit remanded this case to the Tax Court to determine whether it had jurisdiction over a refund claim submitted by Taxpayer in connection with a collection due process (CDP) claim. Taxpayer initiated a CDP claim in response to collection actions associated with federal tax liens for the 2007 and 2014 tax years. Taxpayer submitted an offer in compromise (OIC) on Form 656 based on doubt as to collectability. Taxpayer included a TIRPA payment of $80K, which is required to accompany a lump-sum OIC under section 7122(c)(1)(A)(i), added to the Code in 2005. Form 656 specifically states that a TIRPA payment is a nonrefundable payment of tax that would not be refunded in the event the OIC was withdrawn, rejected, or returned.

The Service rejected his OIC, and Taxpayer commenced a CDP case in the Tax Court, which claimed it was an abuse of discretion to reject the OIC and to fail to refund his TIRPA payment, which Taxpayer characterized as a “deposit”. The Tax Court concluded that the Service did not abuse its discretion in refusing the OIC, and Taxpayer appealed to the Ninth Circuit. The Ninth Circuit affirmed on the matter of refusing the OIC, but it vacated and remanded to the Tax Court the issue of whether it had jurisdiction to consider Taxpayer’s claim for a refund of his TIRPA payment.

The Tax Court concluded it did not have jurisdiction to consider a refund claim. After rehearing the law and legislative history of TIRPA payments, which it concluded were not deposits but nonrefundable payments of tax, the court rejected Taxpayer’s claim that it had jurisdiction under section 6512(b)(2), which allows the court to “order the refund of such overpayment and interest”. According to the court, this provision requires a notice of deficiency. In this case, the court’s jurisdiction derives from a review of a collection due process claim. Even if Taxpayer had challenged the underlying tax liabilities, the Tax Court opined that it would still lack jurisdiction to order a refund in that context.

Comment: This case apparently merited memorandum status based on the established Tax Court and DC Circuit precedent rejecting refund jurisdiction when the Tax Court hears a collection case under section 6330. There is a significant procedural lesson here: if a refund claim lurks, be sure it is filed separately from CDP challenges lest that claim be barred by the statute of limitations.

10. Form 1040X creates a claim for abatement, not a claim for refund, where tax was due at the time it was filed, Carr v. United States, No. 20-cv-00744-WHO, 2021 WL 5449072 (N.D. Cal., Nov. 22, 2021).

Taxpayer filed a refund claim in federal district court after the Service failed to follow up with a refund payment that was promised to her in a letter. Taxpayer had filed a timely return for the 2012 tax year in October 2013. The IRS assessed a deficiency of $46K against her. It applied a $12K overpayment from 2010, but the balance of about $34K remained unpaid.
Taxpayer then filed an amended tax return for 2012 on Form 1040X in February 2015. That return showed that she would owe no tax and would in fact be entitled to a refund.

The Service reviewed the amended return and abated $28K in tax, $5K in penalties, and nearly $2K in interest. It then issued a refund of $2K to Taxpayer. Taxpayer engaged two representatives and objected to the amount of the refund, seeking relief through the Office of the Taxpayer Advocate Service. On January 31, 2019, she received another letter from the IRS indicating that it had accepted her claim and that it would change her account and send a refund if no other taxes are due. No payment was forthcoming, so Taxpayer filed this suit, claiming the IRS owed her $18K.

The government filed a motion to dismiss, claiming that the letter was sent in error on the ground that the Form 1040X was filed when she had an outstanding liability. Therefore, it was a claim for abatement, not a claim for refund. The district court agreed and dismissed her case.

Here, the court’s jurisdiction over a refund claim requires that a claim be “duly filed” under section 6511(a). Full payment of all taxes due is required under Flora (SCT 1960). An amended return filed when taxes are due is treated as a claim for abatement, and this invokes IRS discretionary authority that is not subject to judicial review. Since, at the time the Form 1040X was filed, she did indeed owe taxes according to the record of her account (supplemented by expert testimony), there was no tax on which a refund claim could be based at that time. Had Taxpayer filed another Form 1040X after her 2012 tax liability had been satisfied, there would have been a duly filed claim.

The court also rejected Taxpayer’s claim that her Form 1040X should have been treated as an informal claim. Although the letter sent to Taxpayer was a Letter 570, which is used to close refund claims, the IRS showed that this letter had been sent in error. This was an abatement claim, not a refund claim. The court also noted that the IRS had sent a notice to Taxpayer indicating that she needed to file a refund claim for the 2012 tax year, but she did not do so. She was represented by professional tax advisors in those proceedings, even though she now proceeds pro se. However, the court did not give her any slack when it came to a further basis for denying her claim – even if it was a proper refund claim, she failed to introduce evidence she would be entitled to a refund. The Government also introduced expert testimony to show she still owed taxes due to a penalty on a retirement distribution that the IRS had missed.

Comment: This case should be read by all tax professionals who are dealing with a potential abatement claim. This taxpayer effectively lost the ability to pursue a refund claim because the statute ran on that opportunity. The rules for refunds are strict and must be followed. Even experienced tax professionals failed to recognize this procedural problem that required her to file a new refund claim. The case also illustrates the burden of proof on a taxpayer to establish an overpayment. One can sympathize with the plight of this pro se taxpayer, but hopefully learn a lesson not to repeat this error.
B. Statutes of Limitations.

1. Notice of intent to levy sent to taxpayer’s last known address by certified mail starts 30-day period for Tax Court petition, Ramey v. Commissioner, 156 T.C. No. 1 (2021).

The Service sent Taxpayer a notice of intent to levy by certified mail to his last known address, which happened to be shared by multiple businesses. The person who signed for the letter did not work for Taxpayer and was not authorized to receive mail on his behalf. Taxpayer admitted that the notice was placed on his desk before August 12, 2018, the date by which a request for CDP hearing would be required. However, he did not send a request for a CDP hearing until after that date, more than thirty days after the notice was mailed to him.

The Tax Court held that this notice was effective, as the statute focuses on “sending” not on receipt. The failure to timely request a CDP hearing left the court without jurisdiction to consider his complaints. Although the Appeals office allowed the Taxpayer to have an “equivalent hearing”, such a hearing produces a nonreviewable “decision letter”, not a “notice of determination” that can be reviewed by the Tax Court. A “decision letter” can only trigger Tax Court review if it is received in response to a timely request for a CDP hearing, which was not the case here.

Comment: Process matters.

2. Taxpayers were nonfilers because they filed only in the Virgin Islands, Coffey v. Commissioner, 987 F.3d 808 (8th Cir. 2021).

Taxpayers claimed residence in the U.S. Virgin Islands for 2003 and 2004. They did not file returns with the IRS, but instead filed only with the USVI Bureau of Internal Revenue, which sent the first two pages of their return plus some additional information to the IRS. The IRS, in turn, forwarded funds collected from Taxpayers to the USVI treasury.

In 2009, the Service audited Taxpayers’ returns for 2003 and 2004 and assessed a deficiency, which was more than three years after receiving the documents. The Service challenged their bona fide residency, which thus affected their ability to file only in the USVI. Taxpayers petitioned the Tax Court, and a majority of the court ruled that the statute of limitations barred the assessment of tax. See 150 T.C. 60 (2018). This appeal followed.

The Eighth Circuit reversed, finding that as nonresidents of the USVI, they were required to file returns with the IRS. Since they did not do so, they could not invoke the protection of the statute of limitations. Filing is required, and the transmission of two pages of their return did not constitute filing. Moreover, mere knowledge of the IRS concerning the income reported could not suffice; nor would the fact that the IRS had sufficient information to audit their returns.

Comment: This is a tough result for taxpayers, who may face uncertainty about qualification for residency status. If in doubt, file a return with the Treasury and with the USVI.


Taxpayer challenged the underlying liability for employment taxes in a CDP hearing, which he was allowed to do having raised the matter at Appeals. Among Taxpayer’s defenses:
he was not the proper employer liable for the taxes. He could not prove this claim, however, because he argued that the IRS had previously seized and lost the documentation that proved it. The Tax Court did not grant relief. Even where the Commissioner unintentionally loses a taxpayer’s records, Taxpayers still bear the burden of proof.

Moreover, Taxpayer was not able to mount a statute of limitations defense. The collection limitations period of ten years applies in this case, and that ten-year period was tolled during Taxpayer’s bankruptcy proceedings and for six months after they end. See IRC 6503(h). The Tax Court rejected arguments based on laches, which is generally not applicable to the government.

Comment: One wonders how those records would have proven that there was another employer, but nevertheless: it’s your burden. Note the long period of limitations here may suggest the need to revise record retention policies in some cases.

4. Untimely petition with no proof of mailing results in dismissal, Spain v. Commissioner, TC Memo 2021-58.

Taxpayers sought review of a CDP hearing determination. Their Tax Court petition was dated on October 10, 2019, the day before the 30-day limitation on filing the petition would have expired. However, the Tax Court did not receive the letter containing the petition until October 21, 2019. The letter had appropriate postage and the proper address. However, it had no postmark. The petition was also unsigned.

The Service advised Taxpayers that unless they could prove mailing on or before the 30-day limitation expired, the Service would move to have their case dismissed for want of jurisdiction. The Taxpayers’ accountant responded with a letter to the government counsel stating that Taxpayers had signed the petition in his office on October 10, 2019, and it was mailed that same day. No other corroboration was provided. The accountant later submitted a copy of that letter to the court, after the motion to dismiss had been filed. However, the accountant did not enter an appearance for Taxpayers and Taxpayers did not sign that letter, as required by Rule 23 if the Taxpayer is self-represented.

Although extrinsic evidence can be used to prove mailing in the event a postmark is missing, the Tax Court rejected the letter from Taxpayer’s accountant as insufficient. That evidence was not sufficient: “We are not convinced by these unsworn, uncorroborated statements.”

Comment: Taxpayers might have been better served by advice from counsel about matters of proof. Or an even cheaper option – prevent the problem entirely for the cost of a certified letter. Prevalence of electronic filing may soon make cases like this seem odd indeed. This is another case that illustrates the harsh effect of a jurisdictional approach to the 30-day rule, which will be addressed by the Supreme Court this term in Boechler, P.C. See below.
5. Supreme Court to decide if 30-day rule for filing CDP review petition creates jurisdictional bar, Boechler P.C. v. Commissioner, 967 F.3d 760 (8th Cir. 2020), cert. granted, No. 20-1472, 2021 WL 4464219 (Sept. 30, 2021).

Taxpayer in this case filed a petition for a CDP hearing in the Tax Court to review an adverse determination by Appeals, which was mailed on July 28, 2017, and delivered on July 31, 2017. Unfortunately, Taxpayer mailed a petition on August 29, 2017, one day after the 30-day deadline in IRC § 6330(d)(1) had expired. The Tax Court dismissed his petition, and the Eight Circuit affirmed on the basis that the 30-day rule is jurisdictional and cannot be equitably tolled. In this case, the Supreme Court will evaluate whether its precedents treat the filing deadline as jurisdictional or as a claims processing rule that can be tolled.

Comment: Judge Kelly, concurring in the Eight Circuit judgment, identified a concern that a jurisdictional approach is a “drastic” measure that may impose a disproportionate burden on low-income taxpayers. This may have helped get certiorari. But the counterargument is that without a clear rule, we open Pandora’s box and myriad claims for tolling may emerge. There is merit in a clear and unequivocal rule, even though such rules can have harsh consequences in particular cases.

6. Penalty under section 6700(a) for promoting abusive tax shelters was timely assessed, Crim v. Commissioner, TC Memo 2021-117.

During 1999-2003, Taxpayer promoted a tax shelter scheme involving domestic and offshore trusts. He was indicted for tax crimes, convicted, and imprisoned from 2008-2014. In 2010, the Service notified Taxpayer in a letter addressed to his prison address that it proposed to assess penalties under section 6700(a), which imposes a $1000 penalty for each activity, including assisting in a plan that makes false or fraudulent statements with respect to the allowability of tax benefits. The Service determined that cumulative penalties of over $250,000 for his activities during the 1999-2003 tax years. Taxpayer denied that he “ever promoted any kind of tax shelters or related schemes” and denied liability. Nevertheless, the Service assessed the proposed penalties on July 26, 2010. It also filed a notice of federal tax lien with the county recorder on November 18, 2011, followed by a Letter 3172 addressed to Taxpayer at his prison address.

Given Taxpayer’s incarceration, the Service paused further collection action by placing Taxpayer’s account into “currently not collectible” status until his 2014 release from prison. In 2017, the Service sent Taxpayer a letter at his home address in California a notice of intent to levy regarding the penalties. His attorney responded that Taxpayer had moved to Malta and requested a CDP hearing. At the hearing, his attorney did not dispute that Taxpayer’s activities were subject to penalties under section 6700, but instead he advanced legal defenses that included a lack of supervisory approval (which was obtained before assessment in 2010) and challenging the timeliness of assessment. However, the Settlement Officer (SO) rejected these defenses on the ground that they represented challenges to the underlying liability – challenges that were waived because he failed to raise them in 2011 after the initial Letter 3172 was sent to him. The SO also rejected the limitations claim on the ground that the ten-year period of limitations on collection had not expired as of 2017. A Tax Court petition followed.
The Tax Court granted summary judgment in favor of the Service. The section 6700 penalties are “assessable penalties” that do not require deficiency procedures. See IRC § 6703(b). Although Taxpayer did not receive a notice of deficiency, he did have an opportunity to dispute the penalties in 2011, when he received the initial Letter 3172. The notice in Letter 3172 was received by Taxpayer in prison and he responded to it. By failing to respond with a hearing request, Taxpayer lost his right to dispute the underlying liability before the Tax Court.

But even if his claim had been properly raised, the limitations period had not expired. First, the collection action occurred within ten years of the assessment. The doctrine of laches did not apply here when Congress has granted a ten-year period by statute. Second, the assessment was also timely. Section 6700 penalties are not subject to the ordinary three-year limitations period in section 6501(a) because they do not relate to filing a return. Indeed, no limitations period applies to such penalties, much like filing a “false or fraudulent return”. The court also rejected Taxpayer’s claim that 28 USC § 2462, which requires an “action, suit or proceeding” commenced “for the enforcement” of a fine or penalty to be commenced within five years. Assessment is not a judicial action, but a ministerial act. Moreover, even if such a limit applied, section 6502 which permits collection within ten years would trump that limitation.

Comment: Another example where life is hard for those who promote tax shelters. Even two decades later, the Government is still chasing him. With no limitations periods and no ability to obtain a declaratory judgment, such taxpayers have no repose. Is that a just result?


Taxpayers, husband and wife, followed the advice of their tax adviser (Arias) to form a partnership and a corporation. The partnership paid management fees to the corporation, which it treated as deductible expenses, creating losses that flowed through to Taxpayers. The corporation had an employee benefit plan that paid for Taxpayers’ long term care insurance as well as paid them director fees.

Taxpayers paid fees to Arias for his services, which included the structure for these entities as well as return preparation. The returns for 2010-13 were under audit and the subject of adjustments in this case. In March 2014, Taxpayers granted Arias a power of attorney to act on their behalf with regard to their tax matters. In 2014, Arias filed Form 872 on behalf of Taxpayers to extend the 2010 tax year to October 15, 2015. But Wife subsequently passed away. After her death, on May 28, 2015, Arias signed another Form 872 to extend the limitations period for Taxpayers’ returns, but this only affected Husband because Arias’ power of attorney to act on Wife’s behalf had terminated at her death. Arias would later sign a POA on behalf of Mrs.’ estate, but this was after the statute had expired with regard to Wife. Husband and Arias would also execute Forms 872 to extend the statute for their corporation.

Statutory notices of deficiency were not issued until 2017, after Wife had died. The Service conceded that notices of deficiency that depended on extensions to be valid were untimely as to her estate. As the Tax Court noted, joint taxpayers are one taxable unit, but they maintain their status as separate taxpayers. Waivers to extend the time for assessment are thus valid only for the taxpayer who executes the waiver.
The Service asserted that the other extensions were valid and put the statutory notices within the applicable limitation period. Taxpayer argued that Arias had a conflict of interest on account of his being their paid tax advisor, which prevented him from acting on their behalf. But the Tax Court rejected this claim, which would prove far too much and essentially upset many taxpayer arrangements which appoint their trusted advisors to act on their behalf in tax matters. Adjustments that followed were upheld, but assessed against the corporation and Husband.

Comment: When joint taxpayers are involved in audit, note the possibility of separate decisions regarding whether to extend the limitations period, which could prove useful in the right context. Here, Wife’s estate would apparently not be burdened with the tax claims asserted based on their joint return.

8. Tacit consent to filing joint return and implied authority of attorney extended statute of limitations, Soni v. Commissioner, TC Memo 2021-137.

Taxpayers were married in 1978 in their native country of India. This was an arranged marriage traditional for their culture, and their relationship reflected traditional norms. The couple moved to the United States in 1999 and lived in New York with their son, Kunal.

Husband was an experienced businessman, and Wife was taking care of the home. She did not pay attention to business matters but instead left them to her husband. She generally did not sign documents, such as tax forms, “for fear they might be something nefarious.” In India, an uncle had gotten the family into trouble by forging her father’s signature, so she avoided signing anything. She also apparently had some level of distrust concerning their marriage, as she was concerned that she might be asked to sign a document that would effectuate a divorce or otherwise jeopardize her rights. However, she claimed to trust that her husband was complying with their tax return obligations, even though she never signed a return.

Husband, in turn, left most of the routine tasks, such as paying bills and managing accounts, to administrative staff at his business. The couple also hired an accountant to prepare returns and, apparently, to represent them in tax matters. On occasion, their son Kunal, who worked for his father, would be tasked with taking documents to get his mother’s signature. Kunal, knowing of his mother’s aversion to signing, signed on her behalf as a matter of convenience.

Wife’s signature was forged in several Forms 872, as well as several federal income tax returns. Kunal never told his mother he signed these documents, as the topic of taxes was not discussed.

At issue here was the 2004 tax return, which an outside accounting firm had prepared and filed, after extension, in November 2005. Wife’s signature supposedly appears on the return, dated October 17, 2005, the extended due date. An examination ensued, and in 2008 the IRS received a Form 2848 appointing Grossman to act as the couple’s representative. Grossman was helping Husband with other tax matters at this time. The couple’s signatures appeared on the Form 2848, but Wife did not actually sign. Later that year, the IRS received Forms 2848 from
both Husband and Wife adding Kunal to be their representative. Again, Wife did not actually sign this document.

As the audit progressed, several Forms 872 were executed extending the statute of limitations. The first of these were sent before the IRS had received Form 2848 for Grossman, so the request for extension was mailed directly to Taxpayers. They forwarded the request to Grossman, who then submitted the Form 2848 along with the executed Form 872. Other Forms 872 followed. Wife did not actually sign any of these extensions.

The Service sent a notice of deficiency for 2004 in March 2015, which disallowed a large passthrough loss. This notice would only be timely if the Forms 872 executed by Taxpayers were valid. A Tax Court petition followed.

The first issue to be addressed is whether the couple filed a valid return. If a spouse fails to sign the return, it removes the presumption of correctness attaching to the Commissioner’s determination that a joint return had been filed based on the purported signatures of the spouses. However, an invalid return would also eliminate any claim to the protection of the statute of limitations. The Commissioner satisfied the burden to prove a valid return on the basis of Wife’s tacit consent to filing. Based on the facts and circumstances of their relationship, including her trust for Husband to take care of the taxes as well as her failure to try to file a separate return from her husband, the court found that she had indeed consented.

As for the waivers of the statute of limitation executed on Form 872, the Taxpayers bear the burden of proof that the statute had expired. Since the notice of deficiency was issued nearly ten years after they filed their return, the burden of production was upon the Service to show that they executed valid extensions. After showing that the extension was facially valid, the Taxpayer bears the burden of proving that it was in fact invalid.

Taxpayers could not meet this burden of proof. First, they tried to argue that Grossman did not have their authorization. But Grossman could not have known about the notice of deficiency without Taxpayers bringing that to his attention. Moreover, even though Wife did not sign, she was found to have given implied consent for others to do so. Taxpayers could not meet their burden to show that Husband did not sign the Form 2848. Neither Husband nor Grossman were found to be credible witnesses. Applying the common law of agency, the court found implied authority for Grossman to act on Taxpayers’ behalf. Even if Grossman had forged their signatures on later Forms 2848, the Court would not view those as forgeries to make them invalid if the evidence showed that Taxpayers would have ratified the power of attorney. Taxpayers treated Grossman as their representative throughout the proceedings. Likewise, Wife also gave implied authority for Husband to act on her behalf, as she did nothing to signal a contrary intention.

The Tax Court upheld failure to file and accuracy penalties here, finding no reasonable cause to avoid the penalties.

Comment: As the Tax Court observed, “ignorance is bliss, except when it is not.” One can sympathize with cultural practices that cause a spouse to avoid engagement with the tax system,
but that system cannot permit exploitation based on ignorance. It appears that common law agency principles will be used against taxpayers who seek to avoid the consequences of behavior that otherwise show ratification.

C. Remedies.

1. Sovereign immunity protects conversion of collectible coins, Willis v. Boyd, 993 F.3d 545 (8th Cir. 2021)

   Police executed a search warrant on Willis’ home, seizing 364 boxes of one-dollar coins that commemorated U.S. Presidents. Each box contained $1000 in coins. The coins were passed along to the IRS, and an agent ordered them removed from the boxes, run through a coin counter, and then deposited into a government account. Willis sued the Government for conversion under the Federal Tort Claims Act, which allows damage claims against “for injury or loss of property… caused by the negligent or wrongful act or omission of any employee of the Government while acting within the scope of his office or employment, under circumstances where the United States, if a private person, would be liable to the claimant.” 28 USC § 1346(b)(1). The district court awarded her $94,880 based on the difference in the collectable value from the face value of the coins. The Government appealed.

   The Eighth Circuit reversed, holding that this action was protected by the so-called “discretionary-function exception” applicable to any claim “based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or an employee of the Government, whether or not the discretion involved be abused.” 28 U.S.C. § 2680(a). Here, the Internal Revenue Manual requires currency seized to be deposited within five days, except where it is held as a “collectible asset”. The determination whether the coins were held as a “collectible asset” was a discretionary one. Even if the agent had been negligent in making the determination that the coins were not collectible assets, that would not support liability. The decision to deposit the coins reflected considerations of “social, economic, and political policy” to the extent that competing interests of expeditious deposit and preservation of property were at stake. With no waiver of sovereign immunity, the FTCA claim was dismissed.

   Comment: Does this mean that collectible coins are vulnerable to seizure and conversion by Government agents without an effective remedy for citizens? A petition for certiorari has been filed.

2. Interest abatement claims denied, Verghese v. Commissioner, TC Memo 2021-70.

   Taxpayers invested in partnerships in 1997 and 1998 that generated deductions for charitable contributions. After auditing the partnerships, the Service disallowed partnership-level charitable contributions, which Taxpayers had duly claimed on their individual returns. The partnerships initiated TEFRA proceedings in 2000, but those civil proceedings were held in abeyance while criminal cases proceeded against the promoters of those partnerships, who were ultimately convicted of fraud. Criminal proceedings did not end until 2009. TEFRA proceedings resumed, and ultimately concluded in April 2013 when the Tax Court entered stipulated decisions. In May 2014, Taxpayers received collection notices for increases in income tax and interest running from the 1997-1998 tax years. Taxpayers filed Form 843, Claim for Refund and Request for Abatement, requesting abatement of interest during the TEFRA
proceedings. Their claim was based on unfairness and unreasonable delay. The IRS did not respond. Taxpayers then requested a CDP hearing, and they asserted the abatement claim there. It was also rejected. Finally, they petitioned the Tax Court, which remanded the case to Appeals for further consideration, while Appeals again denied relief, landing the case once again before the Tax Court.

The Service moved for summary judgment on the abatement claim, and the Tax Court granted their motion. First, although IRC section 6404(a) allows a claim for abatement based on unfairness (“excessive in amount”), section 6404(b) precludes an unfairness claim whenever an income, estate, or gift tax is involved. Longstanding interpretations support this restriction.

Second, with regard to abatement based on section 6404(e), the Taxpayer had to prove that ministerial or managerial acts by the Service caused unreasonable delay. However, the conditions surrounding the case provided no basis for relief, with the exception of a short period during the pending TEFRA litigation, in which the court exercised deference to the Taxpayer’s position (as required in summary judgment proceedings).

Among other things, the Taxpayers claimed that the failure to inform them of the right to make a deposit to stop interest from accruing constituted an abuse of discretion. However, the Tax Court rejected such a claim, noting that general guidance for Taxpayers since 1984 had allowed such a deposit. A personal invitation was not required. The mere passage of time during litigation does not constitute error or delay, and Taxpayers could point to no ministerial or managerial act that would give rise to relief. Delays caused by counsel for the partnerships could not be attributed to the government.

Comment: Partners beware. A final determination after more than 20 years suggests justice delayed, which is justice denied. The current low interest rates may make tax debt look like an attractive borrowing source, but that will not always be so.


Taxpayer engaged in tax shelter transactions in 2002 based on disposition of S&P Index Options that it asserted created short-term capital losses totaling over $9.6 million. At the same time, it reported $7.6 million in capital gains from transactions associated with a merger in 2002. Taxpayer now seeks to disavow those gains it had previously reported. The Service wants to stop them from doing so.

Taxpayer’s predecessor, Old Capital, was formed as an insurance company. However, it no longer conducted any significant insurance business and now functioned as an investment company for its 36 shareholders, who descended from the original founder. In 2001, the board of Old Capital sought counsel in order to find a tax-efficient way for the owners to exit from the corporation, which held significant appreciated securities. In early 2002, they undertook a strategy that would first involve the merger of Old Capital with New Capital in a nontaxable F reorganization (see IRC § 368(a)(1)(F)). This merger would terminate Old Capital’s insurance business, and it was approved by the appropriate state regulator.
Following this transaction, New Capital would not issue stock to the shareholders. Instead, it would become a party to a second merger transaction involving the company that desired to purchase Old Capital. New Capital would be the surviving company in that merger. The purchaser obtained a loan from a bank based in part on representations that it would sell the securities formerly held by Old Capital after the merger was completed. Each Old Capital shareholder would effectively receive cash for his shares after the second merger had closed.

New Capital, as the survivor of the second merger, filed its return for 2002. Consistent with the rules for F reorganization, New Capital did not have Old Capital file a return, but instead it filed the return for both companies in the 2002 tax year. That return included both losses from the option transactions noted above, as well as gains from the disposition of the securities previously held by Old Capital. The Service issued a notice of deficiency disallowing the option losses, but it did not initially change the securities gains reported by New Capital. However, in 2012, the Service audited Old Capital and asserted that Old Capital, not New Capital, was the proper taxpayer for the securities gains. New Capital, as successor in interest to Old Capital, filed a petition in the Tax Court alleging that the adjustments to Old Capital were time-barred, and that moreover, the initial transaction was a good F reorganization. The Tax Court agreed that the adjustments were time-barred and did not reach the merits of the F reorganization.

New Capital then claimed that the Service was right in the prior litigation – the proper taxpayer was indeed Old Capital and, since that claim was time-barred, it could not possibly be held responsible for the capital gains reported on its return. The Service objected, arguing that this switch in position was estopped under the duty of consistency and related doctrine of equitable estoppel.

The Tax Court agreed. If New Capital had treated the merger as a taxable event, Old Capital would have recognized capital gains on its securities and New Capital would have taken a fair market value basis in those securities. There was indeed good authority for doing this – as no one now agrees that the first merger was an appropriate F reorganization. Significantly, the transaction would fail the continuity of business enterprise requirement, as there would be no insurance business continued after the merger and the investment business of Old Capital would be extinguished when those investments were sold. But New Capital had rejected that approach in prior litigation. Was it now bound to stick to that position?

In the Second Circuit, to which an appeal would lie, four requirements exist for equitable estoppel against a taxpayer: (1) a false representation or wrongful misleading silence; (2) an error originated in fact, not law; (3) the Commissioner did not know the correct facts; and (4) the Commissioner is adversely affected by the taxpayer’s act or statements. While expressing doubt as to whether the Second Circuit would apply a duty of consistency, especially in a case involving an innocent mistake, the Tax Court nevertheless concluded that New Capital would satisfy the requirements for equitable estoppel.

First, the return reporting position was deemed to be a representation of facts. By reporting a carryover basis in the assets acquired from Old Capital, New Capital represented the merger was nontaxable, even though it did not then claim an F reorganization had occurred. It
also undertook a tax shelter transaction involving the options to shield the corporate-level taxes that would otherwise have applied. And it failed to report on its return the cash-out payments to Old Capital’s shareholders, a matter which the court characterized as “wrongful misleading silence.” This was no innocent mistake.

Second, there was no mistake of law here, which would require that both parties have knowledge of all relevant facts before the limitations period expired. Here, the determination of whether an F reorganization occurred is a legal determination, but it is dependent upon factual determinations. In other words, it requires application of the law to facts, and those facts were represented to the Commissioner to involve a nontaxable merger. Although Taxpayer argued that the Commissioner must have had constructive knowledge of the fact that the F reorganization was not proper, including the failure to file a return for an insurance company after the merger and the presence of the intermediary transaction, the Tax Court allowed the Commissioner to rely on the representations in the return, which was prepared under penalties of perjury. Moreover, even if the insurance line of business did not continue, it was not evident that an investment line of business would also terminate based solely on the sale of the securities.

Finally, the Service would be adversely affected here if taxpayer were not estopped.

Comment: This complex case merits study by those who are interested in equitable estoppel arguments applied against taxpayers. Of course, the prospects for equitable estoppel against the government are not the same. Taxpayers, beware.

4. Alter ego theory based on state law applied to selected corporate transactions, Jenkins v. Commissioner, TC Memo 2021-54.

These consolidated cases involve two taxpayers, Jenkins and Gentry, who were both convicted of multiple felony counts in connection with a fraudulent investment scheme. Through a reverse merger, they acquired a public company and then proceeded to trade its stock based on false statements about products being developed by the company. Those false statements unraveled leaving Taxpayers in the sights of the federal government for various securities fraud claims.

Taxpayers’ trouble with the government was only beginning, however, as in 2011 the Commissioner finally got around to sending a notice of deficiency to these taxpayers for the 2000 tax year. Fortunately for the Commissioner, one of the taxpayers did not file a return for 2000 and the other filed a fraudulent return, which kept the statute of limitations from running. This case involved income issues associated with those returns.

One issue includes the locus of taxable income from various transaction incurred by corporations controlled by one of the taxpayers. The Tax Court explained that under a sham corporation theory, the corporation would simply be disregarded and its property would be deemed to be held by the shareholder. Alternatively, under an assignment of income theory, the income would be assigned to the person who earned it. But here, the Service took a more complex position, alleging that the selling corporations were nominees or alter egos of the shareholder, thereby allowing the transaction to be taxed to them individually on that basis. State law determines whether nominee or alter ego status applies, but that involves a complex
analysis to decide which state law would apply because of the various locales in which these entities had been incorporated or traded.

After rejecting an approach based on federal common law, Judge Holmes turned to established choice of law principles. Section 307 of the Restatement Second of Conflict of Laws suggests the law of the place of incorporation may be apt – which meant either Bahamas, Belize or Arizona, where each of the corporations had been formed. However, Judge Holmes looked instead to section 306, which recognized that although the law of the place of incorporation may be appropriate for matters involving the internal affairs of the corporation, it may not be the best answer when interests of third parties are affected. Section 306 references general principles, including policy considerations, to choose among the competing states to assess the most significant relationship to the issues at hand. Here, Arizona fit the bill, as it had the greatest connection to Taxpayers and their activities that gave rise to tax liabilities in this case.

Arizona law of corporate alter ego is not well developed, but it provides the authority to address the matter of selectively choosing transactions and attributing them to a particular person, shareholder or not, consistent with alter-ego theory. Among other things, the doctrine looks at the unity of interest and ownership, as well as aspects of control, in a manner that allows prevention of fraud and injustice (which are admittedly, rather loose standards).

Taxpayers made some clever arguments, including the application of the law of forfeiture associated with conviction of money laundering crimes. However, Judge Holmes points out, that is not a defense to the inclusion of such amounts in taxable income – in fact, it is destined to keep the “sting” associated with that forfeiture.

Comment: This case includes discussion of choice of law provisions that could prove useful in other matters where the prospects of determining which state law should be applied are part of the controversy.

5. A Notice CP12 is not a settlement agreement, Peak v. Commissioner, TC Memo 2021-128.

Taxpayer received pension distributions in 2017 totaling over $14K. However, despite receiving Forms 1099-R that told him all distributions were “normal” and thus taxable, Taxpayer somehow reported only $1,698 as the taxable amount of those distributions on his 2017 return. Taxpayer received Notice CP12 from the Service, which was dated June 4, 2018, which indicated that Taxpayer’s return contained “miscalculations” that affected the overpayment amount he had claimed on his return. If Taxpayer did nothing, the notice indicated he would receive a refund of only $182 (instead of the $1869 figure he had claimed) “as long as you don’t owe other tax or debts we’re required to collect.”

The Service later issued a notice of deficiency dated January 6, 2020, which proposed additional taxes because the entire amount of these distributions was taxable. Taxpayer petitioned the Tax Court for relief, arguing that the Notice CP12 served as a settlement to bar any further attempt to assess a deficiency, and that he called the “IRS help line” and followed their instructions to the letter.
The Tax Court rejected these arguments. First, a Notice CP12 is not a settlement agreement that can bind the rights of both parties. Instead, it merely provides a “first notice to inform the taxpayer of a math error”. Second, the IRS help line advice, even assuming that Taxpayer did receive and follow it, is not an authoritative source of law. Thus, the IRS was not precluded from assessing a deficiency in this case.

D. Attorney fees, costs, and damages.

1. Taxpayer successfully claims litigation cost award under section 7430, Morreale v. Commissioner, TC Memo 2021-90.

Taxpayer operated various businesses in the Denver area in tax years 2011 and 2012. He failed to file returns for the 2011 and 2012 tax years, and in 2013 he filed a bankruptcy petition. The Commissioner’s bankruptcy specialists referred Taxpayer’s case to Examination for the purpose of preparing and filing substitute returns. However, after meeting with the RA assigned to the case, Taxpayer agreed to prepare and submit the returns himself. He submitted delinquent returns to the RA in April 2016, which the RA then submitted for processing. After reviewing the returns and comparing them with information obtained from the bankruptcy trustee, the RA provided “examination lead sheets” to Taxpayer and his counsel with proposed adjustments. The primary issues involved a failure to substantiate basis in an LLC taxed as a partnership and alleged impropriety in using the accrual method instead of the cash method.

Taxpayer’s counsel provided evidence of consistent use of the accrual method, as well as pointing the agent to requirements that businesses with inventories are required to use accrual accounting. Taxpayer also provided a spreadsheet from his accountant with a full basis calculation for the LLC. Neither of these submissions moved the RA, who provided an RAR with a 30-day letter showing proposed deficiencies of about $56K for 2011 and $542K for 2012. Those numbers were later revised downward in the notice of deficiency that was issued in 2017.

Taxpayer filed a Tax Court petition in 2017, and in early 2018 it also asked the Bankruptcy Trustee to reserve funds as a deposit in the event the deficiency was upheld. The Service filed an answer repeating the positions announced in the Notice of Deficiency, and then it referred the case to Appeals. The AO spent ten months reviewing the case, after which he concluded that none of the adjustments were well-founded and that the additions to tax and penalties should be “conceded in full”. The method of accounting adopted clearly reflected income and there was no evidence that Taxpayer had improperly changed from the cash method. Moreover, the basis computations provided supported the Taxpayer’s position in the LLC entity. Taxpayer entered into a stipulated settlement in which deficiencies of $1367 and $30,639 were owed for the respective tax years, thereby ending the substantive dispute.

Taxpayer then sought reasonable litigation and administrative costs under section 7430. Taxpayer was required to address the recent decision in United States v. Johnson, 920 F.3d 639 (10th Cir. 2019), which covered the matter of whether the government’s position is “substantially justified”, a defense under section 7430. Among other things, Johnson directs that the position of the government should be assessed in its totality, not on an issue-by-issue basis. Nevertheless, the government’s case failed that test.
Here, the government’s answer was based on the RA’s position, and both of them disregarded the applicable regulations under section 446, which requires the accrual method for businesses having an inventory. In fact, the RA’s proposed adjustments include changes to the inventory amounts – demonstrating that he was aware of this fact. Also, there was no evidence of any change in method of accounting here. Likewise, the email showed that documentation had been provided on the basis issue, but it was not taken into account. That adjustment lacked a reasonable basis in fact. Taken in its totality, the government’s case lacked a justification in law and fact on these critical issues.

Taxpayer then had to prove costs related to the tax proceeding, including the fee claim, were justified. The Tax Court restricted the amounts based on billing records, and it refused to enhance the rate beyond the $200/hour statutory rate applicable at that time. The court rejected the application of a special factor to enhance the rate, as the issues here were ordinary ones and the mere difficulty of obtaining counsel at the statutory rate did not provide a basis for enhancement.

Comment: This case should be reviewed by anyone with a tax dispute in bankruptcy, as there are some procedural issues lurking here. Notably, this taxpayer could have had these issues adjudicated in the bankruptcy court instead of litigating in the Tax Court. The outcome here suggests that having a specialized judge familiar with tax issues may have provided an advantage for this taxpayer.

2. Litigation cost award under 7430 denied because IRS position substantially justified, Jacobs v. Commissioner, TC Memo 2021-51.

Taxpayer held a full-time professor position at American University as well as an adjunct professor position at George Washington University. Both employers reported their compensation to him as wages. In 2014, Taxpayer also held an uncompensated position as a “Visiting Scholar” at UCLA. While there, he performed research and worked on a book on the BP oil disaster, which was published in 2016.

In August 2015, Taxpayer left his teaching position at American University and moved to California. He took at position at Loyola Marymount as a professor, and he accepted a part-time “of counsel” position in a Los Angeles law firm.

During 2014 and 2015, Taxpayer claimed Schedule C deductions for travel, meals, and other professional expenses incurred, which he claimed related to his independent business as an attorney and author. An audit ensued, and the Service challenged the substantiation as well as the propriety of these deductions, as it took the position they were either personal in nature or connected to his employment as a full-time professor. A lengthy audit and appeals course was pursued, eventually leading to a Tax Court petition. However, after a settlement conference, the IRS eventually conceded its case against Taxpayer.

Taxpayer then sought litigation costs under section 7430, which required him to demonstrate “that he (1) is the ‘prevailing party,’ (2) has exhausted available administrative remedies within the IRS, (3) has not unreasonably protracted the proceeding, and (4) has claimed ‘reasonable’ costs.” In addition, Taxpayer had to prove that he was eligible based on having a
net worth under $2 million. At issue here was the matter of whether he was a “prevailing party”, as the Service conceded the remaining issues apart from reasonableness, which was not reached in this litigation.

The Tax Court denied the attorney fee award on the basis that the IRS position, despite a complete concession, was indeed “substantially justified”. A reasonable person examining the law and facts in this case could think the IRS position was correct, particularly given the overlapping duties involved in the various activities undertaken by this Taxpayer. Taxpayer used his American University email to make arrangements for trips while resident at UCLA. He also held a position as a visiting scholar, not a visiting professional, suggesting his relationship there had academic rather than independent business purposes. Moreover, the activities he engaged in – including networking, speaking, and conference attendance -- could have related to his work as an academic as well as his claimed activity as an independent author.

Comment: Attention to detail is essential in allocating expenses to different business activities. This taxpayer was successful – but the books and records were not sufficiently detailed to avoid the drawn-out audit and appeals process and ultimately litigation in what would have been a close case.


Last year’s program featured the Federal Circuit’s decision in Adkins v. United States, 960 F.3d 1352 (Fed. Circ. 2020), reversing 140 Fed. Cl. 297 (2018), which finally produced a Taxpayer victory in a claim for refund extending back to events that occurred in 2004 with regard to a “pump and dump” investment scheme. At one point, the Taxpayer had an Appeals Officer recommending concession to the Taxpayer, but Taxpayer filed a refund suit that deprived Appeals of jurisdiction. The subsequent litigation involved the interpretation of regulations determining the timing for theft loss deductions, which the Federal Circuit settled in Taxpayer’s favor. In subsequent proceedings, the matter of costs and fees was contested, with Taxpayer moving for Rule 11 sanctions against the Government, or in the alternative, requesting litigation costs under IRC § 7430.

The Court of Federal Claims ruled that while Rule 11 sanctions would not be sustained, Taxpayers had shown their entitlement to attorney’s fees. The court rejected Rule 11 sanctions in part because of the fact that the Taxpayers waited until their case was complete to file their motion. Instead, it should have been filed promptly when the Government filed its answer. Moreover, the court also rejected any substantive basis for sanctions. Taxpayers alleged that the Government’s response to their litigation disavowed a settlement based on the Appeals Office recommendation for settlement. However, the court found that there was no settlement to abandon, as it had not been completed.

On the matter of attorney’s fees under section 7430, the court focused primarily on the Government’s defense that its position was “substantially justified”. Taxpayers alleged that the Government engaged in abusive behavior in continuing to litigate this case, despite the fact that its position was twice rejected in the Federal Circuit. Although the court rejected Taxpayer’s
contentions based on (a) litigating after a proposed settlement, which was never executed and (b) litigating the matter of whether state law or federal common law controlled the definition of theft, it agreed with the Taxpayer that after these matters were resolved, the Government persisted with an interpretation of its regulations that could not have been correct. Noting that “[o]ther courts have found such an emphatic rejection of the United States’ position to be an important factor in determining whether the position was substantially justified,” the court ruled that since the Government “plainly misinterpreted the relevant Treasury regulation” its position was not substantially justified. The remainder of the case addressed the quantification of the litigation cost award.

Comment: Taxpayers got their award, but at hourly rates that likely undercompensated them for counsel costs. This award came a decade after an Appeals Officer recommended concession. Was a decade of litigation worth the outcome? This case may remind us of the saying, “Justice delayed is justice denied.” And it may also remind us of the importance of discretion and appropriate oversight on behalf of government actors charged with doing justice. As I argued last year, this area of law is also ripe for reforms that remove requirements for predictions about recoveries when theft has occurred. Let’s be honest about the cloudy nature of the crystal ball, no matter who possesses it.

E. Tax Crimes/Civil Fraud.

1. Deficiency proceeding dismissed for lack of prosecution on account of death, Catlett v. Commissioner, TC Memo 2021-102.

Taxpayer was convicted of criminal tax charges, remanded to federal custody, and ordered to pay more than $3 million in restitution for tax losses associated with a fraudulent tax return scheme. While he was in custody, the Service initiated an audit of his 2006-2010 tax years. In 2014, the Service sent notices of deficiency for each of these years, which included significant penalties. Taxpayer filed a petition in the Tax Court in June 2014. However, he died in 2020. The Service moved to dismiss his claim for lack of prosecution.

The Tax Court agreed with the Service and granted the motion to dismiss. Ordinarily, when a taxpayer dies while a case is pending, Taxpayer’s representative may be substituted as a proper party. Alternatively, the Service may be asked to furnish identities of individuals with a “monetary interest” in the outcome of the case. Without such parties identified in this case, dismissal was granted.

In this case, the order of dismissal sustained all adjustments insofar as Taxpayer had the burden of proof. However, the Service bore the burden of production and proof with regard to penalties for fraud and the fraudulent failure to file returns. Looking at the evidence the Service had presented, the court agreed that it had met its burden of production and proof for all years except 2009. Taxpayer’s 2009 tax return was due April 15, 2010, approximately one month after he had been indicted for tax crimes. According to the court, “Under these circumstances, petitioner's failure to file a 2009 return may have been attributable to various causes, e.g., distraction occasioned by the criminal prosecution, advice of counsel, or reluctance to take a position inconsistent with the positions taken on his prior returns.” The court thus concluded that the Service thus could not bear its burden of production and proof regarding fraudulent failure to file for this year.
Comment: The outcome of the tax case likely increased tax debt, which the IRS would then have to collect from Taxpayer’s estate. The absence of potential claimants, including family members who might have an interest in his property, suggests prospects for successful collection were unlikely. It strikes me as exceedingly fair to put the 2009 return filing in a different category from the failure to file other returns despite the fact this it fit this Taxpayer’s general pattern of being a tax scofflaw.

2. Restitution payments by convicted taxpayer did not affect additions to tax for penalties that accrued before sentencing, Ervin v. Commissioner, TC Memo 2021-75.

Taxpayer was convicted of tax evasion and aiding and abetting the same. In 2011, he was sentenced to ten years imprisonment and ordered to pay restitution of $1.4 million, which was the amount of tax losses the Government estimated for the 2000-09 tax years. While Taxpayer was imprisoned, the IRS audited his 2000-07 tax returns. He received two notices of deficiency which also imposed failure to file, failure to pay, and civil fraud penalties. Taxpayer filed a pro se petition for redetermination from prison, in which he alleged no errors in the IRS determinations. However, he alleged that the Government had seized gold coins from him that should be applied to his deficiency. That happened, and in 2016, the Government certified to the district court that Taxpayer had satisfied his restitution obligation in full.

The Service moved for summary judgment on its deficiency determination, alleging that Taxpayer admitted liability for the underlying tax as well as failure to file. On the civil fraud claims, it sought to use Taxpayer’s admissions and collateral estoppel effects from his criminal tax evasion conviction. Taxpayer’s sole response was that it had paid the underlying taxes through satisfaction of the restitution order.

The Tax Court ruled in favor of the Service. Restitution payments from a criminal tax case do indeed offset the underlying tax liabilities, but they do not prevent the assessment and collection of penalties through a civil examination process. The restitution payments here were not completed until 2016, before which penalties could indeed accrue. Moreover, although Taxpayer alleged an inability to pay additional assessments, that is not a defense on the merits. Instead, such a defense must be raised in a collection due process hearing.

Comment: The Government followed the Tax Court’s precedent in Klein v. Commissioner, 149 TC 345 (2017), which held that additions to tax from penalties do not arise from the failure to make restitution payments, as those are not a civil tax liability. Thus, the Service has to commence civil proceedings after obtaining the criminal conviction in order to seek those penalties. The life of the tax evader can be hard.


Taxpayer husband is a U.S. citizen and his wife is a dual citizen of the U.S. and Germany. His wife sometimes went by the name Monica Schroeder. Taxpayer worked for EWH, a Canadian company that exported timber to the EU. He has since retired, and the couple now spend time in both New Zealand and the United States.
Mr. Glube, a Canadian attorney who advised EWH, was also active in forming foreign holding companies in Malta and the Cayman Islands. Taxpayer took over the management of EWH and began working with Glube, whom he thought was an honorable person. However, Glube was later imprisoned for embezzlement.

Taxpayer testified that he sold his house and gave the bulk of the proceeds -- $350,000 -- to Glube for the purpose of stabilizing his employer and showing creditors that it had money in the bank. However, the money was deposited in a UBS account in the Cayman Islands under the name of Reed International, Ltd., an entity that Glube had formed to hold assets for EWH. Documents dated in 2002 indicate that Taxpayer and his wife were the beneficial owners of the Reed Account. He traveled to the Cayman Islands to sign a power of attorney governing the Reed Account assets. Eventually, in 2007, the Reed Account and another account in Malta were both closed, and the balances transferred to a UBS account in Switzerland. UBS advised creating a “stiftung”, a trustlike vehicle based in Liechtenstein. Taxpayer did so and the “Schroeder Stiftung” (named for his wife) held the assets for the benefit of Taxpayer and his family.

In 2009, UBS entered into a deferred prosecution agreement with the U.S. Department of Justice. UBS informed Taxpayer that it would be closing the Schroeder Stiftung account. A UBS banker advised Taxpayer to transfer the assets to a life insurance policy in Liechtenstein, which was valued at over $3 million. In 2013, the life policies were cancelled and the funds were moved to a Liechtenstein bank under his wife’s name, as Taxpayer testified that the bank “wasn’t accepting U.S. clients”.

On the basis of documentary evidence obtained from UBS, the Service selected Taxpayer’s 2005-10 returns for examination in 2012. The documents showed the movement of the cash and Taxpayer’s ownership of the accounts. However, Taxpayers reported no offshore income. Taxpayer moved the life policies in 2013 after the examination had begun. He also began making claims that former business associates had run off with his money. He represented that he had no control over any of the accounts.

Taxpayer and his wife jointly filed amended returns and prepared FBAR disclosures. These amended returns disclosed over $800K in unreported income. The examining agent came up with a similar number using sampling methods to reconstruct his income. She sought approval for fraud penalties from her supervisor before preparing a notice of deficiency. (Notably, no fraud penalties were sought against Mrs. Harrington).

Fraud penalties were upheld, and fraud also provided the basis for assessing deficiencies more than six years after the original returns were filed in all years except one. Taxpayer underreported income – as evidenced by his amended returns showing omitted income. The court treated this as an admission. And Taxpayer failed to show that he lacked control over the accounts, as he asserted. There were ample badges of fraud to support the determination, including concealment, inconsistent explanations, underreporting of significant amounts, and failure to cooperate with authorities.
Comment: Whatever benefits Taxpayer may have obtained from UBS were surely cancelled by the fraud penalties here. Query whether FBAR penalties were also asserted, but those were not discussed in this case.


Judge Holmes issues another epic opinion that addresses multiple issues involving multiple entities engaged in tax avoidance strategies that proved unsuccessful. The assignment of income doctrine proves important for the IRS case, and the opinion provides a thoughtful and succinct exposition for those needing a refresher.

While many of the penalty issues were conceded, a contested penalty involved fraud for failing to file a return, which the IRS must prove by clear and convincing evidence. Judge Holmes ruled for the wife on the ground that she was not a sufficiently sophisticated actor to allow the government to meet its burden of proof. However, the husband did not fare as well. He was trained in tax law at NYU and his repeated and significant concealment of income over many years (paying $31K in taxes on tens of millions of income) supported an inference of fraudulent intent on failing to file returns. Taxpayer also testified that he consciously chose not to file returns for himself and a controlled corporation. He claimed to learn this at the NYU LLM program: “where you’re uncertain as to how you should respond or report, you’re better off not filing than filing at all.”

Comment: I hope my students do not misremember such a distorted view of my teaching.

F. Transferee/Fiduciary Liability.

1. Transferee liability is not required to be separately assessed, United States v. Henco Holding Corp., 985 F.3d 1290 (11th Cir. 2021)

In 2018, the Government filed suit against Henco Holding Corporation, a C corporation, seeking to collect unpaid federal income taxes. This suit was within the ten-year period for collecting an unpaid assessment, which is allowable under IRC § 6502. That suit also targeted the individual former shareholders of Henco, which the Government claimed could be held liable as transferees under section 6901.

During 1996, Henco’s sole asset was a 50.5 percent interest in Belca Foodservice Corporation, which had substantially appreciated in value. The company used an intermediary structure and sham relationships to effectuate a sale of the Belca stock through a series of transactions that would leave Henco without any significant assets, but which would allow the individual stockholders of Henco indirectly to receive cash distributions.

The Service audited Henco’s return and ultimately issued a statutory notice of deficiency involving taxes, penalties, and interest of more than $56 million. Henco did not challenge the notice, but it would later file a Collection Due Process challenge to the resulting federal tax lien. The Tax Court upheld the liability. According to the Government, this decision estops Henco from challenging the underlying liability.
In this case, however, the former shareholders of Henco moved to dismiss the Government’s suit to try to collect Henco’s liabilities from them based on a theory of fraudulent transfer. The district court granted relief, and this appeal followed.

First, the shareholders argued that the suit was untimely because of the four-year statute of limitations applicable to Georgia’s fraudulent transfer statute. However, the Eleventh Circuit rejected this argument, ruling that the Federal government is not bound by the state statute of limitations in pursuing claims under Georgia law.

Second, the shareholders argued that the claims asserted are untimely based on the applicable scheme in section 6501, 6502, and 6901 of the Code. The shareholders argued that section 6502, which imposes a ten-year limitations period for collecting a tax after it is assessed, was not applicable here because only Henco had been assessed; they had not been separately assessed for the liability under the transferee theory.

The Eleventh Circuit rejected this defense, ruling that the Supreme Court’s 1933 decision in Leighton v. United States upholds the Government’s right to seek collection in this context. Other circuit level decisions have likewise upheld this prerogative.

Comment: This case shows how long the clock can keep ticking before a taxpayer is eligible for repose.

2. Alter ego theory applied to Taxpayer’s corporation, causing him to be liable for unpaid corporate taxes, United States v. Lothringer, No. 20-50823, 2021 WL 4714609 (5th Cir. 2021).

Taxpayer was the sole shareholder, director, and only officer of a corporation that operated used car lots. The corporation owed $1.7 million in federal taxes, and the Government sued Taxpayer to collect on the corporate debt. The Government prevailed on an alter ego theory, which was determined under Texas law. “Under Texas law, alter ego applies when there is such unity between corporation and individual that the separateness of the corporation has ceased and holding only the corporation liable would result in injustice.” (internal quotations and alterations omitted). Although Texas statutory law precluded a failure to follow corporate formalities from being considered in contract claims, this was a tax claim.

Comment: Ordinarily a transferee liability theory would provide a sufficient remedy when a corporate tax liability is unpaid, as often assets generated by the corporation associated with taxable income have been distributed without consideration. Presumably the alter ego was needed because of a factual deficiency about transfers to the shareholder. Compare the alter ego theory in Jenkins v. Commissioner, TC Memo 2021-54, supra, which was used to attribute transactions to the owners instead of a corporation.

3. Hospital administrator stung by trust fund penalties as responsible party, Cashaw v. Commissioner, TC Memo 2021-123.

Taxpayer brought this collection due process case to challenge attempts to collect trust fund penalties for failing to pay over employment taxes owed by a hospital in Texas for which she served as the hospital administrator. The hospital fell on hard times after it was cut off from
Medicare and Medicaid due to past fraud, and it also faced litigation during this time, which she asserted created a superior lien on hospital property. The Tax Court disagreed about the lien, as she could not show that the lien was superior to the Government’s claim. Taxpayer knowingly failed to pay over employment taxes, choosing to pay other creditors instead, including vendors who were providing services to patients.

The Tax Court noted:
“The Court appreciates the difficult situation in which petitioner found herself during the periods at issue. Petitioner believed she had a responsibility to ensure that her patients were cared for and that she needed to prioritize whatever funds Riverside had to fulfill this mission. While we may sympathize with petitioner’s dilemma, we are a court of law, not equity. Stovall v. Commissioner, 101 T.C. 140, 149-150 (1993). Petitioner was required to collect and remit withheld funds, and she did not. Her stated justification, no matter how noble, does not make her failure to pay any less willful.

Comment: Taking on administrative responsibility, particularly after prior administrators may have committed some bad acts that weakened the financial position of the hospital, is an inherently risky proposition. Expert counsel may be needed to avoid these trust fund penalties, particularly when there are competing creditor claims.

G. Other.
1. Partial summary judgment order in Tax Court not final appealable order, Minemeyer v. Commissioner, 995 F.3d 781 (10th Cir. 2021).

Taxpayer was convicted of tax evasion related to the 2000 tax year. Charges for 2001 were dropped, but pursuant to a plea agreement, he was ordered to pay restitution of $200K, reflecting government losses for both 2000 and 2001, a fine of $25K, and sentenced to a year in prison. A notice of deficiency followed, which proposed tax deficiencies of $197K plus penalties of $148K, including civil fraud penalties.

Taxpayer filed suit in the Tax Court, which granted partial summary judgment in favor of the Service, upholding the deficiencies and the civil fraud penalty for 2000. However, it denied summary judgment on the matter of the civil fraud penalty for 2001, determining that that issue remained for possible trial. (Notably, a criminal conviction can be used to preclude taxpayer challenges to civil fraud penalties, but this taxpayer was convicted only in 2000, not 2001.)

Taxpayer filed an appeal to the Tenth Circuit. The Tenth Circuit observed that circuit courts are divided on the question of whether a ruling by the Tax Court is appealable when that ruling does not dispose of all claims. The Second and Sixth Circuits hold that appellate jurisdiction exists only after the Tax Court disposes of the entire case. However, other circuits have ruled that appellate review is appropriate if a final order has been issued and there is no just reason to delay appellate review, similar to a Rule 54(b) certification by a district court.

The Tenth Circuit embraced the majority approach and rejected jurisdiction in this case. Section 7482 of the Code grants appellate review “in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury.” This makes the Tax Court the “gatekeeper” in allowing appeal by requiring it to certify a matter for appeal.
Comment: This approach ensures judicial economy and parity in matters initiated in the Tax Court and federal district courts.


The states of New York, Connecticut, Maryland, and New Jersey challenged the SALT limitation imposed by the 2017 Tax Cuts and Jobs Act as unconstitutional. The district court found their claims without merit, and the states appealed. The Second Circuit affirmed, finding first that these states showed a reduction in state taxes connected to the rule that gave them standing to challenge it. In particular, the states alleged that the SALT cap will decrease the frequency at which taxable real estate transactions occur, thereby causing them to lose tax revenues. It also rejected claims under the Tax Injunction Act, finding that the Act was never intended to leave parties like these states without any means to assert their claims.

On the constitutional merits, the Second Circuit likewise found neither a constitutional mandate for a deduction for state and local taxes and nor a violation of any constitutional directive. Although federalism principles require respect for state sovereignty, this is not the only time that Congress denied the deduction for state taxes. For example, the Tax Reform Act of 1986 restricted deductions for sales taxes. Likewise, in 1990, Congress enacted the Pease limitation that reduced the value of the SALT deduction for high-income earners. Other support for Congress’ power to restrict tax benefits for states can be found in cases like South Carolina v. Baker (1988), which recognized that Congress even had the power to tax interest on state-issued debt.

Moreover, the court found no basis in the Tenth Amendment to reject the cap as forcing the states to “abandon their preferred fiscal policies in favor of lower taxes and reduced spending.” Unlike the constraint recognized in NFIB v. Sebelius (2012), which upheld a limitation on the Federal power to coerce Medicaid expansion, the policy choice here is not similarly coercive. Neither could these states show that Congress unfairly targeted them.

Comment: These state attorney generals can satisfy their high-income constituents that they went to court to defend their interests. However, their claims were weak indeed.


The dissent from the en banc review decision summarized this case quite well:

The IRS served the Taylor Lohmeyer law firm with a broad summons requesting the identities of the firm's clients who had engaged the firm to achieve certain offshore financial arrangements from 1995 to 2017. The IRS has traditionally served such summonses on financial institutions and commercial couriers. Not lawyers. There is good reason to be wary of investigations that exert pressure on lawyers. The relationship between a customer and a financial institution or commercial courier plays little, if any, role in our system's ability to administer justice—but the same cannot be said of the
lawyer-client relationship. When the IRS pursues John Doe summonses against law firms, serious tensions with the attorney-client privilege arise. Courts play a crucial role in moderating the executive power with respect to a John Doe summons. See United States v. Bisceglia, 420 U.S. 141, 146, 95 S.Ct. 915, 43 L.Ed.2d 88 (1975) ("Substantial protection is afforded by the provision that an Internal Revenue Service summons can be enforced only by the courts.").

Hearing this case en banc would have helped clarify the boundaries of attorney-client privilege in this precarious area.

Id. at 982 F.3d 409, 410 (5th Cir. 2020).

Comment: Caution is indeed required here when lawyers are involved in order to protect the attorney-client privilege. The entire dissent is worth reading. Both the American College of Tax Counsel and the National Association of Criminal Defense Lawyers supported en banc review. As a related development, the Pandora papers (and the Panama papers before them) also show what can happen when leaks occur – a nightmare for law firm but a nightlight for those who desire greater transparency. There are many significant public issues to be discussed here – more than can be wrangled during an important developments program.

VI. Corporations.

1. Shareholders who served as officers are statutory employees for FICA purposes, upending their compensation scheme, Blossom Day Care Centers, Inc. v. Commissioner, TC Memo 2021-86.

   Taxpayer corporation ("Blossom") faced FICA and FUTA taxes and penalties for payments to a married couple who were the sole shareholders during the 2005-2008 tax years. H owned 49 percent and W owned 51 percent of the company stock. W served as president and H served as vice president. There were no other officers, but Blossom had 90 employees at six locations providing day-care services. Both H and W provided full-time efforts to support Blossom’s business.

   In 2002, H and W formed a separate S corporation for the purported purpose of providing management services to Blossom, its sole client. Blossom conveyed its interest in real estate to the S corporation via a quitclaim deed, but Blossom was not a shareholder in the S corporation. Pursuant to an oral agreement, Blossom paid management fees in the $200-300K range each year, but it paid no salaries to H and W. The S corporation paid salaries to H and W totaling from $40K to $73K per year, and it apparently paid appropriate FICA taxes only on those payments.

   The Service treated the management services payments as compensation to H and W, relying on the presumption that an officer of a corporation who provides more than minor services and receives remuneration for those services is a statutory employee for employment tax purposes. The scope and extent of services provided here supported that claim. Moreover, there was no formal agreement with the S corporation governing so-called management services, which the court viewed as a failure of proof by Blossom. The court also upheld the
Commissioner’s determination that the amounts paid were reasonable compensation. Notably, the amounts paid by their S corporation as compensation were deemed irrelevant to the determination of an employment tax deficiency for Blossom.

Comment: This was a poorly designed scheme. In a related income tax case, Blossom was required to recognize capital gains from the transfers that it failed to report. See TC Memo 2021-87. However, other transfers were found to have been made from the shareholders, not from the corporation. There is a potential “whipsaw” effect here because Blossom owes full employment taxes on the putative management fees, with no credit for the related salary payments by the S corporation. Query whether the S corporation and individual tax years are still open for the years at issue; a refund claim on the FICA taxes paid may be time-barred. Also note the potential impact on the shareholders from quitclaim deeds from Blossom to the S corporation they owned. Did that involve a constructive dividend to them? Perils abound when you choose to structure payments with related entities for tax avoidance purposes.

2. Theft loss from Ponzi scheme disallowed, Vennes v. Commissioner, TC Memo 2021-93. Taxpayers owned an S corporation (Metro Gem) that solicited investments from others, which were structured as loans, and then reinvested those funds in a fraudulent note scheme run by Thomas Petters, a well-known businessperson in Minnesota. Petters had invested in recognizable businesses including Polaroid and Fingerhut, and he used these business connections to induce others to invest in notes that were purportedly used to finance inventory purchases by other recognizable businesses, such as Sam’s Club. However, these transactions were fictitious. Funds were diverted to his personal use and eventually the scheme collapsed, leaving billions of dollars in losses.

Petters was convicted of fraud-based crimes and sentenced to prison. The entities he used in the scheme all filed for bankruptcy in 2008. Metro Gem filed a proof of claim as an unsecured creditor holding some $130 million of notes from Petters’ entities. However, the government filed a petition to put Metro Gem into a receivership so that its assets could be marshalled to benefit investors facing losses in the scheme. Those investors who loaned money to Metro Gem also brought claims against the company and Taxpayer for their role in the scheme. The trustee in bankruptcy for the Petts entities even piled on, seeking to claw back gains that Metro Gem allegedly made over the years in the Ponzi scheme. Taxpayer also was indicted for securities fraud and money laundering, and he made a plea agreement that resulted in a sentence of 180 months in prison. However, that agreement did not charge him with underlying knowledge of the scheme.

The receiver in charge of Metro Gem arranged for the company’s longtime accounting firm to prepare its tax return for 2008. That return reported a $43 million loss on notes held in the Pettis scheme under section 165(a) based on theft. Partnerships in which Taxpayers invested also claimed losses on these investments, which passed through to Taxpayers as partners and were reported on their 2008 returns. An audit commenced in 2012, and the Service disallowed both the partnership losses as well as the pass-through loss from the S corporation. This litigation followed.
The Taxpayers first sought to defend against adjustments to the partnership losses in their own audit based on the fact that the partnerships were TEFRA partnerships. Taxpayers argued that the adjustments should have been made at the partnership level, not at the partner level, as these were partnership items. However, an exception exists in the TEFRA regime for partnership items related to a receivership proceeding, which could be treated as a non-partnership item within the court’s jurisdiction to address in a deficiency proceeding.

As for the substantive claim of a theft loss, Taxpayers had to prove (1) theft occurred under the law of Minnesota; (2) the amount of the loss; and (3) the date of discovery. Minnesota law defines theft to occur “by swindling, whether by artifice, trick, device, or any other means”, which supported theft occurring in this case. However, the Service challenged Taxpayer’s proof of the amount and timing of the loss.

First, Taxpayers failed to prove the market value of the notes it had purchased from the Pettis group before and after the theft was discovered. Some of these notes had been issued in 2008, after Taxpayer was on notice that Pettis was late in paying on other notes. The Tax Court rejected claims that the notes could be valued at face value in these circumstances before the loss had occurred. After the loss, Taxpayer showed only that a third-party investor was not willing to pay face value, but a valuation was not obtained.

Second, Taxpayer failed to prove that there was no reasonable prospect of recovery in 2008, when the losses were claimed. Here, Taxpayers sought to rely on Adkins v. United States, 960 F.3d 1352 (Fed. Cir. 2020), which clarified that “no reasonable prospect” did not require “affirmative proof that a taxpayer’s loss will never be recovered.” However, the Tax Court agreed with the Service that Adkins was distinguishable here because of the extensive involvement of Taxpayers in the scheme, as well as the absence of a bankruptcy proceeding in Adkins. Metro Gem had unsecured claims that had not yet been adjudicated, and Petters’ criminal indictment left open the possibility of criminal restitution. Taxpayers argued that these prospects were illusory since there was a “clawback” claim by the bankruptcy trustee, but the court rejected that argument because any “clawback” would follow the recovery, which precluded proof of a loss at that time.

However, losses claimed by the partnerships and allocated to Taxpayers on their K-1s were held to be eligible for safe-harbor treatment under Rev. Proc. 2009-20. Losses from Metro Gem were not eligible, as among other things, the Taxpayers were held to have known of the fraudulent nature of the scheme, which precludes safe-harbor treatment. Taxpayer had been the chief executive of Metro Gem, and his longstanding dealings with Pettis should have led him to believe that something was awry. The court found that he either knew or deliberately avoided knowing of the scheme. The contrary finding in his plea agreement was not binding on the tax court.

Taxpayer’s knowledge (or constructive knowledge) was not attributed to the partnerships in which Taxpayers were limited partners. The safe harbor applied to them, and they were thus protected from IRS challenges to the underlying deductions. Fortunately for Taxpayers, in 2007 they had “cashed out” the limited partnership investments that were formerly held by Metro Gem and then reinvested in them in an individual capacity.
Comment: Those with theft losses may profit from examining the structural differences between the S corporation and the limited partnership in terms of qualifying for safe-harbor treatment. If Taxpayers had been a general partner, would they have had the same outcome? This taxpayer also may have suffered from a detriment in credibility based on his prior criminal record, which tended to support the court’s findings of actual or constructive knowledge. Losses here could have been claimed in a later tax year – but query: given the passage of time, did Taxpayers file a protective refund claim to prevent the statute from running against them?

3. Related party loans were distributions after financial crisis removed reasonable prospects for repayment, Kelly v. Commissioner, TC Memo 2021-76.

This is a complex case involving numerous intercompany transactions by a boom and bust investor in troubled real estate loans. Taxpayer and his brother used an S corporation, First Commercial Corp. (FCC) to capitalize special purpose entities used to finance various businesses. Later, they would use special purpose entities to purchase nonperforming loans secured by real estate, foreclose on the loans, and then later sell or develop the real estate for a profit. Eventually, Taxpayer formed his own company, Kelly Capital, a single-member LLC, to use as the vehicle for such acquisitions.

Often these ventures were successful. Taxpayer grew his business and had multiple professional employees running the books and doing compliance work. He acquired a Gulfstream aircraft and a yacht, reflecting trappings of his success. But timing is everything. The same processes that allowed them to purchase nonperforming loans for cents on the dollar eventually affected the properties that they acquired, depressing their values and leaving them in a disadvantageous position due to high leverage.

In 2003, Taxpayer acquired a publicly traded company, NSI, for $113 million. He planned to liquidate the assets of this conglomerate and to invest the proceeds in other businesses. He borrowed the funds, giving personal guarantees for the loans. After giving 5 percent of NSI to a trusted employee as a finder’s fee, he transferred the remaining 95 percent interest to Kelly Capital, his single-member LLC. As NSI generated cash from dispositions of assets, it had cash on hand that Taxpayer used to transfer to other of his companies for business ventures. These transfers were structured as loans in order to address NSI’s need to maintain a healthy balance sheet, in part due to the need to pacify plaintiff’s lawyers who had raised asbestos claims against the NSI.

By 2007, Taxpayer acquired the remaining 5 percent of NSI, making it a wholly-owned company. Between 2004 and 2011, NSI had transferred approximately $175 million to Taxpayer and his affiliated companies, all of which were characterized as loans. The loans were accompanied by promissory notes that provided for interest at the short-term Federal rate. Interest was accrued but not paid. Taxpayer also received $16.7 million from NSI during this period, which NSI also recorded as loans.

Among the other businesses in which Taxpayer invested was a hotel, which Taxpayer had initially acquired in 2002. He passed on an offer to sell the hotel for a substantial profit, choosing instead to renovate it. Significant funds were borrowed, and by 2007 over $100 million
had been invested, over $65 million of which was borrowed from outsiders and the rest financed through intercompany loans. In 2008, he tried to sell the hotel for $120 million, but he received offers of only $80 to 90 million. Eventually, it sold for $53 million in 2013, leaving Taxpayer with significant debt subject to personal guarantees. When added to other debts, including the acquisition cost of a Gulfstream aircraft, Taxpayer needed a loan workout.

In 2008, Taxpayer also organized a Cayman Islands corporation to acquire a yacht from a distressed seller – which was also financed by borrowing. He hoped to charter the yacht and repay the loans, but a soft U.S. market forced him to retreat to Europe, where sadly the yacht was damaged in a storm. The loan went into default, and by 2011 the lender repossessed the yacht. It was eventually sold for $3.3 million, generating another deficiency.

Unfortunately, the corporation that owned the yacht was a controlled foreign corporation, and Taxpayer failed to file Form 5471 during the 2008 or 2009 tax years. His accountant informed him of the error, and forms were filed late in 2019.

The business ventures continued to unravel. By 2008, Taxpayer attempted to recapitalize NSI, but by this time there was no prospect to repay the debts he owed. He continued to distribute advances from NSI to other of his companies, totaling $20 million in 2009-10. An asbestos lawsuit against NSI also produced a default judgment of $35.7 million, further crippling the company. NSI filed a bankruptcy petition claiming $300K in assets and over $44 million in liabilities, including unpaid asbestos judgments.

An audit commenced in 2012 to unravel this tangled web of taxable transactions, and that turned out badly for Taxpayer. A notice of deficiency followed in 2015 for the 2010 and 2011 tax years, with a second notice following on May 19, 2016 for the 2007-09 tax years. These notices included a fraud penalty, which was approved in writing before the notice were sent. Tax Court litigation followed.

Taxpayers defended on the basis of the statute of limitations for 2007-2009. The Service argued that the limitations period was extended based on filing false or fraudulent returns, but this theory was unsuccessful. However, Taxpayer had failed to file Form 5471 until 2019, which the court determined would keep the statute open until 2022 – but only for adjustments related to the CFC. Taxpayer appropriately relied on accounting professionals, who failed to file the form despite knowing that a CFC was involved. However, 2009 would remain an open year due to substantial omissions of income alleged by the IRS.

Taxpayer also successfully defended against fraud penalties, which the Service could not prove by clear and convincing evidence. Here, Taxpayer’s consistent reporting practices involving the loans aided his case in resisting a fraud penalty. According to the court, “Mr. Kelly respected his accounting staff. He respected the separate corporate entities and their accounting records, which recorded the transfers of funds generally as loans. *** Regardless of whether the loans were properly characterized as such for tax accounting purposes, the evidence does not prove that the loan characterizations were made with fraudulent intent.”
But the omission of income case would turn on whether the transactions characterized as loans were bona fide. While the formalities were apparently followed in each case and the transactions were duly recorded as loans, Taxpayer could not show the reasonable prospects for repayment existed after 2007, when the valuation of his properties had fallen significantly. After this time, some of the accounting practices also deteriorated. Transfers that could no longer be excluded from gross income as a loan would instead be analyzed through the lens of distribution provisions like section 301 (C corporation) and 1368 (S corporation). These determinations affected other aspects of the case, including the effect of debt distributions by NEC as well as potential COD income exclusions based on Taxpayer’s insolvency.

Comments: This case is factually complex, but it also addresses important tax issues involving transactions between related entities and their characterization. Those who omit filing Form 5471 should also note the prospects for relief when that filing is due to reasonable cause.

4. **S-Corporation law practice delivers tax lessons sole shareholder apparently did not learn in law school, Ward v. Commissioner, TC Memo 2021-32.**

Taxpayer was a lawyer practicing through an S corporation. She was the sole shareholder. Her return failed to match the information reported by the S corporation, including pass-through income and compensation paid to her as an officer of the corporation. When adjustments were made, Taxpayer asserted that the pass-through income was overstated because she was entitled to receive tax-free income in the amount of her basis. But of course, income is not the same as a distribution. Taxpayer also recognized and failed to report income from cancellation of indebtedness, which she failed to prove was excludable from gross income on account of insolvency.

Comment: Here is another lawyer who could have benefitted from taking tax classes in law school. You might get a better grade in “coloring for lawyers” and you got to assuage your fear of not being able to answer tough tax questions, but ultimately that ability proves helpful.

5. **Payments for management fees were disguised dividends, not deductible expenditures, Aspro, Inc. v. Commissioner, T.C. Memo 2021–8.**

At issue in this case was the deductibility of management fees paid to shareholders of C corporation engaged in the asphalt paving business. Taxpayer had three shareholders: Jackson Enterprises (40%), Manatt’s Enterprises (40 percent) and Mr. Dakovich (20%).

Dakovich served as president and ran day-to-day management. He routinely worked 12 hours per day. He received total compensation, including salary and bonus, ranging from about $350K to $550K during the 2012-14 tax years. He also received director fees from $40-50K and management fees ranging from $150K to $200K.

Jackson Enterprises was an S corporation that served as a holding company. It also owned 98% of Cedar Valley Corp., which operated two portable concrete plants. As a concrete contractor, Cedar Valley did not compete with Taxpayer on asphalt projects, but employees of the two companies consulted with one another on matters related to bidding on public contracts. Jackson Enterprises received management fees, even though it had no employees who could have provided services.
Manatt’s Enterprises is a C corporation engaged in farming. The president of Manatt’s Enterprises, Tim Manatt, had previously retired from one of the companies that owned Manatt’s Enterprises, which had also engaged in the road construction business through a subsidiary. Tim occasionally advised Dakovich on business matters for Taxpayer, but he kept no time records. He also engaged in some political activities involving local sales tax issues, but those activities long predated the years at issue.

Putative management fees paid by Taxpayer essentially eliminated its taxable income. They were also paid to shareholders in rough proportion to their interests in the company, and they were paid to the holding companies rather than the persons or enterprises employing those persons who actually performed services. There was a dearth of evidence showing that services were performed and/or the value of such services. In the case of Mr. Dakovich, the court also agreed that the management fees were not shown to be reasonable. In fact, there was reason to question whether his compensation was reasonable in light of the fact that it approached or exceeded the net income of the corporation, margins for the corporation were weak compared to competitors after compensation was included in the calculation, and the corporation never paid dividends. The claimed deductions for management fees were therefore disallowed.

Comment: This taxpayer’s approach may provide an object lesson about what not to do if you want to attempt to bail out earnings from a C corporation. Not only was there insufficient attention to documenting actual services and valuing them appropriately, requisite attention to the entities and persons providing putative services also seemed deficient. An appeal to the Eighth Circuit is pending in this case.


Taxpayer sought to deduct losses against pass-through income from his wholly-owned S corporation based theft losses incurred from a business partner or, alternatively the payment of nonemployee compensation to him. The Service disallowed those deductions, resulting in this litigation.

Taxpayer operated Water Warehouse. His former business partner (R) was no longer a shareholder, but she continued to manage the business. During 2016, Taxpayer was no longer able to work in the business due to an illness. He also apparently could not read, so he relied upon others to manage the books of account and prepare tax returns. In 2016, his bookkeeper advised Taxpayer to report $166,494 in nonemployee compensation to R, which purportedly represented funds she had misappropriated. By 2018, Taxpayer had learned to read and he began to handle tax matters on his own. He also filed a civil suit against R to recover the misappropriated funds. Water Warehouse was initially a plaintiff in that litigation, but in 2019 the complaint was amended to drop the company from the litigation, which remained pending.

Taxpayer filed the 2016 Form 1120S for Water Warehouse in 2018, when he also filed his personal tax returns. In 2019, the Service issued a notice of deficiency for the 2016 tax year. Thereafter, Taxpayer attempted to file an amended return for 2016, which claimed the theft losses. However, that return was not accepted and filed. This litigation ensued in the Tax Court.
The Tax Court agreed with the Service that no theft loss was appropriate for 2016. In order to prove theft, Taxpayer would have to show that it had occurred under state law. However, R asserted that she, as manager of the business, merely drew amounts consistent with “what she felt was her pay”. There was no proof that larceny had occurred. Moreover, the pending litigation alleged that he discovered the loss from R in October 2017 – which was after the 2016 tax year had ended.

On the matter of nonemployee compensation, Taxpayer likewise failed to prove a deduction was appropriate. The matter of her services was contested in the litigation, and he did not take the position of conceding she was owed these amounts. Accordingly, there was not sufficient proof that the amounts she drew were, in fact, compensation. However, taxpayer avoided penalties due to reasonable cause, rooted in his illness and his inability to read, which he remedied in 2018.

Comment: Taxpayer could have benefitted from better tax advice. And query: why was the corporation dropped as the plaintiff in the litigation against R? Isn’t the corporation the legal entity from which the distributions were made? This case shows the importance of respecting the entity and respecting the legal determinations associated with both theft and compensation. The taxpayer must choose carefully and act consistently with the choice. For another case in which theft could not be proven and a worthless stock claim was made too late, see Baum v. Commissioner, TC Memo 2021-46.


Taxpayers formed a corporation to develop a manufacturing system for corrugated metal pipe. They applied for tax exempt status in 2015, soon after the corporation was formed, alleging that the beneficiaries of the corporation would be government agencies that would ultimately benefit from the technology they hoped to develop. However, in the meantime its activities would be “scientific” because it would be conducting research that they hoped would produce technology to reduce the cost of public works projects. In the application, Taxpayers claimed they would own the rights to any such technology developed by the corporation.

The Service rejected the claim to tax exempt status, issuing a final adverse determination letter in 2017. A Tax Court petition followed, and the Tax Court agreed with that determination. The proffered activities were the same ones previously conducted by another closely held corporation, which proved unprofitable. The scientific activities here were related to commercial or industrial operations, which are not eligible for tax-exempt status. Moreover, the charitable ends that Taxpayers may have intended could not be proven. Taxpayers argued that their prototype equipment would lessen governmental burdens in the construction of public works project, but there was no evidence of such a lessening. Moreover, there was also private inurement here to the extent that Taxpayers would benefit from the activities of the company.

Comment: This case should dispel other hopeful inventors from trying the same tactic. One wonders how they reasoned that a charitable deduction could somehow induce investment ex ante where the prospects of participating in a profitable research activity would not.

Taxpayer (CM – a C corporation) participated in a transaction in 2009 in which it acquired the assets from a partnership, CMH, which had a magazine and internet sites. CMH also had a partner that needed to be bought out. So, the parties structured a transaction that involved the exchange of CM common stock for the assets, along with a separate stock repurchase agreement that would require CM to repurchase 1.875 million shares for $3 million, consisting of $2.7 million in cash and $.3 million paid on January 3, 2011. CM then paid this same consideration -- $3 million in total with $.3 million deferred -- for the interest of the exiting partner. Notably, the agreement required that any gain recognized to the partnership would be specially allocated to the departing partner.

On its 2009 tax return, Taxpayer reported that a section 351 transaction had occurred. However, it claimed amortization deductions based on the acquisition of intangibles for $3 million -- the amount ultimately paid to the departing partner. CMH did not report gain in connection with this transaction, and the departing partner reported capital gain from the disposition of his interest.

The Service did not audit the 2009 return, but it did audit 2010-12 returns. Deficiencies were proposed based on disallowing the claimed amortization deductions for section 197 intangibles that Taxpayer claimed to have acquired in this transaction.

The legal analysis in this case is complex, in significant part because the parties – both the government and the Taxpayer – agreed that there was a good 351 transaction in this case. In fact, there was reason to believe that this transaction was taxable because the 80 percent control requirement in section 351 was not met. If this had been a taxable transaction outside of section 351, the assets acquired from CMH would be valued at FMV and they would have a basis equal to FMV, which would have supported section 197 amortization deductions even greater than claimed by Taxpayer.

However, since both the Service and the Taxpayer agreed that section 351 applied, the result then turned on the structure of this transaction. If, as the documents indicate, the redemption transaction is to be viewed separately from the section 351 transaction, Taxpayer would not be viewed as acquiring intangibles other than those acquired with a carry-over basis. There is no section 197 intangible associated with repurchasing one’s own stock.

But if the stock redemption could be collapsed into the terms of the section 351 transaction, then the $3 million payment could be treated as “boot” and gain would be recognized to the asset transferors. That gain would be treated as potentially allocable to a separate section 197 intangible, which would thus be eligible for amortization. See Treas. Reg. 1.197-2(g)(2). In effect, the intangibles acquired from CMH would have their basis recovered using the amortization schedule used by CMH, but the excess basis resulting under section 362 would be treated as a newly acquired intangible and amortized under a new schedule.
So, which structure should be followed? The structure suggested by the documents would have clearly busted the control requirement due to the existence of a contemporaneous obligation to redeem shares at the time of the contribution. See Intermountain Lumber, 65 T.C. 1025 (1976). But again, neither the IRS nor the Taxpayer took that position. But the structure did treat the redemption transaction separately from the contribution of assets. If the taxpayer was going to get its way, it would have to be able to disavow that structure and effectively invoke step transaction principles to treat the $3 million payment as boot.

That is what makes this case so interesting. Ordinarily, Taxpayers must follow the structures they negotiate. But here, Taxpayer was able to convince the Tax Court to allow it to follow the structure that would permit higher amortization deductions. Although Commissioner v. Danielson (3d Cir. 1967) requires a taxpayer to be bound by the terms of the deal he negotiated, the Tax Court does not follow Danielson unless appeal lies to the Third or Fifth Circuits. In effect, the Tax Court retains its ability to analyze transactions according to their substance whether the taxpayer or the government seeks an alternative view from the form reflected in the documents. Here, the court found that policy concerns in Danielson were not presented, as there was no whipsaw position in the taxation of the transaction. All the parties treated the transaction consistently with the way that the Taxpayer sought to treat it in this case.

Although the outcome depended on particular calculations, Taxpayer got most of what it wanted in this case.

Comment: This case has generated considerable commentary, including an extensive piece by Richard Lipton and Brandon King found at 134 J. Tax’n 14 (2021), who conclude that this case may provide “a glimmer of hope to tax practitioners who are looking ‘after the fact’ at a completing transaction and are trying to determine the tax consequences.”

VII. Partnerships.

1. Notable administrative developments on basis reporting.

Draft instructions for partnership tax basis capital reporting were first issued late in 2020, IR-2020-240 (October 22, 2020), https://www.irs.gov/newsroom/irs-releases-draft-form-1065-instructions-on-partner-tax-basis-capital-reporting. After the draft, Treasury announced that it will be looking at comments to improve the matter of capital account reporting, which has produced variable and often confusing outcomes. Subsequent drafts were issued, including the final version on February 12, 2021.

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.

Finally, Notice 2021-13 provides conditions for penalty relief as preparers wrestle to understand the new reporting requirements.

Taxpayers held a partnership interest Cedarwood Ventures, LLC, in 2006. On their 2006 return, they reported $1.5 million as a capital gain on line 13. This figure also appears on Schedule D as a long-term capital gain from a partnership. However, on Schedule E, where Taxpayer was required to list the distributive share of income from each partnership interest they owned, only the name of the partnership was reported.

The Service audited Taxpayers’ return in 2011. After the return was filed, Cedarwood filed its 2006 partnership tax return. Cedarwood had only six domestic partners, and it did not make an election to be treated as a TEFRA partnership.

During the audit, taxpayers consented to extend the limitations period for their 2006 tax year until December 31, 2017. On November 28, 2016, the Service issued a notice of deficiency determining that Taxpayers should have reported capital gain of $4.9 million, which reflects their distributive share of gain that Cedarwood should have reported on option transactions. A Tax Court petition followed.

Taxpayers and the Service moved for summary judgment on the timeliness of the notice of deficiency. Section 6501(a) generally requires that the Service must assess a deficiency within three years after Taxpayer files his return. However, section 6501(e) extends that period to six years if two conditions are satisfied: (1) Taxpayer omits more than 25 percent of the amount of gross income stated in the return; (2) that omitted amount is not adequately disclosed.

Here, Taxpayers argued that they did not “omit” the capital gain from their return, but instead they only under-reported it. The Tax Court rejected this argument based on its decision in Estate of Fry (1987), which treated understatement as sufficient under the statute. As for the matter of adequate disclosure, this was a question of fact. As the court pointed out, “[i]n a quintessential case of adequate disclosure, the taxpayer errs in computing gross income but fully discloses the amounts underlying the error elsewhere in the return.” Where there is adequate disclosure by the partnership, that has been held to be sufficient. But here, no partnership return was filed that would have given the IRS a basis to discern the understatement. Taxpayer’s failure to identify the source of the capital gain on Schedule E, coupled with the partnership’s failure to report, did not provide an adequate disclosure to avoid the six-year limitations period in this context.

Comment: In a context like this one, it seems nearly impossible to satisfy the adequate disclosure requirement without some form of supplemental schedule that would put the IRS on notice that computations of gain were seriously awry. Also at work here is a policy that Taxpayers should not be able to benefit from the failure of their partnership to file proper information returns.
3. Gross income from receipt of a partnership interest for future services is a partnership item for the recipient, ES NPA Holding, LLC v. Commissioner, TC Memo 2021-68.

Petitioner, an LLC classified as a partnership, filed a petition to challenge a FPAA issued on March 2017 that related to the 2011 tax year, which determined that Petitioner omitted $16.1 million from income. The FPAA did not state specific reasons for the adjustment, but the parties stipulated that the adjustment related to its receipt of a 50 percent capital interest in another partnership, or alternatively to an indirect interest in another downstream entity that was subsequently acquired by that partnership. Petitioner allegedly received this interest in exchange for a contribution, along with a promise to provide future services to improve consumer loan businesses that have been contributed to these partnerships by their former owner, who was seeking ultimately to sell his interest in those businesses.

Petitioners argued that the Tax Court lacks jurisdiction in this case, as the FPAA here erroneously determined that the receipt of the partnership interest was a partnership item, when instead it should be treated as a partnership item associated with another partnership in this tiered ownership structure. However, that position was rejected. When, as here, a partnership receives an interest in another partnerships, that does not involve the receipt of a distributive share of income from another partnership – which would not be a partnership item. The property right received is itself a partnership item. The ultimate determination of the amount of income from the receipt of that item would depend on further factfinding – including the matter of whether it was a capital interest or a profits interest, which could not be resolved on summary judgment.

Comment: Tiered partnerships present challenges in determining the proper forum for making adjustments as well as challenging them.

4. Partnership that engaged in Son of Boss transactions was not bona fide, BCP Trading and Investments, LLC v. Commissioner, 991 F.3d 1253 (D.C. Cir. 2021), affirming TC Memo 2017-151.

Individual taxpayers were members of limited partnerships that, in turn, were members of an LLC, BCP Trading, which is the subject of this tax case. Several of the individual taxpayers were senior executives in large U.S. corporations with large incomes. Guided by E&Y and with entities fronted by former E&Y employees, including BCP Trading, these taxpayers participated in tax shelter transactions affecting the 2000 and 2001 tax years. Those transactions included “Son of Boss” transactions involving pairs of option contracts that were designed to produce large losses in connection with the ultimate disposition of foreign currency received in liquidation of a partnership interest. Partnership tax rules were thus at the core of the strategy, and disregarding the partnership would thereby produce the unraveling of the entire strategy to the detriment of individual taxpayers who claimed to partners (or limited partners receiving pass-through treatment from other partnerships).

The IRS attacked these transactions, which landed the partnership in the Tax Court. The Tax Court ruled for the IRS on all relevant points, including the validity of decisions by the Tax Matters Partner to extend the statute of limitations and to uphold deficiencies on the basis that the partnerships could be disregarded. This appeal followed.
The D.C. Circuit upheld the Tax Court on all counts. On the matter of extending the limitations period, the taxpayers argued that actions of the tax matters partner to extend the period, thereby affecting all of the members, were invalid based on principles of agency and fiduciary law. Although the IRS cannot knowingly profit from a fiduciary who breaches his duty to beneficiaries (see United States v. Dunn, 268 U.S. 121, 132 (1925) (“he who fraudulently traffics with a recreant fiduciary shall take nothing by his fraud”)), there was no showing that the Tax Matters partner breached a fiduciary duty here. The facts of this case differed from other partnerships where the Tax Matters partner was under investigation for criminal activity, and thus had incentive to cooperate in order to benefit at the expense of his beneficiaries. Moreover, taxpayers executed individual extensions in this case. They tried to pin this on E&Y, who was advising them, but the court rejected such claims, suggesting that taxpayers were on notice that E&Y was under investigation for their plan, and that they should know to be wary.

On the matter of disregarding the partnership form, the D.C. Circuit affirmed the Tax Court’s legal analysis and upheld its conclusion. Significantly, the partnership did not engage in business together or pursue any legitimate profit-seeking activity, but instead was merely a façade for seeking tax benefits. There was adequate evidence in the record to show that non-tax motivations were fabricated; no valid business purpose was present.

Comment: This opinion provides an instructive example of why these shelters are troublesome: one taxpayer partner had salary income of $492.5 million, capital gains of $35.4 million, but combined losses of $533 million from his participation in the partnerships – reducing his federal tax liability to only $2.7 million. Another taxpayer earned $83.7 million in salary income but ultimately reduced his liability to $14,446 in self-employment taxes and received a net refund of $5.2 million. These taxpayers got caught, but query how many did not.

5. Son of Boss deficiencies affirmed for TEFRA partnership, Greenberg v. Commissioner, No. 20-13001 2021 WL 3700294 (11th Cir. 8/20/21)

Greenberg was a CPA with experience at Big Eight accounting firms. He and Goldberg, an attorney, formed a partnership, GG Capital, in 1997. It purported to be involved in an active business involving “digital option spreads”, although the Tax Court did not find many facts to support this claim. In 1999, Greenberg and Goldberg formed a related partnership, which it used to pursue some of the option tax strategies.

During 1999-2001, Greenberg assigned his accounting firm income – ranging from about $600K to $900K per year during 1999-2001 – to the partnership, supposedly for the purpose of offsetting that income with losses generated from investment strategies. During this time, he was a partner at KPMG and a member of a practice group that sold tax shelters to corporate clients.

Several putative transactions occurred during this time, but documentation was in short supply. Greenberg prepared the partnership tax returns and K-1s for he, Goldberg, and other partners. These returns showed multi-million-dollar losses.

Notices of deficiency followed, which disallowed the claimed losses. The Service took the position that certain entities involved in these transactions were shams. In 2008, it took a further step of notifying Greenberg that because he was the subject of a criminal tax
investigation, his partnership items would be treated as non-partnership items. See IRC § 6231(c). As the Service viewed these entities as shams, their role was disregarded in favor of treating the putative partners as though they engaged in the transactions directly.

Tax Court litigation ensued, with the court siding with the Commissioner on almost all points but finding for the taxpayer on the matter of some penalties for which supervisory approval was not met. Greenberg appealed.

In a lengthy analysis, the Eleventh Circuit upheld the Tax Court’s rulings on a variety of procedural matters, including the timely mailing of a notice of deficiency, the validity of the notice of deficiency, the application of TEFRA partnership rules to a partnership with fewer than ten partners, the statute of limitation where a partnership item is converted to a non-partnership item, and the jurisdiction of the Tax Court over an individual taxpayer’s deficiencies where putative partnership transactions affect those deficiencies. The Eleventh Circuit also upheld the substantive tax adjustments from these tax shelter transactions.

Comment: Each year, I wish that last year’s program would have included the last Son-of-Boss partnership decision I will ever have to wade through. Maybe next year that wish will come true.

6. Taxpayer could not sustain challenge to underlying liability for distributive share of partnership income, Dodd v. Commissioner, TC Memo 2021-118.

After two trips to the Tax Court that resulted in remands to Appeals over Taxpayer’s CDP claim, Taxpayer took a third trip to review the final denial of her challenge to underlying liability in connection with reported but unpaid tax liability in connection with a real estate partnership in which she was a member. Taxpayer had reported over $1 million in gain representing her share of income from a partnership disposition of real estate, but she did not pay the tax when she filed her return. Taxpayer instead claimed that she did not get any proceeds from the sale because those proceeds were required to be paid to reduce other debt pursuant to an agreement with the partnership’s lenders. The Service assessed the tax and sought to collect it. However, Taxpayer convinced the court that she had timely raised an objection to the underlying liability that had not been properly addressed. The Tax Court agreed. On its third review, Appeals finally determined that Taxpayer owed the tax, and Taxpayer again sought review in the Tax Court.

The Tax Court agreed with the Service. Taxpayer was taxable on her distributive share of gain regardless of whether the partnership sales proceeds went to pay off debt. Here, Taxpayer had guaranteed that debt and was relieved of her share of liabilities totaling over $600K. But her liability for partnership gain is independent of whether she “constructively received” the proceeds or not – liability is based on the distributive share being taxable to her under section 702.

Comment: Taxpayer did not understand partnership tax. It was unfortunate that these arguments could not have been ascertained and dismissed the first time around.
7. Partner made loans, not capital contribution, triggering COD income upon termination, Hohl v. Commissioner, TC Memo 2021-5.

In 2009, four partners formed an LLC that entered into a business of providing text message advertising. Their operating agreement (which I will refer to as a partnership agreement below) set forth capital contributions and ownership interests. Three of the partners contributed no money but provided services to the partnership, with each receiving a 30 percent interest in the business. The fourth partner, Rodriguez, contributed $265K and received a 10 percent interest.

Although the partnership agreement had a provision for allocating profits and losses based on capital account balances, that was not followed. It appears that profits and losses would be shared on the 30-30-30-10 basis of their ownership interests. However, the partnership had only losses and it also made guaranteed payments to the service partners. Accordingly, the three service partners had negative capital accounts at the end of year 2009.

Rodriguez made additional infusions of cash totaling $653,506 over the ensuing years, which the partnership recorded as loans. The partnership also continued to hemorrhage cash through expenses and guaranteed payments during the 2010-12 tax years. The partners reported the pass-through of these losses and did not report any basis limitations under section 704(d).

In 2012, the partnership submitted its final return, which showed negative capital account balances for the partners. The return also showed a remaining liability to Mr. Rodriguez of $653K, but no partner reported a share of that liability; neither did any partner report income from discharge of indebtedness.

The Service examined the returns of the service partners, determining a deficiency for each one based on $178K of unreported income due to cancellation of indebtedness. Hohl and Blake petitioned the Tax Court, and a third partner agreed to be bound by the outcome.

The Tax Court first examined the fact question of whether Rodriguez had provided capital contributions or loans to the partnership. Despite the absence of a written loan document, the court viewed the parties’ intention as providing a loan, not a capital contribution. Nothing in their partnership agreement reflected additional capital contributions from Rodriguez. His ownership percentage did not change after making additional contributions that were not shared by the other partners. As for the third factor considered in Greenberg, TC Memo 1992-292, the court also noted that no other lender would have given the money to the business. Despite the negative implications from that factor, the court went with the other evidence of intention to establish a loan.

The working relationship with Rodriguez provided that the loans would be repaid when the business became profitable, which did not happen. Moreover, it would never happen because the business ended in 2012. This provided the triggering event for cancellation of indebtedness income. The Tax Court allocated that income in the manner that the partners had allocated other losses, rather than using the formula in their partnership agreement, which was never followed. That allocation was based on the determination that the loan was a recourse liability, which was consistent with the way the partners treated the debt on their books. Under the regulation under
section 752, a partnership liability is recourse to the extent a partner bears the economic risk of loss. Here, the court viewed that risk as borne by all the partners, including Rodriguez. That was also consistent with how the partners viewed the debt for purposes of determining their basis and the allowable pass-through losses in 2009, but for 2010-11 it did not allocate the liability to any other partner besides Rodriguez, and in 2012 it did not allocate the liability at all.

Taxpayers raised another argument: if the partnership received cancellation of indebtedness income, it would increase their basis in the partnership interests and potentially trigger an abandonment loss in 2013. The court agreed, but the amount of the loss depended on the calculation of their outside basis in their respective interests. The court began with a basis of zero – which it determined was the value of the business when the service partners obtained their interests at the inception of the business. (But is this correct? Is a start-up worth nothing when Rodriguez was willing to put in over $200K for ten percent?)

It then rejected the Taxpayers’ claim that their guaranteed payments increased their basis. Those payments were deductible expenses to the partnership, which were reflected in the partnership losses. However, Taxpayers’ basis increased by the share of the Rodriguez loans each year, which was necessary to allow the pass-through of losses to them. But those losses further reduced their basis, which in fact had become negative. Even the discharge of indebtedness income that passed through to them in 2012 would not avoid taxable income in this case.

Finally, one of the taxpayers, Hohl, argued that he qualified for the insolvency exception. However, the court rejected his claim based on a failure of proof of the amount of insolvency during 2012.

Comment: This case presents many partnership tax issues. Was this really a recourse debt? If the partners agreed it would only be repaid if the partnership became profitable, doesn’t that seem like nonrecourse debt? And if Echo was an LLC, wouldn’t that also suggest nonrecourse treatment? If so, would any of the service partners bear an economic risk of loss? And if that was the case, shouldn’t all of the losses have been allocated to Rodriguez, who financed them? The loose treatment of this arrangement created problems that could have been avoided with more careful planning and better tax advice at the outset. I would also bet that Rodriguez is not going to report this transaction consistently based on the outcome of this case. Blake has appealed to the Ninth Circuit and Hohl has appealed to the Tenth Circuit, presenting some interesting future possibilities for conflicting tax outcomes. Stay tuned for more next year. For additional critical commentary, see Sheldon Banoff, Shop Talk, 134 J. Tax’n 131 (June 2021).

8. Recharacterization of subordinated debt into equity results in gross income for partners in Chicago Cubs, Tribune Media Co. v. Commissioner, TC Memo 2021-122. This case arose from the leveraged acquisition of the Chicago Cubs in Spring 2009. Various entities owned by the Ricketts family acquired a 95 percent interest in the Cubs, with the remaining 5 percent held by Tribune Media.

Tribune dictated the terms of the sale, and it required a highly leveraged deal in which the partnership formed to acquire the Cubs from Tribune Media (known as “CBH”) would make a
significant cash distribution – over $700 million – to Tribune following its contribution of the Cubs and related assets. Tribune itself entered bankruptcy during the negotiations, but the transaction was eventually approved by the bankruptcy court.

Some of the debt to be incurred by the acquiring partnership would come from banks, with the balance consisting of subordinated debt coming from related parties. The debt was subject to a security agreement that included a “cash waterfall”, in which operating revenues would be diverted to secure the payment of banks first, subordinated debt last. Although the subordinated debt had a nominal maturity of fifteen years, expert testimony showed that this debt could be extended depending on the partnership’s ability to pay senior debt first.

At closing, Tribune executed guaranties in favor of the creditors, which were intended to secure repayment of the principal and interest due. At the time of closing in 2009, Tribune was in bankruptcy and had no credit rating. An internal accounting memorandum prepared by Tribune at the time of the transaction accorded no value to the guaranties as they viewed the possibility they would be called as ‘remote”. However, in 2012, shortly before Tribune emerged from bankruptcy, S&P provided a credit rating report that considered the guaranties to be a “significant financial risk” for Tribune.

Tribune reported the transaction with CBH as a “disguised sale” and reported both loss and gain as a result. However, CBH reported that Tribune had a significant basis in the partnership interest based on its guarantee of debt, including subordinated debt loaned by Ricketts’ family members and related entities.

In a 127-page opinion, the Tax Court first provided a tour of the rules governing disguised sales and debt-financed partnership distributions. Tribune’s position depended on the efficacy of its guaranties, as well as on the court’s respect for the debt structure engineered by the parties.

After wading through thirteen factors from its decision in Dixie Dairies, 74 T.C. 476 (1980), the court concluded that the subordinated notes more closely resembled equity than debt. Without the ability to treat the subordinated notes as recourse debt, Tribune would be unable to allocate basis to their partnership interest based on their theory that they bore the economic risk of loss associated with debt. That would, in turn, increase the taxes due associated with cash distributions received from the partnership (technically, an LLC) financed by the putative notes.

Tribune’s position also depended on the senior debt, lent by banks, being characterized as recourse debt and allocated to them because they bore the economic risk of loss. If that debt was nonrecourse debt, in which no partner had the economic risk of loss, then the allocation method would not favor Tribune, which had only a five percent interest in the partnership.

Here, the court focused on whether Tribune’s guaranties affected the economic risk of loss under the constructive liquidation test in Treas. Reg. § 1.752-2(b)(1) (which I tell my students involves the “doomsday assumptions”). The Service took a very restrictive approach to these events, arguing that the senior debt did not become due and payable upon liquidation, but only after lawsuits would have exhausted all other remedies in law and equity. The court
rejected this view, finding that Tribune would indeed bear the economic risk of loss on account of its guarantees, despite some intermediate requirements for creditors’ exhaustion of other legal remedies.

The Service also argued that the anti-abuse rule of Treas. Reg. § 1.752-2(j) allowed it to disregard the payment obligation if it creates “an illusion of the partner’s economic risk of loss without actually subjecting the partner to real financial risk.” Here, the Service relied on various “buffers” that would allegedly shield Tribune from liability under the guaranties, including the interest of the Ricketts family in keeping the team afloat. But the court noted that in a constructive liquidation, the team would be valueless and there would be no incentive to put further cash into the venture. Other common lender protections were also rejected on this basis. As the court noted, “The constructive liquidation test does not posit an expected occurrence; rather, it tests the worst-case scenario, going so far as to assume that even cash is rendered worthless.”

The Tax Court also distinguished this case from that of Canal Corp, 135 T.C. 199 (2010), the only other case to invoke the anti-abuse rule. And it likewise rejected substance over form principles and the general anti-abuse rule found in Treas. Reg. § 1.701-2(a). There was a bona fide business and legitimate business purposes functioning here. Unlike partnerships that had no nontax purpose which might well fail under this analysis, this was a legitimate business. And even if there could have been a challenge to the subordinated debt, the senior debt lent by banks involved a legitimate business arrangement. Tribune bore real consequences from the guaranties, as they affected its credit ratings. And the parties benefitted from them, such as through the likelihood of a more favorable interest rate. Moreover, as to the disguised sale, this was reported accurately by the parties. Substance over form is designed to recharacterize based on economic substance, but the parties here reported the true economic substance of the transactions, albeit with partial recharacterization as noted above.

Finally, the court took up the issue of the deductibility of $2.5 million in expenses that Tribune paid to induce another potential bidder for the Cubs. Tribune agreed to fund the bidding expenses of Utay, who was called in to stimulate continued bidding by the Ricketts family when their initial negotiations stalled. Tribune argued that the fees were deductible expenses, but the Tax Court concluded that they should be capitalized. Rather than a deductible loss on an abandoned transaction, the Tax Court viewed these expenditures as supporting the partnership structure that Tribune desired and facilitating the transaction it ultimately wanted to execute. In effect, Utay helped achieve the transaction they desired – either closing by the Ricketts family or closing with Utay’s group. This expenditure produced a substantial future benefit for the partnership.

Comment: This is an important partnership tax decision that practitioners in this area will want to study carefully. The restrictions on anti-abuse rules articulated here are taxpayer-friendly and provide helpful clarification. Tribune still likely receives significant tax deferral in connection with the sale as a result of using this leveraged partnership structure to facilitate the deal. And if they get basis in their partnership interest for the $2.5 M in fees that had to be capitalized, that should mean lower taxable income from distributions. A little good news can even be found in a loss.
9. Supervisory approval of penalty is a partnership-level defense barred in refund litigation by partner, Ginsburg v. United States, 17 F.4th 78 (11th Cir. 2021).

Taxpayer was a partner in a purported partnership, which in 2001 reported an aggregate total loss of $25,618. However, Taxpayer reported a loss of $10 million from the partnership on his 2001 return. The Service audited the partnership and determined it was a sham formed for tax avoidance purposes. It notified the partnerships and the partners that it was disregarding the partnership, that the purported partners would not be treated as partners for tax purposes, and any losses would not be allowed as deductions. It also determined that a 40% penalty for gross valuation misstatement would be imposed. Taxpayer received a FPAA showing disallowance of his $10 million loss plus the 40% penalty.

A partnership-level proceeding commenced in the Tax Court, in which Taxpayer joined as a party though not as a tax-matters partner. In that litigation, Taxpayer conceded that the losses allocated to him were not allowable as he was not at risk and the partnership allocations lacked economic substance. However, Taxpayer contested the application of the gross valuation misstatement penalty on the ground that he conceded the case on a basis other than valuation. Departing from its prior holdings, the Tax Court held that this concession was not an effective defense to the penalty. AHG Investments, LLC v. Commissioner, 140 T.C. No 7 (2013). No mention of supervisory approval was raised in this proceeding.

Taxpayer then paid the tax and penalty and filed a refund claim. Before the Service, he argued that he was entitled to a refund of the penalty and related interest because he reasonably relied in good faith on professional advice. The Service rejected these arguments, and Taxpayer filed a refund claim in the Middle District of Florida. The Government moved for summary judgment on the ground that he could not and did not reasonably rely on professionals, but Taxpayer moved for summary judgment on the basis of a lack of supervisory approval in advance of penalty assessment, raising that issue for the first time.

The district court granted summary judgment to the Government and denied Taxpayer’s motion. On the matter of supervisory approval, the court determined that Taxpayer was barred from raising it as he failed to raise it before the Service in his administrative claim.

The Eleventh Circuit affirmed. Not only was the supervisory approval issue barred because of the failure to exhaust administrative remedies, but it was also a partnership-level determination. While a partner in a TEFRA partnership can raise individual-level defenses, such as reasonable cause, it may not raise supervisory approval as this is a defense that would apply to all the partners.

Comment: This is a tough outcome and a reminder of the complexity of refund litigation. The supervisory approval defense was likely not on the radar in 2013, when this matter was being litigated, as Tax Court’s decision in Graev, 149 T.C. 485 (2017), which overruled prior precedent, came much later in time. Accordingly, Taxpayer’s counsel may not have foreseen the defense when making the administrative refund claim. Counsel in this case cannot be faulted, as no one’s crystal ball allows a clear view of the future development of tax law. Taxpayer also learned this lesson the hard way back in 2013 with the Tax Court’s decision to change its
approach to the gross valuation penalty, thereby taking away what had previously been a valid defense.

10. Carried interest FAQs and Worksheets, IR-2021-215 (11/3/2021)
    This news release contains a link to a FAQ page and other materials designed to be helpful in fulfilling partnership reporting obligations connected to certain partnership interests held in connection with the performance of services, known as “carried interests.”

VIII. 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 two years. 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. Those returns are challenged below.

2. Returns filed after audit did not prevent disallowance of associated deductions, Adams
Following an adverse determination for this Taxpayer on the matter of effectively
connected income, see 154 T.C. 37 (2020), the Tax Court took up another issue affecting this
foreign taxpayer. Taxpayer failed to file 2009 and 2010 tax returns because it believed it had no
effectively connected income. However, in February 2017 taxpayer filed protective returns
showing no income or deductions, which also included an attachment that explained its position.
These returns were filed after the IRS had already prepared substitute returns and issued a notice
of deficiency. Based on regulations under section 882(c)(2), the Service alleged that Taxpayer
was not entitled to any deductions or credits in the computation of its 2009 and 2010 taxable income because it had failed to file a return.

The Tax Court agreed with the Service. Section 882(c)(2), which conditions a foreign corporation’s ability to claim deductions and credits on filing a true and accurate return, implements a longstanding federal policy that is designed to induce disclosure by foreign corporations. Prior decisions had interpreted the filing requirement to include untimely filing, but only if that filing was before the Service has prepared a substitute return and issued a deficiency notification. Case law that preceding and following applicable Treasury regulations upheld this position, which was consistent with the policy of inducing disclosure through properly filing a return. If Taxpayer could wait to file until after a notice of deficiency was issued and still avoid the loss of deductions, there would be little or no inducement to change behavior to avoid that risk.

Regulations issued in 1990 prescribed a fixed date -- 18 months after the due date – to clarify these issues. But those regulations loosened the requirement of filing a “true and accurate” return by allowing a foreign corporation to file a return reporting no gross income or deductions, stating that it was filed for protective reasons (as Taxpayer did in this case, albeit long after the deadline). Subsequent regulations also provided that a bilateral tax treaty would not immunize a foreign corporation from meeting filing deadlines. The loss of deductions could only be avoided in a narrow set of circumstances where “good faith” had been shown.

Taxpayer challenged those regulations under *Chevron*, but the Tax Court concluded that even under prior authority, the outcome would have been to disallow deductions. The court also upheld the filing deadline in the regulations from this challenge.

Finally, the court also rejected a claim that the Treaty ratified between the UK and the US in 2003 mandates the allowance of deductions in this context.

*Comment:* International tax practitioners should study this decision carefully and remind clients with a plausible case for effectively connected income to file those protective returns.


Taxpayer had been an active member of the Army Reserve, which included a deployment in Iraq from 2003-05. She returned to civilian life, but she became dissatisfied with the corporate world. Instead, she began to pursue opportunities as a military contractor. Ultimately, she settled in a position in Afghanistan, which required her to live on base in Kandahar. Due to local conditions, she spent most of her time on the base and it would have been inadvisable to purchase real estate or otherwise become part of the local culture.

She maintained a property in Texas and visited it when she returned to the U.S., although she spent little time here: 22 days in 2012, 42 days in 2013, zero days in 2014, and 40 days in 2015. Her position in Kandahar ended in 2016 and she returned to the U.S. for a time while she looked for other positions abroad. Eventually, she was able to return to Kandahar in another position.
Taxpayer failed to file U.S. returns while she was working at the base, but when she learned of the obligation to do so, she filed returns from the 2012-16 tax years. The returns were prepared by a company that specialized in Americans living abroad. In each year, Taxpayer claimed an exemption from gross income under section 911 of the Code, which the Service contested.

Taxpayer was able to prove both a foreign residency and a tax home in a foreign country, rather than in the U.S. She did not work in the U.S. since 2011, and the nature and duration of employment supported her foreign residency. Although she did not assimilate into the local Afghan population, she did become part of the particular community available to her – the residents of Kandahar Airfield. Moreover, Taxpayer showed that her ties to the United States were very weak – limited to specific visits to parents and short visits to check on her property in Texas. Her tax home was in Afghanistan, not in the U.S. Taxpayer satisfied her burden for 2012-15, but only for a pro rata portion of 2016 while she lived in Texas for a time and filed for unemployment compensation while she looked for another position.

Taxpayer was thus eligible for the foreign earned income exclusion. Moreover, due to her service in a combat zone, she was also eligible for additional time to file her returns.

Comment: This taxpayer’s situation differed from many others working in foreign environs due to the limited ability to assimilate into local culture on account of combat zone restrictions. She benefitted from a remote trial of these issues.


Taxpayer is a U.S. citizen who resided outside the U.S. with a mailing address in France. She filed her 2013 return as married filing separately, and she claimed a foreign tax credit of $63,632 based on tax payments to Italy and France during the taxable year, along with a carryover of unused credits from prior years. This resulted in zero taxes owed as reported on line 61 of the return. However, Taxpayer also reported Form 8960, which included net investment income tax of $11,540. Rather than reporting it on line 60 of Form 1040, she modified form 8960 to include an offset for foreign tax credits. Accordingly, she reported no net investment income tax due on account of those credits. She also attached Forms 8833 to disclose her treaty-based positions for Italy and France that supporter her position that the foreign tax credits offset net investment income tax.

The Service treated the $11,540 credit as a math error and assessed the additional tax due. Because of this characterization, there was no notice of deficiency. Taxpayer contested the characterization, asserting that there was no math error but only a foreign tax credit offset being claimed. Taxpayer protested the Service’s rejection of this position, which Appeals treated as a claim for refund, which it denied. Collection notices started coming, even during the pending protest. On August 20, 2018, the Service assessed an additional penalty of $2885 for failure to pay the tax, and a final notice of intent to levy came in September 2018. Taxpayer requested a CDP hearing, but the proposed levy was sustained, leading to a Tax Court petition.
The Tax Court reviewed the legal determination on the matter of the credit under a de novo standard, and it found that this issue was properly before the court. After all, there was no prior opportunity to contest the underlying tax liability, as no notice of deficiency was ever issued. The Tax Court rejected Taxpayer’s foreign tax credit claims, finding first that the net investment income tax is structurally separate from the taxes to which the foreign tax credit applies. Sections 27 and 901 provide for the foreign tax credit against taxes imposed by Chapter 1 of the Code, but section 1411 is found in Chapter 2A. This dichotomy is reflected in Treas. Reg. § 1.1411-1(a), which provides in part that “[e]xcept as otherwise provided, all Internal Revenue Code (Code) provisions that apply for chapter 1 purposes in determining taxable income (as defined in section 63(a)) also apply in determining the tax imposed by section 1411”, does not permit a foreign tax to be credited against net investment income taxes. This is explicitly stated in Treas. Reg. § 1.1411-1(e).

Second, the Tax Court addressed the matter of whether treaties somehow changed these Code provisions. The Treaty provisions generally dealt with avoiding double taxation. Moreover, the provisions predated the enactment of section 1411. As a general rule, treaties have precedence over statutes. However, in this case, the treaties specifically referenced the law of the United States (as it may be amended from time to time) as governing the credit provisions. Given that the Code is specific in limiting the scope of the credit – and the court viewed the structure of the Code in creating a separate chapter for section 1411 as intentional and significant – this permits the restriction imposed by U.S. law. The general purpose of the treaty provision – avoiding double taxation – could not override the specific way in which the treaty was written, which contemplated legal changes and limitations.

Summary judgment was entered against the Taxpayer on the matter of the foreign tax credit, but she was able to continue her proceedings on the matter of whether she had reasonable cause that would permit her to avoid the addition for the failure to pay penalty.

Comment: This case illustrates the procedural rule for substantive review of a levy where there is no prior opportunity to dispute the underlying obligation. In this case, the math error approach was invoked. It is also helpful in showing the importance of structure as reflecting the content of the Internal Revenue Code – those provisions that refer to structure, such as Title or Subtitle or Chapter, mean something. We do well to pay attention to them. International tax experts will also find the treaty discussion helpful.

5. FIRPTA withholding by real estate purchaser not subject to declaratory judgment, Gilbert v. United States, 997 F.3d 410 (9th Cir. 2021)

Buyers contracted to buy real estate from a foreign entity. The contract for deed required Taxpayers to pay $1.2 million in a series of payments, including a lump sum down payment and the balance by installments with appropriate interest. The seller guaranteed the property was not encumbered, but a title search after executing the contract indicated federal tax liens on the property. The contract was amended to require the seller to resolve these lien issues prior to closing.

In August 2017, Buyers notified the seller that they were required to withhold a portion of the purchase price under FIRPTA and interest payments under the FDAP rules. However,
Seller disputed that these rules were applicable. Buyers then filed a suit in federal district court seeking a declaratory judgment that withholding did not breach the terms of their contract. In the meantime, Seller declared their nonpayment to be a breach that accelerated the entire balance. The district court denied Buyers’ claim due to lack of subject matter jurisdiction because their requested relief involved federal taxes, for which relief is not allowed under the Declaratory Judgment Act, 28 USC § 2201. Buyers appealed.

The Ninth Circuit affirmed. Here, FIRPTA and the FDAP rules require the payor to withhold taxes when making payments to a foreign entity. Failure to withhold can result in the payor bearing that liability. Buyers argued that because these regimes apply to withholdings made before the IRS assesses liability, the carve-out for declaratory judgments (i.e., “except with respect to Federal taxes”) in IRC 2201(a) is not applicable. However, the Ninth Circuit ruled that the Declaratory Judgment Act was in parity with the Anti-Injunction Act, which had ample authority to deny jurisdiction over withholding matters. Withholding is another form of collection, and Congress precludes interference with or restraining the collection of taxes. Instead, judicial review is limited to post-payment refund proceedings.

Even though Buyers are trying to fulfill their FIRPTA and FDAP obligations, and they even offered to interplead the tax withholding amounts to resolve their issue, this avenue was foreclosed by statute. The court recognized the tension presented for Buyers, but nevertheless ruled: “But this tension is not resolved by filing litigation that interferes with the tax-collection process. It is resolved by parties addressing this issue when they negotiate the terms of their transaction. Unfortunately, the Gilberts failed to do this, and they are suffering the consequences of the uncertainty that comes from such failure.”

Comment: This case provides a clear warning for anyone representing buyers in a real estate deal where the seller may be a foreign person or entity. Make sure the contract permits withholding if it is applicable – or face the dilemma of the Gilberts. If they do pay and the IRS comes calling, do they have a remedy against the sellers?

IX. Employment Taxes.

1. Updated Social Security wage base for 2022

The wage base will increase to $147,000, up from $142,800 in 2021. This reflects a healthy increase of 2.94 percent, slightly below the 3.7 percent increase announced in 2021, but still reflecting strong wage growth. See https://www.ssa.gov/oact/cola/cbb.html

Social Security recipients will receive a 5.9 percent COLA effective in 2022, up from the 1.3 percent COLA announced in 2021. https://www.ssa.gov/oact/cola/colasummary.html

The Retirement earnings test exempt amounts also increased to $19,560 (full retirement age) from $18,970 (3.16%) and from $50,520 to $51,960 (before full retirement).

Comments: It appears that inflation is back. Will wage growth keep up with changes in the price level?
2. Economic hardship exception does not apply to corporate taxpayer, Seminole Nursing Home, Inc. v. Commissioner, 12 F.4th 1150 (10th Cir. 2021), affirming TC Memo 2017-102.

Taxpayer, a corporation engaged in providing nursing home services to patients, failed to pay more than $61 thousand in federal employment taxes in 2013. The Service issued a notice of intent to levy and Taxpayer requested a collection due process hearing. At the hearing, it did not dispute the amount owed. Instead, it proposed an installment agreement in the amount of $6K per month until the debt was satisfied. However, the Service rejected the installment agreement because, among other things, Taxpayer was still behind on its 2014 employment tax balance and it also alleged that it had sufficient assets to pay the tax due.

Taxpayer also raised an additional argument that the Service should grant relief on the grounds of economic hardship. Section 6343(a)(1)(D) includes as one of the five reasons for releasing a levy upon a taxpayer: “the Secretary has determined that such levy is creating an economic hardship due to the financial condition of the taxpayer….” However, Treas. Reg. § 301.6343-1(b)(4), which interprets this restriction in the Code, limits economic hardship relief to individual taxpayers.

Taxpayer petitioned the Tax Court for relief, but the Tax Court rejected the economic hardship argument on the basis that the regulation was valid and entitled to Chevron deference, citing its regular decision in Lindsay Manor Nursing Home, Inc. v. Commissioner, 148 T.C. 235, 26 (2017). Although that decision was later vacated as moot by the Tenth Circuit, the Tax Court nevertheless recognized the substantive validity of Lindsay Manor. It also affirmed the IRS determination sustaining the levy.

On appeal, the Tenth Circuit took a practical approach and upheld the restrictive interpretation of the regulation. Although a corporation can experience “economic hardship”, it could not identify a situation in which that economic hardship might justify releasing a tax levy on its assets. Wouldn’t that simply allow another creditor of the corporation to benefit because the government claim was released? According to the court: “This example points up an essential difference between an individual and a nonindividual entity. We care, care deeply, about the survival of the individual. More than that, we want the individual to have the minimal comforts of life. Taking everything that the individual possesses is not acceptable.”

Comment: The court did not go so far as to hold that all nonindividuals would be excluded from the economic hardship exception, but it did rule that corporations like this taxpayer were not within its purview.


Taxpayer husband was an ordained clergyman who sought a refund of self-employment taxes paid in connection with his salary as a duly licensed minister in his church. The Service rejected their claim on the ground that they had failed to file for an exemption from such taxes as required by IRC § 1402(e). Regulations require them to File Form 4361 and obtain approval by the IRS; merely filing the form is not sufficient.
Taxpayers argued before the claims court that they were exempt from filing because they are eligible for exemption under IRC § 1402(c)(4), which carves out from the definition of earnings from self-employment “the performance of service by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order”. However, flush language in section (c) also provides: “The provisions of paragraph (4) …shall not apply to service (other than service performed by a member of a religious order who has taken a vow of poverty as a member of such order) performed by an individual unless an exemption under subsection (e) is effective with respect to him.” As their complaint failed to allege any vow of poverty, the court denied the claim. Moreover, they were not allowed to amend their complaint to address such a claim, as they failed to explicitly assert this ground for refund in their refund claim to the IRS.

Comment: Taxpayers have appealed to the Federal Circuit. However, the lesson for clergy is clear: unless you are in a religious order subject to a vow of poverty, filing for the exemption is the only path to avoid self-employment taxes. And of course, there are consequences to such an exemption that must be understood, including the potential loss of social security and Medicare benefits that those taxes finance. See the certification required in Form 4361. Other taxpayers can also learn a lesson here: be sure to put the grounds for your refund in your claim to the IRS.

X. Legislation Highlights

Below are highlights from several significant tax bills in the past two years, most of which were enacted in response to the pandemic.


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)(I) 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

• Expands payroll credits for family, medical, and sick leave, including provisions for self-employed workers.


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.

• Extends payroll protection program loans and appropriates additional funds.

• The key tax provisions can be found in Division EE, the Taxpayer Certainty and Disaster Tax Relief Act of 2020, and Division N, the Covid-related Tax Relief Act of 2020 and the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act. Some significant features follow.
• Additional PPP loan funding for eligible business
• Clarification that PPP loan forgiveness will not be treated as taxable income and will not restrict tax attributes acquired from spending PPP loans (reversing IRS positions announced in Notice 2020-32 and Rev. Rul. 2020-27).
• Favorable tax-exempt treatment (similar to PPP loans) accorded to Economic Injury Disaster Loans and related emergency financial aid grants.
• Expansion of employee retention credits.
• Extension and official recognition of Employer deferral of collection and withholding of FICA taxes.
• “Recovery rebates” for eligible individuals ($600 single/$1200 joint, plus $600 per qualifying child
• “Qualified disaster distributions” from retirement accounts, avoiding 10% tax on early withdrawal and allowing taxation over three years (and an amended return to refund such tax if the distribution is returned)
• More generous rules for FSAs, including longer periods for reimbursements and expanded rules for dependent care FSAs.
• Business meals provided by restaurants (see Notice 2021-25 for definition) are 100% deductible for 2021 and 2022.
• Expanded provisions for educational assistance to employees under section 127, which can include student loan repayments.
• Enhanced charitable contribution for nonitemizer of $600 (vs. $300 under prior law), but such amount is not “above the line” in determining AGI.

• Expands funding and availability of PPP loans.
• Extends employee retention credit, as well as employer-provided sick and family leave credits.
• Exempts student loan forgiveness from COD income (paving the way for future legislation on this Biden policy objective)
• Extended supplemental unemployment benefits through Labor Day
• Additional “Recovery rebates” of $1400/person (estimated at $242B), including eligible dependents.
• Significant spending benefitting state and local government ($350B), K-12 education ($130B) and colleges and universities ($40B).
• Child tax credits (up to $3600/child) and dependent care credits (up to 50% of up to $16K of eligible expenditures for 2 or more children), reflecting temporary but substantial increases for 2021. These credits are also fully refundable and advance payments of the child credit can be obtained. See https://www.irs.gov/newsroom/irs-offers-overview-of-tax-provisions-in-american-rescue-plan-retroactive-tax-benefits-help-many-people-now-preparing-2020-returns; https://home.treasury.gov/news/featured-stories/fact-sheet-the-american-rescue-plan-will-deliver-immediate-economic-relief-to-families


• Title V, § 80601: Amends IRC section 118 to provide for an exclusion from gross income for certain contributions to capital received by a regulated public utility which provides water or sewerage disposal services. The rule requires that assets constructed with such contributions have a basis of zero, preventing further tax benefits from the excluded amounts.
  Comment: This loosens restrictions on public contributions enacted in 2018, but only for certain public utilities. Lobbyists at work?

• Title V, § 80603: Amends IRC section 6045 to address additional information reporting requirements for brokers to include “any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.” Amends section 6045A to require information reporting for certain transfers of digital assets. Amends section 6050I(d) to include information reporting obligations on businesses receiving $10,000 in digital assets.
  Comment: This provision is giving consternation to those in the cryptocurrency space, as some claim they will lack the information they are required to report. A bipartisan group of senators is working on a better bill. Some additional details will need to be worked out. For helpful analysis, see Marie Sapirie, Implementing the New Crypto Reporting Guidance, 173 Tax Notes 1058 (11/22/21).

• Title V, § 80604: Repeals the Employee Retention Credit in IRC section 3031 effective for the fourth quarter of 2021.
  Comment: This provision surprised some of us. The lucrative employee retention credit would otherwise have extended through the entire calendar year. Patie