Guam Society of CPAs
Federal Tax Update [Part II]
August 23, 2022

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Tax Court & Board of Tax Appeals Reported Decisions

Michelle DelPonte v. Commissioner, 158 T.C. No. 7, Code Sec(s) 6015; 7803.

MICHELLE DELPONTE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

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Code Sec(s):	6015; 7803
Docket:	Dkt. Nos. 1144-05, 1334-06, 20679-09, 20680-09, 20681-09.
Date Issued:	05/05/**2022** .
Judge:	Opinion by Holmes, *J.*
Prior History:	Earlier proceedings at *David B. Greenberg, et al,* (2018) TC Memo 2018-74, RIA TC Memo ¶2018-074 (opinion by Holmes, *J.*), which was affirmed at *Goddard, William v. Comm.,* (2021, CA9) 128 AFTR 2d 2021-6964, and at *Greenberg, David v. Comm.,* (2021, CA11) 128 AFTR 2d 2021-5547.
Tax Year(s):	Years 1999, 2000, 2001.
Disposition:	Decision against Taxpayer.

HEADNOTE

1. Joint returns—innocent spouse relief—authority to grant or deny relief; IRS Chief Counsel vs. Cincinnati Centralized Innocent Spouse Operation—deficiency petitions. Tax Court determined that IRS's Chief Counsel, not CCISO, had final authority to decide whether to concede or settle innocent spouse relief claim that was raised as affirmative defense for 1st time in long-running deficiency case involving taxpayer's and ex-spouse/attorney/tax shelter promoter's joint liabilities: Code Sec. 7803(b)(2) , assorted delegation orders, Chief Counsel notices, and IRM showed that Chief Counsel had authority to concede or settle if it didn't want to litigate particular case and that CCISO's function was only to provide "assistance" in respect to same, not make final determination. Thus, although CCISO informally determined that taxpayer was entitled to relief under Code Sec. 6015(c) and explained that decision to Chief Counsel, Chief Counsel's decision to override and not adopt same without further investigation governed. Accordingly, taxpayer's motion for entry of decision granting her relief based on CCISO's conclusion was denied.

Reference(s): ¶ 60,155.01(5) Code Sec. 6015;Code Sec. 7803

Syllabus

P raised innocent-spouse relief as an affirmative defense in a deficiency proceeding. Following IRS procedure, R's counsel referred the request to its Cincinnati Centralized Innocent Spouse Operation (CCISO). CCISO concluded that P was entitled to relief under I.R.C. § 6015(c). CCISO communicated this to R's counsel, who asked P for more information to make a final determination. P instead moved for entry of decision granting her relief.

Held: Where innocent-spouse relief is raised as an affirmative defense for the first time in a petition that invokes our deficiency jurisdiction, R's counsel has final authority to concede or settle the issue with P.

Held, further, P's motion for entry of decision will be denied.

Counsel

Alvah Lavar Taylor, Jonathan T. Amitrano, and Lisa O. Nelson, for petitioner.

Benjamin R. Poor and Paul Colleran, for respondent.

HOLMES, *Judge*

OPINION

Michelle DelPonte separated from her ex-husband, William Goddard, in 2000. She is still, more than twenty years later, trying to untangle his affairs from her own. What concerns us is her effort to be relieved of her liability on the joint tax returns she filed with Goddard while they [pg. 90] were married. The part of the IRS bureaucracy that usually handles these sorts of requests thinks she's entitled to relief. The IRS's lawyer disagrees. We must decide who speaks for the IRS.

Background

During his marriage to DelPonte,[1] Goddard was a lawyer who sold exceptionally aggressive tax-avoidance strategies with his business partner David Greenberg and became very wealthy in the process. He tried to shelter his income from selling shelters by using the same shelter strategy he sold, but the IRS soon caught on and issued notices of deficiency for tax years 1999, 2000, and 2001. Most of the facts surrounding Goddard's and Greenberg's schemes—and the audit that led to their notices of deficiency—are irrelevant to these cases. We have already described them in detail in Greenberg v. Commissioner, 115 T.C.M. (CCH) 1403 [2018 RIA TC Memo ¶2018-074] (2018), aff'd, 10 F.4th 1136 (11th Cir. 2021), and aff'd sub nom. Goddard v. Commissioner, No. 20-73023, 2021 WL 5985581 [128 AFTR 2d 2021-6964] (9th Cir. Dec. 17, 2021).

What is relevant, though, is the fact that Goddard filed joint returns with DelPonte for each of those three years. That means she is jointly and severally liable with Goddard for the several millions of dollars in tax that we found were owed to the IRS. *See* § 6013(d)(3).[2] So when the first notice of deficiency arrived in late 2004, it was addressed to "William A. and Michelle Goddard." But DelPonte was kept in the dark about this notice. It had been sent to Goddard's law firm, and Goddard—who had by that time been living apart from DelPonte for a few years—never told her. He instead filed a petition on her behalf asserting that she was an "innocent spouse" under section 6015, apparently recognizing that he was solely responsible for the profits he had accumulated over the years and that it was only fair that he should be solely responsible for any large tax bill that might result.

The IRS sent another notice of deficiency to Goddard's law firm in 2005 and three more in 2009. In response to each notice, Goddard filed a petition in which he asserted innocent-spouse relief on DelPonte's behalf without telling her. It wasn't until November 2010 that DelPonte first became aware of the deficiencies asserted against her and the ongoing litigation before us.[3] She promptly hired her own lawyer and ratified the petitions Goddard had filed.

In April 2011 the Office of Chief Counsel referred DelPonte's claim for innocent-spouse relief to the IRS's Cincinnati Centralized Innocent Spouse Operation (CCISO) "to make a determination regarding [DelPonte's] entitlement to such relief." CCISO is the IRS unit that receives and processes most requests for innocent-spouse relief. Internal Revenue Manual (IRM) 25.15.3. (Dec. 12, 2016).[4] Its determination letters are generally binding on the Commissioner and the

spouse asking for relief, *see* IRM 25.15.18.1.1(2) (Mar. 20, 2019), but the referral letter that accompanied DelPonte's request asked CCISO to not issue a determination letter but instead "provide the results of [its] consideration directly to [the Office of Chief Counsel]." Having received the referral, CCISO reached out to DelPonte directly and instructed her to fill out and return a Form 8857, Request for Innocent Spouse Relief. DelPonte did just that, and after reviewing her paperwork, CCISO concluded in December 2011 that she should be granted relief for each of the years at issue.

CCISO did what the Chief Counsel lawyer had asked. It did not send a determination letter to DelPonte, but instead sent a letter explaining its conclusion directly to the Office of Chief Counsel. And here's where an already unusual case got [pg. 91] even more unusualer. Rather than accepting CCISO's conclusion and settling DelPonte's cases, the Office of Chief Counsel "decided that more information was needed...to allow [DelPonte] relief under I.R.C. [section] 6015." So in August 2012 the Office of Chief Counsel invited DelPonte to participate in a Branerton [5] conference to exchange documents and information "[i]n order for [CCISO] to properly evaluate [her] claim for relief." It also informed her that CCISO had already "rendered its decision in [her favor], but that [the Office of Chief Counsel] had overridden that decision." DelPonte declined the invitation; she argued that additional information would be superfluous because CCISO had already decided she was entitled to relief and that its decision was binding on Chief Counsel.

Aside from some back-and-forth letters between DelPonte and Chief Counsel in which they argued the point, that's where things stood for many years. In the meantime the consolidated deficiency cases begun by Goddard and Greenberg progressed through discovery, trial, and briefing. We released our opinion in those cases in May 2018, and in it we upheld the Commissioner's determinations of deficiencies in all respects except where he failed to meet the supervisory-approval requirement of section 6751(b). Greenberg, 115 T.C.M. (CCH) at 1418. We ordered the parties to compute the correct amounts of tax owed under Rule 155, but in cases as complex as these, that task isn't as simple as plugging numbers into a calculator and getting a total—the parties spent more than a year to precisely calculate the deficiencies. We severed the five cases in which DelPonte was a petitioner in January 2020, and entered decisions in the remaining ten the following April. Goddard and Greenberg then appealed their cases to the Eleventh Circuit in August 2020. Goddard's cases were severed from Greenberg's and transferred to the Ninth Circuit the following October. [6] The Eleventh Circuit affirmed our holdings in Greenberg's cases, Greenberg, 10 F.4th 1136, in August 2021 and the Ninth Circuit did likewise in December, So nearly fifteen years after the lowest numbered cases in that group had first been calendared for trial, they are now final and unappealable.

DelPonte and Chief Counsel resumed their correspondence on the innocent-spouse issue shortly after we released our opinion in the deficiency cases. DelPonte hired a new team of lawyers and responded to the Chief Counsel's discovery requests, but still insisted that discovery was

unnecessary because CCISO had already granted her relief. Chief Counsel stood firm in its position that CCISO didn't speak for the IRS in her cases. DelPonte then moved for entry of decisions in her favor because, in her view, Chief Counsel is wrong.

We usually get motions for entry of decision when a party wants to renege on a settlement or when parties disagree about computations under Rule 155. In these cases, however, there is no stipulation or computation to fight about. This motion is really more like one for partial summary judgment on the issue of whether DelPonte is entitled to relief under section 6015(c) because the CCISO determined that she is.

And that is how we will treat it.

Discussion

This is a novel argument, and to analyze it we will begin with an account of the evolution of the different species of innocent-spouse relief. Congress has since 1918 allowed married taxpayers to file joint returns, Revenue Act of 1918, ch. 18, § 223, 40 Stat. 1057, 1074 (1919); *see also* Camara v. Commissioner, 149 T.C. 317, 327 (2017), and has since 1938 held spouses jointly and severally liable for the tax shown on those joint returns, Revenue Act of 1938, ch. 289, § 51(b), 52 Stat. 447, 476; *see also* Wilson v. Commissioner, 705 F.3d 980, 982 [111 AFTR 2d 2013-522] (9th Cir. 2013), aff'g 99 T.C.M. (CCH) 1552 [2010 RIA TC Memo ¶[pg. 92] 2010-134] (2010). A great many couples benefited richly from the more favorable tax rates available to joint filers, but some were burdened by the harsh consequences of joint liability. *See* Wilson, 705 F.3d at 983. We commented on the harshness of this rule in Scudder v. Commissioner, 48 T.C. 36 (1967), remanded by 405 F.2d 222 [23 AFTR 2d 69-352] (6th Cir. 1968), when we held a wife liable for tax on the money her husband had embezzled from the partnership she and her sisters owned and that he had unsurprisingly failed to report on their joint returns. [7] We found that the language of the statute was clear, and that "only remedial legislation can soften the impact of the rule of strict individual liability." Id. at 41.[8]

In 1971 Congress enacted legislation to allow a spouse relief from joint and several liability in certain limited situations. Act of January 12, 1971, Pub. L. No. 91-679, 84 Stat. 2063 (codified at § 6013(e)). Relief got a little easier in 1984, *see* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 424, 98 Stat. 494, 801 (codified at § 6013), but it still required that a spouse seeking relief show that the joint return showed "a substantial understatement of tax attributable to grossly erroneous items of [the other] spouse," that she signed the return without knowing and without having reason to know of the substantial understatement, and that it would be inequitable to hold her liable for the deficiency attributable to the substantial understatement, id. Neither Congress nor the Secretary wed this substantive liberalization to any special procedural rules for requesting relief. *See* Corson v. Commissioner, 114 T.C. 354, 358 (2000); T.D. 7320, 1974-2 C.B. 391. The result was that

spouses glommed their requests for relief onto petitions to redetermine deficiencies that they filed in our Court or onto complaints for refund filed in a U.S. district court. *See* Corson, 114 T.C. at 358.

Congress liberalized the innocent-spouse-relief provisions again as part of the IRS Restructuring and Reform Act of 1998 (RRA 1998), Pub. L. No. 105-206, § 3201, 112 Stat. 685, 734 (codified as amended at § 6015). Under new section 6015, relief was available even if the understatement was not "substantial" or due to "grossly erroneous" items. Requesting spouses [9] could seek any of three types of relief. The first requires:

- an understatement of tax on the joint return that is attributable to erroneous items of the other spouse;
- that the requesting spouse didn't know or have reason to know of the understatement when she signed the return;
- that, "taking into account all the facts and circumstances, it [would be] inequitable to hold [that spouse] liable for the deficiency...attributable to such understatement;" and
- that the requesting spouse seek relief no later than two years after the Commissioner began collection activities.

§§ 6015(b).

The second requires the requesting spouse to:

- be legally separated or divorced from the nonrequesting spouse at the time of election; and
- have no actual knowledge of any items giving rise to a deficiency at the time she signed the return.

§ 6015(c).

And then there is the catchall third type that requires proof only that, "taking into account all the facts and circumstances, it [would be] inequitable to hold the [requesting spouse] liable for any unpaid tax or any deficiency," and that the requesting spouse is not eligible for either of the other two types of relief. § 6015(f). [pg. 93]

These are known by those who have lettered in innocent-spouse relief as "b", "c", and "f" relief. And each of these three letters can be paired with three paths to **Tax Court** :

- as an issue—usually called a "defense" even though raised by a petitioner—in a deficiency case;
- in an action to review the IRS's determination in a collection-due-process (CDP) case, a new right also created by RRA 1998; or

- in a "stand alone" action in which we review the IRS's administrative determination made in response to a request for relief filed by a spouse directly with the IRS.

We've already outlined a bit of the history of innocent-spouse relief in deficiency cases. To place DelPonte's argument in the proper context, we need to sketch a bit of background for our expanded jurisdiction in CDP and stand-alone innocent-spouse cases.

RRA 1998 created CDP procedures to enable taxpayers to challenge how the Commissioner collected taxes that he assessed. *See* RRA 1998 § 3401, 112 Stat. at 746 (codified as amended at §§ 6320, 6330). This new CDP right made for a major change in the way the IRS used two of its most important collection tools—liens and levies. Once a taxpayer's liability has been assessed, the amount of the liability becomes a lien in favor of the government. § 6321. When that happens, the Commissioner sends the taxpayer a notice of federal tax lien (NFTL), informing him that the lien has been filed and, under RRA 1998, of his right to request a CDP hearing. § 6320. If the Commissioner wishes to collect tax by seizing a taxpayer's property he must now also send him a notice of intent to levy, which, like the NFTL, informs him of his right to a CDP hearing. § 6330. Congress wedded innocent-spouse relief to CDP law by specifically providing that a spouse could raise entitlement to innocent-spouse relief in a CDP hearing. Regulations provide that when a taxpayer raises innocent-spouse relief in a CDP hearing, the innocent-spouse issue is "governed in all respects by the provisions of...section 6015 and the regulations and procedures thereunder." Treas. Reg. §§ 301.6320-1(e)(2), 301.6330-1(e)(2).

Then there's our jurisdiction in stand-alone cases. A spouse may also ask for innocent-spouse relief outside a deficiency case or a CDP hearing. If she does, and if the Commissioner denies her relief, she may, "[i]n addition to any other remedy provided by law,...petition [us] (and [we] shall have jurisdiction) to determine the appropriate relief available" under section 6015. § 6015(e)(1)(A).

Congress wanted a requesting spouse to have only one bite from any of these three legal apples. A requesting spouse is "entitled to only one final administrative determination of relief" for a given assessment. Treas. Reg. § 1.6015-5(c)(1). And once we (or a district court) have rendered a final decision on her eligibility for relief—or if she "participated meaningfully" in a court proceeding and chose not to raise a request for relief—then that spouse is barred from relief thereafter. *See* § 6015(g)(2).

We can now classify DelPonte's request with precision. It is for "c" relief in a deficiency case. But whether it is "b", "c", or "f" relief in a deficiency, CDP, or stand-alone case, a requesting spouse has to navigate her way through the ever more detailed revenue procedures and regulations that the Secretary started to issue after section 6015's enactment. This journey begins with the Form 8857. T.D. 9003, 2002-2 C.B. 294. The regulation requires a requesting spouse to file a Form 8857; submit a written statement containing the same information required by Form 8857; or

"submit information in the manner prescribed by the Treasury and IRS in forms, relevant revenue rulings, revenue procedures, or other published guidance." Treas. Reg. § 1.6015-5(a). A requesting spouse can do this any time after the Commissioner sends her notice of an audit or a letter that tells her there may be an outstanding liability, id. para. (b)(5), but no later than two years after the Commissioner ini- tiates collection activity, id. subpara. (1).[10] A single claim can simultaneously request relief under section 6015(b), (c), and (f). Id. para. (a)(2).

But if the Code is now clear that a spouse has these ways to ask for three kinds of innocent-spouse relief, it is still murky about who gets to act on those requests and whether that answer differs according to which of the three ways a spouse chooses.

We begin with the Code. Section 7803 creates the position of Commissioner of Internal Revenue, to whom are given broad powers to "administer, manage, conduct, direct, and supervise the execution and application of the internal revenue laws or related statutes," as well as any other "such duties and powers as the Secretary may prescribe." § 7803(a)(2). Regulations authorize the Secretary of the Treasury to delegate any function vested in him to the Commissioner, who is in turn authorized to redelegate that function to an officer or employee under his direct or indirect supervision and control. Treas. Reg. § 301.7701-9(b) and (c). The Secretary has of course for decades delegated to the Commissioner the responsibility of administering and enforcing the internal revenue laws, I.R.S. Treas. Order 150-10 (Apr. 22, 1982), which includes making determinations about whether a taxpayer is entitled to innocent-spouse relief under section 6015, *see* § 6015(e)(1)(A)(i), (5), (f). The Commissioner has redelegated the responsibility for processing most requests for innocent-spouse relief to the CCISO. IRM 25.15.7. (Sept. 1, 2006). There are some exceptions: In certain instances, as when there's an ongoing audit for the year for which the requesting spouse is seeking relief, the Field Examination unit conducting the audit has authority to make the determination. *See* IRM 25.15.6.1(4) (Mar. 21, 2008). Once CCISO (or the Field Examination unit) has made a preliminary determination, both the requesting spouse and the nonrequesting spouse can appeal the determination to the Office of Appeals.[11] IRS Appeals is responsible for holding an appeals conference, reviewing the evidence, and issuing a "final determination." IRM 25.15.6.10.3 (June 19, 2017). Or maybe we should say a final *administrative* determination because if Appeals denies her request, a requesting spouse[12] can petition our Court for a really *truly* final determination of her entitlement to relief. § 6015(e). We ourselves can make a determination of our own if CCISO or the Field Examiner doesn't act on a request within six months. § 6015(e)(1)(A).

There is a similarly complicated process when a spouse seeks relief as part of a CDP hearing. She has to first file a Form 12153, Request for a Collection Due Process or Equivalent Hearing (or other written and signed request), with IRS Appeals. IRM 5.19.8.4.2 (Nov. 1, 2007). That form allows her to check a box to claim innocent-spouse relief and, if she does, instructs her to attach a Form 8857. *See* Form 12153 (Rev. Nov. 2006). IRS Appeals ordinarily sends the Form 8857 to

CCISO to investigate the claim, *see* IRM 8.22.1.1.1.5.3 (Oct. 19, 2007), following the same procedures as it would in a stand-alone innocent spouse case, *see* IRM 8.22.2.2.11.3(6) (Jan. 1, 2006). A significant difference, though, is that Appeals retains jurisdiction over the case while CCISO investigates the claim. *See* id. 8.22.2.2.11.3(4). One consequence of this is that CCISO ordinarily doesn't make a *final* determination on what relief is appropriate. *See* IRM 8.22.2.2.11.3.1 and .2 (Mar. 11, 2009). CCISO instead *recommends* a determination to Appeals, which is itself responsible for making a final determination about what relief if any a tax[pg. 95] payer should get. Id.[13] A disgruntled requesting spouse can once again petition us to try again. § 6015(e)(1)(A).

These paths are well trod. And they may help us in the unusual situation in DelPonte's case: where we have a requesting spouse who raised innocent-spouse relief as an affirmative defense in deficiency petitions filed under section 6213(a). DelPonte argues that the Secretary has delegated authority to make a final determination to the administrative, not the litigating, side of the IRS. She has a textualist argument based on the regulations, numerous IRM provisions, the Chief Counsel's own written guidance, and even the instructions to the Form 8857. She also argues more purposively that her position is buttressed by the principles of horizontal equity and fundamental fairness. In short, she contends that it's only fair that a requesting spouse raising innocent-spouse relief for the first time in litigation should have CCISO make the determination, just as if she had raised it for the first time in a stand-alone request. According to her CCISO is the decider in chief, and Chief Counsel's job is only to defend CCISO's determination.

The Chief Counsel, on the other hand, argues that his office is responsible for deciding what positions the IRS takes in litigation, and that decision about whether to concede innocent-spouse relief is a litigating position. He of course may ask CCISO for its advice, but he says he gets the final say.

The Chief Counsel is right that he and his lawyers are responsible for the IRS's litigation decisions. Section 7803—the same section that's the source of the Commissioner's authority—also created the position of Chief Counsel, and authorized him to "perform such duties as may be prescribed by the Secretary, including the duty...to represent the Commissioner in cases before the **Tax Court**." § 7803(b)(2)(D). General Counsel Order No. 4 delegates to the Chief Counsel authority "in cases pending in the **Tax Court**...to decide whether and in what manner to defend, or to prosecute a claim, or to settle, or to abandon a claim or defense therein." *See* IRM 30.2.2–.6 (Aug. 11, 2004). This order also gives the Chief Counsel the authority to redelegate any of his authority to "any officer or employee in the Office of the Chief Counsel, and to authorize further redelegation of such authority." Id.

The question we must answer, then, is whether DelPonte's request for innocent-spouse relief—and CCISO's consideration of that request—was like any claim in a case "pending in **Tax Court**,"

or more like an administrative request for innocent-spouse relief begun by filing a Form 8857 with CCISO.

This is a question in which a page of history enlightens us more than a volume of logic. Taxpayers were raising innocent-spouse claims as affirmative defenses in deficiency proceedings years before today's administrative processes for seeking relief even existed. Our jurisdiction to rule on those claims is part of our authority under section 6213(a) to redetermine a taxpayer's deficiency when she's received a notice of deficiency. *See* Corson, 114 T.C. at 363–64 ("In a deficiency proceeding, we may take into account all facts and circumstances relevant to ascertaining the correct amount of the deficiency, including affirmative defenses"). Our power in a deficiency case is not limited to the issues listed in the notice of deficiency—it includes issues raised in either the petition or answer or even those tried without objection. *See* Ax v. Commissioner, 146 T.C. 153, 160 (2016). Our jurisdiction to decide an issue in a deficiency case is not dependent on the Commissioner's having already made a determination on that issue administratively; all we need to get jurisdiction to decide is a timely filed petition and a valid notice of deficiency. Butler v. Commissioner, 114 T.C. 276, 288 (2000) (citing Naftel v. Commissioner, 85 T.C. 527, 533 (1985)). Once we have jurisdiction over a case where entitlement to inno[pg. 96] cent-spouse relief is an issue, the Commissioner must concede or settle it with a taxpayer if he doesn't want to litigate it. Section 7803(b)(2) and related delegation orders have long delegated those decisions to the Chief Counsel.

But the Chief Counsel also has the power to redelegate authority granted to him. *See* IRM 30.2.2–.6. DelPonte argues in the alternative that Chief Counsel Notice CC-2009-021 (June 30, 2009) is just such a redelegation. That notice instructs attorneys in the Office of Chief Counsel to request CCISO "to make the determination" with respect to cases in which a taxpayer raises innocent-spouse relief for the first time in a deficiency petition. CC-2009-021, at 2. That notice also states: "If CCISO...determines the petitioner is entitled to relief, the case should be conceded...subject to the limitation that a nonrequesting spouse who is a party to the case must agree" with the determination. Id. at 4. If the nonrequesting spouse disagrees, then "the grant of relief must be defended throughout trial and briefing." Id.

We can dispense with this argument quickly. Chief Counsel has authority to delegate functions only to an "officer or employee in the Office of the Chief Counsel," IRM 30.2.2–.6, and CCISO is not within the Office of the Chief Counsel, IRM 1.1.13.12.3.3 (Sept. 1, 2005). The plain language of this order gives the Chief Counsel no authority to delegate any of his functions to CCISO.

But we can reformulate DelPonte's contention just a bit: Even though Chief Counsel has responsibility to respond to requests for relief raised for the first time in a deficiency case, he has instructed his lawyers to adhere to CCISO determinations. Are his lawyers going rogue if they disregard this instruction? This is not an argument based on powers of delegation, but on what

DelPonte identifies as a possible protection of the Due Process Clause—a requirement that the government follow the procedures that it establishes even if it didn't have to establish them in the first place. DelPonte emphasizes that she doesn't raise this issue in her present motion, but we can head off future motion practice by noting that the Chief Counsel attorneys handling these cases *have* been following established procedures.

We first address DelPonte's argument that CC-2009-021 instructs Chief Counsel attorneys to refer cases to CCISO for a "determination," not a "recommendation." She relies heavily on the text of CC-2009-021—along with the Chief Counsel attorney's correspondence with her and CCISO—to argue that "determinations" cannot be disregarded by Chief Counsel attorneys. We, however, are not convinced that use of the word "determination" in the Chief Counsel notice or any other guidance is the same as what the regulation calls a "final administrative determination." *See* Treas. Reg. § 1.6015-5. We have long recognized that "the name or the label of a document does not control whether the document embodies a determination." Wilson v. Commissioner, 131 T.C. 47, 53 (2008).

In CC-2009-021, the Chief Counsel repeatedly uses "should" when instructing his attorneys on how to handle cases where CCISO determines that relief should be granted, e.g., "[i]f CCISO...determines the petitioner is entitled to relief, the case *should* be conceded." CC-2009-021, at 4 (emphasis added). But he elsewhere uses the imperative "must" when describing how an attorney should proceed in different circumstances, e.g., "[i]f the nonrequesting spouse disagrees with the Service's determination to grant relief [to the requesting spouse], then...the grant of relief *must* be defended throughout trial and briefing." Id. (emphasis added). If Chief Counsel had wanted all his attorneys to accept CCISO's determinations in every case, he could easily have conveyed that desire by telling them they "must" do so. But he did not.

CC-2009-021 is, moreover, only one of a series of notices that deal with requests for innocent-spouse relief raised for the first time in cases pending before us. CC-2009-021 was itself a supplement to the earlier Chief Counsel Notice CC-2004-26 (July 12, 2009), id. at 1, which was issued in response to our holding in Ewing v. Commissioner, 122 T.C. 32 (2004), rev'd and vacated, 439 F.3d 1009 [97 AFTR 2d 2006-1224] (9th Cir. 2006). We held in Ewing that, although we [pg. 97] reviewed the Commissioner's denial of equitable relief under section 6015(f) for abuse of discretion, our review was not confined to the administrative record. Ewing, 122 T.C. at 38–39. CC-2004-26 included instructions for how Chief Counsel attorneys should handle section 6015(f) cases to keep the scope-of-review issue alive for appeal. CC-2004-026, at 1–2. It also sought to solve the problem of how to handle requests for equitable relief that were raised for the first time before us—either in deficiency petitions or after six months had passed since the taxpayer requested relief—and in such cases there *would be no* administrative record to review. His solution was to have those cases remanded to CCISO for a determination and to create an administrative record. Id. at 3. The notice told CCISO to "send all evidence the petitioner

presented...and its written analysis to the Chief Counsel attorney handling the docketed case. If CCISO determines the petitioner is entitled to relief, the Chief Counsel attorney *should consider* whether settlement is appropriate." Id. at 4 (emphasis added).

CC-2009-021 itself was prompted by our opinions in Porter v. Commissioner (Porter I), 130 T.C. 115 (2008), and Porter v. Commissioner (Porter II), 132 T.C. 203 (2009), CC-2009-021, at 1, in which we held that we would conduct trials *de novo* in innocent-spouse cases, Porter I, 130 T.C. at 125, and make our own determinations about relief under section 6015(f) with no deference to the IRS, Porter II, 132 T.C. at 210. Like its predecessor, CC-2009-021 provided guidance to the Chief Counsel lawyers on how to preserve these issues for appeal. CC-2009-021, at 2. It also told Chief Counsel attorneys that they should continue asking CCISO to make determinations in all section 6015 cases, and they should continue to concede cases where CCISO determined the requesting spouse was entitled to relief. Id. at 2–4.

Chief Counsel Notice CC-2013-011 (June 7, 2013), issued after Wilson, 705 F.3d 980 [111 AFTR 2d 2013-522], confirmed that section 6015(e)(1)(A) provided for both a *de novo* standard *and* scope of review in section 6015(f) cases, and rendered both these older notices obsolete.[14] This notice was published after CCISO had already rendered its decision on DelPonte's request, but we believe it is still helpful in understanding the Chief Counsel's guidance that was in effect. CC-2013-011 again requires that Chief Counsel attorneys request a determination from CCISO where a petitioner requests relief under any provision of section 6015. CC-2013-011, at 1–2. It also clarifies that "the trial attorney *should, except in rare circumstances* , follow the determination made by CCISO that the petitioner is entitled to relief and settle the case in accordance with CCISO's determination." Id. at 3 (emphasis added). The "should" instead of a "must" means that in this context the CCISO's decisions are advisory, and that Chief Counsel attorneys get to make the final decision about the IRS's views on any particular request for innocent-spouse relief when a taxpayer seeks it in a deficiency case.

And let us zoom out to look one last time at the IRM. It says that if innocent-spouse relief is raised for the first time in a case already docketed in court, "[j]urisdiction is retained by...Counsel, and a request is sent to CCISO to consider the request for relief." IRM 25.15.12.25.2(1) (Nov. 9, 2007). It specifies that "Counsel...has functional jurisdiction over the matter and handles the case and request for relief, and either settles or litigates the issue on its merits, as appropriate." Id. 25.15.12.25.2(3).

We therefore hold that the Chief Counsel notices and the IRM all tell CCISO to provide "assistance," not to make a final determination, and that Chief Counsel attorneys retain their discretion to adopt or reject CCISO's conclusions.

We finally address DelPonte's argument that principles of horizontal equity and "fundamental fairness" require that all taxpayers be entitled to a final determina[pg. 98] tion of relief from CCISO,

regardless of whether they first request relief in a petition for redetermination of a deficiency, in a stand-alone petition, or in a CDP hearing. She correctly points out that taxpayers often have no choice in when they are first able to request relief—her case is an excellent example. She believes that adopting the position of the Office of Chief Counsel would put requesting spouses who first raise innocent-spouse relief in a petition for redetermination of a deficiency in a materially worse position than all other requesting spouses because all other requesting spouses have the opportunity to appeal a denial of relief by CCISO to Appeals before starting a case with us as a last resort. Is it not unfair that some who seek relief can have a try at CCISO, Appeals, and **Tax Court** but others, get **Tax Court** alone?

Arguments from fairness are always fragile, and this one breaks apart for two reasons. The first is its faulty premise—an Appeals officer who receives a request for innocent-spouse relief in a CDP hearing forwards the case to CCISO for processing but retains jurisdiction, *see* IRM 8.22.2.2.11.3(4), and makes the ultimate decision for the IRS about whether to grant relief, *see* IRM 8.22.2.2.11.3.1–.2. In that sense, the Appeals officer's role is very similar to that of the Chief Counsel attorney in deficiency cases—the difference, of course, being that the Appeals officer can make a final determination granting relief, whereas a Chief Counsel attorney can only decide not to argue that we should deny relief. So a requesting spouse who raises an innocent-spouse claim for the first time in a CDP hearing really gets only two levels of review—Appeals and us—not three. Requiring CCISO to have the opportunity to issue a final determination in cases where the requesting spouse raises an innocent-spouse claim for the first time in a deficiency petition would therefore not guarantee that all spouses be treated equally regardless of when they request relief; it would merely make CDP cases the outlier.

The second and more important problem with this argument is that we have no power to adopt it. Congress gave us exclusive jurisdiction to redetermine the correct amount of a taxpayer's deficiency for a given tax year once the taxpayer receives a valid notice of deficiency and timely files a petition with us. *See* § 6213(a); Naftel, 85 T.C. at 532–33. Congress also gave the Chief Counsel the authority to litigate cases before us. § 7803(b)(2) (D). We cannot undo this statutory scheme by depriving either ourselves or the Chief Counsel of the powers it has given to us in the name of fairness.

The Chief Counsel in these cases has considered the determination of CCISO to grant DelPonte relief and decided not to adopt it without further investigation. That is his prerogative, and we will not force him to do otherwise.

An appropriate order will be issued.

---

[1] DelPonte's name during the marriage was "Michelle Goddard," and her petitions were filed under that name. She has since remarried and legally changed her name to "Michelle

DelPonte," and we have amended the captions in these cases to reflect that change.

[2] Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Procedure.

[3] We had in May 2010 already ordered that the litigation should be bifurcated so that we could first decide the amounts of the liabilities owed and then address the issue of whether DelPonte qualified for innocent-spouse relief.

[4] The IRM doesn't have the force of law or confer substantive rights on taxpayers. It does, however, govern the internal affairs and administration of the IRS, and reliably describes the functions delegated to the different offices within the IRS. United States v. McKee, 192 F.3d 535, 540 [84 AFTR 2d 99-6229] (6th Cir. 1999).

[5] Branerton Corp. v. Commissioner, 61 T.C. 691 (1974) (describing **Tax Court's** informal discovery procedure).

[6] Greenberg lived in Florida when he filed his petitions, so the venue for appeal of his cases was the Eleventh Circuit. *See* § 7482(b)(1). Goddard lived in California at the time, so the venue for appeal in his cases was the Ninth Circuit. *See* id. Because DelPonte also lived in California when the petitions in her cases were filed, venue for appeal of her cases would also be in the Ninth Circuit. *See* id.

[7] On appeal, the Sixth Circuit noted that "'trickery' or 'deliberate deception,' employed by [a] husband to obtain his wife's signature to a tax return, will exonerate the victimized wife." Scudder, 405 F.2d at 226. It then ordered us to reexamine our findings while considering whether at least some of the embezzled funds should have more properly been treated as a nontaxable loan to the husband because that was how they were recorded in the partnership's books and because he paid back about half of what he took soon after his wrongdoing was discovered. *See* id. at 225.

[8] Two exceptions to this strict rule were that a spouse wouldn't be held jointly and severally liable if there had been duress, *see, e.g.*, Furnish v. Commissioner, 262 F.2d 727 [3 AFTR 2d 541] (9th Cir. 1958), or fraud, *see, e.g.*, Sharwell v. Commissioner, 419 F.2d 1057 [25 AFTR 2d 70-329] (6th Cir. 1969).

[9] Section 6015 speaks of a spouse who "elects" the application of subsections(b) and (c), and "requests" relief under subsection (f). A spouse seeking relief under any of the three subsections is nevertheless commonly referred to as a "requesting spouse." *E.g.,*Treas. Reg. § 1.6015-5(a).

[10] [pg. 94]

We have held the two-year limitations period is invalid as to requests for equitable relief under section 6015(f). Pullins v. Commissioner, 136 T.C. 432 (2011). The Secretary hasn't revised his regulations, *see* Treas. Reg. § 1.6015-5(a), and the limitations period remains valid for elections under section 6015(b) and (c), *see* Pullins, 136 T.C. at 437. The Seventh Circuit, however, has disagreed with us about the validity of this two-year limitations period. *See* Lantz v. Commissioner, 607 F.3d 479, 482 [105 AFTR 2d 2010-2780] (7th Cir. 2010) ("that Congress designated a deadline in two provisions of the same statute and not in a third is not a compelling argument that Congress meant to preclude the Treasury Department from imposing a deadline applicable to cases governed by that third provision").

[11] Recently renamed the "Independent Office of Appeals." *See* Taxpayer First Act, Pub. L. No. 116-25, § 1001(a), 133 Stat. 981, 983 (2019).

[12] But not a nonrequesting spouse. Maier v. Commissioner, 119 T.C. 267 (2002), aff'd, 360 F.3d 361 [93 AFTR 2d 2004-1139] (2d Cir. 2004)

[13] As always seems to be the case in tax law, there is a complication: The CCISO can itself make a final determination if it concludes the requesting spouse should get relief *and* the nonrequesting spouse doesn't appeal the determination *and* innocent-spouse relief was the only issue raised in the CDP request *and* the requesting spouse chooses to withdraw the CDP request *and* she waives any right to judicial review. *See* IRM 8.22.2.2.11.3.1.

[14] Congress eventually settled the issue when it decided that we should review the IRS *de novo* based upon the administrative record and "any additional newly discovered or previously unavailable evidence." Taxpayer First Act § 1203(a)(1), 133 Stat. at 988 (codified at § 6015(e)(7)).

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Tax Court & Board of Tax Appeals Reported Decisions

Treece Financial Services Group v. Commissioner, 158 T.C. No. 6, Code Sec(s) 7436; 3509.

TREECE FINANCIAL SERVICES GROUP, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 86]

Code Sec(s):	7436; 3509
Docket:	Dkt. No. 20850-19.
Date Issued:	04/19/**2022** .
Judge:	Opinion by Kerrigan, *J.*
Tax Year(s):	Years 2015, 2016, 2017.
Disposition:	Decision against Taxpayer and against Commissioner.

HEADNOTE

1. Employment taxes—employer liability—Voluntary Classification Settlement Program—jurisdiction to review—summary judgment. Tax Court upheld its jurisdiction under Code Sec. 7436(a) to review IRS's determination that VCSP, which provided partial relief from federal

employment taxes for eligible taxpayers that agreed to prospectively treat workers as employees, didn't apply to computation of financial services corp.'s employment tax liabilities with respect to its sole corp. officer/employee for stated years. Notably, under Code Sec. 7436(a) , Court had jurisdiction to determine proper amounts of employment taxes that related to IRS's worker classification determination; so, denial of taxpayer's eligibility for VCSP was subject to review as it directly affected amounts of tax involved. Also, there was genuine fact dispute as to whether there was employment tax audit and thus whether VCSP applied in 1st place.

Reference(s): ¶ 74,365.01(25); ¶ 35,095.01(10) Code Sec. 7436;Code Sec. 3509

Syllabus

P, a corporation, petitioned for review of a notice of employment tax determination under I.R.C. § 7436. The parties agree that respondent properly determined that E is an employee of P but dispute the proper amount of employment tax under that determination. P asserts that the amount should be computed using R's Announcement 2012-45, 2012-51 I.R.B. 724, entitled Voluntary Classification Settlement Program (VCSP). R determined that P may not use the VCSP to compute the proper amount of employment tax and argues that the Court lacks jurisdiction to review that determination. R moved to partially dismiss for lack of jurisdiction. P moved for summary judgment.

Held: R's motion will be denied. The **Tax Court** has jurisdiction in this employment tax case to determine whether R's determination that the VCSP does not apply to the computation of P's employment tax liability is correct.

Held, further, P's motion will be denied. There remains a genuine dispute of material fact as to whether the VCSP applies here.

Counsel

Mark M. Mockensturm and Blanca N. Wheeler, for petitioner.

Gabriel J. Minc, for respondent.

KERRIGAN, *Judge*

OPINION

This case is before the Court on respondent's Motion to Partially Dismiss for Lack of Jurisdiction and petitioner's Motion for Summary Judgment. Respondent contends that this Court lacks jurisdiction in this employment tax case to review respondent's determination that the Voluntary

Classification Settlement Program (VCSP) does not apply to the computation of petitioner's employment tax liabilities. Petitioner contends that it met all the requirements of the VCSP and respondent does not have the discretion to deny its participation in the VCSP.

Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Procedure. All monetary amounts are rounded to the nearest dollar.

On October 10, 2019, respondent sent Treece Financial Services Group a Letter 3523, Notice of Employment Tax Determination Under IRC 7436 (notice), reclassifying Dock D. Treece as an employee instead of an independent contractor for tax years 2015, 2016, and 2017 (years in issue). In the notice respondent determined additions to tax pursuant to section 6651(a) and penalties pursuant to section 6656 for the years in issue. On September 13, 2021, the parties filed a Stipulation of Settled Issues which resolved all but one issue. The remaining issue is the proper amounts of employment taxes which petitioner seeks [pg. 87] to have computed in accordance with respondent's VCSP.

The parties stipulated that Mr. Treece was the sole corporate officer of petitioner for the years in issue. They further stipulated that he was an employee and not an independent contractor for the years in issue. The parties also stipulated that petitioner is not entitled to relief under the Revenue Act of 1978, Pub. L. No. 95-600, § 530, 92 Stat. 2763, 2885, as amended, with respect to Mr. Treece's treatment as an independent contractor.

Pursuant to the Stipulation of Settled Issues petitioner owes the following employment taxes:

Tax period	Return form number	Type of tax	Amount of tax
3/31/15-12/31/15	941	FICA & FITW	$3,738
2015	940	FUTA	420
3/31/16-12/31/16	941	FICA & FITW	4,988
2016	940	FUTA	420
3/31/17-12/31/17	941	FICA & FITW	8,576
2017	940	FUTA	420

Total	$18,562

These amounts are subject to reduction if petitioner qualifies for the VCSP.

Respondent abated additions to tax pursuant to section 6651(a) and penalties pursuant to section 6656.

Background

There is no dispute as to the following facts drawn from the parties' motion papers, affidavits, and attached exhibits. When the Petition was timely filed, petitioner was a corporation with its principal place of business in Ohio. Mr. Treece is a principal of petitioner.

The VCSP provides partial relief from federal employment taxes for eligible taxpayers that agree to treat workers prospectively as employees. I.R.S. Announcement 2012-45, 2012-51 I.R.B. 724, 724. To be eligible for the VCSP, a taxpayer must: (1) have consistently treated the workers as nonemployees; (2) have filed all required Forms 1099, consistent with the nonemployee treatment, for the previous three years; and (3) not currently be under employment tax audit by the Internal Revenue Service (IRS). Id. Petitioner submitted Form 8952, Application for Voluntary Classification Settlement Program (VCSP), on October 23, 2018. Respondent denied petitioner participation in the VCSP on February 28, 2019, stating: "You're under an employment tax examination by the IRS."

Discussion

We will first decide respondent's Motion to Partially Dismiss. If we determine that we have jurisdiction, we will then address petitioner's Motion for Summary Judgment.

I. *Respondent's Motion to Partially Dismiss*

The **Tax Court** may exercise jurisdiction only to the extent expressly provided by Congress. *See* § 7442; Breman v. Commissioner, 66 T.C. 61, 66 (1976). We, however, have the authority to determine whether we have jurisdiction over a particular case. Kluger v. Commissioner, 83 T.C. 309, 314 (1984). Generally, we have jurisdiction under section 7436(a) to determine: (1) whether an individual providing services to a person is that person's employee for purposes of subtitle C; (2) whether the person, if an employer, is entitled to relief under section 530 of the Revenue Act of 1978; and (3) the proper amounts of employment taxes which relate to the Commissioner's determination concerning worker classification.

This Court's deficiency jurisdiction includes reviewing administrative determinations that are necessary to determine the [pg. 88] merits of the deficiency determinations. *See* , e.g., Trimmer v. Commissioner, 148 T.C. 334, 345-48 (2017) (holding that the **Tax Court** has jurisdiction in a deficiency proceeding to review the Commissioner's denial of the taxpayer's request for a hardship waiver of the 60-day rollover requirement under section 402(c)(3)(B)); Capitol Fed. Sav. & Loan Ass'n & Sub. v. Commissioner, 96 T.C. 204, 214-15 (1991) (holding that the Commissioner's refusal to process an application for an accounting method change under section 446(b) is subject to judicial review in a deficiency proceeding); Mailman v. Commissioner, 91 T.C. 1079, 1083 (1988) (holding that the Commissioner's denial of waiver of the addition to tax under former section 6661 is subject to judicial review in a deficiency proceeding); Estate of Gardner v. Commissioner, 82 T.C. 989, 1000 (1984) (holding that the Commissioner's denial of a request under section 6081(a) to extend the time for filing of an estate tax return is subject to judicial review in a deficiency proceeding). Under section 7436(d), the principles of sections 6213(a), (b), (c), (d) and (f), 6214(a), 6215, 6503(a), 6512, and 7481 apply to cases that arise under section 7436, as if the Secretary's notice of determination was a notice of deficiency. Charlotte's Office Boutique, Inc. v. Commissioner, 121 T.C. 89, 103 n.8 (2003), supplemented by T.C. Memo. 2004-43 [2004 RIA TC Memo ¶2004-043], aff'd, 425 F.3d 1203 [96 AFTR 2d 2005-6451] (9th Cir. 2005).

There is a strong presumption that an act of administrative discretion is subject to judicial review. Trimmer, 148 T.C. at 346; Corbalis v. Commissioner, 142 T.C. 46, 56 (2014) (holding that denials of interest suspension under section 6404(h) are subject to judicial review). Under the VCSP, an eligible employer pays a lesser amount of employment tax than would have been due as to certain employees and is not liable for any interest and penalties. *See* I.R.S. Announcement 2012-45, 2012-51 I.R.B. at 725. In 2000 section 7436(a) was amended to provide the **Tax Court** jurisdiction to "determine whether such a determination by the Secretary is correct and the proper amount of employment tax under such determination."*See* Consolidated Appropriations Act, 2001, Pub. L. No. 106 554, § 314(f), 114 Stat. 2763, -2763A-643 (2000); Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105- 206, § 3103, 112 Stat. 685, 731. The U.S. Court of Appeals for the Ninth Circuit held that the amendment in 2000 "indicates that Congress did not intend to limit the **Tax Court's** jurisdiction under section 7436 to determining only whether an individual was an employee." Charlotte's Office Boutique, Inc. v. Commissioner, 425 F.3d at 1208.

Pursuant to statute and caselaw we conclude that this Court has jurisdiction to determine whether the liability is correct in proceedings for determination of employment status. *See* § 7436(a); *see also* Ewens & Miller, Inc. v. Commissioner, 117 T.C. 263, 267-68 (2001). Because the denial of a taxpayer's eligibility for VCSP directly affects the amounts of tax, the procedures that Congress has established for judicial review of the Commissioner's determinations logically contemplate

review of such a denial as one element of the determination. *See* Trimmer, 148 T.C. at 347; Estate of Gardner, 82 T.C. at 996.

We conclude that we have jurisdiction to determine whether the VCSP enters into the computation of petitioner's taxes owed.[1] We will deny respondent's motion.

II. *Petitioner's Motion for Summary Judgment*

Summary judgment may be granted where the pleadings and other materials show that there is no genuine dispute as to any material fact and a decision may be rendered as a matter of law. Rule 121(b); Sundstrand Corp. v. Commissioner, 98 T.C. 518, 520 (1992), aff'd, 17 F.3d 965 [73 AFTR 2d 94-1198] (7th Cir. 1994). The burden is on the moving party to demonstrate that there is no genuine dispute as to any material fact and that the party is entitled to judgment as a matter of law. FPL Grp., Inc. & Subs. v. Commissioner, 116 T.C. 73, 74-75 (2001). After [pg. 89] extex reviewing the pleadings and the motion with accompanying exhibits and declarations, we conclude that there is a material dispute regarding the facts.

Petitioner contends that it has met all requirements for participation in the VCSP. Respondent contends that Mr. Treece's misclassification as a nonemployee was uncovered as the result of an employment tax audit. If respondent's argument is correct, petitioner does not meet the participation requirements of VCSP. We conclude that whether there was an employment tax audit is a dispute of material fact, and therefore we will deny petitioner's Motion for Summary Judgment.

Any contentions we have not addressed are irrelevant, moot, or meritless.

To reflect the foregoing,

An appropriate order will be issued.

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[1] Our review in this case in not contrary to our general policy of not looking behind a statutory notice of determination to examine the Commissioner's motives or conduct in determining a liability because our review is necessary to determine the merits of the Commissioner's determinations. Estate of Gardner, 82 T.C. at 1000.

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Tax Court & Board of Tax Appeals Reported Decisions

Estate of Marion Levine, et al. v. Commissioner, 158 T.C. No. 2, Code Sec(s) 2035; 61; 2042.

ESTATE OF MARION LEVINE, DECEASED, ROBERT L. LARSON, PERSONAL REPRESENTATIVE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 32]

Code Sec(s):	2035; 61; 2042
Docket:	Dkt. No. 13370-13.
Date Issued:	02/28/**2022** .
Judge:	Opinion by Holmes, *J.*
Tax Year(s):	Date of death 1/29/2009.
Disposition:	Decision for Taxpayer.

HEADNOTE

1. Estate and gift taxes—split-dollar life ins. arrangements—valuation—governing rules. In estate tax case involving decedent/entrepreneur who entered split-dollar life ins. arrangements, where her revocable trust paid for premiums on policies which were taken out on daughter and

son-in-law and which were owned by separate irrevocable life ins. trust that alone held termination right, **Tax Court** determined that neither Reg § 1.61-22 nor Code Sec. 2042 governed issues here because reg applied to only gift tax consequences of stated transactions and Code Sec. 2042 applied only to life ins. policies on life of decedent himself or herself, not to split-dollar arrangements with policies taken out on lives of others.

Reference(s): USTR Estate & Gift Taxes ¶20,355.114. Code Sec. 2035;Code Sec. 61;Code Sec. 2042

2. Gross estate—split-dollar life ins. arrangements—transfers with retained life estate; revocable transfers; restrictive agreements—special valuation rules. In estate tax case involving decedent/entrepreneur who entered split-dollar life ins. arrangements, where her revocable trust paid for premiums on policies which were taken out on daughter and son-in-law and which were owned by separate irrevocable life ins. trust that alone held termination right, **Tax Court** determined that estate included stipulated value of split-dollar receivable, not policies' cash-surrender values as IRS determined, because on date of death, decedent possessed only that receivable/right to receive greater of premiums paid or cash-surrender values of policies once they terminated. IRS's underlying theory, that cash-surrender values' inclusion was still required per Code Sec. 2036(a)(2) and/or Code Sec. 2038 , failed in face of above and fact that decedent didn't have any right to terminate policies, and as such no possession or right for Code Sec. 2036 or Code Sec. 2038 purposes to policies' cash-surrender values. And while IRS further argued that decedent through her attorneys-in-fact stood on both sides of split-dollar arrangements such that she could unwind them at will, that as result she had power to surrender policies at any time for their cash-surrender values, and therefore that such power still fell within Code Sec. 2036 or Code Sec. 2038 , this argument failed in face of particular facts of this case. IRS's alternate argument to apply Code Sec. 2703(a)(2) 's special valuation rules for certain restrictions was also unsuccessful. Since property being valued here was receivable and there were no restrictions on same, Code Sec. 2703 didn't apply.

Reference(s): USTR Estate & Gift Taxes ¶20,335.60(35); 20,365.01(7); 20,385.01(3); 27,035.01(3). Code Sec. 2033;Code Sec. 2036;Code Sec. 2038;Code Sec. 2703

Syllabus

D, the deceased, entered into split-dollar life-insurance arrangements which required her revocable trust to pay premiums for life-insurance policies taken out on the lives of her daughter and son-in-law. When the arrangements terminate, D's revocable trust has the right to be paid the greater of the premiums paid or the cash surrender value of the policies. An irrevocable life-insurance trust was the owner of these policies. D's children and grandchildren were the beneficiaries of the irrevocable trust, and F, a family friend who was

substantially involved in the family's businesses, was the sole member of the investment committee that managed the irrevocable trust. F and two of D's children also acted as D's attorneys-in-fact and as the revocable trust's successor cotrustees. As the sole member of the irrevocable trust's investment committee, only F had the right to prematurely terminate the life-insurance policies: the arrangements gave D and the other two attorneys-in-fact no rights to terminate the policies or the arrangement itself.

[pg. 33]

1. *Held*: Treasury Regulation § 1.61-22 governs only the gift-tax consequences of this transaction.

2. *Held, further*, as of the date of her death, D possessed a receivable created by the arrangements, which was only the right to receive the greater of premiums paid or the cash surrender values of the policies when they are terminated.

3. *Held, further*, I.R.C. § 2036(a)(2) and 2038 do not require inclusion of the policies' cash-surrender values because D did not have any right, whether by herself or in conjunction with anyone else, to terminate the policies because only the irrevocable trust had that right.

4. *Held, further*, I.R.C. § 2703 applies only to property interests that D held at the time of her death. There were no restrictions on the split-dollar receivable, so I.R.C. § 2703 is inapplicable.

Counsel

G. Michelle Ferreira, Brooke D. Anthony, and Joseph W. Anthony, for petitioner.

Randall L. Eager, for respondent.

HOLMES, *Judge*

OPINION

Marion Levine entered into a complex transaction in which her revocable trust paid premiums on life-insurance policies taken out on her daughter and son-in-law that were held by a separate and irrevocable life-insurance trust. Levine's revocable trust had the right to be repaid for those premiums. Levine has since died, and the question is what has to be included in her taxable estate because of this transaction—is it the value of her revocable trust's right to be repaid in the future, or is it the cash surrender values of those-life-insurance policies right now?

We considered aspects of similar transactions both in Estate of Morrissette v. Commissioner,[1] and in Estate of Cahill v. Commissioner,[2] but in this one we have novel questions of how to decide what the revocable trust transferred before Levine's death and what it held when she died.

Background

Levine was born in St. Paul, Minnesota in 1920. She lived there with her nine brothers and sisters through the Great Depression until she married George Levine. They were of the Greatest Generation, and Levine followed her new husband as best she could even after he was drafted into service. He served honorably, and when we had won, he and she made their way back to St. Paul. They enlisted together in the ensuing baby boom, and had two children—Nancy and Robert. Nancy married Larry Saliterman, and they themselves had three children: Scott, P.J., and Jonathan. Robert has two of his own: Charles and Michel. A family tree may be helpful here:

George died in 1974, and Levine married Henry Orenstein sometime in the 1980s. This marriage lasted only a year before it ended in divorce. Levine then married Harold Frishberg around 1990, and they remained married until his death in 2005.

I. *Levine's Business Success*[pg. 34]

A. *Humble Beginnings*

Levine graduated from high school and received some business-school training, but never earned a college degree. At a time when it was especially unusual, she nevertheless became a highly successful businesswoman. Her success began in 1950 when the Levines opened Penny's Supermarket. This small family business eventually grew to a 27-store, multimillion-dollar company. Levine did almost everything at Penny's—she collected timecards, oversaw payroll, paid bills, and tracked inventory. She became the sole boss after George died, until after more than three decades of minding the store, she sold the business for $5 million in 1981. The proceeds did not become a nest egg for a comfortable retirement; Levine used them instead as capital to hatch new businesses that increased her net worth to $25 million over the next twenty years.

B. *After Penny's*

None of these new businesses had anything to do with groceries. They were real-estate investments, a stock portfolio that she had begun in the early '60s and tended herself, interests in two Renaissance fairs and several mobile-home parks, and loans to real-estate partnerships and mobile-home park residents.

1. *Real Estate Investments*

Most of Levine's real-estate investment activity was as a lender. Levine, her close personal friend Bob Larson, Larry, and Robert created two companies named 5005 Properties and 5005 Finance to manage all the real-estate ventures.[3] Larson, Larry, and Robert managed the day-to-day business for these properties, while Levine mostly supplied the financing. One of Levine's biggest and most profitable assets in her real-estate portfolio was Penn Lake Shopping Center, LLC (Penn Lake). She and her late husband had built Penn Lake in 1959, and by 2007 the property was free of debt and produced approximately $200,000 in annual income.

2. *Mobile Home Parks*

Levine owned several mobile-home parks through 5005 Properties. This business began in 1979 when she bought a mobile-home park in Dayton, Minnesota. These investments settled into a simple pattern: 5005 Properties would buy the property and rent spaces to residents. At the height of this business, 5005 Properties owned 30 mobile-home parks, but its portfolios had shrunk. Banks had stopped financing mobile homes after enactment of reform legislation,[4] so 5005 Finance itself stepped in and got extra revenue from lending to prospective residents. Many of these tenants had low credit scores, but 5005 knew its tenants and with some care could lend them money to buy their homes at rates they could afford. Levine took pride in avoiding evictions and was pleased when the tenants' improved scores let them climb the ownership ladder up to "stick-built" homes.

3. *Renaissance Fairs*

Levine also began to invest at some point in Renaissance fairs. These are a bit like state fairs, if the state were a small principality in fifteenth-century Europe populated entirely by modern people who enjoy costumed role-playing and adding extra "e's" to words like "old" and "fair." There are 20 major Renaissance fairs around the country, and 5005 Properties owns and runs 2 of them—the Arizona and Carolina Renaissance Festivals (the latter in North Carolina). Levine entered the business in 1988 and her festivals were generally open 7-8 weekends a year. Each festival is a small business. 5005 Properties charges admission, sells food and drinks for all concessions, contracts with skilled craftsmen and entertainers, and buys advertising to make it all profitable.

II. *Family and Business Dynamics*

Levine's entrepreneurial success allowed her to support her children. Nancy graduated from the University of Minnesota in 1967 with a major in English literature and [pg. 35] minors in humanities

and art history. She worked mainly in different retail jobs after college (including at Penny's for a short time), but for the most part was not active in the family businesses.

Her brother Robert, on the other hand, became deeply involved early on and remains so today. He graduated from the Wharton School of Business with a degree in economics and a major in accounting and finance. He then went on to get his J.D. from the University of Colorado Law School in 1977. He is still a member of the Minnesota bar, although he has not practiced since the mid-1980s.

He also seems to have inherited his parents' business acumen. He acquired his first piece of real estate—the Time Square Shopping Center in Minnesota—in 1974 upon his father George's death. He got involved in the purchase of Levine's first mobile-home park in 1979 and even worked at Penny's for about two years until its sale in 1981. He now works at 5005 Properties, where he is an astute manager of the Levine family's investments.

As the turn of the millennium neared, Levine began to plan for her own old age. She gave both of her children a statutory power of attorney in 1996 to take care of her affairs if something happened. But Nancy and Robert have not always gotten along, so Levine thought it was necessary to have a third attorney-in-fact to play the referee. This role was played by Bob Larson.

Larson is a Vietnam-era Marine who earned an accounting degree in 1966. He was working two different accounting jobs when his career—and his life—changed after meeting Levine in 1969. Larson's wife was Levine's hair dresser, and the Larsons got invited to Nancy and Larry's wedding. After meeting Levine at the wedding, Larson ran into her again while she was getting her hair done at his wife's salon. They started chatting, and at one point he complained about the prospect of moving to a small town in Oklahoma for a job. Levine listened, and she had a better idea. She told Larson that she needed an in-house controller for Penny's and he should consider interviewing for the job. It all worked out very well. Larson won the position and began a 50-year professional and personal relationship.

Penny's had just moved its accounting in-house, and Larson became head of its accounting staff, took care of the financial statements, and did the bank reconciliations. After George died in 1974, Larson became more deeply involved with the family's business. When the family sold Penny's, he even stayed on for another year or two to help close the business out.

He also helped Levine as she began exploring other investments. According to Larson, Levine had her eye out for investments that would help the key people that she worked with, all of whom were family—except for Larson himself. Indeed, it was Larson who saw the potential in that first mobile-home park in Dayton, Minnesota. He brought the idea to Levine, she approved, and the family went off in that new direction.

Larson's role grew with the business, and he has stayed on with 5005 Properties and 5005 Finance, where he is president of both. He oversees the tax and accounting work for the companies, and he signs most of the companies' tax returns. Levine's making him one of her attorneys-in-fact was especially sensible as he was close with every member of the Levine family.[5] Levine drafted these powers of attorney; if there are any disagreements among the three attorneys-in-fact, the decision of the majority takes the day.

Levine's decision to name attorneys-in-fact meant that she contemplated her mortality, but it didn't mean at first that she was any less active. She continued to manage her own legal affairs and stayed involved in the businesses. She was happy to delegate, but always stayed alert as the "watchdog." She would look over financials with Larson monthly and made sure she knew all that was going on with the businesses. Then, in 2003, she suffered [pg. 36] a stroke while on vacation in Palm Springs.[6] In 2004 or 2005 Robert and Nancy became concerned about her driving skills. They arranged for her to take a driver's test, and her driver's license was taken away. This was an important event. Levine remained involved in the business, but she worked less and less. She hired someone to drive her to the office but came in only about twice a week. Her health did not improve. It took another step down in 2008, when signs of dementia began to appear, but even as she neared 90, Levine still wanted to know what was going on. Larson began to go to her home with financial statements to review, but more out of habit and to hear echoes of earlier times than to get her advice or seek her approval.

III. *Levine's Estate Planning*

Well before any of these health issues arose, Levine began to plan her estate. She first created a revocable trust—the Marion Levine Trust—in May 1988. Levine herself was the trustee; she named Larson, Robert, and Nancy as successor trustees; and Nancy, Robert, and their children as beneficiaries.[7] She first amended this trust agreement in May 1996 to add Larson, Robert, and Nancy as cotrustees. Then, in February 2005 she resigned as trustee and made Larson, Nancy, and Robert the sole cotrustees at about the same time as she signed the short-form power of attorney that we've already mentioned. *See* Minn. Stat. § 523.23 (2005).

Between 1996 and 2007 Levine used an attorney named Bill Brody to do her estate planning, and Brody had prepared all of Levine's estate-planning documents. But as Levine's health grew worse, her family and Larson pressed her to search for a new lawyer to advise them. Shane Swanson, an attorney at Parsinen Kaplan Rosberg & Gotlieb, P.A. (Parsinen), was referred to the Levine family by Levine's sister, who had been using Swanson and was extremely pleased with his work. The family and Swanson clicked, and in November 2007 they retained the Parsinen firm to review and revise Levine's estate plan. Although Howard Rubin, a senior estate-planning partner at Parsinen, negotiated the fee for services and signed the engagement letter on behalf of the firm, Swanson

was the primary point of contact for Levine and her attorneys-in-fact, and he took the lead on the estate-planning work.

Swanson first worked with Levine to make sure all her business entities both were properly structured and meshed well with a comprehensive estate plan. Many of the entities that Levine had invested in—especially the partnerships—were governed by old documents, so Swanson worked to revise them. While he ran into difficulties when multiple other partners and parties were involved, Swanson was able to either update or restructure the partnerships that Levine controlled directly into more modern entities such as LLCs. Swanson also created different trusts to hold some of Levine's real-estate assets which allowed her to pass them to her children in ways that would produce estate-tax savings. He wasn't looking to do anything radical and started by using two tools well known to estate planners: the grantor retained annuity trust (GRAT) and the qualified personal residence trust (QPRT).

A GRAT is a "tax-saving device in which a grantor transfers assets into trust and retains an annuity payable for a specified term." Estate of Hurford v. Commissioner, T.C. Memo. 2008-278 [2008 RIA TC Memo ¶2008-278], 96 T.C.M. (CCH) 422, 425 n.2 (citing Bittker et al., Federal Estate and Gift Taxation 80-81 (9th ed. 2005)). When these GRATS are structured according to the Code, the transferor avoids incurring any gift tax-liability. *See*, Grieve v. Commissioner T.C. Memo. 2020-28, at *6 [2020 RIA TC Memo ¶ 2020-028] & n.4. If the grantor survives to [pg. 37] the end of the specified term, any appreciation in the asset's value over the rate specified in section 7520 passes to the beneficiaries without any gift or estate tax. Id. If the grantor does not survive, however, the full value of the asset is included in her gross taxable estate. Treas. Reg. § 20.2036-1(c)(2)(i). This GRAT structure is specifically provided for in the regulations under special valuation rules. *See* Treas. Reg. § 25.2701-1 to -8. Levine placed her Dayton Park project partnership—located in Dayton, Minnesota—into the GRAT with a two-year term, with any appreciation on the asset to pass to Nancy and Robert at the end of this term.

A QPRT allows an individual to transfer her home into a trust, which makes it exempt from estate and gift taxes so long as the transferor uses the home as her personal residence for the specified term. *See* § 2702; Treas. Reg. § 25.2702-5. Levine placed 50% of her Minneapolis condo into a QPRT with a two-year term, and the other 50% in a different QPRT with a three-year term. During these terms, she was able to live in her condo rent free, but after the terms expired, title would pass to Nancy and Robert. If Levine wanted to continue to live in the condo, she would at that point be required to pay fair market rent to them to do so. A QPRT can reduce the value of the property it holds by an amount equal to the value of the right to live in it for the trust's term, which would also reduce potential estate tax.[8] *See*, Estate of Riese v. Commissioner T.C. Memo. 2011-60 [2011 RIA TC Memo ¶2011-060], 101 T.C.M. (CCH) 1269.

Levine's specific estate-planning goals and her diverse assets presented challenges even to estate planners as skilled as the ones the family retained. From the beginning, Larson and Levine's children made it clear to Swanson that Levine wanted enough money to maintain her lifestyle until her death. This meant that any estate planning needed to be done with Levine's excess capital—i.e., assets that she would not likely need during her lifetime. This would be difficult in most circumstances, but especially because so much of Levine's wealth was in real estate or partnerships that owned real estate. She owned a number of properties that were unencumbered by any debt—her condo in Minneapolis, a home in Rancho Mirage, California, her interests in the mobile-home parks and the two Renaissance fairs, and the Penn Lake Shopping Center. Levine wanted these assets to stay in her estate so that her children would inherit them with stepped-up bases when they passed to her children.[9] But, like a halberd, stepped-up basis cuts both ways. Holding onto real estate might cut future capital-gains tax, but it also meant that its value would be part of Levine's gross taxable estate. In situations like this, Swanson typically suggested looking to insurance as a way to help clients prepare to pay the estate tax that would eventually be due on these relatively illiquid investments. Swanson knew that Levine earned more than $1 million annually and that this money would need to be redeployed into other investments. He also thoughtfully asked about the children's situation and learned that they themselves also had large real-estate holdings and completely lacked any estate plans. So he suggested to them and Larson that there just might be a way for Levine to invest her excess capital to provide her with a good return, while at the same time meshing with the Levine children's needs for estate plans of their own.

His idea: intergenerational split-dollar life insurance.

A. *Planning the Split-Dollar Life-Insurance*

While Swanson had done a split-dollar insurance arrangement before, he had never done a transaction like the one he was proposing for Levine—loans from a parent to her children to buy life insurance for *them*. He explained that the circumstances that might make this type of transaction attractive are very rare, and require that the client [pg. 38]

- has enough cash to buy a substantial amount of life insurance, and to live on for the rest of her life;
- faces an estate-tax bill large enough to justify the costs of planning and execution;
- has children whose lives would be insured, and who themselves have a sufficient net worth to qualify for large life-insurance policies; and
- has children who are healthy enough to navigate the underwriting process successfully.

Swanson spent a good deal of time thinking through all the advantages and disadvantages, conditions and qualifiers. He put together a PowerPoint presentation for the family in late 2007 or

early 2008. Then in January 2008 he sent a letter to Larson and the children in which he described the transaction and its legal and tax implications.

He told them that Levine could contribute money to a trust that would be for the benefit of Robert, Nancy, and her grandchildren. Its trustees would then use the money to buy life-insurance policies on Nancy and Robert's lives. This would not be purely a gift—the trust would get Levine's money only in exchange for a promise by the trust to pay her the greater of the money she advanced, or the cash value of the policies upon the earlier of the insureds' deaths or the policies' surrender. The right to this repayment would be held by Levine as a "receivable",[10] or in other words an asset that the Estate had to report on its estate-tax return. His proposal assumed that Levine would lend the trust enough to pay $10 million in premiums, but he said that the technique could be used at any premium level depending on the insured's insurability—i.e., "proof of good health of the insured." *See* Likly & Rockett Trunk Co. v. Provident Mut. Life Ins. Co., 85 F.2d 612, 613 (6th Cir. 1936). Swanson's proposal was complex, and we believe the testimony of Levine's children and Larson that, even though they each received a copy of this detailed proposal letter, they actually learned more about the transaction and finally understood it better through Swanson's discussions with them.

Levine, her children, and Larson spoke among themselves about the costs and benefits of the deal. Levine herself approved the transaction, but limited the amount that she was willing to lend to the trust for premiums to $6.5 million. Levine thought that she had done enough for her kids and wanted to make sure that she could take care of her grandchildren.

Swanson set to work.

1. *Establishing the Irrevocable Life-Insurance Trust*

First he created the trust that would own the split-dollar life-insurance policies—the Marion Levine 2008 Irrevocable Trust (Insurance Trust).[11] Irrevocable life-insurance trusts are typically used as a vehicle to own life-insurance policies to reduce gift and estate taxes. *See*, Estate of Petter v. Commissioner T.C. Memo. 2009-280 [2009 RIA TC Memo ¶2009-280], 98 T.C.M. (CCH) 534, 535 n.3, aff'd, 653 F.3d 1012 [108 AFTR 2d 2011-5593] (9th Cir. 2011). If done properly, a life-insurance trust can take a policy out of its settlor's estate and allow the proceeds to flow to beneficiaries tax free. Id. Levine's Insurance Trust was signed at the end of January 2008 by her children and Larson as attorneys-in-fact and the South Dakota Trust Company, LLC (South Dakota Trust) as an independent trustee. The Insurance Trust's beneficiaries were Robert, Nancy, and Levine's grandchildren—the grandchildren that Levine naturally wanted to take care of.

Swanson settled the Insurance Trust in South Dakota because its laws are favorable—it has no rule against perpetuities, but does have a taxpayer-friendly state income tax and a favorable premium tax. South Dakota is also one of the few states with a "directed" trustee statute, which

allows the separation of management and administration of a trust's investments. *See* S.D. Codified Laws ch. 55-1B (1997). Levine's Insurance Trust named South Dakota Trust as its directed trustee. [pg. 39] This put South Dakota Trust in charge of administration—opening up trust accounts and handling them according to the terms of the trust document. But South Dakota Trust was only the administrator—it had no authority to choose what the trust would invest in.[12] Swanson drafted the trust to have trustees whose job it would be to direct its investments. This was the "investment committee," and its membership consisted of one person—Larson.[13] Levine picked Larson for this role because he had long been very close to the Levine family yet was not a part of it. Levine knew the relationship between her children was fraught. She wanted someone she could trust to manage not just the trust but the relationship—and her children understood this. Larson has been the sole member of the investment committee since it began. South Dakota law defines this committee's fiduciary obligations to the Insurance Trust and its beneficiaries. *See* S.D. Codified Laws § 55-1B-4 (1997). And we specifically find that, as the committee's only member, Larson was under a fiduciary duty to exercise his power to direct the Insurance Trust's investments prudently, and he faced possible liability to its beneficiaries if he breached that duty.

Larson approved the split-dollar life-insurance arrangement on behalf of the Insurance Trust in his role as the investment committee.

2. *Acquiring the Life Insurance Policies*

The next step was for the Insurance Trust to buy insurance. Levine, her children, and Larson first had to decide who would be the insured parties. Swanson initially suggested that the life-insurance policies should be taken out on the lives of both Nancy and Robert. But Robert had a preexisting medical condition that would have made him uninsurable at a reasonable price. So Levine, her children, and Larson decided instead that the Insurance Trust would buy policies on the lives of Nancy and her husband Larry. Swanson then worked with an insurance broker to find the right insurance companies. After mulling over Swanson's advice Levine, her children, and Larson settled on two last-to-die policies with John Hancock and Pacific Life. Once the applications for the life-insurance policies were submitted in April 2011, the process of pulling together the cash to fund the policies began.

This had to be given some thought. Even though Levine had a net worth in excess of $25 million in 2008, Swanson and Levine's children decided to borrow money to fund these life-insurance premiums.[14] This was an investment decision made by Levine and her children. They wanted to lock in the quoted premium rates for the policies, so they quickly took out short-term loans to do so. Several of these loans would be taken out by Levine's real-estate partnerships. And, with the exception of the Central Bank loan, they expected to quickly repay the loans and any of Levine's advances by refinancing the debt on the partnerships, as well through the sale of the Arizona Renaissance Festival.

Between June and August 2008, the children and Larson—as Levine's attorneys-in-fact-executed the paperwork to marshal the $6.5 million they needed, almost all through loans: [pg. 40]

Source	Amount	Annual interest rate	Term
Central bank loan	$3,800,000 ($3,730,000 used for premiums)	6.35%	60 equal monthly payments
Private bank line of credit	$2,000,000	5.25%	1 year, single balloon payment
Business bank loan	$516,000 ($500,000 used for premiums)	6.9%	60 monthly payments, plus one lump-sum payment at end of 5 years
Penn Lake Shopping Center's savings account	$270,000	N/A	N/A

a. *Central Bank Loan*

The first loan was $3.8 million from Central Bank to Penn Lake. Levine owned 100% of Penn Lake and had paid off the mortgage on the property years before. This loan had an interest rate of 6.35%, and Penn Lake promised to make 60 equal monthly payments until July 1, 2013. Penn Lake pledged various properties that it owned as collateral.

Levine and her children felt no urgency to repay the principal of this loan. Their plan was instead to pay the interest, which they'd been advised would increase Levine's basis in the receivable that the Estate would be obtaining as part of this split-dollar transaction.[15] Levine's estate would eventually owe tax on what it got back from the Insurance Trust through the receivable the Estate held, and that tax would shrink if Levine's basis in the receivable increased.[16]

b. *Private Bank Line of Credit*

The children and Larson, acting as her attorneys-in-fact, also opened a personal line of credit with Private Bank of Minnesota. This gave Levine access to $2 million for a term of one year at 5.25%. Any outstanding balance was due and payable in a single balloon payment in thirteen months. They secured this line of credit with various properties and assets that Levine Investments, 5005 Properties, and 5005 Finance owned.

c. *Business Bank Loan*

The last of the three loans was arranged by Nancy and Robert in their capacities as cotrustees of Levine's Revocable Trust. It was with Business Bank for $516,000 at an annual rate of 6.9%, with monthly payments of $4,000 over the course of 5 years, followed by a balloon payment of any unpaid principal and interest at the end of that term. They secured it with the Revocable Trust's interests in several installment-sales contracts and leases.

With the loan proceeds and some cash from Penn Lake's account, Levine's children and Larson—again acting as her attorneys-in-fact—wired $4 million from Penn Lake to the Pacific Life Insurance Company to pay the one-time premium for insurance on the lives of Nancy and Larry. It is a whole-life policy with a face value of $10,750,000 that will pay out after both of their deaths. It also had a cash-surrender value that was guaranteed to increase by at least 3% per year.

A few days later, Private Bank of Minnesota wired $2 million to the John Hancock Life Insurance Company. A month later, Business Bank wired another $500,000. This paid the one-time premium for another last-to-die whole-life policy, this one for $6,496,877. It had a cash-sur[pg. 41] render value guaranteed to increase by at least 3% per year.

B. *Levine's Split Dollar Arrangement*

Between June and July 2008, Nancy, Robert, and Larson—in their capacities as Levine's attorneys-in-fact and as trustees of her Revocable Trust—executed several documents to put the split-dollar arrangement into effect. We summarize the most important parts of the deal:

- The Insurance Trust agreed to buy insurance policies on the lives of Nancy and Larry;
- The Revocable Trust agreed to pay the premiums on these policies;
- The Insurance Trust agreed to assign the insurance policies to the Revocable Trust as collateral;
- The Insurance Trust agreed to pay the Revocable Trust the greater of (i) the total amount of the premiums paid for these policies—$6.5 million—and (ii) either (a) the current cash-surrender values of the policies upon the death of the last surviving insured or (b) or the cash-surrender values of the policies on the date that they were terminated, if they were terminated before both insureds died.

It was very important, if this deal was to work, that the Insurance Trust and not the Revocable Trust own the policies. The recitals in the arrangements state that the parties do *not* intend to convey to Levine or the Revocable Trust any "right, power or duty that is an incident in ownership...as such is defined under Section[s] 2035 and 2042" in the life-insurance policies at the time of Levine's death. They also state that neither the Insurance Trust, nor its beneficiaries, nor the insureds—Nancy and Larry—would have access to any current or future interest in the cash value of the insurance policies.

We also specifically find that *only* the Insurance Trust—and that means Larson—had the right to terminate the arrangements. There were two split-dollar arrangements, one for each insurance company. Paragraph 6 from both arrangements controlled the right to terminate the arrangements:

> The Insurance Trust shall have the sole right to surrender or cancel the Policy during the lifetime of either insured. In addition the Insurance Trust may terminate this Agreement in a writing delivered to the other party, effective upon the date set forth in such writing.

If the Insurance Trust did terminate the Agreement, however, it would get nothing:

> The Revocable Trust shall have the unqualified right to receive the total amount payable upon such surrender or cancellation of this Policy, or upon termination by notice from the Insurance Trust, and the Insurance Trust shall not have access to, or any current or future interest in, the Cash Value. Upon such payment of said funds to, and receipt of said funds by, the Revocable Trust, this Agreement shall terminate.

With the split-dollar deal done, Swanson had finished hammering into place the paper armor he had designed to protect as many of Levine's assets from tax as he legally could. He was just in time; within months, Levine's physical and mental health began to deteriorate more rapidly. She became more forgetful and began to not recognize her family and friends. At the start of 2009, she became bedridden. On January 22 she died.

C. Tax Reporting

Everyone involved knew that Levine, through her Revocable Trust, had given away some of her property to the Insurance Trust and its beneficiaries—they knew, in other words, that the value of the money the Revocable Trust would get years later wasn't equal to the $6.5 million it had given to the Insurance Trust for it to buy the insurance policies on Nancy and her husband. They knew that this was a taxable gift. Swanson prepared gift-tax returns for 2008 and 2009. Larson and Nancy signed these returns in their capacities as Levine's attorneys-in-fact. Each Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, reported the value of the gift as the eco[pg. 42] nomic benefit transferred from the Revocable Trust to the Insurance Trust. Gifts of valuable property for which the donor receives less valuable property in return are called "bargain

sales." *See*, Estate of Bullard v. Commissioner 87 T.C. 261, 265 (1986). And the value of gifts made in bargain sales is usually measured as the difference between the fair market value of what is given and what is received. Id. at 270-71. Not so here. The Secretary, for whatever reason, has issued regulations that provide a different measure of value when split-dollar life insurance is involved. *See* Treas. Reg. § 1.61-22(d)(2). The number Larson and Nancy came up with after applying the valuation rules in the regulations was $2,644. *See* Treas. Reg. § 25.2512-1.

Everyone involved also knew that the promise of the Insurance Trust to pay the Revocable Trust some amount sometime in the future was also valuable. It had to be reported on the Levine's estate-tax return. And on Levine's Schedule G, Transfers During Decedent's Life, of the Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, the value of the split-dollar receivable, as owned by the Revocable Trust on the alternate valuation date, was reported as an asset worth about $2 million. [17]

IV. *Audit and Trial*

This shift of money from the Revocable Trust for the purchase of the life-insurance policies that benefited the Insurance Trust caught the IRS's attention. The Commissioner issued his challenge, and the joust between the IRS and the Estate began. The Commissioner noticed two things in particular. The first was the small amount—only $2,644—that Levine reported as the gift that her Revocable Trust had made to the Insurance Trust. The second was that the Insurance Trust had promised to pay the Revocable Trust the *greater* of $6.5 million or the policies' cash surrender value at *either* the death of both Nancy and her husband *or* upon termination of the policies. At the time of Levine's death, this value was close to $6.2 million, and the Commissioner suspected there was no insurmountable hurdle to the Insurance Trust's terminating the policies well before Nancy and her husband both died. This would mean that the Insurance Trust and Levine's descendants, as beneficiaries of the Revocable Trust, had ready access to $6.2 million, not just the $2.1 million + $2,644 that was reported on the estate and gift-tax returns.

The Commissioner assigned as his champion estate-and-gift-tax attorney Scott Ratke. Ratke conducted an extensive audit, and in the end the Commissioner issued a notice of deficiency to the Estate for slightly more than $3 million. This reflected several adjustments, but his adjustment to the value of Levine's rights under the split-dollar arrangement was by far the biggest. He also determined that the Estate was liable for a 40% gross-misvaluation penalty under section 6662(h) because the value that it had reported for the split-dollar receivable was way too low. Ratke prepared a penalty-approval form for this penalty, which was signed by his immediate supervisor at the time—Nicole Bard—before the notices of deficiency were sent. [18]

Counsel for the parties worked together to narrow the issues so their combat could be confined to a small tilt and not become a general melee. Three stipulations settled most issues. Only two

remain:

- Was the value of the split-dollar receivable in Levine's estate on the alternative valuation date $2,282,195, or the policies' cash-surrender value of $6,153,478; and
- Is any resulting underpayment subject to the 40% gross-misvaluation penalty under section 6662(h). [19]

[pg. 43]

The parties have also stipulated that this case is appealable to the Eighth Circuit. *See* § 7482(b)(2).

Discussion

I. *Split Dollar Life Insurance*

Split-dollar life-insurance deals began as a form of employment compensation. Employers wanted to pay the premiums on life insurance for their employees, keep an interest in the insurance policy's cash value and death proceeds, and pass on to the employee—or the employee's designated beneficiary—any remaining death benefit. *See* De Los Santos v. Commissioner, T.C. Memo. 2018-155 [2018 RIA TC Memo ¶2018-155], 116 T.C.M. (CCH) 304, 306. (The "split" in "split-dollar" refers to this division of the insurance proceeds between the insured and the person or entity that paid the premium.) In 1964, the IRS issued Revenue Ruling 64-328, 1964-2 C.B. 11, *revoking* Rev. Rul. 55-713, 1955-2 C.B. 23, in which it announced that it would include the death-benefit portion of a life-insurance policy in a recipient's income because it was an economic benefit. Tax planners and professionals began to devise different variations of these sorts of plans, and split-dollar arrangements eventually moved beyond the employment field.

They became a tool for estate planners who aimed to remove death benefits from their clients' taxable estates—or at least defer payment of any tax owed. What makes this attractive are some unusual advantages that the Code gives to buyers of life insurance—especially on what is called "inside buildup." An insurance company can sell a policy with premiums much larger than one would pay for term insurance. This money can go to work for the policyholder or her beneficiaries and "build up" as long as the policy remains in effect. It can make for a much larger death benefit or a substantial cash surrender value. Details quickly become very complicated, but it suffices here to characterize these policies as a form of tax-advantaged savings. Unlike income earned on other savings accounts–such as bank CDs or mutual funds—inside buildup is not taxed under section 72(e) as it accrues. It *is* eventually taxed when it is distributed to the policy holders, id., but that can be a long time into the future, and all other things being equal, tax tomorrow is better than tax today. And tax decades from now is better still.

Over the years, the IRS provided limited guidance on the taxation of split-dollar life-insurance arrangements, mostly in the form of notices and revenue rulings.[20] That all changed when the Treasury Department issued final regulations in 2003. These govern all split-dollar arrangements entered into or materially modified after September 17, 2003. Treas. Reg. § 1.61-22. The final regulations broadly define a split-dollar life-insurance arrangement between an owner and a nonowner of a life-insurance contract in which:

- either party to the arrangement pays, directly or indirectly, all or a portion of the premiums;
- the party making the premium payments is entitled to recover all or a portion of those premium payments, and repayment is to be made from or secured by the insurance proceeds; and
- the arrangement is not part of a group-term life insurance plan (other than one providing permanent benefits).

Id. para. (b)(1)

The split-dollar arrangement in this case meets these specific requirements. After defining what a split-dollar arrangement is, the final regulations create two different and mutually exclusive regulatory regimes—called the "economic benefit regime" and the "loan regime"—that govern the income-and gift-tax consequences of split-dollar arrangements. Which regime a particular arrangement falls under depends on who "owns" the life-insurance policy at issue. Id. subpara. (3)(i). The general rule is that the person named as the owner is the owner. Id. para. (c)(1). [pg. 44] Nonowners are any person other than the owner who has a direct or indirect interest in the contract. Id. subpara. (2). Under this general rule, the Insurance Trust would be the owner of the policies here, and the loan-regime rules would apply.

But there is an exception to this general rule. If the only right or economic benefit provided to the donee under a split-dollar life-insurance arrangement is an interest in current life-insurance protection, then the regulations tell us to ignore the formal ownership designation and treat the donor as the owner of the contract. This is the economic-benefit regime. Id. subpara. (1)(ii)(A)(2). So there's at least a threshold question here about whether the Insurance Trust received any economic benefit in addition to current life-insurance protection.

On this we have precedent. In Morrissette I, we held that a split-dollar arrangement much like this one fell under the economic-benefit regime for gift-tax purposes. But we also noted in Morrissette I, 146 T.C. at 172 n.2, that "we [were] not deciding whether the estate's valuation of the receivables...in the gross estate [was] correct." And section 1.61-22(a)(1) seems not to cover the estate-tax consequences of split-dollar arrangements at all.[21] The final regulations do make one reference to estate tax in their preamble, which states "[f]or estate tax purposes, regardless of

who is treated as the owner of a life insurance contract under the final regulations, the inclusion of the policy proceeds in a decedent's gross estate will continue to be determined under section 2042." T.D. 9092, § 5, 2003-2 C.B. 1055, 1063. But the express terms of section 2042 limit its applicability to life-insurance policies on a decedent's own life, not split-dollar arrangements where policies are taken out on the lives of others. *See* § 2042(1); Treas. Reg. § 20.2042-1(a)(2) ("[S]ection 2042 has no application to the inclusion in the gross estate of the value of rights in an insurance policy on the life of a person other than the decedent"). From this we conclude that neither the regulation nor section 2042 governs our valuation of the split-dollar arrangement we have to analyze.

II. Estate Tax Generally

That leaves us to look to the default rules of the Code's estate-tax provisions to figure out how to account for the effect of *this* split-dollar arrangement on the gross value of *this* estate. The Code defines a taxable estate as the value of a decedent's gross estate minus applicable deductions. § 2051. A decedent's gross estate includes the value of any property that a decedent had an interest in at the time of her death. § 2033. Some taxpayers reduce their estate-tax liability by making *inter vivos* transfers several years before death [22] and pay a usually smaller tax on the transfer. [23] § 2501(a). Sections 2034 through 2045 tell us what other property to include in an estate.

Among these sections is section 2036, which generally includes in a decedent's taxable estate the value of property that she transfers if, after the transfer, she kept either possession or the right to income from the property; or even if she kept a right—either alone or in conjunction with another—to designate who would receive possession of that property or its income. Section 2038 generally claws back into a decedent's estate the value of property that she transferred in which she retained an interest or right—either alone or in conjunction with another—to alter, amend, revoke, or terminate the transferee's enjoyment of the transferred property. Both sections 2036 and 2038 include an exception for transfers that are "a bona fide sale for an adequate and full consideration in money or money's worth." §§ 2036(a), 2038(a)(1).

Section 2703 also tells us how to value property for gift, estate, and generation-skipping-transfer tax purposes. It states that [pg. 45] under certain circumstances property must be valued without regard to any right or restriction relating to the property that would result in the property's being valued at less than its fair market value. *See* § 2703(a).

The Estate asserts that the only asset from the split-dollar arrangement that Levine's Revocable Trust owned at the time of her death was the split-dollar receivable. In its view, Levine did not own, or have any other interest in, the life-insurance policies because those policies were owned by the Insurance Trust. And, as the Estate also points out, the value of that receivable is a number that the parties have stipulated. *See* supra note 17.

In the Commissioner's view, this entire transaction was merely a scheme to reduce Levine's potential estate-tax liability and, if it was a sale, it was not *bona fide* because it lacked any legitimate business purpose. He argues that the Estate should have reported on its return the cash-surrender values of the life-insurance policies, not the value of the receivable. He reasons that:

- under section 2036 Levine retained the right to income—or the right to designate who would possess the income—from the split-dollar arrangement, and
- under section 2038 she maintained the power to alter, amend, revoke, or terminate the enjoyment of aspects of the split-dollar arrangement,
- even if the full values of the life-insurance policies are not includible in Levine's estate under section 2036 or 2038, the restrictions in the split-dollar arrangement should be disregarded under the special valuation rules provided in section 2703, which would force the Estate to include in its taxable value the full cash-surrender values of the policies.

III. *Sections 2036 and 2038: What Rights Were Transferred and Retained*

We look first at what rights the Estate, through the Revocable Trust, transferred and what rights it retained. We agree with the Commissioner that the two snippets of the Code that we have to decrypt here are sections 2036 and 2038.

Section 2036(a) is a catchall designed to prevent a taxpayer from avoiding estate tax simply by transferring assets before she dies. Strangi v. Commissioner, 417 F.3d 468, 476 [96 AFTR 2d 2005-5230] (5th Cir. 2005), aff'g Estate of Strangi v. Commissioner, T.C. Memo. 2003-145 [2003 RIA TC Memo ¶2003-145], 85 T.C.M. (CCH) 1331; Estate of Bigelow v. Commissioner, 503 F.3d 955, 963 [100 AFTR 2d 2007-6016] (9th Cir. 2007), aff'g T.C.M. (RIA) 2005-065; Estate of Thompson v. Commissioner, 382 F.3d 367, 375 [94 AFTR 2d 2004-5764] (3d Cir. 2004), aff'g 84 T.C.M. (CCH) 374 [2002 RIA TC Memo ¶2002-246] (2002). It states:

> Sec. 2036(a). General rule.—The value of the gross estate shall include the value of all *property* to the extent of any interest therein of which the decedent has at any time *made a transfer* (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> (1) the possession or enjoyment of, or the right to the income from, the *property* , or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the *property or the income* therefrom.

(Emphasis added.) Section 2038 also speaks of transferred "property", and includes in the gross value of an estate all property

> [t]o the extent of any interest therein of which the decedent has at any time [pg. 46] made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent's death.

(Emphasis added.)

The Estate argues that:

- it made no transfer of its property that could trigger these sections,
- it retained no interest in the property that it did transfer, and in any event,
- the *bona fide* sale for adequate and full consideration exemption applies.

We will take these arguments in order.

A. *What Was "Transferred"?*

Cases tell us to define "transfer" broadly. Estate of Bongard v. Commissioner, 124 T.C. 95, 113 (2005); Estate of Jorgensen v. Commissioner, T.C. Memo. 2009-66 [2009 RIA TC Memo ¶2009-066], 97 T.C.M. (CCH) 1328, 1333, aff'd, 431 F. App'x 544 [107 AFTR 2d 2011-2069] (9th Cir. 2011). "A section 2036(a) transfer includes any inter vivos voluntary act of transferring property." Estate of Jorgensen, 97 T.C.M. (CCH) at 1333 (citing Estate of Bongard, 124 T.C. at 113). Section 2038's scope likewise imposes "a broad scheme." Estate of Morrissette v. Commissioner (Morrissette II), T.C. Memo. 2021-60, at *66 [2021 RIA TC Memo ¶2021-060], 121 T.C.M. (CCH) 1447 (quoting Guynn v. United States, 437 F.2d 1148, 1150 [27 AFTR 2d 71-1653] (4th Cir. 1971)).

But what property? Here the parties disagree. Is the property we look at the policies themselves? Is it the rights under the split-dollar arrangement to receive the greater of $6.5 million or the cash-surrender values of those policies? Or is it simply the $6.5 million in cash wired to the Insurance Trust from Levine's assets before she died?

We find that the "property" at issue cannot be the life-insurance policies, as these policies have always been owned by the Insurance Trust. The split-dollar transaction was structured so that the $6.5 million was paid by the Revocable Trust in exchange for the split-dollar receivable. It was the Insurance Trust that bought the policies and held them. These policies were never owned by the Revocable Trust, and there was no "transfer" of these policies from the Revocable Trust to the Insurance Trust.

The "property" is also not the receivable itself. That property belonged to the Revocable Trust and now it belongs to the Estate. It wasn't "transferred"; it was retained.

That leaves the $6.5 million that Levine sent to the Insurance Trust from her assets that the Insurance Trust used to pay for the insurance policies. And we do find that through her attorneys-in-fact-Levine made a voluntary *inter vivos* transfer within the meaning of sections 2036(a) and 2038 when she wired $6.5 million to the life-insurance companies.

From the Commissioner's perspective, this is much too abbreviated an analysis. Don't look at the money or the policies or the receivable, he argues. Look for that right to unlock the cash-surrender values of those policies. To be sure, those values may be defined by the terms of the life-insurance policies and thus defined by an arrangement between the Insurance Trust and the insurance companies in property that the Estate did not itself *transfer*; but does the right of the Revocable Trust (and now the Estate) under the split-dollar arrangement to receive those cash-surrender values not somehow make them includible in the Estate's gross value?

Perhaps it might make sense, were this our first pass at the target, to more simply analyze the problem. We might just ask whether an estate that holds a split-dollar receivable has a right to a policy's cash surrender value in its gross value directly—to ask first whether an estate has [pg. 47] such a right and, if so, what its value is as of the date of death.[24] But our approach as it has evolved instead elides the questions of whether this right was retained when the property creating it was transferred and whether it might somehow be exercised by the estate.

B. *Were Rights Retained?*

Section 2036's regulations tell us that "[a]n interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred." Treas. Reg. § 20.2036-1(c)(1)(i). The use, possession, enjoyment, right to income, or other enjoyment of property is considered having been retained or reserved "to the extent that the use, possession, right to the income, or other enjoyment is to be applied towards the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit." Id. para. (b)(2).

If we are right that the only property that Levine transferred was cash, then our analysis under section 2036 would seem to be easy—she retained no "interest" in that *cash*. But she did get something in return—the split-dollar receivable created and defined by the split-dollar arrangements. The receivable gave her the right to the greater of $6.5 million or the cash-surrender values of the policies. Under the terms of the split-dollar arrangements, however, Levine did not have an immediate right to this cash-surrender value. She (or her estate) had to wait until the deaths of both Nancy and Larry, or the termination of the policies according to their terms. Here we find what could be a very important difference between the split-dollar arrangements here and those analyzed in Estate of Cahill and Morrissette II. In Levine's case, the split-dollar arrangements between the Revocable Trust and the Insurance Trust expressly stated that *only* the Insurance Trust had the right to terminate the arrangement.

The split-dollar arrangements we analyzed in Morrissette II and Estate of Cahill were different. Look at the language in those arrangements. In Morrissette II:

> The Donor and the Trust may *mutually* agree to terminate this agreement by providing written notice to the Insurer, but in no event shall either the Donor or the Trust possess the unilateral right to terminate this Agreement.

And in Estate of Cahill:

> This Agreement may be terminated during the Insured's lifetime *only* by written agreement of the Donor *and* the Donee acting unanimously. Such termination shall be effective as of the date set forth in such termination agreement.

This difference matters. Unlike what we saw in Morrissette IIand Estate of Cahill, we see here a carefully drafted arrangement that expressly gives the power to terminate *only* to the Insurance Trust. It gave Levine herself no unilateral power to terminate the policies and no language like that in the arrangement at issue in Estate of Cahill or Morrissette II that gave her that right acting in conjunction with the Insurance Trust. *See* supra pp. 16-17. By requiring *both* parties' approval, the arrangements that we analyzed in Morrissette II and Estate of Cahill necessarily *required* each decedent's approval to terminate the arrangement. The opposite is true here, where only the Insurance Trust could terminate the arrangement. Without any contractual right to terminate the policies, we can't say that Levine had any sort of possession or rights to their cash-surrender values. If the contest between the Estate and the Commissioner were confined to the tiltyard defined by the transactional documents, we would have to conclude that sections 2036(a) and 2038 do not tell us to include the polices' cash surrender values in the Estate's gross value.

The Commissioner, however, tries to unhorse the Estate's argument with the pointed assertion that we should look at the transaction as a whole to get a clear picture of where each party stands and its [pg. 48] role in the transaction. And that is exactly what we will do. We'll do it in two ways. We

will question whether our review of the rights that any decedent might keep in a split-dollar arrangement really should be defined by the documents alone. Then we will look carefully to the particular circumstances of this transaction to see whether, as a practical matter on the facts of this case, Levine kept a right to the cash-surrender values of the policies bought by the Insurance Trust.

First to the law—should it make a difference whether the transactional documents in a split-dollar arrangement put the unilateral right to unwind the transaction onto the donee rather than split it between the donor and donee? First-year law students almost all learn that a black-letter rule of contract law is that the parties to a contract are free to modify it. *See* Joseph M. Perillo, Contracts (7th ed. 2014). The Commissioner would surely have a strong argument that this implicit power of parties to a contract is a "right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." § 2036(a)(2).

The Commissioner's first pass at the Estate in this part of their joust would thus be something like this: The Estate is a party to the split-dollar arrangement with the Insurance Trust. The insurance policies belong to the Insurance Trust. But the policies' cash-surrender values are a form of income from that property. The right to the cash-surrender values belongs to the Revocable Trust (and thus the Estate) if the split-dollar arrangements are terminated. The arrangement may say that only the Insurance Trust has the power to terminate the deal and hand over that income to the Estate, but general principles of contract law allow the Estate to modify any term of the arrangements in conjunction with the Insurance Trust.

The language of section 2036(a)(2) *is* broad—it uses the word "right" without a modifier like "contract" or "instrument creating the." So why shouldn't we construe that word to include background rights like the right to modify a contract? And, if so, wouldn't the cash-surrender values of the insurance policies be either a "right to the income" from that property, § 2036(a)(1), or a right that could be exercised in "conjunction with" another to the income from that property, §§ 2036(a)(2), 2038(a)(1)?

The problem for the Commissioner is Helvering v. Helmholz, 296 U.S. 93 [16 AFTR 979] (1935), a case about revocable transfers. Helmholz was a widower, whose wife had named him her sole heir. Id. at 96. While she was alive, she settled valuable stock in a privately held corporation into a trust. Id. at 94. Her brothers and sisters and her parents were the other shareholders, and the trust corpus was destined for later descendants or, if her family line died out, to charity. Id.

But her will left everything she owned at death to her husband. Id. at 96. The Commissioner argued that settlors of a trust may, with the consent of its beneficiaries, terminate the trust and restore the contributed property to the settlors. Id. at 97. Is this not, the Commissioner argued (and here the quote is from the slightly different language of the Code's equivalent of section 2038

back then) "a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke" a transfer of property? Id. at 96.

A persnickety textualist might quickly respond that it was. But the Supreme Court looked at the text of the trust agreement itself. That language had express provisions for the trust's termination—the death of the last surviving grandchild in the family, the written agreement of all the beneficiaries, a resolution by the directors of the family's corporation, or the corporation's liquidation. Id. at 97. The Court characterized these express provisions for the termination of the trust as typical of "every welldrawn instrument." Id. at 96. The Court acknowledged that it was true that "a writing might have been executed by Mrs. Helmholz and her cobeneficiaries while she was alive, with the effect of revesting in her the shares which she had delivered into the trust." Id. at 97. But it held that

> [t]his argument overlooks the essential difference between a power to revoke, alter or amend, and a *condition* which the law imposes. The general rule is that [pg. 49] all parties in interest may terminate the trust. The clause in question added nothing to the rights which the law conferred. Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits all the beneficiaries to terminate the trust.

Id. (emphasis added) (footnote omitted).

A more recent case that addresses the same problem is Estate of Tully v. United States, 528 F.2d 1401 [37 AFTR 2d 76-1529] (Ct. Cl. 1976). Tully owned half the stock in a private corporation. Id. at 1402. He and his partner reached an agreement long before his death that their company would pay a large death benefit to each of their widows. Id. Tully died, and the government argued that the death benefit owed his widow from the corporation had to be included in his estate. Id. There was nothing in the instrument that created the benefit that gave Tully himself any interest in it at the date of death, but the government noted that he continued to own half his company till the day he died. Id. at 1403. It reasoned that this meant that he had the power, acting with his partner, to do anything he wanted with corporate assets, and maybe he could have persuaded his partner to change the death benefit at any time. Id.

Nice try, held the Court of Claims. A power to "alter, amend, revoke or terminate" would trigger inclusion in an estate, but that kind of power "does not extend to powers of persuasion." Id. at 1404. To be included within the Code's sweep, a power has to be in the instrument itself, not a speculative possibility allowed by general principles of law. A broader reading—that a power to amend an instrument in conjunction with others includes all speculative possibilities—"would sweep all employee death benefit plans into the gross estates of employees." Id. at 1405.

We encountered a somewhat similar argument in conservation-easement cases. Congress enacted a Code section to allow a deduction for such easements if done properly. One

requirement of a proper easement is that it preserve land in perpetuity. But remember that the parties to a contract can modify its terms, and easements are a kind of contract. We rejected the Commissioner's argument that a power to amend means that the parties *might* amend it so as to destroy perpetuity, which means that the easement wasn't perpetual. We disagreed: "Generally speaking, the parties to a contract are free to amend it, whether or not they explicitly reserve the right to do so. . . . Respondent's argument would apparently prevent the donor of any easement from qualifying for a charitable contribution deduction under section 170(h) if the easement permitted amendments." Pine Mountain Pres. LLLP v. Commissioner, 151 T.C. 247, 282 (2018), rev'd in part, aff'd in part, vacated and remanded, 978 F.3d 1200 [126 AFTR 2d 2020-6617] (11th Cir. 2020).

We therefore agree with Helmholz and Estate of Tully that general default rules of contract—rules that might theoretically allow modification of just about any contract in ways that would benefit the IRS—are not what's meant in phrases like section 2036's "right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom," or section 2038's "power . . . by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power)." What's meant are rights or powers created by specific instruments. A more extensive reading, as the old Court of Claims noted in Estate of Tully, would swing a broadax to fell large swaths of estate and retirement planning that Congress meant to allow to stand.

We therefore conclude that the Commissioner doesn't win as a matter of law here.

But we do think he's correct that we also must avoid being so blinded by any formal gleam from the Estate's armor that we overlook some practical chinks that deals like this may have: Can the Commissioner dismount from purely legal or theoretical arguments and start wielding shorter, sharper weapons forged from the particular facts of particular cases? [pg. 50]

The Commissioner thinks he can, and would have us focus on our holdings in Estate of Strangi, 85 T.C.M. (CCH) 1331 [2003 RIA TC Memo ¶2003-145], and Estate of Powell v. Commissioner, 148 T.C. 392 (2017), cases in which we concluded that section 2036(a)(2) clawed value back into a decedent's taxable estate despite the drafting skills of talented estate lawyers. In both Estate of Strangi and Estate of Powell we distinguished the Supreme Court's opinion in United States v. Byrum, 408 U.S. 125 [30 AFTR 2d 72-5811] (1972), in which an estate won, so we can begin by summarizing that case.

In Byrum, the Supreme Court held that a decedent's right to vote shares of stock in three corporations that he had transferred to a trust for the benefit of his children did not cause those shares to be included in his estate under section 2036(a)(2). The Court noted that any powers the decedent might have had were subject to a number of different "economic and legal constraints" that prevented those powers from being equivalent to the right to designate a person

to enjoy trust income. Id. at 144. One of these constraints was that the decedent, as the controlling shareholder of each corporation whose stock was transferred into the trust, owed fiduciary duties to minority shareholders that limited his influence over the corporations' dividend policies. Id. at 142-43. The Supreme Court also noted that an independent corporate trustee alone had the right under the trust agreement to pay out or withhold income, id. at 137, so the decedent had no way of compelling the trustee to pay out or accumulate that income, id. at 144. That the decedent had fiduciary duties to these minority shareholders—duties that were legally enforceable—was important to the Supreme Court's analysis. Id. at 141-42.

We have been careful to distinguish Byrum in later cases when we see something behind a transaction's facade that suggests appearance doesn't match reality. Estate of Strangi, 85 T.C.M. (CCH) at 1333-34, featured a decedent who could act with others to dissolve a family limited partnership to which he had transferred property in exchange for a 99% limited-partner interest. The decedent in Estate of Strangi—through his son-in-law—also had the right to determine the amount and timing of partnership distributions. Id. at 1337. This led us to distinguish Byrum, because in Byrum the son-in-law had fiduciary duties to other members of the family limited partnership; in Estate of Strangi, the son-in-law's potential fiduciary duties—as the decedent's attorney-in-fact and 99% owner of the family limited partnership—were duties he owed "essentially to himself." Id. at 1343.

We decided Estate of Powell on essentially the same grounds as Estate of Strangi. In Estate of Powell, 148 T.C. at 394-95, a fiduciary also owed duties to the decedent both as his attorney-in-fact and as partner in a family limited partnership. We found that there was nothing in the record of that case to suggest that as a fiduciary he "would have exercised his responsibility as a general partner of [the family limited partnership] in ways that would have prejudiced decedent's interests." Id. at 404. And we again determined that whatever duties were owed were duties that "he owed almost exclusively to decedent herself." Id.

Here's where the Commissioner makes his thrust. He contends that Levine—through her attorneys-in-fact—stood on both sides of these transactions and therefore could unwind the split-dollar transactions at will. This meant that she—again through the attorneys-in-fact—had the power to surrender the policies at any time for their cash-surrender values. (Remember that, under the terms of the split-dollar arrangements, if the Insurance Trust surrendered the policies before the deaths of both Nancy and her husband, it would immediately owe the Revocable Trust the full cash-surrender values of the policies.) The Commissioner argues that these powers constitute the right to possession and enjoyment of, or the right to income from, the split-dollar receivable under section 2036(a)(1). If he's right, we would have to value the receivable at the policies' cash-surrender values.

We agree that Robert, Nancy, and Larson—as Levine's attorneys-in-fact—stood in the shoes of Levine for this split-dollar arrangement. That is the point of giving someone a power of attorney. The Revoca[pg. 51] ble Trust is the entity that paid the $6.5 million, and its cotrustees are Nancy, Larry, and Larson. The Insurance Trust, however, owns the life-insurance policies, and its trustee is South Dakota Trust. South Dakota Trust is directed by the investment committee, and the investment committee's only member is Larson. This, however, means that the only person that stood on both sides of the transaction is Larson—in his role as the investment committee and as one of Levine's attorneys-in-fact.

We therefore must look at each of Larson's roles in this transaction to consider how to apply sections 2036(a) and 2038. Under the 1996 power of attorney and Minnesota law, all actions taken by Larson as an attorney-in-fact are considered to be actions of Levine. *See* Minn. Stat. § 523.12 (2008).[25] The Insurance Trust's instrument, however, states that the Insurance Trust is irrevocable. We have no reason to doubt that this means what it says. And the consequence is that Levine irrevocably surrendered her interest in the Insurance Trust and had no right to change, modify, amend, or revoke its terms. Once it was created, Levine had no legal power over its assets. Levine did not have the power to surrender the policies by herself. Since Larson—in his role as an attorney-in-fact—could not take any action which Levine could not take herself, we find that he could not surrender the policies in his capacity as attorney-in-fact. This means that even if we treat the Insurance Trust, the policies, or *that* Trust's rights under the split-dollar deal as the "property transferred" (and thus the property whose value we look for) under section 2036, Levine did not retain any right to possession or enjoyment of the property transferred.

To get around these problems, the Commissioner has to argue that Larson has the right to designate who shall possess or enjoy the cash-surrender value of the policies, either by surrendering them or by terminating the entire arrangement. *See* Estate of Cahill, 115 T.C.M. (CCH) at 1467. For example, in Estate of Cahill, we found that section 2036(a)(2) applied when the decedent jointly held the right to terminate the split-dollar life-insurance policy with the irrevocable trust that held the policies. Id. We think that's the only way the Commissioner can include the combined cash-surrender values of the life-insurance policies in Levine's estate under section 2036(a)(2) or section 2038.

But we also think that this argument fails to consider the fiduciary obligations Larson owes to the beneficiaries of the Insurance Trust—obligations that would prevent him from surrendering the policies. The Commissioner first questions the validity and existence of these duties. He notes that "Larson was not compensated for his role as the sole member of the Investment Committee despite the fact that petitioner has taken the position that he assumed significant fiduciary responsibilities under this role." But we don't think that matters. There is no requirement under either South Dakota law[26] or general trust law[27] that a trustee or trust adviser be compensated to have fiduciary obligations. The terms of the Insurance Trust expressly state that Larson—in his

role as the single-member investment committee—shall be considered to be acting in a fiduciary capacity. Therefore we do find that Larson was under fiduciary obligations in his role as the sole member of the investment committee.

Larson's duties in his role for the Insurance Trust required him, however, to look [pg. 52] out for the interests of *that* Trust's beneficiaries. And here is where the Commissioner makes a different and subtler argument. He contends that, since Nancy and Robert are beneficiaries of the Insurance Trust, they stand to benefit under the split-dollar arrangement regardless of whether the life-insurance policies remain in place or are surrendered during their lifetime. This means, he says, that Larson would not violate his fiduciary duties to the beneficiaries of the Insurance Trust if he either surrendered, or didn't surrender, the policies because Nancy and Robert would benefit no matter what. If Larson immediately terminated the split-dollar arrangement, surrendered the policies, and sent the money out of the Insurance Trust to the Estate and then to Levine's children, he'd just be benefiting the children in a different capacity.

To this subtle thrust, the Estate has a blunt parry: Levine's children are not the only beneficiaries under the Insurance Trust. Her grandchildren are also beneficiaries, and Larson has fiduciary obligations to them as well. According to the terms of the Insurance Trust, Levine's grandchildren would receive nothing if the life-insurance policies were surrendered. Left unmentioned is the final step in this argument—that Larson has no right to violate his fiduciary obligations by looting the Insurance Trust for the benefit of only some of its beneficiaries.

The Commissioner counters by arguing that the Insurance Trust itself allows Nancy and Robert to extinguish their children's interests in it. This means, he says, that Nancy and Robert are the only real beneficiaries, and stand to benefit regardless of whether the life insurance policies stay in effect.

This misinterprets the way that "extinguishment" works under the provisions of the Insurance Trust, however. The Trust plainly states that "the special testamentary power of appointment hereby granted to said Beneficiary shall not be exercisable in favor of or for the benefit of the Beneficiary . . ."—i.e. they can't extinguish another beneficiary's interest in favor of themselves. The Insurance Trust also states that extinguishment of a beneficiary's interest can occur only by will and cannot take place until the death of the beneficiary doing the extinguishing (which in this case would be Nancy or Robert). So if Nancy and Larry hoped to extinguish the interests of their own children, they couldn't do so until they themselves directly named some other beneficiary to take their place. This means that during the lives of Nancy and Robert, their children will remain beneficiaries of the Insurance Trust, and a decision by Larson to surrender the policies would mean the grandchildren would receive nothing. This would breach his fiduciary duties to them.

Levine's case is thus distinguishable from Estate of Strangi and Estate of Powell. Many of the same "economic and legal constraints" that existed in Byrum exist here. First, the fiduciary

obligations that Larson owed were not duties that he "essentially owed to himself." His fiduciary obligations are owed to all the beneficiaries of the Insurance Trust, which include not just Levine's children, but her grandchildren. As we've already discussed, if Larson surrendered the life insurance-policies, those grandchildren would receive nothing as beneficiaries. That makes these fiduciary obligations more analogous to the duties owed to the minority shareholders in Byrum, which like them are duties that do limit the powers of the person who holds them. They are also legally enforceable duties, established by South Dakota state law, *see, e.g.* , S.D. Codified Laws §§ 55-2-1, 55-1B-4 (2008), and if Larson breached these duties or was put in a position where he was forced to do so, he would be required under S.D. Codified Law § 55-2-6 (2008) to inform all of the beneficiaries of the Insurance Trust, and he could be removed. He could also be subject to liability under South Dakota law for breach of his duty. *See, e.g.*, Matter of Heupel Fam. Revocable Tr., 914 N.W.2d 571 (S.D. 2018) (trustee breaching fiduciary duties removed and required to personally reimburse trust).

We stress that the fiduciary duties that Larson owed to the beneficiaries of the Insurance Trust do not conflict with the fiduciary duties that he owed Levine as one of her attorneys-in-fact. In both Estate of Strangi and Estate of Powell we held that the fiduciary's role as the attorney-in-fact [pg. 53] would potentially require him to go against his duties as a trustee. Estate of Strangi, 85 T.C.M. (CCH) at 1343; Estate of Powell, 148 T.C. at 404. This is not the case here: Under Minne sota law, whenever Larson and the other attorneys-in-fact exercise their powers, they are to do so "in the same manner as an ordinarily prudent person of discretion and intelligence would exercise in the management of the person's own affairs and shall have the interests of the principal utmost in mind." Minn. Stat. § 523.21 (1992). And Larson, Nancy, and Robert all credibly testified that one of the reasons for this split-dollar arrangement was that Levine wished to provide for her grandchildren and keep this arrangement in effect until the insureds died. So not only did Larson's role as an attorney-in-fact not require him to go against his duties as a trustee, the two roles reinforced each other and pushed him to fulfill Levine's stated purpose in her estate planning. They made it more likely that he would not want to cancel the life-insurance policies.

We therefore find it more likely than not that the fiduciary duties that limit Larson's ability to cancel the life-insurance policies were not "illusory". It also persuades us that we cannot characterize his ability to unload the policies and realize their cash-surrender values as a right retained by Levine, either alone or in conjunction with Larson, to designate who shall possess or enjoy the property transferred or the income from it.

We conclude that this precludes the inclusion of the cash-surrender values of the life-insurance policies in Levine's estate under section 2036(a)(2).[28]

Section 2038 focuses on a decedent's power to "alter, amend, revoke, or terminate" the enjoyment of the property in question. The Commissioner's argument under section 2038

mirrors his argument under section 2036—that the attorneys-in-fact have controlled the entirety of Levine's affairs since 1996, and that this control includes the ability to "alter, amend, revoke or terminate" any aspect of the split-dollar arrangements. He argues again that the termination of the split-dollar arrangements would provide Levine—through her attorneys-in-fact—with complete control over the cash-surrender values of the policies, and the power to do this would fall within section 2038(a)(1). He argues that it applies to section 2038(a)(1) for the same reasons that he argues it applies to section 2036. We disagree for the same reasons and need not repeat them.

The cash-surrender values of the insurance policies are not includible under section 2038(a)(1) either. The cash-surrender values of the insurance policies are not includible under section 2038(a)(1) either.[29]

IV. Section 2703

The Commissioner argues as a third alternative that the special valuation rules under section 2703 apply to Levine's split-dollar arrangement. Section 2703(a) provides:

> Sec. 2703(a). General Rule.—For purposes of this subtitle, the value of any property shall be determined without regard to—
>
> > (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or
> >
> > (2) any restriction on the right to sell or use such property.

The Commissioner argues that when Levine—through her attorneys-in-fact—entered into the split-dollar arrangement, she placed a restriction on her right to control the $6.5 million in cash and the life-insurance policies. And the restriction on Levine's right to unilaterally access the funds transferred to the insurance companies for the benefit of the Insurance Trust is what should be disregarded when determining the value of the property under section 2703(a)(2). [pg. 54]

The Estate argues that section 2703 applies only to property owned by Levine at the time of her death, not to property she'd disposed of before, or property like the insurance policies that she never owned at all. If the inability to surrender the life-insurance policies is considered a "restriction", it is not a restriction on any property rights held by Levine since she never owned the policies.

The Commissioner doesn't parry this other argument, but argues instead that if we focus on the "rights" held by Levine under the split-dollar arrangement—and not the $6.5 million in cash—the result would remain the same. He wants to imagine that despite the different language in the split-dollar arrangement here compared to those in Morrissette II and Estate of Cahill, it should still be

read to mean that both parties may consent to any early termination of the insurance policies. He says that without this restriction, the value of Levine's rights would equal the cash-surrender values of the life-insurance policies.

We disagree. Section 2703 does refer to "any property." But the "any property" it refers to is property of an estate, not some other entity's property. Our caselaw confirms the plain meaning of the Code, and tells us to confine section 2703's valuation rule to property held by a decedent at the time of her death. *See, e.g.*, Estate of Strangi v. Commissioner, 115 T.C. 478 (2000), aff'd in part, rev'd in part, 293 F.3d 279 [89 AFTR 2d 2002-2977] (5th Cir. 2002). The district court in Church v. United States, 85 A.F.T.R.2d 2000-804 [85 AFTR 2d 2000-804] (W.D. Tex. 2000), aff'd without published opinion, 268 F.3d 1063 [88 AFTR 2d 2001-5352] (5th Cir. 2001), rejected precisely this argument when it held that "property" in section 2703 consideration does not include assets that a decedent contributed to a partnership before her death, but only the partnership interest she got in exchange. *See also* Estate of Strangi, 115 T.C. at 488 ("Congress 'wanted to value property interests more accurately when they transferred, instead of including previously transferred property in the transferor's gross estate'" (citing Kerr v. Commissioner, 113 T.C. 449 (1999), aff'd, 292 F.3d 490 [89 AFTR 2d 2002-2838] (5th Cir. 2002))).

The property we have to value here is the property in Levine's estate, which is the split-dollar receivable she held at the time of her death. There were no restrictions on *that* property. She could do with the receivable what she wanted. She was free to sell it or transfer it as she wished. One needs to remember that what the Estate valued on its return was the receivable owned by Levine in her Revocable Trust. Section 2703 is not relevant to the valuation of the receivable because Levine had unrestricted control of it. Section 2703 therefore does not apply.

The only property left in the Estate after this arrangement was done was the split-dollar receivable. It is the value of *that* property that must be included in the gross estate, and the parties have agreed that its value is $2,282,195. The Estate having almost entirely prevailed, no accuracy-related penalties apply.

Conclusion

If there is a weakness in this transaction, it lies in the calculation of the value of the gift between Levine and the Insurance Trust—the difference between the value that her Revocable Trust gave to the Insurance Trust and what it got in return. But the gift-tax case is not this estate-tax case.

And the problem there is traceable to the valuation rule in the regulations. No one has suggested that this rule is compelled by the Code and, if it isn't, the solution lies with the regulation writers and not the courts. *See* Carpenter Fam. Invs., LLC v. Commissioner, 136 T.C. 373, 387 (2011).

Decision will be entered under Rule 155.

[1] 146 T.C. 171 (2016).

[2] 115 T.C.M. (CCH) 1463 [2018 RIA TC Memo ¶2018-084] (2018).

[3] 5005 was the address of the office building that used to house Penny's business.

[4] Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), manufactured-home loans were classified as "high cost." The Act also classified manufactured-home retailers as "mortgage originators." A widely reported, if unintended, consequence was that almost all lenders chose to stop making these loans. *See The Impact of* Dodd-Frank's *Home Mortgage Reforms: Consumer and Market Perspectives: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the Comm. on Fin. Servs.,* 112th Cong. 10-11 (2012) (statement of Tom Hodges, General Counsel, Clayton Homes, Inc., on behalf of the Manufactured Housing Institute). Congress later amended the Truth in Lending Act to solve this problem. *See* Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296 (2018).

[5] Larson described Levine as "my second mom." Nancy claimed that Larson was "as close to [Levine] as any person could have been" and his role as an attorney-in-fact was to protect her. And Robert credibly stated that he and Larson "have been friends forever."

[6] There was sincere but conflicting testimony regarding when and exactly how much Levine's health began to decline. Robert identified the stroke in 2003 as the first sign that his mother was no longer as mentally sharp as she used to be. Larson also thought that her mental activity probably started to decline after the stroke, although at first he didn't notice anything different about her when she returned to work. And Nancy claimed not to notice any real changes until around 2006, after her mother's third husband died.

[7] Levine limited the interests of her grandchildren to a subtrust that would be funded by whatever was left of her generation-skipping-transfer-tax (GSTT) exemption. (The GSTT prevents taxpayers from avoiding the estate tax by passing their property to grandchildren instead of children. It includes an exemption that allows taxpayers to exclude a certain amount, and in 2009, this amount was $3.5 million. *See* § 2010.) The remaining unused amount of Levine's GSTT exemption that was accounted for in creating the grandchildren's subtrust was a little over $3 million. (All section references are to the Internal Revenue Code and regulations in effect at the relevant time, and all Rule references are to the **Tax Court** Rules of Practice and Procedure, unless we state otherwise.)

[8] Since Levine did not survive the full term of either the QPRTs or the GRAT, the gamble did not pay off, and the full values of both the Dayton Park partnership and the Minneapolis condo

became includible in her gross estate.

9 Section 1014 resets basis in property to its fair market value at the time of its owner's death. This results in a smaller taxable gain realized by the heir if he ever sells the property and the property's value has increased.

10 When we refer to the "split-dollar receivable" or "receivable" we are referring to this contract right.

11 While Swanson created the Insurance Trust to own the life-insurance policies taken out as part of the split-dollar transaction, we find him credible when he said that he also viewed the Insurance Trust as something Nancy and Robert could use in their own eventual estate planning.

12 South Dakota Trust could also be directed by the investment committee on how to deal with distributions for the trust, although it maintained discretion on how to do this.

13 S.D. Codified Laws § 55-1B-9 (2017) states:

> A trust instrument governed by the laws of South Dakota may provide for a person to act as an investment trust advisor or a distribution trust advisor, respectively, with regard to investment decisions or discretionary distributions. Unless otherwise provided or restricted by the terms of the governing instrument, any person may simultaneously serve as a trust advisor and a trust protector.

This allows for an investment committee of just one person.

14 Larson credibly testified that they could have paid all the premiums in cash if they had decided to take that route.

15 While interest paid can be deducted from income under section 163, section 264 denies this deduction to the extent that the money is borrowed to fund a life-insurance policy, and in effect defers the deduction until the policy matures.

16 The family thought that the tax that would eventually be owed by Levine's estate on this receivable would be determined by the difference between the receivable's value at the date of its repayment and its basis. The receivable's basis would be the receivable's reported value on the estate-tax return plus the total deferred interest payments from the Central Bank loan. If it all worked, the arrangement would produce a nice deferral of the tax owed until the Insurance Trust repaid the Estate its receivable.

17 The parties later stipulated that the fair market value of the split-dollar receivable, if the Estate prevails, is a bit higher—$2,282,195.

[18] The Commissioner also issued a notice of deficiency for Levine's 2008 gift-tax return. Levine's estate challenged this as well, and we consolidated the cases. We then issued our opinion in Estate of Morrissette v. Commissioner (Morrissette I), 146 T.C. 171 (2016). Both the Estate and the Commissioner agreed that Morrissette I required us to enter judgment against the Commissioner in the gift-tax case. We then severed the cases. The decision in the gift-tax case—that there was no deficiency despite the remarkably low value of the gift—has long since become final and unappealable.

[19] There was one additional issue that the parties did not settle—whether the Estate was entitled to a $1 million charitable contribution to the George and Marion Levine Foundation. That contribution has not yet been made, but the parties stipulated that this deduction will be allowable once the Estate provides proof of payment. The Estate intends to make this charitable contribution once we enter a decision.

[20] William L. Raby & Burgess J.W. Raby, The Split-Dollar life Insurance Regimes, 94 Tax Notes 353 (2002); Sherwin P. Simmons, Economic Benefit Under A Split Dollar Arrangement, 1 Tax Prac. & Controv. 550 (Mar. 21, 1994).

[21] Treasury Regulation § 1.61-22(a)(1) states:

> This section provides rules for the taxation of a split-dollar life insurance arrangement for purposes of the*income* tax, the *gift* tax, the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), the Railroad Retirement Tax Act (RRTA), and the Self-Employment Contributions Act of 1954 (SECA).

(Emphasis added.)

[22] To reduce her estate-tax liability, a decedent must give property away more than three years before her death. If she doesn't, any tax paid on the gift must be added to her estate. § 2035(b).

[23] Usually, but not always. Federal gift-and-estate-tax law allows a credit that reduces the tax on gifts made while the donor is alive; and if it's not used up, it can reduce the estate tax. § 2505(a).

[24] Remember that an estate's gross value is "the value at the time of . . . death of all property, real or personal, tangible or intangible, wherever situated." § 2031(a).

[25] The Minnesota statute states: "Any action taken by the attorney in-fact-pursuant to the power-of-attorney binds the principal, the principal's heirs and assigns, and the representative of the estate of the principal *in the same manner as though the action was taken by the principal . . .*" (Emphasis added.)

[26] S.D. Codified Laws § 55-1B-4 (2008) provides:

> If one or more trust advisors are given authority by terms of the governing instrument to direct, consent to, or disapprove a fiduciary's investment decisions, or proposed investment decisions, *such trust advisors shall be considered to be fiduciaries when exercising such authority unless the governing instrument provides otherwise"*

(Emphasis added).

And S.D. Codified Laws § 55-2-1 (2008) provides that "[i]n all matters connected with his trust a trustee is bound to act in the highest good faith toward his beneficiary . . . ."

[27] Restatement (Third) of Trusts § 70, cmt. d(1) (Am. L. Inst. 2007) states that "[w]hether or not a person receives compensation for serving as trustee, the person is subject to a duty to administer the trust in accordance with its terms . . . with prudence . . . and in good faith and conformity with other fiduciary duties referred to in Clause (b)."

[28] Section 2036(a) also excepts from its sweep transfers that are *bona fide* sales for adequate and full consideration. We need not determine whether this exception applies.

[29] Section 2038 also includes an exception for a "bonafide sale for an adequate and full consideration in money or money's worth." We need not decide whether this exception applies here.

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Tax Court & Board of Tax Appeals Reported Decisions

TBL Licensing LLC, et al. v. Commissioner, 158 T.C. No. 1, Code Sec(s) 367; 368; 7701; 361.

TBL LICENSING LLC f.k.a. THE TIMBERLAND COMPANY, AND SUBSIDIARIES (A CONSOLIDATED GROUP), Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 1]

Code Sec(s):	367; 368; 7701; 361
Docket:	Dkt. No. 21146-15.
Date Issued:	01/31/**2022** . Corrected 2/8/**2022**
Judge:	Opinion by Halpern, *J.*
Tax Year(s):	Year 2011.
Disposition:	Decision for Commissioner.

HEADNOTE

1. Corp. reorgs. and transfers to foreign corps.—constructive transfers of intangibles—entity status—income recognition and timing. Tax Court determined in extensive opinion that

taxpayer/domestic LLC, which was originally classified as corp. for tax purposes, was required to recognize gain in year of former Code Sec. 936 intangible property's constructive transfer to foreign entity as part of Code Sec. 368(a)(1)(F) reorg. To that end, Court first determined that reorg. transaction, as effected by foreign corp.'s (F1) transfer to foreign sub. (F2) of sole member interest in disregarded entity that owned taxpayer, followed by taxpayer's own Reg § 301.7701-3(c)(1)(i) disregarded entity election, resulted in taxpayer being treated as having transferred its intangible and other properties to F2 for F2 stock, and distributing same to F1 in cancellation of stock F1 had been treated as holding in taxpayer during time taxpayer was classified as corp. Further, and considering parties' agreement that taxpayer was treated under Code Sec. 367(d)(2)(A)(i) as having sold its intangible property for one or more contingent payments, Court determined that taxpayer's constructive stock distribution was "disposition" within meaning of Code Sec. 367(d)(2)(A)(ii)(II) , that disposition "followed" intangible property's constructive transfer, and that such occurred within intangible property's useful life such that immediate gain recognition applied. Moreover, nothing in regs allowed taxpayer to avoid same. Its arguments, including that those steps were simultaneous or that deemed annual payments were properly reported by F1's indirect parent/"U.S. person" under Code Sec. 367(d)(2)(A)(ii)(I) , were rejected accordingly. Also, FMV would be determined for Code Sec. 367(d)(2)(A)(ii)(II) gain recognition purposes on basis of intangible property's entire expected useful life and without regard to Temp Reg § 1.367(d)-1T(c)(3) 's 20-year limit.

Reference(s): ¶ 3675.02(10) Code Sec. 367;Code Sec. 368;Code Sec. 7701;Code Sec. 361 Former Code Sec. 936

Syllabus

Official Tax Court Syllabus

CORRECTED

F1, a foreign corporation, transferred to F2, its foreign subsidiary, the sole member interest in DE, an entity disregarded for Federal tax purposes. DE owned P, a domestic limited liability company then treated as a corporation for Federal tax purposes. P owned intangible property, within the meaning of I.R.C. § 936(h)(3)(B). P then elected to be disregarded as a separate entity for Federal tax purposes. P and R agree that F1's transfer of DE to F2 and P's election to be disregarded constituted a "reorganization" within the meaning of I.R.C. § 368(a)(1)(F) and that, as part of that reorganization, P constructively transferred intangible property to F2. For the taxable years 2011 through 2017, US1, a domestic corporation and indirect parent of F1 and F2, included in its income deemed annual payments under I.R.C. § 367(d)(2)(A)(ii)(I) attributable to that constructive transfer.

Held: In order for the operative nonrecognition rules of I.R.C. §§ 354, 356, and 361 to apply to a reorganization described in I.R.C. § 368(a)(1)(F), the transaction—however actually effected—should be treated as involving (1) a transfer of the old corporation's assets to the new corporation, in exchange for stock of the new corporation and the new corporation's assumption of any liabilities of the old corporation, and (2) the old corporation's distribution to its shareholders of the stock of the new corporation in cancellation of their stock in the old corporation.

Held, further, the constructive distribution by P to F1 of F2 stock that occurred as part of the reorganization by [pg. 2] which F2 acquired P was a "disposition" within the meaning of I.R.C. § 367(d)(2)(A)(ii)(II).

Held, further, P's constructive distribution of F2 stock to F1 necessarily followed the constructive transfer of intangible property by P to F2 that occurred as part of the reorganization; consequently, in the absence of a provision in the regulations to the contrary, P is required to recognize gain in the intangible property under I.R.C. § 367(d)(2)(A)(ii)(II).

Held, further, no provision in the regulations allows reporting of deemed annual payments under I.R.C. § 367(d)(2)(A)(ii)(I) rather than immediate gain recognition under I.R.C. § 367(d)(2)(A)(ii)(II) by reason of P's constructive transfer of intangible property. Because P was no longer recognized as a separate entity for Federal tax purposes after the reorganization, it could not report the deemed annual payments described in I.R.C. § 367(d)(2)(A)(ii)(I), and US1 was neither the U.S. transferor of the intangible property nor the recipient of the FS2 stock.

Held, further, the fair market value of transferred intangible property, for the purpose of determining gain that must be recognized under I.R.C. § 367(d)(2)(A)(ii)(II), should be determined on the basis of the property's entire expected useful life, without regard to the 20-year limit imposed, for some purposes, by Temp. Treas. Reg. § 1.367(d)-1T(c)(3).

Counsel

James P. Fuller, Kenneth B. Clark, Larissa B. Neumann, Julia V. UshakovaStein, and Sean P. McElroy, for petitioner.

John E. Budde, Gretchen A. Kindel, Kimberly B. Tyson, and James M. Cascino, for respondent.

HALPERN, *Judge*

OPINION

In a notice dated May 11, 2015, respondent advised petitioner that he had determined a deficiency of $504,691,690 in the income tax of the affiliated group of corporations of which petitioner had been the common parent for the group's taxable year ended September 23, 2011. We must decide whether petitioner is required to recognize ordinary income under section 367(d)(2)(A)(ii)(II)[1] as a result of a constructive transfer of intangible property to TBL Investment Holdings GmbH (TBL GmbH), a Swiss corporation, and, if so, whether, in determining the amount of that income, the property should be treated, as a matter of law, as having a useful life limited to 20 years. Each party has moved for summary judgment. In addition, respondent has submitted a motion in limine seeking to exclude stipulations set forth in the parties' stipulations of fact and exhibits offered by petitioner. Respondent has also submitted a motion to strike material included in the memorandum petitioner submitted in support of its motion for summary judgment. For the reasons explained below, we will grant respondent's motion for summary judgment and deny petitioner's motion for summary judgment. Because we conclude that the materials subject to respondent's motion in limine or motion to strike neither demonstrate petitioner's entitlement to summary judgment nor call into question respondent's entitlement to summary judgment, we will deny as moot respondent's motion in limine and motion to strike.

Background

The events that gave rise to the dispute before us occurred as part of a postacquisition restructuring carried out after a business combination involving VF Corp. (VF) and the Timberland Co. (Timberland). Through its subsidiaries, VF designs, manufactures, and sells apparel and footwear under brands such as Lee, Wrangler, Nautica, Vans, and the North Face. Timberland's business involved the design, development, manufacture, marketing, and sale of footwear, apparel, and accessories under its own brand and others, such as SmartWool.

The VF and Timberland businesses were combined on September 13, 2011, by [pg. 3] means of a merger into Timberland of an acquisition subsidiary of TBL International Properties, LLC (International Properties). In the merger, the former Timberland shareholders received cash in exchange for their Timberland stock.

VF had organized International Properties in August 2011 as a limited liability company under Delaware law. The parties have stipulated that International Properties "has been a disregarded entity from the time of its formation."

Petitioner is also a Delaware limited liability company whose sole member interest was owned, throughout the events in issue, by International Properties. The parties have stipulated that "[p]etitioner was treated as a corporation for U.S. federal income tax purposes at all times during the taxable year at issue."

Before the merger in which International Properties acquired Timberland, VF transferred its membership interest in International Properties to VF Enterprises S.à.r.l. (VF Enterprises), an indirect foreign subsidiary of VF. As part of the postacquisition restructuring, petitioner came to own Timberland's intangible property, including trademarks, foreign workforce, and foreign customer relationships.

On September 22, 2011, after the close of the merger by which International Properties acquired the Timberland stock and after petitioner had acquired Timberland's intangible property, VF Enterprises contributed to TBL GmbH the sole member interest in International Properties. [2] About a week later, petitioner elected under Treasury Regulation § 301.7701-3(c)(1)(i) to be disregarded as an entity separate from its owner, effective September 24, 2011.

On the Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation, included with its Federal income tax return for the taxable year ended September 23, 2011, petitioner reported that the trademarks it acquired from Timberland had a fair market value of $1,274,100,000. Respondent assigned the same value to the trademarks in computing the deficiency in issue.

The parties have stipulated that Lee Bell, Inc. (Lee Bell), an indirect domestic subsidiary of VF and indirect parent of VF Enterprises, reported income under section 367(d)(2)(A)(ii)(I) in specified amounts for the taxable years 2011 through 2017. The stipulation does not attribute those amounts to petitioner's constructive transfer of intangible property to TBL GmbH, but the materials the parties have submitted in support of and opposition to the pending motions for summary judgment demonstrate that each accepts that the inclusions in Lee Bell's income relate to that transfer. [3] The parties also stipulated that Lee Bell never owned the intangible property that petitioner constructively transferred to TBL GmbH.

Discussion

I. *Introduction*

Petitioner and respondent agree that, in the restructuring that followed the acquisition of Timberland by VF Enterprises, through International Properties, [4] petitioner came to own Timberland's intangi[pg. 4] ble property and then made a constructive transfer of that property to TBL GmbH, a subsidiary of VF Enterprises. They agree that petitioner's cons tructive transfer of intangible property occurred as part of a "reorganization" described in section 368(a)(1)(F). And they agree that, because petitioner—then treated as a U.S. corporation—constructively transferred intangible property to a foreign corporation in a transaction that would otherwise qualify for nonrecognition treatment under section 361(a), section 367(d) applies to the transfer. The parties disagree, however, on the consequences of section 367(d)'s application.

The rules of section 367 provide an overlay to the corporate nonrecognition provisions found in subchapter C of subtitle A, chapter 1 of the Code. When one of the parties to a transaction is a foreign corporation, affording the transaction the same nonrecognition treatment it would receive if the parties were domestic could lead to inappropriate results. When foreign corporations are involved, property can move in and out of the U.S. tax jurisdiction. Reflecting those changes in status requires adjustments to the normal nonrecognition rules. In particular, a U.S. person who makes an "outbound" transfer of property to a foreign corporation might be required to recognize gain even if, had the transfer been made to a U.S. corporation, it would have been entitled to nonrecognition treatment. Section 367(a), which applies to outbound transfers of most types of property, achieves that result by providing, subject to significant exceptions, that the foreign corporation that receives the property is not treated as a corporation. Outbound transfers of intangible property are not covered by section 367(a) but are instead addressed by section 367(d). Section 367(d) generally requires the U.S. transferor of intangible property to recognize gain in the form of ordinary income, but the timing of that income recognition varies depending on the circumstances. The principal dispute between the parties centers on the timing of the income recognition required by section 367(d).

II. *Recharacterizing the Transaction*

The parties' disagreement concerning the effect of section 367(d) turns, in part, on the proper characterization of the larger transaction of which petitioner's constructive transfer of intangible property was a part. The parties agree that the actual transaction should be recharacterized for Federal income tax purposes but disagree on how. Therefore, we begin our analysis by describing the actual transaction and deciding on the appropriate recharacterization.

A. *The Actual Transaction*

The actual events that gave rise to petitioner's constructive transfer of intangible property were quite simple. First, VF Enterprises, an indirect foreign subsidiary of VF, contributed to TBL GmbH, its own foreign subsidiary, the sole member interest in International Proper ties. At that time, International Properties owned the sole member interest in petitioner, and petitioner owned assets, including intangible property, that it had acquired from Timberland. Petitioner then elected to be disregarded as an entity separate from its owner, International Properties (which, in turn, was disregarded as an entity separate from TBL GmbH). That is the extent of the actual events that gave rise to the dispute before us. Those events did not include a transfer of intangible property. Upon the completion of those events, petitioner continued to own the Timberland intangible property. Yet, the parties agree that petitioner should be treated as having made a transfer of intangible property to which section 367(d) applies. Therefore, both parties accept that the actual transaction must be recharacterized in some fashion.

Adding further complexity, the necessary recharacterization must proceed in stages. The first stage takes into account various fictions resulting from application of the entity classification regulations.

B. *Impact of the Entity Classification Regulations*

As a domestic "eligible entity" with a single owner, International Properties would have been classified as a disregarded entity unless it had made an elec[pg. 5] tion to be classified as a corporation. [5] *See* Treas. Reg. § 301.7701-3(b)(1)(ii). We infer from the parties' stipulation that International Properties has always been disregarded that it made no election to be classified as a corporation.

As a domestic eligible entity, petitioner would have been classified, in the absence of an election to the contrary, as either a partnership or a disregarded entity, depending on the number of its owners. Id. subpara. (1). We thus infer from the parties' stipulation that petitioner was treated as a corporation throughout the taxable year in issue (ended September 23, 2011) that petitioner initially filed an election under Treasury Regulation § 301.7701-3(c)(1)(i) to be classified as an "association" (and thus as a corporation). *See* Treas. Reg. § 301.7701-2(b)(2) (including within the definition of "corporation" any "association (as determined under § 301.7701-3)").

Because International Properties was disregarded as an entity separate from its owner and petitioner was, on September 22, 2011, classified as a corporation, VF Enterprises' contribution to TBL GmbH of the sole member interest in International Properties should be treated, in the first instance, as a contribution of "stock" in petitioner.

Next, we consider the effects of what we infer to have been petitioner's second entity classification election: the election that became effective on September 24, 2011, to be disregarded as an entity separate from its owner. As a general matter, an eligible entity cannot make more than one entity classification election every five years. Treas. Reg. § 301.7701-3(c)(1)(iv). That limitation, however, does not apply to "[a]n election by a newly formed eligible entity that is effective on the date of formation." Id. Because the parties accept the validity of petitioner's election to be a disregarded entity, we assume that its prior classification as a corporation resulted from an election that was effective on the date of its formation.

The regulations provide a series of constructs to explain an entity's change in classification for Federal tax purposes. Treasury Regulation § 301.7701-3(g)(1)(iii) supplies the construct for cases in which an entity with a single owner that had been classified as an association elects to be disregarded. In that event, "the following is deemed to occur: The association distributes all of its assets and liabilities to its single owner in liquidation of the association." Treas. Reg. § 301.7701-3(g)(1)(iii).

Taking into account only the constructs required to explain the Federal tax classifications of the participating entities, the actual transaction would be recharacterized as a (1) contribution by VF Enterprises to TBL GmbH of the stock of petitioner (then a corporation), followed by (2) petitioner's distribution of all of its assets and liabilities to TBL GmbH in liquidation. Under that construct, petitioner *would* be treated as having transferred intangible property. But that transfer—a liquidating distribution to TBL GmbH—would not have been a transfer to which section 367(d) applies. Section 367(d) applies to a transfer of intangible property by a U.S. person to a foreign corporation only if the transfer takes the form of "an exchange described in section 351 or 361." For an exchange to be described in section 351 or 361, it must be a transfer of property in exchange—at least in part—for stock of the recipient. Under the construct supplied by the entity classification regulations, petitioner would not be treated as having received TBL GmbH stock in exchange for the transferred intangible property. Instead, petitioner would be treated as having distributed the intangible property in liquidation—in cancellation of its own stock. Because the parties agree that petitioner made a transfer of intangible property to which section 367(d) applies, it follows that our recharacterization of the actual transfer remains incomplete. [pg. 6]

C. *Further Recharacterization Under the Reorganization Rules*

The next stage of recharacterization results from the application of the reorganization rules to the transactions imputed under the entity classification regulations. The parties stipulated that "[t]he contribution by VF Enterprises S.a.r.l. of TBL International Properties LLC to TBL Investment Holdings GmbH...combined with the check-the-box election for Petitioner to be treated as a disregarded entity...was an F reorganization under Section 368(a)(1)(F)." Section 368(a)(1)(F) includes within the definition of "reorganization" "a mere change in identity, form, or place of organization of one corporation, however effected." In 2015, the Treasury Department issued regulations that elaborate on that sparse statutory definition. Treas. Reg. § 1.368-2(m). By its terms, however, paragraph (m) of Treasury Regulation § 1.368-2 "applies to transactions occurring on or after September 21, 2015." Id. subpara. (5). The regulations thus do not apply to the transaction in issue. For periods before the current regulations were effective, elaboration on the statutory definition was left to the courts. One leading case stated:

> Although the exact function and scope of the (F) reorganization in the scheme of tax-deferred transactions described in section 368(a)(1) have never been clearly defined, it is apparent from the language of subparagraph (F) that it is distinguishable from the five preceding types of reorganizations as encompassing only the simplest and least significant of corporate changes. The (F)-type reorganization presumes that the surviving corporation is the same corporation as the predecessor in every respect, except for minor or technical differences....For instance, the (F) reorganization typically has been understood to

> comprehend only such insignificant modifications as the reincorporation of the same corporate business with the same assets and the same stockholders surviving under a new charter either in the same or in a different State, the renewal of a corporate charter having a limited life, or the conversion of a U.S.- chartered savings and loan association to a State-chartered institution.
>
> The decisions involving subparagraph (F) or its counterpart in prior revenue acts consistently have imposed at least one major limitation on transactions that have been claimed to qualify thereunder: if a change in stock ownership or a shift in proprietary interest occurs, the transaction will fail to qualify as an (F) reorganization....

Berghash v. Commissioner, 43 T.C. 743, 752 (1965) (footnote omitted), aff'd, 361 F.2d 257 [17 AFTR 2d 1163] (2d Cir. 1966).

The parties' stipulation that VF Enterprises' contribution to TBL GmbH of the sole member interest in International Properties and petitioner's election to be a disregarded entity resulted in a reorganization described in section 368(a)(1)(F) is consistent with the caselaw interpreting that section. Accordingly, we see no reason to set aside the parties' stipulation. TBL GmbH emerged from the construct imposed by the entity classification regulations as "the same corporation" as petitioner "except for minor or technical differences." Id. VF Enterprises' transfer to TBL GmbH of the stock of petitioner and the deemed liquidation of petitioner into TBL GmbH simply "reincorporat[ed]" petitioner's business. Id. After the transactions, TBL GmbH owned "the same assets" and had "the same stockholder[]" as petitioner. Id. Petitioner's business survived in a new legal form, incorporated in Switzerland rather than Delaware.

That the constructive transactions resulting from the application of the entity classification regulations effected a reorganization described in section 368(a)(1)(F) requires further recharacterization. Section 368(a) is only a definitional provision; it describes those transactions that qualify as reorganizations but does not itself prescribe their tax consequences. The operative rules are found elsewhere. Sections 354 and 356 provide nonrecognition treatment in whole or in, part, at the shareholder level, and section 361 provides nonrecognition treatment at the corporate level. Fitting an F reorganization within the operative nonrecognition rules requires that the transaction— [pg. 7] however actually effected—be treated as a transfer of assets by the old corporation to the new in exchange for stock of the new corporation and the old corporation's distribution of that stock to its shareholders. Under that construct, the old corporation's asset transfer will qualify for nonrecognition treatment under section 361(a) and the stock distribution will qualify for nonrecognition treatment under section 361(c). [6] The shareholders' exchange of stock of the old corporation for that of the new will receive nonrecognition treatment under section 354(a). [7]

Treasury Regulation § 1.367(a)-1(f) confirms that the above construct applies at least to those reorganizations described in section 368(a)(1)(F) in which "the transferor corporation is a domestic corporation, and the acquiring corporation is a foreign corporation." In those circumstances there is considered to exist—

> (i) A transfer of assets by the transferor corporation to the acquiring corporation under section 361(a) in exchange for stock (or stock and securities) of the acquiring corporation and the assumption by the acquiring corporation of the transferor corporation's liabilities;
>
> (ii) A distribution of the stock (or stock and securities) of the acquiring corporation by the transferor corporation to the shareholders (or shareholders and security holders) of the transferor corporation; and
>
> (iii) An exchange by the transferor corporation's shareholders (or shareholders and security holders) of their stock (or stock and securities) of the transferor corporation for stock (or stock and securities) of the acquiring corporation under section 354(a).

Treas. Reg. § 1.367(a)-1(f)(1).

Although the Treasury Department adopted the rule quoted above in final form in September 2015, T.D. 9739, 2015-41 I.R.B. 528, the rule applies "to transactions occurring on or after January 1, 1985," Treas. Reg. § 1.367(a)-1(g)(4). The rule first appeared in proposed and temporary regulations issued in January 1990. T.D. 8280, 1990-1 C.B. 80.

The preamble to the 1990 temporary regulations states that they were intended to "clarify" that reorganizations described in section 368(a)(1)(F) include "exchanges under sections 354(a) and 361(a)." Id. at 80. The Treasury Department provided the guidance "to apprise taxpayers of the transfers occurring in a reorganization and to prevent tax avoidance in these transactions." Id.

As explained above, the construct described in Treasury Regulation § 1.367(a)-1(f) would be necessary, regardless of the jurisdictions in which the parties are incorporated, to allow for the application to the transaction of the operative nonrecognition rules provided in sections 354 and 361. Taxpayers would have no apparent incentive to argue for an alternative construct. Any construct that would avoid a section 367 transfer would also avoid a section 361(a) exchange, thereby calling into question the eligibility of the transaction for nonrecognition treatment in the first instance. The parties involved in an outbound F reorganization, however, might have argued that their transaction, having effected "only the simplest and least significant of corporate changes," Berghash, 43 T.C. at 752, did not involve any transfers or distributions at all—that the reorganization was a nonevent. Treasury Regu[pg. 8] lation § 1.367(a)-1(f) forecloses any such argument. [8]

Respondent relies on Treasury Regulation § 1.367(a)-1(f) to establish that the constructive events that the parties agree constituted an F reorganization included a distribution of TBL GmbH stock by petitioner to VF Enterprises. Petitioner describes respondent's reliance on that regulation as "erroneous[]." According to petitioner, "Treas. Reg. § 1.367(a)-1 applies to § 367(a), not § 367(d) or the § 367(d) Regulations."[9]

Petitioner's position, as we understand it, rests on paragraph (a) of Temporary Treasury Regulation § 1.367(a)-1T (captioned "Purpose and scope of regulations"), as adopted in 1986. Temporary Treasury Regulation § 1.367(a)-1T(a), when initially adopted, began as follows: "These regulations set forth rules relating to the provisions of section 367(a) concerning certain transfers of property to foreign corporations. This § 1.367(a)-1T provides general rules explaining the effect of section 367(a)(1) and describing the transfers of property that are subject to the rule of that section." T.D. 8087, 1986-1 C.B. 175, 177. When the Treasury Department added paragraph (f) to Temporary Treasury Regulation § 1.367(a)-1T in 1990, it did not revise paragraph (a). T.D. 8280, 1990-1 C.B. at 82. Therefore, petitioner apparently reasons, the rule that now appears in Treasury Regulation § 1.367(a)-1(f), when initially adopted, applied only for the purpose of implementing section 367(a) and had no application to section 367(d). And when the rule was adopted in its current form, the Treasury Department did not indicate an intent to broaden the provision's scope.

From a narrow, technical standpoint, petitioner's argument might have some merit. But the argument raises difficult questions that petitioner neither addresses nor even acknowledges. As noted above, the Treasury Department added paragraph (f) to Temporary Treasury Regulation § 1.367(a)-1T "to prevent tax avoidance" in outbound F reorganizations. T.D. 8280, 1990-1 C.B. at 80. The preamble to the 1990 amendments did not limit their purpose to preventing the avoidance of section 367(a). We can think of no reason why concerns about tax avoidance in outbound F reorganizations would be limited to those involving tangible property. Moreover, as respondent observes, petitioner's argument suggests that its transfer of intangible property was governed by a construct different from that applicable to its transfer of other property. Petitioner offers no explanation for why and how an outbound F reorganization would be treated as having been effected by two different and contrary constructs.

Even if we were to leave policy considerations (and perhaps common sense) aside and accept petitioner's technical argument that the construct provided in Treasury Regulation § 1.367(a)-1(f) does not apply to the F reorganization in issue, we would need to identify an alternative construct to explain the transaction. That construct would necessarily include an asset transfer described in section 361(a). (Otherwise, section 367(d) would not apply to the transaction in the first place.) Thus, petitioner would necessarily be treated as having transferred its intangible property to TBL GmbH in exchange for TBL GmbH stock. Upon the completion of the transaction, however, petitioner no longer owned any TBL GmbH stock. In fact, petitioner [pg. 9] was no longer

recognized as a corporation or any other type of entity for Federal tax purposes. As a result of its second entity classification election, petitioner was disregarded as an entity separate from TBL GmbH. Upon completion of the transaction, VF Enterprises owned all of the TBL GmbH stock. Therefore, any TBL GmbH stock constructively issued to petitioner must have found its way—by some means—to VF Enterprises. The circumstances do not allow for treating petitioner as having received consideration in exchange for the TBL GmbH stock that ended up with VF Enterprises. It follows that petitioner's constructive disposition of that stock necessarily took the form of a distribution by petitioner to VF Enterprises in respect of the stock of petitioner that VF Enterprises was treated as having owned while petitioner was classified as a corporation. If that distribution was not "in pursuance of the plan of reorganization," and therefore not covered by section 361(c), petitioner would have recognized gain on the distribution in an amount equal to the gain in the property it constructively transferred to TBL GmbH. *See* § 311(b) (requiring recognition of gain on distributions by a corporation of appreciated property) § 358(a)(1) (providing as a, general rule that the basis of nonrecognition property received in a section 361 exchange equals the basis of the property exchanged).

On balance, we find unpersuasive petitioner's argument about the scope of Treasury Regulation § 1.367(a)-1(f). Treasury Regulation § 1.367(a)-1(a) provides:

> Section 367(a)(1) provides the general rule concerning transfers of property by a United States person...to a foreign corporation. Paragraph (b) of this section provides general rules explaining the effect of section 367(a)(1). Paragraph (c) of this section describes transfers of property that are described in section 367(a)(1). Paragraph (d) of this section provides definitions that apply for purposes of sections 367(a) and (d) and the regulations thereunder. Paragraphs (e) and (f) of this section provide rules that apply to certain reorganizations described in section 368(a)(1)(F). Paragraph (g) of this section provides dates of applicability. For rules concerning the reporting requirements under section 6038B for certain transfers of property to a foreign corporation, see § 1.6038B-1.

While paragraphs (b) and (c) of Treasury Regulation § 1.367(a)-1 are limited to the interpretation of section 367(a), no such limitation applies to paragraph (f). Even if petitioner were correct that Temporary Treasury Regulation § 1.367(a)-1T(f) applied only for the purpose of implementing section 367(a), that temporary provision expired three years after its issuance. *See* § 7805(e)(2). Petitioner's transaction is governed not by the expired temporary provision but by the provision proposed in 1990 and adopted in final form in 2015. We reject as contrary to the stated purpose of the provision any inference that might otherwise be drawn from the failure to amend Temporary Treasury Regulation § 1.367(a)-1T(a) when the provision in question was initially adopted as paragraph (f) of that same regulation.[10]

In any event, we do not regard the applicability of Treasury Regulation § 1.367(a)-1(f) as dispositive. As we read that provision, it simply clarifies that the construct that necessarily applies to an F reorganization to allow for the application of the operative nonrecognition provisions of sections 354 and 361 applies without regard to whether the transaction is "inbound, outbound, [or] foreign to foreign." T.D. 8280, 1990-1 C.B. at 80. To ensure that the operative nonrecognition provisions apply, we would characterize the [pg. 10] transaction that the parties agree to have been an F reorganization as involving both a transfer of property described in section 361(a) and a distribution of the stock of the acquiring corporation described in section 361(c). We would apply that construct regardless of whether Treasury Regulation § 1.367(a)-1(f) directs us to do so.

We thus need not address petitioner's argument that the circumstances surrounding the adoption of Treasury Regulation § 1.367(a)-1(f) require us to disregard it. Petitioner contends that "[t]he facts here lead to the reasonable inference that Respondent finalized Treas. Reg. § 1.367(a)-1 to support his argument that Treas. Reg. § 1.367(a)-1(f) applies in this case." On the basis of such an inference, petitioner argues that "Respondent's interpretation and application of Treas. Reg. § 1.367(a)-1(f) to the transaction at issue is therefore a litigating position that should be disregarded." In support of that argument, petitioner seeks to submit two sets of materials that are covered by respondent's motion in limine and motion to strike. First, petitioner proffered materials from the legal file relating to the adoption of Treasury Regulation § 1.367(a)-1(f) that it received in response to requests made under the Freedom of Information Act (FOIA). Second, petitioner seeks to submit the annual priority guidance plans for 2010-2011 through 2017-2018 published by the Treasury Department's Office of Tax Policy and the Internal Revenue Service (IRS).

It is perhaps unsurprising that petitioner is unable to point to any material obtained in response to its FOIA requests that acknowledges that respondent's schedule in adopting Treasury Regulation § 1.367(a)-1(f) was motivated by an effort to improve his position in the case before us. Petitioner's only citation of that material in the arguments it advanced concerning the motions for summary judgment is to a "Case History" that states that the "case" (relating to the regulation project) was opened on May 15, 2015—four days after respondent issued the notice of deficiency in the present case. From that coincidence in timing, petitioner surmises that "Respondent was developing his litigation position...[when] he began the process for finalizing Treas. Reg. § 1.367(a)-1(f)." And on the basis of that surmise, petitioner then infers that respondent's purpose in adopting the regulation in final form when he did was to bolster his litigating position in the present case.

In his motion in limine, respondent observes that petitioner did not cite the so-called business plans in the memorandum it submitted in support of its motion for summary judgment. In its opposition to respondent's motion in limine, petitioner advised us that those documents are relevant, in its view, because of respondent's reliance on Treasury Regulation § 1.367(a)-1(f).

Petitioner observes that "Treas. Reg. § 1.367(a)-1(f) was not on the IRS Priority Guidance Plan between 2010 and 2016." Thus, the annual business plans for that period, petitioner suggests, "help confirm that the three decades late, retroactive, and surprising finalization of Treas. Reg. § 1.367(a)-1(f) in the course of this litigation was not an ordinary, planned event."

The mere coincidence in timing between the initiation of the present case and the adoption in final form of Treasury Regulation § 1.367(a)-1(f) hardly establishes that the agency's purpose in finalizing the regulation when it did was to bolster its position in the case before us. Moreover, the rule had been proposed in 1990—long before petitioner engaged in the transaction in issue.

In any event, for the reasons explained above, our conclusion that the F reorganization included a constructive distribution of TBL GmbH stock does not depend on Treasury Regulation § 1.367(a)-1(f). Consequently, we need not address further petitioner's argument concerning the circumstances that precipitated the adoption of the regulation in final form.

D. *Conclusion: Result of Recharacterization*

We conclude that VF Enterprises' transfer to TBL GmbH of the sole member interest in International Properties and petitioner's election to be disregarded as an entity separate from TBL GmbH effected a reorganization described in section 368(a)(1)(F). As part of that reorganization, petitioner should be treated as having transferred its intangible and other proper[pg. 11] ties to TBL GmbH in exchange for TBL GmbH stock and as having distributed that TBL GmbH stock to VF Enterprises in cancellation of the stock VF Enterprises had been treated as holding in petitioner during the time that petitioner was classified as a corporation for Federal tax purposes. We now turn to the question of how section 367(d) applies to those constructive transactions.

III. *Application of Section 367(d)*

Section 367(d)(1) applies, "[e]xcept as provided in regulations...if a United States person transfers any intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 351 or 361." § 367(d)(1). The parties agree that petitioner's constructive transfer of property to TBL GmbH as part of the F reorganization was subject to section 367(d). Thus, the parties apparently agree that petitioner was a United States person, that the property petitioner constructively transferred to TBL GmbH in the F reorganization included intangible property, within the meaning of section 936(h)(3)(B), and that the transfer was an exchange described in section 361.

> When section 367(d)(1) applies to a transfer,
>
> the United States person transferring...[the intangible] property...[is] treated as—

(i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and

(ii) receiving amounts which reasonably reflect the amounts which would have been received —

(I) annually in the form of such payments over the useful life of such property, or

(II) in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition.

§ 367(d)(2)(A). Section 367(d)(2)(C) provides: "For purposes of this chapter, any amount included in gross income by reason of this subsection shall be treated as ordinary income. For purposes of applying section 904(d) [related to the foreign tax credit], any such amount shall be treated in the same manner as if such amount were a royalty."

Given the parties' agreement on the application of section 367(d), it follows that they agree that petitioner is treated under section 367(d)(2)(A)(i) as having sold its intangible property for one or more contingent payments. Their disagreement centers on when petitioner should be treated as having received payment and thus when the resulting income should be recognized. The answer to that question turns on which of the two subclauses of section 367(d)(2)(A)(ii) applies. [11] Respondent argues that subclause (II) applies, with the result that petitioner recognized all of the income from its deemed sale of intangible property for the taxable year in issue. Petitioner disputes the application of the immediate gain recognition rule provided in that subclause.

A. *Did a "Disposition" Occur?*

Subclause (II) applies only in the event of a "disposition following [the] transfer" of intangible property. Respondent argues that petitioner's constructive distribution to VF Enterprises of the stock of TBL GmbH that it (constructively) received in exchange for its intangible property was a "disposition" within the meaning of subclause (II). In support of his position, respondent invokes the conference report on the Deficit Reduction Act of 1984, which states the conferees' intent "that disposition of (1) the transferred intangible by a transferee corporation, or (2) the transferor's interest in the transferee corporation will result in recognition of U.S.-source ordinary income to the original transferor." [pg. 12] H.R. Rep. No. 98-861, at 955 (1984) (Conf. Rep.). As respondent reads the conference report, it establishes that, when subclause (II) refers to a "direct disposition," it means "a disposition of the IP [intangible property] itself by the transferee foreign corporation," and its reference to "indirect" dispositions encompasses "a disposition by the domestic corporation of an interest in, i.e., the stock of, the transferee foreign corporation that owns the IP."

Although petitioner alludes to the prospect that any distribution of TBL GmbH stock deemed to have occurred as part of the reorganization was not a "disposition" within the meaning of section 367(d)(2)(A)(ii)(II), it does not develop a coherent argument to that effect. Petitioner suggests that "[t]he deemed distribution is a constructive transaction that occurs only for purposes of applying certain reorganization rules." Petitioner offers no explanation, however, for why the constructive distribution should be taken into account in applying section 361(c) but not section 367(d). In fact, the deemed transfer of intangible property that petitioner accepts as the basis for section 367(d)'s application was just as much a construct of the reorganization rules as the deemed distribution. We see no reason to take one aspect of the reorganization construct into account in applying section 367(d) but not the other.

We agree with respondent's reading of the 1984 conference report and conclude, in the absence of any credible argument to the contrary, that petitioner's constructive distribution to VF Enterprises of the stock of TBL GmbH, the transferee foreign corporation, was a "disposition" within the meaning of section 367(d)(2)(A)(ii)(II).

B. *Did the Disposition "Follow" the Section 367(d) Transfer?*

We next take up the question of whether the disposition "followed" the section 367(d) transfer. Petitioner accuses respondent of "slic[ing]" the F reorganization "into its component parts...so that there is first a deemed asset transfer of the IP and then there is a separate, subsequent deemed indirect disposition of that same intangible property in the same reorganization transaction." Relying on the step trans action doctrine, petitioner asserts that, because any deemed distribution of TBL GmbH stock was, along with the section 367(d) transfer, part of a single reorganization, both steps should be treated as having occurred simultaneously.

We are unpersuaded by petitioner's step transaction argument. That the asset transfer and stock distribution were elements of a single overall reorganization does not require treating them as having occurred in precise simultaneity. As respondent observes, petitioner cannot have distributed the stock it received in exchange for its intangible property until it first received that stock: Its constructive exchange of intangible property for TBL GmbH stock necessarily preceded —if only by a moment—its distribution of that stock to VF Enterprises. [12] The stock distribution might not have "follow[ed]" the transfer of intangible property by much, but, as a matter of logic, it had to "follow[]." [13]

The principal authority petitioner relies on in support of its step transaction argument, Commissioner v. Clark, 489 U.S. 726 [63 AFTR 2d 89-860] (1989), is readily distinguishable from the present case. Clark involved the question of whether a shareholder's receipt of cash "boot" in a reorganization "ha[d] the effect of the distribution of a dividend" and thus should have

been taxed as ordinary income rather than capital gain. *See* § 356(a)(2). The taxpayer in Clark had been the sole shareholder of Basin Surveys, Inc. (Basin). N.L. Industries, Inc. (NL), acquired Basin by means of a merger of Basin into an acquisition subsidiary of NL (a "forward triangular merger"). The taxpayer received [pg. 13] both NL stock and cash in exchange for his Basin stock.

The Court reasoned that the question of whether the boot the taxpayer received was equivalent to a dividend "should be answered by examining the effect of the exchange as a whole." Commissioner v. Clark, 489 U.S. at 737. The Court found support for its reading of the statute in the "well-established `step-transaction' doctrine." Id. at 738. It described that doctrine as providing that "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction." Id.

Because it concluded that the characterization of the boot had to be made looking at the overall transaction, the Court rejected the Commissioner's analogy to a cash distribution before the reorganization. Had the taxpayer received the cash in redemption of part of his stock in the target corporation before the reorganization, his receipt of the cash would have been equivalent to a dividend because it would not have reduced his proportionate ownership of the target. The taxpayer would have owned fewer shares in the target but would still have owned 100% of the target's stock. *See* § 302(d) (treating redemptions not qualifying for exchange treatment under section 302(a) and (b) as distributions in respect of stock); United States v. Davis, 397 U.S. 301, 307 [25 AFTR 2d 70-827] (1970) (holding that a redemption of stock from a sole shareholder is always equivalent to a dividend). As the Court explained in Clark:

> Viewing the exchange in this case as an integrated whole, we are unable to accept the Commissioner's prereorganization analogy. The analogy severs the payment of boot from the context of the reorganization. Indeed, only by straining to abstract the payment of boot from the context of the overall exchange, and thus imagining that Basin made a distribution to the taxpayer independently of NL's planned acquisition, can we reach the rather counterintuitive conclusion urged by the Commissioner—that the taxpayer suffered no meaningful reduction in his ownership interest as a result of the cash payment....

Commissioner v. Clark, 489 U.S. at 738. Measuring the effect of the taxpayer's receipt of cash by the extent to which it required him to forgo an increased proportionate interest in NL, the Court concluded that the taxpayer was not required to recognize ordinary income as a result of his receipt of boot.

Respondent's position in the case before us is not contrary to Clark. Respondent accepts that petitioner's section 361(a) transfer of intangible property and its section 361(c) distribution of the stock it received in exchange for that property occurred as part of an overall reorganization. Respondent is hardly considering the asset transfer and stock distribution separately. Indeed, respondent has determined the tax consequences of petitioner's constructive transfer of intangible

property taking into account the distribution of TBL GmbH stock that occurred as part of the same overall transaction. He simply recognizes that, as a logical matter, petitioner's receipt of the TBL GmbH stock in exchange for the transferred intangible property was a precondition to its distribution of that stock to VF Enterprises. The distribution could not have occurred until the exchange of property for stock had been completed: One cannot distribute what one does not have. Characterizing one step by reference to other steps that occur as part of a larger transaction does not require viewing the steps as having occurred simultaneously. Nothing in Clark suggests otherwise.[14]

Petitioner also invokes Treasury Regulation § 301.7701-3(g)(3)(i) in support of its claim that ``[t]he Outbound F Reorganization[[15]] and its deemed component parts...all occurred *simultaneously*." That section provides: "Any transactions that are deemed to occur under this paragraph (g) [pg. 14] as a result of a change in classification are treated as occurring immediately before the close of the day before the election is effective." Petitioner reasons that its election to be disregarded "caused" the outbound F reorganization. Consequently, the constituent elements of that reorganization necessarily occurred "immediately before the close of" September 23, 2011, the day before its election to be disregarded became effective. If the constituent elements of the F reorganization all happened immediately before the close of that day, petitioner concludes, they must all have occurred simultaneously.

Again, petitioner's argument is flawed in several respects. First, the timing rule provided in Treasury Regulation § 301.7701-3(g)(3)(i) applies only to "transactions that are deemed to occur under this paragraph (g)." The transaction that would have been "deemed to occur" under Treasury Regulation § 301.7701-3(g)(1)(iii) as a result of petitioner's election to be a disregarded entity was petitioner's "distribut[ion of] all of its assets and liabilities to its single owner in liquidation." That liquidation, viewed in isolation, would have been subject to section 332, which addresses the liquidation of a subsidiary corporation into a parent corporation that owns at least 80% of the subsidiary's stock. But petitioner accepts that the transaction in issue "cannot possibly be characterized as a parent-subsidiary liquidation governed by § 332." So petitioner necessarily accepts that the transactions "deemed to occur" in the outbound F reorganization are not those described in paragraph (g) of Treasury Regulation § 301.7701-3. Instead, because petitioner's election to be disregarded resulted in a reorganization described in section 368(a)(1)(F), the construct that would otherwise have been supplied by the entity classification regulations is superseded by a construct necessary to apply to the reorganization the operative nonrecognition provisions of sections 354 and 361.

Even when applicable, the "end-of-the-prior-day" timing rule provided in Treasury Regulation § 301.7701-3(g)(3)(i) does not treat all of the transactions "deemed to occur under...paragraph (g)" as having occurred simultaneously. For example, Treasury Regulation § 301.7701-3(g)(1)(i) provides: "If an eligible entity classified as a partnership elects...to be classified as an association,

the following is deemed to occur: The partnership contributes all of its assets and liabilities to the association..., and immediately thereafter, the partnership Under liquidates by distributing the stock of the association to its partners." [16] Under Treasury Regulation § 301.7701-3(g)(3)(i) the contribution of the partnership's assets and liabillties and its distribution of the stock of the association are both "treated as occurring immediately before the close of the day before the election is effective." Even so, the two steps are not treated as having occurred at the same time. The drafters of the regulation, in specifying that the partnership's liquidation occurs "immediately []after" its contribution to the corporation of its assets and liabilities, recognized that the second step could not have happened until completion of the first: The partnership could not have distributed to its partners the stock of the association until it first received that stock in exchange for its assets and liabilities. Both the contribution and the distribution may occur "immediately before the close of the day before" the partnership's election to be treated as a corporation becomes effective, but one step is more "immediately before" than the other. The distribution does not—and cannot—occur until after the contribution. The same is true of petitioner's distribution to VF Enterprises of the stock of TBL GmbH that it was treated as having received in exchange for its intangible property.

C. *Was the Disposition Within the Property's Useful Life?*

Under the terms of section 367(d)(2)(A)(ii)(II), a "disposition" requires the U.S. transferor of intangible property to recognize gain when it "follow[s]" the transfer. Although a disposition after the end of the property's useful life would "follow" the transfer, it would make no sense in that circumstance to require the U.S. transferor to recognize gain under subclause (II) after already having [pg. 15] included in income all of the deemed annual payments contemplated by subclause (I). In recognition of that point, Temporary Treasury Regulation § 1.367(d)-1T(d)(1) requires a U.S. transferor to recognize gain under section 367(d)(2)(A)(ii)(II) upon disposing of stock of the transferee foreign corporation to a person unrelated to the U.S. transferor only if the disposition occurs "within the useful life of the intangible property." Petitioner relies on that regulation for a novel argument that, even if its distribution of TBL GmbH stock "follow[ed]" its section 367(d) transfer of intangible property, the distribution nonetheless did not require immediate gain recognition because it occurred before the intangible property's useful life began. As explained below, the authorities petitioner relies on do not support its argument.

Petitioner asserts that "[t]he useful life of property commences when the new owner places the property into service." Petitioner cites no authority specific to section 367(d) in support of that proposition. Instead, petitioner looks to a regulation dealing with depreciation allowances for intangible assets. Treasury Regulation § 1.167(a)-3 allows the cost of an intangible asset to be recovered over either 15 or 25 years. Treasury Regulation § 1.167(a)-3(b)(3) provides that a taxpayer who depreciates an intangible asset over the specified 15-or 25-year useful life "must determine the allowance by amortizing the basis of the intangible asset...ratably over the useful life

beginning on the first day of the month in which the intangible asset is placed in service by the taxpayer." Petitioner draws out its argument as follows:

> The reorganization transaction in issue was completed immediately before midnight on September 23, 2011[,] pursuant to a check-the-box election that was effective on September 24, 2011. Therefore, the earliest that the useful life of the Timberland Intangible Assets[[17]] could begin with TBL GmbH was Saturday, September 24, 2011. However, since that was a Saturday, the earliest possible placed in service date here would be Monday, September 26, 2011.

Petitioner apparently reasons that, because any distribution it made of TBL GmbH stock to VF Enterprises occurred before September 26, 2011, the distribution did not occur within the useful life of the transferred intangible property and thus cannot have required immediate gain recognition under section 367(d)(2)(A)(ii)(II).

Treasury Regulation § 1.167(a)-3 manifestly has no bearing on the useful life of intangible property for purposes of section 367(d). Treasury Regulation § 1.167(a)-3 deals with cost recovery deductions allowable in respect of intangible assets—a question that would be irrelevant to a transferee foreign corporation that received intangible property in a section 367(d) transfer unless that foreign corporation were engaged in a U.S. trade or business or subject to the rules of subpart F of part III, subchapter N of chapter 1 of subtitle A of the Code (sections 951-965).[18] More specifically, Treasury Regulation § 1.167(a)-3 prescribes a general useful life of 15 years, although specified assets are assigned 25-year lives. By contrast, Temporary Treasury Regulation § 1.367(d)-1T(c)(3) as in effect for the taxable year in issue, provided: "For purposes of this section, the useful life of intangible property is the entire period during which the property has value. However, in no event shall the useful life of an item of intangible property be considered to exceed twenty years."[19]

Finally, even if we were to accept that (1) a disposition requires immediate gain recognition under section 367(d)(2)(A)(ii)(II) only if it occurs after [pg. 16] the beginning of the useful life of the transferred intangible property and (2) the useful life of the intangible property that petitioner transferred to TBL GmbH is defined by Treasury Regulation § 1.167(a)-3(b)(3), rather than Temporary Treasury Regulation § 1.367(d)-1T(c)(3), it would not follow that petitioner's distribution of TBL GmbH stock to VF Enterprises occurred before the useful life of the transferred intangible property began. Under the plain terms of Treasury Regulation § 1.167(a)-3(b)(3) the useful life of the intangible property in TBL GmbH's hands would have begun on September 1, 2011—the first day of the month in which TBL GmbH placed the property in service. Even accepting that petitioner's distribution of TBL GmbH stock occurred before the end of the day on September 23, 2011, that distribution would have occurred after the useful life of the intangible property, as defined by Treasury Regulation § 1.167(a)-3(b)(3), had already begun.[20]

D. *Failure of "No Disposition" Arguments To Explain Reporting*

Petitioner's various arguments that any "disposition" did not occur within the relevant period share a fundamental problem: They fail to explain the tax reporting undertaken in regard to petitioner's constructive transfer of intangible property. Under the terms of the statute, in the absence of a "disposition following [the section 367(d)] transfer," the annual payments described in section 367(d)(2)(A)(ii)(I) are to be reported by "the United States person transferring such property." Petitioner, then classified as a corporation, was the United States person who transferred the intangible property in issue. Lee Bell did not transfer the intangible property that TBL GmbH acquired in the F reorganization. Indeed, Lee Bell never owned that property.

E. *Conclusion*

For the reasons explained above, we conclude that petitioner's constructive distribution to VF Enterprises of the TBL GmbH stock was a "disposition," within the meaning of section 367(d)(2)(A)(ii)(II), and that the disposition "follow[ed]" petitioner's transfer of intangible property to TBL GmbH. Therefore, unless the regulations provide for a different result, petitioner was required to recognize its gain in the transferred intangible property "at the time of the disposition." § 367(d)(2)(A)(ii)(II).

IV. *Impact of the Regulations*

We find nothing in the regulations that would allow petitioner to avoid immediate gain recognition under section 367(d)(2)(A)(ii)(II). Because petitioner was no longer recognized as a separate entity for Federal tax purposes after the completion of the F reorganization that included the section 367(d) transfer, it could not report the deemed annual payments described in section 367(d)(2)(A)(ii)(I). And, as explained below, no provision in the regulations allows Lee Bell to assume responsibility for reporting those payments: Lee Bell was neither the U.S. transferor of the intangible property nor the recipient of the stock of TBL GmbH, the transferee foreign corporation.

A. *Propriety of Lee Bell's Reporting*

1. *Temporary Treasury Regulation § 1.367(d)-1T(c)(1)*

Petitioner contends that Lee Bell's inclusion in income of deemed annual payments was "proper[]" under the terms of Temporary Treasury Regulation § 1.367(d)-1T(c)(1). That section essentially restates the annual inclusion rule of section 367(d)(2)(A)(ii)(I). The regulation provides: "If a U.S. person transfers intangible property that is subject to section 367(d) and the rules of this section

to a foreign corporation in an exchange described in section 351 or 361, then such person shall be treated as having transferred that property in exchange for annual payments contingent on the productivity or use of the property." Temp. Treas. Reg. § 1.367(d)-1T(c)(1).

Temporary Treasury Regulation § 1.367(d)-1T(c)(1) does not require or allow Lee Bell to include in income the annual payments described in section [pg. 17] 367(d)(2)(A)(ii)(I) as a result of petitioner's constructive transfer of intangible property to TBL GmbH. As noted above, Lee Bell was not the United States person that transferred intangible property subject to section 367(d).

Petitioner contends that its interpretation of Temporary Treasury Regulation § 1.367(d)-1T(c)(1) was reasonable because "Lee Bell indirectly owned the transferred Timberland Intangible Assets and was a reasonable U.S. person to include the Annual section 367(d) Payments[[21]] as it was the first U.S. person that owned both TBL (Petitioner) and TBL GmbH." Petitioner's professedly reasonable interpretation of the regulations, however, is contrary to its plain terms. Temporary Treasury Regulation § 1.367(d)-1T(c)(1) does not require the deemed annual payments to be reported by the U.S. transferor of intangible property or, instead, a "reasonable" substitute. When applicable, it requires annual income inclusions by the U.S. transferor. Because Temporary Treasury Regulation § 1.367(d)-1T(c)(1) simply restates the statutory annual inclusion rule provided in section 367(d)(2)(A)(ii)(I), that regulation cannot be read to override the immediate gain recognition rule provided in section 367(d)(2)(A)(ii)(II). Both subclauses of section 367(d)(2)(A)(ii) must be given effect: Each is an alternative to the other. Subclause (I) requires the U.S. transferor, in the absence of a "disposition," to include in income deemed annual payments that reflect the "productivity, use, or disposition" of the transferred intangible property. §367(d)(2)(A)(i) and (ii)(I). And subclause (II) provides that, in the event of a disposition, the U.S. transferor must recognize gain at the time of the disposition-- essentially taking into account at that time the deemed payments that it would otherwise have taken into account over the remaining useful life of the transferred intangible property. § 367(d)(2)(A)(ii)(II). For petitioner to avoid immediate gain recognition, it must find a provision, applicable to its circumstances, that allows continued reporting of deemed annual payments not withstanding its "disposition" of TBL GmbH stock. Temporary Treasury Regulation § 1.367(d)-1T(c)(1) is not that provision.

2. *Temporary Treasury Regulation § 1.367(d)-1T(e)(3)*

Petitioner also claims that Lee Bell's reporting complied with Temporary Treasury Regulation § 1.367(d)-1T(e)(3). In relevant part that section provides:

> If a U.S. person transfers intangible property that is subject to section 367(d) and the rules of this section to a foreign corporation in an exchange described in section 351 or 361, and within the useful life of the transferred intangible property, that U.S. transferor subsequently transfers any of the stock of the transferee foreign corporation to one or more

foreign persons that are related to the transferor within the meaning of paragraph (h) of this section, then the U.S. transferor shall continue to include in its income the deemed payments described in paragraph (c) of this section in the same manner as if the subsequent transfer of stock had not occurred....

Petitioner views it as "quite obvious[]" that Temporary Treasury Regulation § 1.367(d)-1T(e)(3) would apply if its constructive distribution of TBL GmbH stock to VF Enterprises were treated as a disposition because, it contends, VF Enterprises was "related" to petitioner. "Under the circumstances of this case," petitioner alleges, "the inclusion of Annual § 367(d) Payments by Lee Bell constituted compliance with Temporary Treas. Reg. § 1.367(d)-1T(e)(3)."

We disagree. Lee Bell's reporting of the deemed annual payments as a result of petitioner's section 367(d) transfer of intangible property could not have "compl[ied]" with Temporary Treasury Regulation § [pg. 18] 1.367(d)-1T(e)(3) because—to reiterate—Lee Bell was not the U.S. transferor of the intangible property. Under the plain terms of the regulation, it is of no consequence that Lee Bell is, in petitioner's description, "a closely related U.S. party" that might be viewed as a "reasonable proxy" for petitioner. Temporary Treasury Regulation § 1.367(d)-1T(e)(3) does not contemplate the reporting of deemed annual payments by U.S. persons who are "reasonable proxies" for the U.S. transferor.

Petitioner argues that "Temp. Treas. Reg. § 1.367(d)-1T(e)(3)...does not limit the inclusion of Annual § 367(d) Payments to the initial `U.S. transferor.'" We find petitioner's reference to an "initial `U.S. transferor'" puzzling. A section 367(d) transfer occurs only once. It can have only one U.S. transferor—not an "initial" U.S. transferor who may be replaced (or joined) by another. In specified circumstances, a U.S. person related to the U.S. transferor of intangible property in a section 367(d) exchange must assume the obligation to report the deemed annual payments described in section 367(d)(2)(A)(ii)(I). *See* Temp. Treas. Reg. § 1.367(d)-1T(e)(1). Temporary Treasury Regulation § 1.367(d)-1T(e)(1) applies when the U.S. transferor of the intangible property "transfers the stock of the transferee foreign corporation to U.S. persons that are related to the transferor within the meaning of paragraph (h) of this section." Nothing in Temporary Treasury Regulation § 1.367(d)-1T(e)(1), however, describes as a "subsequent U.S. transferor" the related U.S. person who receives the stock of the transferee foreign corporation from the "initial" U.S. transferor. Moreover, that regulation does not apply to the present case because VF Enterprises, even if "related" to petitioner within the meaning of Temporary Treasury Regulation § 1.367(d)-1T(h) was not a "U.S. person." *See* § 7701(a)(30) (defining "United States person" to include domestic but not foreign corporations), § 7701(a)(4) ("The term `domestic' when applied to a corporation...means created or organized in the United States or under the law of the United States or of any State."). [22]

More generally, Temporary Treasury Regulation § 1.367(d)-1T(e)(3), as we read it, *does* "limit the inclusion of Annual § 367(d) Payments to the...`U.S. transferor.'" When applicable, that section provides that "*the U.S. transferor* shall continue to include in its income the deemed payments described in paragraph (c) of this section." Temp. Treas. Reg. § 1.367(d)-1T(e)(3) (emphasis added). As petitioner observes, "[t]he regulation does not contain limitation language." "[I]t does not say that the income inclusion contemplated by the section can `*only* be by the U.S. transferor' or that the Annual § 367(d) Payments must be included `*exclusively* [by] the U.S. transferor." But "limitation language" of the type petitioner posits is unnecessary. When the regulation provides that, in specified circumstances, the U.S. transferor must continue to include in its income the deemed annual payments described in section 367(d)(2)(A)(ii)(I) and gives no indication that any other person would be allowed to take on that reporting obligation, the regulation should be read to "limit" the required income inclusions to the U.S. transferor. [23] As paragraph (e)(1) of Temporary Treasury Regulation § 1.367(d)-1T demonstrates, when the drafters of the regulation intended to allow or require a person other than the U.S. transferor to take on the reporting obligation they knew how to say so.

Petitioner contends that its "reasonable interpretation of Temp. Treas. Reg. § 1.367(d)-1T(e)(3), requiring Lee Bell to include the Annual § 367(d) Payments, is consistent with Respondent's administrative practice." In its motion for summary judgment, petitioner singled out Priv. Ltr. Rul. 9731039 (Aug. 1, 1997) as illustrative of that practice. Petitioner's reply to respondent's response to its motion refers to [pg. 19] an earlier ruling: Priv. Ltr. Rul. 9024004 (June 15, 1990).

Petitioner sought to include copies of each of those rulings along with the parties' first stipulation of facts. In his motion in limine, respondent asked to "exclude" the proffered copies of the rulings. Respondent objected to the "admission" of the private letter rulings because "they are not relevant or material to any issue in the case." Respondent observes that neither ruling was issued to petitioner or addressed a transaction in which petitioner engaged. Those rulings, respondent argues, "do not have any tendency to make a fact more or less probable in Petitioner's case than it would be without such evidence."

We agree with respondent that "admission of...[the private letter] rulings into evidence is inappropriate." But respondent misunderstands petitioner's purpose in submitting copies of the rulings. As petitioner explained in its opposition to respondent's motion in limine, "these exhibits were included in the record for the Court's convenience."

On the merits, respondent reminds us, citing section 6110(k)(3), that "Private Letter Rulings may not be used or cited as precedent." We have accepted, however, that "[p]rivate letter rulings may be cited to show the practice of the Commissioner." Dover Corp. & Subs. v. Commissioner, 122 T.C. 324, 341 n.12 (2004). Even so, two private letter rulings do not an established administrative practice make. *See* Lucky Stores, Inc. & Subs. v. Commissioner, 153 F.3d 964, 966 [82 AFTR

2d 98-5815] n.5 (9th Cir. 1998) (declining to allow taxpayer to rely on "several private letter rulings and one technical advice memorandum"), aff'g 107 T.C. 1 (1996). Moreover, the transactions addressed in the rulings petitioner cites appear to be distinguishable from its case.

Priv. Ltr. Rul. 9731039 involved a section 355 distribution by Distributing to its shareholders of the stock of New Controlled. New Controlled was a foreign corporation that had succeeded to Controlled, a domestic corporation, in a reorganization described in section 368(a)(1)(F). Before that reorganization, Controlled had transferred intangible property to its foreign subsidiary, Subsidiary. Among other things, the ruling held that Controlled's transfer of intangible property to Subsidiary was subject to section 367(d). It also held that "the transfer of the stock of Subsidiary from Controlled to New Controlled [in the F reorganization] is governed by § 1.367(d)-1T(e)(3)." And it held that "Distributing's distribution of its stock in New Controlled to Distributing's shareholders is governed by § 1.367(d)-1T(d) to the extent Distributing's shareholders are not related persons within the meaning of § 1.367(d)-1T(h)." Thus, in the transaction addressed in the ruling, the section 367(d) transfer of intangible property preceded the outbound F reorganization. In the outbound F reorganization, the U.S. transferor of the intangible property transferred the stock of the transferee foreign corporation that it had received in exchange for the intangible property. *That* transfer did not cause the U.S. transferor (Controlled) to go out of existence. If one froze the action at that point, one might say that Temporary Treasury Regulation § 1.367(d)-1T(e)(3) could apply. The U.S. transferor of the intangible property (Controlled) transferred the stock of the foreign transferee corporation (Subsidiary) to a related foreign person (New Controlled). After that specific step, Controlled could continue reporting deemed annual payments under Temporary Treasury Regulation § 1.367(d)-1T(e)(3). But in the very next step in the outbound F reorganization, Controlled distributed to Distributing the stock of New Controlled and, in so doing, went out of existence. Thus, upon completion of the outbound F reorganization, it would no longer be possible for Controlled to continue reporting deemed annual payments. It is therefore unclear what was meant by the holding that Controlled's transfer of Subsidiary stock to New Controlled was "governed by § 1.367(d)-1T(e)(3)." Perhaps Distributing was allowed to step (momentarily) into Controlled's shoes. But Distributing promptly distributed the stock of New Controlled to its shareholders, thereby requiring the recognition of gain under section 367(d)(2)(A)(ii)(II) and Temporary [pg. 20] Treasury Regulation § 1.367(d)-1T(d), except to the extent that a shareholder of Distributing owned enough Distributing stock to be related to Distributing. That all or most of the gain in the transferred intangible property may well have been triggered before the completion of the overall transaction renders of little consequence the prospect that Temporary Treasury Regulation § 1.367(d)-1T(e)(3) might have allowed the reporting of deemed annual payments to continue between interim steps in that overall transaction.

Priv. Ltr. Rul. 9024004 involved a transaction in which Target, a domestic corporation, transferred its assets to Acquiring, a foreign corporation, in exchange for Acquiring voting stock and Acquiring's assumption of Target's liabilities. Target then liquidated. The ruling held that the

transaction "constitute[d] a reorganization within the meaning of section 368(a)(1)(C) of the Code." It also held that the goodwill included among the transferred assets would be "treated as having been transferred in exchange for annual payments contingent on the productivity or use of such property" and that "[s]uch payments" would be "imputed" to Target's shareholders. Because each of Target's three shareholders was a U.S. citizen who owned more than 10% of Target's stock, the conclusion that the shareholders could succeed to Target's obligation to report deemed annual payments was a straightforward application of Temporary Treasury Regulation § 1.367(d)-1T(e)(1). *See* § 267(b)(2); Temp. Treas. Reg. § 1.367(d)-1T(h). Petitioner alleges that "PLR 9024004...shows that Respondent's consistent administrative practice was to fit transactions within the § 367(d) regulatory structure." That the transaction addressed in Priv. Ltr. Rul. 9024004 "fit...within the § 367(d) regulatory structure" does not establish that any provision therein allows petitioner to avoid the recognition of gain under section 367(d)(2)(A)(ii)(II).

Petitioner also observes that, "regardless of the interpretation of the phrase `U.S. transferor,' no language in Temporary Treas. Reg. § 1.367(d)-1T(e)(3) provides for a lump-sum inclusion." Petitioner's observation is accurate but beside the point. The relevant question is not whether Temporary Treasury Regulation § 1.367(d)-1T(e)(3) requires petitioner to include in income the excess of the fair market value of the transferred intangible property over its basis. Instead, the question is whether that regulation section or any other allows petitioner, notwithstanding its "disposition" of TBL GmbH stock, to avoid gain recognition under section 367(d)(2)(A)(ii)(II) by continued reporting of the deemed annual payments described in section 367(d)(2)(A)(ii)(I).

B. *Petitioner's Inability To Comply With Temporary Treasury Regulation § 1.367(d)-1T(e)(3)*

That said, Temporary Treasury Regulation § 1.367(d)-1T(e)(3), when applicable, *does* allow a U.S. transferor to continue reporting deemed annual payments instead of recognizing immediate gain. Moreover, the conditions for the application of that rule—at least those expressly stated—have been met in the present case. Petitioner, a U.S. person, *did* transfer intangible property that is subject to section 367(d) and the rules of Temporary Treasury Regulation § 1.367(d)-1T to TBL GmbH, a foreign corporation, in an exchange described in section 361. And before the end of the useful life of that property, petitioner transferred the TBL GmbH stock that it received for the property to VF Enterprises, a foreign person whom the parties seem to accept was "related" to petitioner within the meaning of Temporary Treasury Regulation § [pg. 21] 1.367(d)-1T(h).[24] Nonetheless, we conclude that Temporary Treasury Regulation § 1.367(d)-1T(e)(3) does not apply to petitioner's case. We reach that conclusion not because of a failure to satisfy the express conditions for the rule's application but instead because the rule cannot be applied. When applicable, Temporary Treasury Regulation § 1.367(d)-1T(e)(3) requires the U.S. transferor—not some other U.S. person of the taxpayer's choosing—to continue including in its income the

deemed annual payments described in section 367(d)(2)(A)(ii)(I). Petitioner cannot comply with that provision because it is no longer recognized as a separate entity for Federal tax purposes.[25] By directing a U.S. transferor to "continue to include in its income the deemed payments described in paragraph (c)," Temporary Treasury Regulation § 1.367(d)-1T(e)(3) implicitly requires the U.S. transferor to remain a person with cognizable income. It is that implicit requirement that has not been met in the present case. After the deemed liquidation resulting from its election to be a disregarded entity, petitioner itself had no income in which to include the deemed annual payments.

In support of its argument that, if Lee Bell is not an acceptable substitute, it should itself be required to include in its own income the deemed annual payments described in section 367(d)(2)(A)(ii)(I), petitioner observes that "[t]here is no requirement under Temp. Treas. Reg. § 1.367(d)-1T(e)(3) that the U.S. transferor remain a U.S. entity." Strictly speaking, that is true. Nothing in the section 367(d) regulations impinged on petitioner's freedom to participate in a reincorporation in which the surviving corporation was foreign. But exercising that choice left petitioner unable to comply with Temporary Treasury Regulation § 1.367(d)-1T(e)(3). As a result of the reincorporation, petitioner ceased to exist as a recognized taxable entity and, thereafter, had no income to report.

Petitioner posits that, were it to "report" the deemed annual payments described in section 367(d)(2)(A)(ii)(I), "Lee Bell would be taxed on the same amounts that it reported directly, but...under Subpart F instead." We are unconvinced by petitioner's speculations about the potential impact of subpart F. Section 951(a)(1)(A) requires each "United States shareholder" of a CFC to include in its gross income its pro rata share of the CFC's "subpart F income." After petitioner distributed to VF Enterprises the TBL GmbH stock that it constructively received in exchange for its intangible property, petitioner was not a CFC. *See* § 957(a) (defining "controlled foreign corporation" to mean specified foreign corporations). Petitioner is no longer recognized for Federal tax purposes as any type of entity. It can no longer be required to "report" anything. Accepting that TBL GmbH is a CFC and that Lee Bell is a United States shareholder of TBL GmbH, Lee Bell would indeed be required under section 951(a)(1) to include in its income its pro rata share of TBL GmbH's subpart [pg. 22] F income.[26] But Temporary Treasury Regulation § 1.367(d)-1T(e)(3) does not authorize treating TBL GmbH as the recipient of the deemed payments described in section 367(d)(2)(A)(ii)(I). TBL GmbH was not the U.S. transferor in the section 367(d) transfer at issue. It was, instead, the transferee foreign corporation. It was not the seller of the intangible property but the purchaser. Designating TBL GmbH as the recipient of the payments deemed to be made in exchange for the transferred property would treat it as paying itself.

C. *TBL GmbH as Successor to Petitioner*

Petitioner suggests that, under Temporary Treasury Regulation § 1.367(d)-1T(e)(3), TBL GmbH could be allowed or required to include in its income the deemed annual payments described in section 367(d)(2)(A)(ii)(I) because TBL GmbH is petitioner's "successor" and, "even more to the point, under the direction of section 368(a)(1)(F), is one in the same entity" as petitioner. Petitioner contends that it "did not go out of existence" but instead merely "changed form."

In some reincorporation transactions, the identity between the old and new corporations may be so strong as to allow treating the two as a single corporation. *See, e.g.*, Weiss v. Stearn, 265 U.S. 242 [4 AFTR 3986] (1924) (holding that, in reincorporation in which both corporations were organized under the laws of the same State, participating shareholders realized gain only to the extent of the cash they received). In those situations, the shareholders' exchange of stock of the old corporation for that of the new corporation would not be a realization event. The shareholders would have no need for section 354(a)'s nonrecognition rule. And, in that circumstance, the corporate-level nonrecognition rules provided in section 361 might be unnecessary because no transfer of assets or stock distribution need be imputed.

The transaction in which TBL GmbH acquired petitioner, however, is not of the type in which the participating entities can be viewed, for all purposes, as one and the same. *See, e.g.*, Marr, 268 U.S. 536 [5 AFTR 5393]; Phellis, 257 U.S. 156 [3 AFTR 3123]. Because TBL GmbH was organized under the laws of Switzerland, it is "essentially different" from a limited liability company organized under the laws of Delaware that is treated as a corporation for Federal tax purposes by reason of the entity's election. *See* Marr, 268 U.S. at 541. [27]

D. *Temporary Treasury Regulation § 1.367(d)-1T(d)(1)*

Petitioner also argues that "[t]he § 367(d) Regulations provide that a lump-sum inclusion under the Lump-Sum Exception results only where there is a subsequent transfer to an unrelated party." Petitioner apparently has in mind Temporary Treasury Regulation § 1.367(d)-1T(d)(1), which provides:

> If a U.S. person transfers intangible property that is subject to section 367(d) and the rules of this section to a foreign corporation in an exchange described in section 351 or 361, and within the useful life of the intangible property that U.S. transferor subsequently disposes of the stock of the transferee foreign corporation to a person that is not a related person (within the meaning of paragraph (h) of this section), then the U.S. transferor shall be treated as having simultaneously sold the intangible property to the person acquiring the stock of the [pg. 23] transferee foreign corporation. The U.S. transferor shall be required to recognize gain (but not loss) from sources within the United States in an amount equal to the difference between the fair market value of the transferred intangible property on the date of the

subsequent disposition and the U.S. transferor's former adjusted basis in that property (determined as of the original transfer)....

Contrary to petitioner's description, Temporary Treasury Regulation § 1.367(d)-1T(d)(1) does not provide that a U.S. transferor recognizes gain upon a disposition of the stock of the transferee foreign corporation *only* if that disposition is to an unrelated party. Instead, it says that *when* the disposition is to an unrelated party, the U.S. transferor must recognize gain. Temporary Treasury Regulation § 1.367(d)-1T(d)(1) says nothing about the consequences of a U.S. transferor's disposition of the stock of the transferee foreign corporation to a related person. Those dispositions are addressed elsewhere in the regulations—in particular, Temporary Treasury Regulation § 1.367(d)-1T(e)(1) and (3). As explained above, subparagraph (1) does not apply to petitioner's case and petitioner cannot comply with the mandate of subparagraph (3).

E. *Notice 2012-39*

Petitioner suggests that "Respondent's position in this case" "is directly at odds" with a notice respondent issued in 2012. Notice 2012-39, § 1, 2012-31-I.R.B. 95, 95, announced plans for the issuance of regulations to address "significant policy concerns" about outbound reorganizations that involve transfers of intangible property. [28] According to the notice, the forthcoming regulations would "apply to transfers occurring on or after July 13, 2012." Id. The notice goes on to state: "No inference is intended as to the treatment of transactions described in this notice under current law, and the IRS may challenge such transactions under applicable Code provisions or judicial doctrines." Id. § 5, 2012-31 I.R.B. at 98.

The notice describes the transactions of concern as having the "inten[t] to repatriate earnings from foreign corporations without the appropriate recognition of income." Id. §3, 2012-31 I.R.B. at 96. Among the examples given of those transactions are "cases in which a controlled foreign corporation uses deferred earnings [an apparent reference to earnings not previously subject to U.S. tax] to fund an acquisition of all or part of the stock of a domestic corporation from an unrelated party for cash, followed by an outbound asset reorganization of the domestic corporation to avoid an income inclusion under section 956." [29] Id.

Under one of the rules that would be added to the regulations, the U.S. transferor of intangible property would "take into account income under section 367(d)(2)(A)(ii)(II)" to the extent that the stock of the transferee foreign corporation that the U.S. transferor distributes in the reorganization is received by "non-qualified successors." Id. § 4.03. For that purpose, foreign corporations, individuals, and some domestic corporations subject to special tax treatment would be nonqualified successors. Id. § 4.07, 2012-31 I.R.B. at 97. Therefore, if a domestic target corporation, after being acquired by a CFC, transferred intangible property in a subsequent

outbound reorganization, the target would recognize immediate gain under section 367(d)(2)(A)(ii)(II) because its shareholder, as a foreign corporation, would be a nonqualified successor.

If the rules announced in Notice 2012-39, supra, had applied to the outbound F reorganization in which petitioner constructively transferred intangible property to TBL GmbH, petitioner would clearly have been required to recognize gain under section 367(d)(2)(A)(ii)(II) as a result of the transfer. Its shareholder, VF Enterprises, was a foreign corporation and, thus, a "non-qualified successor" within the meaning of the notice. Respondent asserts that the same result obtains under the law in effect during 2011. If that were so, [pg. 24] petitioner reasons, respondent would have had no need to issue Notice 2012-39, supra.[30]

As respondent observes, however, the notice's scope extends well beyond transactions such as petitioner's. For example, the notice addresses situations in which the outbound reorganization involves the payment of boot. Even the specific rule that would address transactions like petitioner's—applicable to U.S. transferors owned by nonqualified successors—would apply to circumstances beyond those of the present case. The nonqualified successor rule would require the recognition of gain not only by U.S. transferors, like petitioner, owned by foreign corporations but also those owned by individuals. (The notice reflects the view that the tax paid by individual shareholders deemed to receive annual payments described in section 367(d)(2)(A)(ii)(I) would not be an adequate substitute for the corporate-level tax that would, in the absence of a disposition, have been paid by the U.S. transferor.) Therefore, the pending amendments to the regulations announced in Notice 2012-39, supra, would have been necessary, at least in part, even it if it had already been clear that a transfer of intangible property in an outbound reorganization by a U.S. transferor owned by a foreign corporation requires the recognition of gain under section 367(d)(2)(A)(ii)(II). The notice's inclusion of foreign corporations in the definition of "non-qualified successor" could have either restated existing law or addressed an issue on which existing law was uncertain.[31]

In short, petitioner's task, again, is to identify one or more provisions of the regulations that allow it to avoid gain recognition under section 367(d)(2)(A)(ii)(II) notwithstanding its disposition of TBL GmbH stock. Its invocation of Notice 2012-39, supra, does not accomplish that task. The notice does not give us grounds to conclude that the law in effect before its issuance allowed petitioner to avoid gain recognition by means of reporting of deemed annual payments by Lee Bell, TBL GmbH, or any other person or entity recognized for Federal tax purposes.

F. *New York State Bar Association Tax Section Report*

Finally, petitioner suggests that a 2010 report on section 367(d) prepared by the New York State Bar Association Tax Section (NYSBA report) "supports... [its] reporting position." *See* N.Y. State Bar Ass'n (NYSBA), *Report on Section 367(d)* (2010). As we read the NYSBA report, however, it

does not support the specific reporting undertaken in respect of the transaction at issue in this case—that is, Lee Bell's inclusion in income of deemed annual payments under section 367(d)(2)(A)(ii)(I). The NYSBA report does take the position that immediate gain recognition should not be required in the case of an outbound reorganization involving a transfer of intangible property by a U.S. corporation owned by a CFC parent. As explained below, however, we find unpersuasive the analysis offered in the report in support of that conclusion.

Before turning to the merits of the report's recommendation, we first address the more general question of its status as authority. Petitioner sought to include a copy of the NYSBA report as part of the parties' first stipulation of facts. Respondent dismisses the report as "not authoritative, binding, or otherwise dispositive" and, in his motion in limine, asks us to disregard the report. Petitioner responds that it "never claim[ed] the NYSBA Report is binding, but rather that it is a type of persuasive authority that courts may look to and that it warrants consideration by this Court." [pg. 25]

In his motion in limine, respondent accepts that the NYSBA report "should be viewed as secondary legal authority." He seeks only to strike the report "as factual evidence." But petitioner's purpose in submitting the report was not to establish any fact relevant to the case. As petitioner explains in its opposition to respondent's motion to strike, it "attached the NYSBA Report to...[the parties' first stipulation of facts] for the Court's convenience." We will therefore consider the report as secondary authority to the extent that it may assist us in resolving the legal dispute before us.

The parties offer competing interpretations of the NYSBA report, with each claiming that the report supports its or his own position. It seems clear that the drafters of the report believed that a domestic target corporation acquired in an outbound reorganization should not be required to recognize immediate gain under section 367(d)(2)(A)(ii)(II) as a result of its distribution of stock of the transferee foreign corporation if the domestic target is owned by a CFC that, in turn, is owned entirely by United States shareholders who would be required to include in their income their ratable shares of the CFC's subpart F income. It is less clear, however, whether, in that respect, the report reflects the drafters' understanding of then-current law or, instead, their recommendation that new regulations be issued to achieve that result.

The drafters begin by acknowledging that "[t]he Temporary Section 367(d) Regulations do not specifically address what happens if the U.S. transferor goes out of existence, either in connection with the Section 367(d) transfer or after the transfer." NYSBA, supra, at 76. The drafters then consider an outbound reorganization in which a domestic target corporation is owned by a U.S. parent corporation. If the transferred assets include intangible property, the drafters reason, "it should be clear that the U.S. parent should be required to continue to include deemed Section 367(d) income as a result of the outbound transfer of Section 936 Intangibles over the life of such Intangibles." Id. at 77. That conclusion reflects a relatively straightforward application of

Temporary Treasury Regulation § 1.367(d)-1T(e)(1). If the U.S. parent is viewed as a person "related" to the U.S. transferor, on the basis of the relationship that existed before the U.S. transferor's dissolution, the U.S. parent can step into the shoes of the U.S. transferor and report the deemed annual payments described in section 367(d)(2)(A)(ii)(I).

The NYSBA report then considers the consequences of an outbound reorganization of a domestic target owned by a foreign corporation:

> Somewhat more complicated is the situation where a U.S. target owned by a foreign corporation effects an outbound...reorganization of Section 936 Intangibles. In the easier case, assume U.S. Target is owned by a controlled foreign corporation ("CFC") subject to Subpart F. As a statutory construction matter, we would think that Section 367(d) displaces Section 367(a) only for U.S. Target's transfer of a Section 936 Intangible to the foreign transferee. U.S. Target's subsequent distribution to its parent of the transferee's stock in liquidation should be eligible for non-recognition under Section 361(c) and Section 367(a)(2).[32] Accordingly, a tax free distribution of the transferee's shares should be available to the U.S. target's CFC/parent. The CFC/parent as successor to U.S. Target's attributes under Section 381(c) would succeed to and recognize subsequent Section 367(d) inclusions over the useful life of the transferred Section 936 Intangibles or until it ceased to be a CFC. In the case of a CFC, this analysis preserves the widest ambit for Section 367(d) to operate and avoids allowing taxpayers to elect current recognition and elect out of Section 367(d) by such related person transfers.
>
> However, in the case of a foreign parent corporation that is not a CFC (or to the extent the foreign parent corpora[pg. 26] tion's shareholders are not U.S. Shareholders within the meaning of Section 951(b)), continuation of the Section 367(d) regime would ensure that Section 367(d) income would be taxable. For example, existing Regulation § 1.367(d)-1T(e)(3) provides that, in the case of subsequent transfers of shares bearing a Section 367(d) obligation to a related CFC, only the continuing U.S. transferor continues absorbing the Section 367(d) inclusions. Accordingly, new regulations could provide, with respect to an outbound...reorganization in which the transferor of Section 936 Intangibles goes out of existence in connection with the transaction, that the transferor is taxed currently on its gain as in the case of a terminating disposition under Section 367(d)(2)(A)(ii) unless the distributee is domestic or, if foreign, is, e.g., a CFC more than 80% of whose shares are held by U.S. shareholders, in which case the distributee would continue recognition of Section 367(d) inclusions.

NYSBA, supra, at 78-79 (footnote omitted).

Petitioner, apparently referring to the first paragraph quoted above, observes that "the NYSBA Report...concluded that a transaction very similar to the one at issue does not require a lump-sum

inclusion." More specifically, petitioner contends that the report "supports Lee Bell's inclusion of Annual § 367(d) Payments."

Focusing on the second of the above-quoted paragraphs, respondent interprets the NYSBA report as "saying that the regulations could—but presently do not—provide an exception to immediate reporting for a situation like Petitioner's." Thus, respondent concludes that "a close reading of the...report demonstrates that it actually confirms that Respondent's position is correct."

We are inclined to accept petitioner's interpretation of the NYSBA report. The first of the quoted paragraphs concludes, on the basis of statutory interpretation, that a target corporation's distribution of stock of the transferee foreign corporation to a CFC parent does not require the recognition of immediate gain under section 367(d)(2)(A)(ii)(II). The report's reference to possible new regulations in the second paragraph is unclear. Would those regulations be necessary to require the recognition of gain on a liquidating distribution of stock of the transferee foreign corporation or instead to provide that immediate gain recognition is not required when the distribution is to a CFC a sufficient portion of whose stock is owned by United States shareholders who would be required to include in income their respective shares of the CFC's subpart F income? Even if the hypothesized regulations would serve the latter purpose—providing an exemption from the recognition of immediate gain that would otherwise be required—the drafters may have envisioned those regulations as simply confirming their interpretation of the statutory provisions they viewed as governing.

Even so, the NYSBA report does not support the specific reporting undertaken to reflect the transaction in issue. The report posits that, when a U.S. target owned by a CFC transfers intangible property in an outbound reorganization, the target's CFC parent should assume the obligation to report the deemed annual payments described in section 367(d)(2)(A)(ii)(I). In the present case, that would be VF Enterprises. By contrast, Lee Bell—a U.S. corporation other than petitioner's CFC parent—voluntarily reported deemed annual payments—apparently not as its share of subpart F income of VF Enterprises but as income of Lee Bell in its own right. In support of its motion for summary judgment, petitioner suggested the alternative possibility of TBL GmbH reporting deemed annual payments as petitioner's successor. But that approach would differ from the one recommended by the NYSBA report.

Leaving those details aside, we accept that the drafters of the NYSBA report concluded by means of statutory analysis that a U.S. target's distribution to a CFC parent of stock of the transferee foreign corporation as part of an outbound reorganization should not require immediate gain recognition under section 367(d)(2)(A)(ii)(II). To the extent that that analysis supports petitioner's position, however, we find it unpersuasive. The drafters' conclusion rests on the premise that, while section 367(d) [pg. 27] can override section 361(a) (the nonrecognition rule applicable to transfers of assets), it should not be interpreted to override section 361(c) (the nonrecognition

rule that applies to distributions of the stock received in exchange for transferred assets). While we agree with that premise, it does not support the drafters' conclusion. Treating the target's distribution of stock of the transferee foreign corporation as the trigger for the recognition of gain in the transferred intangible property would not affect the nonrecognition treatment afforded by section 361(c) on the distribution of stock. The stock distribution itself would remain eligible for nonrecognition treatment. The occurrence of that nonrecognition event would simply determine when the gain on the transferred intangible property must be recognized.

Moreover, the drafters of the NYSBA report erred in another respect in their reading of the statutes they relied on. They suggest that section 381(c) supports having the parent of the target corporation assume responsibility for the reporting of the deemed annual payments described in section 367(d)(2)(A)(ii)(I). Section 381 does provide for the carryover of the tax attributes of a target corporation acquired in specified types of reorganizations, including one described in section 368(a)(1)(F). But the entity that succeeds to those attributes is not the target's And, as parent corporation (if any), but instead the acquiring corporation. And, as[33] explained supra part IV.B, it would make no sense to have the acquiring corporation in the reorganization (the transferee foreign corporation) assume responsibility for reporting the payments described in section 367(d)(2)(A)(ii)(I). Doing so would treat that corporation as making payments to itself, as simultaneously buyer and seller of the transferred intangible property.

In short, we do not agree that, "[a]s a statutory construction matter," a U.S. transferor of intangible property in an outbound reorganization is not required to recognize gain under section 367(d)(2)(A)(ii)(II) if that corporation was (before its dissolution) owned by a CFC and that, instead, the CFC parent should be required to include in income the deemed annual payments described in section 367(d)(2)(A)(ii)(I). On the contrary, for the reasons explained supra part III.A, the U.S. transferor's distribution of the stock of the transferee foreign corporation is a "disposition" within the meaning of section 367(d)(2)(A)(ii)(II). Therefore, the distribution will require the U.S. transferor to recognize any gain in intangible property transferred in pursuance of the plan of reorganization in the absence of a rule in the regulations providing contrary treatment. The NYSBA report identifies no provision in the regulations that would allow reporting of deemed annual payments notwithstanding the U.S. transferor's "disposition" of the stock of the transferee foreign corporation.

G. *Conclusion*

For the reasons explained supra part III, we have concluded that petitioner's constructive distribution to VF Enterprises of the TBL GmbH stock that petitioner constructively received in exchange for its intangible property was a "disposition" within the meaning of section 367(d)(2)(A)(ii)(II). We also conclude, for the reasons explained in this part IV, that no provision of the regulations allows petitioner to avoid the recognition of gain under that statutory provision.

Petitioner suggests that respondent is to blame for the absence of a provision in the regulations that can be applied to petitioner's circumstances. The absence of an applicable regulatory provision, however, requires that we look to the statute alone to determine the tax consequences of petitioner's transaction. For the reasons explained supra part III, section 367(d)(2)(A)(ii)(II), interpreted in accor[pg. 28] dance with the legislative history, requires petitioner to recognize gain. The absence of a provision in the regulations providing otherwise is petitioner's problem—not respondent's.

Because respondent's position is grounded in an interpretation of the applicable statutory provisions and not on any regulations, we do not understand petitioner's argument that respondent's "litigating position" is "impermissible" under Bowen v. Georgetown University Hospital, 488 U.S. 204 (1988). Bowen stands for the proposition that an agency's litigating position is not entitled to the same deference a court would give to a position adopted through notice and comment rulemaking. *See* id. at 212-13; *see also* Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 842-43 (1984). Respondent does not ask that we grant Chevron deference to the interpretation of the applicable statutes that he advances in this case.

In support of its efforts to cast disfavor on respondent's litigating position, petitioner asks us to consider facts concerning the examination of its return for the year in issue. In the memorandum it submitted in support of its motion for summary judgment, petitioner proposed a finding to the effect that the team initially assigned to the examination "did not make an adjustment for Petitioner to include immediate lump-sum gain under § 367(d)(2)(A)(ii)(II) or Temp. Treas. Reg. § 1.367(d)-1T." Respondent does not contest the accuracy of that proposed finding but nonetheless objects to it as "irrelevant, vague, [and] misleading." In addition, respondent has asked us to strike the declaration of a former VF employee that petitioner submitted in support of its proposed findings concerning the circumstances of the examination. Petitioner cites no authority for the proposition that views expressed during the course of the audit bind respondent for purposes of the present litigation.

Petitioner suggests that the disputed evidence demonstrates that the position respondent now advances "was not foreseeable." The extent to which a taxpayer might have been subjectively surprised by a position advanced by the Commissioner has no direct bearing, however, on the position's merits. Moreover, as the NYSBA report acknowledges, the regulations "do not specifically address" cases like petitioner's, in which a U.S. transferor of intangible property "goes out of existence" in the act of disposing of the stock of the transferee foreign corporation. Petitioner chose to carry out a transaction in regard to which the law was, at best, uncertain. In doing so, it necessarily assumed the risk of an outcome that, by its lights, would be unfavorable. [34]

We are left with one task remaining. Having determined that petitioner must recognize gain for the taxable year in issue by reason of the application of section 367(d)(2)(A)(ii)(II), we now

determine the amount of that gain.

V. *Amount of Required Income Inclusion*

The parties agree on the amount of income inclusion required under section 367(d)(2)(A)(ii)(II) by reason of petitioner's transfer of foreign workforce and foreign customer relationships. They have stipulated that, "[i]f the Court decides that a lump-sum inclusion of income is required under I.R.C. § 367(d)(2)(A)(ii)(II), then Petitioner's increase in income for the transfer of the foreign workforce and the foreign customer relationships would be $23,400,000 and $174,400,000, respectively." The parties agree only in part, however, as to the income inclusion required by reason of petitioner's transfer of trademarks. As to that question, their stipulation states:

> If the Court decides that a lump-sum inclusion of income is required under I.R.C. § 367(d)(2)(A)(ii)(II), then Petitioner's increase in income for the transfer of the trademarks is $1,274,100,000, unless the Court agrees to reduce the adjustment to income for the trademarks based on a 20-year useful life limitation, pursuant to Temp. Treas. Reg. § 1.367(d)-1T, in which case the increase in income for the transfer of the trademarks is $1,029,200,000, in each case [pg. 29] less the reported trademark basis of $19,339,000.

Thus, the parties apparently agree that the income inclusion required by section 367(d)(2)(A)(ii)(II) is the excess of the fair market value of the transferred intangible property at the time of petitioner's disposition of the TBL GmbH stock over the basis of that property. Cf. Temp. Treas. Reg. § 1.367(d)-1T(d)(1). They also agree on the values of the foreign workforce and customer relationships that petitioner constructively transferred to TBL GmbH. And they agree as to petitioner's tax basis in the transferred property. And, finally, they agree on the resolution of the factual question of the trademarks' value under two alternative legal assumptions. Their point of disagreement is whether, as a matter of law, the fair market value of the trademarks must be determined by treating each as having a useful life of no more than 20 years. That legal question, which petitioner raised in an amendment to its petition, arises by reason of Temporary Treasury Regulation § 1.367(d)-1T(c)(3), which, as in effect for 2011, provided: "For purposes of this section, the useful life of intangible property is the entire period during which the property has value. However, in no event shall the useful life of an item of intangible property be considered to exceed twenty years."

Petitioner argues: "If this Court determines that a subsequent transfer occurred resulting in a lump-sum inclusion amount under the Lump-Sum Exception, Temp. Treas. Reg. § 1.367(d)-1T(c)(3) requires that the inclusion be calculated with a 20-year useful life limitation." Respondent counters that section 367(d)(2)(A)(ii)(II) "makes no reference whatsoever to `useful life' of the transferred property." Respondent characterizes Temporary Treasury Regulation § 1.367(d)-1T(c)(3) as a "regulatory grace applicable to the annual inclusion paradigm." According to respondent:

"Petitioner cannot rely on an administrative limitation on the time period over which annual inclusions would be taken into account for purposes of reducing its disposition rule amount. The 20-year regulatory limitation on the annual inclusion period is not a substitute methodology overriding settled law concerning the definition of fair market value." In that regard, respondent points to Temporary Treasury Regulation § 1.367(d)-1T(g)(5), which provides: "For purposes of determining the gain to be recognized immediately under paragraph (d), (f), or (g)(2) of this section, the fair market value of transferred property shall be the single payment arm's-length price that would be paid for the property by an unrelated purchaser determined in accordance with the principles of section 482 and regulations thereunder." Finally, respondent suggests that imposing an "artificial limitation" on the value of transferred intangible property would frustrate Congress' purpose in enacting section 367(d). "Because the limitation on useful life in Temp. Treas. Reg. § 1.367(d)-1T(c)(3) could only have the effect of reducing the amount that would be taxed pursuant to Congress's intentions under section 367(d)," respondent reasons, "the limitation should be read narrowly and applied only to the circumstances specified in the regulations, *i.e.*, annual inclusions and the time frame within which the intangible property must be transferred to trigger [section 367(d)(2)(A)(ii)(II)]."

In response to respondent's argument, petitioner observes that "Temp. Treas. Reg. § 1.367(d)-1T(c)(3) does not state that it only applies to Annual § 367(d) Payments." Instead, paragraph (c)(3) of Temporary Treasury Regulation § 1.367(d)-1T provided that it applied "[f]or purposes of this section." Petitioner notes that a property's useful life is a relevant factor in determining its fair market value and insists that "the regulations require a 20-year time frame for all useful life analyses."

Our conclusion that petitioner must recognize gain as a result of its constructive transfer of intangible property to TBL GmbH does not rest on any provision in Temporary Treasury Regulation § 1.367(d)-1T. The only rule in that section of the regulations that requires the recognition of gain upon a disposition of stock of the transferee foreign corporation applies when that disposition is to a person unre[pg. 30] lated to the U.S. transferor. Temp. Treas. Reg. § 1.367(d)-1T(d)(1). We have accepted the parties' apparent view that VF Enterprises was related to petitioner within the meaning of Temporary Treasury Regulation § 1.367(d)-1T(h). Consequently, Temporary Treasury Regulation § 1.367(d)-1T(d)(1) is not the basis for our conclusion that petitioner must recognize gain in the transferred intangible property as a result of its constructive distribution to VF Enterprises of TBL GmbH stock. Instead, our conclusion rests on the statutory gain recognition rule provided in section 367(d)(2)(A)(ii)(II).

Accordingly, we might dismiss petitioner's argument on that ground that, regardless of the extent to which Temporary Treasury Regulation § 1.367(d)-1T(c)(3) applies in implementing other rules of that section of the regulations, it does not apply when gain recognition is required by the statute and the statute alone. Under that analysis, however, a U.S. transferor who disposes of stock of the

transferee foreign corporation to a related person and, in so doing, goes out of existence might be required to recognize gain in a greater amount than if the disposition had been to an unrelated person. That distinction would be unsupported by any apparent policy grounds. Therefore, we will accept that, if the 20-year useful life limitation imposed by Temporary Treasury Regulation § 1.367(d)-1T(c)(3) can limit the amount of gain required to be taken into account under Temporary Treasury Regulation § 1.367(d)-1T(d)(1) upon a disposition of the stock of the transferee foreign corporation to a person unrelated to the U.S. transferor, it should also reduce the amount of gain petitioner is required to take into account under the statutory gain recognition rule of section 367(d)(2)(A)(ii)(II).

As petitioner emphasizes, paragraph (c)(3) applied, by its terms, "[f]or purposes of" Temporary Treasury Regulation § 1.367(d)-1T. We therefore ask: For what other provisions within Temporary Treasury Regulation § 1.367(d)-1T is the useful life of transferred intangible property relevant? "[U]seful life" appears seven times in provisions of that section, as in effect during 2011, other than paragraph (c)(3). Each of those instances has to do with the period during which (1) deemed annual payments must be taken into account and (2) a direct or indirect disposition of the transferred intangible property can require the recognition of gain.[35] The provisions that require or allow the recognition of gain refer to the fair market value of the intangible property but do not expressly make the property's useful life relevant in determining that value. If the 20-year useful life limitation applies for that purpose, it does so only implicitly.

Any implication that the useful life limitation imposed by Temporary Treasury Regulation § 1.367(d)-1T(c)(3) might apply in determining the amount of gain that must be recognized under paragraph (d)(1) would conflict with the definition of "fair market value" provided in paragraph (g)(5). As respondent observes, Temporary Treasury Regulation § 1.367(d)-1T(g)(5) provides that the fair market value of transferred property is the amount that an unrelated purchaser would pay for the property. Temporary Treasury Regulation § 1.367(d)-1T(g)(5) expressly applies "[f]or purposes of determining the gain...recognized immediately under paragraph (d), (f), or (g)(2)" of Temporary Treasury Regulation § 1.367(d)-1T.[36] In an arm's-length transaction, an unrelated purchaser of intangible property would consider the entire period during which the property would have value in determining the price it would pay for the property. The terms of [pg. 31] paragraph (g)(5), which specifically and expressly govern the determination of the fair market value of intangible property for the purpose of determining gain that must be recognized under an immediate gain recognition rule must take precedence over possible implications of a more general provision regarding the property's useful life. As petitioner recognizes, "[s]pecific regulations govern over general regulations."

Petitioner admits that $1,029,200,000 is not "the full fair market value" of the trademarks it constructively transferred to TBL GmbH. Petitioner acknowledges that the values it reported on its Form 926, including the $1,274,100,000 value assigned to the trademarks, were "the fair market

values of the Timberland Intangible Assets...without the application of the regulations' useful life limitation." Petitioner reported those amounts, it explained, because "Form 926 states that the full fair market value be stated on the form."

By contrast, petitioner offers us no explanation for why the drafters of Temporary Treasury Regulation § 1.367(d)-1T might have intended that the amount of gain a U.S. transferor is required to recognize upon a direct or indirect disposition of transferred intangible property should be computed on the basis of a value that is less than the property's "full fair market value." The useful life limitation provided in Temporary Treasury Regulation § 1.367(d)-1T(c)(3), when applicable, allowed a U.S. transferor to recognize less than the full amount of gain in intangible property transferred to a foreign corporation. As applied to the requirement to report deemed annual payments, the useful life limitation could have been understood as a rule of administrative convenience. And it follows that a U.S. transferor should not be required to recognize gain upon a direct or indirect disposition of the intangible property that occurs after all required annual deemed payments have been taken into account. Applying the 20-year useful life limitation to limit the amount of gain recognized upon a disposition before all deemed annual payments have been reported, however, cannot be understood as a rule of convenience. Allowing the U.S. transferor, in that circumstance, to avoid recognizing the full amount of gain in the transferred intangible property would have no apparent justification. If the drafters of Temporary Treasury Regulation § 1.367(d)-1T had intended that result, we would have expected them to have been more explicit.

Therefore, we decline to apply Temporary Treasury Regulation § 1.367(d)-1T(c)(3) beyond the purposes for which it was expressly relevant (that is, for purposes of applying other provisions of the regulations that explicitly refer to the intangible property's "useful life"). By reason of Temporary Treasury Regulation § 1.367(d)-1T(g)(5), the gain that a U.S. transferor must recognize under paragraph (d)(1) upon disposing of the stock of the transferee foreign corporation to an unrelated person should take into account the actual fair market value of the transferred intangible property on the date of the disposition. That fair market value should reflect the amount that an unrelated purchaser would pay for the property in an arm's-length transaction, taking into account the entire period during which the property may be expected to have value.

Because we do not "agree[] to reduce the adjustment to income for the trademarks based on a 20-year useful life limitation, pursuant to Temp. Treas. Reg. § 1.367(d)-1T," we determine, in accordance with the parties' stipulation, that "[p]etitioner's increase in income for the transfer of the trademarks is $1,274,100,000." Adding that figure to the agreed value of the foreign workforce and customer relationships that petitioner transferred to TBL GmbH and reducing the sum by the agreed trademark basis, we conclude that petitioner's income for the taxable year in issue should be increased by $1,452,561,000 ($1,274,100,000 + $23,400,000 + $174,400,000-$19,339,000), as determined in the notice of deficiency. Because petitioner did not assign error to the other two adjustments reflected in the notice of deficiency, it follows that respondent is entitled to judgment

as a matter of law. Accordingly, we will grant respon[pg. 32] dent's motion for summary judgment and deny petitioner's corresponding motion. We will also deny as moot respondent's motion in limine and motion to strike.

An appropriate order will be issued, and decision will be entered for respondent.

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code (Code), Title 26 U.S.C., in effect for the year in issue, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect for the year in issue, and all Rule references are to the **Tax Court** Rules of Practice and Procedure.

[2] The record provides no indication that TBL GmbH owned any material assets before it acquired the sole member interest in International Properties. The parties stipulated that VF Enterprises capitalized TBL GmbH with cash equal to "the minimum capital amount for a GmbH under Swiss law."

[3] For example, respondent acknowledges that the income reported by Lee Bell is "attributable to the IP." And petitioner states that Lee Bell included deemed annual payments in income "[a]s a result of the Outbound F Reorganization" by which TBL GmbH acquired petitioner.

[4] The parties apparently disagree as to how the Timberland acquisition was financed. In the memorandum it submitted in support of its motion for summary judgment, petitioner proposed a finding of fact that VF Enterprises "funded the acquisition of Timberland from existing sources of cash, collecting receivables, and through related party borrowings." Respondent objects to petitioner's proposed finding. Respondent alleges that VF was the ultimate source of the funds VF Enterprises used to acquire Timberland. And the materials petitioner cites in support of its proposed finding are among those covered by respondent's motion in limine and motion to strike. Respondent's principal policy objection to the transaction in issue, however, seems to be that, in his view, the transaction involved the use of "untaxed foreign earnings and profits to acquire an unrelated domestic target." We see no respect in which the application of section 367(d) to the transaction should turn on whether it occurred as part of a larger transaction that may have involved a tax-free repatriation of foreign earnings. In any event, if VF was the ultimate source of the funds used to acquire Timberland, as respondent alleges, we do not see how the transaction could be viewed as having effected a repatriation of earnings of VF Enterprises that had not previously been subject to U.S. tax. More generally, each party's motion for summary judgment necessarily rests on the premise that the case presents "no genuine dispute as to any material fact." Rule 121(b). Therefore, each party has implicitly represented that any factual dispute concerning the source of the funds VF Enterprises used to acquire Timberland is not material to the legal issue before us. And we, as

well, see no respect in which the financing of the acquisition would affect the question of how section 367(d) applies to the transaction in issue.

[5] The regulations use the term "eligible entity" to refer to a "business entity" other than a state law corporation or other entity that is required to be classified as a corporation for Federal tax purposes. Treas. Reg. § 301.7701-3(a). An entity is a business entity if it is recognized for Federal tax purposes and not classified as a trust "or otherwise subject to special treatment under the Internal Revenue Code." Treas. Reg. § 301.7701-2(a). Thus, limited liability companies like International Properties are generally eligible entities.

[6] Section 361(a) provides: "No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization." Under section 361(c), a corporation that is a party to a reorganization does not recognize gain or loss on a distribution of "qualified property" in pursuance of the plan of reorganization. For purposes of section 361(c), the term "qualified property" includes "any stock in (or right to acquire stock in) another corporation which is a party to the reorganization...if such stock (or right)...is received by the distributing corporation in the exchange." § 361(c)(2)(B)(ii).

[7] Section 354(a) provides: "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities...in another corporation a party to the reorganization."

[8] An argument that an outbound F reorganization involves no actual or constructive exchanges or distributions would have been difficult to sustain in any event in the face of United States v. Phellis, 257 U.S. 156 [3 AFTR 3123] (1921), and Marr v. United States, 268 U.S. 536 [5 AFTR 5393] (1925). In those cases, the Supreme Court concluded that participating shareholders recognized income or gain from transactions in which New Jersey corporations reincorporated in Delaware. As Justice Brandeis observed in Marr, 268 U.S. at 541: "[T]he new corporation is essentially different from the old. A corporation organized under the laws of Delaware does not have the same rights and powers as one organized under the laws of New Jersey." If a New Jersey corporation is "essentially different" from a Delaware corporation, so that a reincorporation from one state to the other would be a taxable transaction in the absence of an applicable nonrecognition rule, then, a fortiori, a Swiss corporation cannot be viewed as the same entity as a Delaware corporation (much less a Delaware limited liability company that has elected, for Federal tax purposes, to be treated as a corporation). A year after the issuance of the 1990 proposed and temporary regulations, the Court relied on Phellis and Marr to hold that "an exchange of property gives rise to a realization event so long as the exchanged properties are `materially different'—that is, so

long as they embody legally distinct entitlements." Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554, 566 [67 AFTR 2d 91-808] (1991).

9 Petitioner's submissions display a marked penchant for defined terms, demonstrated by the four-page glossary included with its motion for summary judgment. Petitioner's glossary defines "§ 367(d) Regulations" as "Temp. Treas. Reg. § 1.367(d)-1T that was in effect throughout the calendar year 2011." Respondent purports to "object[]" to petitioner's use of its own defined terms "on the ground that tat they are not neutral terms with neutral definitions to assist the reader, but rather carry embedded interpretations or connotations which skew their meaning." To the extent that our quotations of petitioner's arguments include petitioner's own defined terms, we intend those quotations only to indicate what petitioner argues. We recognize that the definitions petitioner offers of the terms of its own creation, like the arguments of parties generally, may not be "neutral."

10 Petitioner has no cause for complaint about the retroactive effect of Treasury Regulation § 1.367(a)-1(f). Until a 1996 amendment of section 7805(b), regulations generally applied retroactively unless the Secretary of the Treasury exercised his discretion to apply them prospectively. As amended in 1996, section 7805(b) limits the extent to which regulations can apply retroactively. The amendment, however, applies only to regulations that relate to statutory provisions enacted on or after July 30, 1996. Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 1101(b), 110 Stat. 1452, 1469. While Congress has amended section 367(d) several times since July 30, 1996, those amendments have no apparent bearing on the issue before us. Therefore, it is not clear whether the 1996 amendment of section 7805(b) limits the extent to which Treasury Regulation § 1.367(a)-1(f) can be applied retroactively. Moreover, respondent's application of Treasury Regulation § 1.367(a)-1(f) to the transaction in issue would not violate section 7805(b) even if that provision, in its current form, were applicable. The statute allows regulations to apply retroactively back to "the date on which any proposed or temporary regulation to which such final regulation relates was filed with the Federal Register." § 7805(b)(1)(B).

11 Respondent accepts the framing of the issue presented in the text, but petitioner does not. Respondent describes the parties' dispute as being "over which rule of section 367(d)(2)(A)(ii) applies." That is how we see the dispute as well. Petitioner, however, contends that respondent's "statement of the issue...is an apparent attempt to dodge...specific provisions" in the applicable regulations. Petitioner suggests that the analysis should "start[] with" the regulations, rather than the statute that those regulations serve to interpret. Petitioner's reframing of the issue, however, would have no apparent consequence. Even if we were to start our analysis with the regulations, that analysis would be incomplete without considering the statute as well.

[12] Petitioner accuses respondent of "conflat[ing] a deemed distribution with an actual distribution." "If a deemed event is created," petitioner reasons, "there is nothing illogical or improper about providing for simultaneity." We question the appropriateness of deeming circumstances whose actual occurrence would be impossible. Moreover, petitioner's reasoning would draw an unjustifiable distinction among F reorganizations depending on the manner in which they were implemented.

[13] We therefore view it as being of no moment that, as petitioner observes, "Treas. Reg. § 1.367(a)-1(f)...does not contain a timing sequence for when the distribution is deemed to occur." The relative timing of the three steps in the construct adopted in the regulation to explain an outbound F reorganization was apparently unimportant to the drafters of the regulation. Therefore, the regulation states only that the three components are "considered to exist." Id. But we need not rely on the specific terms of the regulation for the proposition that the U.S. transferor's distribution of stock of the transferee foreign corporation necessarily follows its receipt of that stock in exchange for the transferred intangible property.

[14] Clark raised no issue of temporal sequence: It involved a single exchange of Basin stock for NL stock and cash.

[15] In regard to the term "Outbound F Reorganization," petitioner's glossary states: "TBL (Petitioner) was reorganized into TBL GmbH, a Swiss controlled foreign corporation within the VF Controlled Group, in an outbound § 368(a)(1)(F) reorganization transaction." Regarding "VF Controlled Group," the glossary states: "VF is the ultimate U.S. parent company, and the direct or indirect owner, of an affiliated group of global corporations."

[16] A similar two-step construct applies when an entity classified as a corporation elects to change its classification to partnership. *See* Treas. Reg. § 301.7701-3(g)(1)(ii).

[17] Petitioner's glossary defines "Timberland Intangible Assets" as "[t]he Timberland and SmartWool intangible assets, consisting of trademarks, customer relationships, and foreign workforce, subject to the license of the domestic rights in the intangible assets to Vans, Inc., a member of the VF Consolidated Group." In regard to "VF Consolidated Group," petitioner's glossary states: "VF is the parent of an affiliated group of domestic corporations on behalf of which it files consolidated U.S. federal income tax returns."

[18] Foreign corporations are generally subject to U.S. tax at the regular graduated rates on income effectively connected with a U.S. trade or business. *See* § 882(a)(1). The so-called subpart F provisions require significant U.S. shareholders of "controlled foreign corporations" (CFCs) to pay current U.S. tax on investment income and other types of mostly "portable" income earned through the foreign corporations.

19 As discussed in more detail infra part V, the apparent intent of Temporary Treasury Regulation § 1.367(d)-1T(c)(3) was to limit the period during which a U.S. transferor was required to take deemed annual payments into account under section 367(d)(2)(A)(ii)(I). Temporary Treasury Regulation § 1.367(d)-1T(c)(3) was removed and reserved by T.D. 9803, 2017-3 I.R.B. 384.

20 Petitioner's argument, if accepted, would mean that a U.S. transferor with the foresight to transfer intangible property late in the day on a Friday would have until the following Monday to dispose of the stock of the transferee foreign corporation without triggering gain recognition under section 367(d)(2)(A)(ii)(II). Petitioner makes no effort to explain how that prospect makes any sense.

Therefore, we would be loath to accept the argument even without regard to its several technical problems.

21 In regard to the term "Annual § 367(d) Payments," petitioner's glossary states:

> Section 367(d) and Temp. Treas. Reg. § 1.367(d)-1T provide that in an exchange described in §§ 351 or 361 in which a United States person (U.S. transferor) transfers IP to a foreign corporation (transferee foreign corporation) the United States person transferring the IP (the U.S. transferor) will be treated as having sold the IP in exchange for payments that are contingent on the productivity, use, or disposition of the IP. The U.S. person is treated as receiving or having received these amounts (I) annually over the useful life of the property ***("Annual § 367(d) Payments")*** , or (II) in the case of a A disposition following such transfer [the temporary regulations define this as "a subsequent transfer during the transferred IP's useful life" to an unrelated person], at the ***("Lump-Sum Exception")***.

22 If petitioner's shareholder had been a U.S. person, Temporary Treasury Regulation § 1.367(d)-1T(e)(1) would have allowed petitioner to avoid immediate gain recognition under section 367(d)(2)(A)(ii)(II). Therefore, contrary to petitioner's claim, respondent's position that the section 361(c) distribution that necessarily occurs in an outbound reorganization is a "disposition" within the meaning of section 367(d)(2)(A)(ii)(II) does not mean that immediate gain recognition is required "in every outbound § 361 reorganization."

23 While Temporary Treasury Regulation § 1.367(d)-1T(e)(3) does not 23 include the limiting language petitioner imagines, it also does not provide that the deemed annual payments must continue to be reported by (1) the U.S. transferor or (2) in the event that the U.S. transferor is no longer recognized as a separate entity for Federal tax purposes following its disposition of the stock of the transferee foreign corporation, then by any other U.S. taxpayer of the U.S. transferor's choosing that is sufficiently related to the U.S. transferor.

24 A parent corporation and its subsidiary are related, within the meaning of Temporary Treasury Regulation § 1.367(d)-1T(h), if the parent owns at least 10% of the subsidiary's stock. Temporary Treasury Regulation § 1.367(d)-1T(h) cross-references section 267(b), (c), and (f) in defining related persons. Section 267(f), in turn, cross-references the "controlled group" rules of section 1563(a). Under the controlled group rules, a parent and its subsidiary are members of the same group if the parent owns at least 80% of the subsidiary's stock. For purposes of section 267(b)(3) and (f), however, the ownership threshold is reduced to 50%. And for purposes of Temporary Treasury Regulation § 1.367(d)-1T(h) the threshold is further reduced, to 10%. Temp. Treas. Reg. § 1.367(d)-1T(h)(2)(i). Because VF Enterprises was treated as having owned all of petitioner's stock before petitioner's distribution of TBL GmbH stock, VF Enterprises was related to petitioner before the distribution. The parties apparently agree that, at least in the circumstances of the present case, "relatedness," for purposes of Temporary Treasury Regulation § 1.367(d)-1T(h), is determined before the completion of the disposition in question. In other circumstances, however, that approach could lead to arguably inappropriate results. For example, a disposition of stock of the transferee foreign corporation in the form of a U.S. transferor's nonliquidating distribution of that stock to a distributee shareholder would sever the parties' relationship if the distribution were made in redemption of all of the stock in the U.S. transferor held by the distributee shareholder. Thereafter, both the U.S. transferor and the distributee shareholder would remain in existence but would have no ongoing relationship. In such a case, it might be inappropriate to allow continued reporting of deemed annual payments by either the U.S. transferor or distributee shareholder in lieu of immediate gain recognition.

25 Petitioner argues that "[t]he U.S. transferor's continuing to include the Annual § 367(d) Payments is a result [of the application of Temporary Treasury Regulation § 1.367(d)-1T(e)(3)], not a condition." Whatever label one applies, it remains the case that petitioner is unable to comply with the regulation.

26 Petitioner cites no authority for the proposition that the deemed annual payments described in section 367(d)(2)(A)(ii)(I) would, if treated as received by a CFC, be included in the CFC's subpart F income. Section 954(c)(1)(A) includes "royalties" in foreign personal holding company income, which is an element of subpart F income. *See* § 952(a)(2) (providing that subpart F income includes "foreign base company income"), § 954(a)(1) (defining "foreign base company income" to include foreign personal holding company income). While amounts described in section 367(d)(2)(A)(ii)(I) may be akin to royalties, they are expressly treated as such only "[f]or purposes of applying section 904(d)" (dealing with the foreign tax credit). § 367(d)(2)(C). Moreover, the subpart F income of a CFC for a taxable year is limited to the corporation's earnings and profits. § 952(c)(1)(A). Therefore, if a CFC were treated as having received the payments described in section 367(d)(2)(A)(ii)(I), those amounts, even if included within the definition of foreign personal holding company

income, would not be subpart F income for any year for which the CFC had sufficient expenses to offset them.

[27] Petitioner's "same entity" argument may rest on section 368(a)(1)(F)'s reference to "one corporation." Congress added the phrase "of one corporation" to that section to deny F reorganization treatment to fusions of two commonly owned operating corporations. The amendment was part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, § 225(a), 96 Stat. 324, 490. The TEFRA conference report describes the amendment as "limit[ing] the F reorganization definition to a change in identity, form, or place of organization of a single operating corporation." H.R. Rep. No. 97-760, at 541 (1982) (Conf. Rep.). The conferees explained: "This limitation does not preclude the use of more than one entity to consummate the transaction provided only one operating company is involved. The reincorporation of an operating company in a different State, for example, is an F reorganization that requires that more than one corporation be involved." Id. Therefore, Congress' addition of the phrase "of one corporation" to section 368(a)(1)(F) should not be understood to mean that, when an F reorganization involves two corporate entities, the successor must be treated for all purposes as one and the same as its predecessor.

[28] A copy of Notice 2012-39 that petitioner sought to include with the parties' first stipulation of facts is also covered by respondent's motion in limine and motion to strike.

[29] Under section 956, investments in U.S. property by CFCs generally result in deemed repatriation of the CFC's earnings.

[30] In effect, petitioner asks us to draw inferences about the state of the law before the IRS' issuance of Notice 2012-39, supra, notwithstanding the customary "no inference" disclaimer included in the notice.

[31] For similar reasons, we decline to draw the inferences petitioner would have us draw from the Office of Tax Policy/IRS business plans that are among the documents covered by respondent's motion in limine and motion to strike. As explained supra part II.C, petitioner views those documents as relevant primarily to support an inference regarding the purposes behind the timing of the adoption of Treasury Regulation § 1.367(a)-1(f) in final form. In its opposition to respondent's motion in limine, however, petitioner suggests that the proffered business plans are also relevant because they include regulations under section 367(d) among the priority guidance projects. Petitioner presumes that "Regulations under consideration...would include regulations identified as necessary by Notice 2012-39." The announced plans for future guidance, petitioner reasons, "also support[] that § 367(d) Regulations are needed to achieve Respondent's litigating position in this case, and that Treas. Reg. § 1.367(a)-1(f) is insufficient to reach the result Respondent seeks." To the extent that the intended regulations would address petitioner's transaction and, in particular, would

require the recognition of immediate gain upon the U.S. transferor's distribution of the stock of the transferee foreign corporation, those regulations could be understood as simply confirming —or at least resolving uncertainty in—current law.

32 Section 367(a)(2) provides generally that the gain recognition rule of 32 section 367(a)(1) "shall not apply to the transfer of stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization."

33 Sec. 381(a). General rule.—In the case of the acquisition of assets of a corporation by another corporation—

....

> (2) in a transfer to which section 361...applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D), (F), or (G) of section 368(a)(1),

> the acquiring corporation shall succeed to and take into account...the items described in subsection (c) of the...transferor corporation

....

34 Petitioner repeatedly invokes our observation in Xilinx Inc. & Consol. Subs. v. Commissioner, 125 T.C. 37, 62 (2005), aff'd, 598 F.3d 1191 [105 AFTR 2d 2010-1490] (9th Cir. 2010), that taxpayers "are merely required to be compliant, not prescient." We made that observation, however, in regard to a position advanced by the Commissioner that was contrary to governing regulations.

35 Temporary Treasury Regulation § 1.367(d)-1T(a), captioned "Purpose and scope," states the general rule that, as a result of a transfer of intangible property to which section 367(d) applies, "the U.S. transferor will be treated as receiving annual payments contingent on productivity or use of the transferred property, over the useful life of the property (regardless of whether such payments are in fact made by the transferee)." Temporary Treasury Regulation § 1.367(d)-1T(c)(1) in restating that general rule, again refers to the property's useful life. Temporary Treasury Regulation § 1.367(d)-1T(d)(1) requires the U.S. transferor to recognize gain upon disposing of the stock of the transferee foreign corporation to an unrelated person if the disposition occurs "within the useful life of the intangible property." Temporary Treasury Regulation § 1.367(d)-1T(e)(1) applies if the disposition of the stock of the foreign transferee corporation "within the useful life of the transferred intangible property" is to a related U.S. person. In that event, the related U.S. person must include deemed annual payments in income "over the useful life of the property." Temp. Treas. Reg. § 1.367(d)-1T(e)(1)(ii). Temporary Treasury Regulation § 1.367(d)-1T(e)(3) applies when the

disposition of transferee foreign corporation stock, "within the useful life of the transferred intangible property," is to a related foreign person. And Temporary Treasury Regulation § 1.367(d)-1T(f)(1) requires the recognition of gain if the transferee foreign corporation, "within the useful life of the intangible property," transfers that property to an unrelated person.

[36] Temporary Treasury Regulation § 1.367(d)-1T(g)(2) allows a U.S. transferor of intangible property to a foreign corporation, under specified circumstances, to elect immediate gain recognition.

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Tax Court & Board of Tax Appeals Memorandum Decisions

Gregg M. Kellett v. Commissioner, T.C. Memo. 2022 -62 , Code Sec(s) 41; 162; 174; 195; 263; 7491.

GREGG MICHAEL KELLETT, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

Code Sec(s):	41; 162; 174; 195; 263; 7491
Docket:	Docket No. 21518-18.
Date Issued:	06/13/**2022**

HEADNOTE

XX.

Reference(s): Code Sec. 41; Code Sec. 162; Code Sec. 174; Code Sec. 195; Code Sec. 263; Code Sec. 7491

Syllabus

Counsel

Lawrence A. Sannicandro, for petitioner.

Ka Tam and Bartholomew Cirenza, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GREAVES, *Judge*: Respondent disallowed a $25,922 business expense deduction and determined a corresponding $6,475 deficiency for petitioner's 2015 tax year. We must decide what portion of these expenditures petitioner may deduct on his 2015 federal income tax return as costs of developing a business information website. Petitioner's active trade or business began when he opened his website to the public in September 2015. Section 162(a) allows him to deduct the $8,087 of business-related expenditures he paid thereafter as trade or business expenses, and section 195(b)(1)(B) allows him to ratably deduct the remaining $16,553 of business-related expenditures as start-up expenditures over the 180-month period beginning with September 2015. [1] [1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code (Code), Title 26 U.S.C., in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all **Served 06/14/22**[2]

FINDINGS OF FACT[*2]

The parties filed a Stipulation of Facts and a Supplemental Stipulation of Facts, both with accompanying exhibits, that are incorporated by this reference. Petitioner resided in Virginia when he petitioned this Court.

Petitioner is an entrepreneur with experience in information technology. After graduating from Marshall University in 2002 with a bachelor's degree in business management, petitioner launched a retail website, which he operated until 2007. He later joined the online marketing division of MarketResearch.com, a company that sells online reports and industry studies from more than 350 publishers. In 2011 he moved to Bloomberg Industry Group, a major publisher of legal and business information, where he managed paid advertising, web analytics and reporting, and search engine optimization for various Bloomberg brands.

While working approximately 40 hours per week at Bloomberg, petitioner began to work part time from home on his next venture: building an online repository of demographic, social, and economic data. He settled on the project after studying existing websites that aggregate this kind of information, which he found less user-friendly than investment information platforms like Google Finance and Yahoo Finance. He also discovered that he could download the data from free public domain sources like the International Monetary Fund, the World Bank, the United Nations Statistics Division, the World Health Organization, and the U.S. Department of Labor.

Petitioner set out to create a single user-friendly interface that would provide data from these dispersed sources to investment bankers, economists, journalists, investment management firms, and market research firms. In 2013 he purchased the vizala.com domain name and formed Vizala, LLC (Vizala or business), of which he was the sole member. Petitioner himself created the simple webpages such as the "About Us" page and instructions on how to use the website. He hired remote computer engineers to develop Vizala's interactive features that allowed users, for example, to create charts comparing countries' health expenditures per capita. Users could save their charts, export them to Microsoft Excel, and upload them to social media and their own relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Procedure. This opinion rounds monetary amounts to the nearest dollar other than in the Appendixes. [3] **[*3]** websites. Petitioner described to the engineers how he wanted these features to work, and the engineers developed them using open-source software--free downloadable generic code for databases and advanced websites. Petitioner and the engineers completed Vizala's core functionality in March 2015, and worked to resolve software "bugs" before opening both the desktop and mobile versions of Vizala to the public in or around September 2015. In an example of a bug discussed at trial, petitioner asked an engineer to fix an interactive table that displayed incorrectly in the Firefox web browser.

Petitioner envisioned at least four ways to make money from Vizala: (1) selling advertising space to third parties, (2) implementing a "paywall" and charging a monthly fee for access to certain features of the website, (3) selling personalized charts and reports of information from the website, and (4) licensing data from the website to other companies. He did not pursue any of these strategies in 2015, and Vizala did not begin to earn revenue until 2019. Petitioner spent 2015 perfecting and promoting Vizala, convinced he could maximize long-term profit by cultivating confidence and dependence among users and advertisers before monetizing the business. After the website opened, petitioner and a marketing professional promoted the website to over a hundred universities and professional organizations, and about half these institutions added Vizala to their lists of research databases.

Petitioner timely filed Form 1040, U.S. Individual Income Tax Return, for his 2015 tax year, wherein he deducted $25,922 of "Other Expenses" on Schedule C, Profit or Loss From Business, 2 using cash method accounting. 3 These expenses consisted of $20,509 of payments to the engineers (engineer expenses), $2,410 paid to marketing professional Stacey Weliver (marketing expenses), $1,856 of payments to Verizon for cell phone service and internet service at petitioner's home [2] Subject to exceptions not applicable here, a business entity that has a single owner and is not a corporation is disregarded as an entity separate from its owner for federal income tax purposes. *See* Treas. Reg. § 301.7701-2(c)(2)(i). An individual who owns a disregarded entity reports the entity's tax items on Schedule C. *See* 2015 Instructions for Schedule C , at C-1. [3] The cash receipts and disbursements method generally requires that expenditures be deducted for the taxable year in which actually made. Treas. Reg. §§ 1.446-1(c)(1)(i), 1.461-1(a)(1); *see also*

Saviano v. Commissioner , 80 T.C. 955, 964 (1983) ("[U]ntil a cash basis taxpayer suffers an economic detriment, i.e., an a ctual depletion of his property, he has not made a payment which will give rise to an expense deduction." (quoting *Rife v. Commissioner* , 356 F.2d 883, 889 [17 AFTR 2d 367] (5th Cir. 1966), *rev'g and remanding* 41 T.C. 732 (1964))), *aff'd* , 765 F.2d 643 [56 AFTR 2d 85-5337] (7th Cir. 1985). [4] **[*4]** (Verizon expenses), and $1,148 for miscellaneous items related to Vizala (miscellaneous expenses). *See infra* Appendixes (listing the date and amount of each payment in the foregoing four categories). Respondent disallowed the entire deduction in a notice of deficiency mailed to petitioner on July 31, 2018, and petitioner sought redetermination of the deficiency in this Court. 4

OPINION

I. Burden of Proof

The Commissioner's determinations set forth in a notice of deficiency are generally presumed correct, and the taxpayer bears the burden of proving the determinations are in error. Rule 142(a)(1); *Welch v. Helvering* , 290 U.S. 111, 115 [12 AFTR 1456] (1933). Moreover, d eductions are a matter of legislative grace, and the taxpayer bears the burden of proving his entitlement to any deduction claimed. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 [69 AFTR 2d 92-694] (1992). We denied by Order issued on February 4, 2021, petitioner's Motion of January 21, 2021, to shift the burden of proof to respondent under Rule 142(a)(1).

Petitioner made an oral motion at trial to shift the burden of proof to respondent under section 7491(a), paragraph (1) of which providesin pertinent part that if "a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for [the federal income tax], the Secretary shall have the burden of proof with respect to such issue." 5 Paragraph (2)(B) further provides that the paragraph (1) burden shift applies with respect to an issue only if the taxpayer has maintained all records required by the Code.

As explained *infra* Part II, the burden of proof does not shift to respondent as to the date petitioner opened his website, the business purpose of the Verizon expenses, or the total amount of start-up expenditures. We otherwise decide the factual issues in this case on the preponderance of the evidence, and we need not decide which party has 4The notice of deficiency imposed a section 6662(a) accuracy-related penalty of $1,295, which respondent conceded before trial. [5] Section 7701(a)(11)(B) defines the "Secretary" as the Secretary of the Treasury or his delegate. The Secretary of the Treasury has delegated to the Commissioner the authority to litigate cases on behalf of the United States in the **Tax Court**. *See, e.g.* , Treas. Reg. § 601.509. [5] **[*5]** the burden of proof. *See Knudsen v. Commissioner*, 131 T.C. 185, 189 (2008), *supplementing* T.C. Memo. 2007-340 [2007 RIA TC Memo ¶2007-340].

II. Trade or Business Expenses and Start-Up Expenditures

Petitioner argues that he can deduct all $25,922 reported on Schedule C as section 162 trade or business expenses. Respondent would deny the full amount as section 195 start-up expenditures that petitioner cannot deduct for 2015 because his active trade or business had not begun by the end of the year. We conclude in this Part II that section 162 permits petitioner to deduct the $8,087 of engineer expenses, marketing expenses, business-related Verizon expenses, and miscellaneous expenses paid after September 30, 2015, when his active trade or business began. He may deduct the remaining $16,553 of business-related expenditures, which are section 195 start-up expenditures, ratably over the 180-month period beginning with September 2015.

A. When Petitioner's Active Trade or Business Began

Section 162(a) permits a deduction for ordinary and necessary expenses paid or incurred during the taxable year "in carrying on any trade or business." Section 195(a), on the other hand, generally denies a deduction for start-up expenditures, which section 195(c)(1)(A)(iii) defines in pertinent part to include any amount paid or incurred in connection with "any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business." *See Hardy v. Commissioner*, 93 T.C. 684, 687 (1989) ("Start-up or pre-opening expenses are not currently deductible under section 162."). Without any regulations to tell us when an active trade or business begins, 6 we rely on a test developed by the U.S. Court of Appeals for the Fourth Circuit, the appellate venue for this case absent a stipulation by the parties. *See* § 7482(b); 28 U.S.C. § 41 (2018). [7] In the Fourth Circuit, a taxpayer does not begin carrying on a trade or business "until such time as the business has begun to function as a going concern and [6] Sections 195(c)(2)(A) and 7701(a)(11)(B) direct us to determine when an active trade or business begins on the basis of regulations prescribed by the Secretary of the Treasury or his delegate, although no regulations have been promulgated . [7] The **Tax Court** will follow a Court of Appeals decision which is squarely on point where appeal from our decision lies to that Court of Appeals alone. *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 [27 AFTR 2d 71-1583] (10th Cir. 1971). [6] **[*6]** performed those activities for which it was organized." *Richmond Television Corp. v. United States*, 345 F.2d 901, 907 [15 AFTR 2d 880] (4th Cir. 1965), [8] *vacated and remanded per curiam on other grounds*, 382 U.S. 68 [16 AFTR 2d 5858] (1965). The **Tax Court** determines when this happens on the basis of the facts and circumstances of a given case. *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521, 566 (1979), *aff'd*, 633 F.2d 512 [46 AFTR 2d 80-5955] (7th Cir. 1980).

The Fourth Circuit did not allow Richmond Television Corp. to deduct staff training costs incurred in 1953-55 for its new television station because the business did not begin until the station went on the air in 1956. *Richmond Television*, 345 F.2d at 903-07. A television station, like a business information website, exists to communicate information to the public, via television programming in the form er case and data aggregation and analysis software in the latter. Just as a television station can have no viewers until it begins broadcasting, Vizala could have no users before the website opened. Petitioner's active trade or business could not begin until that happened.

Unlike the television station in *Richmond Television* , however, Vizala had no revenue until well after going live. *See id.* at 903-04, 909 (explaining that the station launched in 1956 and sought to carry forward its business expense deductions as net operating losses to 1956 and 1957, which indicates it had income in those years). Respondent argues that none of the expenditures petitioner reported on Schedule C, even amounts paid after the website opened, is a section 162 expense because Vizala had no revenue and no means of generating revenue in 2015. A taxpayer's effort to sell goods or services may qualify as an active trade or business even if the taxpayer makes no sales and therefore has zero gross receipts. *See Cabintaxi Corp. v. Commissioner*, 63 F.3d 614, 620 [76 AFTR 2d 95-5960] (7th Cir. 1995), *aff'g in part, rev'g in part* T.C. Memo. 1994-316 [1994 RIA TC Memo ¶94,316]. Vizala, on the other hand, made no attempt to sell anything--[8] The same case points out that the Code prohibits a business expense deduction for capital expenditures. *Richmond Television* , 345 F.2d at 907-08; *see also* § 263 (denying a deduction for capital expenditures) . Respondent does not argue that any portion of the claimed deduction is a section 263 capital expenditure and concedes that only section 195 is at issue as to the business-related expenditures petitioner reported on Schedule C.[7] **[*7]** advertisements, access to website features, customized reports, or licensed data--until after 2015.[9]

The typical case determining when an active trade or business begins contemplates a traditional business archetype: If initial operations succeed, the company should start earning revenue as soon as the active trade or business begins. For example, a grocery store will earn revenue by selling groceries as soon as it draws customers. *See Piggly Wiggly S., Inc. v. Commissioner*, 84 T.C. 739, 745-48 (1985) (allowing a store operator to deduct the cost of equipment placed in open stores, but denying the same deduction for stores not yet open), *aff'd* , 803 F.2d 1572 [59 AFTR 2d 87-304] (11th Cir. 1986). By the same token, a company operating an apartment or office building should receive rent payments as soon as it admits tenants. *See Johnsen v. Commissioner*, 83 T.C. 103, 114-18 (1984) (denying deductions for pre-opening costs of rental property and discussing other cases reaching the same result), *rev'd on other grounds* , 794 F.2d 1157 [58 AFTR 2d 86-5396] (6th Cir. 1986).

Vizala does not fit this traditional archet ype. Petitioner doubted that any of his revenue strategies could succeed until Vizala built rapport with users and advertisers. He therefore prioritized web

traffic over revenue by charging no user fees and marketing the site to institutional customers. Even though petitioner made no attempt to earn revenue in 2015, his business began providing the services "for which it was organized," with an eye to long-term profit, once he opened the website. *See Richmond Television*, 345 F.2d at 907. Such activity, at least under these circumstances, constitutes an active trade or business.

The parties agree that Vizala opened to the public in or around September 2015. The burden of establishing the opening date does not shift to respondent under section 7491(a), *see supra* Part I, because petitioner has not proposed, let alone introduced credible evidence of, an opening date. We therefore err on the side of respondent by postulating [9] In announcing its going-concern test, the Fourth Circuit cites Justice Frankfurter's concurring opinion in *Deputy v. du Pont* , 308 U.S. 488, 499 [23 AFTR 808] (1940), which asserts that carrying on a trade or business "involves holding one's self out to others as engaged in the *selling* of goods or services ." *Richmond Television* , 345 F.2d at 907 n.7 (emphasis added). The Supreme Court later formally rejected Justice Frankfurter's gloss on the trade or business inquiry. *Commissioner v. Groetzinger* , 480 U.S. 23, 34 [59 AFTR 2d 87-532] (1987). [8] **[*8]** that petitioner opened the website at the end of the day on September 30, 2015.

B. Trade or Business Expenses Deductible for 2015

Respondent concedes the business purpose of the engineer expenses, marketing expenses, and miscellaneous expenses. We therefore conclude that petitioner may deduct the $7,928 of such expenses paid after September 30 as section 162 trade or business expenses. However, respondent argues that petitioner has not demonstrated the business purpose of the Verizon expenses. The Court should treat petitioner's payments for cell phone and internet services as nondeductible section 262(a) personal expenses, respondent contends, including amounts paid after petitioner's active trade or business began. A taxpayer generally bears the burden of distinguishing the portion of an expense paid or incurred in carrying on a trade or business, which he may deduct under section 162(a), from any portion that is nondeductible as a section 262(a) personal expense. *See Commissioner v. Doak* , 234 F.2d 704, 708 [49 AFTR 1491] (4th Cir. 1956) (citing *Sutter v. Commissioner*, 21 T.C. 170 (1953)), *rev'g* 24 T.C. 569 (1955). Petitioner's burden of proof with respect to the business purpose of the Verizon expenses does not shift to respondent under section 7491(a), *see supra* Part I, because petitioner failed to maintain documentation that differentiates his personal and business use of the Verizon services, *see* § 6001; Treas. Reg. § 1.6001-1(a), (e).

In certain circumstances, however, the Court may approximate a business expense if the taxpayer cannot substantiate its exact amount. *Cohan v. Commissioner* , 39 F.2d 540, 543-44 [8 AFTR 10552] (2d Cir. 1930). [10] The Court must have some basis on which to make an estimate, *Vanicek v. Commissioner*, 85 T.C. 731, 743 (1985), and "bear[s] heavily . . . upon the [10]

Although the Court may not approximate business expenses that are subject to the strict substantiation requirements of section 274(d), *Boyd v. Commissioner*, 122 T.C. 305, 320 (2004), section 274(d) does not apply to cell phone or internet expenses, *see* Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2043(a), 124 Stat. 2504, 2560 (removing cell phones from the defini tion of section 280F(d)(4) listed property, and thus from the scope of sec tion 274(d), for tax years beginning after December 31, 2009); *Farran v. Commissioner*, T.C. Memo. 2007-151 [2007 RIA TC Memo ¶2007-151], slip op. at 14-15 (characterizing internet expenses as utility expenses an d therefore not subject to strict substantiation). [9] **[*9]** taxpayer whose inexactitude is of his own making," *Cohan v. Commissioner*, 39 F.2d at 544.

Petitioner credibly testified that he used the Verizon services 80% to 90% for Vizala in 2015, with the remainder for personal reasons, but he presented no records tracking his business and personal use . Petitioner did submit a contemporaneously prepared Excel spreadsheet indicating that he averaged 49 hours per week working on Vizala during the last three months of 2015, which we find helpful in approximating petitioner's potential business use of the cell phone and internet services.

The 49 hours per week petitioner spent on Vizala required extensive use of his cell phone and the internet: talking with his hired personnel, downloading data, sending emails, and reviewing the progress of the website online. Added to the 40 hours per week petitioner spent working for Bloomberg, during which time he used the Verizon service only sparingly, that makes 89 hours per week he spent working and 79 hours per week he spent not working. We appreciate that he did not use the Verizon service for nonbusiness purposes during the entire 79 nonworking hours in each week, but petitioner did not submit evidence allocating this time to other activities such as eating and sleeping.

Bearing heavily against petitioner, we estimate his business use of the Verizon services on the basis of the ratio of the 49 hours per week he spent on Vizala to the 128 hours per week he spent working on Vizala or not working. Accordingly, petitioner has established the business purpose of 38.3% of the $415 of Verizon expenses paid after September 30, or $159.

C. Years for Which Petitioner Can Deduct His Start-Up Expenditures

Section 195(b)(1)(A) generally permits a taxpayer to deduct up to $5,000 of start-up expenditures for the year his active trade or business begins. 11 Section 195(b)(1)(A)(ii) denies this deduction to a taxpayer whose total start-up expenditures, including those paid or incurred [11] Section 195(d) requires a taxpayer to elect into section 195(b), which petitioner did by claiming a deduction for the start-up expenditures he paid in 2015 on his timely filed return. *See* I.R.S. Publication 535, Business Expenses: For Use in Preparing 2015 Returns, 24; *see also*

Treas. Reg. § 1.195-1(b) (explaining that a taxpayer is deemed to have made a section 195(b) election). [10] **[*10]** before the year his active trade or business begins, exceed $55,000. Petitioner failed to introduce any evidence, let alone credible evidence, of his costs of developing Vizala from the time he began work on the project circa 2013 to the end of 2014, leaving us to guess his total start-up expenditures. Petitioner retains the burden of proof on this issue, *see supra* Part I, which he has not satisfied, and he may not deduct start-up expenditures under section 195(b)(1)(A).

Section 195(b)(1)(B) allows a taxpayer to deduct start-up expenditures ratably over the 180-month period beginning with the month in which the active trade or business begins. Petitioner's Excel spreadsheet shows he averaged 37 hours per week working on Vizala during the first nine months of 2015. By the reasoning *supra* Part II.B, petitioner has established the business purpose of 28.8% of the $1,441 of Verizon expenses paid before September 30, or $414. Adding this to the $16,138 of engineer expenses, marketing expenses, and miscellaneous expenses paid before September 30 makes a total of $16,553 of 2015 start-up expenditures. Petitioner may deduct this amount ratably over the 180- month period beginning with September 2015, when his active trade or business began.

III. Petitioner's Alternative Arguments

To the extent we hold that he may not deduct any of the engineer expenses as section 162 trade or business expenses, petitioner argues that he can deduct them as section 174 research or experimental expenditures, or as costs of developing computer software under Rev. Proc. 2000-50, 2000-2 C.B. 601. We address each argument in turn.

A. Section 174

Section 195(c)(1) excludes from the definition of start-up expenditures any amount with respect to which a deduction is allowable under section 174. Section 174(a)(1), as in effect for 2015, allows a taxpayer to deduct "research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business." [12] Treasury Regulation § 1.174-2(a)(1) defines research or experimental expenditures as "expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory [12] Congress withdrew the deduction for amounts paid or incurred in t ax years beginning after December 31, 2021. *See* Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13206, 131 Stat. 2054, 2111 (2017). [11] **[*11]** sense." This means the expenditures "are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product." *Id.* "Uncertainty exists," the regulation continues, "if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product." *Id. Petitioner* may not deduct any of his expenditures under section 174 because he did not encounter this kind of uncertainty in

creating Vizala. A pair of cases involving the section 41 credit for increasing research activities, which requires the taxpayer to demonstrate that expenditures may be treated as section 174 expenditures, *see* § 41(d)(1)(A), 13 illustrates how to understand "uncertainty" in the context of software development. In the first case the court denied taxpayer Morris Davenport a section 41 credit for wages paid to develop software that would automate and integrate the manufacturing, design, sales, accounting, and shipping aspects of his business. *United States v. Davenport*, 897 F. Supp. 2d 496, 499-501 [110 AFTR 2d 2012-5927], 518 (N.D. Tex. 2012). An outside contractor created the software using a commercially available software application suite. *Id.* at 500, 510-11. After conferring with Mr. Davenport's employees to understand their needs, the contractor developed a preliminary product by following a standardized process based on "industry best practices" and resolved problems and added functionalities according to the employees' feedback. *See id.* at 510-14. Although the project consumed lots of time and effort, the record reflected a straightforward application of the tried and true development process the contractor apparently followed in service of other clients. *See id.* at 515.

At the other end of the spectrum lies Eric Suder, whose company's costs of developing a series of phone systems passed the section 174 test. *See Suder v. Commissioner*, T.C. Memo. 2014-201, at *1 [2014 RIA TC Memo ¶2014-201]-30, *42-44. Although the company followed a systematic development process, neither Mr. Suder nor his team knew exactly what steps to follow to create the products they conceived or how the products would be designed. *Id.* at *8, *42-43. Each project began at th e drawing board: Senior management brainstormed an idea for a new product and drafted a rudimentary diagram and specifications which their engineers used to make the idea commercially viable. *Id.* at *8-9. The company's [13] Congress revised section 41(d)(1)(A) effective for tax years beginning after December 31, 2021, to conform to the revision of section 174 described in the preceding note. *See* Tax Cuts and Jobs Act § 13206(d)(1), 131 Stat. at 2112. [12] **[*12]** hardware was proprietary, so employees had to create what they needed out of whole cloth using their own expertise. *Id.* at *10-11. Software engineers tested and retested computer code to perfect the timing of the products' components within milliseconds. *Id. at *12. In* one case the company created a softphone that allowed the user to make calls from a personal computer while traveling, which presented the challenge of developing software capable of transferring calls through hotel routers and firewalls. *Id.* at *18. When the Internal Revenue Service (IRS) expert questioned the team's failure to develop the softphone using open-source software, an employee credibly testified that this would have required significant and time-consuming changes to the product. *Id.* at *41.

Vizala followed the *Davenport* paradigm: Petitioner and his engineers adapted widely used software to solve a complex but familiar problem. Petitioner's project did not start from the "drawing board" in the same sense as Mr. Suder's softphone. Petitioner aimed to create a data aggregation website, which companies such as Google Finance had done before, only his website would present demographic, social, and economic data instead of the financial information

available on professional-quality platforms. Whereas the softphone required Mr. Suder's team to write code from a blank slate, Vizala permitted the use of open-source software customized for petitioner's needs. Like Mr. Davenport's employees, petitioner described to his engineers how the product should work, and, as an inherent part of designing complex software, collaborated with the engineers to troubleshoot problems before launch. *Cf. id.* at *39-40 (disagreeing with the IRS's position that Mr. Suder's team encountered only the kind of uncertainty inherent in every large development effort). As in Mr. Davenport's case, we conclude that petitioner may not deduct his expenses under section 174.

B. Rev. Proc. 2000-50

Petitioner argues that he may deduct the engineer expenses on the basis of Rev. Proc. 2000-50, §§ 4, 5.01, 2000-2 C.B. at 601, which announces that the IRS will not disturb a taxpayer's immediate deduction of certain costs of developing computer software that the taxpayer has not treated as section 174 research or experimental expenditures. We must reject this argument because, to the extent Rev. Proc. 2000-50 purports to establish a taxpayer's entitlement to a deduction, petitioner has not demonstrated that the Code authorizes any such deduction. [13] **[*13]** Rev. Proc. 2000-50 mimics the section 174 exception to the capitalization rules of sections 195 and 263. As explained *supra* Part II.A, section 162(a) permits a deduction for ordinary and necessary expenses paid or incurred during a taxable year "in carrying on any trade or business," but section 195 generally denies an immediate deduction for start-up expenditures paid or incurred before the "active trade or business" begins. Moreover, section 263(a)(1) generally denies an immediate deduction for amounts paid for permanent improvements to property, which the title of section 263 calls "capital expenditures." *See Woodward v. Commissioner* , 397 U.S. 572, 575 [25 AFTR 2d 70-964] (1970) (explaining that a taxpayer cannot deduct a capital expenditure under section 162). The taxpayer "capitalizes" section 195 and section 263 expenditures, *see*§ 1016(a)(1) (providing a basis adjustment for expenditures "properly chargeable to capital account"), and in some cases can deduct them over subsequent years through depreciation or amortization, *see, e.g.*, §§ 167, 195(b).

As in effect for 2015, *see supra* note 12, section 174(a)(1) overrides these capitalization rules for research or experimental expenditures paid or incurred by the taxpayer during the taxable year " n connection i with his trade or business." The taxpayer need not actually be engaged in a trade or business to incur an expenditure "in connection with his trade or business," but there must be a realistic prospect at the time of the expenditure that the taxpayer will enter a trade or business involving the technology being developed. *See Lewin v. Commissioner*, 335 F.3d 345, 347-48 [91 AFTR 2d 2003-1435] (4th Cir. 2003), *aff'g per curiam* T.C. Memo. 2001-10 [2001 RIA TC Memo ¶2001-010]. Such expenditures are not start-up or capital expenditures. *See* §§ 195(c)(1) (flush text), 263(a)(1)(B); *see also* § 263A(c)(2) (exempting any amount allowable as a deduction under section 174 from section 263A(a)(1), which requires that certain costs be included in

inventory costs or capitalized). The taxpayer may either deduct the expenditures in the taxable year they are paid or incurred, § 174(a), or capitalize and deduct them ratably over 60 months, § 174(b).

On the theory that they "so closely resemble" section 174 expenditures "as to warrant similar accounting treatment," Rev. Proc. 2000-50, §§ 4 and 5.01, purports to allow the same timing election for certain costs of developing computer software that the taxpayer has not treated as section 174 expenditures. The revenue procedure announces in pertinent part that the IRS "will not disturb" a taxpayer's deduction of these costs "in accordance with rules similar to those applicable under § 174(a)," or capitalization and recovery of the costs through amortization deductions "in accordance with rules similar to those [14] **[*14]** provided by § 174(b) and the regulations thereunder" or other rules described in the revenue procedure. *Id.*; *see also* T.D. 9107, 2004-1 C.B. 447, 452 (preamble to regulations under section 263 directing taxpayers to rely on Rev. Proc. 2000-50 to determine when to deduct computer software development costs). 1. *Respondent Failed to Explain How to Coherently Apply Rev. Proc. 2000-50.* Respondent does not dispute that the engineer expenses are costs of developing computer software as defined in Rev. Proc. 2000-50, but insists that petitioner cannot deduct any of the expenses he reported on Schedule C because his active trade or business did not begin until after 2015. Respondent argues that allowing petitioner to deduct amounts paid before his active trade or business began, even if they satisfy the criteria of Rev. Proc. 2000-50, is not authorized by the Code and would be "making new law contrary to congressional intent."

We cannot reconcile respondent's gloss on Rev. Proc. 2000-50 with the terms of the revenue procedure itself, for two reasons. First, Rev. Proc. 2000-50 announces that the IRS "will not disturb" a deduction that satisfies its criteria, with no caveat about an active trade or business. Unlike section 174, the revenue procedure does not even require that expenditures be incurred "in connection with" a trade or business. Yet even if it did, respondent does not deny that petitioner had a realistic prospect as of the beginning of 2015 of entering a trade or business involving the website under development. *See Lewin v. Commissioner*, 335 F.3d at 347-48 (discussed *supra*). Second, the stated purpose of Rev. Proc. 2000-50 is to provide accounting treatment of the kind allowed by section 174, and the manifest purpose of section 174 is to suspend the capitalization rules of sections 195 and 263 for research or experimental expenditures. Withholding the Rev. Proc. 2000-50 deduction from a taxpayer whose active trade or business has yet to begin makes no sense because the revenue procedure is meant to provide relief from this requirement.

Neither do we agree with respondent's attempt to reconcile Rev. Proc. 2000-50 with the Code. Rev. Proc. 2000-50 does not say which part of the Code authorizes its timing rule for costs of developing computer software that the taxpayer has not treated as section 174 expenditures. Although respondent argued at trial that the authority comes from section 162, *see also* David

E. Hardesty, Electronic Commerce: Taxation & Planning, para. 7.06(3)(b)(iv) (2021) , Westlaw ECOMM WGL [15] **[*15]** (inferring the same), the rule is both too narrow and too broad for this argument to hold water. On the one hand, section 162 allows as a deduction "*all the ordinary and necessary expenses* paid or incurred during the taxable year in carrying on any trade or business." (Emphasis added.) Yet Rev. Proc. 2000-50 applies only to costs of developing computer software, not any other costs paid or incurred in carrying on the same trade or business, assuming arguendo that a taxpayer who pays or incurs such costs is carrying on a trade or business at all. On the other hand, Rev. Proc. 2000-50 purports to allow a taxpayer to deduct costs paid or incurred before his active trade or business begins per section 195, if indeed an active trade or business ever begins, and irrespective of whether the costs otherwise would be nondeductible section 263 capital expenditures. As explained *supra* , Rev. Proc. 2000-50 exists to supersede these capitalization rules, which themselves supersede the section 162 deduction for trade or business expenses. 2. *Petitioner Failed to Advance a Viable Claim Based on Rev. Proc. 2000-50.* Petitioner makes no attempt to justify Rev. Proc. 2000-50 as consistent with the Code. He argues that the engineer expenses satisfy the Rev. Proc. 2000-50 criteria for deduction and that the IRS is "estopped" from taking a position contrary to its own guidance. Petitioner has the burden of establishing his entitlement to any deduction claimed, as explained *surpa* Part I, so we assume without deciding that the Rev. Proc. 2000-50 deduction lacks statutory authorization.

Courts generally treat revenue procedures as governing internal IRS operations and hold that they do not create substantive rights in the public. *Capitol Fed. Sav. & Loan Ass'n & Sub. v. Commissioner*, 96 T.C. 204, 216-17 (1991). The Fourth Circuit reached the same holding as to "rules laid down by the Commissioner for the regulation of the affairs of his office." *See Luhring v. Glotzbach*, 304 F.2d 560, 563-65 [9 AFTR 2d 1827] (4th Cir. 1962). To the extent Rev. Proc. 2000-50 establishes an administrative policy not to "disturb" a deduction that complies with its criteria, irrespective of whether the Code authorizes the deduction, *Capitol Federal* and *Luhring* dictate that Rev. Proc. 2000-50 offers petitioner no remedy.

When the IRS has announced to taxpayers in a revenue procedure how it will exercise discretion conferred by the Code, however, the Tax [16] **[*16]** Court has set aside as an abuse of discretion the IRS's failure to honor the revenue procedure in individual cases. *See Capitol Fed.*, 96 T.C. at 217-20. Section 446(b), for example, grants the IRS broad discretion to determine whether an accounting method "clearly reflect[s] income," a concept the Code does not define, and therefore whether a taxpayer may use that method to compute taxable income. [14] *SeeCommissioner v. Hansen* , 360 U.S. 446, 467 [3 AFTR 2d 1690] (1959) (discussing the predecessor of section 446). The IRS abused this discretion by denying a taxpayer the use of an accounting method permitted by Rev. Proc. 71-21, 1971-2 C.B. 549, even though the taxpayer qualified to use the method by the terms of the revenue procedure itself. *Barnett Banks of Fla., Inc. v. Commissioner*, 106 T.C. 103, 116-17 (1996).

Before we can find an abuse of discretion, however, we must find a grant of discretion. *See Woodral v. Commissioner*, 112 T.C. 19, 25 (1999) ("[A] person with no discretion simply cannot abuse it."). The Supreme Court has acknowledged the self-evident principle that "Congress, not the Commissioner, prescribes the tax laws." *Dixon v. United States*, 381 U.S. 68, 73 [15 AFTR 2d 842] (1965). IRS guidance that operates to create a rule out of harmony with the Code is a mere nullity, *see id.* at 74 (citing *Manhattan Gen. Equip. Co. v. Commissioner*, 297 U.S. 129, 134 [17 AFTR 214] (1936)), and cannot in and of itself bar the United States from collecting a tax otherwise lawfully due, *see id.* at 73. To the extent Rev. Proc. 2000- 50 purports to establish the taxpayer's entitlement to a deduction, therefore, we cannot sustain the rule without a statutory predicate.

Petitioner apparently asks us to enforce the Rev. Proc. 2000-50 deduction on the basis of a theory of equitable estoppel, [15] whereby courts aid a party who has relied in good faith to his detriment upon the representations of another. *United States v. Fid. & Cas. Co. of N.Y.*, 402 F.2d 893, 897 (4th Cir. 1968) . The doctrine "operates to place the person entitled to its benefit in the same position he would have been in had the representations been true." *CIGNA Corp. v. Amara*, 563 U.S. 421, 14Sections 446(b) and 7701(a)(11)(B) confer this authority on the Secretary of the Treasury or his delegate, and t he regulations underlying section 446 confirm that the Secretary of the Treasury has delegated this authority to the IRS. *See, e.g.* , Treas. Reg. § 1.446-1(a)(2) (" [N]o method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income."). [15] Petitioner cites *Rauenhorst v. Commissioner* , 119 T.C. 157 (2002), which did not estop the IRS from disavowing its own guidance. The Court treated as an IRS concession its own bright-line rule, announced in a revenue ruling that acquiesced in a **Tax Court** decision, simplifying the complex question of when a taxpayer recognizes income on a post-donation sale of donated property. *See id.* at 164-73.[17] **[*17]** 441 (2011) (quoting J. Eaton, Handbook of Equity Jurisprudence § 62 (1901)). Even if the Rev. Proc. 2000-50 deduction lacks congressional authorization, that is, petitioner argues that it would be unfair to allow the IRS to deny a deduction it guaranteed in published guidance. Assuming arguendo that equitable estoppel ever applies against the Government, *see Dawkins v. Witt*, 318 F.3d 606, 611 (4th Cir. 2003) (expressing skepticism), the remedy is available only in a court of equity, not a court of law, *see McCravy v. Metro. Life Ins. Co.*, 690 F.3d 176, 180-81 (4th Cir. 2012) (citing *Amara*, 563 U.S. at 439-41). As a court of law, the **Tax Court** has no authority to impose equitable estoppel. *See Stovall v. Commissioner*, 101 T.C. 140, 149-50 (1993).

To reflect the foregoing, *An order will be issued denying petitioner's oral Motion to Shift Burden of Proof under section 7491(a), and decision will be entered under Rule 155.*[18] **[*18]** APPENDIX A: Engineer Expenses *Date Recipient Amount* 1/2/2015 Joachim Noreiko $664.46

1/2/2015 Thomas Seidl 3,439.76

1/26/2015 Joachim Noreiko 513.88

4/3/2015 Rik de Boer 280.53

4/8/2015 Thomas Seidl 1,876.62

8/20/2015 Thomas Seidl 7,347.77

10/1/2015 Joachim Noreiko 716.07

11/3/2015 Mike Stefanello 100.00

12/23/2015 Thomas Seidl 5,569.41 APPENDIX B: Marketing Expenses Petitioner paid the amounts in the following table to Stacey Weliver. *Date Amount* 6/23/2015 $230

7/28/2015 250

8/20/2015 690

9/3/2015 130

10/5/2015 430

10/19/2015 310

11/2/2015 370 [19] **[*19]** APPENDIX C: Verizon Expenses Petitioner paid the amounts in the following table to Verizon for cell phone service and internet service at petitioner's home. *Date Amount* 1/12/2015 $76.13

1/20/2015 79.99

2/11/2015 84.92

2/18/2015 79.99

3/11/2015 76.09

3/20/2015 79.99

4/10/2015 77.35

4/17/2015 79.99

5/12/2015 77.18

5/22/2015 79.99

6/10/2015 88.77

6/17/2015 79.99

7/10/2015 83.71

7/20/2015 79.99

8/12/2015 79.51

8/17/2015 79.99

9/10/2015 77.21

9/17/2015 79.99

10/13/2015 53.00

10/19/2015 87.99

11/12/2015 49.18

11/17/2015 87.99

12/10/2015 49.20

12/18/2015 87.99 [20] **[*20]**

APPENDIX D: Miscellaneous Expenses Date Schedule C Designation Amount

1/5/2015 UPS Store - Business Mailbox $202.40

1/20/2015 Audible.com Education 22.95

2/3/2015 Harvard Business Services 249.00

2/20/2015 Audible.com Education 22.95

3/23/2015 GoDaddy.com 25.16

3/23/2015 GoDaddy.com 50.32

4/27/2015 External Hard Drive 69.15

4/28/2015 Audible.com Education 14.95

5/28/2015 Audible.com Education 14.95

6/29/2015 Audible.com Education 14.95

7/28/2015 Audible.com Education 7.49

8/28/2015 Audible.com Education 7.49

9/9/2015 Microsoft Office 6.00

9/28/2015 Audible.com Education 7.49

10/9/2015 Microsoft Office 6.00

10/14/2015 USTPO Trademark application 275.00

10/28/2015 Audible.com Education 14.95

11/9/2015 Microsoft Office 6.00

11/30/2015 Audible.com Education 14.95

12/9/2015 Microsoft Office 6.00

12/28/2015 Crashplan Computer Backup Service 59.99

12/28/2015 Harvard Business Services 50.00

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Tax Court & Board of Tax Appeals Memorandum Decisions

Morgan Run Partners, LLC et al. v. Commissioner, T.C. Memo. 2022 -61 , Code Sec(s) 170; 6751.

MORGAN RUN PARTNERS, LLC, OVERFLOW MARKETING, LLC, TAX MATTERS PARTNER, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

Code Sec(s):	170; 6751
Docket:	Docket No. 8669-20.
Date Issued:	06/14/**2022**

HEADNOTE

XX.

Reference(s): Code Sec. 170; Code Sec. 6751

Syllabus

Counsel

Vivian D. Hoard, for petitioner.

John T. Arthur, Christopher D. Bradley, Marissa J. Savit, and Alexan-dra E. Nicholaides, for respondent.

MEMORANDUM OPINION

LAUBER, *Judge*: This is a syndicated conservation easement case. The Internal Revenue Service (IRS or respondent) disallowed the charitable contribution deduction claimed for the easement by Morgan Run Partners, LLC (Morgan), and determined penalties. Currently be-fore the Court is respondent's Motion for Partial Summary Judgment. Respondent contends that the deduction was properly disallowed be-cause the easement's conservation purpose was not "protected in perpe-tuity." *See* § 170(h)(5)(A). 1 Separately, respondent contends that the IRS complied with the requirements of section 6751(b)(1) by securing timely supervisory approval of the penalties. We will deny the Motion [1] Unless otherwise indicated, all statutory references are to the Internal Reve-nue Code (Code), Title 26 U.S.C., in effect at all relevant times, all regulation refer-ences are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Pro-cedure. **Served 06/14/22**[2] **[*2]** on the section 170(h)(5)(A) question but grant it with respect to sec-tion 6751(b)(1).

Background

The following facts are derived from the pleadings, the parties' motion papers, and the exhibits and declarations attached thereto. They are stated solely for purposes of deciding respondent's Motion and not as findings of fact in this case. *See Sundstrand Corp. v. Commissioner*, 98 T.C. 518, 520 (1992), *aff'd*, 17 F.3d 965 [73 AFTR 2d 94-1198] (7th Cir. 1994).

Morgan is an Alabama limited liability company organized in May 2016. It is treated as a TEFRA partnership for Federal income tax purposes, and petitioner Overflow Marketing, LLC, is its tax matters partner. 2 Morgan had its principal place of business in Alabama when the Petition was timely filed.

In November 2016 Greenwood Partners, LLC, acquired a 94% membership interest in Morgan by contributing to it roughly 232 acres of land (Property) in Jefferson County, Alabama. In December 2016 Morgan granted to the National Farmer's Trust (Trust or grantee) a con-servation easement over the Property. The deed of easement was rec-orded on December 20, 2016.

The easement deed states that it "gives rise to a real property right and interest." Article 6.1 provides that the fair market value (FMV) of the Trust's right and interest "shall be equal to the difference between (a) the [FMV] of the Conservation Area as if not burdened by th[e] Conservation Easement, and (b) the [FMV] of the Conservation Area burdened by th[e] Conservation Easement." The deed thus defines the Trust's property right as equal to the FMV of the easement, but it does not specify the point in time at which this calculation is to be made.

The deed does not address the possibility that the easement might be extinguished in a future judicial proceeding. Rather, article 6.5 ex-presses the parties' intention that "no change in conditions . . . will at any time or in any event result in the extinguishment of any of the cov-enants, restrictions or easements" specified in the deed. Article 6.7 acknowledges "that circumstances could arise which would justify the modification of certain of the restrictions" set forth in the deed. In that [2] Before its repeal, TEFRA (the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §§ 401-07, 96 Stat. 324, 648-71) governed the tax treatment and audit procedures for many partnerships, including Morgan . [3] **[*3]** event article 6.7 specifies that the Trust and owner (viz., Morgan or its successor) "shall mutually have the right, in their sole discretion, to agree to amendments to [the deed] which are not inconsistent with the Conservation Purposes." This procedure is subject to the proviso that the Trust shall have no power to agree to any amendment "that would result in this Conservation Easement failing to qualify as a qualified contribution under Section 170(h) of the Internal Revenue Code."

Article 6.6 addresses the possibility that the easement re-strictions might be abrogated "by exercise of eminent domain." In that event the Trust and owner "shall join in appropriate actions . . . to re-cover the full value of the taking and all incidental or direct damages." Upon such recovery, " [t]he Trust shall be entitled the Trust's Propor-tionate Share of the recovered proceeds," but the term "Proportionate Share" is not defined. In connection with any eminent domain action, "[a]ll expenses incurred by Owner and the Trust reasonable attorneys' fees . . . shall be paid out of the recovered proceeds."

Morgan timely filed Form 1065, U.S. Return of Partnership In-come, for its 2016 tax year. On that return it claimed a charitable con-tribution deduction of $26 million for the donation of the easement. In support of this supposed value Morgan relied on an appraisal prepared by Ronald Foster.

The IRS selected Morgan's return for examination and assigned the case to Revenue Agent (RA) Karen Alibozek. In September 2019, as the examination neared completion, RA Alibozek recommended asser-tion of penalties against Morgan under sections 6662 and 6662A. Her recommendations to this effect were set forth in a civil penalty approval form. RA Alibozek's group manager, Margaret McCarter, digitally signed the form on September 17, 2019. Ms. McCarter has submitted a declaration confirming that she supervised RA Alibozek's work during the examination.

On October 21, 2019, RA Alibozek mailed petitioner a packet of documents, including Letter 1807, that set forth her proposed adjust-ments and penalty recommendations. More than two months later, on January 10, 2020, the IRS issued petitioner a notice of final partnership administrative adjustment (FPAA), including a Form 886-A, Explana-tion of Items, disallowing the charitable contribution deduction in full and determining penalties. As an alternative, the FPAA determined that any allowable charitable contribution deduction could not exceed [4] **[*4]** $989,357. Petitioner

timely petitioned this Court for readjustment of the partnership items. *Discussion* A. *Summary Judgment Standard*

The purpose of summary judgment is to expedite litigation and avoid costly, unnecessary, and time-consuming trials. *See FPL Grp., Inc. & Subs. v. Commissioner* , 116 T.C. 73, 74 (2001). We may grant partial summary judgment regar ding an issue as to which there is no genuine dispute of material fact and a decision may be rendered as a matter of law. *See* Rule 121(b); *Sundstrand Corp.*, 98 T.C. at 520. In deciding whether to grant partial summary judgment, we construe fac-tual materials and inferences drawn from them in the light most favor-able to the nonmoving party. *Sundstrand Corp.*, 98 T.C. at 520. Where the moving party properly makes and supports a motion for summary judgment, "an adverse party may not rest upon the mere allegations or denials of such party's pleading" but must set forth specific facts, by af-fidavit or otherwise, showing that there is a genuine dispute for trial. Rule 121(d). B. *Analysis* 1. *"Protected in Perpetuity"*

The Code generally restricts a taxpayer's charitable contribution deduction for the donation of "an interest in property which consists of less than the taxpayer's entire interest in such property." § 170(f)(3)(A). But there is an exception for a "qualified conservation contribution." § 170(f)(3)(B)(iii), (h)(1). For the donation of an easement to be a "qual-ified conservation contribution," the conservation purpose must be "pro-tected in perpetuity." § 170(h)(1)(C), (5)(A); *see TOT Prop. Holdings, LLC v. Commissioner*, 1 F.4th 1354, 1362 (11th C ir. 2021); *PBBM-Rose Hill, Ltd. v. Commissioner* , 900 F.3d 193, 201 [122 AFTR 2d 2018-5471] (5th Cir. 2018).

In 1986 the Department of the Treasury issued final rules for de-termining whether this "protected in perpetuity" requirement is met. Of importance here are the rules governing the mandatory division of pro-ceeds in the event the property is sold following extinguishment of the easement. *See* Treas. Reg. § 1.170A-14(g)(6). The regulations recognize that "a subsequent unexpected change in the conditions surrounding the [donated] property . . . can make impossible or impractical the continued use of the property for conservation purposes." *Id.* subdiv. (i). Despite 5 **[*5]** that possibility, "the conservation purpose can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding" and the easement deed ensures that the charitable grantee, following sale of the property, will receive a proportionate share of the proceeds and use those proceeds consistently with the conserva-tion purposes underlying the original gift. *Ibid.* In effect, the "perpetu-ity" requirement is deemed satisfied because the sale proceeds replace the easement as an asset deployed by the donee "exclusively for conser-vation purposes." § 170(h)(5)(A).

Treasury Regulation § 1.170A-14(g)(6)(i) sets forth a formula for determining the proportionate share the grantee must receive upon any extinguishment of the easement, providing that the grantee must be en-titled to proceeds "determined under paragraph (g)(6)(ii)." That para-graph, captioned "Proceeds," provides in part as follows: [F]or a deduction to be allowed under this

section, at the time of the gift the donor must agree that the donation of the perpetual conservation restriction gives rise to a prop-erty right, immediately vested in the donee organization, with a fair market value that is at least equal to the pro-portionate value that the perpetual conservation re-striction at the time of the gift, bears to the value of the property as a whole at that time. . . . For purposes of this paragraph . . . , that proportionate value of the donee's property rights shall remain constant. Accordingly, when a change in conditions give rise to the extinguishment of a perpetual conservation restriction under paragraph (g)(6)(i) of this section, the donee organization, on a subse-quent sale, exchange, or involuntary conversion of the sub-ject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds . . . . In other words the grantee's proportionate share is to be determined by a fraction, the numerator of which is "the fair market value of the con-servation easement on the date of the gift," and the denominator of which is "the fair market value of the property as a whole on the date of the gift." *Carroll v. Commissioner*, 146 T.C. 196, 216 (2016); *see alsoPBBM-Rose Hill* , 900 F.3d at 207.

6 **[*6]** Respondent contends that the deed at issue violates the "judicial extinguishment" regulation. But this deed, unlike most easement deeds the Court has examined, does not explicitly address the subject of judi-cial extinguishment. Rather, it expresses the parties' intention that "no change in conditions . . . will at any time or in any event result in the extinguishment" of the easement. Should circumstances arise that would justify modifying certain restrictions, the deed envisions that Morgan and the Trust would agree to appropriate amendments, with the proviso that the Trust would have no power to agree to any amend-ment that would violate section 170(h). Given this text, petitioner has a reasonable argument that the deed violates nei ther the "judicial extin-guishment" regulation nor the statutory requirement that the conserva-tion purpose be "protected in perpetuity." *See* § 170(h)(5)(A).

The deed does address, in article 6.6, the possibility that the re-strictions might be abrogated "by exercise of eminent domain." Refer-ring to article 6.1 of the deed, respondent urges that the Trust would then be limited to receiving proceeds equal to the value of the easement when initially granted, with no protection against inflation. That out-come would be at odds with the "protected in perpetuity" requirement. *See, e.g.* , *R.R. Holdings, LLC v. Commissioner*, T.C. Memo. 2020-22 [2020 RIA TC Memo ¶2020-022], 119 T.C.M. (CCH) 1136, 1139. But article 6.6 says that in the event of emi-nent domain the Trust shall be entitled , not to a fixed historical value, but to "the Trust's Proportionate share of the recovered proceeds." Oddly, the term "Proportionate Share," though seemingly intended as a term of art, is not defined in the deed. This creates an ambiguity that would need to be resolved under principles of Alabama law, which might include parol evidence. *See Moore v. Pa. Castle Energy Corp.*, 89 F.3d 791, 795-96 (11th Cir. 1996).

Respondent also faults the deed for providing that, in the event of an eminent domain recovery, " [a]ll expenses incurred by Owner and the Trust reasonable attorneys' fees . . . shall be paid out of the recovered proceeds." But as we have previously noted, "[i]t is not necessarily un-reasonable

for a deed to provide that prior claims [or expenses] may be paid from sale proceeds." *Coal Prop. Holdings, LLC v. Commissioner*, 153 T.C. 126, 145 n.5 (2019). What would be unreasonable (and violative of the regulation) would be a requirement that *all* claims and expenses of sale be paid out of *the Trust's share* of the proceeds. *See ibid.* Here, the deed provides that the proceeds will be reduced by both parties' ex-penses. It is not obvious that this violates the "judicial extinguishment" regulation or the statutory requirement that the conservation purpose be "protected in perpetuity." *See* § 170(h)(5)(A). We will accordingly [7] **[*7]** deny respondent's Motion with respect to the "protected in perpetu-ity" requirement. 2. *Penalty Approval*

Section 6751(b)(1) provides that "[n]o penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the in-dividual making such determination." In a TEFRA case such as this, supervisory approval generally must be obtained before the IRS issues an FPAA to the partnership. *See Palmolive Bldg. Inv'rs, LLC v. Com-missioner* , 152 T.C. 75, 83 (2019). If supervisory approval is obtained by that date, the partnership must establish that the approval was un-timely, i.e., "that there was a formal communication of the penalty be-fore the proffered approval" was secured. *See Frost v. Commissioner*, 154 T.C. 23, 35 (2020). [3]

Respondent has supplied a copy of the civil penalty approval form by which RA Alibozek recommended assertion of penalties against Mor-gan. RA Alibozek's immediate supervisor, Ms. McCarter, signed the penalty approval form on September 17, 2019. The Letter 1807 notify-ing petitioner of the proposed penalties was issued on October 21, 2019. The FPAA with enclosed Form 886-A was issued on January 10, 2020. Because RA Alibozek secured supervisory approval from Ms. McCarter before either of those communications was made to petitioner, the ap-proval was timely. *See Frost*, 154 T.C. at 35. [4]

Petitioner does not allege that the IRS formally communicated to Morgan, before September 17, 2019, its decision to assert penalties. Pe-titioner nonetheless argues that there is a dispute of fact as to whether the IRS issued some sort of penalty communication before that date. Pe-titioner asserts that the answer to this question is currently "unknowa-ble" and must be determined by trial.

We disagree. Respondent has supplied documentary evidence confirming that RA Alibozek's immediate supervisor approved the [3] Although the Commissioner does not bear a burden of production with respect to penalties in a partnership-level proceeding, a partnership may raise section 6751(b) as an affirmative defense. *See Dynamo Holdings Ltd. P'ship v. Commissioner* , 150 T.C. 224, 236-37 (2018). [4] Because RA Alibozek secured supervisory approval on September 17, 2019, we need not decide whether the "initial determination" to assert penalties was embod-ied in the Letter 1807 (dated October 21, 2019) or the FPAA (dated January 10, 2020). [8] **[*8]** assertion of penalties on September 17, 2019, well before the IRS formally

communicated its penalty determinations to petitioner. As we have repeatedly held, the statute's timeliness inquiry "turns on the tim-ing of the first `formal written communication' to the taxpayer against whom the penalties are being asserted." *Oxbow Bend, LLC v. Commis-sioner* , T.C. Memo. **2022** -23, at *8 [**2022** RIA TC Memo ¶2022-023] (quoting *Belair Woods, LLC v. Commissioner* , 154 T.C. 1, 10 (2020)). We have regularly decided this ques-tion on summary judgment, on the basis of IRS records and declarations from relevant IRS officers. *See, e.g.*, *Sand Inv. Co. v. Commissioner*, 157 T.C. 136 (2021); *Long Branch Land, LLC v. Commissioner*, T.C. Memo. **2022** -2 [**2022** RIA TC Memo ¶2022-002]; *Excelsior Aggregates, LLC v. Commissioner*, T.C. Memo. 2021- 125 [2021 RIA TC Memo ¶2021-125]. [5]

If the IRS issued Morgan or its representatives any "formal writ-ten communication" of penalties before September 17, 2019, they would presumably have that document in their possession. Petitioner does not allege that Morgan received any such document or that any other type of formal penalty communication occurred. There being no genuine dis-pute of material fact on this point, we will grant respondent's Motion with respect to penalty approval. *See* Rule 121(d) (providing that a party opposing summary judgment may not rely on "mere allegations or deni-als" but "must set forth specific facts," including facts established "by affidavits or declarations").

To reflect the foregoing, *An order will be issued granting in part and denying in part re-spondent's Motion for Partial Summary Judgment* . [5] In *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner* , 29 F.4th 1066 (9th Cir. **2022**), *rev'g and remanding* 154 T.C. 68 (2020), the U.S. Court of Appeals for the Ninth Circuit considered the timeline for obtaining supervisory approval of "assessable penalties," which are not subject to deficiency or TEFRA procedures. The court held that, for an assessable penalty, supervisory approval is timely if secured before the penalty is assessed or "before the relevant supervisor loses discretion whether to ap-prove the penalty assessment." *Id.* at 1074. The court suggested that, in a deficiency or TEFRA case such as this, the deadline for securing supervisory approval would be the issuance of the notice of deficiency or the FPAA. *Id.* at 1071 n.4. If that analysis were adopted here, supervisory approval of the penalties was clearly timely: Approval was secured in September 2019, and the FPAA was not issued until January 2020.

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Tax Court & Board of Tax Appeals Memorandum Decisions

William E. Musselwhite, JR. et vir. v. Commissioner, T.C. Memo. 2022 -57 , Code Sec(s) 735; 1221.

WILLIAM E. MUSSELWHITE, JR. AND MELISSA MUSSELWHITE, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

Code Sec(s):	735; 1221
Docket:	Docket No. 14380-16.
Date Issued:	06/08/**2022**

HEADNOTE

XX.

Reference(s): Code Sec. 735; Code Sec. 1221

Syllabus

Counsel

Felicia L. Branch, for petitioners.

Scott Lyons and Tammie A. Geier, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

ASHFORD, *Judge*: By statutory notice of deficiency dated March 30, 2016, respondent determined a deficiency in petitioners' f deral e income tax of $356,607 and an accuracy -related penalty pursuant to section 6662(a) of $71,321 for the 2012 taxable year. [1] After certain concessions by the parties, 2 the sole issue remaining for decision is whether Mr. Musselwhite's sale of four land lots resulted in a $1,022,726 [1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Procedure. [2] As set forth in a Joint Stipulation of Settled Issues filed by the parties before the trial of this case, the parties agree that for 2012 petitioners (1) are entitled to a $2,847 additional deduction for "Self-employed SEP, Simple, and Qualified Plans,"

(2) received but failed to report a state income tax refund of $84, (3) have Schedule E,

Supplemental Income and Loss, passive income from a partnership of $4,594 , and

(4) are not liable for the accuracy-related penalty. **Served 06/08/22**[2] **[*2]** ordinary loss as petitioners reported on Schedule C, Profit or Loss From Business. 3 We resolve this issue in favor of respondent.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and the attached exhibits are incorporated herein by this reference. Petitioners resided in North Carolina when their petition was timely filed with the Court.

I. Mr. Musselwhite's Background

Mr. Musselwhite received his undergraduate degree, majoring in business, from Wake Forest University and his law degree from Campbell University. Since 1981 (the year he graduated from Campbell University's law school) he has been a personal injury attorney at the law firm started by his father and uncle in 1955 in Lumberton, North Carolina.

In addition to being actively engaged in the practice of law, Mr. Musselwhite has been involved in several real estate ventures, as further discussed below.

II. Mr. Musselwhite's Real Estate Ventures

Mr. Musselwhite's first real estate venture was in 1986 with his father, uncle, and brother. 4 The four of them, along with two engineers, purchased 100 acres of undeveloped land adjacent to an existing residential subdivision in Lumberton. The land was divided into approximately 90 lots that were developed with homes in phases, creating a new subdivision called Wycliffe East. The project lasted 13 years, and all 90 lots were eventually sold.

During the development of Wycliffe East, Mr. Musselwhite and his brother were approached to participate in another real estate venture, also in Lumberton. They formed Carolina Group Partnership (CGP), and CGP purchased 100 acres of undeveloped land which was developed in phases into a residential subdivision called Northwoods. [3] Mrs. Musselwhite is a party to this case because she filed a joint federal income tax return for 2012 with her husband, Mr. Musselwhite. [4] Mr. Musselwhite's brother attended Campbell University's law school at the same time he did, and his brother also practiced law at the family's law firm. [3] **[*3]** In 1989 Mr. Musselwhite purchased a lot in Wrightsville Beach, North Carolina, with the intent to build a home for his family. Ultimately, Mr. Musselwhite became good friends with the builder who built that home, and because of that relationship Mr. Musselwhite became interested in getting involved in real estate ventures in the Wrightsville Beach-Wilmington, North Carolina, area.

Mr. Musselwhite's first real estate venture in the Wrightsville Beach-Wilmington area was with David Stephenson. Mr. Stephenson had been a successful businessman with an existing real estate development company in Lumberton and initially had been friends with Mr. Musselwhite's father. Mr. Stephenson and Mr. Musselwhite got to know each other well in 2003, when Mr. Stephenson bought a house across the street from Mr. Musselwhite in Wrightsville Beach. In 2005 Mr. Stephenson approached Mr. Musselwhite seeking a business partner (as Mr. Stephenson's two previous business partners had passed away), and on or about June 22, 2005, th ey formed DS&EM Investments, LLC (DS&EM Investments), as a two-member limited liability company. DS&EM Investments' Limited Liability Company Annual Report filed with the State of North Carolina (LLC report) for 2005 indicated that the nature of its business was real estate investment. DS & EM Investments' 2006-12 LLC reports continued to report the nature of its business as real estate investment. DS&EM Investments initially purchased for investment five condominiums in Wrightsville Beach; they immediately sold two, one to a realtor friend. DS&EM Investments also acquired for investment purposes undeveloped lots in Lumberton and in the Seawatch subdivision in Brunswick County, North Carolina, and a house in Wilmington (Wilmington House). [5]

In summer 2006 Adam Lisk, a North Carolina real estate developer, contacted DS&EM Investments, proposing an arrangement whereby he would purchase the Wilmington House and DS&EM Investments would purchase four undeveloped wooded lots in the [5] Separate and apart from DS&EM Investments, Mr. Musselwhite owned portion s of several mobile home pa rks that Mr. Stephenson had conveyed to him. Additionally, sometime in 2006 he and Mr. Stephenson, together with Nick Garrett, formed Garrett&Stephenson, LLC, which in turn acquired 14 acres of

undeveloped land in the Landfall subdivision in the Wrights ville Beach-Wilmington area. Mr. Musselwhite got out of that venture in 2010 before any development began. [4] **[*4]** Cypress Lakes subdivision in Brunswick County that Mr. Lisk owned. From Mr. Musselwhite's perspective the arrangement was an opportunity to invest in a subdivision that Mr. Lisk was developing (the subdivision consisted of nine undeveloped wooded lots owned by Mr. Lisk). After several weeks of discussions that included creating an implementable plan as to all nine lots, on August 30, 2006, Mr. Lisk and DS&EM Investments entered into a written agreement memorializing the plan.

Pursuant to this agreement, Mr. Lisk agreed to give DS&EM Investments a one-year personal guaranty that the four lots it was purchasing would sell within one year and that it would net $1 million from such a sale or he would buy back the remaining unsold lots. Additionally, Mr. Lisk and DS&EM Investments agreed that Mr. Lisk would receive the first $49,000 of potential profit on the four lots over the net $1 million, with Mr. Lisk and DS&EM Investments splitting 50/50 any additional profit over the $49,000. Mr. Lisk also agreed that he and his real estate agent, Amanda Carpenter of Intracoastal Realty (Intracoastal), would, in good faith, equally market all nine lots, and he agreed to give DS&EM Investments a deed of trust covering his five lots. DS&EM investments agreed to release the first three of the five lots from the deed of trust upon Mr. Lisk's sale of those three lots with some mutually agreed-upon payment to it. Mr. Lisk and DS&EM Investments further agreed that Mr. Lisk could not sell his remaining two lots until DS&EM Investments had only two of its four lots remaining, at which time Mr. Lisk could sell one of his remaining lots, and Mr. Lisk could only sell his final remaining lot once DS&EM Investments had only one lot remaining of its four lots. Finally, although this arrangement was not reflected in the agreement, Mr. Lisk agreed to complete certain improvements to all nine lots so that the lots could be effectively marketed by Ms. Carpenter.

On August 31, 2006, in accordance with the agreement, DS&EM Investments purchased the four lots from Mr. Lisk for $1 million and Mr. Lisk purchased the Wilmington House from DS&EM Investments for $2,069,000. DS&EM Investments partially financed its purchase with a $750,000 loan from BB&T Bank (BB&T), which was secured by a deed of trust covering the four lots in favor of BB&T; to purchase the Wilmington House, Mr. Lisk used $1,069,000 of his own money and the $1 million he received from DS&EM Investments for the four lots.

In 2007 the real estate market across the country began to take an ugly turn. It was even worse in Brunswick County than across the [5] **[*5]** country because the developer of the Seawatch subdivision, Mark Saunders, had not completed all the improvements he had promised; consequently, he was being sued by multiple landowners alleging that he had misrepresented the Seawatch subdivision development, and he had started to flood the market in Brunswick County with hundreds of distressed properties. Mr. Lisk felt the crunch of the downward-spiraling and distressed real estate market and slowed on completing the improvements for all nine lots. He had

multiple other business partners filing for bankruptcy or having serious financial problems. He started having financial problems himself, as well as family problems.

The four lots did not sell within one year; and on or about November 15, 2007, DS&EM Investments filed a complaint against Mr. Lisk in the General Court of Justice, Superior Court Division, in Robeson County, North Carolina, alleging that he was in breach of the August 30, 2006, agreement and that his actions were fraudulent in that he had failed to (1) complete all planned improvements, (2) properly market the four lots, (3) buy back the four lots (and instead spent large sums of money on the Wilmington House), and (4) provide a deed of trust covering his five lots . DS&EM Investments sought specific performance of the agreement or alternatively an order that Mr. Lisk reconvey the Wilmington House and transfer his five lots to it, and punitive damages and costs.

Ultimately, DS&EM Investments and Mr. Lisk came to an agreement resolving all issues in the Robeson County court action. Mr. Lisk agreed to complete the rest of the improvements and transfer his five lots to DS&EM Investments so that DS&EM Investments would have the whole subdivision, and in exchange DS&EM Investments agreed to voluntarily dismiss its lawsuit against Mr. Lisk.

On December 22, 2008, Mr. Lisk transferred his five lots to DS & EM Investments, and on or about January 8, 2009, DS&EM Investments voluntarily dismissed its lawsuit against Mr. Lisk. After December 22, 2008, Mr. Lisk had no i nvolvement with the Cypress Lakes subdivision, any of the nine lots, or DS&EM Investments.

With respect to the lots, Mr. Lisk as of December 22, 2008, had: (1) removed trees to build a road; (2) removed underbrush from the lots; (3) completed grading for the creation of a road; (4) completed grading for the creation of storm water drainage; (5) paved a road (with a curb and gutter added); (6) obtained septic tank permits; (7) designed a gate and fence; (8) obtained a Coastal Area Management Act permit for a [6] **[*6]** kayak dock; (9) requested additional entrance approval from the North Carolina Department of Transportation; and (10) confirm d that e the lots could support well systems and were close to electric service and water lines. After December 22, 2008, no improvements were made to the lots by DS&EM Investments except to occasionally clean up the lots.

After December 22, 2008, Intracoastal's for sale signs remained on the lots for an unspecified period (but no later than the end of September 2011, when BB&T prepared an appraisal of the lots, as discussed below), although by May 2008 Ms. Carpenter had left Intracoastal to work with another real estate company in Wilmington. The record is unclear as to what, if any, additional marketing of the lots was done. BB&T had appraisals prepared with respect to the four lots on or about May 1, 2009, September 29, 2011, and June 27, 2012. The appraised values reflect the continued effect of the housing market crash; the appraised value of the four lots was $55,000 in

May 2009, $23,500 in September 2011, and $17,500 in June 2012. [6] The 2011 and 2012 appraisals also recited the following with respect to the four lots: "THE SUBJECT HAS NO KNOWN PRIOR SALES HISTORY WITHIN THE PAST 3 YEARS AND IS NOT KNOWN TO BE CURRENTLY FOR SALE."

In the light of the continued depressed housing market, BB&T's mounting pressure with respect to the four lots as the holder of a deed of trust covering these lots, and both Mr. Musselwhite's and Mr. Stephenson's personal debt exposure with respect to the mobile home parks, Mr. Musselwhite and Mr. Stephenson agreed that it was prudent to distribute or convey to each other some of their properties (including properties of DS&EM Investments), dividing up the debt. Accordingly, Mr. Musselwhite conveyed his interest in the mobile home parks to Mr. Stephenson (and Mr. Stephenson promised to remove Mr. Musselwhite from the personal guaranty). Additionally, sometime in either 2011 or 2012 DS&EM Investments distributed a condominium to Mr. Musselwhite, and on July 27, 2012, it distributed the four lots to Mr. Musselwhite. [6] BB&T also had an appraisal prepared with respect to the four lots on or about June 2, 2006; the appraised value of the four lots was $952,000 in June of 2006. [7] **[*7]** On August 3, 2012, Mr. Musselwhite sold the condominium for $515,250, resulting in a $137,780 loss. Regarding the four lots, Mr. Musselwhite hired Donna Cote, a licensed real estate broker in North Carolina with her own company in Wilmington, to market the lots and bring them to sale. The record in this case includes a January 8, 2016, letter from Ms. Cote to petitioners' former counsel of record. [7] In this letter Ms. Cote recites that in early summer 2012 she met with Mr. Musselwhite to discuss assisting him with aggressively marketing the lots and bringing them to sale. She further recites that just after DS & EM Investments distributed the four lots to Mr. Musselwhite, she met with him again, spending much of a day at the lots assessing them and assessing the general geographical area to discern what other properties were for sale and their values. According to Ms. Cote, she immediately began to aggressively market the four lots and explore various options for their disposition; to wit, with an extensive network of developers, builders, investors, realtors, and potential purchasers from having actively participated in the development and sale of lots in so many subdivisions in Brunswick and neighboring New Hanover Counties, she consistently presented information on the lots to multiple people and spent substantial time and effort marketing the lots for sale. Ultimately, on or about November 14, 2012, Mr. Musselwhite was able to sell the four lots for a total of $17,500, resulting in a $1,022,726 loss.

III. DS&EM Investments' and Petitioners' Tax Reporting

Mr. Musselwhite hired Charles Edwards, a certified public accountant (CPA) with his own CPA firm in Lumberton to prepare and file DS&EM Investments' 2005-12 Forms 1065, U.S. Return of Partnership Income, and petitioners' 2011-13 Forms 1040, U.S. Individual Income Tax Return. [8]

A. DS&EM Investments

DS&EM Investments' 2005-12 Forms 1065 reported that (1) DS & EM Investments' principal business activity was "INVESTMENT ," (2) its principal product or service was "PROPERTY," and (3) it had no [7] OnNovember 1, 2017, the Court granted this individual's Motion to Withdraw as counsel in this case. Five days before that, petitioners' current counsel of record entered an appearance in this case. [8] Although the record includes only these tax returns, Mr. Edwards has been doing tax preparation work for Mr. Musselwhite's entire family and their various business entities since at least 1981. [8] **[*8]** gross receipts or sales. However, capital gains and/or losses with respect to sales of real property were reported on DS&EM Investments' 2006, 2007, 2009, 2010, and 2012 Forms 1065 (and also reflected on Schedules D, Capital Gains and Losses, which were attached to those forms); no sales of real property were reported on its Forms 1065 for 2005, 2008, and 2011 (and no Schedules D were attached to those forms).

The Schedules L, Balance Sheets per Books, of DS&EM Investments' 2005-10 Forms 1065 reported that DS&EM Investments had no "[i]nventories"; these Schedules L reflected, inter alia, that DS & EM Investments had "[o]ther investments," which included "INVESTMENT-REAL ESTATE."

It was on DS&EM Investments' Schedule L of the 2011 Form 1065 that the four lots (as well as the five lots that Mr. Lisk had transferred to DS&EM Investments in 2008) were first reported as being held as "[i]nventories" at the beginning and end of the taxable year. When DS&EM Investments' 2011 Form 1065 was filed on April 29, 2012, DS&EM Investments and Mr. Musselwhite were aware that the fair market values of the nine lots were less than DS&EM Investments' bases in the lots. The Schedule L of DS&EM Investments' 2012 Form 1065 also reported "[i]nventories" at the beginning of the taxable year but with a blank as to the end of the taxable year .

Despite the fact that (1) the four lots were reported as being held as "[i]nventories" on DS&EM Investments' 2011 and 2012 Schedules L and (2) Mr. Edwards testified at trial that it was his professional judgment that the lots were always held as inventory (upon reviewing the August 30, 2006, agreement , which Mr. Musselwhite first presented to him in the 2010-11 timeframe), Mr. Edwards did not file amended Forms 1065 for DS&EM Investments as to the prior taxable years reporting the lots' purported status as inventory. Additionally, the record is unclear as to whether Mr. Edwards had any discussions with Mr. Musselwhite regarding the lots' reclassification from investment to inventory before filing either the 2011 or the 2012 Form 1065 for DS & EM Investments.

B. Petitioners

Petitioners' 2011 Form 1040 reported total income of $928,332, the bulk of which consisted of (1) $111,679 of capital gain primarily attributable to the sale of various stocks and (2) $750,154 of income from partnerships and S corporations, zero of which was attributable to DS [9] **[*9]** & EM

Investments but most of which was attributable to $708,042 of income Mr. Musselwhite received from his family's law firm. The return also claimed various deductions (including various itemized deductions as detailed on Schedule A, Itemized Deductions) and reported four exemptions, a credit from Form 8801, Credit for Prior Year Minimum Tax--Individuals, Estates, and Trusts, and payments for federal income tax withheld and "2011 estimated tax payments and amount applied from 2010 return." No Schedule C relating to Mr. Musselwhite's real estate activities was attached to this return. 9

Petitioners' 2012 Form 1040 reported total income of $225,568, the bulk of which was attributable to $1,202,943 of income from partnerships and S corporations, zero of which was attributable t o DS & EM Investments but most of which was attributable to $1,182,664 of income Mr. Musselwhite received from his family's law firm, which was offset by a deduction for a $1,022,726 business loss as detailed on an attached Schedule C. This Schedule C was for Mr. Musselwhite's "ACTIVTIES RELATED TO REAL ESTATE"; to wit, the sale of the four lots on or about November 14, 2012. The lots' price ($17,500) was reported as gross receipts or sales, and Mr. Musselwhite's adjusted bases in the lots ($1,040,226) were reported as cost of goods sold. Mr. Musselwhite's $137,780 loss from the sale of the condominium on August 3, 2012 (i.e., "SALE OF INVESTMENT CONDO") was reported, together with a net long-term capital gain of $108,500, on an attached Schedule D; but because of section 1211(b), petitioners' total income included only the maximum amount allowed for a net capital loss (-$3,000). Petitioners' 2012 Form 1040 also claimed various deductions (including various itemized deductions as reflected on Schedule A) and reported three exemptions and payments for federal income tax withheld and "2012 estimated tax payments and amount applied from 2011 return." [10]

Petitioners' 2013 Form 1040 reported total income of $936,699, the bulk of which consisted of $846,465 of income from partnerships and S corporations, nearly all of which was attributable to $845,786 of income Mr. Musselwhite received from his family's law firm. Petitioners' total income also included business income of $4,431, consisting of gross receipts or sales of that same amount from "LEGAL [9] Ultimately,this return reported a refund, which was directed to be applied to petitioners' 2012 estimated tax. [10] Ultimately, this return reported a refund, which was directed to be applied to petitioners' 2013 estimated tax. [10] **[*10]** SERVICES" of Mr. Musselwhite as reflected on an attached Schedule C. No other Schedule C was attached to this return. This return claimed various deductions (including various itemized deductions as detailed on Schedule A) and reported two exemptions, a credit from Form 8801, and payments for federal income tax withheld and "2013 estimated tax payments and amount applied from 2012 return." 11

IV. Notice of Deficiency

Following an examination of petitioners' 2012 Form 1040, respondent determined in pertinent part that petitioners are not entitled to the reported $1,022,726 Schedule C loss because the four lots

were capital assets and thus their sale generated a capital (and not ordinary) loss. The March 30, 2016, notice of deficiency issued to petitioners reflects this determination.

OPINION

I. Applicable Law Regarding the Character of Petitioners' Reported Loss

On or about November 14, 2012, I ess than four months after DS & EM Investments distributed the four lots to Mr. Musselwhite, he sold them for $17,500, realizing a loss of $1,022,726. The sole dispute here is whether that loss should be characterized as an ordinary loss, as petitioners contend, or as a capital loss, as respondent contends. Both parties agree that the resolution of this dispute centers around whether the lots were stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. *See* § 1221(a)(1). If they were, then their sale resulted in an ordinary loss and not a capital loss.

The purpose of section 1221(a)(1) is to "differentiate between the `profits and losses arising from the everyday operation of a business' on [11] Ultimately, this return reported a refund, which was directed to be applied to petitioners' 201 4 estimated tax. [11] **[*11]** the one hand . . . and `the realization of appreciation in value accrued over a substantial period of time' on the other hand." *Malat v. Riddell*, 383 U.S. 569 [17 AFTR 2d 604], 572 (1966) (first quoting *Corn Prods. Refining Co. v. Commissioner*, 350 U.S. 46, 52 [47 AFTR 1789] (1955); and then quoting *Commissioner v. Gillette Motor Transp., Inc.* , 364 U.S. 130, 134 [5 AFTR 2d 1770] (1960)).

The Supreme Court has defined "primarily" as used in section 1221(a)(1) to mean "of first importance" or "principally." *Malat*, 383 U.S. at 572. Additionally, whether property is property described in section 1221(a)(1) is purely a factual question, and the burden of proof is on petitioners to demonstrate that Mr. Musselwhite held the four lots as described in section 1221(a)(1) (and not as a capital asset). [12] *SeePasqualini v. Commissioner* , 103 T.C. 1, 6 (1994) (and cases cited thereat); *Maddux Constr. Co. v. Commissioner*, 54 T.C. 1278, 1284 (1970); *see also* Rule 142(a).

The U.S. Court of Appeals for the Fourth Circuit, the court to which an appeal of this case would lie absent stipulation of the parties otherwise, *see* § 7482(b)(1)(A), (2), [13] has held that several factors are relevant in resolving a section 1221(a)(1) dispute. Among the factors to be considered are (1) the purpose for which the property was acquired; (2) the purpose for which the property was held; (3) improvements, and their extent, made to the property by the taxpayer; (4) the frequency, number, and continuity of sales; (5) the extent and substantiality of the transaction;

(6) the nature and extent of the taxpayer's business; (7) the extent of advertising or lack thereof; and (8) the listing of the property for sale directly or through a broker. *Graves v. Commissioner*, 867 F.2d 199, 202 [63 AFTR 2d 89-692] (4th Cir. 1989) (citing *Mathews v. Commissioner*, 315 F.2d 101 [11 AFTR 2d 1077] (6th Cir. 1963), *aff'g* T.C. Memo. 1961-213 [¶61,213 PH Memo TC], 1961 Tax Ct. Memo LEXIS 136). However, no one factor or group of factors is determinative, *id.* , and not all factors may be relevant in a particular case or factors may have varying degrees of relevance depending on the facts of a particular case, *S&H, Inc. v. Commissioner*, 78 T.C. 234, 243-44 (1982). Additionally, objective factors carry more weight than the taxpayer's subjective statements of intent. *See Guardian Indus. Corp. v.* [12] Petitioners do not otherwise contend that the burden of proof should shift to respondent under section 7491(a) as to any relevant issue of fact, nor have they established that they met the requirements for shifting the burden of proof. Accordingly, the burden of proof remains on petitioners. *See* § 7491(a)(2). [13] We follow the relevant precedent of the Court of Appeals to which an appeal would generally lie. *See Golsen v. Commissioner* , 54 T.C. 742, 757 (1970), *aff'd* , 445 F.2d 985 [27 AFTR 2d 71-1583] (10th Cir. 1971). [12] **[*12] Commissioner** , 97 T.C. 308, 316 (1991), *aff'd without published opinion*, 21 F.3d 427 (6th Cir. 1994).

Accordingly, we will consider and weigh these factors to resolve the sole dispute here concerning the character of petitioners' reported loss arising from Mr. Musselwhite's sale of the four lots.

II. Analysis

A. The Purpose for Which the Property Was Initially Acquired and Subsequently Held (Factors 1 and 2)

Mr. Musselwhite acquired the four lots via a distribution by DS & EM Investments as part of an agreement with Mr. Stephenson to deal with the mounting pressure DS&EM Investments was facing from BB&T as the holder of a deed of trust covering these lots and his and Mr. Stephenson's personal debt exposure with respect to certain mobile home parks. Mr. Musselwhite had no intention whatsoever of developing the lots when he acquired them and thereafter while holding them, and he never undertook any development of the lots during the few months he held them before they were sold; investment was his principal (or really sole) purpose. Indeed, as part of the agreement with Mr. Stephenson, DS&EM Investments also distributed a condominium to Mr. Musselwhite. Like the four lots, he sold the condominium in 2012, but he reported the condominium sale as a Schedule D loss.

Furthermore, in point of fact, when the four lots were distributed to Mr. Musselwhite, there was no change in purpose. We are very much convinced that DS&EM Investments purchased and held the lots for investment, the same purpose it had with respect to all of its property. Mr. Musselwhite testified that all the things he and Mr. Stephenson were doing through DS&EM Investments were

"really investment" and that specifically with respect to DS&EM Investments' acquisition of the four lots, it was an opportunity to invest in a subdivision that Mr. Lisk (who was an established developer) was already developing (as the owner of the other five lots in the subdivision). His testimony is consistent with the representations made on (1) DS&EM Investments' 2005-12 Forms 1065 that its principal business activity was "INVESTMENT" and (2) DS&EM Investments' 2005-12 LLC reports that its business was real estate investment. The 2005-12 Forms 1065 also reported no gross receipts or sales, but sales of real property were reported on DS&EM Investments' 2006, 2007, 2009, 2010, and 2012 Forms 1065 (as well as detailed on attached Schedules D), while no sales [13] **[*13]** whatsoever of real property were reported on DS&EM Investments' 2005, 2008, and 2011 Forms 1065 (and no Schedu les D were attached to those forms). Additionally, the August 30, 2006, agreement between DS&EM Investments and Mr. Lisk, together with the testimony of Messrs. Musselwhite and Lisk, shows that DS&EM Investments had no responsibility at all for developing and marketing the four lots (and did none), but, rather, Mr. Lisk did.

Even assuming, arguendo, that DS&EM Investments acquired the four lots in 2006 for development purposes, all the evidence shows that it abandoned its "development plan" by the end of 2008. On December 22, 2008, in connection with DS&EM Investments' agreeing to voluntarily dismiss the lawsuit it had filed against Mr. Lisk , Mr. Lisk transferred his five lots to DS&EM Investments. As of that date, Mr. Lisk had completed certain development actions; after that date, he had no involvement with the subdivision, any of the nine lots, or DS&EM Investments, and DS&EM Investments did nothing to improve any of the lots (except to occasionally clean them up) or market them for sale. Indeed, the 2011 and 2012 appraisals of the lots by BB&T recited that the lots were not listed for sale at the time the appraisals were made. To be sure, "a taxpayer may hold lands primarily for sale to customers in the ordinary course of his trade or business and, at the same time, hold other lands for investment," *Gardner v. Commissioner*, T.C. Memo. 2011-137 [2011 RIA TC Memo ¶2011-137], slip op. at 8 (quoting *Mathews v. Commissioner*, 315 F.2d at 106), but said taxpayer can cease holding property primarily for sale to customers in the ordinary course of its business and begin to hold it only for investment purposes, *Sugar Land Ranch Dev., LLC v. Commissioner*, T.C. Memo. 2018-21, at *10 [2018 RIA TC Memo ¶2018-021]-11.

Factors 1 and 2 weigh against petitioners (and in favor of respondent).

B. The Extent of Improvements to the Property (Factor 3)

Development activities may convert property originally acquired for investment into property held for sale to customers in the ordinary course of business. *See Bush v. Commissioner*, T.C. Memo. 1977-75 [¶77,075 PH Memo TC], *aff'd* , 610 F.2d 426 [45 AFTR 2d 80-356] (6th Cir. 1979). The only improvements to the four lots were made by Mr. Lisk, and he made them no later than December 22, 2008, the date he transferred the lots to DS&EM Investments, which was approximately 3 1/2 years before DS&EM Investments distributed the lots to Mr. Musselwhite.

After that date, as indicated above, no improvements were made to the lots by DS&EM Investments [14] **[*14]** (except to occasionally clean them up) and after DS&EM Investments distributed the lots to Mr. Musselwhite, he never made any improvements to the lots during the approximate 3 1/2 months that he held them in 2012.

Factor 3 weighs against petitioners (and in favor of respondent).

C. The Frequency, Number, and Continuity of Sales (Factor 4)

On the one hand, in the 1980s and 1990s, other entities that Mr. Musselwhite and members of his family jointly owned developed land lots and sold those lots. On the other hand, as indicated above, from its inception in 2005 through 2012, DS&EM Investments did not report on its Forms 1065 any gross receipts or sales; the only reported sales of any kind were those from the sale of investment properties that resulted in capital gain or loss (and those sales did not include any of the nine lots during the time that DS&EM Investments held them). Ultimately, given the facts of this case, Mr. Musselwhite's activity alone should be the focus. To this end, all evidence supports the isolated nature of Mr. Musselwhite's sale of the four lots, rather than an ongoing sole proprietorship engaged in activities related to real estate.

Factor 4 weighs against petitioners (and in favor of respondent).

D. The Extent and Substantiality of the Transaction (Factor 5)

Mr. Musselwhite's sale of the four lots was the only sale associated with the transaction, and the record is silent as to any continued involvement by Mr. Musselwhite with the lots, e.g., development plans, after he sold them. Indeed, as indicated above, when DS&EM Investments distributed the lots to him, he had no intention of developing them, and by April 29, 2012, the date on which DS&EM Investments' Form 1065 was filed, he (and DS&EM Investments) knew that the fair market values of the lots were less than DS&EM Investments' bases in the lots. Incredibly, the 2011 Form 1065 was the first such form for DS&EM Investments on which the lots were classified as being held as "[i]nventories." To be sure, Mr. Musselwhite was continuing to experience financial problems in 2012, but such reclassification provided no incentive for him to hold on to the four lots and develop them; the reclassification was his purported "ticket" to getting a significant ordinary loss through a quick sale of the lots.

Factor 5 weighs against petitioners (and in favor of respondent). [15]

E. [*15] The Nature and Extent of the Taxpayer's Business

(Factor 6)

Mr. Musselwhite's everyday business was not the development and sale of real estate. Since the 1980s Mr. Musselwhite has been actively engaged in the practice of law as a personal injury attorney at his family's law firm in Lumberton , and his reported income from that endeavor for at least 2011-13 was substantial. According to petitioners' 2011-13 Forms 1040, Mr. Musselwhite received income from his family's law firm of $708,042 in 2011, $1,182,664 in 2012, and $845,786 in 2013. As relevant here, he (and Mr. Stephenson) formed and operated DS&EM Investments as a vehicle to invest in real estate and DS&EM Investments' federal and state filings bear this out.

Factor 6 weighs against petitioners (and in favor of respondent).

F. The Extent of Advertising or Lack Thereof and the Listing of the Property for Sale Directly or Through a Broker (Factors 7 and 8)

Once DS&EM Investments distributed the four lots to Mr. Musselwhite, he immediately hired Ms. Cote, a North Carolina-licensed real estate broker with her own company in Wilmington, to market and sell the lots. Although Ms. Cote did not testify at trial, the parties stipulated a January 8, 2016, letter from her to petitioners' former counsel of record. In this letter Ms. Cote outlines her discussions with Mr. Musselwhite regarding his desire to aggressively market the four lots and bring them to sale. She also indicates in the letter that she consistently presented information on the lots to multiple people and spent substantial time and effort marketing the lots for sale. With there being no objections reserved by respondent as to the letter, we have no reason to doubt the veracity of its contents. [14] [14] We also note that the fact that Ms. Cote and not Mr. Musselwhite personally marketed and sold the lots does not per se remove this case from section 1221(a)(1) treatment. Courts have routinely held that the activities of brokers are attributable to the taxpayer who hired them. *See, e.g.* , *Hansche v. Commissioner* , 457 F.2d 429, 434 [29 AFTR 2d 72-774] (7th Cir. 1972) ("That the actual advertising sales activities are here not performed by the taxpayers does not mean that they were not holding the property `primarily for sale to customers in the ordinary course of [the taxpayers'] trade or business.'"), *aff'g* T.C. Memo. 1970-342 [¶70,342 PH Memo TC]; *Gamble v. Commissioner* , 242 F.2d 586, 592 [50 AFTR 2033] (5th Cir. 1957) (" [P]roperty may be held primarily for sale in [the] ordinary course of [the taxpayer's] trade or business notwithstanding [that] sales are made only through [16] **[*16]** Factors 7 and 8 weigh in favor of petitioners (and against respondent).

On the basis of our review of the record before us, the overwhelming weight of these factors is against petitioners (and in favor of respondent). Accordingly, under the factors discussed above, we hold that the four lots in the hands of Mr. Musselwhite were neither his stock in trade, inventory, or property he held primarily for sale to customers in the ordinary course of business under section 1221(a)(1) but, rather, were capital assets.

G. Petitioners' Other Argument

Separate and apart from arguing that the aforementioned factors weigh in their favor, petitioners also argue that the four lots in DS & EM Investments' hands were inventory as defined in section 751(d) and that pursuant to section 735(a), the lots retained their inventory character, resulting in an ordinary loss to Mr. Musselwhite when he sold them because he did so well within five years of DS&EM Investments' distributing them to him.

Section 735(a)(2) provides that "[g]ain or loss on the sale or exchange by a distributive partner of inventory items (as defined in section 751(d)) distributed by a partnership shall, if sold or exchanged within 5 years from the date of the distribution, be considered as ordinary income or as ordinary loss, as the case may be." Under section 751(d), inventory items are defined by reference to section 1221(a)(1).

On the basis of our analysis and holding above, section 735(a) is inapplicable here and thus petitioners' argument lacks merit.

H. Conclusion

We sustain respondent's determination that the $1,022,726 loss resulting from Mr. Musselwhite's sale of the four lots was a capital loss. an agent."), *aff'g* T.C. Memo. 1955-289 [¶55,289 PH Memo TC]; David Taylor Enters., Inc.&Subs. v.

Commissioner , T.C. Memo. 2005-127 [2005 RIA TC Memo ¶2005-127], slip op. at 23 (finding that the taxpayer's sales activities included those carried on through a broker); *Mathews,* 1961 Tax Ct. Memo LEXIS 136, at *16 (finding that the "[taxpayer] continuously made numerous and frequent sales of property " even though the taxpayer marketed and sold the pr operty through brokers rather than personally). [17] **[*17]** We have considered all of the arguments made by the parties and, to the extent they are not addressed herein, we find them to be moot, irrelevant, or without merit.

To reflect the foregoing, *Decision will be entered under Rule 155.*

1

Tax Court & Board of Tax Appeals Memorandum Decisions

Martha L. Albrecht v. Commissioner, T.C. Memo. 2022 -53 , Code Sec(s) 170.

MARTHA L. ALBRECHT, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 414]

Code Sec(s):	170
Docket:	Dkt. No. 13314-20.
Date Issued:	05/25/**2022**.
Judge:	Opinion by Greaves, *J.*
Tax Year(s):	Year 2014.
Disposition:	Decision for Commissioner.

HEADNOTE

1. Charitable contribution deductions—noncash donations—substantiation—contemporaneous written acknowledgment. Taxpayer's charitable deduction claims for donation of Native American jewelry and artifacts to museum were denied due to her failure to comply with CWA requirement under Code Sec. 170(f)(8) . Although taxpayer received gift deed from museum before filing return, [pg. 415] deed didn't specify whether museum provided any

goods or services in return for donation or state that it represented entire agreement between museum and taxpayer; rather, deed's terms were subject to separate/gift agreement, which wasn't provided to taxpayer before return was filed. Arguments that gift agreement was irrelevant to issue of whether museum provided goods or services in exchange for donation because its sole purpose was to describe donor's rights in donation, and/or that museum's failure to provide taxpayer with such agreement created presumption that all of her rights in donated property were included in donation, were unsupported. Also, CWA requirement couldn't be satisfied via substantial compliance.

Reference(s): ¶ 1705.50(10) Code Sec. 170

Syllabus

Counsel

Gregory W. MacNabb, for petitioner.

Alicia E. Elliott, for respondent.

GREAVES, *Judge*

MEMORANDUM OPINION

Section 170[1] permits taxpayers to deduct charitable contributions made during a taxable year, provided certain substantiation requirements are satisfied. The issue for decision is whether petitioner satisfied the requirements of section 170(f)(8)(B) for a charitable contribution she made during 2014 (year at issue).[2] For the reasons set forth below, we resolve this issue in favor of respondent.

[*2] Background

The parties submitted this case for decision without trial under Rule 122. Relevant facts have been stipulated or otherwise included in the record. *See* Rule 122(a). Petitioner resided in New Mexico when she filed the Petition.

Petitioner and her late husband acquired a large collection of Native American jewelry and artifacts during their marriage. On or around December 19, 2014, petitioner donated approximately 120 items from this collection (donation) to the Wheelwright Museum of the American Indian (Wheelwright Museum). In connection with the donation the Wheelwright Museum and petitioner executed a "Deed of Gift" (deed) dated December 19, 2014, that consisted of five pages. The first page stated that petitioner "hereby donates the material described below to the Wheelwright

Museum of the American Indian under the terms stated in the Conditions Governing Gifts to the Wheelwright Museum of the American Indian." Immediately under this clause was the heading "Description of Material: See Attached List." The first page also included the museum's logo, petitioner's address, and her donor identification number, as well as the signatures of petitioner and a museum official.

The second page of the deed was titled "Conditions Governing Gifts to the Wheelwright Museum of the American Indian" and specified conditions governing gifts to the museum. One of these conditions stipulated in relevant part that "the donation is unconditional and irrevocable; that all rights, titles and interests held by the donor in the property are included in the donation, unless otherwise stated in the Gift Agreement." The final three pages of the deed listed items of donated property. Despite "the Gift Agreement" reference on the second page of the deed, no such agreement was included with the deed, and the Wheelwright Museum did not provide petitioner with any further written documentation concerning the donation.

Petitioner electronically filed Form 1040, U.S. Individual Income Tax Return, for the year at issue in which she reported the donation on Schedule A, Itemized Deductions, and attached a copy of the deed to the return. Following an examination of petitioner's 2014 return, respondent timely issued petitioner a notice of deficiency disallowing the donation on the ground that the requirements of section 170 were not [pg. 416] met. Petitioner timely sought review in this Court.

[*3] Discussion

I. *Burden of Proof*

In general the Commissioner's determinations in a notice of deficiency are presumed correct, and the taxpayer bears the burden of proving that the determinations are in error.[3] Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 [12 AFTR 1456] (1933). In addition, the taxpayer bears the burden of proving entitlement to any deduction claimed. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 [69 AFTR 2d 92-694] (1992). Thus, a taxpayer claiming a deduction on a federal income tax return must demonstrate that the deduction is provided for by statute and must maintain records sufficient to enable the Commissioner to determine the correct tax liability. *See* § 6001; Hradesky v. Commissioner, 65 T.C. 87, 89–90 (1975), aff'd per curiam, 540 F.2d 821 [38 AFTR 2d 76-5935] (5th Cir. 1976); Treas. Reg. § 1.6001-1(a).

II. *Charitable Contributions*

A taxpayer may deduct charitable contributions made during the taxable year. § 170(a)(1). Such deductions are allowable only if the taxpayer satisfies specific statutory and regulatory substantiation requirements. *See* id.; Treas. Reg. § 1.170A-13. For any contribution of $250 or

more, section 170(f)(8)(A) requires that the taxpayer obtain from the donee organization, and maintain in his files, a "contemporaneous written acknowledgement" (CWA). The CWA must include (i) the amount of cash and a description (but not value) of any property other than cash contributed; (ii) whether the donee organization provided any goods or services in consideration, in whole or in part, for any such property; and (iii) a description and good faith estimate of the value of any such goods or services. § 170(f)(8)(B); 15 W. 17th St. LLC v. Commissioner, 147 T.C. 557, 563 (2016); Treas. Reg. § 1.170A-13(f)(2). Furthermore, the taxpayer must receive the CWA from the donee organization on or before the earlier of the date the taxpayer files his return or the due date for filing such return. Sec. 170(f)(8)(C).

A CWA is not required to take any particular form but the requirement that a CWA be obtained "is a strict one." 15 W. 17th St. LLC, 147 T.C. at 562; *see also* Izen v. Commissioner, 148 T.C. 71, 78 **[*4]** (2017) (noting that a deed of gift can serve as a de facto CWA). A taxpayer may not deduct the contribution if the donation acknowledgment fails to meet these strict demands. *See* 15 W. 17th St. LLC, 147 T.C. at 562 (emphasizing that the doctrine of substantial compliance does not apply for purposes of section 170(f)(8)); *see also* Addis v. Commissioner, 374 F.3d 881, 887 [94 AFTR 2d 2004-5134] (9th Cir. 2004) ("The deterrence value of...[a] total denial of a deduction [in the case of an improper CWA] comports with the effective administration of a self-assessment and self-reporting system."), aff'g 118 T.C. 528 (2002).

The parties do not dispute that petitioner received the deed from the Wheelwright Museum before filing her return; however, respondent contends that the deed does not comply with section 170(f)(8)(B) on the grounds that it did not specify whether the Wheelwright Museum provided any goods or services in return for the donation or state that it represented the entire agreement between the museum and petitioner. Specifically, respondent points out the reference in the deed to the "Gift Agreement" as creating ambiguity as to whether additional terms, including donee provision of goods or services, were part of the donation.

The deed does not state whether the Wheelwright Museum provided any goods or services with respect to the donation. Where a deed does not contain such an explicit statement, we have previously looked to the deed as a whole to determine whether the donee provided goods or services in return for the donation. *See, e.g.*, French v. Commissioner, T.C. Memo. 2016-53, at *10–12 [2016 RIA TC Memo ¶2016-053]; RP Golf, LLC v. Commissioner, T.C. Memo. 2012-282, at *10–11 [2012 RIA TC Memo ¶2012-282]; Averyt [pg. 417] v. Commissioner, T.C. Memo. 2012-198 [2012 RIA TC Memo ¶2012-198], slip op. at 12–13. Specifically, we have considered whether the deed (i) effectively states whether any goods or services were provided in the exchange; (ii) states the donation is an unconditional gift; (iii) recites no consideration received in the exchange; and (iv) contains a provision stating that the deed is the entire agreement of the parties. *See* French, T.C. Memo. 2016-53, at *10–12 [2016 RIA TC Memo ¶2016-053]; RP Golf, LLC, T.C.

Memo. 2012-282, at *10–11 [2012 RIA TC Memo ¶2012-282]; Averyt, T.C. Memo. 2012-198 [2012 RIA TC Memo ¶2012-198], slip op. at 12–13.

Although the deed in this case provides that the donation was "unconditional and irrevocable," it continues that "all rights, titles and interests held by the donor in the property are included in the donation, *unless otherwise stated in the Gift Agreement.*" (Emphasis added.) Thus, the terms of the deed were subject to a separate agreement, but the **[*5]** Wheelwright Museum did not provide petitioner with this document before the return was filed.[4]

Petitioner contends that the Gift Agreement is irrelevant to the issue of whether the Wheelwright Museum provided goods or services in exchange for the donation because the sole purpose of the Gift Agreement was to describe the extent to which petitioner retained certain rights, titles, or interests in the donation. Petitioner also insists that the Wheelwright Museum's failure to provide her with a Gift Agreement "indicates the presumption that all [of] [p]etitioner's right[s], title[s] and interest[s] in the donated property [are] included in the donation." We do not find these arguments persuasive when construing the plain text of the deed. By referencing another document that superseded the terms of the deed with respect to the donor's rights in the donation, the deed provided the donor with the ability to retain an interest in the donation, including under a potential quid pro quo arrangement.

Petitioner cited no authority for the proposition that a separate agreement referenced in a deed but unattached thereto creates a presumption that the deed alone satisfies section 170(f)(8). We are unwilling to create such a rule, especially when the deed did not indicate it constituted the entire agreement of the parties or that any prior discussions, negotiations, or understandings between them were merged into the deed. When looking exclusively at the deed and considering it as a whole, it leaves open a significant question about whether the parties had entered into a side agreement that included additional, superseding terms. *See* French, T.C. Memo. 2016-53, at *10–12 [2016 RIA TC Memo ¶2016-053] (refusing to uphold as a CWA a deed that, when analyzed as a whole, did not represent the entire agreement between the donee and donor).

We appreciate what appears to have been a good faith attempt by petitioner to substantially comply with the Code by executing the deed with the Wheelwright Museum. Substantial compliance, unfortunately for petitioner, does not satisfy the strict requirements of section 170(f)(8)(B). *See* 15 W. 17th St. LLC, 147 T.C. at 562. Thus, for the reasons given above, petitioner is not entitled to a charitable **[*6]** contribution deduction with respect to the donation as the deed does not satisfy these requirements.

To reflect the foregoing,

Decision will be entered under Rule 155.

---

[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C. (Code), in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Procedure.

[2] The parties submitted a Stipulation of Settled Issues whereby petitioner conceded a failure to report a taxable refund of state income taxes of $363 for the year at issue.

[3] The burden of proof may shift from the taxpayer to the Commissioner in certain circumstances under section 7491(a), but petitioner does not allege, nor does the evidence suggest, that the burden of proof should shift to respondent under section 7491(a) as to any issue of fact.

[4] The fact that the parties now agree that the Wheelwright Museum did not provide any consideration as part of the donation is of no consequence. In assessing whether a taxpayer has strictly complied with section 170(f)(8), the focus is exclusively on what the taxpayer obtained from the donee organization at the earlier of the time the return was filed or the filing due date, as discussed supra.

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Tax Court & Board of Tax Appeals Memorandum Decisions

Paul C. Caldwell v. Commissioner, T.C. Memo. 2022 -51 , Code Sec(s) 61; 104.

PAUL CHRISTOPHER CALDWELL, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 385]

Code Sec(s):	61; 104
Docket:	Dkt. No. 3333-19.
Date Issued:	05/18/**2022.**
Judge:	Opinion by Lauber, *J.*
Tax Year(s):	Year 2011.
Disposition:	Decision for Commissioner.

HEADNOTE

1. Unreported income—disability benefits—income exclusions—accident and health ins. plans. IRS's determination that communications co. account executive had unreported income from payments he received under 2 disability plans, for one of which co. paid all premiums directly and other of which was "buy-up plan" under which record showed he paid premiums with pre-tax

payroll deductions, was upheld: IRS established requisite evidentiary foundation with Form W-2 and ins. co.'s business records showing amounts paid to taxpayer; and he failed to effectively rebut same where making only unsupported arguments such as that documents regarding first plan were forged or that he had overpayment recoupment in later years regarding that plan which eliminated his taxable income in year at issue. Also, he didn't offer any credible evidence that he actually paid buy-up plan premiums with after-tax, vs pre-tax, dollars for Code Sec. 104(a)(3) pur[pg. 386] poses.

Reference(s): ¶ 615.047(5) ;¶ 1045.03(10) Code Sec. 61; Code Sec. 104

2. Failure to file returns penalties—burden of proof and production—reasonable cause. Failure to file returns penalty was upheld against communications co. account executive for year for which he received taxable disability benefits but for which IRS had no record of him filing return: IRS met its burden of production on penalty's applicability with account transcript showing no return was filed; and taxpayer failed to establish reasonable cause for same and instead just claimed he believed he filed return with assistance of volunteers at disability resource center, but offered no proof of same.

Reference(s): ¶ 66,515.14(10) ;¶ 74,915.03(15) Code Sec. 6651; Code Sec. 7491

3. Failure to pay tax shown due on returns penalties—burden of proof and production—reasonable cause. Failure to pay tax shown due on returns penalty was upheld against communications co. account executive for year for which he didn't file return despite receiving taxable disability income, but in respect to which IRS prepared return substitute showing amount due: IRS met its burden of production on penalty's applicability with proof of above plus account transcript showing taxpayer made no payments; and he failed to establish reasonable cause for same in that, although he claimed he struggled with depression and sleep and memory problems, he failed to show that these conditions prevented him from paying tax.

Reference(s): ¶ 66,515.14(15) ;¶ 74,915.03(20) Code Sec. 6651; Code Sec. 7491

Syllabus

Counsel

Shannon C. Fiedler and Brian C. McManus, for petitioner.

Christine A. Fukushima, Jeffrey A. Rodgers, and Katherine Holmes Ankeny, for respondent.

LAUBER, *Judge*

MEMORANDUM FINDINGS OF FACT AND OPINION

With respect to petitioner's Federal income tax for 2011, the Internal Revenue Service (IRS or respondent) determined a deficiency of $21,977 and additions to tax under sections 6651 and 6654.[1] After concessions by respondent,[2] the questions remaining for decision are whether petitioner (1) is required to include in gross income $88,391 of disability benefits received during 2011 and (2) is liable for additions to tax for failure to file and failure to pay. We rule for respondent on each point.

[*2] FINDINGS OF FACT

The following facts are derived from the parties' pleadings, the documents admitted into evidence at trial, the trial testimony, and the documents and information admitted into evidence pursuant to Rule 91(f). Petitioner resided in California when he petitioned this Court.

In 2007 petitioner began working for Sprint Nextel (Sprint or employer) as an account executive. He remained employed by Sprint during 2011 and at all relevant times. Through his employer he enrolled in two disability plans: the "Core Plan" (basic long-term disability, enrollment date March 21, 2008), and the "Buy-Up Plan" (supplemental long-term disability, enrollment date January 1, 2009). These plans provided for payments in the event petitioner was unable to perform the material duties of his job because of injury or illness.

An affiliate of United Healthcare (United) was the administrator of both plans when petitioner originally enrolled in them. In June 2010 or earlier, Aetna Life Insurance Co. (Aetna) replaced United as the administrator of both plans. Aetna was the administrator of both plans during 2011, and it made all of the disability payments at issue.

Under the Core Plan, Sprint paid all premiums directly without any contribution from petitioner. The normal monthly benefit payable under the Core Plan was 50% [pg. 387] of petitioner's monthly salary. For purposes of calculating this benefit, petitioner's annual salary was determined to be $123,300, or $10,275 monthly. The normal monthly benefit payable under the Core Plan was thus $5,137.50.

Under the Buy-Up Plan, petitioner paid all premiums himself through pre-tax payroll deductions from his Sprint wages. Aetna's documentation states that the Buy-Up Plan was "contributory, pre-tax" and that the "post-tax employee contribution" was 0%. The normal monthly benefit payable under the Buy-Up Plan was 15% of petitioner's monthly salary. For purposes of calculating this benefit, petitioner's annual salary was again determined to be $123,300, or $10,275 monthly. The normal monthly benefit payable under the Buy-Up Plan was thus $1,541.25.

Petitioner suffered a knee injury in 2009 and applied for long-term disability benefits in June 2010. After a period of review, Aetna approved, with retroactive effect to February 14, 2010, petitioner's claims for disability benefits under the Core Plan (claim No. 2888485) and the Buy-Up Plan (claim No. 3159492). Petitioner remained eligible **[*3]** for benefits under the Core Plan throughout 2011. On August 22, 2011, Aetna determined that he ceased to be eligible for benefits under the Buy-Up Plan.

Under the Core Plan, Aetna made monthly disability payments to petitioner throughout 2011. Aetna issued each payment by generating a physical check and mailing it to petitioner. Aetna's records show that petitioner cashed all 12 monthly checks.

For each of the first eight months of 2011, Aetna issued petitioner a check for $5,137.50, the usual monthly payment under the Core Plan. For September Aetna reduced his monthly payment by $462.38 to recoup an overpayment it had made to him under the Buy-Up Plan, which was terminated in August. For October Aetna reduced his monthly payment to $856.25 because of a temporary dispute about his continued eligibility. When that dispute was resolved in petitioner's favor, Aetna made a catch-up payment of $9,418.75 in November that restored petitioner to the status quo ante ($856.25 + $9,418.75 = $10,275 = 2 X $5,137.50). For December Aetna resumed the usual monthly payment of $5,137.50, yielding total monthly payments to petitioner of $61,187.62 under the Core Plan, as follows:

Check No.	Date Issued	Period	Amount
1778282	1/21/11	January	$ 5,137.50
1799088	2/18/11	February	5,137.50
1825876	3/29/11	March	5,137.50
1842805	4/21/11	April	5,137.50
1867223	5/20/11	May	5,137.50
1889329	6/21/11	June	5,137.50
1910883	7/21/11	July	5,137.50
1935279	8/19/11	August	5,137.50

1957882	9/21/11	September	4,675.12
1971100	10/13/11	October	856.25
2005107	11/21/11	November	9,418.75
2027845	12/21/11	December	5,137.50
Total			$61,187.62

Under the Buy-Up Plan, petitioner's normal monthly benefit was $1,541.25. Aetna made a large payment in February 2011 that included petitioner's January benefit [pg. 388] and payment in arrears for the period during 2010 for which he had been determined retroactively eligible. Aetna made the normal monthly payment for March through August 2011.

[*4] Having determined that petitioner's eligibility under the Buy-Up Plan ceased as of August 22, 2011, Aetna subsequently recouped $462.38 of the August payment by debiting that sum against his September payment under the Core Plan. *See* supra p. 3. Petitioner thus received during 2011 total payments of $27,204.07 under the Buy-Up Plan, as follows:

Check No.	Date Issued	Period	Amount
1791158	2/16/11	2/14/10-1/31/11	$16,415.32
1799089	2/18/11	2/1/11-2/28/11	1,541.25
1820377	3/29/11	3/1/11-3/31/11	1,541.25
1842806	4/21/11	4/1/11-4/30/11	1,541.25
1867224	5/20/11	5/1/11-5/31/11	1,541.25
1889330	6/21/11	6/1/11-6/30/11	1,541.25
1910884	7/21/11	7/1/11-7/31/11	1,541.25

1935280	8/19/11	8/1/11-8/31/11	1,541.25
Total			$27,204.07

Petitioner did not file a Federal income tax return for 2011. At trial he testified as to his recollection that he had filed a return with the assistance of volunteers at a disability resource center. But IRS records show that no return was filed, and petitioner could not produce a copy of a 2011 return or evidence that such a return had been filed, by mail or electronically. We did not find petitioner's testimony on this point reliable.

Having received no return from petitioner for 2011, the IRS prepared, on October 9, 2018, a substitute for return (SFR) on the basis of third-party reporting. The IRS received from Aetna Form W–2, Wage and Tax Statement, reporting that it had paid petitioner during 2011 "wages, tips, or other compensation" of $88,391.69. The IRS determined that these payments were includible in petitioner's gross income. Allowing him the standard deduction and one personal exemption, the IRS determined taxable income of $101,286 and a tax liability of $21,977. The SFR was properly certified by the appropriate IRS officer, and it met all the requirements of section 6020(b).

On December 10, 2018, the IRS sent petitioner a timely notice of deficiency, determining the deficiency set forth in the SFR and additions to tax under sections 6651(a)(1), (a)(2), and 6654. (Respondent has since conceded $22,395 of Social Security income included in the notice of deficiency and the section 6654 addition to tax. *See* supra note 2.) Petitioner timely petitioned this Court. In response to trial subpoenas, **[*5]** Aetna produced to petitioner and respondent 1,097 pages of documents, consisting of its entire claim file for petitioner. These documents, certified by an appropriate Aetna officer as authentic business records, were admitted into evidence at trial.

OPINION

A. *Burden of Proof*

The Commissioner's determinations in a notice of deficiency are generally presumed correct, and the taxpayer bears the burden of proving them erroneous. Rule 142(a); *see* Welch v. Helvering, 290 U.S. 111, 115 [12 AFTR 1456] (1933). In certain circumstances section 7491 may shift the burden of proof to the Commissioner. But that section applies only if the tax-payer (among other things) "introduces credible evidence" and "has maintained all records required under this title." § 7491(a)(1), (2)(B). Petitioner does not contend, and he could not plausibly contend, that he met these requirements.

B. *Unreported Income*

Section 61(a) provides that "gross income means all income from whatever source derived." In cases of unreported income, the Commissioner must establish an [pg. 389] evidentiary foundation connecting the taxpayer to the income-producing activity, Weimerskirch v. Commissioner, 596 F.2d 358, 361 [44 AFTR 2d 79-5072] (9th Cir. 1979), rev'g 67 T.C. 672 (1977), or demonstrate that the taxpayer actually received income, Edwards v. Commissioner, 680 F.2d 1268, 1270-71 [50 AFTR 2d 82-5390] (9th Cir. 1982). Once the Commissioner has met his threshold burden, the burden shifts to the taxpayer to show that the Commissioner's determinations are arbitrary or erroneous. *See* Hardy v. Commissioner, 181 F.3d 1002, 1004–05 [84 AFTR 2d 99-5015] (9th Cir. 1999), aff'g T.C. Memo. 1997-97 [1997 RIA TC Memo ¶97,097].

Information supplied to the IRS on a Form W–2 is sufficient to meet the Commissioner's initial burden. *See* id. at 1005. Respondent introduced into evidence a Form W–2 from Aetna reporting that it had paid petitioner $88,391.69 of "wages, tips, or other compensation" during 2011. Petitioner produced no evidence to establish a "reasonable dispute" with respect to the accuracy of this information. *See* § 6201(d). In any event respondent introduced certified business records of Aetna that connected petitioner to the unreported income. The burden thus shifts to petitioner to prove, by a preponderance of the evidence, that respondent's determination of unreported income is arbitrary or erroneous. *See* Hardy, 181 F.3d at 1004–05.

[*6] Respondent determined that petitioner during 2011 received unreported income of $88,391, the amount of disability benefits reported by Aetna. Petitioner concedes that disability benefits, as a replacement for wages, constitute taxable income unless the premiums therefor are paid with after-tax dollars. *See* § 104(a)(3); Tuka v. Commissioner, 120 T.C. 1, 4 (2003) ("[E]xemption of benefits depends on whether contributions...involve after-tax dollars."), aff'd, 85 F. App'x 875 [94 AFTR 2d 2004-5497] (3d Cir. 2003). At various points in this litigation petitioner has advanced numerous (often inconsistent) theories in contending that he received less income than Aetna reported. None of his theories has any plausibility, and none is sufficient to carry his burden of proof.

• Before, during, and after the tax year in issue, petitioner had repeated disagreements with Aetna about his disability coverage. At various points in this litigation he asserted that Aetna had embarked on a vendetta against him by creating records that were "completely bogus," a "forgery," "fraudulently created," and "not[] legit." He asserted at trial that the plans shown in Aetna's records "were bogus group plans." We did not find any of these assertions remotely credible. Aetna's complete claim file was admitted into evidence, supported by a proper certification of authenticity. Its records are thoroughly consistent in setting forth the types of payments made to petitioner and the amounts thereof.

• In his Petition, petitioner alleged that he "had overpayment recoupment from Aetna [during 2012–2018] which left [his] taxable income for tax year 2011 ZERO." He introduced no credible evidence

to this effect and abandoned this argument in his Post-Trial Brief. In any event, post-2011 reductions in benefits would not eliminate taxable income that petitioner in fact received during 2011. *See* Treas. Reg. § 1.451-1(a); *see also* N. Life Ins. Co. v. United States, 685 F.2d 277, 278 [50 AFTR 2d 82-5757] (9th Cir. 1982) ("Income accrues when the right to receive it becomes fixed...even if later events may require the recipient to repay it.").

• In his Pretrial Memorandum petitioner asserted that his claim under the Core Plan was terminated on June 1, 2011, that it was never reinstated, and that he was taxable only on five monthly disability payments of $1,541.25 allegedly received under the Core Plan. The evidence contradicted these assertions. Aetna's records show that petitioner's monthly benefit under the Core Plan was $5,137.50; payments of $1,541.25 were made under the Buy-Up Plan, which supplemented the Core Plan, and petitioner's assertion that Aetna malevolently "switched the plans [around]" was not credible. [pg. 390]

[*7] Aetna's records likewise show that it made payments to petitioner under the Core Plan throughout 2011. There was a brief hiatus in October, when his payment was reduced to $856.25 because of an eligibility dispute. But Aetna quickly resolved that dispute in his favor and made a catch-up payment of $9,418.75 in November. For the entire year Aetna issued checks to petitioner under the Core Plan totaling $61,187.62—the equivalent of $5,137.50 per month, minus $462.38 recouped from the September payment on account of the August overpayment under the Buy-Up Plan. Aetna's records show that petitioner cashed each monthly check. Sprint paid all premiums for the Core Plan, and the benefits petitioner received under it were thus taxable in full. *See* Tuka, 120 T.C. at 3–4; Connors v. Commissioner, T.C. Memo. 2006-239 [2006 RIA TC Memo ¶2006-239], 92 T.C.M. (CCH) 404, 408, aff'd, 277 F. App'x 122 [101 AFTR 2d 2008-2230] (2d Cir. 2008).[3]

• Petitioner paid the premiums on the Buy-Up Plan, and these amounts were withheld from his paychecks. But he errs in asserting that the Buy-Up Plan was "pre-taxed and not subject to Federal or State taxes." Petitioner supplied no credible evidence that he paid premiums for the Buy-Up Plan with after-tax dollars. Aetna's records repeatedly and consistently state that the Buy-Up Plan was "contributory, pre-tax" and that the "post-tax employee contribution" was 0%.

• Petitioner asserts that he never received the Buy-Up Plan payment issued in February 2011, which included payment in arrears for 2010. We did not find his testimony on this point credible. Aetna's records show that on February 16, 2011, it issued him check No. 1791158 for $16,415.32, and that he cashed this check.

In sum, the Form W–2 that Aetna issued to petitioner, as well as the company's voluminous business records, show that it paid him $88,391 of disability benefits during 2011. Petitioner concedes that Aetna paid all premiums under the Core Plan. Aetna's records show that petitioner paid premiums under the Buy-Up Plan with pre-tax dollars, and he submitted no credible evidence

to the contrary. He is therefore taxable on all benefits received, and he did not carry his burden of **[*8]** proving that the amount of these payments was less than $88,391, as determined in the notice of deficiency. That amount is thus includible in his gross income.[4]

C. *Additions to Tax*

1. *Failure to File*

Section 6651(a)(1) provides for an addition to tax of 5% of the tax required to be shown on the return for each month or fraction thereof for which there is a failure to file the return, not to exceed 25% in toto. Respondent contends that petitioner is liable for an addition to tax (reduced as discussed supra note 2). Respondent has the burden of production on this point. *See* § 7491(c).

Petitioner's return for 2011 was due on April 17, 2012. *See*§§ 6072(a), 7503. Respondent has produced a certified transcript of petitioner's account for 2011 showing that no return was filed. This was sufficient to satisfy respondent's burden of production. *See* Catlett v. Commissioner, T.C. Memo. 2021-102 [2021 RIA TC Memo ¶2021-102], 122 T.C.M. (CCH) 147, 152.

At trial petitioner testified as to his recollection that he had filed a return for 2011 with the assistance of volunteers at a disability resource center. But IRS records show that no return was filed, and petitioner produced neither a copy of a 2011 return nor any evidence that such a return had been filed, by mail or electronically. Nor did he produce any documents or testimony from the people who allegedly helped him prepare the return. We did not [pg. 391] find petitioner's testimony credible, and we find that he failed to file a return for 2011.

No addition to tax will apply if the taxpayer shows that his failure to file was "due to reasonable cause and not due to willful neglect." § 6651(a)(1). Petitioner supplied no evidence seeking to establish reasonable cause for failure to file. Rather, his testimony was that he did file a return, but we found that testimony unsupported by any **[*9]** objective evidence. We will thus sustain an addition to tax for failure to file.

2. *Failure to Pay*

Section 6651(a)(2) provides for an addition to tax when a taxpayer fails to pay timely the tax shown on a return. To meet his burden of production under section 7491(c) with respect to the section 6651(a)(2) addition to tax, respondent must provide evidence of a tax return. *See* Wheeler v. Commissioner, 127 T.C. 200, 208–11 (2006), aff'd, 521 F.3d 1289 [101 AFTR 2d 2008-1696] (10th Cir. 2008). An SFR that meets the requirements of section 6020(b) is treated as the "return" filed by the taxpayer for this purpose. *See* § 6651(g)(2).

The IRS determined an addition to tax under section 6651(a)(2). Respondent has met his burden of production by producing a certified copy of the SFR that the IRS prepared on petitioner's behalf for 2011. Petitioner's account transcripts show that he has made no payments toward his 2011 tax liability. Respondent has thus satisfied his threshold burden. *See* Catlett, 122 T.C.M. (CCH) at 152.

No addition to tax will apply if the taxpayer shows that his failure to pay was "due to reasonable cause and not due to willful neglect." § 6651(a)(2). At trial petitioner produced no evidence, in the form of testimony or documents, to show that he had "reasonable cause" for failure to pay his 2011 tax. Although he was receiving long-term disability benefits because of a knee injury, he did not contend that his knee injury prevented him from filing a return or paying his tax. On Post-Trial Brief he asserted that he also suffered from depression, had trouble sleeping and concentrating, and "struggled with memory problems" at various times. But he offered no testimony at trial to establish that he suffered from these conditions or that these (or any other) conditions prevented him from timely paying his tax. We will thus sustain an addition to tax for failure to pay.

To implement the foregoing, and in the light of respondent's concessions,

Decision will be entered under Rule 155.

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Procedure.

[2] Respondent concedes that petitioner during 2011 did not receive taxable Social Security benefits of $22,395 and is not liable for an addition to tax under section 6654.

[3] At trial petitioner noted that Aetna in 2012 issued him a check for $30,825 and asserted that this corresponded to six months of "missing payments" that he allegedly did not receive during 2011 after Aetna supposedly terminated the Core Plan on June 1 of that year. There is no evidence that Aetna terminated the Core Plan in 2011; petitioner's trial testimony showed that he was confusing the Core Plan with Aetna's termination of the Buy-Up Plan in August 2011. As indicated in the text, Aetna's records consistently show that it made payments to him under the Core Plan for every month in 2011.

[4] In his Post-Trial Brief petitioner contends that "respondent did not enter into evidence any bank records establishing that the alleged [disability] payments were actually paid or received" and that petitioner "did not constructively receive any other checks in 2011." Contrary to petitioner's view, it was his burden to establish that respondent's determination of unreported

income was "arbitrary or erroneous," Hardy, 181 F.3d at 1004–05, not respondent's burden to disprove the existence of the income reported on the Form W–2. And since we find that petitioner actually received $88,391 of disability benefits during 2011, his arguments about constructive receipt are beside the point.

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Tax Court & Board of Tax Appeals Memorandum Decisions

Michael J. Rogerson v. Commissioner, T.C. Memo. 2022 -49 , Code Sec(s) 469.

MICHAEL J. ROGERSON, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 360]

Code Sec(s):	469
Docket:	Dkt. No. 5848-20.
Date Issued:	05/12/**2022**.
Judge:	Opinion by Toro, *J.*
Tax Year(s):	Years 2014, 2015, 2016.
Disposition:	Decision for Taxpayer in part and for Commissioner in part.

HEADNOTE

1. Passive activity losses—material participation—nonpassive income and passive losses—aerospace business and yacht rentals—proof. Taxpayer/entrepreneur, who ran aerospace business activity through various entities and who was also boating enthusiast with yachts he

intended to charter, wasn't entitled to offset aerospace activity income with losses from yacht chartering activity where yacht chartering was per se passive rental activity, whereas aerospace activity was nonpassive activity in which he materially participated under Reg § 1.469-5(j)(1) 's 5-of-10 test. Taxpayer's arguments that 5-of-10 test wasn't properly at issue or that reg was substantively invalid because it contradicted Code Sec. 469 were meritless. Alternate argument that reg was procedurally invalid because it didn't comply with APA was also unavailing in that, even putting reg aside, taxpayer's involvement in aerospace activities still clearly qualified as material participation under Code Sec. 469(h) 's regular-continuous-substantial test when considering his role as CEO and that he was involved in all aspects of aerospace business, from accounting and finance to sales and customer relations.

Reference(s): ¶ 4695.06(10) ;¶ 4695.30(37) Code Sec. 469

2. Accuracy-related negligence or substantial understatement penalties—burden of proof and production—reasonable cause; good faith—reliance on professional. Accuracy-related negligence or substantial understatement penalties weren't upheld against taxpayer/entrepreneur for years for which he improperly attempted to offset passive activity losses from yacht rental activity with non-passive income from his aerospace business: taxpayer showed reasonable and good faith reliance on longtime CPA, who had sufficient expertise to justify reliance, to whom taxpayer provided all relevant information, and from whom taxpayer actually received advice regarding underlying issues. Although taxpayer was sophisticated business professional, such didn't negate or preclude his reliance on CPA to advise him on technical tax matters and prepare his returns.

Reference(s): ¶ 66,625.01(45) Code Sec. 6662; Code Sec. 7491

Syllabus

Between 2005 and 2013, P was the president and 100% owner of S1, an S corporation engaged (directly or through wholly owned entities) in manufacturing aircraft parts and components (aerospace business). S1 and its wholly owned entities had multiple product lines, some of which involved digital products and some of which involved analog products.

In 2014, P began reorganizing the aerospace business to separate the digital products, analog products, and corporate [pg. 361] functions. Following the reorganization, P owned the business directly through three S corporations: S1 (digital products), S2 (analog products), and S3 (corporate functions), each of which filed its own tax return.

In addition to the aerospace business, P owned two yachts that he intended to charter. However, P did not charter the yachts during the years at issue.

Each year, from at least 2005 to 2013, S1 filed Form 1120S, U.S. Income Tax Return for an S Corporation, reflecting all the results of the aerospace business that it and its wholly owned entities conducted. For these years, S1's returns did not separate out the various activities of **[*2]** the aerospace business for purposes of the rules under I.R.C. § 469.

On his personal income tax returns for 2005 to 2013, P reported his involvement in S1's overall aerospace business as nonpassive for purposes of I.R.C. § 469. But on his 2014, 2015, and 2016 tax returns, P reported his involvement in S2 as passive and his involvement in the remaining portion of the aerospace business (in S1 for 2014 and in S1 and S3 for 2015 and 2016) as nonpassive. He also reported his involvement in his yacht activities as nonpassive for 2014, 2015, and 2016.

R issued a notice of deficiency for tax years 2014, 2015, and 2016, determining among other things that P materially participated in S2 and therefore was required to treat income from S2 as nonpassive for the years at issue. The notice further determined that P's yacht activities were passive rental activities and that P was liable for accuracy-related penalties under I.R.C. § 6662(a).

P challenges R's notice, arguing among other things that (1) P did not materially participate in S2 during the years at issue, (2) R's reliance on the test for material participation set out in Temp. Treas. Reg. § 1.469-5T(a)(5) is a new matter not pleaded by R, (3) Temp. Treas. Reg. § 1.469-5T(a)(5) is procedurally and substantively invalid, (4) P's yacht activities qualify as nonpassive based on the rental exceptions of Temp. Treas. Reg. § 1.469-1T(e)(3)(ii), and (5) the accuracy-related penalties should not apply because P had reasonable cause and acted in good faith with respect to any underpayment.

Held: Under Temp. Treas. Reg. § 1.469-5T(a)(5) and Treas. Reg. § 1.469-5(j)(1), P materially participated in S2 during 2014, 2015, and 2016 because he materially participated in S1's overall business of manufacturing aircraft parts and components for at least five of the ten immediately preceding years.

Held, further, P's contention that R's reliance on Temp. Treas. Reg. § 1.469-5T(a)(5) is a new matter not pleaded by R is rejected.

[*3] *Held, further,* P's arguments regarding the substantive validity of Temp. Treas. Reg. § 1.469-5T(a)(5) fail because the regulation is not contrary to I.R.C. § 469.

Held, further, we need not address P's argument that Temp. Treas. Reg. § 1.469-5T(a)(5) is procedurally invalid because, even assuming for the sake of argument that P's argument is correct, P would not prevail under the text of I.R.C. § 469.

Held, further, P's yacht activities are rental activities that do not qualify for the exceptions described in Temp. Treas. Reg. § 1.469-1T(e)(3)(ii).

Held, further, the accuracy-related penalties under I.R.C. § 6662(a) do not apply because P had reasonable cause and acted in good faith with respect to his underpayments of tax.

Counsel

Steven R. Mather, for petitioner.

Monica D. Polo and Samuel M. Warren, for respondent.

TORO, *Judge*

[pg. 362]

MEMORANDUM FINDINGS OF FACT AND OPINION

This deficiency case calls on us to apply the passive activity loss rules of section 469.[1] Enacted by Congress as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a), 100 Stat. 2085, 2233, the rules limit a taxpayer's use of losses generated by passive activities to offset unrelated income generated by nonpassive activities.

Petitioner Michael Rogerson is a successful entrepreneur. A patent holder and certified commercial pilot, Mr. Rogerson has owned and led an eponymous group of companies in the aerospace industry **[*4]** since the late 1970s. Also a sailing and boating enthusiast, during the tax years 2014, 2015, and 2016, Mr. Rogerson owned two yachts that he intended to charter.

The issues for our decision relate to the federal income tax consequences of Mr. Rogerson's participation in these two endeavors. Specifically, we must decide three questions: (1) whether, for the tax years 2014, 2015, and 2016, Mr. Rogerson materially participated in certain of his aerospace activities, with the result that income from those activities must be treated as nonpassive (we conclude he did); (2) whether Mr. Rogerson's yacht activities during the same years were per se passive as rental activities (we conclude they were); and (3) whether Mr. Rogerson is liable for accuracy-related penalties on the underpayments of tax resulting from our first two holdings (we conclude he is not).

As we explain in greater detail below, in light of the answers to the first two questions, Mr. Rogerson may not offset losses resulting from his passive yacht activities against income from his nonpassive aerospace activities. He is not liable for the accuracy-related penalties the Commissioner determined, however, because Mr. Rogerson had reasonable cause and relied in

good faith on his certified public accountant in connection with the preparation of the returns at issue.

FINDINGS OF FACT

The parties have filed First and Second Stipulations of Fact, both with attached exhibits, and a Stipulation of Settled Issues, all of which are incorporated by this reference. Trial of this case was held remotely on May 5 and 6, 2021. Mr. Rogerson resided in Nevada when he filed his petition.

I. *Aerospace Activities*

A. *Establishment of the Rogerson Companies*

In the late 1970s, Mr. Rogerson had a summer job in the aerospace industry. When an acquaintance called to ask for help finding a new part, Mr. Rogerson decided that he would build the part himself. He engaged an engineer to design the part and a manufacturer to build it, and soon established his first company: Rogerson Aircraft Controls, Inc. The company manufactured electromechanical products and eventually changed its name to Rogerson Aircraft Corporation (RAC), which still operates today.

[*5] Over the next 40 years, Mr. Rogerson grew his business by acquiring and developing new product lines, all of which were held directly or indirectly by RAC. Business operations were located in California, in Irvine and Pasadena. Mr. Rogerson served as the chief executive officer of RAC and its subsidiaries at all times, personally held patents used in certain product lines, and obtained his commercial pilot's license to better understand the industry. By the end of 2013, the Rogerson companies included the following units, which Mr. Rogerson referred to as "brands": [pg. 363]

Name of Unit	Product Line	Location of Operations	Product Type	Owned Since at Least 2005?
Rogerson Aircraft Controls (Controls)	Controls systems	Irvine	Analog	Yes
Rogerson Aircraft	Lavatory	Irvine	Analog	Yes

Systems (Systems)	systems			
Rogerson ATS	Auxiliary fuel systems	Irvine	Analog	Yes
Kratos Pressure Products (Pressure)	Pressure gauges	Irvine	Analog	Yes
Kratos Instruments	Analog instruments	Pasadena	Analog	Yes
Rogerson Kratos	Digital flat panel displays	Pasadena	Digital	Yes
InTheAirNet (ITAN)	Passenger entertainment systems	Irvine	Digital	Yes

B. *2014 Reorganization*

By 2014, Mr. Rogerson was making an effort to separate the Rogerson companies' product lines based on whether they included legacy analog products or contemporary digital products. With the exception of analog instruments made by Kratos Instruments, the analog product lines were located together at RAC's facilities in Irvine.

[*6] During 2014, Mr. Rogerson gave further consideration to the organization of the Rogerson companies. In his view, the digital products of Rogerson Kratos were different from the analog products made by Kratos Instruments. Additionally, Mr. Rogerson had spoken with attorneys about estate planning and thought that "there was really no way the businesses would keep operating ... after [his] demise." Accordingly, Mr. Rogerson wanted to reorganize the Rogerson companies.

In 2014, Mr. Rogerson decided that Kratos Instruments' operations should be moved from Pasadena to Irvine. He further decided to reorganize the Rogerson companies' legal structure: While all product lines had previously been owned directly or indirectly by RAC, Mr. Rogerson determined that the digital and the analog product lines would be divided and held (directly or indirectly) by two separate legal entities, each of which Mr. Rogerson would own directly.

Mr. Rogerson's plans were implemented in 2014 and 2015. First, RAC transferred all its interests in the analog product lines (including interests in legal entities that manufactured analog products) to Rogerson ATS, a corporation wholly owned by RAC, effective January 1, 2014.[2] RAC then transferred 100% of the stock of Rogerson ATS to Mr. Rogerson, also effective January 1, 2014. Kratos Instruments' employees, inventory, and equipment were physically moved from Pasadena to Irvine during the second half of 2014, and the move was nearly complete by January 2015. Rogerson ATS changed its name to Rogerson Aircraft Equipment Group (RAEG), effective November 5, 2014. Finally, effective January 1, 2015, RAC transferred to Mr. Rogerson 100% of the [pg. 364] stock of Rogerson Corporation (RC), a management company that provided services to the other Rogerson companies.[3]

After the 2014 reorganization was completed, Mr. Rogerson held his aerospace business through three corporations: RAC, RAEG, and RC. RAC (directly or indirectly) owned Rogerson Kratos and ITAN and was primarily engaged in manufacturing and selling digital products. **[*7]** RAEG (directly or indirectly) owned Controls, Systems, Pressure, and Kratos Instruments and was engaged in manufacturing and selling analog products.[4] RC employed the executive team and provided finance, legal, human resources, sales, and other support to RAC and RAEG.

C. *Management of RAEG*

Before and after the 2014 reorganization, the operations of RAEG's business units remained generally the same. With the exception of the physical relocation of Kratos Instruments to Irvine, the units manufactured the same products in the same locations and sold those products to the same customers. Indeed, at least some major customers were unaware of the reorganization as late as 2016. A small number of employees who declined to move with Kratos Instruments to Irvine were terminated, but otherwise staffing generally remained the same. And Mr. Rogerson continued to oversee the business as a whole.

Mr. Rogerson remained the CEO of RAC, RAEG, and RC from the time of their incorporation through the years at issue. While other company employees, including a small number of executives, ran the day-to-day operations of each corporation, Mr. Rogerson was actively engaged with them all, including RAEG, in particular by monitoring operations and production, communicating with management on employment issues, and taking a hands-on approach to sales and customer relations.

With respect to RAEG specifically, Mr. Rogerson received regular reports on the company's results, attended meetings to discuss the results, and took action when they fell below expectations.[5] He ordered the Kratos Instruments move from Pasadena to Irvine and oversaw its progress, including setting the timeline, making decisions with respect to staffing matters, and deciding on the wording of materials explaining the move to employees and customers. As one

company executive put it **[*8]** when discussing the phrasing of an employee offer letter: "Michael gets the last word." Mr. Rogerson directed executives as to which engineers within the Rogerson companies could work on Kratos Instruments projects. He approved capital expenditures and provided input on accounting issues. He also was involved in the refurbishment of the Irvine facilities to accommodate the Kratos Instruments move.

On employment matters, Mr. Rogerson hired and fired executives, set department budgets, and weighed in on staffing at all levels of the company. During the years at issue, he was asked to approve all bonuses and even an hourly rate increase of $0.50. Generally, not even the president of RAEG was authorized to increase salaries or provide bonuses to RAEG employees—those decisions were made by Mr. Rogerson.

Consistent with his authority over staffing matters, Mr. Rogerson knew employees by their first names, communicated with them directly, and weighed in on how and when they should be replaced. When one employee was out on medical leave, Mr. Rogerson directed that his replacement should be hired from outside the company rather than promoted from within, citing "mid management depth" that was "too thin." Mr. Rogerson alerted executives when he felt certain employees were not pulling their weight, noting in one instance that an engineer "did not carry his own load during the [Kratos Instruments] move" and that Mr. Rogerson "[did not] see rewarding him by having [another engineer] doing his job now." [pg. 365]

During this period, Mr. Rogerson was perhaps most extensively involved in sales and customer relations. On multiple occasions, he personally met with RAEG customers and potential customers and participated in customer negotiations. He traveled to visit customers, including internationally, and also hosted customers at RAEG's offices.[6] He drafted press releases, received reports on customer visits that he did not attend, and got personally involved when disputes with customers arose. More than once, Mr. Rogerson told RAEG executives that he would resolve a problem by meeting personally with the customer involved. And customers sometimes reached out directly to Mr. Rogerson with complaints. His approval was required for any bid **[*9]** provided to a customer with an aggregate value over $100,000; in one month in 2016, that approval was requested at least a dozen times.

As part of his activities, Mr. Rogerson discussed RAEG with company executives, both in person and on the phone. During the years at issue, he communicated with RC and RAEG executives regarding RAEG's finances, its operations, the Kratos Instruments move, and the potential sale of the company. The RAEG president and the Rogerson companies' chief financial officer, together or separately, spent at least 10 to 15 hours per month with Mr. Rogerson on RAEG financial and operational matters. Mr. Rogerson also communicated with those individuals and others via email, including on weekends and holidays.

In short, Mr. Rogerson was an actively engaged CEO throughout the years at issue. And his level of involvement in RAEG in particular and in the Rogerson companies more generally during those years was substantially the same as it was during the years preceding the 2014 reorganization.

II. *Mr. Rogerson's Yachts*

In addition to being interested in aviation, Mr. Rogerson was a sailing enthusiast from an early age. He eventually developed an interest in powerboats, and during the years at issue he owned two yachts—the TOTO and the Falcon Lair—that he intended to make available for charter.

A. *The* TOTO

Mr. Rogerson purchased the TOTO, a 1983 Palmer Johnson 110-foot cutter, in or around 1999.[7] In 2014, 2015, and 2016, Mr. Rogerson kept the TOTO at a marina in Fort Lauderdale, Florida. Insurance policies that covered the TOTO for the period May 22, 2015, to May 22, 2017, permitted charters for a maximum of 12 weeks each year.[8] The TOTO was not commercially registered from 2014 to 2016 and was not available for charter during those years.

[*10] The TOTO was managed by a four-person crew, including a captain, a deckhand, a stewardess, and an individual that would help with the engine room and serve as a deckhand when needed. Because the TOTO was not chartered, the crew did not provide services to any customers during 2014, 2015, an d 2016. For at least a portion of those years, the TOTO was in a shipyard for repairs.

B. *The* Falcon Lair

In 2014, Mr. Rogerson purchased the Falcon Lair, a 225-foot vessel built in 1983.[9] The yacht underwent a major refit during 2014 and early 2015 before being relaunched during the summer of 2015. During 2014, 2015, and 2016, the Falcon Lair was held at various marinas in Europe. Insurance policies covering the Falcon Lair for the periods May 27, 2014, to May 27, 2015, and July 15, 2016, to July 14, 2017, prohibited charters unless ap[pg. 366] proved by the insurer in advance in writing, or else prohibited charters outright.[10]

Like the TOTO, the Falcon Lair was not commercially registered during 2014, 2015, and 2016, nor was it chartered. Nevertheless, Mr. Rogerson engaged a management company to manage the Falcon Lair. The management company was responsible for arranging the Falcon Lair's trips from harbor to harbor, including by provisioning the yacht with fuel and food.

The Falcon Lair initially was operated by a 12-person crew, but that number dropped to 8 or 9 while the yacht was in the shipyard for refurbishment. Because the Falcon Lair was not chartered,

the crew did not provide services to any customers during 2014, 2015, and 2016. When the Falcon Lair was not in the shipyard for repairs or **[*11]** refurbishment, Mr. Rogerson and his family sometimes used the yacht for personal trips.

III. *Tax Reporting*

A. *Tax Preparation*

From 2002 through the years at issue, Mr. Rogerson's personal income tax returns and the tax returns of the Rogerson companies were prepared by Tony Chang, a certified public accountant and tax professional.

Mr. Chang worked for one major accounting firm from 1994 to 1996 and for a second major accounting firm from 1996 to 2002. He then opened his own boutique practice with a partner. Mr. Rogerson and his companies had been clients of the second major accounting firm and continued to use Mr. Chang and his partner after they opened their boutique practice.

By 2014, Mr. Chang had been preparing Mr. Rogerson's personal income tax returns and the tax returns of the Rogerson companies for at least 12 years. He was familiar with the various entities in the corporate structure and the mechanics of the 2014 reorganization. He also was familiar with Mr. Rogerson's yacht activities. For each year from 2014 to 2016, Mr. Chang considered the application of the passive loss rules to Mr. Rogerson's activities and provided advice to Mr. Rogerson about how the activities should be reported on his personal income tax returns. As part of Mr. Chang's analysis, he collected information from Mr. Rogerson and other executives at the Rogerson companies, generally by having informal discussions with those individuals rather than requesting documentation. For each of the years at issue, Mr. Rogerson reported his activities consistent with Mr. Chang's advice.

B. *Aerospace Activities*

From at least 2005 to 2013, RAC filed Form 1120S, U.S. Income Tax Return for an S Corporation, reflecting all the results of Mr. Rogerson's aerospace business. For these years, no effort was made on the RAC returns to separate out the various activities of the Rogerson companies for purposes of the passive activity loss rules of section 469. In his personal income tax returns, Mr. Rogerson reported his involvement in RAC's combined activity as nonpassive.

[*12] Starting in 2014, RAC and RAEG each filed separate Forms 1120S. In his personal income tax returns for 2014, 2015, and 2016, Mr. Rogerson reported his involvement in RAC as nonpassive and his involvement in RAEG as passive. Based on Schedules K-1, Shareholder's Share of Income, Deductions, Credits, etc., issued by RAC, Mr. Rogerson reported a loss of

$3,926,922 for 2014, income of $163,814 for 2015, and a loss of $2,855,771 for 2016. For the same years, he reported income of $7,093,760, $3,238,454, and $4,762,543 based on Schedules K-1 issued to him by RAEG.

RC filed a separate Form 1120S starting in 2015, and Mr. Rogerson reported his involvement in RC as nonpassive. For the taxable years 2015 and 2016, Mr. Rogerson reported ordinary income of $391,615 and $380,027, respectively, based on Schedules K-1 issued by RC.

C. *Yacht Activities*

In his 2014 personal income tax return, Mr. Rogerson sought to apply a passive loss carryforward of $3,409,986 related to his pre-2014 TOTO activity to offset the [pg. 367] passive income that he reported from RAEG.[11] For 2014, 2015, and 2016, however, Mr. Rogerson reported his involvement in both the TOTO and the Falcon Lair as nonpassive. With respect to the TOTO, Mr. Rogerson claimed losses of $1,110,387, $583,165, and $818,841 in 2014, 2015, and 2016, respectively. With respect to the Falcon Lair, he claimed losses of $2,009,554, $4,993,719, and $5,028,440 during the same years.[12]

IV. *Examination and Notice of Deficiency*

Revenue Agent Amanda Dougherty conducted an examination of Mr. Rogerson's tax returns for 2014, 2015 and 2016.[13] As part of the examination, Ms. Dougherty considered whether Mr. Rogerson properly characterized his aerospace and yacht activities as passive and nonpassive and ultimately determined that he did not.

[*13] Near the conclusion of the examination, Ms. Dougherty mailed Mr. Rogerson a Letter 5153, dated March 20, 2018, with an attached examination report proposing, among other adjustments, an accuracy-related penalty under section 6662(a) for each tax year at issue. The letter was the first written communication sent to Mr. Rogerson regarding the penalties under section 6662(a) and was mailed before Ms. Dougherty had secured supervisory approval of the penalty assertion from her supervisor, Acting Group Manager Mayank Patel. When Mr. Rogerson failed to respond to the letter, Mr. Patel sent to Mr. Rogerson a signed "30-day letter" (Letter 950) on April 11, 2018, which again asserted the penalties under section 6662(a) and offered Mr. Rogerson the option to appeal. Additionally, on April 5, 2018, Ms. Dougherty prepared Form 300, Civil Penalty Approval Form. Mr. Patel signed the Civil Penalty Approval Form on June 25, 2018.

Mr. Rogerson appealed his case to the Internal Revenue Service Office of Appeals (IRS Appeals),[14] but was unable to reach a resolution with that office. On March 17, 2020, the Commissioner issued to Mr. Rogerson a notice of deficiency that recharacterized his activity with respect to RAEG as nonpassive and with respect to the yachts as passive.[15] Regarding RAEG, the notice

stated, among other things, that Mr. Rogerson "materially participated in RAEG" and therefore that "the income should be treated as non-passive income." The notice determined deficiencies in Mr. Rogerson's federal income tax of $2,136,552, $1,884,960, and $1,558,158, plus accuracy-related penalties of $427,310, $376,992, and $311,632, for 2014, 2015, and 2016, respectively. Mr. Rogerson timely petitioned the Court seeking a redetermination of the deficiencies and penalties.

[*14] OPINION

I. *Burden of Proof*

In general, the Commissioner's determinations set forth in a notice of deficiency are presumed to be correct, and the taxpayer bears the burden of showing that those determinations are in error. Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 [12 AFTR 1456] (1933). But the Commissioner bears the burden of proof with respect to any "new matter" he raises. *See* Rule 142(a). Where relevant, we discuss burden of proof in the individual issue sections below.[16]

II. *Section 469 Issues*

Individual taxpayers may generally deduct, under sections 162 and 212 respec[pg. 368] tively, ordinary and necessary expenses paid or incurred in carrying on a trade or business or for the production of income. But the Code disallows any current deduction for a "passive activity" loss. I.R.C. § 469(a)(1), (b). A passive activity loss is the amount (if any) by which the aggregate losses from the taxpayer's passive activities for a taxable year exceed the aggregate income from passive activities for that year. I.R.C. § 469(d)(1). Thus, under the Code, passive losses cannot be used to offset income from nonpassive activities. *See* Beecher v. Commissioner, 481 F.3d 717, 721 [99 AFTR 2d 2007-1807] (9th Cir. 2007), aff'g Cal Interiors Inc. v. Commissioner, T.C. Memo. 2004-99 [2004 RIA TC Memo ¶2004-099]. A disallowed passive activity loss is not lost; rather, it is deferred or suspended and remains available as a deduction against future passive income. I.R.C. § 469(b).

In light of these rules, a great deal turns on whether an activity is passive or nonpassive under section 469. We therefore provide a brief discussion of how one makes that determination and then apply the relevant principles to Mr. Rogerson's case.

A. *Passive Activities*

A passive activity generally is an activity involving the conduct of a trade or business in which the taxpayer does not materially **[*15]** participate. I.R.C. § 469(c)(1). Moreover, subject to certain exceptions not relevant here, rental activities are passive regardless of whether the taxpayer materially participates. *See* I.R.C. § 469(c)(2), (4), (7).

B. *Material Participation*

A taxpayer's participation in an activity is "material" only if his involvement in the operations of the activity is regular, continuous, and substantial. I.R.C. § 469(h)(1). Temporary regulations first issue in 1988 provide seven tests for determining when this standard is satisfied. *See* Temp. Treas. Reg. § 1.469-5T(a) (stating that an individual will be treated as materially participating in an activity "if and only if" one of the seven tests is satisfied). Because, as explained below, we can resolve Mr. Rogerson's case based on one of the regulatory tests (the "five of ten" test), we do not discuss the remaining ones.

1. *The Five of Ten Test*

For purposes of section 469(h)(1), a taxpayer is treated as materially participating in an activity if he materially participated in the activity for any five out of the ten years immediately preceding the taxable year. Temp. Treas. Reg. § 1.469-5T(a)(5). The preamble to the temporary regulations adopting the test explained its purpose as follows:

> These rules are included because the Service believes that an activity in which an individual has materially participated over a long period of time...is likely to represent the individual's principal livelihood rather than a passive investment. In particular, the Service does not believe that withdrawal from a longstanding active business ... should convert an individual's earnings from the business to passive income.

T.D. 8175, 1988-1 C.B. 191, 203.

By its terms, the five of ten test applies to an activity that is the same over time. But the regulations also explain how to apply the test when a taxpayer's activities change over time. In these circumstances, final regulations call for a comparison of the taxpayer's current year-activities with his preceding-year activities. Specifically, Treasury Regulation § 1.469-5(j)(1) provides as follows:

> **[*16]** purposes of [the five of ten test], a taxpayer has For materially participated in an activity for a preceding taxable year if the activity includes significant section 469 activities [[17]] that are substantially the same as significant section 469 activities that were included in an activity in which the taxpayer materially participated (determined without regard to [the five of ten test]) for the preceding taxable year.

In other words, if there is substantial similarity between the current-year activity and activities that the taxpayer materially participated in during a preceding year, [pg. 369] then that preceding year counts as one year in applying the five of ten test to the current-year activity. See id. If there is substantial similarity between the current-year activity and activities that the taxpayer materially participated in for five of the last ten years, then the five of ten test is satisfied and the taxpayer is

treated as materially participating in the current year-activity for the current year. *See* id.; Temp. Treas. Reg. § 1.469-5T(a)(5).

The history of Treasury Regulation § 1.469-5(j)(1) confirms this interpretation. When temporary regulations first established the five of ten test in 1988, they did not initially address how the test should apply to a situation in which an individual's business activities evolve during the ten-year period. *See* T.D. 8175, 1988-1 C.B. at 203; *see also* T.D. 8253, 1989-1 C.B. 121, 122 (noting the omission). In 1989, however, the Department of the Treasury (Treasury) and the IRS[18] issued additional temporary regulations under section 469 (1989 amendments). The 1989 amendments added Temporary Treasury Regulation § 1.469-4T to define the concept of an "activity" for purposes of section 469. *See* T.D. 8253, 1989-1 C.B. at 122–23. The definition included the concept of an "undertaking," which was the smallest unit that could constitute an activity. Id at 122.

As relevant here, the 1989 amendments also made certain changes to Temporary Treasury Regulation § 1.469-5T, including adding paragraph (j)(1), T.D. 8253, 1989-1 C.B. at 158, the precursor to Treasury Regulation § 1.469-5(j)(1). The preamble to the 1989 amendments explained the new rule as follows:

> **[*17]** Under § 1.469-4T, the business and rental operations that constitute an activity may change from year to year. The existing regulations do not address how the material participation tests that are based on participation in prior years will apply in cases in which such changes occur. Accordingly, this document amends § 1.469-5T to provide that, for purposes of the material participation tests that are based on participation in prior years, a taxpayer is treated as materially participating in an activity for a prior taxable year if the activity includes an undertaking involving substantially the same operations as an undertaking that was included in an activity in which the taxpayer materially participated during such prior taxable year.

T.D. 8253, 1989-1 C.B. at 126. The text of the temporary rule tracked the preamble's explanation:

> For purposes of [the five of ten test], a taxpayer has materially participated in an activity for a preceding taxable year if such activity includes an undertaking that involves substantially the same business and rental operations as an undertaking that was included in an activity in which the taxpayer materially participated...for such preceding taxable year.

Temp. Treas. Reg. § 1.469-5T(j)(1), T.D. 8253, 1989-1 C.B. at 158. Like the current rule, therefore, the rule issued as part of the 1989 amendments required a comparison of the taxpayer's current-year activity to his preceding-year activity. If the activities were sufficiently similar—i.e., if they included undertakings that involved similar business operations—and if the taxpayer materially participated in the preceding-year activity, then the taxpayer would also be treated as materially participating in the current-year activity during the preceding year. *See* id.

By 1992, Treasury determined that the 1989 definition of activity, including the concept of undertaking, was too complicated and mechanical and that a more flexible approach was required. *See* Limitation on Passive Activity Losses and Credits—Definition of Activity, 57 Fed. Reg. 20,802, 20,803 (proposed May 15, 1992). As a result, Treasury issued Proposed Treasury Regulation § 1.469-4, 57 Fed. Reg. at 20,804, to replace Temporary Treasury Regulation § 1.469-4T.

[*18] Simultaneously, Treasury finalized other parts of the 1989 amendments, including the clarification of the five of ten [pg. 370] test that previously appeared at Temporary Treasury Regulation §1.469-5T(j)(1). T.D. 8417, 1992-1 C.B. 173, 186.[19] Treasury did not, however, finalize the original temporary regulations—i.e., rules that were issued in 1988 and not amended in 1989. Those regulations, which include the seven regulatory tests for determining material participation and certain related rules, continued in their temporary form. Thus, today, the five of ten test appears in a temporary regulation, while the rule explaining how the five of ten test should be applied appears in a final regulation.

When it was finalized in 1992, the rule explaining how the five of ten test should be applied was modified slightly to its current form, essentially replacing the concept of an "undertaking" with that of a "significant section 469 activit[y]." *See* Treas. Reg. § 1.469-5(j)(1). In describing the change, Treasury stated:

> The final regulations generally adopt the amendments as originally proposed. They only make certain minor technical modifications to the amendments, including changes that conform them to the proposed regulations under § 1.469-4, relating to the definition of activity.

T.D. 8417, 1992-1 C.B. at 174.

Thus, the differences between the explanatory rule as originally proposed at Temporary Treasury Regulation § 1.469-5T(j)(1) and the final rule at Treasury Regulation § 1.469-5(j)(1) were not intended to be significant. And while the final rule's phrasing is somewhat convoluted, the text and regulatory history leave us with no doubt regarding its meaning. Specifically, the rule provides that even if a taxpayer's mix of activity changes over time, the taxpayer is treated as materially participating in a current-year activity if that activity substantially overlaps with activities that the taxpayer materially participated in for **[*19]** five of the last ten years. *See* Treas. Reg. § 1.469-5(j)(1); Temp. Treas. Reg. §. 1.469-5T(a)(5). As one commentator put it, "any significant overlap between activities for different tax years causes them to be treated as the same activity for purposes of the 5-out-of-10-years test." Libin Zhang, Passive Loss Rules, 549-3rd Tax Mgmt. (BNA), at IV.A.5.

2. *Application to Mr. Rogerson and RAEG*

In this case, we apply the material participation rules, and the five of ten test in particular, to determine whether Mr. Rogerson's involvement in RAEG was passive or nonpassive during 2014, 2015, and 2016. The Commissioner contends that Mr. Rogerson's involvement was nonpassive because Mr. Rogerson has failed to carry his burden to establish that he did not materially participate in RAEG. Additionally, the Commissioner argues that Mr. Rogerson satisfies the five of ten test for material participation.[20] For the reasons described below, we agree that Mr. Rogerson materially participated in RAEG under the five of ten test, and therefore that his involvement in the activity must be treated as nonpassive.

Applying the five of ten test to RAEG for the tax years 2014, 2015, and 2016 requires us to examine Mr. Rogerson's pre-2014 involvement in the activities that ultimately constituted RAEG. *See* Temp. Treas. Reg. § 1.469-5T(a)(5). Moreover, given that the organization of Mr. Rogerson's activities changed during the relevant years (e.g., because of the 2014 reorganization), Treasury Regulation § 1.469-5(j)(1) informs our analysis.

Turning first to Mr. Rogerson's tax reporting, we have found at his request that all the results of his aerospace business, including the RAEG-related activity, were reported on RAC's income tax returns from 2005 to 2013. We have further found, again at Mr. Rogerson's request, that no effort was made during these years to separate the various activities of the Rogerson companies for purposes of the passive activity loss rules. In other words, RAC [pg. 371] treated the aerospace business, including the activities that became part of RAEG, as a single, undifferentiated activity on its tax returns and when it issued Schedules K-1 to Mr. Rogerson. Mr. Rogerson reported his involvement in this **[*20]** consolidated activity as nonpassive on his personal income tax returns and similarly did not attempt to separate the activities. Cf. Treas. Reg. § 1.469-4(d)(5)(i) (providing that a shareholder of an S corporation may not treat activities grouped together by his corporation as separate activities). According to his own tax returns, therefore, Mr. Rogerson maintained that he materially participated in his aerospace business as a whole from at least 2005 to 2013.

Mr. Rogerson does not seem to dispute that his involvement in the overall business was nonpassive during those years; indeed, he maintains that Rogerson Kratos, which also was part of the aerospace business from 2005 to 2013, required large amounts of his time, and that he was involved with product development, manufacturing, and sales for the Rogerson Kratos product lines. Mr. Rogerson continued to report his activity with respect to Rogerson Kratos (i.e., RAC), as well as RC, as nonpassive during the years 2014 to 2016. And Mr. Chang, Mr. Rogerson's tax return preparer, testified with respect to the consolidated RAC activity that "it was pretty clear [Mr. Rogerson] was involved in that business."

There also is no dispute that, for the years 2005 to 2013, the product lines that ultimately were combined into RAEG in 2014 were a significant part of the consolidated RAC activity that Mr. Rogerson characterized as nonpassive. As described above, for purposes of applying the five of

ten test, a taxpayer is treated as materially participating in an activity (here, RAEG) during a preceding year if the activity was included in an activity, or substantially overlaps with an activity (here, the aerospace business as a whole), in which the taxpayer materially participated for the preceding year. Treas. Reg. § 1.469-5(j)(1).

There can be no question there is substantial overlap between RAEG's activities in 2014 and later years and the activities of the overall aerospace business before 2014. Documentary evidence and the testimony of multiple witnesses confirms that the products, employees, and customers of the Rogerson companies were generally the same before and after the 2014 reorganization. In other words, the business activities that became part of RAEG were the same before and after the reorganization, but organized differently. And each of the RAEG product lines had been part of the RAC consolidated activity since long before the relevant ten-year period. As Mr. Rogerson states in his opening brief: "[T]he RAEG Activity that commenced in 2014 is really the compilation and consolidation of multiple product lines from various **[*21]** entities that had been conducted on a historical basis." Pet'r's Simultaneous Opening Br. 73.

In light of these facts and the applicable regulations, we conclude that, in 2014, 2015, and 2016, Mr. Rogerson's RAEG activity substantially overlapped with an activity (i.e., the aerospace business as a whole) that he materially participated in from at least 2005 to 2013. Under Treasury Regulation § 1.469-5(j)(1), therefore, the five of ten test has been met for each of 2014, 2015, and 2016, and Mr. Rogerson is treated as materially participating in RAEG for those years. *See also* Temp. Treas. Reg. § 1.469-5T(a)(5) (setting forth the five of ten test).

3. Mr. Rogerson's Counterarguments

Mr. Rogerson makes three primary arguments regarding the five of ten test: (1) the test is a new matter not properly before the Court, (2) the regulation containing the test is substantively and procedurally invalid, and (3) even if it does apply, the test does not require that Mr. Rogerson be treated as materially participating in RAEG. As we explain below, none of these arguments changes our conclusion.

a. *New Matter*

To begin with, Mr. Rogerson argues that the five of ten test is a new matter not pleaded by the Commissioner. Therefore, Mr. Rogerson contends, the matter is not properly before the Court or, in the alternative, the Commissioner bears the burden [pg. 372] of proof.[21] *See* Shea v. Commissioner, 112 T.C. 183, 191 (1999). This argument borders on frivolous.[22]

[*22] The Commissioner is considered to have raised a new matter when the theory or basis upon which he relies was not stated in the notice of deficiency and the new theory or basis requires the

presentation of different evidence. Id. at 197. But a new theory that merely clarifies or develops the original determination is not a new matter in respect of which the Commissioner bears the burden of proof. Id. at 191 (citing Wayne Bolt & Nut Co. v. Commissioner, 93 T.C. 500, 507 (1989)).

The notice of deficiency in this case stated that Mr. Rogerson's income from RAEG should be treated as nonpassive because he "materially participated in RAEG." Consistent with the notice, the Pretrial Memoranda of each party reflects an understanding that the nature of Mr. Rogerson's participation in RAEG would be addressed at trial.

As already discussed, the five of ten test is one of the seven regulatory tests for determining whether a taxpayer materially participated in an activity. *See* discussion in Opinion Part II.B.1 above. Indeed, Mr. Rogerson's own Pretrial Memorandum explained that the applicable regulations include "seven tests to determine whether a taxpayer has materially participated."[23] Pet'r's Pretrial Mem. 6. We therefore have no trouble concluding that the Commissioner's reliance on the five of ten test is a clarification or development of his original determination and not a new matter. *See* Estate of Abraham v. Commissioner, 408 F.3d 26, 36 [95 AFTR 2d 2005-2591] (1st Cir. 2005) (stating there is no requirement that a notice of deficiency be as detailed as a trial brief), aff'g T.C. Memo. 2004-39 [2004 RIA TC Memo ¶2004-039], amended 429 F.3d 294 (1st Cir. 2005); Ax v. Commissioner, 146 T.C. 153, 170–71 (2016) (construing a notice of deficiency with "reasonable breadth" to conclude that it encompassed assertions later made by the Commissioner).[24] Nor do we perceive any surprise or prejudice to Mr. Rogerson where the Commissioner has consistently maintained—in his notice of deficiency, Answer, and **[*23]** Pretrial Memorandum—that Mr. Rogerson materially participated in RAEG.

In summary, we conclude the five of ten test is properly before this Court. And, although we do not decide this issue based on the burden of proof, the burden with respect to the five of ten test remains with Mr. Rogerson.

b. *Regulation Validity*

Mr. Rogerson also contends, for the first time in his Supplemental Briefing, that the five of ten test is an invalid rule, both substantively and procedurally. We address these arguments in turn.

i. *Substantive Validity*

Mr. Rogerson argues that the five of ten test is substantively invalid because it contradicts section 469. Specifically, Mr. Rogerson contends that material participation exists under the statute only to the extent that a taxpayer's involvement in an activity is regular, continuous, and substantial during the year under consideration, citing section 469(h). Because the five of ten test analyzes

taxpayer participation in an activity during prior years for purposes of determining participation in the current year, Mr. Rogerson views the test as contrary to the statute. We disagree.

Contrary to Mr. Rogerson's assertion, section 469 does not mandate the consideration of only present-year activity in determining material participation. Rather, section 469(h)(1) provides that "[a] taxpayer shall be treated as materially participating [pg. 373] in an activity only if the taxpayer is involved in the operations of the activity on a basis which is—(A) regular, (B) continuous, and (C) substantial." Nothing in the section addresses the timing of the taxpayer's involvement. Further, the statute dictates that "[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out provisions of this section, including regulations [that] specify what constitutes...material participation...for purposes of this section." I.R.C. § 469(*l*)(1). In other words, the statute is silent on the relevant period for assessing **[*24]** a taxpayer's involvement and directs the Secretary to fill in any gaps via regulation.[25]

In light of these provisions, we easily conclude that the five of ten is not contrary to section 469 and that the authorities Mr. Rogerson cites are inapplicable.[26]

ii. *Procedural Validity*

Next, Mr. Rogerson argues that the five of ten test is procedurally invalid because the temporary regulation in which it appears was enacted in violation of the notice and comment requirements of the Administrative Procedure Act (APA). *See* 5 U.S.C. § 553(b) and (c). Specifically, Mr. Rogerson observes that the five of ten test appears in Temporary Treasury Regulation § 1.469-5T, which was issued in 1988 without notice and comment. As described in Opinion Part II.B.1 above, certain parts of the original package were amended in 1989 and finalized in 1992, including Treasury Regulation § 1.469-5(j)(1). But the seven tests for material participation remain in their original temporary form.

Mr. Rogerson's argument raises an interesting issue that has been analyzed by judges and legal scholars. *See, e.g.,* Intermountain Ins. Serv. of Vail, LLC v. Commissioner, 134 T.C. 211, 238–48 (2010) (Halpern & Holmes, JJ., concurring), supplementing T.C. Memo. 2009-195 [2009 RIA TC Memo ¶2009-195], rev'd and remanded on other grounds, 650 F.3d 691 [107 AFTR 2d 2011-2613] (D.C. Cir. 2011), vacated and remanded, 566 U.S. 972 (2012); Eleanor D. Wood, Note, *Rejecting Tax Exceptionalism: Bringing Temporary Treasury Regulations Back in Line With the APA*, 100 Minn. L. Rev. 839 (2015). **[*25]** (collecting authorities); cf. Mann Constr., Inc. v. United States, 27 F.4th 1138, 1148 (6th Cir. **2022**) ("Because the IRS's process for issuing Notice 2007-83 did not satisfy the notice-and-comment procedures for promulgating legislative rules under the APA, we must set it aside."). We need not resolve this issue, however, because it does not change the result in Mr. Rogerson's case, as described below.

For purposes of this discussion, we will assume (only for the sake of analysis) that Mr. Rogerson is correct and that the five of ten test is a procedurally invalid regulation that cannot be applied here. Because Mr. Rogerson's challenge to the regulation is that it was issued without first being subject to notice and comment, accepting his theory would mean that other temporary regulations issued as part of the same package would also be invalid. This would include all seven regulatory tests for determining material participation and the related rules in Temporary Treasury Regulation § 1.469-5T.

Assuming solely for the sake of analysis that (as Mr. Rogerson argues) the seven regulatory tests for material participation would need to be disregarded, we would be left with the general statutory rule of section 469(h) to determine whether Mr. Rogerson materially participated in RAEG during 2014, 2015, and 2016. As noted above, that provision states as follows: "A taxpayer shall be treated as materially participating in an activity only if the taxpayer [pg. 374] is involved in the operations of the activity on a basis which is—(A) regular, (B) continuous, and (C) substantial."[27] Based on the record before us, we are convinced that Mr. Rogerson's involvement in RAEG satisfied this standard for 2014, 2015, and 2016.[28]

[*26] Mr. Rogerson was a hands-on CEO during the years at issue. No major decisions could be made without his input, and no detail was too small for his attention. For example, Mr. Rogerson weighed in on accounting and financial reporting minutiae, interacted directly with company employees, and line-edited company documents, such as offer letters and press releases. Top RAEG executives reached out to him for permission to undertake routine actions, such as responding to customer inquiries or providing small bonuses or raises to company employees. On one occasion, RAEG's president sought approval from Mr. Rogerson to offer an employee a raise of $0.50 per hour. On other occasions, executives confirmed that Mr. Rogerson's direct involvement, whether in the form of "ongoing and specific directives," "edict[s]," or other directions, would be required to get things done.

Mr. Rogerson's involvement in sales and customer relations further belies any assertion that he was not substantially involved in RAEG's operations. Mr. Rogerson traveled to meet with RAEG customers, including on one occasion to Indonesia. He also met with RAEG customers at RAEG's offices. Indeed, the record reflects more than one instance in which Mr. Rogerson told RAEG executives that he would resolve a problem by meeting personally with the customer involved. Customers sometimes reached out to Mr. Rogerson directly to discuss issues, and Mr. Rogerson was involved in multiround negotiations with customers on pricing and other matters. He also approved any bid provided to a customer with an aggregate value over $100,000; in one month in 2016, that approval was requested at least a dozen times.

In the face of a record demonstrating that he spoke and emailed with executives regularly on RAEG matters, Mr. Rogerson asserts that most of these interactions took only minutes of his time.

Even assuming that to be the case, however, Mr. Rogerson's ability to respond to detailed inquiries so quickly shows his detailed knowledge of every aspect of the business. Indeed, many of Mr. Rogerson's communications reflect first-hand experience with RAEG's employees, customers, and products that extends far beyond what could have been acquired by a passive investor.

[*27] To summarize, Mr. Rogerson would not prevail even if he were correct about the procedural validity of the five of ten test, because we find that he was regularly, continuously, and substantially involved in the operations of RAEG during 2014, 2015, and 2016 within the meaning of section 469(h). Accordingly, we need not decide whether the five of ten test is procedurally valid and turn instead to Mr. Rogerson's final argument.

c. *Application of the Five of Ten Test*

Mr. Rogerson argues that even if the five of ten test is valid and potentially applicable here, he should still prevail. Specifically, Mr. Rogerson asserts that applying the rules defining an "activity" for purposes of section 469 to the RAEG product lines before and after the 2014 reorganization results in two possible alternatives. First, RAEG could be viewed as an entirely new activity following the 2014 reorganization, with the result that there are no prior years of involvement for purposes of applying the five of ten test. Second, if a comparison of Mr. Rogerson's involvement in the RAEG activities before and after 2014 is required despite the 2014 reorganization, Mr. Rogerson contends that the five of ten test still does not apply because his involvement in the RAEG prod[pg. 375] uct lines was passive even before 2014. We take these arguments in turn.

i. *New Activity Argument*

Treasury Regulation § 1.469-4(c)(1) discusses the concept of an "activity" for purposes of section 469 and provides as follows: "One or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469." If a taxpayer decides based on all the facts and circumstances that multiple activities constitute a single economic unit and therefore may be treated as a single activity, the regulations refer to that determination as "grouping." *See* Treas. Reg. § 1.469-4(c)(2).

In support of his first proposed alternative—i.e., that for purposes of the five of ten test, RAEG did not exist as activity before 2014—Mr. Rogerson states as follows:

> It is clear that the Rogerson companies did not actually segregate [R]AEG as a separate "activity" before 2014. No position was taken on any RAC return before 2014 reflecting anything other than a single activity. **[*28]** [Mr.] Chang clearly believed no such determination

was appropriate because everything related to the Rogerson companies was reported on a single RAC return.

Pet'r's Simultaneous Suppl. Br. 25. Accordingly, Mr. Rogerson appears to contend that before the 2014 reorganization, the aerospace business as a whole (as reflected on RAC's returns) was the relevant activity under the regulations and that RAEG should therefore be treated as a new activity for 2014, 2015, and 2016. If RAEG was a new activity starting in 2014, Mr. Rogerson further contends, then the five of ten test cannot apply, because Mr. Rogerson would have no history of involvement in the activity.

Mr. Rogerson's argument is foreclosed by Treasury Regulation § 1.469-5(j)(1). As discussed in detail in Opinion Part II.B.1 above, that rule does not require the taxpayer's precise activity to have existed in prior years for purposes of applying the five of ten test. Indeed, the entire point of the rule is to address situations in which circumstances change over time. The rule applies as long as the taxpayer's current-year activity (here, RAEG) "includes significant section 469 activities" (here, the RAEG product lines or RAEG as a whole) "that are substantially the same as significant section 469 activities there were included in [a preceding-year activity] in which the taxpayer materially participated" (here, the aerospace business as a whole). In other words, all that is required is substantial overlap between the current and preceding-year activities. The record here leaves no doubt that the activity conducted by RAEG in 2014, 2015, and 2016 overlaps substantially with the "single activity" reflected on RAC's prior returns—i.e., the aerospace business as a whole.

ii. *Passive Activity Argument*

Mr. Rogerson's second alternative—that his involvement in the RAEG product lines was passive even before 2014—faces a factual problem. There is no question that before 2014 Mr. Rogerson's involvement in the aerospace business as a whole was nonpassive. Similarly, there is no dispute that Mr. Rogerson reported his involvement in the aerospace business as a whole, including the activities that became part of RAEG, as nonpassive. In light of Treasury Regulation § 1.469-5(j)(1), these facts are sufficient to satisfy the five of ten test with respect to RAEG in 2014, 2015, and 2016.

[*29] In an attempt to escape the implications of his prior reporting, Mr. Rogerson contends that neither he nor RAC ever made an affirmative decision to group the RAEG product lines with his other aerospace activities. According to Mr. Rogerson, RAC's returns made no effort to indicate whether they reported "one activity or many activities, grouped or not." Pet'r's Simultaneous Answering Br. 34. The implication seems to be that, if the product lines that became part of RAEG were not formally grouped with RAC in prior years, then Mr. Rogerson's reporting and activity with

respect to RAC as a whole would be irrelevant in applying the five of ten test to the RAEG product lines in subsequent years. But Mr. Rogerson is incorrect. [pg. 376]

The regulations Mr. Rogerson cites required RAC to perform a grouping analysis for the years before 2014. *See* Treas. Reg. § 1.469-4(d)(5)(i) ("[A]n S corporation...must group its activities under the rules of this section."). Mr. Rogerson concedes that, before 2014, RAC reported the consolidated results of the entire aerospace business without differentiation.[29] This approach indicates that RAC treated the aerospace business as a single activity (or as multiple activities grouped into a single activity) for purposes of section 469. Mr. Rogerson concedes as much, stating: "No position was taken on any RAC return before 2014 reflecting anything other than a single activity." Pet'r's Simultaneous Suppl. Br. 25. And Mr. Rogerson was not free to distinguish between his various aerospace activities for purposes of section 469 for any year in which RAC combined them. *See* Treas. Reg. § 1.469-4(d)(5)(i) (providing that a shareholder of an S corporation may not treat activities grouped together by his corporation as separate activities). Accordingly, RAC's treatment of the aerospace business as a single activity before 2014 required Mr. Rogerson to take the same approach. He did so and determined that his involvement in the overall business was active. The five of ten test requires nothing more.

[*30] Having addressed Mr. Rogerson's involvement with RAEG, we next turn to the proper characterization under section 469 of Mr. Rogerson's yacht activities for 2014, 2015, and 2016.

C. *Rental Rules and the Yacht Activities*

1. *Rental Activities*

As noted above, rental activities are passive regardless of a taxpayer's participation, subject to certain exceptions. *See* I.R.C. § 469(c)(2), (4), (7).[30] A rental activity is "any activity where payments are principally for the use of tangible property." I.R.C. § 469(j)(8); *see also* Temp. Treas. Reg. § 1.469-1T(e)(3)(i) (stating that an activity is a rental activity if during the taxable year tangible property held in connection with the activity is used by customers or held for use by customers and gross income (or expected gross income) attributable to the activity represents amounts paid or to be paid principally for the use of the tangible property).

Neither of Mr. Rogerson's yachts (the TOTO and the Falcon Lair) was chartered during 2014, 2015, or 2016, but the parties agree that Mr. Rogerson intended to charter the yachts. Accordingly, the yachts were tangible property held for use by customers, and any income from the yacht activities would have represented amounts paid principally for the use of the tangible property. The yacht activities therefore were rental activities unless an exception applies.[31] *See* I.R.C. § 469(j)(8); Temp. Treas. Reg. § 1.469-1T(e)(3)(i).

2. *Exceptions to Rental Activity*

The regulations provide six exceptions to the definition of "rental activity," two of which are relevant to our analysis. Specifically, an activity involving the use of tangible property is not a rental activity if for the taxable year—(1) the average period of customer use for the **[*31]** property is seven days or less; or (2) the average period of customer use for such property is 30 days or less, and significant personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers. Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(A) and (B).

For purposes of these rules, a period of customer use is the period "during which a customer has a continuous or recurring right to use" the property. Treas. Reg. § 1.469-1(e)(3)(iii)(D). The average period of customer use is calculated by dividing the aggregate number of days in all periods of customer use of the property by the num[pg. 377] ber of periods of customer use. Id. subdiv. (iii)(C).[32] And finally, to determine whether services are significant personal services, all of the relevant facts and circumstances are considered, including the frequency with which the services are provided, the type and amount of labor required to perform the services, and the value of the services relative to the amount charged for the use of the property. Temp. Treas. Reg. § 1.469-1T(e)(3)(iv)(A).

Mr. Rogerson claims that his yacht activities qualify for both exceptions. We disagree.

a. *Seven Days or Less Exception*

As to the first exception, Mr. Rogerson has not requested any findings of fact or provided any evidence to allow us to conclude that his yacht activities involved charters of seven days or less during the years at issue or any other year. Mr. Rogerson claims that "[n]either TOTO nor Falcon Lair was available to be `rented' for weeks at a time" and that "the Yacht Charter Activity was intended to provide short-term use for day trips and other short-term excursions." Pet'r's Simultaneous Opening Br. 78. But regardless of these plans, no customers chartered the yachts during 2014, 2015, or 2016. And unlike the affirmative rule for defining a rental activity, which considers a taxpayer's intended or expected use of property, the exceptions to that rule turn on what actually happened during the taxable year. *Compare* Temp. Treas. Reg. § 1.469-1T(e)(3)(i) (allowing consideration of potential customer use and expected income in identifying a rental activity), *with* id. subdiv. (ii)(A) and (B) (establishing exceptions based on the "average period of customer use"), *and* Treas. Reg. § 1.469-1(e)(3)(iii)(C) and (D) **[*32]** (calculating the average period of customer use based on actual customer activity). Without any customer use, it is impossible to establish (as required by the regulations) the average period of customer use for the yachts. Accordingly, Mr. Rogerson fails to qualify for the first exception.[33]

b. *30-day Exception*

Mr. Rogerson's argument for the second exception falls short for the same reason. A claim in Mr. Rogerson's brief that "[n]o charter would have been for more than 30 days," Pet'r's Simultaneous Opening Br. 79, is not evidence, and again, the absence of any actual customer use of the yachts precludes us from determining that the average period of customer use was 30 days or less. Similarly, the fact that the TOTO and the Falcon Lair each had crews that conceivably could have provided services does not establish that significant personal services were in fact provided to customers. *See* Temp. Treas. Reg. § 1.469-1T(e)(3)(ii). Mr. Rogerson has requested no findings of fact nor produced any evidence about the kinds of services that crew members could or would provide to customers. And, more to the point, we know that no services were provided during the years at issue because the yachts were not chartered.

Mr. Rogerson has failed to establish that his yacht activities qualify under the exceptions provided in the temporary regulations. The activities therefore constituted rental activities and were per se passive during the years at issue.[34] *See* I.R.C. § [pg. 378] 469(c)(2), (4), (j)(8); Temp. Treas. Reg. § 1.469-1T(e)(3)(i).[35]

[*33] III. *Accuracy-Related Penalties*

Lastly we must determine whether the section 6662 penalties the Commissioner determined in the notice of deficiency properly apply.

The Commissioner bears the burden of production with respect to an individual taxpayer's liability for a penalty and is required to present sufficient evidence showing that the penalty is appropriate. I.R.C. § 7491(c); Higbee v. Commissioner, 116 T.C. 438, 446–47 (2001). To meet this burden for a penalty under section 6662(a), the Commissioner must show that he complied with the procedural requirements of section 6751(b)(1). *See* I.R.C. § 7491(c); Frost v. Commissioner, 154 T.C. 23, 34 (2020). Once the Commissioner satisfies his burden of production, the taxpayer bears the burden of proving that the Commissioner's penalty determination is incorrect or that the taxpayer has an affirmative defense such as reasonable cause. *See* Rule 142(a); Higbee, 116 T.C. at 446–47.

Because we conclude that Mr. Rogerson had reasonable cause and relied in good faith on his adviser Mr. Chang in connection with the preparation of the 2014 to 2016 returns, we conclude that the penalties do not apply.

A. *Section 6662(a) Penalty*

Section 6662(a) and (b)(1) and (2) imposes a penalty equal to 20% of the portion of an underpayment of tax required to be shown on a taxpayer's return that is attributable to "[n]egligence or disregard of **[*34]** rules or regulations" and/or a "substantial understatement of income tax." Negligence includes "any failure to make a reasonable attempt to comply with the provisions of this title." I.R.C. § 6662(c). An understatement of income tax is a "substantial understatement" if it exceeds the greater of 10% of the tax required to be shown on the return or $5,000. I.R.C. § 6662(d)(1)(A). The Commissioner here has asserted section 6662(a) penalties on the basis of both negligence and substantial understatement.

B. *Reasonable Cause and Good Faith*

A taxpayer may avoid a section 6662(a) penalty by showing that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. I.R.C. § 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all of the pertinent facts and circumstances, including the taxpayer's efforts to assess the proper tax liability and the taxpayer's knowledge, experience, and education. Treas. Reg. § 1.6664-4(b)(1).

Mr. Rogerson contends, among other things, that he had reasonable cause for the position he took on his tax returns because he reasonably relied on Mr. Chang's advice.[36] Reasonable reliance on professional advice may constitute reasonable cause and good faith if the taxpayer proves, by a preponderance of the evidence, that (1) the adviser was a competent professional with sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment. *See* Alt. Health Care Advocates v. Commissioner, 151 T.C. 225, 246 (2018); Neonatology Assocs., P.A. v. Commissioner, 115 T.C. 43, 99 (2000), aff'd, 299 F.3d [pg. 379] 221 [90 AFTR 2d 2002-5442] (3d Cir. 2002); *see also* Charlotte's Office Boutique, Inc. v. Commissioner, 425 F.3d 1203, 1212 [96 AFTR 2d 2005-6451] n.8 (9th Cir. 2005) (quoting the three-pronged test with approval), aff'g T.C. Memo. 2004-43 [2004 RIA TC Memo ¶2004-043] *and* 121 T.C. 89 (2003).

[*35] 1. *Competent Tax Adviser*

There is no precise threshold of competence that a tax adviser must have to justify a taxpayer's reliance. Rather, our practical test looks for expertise in the context of the facts of each case. CNT Inv'rs, LLC v. Commissioner, 144 T.C. 161, 224 (2015); *see also* 106 Ltd. v. Commissioner, 136 T.C. 67, 77 (2011) (finding the taxpayer's longtime attorney and accounting firm, who "would have appeared competent to a layman," and especially so to the taxpayer, had adequate expertise), aff'd, 684 F.3d 84 [109 AFTR 2d 2012-2723] (D.C. Cir. 2012); Neonatology Assocs., P.A., 115 T.C. at 99 (holding that an insurance agent who did not claim to be a tax professional and

had a direct financial interest in the transaction at issue lacked sufficient expertise to advise on the tax consequences of complex life insurance transactions).

Applying this practical test, we find that Mr. Chang was a competent tax adviser with sufficient expertise to justify reliance. Mr. Chang was a professionally licensed and experienced tax return preparer with his own practice. He knew Mr. Rogerson's personal and business affairs from his long relationship with Mr. Rogerson and his companies. There is no indication in the record that Mr. Rogerson had any reason to doubt Mr. Chang's competence to provide the advice he sought.

2. *Provision of Information*

To meet the second requirement of reasonable reliance, the taxpayer must provide necessary and accurate information to the adviser. *See* Alt. Health Care Advocates, 151 T.C. at 246. Additionally, the taxpayer cannot "fail[] to disclose a fact that [he] knows, or reasonably should know, to be relevant to the proper tax treatment of an item." Treas. Reg. § 1.6664-4(c)(1)(i). But a taxpayer is not obligated to share details that a reasonably prudent taxpayer would not know, or that he neither would know nor reasonably should know are relevant. CNT Inv'rs, LLC, 144 T.C. at 228.

We conclude that Mr. Rogerson provided Mr. Chang with necessary and accurate information during their discussions about Mr. Rogerson's activities and the positions taken on Mr. Rogerson's returns. Mr. Chang was Mr. Rogerson's long-time adviser and demonstrated his familiarity with Mr. Rogerson's affairs at trial. Additionally, Mr. Chang and Mr. Rogerson both credibly testified that Mr. Rogerson provided Mr. Chang with information regarding his level of involvement (generally in **[*36]** the form of hours estimates) in each of his activities each year for purposes of applying the passive loss rules.[37] And while ultimately we resolve this case on grounds unrelated to the number of hours Mr. Rogerson spent on his various activities during the years at issue, we do not believe that Mr. Rogerson knew or reasonably should have known that factors other than his hours were relevant to the treatment of his activities. *See* id. Mr. Chang, an experienced tax professional, focused his analysis and advice on Mr. Rogerson's activity levels, and Mr. Rogerson had no reason to question that approach. As the Supreme Court has said,

> When an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice [pg. 380] of a presumed expert in the first place. *See* Haywood Lumber [& Mining Co. v. Commissioner, 178 F.2d 769, 771 [38 AFTR 1223] (2d Cir. 1950), *modifying* 12 T.C. 735 (1949)]. "Ordinary business care and prudence" do not demand such actions.

United States v. Boyle, 469 U.S. 241, 251 [55 AFTR 2d 85-1535] (1985).

3. *Good Faith Reliance on Advice*

The last requirement is that a taxpayer must have actually received advice and relied upon it in good faith. Neonatology Assocs., P.A., 115 T.C. at 99. Advice is "any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the **[*37]** benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly." Treas. Reg. § 1.6664-4(c)(2).

Mr. Chang credibly testified at trial that he provided Mr. Rogerson with advice regarding the proper reporting of his activities under the passive loss rules for 2014, 2015, and 2016 and that Mr. Rogerson's reporting on his personal income tax returns was consistent with that advice. Mr. Rogerson likewise credibly testified that he received advice from Mr. Chang regarding the application of the passive loss rules to his activities and that he followed that advice. We believe their testimony and conclude that Mr. Rogerson reasonably relied on Mr. Chang's advice.

We note that we find credible Mr. Rogerson's reliance upon Mr. Chang's advice in part because Mr. Chang had been preparing Mr. Rogerson's individual returns and the Rogerson companies' returns for over a decade. *See* Schwalbach v. Commissioner, 111 T.C. 215, 230–31 (1998) (finding reasonable reliance where taxpayers consulted their long-time business and tax adviser, he advised them on what he believed was the correct reporting position, and they followed his advice). And Mr. Chang demonstrated his knowledge of the returns and the facts underlying them at trial. That Mr. Rogerson is a well-educated, sophisticated businessman does not preclude him from relying on Mr. Chang, his long-term tax adviser, to advise him regarding technical tax matters and prepare his returns. *See* Boyle, 469 U.S. at 251.

In light of these considerations, taking into account all of the facts and circumstances, we hold that Mr. Rogerson is not liable for the section 6662 accuracy-related penalties.

IV. *Conclusion*

For the reasons described above, we conclude that Mr. Rogerson materially participated in RAEG for the tax years 2014, 2015, and 2016, with the result that income from that activity must be treated as nonpassive in each of those years. We further conclude that Mr. Rogerson's yacht activities during the same years were per se passive as rental activities and therefore that the income associated with those activities must likewise be passive. Finally, we conclude that the penalties the Commissioner determined in the notice of deficiency do not apply.

[*38] To reflect the foregoing,

An appropriate order will be issued, and decision will be entered under Rule 155.

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C. (I.R.C. or Code), in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Procedure. We round all monetary amounts to the nearest dollar.

[2] Rogerson ATS's own business making auxiliary fuel systems had dwindled to almost nothing by the time of the transfer, because newer aircraft generally do not require such systems.

[3] RC changed its name to Rogerson Capital in 2016. Additionally, certain steps of the reorganization not relevant to our analysis have been omitted from the summary above.

[4] The parties stipulated that RAEG reported ITAN's activity on its tax returns during the years at issue, but other evidence confirms that ITAN was owned by RAC rather than RAEG for 2014, 2015, and 2016. We are not obliged to accept a stipulation between the parties when it is clearly contrary to facts disclosed by the record. CalMaine Foods, Inc. v. Commissioner, 93 T.C. 181, 195 (1989). And, in any event, the question of ITAN's ownership is not dispositive to the outcome of this case.

[5] On more than one occasion during the years at issue, RAEG executives stated that Mr. Rogerson's direct involvement, whether in the form of "ongoing and specific directives," "edict[s]," or other directions, would be required to complete an initiative.

[6] At least one trip during the years at issue was to an RAEG customer in Indonesia.

[7] Mr. Rogerson owned the TOTO through a limited liability company named Toto, LLC.

[8] The policies defined a charter agreement as a "written contract between the owner of the insured yacht and the charterer in which the insured yacht is rented for one or more voyages or a fixed period of time."

[9] Mr. Rogerson established two limited liability companies to manage and hold the Falcon Lair: Platinum Marine Ventures, LLC (Platinum), and Sterling Marine Ventures, LLC (Sterling). Platinum generally paid the Falcon Lair's operating expenses, including the costs of crew, fuel, and guests. Sterling held legal title to the Falcon Lair and paid expenses associated with insurance, depreciation, and freight fees, among others.

[10] One policy, for example, stated that the Falcon Lair's "use" was "Private Pleasure and / or Corporate Entertaining" and that the yacht was "Warranted to be used solely for private pleasure purposes and not to be hired or chartered unless approved and permission endorsed hereon." The record does not reflect any such endorsement.

[11] The parties have since stipulated that the correct amount of the carryover is $3,382,990.

[12] The total loss for the tax year 2015 shown above is net of $147,050 of income related to the Falcon Lair. That income arose from the favorable resolution of a lawsuit.

[13] At the time of the examination, Ms. Dougherty's name was Amanda Davis.

[14] On July 1, 2019, the Office of Appeals was renamed the Independent Office of Appeals. *See* Taxpayer First Act, Pub. L. No. 116-25, § 1001, 133 Stat. 981, 983 (2019). We will use the name in effect at the times relevant to this case, i.e., the Office of Appeals.

[15] With respect to the yachts, the notice elaborated that "Appeals previously determined that a similar activity...was a valid rental activity despite the extremely limited rental income generated; therefore, [Revenue Agent Dougherty] in being consistent with the prior Appeals ruling has allowed the activity to remain but limited the Passive Losses to the passive income available."

[16] Generally speaking, a burden of proof analysis is required only in the rare instance of an evidentiary tie. *See, e.g.*, Knudsen v. Commissioner, 131 T.C. 185, 189 (2008), supplementing T.C. Memo. 2007-340; *see also* FRGC Inv., LLC v. Commissioner, 89 F. App'x 656 (9th Cir. 2004), aff'g T.C. Memo. 2002-276. As we discuss further below, we resolve this case on the preponderance of the evidence, and therefore Mr. Roger son's arguments regarding the burden of proof are unavailing. *See, e.g.*, Dagres v. Commissioner, 136 T.C. 263, 279 (2011).

[17] We explain further below the origin and meaning of the phrase "significant section 469 activities."

[18] For simplicity, we refer to both Treasury and the IRS as "Treasury."

[19] Treasury finalized the 1989 amendments to avoid potential disputes about whether they would expire under section 7805(e)(2), which provides that all temporary regulations expire three years after the date they are issued. *See* T.D. 8417, 1992-1 C.B. at 174. Section 7805(e)(2) was enacted in 1988 and applies only to temporary regulations issued after November 20, 1988. *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6232, 102 Stat. 3342, 3734. Accordingly, section 7805(e)(2) potentially applied to the 1989 amendments, but not to the original temporary regulations. *See* T.D. 8175, 1988-1 C.B. at 233–34.

[20] The Commissioner makes certain other arguments based on the amount of time Mr. Rogerson spent on RAEG during 2014, 2015, and 2016, but in light of our analysis under the five of ten test, we need not reach those arguments.

[21] Mr. Rogerson also contends that the Commissioner bears the burden of proof with respect to certain other arguments raised by the Commissioner. Because we resolve this case without reaching those arguments, we need not address Mr. Rogerson's further contentions.

[22] As one component of the argument, Mr. Rogerson characterizes the five of ten test as an "estoppel" theory. Pet'r's Simultaneous Suppl. Br. 8. But Mr. Rogerson's characterization demonstrates a misunderstanding of the rule. The five of ten test does not estop anyone from doing anything. Rather it provides guidance on how the statutory material participation test applies when either a relevant activity or a taxpayer's participation in a relevant activity changes over time. And Treasury Regulation § 1.469-5(j)(1) provides more specific guidance on the application of the five of ten test. As Mr. Rogerson notes, it is a "Definitional Reg." Pet'r's Simultaneous Suppl. Br. 2.

[23] The Pretrial Memorandum also claimed that only three of the tests were relevant to this case, not including the five of ten test. But that statement simply represents Mr. Rogerson's view of the case and, of course, is not binding on the Commissioner or the Court.

[24] In Ax, we also cited the following statement from Abatti v. Commissioner, 644 F.2d 1385, 1390 [48 AFTR 2d 81-5020] (9th Cir. 1981), rev'g T.C. Memo. 1978-392 [¶78,392 PH Memo TC]: "[I]f a deficiency notice is broadly worded and the Commissioner later advances a theory not inconsistent with that language, the theory does not constitute new matter, and the burden of proof remains with the taxpayer." Ax, 146 T.C. at 171 n.18.

[25] The provisions Mr. Rogerson cites—section 469(a)(1), (c)(1), and (f)—do not support a different conclusion. In relevant part, section 469(a)(1) simply states that passive activity losses are disallowed "for the taxable year," and section 469(c)(1) provides that a passive activity is any activity in which a taxpayer does not materially participate. That section 469 specifies the year in which the loss is disallowed says nothing about the timeframe for assessing a taxpayer's participation in an activity. Nor does the special rule for carryover losses from a former passive activity in section 469(f)—an issue that is irrelevant in the case of a former *nonpassive* activity—preclude Treasury from issuing other rules for taxpayers who change their participation levels over time.

[26] The determination that the five of ten test is not contrary to section 469 also resolves Mr. Rogerson's argument that the five of ten test is unconstitutional, because that argument is premised on the existence of a direct conflict between the statute and the regulation. Additionally, because this conclusion fully addresses Mr. Rogerson's arguments, we need not decide on the appropriate standard of review for temporary Treasury regulations such as those at issue here.

[27] One of the seven regulatory tests is similar to the statutory rule, but with some additional limitations related to the number of hours required and the types of hours that qualify. *See* Temp. Treas. Reg. § 1.469-5T(a)(7), (b)(2), (f)(2); *see also* Mordkin v. Commissioner, T.C. Memo. 1996-187 [1996 RIA TC Memo ¶96,187], slip op. at 24, 45–48 (describing limiting rules). The effect of these rules is to limit a taxpayer's ability to qualify as materially participating, which in this case could help Mr. Rogerson. But if one accepts the premise of Mr. Rogerson's argument that Temporary Treasury Regulation § 1.469-5T(a)(5) is procedurally invalid, then the other portions of the regulation would also need to be ignored and therefore would not afford him any protection.

[28] This conclusion is consistent with Treasury Regulation § 1.469-5(f)(1), which was finalized in 1992 and states that

> any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated for purposes of this section as participation of the individual in the activity.

[29] Mr. Rogerson cites Hardy v. Commissioner, T.C. Memo. 2017-16 [2017 RIA TC Memo ¶2017-016], in which our Court concluded that taxpayers who merely report an S corporation's activity as nonpassive do not thereby group that activity with their other nonpassive activity. But that case considered whether activity reported on a Schedule K-1 had been grouped with other activity not reported on the Schedule K-1; it did not consider whether undifferentiated amounts reported on a single Schedule K-1 had been grouped together. Id. at *15–16. Additionally, Hardy analyzed only the grouping regulations under Treasury Regulation § 1.469-4 and did not consider the five of ten test.

[30] *See also*, *e.g.*, Kessler v. Commissioner, T.C. Memo. 2003-185 [2003 RIA TC Memo ¶2003-185]; Tarakci v. Commissioner, T.C. Memo. 2000-358 [2000 RIA TC Memo ¶2000-358]; Frank v. Commissioner, T.C. Memo. 1996-177 [1996 RIA TC Memo ¶96,177].

[31] The Commissioner argues that, for purposes of analyzing the yacht activities, the TOTO should be viewed as a separate activity from the Falcon Lair and that each of the entities through which Mr. Rogerson held and operated the Falcon Lair (Platinum and Sterling) also should be analyzed separately. By contrast, Mr. Rogerson argues that all his yacht activities should be treated as a single activity. Because our conclusion would be the same regardless of how the yacht activities are grouped, we need not resolve this issue.

[32] The rules are slightly more nuanced with respect to activities involving multiple classes of property, but those nuances are irrelevant for purposes of our analysis. *See* Treas. Reg. § 1.469-1(e)(3)(iii)(A) and (B).

33 We express no view as to the outcome of a case in which the evidence demonstrates that one or more of the exceptions under Temporary Treasury Regulation § 1.469-1T(e)(3)(ii) had been met in prior years, but not during the years at issue. This case does not present such a scenario.

34 Mr. Rogerson's argument that he materially participated in the yacht activity would not change this conclusion, because rental activities are considered passive without regard to the taxpayer's level of participation. I.R.C. § 469(c)(2), (4). We therefore need not address it further.

35 On January 12, 2021, just over two months before the trial of this case was scheduled to begin in March, the Commissioner filed a Motion for Leave to File an Amendment to Answer to further allege under section 183 that Mr. Rogerson did not engage in his yacht activities with an objective of realizing a profit. Mr. Rogerson objected on the ground that permitting the amendment would prejudice his preparation for trial. He further argued that the amendment came too late and essentially was designed to permit the Commissioner a "do-over" after the period for discovery had already run. After holding a status conference with the parties, the Court advised them that it intended to deny the Motion. The Court observed that permitting amendment would not be in the interest of justice in light of the procedural posture of the case, the timing of the request after the close of discovery, and the prejudice to Mr. Rogerson in preparing for trial on the existing issues, while at the same time being required to prepare for trial a different issue that turned on much different evidence. The Court also noted that the notice of deficiency specifically highlighted the issue sought to be challenged in the proposed amendment, while observing that the Commissioner had decided not to raise the issue in light of a prior resolution by IRS Appeals. The Court also advised the parties that the Motion would be formally addressed in any opinion issued in the case. Trial of this case was later postponed from March to May at the parties' request. Upon further consideration, for the reasons noted above, we will deny the Commissioner's Motion. *See* Waterman v. Commissioner, 91 T.C. 344, 349–51 (1988) (leave to amend may be denied upon a showing of prejudice to the petitioner); Law v. Commissioner, 84 T.C. 985, 990 (1985) (whether leave will be granted is a question falling within the discretion of the Court).

36 One of Mr. Rogerson's alternative arguments is that the penalties were not timely approved under section 6751(b). The U.S. Court of Appeals for the Ninth Circuit recently considered this question in the context of an assessable penalty under section 6707A, which, as the Ninth Circuit noted, is not subject to the Code's deficiency procedures. *See* Laidlaw's Harley Davidson Sales, Inc. v. Commissioner, 29 F.4th 1066, 1071 (9th Cir. **2022**), rev'g and remanding 154 T.C. 68 (2020). In light of our determination that Mr. Rogerson is not liable for the section 6662(a) penalties, we need not consider the penalty approval issue.

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[37] The Commissioner argues that Mr. Rogerson's failure to keep logs of his hours was negligent, but the Commissioner's own regulations state that logs are not required. *See* Temp. Treas. Reg. § 1.469-5T(f)(4). Moreover, as the extensive discussion in Opinion Part II demonstrates, we do not resolve this case on the basis of hours Mr. Rogerson spent on each activity during the years at issue. We further note that this Court has found that a taxpayer acted with reasonable cause and good faith when a deficiency is the result of an issue of first impression and the taxpayer's position is reasonably debatable. *See* Williams v. Commissioner, 123 T.C. 144, 153–54 (2004).

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Tax Court & Board of Tax Appeals Memorandum Decisions

Gregory J. Podlucky, et ux. v. Commissioner, T.C. Memo. 2022 -45 , Code Sec(s) 61; 301; 316.

GREGORY J. PODLUCKY AND KARLA S. PODLUCKY, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 331]

Code Sec(s):	61; 301; 316
Docket:	Dkt. No. 453-17.
Date Issued:	05/05/**2022**.
Judge:	Opinion by Lauber, *J.*
Tax Year(s):	Years 2003, 2004, 2005, 2006.
Disposition:	Decision for Commissioner.

HEADNOTE

1. Unreported income—constructive distributions—proof. IRS's determination that CPA-beverage co. owner and wife had significant unreported income, in form of constructive distributions, for number of years that included years for which husband was convicted of tax

evasion, and both he and wife were convicted of money laundering-related offenses, incident to scheme to siphon money from co. for personal purposes and finance lavish lifestyle, was upheld: IRS established requisite evidentiary foundation with bank statements and other documents showing taxpayers used co. funds to buy things like home construction project, millions of dollars in luxury jewelry, and more; and taxpayers failed to adequately rebut same where making only incredible or insupportable claims such as that luxury jewelry was really for co. dealings with foreign monks who needed "hard assets" or that construction project, on residentially zoned lot, was for co. training facility.

Reference(s): ¶ 615.047(5) Code Sec. 61; Code Sec. 301; Code Sec. 316

2. Loss deductions—criminal forfeiture—time for deduction. CPA-beverage co. owner's and wife's loss deduction claim, seeking to offset their income for stated years by amount of assets they were required to forfeit in connection with their convictions for money laundering and tax offenses, was denied. Taxpayers untimely raised this claim only in post-trial brief and didn't show if restitution payments were in fact made, didn't show what value of any forfeited assets was, and wouldn't in any event be entitled to deduct loss in years claimed since loss would have arisen much later.

Reference(s): ¶ 1655.080(5) Code Sec. 165

[pg. 332]

3. Fraud penalties—burden of proof and production; clear and convincing evidence—unreported income—civil and criminal cases. Fraud penalties were upheld against CPA-beverage co. owner for multiple years, including year for which he was convicted of tax evasion and money laundering offenses relating to scheme to siphon money from co. to finance his and wife's lavish lifestyle. IRS showed it complied with Code Sec. 6751(b)(1) 's written supervisory approval prerequisite for penalties and otherwise proved with clear and convincing evidence that there were underpayments for each year at issue attributable to fraud. Notably, husband's tax evasion conviction precluded him from contesting his fraud for that year. And badges of fraud for other years included that he had pattern of underreporting and underpaying taxes, including by creating false financial records so as to induce lenders and investors to advance funds to co., which he then diverted; that he didn't otherwise keep adequate records; that he gave implausible explanations, including incredible attempt to explain away mansion property financed with co. funds as being co. training facility; that he also tried to conceal assets by building secret room where he hid millions of dollars in luxury jewelry; and that he refused to cooperate with IRS.

Reference(s): ¶ 66,635.01(5) Code Sec. 6663; Code Sec. 6751

4. Limitations periods on assessments—fraud—joint returns. Limitations periods didn't bar assessments against husband/CPA and wife for years for which they filed joint returns and in respect to which husband was found liable for fraud penalties, such that Code Sec. 6501(c) 's open-ended period applied.

Reference(s): ¶ 65,015.13(45) Code Sec. 6501

5. Joint returns—innocent spouse relief—attribution of items; knowledge or reason to know; equity—proof. Wife was denied innocent spouse relief under Code Sec. 6015(b) from joint liabilities for years during which husband/CPA siphoned money off his beverage co. to finance his and wife's lavish lifestyle. Although husband directed said scheme, wife couldn't show that any portion of understatement wasn't attributable to her for Code Sec. 6015(b)(1)(B) purposes when considering she played crucial role in scheme, including by having authority over shell co. account through which stated funds were diverted and signing over 100 checks on that account, which in turn were made out to various vendors for various items, including millions of dollars in luxury jewelry benefitting her personally. Similarly, she was considered to have knowledge or reason to know of understatements for Code Sec. 6015(b)(1)(C) purposes when considering above and that although jewelry was placed in secret room on co. property, her claim that she thought that meant jewelry was co. property wasn't credible. Finally, it wouldn't be inequitable to hold her liable under Code Sec. 6015(b)(1)(D) when considering her involvement and personal benefit from stated understatements.

Reference(s): ¶ 60,155.01(12) ;¶ 60,155.01(15) Code Sec. 6015

Syllabus

Counsel

Gregory J. Podlucky and Karla S. Podlucky, pro sese.

Kirsten E. Brimer, Harry J. Negro, Douglas C. Rennie, Chelsey M. Pearson, Francesca M. Ugolini, Curtis C. Pett, Ronald S. Collins, and Laurel B. Stout, for respondent.

LAUBER, *Judge*

MEMORANDUM FINDINGS OF FACT AND OPINION

During 2003–2006 petitioner Gregory Podlucky extracted more than $30 million from a corporation he controlled to purchase for himself and his wife luxury jewelry and a mansion, among other things. In 2009 petitioners were indicted in the U.S. District Court for the Western District of

Pennsylvania for crimes including mail fraud, money laundering, and tax evasion. Both were convicted and sentenced to lengthy terms of imprisonment.

After petitioners were remanded to custody, the Internal Revenue Service (IRS or respondent) completed a civil examination of their 2003–2006 tax returns. In 2016 the IRS determined deficiencies of $476,123, $1,189,550, $1,091,254, and [pg. 333] $2,024,775, respectively, plus civil fraud penalties (against Mr. Podlucky only) of $357,092, $892,163, $818,441, and $1,518,581, respectively. Petitioners dispute these determinations and contend that Mrs. Podlucky is entitled to relief from joint and **[*2]** several liability under section 6015.[1] For the reasons that follow, we sustain the IRS's deficiency and penalty determinations and hold that Mrs. Podlucky is not entitled to "innocent spouse" relief.

FINDINGS OF FACT

The following facts are drawn from the pleadings, the trial testimony, documents admitted into evidence at trial, and a stipulation of facts with attached exhibits admitted into evidence under Rule 91(f). Petitioners Gregory Podlucky (Greg) and Karla Podlucky (Karla), husband and wife, filed joint returns for the four tax years at issue. When they filed the petition, Greg was incarcerated in Fort Dix, New Jersey, and Karla resided in Newhall, California.

I. *Background*

Greg is a certified public accountant. He graduated from West Virginia University in 1984 with a degree in accounting and finance. After graduating he worked for his father, who owned a brewing company in Pennsylvania.

In the 1990s Greg started his own beverage bottling business, originally called Genesis, Inc. In 1995 he changed the company's name to Global Beverage Systems, Inc., and expanded its product line. In 2002 he changed its name to Le-Nature's, Inc. (LNI). LNI, a C corporation, specialized in bottling waters, teas, and similar beverages.

At all relevant times Greg was LNI's chief executive officer (CEO), majority shareholder, and chairman of the board. He headquartered LNI in Latrobe, Pennsylvania, about 12 miles from Ligonier, Pennsylvania, where he and Karla lived. He formed a subsidiary called Tea Systems International to sell tea concentrate to other bottlers. LNI had accounts at Merrill Lynch and various banks, and these financial records were introduced into evidence at trial.

During its early years LNI appears to have been successful. It grew rapidly, employing roughly 100 people by 2004. Greg hired his brother to serve as the company's chief operating officer. Under Greg's **[*3]** leadership LNI reported steadily rising year-over-year revenues and profits.

During the tax years at issue LNI had two minority shareholders, Smith Whiley & Co. (Smith Whiley) and George K. Baum Capital Partners (Baum). Both were private equity funds. Venita Fields, Smith Whiley's managing director, had learned about LNI in 1999 from an investment bank. She was interested in "alternative beverages" as an investment concept and believed that LNI might be attractive. On her recommendation Smith Whiley in 2000 invested $10 million in LNI.

In connection with this investment Smith Whiley was given one seat on LNI's board, which was occupied by Ms. Fields. Smith Whiley purchased another $5 million of LNI stock in 2002. It was then given a second seat on LNI's board, which was occupied by Ruth Huet. Both testified at trial of this case. Baum, the other minority shareholder, held the third outside seat on LNI's board. LNI also secured hundreds of millions of dollars in debt financing from larger financial institutions, including AIG, Wachovia, Wells Fargo, and Merrill Lynch.

When recommending the initial investment in LNI, Ms. Fields envisioned a holding period of about six years. In 2005, as that period neared its end, Smith Whiley considered cashing out its investment. Ms. Fields believed, on the basis of quarterly and annual reports furnished to her, that LNI had enjoyed a "sharp incline in revenues and profits." Sale of the LNI stock, she thought, would generate a significant return on Smith Whiley's investment.

Ms. Fields coordinated with Baum, the other minority share-holder, to investigate [pg. 334] possible sale of their stock (or of the company). They hired an investment banker to estimate LNI's value and look for potential buyers. Ms. Fields received expressions of interest from several buyers, but no deal ever closed. Ms. Fields testified that Greg "sabotaged" the negotiations by refusing to give potential buyers access to LNI's accounting records. Rather than sell the company, Greg insisted on expanding its operations by building a production facility in Florida, but he never received board authorization to do that.

In May 2006 the minority shareholders sued LNI in the Delaware Chancery Court. *See* George K. Baum Cap. Partners, LP v. Le-Nature's, Inc., No. CA2158 (Del. Ch. filed May 16, 2006). They alleged that Greg had intentionally obstructed their attempts to sell their stock by blocking access to LNI's books and records. A few months later AIG, one of **[*4]** LNI's lenders, informed the minority shareholders of its belief that Greg had forged documents in order to secure loans and had used loan proceeds to purchase millions of dollars of assets for himself and his wife.

After receiving this information, the chancery court in October 2006 removed Greg as CEO and appointed a custodian to take control of LNI. Salvatore LoBiondo, the custodian's financial restructuring specialist, was directed to manage LNI on an interim basis and review its financial records to determine whether it could continue to operate. Mr. LoBiondo quickly discovered that LNI had maintained two sets of books: one set that reported actual sales and profits, and another that reported fictitious sales and profits. The gap between the two sets of figures was huge: In one

year LNI reported roughly $300 million in revenue, but its actual revenues were closer to $30 million.

These findings prompted LNI's creditors to file an involuntary bankruptcy petition against it in the U.S. Bankruptcy Court for the Western District of Pennsylvania. The bankruptcy court granted that petition and directed Mr. LoBiondo to continue to manage LNI. By the end of November 2006 Mr. LoBiondo concluded that LNI could not be resuscitated. The company's Latrobe and Arizona facilities were closed, and it ceased operations. The minority shareholders lost virtually all of their investments, and LNI's lenders lost more than $600 million.

II. *Criminal Investigation*

In December 2006 the Department of Justice, the IRS Criminal Investigation Division (CID), and the Postal Inspection Service began investigating petitioners for criminal wrongdoing. The Government believed that Greg had supplied LNI's lenders and minority shareholders with false financial documents to induce them to invest in LNI. And the Government believed that Greg had extracted funds from LNI, through a money laundering scheme, to purchase luxury goods for himself and his wife.

CID uncovered evidence that Greg had directed one of his employees to keep accounting records using two different software systems: One system was used to record LNI's actual results, and the other was used to create fictitious (and much more favorable) results. Greg told this employee "what he wanted LNI's sales to be" and instructed her to create fake invoices to support the fictitious sales numbers. This employee, who also pleaded guilty to criminal charges, helped Greg **[*5]** fabricate checks, create fictitious banking records, and generate false financial statements for LNI. The Government found on Greg's computer "templates" that he used to photoshop checks and bank statements. Greg used these bogus documents to induce lenders and potential investors to advance funds to the business.

The investigation also revealed that Greg had siphoned money out of LNI by writing checks on LNI's accounts and by wiring funds from those accounts to two shell companies he controlled: GVS Services (GVS) and Melissa Morgan Capital Corp. (2MC), the latter being named after his daughter.[2] There is no evidence that GVS or 2MC engaged in any meaningful business activities. Both were in essence "incorporated pocketbooks" through which Greg channeled funds in an effort to conceal LNI's identity as the source. GVS and 2MC had numerous bank and brokerage [pg. 335] accounts, and their financial records were introduced into evidence at trial.

The banking records showed that Greg had siphoned more than $30 million out of LNI to purchase assets for himself and his wife. Roughly 70% of the assets thus purchased consisted of luxury jewelry—mostly women's jewelry—including bracelets, necklaces, diamond rings, and watches designed by Chopard, Patek Philippe, and Rolex.

When purchasing jewelry, Greg (or his employee) would often create fictitious invoices from LNI's suppliers. Greg would wire funds from LNI to a bank account in the name of 2MC or GVS, supposedly in payment of these invoices. Greg or Karla would then write checks on these accounts to jewelry vendors. Criminal investigators analyzed these checks and bank transfers and ascertained that Greg used LNI's funds to acquire more than $22 million in jewelry during 2003–2006.

Greg needed a safe place to store all this jewelry. He directed an employee to build a "secret room" at LNI's headquarters in Latrobe. The secret room was described as "a corner of another room that had been walled off with cinder block." To enter the room an individual had to walk through "a small metal door, lift a rug, and crawl." Criminal investigators executed a search warrant and found in the room commercial grade safes stocked with gemstones, necklaces, watches, bracelets, and diamond rings, as well as filing cabinets cataloging each piece.

[*6] Needless to say, LNI's board of directors did not know about this secret room or its contents.

Greg also used company funds to purchase real estate that he diverted to his personal use. In 2002 the board of directors approved an expansion of the Latrobe bottling plant; the new facilities included ample space for conference rooms and employee offices. But Greg insisted that LNI also purchase a 4.7-acre plot of land (Lot 21) in Ligonier. This property was 12 miles from the bottling plant, but it was adjacent to petitioners' primary residence. LNI never listed Lot 21 as a corporate asset on its financial statements. The property was zoned for residential (not commercial) use; at no time did Greg or LNI seek to change its zoning.

In 2003 LNI transferred Lot 21 to petitioners for $1. A trial Ms. t Huet credibly testified that the board of directors never approved this transfer. Greg cross-examined Ms. Huet and showed her board meeting notes that purported to grant approval. Ms. Huet reiterated that the board never approved the proposal and that the document in question appeared to be one of many "board document[s] that [Greg] altered."

Later that year petitioners applied for, and received, a building permit to construct on Lot 21 a 12,071-square-foot single-family house. They hired an architect and a general contractor known in the area for undertaking "high-end residential projects." One of the invoices referred to the property as the "Podlucky Gate House." The architects and contractors were generally paid by checks drawn on 2MC or GVS bank accounts. The house was described as a "mansion" with six bedrooms and nine baths.

CID also discovered that Greg was an avid collector of toy trains, preferring the Lionel brand. In 2005 and 2006 Greg used LNI's funds to purchase Lionel trains from a variety of vendors, including Toy Trains Unlimited, Nicholas Smith Trains, Eastside Trains, and the Train Engineer. In 2005 he placed orders totaling $1,066,628, and in 2006 he placed orders totaling $76,662. He

typically purchased two of each item, leaving one in its original packaging to preserve it in mint condition. He stored the model trains in LNI's warehouse. LNI's board of directors had no knowledge of, and did not approve, these purchases.

Finally, CID questioned a $10,772 college tuition payment for petitioners' son, Jesse Podlucky. In 2004 Jesse attended Saint Vincent College. On May 3, 2004, Greg wired $750,000 from LNI to one of 2MC's **[*7]** bank accounts. Five days later, Karla drew a check on 2MC's account for $10,772, payable to Saint Vincent College. This covered two semesters of tuition, a [pg. 336] parking ticket assessed by the school, and other miscellaneous fees.

In September 2009 Greg was indicted on counts of mail fraud, conspiracy to commit money laundering, and attempting to evade or defeat tax in violation of section 7201. The tax charges were based on his failure to report roughly $35 million of income, in the form of constructive distributions from LNI. Greg pleaded guilty to one count of tax evasion (for 2005), as well as one count of conspiracy and mail fraud. He was sentenced to 20 years' imprisonment.

Karla was indicted on counts of money laundering and conspiracy to commit money laundering. The Government alleged that Karla sold jewelry during the investigation and attempted to conceal the proceeds in trusts and shell companies. She was tried in the U.S. District Court for the Western District of Pennsylvania. In November 2011 she was found guilty of money laundering and sentenced to 51 months' imprisonment. Her conviction was affirmed on appeal. *See* United States v. Podlucky, 567 F. App'x 139 (3d Cir. 2014).

The Government called Brent Nestor to testify as a witness during Karla's criminal trial. At that time Mr. Nestor served as senior vice president of sales for Van Cleef & Arpels (VCA), working in the company's New York office. Mr. Nestor testified about Greg's jewelry purchases from VCA, explaining that most of the jewelry was custom made for Karla. To enable these orders to be filled, Mr. Nestor traveled to Pennsylvania to take Karla's measurements so that rings, bracelets, and necklaces could be sized to fit her exactly.

Mr. Nestor testified that Greg "was quite specific about making the pieces a certain size to fit his wife" and that Karla had personally confirmed her own jewelry preferences. He recalled Karla's writing in one email that she "like[s] the stones to be the center stars," that "diamond encrusted bangles are not comfortable," and that she "like[s] simple, classic, tailored designs." With respect to a special "diamond wedding band" request, Mr. Nestor emailed Greg saying that VCA's **[*8]** "designer has revised several proposals because we want to make sure the motifs around the ring are comfortable for Mrs. P to wear."[3]

If petitioners had a particularly unique or special request, Mr. Nestor would refer it to Lily Vongwattanakit, VCA's director of gem purchasing and special orders. Her role was to discuss the request with the client, take measurements, and send the relevant information to VCA's

headquarters in Paris. Ms. Vongwattanakit credibly testified during the **Tax Court** trial that she met with petitioners to discuss their special requests and take Karla's measurements. Ms. Vongwattanakit testified that she had placed a number of these special orders for petitioners. Petitioners purchased so much jewelry from VCA that its employees called their orders the "Podlucky Collection."

Petitioners also worked closely with Angela Patin, a sales representative for Traditional Jewelers. Ms. Patin credibly testified during the **Tax Court** trial that Greg generally placed the orders but that the jewelry "was mostly for Karla." The jewelry included custom made rings, earrings, bracelets, and necklaces. Ms. Patin credibly testified that she took Karla's measurements so that the jewelry could be sized to fit her exactly.

III. *IRS Examination and Tax Court Proceedings*

Following petitioners' criminal investigation, the IRS in 2012 initiated a civil examination of their 2003–2006 joint Federal income tax returns. For these years petitioners reported between $350,000 and $600,000 of income. The case was assigned to Revenue Agent (RA) Lisa Gaiser. RA Gaiser reconstructed petitioners' income by reviewing bank records, checks, invoices, and other documents obtained during the criminal investigation. She also relied on the prosecution report that underlay the Government's criminal tax evasion charges. Evaluating this information, RA Gaiser determined that peti[pg. 337] tioners had received **[*9]** unreported income during 2003–2006, in the form of constructive distributions from LNI, as follows:

Year	Jewelry	Lot 21	Trains	Tuition	Total
2003	$6,086,621	$347,071	--	$6,433,692	--
2004	4,552,786	3,322,063	--	$10,772	7,885,621
2005	2,150,637	3,899,182	$1,066,628	--	7,116,447
2006	9,959,935	3,418,351	76,662	--	13,454,948

Total	$22,749,979	$10,986,667	$1,143,290	$10,772

$34,890,708

RA Gaiser then calculated petitioners' taxable income using the rules set forth in section 301. It provides that distributions from a C corporation are taxable as dividends to the extent of the corporation's earnings and profits (E&P). *See* §§ 301(c)(1), 316(a). If distributions exceed E&P, they are nontaxable returns of capital to the extent of the share-holder's basis in his stock. *See* § 301(c)(2). Distributions in excess of basis are taxed as capital gain. *See* §§ 301(c)(3), 1001(a).

Setting aside LNI's fictitious financial statements, RA Gaiser determined that the company actually had zero E&P during 2003–2006. She determined that Greg had $3,354,021 of basis in his LNI stock, so a portion of the 2003 distribution constituted a nontaxable return of capital. She determined that a dividend of $93,500, which petitioners reported as having been paid by LNI in 2004, should be recharacterized as capital gain given the absence of E&P. RA Gaiser accordingly deter-mined for each year additional income in the form of long-term capital gain, producing deficiencies (after other minor income adjustments) and civil fraud penalties (against Greg only) as follows:

Year	Capital Gain	Deficiency	Fraud Penalty
2003	$3,079,671	$476,123	$357,092
2004	7,979,121	1,189,550	892,163
2005	7,116,447	1,091,254	818,441
2006	13,454,948	2,024,775	1,518,581
Total	$31,630,187	$4,781,702	$3,586,277

[*10] In April 2012 RA Gaiser prepared Form 11661, Fraud Development Recommendation–Examination. On that form she recommended that the IRS assert against Greg fraud penalties under section 6663 for 2003–2006. She forwarded the case file to Renee Zaffino, her

supervisor. Ms. Zaffino signed the form on April 23, 2012, as RA Gaiser's "Group Manager." Susan Harper, an IRS fraud technical advisor, signed the Form 11661 on May 14, 2012.

On March 22, 2013, RA Gaiser sent petitioners a 30-day letter. She attached to that letter Form 4549–A, Income Tax Discrepancy Adjustments. These documents communicated to Greg that the IRS proposed to assert fraud penalties against him.

On November 21, 2016, the IRS issued petitioners a notice of deficiency for 2003–2006. The notice determined deficiencies totaling $4,781,702 and fraud penalties against Greg totaling $3,586,277. Petitioners timely petitioned this Court, proceeding pro se.

Throughout these proceedings petitioners have refused to cooperate with respondent in preparing this case for trial. They refused to stipulate a single document, and they refused to stipulate undisputed facts, both in violation of Rule 91 (a)(1). By Order served July 15, 2021, we granted respondent's Motion to deem certain facts, [pg. 338] documents, and information established for purposes of this case. *See* Rule 91(f).

Greg has advanced many frivolous arguments and submitted filings plainly intended to delay these proceedings: He has challenged the income tax as unconstitutional; he has asserted that we lack personal and subject matter jurisdiction over him; and he has demanded that we award him $22 billion in damages for operating as a "Star Chamber Court."[4] Greg has filed ten improper appeals from our interlocutory orders.[5]

[*11] Several days before trial Greg filed 3,800 pages of documents. One of these filings included amended joint Federal income tax returns for 2003–2006. These amended returns, which were signed by petitioners,[6] reported all the additional income determined in the notice of deficiency. In an attachment petitioners explained that "we are amending our 2003, 2004, 2005 and 2006 tax returns...to include all the audit adjustments as determined by [the IRS]."

Petitioners alleged that the sentencing court had ordered Greg to pay restitution of $660 million, that certain of their assets had been forfeited, and that they were allowed loss deductions that would completely offset the deficiencies determined by the IRS. They asserted that they were therefore "rescinding" their petitions, that no trial should be held, and that this case should be dismissed.

We informed petitioners that, unless they wished to make a full concession, the case would proceed to trial. We explained "that in deficiency cases brought pursuant to section 6213 a taxpayer may not with-draw a petition in order to avoid a decision." Davidson v. Commissioner, 144 T.C. 273, 274 (2015); Estate of Ming v. Commissioner, 62 T.C. 519, 521 (1974) ("[A] taxpayer may not unilaterally oust the **Tax Court** from jurisdiction which, once invoked, remains unimpaired until it decides the controversy."). Under Rule 123(d), dismissal of a case, other than a

dismissal for lack of jurisdiction, "shall operate as an adjudication on the merits." Thus, if we were to dismiss this case as petitioners suggested, we would be required to enter a decision against them in the full amounts of the deficiencies and penalties determined in the notice of deficiency. The case accordingly proceeded to trial.

OPINION

I. *Unreported Income*

Section 61(a) provides that "gross income means all income from whatever source derived." In cases of unreported income, the Commissioner must establish an evidentiary foundation connecting the tax-payer to the income-producing activity, Weimerskirch v. Commissioner, 596 F.2d 358, 361 [44 AFTR 2d 79-5072] (9th Cir. 1979), rev'g 67 T.C. 672 (1977), or demonstrate that the taxpayer actually received income, Edwards v. Commissioner, 680 F.2d 1268, 1270–71 [50 AFTR 2d 82-5390] (9th Cir. 1982). Once the Commissioner has met his threshold burden, the burden shifts to the taxpayer to show **[*12]** that the Commissioner's determinations are arbitrary or erroneous.[7] *See* Hardy v. Commissioner, 181 F.3d 1002, 1004–05 [84 AFTR 2d 99-5015] (9th Cir. 1999), aff'g T.C. Memo. 1997-97 [1997 RIA TC Memo ¶97,097]; Anastasato v. Commissioner, 794 F.2d 884, 887–88 [58 AFTR 2d 86-5349] (3d Cir. 1986), *vacating and remanding* T.C. Memo. 1985-101 [¶85,101 PH Memo TC].

To satisfy his burden respondent produced extensive bank records, invoices, checks, and receipts gathered during the criminal and civil examinations. During petitioners' criminal investigation the Government discovered a "secret room" in LNI's office building, which contained jewelry worth well in excess of $22 mil[pg. 339] lion.[8] The documents introduced into evidence at trial showed that Greg used roughly $11 million of LNI's funds to finance his Lot 21 construction project and spent $1 million on his toy train collection. During 2003–2006 Greg made these personal expenditures by writing checks on LNI's accounts and by wiring money from LNI to one of the shell companies he controlled.

The IRS computed the deficiencies for 2003–2006 by reviewing these records in conjunction with the Government's prosecution report. The IRS ultimately determined that Greg, as LNI's majority share-holder, received from it constructive distributions of almost $35 million. Respondent has clearly supplied a threshold evidentiary foundation connecting petitioners to unreported income. *See* Petzoldt v. Commissioner, 92 T.C. 661, 687 (1989) (holding that the IRS has great latitude in re-constructing a taxpayer's income, and the reconstruction "need only be reasonable in light of all surrounding facts and circumstances").

Petitioners thus bear the burden of proving that respondent's determinations of unreported income, as set forth in the notice of deficiency, are "arbitrary or erroneous." *See* Hardy, 181 F.3d at 1004;

Anastasato, 794 F.2d at 887–88. Petitioners' submissions have not been a model of clarity. Early in the case they insisted that the income tax laws are unconstitutional. More recently they submitted copies of amended returns reporting all the income determined in the notice of deficiency. **[*13]** These returns could be taken as admissions by petitioners that those unreported income numbers are correct. *See* Badaracco v. Com-missioner, 464 U.S. 386, 399 [53 AFTR 2d 84-446] (1984) ("An amended return, of course, may constitute an admission ...."); Lare v. Commissioner, 62 T.C. 739, 750 (1974) ("Statements made in a tax return signed by a taxpayer may be treated as admissions."), aff'd, 521 F.2d 1399 (3d Cir. 1975).

At trial petitioners focused much attention on the IRS's computations, questioning where the IRS "g[o]t the underpayment numbers from." In their post-trial brief they assert that these numbers "were never corroborated, sustained, and detailed." But petitioners presented nothing credible to rebut the overwhelming amount of evidence linking them to unreported income. They have submitted nothing but general denials, which are "insufficient to meet [their] burden of nonpersuasion." Anastasato, 794 F.2d at 888.

Petitioners appear to contend that the IRS had the burden of producing evidence to prove (for example) that the jewelry petitioners purchased during 2003–2006 was worth $22,749,979. If that is petitioners' argument, it is misconceived. Once the Commissioner produces evidence linking taxpayers to unreported income—as respondent did—tax-payers have the burden of proving that the IRS's determinations of unreported income are "arbitrary and erroneous." Id. at 887; *see* Keogh v. Commissioner, 713 F.2d 496, 502 [52 AFTR 2d 83-5881] (9th Cir. 1983) (holding that the tax-payers failed to prove that the Commissioner's estimates were arbitrary or erroneous where they advanced general denials and "self-serving testimony"). Petitioners have not carried this burden; indeed, they made no genuine effort at trial to do so.

Petitioners alternatively contend that the assets they purchased were acquired for LNI's benefit, not for their own. Greg testified that he purchased luxury jewelry because LNI was "diversifying [its] product lines" and "dealing with Tibetan monks in Asia" who "want[ed] hard assets" rather than cash. According to Greg, the monks had access to valuable species of tea, which LNI wished to acquire by using jewelry in "bartering transactions."

This testimony was utterly implausible. Greg was unable to tell the Court where the putative monks resided or confirm that the country in which they lived produced tea. He could not explain why the monks would prefer jewelry to the U.S. dollar as a medium of exchange. He could not explain why Buddhist monks would be eager [pg. 340] to acquire women's jewelry, particularly jewelry that was sized to fit Karla's wrist, **[*14]** neck, and ring finger. And he could not explain why $22 million of jewelry, if an asset of LNI, was neither shown on its balance sheet nor brought to the attention of its directors.

Greg's testimony about Lot 21 was no more persuasive. He insisted that the "Podlucky Gate House," situated on land zoned for residential use, was intended to be used as a "training facility" for LNI's staff. He could not explain why LNI would have chosen to build an employee training facility next door to his house, 12 miles away from the production facility in Latrobe. He could not explain why LNI needed a separate training center, when its Latrobe facility had recently been expanded to include ample space for conference rooms and employee offices. He asserted that more space was needed for "300 new sales representatives," but he supplied no evidence that LNI ever considered hiring 300 new workers, which would have quadrupled its workforce. He could not explain why a training facility would have been configured as a six-bedroom, nine-bath mansion. And he could not explain why, if the house really was a training facility for LNI, Lot 21 was transferred to him personally for $1, without board approval.[9]

Petitioners offered little testimony about the model train collection, apart from Greg's assertion that the trains were intended for use in a company "marketing campaign." But he offered no evidence that LNI had ever considered such a campaign, no evidence as to who was supposed to conduct it, and no explanation as to how model trains could usefully be deployed to advertise tea-flavored beverages. Assuming arguendo that they could be so used, Greg could not explain why it was necessary to acquire $1.1 million worth of model trains, including duplicates of each item.[10]

[*15] Petitioners also contested the taxability of the $10,772 tuition payment. At trial they asserted that this represented a stipend their son earned for completing an internship with LNI. But they presented no evidence of an internship agreement; no evidence that LNI's board of directors approved any internship or scholarship program; and no evidence that LNI benefited from their son's services. Nor could petitioners explain why the tuition (plus a parking ticket and other fees) was paid out of Greg's shell company by Karla, who was not an officer of LNI. In any event, even if LNI were thought to have derived some benefit from the son's participation in a college internship, petitioners have not shown why such a payment—which relieved them of their own tuition obligation—would be nontaxable. Cf. Hacker v. Commissioner, T.C. Memo. **2022** -16, at *17 [**2022** RIA TC Memo ¶2022-016] (ruling that a shareholder "must include in gross income payments the corporation made on the shareholder's behalf").

In the alternative petitioners contend that they are entitled, under section 165, to loss deductions that completely offset the income determined in the notice of deficiency. They allege that the sentencing court ordered Greg to pay $660 million of restitution and that certain of their assets were forfeited to the Government following their convictions in 2011. "Property forfeited pursuant to a taxpayer's guilty plea," they say, "is properly characterized as a loss item."

This argument fails for at least three reasons. First, petitioners have not properly raised this issue. They did not claim section 165 deductions on their original returns, and they did not mention section 165 in the Petition. *See* Rule 34(b)(4) ("Any issue not raised in the...[petition] [pg. 341]

shall be deemed to be conceded."). Rather, they advanced this new argument one month before trial, in a filing in which they referred to themselves as "Former Petitioners." They asserted that the purported loss deductions obviated the need for trial, demanding that their **Tax Court** Petition be "withdrawn" or "rescinded." They did not submit a pre-trial memorandum, so respondent had no reason to believe that section 165 deductions were actually at issue in this case. To permit petitioners to raise this issue in a post-trial brief, after the trial record closed, would be prejudicial to respondent. *See* Seligman v. **[*16]** Commissioner, 84 T.C. 191, 199 (1985) (finding prejudice where opposing party had no opportunity to present evidence on issue that was not raised in the pleadings), aff'd, 796 F.2d 116 [58 AFTR 2d 86-5539] (5th Cir. 1986).

In any event, petitioners have failed to prove that they are entitled to loss deductions. Section 165(a) permits a taxpayer to deduct "any loss sustained during the taxable year" if "not compensated for by insurance or otherwise." Assuming arguendo that Greg was ordered to pay restitution, petitioners offered no evidence that he actually made restitution payments or (if so) how much restitution he paid. And while petitioners assert that their property was forfeited, they offered no evidence to establish which assets were forfeited or the value of such property.

Finally, petitioners have not established that they sustained any loss during the tax years at issue, i.e., during 2003–2006. *See* Treas. Reg. § 1.165-1(d)(1) (providing that loss deductions are allowed "for the taxable year in which the loss is sustained"). To the contrary, their alleged losses would have occurred (if at all) after 2006, when assets were allegedly "forfeited pursuant to [Greg's] guilty plea" or when restitution ordered by the sentencing court was allegedly paid. *See* Stephens v. Commissioner, 905 F.2d 667, 671 [66 AFTR 2d 90-5147] (2d Cir. 1990) (noting that taxpayers who repay embezzled funds might be "entitled to a deduction in the year in which the funds are repaid"), rev'g 93 T.C. 108 (1989); Norman v. Commissioner, 407 F.2d 1337, 1338 [23 AFTR 2d 69-696] (3d Cir. 1969) (per curiam) (noting that "restitution [paid] in a subsequent year might provide a proper basis for a deduction allowable in that year"), aff'g T.C. Memo. 1968-40 [¶68,040 PH Memo TC]; Treas. Reg. § 1.6001-1(a) (requiring taxpayers to identify the deduction, show that they have met all relevant requirements, and keep books or records to substantiate the amounts claimed).

II. *Fraud Penalties*

Section 6501(a) generally requires the IRS to assess a tax within three years after the return was filed. The period of limitations is extended to six years where the taxpayer omits from gross income an amount "in excess of 25 percent of the amount of gross income stated in the return." § 6501(e)(1)(A)(i). The notice of deficiency in this case was issued on November 21, 2016, more than six years after the period of limitations began to run for 2006, the last year at issue.

However, section 6501(c)(1) provides that, where a taxpayer has filed "a false or fraudulent return with the intent to evade tax," there is **[*17]** no period of limitations, and the tax "may be assessed...at any time." In the case of a joint return, fraud by either taxpayer suspends indefinitely the period of limitations for both taxpayers. Vannaman v. Commissioner, 54 T.C. 1011, 1018 (1970); *see* Richardson v. Commissioner, 509 F.3d 736, 745 [100 AFTR 2d 2007-6970] (6th Cir. 2007) (holding that fraud by one spouse "lifts the statute of limitations" for both), aff'g T.C. Memo 2006-69 [2006 RIA TC Memo ¶2006-069]; Ballard v. Commissioner, 740 F.2d 659, 663 [54 AFTR 2d 84-5745] (8th Cir. 1984) (same), aff'g in part, rev'g in part T.C. Memo 1982-466 [¶82,466 PH Memo TC].

"[T]he determination of fraud for purposes of the period of limitations on assessment under section 6501(c)(1) is the same as the determination of fraud for purposes of the penalty under section 6663...." Neely v. Commissioner, 116 T.C. 79, 85 (2001). Whether the underpayments at issue were due to fraud thus determines [pg. 342] both whether Greg is liable for civil fraud penalties and whether respondent can assess the deficiencies.

A. *Supervisory Approval*

Section 6751(b)(1) provides that "[n]o penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination." As a threshold matter, respondent must show that he complied with section 6751(b)(1). *See* Chai v. Commissioner, 851 F.3d 190, 221 [119 AFTR 2d 2017-1158] (2d Cir. 2017) (ruling that "compliance with § 6751(b) is part of the Commissioner's burden of production" under § 7491(c)), aff'g in part, rev'g in part T.C. Memo. 2015-42 [2015 RIA TC Memo ¶2015-042].

In Belair Woods, LLC v. Commissioner, 154 T.C. 1, 14–15 (2020), we explained that the "initial determination" of a penalty assessment is typically embodied in a letter "by which the IRS formally notifie[s] [the taxpayer] that the Examination Division ha[s] completed its work and...ha[s] made a definite decision to assert penalties." Once the Commissioner introduces evidence sufficient to show written supervisory approval, the burden shifts to the taxpayer to show that the approval was untimely, i.e., "that there was a formal communication of the penalty [to the taxpayer] before the proffered approval" was secured. Frost v. Commissioner, 154 T.C. 23, 35 (2020).

Respondent has produced the Form 11661 by which RA Gaiser recommended assertion of fraud penalties against Greg. RA Gaiser's immediate supervisor, Ms. Zaffino, signed that form on April 23, 2012. The recommendation to assert fraud penalties was communicated to **[*18]** Greg 11 months later, in a 30-day letter dated March 22, 2013, with an attached Form 4549–A showing the penalty calculation. Respondent has thus met his burden of production by showing timely approval. *See* Frost, 154 T.C. at 35.[11]

B. *Existence of Fraud*

"If any part of any underpayment of tax required to be shown on a return is due to fraud," section 6663(a) imposes a penalty of 75% of the portion of the underpayment attributable to fraud. Respondent has the burden of proving fraud, and he must prove it by clear and convincing evidence. *See* § 7454(a); Rule 142(b). To sustain his burden, respondent must establish two elements: (1) that there was an underpayment of tax for each year at issue and (2) that at least some portion of the underpayment for each year was due to fraud. *See* Hebrank v. Commissioner, 81 T.C. 640, 642 (1983).

Where the Commissioner determines fraud penalties for multiple tax years, his burden of proving fraud "applies separately for each of the years." Vanover v. Commissioner, T.C. Memo. 2012-79 [2012 RIA TC Memo ¶2012-079], 103 T.C.M. (CCH) 1418, 1420 (quoting Temple v. Commissioner, T.C. Memo. 2000-337 [2000 RIA TC Memo ¶2000-337], 80 T.C.M. (CCH) 611, 618, aff'd, 62 F. App'x 605 [91 AFTR 2d 2003-1806] (6th Cir. 2003)). If the Commissioner proves that some portion of an underpayment for a particular year was attributable to fraud, then "the entire underpayment shall be treated as attributable to fraud" unless the taxpayer shows, by a preponderance of the evidence, that the balance was not so attributable. § 6663(b).

For the reasons stated previously, respondent has carried his burden of proving by clear and convincing evidence that Greg underreported his income and underpaid his tax for 2003–2006. On August 24, 2021, we granted respondent's Motion for Partial Summary Judgment regarding the existence of fraud for 2005. Because Greg was convicted of tax **[*19]** evasion for that year, he is collaterally estopped from denying that his underpayment for 2005 was due to fraud. *See* DiLeo v. Commissioner, 96 T.C. 858, 885 (1991), aff'd, 959 F.2d 16 [69 AFTR 2d 92-998] (2d Cir. 1992); *see also* Anderson v. Commissioner, 698 [pg. 343] F.3d 160, 164–65 [110 AFTR 2d 2012-5841] (3d Cir. 2012), aff'g T.C. Memo. 2009-44 [2009 RIA TC Memo ¶2009-044]; United States v. Schiff, 240 F. App'x 738 (9th Cir. 2006). At trial respondent thus bore the burden of proving that at least some portions of the underpayments for 2003, 2004, and 2006 were due to fraud.

Fraud is intentional wrongdoing designed to evade tax believed to be owing. Neely, 116 T.C. at 86. The existence of fraud is a question of fact to be resolved upon consideration of the entire record. Estate of Pittard v. Commissioner, 69 T.C. 391, 400 (1977). Fraud is not to be presumed or based upon mere suspicion. Petzoldt, 92 T.C. at 699–700. But because direct proof of a taxpayer's intent is rarely available, fraudulent intent may be established by circumstantial evidence. Id. at 699. The Commissioner satisfies his burden of proof by showing that "the taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes." Parks v. Commissioner, 94 T.C. 654, 661 (1990). The taxpayer's entire course of conduct may be examined to establish the requisite intent, and an intent to mislead may

be inferred from a pattern of conduct. Webb v. Commissioner, 394 F.2d 366, 379 [21 AFTR 2d 1150] (5th Cir. 1968), aff'g T.C. Memo. 1966-81 [¶66,081 PH Memo TC]; Stone v. Commissioner, 56 T.C. 213, 224 (1971).

Circumstances that may indicate fraudulent intent, often called "badges of fraud," include but are not limited to: (1) understating income, (2) keeping inadequate records, (3) giving implausible or inconsistent explanations of behavior, (4) concealing income or assets, (5) failing to cooperate with tax authorities, (6) engaging in illegal activities, (7) supplying incomplete or misleading information to a tax return preparer, (8) providing testimony that lacks credibility, (9) filing false documents (including false tax returns), (10) failing to file tax returns, and (11) dealing in cash. *See* Schiff v. United States, 919 F.2d 830, 833 [67 AFTR 2d 91-1062] (2d Cir. 1990); Bradford v. Commissioner, 796 F.2d 303, 307–08 [58 AFTR 2d 86-5532] (9th Cir. 1986), aff'g T.C. Memo. 1984-601 [¶84,601 PH Memo TC]; Parks, 94 T.C. at 664–65; Recklitis v. Commissioner, 91 T.C. 874, 910 (1988); Morse v. Commissioner, T.C. Memo. 2003-332 [2003 RIA TC Memo ¶2003-332], 86 T.C.M. (CCH) 673, 675, aff'd, 419 F.3d 829 [96 AFTR 2d 2005-5814] (8th Cir. 2005). No single factor is dispositive, but the existence of several factors "is persuasive circumstantial evidence of fraud." Vanover, 103 T.C.M. (CCH) at 1420–21. We conclude that at least eight of these badges demonstrate that Greg acted with fraudulent intent during 2003, 2004, and 2006.

[*20] 1. *Understating Income*

A pattern of substantially understating income for multiple years is strong evidence of fraud, particularly if the understatements are not satisfactorily explained. *See* Vanover, 103 T.C.M. (CCH) at 1421. Greg understated his income by $3,120,163 for 2003, $7,904,784 for 2004, $7,184,409 for 2005, and $13,480,876 for 2006. The volume of this income was extremely large relative to the income that Greg actually re-ported for each year, which was between $350,000 and $600,000.

During 2003–2006 Greg created false financial records to induce lenders and investors to advance funds to LNI. The Third Circuit stated that Greg's scheme "bilked LNI's investors and banks of more than $628 million." Podlucky, 567 F. App'x at 141. He then extracted $35 million of loan proceeds from the company to purchase luxury jewelry and a mansion for himself and his wife. Given the source of this income, the substantial amounts underreported, and Greg's pattern of underreporting, these understatements are persuasive evidence of fraudulent intent.

2. *Keeping Inadequate Records*

Greg not only failed to supply adequate records of his assets and income but actively falsified documents during 2003–2006. He told one of his employees "what he wanted [LNI's] sales to be" and directed her to "create fake invoices to support the fictitious sales numbers." Together they fabricated checks, created [pg. 344] fictitious bank statements, and generated fraudulent financial

statements for LNI. Greg's computer contained "templates" that he used to photoshop bank checks and other documents.

As part of this scheme Greg maintained two sets of books for LNI. He instructed his employee to use two separate software systems: one to track the company's actual results and the other to store the fraudulent accounting records. Needless to say, Greg did not inform LNI's investors, creditors, or outside shareholders that the records he supplied to them were false.

Greg also took steps to conceal LNI's identity as the source of funds used to purchase jewelry and fund the Podlucky Gate House. Most of the payments to jewelers, architects, and contractors were drawn on bank accounts of shell companies under Greg's control, to which he had wired funds from LNI. He fabricated invoices from suppliers to create an illusory justification for these transfers. The **[*21]** creation of fictitious records supplies strong evidence of fraudulent intent.

3. *Giving Implausible or Inconsistent Explanations*

Greg offered to the IRS and the Court a variety of implausible and inconsistent explanations about his income and assets. At trial he argued that he purchased diamond rings and necklaces, sized specifically for Karla, because LNI was engaging in "barter" transactions with "Tibetan monks in Asia" who "want[ed] hard assets" rather than cash. And he advanced the wholly implausible argument that a six-bedroom, nine-bath mansion was intended to be used as a "training facility" for LNI's employees. As a certified public accountant and CEO of a large corporation, Greg must have known that these theories were untenable.

4. *Concealing Income or Assets*

A willful attempt to evade tax may be inferred from a taxpayer's concealment of income or assets. Spies v. United States, 317 U.S. 492, 499 [30 AFTR 378] (1943). Greg intentionally concealed LNI's true accounting records in a set of books to which only he (and his partners in crime) had access. He falsified LNI's revenues and profits, and he concealed the fact that he was funneling LNI's funds to shell companies to purchase personal assets.

The clearest indication that Greg attempted to conceal assets is that he built a "secret room" to hide assets. He hid more than $20 million of jewelry in this "secret room," tucked away behind a cinderblock wall in LNI's headquarters, which could be entered only by walking through "a small metal door, lift[ing] a rug, and crawl[ing]." Greg's entire course of conduct reveals a deliberate intent to conceal income and assets.

5. *Failure to Cooperate with Tax Authorities*

Throughout these proceedings Greg refused to cooperate with respondent in preparing this case for trial. He refused to stipulate undisputed facts and exhibits (e.g., the tax returns that petitioners them-selves filed) in violation of Rule 91(a)(1). He made frivolous arguments and submitted filings intended to delay proceedings: He challenged the income tax as unconstitutional; he asserted that the Court lacks personal and subject matter jurisdiction over him; and he demanded that the Court award him $22 billion in damages for operating as a "Star Chamber Court." This obstructive behavior is a badge of fraud. *See* **[*22]** Curtis v. Commissioner, T.C. Memo. 2013-12 [2013 RIA TC Memo ¶2013-012], 105 T.C.M. (CCH) 1100, 1104 (holding that the "assertion of frivolous arguments" and "tax-protestor beliefs demonstrate a clear intent to evade" tax), aff'd, 648 F. App'x 689 [117 AFTR 2d 2016-1347] (9th Cir. 2016).

6. *Engaging in Illegal Activities*

During 2003–2006 Greg falsified LNI's financial records to induce investors and lenders to advance funds to the business. He extracted $35 million from the company to purchase luxury jewelry and a mansion. In September 2009 he was indicted for multiple crimes and pleaded guilty to tax evasion, mail fraud, and conspiracy. These illegal activities are definite badges of fraud. *See* Catlett v. Commissioner, T.C. Memo. 2021-102, at *19 [2021 RIA TC Memo ¶2021-102]; Le v. Commissioner, T.C. Memo. 2020-27 [2020 RIA TC Memo ¶2020-027], 119 T.C.M. [pg. 345] (CCH) 1165, 1173 [2020 RIA TC Memo ¶2020-027].

7. *Lack of Credibility of Taxpayer's Testimony*

We did not find Greg to be a credible witness. We have noted above numerous specific points on which we found his testimony to lack credibility. His primary defense—that he purchased inherently personal assets for LNI's benefit—was wholly implausible in the light of the illegal accounting scheme that he concealed from LNI's investors and creditors.

8. *Filing False Documents*

Greg filed false income tax returns for 2003–2006, omitting more than $30 million of gross income. As a certified public accountant, he must have recognized his obligation to report this income, which enabled his lavish spending and lifestyle. He also supplied auditors, lenders, and potential investors with fraudulent documents that he fabricated or caused to be fabricated. These false documents furnish additional evidence of fraudulent intent.

We conclude that respondent has established by clear and convincing evidence that the underpayments of tax for 2003–2006 were attributable to fraud. Greg did not establish, "by a preponderance of the evidence," that any portions of the underpayments were not attributable to fraud. *See* § 6663(b). We thus sustain respondent's determinations that (1) Greg is liable for civil

fraud penalties for 2003–2006 and (2) the notice of deficiency for 2003–2006 was timely under section 6501(c)(1).

[*23] III. *"Innocent Spouse" Relief*

Married taxpayers may elect to file a joint Federal income tax return. § 6013(a). After making this election, each spouse is jointly and severally liable for the entire tax due for that year. § 6013(d)(3); Butler v. Commissioner, 114 T.C. 276, 282 (2000). But in certain circumstances a spouse who has filed a joint return may seek relief from joint and several liability under section 6015.

Section 6015(b) specifies procedures for relief from liability for all joint filers, and subsection (c) specifies procedures to limit liability for taxpayers who are no longer married or are living separately. Karla is not eligible for relief under subsection (c) because she remains married to, and continues to live with, Greg.[12] *See* § 6015(c)(3)(A)(i). However, Karla contends that she meets the requirements of subsection (b). She bears the burden of proving that she is entitled to relief. *See* Rule 142(a); Alt v. Commissioner, 119 T.C. 306, 311 (2002), aff'd, 101 F. App'x 34 [93 AFTR 2d 2004-2561] (6th Cir. 2004).

Section 6015(b)(1) provides that a requesting spouse shall be relieved of joint and several liability for a particular year if: (1) the requesting spouse filed a joint return, (2) the return contains an understatement of tax attributable to an erroneous item of the nonrequesting spouse, (3) the requesting spouse did not know and had no reason to know about the understatement, (4) it would be inequitable to hold the requesting spouse liable for the deficiency attributable to the understatement, and (5) the requesting spouse's claim for relief is timely. Failure to meet any one of these requirements precludes relief under section 6015(b). Alt, 119 T.C. at 313. We find that Karla does not meet the second, third, or fourth requirement.

A. *Whether the Understatement is Attributable to Karla*

A requesting spouse is not eligible for relief under section 6015(b) if the understatement of tax is attributable to her own erroneous items. § 6015(b)(1)(B). In this case the understatements arose out of Greg's extraction of funds from LNI, which he used to finance his and Karla's lavish lifestyle. Although Greg directed the scheme, causing LNI to make constructive distributions of property, Karla played a crucial role.

[*24] Karla had signature authority over the bank accounts of 2MC, a shell company that Greg deployed to carry out his fraud. One step in the arrangement in[pg. 346] volved Greg's wiring money from LNI to 2MC. Karla would then draw money from 2MC's accounts to purchase jewelry and to pay for services related to the Podlucky Gate House.

During 2003–2006 Karla signed at least 100 checks on behalf of 2MC. The amounts ranged from $60 to $500,000, and the checks were made out to her, Greg, Traditional Jewelers, Blackstone Fine Jewelers, Fine Gems International, and VCA, as well as architects and contractors involved in the Lot 21 construction. Karla signed at least $6,628,139 in checks during these years. These payments far exceeded the total income that petitioners reported on their joint returns for 2003–2006, which was between between $350,000 and $600,000 annually.

At trial Karla conceded that some of the jewelry belonged to her. She stated that Greg had purchased the jewelry after securing a $5 million investment for LNI in 2000, and that she "assumed [all the jewelry] was being purchased with that $5 million." She argued that respondent "never differentiated between [her] personal jewelry and the investment jewelry for Le-Nature's."

We did not find this line of argument persuasive. As the person seeking relief from joint and several liability, Karla bears the burden of proving that she is entitled to relief. *See* Rule 142(a); Alt, 119 T.C. at 311. Petitioners did not carry their burden to prove that any of the jewelry was "investment jewelry" purchased for LNI's benefit. In any event, it was Karla's responsibility, not respondent's, to "differentiate[] between [her] personal jewelry and the investment jewelry." She did not produce any documents or other information that could enable the Court to determine which (if any) pieces were actually purchased as an investment for LNI.

While Karla may not have acted with fraudulent intent, the evidence shows that the ill-gotten gains were attributable to her, at least in part. She signed more than 100 checks on behalf of 2MC. These checks, made out to jewelry vendors, architects, and contractors, totaled more than $6 million and benefited her personally. We conclude that Karla has failed to establish that any portion of the understatements is not attributable to her.

[*25] B. *Knowledge or Reason to Know*

Section 6015(b)(1)(C) provides that a requesting spouse may be eligible for relief if she establishes that "she did not know, and had no reason to know," about the understatement of tax. The "reason to know" test is subjective. *See* Butler, 114 T.C. at 284. We consider several factors, including the requesting spouse's involvement in the events leading to the understatement and the existence of expenditures that are "lavish or unusual when compared to the family's past income levels." Ibid.

As explained above, Karla was directly involved in the transactions that led to the understatements of tax, because she signed more than $6 million of checks to jewelry vendors and contactors working on their mansion. At trial Karla downplayed her role. Although she acknowledged that she had signed many checks, she said that Greg was "very secretive" and that she did not "kn[o]w the extent of his purchases." She said that she had no "social life outside of church" and "would never ostentatiously wear the sort of pieces [of jewelry] that Greg Podlucky was buying." She testified

that, because Greg had stashed most of the jewelry in LNI's secret room, she thought that the jewelry belonged to LNI.

We did not find this testimony credible. VCA's senior vice president of sales (Mr. Nestor) and VCA's director of gem purchasing and special orders (Ms. Vongwattanakit) both testified that they had traveled to Pennsylvania specifically to take Karla's measurements. Indeed, Mr. Nestor testified that Greg "was quite specific about making the pieces a certain size to fit his wife." After sizing Karla's neck, fingers, and wrists, Mr. Nestor and Ms. Vongwattanakit helped petitioners design custom made diamond rings, earrings, bracelets, and necklaces. Petitioners ordered so much jewelry that VCA's employees referred to their stash as the "Podlucky Collection."

Although Greg served as VCA's main point of contact, Mr. Nestor received emails in which Karla specified her jewelry preferences. She wrote in one email [pg. 347] that she "like[s] the stones to be the center stars," that "diamond encrusted bangles are not comfortable," and that she "like[s] simple, classic, tailored designs." These are not the observations of a spouse who did not "kn[o]w the extent of [her husband's] purchases."

Ms. Patin, a sales representative for Traditional Jewelers, similarly testified about her business relationship with petitioners. She **[*26]** credibly testified that petitioners ordered custom made rings, earrings, bracelets, and necklaces for Karla and that she took Karla's measurements so that the jewelry could be sized to fit her exactly. Although Greg at times ordered men's watches, Ms. Patin testified that the jewelry "was mostly for Karla." During 2003–2006 Karla signed at least 20 checks to Traditional Jewelers, totaling more than $1,900,000.

These jewelry purchases alone vastly exceeded the income that petitioners reported for 2003–2006, which ranged between $350,000 and $600,000. These expenditures were plainly "lavish or unusual when compared to the family's past income levels." Butler, 114 T.C. at 284. Considering her husband's purported income, a reasonable person in her position would have questioned their ability to buy all this jewelry, not to mention an $11 million mansion. *See* Price v. Commissioner, 887 F.2d 959, 965 [64 AFTR 2d 89-5822] (9th Cir. 1989) (discussing the requesting spouse's "duty of inquiry"). As we have repeatedly held, "[s]ection 6015 does not protect a spouse who turns a blind eye to facts readily available to her." Porter v. Commissioner, 132 T.C. 203, 212 (2009); *see* Guth v. Commissioner, 897 F.2d 441, 444 [65 AFTR 2d 90-657] (9th Cir. 1990) (noting that in unreported income cases the requesting spouse must show that "she had no knowledge of the transactions leading to the understatement"), aff'g T.C. Memo. 1987-522 [¶87,522 PH Memo TC]. For all these reasons we conclude that Karla knew or should have known, when signing the 2003–2006 returns, that the returns significantly understated their tax.[13]

C. *Equitable Considerations*

Under section 6015(b)(1)(D), a requesting spouse may be eligible for relief if she establishes, based on "all the facts and circumstances," that it would be "inequitable" to be held liable for the tax. "[T]he equitable factors we consider[] under section 6015(b)(1)(D) are the same equitable factors we consider under section 6015(f)." Alt, 119 T.C. at 316. We generally consider: (1) marital status, (2) economic hardship, (3) significant benefit, (4) subsequent compliance with Federal tax laws, (5) legal obligation to pay the outstanding tax liability, (6) knowledge or reason to know about the understatement, and (7) mental or physical health. *See* Rev. Proc. 2013-34, § 4.03(2), 2013-43 I.R.B. 397, 400–03 (listing these seven factors for consideration in determining whether **[*27]** equitable relief should be granted under section 6015(f)); *see also* Treas. Reg. § 1.6015-2(d).[14]

We find that five of these factors are neutral. But the third and sixth factors weigh heavily against relief. As explained above, Karla knew or had reason to know about the understatements of tax. And she also derived a "significant benefit" from those understatements.

The "significant benefit" factor requires the Court to consider whether the requesting spouse benefited in excess of normal support. *See* Robinson, 120 T.C.M. (CCH) at 224; Rev. Proc. 2013-34, § 4.03(2)(e), 2013-43 I.R.B. at 402. If the understatement enabled the requesting spouse to purchase "luxury assets" or live a "lavish lifestyle," then this factor weighs against relief. Rev. Proc. 2013-34, § 4.03(2)(e), 2013-43 I.R.B. at 402; *see* Alt, 119 T.C. at 314 (finding that the requesting spouse benefited from the understatement where it [pg. 348] enabled her to pay for land, antiques, and her child's college tuition).

Petitioners understated their income by $3,120,163 for 2003, $7,904,784 for 2004, $7,184,409 for 2005, and $13,480,876 for 2006. These understatements enabled them to purchase massive amounts of luxury jewelry and an $11 million mansion. These were plainly "luxury assets" incident to a "lavish lifestyle," and Karla failed to prove that Greg made all these spending decisions. *See* Rev. Proc. 2013-34, § 4.03(2)(e). Indeed, Karla herself issued more than $6 million in checks to jewelry vendors and contractors. We find that the "significant benefit" factor weighs heavily against relief.

In sum, we conclude that the "reason to know" and "significant benefit" factors cut decisively against Karla's claim for relief under section 6015(b). No equitable factor (from the revenue procedure or otherwise) weighs in favor of relief. Weighing these seven factors, we conclude that Karla has failed to carry her burden of proving that it would be "inequitable" to be held liable for the tax. Karla is therefore not eligible for relief under section 6015(b). *See* Alt, 119 T.C. at 313 (noting that the section 6015(b)(1) requirements are "conjunctive," and "a **[*28]** failure to meet any one of them prevents a requesting spouse from qualifying for relief").[15]

We have considered all remaining arguments the parties made and, to the extent not addressed, we find them to be irrelevant or meritless.

To implement the foregoing,

Decision will be entered for respondent.

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Procedure. We round all monetary amounts to the nearest dollar.

[2] Greg created several partnerships related to 2MC; for convenience we refer to all of these related entities as "2MC."

[3] Respondent filed a Motion in Limine requesting that Mr. Nestor's prior testimony be admitted under Rule 804(b)(1) of the Federal Rules of Evidence. That provision provides an exception to the hearsay rules when the declarant is unavailable, the testimony was given "at a trial," and the testimony is "now offered against a party who had...an opportunity and similar motive to develop it by direct, cross-, or redirect examination." Fed. R. Evid. 804(b)(1). Mr. Nestor resides in Switzerland and was unavailable at the time of the **Tax Court** trial. By Order served October 21, 2021, we granted respondent's motion.

[4] Petitioners improperly attached "exhibits" and other documentary evidence to their post-trial briefs. By Order served March 23, **2022**, we struck these "exhibits" from the record. We explained that the record had been closed since October 2021 and that documents cannot be "interjected into the record as attachments to pleadings or briefs." We did not consider these documents when preparing this opinion.

[5] Greg initially filed these interlocutory appeals in the U.S. Court of Appeals for the Third Circuit. After the Department of Justice moved to enjoin him from filing any more frivolous appeals, he began filing appeals in the U.S. Court of Appeals for the Ninth Circuit.

[6] Karla signed the amended returns as "Innocent Spouse KSP."

[7] Petitioners assert that the RA lacked authority under section 7608 and that the evidence introduced at trial is "poisoned fruit of the poisonous tree." This is a frivolous argument. Section 7608, which governs certain criminal enforcement actions, does not limit the Commissioner's authority to conduct civil examinations under section 6201, determine deficiencies under section 6212, or collect taxes under section 6301.

[8] The criminal investigators actually discovered $33,972,473 of jewelry in the "secret room." But the IRS determined that only $22,749,979 worth of jewelry had been constructively

distributed to petitioners during the 2003–2006 tax years at issue.

[9] Karla testified, in the alternative, that the Podlucky Gate House was in-tended for use by religious missionaries whom she admired. We did not find that testimony credible. In any event, that would have been a personal use, as opposed to a business use of the company, and the Lot 21 expenditures would still be constructive distributions. Cf. Magnon v. Commissioner, 73 T.C. 980, 994 (1980) ("The crucial test of the existence of a constructive dividend is whether `the distribution was primarily for the benefit of the shareholder.'").

[10] Greg contended that LNI must have "owned" the model trains because the bankruptcy court ultimately directed that they be sold for the benefit of creditors. The conclusion does not follow from the premise. Greg extracted $3 5 million from LNI at a time when he was defrauding LNI's lenders and minority shareholders. Under these circumstances, the bankruptcy trustee attempted to recoup what he could from the assets Greg had wrongfully acquired. But this does not negate Greg's receipt of gross income in the year the property was constructively distributed to him. This resembles the embezzlement scenario: The fact that an embezzler repays the funds in a later year does not negate his receipt of gross income in the year of the embezzlement. *See* Yerkie v. Commissioner, 67 T.C. 388, 390 (1976) ("Although the proceeds of an embezzlement are not obtained lawfully, they result in economic gains for the embezzler and, as such, are included in his gross income for the year in which the funds were misappropriated." (citing James v. United States, 366 U.S. 213 [7 AFTR 2d 1361] (1961))).

[11] In Laidlaw's Harley Davidson Sales, Inc. v. Commissioner, 29 F.4th 1066 (9th Cir. **2022**), rev'g and remanding 154 T.C. 68 (2020), the Ninth Circuit considered the timeline for obtaining supervisory approval of "assessable penalties," which are not subject to deficiency procedures. The court held that, for an assessable penalty, supervisory approval is timely if secured before the penalty is assessed or "before the relevant supervisor loses discretion whether to approve the penalty assessment." Id. at 1074. The court suggested that, in a deficiency case such as this, the deadline for securing supervisory approval would be the issuance of the notice of deficiency. Id. at 1071 n.4. If that analysis were adopted here, supervisory approval of the fraud penalties was clearly timely: Approval was secured in April 2012, and the notice of deficiency was not issued until November 2016.

[12] Although Greg was sentenced to 20 years' imprisonment, he was evidently released early. Greg and Karla now share an address in Colorado, and they appeared together for the remote trial.

[13] This is not a case where Karla's knowledge is "negated" because of spousal abuse or lack of access to household finances. Cf. Robinson v. Commissioner, T.C. Memo. 2020-134 [2020 RIA TC Memo ¶2020-134], 120 T.C.M. (CCH) 217, 224 (concluding that the spouse's

knowledge was negated because her husband "prevented [her] from questioning the payment of tax reported as due").

[14] Rev. Proc. 2013-34, which modified and superseded Rev. Proc. 2003-61, 2003-2 C.B. 296, applies to requests for equitable relief under section 6015(f) that were filed on or after September 16, 2013. Although we are not bound by the guidelines set forth in Rev. Proc. 2013-34, we consult those guidelines in considering whether a taxpayer is entitled to equitable relief under section 6015(f). *See* Pullins v. Commissioner, 136 T.C. 432, 438–39 (2011).

[15] Karla did not argue that she is eligible for relief under section 6015(f). But even if she had, her claim would fail for several reasons. First, Rev. Proc. 2013-34, which specifies the procedures governing equitable relief under section 6015(f), sets forth seven "threshold conditions" that a requesting spouse must satisfy to be eligible for relief. Rev. Proc. 2013-34, § 4.01, 2013-43 I.R.B. at 399-400. Karla cannot satisfy the seventh condition, which requires that the tax liability be attributable to an item of the non-requesting spouse. *See* supra pp. 23–24. Assuming arguendo that Karla could surmount this threshold hurdle, her claim for equitable relief would fail for the reasons discussed in the text.

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Tax Court & Board of Tax Appeals Memorandum Decisions

Michael T. Sestak v. Commissioner, T.C. Memo. 2022 -41 , Code Sec(s) 165.

MICHAEL T. SESTAK, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 296]

Code Sec(s):	165
Docket:	Dkt. No. 17285-18.
Date Issued:	04/25/**2022**.
Judge:	Opinion by Weiler, *J.*
Tax Year(s):	Year 2012.
Disposition:	Decision for Commissioner.

HEADNOTE

1. Loss deductions—criminal forfeiture; foreign real estate holdings. Taxpayer/former U.S. State Dept. consular officer wasn't entitled to deduct loss on forfeiture sale of foreign real estate holdings, which he agreed in criminal plea agreement represented bribery proceeds traceable to fraudulent visa scheme. Although taxpayer's foreign holdings were sold at loss, allowing taxpayer

to deduct proceeds obtained through illegal activities would undermine public policy as it would permit portion of his forfeiture obligation to be borne by govt.

Reference(s): ¶ 1655.080(5) Code Sec. 165

2. Fraud penalties—burden of proof and production—written approval of assessment—unreported income. Fraud penalties were upheld against taxpayer/former U.S. State Dept. consular officer for year for which he had unreported income, including unreported proceeds relating to bribery and fraudulent visa scheme: IRS showed that it satisfied Code Sec. 6751(b) 's written supervisory approval prerequisite for penalties, that taxpayer had underpayment relating to above, and that such was attributable to fraud. Fraud evidence included taxpayer's income underreporting plus facts that he dealt in cash; that he filed false documents, including tax return; that he engaged in criminal conduct, using influential position within State Dept. for personal gain; and that he employed sophisticated means to conceal his income, including by using co-conspirators to transfer funds through foreign bank accounts in one country and then purchase real estate holdings in another country. His argument [pg. 297] that despite above, he wasn't liable for fraud penalty because once incarcerated, he directed his preparer to file amended return reporting his bribery proceeds as income, was meritless in that fraud occurred when he filed his original return omitting said income.

Reference(s): ¶ 66,635.01(5) Code Sec. 6663; Code Sec. 6751; Code Sec. 7491

Syllabus

Counsel

Michael T. Sestak, pro se.

Joel D. McMahan and A. Gary Begun, for respondent.

WEILER, *Judge*

MEMORANDUM FINDINGS OF FACT AND OPINION

This case arises from a statutory notice of deficiency issued to petitioner for tax year 2012. The issues for decision are: (1) whether petitioner is entitled to a deduction with respect to a loss on the sale of his foreign real estate holdings as part of his criminal forfeiture with the United States and (2) whether petitioner is liable for the civil fraud penalty under section 6663. [1]

FINDINGS OF FACT

This case was tried during the Jacksonville, Florida remote trial, session of the Court. At trial the parties stipulated most of the relevant facts, which are so found, including the bribery proceeds petitioner **[*2]** received during tax year 2012. Petitioner is a U.S. citizen and resided in Florida when he timely filed his Petition.

On November 15, 2000, petitioner received a bachelor of arts degree in social sciences and history from Thomas Edison State College. On January 27, 2003, he received a master of arts degree in politics from New York University, and in August 2009 he received a diploma from the U.S. War College Distance Education Program.

Petitioner was employed by the U.S. Department of State from May 2003 until March 2014 and had had previous overseas assignments in Bogota, Colombia, Madrid, Spain, and Krakow, Poland. Between August 2010 and September 2012 petitioner was employed as a consular officer by the State Department at the U.S. Consulate in Ho Chi Minh City, Vietnam. While employed as a consular officer, he served as chief of the Consulate's Nonimmigrant Visa Unit. Petitioner 's responsibilities included reviewing U.S. visa applications, conducting interviews, and issuing U.S. visas to applicants.

In 2010 petitioner met a fellow U.S. citizen and resident of Vietnam named Binh Vo. Mr. Vo and petitioner devised a scheme whereby they would receive compensation in exchange for petitioner's facilitating approval of nonimmigrant visas to the United States through his position as a consular officer. Petitioner agreed to accept compensation from applicants—or their families—in exchange for approval of nonimmigrant visas to the United States.

This scheme required petitioner to use fake or code names, special email accounts, and cellphones for communication with Mr. Vo. Mr. Vo would inform petitioner in advance of the identity of each foreign national who agreed to pay money in exchange for a U.S. visa, and petitioner would then attempt to personally handle the applicant's visa application, including conducting the applicant's interview. In several instances petitioner issued visas to applicants who had been previously denied visas. From February to September 2012 petitioner approved 410 visa applications directed to him by Mr. Vo and others participating in the fraudulent scheme.

Initially, petitioner was compensated for his part in this fraudulent scheme in cash, which he stored in a safe at his residence in Vietnam. However, as the bribery proceeds continued to grow, petitioner asked Mr. Vo to maintain custody of them and to assist him in moving the funds to petitioner's bank account in Thailand. This request involved **[*3]** making wire transfers of funds through intermediaries in China and elsewhere. In all petitioner received wire transfers totaling $3,227,501 to his bank account in Thailand during 2012. [pg. 298]

In an attempt to hide his bribery proceeds from the U.S. Government, petitioner acquired real property in Thailand, and from June to December 2012 he purchased nine real estate properties

for a total of approximately $3.2 million. Petitioner also arranged for his sister—who lived in the United States—to receive $150,000 of his bribery proceeds, which she used to purchase a home in Yulee, Florida.

On or about September 24, 2012, petitioner submitted signed responses to a "Questionnaire for National Security Positions (SF86 Format)" in which he falsely claimed he held no foreign financial interests and did not own, anticipate owning, or plan to purchase real estate in a foreign country. On October 19, 2012, petitioner was interviewed by two diplomatic security special agents from the State Department in the District of Columbia. During his interview, petitioner was asked by the special agents whether he was aware of any State Department officials who had unexpectedly come into a lot of money, not in line with regular salary, while he was stationed at the U.S. Consulate in Ho Chi Minh City. At the time of his interview with the special agents, petitioner gave false answers in an effort to conceal the existence of the fraudulent scheme and the proceeds derived therefrom.

In early 2013 petitioner timely filed his 2012 Form 1040, U.S. Individual Income Tax Return, reporting therein wages of $122,029 as an employee of the State Department. However, petitioner failed to report on this tax return the $3,227,501 in bribery proceeds he received. Petitioner is a well-educated man who had been employed by the State Department and worked overseas for many years. Consequently, we find that when he filed his 2012 tax return, he knew (or should have otherwise known) that he was required to recognize his bribery proceeds as income; and he intentionally did not do so to continue his participation in the fraudulent scheme.

The State Department uncovered the fraudulent scheme, and petitioner was arrested by local authorities in Thailand. Petitioner was then extradited to the United States, where he was subsequently named a defendant in a criminal complaint filed in the U.S. District Court for the District of Columbia, in a case brought by the U.S. Department of Justice. Ultimately, petitioner pleaded guilty to one count of conspiracy to commit offenses against the United States and to defraud the United **[*4]** States, one count of bribery of a public official, and one count of conspiracy to engage in a monetary transaction in property derived from specified unlawful activity.

On November 1, 2013, petitioner entered into a written plea agreement with the United States. As part of the plea agreement he also executed a preliminary consent order of forfeiture imposing a forfeiture money judgment of $6,021,441 in favor of the United States, which included forfeiture of his real estate holdings in Thailand and other assets held by his co-defendants. Under his plea agreement, he agreed that his real estate holdings in Thailand represented bribery proceeds traceable to the fraudulent visa scheme, constituted property involved in the conspiracy to engage in a monetary transaction to which he pleaded guilty, and were subject to forfeiture pursuant to 18 U.S.C. § 981(a)(1)(C), 18 U.S.C. § 982(a)(1) and (6), 21 U.S.C. § 853(p), and 28 U.S.C. § 2461. Pursuant to the written plea agreement and under the terms of the preliminary consent order of

forfeiture, petitioner agreed to cooperate and voluntarily sell his real estate holdings in Thailand and to transfer the net proceeds to the United States to satisfy a portion of the money judgment entered against him.

As part of his plea agreement petitioner retained an independent appraiser and agent to appraise, market, and sell the real estate holdings in Thailand. Subject to the approval of the United States, the properties were to be sold at any price and only to unrelated third parties. It was also agreed that in the event the net proceeds from the sale of the real estate holdings in Thailand collectively exceeded $3,255,840, then 50% of the excess would be used by petitioner to pay any federal income tax due for tax years 2012 and 2013. Ultimately, petitioner sold his real estate holdings during 2013 to 2015, and in connection with the sales of his real estate [pg. 299] holdings in Thailand and other criminal forfeitures, the United States received $1,551,134. [2]

The IRS first corresponded with petitioner by letter dated September 21, 2015, concerning the civil resolution of his criminal proceedings. The IRS audited petitioner's 2012 return, and through IRS Letter 950 (a 30-day letter) dated December 6, 2017, along with Form 4549–A, Income Tax Examination Changes, the IRS first asserted the civil fraud penalty against petitioner. Revenue Agent (RA) Janett **[*5]** Ballentine, during the audit, made the initial determination to assert the civil fraud penalty under section 6663 against petitioner. RA Ballentine obtained prior written supervisory approval to assert the civil fraud penalty pursuant to section 6663 from her immediate supervisor, Patrick L. Freeman, Jr., before she formally communicated the penalty to petitioner.

OPINION

I. *Summary of the Parties' Arguments*

At trial petitioner readily acknowledged receipt of the stipulated bribery proceeds during tax year 2012. However, he argues that the liquidation of his real estate holdings in Thailand was not a forfeiture, because the properties were located outside of the United States and, therefore, outside the jurisdiction of the U.S. court system. Petitioner contends that because the proceeds from the sales of his real estate holdings were voluntarily transferred at a loss to the United States as part of his plea agreement, he is entitled to deduct the loss from his bribery proceeds. [3] In furtherance of his argument, petitioner refers the Court to Stephens v. Commissioner, 905 F.2d 667, 671 [66 AFTR 2d 90-5147] (2d Cir. 1990), rev'g on other grounds 93 T.C. 108 (1989), and contends that his payments to the United States are appropriately classified as compensatory and are, therefore, tax deductible. Next, petitioner contends that he purchased eight of the nine real estate holdings in Thailand for investment purposes, with the plan to rent the properties as an income-generating business. Therefore, he concludes that the liquidation of his real estate holdings resulted in a substantial business loss.

Finally, petitioner disputes the civil fraud penalty determined under section 6663 and contends that he should be granted credit for those funds that he transferred to the United States as part of his plea agreement for any civil fraud penalty imposed.

In dispute of petitioner's arguments respondent contends petitioner is not entitled to a loss deduction for tax year 2012 on the liquidation of his real estate holdings in Thailand because he is precluded from deducting losses as a result of the criminal forfeiture and because the real estate sales occurred in tax years other than the tax **[*6]** year in which he received the bribery proceeds. Respondent further contends—assuming arguendo that he incurred a loss in the tax year at issue —that petitioner is not entitled to deduct a loss from the criminal forfeitures of property because allowance of such a deduction would frustrate established U.S. and state policy.

II. *Discussion*

Generally, the taxpayer bears the burden of proving that the Commissioner's determinations are erroneous. Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 [12 AFTR 1456] (1933). Under section 7491(a)(1), "[i]f, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue." *See* Higbee v. Commissioner, 116 T.C. 438, 442 (2001). Petitioner has not introduced credible evidence sufficient to shift the burden of proof to respondent under section 7491(a) as to any relevant issue in dispute.

A. *Gross Income*

Section 61 provides that gross income from whatever source derived is subject to [pg. 300] federal income taxation. We have found that gross income specifically includes income from illegal sources, such as bribes. Traficant v. Commissioner, 89 T.C. 501 (1987), aff'd, 884 F.2d 258 [64 AFTR 2d 89-5560] (6th Cir. 1989). Taxable income, however, means gross income minus those deductions allowed by law. I.R.C. § 63.

B. *Loss Deduction*

Section 165(a) allows a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." In the case of an individual, the deduction is limited to losses incurred in a trade or business or in any transaction entered into for profit or to certain theft or casualty losses. I.R.C. § 165(c). Furthermore, a deduction arising from a loss on the sale or exchange of a capital asset can be claimed only to the extent allowed by sections 1211 and 1212. I.R.C. § 165(f). A deduction for property forfeited, if allowed, falls under section 165 and not under section 162. *See*, e.g., Holmes Enters., Inc. v. Commissioner, 69 T.C. 114 (1977);

Holt v. Commissioner, 69 T.C. 75 (1977), aff'd per curiam without published opinion, 611 F.2d 1160 [45 AFTR 2d 80-763] (5th Cir. 1980).

[*7] Federal courts consistently have disallowed loss deductions where the deduction would frustrate a sharply defined federal or state policy. *See, e.g.,* Wood v. United States, 863 F.2d 417 [63 AFTR 2d 89-709] (5th Cir. 1989); United States v. Algemene Kunstzijde Unie, N.V., 226 F.2d 115, 119-20 [47 AFTR 1976] (4th Cir. 1955); Fuller v. Commissioner, 213 F.2d 102 [45 AFTR 1551] (10th Cir. 1954), aff'g 20 T.C. 308 (1953); Blackman v. Commissioner, 88 T.C. 677, 682-83 (1987), aff'd without published opinion, 867 F.2d 605 (1st Cir. 1988); Holmes Enters., 69 T.C. 114. The test of "nondeductibility on public policy grounds under section 165" is the severity and immediacy of the frustration of a "sharply defined national or state policy" that would result from allowance of the deduction. Stephens v. Commissioner, 905 F.2d at 670; Wood v. United States, 863 F.2d 417 [63 AFTR 2d 89-709].

C. *Trade or Business Deduction*

Taxpayers are allowed deductions for certain business and investment expenses pursuant to sections 162 and 212. Petitioner has not argued that this deduction falls under section 212 as an expense incurred in the management, conservation, or maintenance of property held for the production of income (nor could he reasonably make such arguments), so we limit our analysis here to section 162.

Section 162(a) "allow[s] as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." However, neither the Code nor the regulations provide a generally applicable definition of a "trade or business." Commissioner v. Groetzinger, 480 U.S. 23, 27 [59 AFTR 2d 87-532] (1987); McManus v. Commissioner, T.C. Memo. 1987-457 [¶87,457 PH Memo TC], 1987 Tax Ct. Memo LEXIS 454, at *19, aff'd per curiam without published opinion, 865 F.2d 255 (4th Cir. 1988). Determining the existence of a trade or business "requires an examination of the facts in each case." Commissioner v. Groetzinger, 480 U.S. at 36 (quoting Higgins v. Commissioner, 312 U.S. 212, 217 [25 AFTR 1160] (1941)). When examining the facts of each case to determine whether a trade or business exists, we have focused on three factors: (1) whether the taxpayer undertook the activity intending to earn a profit; (2) whether the taxpayer is regularly and actively involved in the activity; and (3) whether the taxpayer's activity has actually commenced. *E.g.,* Weaver v. Commissioner, T.C. Memo. 2004-108 [2004 RIA TC Memo ¶2004-108], 2004 WL 938293, at *6; McManus, 1987 Tax Ct. Memo LEXIS 454, at *20.

[*8] D. *Civil Tax Fraud*

"If any part of any underpayment of tax required to be shown on a return is due to fraud," section 6663(a) imposes a penalty of 75% of the portion of the underpayment attributable to fraud. The Commissioner has the burden of proving fraud, and he must prove it by clear and convincing evidence. I.R.C. § 7454(a); Rule 142(b). To sustain his burden, the Commissioner must establish two elements: (1) that there was an underpayment of tax for each year at is[pg. 301] sue and (2) that at least some portion of the underpayment for each year was due to fraud. Hebrank v. Commissioner, 81 T.C. 640, 642 (1983).

Section 6751(b)(1) provides that "[n]o penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination." As a threshold matter, the Commissioner must show compliance with section 6751(b)(1). *See* Chai v. Commissioner, 851 F.3d 190, 221 [119 AFTR 2d 2017-1158] (2d Cir. 2017) ("[C]ompliance with § 6751(b) is part of the Commissioner's burden of production "), aff'g in part, rev'g in part T.C. Memo. 2015-42 [2015 RIA TC Memo ¶2015-042]. Under section 7491(c), the Commissioner carries "the burden of production in any court proceeding with respect to the liability of any individual for any penalty." This burden requires the Commissioner to come forward with sufficient evidence indicating that imposition of the penalty is appropriate. *See* Higbee, 116 T.C. at 446. The Commissioner's burden of production under section 7491(c) includes establishing compliance with section 6751(b)(1). *See* Chai v. Commissioner, 851 F.3d at 217, 221–22; Graev v. Commissioner, 149 T.C. 485 (2017), supplementing and overruling in part 147 T.C. 460 (2016).

Before trial, the parties stipulated that respondent has met his initial burden of production under section 7491(c) with respect to the requirements under section 6751(b)(1) because RA Ballentine obtained written supervisory approval of the penalty being asserted under section 6663 before the penalty determination was formally communicated to petitioner. On the basis of the evidence before the Court, we accept this stipulation as true and find respondent has met his initial burden of production under section 7491(c) with respect to the requirements of section 6751(b)(1).

[*9] III. *Analysis of Petitioner's Arguments*

It is undisputed that petitioner's real estate holdings in Thailand were sold at a loss, meaning the funds received were less than the amount he paid to acquire the properties. The legal question to be resolved by the Court is whether petitioner is entitled to a tax deduction for the financial loss against his bribery proceeds received for the tax year in question.

Petitioner pleaded guilty to one count of conspiracy to commit offenses against the United States and to defraud the United States and one count of bribery of a public official. [4] The criminal forfeiture of petitioner's funds was made pursuant to 18 U.S.C. § 981, and the district court ordered

him to forfeit to the United States "any property, real or personal, which constitutes or is derived from proceeds traceable to the offense of Conspiracy to Commit Bribery, pursuant to 18 U.S.C. § 981(a)(1)(C) and 28 U.S.C. § 2461(c)."

In Stephens the taxpayer was convicted and sentenced in a scheme to defraud Raytheon, a Delaware corporation, of which he was a principal owner. As part of his sentence, the district court ordered the taxpayer to make restitution of $1 million to Raytheon. As part of his settlement agreement with Raytheon, and in connection with two civil actions, the taxpayer turned over $530,000 in cash held in his name at a Bermuda bank and signed a promissory note for $470,000. The taxpayer later claimed as a tax deduction the $530,000 in restitution. Although this Court denied the deduction, the Court of Appeals for the Second Circuit reversed and remanded the case, determining the taxpayer was entitled to a deduction under the circumstances of his restitution order. Stephens v. Commissioner, 905 F.2d at 674 ("Stephens' restitution payment was neither a fine or similar penalty, nor paid to the government. Thus, we hold that neither the public policy exception to [s]ection 165, precluding a deduction when it would severely and im[pg. 302] mediately frustrate public policy to allow it, nor the codification of the **[*10]** public policy exception to deductibility of expenses pursuant to [s]ection 162, bars deduction of Stephens' restitution payment.").

In this case there was no restitution made by petitioner; rather the proceeds derived from his bribery scheme with Mr. Vo were subject to a court-ordered forfeiture. Consequently, petitioner's reliance upon Stephens is misplaced since the case is distinguishable. To allow petitioner a deduction for losses arising out of forfeited proceeds obtained through illegal activities would undermine public policy by permitting a portion of the forfeiture to be borne by the Government, thus taking the "sting" out of the forfeiture. *See* Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 35 [1 AFTR 2d 1154] (1958); Wood, 863 F.2d at 422; Holt, 69 T.C. at 81; Farris v. Commissioner, T.C. Memo. 1985-346 [¶85,346 PH Memo TC], aff'd without published opinion, 823 F.2d 1552 (9th Cir. 1987). In accordance with these controlling precedents, petitioner is not entitled to a loss deduction under section 165 for the proceeds (including the proceeds from the real estate sales) that he later forfeited pursuant to the forfeiture agreement with the United States.

Petitioner seeks to draw a distinction between his situation and those prior cases denying deductions for forfeitures on the ground that his plea agreement called for voluntary sales and forfeiture of funds along with profit sharing for tax purposes, which deviates from the norm in punitive actions and indicates a more compensatory approach to the liquidation of his real estate holdings in Thailand. We think petitioner's distinctions are unpersuasive considering the potential angles, as discussed below.

In Lilly v. Commissioner, 343 U.S. 90 [41 AFTR 591] (1952), opticians sought to deduct payments that they made to eye doctors as ordinary and necessary business expenses. These

payments were made pursuant to agreements that reflected an established and widespread practice in that industry, whereby the eye doctors agreed to recommend certain opticians to their patients and the opticians agreed to pay those referring eye doctors one-third of the retail sale prices that they received for the eyeglasses that they sold. The Court of Appeals for the Fourth Circuit held such payments were nondeductible on the grounds that they were against public policy. The Supreme Court reversed, however, holding that the payments did not stand on the same basis as expenditures that violated some federal or state law or that were incidental to such violations. The Supreme Court drew a distinction between these payments, which were at most professionally unethical, **[*11]** from those of outlawed expenditures, which, by virtue of their illegality, frustrate federal or state policy.

Petitioner's proceeds from his fraudulent scheme are not akin to the payments in dispute in Lilly. The moneys petitioner forfeited were admittedly the essence of his illegal venture. The forfeiture was incidental to his violation of federal laws. Therefore, the holding in Lilly does not support petitioner's argument.

In Commissioner v. Sullivan, 356 U.S. 27 [1 AFTR 2d 1158], the Supreme Court held that an illegal gambling enterprise was a business for federal tax purposes and that deductions for ordinary and necessary business expenses involved in operating the enterprise were allowable. The Supreme Court reasoned that to deny such deductions would result in taxing the gross receipts of the business rather than its net income. In Commissioner v. Tellier, 383 U.S. 687 [17 AFTR 2d 633] (1966), the taxpayer sought a deduction for legal fees incurred in the unsuccessful defense of a criminal prosecution relating to his business. The Commissioner conceded that the fees were ordinary and necessary business expenses. The only question was whether the allowance of a deduction would frustrate public policy. The Supreme Court held that no public policy was frustrated by allowing these legal fees to be deducted as ordinary and necessary business expenses.

Sullivan and Tellier stand for the proposition that a taxpayer may be allowed to deduct legitimate (i.e., ordinary and necessary) business expenses in the operation of an illegitimate enterprise. That concept is not determinative in our analysis of this [pg. 303] case because we are dealing with a forfeiture that (as discussed above) does not qualify as an ordinary and necessary business expense under section 162. [5] Furthermore, the allowance of a loss deduction in this case would undermine the impact of the sharply defined policy against bribery of a government official. Accordingly, Sullivan and Tellier are inapposite to the case here.

Accordingly, we will sustain respondent's disallowance of petitioner's loss deduction claimed with respect to his criminal **[*12]** forfeiture. Next we will turn to the civil fraud penalty determined against petitioner under section 6663.

The Commissioner must prove an underpayment of tax in support of the fraud penalty. To sustain his burden, the Commissioner need not prove the precise amount of the underpayment attributable to fraud, but only that a part of the underpayment is attributable to fraud. Estate of Beck v. Commissioner, 56 T.C. 297, 363–64 (1971). When the allegations of fraud are intertwined with unreported income and indirectly reconstructed income, as they are in this case, the Commissioner may prove an underpayment by proving a likely source of the unreported income. Id. at 361.

As previously discussed, respondent has shown sources of unreported income to petitioner, and petitioner has failed to show that the receipts were offset by deductible costs or expenses. Furthermore petitioner agrees that he failed to report his bribery proceeds for 2012. As a result, it is established by clear and convincing evidence that he has an underpayment for the 2012 tax year.

We now turn to the second element of the penalty, fraudulent intent. Fraud is intentional wrongdoing designed to evade tax believed to be owing. Neely v. Commissioner, 116 T.C. 79, 86 (2001). The existence of fraud is a question of fact to be resolved upon consideration of the entire record. Estate of Pittard v. Commissioner, 69 T.C. 391, 400 (1977). Fraud is not to be presumed, nor should a finding of fraudulent intent be based upon mere suspicion. Petzoldt v. Commissioner, 92 T.C. 661, 699–700 (1989). But because direct proof of a taxpayer's intent is rarely available, fraudulent intent may be established by circumstantial evidence. Id. at 699. The Commissioner satisfies his burden of proof by showing that "the taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes." Parks v. Commissioner, 94 T.C. 654, 661 (1990). The taxpayer's entire course of conduct may be examined to establish the requisite intent, and an intent to mislead may be inferred from a pattern of conduct. Webb v. Commissioner, 394 F.2d 366, 379 [21 AFTR 2d 1150] (5th Cir. 1968), aff'g T.C. Memo. 1966-81 [¶66,081 PH Memo TC]; Stone v. Commissioner, 56 T.C. 213, 224 (1971).

Circumstances that may indicate fraudulent intent, often called "badges of fraud," include but are not limited to: (1) understating income, (2) keeping inadequate records, (3) giving implausible or inconsistent explanations of behavior, (4) concealing income or assets, **[*13]** (5) failing to cooperate with tax authorities, (6) engaging in illegal activities, (7) supplying incomplete or misleading information to a tax return preparer, (8) providing testimony that lacks credibility, (9) filing false documents (including false tax returns), (10) failing to file tax returns, and (11) dealing in cash. *See* Schiff v. United States, 919 F.2d 830, 833 [67 AFTR 2d 91-1062] (2d Cir. 1990); Bradford v. Commissioner, 796 F.2d 303, 307–08 [58 AFTR 2d 86-5532] (9th Cir. 1986), aff'g T.C. Memo. 1984-601 [¶84,601 PH Memo TC]; Parks, 94 T.C. at 664–65; Recklitis v. Commissioner, 91 T.C. 874, 910 (1988); Morse v. Commissioner, T.C. Memo. 2003-332 [2003 RIA TC Memo ¶2003-332], 86 T.C.M. (CCH) 673, 675, aff'd, 419 F.3d 829 [96 AFTR 2d 2005-

5814] (8th Cir. 2005). No single factor is dispositive, but the existence of several factors is "persuasive circumstantial evidence of fraud." Niedringhaus v. [pg. 304] Commissioner, 99 T.C. 202, 211 (1992); Petzoldt, 92 T.C. at 700.

According to the record before the Court petitioner's prior criminal conviction demonstrates his intent to mislead, conceal, or otherwise interfere with the IRS's ability to assess and collect his federal income tax. [6] Petitioner was employed as a Consular Officer and served as chief of the Nonimmigrant Visa Unit at the U.S. Consulate in Ho Chi Minh City, an influential position within the State Department, which he illegally used for personal financial gain. Furthermore, his use of co-conspirators to transfer funds through foreign bank accounts in China and subsequent purchase of real estate holdings in Thailand reflect petitioner's sophisticated effort to conceal and otherwise prevent the collection of tax.

We find that respondent has shown that five "badges of fraud" exist in this case, including understating income, concealing income or assets, engaging in illegal activities, dealing in cash, and filing false documents, including a false tax return. These factors favor a finding of fraud. Petitioner has provided evidence of his cooperation with U.S. authorities, including the IRS; however, this evidence is only a single factor weighing against fraudulent intent.

Furthermore, petitioner does not dispute that he intended to evade tax by not reporting his bribery proceeds, but he tries to offset the penalty solely through a reduction of the underpayment amount.

[*14] Considering the evidence before the Court, we have no doubt that petitioner—being a well-educated individual employed by the State Department and having worked overseas for most of his career—knew that the bribes were in fact taxable income to him, which he failed to report with the intent, at least in part, to evade tax.

Petitioner asserted that he is not liable for the fraud penalty because while incarcerated he directed his tax preparer to file an amended return for 2012, reporting his bribery proceeds as income. Petitioner is mistaken on this point. Fraud occurs upon the filing of a false return with the requisite fraudulent intent, and that conduct cannot be subsequently purged through the filing of an amended return. *See* Badaracco v. Commissioner, 464 U.S. 386, 394 [53 AFTR 2d 84-446] (1984). Furthermore, respondent furnished a Certification of Lack of Record which showed that no amended tax return for 2012 has been received from petitioner.

Petitioner's activities with regard to the receipt of bribery proceeds and his attempts to hide the activities associated therewith are "badges of fraud" that clearly and convincingly indicate the civil fraud penalty under section 6663 applies for the tax year at issue. Accordingly, we will sustain respondent's determination of the fraud penalty in this case.

We have considered all of the arguments that petitioner has made, and to the extent they are not addressed herein, we find the arguments to be moot, irrelevant, or without merit.

To reflect the foregoing,

Decision will be entered for respondent.

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code (Code), Title 26 U.S.C., in effect at all relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Procedure. All monetary amounts are rounded to the nearest dollar.

[2] During its investigation the United States identified the Yulee, Florida, property owned by petitioner's sister as being purchased using funds originating from his bribery proceeds. However, at no time did the United States move to foreclose on the Yulee, Florida, property.

[3] Petitioner seeks a deduction against his income equal to the difference between his acquisition costs (or tax bases) in his real estate holdings, less the amount realized on the liquidation of the properties.

[4] We note that Congress does not concern itself with the lawfulness of the income it taxes; income from criminal enterprises is taxed at the same rate. And it is true that taxpayers, in some instances, have been allowed deductions against gross income otherwise illegal under state or federal laws. *See* Commissioner v. Sullivan, 356 U.S. 27 [1 AFTR 2d 1158] (1958) (allowing deductions for rent and wages paid to the operator of an illegal gambling enterprise).

[5] It is unclear whether petitioner claims his real estate activity was a separate trade or business, or, as it seems, he is claiming that his real estate activity was part of his illegitimate bribery business activity. While petitioner does not consider the transfer of the sales proceeds to the government to be a forfeiture, the preliminary consent order and our findings which should be with respect thereto reflect otherwise.

[6] Convictions for crimes involving perjury, deceit, breach of fiduciary duty, and concealment of criminal proceeds are highly probative of the intent to evade tax. *See* Wright v. Commissioner, T.C. Memo. 2000-336 [2000 RIA TC Memo ¶2000-336], 2000 WL 1635407, at *6. Admission of facts showing fraudulent behavior in a criminal plea agreement is also relevant to finding fraudulent intent. *See* Duncan & Assocs. v. Commissioner, T.C. Memo. 2003-158 [2003 RIA TC Memo ¶2003-158], 2003 WL 21233527, at *6.

Tax Court & Board of Tax Appeals Memorandum Decisions

Steven W. Webert, et ux. v. Commissioner, T.C. Memo. 2022 -32 , Code Sec(s) 121.

STEVEN W. WEBERT AND CATHERINE S. WEBERT, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 240]

Code Sec(s):	121
Docket:	Dkt. No. 15981-17.
Date Issued:	04/07/**2022**.
Judge:	Opinion by Gustafson, *J.*
Tax Year(s):	Year 2015.
Disposition:	Decision for Taxpayers in part and for Commissioner in part.

HEADNOTE

1. Income exclusions—gain on sale of principal residence—health problems—summary judgment. IRS's motion for partial summary judgment on married taxpayers' claim for Code Sec. 121 income exclusion for portion of gain from sale of home which wife purchased in year of cancer

diagnosis and lived in with husband for period years, before turning same into rental property, was granted in part and denied in part. While taxpayers failed to show they used home as principal residence for any of 5 years preceding sale, there was genuine fact dispute as to whether wife's cancer diagnosis and ensuing health issues were primary reason for sale for purposes of Code Sec. 121(c) 's health-related provision. However, parties would need to address whether taxpayers could qualify thereunder in first place, since that provision also appeared to be premised in part on residential use.

Reference(s): ¶ 1215.01(3) Code Sec. 121

Syllabus

P–W purchased a house in 2005, and Ps resided in it. P–W suffered multiple health problems that first caused her to draw on an equity line of credit to pay medical bills and eventually led her to [pg. 241] attempt to sell the house, but the attempt failed. Beginning in 2009, Ps rented the house to third parties while trying from time to time to sell the property. Ps did not thereafter reside in the house.

P–W finally sold the house in 2015, realizing long-term capital gain pursuant to the sale. Ps reported the sale of the house on their 2015 return but claimed an exclusion of the gain from gross income under I.R.C. § 121.

In a statutory notice of deficiency, the IRS determined Ps were ineligible to exclude that capital gain under I.R.C. § 121. Ps filed with the **Tax Court** a petition for redetermination. R moved for partial summary judgment as to the capital gain. P–W consents to the entry of partial summary judgment, but P–H opposes it.

Held: R's motion for partial summary judgment will be granted in part on the issue of use of the property under I.R.C. § 121(a), because R showed that there is no genuine dispute that Ps did not use the house as their principal residence for at least two of the five years preceding the **[*2]** sale. However, R's motion will be denied in part without prejudice, because there is a genuine dispute of fact on the issue (first addressed in R's reply brief) of whether, under I.R.C. § 121(c)(2)(B), the sale was "by reason of a change in place of employment, health, or ... unforeseen circumstances", and because R has not addressed whether, as a matter of law, this fact is material to the amount of the exclusion in this case.

Counsel

Steven W. Webert, for himself.

Henry C. Cheng, David F. Gross, and Amy N. Spivey, for Catherine S. Webert.

Amy Chang and Alicia H. Eyler, for respondent.

GUSTAFSON, *Judge*

MEMORANDUM OPINION

The Internal Revenue Service ("IRS") issued to petitioners Steven W. Webert and Catherine S. Webert statutory notices of deficiency ("SNODs") pursuant to section 6212,[1] determining deficiencies and additions to tax for six years[2] including 2015.

The Weberts timely petitioned this Court for redetermination of the deficiencies pursuant to section 6213(a). Respondent, the Commissioner of the IRS, has filed a motion for partial summary judgment, asserting that the Weberts do not meet the requirements of section 121 and therefore may not exclude from their 2015 gross income the capital gain realized on the sale of their house on Mercer Island, Washington (the "Mercer Island house"). For the reasons stated below, we will grant the Commissioner's motion in part and deny it in part.

[*3] *Background*

For the reasons explained in part I.A of the Discussion below, we assume for purposes of the Commissioner's motion the facts that he has shown to be not subject to genuine dispute, drawing all reasonable inferences in favor of Mr. Webert, the non-movant. Those assumed facts are as follows.

The Weberts' background

The Weberts married in 2004. In 2005 Ms. Webert was diagnosed with cancer, for which she had extensive surgery. In that same year, she purchased the Mercer Island house, where the Weberts allege, and we assume, they resided from 2005 through 2009.

Medical problems and financial hardship

Ms. Webert's health problems immediately became a financial challenge, and she took out a line of credit on the property, which (she explained) the Weberts used "to pay for medical insurance premiums and other medical expenses as she was becoming very ill". After 2005 Ms. Webert continued to suffer numerous accumulating [pg. 242] and cascading health problems, which required multiple treatments and for which they accrued extensive medical bills. Ms. Webert's health conditions reduced her working capacity permanently, which contributed to an extended period of financial hardship.

Rental and sale of the Mercer Island house

Ms. Webert attempted to sell the Mercer Island house beginning in 2009, but for years she was unsuccessful. As Ms. Webert explained:

> The financial and housing markets crashed in 2008 and hit the Seattle area particularly hard, so the house in Mercer Island would not sell when funds were needed to make the payments and to pay Ms. [Webert]'s mounting health premiums, medical, and dental bills.
>
> The house was in escrow and the sale fell through before it finally got rented out in sheer desperation, because [Mr. Webert] was no longer able to pay the payments. I believe it was for sale at different points during the rental time. After another realtor was enlisted, **[*4]** before it finally sold [in 2015] it was in escrow again and the sale fell through yet another time.

The Weberts did not reside at the Mercer Island house after 2009. Rather, Mr. Webert owned a second house in Sammamish, Washington, where the Weberts evidently resided during the years at issue. They began renting the Mercer Island house to third parties in 2009, and it remained rented for the entire year in 2010, 2011, 2012, and 2013, from January through July in 2014, and from March through June in 2015. The Weberts did not use the Mercer Island house personally for any substantial period in 2010 or at all from 2011 through 2015–even during the periods in which it was not rented.

Ms. Webert sold the Mercer Island house on October 20, 2015, for $1,140,000 and realized $194,752 of long-term capital gain pursuant to the sale. In sum, Ms. Webert owned the property for roughly 11 years (2005–15), of which she used it as her principal residence for 5 years (2005–09) and used it as rental property for 6 years (2010–15).

The Weberts were divorced in 2016 (after the years at issue).

Federal income tax returns

The Weberts filed joint federal income tax returns for the years 2010, 2011, 2012, 2013, 2014, and 2015 no earlier than December 15, 2016, more than a year after the sale of the Mercer Island house. [3] The Weberts reported the sale of the Mercer Island house on Schedule D, "Capital Gains and Losses", attached to their 2015 Form 1040, "U.S. Individual Income Tax Return", but they excluded the realized gain on the sale from their gross income.

The Weberts also reported income from their lease of the Mercer Island house each year on Schedule E, "Supplemental Income and Loss", attached to their return. Schedule E requires a taxpayer to report the amount of time the rental real estate property is rented to third parties or

used personally by the taxpayer. Schedule E has been revised over the years. For 2010 the Weberts reported that they did not use the Mercer Island house "during the tax year for personal purposes for more than...14 days or 10% of the total days rented at fair rental value". The Schedules E for 2011 through 2015 asked the Weberts to report **[*5]** specifically the number of days in the year they rented the Mercer Island house at fair rental value and the number of days they used the property for personal use. The Weberts reported 365 fair rental days and zero personal use days of the Mercer Island house for 2011, 2012, and 2013, 212 fair rental days and zero personal use days for 2014, and 122 fair rental use days and zero personal use days for 2015.

The Weberts also attached to each return a "Depreciation and Depreciation Re-capature [sic]" schedule. Each depreciation schedule lists the precise dates that the Mercer Island house spent in rental service during the year. Mirroring the fair rental days reported on the Schedules E, the depreciation schedules reflect that the Weberts rented the Mercer Island house to third parties for 12 months each year from [pg. 243] 2010 through 2013, for 7 months in 2014, and for 4 months in 2015. The depreciation schedules indicate that, during the entire 2010 through 2015 period, the Mercer Island house spent only 11 months out of rental service.

Both of the Weberts signed each return below the preprinted statement that reads:

> Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete.

Notice of deficiency and petition

After receiving the Weberts' returns for 2010–15, the IRS issued SNODs (and, shortly thereafter, supplemental SNODs) determining deficiencies totaling $231,371 for the 2015 tax year,[4] partially due to an adjustment including $194,752 of capital gain in gross income from sale of the Mercer Island house.

The Weberts timely filed a petition in this Court contesting the IRS's determinations. Pursuant to Rule 121, the Commissioner filed a **[*6]** motion for partial summary judgment contending that there is no genuine dispute of material fact regarding whether the Weberts may exclude from gross income the capital gain realized from the sale of the Mercer Island house. Specifically, the Commissioner argues that the Weberts failed to use the Mercer Island house as their principal residence for the requisite period under section 121(a). Ms. Webert does not oppose the Commissioner's motion. Mr. Webert opposes the Commissioner's motion, generally denying the correctness of the Commissioner's fact statements and seeming to assert in his response (but not in any affidavit or declaration) that the Weberts did use the Mercer Island house as a residence and that the reasons for the sale included Ms. Webert's health problems. The Commissioner

argues (in his reply) that the Webberts may not exclude the capital gain realized because—in addition to their failure to use the Mercer Island house—the primary reason for the sale was not a change in place of employment, health, or unforeseen circumstances (as required by section 121(c)(2)(B)).

Discussion

I. *General principles of law*

A. *Summary judgment standard*

The Court may grant summary judgment when there is no genuine dispute as to any material fact and a decision may be rendered as a matter of law. Rule 121(b); Sundstrand Corp. v. Commissioner, 98 T.C. 518, 520 (1992), aff'd, 17 F.3d 965 [73 AFTR 2d 94-1198] (7th Cir. 1994). A partial summary adjudication is appropriate if some but not all issues in the case may be decided as a matter of law, even though not all the issues in the case are disposed of. *See* Rule 121(b); Turner Broad. Sys., Inc. & Subs. v. Commissioner, 111 T.C. 315, 323–24 (1998).

The moving party (here, the Commissioner) bears the burden of showing that no genuine dispute of material fact exists, and the Court will make factual inferences in the light most favorable to the nonmoving party (here, Mr. Webert). Dahlstrom v. Commissioner, 85 T.C. 812, 821 (1985). However, Rule 121(d) imposes a duty on a party resisting summary judgment:

> **[*7]** When a motion for summary judgment is made and supported as provided in this Rule, an adverse party may not rest upon the mere allegations or denials of such party's pleading, but such party's response, by affidavits or declarations or as otherwise provided in this Rule, must set forth specific facts showing that there is a genuine dispute for trial. If the adverse party does not so respond, then a decision, if appropriate, may be entered against such party.

B. *Exclusion of gain from sale of principal residence*

Gross income means all income from whatever source derived, unless specifically excluded by law. *See* § 61(a); Treas. [pg. 244] Reg. § 1.61-1(a). Generally, gain realized on the sale of property is included in a taxpayer's income. § 61(a)(3). Section 121, however, excludes gain on the sale or exchange of property from gross income in certain circumstances.

1. *Section 121(a) and (b)*

Section 121(a) excludes gain on the sale of property if the taxpayer has both "owned and used" such property as her principal residence for at least two of the five years immediately preceding the sale. The term "principal residence" means "the chief or primary place where a person lives or...the dwelling in which a person resides." Gates v. Commissioner, 135 T.C. 1, 7 (2010) (emphasis omitted). Whether property is used by the taxpayer as the taxpayer's residence depends upon all the facts and circumstances. Treas. Reg. § 1.121-1(b)(1).

The maximum exclusion of gain from a residence is $250,000 for an individual, § 121(b)(1), or $500,000 for joint returns under section 121(b)(2)(A) "if—(i) either spouse meets the ownership requirements of subsection (a) with respect to such property; (ii) both spouses meet the use requirements of subsection (a) with respect to such property;" and the taxpayers meet a third condition not in dispute here.

If the spouses do not collectively meet the requirements of section 121(b)(2)(A), the spouses may exclude an amount of gain equal to the sum of the exclusion amount to which each spouse would be entitled if they had not been married. § 121(b)(2)(B); *see also* Treas. Reg. § 1.121-2(a)(4) (example 4). For the purposes of this analysis, each spouse is treated as owning the property during the period in which **[*8]** either spouse owned the property. § 121(b)(2)(B). Thus, under this provision, some exclusion may be claimed if either spouse (not necessarily the taxpayer who is the owner) used the property as a principal residence.

For a taxpayer who qualifies under section 121(a) (because she satisfies the ownership and use requirements) but has some "periods of nonqualified use" of the property, section 121(b)(5) provides for computing the exclusion by allocating gain to "periods of nonqualified use" (which gain is then not excluded). Under section 121(b)(5)(C)(ii)(III), those "periods of nonqualified use" do not include a "period of temporary absence (not to exceed an aggregate period of 2 years) due to change of employment, health conditions, or ... other unforeseen circumstances". But this computation of nonqualified use is called for only in the instance of a taxpayer who otherwise meets the use requirement.

2. *Section 121(c)*

A taxpayer who fails to satisfy the ownership or use requirement under section 121(a) and (b) may nonetheless qualify for a reduced exclusion amount if, under section 121(c)(2)(B), the "sale or exchange is by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances." Treasury Regulation § 1.121-3 provides safe harbors in which a sale or exchange is deemed to be by reason of a change in place of employment, health, or unforeseen circumstances. Under those provisions, a sale or exchange is deemed to be by reason of health if a physician recommends a change of residence for reasons of health. Treas. Reg. § 1.121-3(d)(2).

If a safe harbor does not apply, "a sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances only if the *primary reason* for the sale or exchange is a change in place of employment..., health..., or unforeseen circumstances". Treas. Reg. § 1.121-3(b) (emphasis added).

However, this special exclusion of section 121(c) has its own limitation: The amount of the exclusion that might otherwise have been permitted for an exclusion under section 121(a) (i.e., limited for a single return to $250,000 or for some joint returns to $500,000 under section 121(b)(1) or (2)) is multiplied by a fraction defined by the statute. The numerator is defined (as relevant here) in section 121(c)(1)(B)(i)(I) as—

> **[*9]** the aggregate periods, during the 5-year period ending on the date of such sale or exchange, such property has been owned *and used* by the taxpayer as the taxpayer's principal residence—

[pg. 245]

—and the denominator is defined in section 121(c)(1)(B)(ii) as "2 years" (or 730 days or 24 months, depending on the measure of time used in the numerator). *See* Treas. Reg. § 1.121-3(g)(1). Consequently, if a single taxpayer has (for example) owned her house for only one year and is forced to sell it because of a change in place of employment, her one-year ownership will fail to qualify under section 121(a) for the $250,000, but that one year of ownership as a numerator over the two-year denominator of section 121(c)(1)(B)(ii) will give her a fraction of one over two. This hypothetical taxpayer may therefore exclude one-half of the $250,000 amount, or $125,000. But to get any exclusion under this special rule of section 121(c), the taxpayer must have resided in the house for at least one day (or else the numerator of the fraction will be zero, and the exclusion amount will therefore likewise be zero).

II. *Analysis*

A taxpayer who files a return other than a joint return and who meets the ownership and use requirements of section 121(a) is entitled to the exclusion under section 121(b)(1). The use requirement is two years' use as a principal residence in the five years before the sale (which we refer to as "two-out-of-five-years use requirement"). However, the Weberts filed a joint return for the 2015 tax year, and they may exclude the capital gain realized on the sale of the Mercer Island house from their gross income only if they satisfy the ownership and use requirements of section 121(b)(2)(A) or (B), or the requirements of section 121(c).

A. *The use requirements of section 121(b)(2)*

1. *The two exclusions under section 121(b)(2)(A) and (B) both impose a use requirement.*

Ms. Webert owned the Mercer Island house continuously from 2005 through 2015, and the Weberts thus satisfy the ownership requirements of section 121(b)(2)(A) and (B). The only dispute in this case is as to the use requirements. To qualify for a $500,000 gain exclusion under section 121(b)(2)(A), both spouses must satisfy the two-out-of-five-years use requirement of subsection (a).

[*10] If unable to meet that requirement, then under section 121(b)(2)(B) they may exclude an amount of capital gain equal to the sum of each spouse's qualifying exclusion amount determined on a separate basis as if they had not been married—i.e., determined for each of them as if under section 121(a) and (b)(1), with the two-out-of-five-years use requirement of section 121(a) applied separately to each spouse.

Consequently, whether the Weberts qualify for any capital gain exclusion either under section 121(b)(2)(A) ($500,000) or under section 121(b)(2)(B) (with its limitation) hinges on whether either or both of the Weberts satisfy the two-out-of-five-years use requirement.

2. *The Weberts do not meet that use requirement.*

We hold that the Commissioner has established that there is no genuine dispute as to the fact that neither of the Weberts used the Mercer Island house as a personal residence for any of the years 2010 through 2015. The Weberts' returns for the years 2010 through 2015—signed by the Weberts under penalty of perjury—demonstrate their lack of personal use of the Mercer Island house. The Schedules E and the depreciation schedules attached to each return show that the Weberts rented out the Mercer Island house to third parties for all but 11 months from 2010 to 2015. Mr. Webert does not offer specific factual support "by affidavits or declarations or as otherwise provided in [Rule 121]" for the proposition that he used the Mercer Island house as his principal residence at any point in the five years preceding its sale—only his general allegation (in his response and not in an affidavit or declaration) that "[the Mercer Island house] was used [by the Weberts] as a principal residence during the five years prior to its eventual sale".

This broad generalization, made in contradiction of his own previous and specific accounting, cannot create a genuine dispute [pg. 246] of fact. Under Rule 121(d) Mr. Webert "may not rest upon the mere allegations or denials of [his] pleading, but [his] response, by affidavits or declarations or as otherwise provided in this Rule, must set forth specific facts showing that there is a genuine dispute for trial." He offers no specific facts to dispute the fair rental days (or zero personal use days) that he reported on the Schedules E and the depreciation schedules, which directly contradict his current claim of personal use. Therefore, Mr. Webert has failed to make any

actual showing that the Weberts (or either of them) used the Mercer Island house as their principal residence for the requisite period, and the Weberts accordingly cannot meet the **[*11]** use test to qualify for a capital gain exclusion under section 121(b)(2)(A) or (B).

B. *"Health" in section 121(b)(5)(C)(ii)(III) and (c)(2)(B)*

As we noted, taxpayers who claim an exclusion under section 121(b)(2) may avoid a characterization of "nonqualified use" where they were temporarily absent from the property because of "health conditions" (or other circumstances), § 121(b)(5)(C)(ii)(III); and taxpayers who fail to meet the ownership and use requirements of section 121(a) and (b) may qualify for a lesser exclusion amount under section 121(c) if the "sale...is by reason of...health" (or other circumstances), § 121(c)(2)(B). Mr. Webert's opposition to the Commissioner's motion invokes both of these "health" provisions, and the Commissioner replies to the effect that Mr. Webert did not show the requisite causal connection between the health problems and the absence or the sale. We think these health-related issues are not subject to summary disposition at this point.

1. *There appear to be genuine disputes of fact.*

During the period at issue, it is clear that the Weberts suffered many unfortunate and prolonged difficulties. They are not mentioned in the Commissioner's motion (Doc. 53); they are alluded to in Mr. Webert's response (Doc. 60); and in Ms. Webert's response, those problems and their effects are described in some detail in an attachment (Doc. 57 at "Page 11" to "Page 16") to her Form 8857, "Request for Innocent Spouse Relief", which was signed under penalty of perjury. It seems clear that Ms. Webert's health was both a cause of the need to move from the Mercer Island house and a precipitating cause for the financial circumstances that contributed to that need. However, in his response to the Commissioner's motion for summary judgment, Mr. Webert did not anticipate the Commissioner's arguments (for which we do not blame him), and he therefore did not argue that any of these difficulties fall under the safe harbors enumerated under Treasury Regulation § 1.121-3(b) nor that they were the "primary reason" for the sale of the Mercer Island house in 2015. If we draw all reasonable inferences in Mr. Webert's favor (as Rule 121 requires), it appears that the health problems may have been the primary reason for the attempts to sell which began in 2009 and did not succeed until 2015. Consequently, we find a genuine dispute on that factual issue, and we assume that health reasons *were* the primary reason for the sale. We cannot grant partial summary judgment to the Commissioner on the **[*12]** section 121 exclusion issue if, in order to do so, we must assume otherwise.

2. It is not yet clear whether the facts about Ms. Webert's health are material.

However, it is not clear to us that the facts about Ms. Webert's health and its effect on the sale are actually material to this case. Because the Commissioner's motion did not mention health problems, it did not discuss or even cite section 121(b)(5)(C)(ii)(III) or (c)(2)(B). Mr. Webert's response cited them but said little else. The Commissioner's reply did not analyze the statute but explained why the health problems did not (in his view) really constitute the primary reason for the sale. But when we analyze the statute without substantial help from the parties, the health problems seem not to affect the outcome.

As we have explained, under section 121(b)(5)(C)(ii)(III), temporary absence due to "health conditions" may avoid being characterized as "nonqualified use" for purposes of the allocation under section 121(b)(5)(A). But as we understand the statute, one undertakes this allocation only in the case of taxpayers who have other[pg. 247] wise shown an entitlement to the exclusion under section 121(a) and (b)—i.e., to a taxpayer who has met the ownership and use requirements. It appears to us that the "health conditions" provision of section 121(b)(5)(C)(ii)(III) (unlike the "health" provision of section 121(c)(2)(B)) does not abrogate the use requirements, and neither party has argued that it does or does not. They seem instead to have assumed that it does, and it does not seem that that assumption is correct.

As for section 121(c), which we explained briefly above, it appears to be a different sort of provision. By its terms "the...use requirement[] of subsection (a)...shall not apply", § 121(c)(1), where the "sale...is by reason of...health", § 121(c)(2)(B). But this provision does not merely drop the use requirement in an instance in which health problems prompted the sale. Rather, it sets up an alternative limitation, which also turns on "use": It creates a fraction that is multiplied to potentially reduce the exclusion amount that would otherwise be claimed. The denominator of that fraction is two years and the numerator is "the aggregate periods, during the 5-year period ending on the date of such sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence." § 121(c)(1)(B)(i)(I) (emphasis added). If the taxpayer can show two years **[*13]** of residential use in the last five, then her fraction is two over two (i.e., a whole one), and she gets the entire exclusion amount. If she can show only one year of residential use, then her faction is one over two (i.e., one-half), and she gets half the exclusion amount. But if her residential use during the five-year period ending on the date of the sale was zero (as the Weberts' was), then it appears her fraction is zero over two, and she gets a zero exclusion.

If this is correct, then we need no trial on health problems, in view of the fact (as to which we hold there is no genuine dispute) that neither of the Weberts resided in the Mercer Island house during the five years before the sale in 2015. If either of the parties believes that this is not correct, then we need additional argument from them.

Conclusion

In conclusion, we hold that there is no genuine dispute of material fact regarding whether, for the years 2010 through 2015, the Weberts did not use the Mercer Island house as their principal residence for purposes of section 121(a) and (b). There is a genuine dispute of fact regarding whether the primary reason for the Weberts' sale of the Mercer Island house was Ms. Webert's health, but the parties have not yet addressed whether, as a matter of law, that disputed fact is a "material" fact. We will therefore grant the Commissioner's motion in part and deny it in part.

To reflect the foregoing,

An appropriate order will be issued.

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[1] Unless otherwise indicated, statutory references are to the Internal Revenue Code, Title 26, U.S.C., as in effect at all relevant times; all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times; and all Rule references are to the **Tax Court** Rules of Practice and Procedure.

[2] Although the Weberts filed joint returns for the years 2010, 2011, 2012, 2013, 2014, and 2015, the IRS issued SNODs for these years to each of the Weberts individually.

[3] The date the Weberts filed their returns is in dispute, but our resolution of the Commissioner's motion does not require a determination on this issue

[4] We aggregate the deficiencies the Commissioner determined for Ms. Webert ($123,768) and Mr. Webert ($107,603) for ease of discussion. The Commissioner allocated half the gain from the sale of the Mercer Island house to each of them. The deficiencies and additions to tax the IRS determined for 2010, 2011, 2012, 2013, and 2014 are in dispute but are not the subject of the Commissioner's motion for partial summary judgment.

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Tax Court & Board of Tax Appeals Memorandum Decisions

Sherwin Community Painters, Inc. v. Commissioner, TC Memo 2022 -19 , Code Sec(s) 162.

SHERWIN COMMUNITY PAINTERS INC., Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent, ROBERT WARD, JR. AND SWANETTE TRIEM WARD, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 164]

Code Sec(s):	162
Docket:	Dkt. Nos. 4113-19, 4647-19.
Date Issued:	03/09/**2022**.
Judge:	Opinion by Goeke, *J.*
Tax Year(s):	Year 2016.
Disposition:	Decision for Taxpayers in part and for Commissioner in part.

HEADNOTE

1. Business deductions—office, supplies, and promotional expenses—business purpose. Solely owned commercial painting contracting corp. was entitled to deduct office, supplies, and promotional expenses in amounts above amounts IRS allowed. Corp. substantiated both amount and business purpose of stated expenses, which went to various items including iPads, iPhones, and service plans that were used in employees' performance of their jobs.

Reference(s): ¶ 1625.018(5) Code Sec. 162

2. Business deductions—education expenses—business purpose. Solely owned commercial painting contracting corp. wasn't entitled to deduct cost of computer [pg. 165] course for owner's son-in-law. Although son-in-law provided computer services to corp. following course completion, he wasn't employee and his services weren't performed pursuant to any agreement; so, it appeared corp. provided payment for his course without expectation of return and thus had no valid business purpose for same.

Reference(s): ¶ 1625.019(5) Code Sec. 162

3. Gross income—constructive dividends—closely owned corps. IRS's determination in consolidated deficiency case to charge sole owner of commercial painting contracting corp. with constructive dividends from shareholder loan or disallowed deductions was rejected. Notwithstanding IRS's attempt to equate amount of constructive dividends which it initially determined in deficiency notice, on basis of shareholder loan, with amount of business deductions corp. was found to have failed to substantiate, there was no relationship between those amounts. Although corp. did fail to substantiate stated expenses, there was no indication that owner received economic benefit from same and there was no other basis for charging her with constructive dividends.

Reference(s): ¶ 615.047(10) ;¶ 3165.01(82) Code Sec. 61; Code Sec. 316

Syllabus

Counsel

Leonard J. Gernstein, for petitioners.

Kaitlyn N. Christensen, Justin D. Scheid, and Kerrington A. Hall, for respondent.

GOEKE, *Judge*

MEMORANDUM OPINION

These consolidated cases have been submitted without trial pursuant to Rule 122. [1] Respondent determined a deficiency against Sherwin Community Painters, Inc. (Sherwin), of $8,224 and an accuracy-related penalty under section 6662(a) for the **[*2]** taxable year 2016. Respondent also determined a deficiency against Robert Ward, Jr., and Swanette Triem Ward of $4,890 and an addition to the tax under section 6651(a)(1) for failure to timely file and an accuracy-related penalty under section 6662(a). After concessions, the issues for decision are: (1) whether Sherwin is entitled to certain business expense deductions; we hold it is to the extent set out below; and (2) whether Mrs. Ward received constructive dividends from Sherwin; we hold she did not. Petitioners have conceded the addition to tax and the penalties to the extent applicable.

Background

The following facts are derived from the Stipulations of Fact and Attachments. We overrule respondent's objections to three exhibits attached to the First Stipulation of Facts. Mr. and Mrs. Ward resided in Wisconsin when they timely filed their Petition. Sherwin, a C corporation, is solely owned by Mrs. Ward and had its principal place of business in Illinois is when it timely filed its Petition. The Wards filed their 2016 joint tax return late on October 12, 2017.

Sherwin is a commercial painting contractor for commercial warehouses, residential complexes, and multipurpose highrise buildings. Both Mr. and Mrs. Ward work for the business. Sherwin receives customer referrals from property management companies. It claimed business expense deductions for office equipment, office supplies, gas, entertainment, and promotional materials. It also claimed a business expense deduction for the costs of a coding course at Northwestern University for Lucas Kocemba. The Wards met Mr. Kocemba in 2016 when he was dating their daughter. Mr. Kocemba expressed an interest in the course, and the Wards offered to pay the tuition if he was admitted. Before taking the course, he worked in the construction industry and had no previous coding experience. After completing the course in 2017, Mr. Kocemba used the skills that he had learned to update Sherwin's website over the course of several months and spent a considerable amount of time working on the website. Sherwin did not pay him for his work. Mr. Kocemba later married the Wards' daughter. He has [pg. 166] performed additional computer-related work for Sherwin without compensation.

Discussion

Section 162(a) generally allows a deduction for the ordinary and necessary expenses paid during the taxable year in carrying on a trade **[*3]** or business. The term "ordinary" means that the expense is normal, usual, or customary in the taxpayer's trade or business. Deputy v. du Pont, 308 U.S. 488, 495 [23 AFTR 808] (1940). The term "necessary" means the expense is appropriate or helpful in carrying on the trade or business. Heineman v. Commissioner, 82 T.C. 538, 543 (1984). The expenses must proximately relate to the taxpayer's trade or business. Larrabee v.

Commissioner, 33 T.C. 838, 843 (1960); Treas. Reg. § 1.162-1(a). The determination of whether an expense satisfies the requirements for deduction is a question of fact. Commissioner v. Heininger, 320 U.S. 467, 475 [31 AFTR 783] (1943). A taxpayer is required to substantiate the expenses underlying a deduction by keeping and producing adequate records that enable the Commissioner to determine the correct tax liability, including the amounts paid; and to demonstrate that the deduction is allowable pursuant to some statutory provision. § 6001. A taxpayer is not entitled to deduct personal, living, or family expenses. § 262.

Respondent disallowed business expense deductions for Sherwin of $26,500. After concessions, respondent challenges $5,888.80 of the disallowed business expenses (excluding the tuition discussed below); on brief, Sherwin conceded $2,056.54 of the disputed $5,888.80. The unresolved expenses relate to office equipment and supplies and promotional materials. Petitioners have substantiated the amounts of the disputed expenses, and the remaining issue is the business purpose of the expenses. The office equipment expenses relate primarily to the purchase of iPads, iPhones, a speaker, and related expenses for service plans and an accessory. Petitioners assert that Sherwin's employees use these items in the performance of their jobs. On the basis of the record, we accept petitioners' assertion as to the business purpose and find that Sherwin has substantiated the amount and business purpose of each expense. We also accept petitioners' proffered business purpose of office supplies and promotional items totaling $387.08. Accordingly, Sherwin is entitled to deduct $3,832.26 of the disputed expenses.

In addition to the deductions addressed above, Sherwin deducted the tuition that it paid for Mr. Kocemba's coding course. Petitioners contend that Sherwin received website services in exchange for the tuition. While Mr. Kocemba has provided services to Sherwin free of charge that would have likely cost Sherwin more than the amount of the tuition, we nevertheless find that petitioners have not established that Sherwin is entitled to deduct the tuition. Mr. Kocemba was not an employee of Sherwin. The Wards did not have an agreement with Mr. Kocemba that he would perform any services in exchange for the tuition payment. Sherwin paid the tuition without any expectation of a return **[*4]** and thus did not have a business purpose for the payment. The tuition was a personal expense, and Sherwin is not entitled to deduct it.

Respondent asserts that the Wards received a constructive dividend in the amount of the disallowed deductions. A constructive dividend arises when a corporation confers an economic benefit on a shareholder without an expectation of repayment where the corporation has current or accumulated earnings and profits. Truesdell v. Commissioner, 89 T.C. 1280, 1295 (1987). Constructive dividends are includible in the shareholder's gross income under section 61(a)(7).

In the notice of deficiency issued to the Wards, respondent recharacterized a shareholder loan made during 2016 of $38,199 as a constructive dividend from Sherwin to Mrs. Ward. However, Sherwin records establish that the return reported that the loan was made from Mrs. Ward to

Sherwin. Respondent refuses to concede his error and instead argues on brief that the disallowed business expense deductions should be treated as constructive dividends to Mrs. Ward. We reject this new position. There is no relationship between the disallowed expenses and the amount of the purported constructive dividends determined in the Wards' notice of deficiency. Sherwin's [pg. 167] failure to substantiate the business purpose of the disallowed deductions does not render the amount a constructive dividend under the circumstances of these cases. There is no indication that the Wards received an economic benefit from the amount of disallowed expenses. Accordingly, we hold that the Wards did not receive any unreported dividends from Sherwin.

In reaching our holdings, we have considered all arguments made, and, to the extent not mentioned above, we conclude they are moot, irrelevant, or without merit.

To reflect the foregoing,

Decisions will be entered under Rule 155.

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Procedure.

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Tax Court & Board of Tax Appeals Memorandum Decisions

Barry A. Hacker, et ux. v. Commissioner, T.C. Memo. 2022 -16 , Code Sec(s) 61; 301; 316.

BARRY A. HACKER AND CELESTE HACKER, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 128]

Code Sec(s):	61; 301; 316
Docket:	Dkt. No. 3870-12.
Date Issued:	03/07/**2022.**
Judge:	Opinion by Paris, *J.*
Tax Year(s):	Years 2004, 2005, 2006, 2007, 2008.
Disposition:	Decision for Taxpayers in part and for Commissioner in part.

HEADNOTE

1. Gross income—wages—constructive dividends—bank deposits—proof. IRS's wage adjustments to married taxpayers/day care corp. owners' income for years for which they reported

no salary or wages from corp., despite receiving significant direct or indirect payments from same, were upheld in accord with earlier decision in corp.'s case, which found that taxpayers provided substantial services to and were employees of corp., and thus that stated remuneration provided directly or indirectly to them constituted wages. Taxpayers were also charged with constructive dividend income from corp. based on corp.'s payment of taxpayers' personal expenses and/or corp.'s distributions of cash or property to them. But amount of dividend income that IRS determined was adjusted to account for facts that some of corp.'s expense payments were for legitimate business expenses and that certain properties were never held, and thus weren't distributed, by corp. to taxpayers. Finally, taxpayers were charged with unreported income from unexplained bank deposits to their accounts in stated amount.

Reference(s): ¶ 615.047(10) ;¶ 3165.01(82) Code Sec. 61; Code Sec. 301; Code Sec. 316

2. Gross income—rents, royalties, other income—S corp. shareholders; partners and partnerships—passthrough income. Tax Court redetermined married taxpayers/day care corp. owners' passthrough income from solely owned S corp. that they used to provide management services to day care corp. To that end, Court accepted number of, but also rejected some of, IRS's adjustments to such items as payments S corp. received from day care corp.; interest deductions S corp. claimed in respect to interest paid on note on certain properties which S corp. didn't acquire until middle of year claimed; and depreciation on certain properties. Adjustments to various items claimed by/for investment LLC which taxpayers also owned and through which they conducted some rental property activities were also addressed.

Reference(s): ¶ 615.047(5) ;¶ 13,665 Code Sec. 61; Code Sec. 1366

3. S corp. shareholders—distributions in excess of basis. IRS's determination that married taxpayers had distributions in excess of basis from their solely owned S corp. was rejected. Notably, IRS failed to account for certain properties which taxpayers contributed to S corp. when computing basis and made other miscalculations or "misreading[s]" in computing its results. Parties were ordered to address this issue on Rule 155 computations.

Reference(s): ¶ 13,685.01(50) Code Sec. 1368

4. Capital gains and losses—property sales—basis. Tax Court redetermined married taxpayers' reportable capital gain on sale of 1 of multiple rental properties [pg. 129] they improved before selling, allowing them slightly higher amount of additional basis for improvements than IRS allowed.

Reference(s): ¶ 10,015.13(50) Code Sec. 1001

5. Failure to timely file returns penalties—burden of proof and production—reasonable cause. Failure to timely file returns penalty was upheld against married taxpayers for year for

which they filed after extended due date: IRS met its burden of production on penalty's applicability with proof of above; and taxpayers offered no reasonable cause for their delinquency.

Reference(s): ¶ 66,515.14(15) ;¶ 74,915.03(15) Code Sec. 6651; Code Sec. 7491

6. Penalties for fraud and accuracy-related substantial understatements—burden of proof and production—written approval of assessment—unreported income. Fraud penalties were upheld in part/on portions of married taxpayers' underpayments for years for which they had significant unreported income. IRS both showed it complied with Code Sec. 6751(b) 's written supervisory approval prerequisite for penalties and clearly proved fraud as to portions of underpayments from taxpayers' unreported income from unexplained bank deposits and unreported wage and dividend income from corp. Fraud evidence as to those items included that taxpayers claimed no salary from daycare corp. while using same to fund lavish lifestyle and then made misleading or false statements to IRS during exam regarding same. But, record showed that other portions of underpayments, relating to various other adjustments to taxpayers' income, weren't attributable to fraud. Nonetheless, for those portions of underpayments to which fraud penalties didn't apply, accuracy-related substantial underpayment penalties did.

Reference(s): ¶ 66,635.01(5) ;¶ 67,515.01(5) ;¶ 66,625.01(10) Code Sec. 6663; Code Sec. 7491; Code Sec. 6751; Code Sec. 6662

Syllabus

Counsel

Steven P. Flowers and Nathalie M. Cornett, for petitioners.

William F. Castor and Vassiliki Economides Farrior, for respondent.

PARIS, *Judge*

MEMORANDUM FINDINGS OF FACT AND OPINION

By notice of deficiency dated November 14, 2011, respondent determined deficiencies in federal income tax of $125,070, $191,417, $146,712, $196,940, and $171,760 for petitioners' tax years 2004, 2005, 2006, 2007, and 2008, respectively, and civil fraud penalties under section 6663(a)[1] of $93,802.50, $126,201.75, $110,034, $121,176.75, and $128,820 for petitioners' tax years 2004, 2005, 2006, 2007, and 2008, respectively. In the alternative, respondent determined accuracy-related penalties pursuant to section 6662(a) for the years at issue. Respondent additionally determined that petitioners are liable for an addition to tax pursuant to section 6651(a)(1) for 2004 of $12,507.40.

[*2] After concessions, [2] the issues for decision are whether:

1. petitioners received imputed wage income from Blossom Day Care Centers, Inc. (Blossom), of $198,740, $209,200, $220,210, $231,800, and $244,000 for 2004, 2005, 2006, 2007, and 2008, respectively, from distributions and personal expenses Blossom paid for services petitioners performed as employees;

2. petitioners received constructive dividends from Blossom of $594,170, $446,782, $375,246, $327,503, and $319,854 for 2004, 2005, 2006, 2007, and 2008, respectively, relating to distri[pg. 130] butions and personal expenses Blossom paid to or on behalf of petitioners as shareholders;

3. petitioners received unreported gross income based upon unexplained cash deposits into their personal bank accounts of $20,221, $57,322, $69,088, $98,567, and $24,895 for 2004, 2005, 2006, 2007, and 2008, respectively;

4. petitioners' net nonpassive income from Hacker Corporation (Hacker Corp.), reported on Schedule E, Supplemental Income and Loss, should be decreased by $96,647 for 2004 and increased by $66,956, $13,694, $99,902, and $156,653 for 2005, 2006, 2007, and 2008, respectively;

5. petitioners received distributions in excess of basis from Hacker Corp. of $65,914 for 2008;

[*3] 6. petitioners received unreported rental income of $1,180 for 2004;

7. petitioners are entitled to deduct rental expenses reported on Schedule E of $31,164 in excess of those amounts respondent allowed for 2004;

8. petitioners failed to report capital gain income of $21,031 on the sale of the property located at 1006 Cleveland Avenue, Sand Springs, Oklahoma (Cleveland Ave.), for 2005;

9. petitioners' net Schedule E passive income from Hacker Investment, LLC (Hacker Investment), should be increased by $18,919, $29,149, $106, and $14,019 for 2005, 2006, 2007, and 2008, respectively;

10. petitioners failed to report capital gain income of $138,612 on the sale of rental real estate by Hacker Investment for 2007;

11. petitioners are liable for an addition to tax for failure to timely file, pursuant to section 6651(a)(1), for 2004; and

12. petitioners are liable for civil fraud penalties under section 6663(a) or, in the alternative, accuracy-related penalties under section 6662(a) for 2004 through 2008.[3]

FINDINGS OF FACT

I. *Related Cases and Entities*

This case is before the Court in connection with respondent's examination of returns of petitioners and Blossom, an Oklahoma corporation of which petitioners are the sole shareholders. Following that examination, respondent issued to Blossom notices of deficiency **[*4]** and determination of worker classification, and to petitioners a notice of deficiency that is the subject of this opinion. Petitioners and Blossom petitioned this Court for redetermination of the deficiencies and employment classification, and those cases were consolidated for trial, briefing, and opinion.[4] The records for the consolidated cases include the consolidated Stipulation of Facts, the First through Sixth Supplemental Stipulations of Facts, evidence presented at trial, and the consolidated Stipulation of Settled Issues. The Court determined that petitioners were both employees of Blossom in Blossom Day Care Centers, Inc. v. Commissioner (Blossom I), T.C. Memo. 2021-86 [2021 RIA TC Memo ¶2021-086], and that Blossom was liable for deficiencies in Blossom Day Care Centers, Inc. v. Commissioner (Blossom II), T.C. Memo. 2021-87 [2021 RIA TC Memo ¶2021-087]. As discussed in greater detail below, many of the Court's holdings in those cases affect the resolution of the issues herein. The Court takes judicial notice of all facts and issues presented at trial in the three consolidated cases in considering the issues relating to this case.

II. *Background of Petitioners*

Barry A. Hacker and Celeste Hacker (Hackers or petitioners), husband and wife, resided in Oklahoma at the time they filed the Petition.

Beginning in 1986 and at all relevant times, petitioners were the sole shareholders and corporate officers of Blossom, an [pg. 131] Oklahoma corporation that operated childcare centers in the Tulsa metropolitan area. In addition to running the daycare centers, Mr. Hacker worked as an electrician, doing business under the name Accurate Electric and reporting income on Schedule C. The Hackers were also the sole owners of the passthrough entities Hacker Corp., an S corporation, and Hacker Investment, a limited liability company.

Petitioners have three children, sons Steven and Ashley, born in 1975 and 1979, respectively, and daughter Whitney, born in 1987 (collectively, Hacker children or their children).

[*5] III. *Blossom Day Care Centers*

Blossom is discussed more fully in Blossom II, at *5–18. The Court restates those findings relevant to the resolution of petitioners' liability herein.

A. *Operation of Business*

Mrs. Hacker opened Blossom as an unincorporated business entity in 1982. Blossom was incorporated in 1986 and was a valid corporation in the State of Oklahoma during all years at issue. Petitioners were the sole shareholders of Blossom, with Mrs. Hacker owning 51% and Mr. Hacker owning 49% of Blossom's stock.

During the years at issue Blossom operated child daycare centers in the Tulsa metropolitan area at the following locations:

1. 801 Long St., Sand Springs, Oklahoma (Long St.);
2. 4744 South Mingo Rd., Tulsa, Oklahoma (Mingo Rd.);
3. 800 North 81st West Ave., Tulsa, Oklahoma (81st West Ave.);
4. 11505 East 76th St. North, Owasso, Oklahoma (76th St.North); and
5. 9135 East 61st St., Tulsa, Oklahoma (East 61st St.).

Beginning in May 2005 and through the years at issue, Blossom also operated a sixth location at 1020 South Elm Pl., Broken Arrow, Oklahoma (Elm Pl.). Before the property transfers described infra, petitioners owned the Long St. and Mingo Rd. properties, and Blossom owned the 81st West Ave., 76th St. North, East 61st St., and Elm Pl. properties.

B. *Role of the Hackers*

Petitioners were Blossom's only corporate officers from its incorporation through the years at issue. Mrs. Hacker served as Blossom's president, as well as its director of curriculum and education. Her duties included personally overseeing and supervising employees, making hiring and firing decisions, and managing Blossom's six daycare directors. All of Blossom's employees ultimately reported to her.

[*6] Mr. Hacker, also since 1986 and through the years at issue, served as Blossom's corporate vice president, as well as its secretary and treasurer. During the years at issue Mr. Hacker also served as Blossom's director and as its director of accounting and finance. He had authority over all of Blossom's bank accounts, and his daily responsibilities included depositing parents' payments for childcare into Blossom's bank accounts and personally writing all of the payroll checks to Blossom's 90 employees.

Together petitioners actively participated in Blossom's daily operation, frequently working 50 to 60 hours per week, performing all levels of tasks from maintenance and custodial duties to classroom instruction and supervision of teachers to purchasing and delivering food. They were also responsible for ensuring that the programs and employees at Blossom complied with the standards of the Oklahoma Department of Human Services.

During the years at issue petitioners did not receive a salary or wages from Blossom. Rather, Blossom made payments in the form of management fees to Hacker Corp., [5] which in turn paid wages to petitioners and the Hacker children for services rendered to Blossom. The Hacker children were not employees of Blossom during the years at issue.

C. *Corporate Spending*

During the years at issue Blossom maintained an American Express (AMEX) [pg. 132] credit card, account ending x4001, for which petitioners were authorized users. Whitney was added as an authorized user in 2005 and Ashley in 2006. Mr. Hacker also maintained an AMEX credit card, account ending x1009, on which he, Mrs. Hacker, and Ashley were authorized users. Beginning in 2007 Mr. Hacker also maintained a Citi Cards (Citi) credit card account on which he was the sole authorized user, and Mrs. Hacker maintained a Bank of America credit card on which she was the sole authorized user.

Petitioners and their children used the credit cards to make purchases necessary to operate the daycare centers, but they also regularly used them to pay personal expenses. During 2004 through 2007 the Hackers and their children charged thousands of dollars in personal expenses on Blossom's credit card account, as well as their own **[*7]** AMEX, Citi, and Bank of America credit cards, all of which Blossom invariably paid. In addition to routine personal purchases, such as restaurant meals, auto expenses, and personal medical expenses, the Hackers either used the corporate credit card or had Blossom pay their personal credit card charges for such expenses as college tuition, vacations, jewelry, and other luxury items. The Hacker children continued to make personal purchases with the credit cards even though they were not employees of Blossom and during periods when they were not employees of Hacker Corp.

In addition to paying for credit card purchases, Blossom provided petitioners and their children with vehicles. During the years at issue, Mr. Hacker drove a 2003 Hummer as his personal vehicle, while Mrs. Hacker primarily used a 2000 Lexus as her personal vehicle. Both vehicles were titled in petitioners' names, but Blossom paid the notes on the vehicles and claimed depreciation deductions for them on its tax returns. In March 2004 Blossom traded in a Ford Expedition that it owned for $24,919 toward the purchase of a 2004 BMW, which was titled in Steven's name. Steven was the borrower on the car loan and used the BMW for commuting and other personal purposes. Similarly, beginning in April 2004 Ashley began driving a 2004 Cadillac Escalade as his

personal vehicle. The Escalade was titled in Ashely's name, and Ashley was the borrower on the car loan. Blossom paid the notes on both Steven's and Ashley's vehicles and claimed depreciation for those vehicles on its tax returns. Neither petitioners nor their children maintained any mileage logs or other records of the extent, if any, to which they used the vehicles for Blossom's business purposes.

D. *Bookkeeping and Return Preparation*

1. *Bookkeeping*

Blossom did not have an in-house bookkeeper before December 2007. Rather, Blossom engaged the services of Walters & Bailey, C.P.A., Inc. (Walters & Bailey), for bookkeeping and tax return preparation. Rob Crowder, a certified public accountant performing independent contract work for Walters & Bailey, prepared Blossom's general ledgers and financial statements, which would serve as the basis for its tax returns for 2004, 2005, and 2006.

Mr. Crowder prepared Blossom's general ledgers and financial statements using information petitioners provided. They gave him bank statements from Blossom's operating, payroll, and loan accounts but **[*8]** failed to provide any records relating to substantial undeposited cash payments received from Blossom parents. The Hackers also provided credit card statements but did not provide Mr. Crowder with any guidance as to which expenditures were business expenses and which were personal. Although the petitioners and their children used the credit cards for both business purchases and personal expenditures, they did not categorize their business expenses or notate the statements to indicate which purchases were personal. Similarly, the checks reflected on Blossom's bank statements were not coded as to whether they related to a business expense or a personal expense.

Despite the lack of guidance from petitioners, Mr. Crowder determined that many of the expenses on the credit card statements were personal and used a general ledger account entitled "A/R–Officer" as a catchall for credit card charges that he determined were petitioners' personal expenses. The "A/R–Officer" general ledger account increased from $208,776.22 [pg. 133] at the beginning of 2004 to $1,379,408.30 at the end of 2006 primarily on account of charges to the credit cards.

In December 2007 Blossom hired Bonnie King to perform in-house bookkeeping and accounting functions, including the preparation of its general ledger and financial statements for 2007 and 2008. Ms. King prepared the general ledger using Blossom's bank statements from its operating, payroll, and loan accounts, but, as with Mr. Crowder, petitioners did not provide any information regarding the undeposited cash or other payments. Ms. King prepared general ledgers that included the posting of payments of charges on the two AMEX credit card accounts, as well as the

Bank of America credit card and the Citi credit card. Petitioners did not notate which expenditures were personal and which were business. Ms. King posted the majority of the credit card expenditures to Blossom's general ledger supplies account and the remainder to food and activities. Like Mr. Crowder, Ms. King posted in the "A/R–Officer" account those expenses that appeared to her to be personal.

2. *Blossom's Tax Returns*

Blossom's tax returns were prepared by Walters & Bailey, using the general ledgers and financial statements prepared by Mr. Crowder or Ms. King. The returns reported gross receipts of $2,473,118, $2,864,239, $2,766,247, and $2,718,796 for 2004, 2005, 2006, and 2007, **[*9]** respectively. [6] Blossom claimed deductions for the expenses as posted in its general ledger. It included "Note Rec. Officer" among its current assets on the Schedule L, Balance Sheets per Books, attached to the returns, reporting the amounts believed to be personal expenditures. On its returns for 2004 through 2007, Blossom reported the beginning and ending balances of the "Note Rec. Officer" as follows:

Year	Beginning balance	Ending balance
2004	$236,189	$685,694
2005	685,694	348,390
2006	348,390	1,210,159
2007	1,210,159	1,332,066

Petitioners never made any repayment of the amounts designated as the "Note Rec. Officer", nor did Blossom pay them any wages or salary.

IV. *Hacker Corp.*

A. *Management Fees*

In 2002 petitioners incorporated Hacker Corp. as an Oklahoma corporation. During all years relevant to this case Hacker Corp. elected to be treated as an S corporation for federal income tax

purposes. Petitioners were the sole shareholders of Hacker Corp., each owning 50% of the company's stock.

During 2004 through 2008 Blossom made payments in the form of management fees to Hacker Corp., which in turn paid wages to petitioners and their children for services they rendered to Blossom. Hacker Corp. paid wages to petitioners as follows:

Year	Mr. Hacker	Mrs. Hacker
2004	$44,615	$44,618
2005	36,923	36,925
2006	19,999	20,001
2007	26,153	27,694
2008	29,230	29,232

[*10] Ashley was a paid employee of Hacker Corp. from 2005 through 2008. Steven was a paid employee of Hacker Corp. during 2004 and 2005. From January 2006 to August 2008 Steven operated a car stereo modification business and was not employed by Hacker Corp. Whitney was not a paid employee of Hacker Corp. dur[pg. 134] ing the years at issue. No written contract or fee agreement was prepared in connection with Blossom's arrangement with Hacker Corp.

B. *Property Transfers*

Before May 2005 Blossom or petitioners owned the real properties on which Blossom's daycare locations operated. In May 2005 title to each property was transferred by quitclaim deed to Hacker Corp., and the transfers were recorded in the Tulsa County land records. Following the transfers, Blossom continued to operate its daycare centers at the same locations, but Hacker Corp. assumed payment of the property taxes and in June 2005 began making payments on the mortgages securing the properties held by Security Bank. No formal lease agreement between Blossom and Hacker Corp. was signed, but Blossom began making rent payments either directly to Hacker Corp. or to Security Bank in payment of the mortgages on behalf of Hacker Corp. Beginning on its tax return for 2005, Hacker Corp. claimed deductions for depreciation with respect

to the buildings, for payment of property taxes, and for interest paid in connection with the mortgages.

The management fees and rent payments from Blossom were Hacker Corp.'s only income for 2004 through 2008.

V. *Rental Real Estate Activities*

A. *Hacker Investment, LLC*

Petitioners formed Hacker Investment as an Oklahoma limited liability company in August 2002. During 2005, 2006, 2007, and 2008 Mr. and Mrs. Hacker each held one-half of the outstanding membership interests in Hacker Investment. Hacker Investment filed Form 1065, U.S. Return of Partnership Income, for 2005, 2006, and 2008; although Hacker Investment prepared a Form 1065 for 2007, respondent has no record that the return was filed.[7]

[*11] B. *Rental Activities*

During the years at issue petitioners owned, either directly or through Hacker Investment, several rental properties. They maintained a spreadsheet to track the rents received from each property. They reported the income and expenses from their rental activities directly on Schedule E attached to their individual return for 2004. For subsequent years Hacker Investment reported the rental income and expenses on Forms 1065, and those amounts flowed through to petitioners' individual returns.[8]

In June 2002 petitioners purchased the property located at 419 North Lincoln Avenue, Sand Springs, Oklahoma (Orleans Apartments), for $355. They subsequently transferred that property to Hacker Investment. They continued to make various improvements to the property. In May 2007 Hacker Investment sold the Orleans Apartments for $475,000.

Petitioners purchased the property located at 500 North Washington Avenue, Sand Springs, Oklahoma (Washington Ave.), for $39,000 in June 2004 and subsequently deeded it to Hacker Investment. On August 21, 2007, Hacker Investment divided the property in half and sold one portion for $16,000.

In June 2004 petitioners also acquired the Cleveland Ave. property for $27,500. They made various improvements to the property before selling it for $95,500 in November 2005. After settlement fees, they received proceeds of $88,942. They did not report the sale on their 2005 tax return.

VI. *Return Preparation*

Petitioners received extensions of time to file their return for each of the years at issue and filed joint individual income tax returns for 2004, 2005, 2006, 2007, and 2008 on December 5, 2005, October 15, 2006, October 15, 2007, October 15, 2008, and October 15, 2009, respectively. On their returns, they reported total tax of $50,775, $6,976, $65,568, zero, and zero for 2004, 2005, 2006, 2007, and 2008, **[*12]** respectively. Their reported income for each year included the wages received from Hacker Corp.; income or loss from Hacker Corp., reported on Schedule E; and income or loss from rental real estate [pg. 135] (which they reported directly on Schedule E for 2004 and as flowthrough amounts from Hacker Investment in subsequent years). For 2006, 2007, and 2008, they also reported income from Accurate Electric on Schedule C. They did not report wages, salary, or dividends from Blossom for any year 2004 through 2008.

VII. *Examination*

Respondent examined petitioners' tax returns for 2004, 2005, 2006, 2007, and 2008 in an examination that also covered the tax returns of Hacker Corp. for 2004 through 2008, Hacker Investment for 2005 through 2008, and Blossom for 2004 through 2007, as well as Blossom's worker classifications of petitioners for 2005 through 2008. Beginning in March 2008 petitioners executed, both for themselves and on behalf of Blossom, a series of timely Forms 872, Consent to Extend the Time to Assess Tax, for 2004, 2005, 2006, and 2007.

During the examination of petitioners' returns, Revenue Agent Floyd (RA Floyd) conducted a bank deposits analysis of petitioners' bank accounts, as well as the accounts of their business entities. RA Floyd examined their bank account records, identified all of the deposits, and, after subtracting out reported income and items identified as nontaxable, concluded that petitioners had received unreported income. RA Floyd additionally determined that the 2004 Note Rec. Officer beginning balance was a personal loan forgiven by Blossom. Throughout the examination, petitioners attempted to conceal their receipt of personal benefits from Blossom. Mr. Hacker claimed that Steven's wedding was "a big celebration of Blossom" and that the various trips of petitioners and their children to the Bahamas, Europe, Hawaii, Las Vegas, and New Orleans, paid for by Blossom, were for business or so that they would not be distracted while performing administrative tasks. Following the examination, respondent issued the notice of deficiency to petitioners, as well as notices of deficiency and determination of worker classification to Blossom, determining that petitioners were employees of Blossom and should have received wage compensation during the years covered.

In the notice issued to petitioners, respondent determined deficiencies of $125,070, $191,417, $146,712, $196,940, and $171,760 for **[*13]** 2004, 2005, 2006, 2007, and 2008, respectively, on the basis of the following adjustments:

	2004	2005	2006
a. Wages from Blossom - Taxpayer Wife (TPW)	$99,370	$104,600	$110,105
b. Wages from Blossom - Taxpayer Husband (TPH)	99,370	104,600	110,105
c. Rental expenses/depr.	31,164	–	–
d. Sch. E1 - rents received	1,180	–	–
e. Distributions from Hacker Corp. in excess of basis	8,400	–	–
f. Sch. E nonpassive income/loss Hacker Corp.	(96,647)	66,956	13,694
g. Sch. E passive income/ loss Hacker Corp.	(86,803)	(10,762)	(107,102)
h. Unexplained deposits	20,221	57,322	69,088
i. Qualified dividends from Blossom	594,1709	446,782	375,246
j. SE AGI adjustments	(1,429)	(4,050)	(4,036)
k. Itemized deductions	17,804	27,558	11,982
l. Standard deduction	(9,700)	(10,000)	–
m. Exemptions	9,920	9,600	3,168
n. Sch. E passive income/ loss Hacker Investment	–	18,919	29,149

o. Capital gain or loss	–	22,085	–
p. 1099 Income – Oklahoma Child Care Association	–	–	4,950
q. Sch. C from Accurate Electric loss	–	–	–
r. Interest income	–	–	–
s. State refunds, offsets	–	–	–
t. Gambling winnings	–	–	–
Total Adjustments	$687,020	$833,610	$616,349

	2007	2008
a. Wages from Blossom - Taxpayer Wife (TPW)	$115,900	$122,000
b. Wages from Blossom - Taxpayer Husband (TPH)	115,900	122,000
c. Rental expenses/depr.	–	–
d. Sch. E1 - rents received	–	–
e. Distributions from Hacker Corp. in excess of basis	–	65,914
f. Sch. E nonpassive income/loss Hacker Corp.	99,902	156,653
g. Sch. E passive income/		

loss Hacker Corp.	–	–
h. Unexplained deposits	98,567	24,895
i. Qualified dividends from Blossom	327,503	319,854
j. SE AGI adjustments	(5,462)	(3,213)
k. Itemized deductions	18,284	3,682
l. Standard deduction	–	–
m. Exemptions	6,801	3,501
n. Sch. E passive income/ loss Hacker Investment	106	14,019
o. Capital gain or loss	138,612	–
p. 1099 Income - Oklahoma Child Care Association	–	1,600
q. Sch. C from Accurate Electric loss	11,638	20,750
r. Interest income	1,450	79
s. State refunds, offsets	–	2,783
t. Gambling winnings	–	15,140
Total Adjustments	$929,201	$869,657

/9/ This amount includes the $236,189 Note Rec. Officer beginning balance determined to be a loan forgiven.

[*14] In addition respondent determined civil fraud penalties under section 6663 of $93,802.50, $126,201.75, $110,034, $121,176.75, and $128,820 for the years at issue. Respondent determined the $93,802.50 fraud penalty for 2004 on the basis of the following adjustments:

Adjustments to income to which fraud penalty applies	Amount
Wages from Blossom-TPW	$99,370
Wages from Blossom-TPH	99,370
Dividends	594,170
Unexplained deposits	20,221

Respondent determined the $126,201.75 fraud penalty for 2005 on the basis of the following adjustments:

Adjustments to income to which fraud penalty applies	Amount
Wages from Blossom-TPW	$104,600
Wages from Blossom-TPH	104,600
Dividends	446,782
Unexplained deposits	57,322

Respondent determined the $110,034 fraud penalty for 2006 on the basis of the following adjustments:

Adjustments to income to which fraud penalty applies	Amount

Wages from Blossom-TPW	$110,105
Wages from Blossom-TPH	110,105
Dividends	375,246
Unexplained deposits	69,088

Respondent determined the $121,176.75 fraud penalty for 2007 on the basis of the following adjustments:

Adjustments to income to which fraud penalty applies	Amount
Wages from Blossom-TPW	$115,900
Wages from Blossom-TPH	115,900
Dividends	327,503
Unexplained deposits	98,567

Respondent determined that the fraud penalty applies to all of the adjustments to petitioners' 2008 income.

[*15] A Civil Penalty Approval Form was signed on November 10, 2009, by the immediate supervisor of RA Floyd, who examined petitioners' returns, approving the imposition of the fraud penalties and the accuracy-related penalties for underpayments due to substantial understate[pg. 137] ments of income tax. Respondent also determined that petitioners were liable for an addition to tax pursuant to section 6651(a)(1) for 2004 of $12,507.40.

Respondent issued the notice of deficiency on November 14, 2011, and petitioners timely petitioned this Court for redetermination.

OPINION

I. *Burden of Proof*

In general the Commissioner's determinations set forth in a notice of deficiency are presumed correct, and the taxpayer bears the burden of showing the determinations are in error. Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 [12 AFTR 1456] (1933). When, as here, a case involves unreported income, however, the U.S. Court of Appeals for the Tenth Circuit, to which this case would be appealable absent a stipulation to the contrary, *see* § 7482(b); Golsen v. Commissioner, 54 T.C. 742, 757 (1970), aff'd, 445 F.2d 985 [27 AFTR 2d 71-1583] (10th Cir. 1971), has held that the Commissioner's determination of unreported income is entitled to a presumption of correctness only once some substantive evidence is introduced demonstrating that the taxpayer received unreported income, United States v. McMullin, 948 F.2d 1188, 1192 [68 AFTR 2d 91-5888] (10th Cir. 1991). Once the Commissioner introduces some substantive evidence linking the taxpayer to the income, the presumption of correctness applies, and the burden shifts to the taxpayer to produce substantial evidence overcoming it. [10] Id.

II. *Income from Blossom*

A. *Background*

During the years at issue, petitioners were the sole corporate officers of Blossom and performed substantial services for Blossom in that capacity. They were also its sole shareholders. They did not receive **[*16]** a salary or wages from Blossom during the years at issue. Nevertheless, during that time, they received, either directly to themselves or indirectly to their children or other businesses, substantial economic benefit from Blossom in the form of money, property, and other remuneration. Respondent contends that such benefits constitute wages and dividends.

B. *Wages*

Respondent determined that petitioners received wage income from Blossom as follows:

Year	Mr. Hacker	Mrs. Hacker	Total
2004	$99,370	$99,370	$198,740
2005	104,600	104,600	209,200
2006	110,105	110,105	220,210

2007	115,900	115,900	231,800
2008	122,000	122,000	244,000

Respondent's wage determinations were considered in connection with the notice of determination of worker classification that was the subject of Blossom I and the notice of deficiency that was the subject of Blossom II. In those reports the Court sustained respondent's determinations that petitioners were employees of Blossom and that remuneration provided directly or indirectly to them for their work as such constituted wages. Petitioners provided substantial services to Blossom and received compensation in the form of money, property, and other direct and indirect benefits. Such compensation constitutes gross income to them. *See* Treas. Reg. § 1.61-2(a)(1) ("Wages...are income to the recipients unless excluded by law."). Petitioners offer no argument or evidence to show that the wages respondent determined are erroneous or unreasonable or should be excluded from gross income. Consistent with our holdings in Blossom I and Blos[pg. 138] som II, the wage adjustments here are sustained.

C. *Constructive Dividends*

Respondent determined that petitioners, as shareholders, received constructive dividends from Blossom of $594,169.87, $446,782.26, $375,246.30, $327,503.57, and $319,854 for 2004, 2005, 2006, 2007, and 2008, respectively.

Section 61(a)(7) includes dividends in a taxpayer's gross income. When a corporation distributes property to a shareholder as a dividend, **[*17]** whether formally or informally, the shareholder must include the distribution in gross income to the extent of the corporation's earnings and profits. *See* §§ 301(a), (c)(1), 316; *see also* Welle v. Commissioner, 140 T.C. 420, 422 (2013). A constructive dividend arises when a corporation confers an economic benefit upon a shareholder without expectation of repayment and the corporation on the date of the deemed distribution had current or accumulated earnings and profits. *See* Welle, 140 T.C. at 422. The shareholder need not receive the dividend directly and must include in gross income payments the corporation made on the shareholder's behalf. *See* Epstein v. Commissioner, 53 T.C. 459, 474–75 (1969); Vlach v. Commissioner, T.C. Memo. 2013-116, at *32–33 [2013 RIA TC Memo ¶2013-116]. In determining whether a shareholder received a constructive dividend, the Court considers whether the payment benefited the shareholder personally rather than furthering the interest of the corporation. Hagaman v. Commissioner, 958 F.2d 684, 690–91 [69 AFTR 2d 92-906] (6th Cir. 1992), aff'g *in part and remanding on other grounds* T.C. Memo. 1987-549 [¶87,549 PH Memo TC]; Vlach, T.C. Memo. 2013-116, at *33 [2013 RIA TC Memo ¶2013-116]. Where a corporation constructively distributes property to a shareholder, the constructive dividend

received by the shareholder is ordinarily measured by the fair market value of the benefit conferred. Welle, 140 T.C. at 423.

Respondent based his determination of dividends on distributions of cash and property and payments of personal expenses by Blossom as follows:

	2004	2005	2006
Checks	$36,779.02	$14,862.33	$14,077.99
Credit card charges for personal expenses	312,031.44	389,056.95	342,411.60
Payments on personal vehicle loans	93,715.34	105,439.25	84,984.88
Personal auto, insurance, and interest expenses	41,827.76	48,286.54	40,417.96
Undeposited payments from parents	47,448.31	54,839.21	86,228.74
Distribution of vehicles	24,919.00	–	14,000.00
2004 A/R - officer beginning balance recharacterized as dividend	236,189.00	–	–
[*18] Repairs	–	9,535.95	–
Net value of distributed real			

property	–	33,962.00	–
Real property tax payments	–	–	3,835.13
Loan payments on petitioners' personal residence	–	–	–
Transfers	–	–	–
Payments to Accurate Electric	–	–	9,500.00
Other payments of personal expenses	–	–	–
Reduction for wage adjustment	(198,740.00)	(209,200.00)	(220,210.00)
Total	$594,169.87	$446,782.23	$375,246.30

	2007	2008
Checks	$26,830.00	$74,803.13
Credit card charges for personal expenses	271,867.00	–
Payments on personal vehicle loans	73,462.74	57,423.50
Personal auto, insurance, and interest expenses	31,865.00	71,798.00

Undeposited payments from parents	88,767.78	99,798.00
Distribution of vehicles	–	–
2004 A/R – officer beginning balance recharacterized as dividend	–	–
[*18] Repairs	–	–
Net value of distributed real property	–	–
Real property tax payments	–	2,866.00
Loan payments on petitioners' personal residence	29,811.05	39,522.84
Transfers	9,000.00	–
Payments to Accurate Electric	27,700.00	41,631.00
Other payments of personal expenses	–	176,011.23
Reduction for wage adjustment	(231,800.00)	(244,000.00)
Total	$327,503.57	$319,853.70

Petitioners do not present any arguments or evidence to dispute respondent's determination of dividends, except insofar as they disagree with the adjustments to Blossom's income and deductions. In Blossom II, at *32–46, the Court considered those arguments and found that certain expenditures paid by credit card and determined by respondent to be personal were in fact business expenses. The Court concluded that Blossom was entitled to additional business expense deductions totaling $95,452.59, $83,671.47, and $23,023.57 for 2004, 2005, and 2007, respectively. Id. Accordingly, the Court concludes those expenditures were business expenses and not personal expenses of petitioners, and those amounts do not constitute dividends to them. The credit card amounts shown above should be reduced by those same amounts for 2004, 2005, and 2007, respectively.

At all relevant times prior to the transfer to Hacker Corp., petitioners owned the Long St. and Mingo Rd. properties. Therefore, Blossom did not own two of the properties that petitioners caused to be transferred to Hacker Corp. in 2005. Id. at *26–31. Blossom did not distribute those properties, and the net value of those properties thus does not constitute dividends to petitioners. The 2005 dividend amount should be reduced by the net value of the Long St. and Mingo Rd. properties.

The remaining amounts constitute economic benefits to petitioners, either directly or indirectly, as shareholders of Blossom. The **[*19]** Court holds that those amounts are dividends to petitioners subject to the above adjustments: [pg. 139]

Year	Dividend per respondent	Adjustment per opinion	Dividend after adjustment
2004	$594,169.87	$95,452.59	$498,717.28
2005	446,782.23	*	*
2006	375,246.30	–	375,246.30
2007	327,503.57	23,023.57	304,480.00
2008	319,853.70	–	319,853.70

The Court holds that the 2005 dividend amount should be reduced by $83,671, which relates to reasonable business expenses of Blossom, and further reduced by the net value of the Long St.

and Mingo Rd. properties, which were not distributions to petitioners. The 2005 dividend after adjustment shall reflect these reductions to respondent's dividend determination.

III. *Unexplained Deposits*

As previously discussed, gross income means all income from whatever source derived. § 61(a). Gross income is construed broadly to include all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 [47 AFTR 162] (1955). Every person subject to income tax is required to maintain books and records to establish the amount of gross income and deductions shown by that person on his or her income tax return. *See* § 6001; Treas. Reg. § 1.6001-1(a).

Bank deposits are prima facie evidence of income. Tokarski v. Commissioner, 87 T.C. 74, 77 (1986); Bolles v. Commissioner, T.C. Memo. 2019-42, at *14 [2019 RIA TC Memo ¶2019-042]. The bank deposits method of proof presumes that all deposits into a taxpayer's bank account during a given period constitute taxable income unless the taxpayer can show that the deposits were nontaxable. Clayton v. Commissioner, 102 T.C. 632, 645 (1994). The Government must take into account any nontaxable source or deductible expense of which it has knowledge. DiLeo v. Commissioner, 96 T.C. 858, 868 (1991), aff'd, 959 F.2d 16 [69 AFTR 2d 92-998] (2d Cir. 1992).

During the examination of petitioners' returns, RA Floyd conducted a bank deposits analysis of their accounts and concluded that they received unreported income of $20,221, $57,322, $69,088, $98,567, and $24,895 for 2004, 2005, 2006, 2007, and 2008, respectively.

[*20] Petitioners acknowledge that the funds were deposited in their accounts but do not offer any satisfactory explanation as to the source of the funds or whether the funds were nontaxable or otherwise reported on their returns. At trial Mr. Hacker speculated that the funds may have been gambling winnings or rental payments but provided no additional evidence or explanation to corroborate this testimony. He was emphatic, however, that the unexplained deposits were "absolutely not" the undeposited payments from Blossom parents. Respondent's determination of gross income based on unexplained deposits is sustained.

IV. *Income from Hacker Corp.*

A. *Schedule E Nonpassive Income*

1. *Adjustments*

An S corporation is not subject to federal income tax at the entity level. § 1363(a). The corporation's income, losses, deductions, and credits are passed through to the shareholders at their pro rata shares. § 1366(a). Where a notice of deficiency includes adjustments for S corporation items with other items unrelated to the S corporation, the Court has jurisdiction to determine the correctness of all adjustments. *See* Winter v. Commissioner, 135 T.C. 238 (2010); Berry v. Commissioner, T.C. Memo. 2018-143, at *6 [2018 RIA TC Memo ¶2018-143]. The substantiation requirements of section 162 also apply to business expense deductions for S corporations. Tabe v. Commissioner, T.C. Memo. 2019-149, at *21 [2019 RIA TC Memo ¶2019-149]; *see also* § 1363(b). [pg. 140]

On its returns, Hacker Corp. reported income of $173,606, $21,525, and $114,204 for 2004, 2005, and 2006, respectively, an d losses of $47,560 and $114,609 for 2007 and 2008, respectively, which petitioners reported on Schedules E of their returns for the respective years.[11] Respondent determined adjustments to the tax returns of Hacker Corp. as follows:

[*21]	2004	2005	2006	2007	2008
Gross receipts	($183,450)	($38,187)	($6,499)	$86,811	$142,917
Interest expense	--	59,066	--	--	345
Depreciation	--	35,315	13,091	13,091	13,091
Advertising expense /12/	--	--	--	--	300
Total adjustments	($183,450)	$56,194	$6,592	$99,902	$156,653

/12/ Petitioners concede that respondent properly disallowed the claimed $300 advertising expense deduction.

The Court addresses respondent's adjustments below.

2. *Gross Receipts*

Gross income means all income from whatever source derived, including income derived from business. *See* § 61(a)(2). Hacker Corp. received payments from Blossom for services the Hackers and their children rendered and, beginning in May 2005, for the use of the buildings. On its returns, Hacker Corp. reported gross receipts of $309,300, $342,650, $377,125, $228,100, and $204,514 for 2004, 2005, 2006, 2007, and 2008, respectively. During the examination of Hacker Corp.'s returns, RA Floyd performed a bank deposits analysis of Hacker Corp.'s bank accounts, as well as the books and records of Blossom, and determined that Hacker Corp. received payments from Blossom totaling $125,850, $304,463, $370,626, $314,911, and $347,431 for 2004, 2005, 2006, 2007, and 2008, respectively.

Petitioners disagree with respondent's adjustments of Hacker Corp.'s gross receipts but do not identify any errors in respondent's analysis. Indeed, on brief, they appear to accept that adjustments for 2004, 2005, and 2006 are appropriate when arguing for an increase in Blossom's deductions for management fees. *See* Blossom II, at *41–42. Consistent with the Court's findings in Blossom II, the Court finds that [pg. 141] Hacker Corp. received gross receipts of $125,850, $304,463, and $358,026 for 2004, 2005, and 2006, respectively. The evidence supports respondent's adjustments to gross receipts for 2007 and 2008, and those adjustments are sustained.

[*22] 3. *Interest Expense*

Respondent determined adjustments to Hacker Corp.'s claimed interest expense deductions for 2005 and 2008. For 2005 Hacker Corp. deducted interest expenses of $118,132 paid on the note on the daycare center properties it acquired from Blossom and petitioners in May of that year. Respondent disallowed $59,066, or one-half of the claimed amount, on the grounds that that amount was paid by the properties' respective prior owners and not by Hacker Corp.[13] Respondent additionally disallowed $345 of a claimed interest expense deduction for 2008 on account of lack of substantiation.

Hacker Corp. acquired the daycare center properties in May 2005 and did not begin making the note payments until June 2005. *See also* Blossom II, at *9. Accordingly, it is not entitled to deductions for interest paid before that time. With respect to the 2008 interest, petitioners have not offered any evidence or argument to support Hacker Corp.'s entitlement to the disallowed deduction. Respondent's adjustments are sustained.

4. *Depreciation*

On its 2005, 2006, 2007, and 2008 returns, Hacker Corp. claimed a depreciation deduction of $72,747 with respect to the daycare center properties for each year. Hacker Corp. calculated its depreciation by carrying over the same cost basis in the properties that Blossom had used to

calculate the depreciation on its 2004 return. Respondent recalculated a depreciation amount using the fair market value of the buildings at the time of transfer and, in turn, increased Hacker Corp.'s cost basis in the property acquired from Blossom.

Section 301(d) provides that the basis of property received in a distribution made by a corporation to a shareholder shall be the fair market value of the property. Section 362(a)(1) provides that, in the case of a transaction to which section 351 (relating to transfer of property to a corporation controlled by the transferor) applies, the transferee corporation's basis in the transferred property shall be the same as it would be in the hands of the transferor. In May 2005 Blossom transferred to Hacker Corp. the properties at 81st West Ave., 76th St. North, East 61st St., and Elm Pl. in a transaction deemed to be a **[*23]** distribution to petitioners pursuant to section 301(a). *See also* Blossom II, at *26. Accordingly, respondent correctly determined that the depreciable bases in those properties should have been the fair market value at the time of distribution.

With respect to the Long St. and Mingo Rd. properties, however, Blossom did not own the properties or distribute them to petitioners. Petitioners owned the properties, and upon their transfer of those properties to Hacker Corp., Hacker Corp.'s basis in such properties is the same as it was in the hands of petitioners. *See* § 362(a)(1). The Court thus finds that Hacker Corp. properly calculated its depreciation from the basis carried over from the 2004 return. The amounts Hacker Corp. claimed with respect to those properties were correct.[14]

B. *Distributions in Excess of Basis*

Sections 1366 through 1368 govern the tax treatment of S corporation shareholders with respect to their investments in such entities. Section 1366(a)(1) provides that a shareholder shall take into account his or her pro rata share of the S corporation's items of income, loss, deduction, or credit for the S corporation's taxable year ending with or in the shareholder's taxable year.

With respect to basis, section 1012 sets forth the foundational principle that the basis of property for tax purposes shall be the cost of the property. Cost, in turn, is defined by regulation as the amount paid for the property in cash or other property. [pg. 142] Treas. Reg. § 1.1012-1(a). Section 1367 then specifies adjustments to basis applicable to investments in S corporations. Basis in S corporation stock is increased by income passed through to the shareholder under section 1366(a)(1) and decreased by, inter alia, distributions not includable in the shareholder's income pursuant to section 1368; items of loss and deduction passed through to the shareholder under section 1366(a)(1); and certain nondeductible, noncapital expenses. § 1367(a); *see also* Gleason v. Commissioner, T.C. Memo. 2006-191 [2006 RIA TC Memo ¶2006-191], 2006 WL 2601835, at *5.

Section 1368 addresses treatment of distributions. The typical rule for entities without accumulated earnings and profits is that distributions are not included in a shareholder's gross income to the **[*24]** extent that they do not exceed the adjusted basis of his or her stock (but are applied to reduce basis), while any distribution amount in excess of basis is treated as gain from the sale or exchange of property. § 1368(b); *see also* Gleason v. Commissioner, 2006 WL 2601835 [2006 RIA TC Memo ¶2006-191], at *6.

Petitioners' basis in Hacker Corp. at the end of 2004 was zero, because of distributions in excess of basis in 2004.[15] Following the adjustments to Hacker Corp.'s income for 2005 through 2008, respondent computed petitioners' basis for each year and determined that they received distributions from Hacker Corp. in excess of basis in 2008 of $65,914. Respondent determined this amount by using a 2008 beginning basis of $240,857, adding post examination ordinary income of $156,653 and capital contributions of $9,168, then subtracting distributions of $340,764, to arrive at an adjustment for distributions in excess of basis of $65,914.[16]

The Court has determined that in 2005 the Hackers contributed daycare center properties to Hacker Corp. Respondent's calculation of basis fails to take into account their 2005 contributions of the daycare center properties, which increase petitioners' basis in Hacker Corp. by their bases in those properties. *See* § 358(a). The parties have stipulated that petitioners' basis in Hacker Corp. at the end of 2004 was zero. Petitioners' basis for 2005 should include the adjustments for the contribution of the properties. Even if the Court accepts respondent's starting 2008 basis of $240,857, adjusts for income and capital contributions as determined by respondent, then subtracts distributions of $340,764, respondent has misread the results. The remaining $65,914 represents petitioners' remaining basis and not distributions in excess of basis. Further, the Court has redetermined Hacker Corp.'s income to reflect substantial adjustments, as discussed supra. In the Rule 155 computation, the parties shall take these adjustments into account and recalculate the amount, if any, by which petitioners' 2008 distributions from Hacker Corp. exceeded their basis therein.

[*25] V. *Rental Real Estate Activities*

A. *The Hackers*

1. *2004 Rental Income and Expenses*

On Schedule E, attached to their 2004 return, petitioners reported rental income of $77,862 and expenses totaling $102,289. Respondent determined that they failed to report $1,180 in rental income, on the basis of a review of petitioners' records. Respondent additionally disallowed claimed deductions for insurance expenses of $783, interest payments totaling $28,487, and depreciation of $1,894, on account of lack of substantiation. Petitioners dispute the adjustments,

but did not present any evidence at trial or offer any argument on brief in support of their position. Respondent's determinations are sustained.

2. *2005 Capital Gains Income*

Respondent determined that petitioners failed to report capital gains income of $21,031 on the sale of the Cleveland Ave. property in 2005.

Gross income includes gains from dealings in property. § 61(a)(3). A taxpayer must recognize gain on the sale of property in an amount equal to the difference between the amount realized and basis. §§ 1001, 1012; *see also* O'Boyle v. Commis[pg. 143] sioner, T.C. Memo. 2010-149 [2010 RIA TC Memo ¶2010-149], 2010 WL 2766818, at *3, aff'd *per curiam*, 464 F. App'x 4 [111 AFTR 2d 2013-1367] (D.C. Cir. 2012). Petitioners bear the burden of establishing basis in their property. *See* Rule 142(a); O'Boyle v. Commissioner, 2010 WL 2766818 [2010 RIA TC Memo ¶2010-149], at *3.

Petitioners purchased the Cleveland Ave. property in June 2004 for $27,500 and sold it in November 2005 for $95,500. After settlement fees, petitioners received net proceeds of $88,942. On the basis of invoices and verified payments petitioners submitted, respondent allowed additional basis of $40,411 for improvements to the property. Respondent therefore determined a gain of $21,031.

On review of the evidence, including petitioners' bank statements and claimed improvements, the Court finds that petitioners are entitled to additional basis of $1,294 paid on November 15, 2004, for miscellaneous improvements provided on check No. 6094. Petitioners did not introduce any additional evidence or arguments to otherwise rebut respondent's determination. Accordingly, the Court finds that **[*26]** petitioners' adjusted basis in the Cleveland Ave. property was $69,205, and that their gain on the sale was $19,737.

B. *Hacker Investment*

1. *Overview*

As a general rule partnerships are not subject to Federal income tax, and items of partnership income, loss, deduction, and credit are reflected on the partners' individual income tax returns. *See* § 701; Keeter v. Commissioner, T.C. Memo. 2018-191, at *9 [2018 RIA TC Memo ¶2018-191]. On its returns Hacker Investment reported losses of $5,616, $30,295, and $14,019 for 2005, 2006, and 2008, respectively. Hacker Investment prepared a return for 2007, showing income of $4,536, but respondent has no record that the return was filed. Petitioners reported those amounts as passive income or loss on Schedules E of their returns for the respective years.

Respondent determined adjustments to the income and expenses of Hacker Investment as follows:[17]

	2005	2006	2007	2008
Rental income	$12,002	$9,752	$51,715	--
Depreciation	2,227	2,138	(4,673)	$4,346
Interest	4,690	(4,072)	(16,751)	3,341
Repairs	--	21,626	--	--
Depreciation--windows/doors	--	(295)	--	--
Other rental expenses	--	--	(25,649)	--
Total	$18,919	$29,149	$4,642	$7,687

[*27] On the basis of these adjustments, respondent determined an increase in Schedule E income of $18,919, $29,149, $106, [18] and $14,019[19] for 2005, 2006, 2007, and 2008, respectively.[20] [pg. 144]

2. *Rental Income*

Hacker Investment reported gross rents of $78,963, $79,536, and $55,014 for 2005, 2006, and 2007, respectively. Hacker Investment maintained records that showed it received gross rents of $90,965, $89,288, and $51,715 for 2005, 2006, and 2007, respectively, [21] and respondent determined that these amounts constituted the correct rents received by Hacker Investment. Petitioners have not offered any argument or evidence to dispute respondent's adjustment. Respondent's adjustment is sustained.

3. *Repairs Expense*

Section 162(a) allows as a deduction all ordinary and necessary business expenses paid or incurred in carrying on any activity that constitutes a trade or business. No current deduction is

allowed for capital expenditures, however. *See* § 263(a). Capital expenditures include amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 83 [69 AFTR 2d 92-694] (1992); *see also* § 263(a)(1). The capitalization rules of section 263(a) and the regulations thereunder do not treat an expense to repair property as **[*28]** a capital expenditure. *See* Gibson & Assocs., Inc. v. Commissioner, 136 T.C. 195, 232 (2011). Such an expense is not a capital expenditure because it does not increase the value or prolong the useful life of the property (or adapt the property to a different or new use). Id. at 232–33. Whether an expense is for a repair is a factual determination that turns on a finding that the work did or did not prolong the useful life of the property, increase its value, or make it adaptable to a different use. Id. at 233. As a general, though not absolute, rule, an important factor in determining whether the appropriate tax treatment is an immediate deduction or capitalization is the taxpayer's realization of benefits beyond the year in which the expenditure is incurred. INDOPCO, Inc. v. Commissioner, 503 U.S. at 87; Tsakopoulos v. Commissioner, T.C. Memo. 2002-8 [2002 RIA TC Memo ¶2002-008], 2002 WL 23952, at *7–8.

On its 2006 return Hacker Investment claimed a deduction for rental repair expenses of $34,994. Respondent disallowed $21,626 of that amount, comprising $11,309.31 for a new roof on the Orleans Apartments and $10,316.96 to replace windows and doors, on the grounds that such costs should have been capitalized, rather than deducted. Petitioners introduced into evidence invoices from Metro Construction, Inc., showing work performed on various properties, but not showing that the replacement roof, doors, or windows were of such a nature as to constitute only minor repairs. The Court concludes that those expenses should have been capitalized.[22] In turn the basis of the Orleans Apartments should also be adjusted to reflect the capital improvements of the new roof, windows, and doors.

4. *Depreciation*

Hacker Investment claimed depreciation deductions of $16,980, $16,980, $8,892, and $12,841 for 2005, 2006, 2007, and 2008, respectively. These amounts included depreciation with respect to Hacker Investment's rental properties for each year, as well as the 839 Katy Street property and a warehouse.

Relying on real property records and petitioners' cost bases, respondent calculated the depreciable basis, excluding land value, for each of the properties. In addition, respondent disallowed the claimed depreciation deduction for the property at 839 Katy Street, which **[*29]** Blossomed owned, and the warehouse, which petitioners maintained for personal use. Respondent concluded that Hacker Investment was entitled to depreciation of $14,753, $14,842, $4,673, and $8,495 for 2005, 2006, 2007, and 2008, respectively.

Petitioners have not introduced any evidence or advanced any argument in support of their assertion that respondent's determinations of allowable depreciation are incorrect, and the Court sustains respondent's determinations.[23] [pg. 145]

5. *Interest and Other Rental Expenses*

Petitioners do not raise any arguments or identify evidence in support of their position with respect to the disallowed deductions for interest or other rental expenses. Those adjustments are sustained.

6. *2007 Capital Gains Income*

On Form 4797, Sales of Business Property, attached to their 2007 return, petitioners reported gain of $27,200. The reported gain pertained to Hacker Investment's sale of the Orleans Apartments and was based on a sale price of $335,000 and an adjusted basis of $307,800. Respondent determined that petitioners underreported their gain by $138,612 by understating Hacker Investment's gain from the sale of the Orleans Apartments and omitting the sale of the Washington Ave. property. Respondent determined that Hacker Investment realized total gain of $165,812 on its sales, calculated as follows:

Property	Amount realized	Cost	Capital improvements	Depreciation	Gain
Orleans Apartments	$475,000	$355,000	$21,331	($51,143)	$149,812
Washington Ave.	16,000	--	--	--	16,000

Petitioners contend that respondent did not properly calculatethe gain on either property. With respect to the Orleans Apartments, they **[*30]** identify no error in respondent's calculation, and the calculation is supported by the evidence. The Court sustains respondent's determination regarding the Orleans Apartments.

In the case of the Washington Ave. property, however, respondent has treated the gross amount received as income without taking into consideration the basis in the property or any adjustments thereto. Petitioners acquired the Washington Ave. property in June 2004 for $39,000 and

subsequently deeded the property to Hacker Investment. Respondent determined that the correct depreciation on the Washington Ave. property in 2004 was $469, and that the correct depreciation in each of 2005, 2006, and 2007 was $865. In 2007 Hacker Investment divided the property in half and sold one portion for $16,000. Hacker Investment's correct basis in the sold portion of the Washington Ave. property, therefore, should have been one-half of the $39,000 purchase price, adjusted downward for allowable depreciation through the date of sale. The parties shall submit computations pursuant to the Court's determination of the issues in accordance with their Rule 155 computations.

VI. *Additions to Tax and Penalties*

A. *Section 6651(a)(1) Addition to Tax*

Section 6651(a)(1) imposes an addition to tax for failure to timely file a Federal income tax return unless it is shown that the failure is due to reasonable cause and not due to willful neglect. *See also* Higbee v. Commissioner, 116 T.C. 438, 447 (2001). The addition to tax is equal to 5% of the amount required to be shown as tax on the delinquent return for each month or fraction thereof during which the return remains delinquent, up to a maximum addition of 25% for returns more than four months delinquent. § 6651(a)(1). Under section 7491(c) the Commissioner bears the burden of producing evidence with respect to the liability of the taxpayer for any addition to tax. *See* Higbee, 116 T.C. at 446–47. The burden of proving reasonable cause and lack of willful neglect falls on the taxpayer. *See* § 6651(a); Higbee, 116 T.C. at 446–47.

For 2004 petitioners filed their income tax return on December 5, 2005, which was after the due date of October 15, 2005. *See* § 6081(a). Respondent has thus met his burden of production. Petitioners have not established that their failure to timely file was due to reasonable cause. [pg. 146] Accordingly, the section 6651(a)(1) addition to tax is sustained for 2004.

[*31] B. *Penalties*

1. *Compliance with Section 6751(b)*

Respondent determined that petitioners are liable for section 6663(a) fraud penalties or, in the alternative, section 6662(a) accuracy-related penalties on the basis of underpayments due to negligence or substantial understatements of income tax for the years at issue. The Commissioner bears the burden of production with respect to an individual taxpayer's liability for any penalty, requiring the Commissioner to come forward with sufficient evidence indicating that the imposition of the penalty is appropriate. *See* § 7491(c); Higbee, 116 T.C. at 446–47. As part of that burden, the Commissioner must produce evidence that he complied with the procedural requirements of section 6751(b)(1). *See* Graev v. Commissioner, 149 T.C. 485, 492–93 (2017), *supplementing*

and overruling in part 147 T.C. 460 (2016). Section 6751(b)(1) requires the initial determination of certain penalties to be "personally approved (in writing) by the immediate supervisor of the individual making such determination." *See* Graev, 149 T.C. at 492–93; *see also* Clay v. Commissioner, 152 T.C. 223, 248 (2019) (quoting section 6751(b)(1)), aff'd, 990 F.3d 1296 [127 AFTR 2d 2021-1207] (11th Cir. 2021).

Where the taxpayer has challenged the Commissioner's penalty determination, the Commissioner must come forward with evidence of proper penalty approval as part of his initial burden of production under section 7491(c). Frost v. Commissioner, 154 T.C. 23, 34 (2020). Once the Commissioner makes that showing, the taxpayer must come forward with contrary evidence. Id. The supervisory approval must be secured no later than (1) the date on which the IRS issues the notice of deficiency or (2) the date, if earlier, on which the IRS formally communicates to the taxpayer the Examination Division's determination to assert a penalty. Belair Woods, LLC v. Commissioner, 154 T.C. 1, 15 (2020).

Respondent produced a copy of the Civil Penalty Approval Form signed on November 10, 2009, by the immediate supervisor of RA Floyd, who examined petitioners' returns, and approving the imposition of the fraud penalties and the accuracy-related penalties for underpayments due to substantial understatements of income tax. Respondent formally communicated his determination to assert the fraud penalties and the accuracy-related penalties against petitioners in the examination report, which respondent issued to petitioners on November 12, 2009. The notice of deficiency in this case was issued on November 14, 2011. Petitioners do not claim, and the record does not support a conclusion, **[*32]** that respondent communicated his initial determination to petitioners before the date the examining agent's manager signed the Civil Penalty Approval Form. Accordingly, respondent has satisfied his burden with respect to section 6751(b).[24]

2. *Section 6663(a) Fraud Penalties*

Section 6663(a) imposes a penalty equal to 75% of the taxpayer's underpayment of Federal income tax that is due to fraud. Fraud is an intentional wrongdoing on the part of the taxpayer with the specific purpose of evading a tax believed to be owing. Petzoldt v. Commissioner, 92 T.C. 661, 698 (1989); Minchem Int'l, Inc. v. Commissioner, T.C. Memo. 2015-56, at *43 [2015 RIA TC Memo ¶2015-056], aff'd sub nom. Sun v. Commissioner, 880 F.3d 173 [121 AFTR 2d 2018-474] (5th Cir. 2018). If any portion of the underpayment is attributable to fraud, the entire underpayment will be treated as attributable to fraud unless the taxpayer establishes by a preponderance of the evidence that part of the underpayment is not due to fraud. § 6663(b); *see also* Minchem Int'l, Inc., T.C. Memo. 2015-56, at *43–44 [2015 RIA TC Memo ¶2015-056].

Respondent has the burden of proving fraud by clear and convincing evidence. *See* § 7454(a); Rule 142(b). To carry that burden of proof, respondent must show, for each year, that (1) an

underpayment of tax exists and (2) some portion is attributable to the Hackers' fraud. *See* Hebrank v. Commissioner, 81 T.C. 640, 642 (1983); Benavides & Co., P.C. v. Commissioner, [pg. 147] T.C. Memo. 2019-115, at *31 [2019 RIA TC Memo ¶2019-115]. Fraud is a question of fact to be resolved upon consideration of the entire record. DiLeo, 96 T.C. at 874. Fraud is never presumed and must be established by independent evidence. Minchem Int'l, Inc., T.C. Memo. 2015-56, at *45 [2015 RIA TC Memo ¶2015-056].

Respondent has clearly and convincingly demonstrated for each year at issue that petitioners failed to report income from various sources. The first element of the fraud penalty has been established.

The Court now turns to the second element of the fraud penalty and must determine whether petitioners had the requisite fraudulent intent. Because direct evidence of fraudulent intent is seldom available, fraud may be proven by circumstantial evidence and reasonable inferences drawn from the facts. Niedringhaus v. Commissioner, 99 T.C. 202, 210 (1992); Benavides & Co., P.C., T.C. Memo. 2019-115, at *34 [2019 RIA TC Memo ¶2019-115]. **[*33]** The taxpayer's entire course of conduct may be indicative of fraudulent intent. Niedringhaus, 99 T.C. at 210.

Circumstances that may indicate fraudulent intent, commonly referred to as "badges of fraud," include but are not limited to (1) understating income; (2) maintaining inadequate records; (3) giving implausible or inconsistent explanations; (4) concealing in come or assets; (5) failing to cooperate with authorities; (6) engaging in illegal activities; (7) providing incomplete or misleading information to one's tax return preparer; (8) lack of credibility of the taxpayer's testimony; (9) filing false documents, including false income tax returns; (10) failing to file tax returns; and (11) dealing in cash. Minchem Int'l, Inc., T.C. Memo. 2015-56 [2015 RIA TC Memo ¶2015-056] at *46. No single factor is dispositive; however, the existence of several factors "is persuasive circumstantial eviden e of c fraud." Vanover v. Commissioner, T.C. Memo. 2012-79 [2012 RIA TC Memo ¶2012-079], 2012 WL 952871, at *4.

Respondent argues that petitioners' fraudulent intent is demonstrated by a number of the badges of fraud, including their failure to maintain records with respect to personal expenses and cash receipts, the extravagant uses of Blossom's funds on personal expenses, and Mr. Hacker's vague, misleading, or uncorroborated statements to RA Floyd.

The Court agrees. Blossom consistently reported gross receipts over $2,000,000 while during the same period petitioners received no wages from Blossom. Even though Blossom paid a management fee to Hacker Corp., the Hackers were paid only relatively low wages. Mr. Hacker received wages of only $44,615, $36,923, $19,999, $26,153, and $29,230 while Mrs. Hacker received wages of $44,618, $36,925, $20,001, $27,694, and $29,232 for 2004, 2005, 2006, 2007, and 2008, respectively. Despite these low wages, petitioners and their children financed a lavish lifestyle through Blossom. Blossom provided petitioners and their children with the use of personal

vehicles; paid for vacations for petitioners and their children to the Bahamas, Europe, Hawaii, Las Vegas, and New Orleans; purchased jewelry and other luxury items; and paid numerous routine personal expenses, including restaurant meals, auto expenses, personal medical expenses, mortgage payments, and college tuition. Petitioners did not report on their personal returns the receipt of these benefits, providing incomplete information to their bookkeepers and return preparers. During the examination of their returns, petitioners attempted to conceal them from respondent through the examination, such as by providing vague, misleading, or outright false statements to RA Floyd. **[*34]** If any portion of an underpayment is attributable to fraud, the entire underpayment will be treated as attributable to fraud unless the taxpayer establishes by a preponderance of the evidence that part of the underpayment is not due to fraud. § 6663(b); *see also* Minchem Int'l, Inc., T.C. Memo. 2015-56, at *43–44 [2015 RIA TC Memo ¶2015-056]. In the notice of deficiency, respondent laid out the adjustments on which the fraud determination was based. The Court examines those amounts in greater detail below. [pg. 148]

In the notice of deficiency, respondent determined the fraud penalty for 2004 on the basis of the following adjustments to income:

Adjustments to income to which fraud penalty applies	Amount
Wages from Blossom-TPW	$99,370
Wages from Blossom-TPH	99,370
Dividends	594,170
Unexplained deposits	20,221

The Court held supra that $95,452 of the 2004 dividend amount respondent determined related to reasonable business expenses of Blossom and was not a dividend to petitioners. With respect to the remaining adjustments to petitioners' wages from Blossom, dividends, and unexplained deposits, the Court sustains the application of the fraud penalty. However, the evidence shows and the Court finds that the adjustments to petitioners' income other than wages from Blossom, dividends, or unexplained deposits were not due to fraud and therefore not subject to the fraud penalty.

In the notice of deficiency, respondent determined the fraud penalty for 2005 on the basis of the following adjustments to income:

Adjustments to income to which fraud penalty applies	Amount
Wages from Blossom-TPW	$104,600
Wages from Blossom-TPH	104,600
Dividends	446,782
Unexplained deposits	57,322

The Court held supra that the 2005 dividend amount should be reduced by $83,671, which related to reasonable business expenses of Blossom, and further reduced by the net value of the Long St. and Mingo Rd. properties, which were not distributions to petitioners. With respect to the remaining adjustments to petitioners' wages from Blossom, dividends, and unexplained deposits, the Court sustains the application **[*35]** of the fraud penalty. However, the evidence shows and the Court finds that the adjustments to petitioners' income other than wages from Blossom, dividends, or unexplained deposits were not due to fraud and therefore not subject to the fraud penalty.

In the notice of deficiency, respondent determined the fraud penalty for 2006 on the basis of the following adjustments to income:

Adjustments to income to which fraud penalty applies	Amount
Wages from Blossom-TPW	$110,105
Wages from Blossom-TPH	110,105
Dividends	375,246

Unexplained deposits	69,088

The Court sustained respondent's 2006 adjustments to petitioners' wages, dividends, and unexplained deposits. The fraud penalty, as applied to those adjustments, is sustained. However, the evidence shows and the Court finds that any adjustment to petitioners' income other than wages from Blossom, dividends, or unexplained deposits were not due to fraud and therefore not subject to the fraud penalty.

[pg. 149]

In the notice of deficiency respondent determined the fraud penalty for 2007 applies to the following adjustments to income:

Adjustments to income to which fraud penalty applies	Amount
Wages from Blossom-TPW	$115,900
Wages from Blossom-TPH	115,900
Dividends	327,503
Unexplained deposits	98,567

The Court held supra that $23,023.75 of the 2007 dividend amount respondent determined related to reasonable business expenses of Blossom and was not a dividend to petitioners. With respect to the remaining adjustments to petitioners' wages from Blossom, dividends, and unexplained deposits, the Court sustains the application of the fraud penalty. However, the Court finds that the adjustments to petitioners' income other than wages from Blossom, dividends, or unexplained deposits were not due to fraud and therefore not subject to the fraud penalty.

In the notice of deficiency respondent determined that the fraud penalty for 2008 applies to all of the adjustments to petitioners' income. **[*36]** The Court held supra that respondent erred in calculating petitioners' distributions in excess of basis from Hacker Corp. In addition, respondent has conceded the $20,750 adjustment to petitioners' net income from Accurate Electric. The Court sustains the application of the fraud penalty to the adjustments to petitioners' wages from

Blossom, dividends, unexplained deposits, and unreported gambling winnings. However, the evidence shows and the Court finds that the adjustments to petitioners' income other than wages from Blossom, dividends, unexplained deposits, or gambling winnings were not due to fraud and therefore not subject to the fraud penalty.

Petitioners have not raised any additional arguments or shown that any other amounts should be excluded from the fraud penalty. Accordingly, the Court holds that they are liable for fraud penalties for the years at issue to the extent discussed herein. To the extent that the Court's redetermination of petitioners' income affects those items to which respondent determined fraud penalties, however, a commensurate adjustment to the fraud penalties is required.

3. Section 6662(a) Accuracy-Related Penalties

Respondent determined, in the alternative, that petitioners are liable for accuracy-related penalties pursuant to section 6662(a) for the years at issue. Section 6662(a) and (b)(2) imposes an accuracy-related penalty equal to 20% of the portion of an underpayment of tax required to be shown on a tax return that is attributable to a "substantial understatement of income tax." An understatement of income tax is a "substantial understatement" if it exceeds the greater of 10% of the tax required to be shown on the return or $5,000. § 6662(d)(1)(A). Taxpayers may avoid a section 6662(a) penalty if they can show that they had reasonable cause and acted in good faith. § 6664(c). The accuracy-related penalty does not apply to any portion of an underpayment on which a fraud penalty is imposed under section 6663. § 6662(b) (flush language).

Petitioners reported income tax of $50,775, $6,976, $65,568, zero, and zero for 2004, 2005, 2006, 2007, and 2008, respectively. Even allowing for the adjustments the Court has made to respondent's determinations, petitioners' understatements of income tax were substantial for all years at issue. Petitioners do not argue that they had reasonable cause for their understatements. Petitioners are therefore liable for the accuracy-related penalty on those portions of the underpayment not subject to the fraud penalty for each year at issue. [pg. 150]

[*37] VII. *Conclusion*

Petitioners are liable for deficiencies for 2004, 2005, 2006, 2007, and 2008 to the extent discussed herein. Respondent's determinations of fraud penalties for all years are sustained in part, and respondent's determinations of accuracy-related penalties for all years and an addition to tax for 2004 are sustained as set forth above.

The Court has considered all of the arguments made by the parties, and to the extent they are not addressed herein they are considered unnecessary, moot, irrelevant, or otherwise without merit.

To reflect the foregoing,

Decision will be entered under Rule 155.

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C. (section), in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Procedure.

[2] Petitioners have conceded that they received (1) distributions in excess of basis from Hacker Corporation (Hacker Corp.) of $8,400 in 2004; (2) unreported nonemployee compensation from the Oklahoma Child Care Association of $4,950 and $1,600 in 2006 and 2008, respectively; (3) unreported interest income of $1,450.26 and $79.49 in 2007 and 2008, respectively; (4) an unreported taxable State income tax refund of $2,783 in 2008; and (5) unreported gambling winnings of $15,140 in 2008. Petitioners have also conceded that Hacker Corp. was not entitled to deduct reported advertising expenses of $300 in 2008, and that all income or loss from Hacker Corp. reported as passive should be reclassified as nonpassive for 2004, 2005, and 2006. Respondent has conceded adjustments to petitioners' net income from Accurate Electric reported on Schedule C, Profit or Loss From Business, of $11,638 and $20,750 for 2007 and 2008, respectively.

[3] Respondent additionally reduced petitioners' 2004 net capital loss carryforward from $1,332 to $278, resulting in an increase in 2005 capital gain income of $1,054, and disallowed $3,091 of petitioners' claimed mortgage interest expense deduction for 2007. Although petitioners challenged the adjustments in the petition, they did not introduce any evidence at trial or raise any arguments on brief in support of their positions. Accordingly, the Court deems petitioners to have conceded those issues. Respondent's remaining adjustments are computational; the Court does not further address them.

[4] By Order dated July 7, 2021, after trial and briefing were complete, the Court severed the present case from the consolidated group.

[5] Hacker Corp. is described in greater detail infra Findings of Fact, section IV.

[6] Blossom's 2008 tax return was not submitted into evidence or otherwise included in the record.

[7] Petitioners' 2007 tax return is consistent with the amounts reported on the unfiled 2007 Form 1065.

[8] Among the rents received listed in the spreadsheet were rents attributable to the property located at 839 Katy Street. Although Hacker Investment reported those rents on its returns, property records show that Blossom owned that property during the years at issue. The Court

has held that those rents are income to Blossom for 2005, 2006, and 2007. *See* Blossom II, at *31–32.

[9] This amount includes the $236,189 Note Rec. Officer beginning balance determined to be a loan forgiven.

[10] Petitioners have not raised the issue of section 7491(a), which shifts the burden of proof to the Commissioner in certain situations. The Court concludes that section 7491(a) does not apply here because petitioners have not produced any evidence that they have satisfied the preconditions for its application.

[11] For each year, 2004 through 2006, petitioners reported 50% of the income from Hacker Corp. as passive income and 50% of the income as nonpassive. The parties have stipulated that all income or loss from Hacker Corp. should have been classified as nonpassive. In addition, because of a clerical error, petitioners erroneously reported 2006 income from Hacker Corp. of $214,204, rather than $114,204.

[12] Petitioners concede that respondent properly disallowed the claimed $300 advertising expense deduction.

[13] Respondent allowed (and the Court sustained) a corresponding increase in Blossom's interest expense deduction for 2005 to account for the other half of the interest paid that year. *See* Blossom II, at *42–43.

[14] Respondent does not dispute Hacker Corp.'s reported depreciation method or recovery period. The Court will accept them as correct.

[15] Respondent determined, and petitioners agree, that they received distributions from Hacker Corp. in excess of basis of $8,400 in 2004.

[16] The parties are in agreement that Hacker Corp. did not have accumulated earnings and profits at the time of the distributions at issue.

[17] Respondent's adjustments to Hacker Investment's income and expenses, set forth on the Form 4605–A, Examination Changes–Partnerships, Fiduciaries, S Corporations, Etc., issued after respondent's examination of Hacker Investment, are based on a 2007 reported income of zero.

[18] Petitioners' 2007 tax return reflected income from Hacker Investment of $4,536 as calculated on the prepared 2007 partnership return. The $106 adjustment in the notice of deficiency is the difference between respondent's adjustment in the Form 4605-A and the amount petitioners reported.

[19] Although respondent determined a $7,687 adjustment to the 2008 partnership return, respondent disallowed the entirety of petitioners' claimed loss of $14,019, as the loss was claimed as passive on petitioners' Schedule E. *See* § 469.

[20] The unified audit and litigation procedures of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, §§ 401–406, 96 Stat. 324, 648–71, do not apply to Hacker Investment. Hacker Investment qualifies as a small partnership under section 6231(a)(1)(B)(i) and did not elect, pursuant to section 6231(a)(1)(B)(ii), to have TEFRA apply. *See* Cvancara v. Commissioner, T.C. Memo. 2013-20, at *3 [2013 RIA TC Memo ¶2013-020] n.4; Wadsworth v. Commissioner, T.C. Memo. 2007-46 [2007 RIA TC Memo ¶2007-046], 2007 WL 610069, at *6 ("The small partnership exception permits this Court to review in a deficiency suit items that otherwise would be subject to partnership- level proceedings.").

[21] These amounts exclude amounts attributable to the property located at 839 Katy Street, which was owned by Blossom during the years at issue.

[22] On the basis of the invoices introduced at trial, respondent concedes that Hacker Investment is entitled to additional deductions for repair expenses of $9,535 for 2005 and $17,280.23 for 2006.

[23] The Court holds infra that respondent failed to include Hacker Investment's basis in the subdivided portion of the Washington Ave. property sold in 2007 and instructs the parties to calculate the correct basis and include in the computations pursuant to their Rule 155 submission in determining petitioners' capital gain income for that year. Although the basis calculation may result in a reduction in the allowable depreciation for 2007 and 2008, the Court will treat any reduction as a concession on the part of respondent.

[24] Because petitioners' substantial understatement of income tax for each year is sufficient to sustain the accuracy-related penalty (to the extent that petitioners' conduct was not fraudulent), the Court does not address the accuracy-related penalties for negligence.

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Tax Court & Board of Tax Appeals Memorandum Decisions

John D. Lord, et ux. v. Commissioner, T.C. Memo. 2022 -14 , Code Sec(s) 280E; 61; 263A; 167; 168; 471; 446.

JOHN D. LORD AND BELINDA LORD, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 100]

Code Sec(s):	280E; 61; 263A; 167; 168; 471; 446
Docket:	Dkt. No. 19224-18.
Date Issued:	03/01/**2022**.
Judge:	Opinion by Kerrigan, *J.*
Tax Year(s):	Year 2012.
Disposition:	Decision for Commissioner.

HEADNOTE

1. Businesses trafficking in controlled substances—medical marijuana—cost of goods sold—inventory costs—capitalization and inclusion—inventory production assets—

depreciation—best accounting practices and clear reflection of income. In case involving married couple's passthrough income from medical marijuana businesses/LLC and S corp., which were subject to Code Sec. 280E , which weren't required to keep books and records for non-tax purposes in accordance with GAAP, and which computed depreciation included in COGS using accelerated cost recovery method and also claimed bonus depreciation under Code Sec. 168 , **Tax Court** determined that stated tax depreciation methods for inventory production assets couldn't be used under either section Code Sec. 263A or Code Sec. 471 . As to Code Sec. 263A , Court found that such couldn't be relied on to calculate inventory costs given Code Sec. 280E 's interposition and Code Sec. 263A 's plain language. Taxpayers' arguments, that Code Sec. 263A 's costs prohibition meant personal vs. business costs, that it would be unconstitutional not to be able to calculate business inventories pursuant to Code Sec. 263A , and/or that Code Sec. 280E itself was unconstitutional, were rejected accordingly. And as to Code Sec. 471 , Court found that statute's "best accounting practice" conformity requirement couldn't be met since that term was interpreted to mean GAAP-conforming methods, and businesses' methods didn't so conform. Moreover, although businesses' depreciation method was provided for by Code Sec. 168 , since Code Sec. 168 provided methods for Code Sec. 167 deductions and since Code Sec. 167 deductions in turn weren't available to Code Sec. 280E -affected businesses, Code Sec. 168 method was also not allowable here; and thus, IRS was entitled to change businesses' method as not clearly reflecting in[pg. 101] come.

Reference(s): ¶ 280E5.01(5) ;¶ 263A5.01(17) ;¶ 4715.30(20) ;¶ 4465.31(20) Code Sec. 280E; Code Sec. 61; Code Sec. 263A; Code Sec. 167; Code Sec. 168; Code Sec. 471; Code Sec. 446

Syllabus

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Luke D. Ortner and Tamara L. Kotzker, for respondent.

KERRIGAN, *Judge*

MEMORANDUM OPINION

In a notice of deficiency (notice) dated July 3, 2018, respondent determined that petitioners had a deficiency of $376,299 and an accuracy-related penalty pursuant to section 6662(a) of $75,260 for 2012. In the notice respondent made adjustments to passthrough income petitioners received from two businesses—Beyond Broadway, LLC (Broadway), and Artistant Dispensary Center, Inc. (Artistant) (together, businesses).

After concessions, the sole issue for consideration is whether tax depreciation methods for inventory production assets can be used under either section 263A or section 471 when section 280E is applied.[1]

[*2] Unless otherwise indicated, all statutory references are to the Internal Revenue Code (Code), Title 26 U.S.C., in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Procedure. We round all monetary amounts to the nearest dollar.

Background

This case was submitted pursuant to Rule 122. The stipulated facts are incorporated by this reference. When they timely filed their petition, petitioner husband resided in Colorado and petitioner wife resided in Arkansas.

For 2012 petitioners, then married, timely filed a joint Form 1040, U.S. Individual Income Tax Return. They reported passthrough income attributable to two businesses in which petitioner husband held ownership interests—Broadway and Artistant.

In 2012 the State of Colorado licensed the businesses to cultivate, process, and distribute medical marijuana and medical marijuana products. The businesses produced medical marijuana products for sale to patients and other licensees. Broadway was formed under Colorado state law as a limited liability company and in 2012 was treated as a partnership for tax purposes. On its 2012 Form 1065, U.S. Return of Partnership Income, Broadway reported gross receipts of $9,687,191. After agreed adjustments, Broadway's costs of goods sold (COGS) for 2012 was $5,864,999. [2]

Artistant was incorporated under Colorado state law and in 2012 was treated as an S corporation for tax purposes. On its 2012 Form 1120S, U.S. Income Tax Return for an S Corporation, Artistant reported gross receipts of $1,112,588. After agreed adjustments, Artistant's COGS was $1,085,006. Petitioner husband acquired a 90% ownership interest in Artistant on July 31, 2012.

For 2012 petitioner husband was allocated 50% of Broadway's allocable items and 37.38% of Artistant's allocable items. The businesses did not have audited financial statements for 2012 and for **[*3]** nontax purposes were not required to maintain books and records or financial reports in accordance with U.S. Generally Accepted Accounting Principles (GAAP). In 2012 the businesses maintained their books and records and financial reports on a tax basis using Quick Books. The businesses computed their depreciation included in COGS for 2012 using the accelerated cost recovery method detailed in section 168(a); they also claimed bonus depreciation for 2012 pursuant to section 168(k). The businesses used methods pursuant to section 168(a) and (k) that did not conform with GAAP, but the recovery periods that they used did conform with

GAAP. The parties agree that depreciation related to production assets is includible in inventory costs. [pg. 102]

In the notice issued to petitioners on July 3, 2018, respondent determined adjustments to the depreciation deductions claimed by the businesses for 2012. Respondent adjusted Broadway's and Artistant's depreciation by $65,813 and –$716, respectively. Respondent's adjustments reflect respondent's position that section 263A should not be relied upon for the calculation of inventory and determination of COGS. Petitioners' income attributable to the businesses was likewise adjusted by $32,907 and–$268, reflecting petitioner husband's ownership interests in Broadway and Artistant, respectively.

Discussion

I. *Burden of Proof*

Generally, the Commissioner's determinations in a notice of deficiency are presumed correct, and the taxpayer bears the burden of proving those determinations erroneous. Rule 142(a)(1); Welch v. Helvering, 290 U.S. 111, 115 [12 AFTR 1456] (1933). Under section 7491(a) in certain circumstances the burden of proof may shift from the taxpayer to the Commissioner. Petitioners have neither shown nor claimed that the burden of proof should shift to respondent as to any relevant factual issue. Accordingly, the burden of proof remains with petitioners.

II. *Section 280E*

Generally, section 162(a) allows a taxpayer to deduct from gross income ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Section 261, however, provides that "[i]n computing taxable income no deduction shall in any case be allowed in respect of the items specified in this part," which includes section 280E. *See* Californians Helping to Alleviate Med. Probs., Inc. v. Commissioner (CHAMP), 128 T.C. 173, 180 (2007). **[*4]** Section 280E precludes taxpayers from deducting any expense related to a business that consists of trafficking in a controlled substance. *See* Olive v. Commissioner, 139 T.C. 19, 29 (2012), aff'd, 792 F.3d 1146 [116 AFTR 2d 2015-5150] (9th Cir. 2015). Section 280E disallows deductions only for business expenses and does not preclude the businesses from taking into account their COGS. *See* CHAMP, 128 T.C. at 178 n.4.

We have previously held that medical marijuana is a controlled substance. Id. at 180–81; *see also* Gonzales v. Raich, 545 U.S. 1 (2005); United States v. Oakland Cannabis Buyers' Coop., 532 U.S. 483 (2001). The dispensing of medical marijuana, while legal in Colorado, is illegal under federal law. *See* Olive, 139 T.C. at 39. Congress in section 280E has set an illegality under federal law

as one trigger to preclude a taxpayer from deducting expenses incurred in a medical marijuana dispensary business. Id. This is true even if the business is legal under state law. Id.

III. *Cost of Goods Sold*

COGS is not a deduction within the meaning of section 162(a) but is subtracted from gross receipts in determining a taxpayer's gross income. *See* Max Sobel Wholesale Liquors v. Commissioner, 69 T.C. 477 (1977), aff'd, 630 F.2d 670 [46 AFTR 2d 80-5799] (9th Cir. 1980); Treas. Reg. § 1.162-1(a). COGS is the cost of acquiring inventory, through either production or purchase. Patients Mut. Assistance Collective Corp. v. Commissioner, 151 T.C. 176, 205 (2018), aff'd, 995 F.3d 671 [127 AFTR 2d 2021-1737] (9th Cir. 2021); Reading v. Commissioner, 70 T.C. 730, 733 (1978), aff'd, 614 F.2d 159 [45 AFTR 2d 80-591] (8th Cir. 1980). COGS is generally determined under section 471 and its accompanying regulations. *See* Treas. Reg. §§ 1.471-3, 1.471-11. Producers are required to include in COGS both the direct and indirect costs of creating their inventory. *See* Treas. Reg. §§ 1.471-3(c), 1.471-11.

Section 471 and its accompanying regulations direct taxpayers to section 263A for additional rules. Section 263A instructs both producers and resellers to include "indirect" inventory costs in the cost of their inventory. *See* § 263A(a)(2)(B), (b); Treas. Reg. § 1.263A-1(a)(3), (c)(1), (e). Indirect costs are defined broadly as all costs other than direct material costs and direct labor costs (for producers) and acquisition costs (for resellers). Treas. Reg. § 1.263A-1(e)(3). Depreciation of production assets is an indirect cost. *See* Treas. Reg. § 1.471-11(c)(2). [pg. 103]

[*5] IV. *Section 263A*

The flush text of section 263A(a)(2) provides: "Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph." Deductions disallowed by section 280E are costs subject to the prohibition of section 263A(a)(2). Patients Mut., 151 T.C. at 209–10. Petitioners argue that the holding in Patients Mutual was overbroad. Citing legislative history, petitioners argue that the word "cost" in the flush text of section 263A(a)(2) is limited to personal, rather than business, costs. We disagree.

Section 263A(2)(a) does not define "cost"; therefore, the word is given its ordinary meaning: "the amount or equivalent paid or charged for something." Cost, Webster's New Collegiate Dictionary 255 (1980). Nothing in the text of section 263A suggests that Congress intended to restrict the prohibition of section 263A(2)(a) to any personal expenses. Petitioners do not offer any evidence demonstrating a clear intent on the part of Congress to enforce section 263A(2)(a) contrary to the plain text of the statute. *See* Conn. Nat'l Bank v. Germain, 503 U.S. 249, 253-54 (1992) ("We have stated time and again that courts must presume that a legislature says in a

statute what it means and means in a statute what it says there."). Had Congress intended to exclude business expenses from this restriction it could have; it did not. The statute as to this point is unambiguous; therefore, the inquiry is complete. Id. at 254 (citing Rubin v. United States, 449 U.S. 424, 430 (1981)). Petitioners are therefore not able to rely on section 263A to calculate inventory costs.

V. *Constitutional Entitlement*

Petitioners argue the businesses are constitutionally entitled to accelerated and bonus depreciation because, as they claim, enforcement of respondent's adjustments would result in an impermissible tax on gross receipts, rather than gross income. They contend it would be unconstitutional not to be able to calculate their businesses' inventories pursuant to section 263A. We are not persuaded.

In general, gross income is gross receipts less COGS. Treas. Reg. § 1.61-3(a). COGS is calculated by using either section 263A or 471. By using section 471 to calculate inventory, the businesses are able to deduct their direct inventory costs. *See* Patients Mut., 151 T.C. at 208–09. Other deductions from gross receipts are permitted at Congress' discretion. Helvering v. Indep. Life Ins. Co., 292 U.S. 371, 381 [13 AFTR 1175] (1934).

[*6] Depreciation is an indirect cost of production, and the businesses are not entitled by the Constitution or statute to deduct depreciation of production assets.

Petitioners also contend that section 280E is unconstitutional. Petitioners argue that section 280E cannot be upheld because Congress did not describe it as an excise tax. We disagree. The terms that Congress uses to describe exactions have no bearing on whether the taxes themselves are constitutional. *See* Nat'l Fed'n of Indep. Bus. v. Sebelius, 567 U.S. 519, 564-65 [109 AFTR 2d 2012-2563] (2012).

They further argue that section 280E is unconstitutional on Fifth Amendment grounds. We disagree. The U.S. Court of Appeals for the Tenth Circuit has stated that "the unlawfulness of an activity does not prevent its taxation." Alpenglow Botanicals, LLC v. United States, 894 F.3d 1187, 1197 [122 AFTR 2d 2018-5035] (10th Cir. 2018) (quoting Marchetti v. United States, 390 U.S. 39, 44 [21 AFTR 2d 539] (1968)).

VI. *Inventory Accounting*

Respondent has determined that the businesses' inventory accounting method does not clearly reflect income because, as the parties have stipulated, it does not conform with GAAP. Respondent changed the businesses' inventory accounting method to one that respondent

concluded does clearly reflect income. Petitioners argue that the businesses' inventory accounting method is permitted under section 471.

In general, a taxpayer challenging the Commissioner's decision to change an ac[pg. 104] counting method must show that the Commissioner's action was "arbitrary and capricious and without sound basis in fact or law." Ford Motor Co. v. Commissioner, 102 T.C. 87, 92 (1994), aff'd, 71 F.3d 209 [76 AFTR 2d 95-7789] (6th Cir. 1995).

For the purpose of inventory accounting the businesses are subject to section 471. Under section 471, an inventory accounting method must: (1) conform as nearly as may be to the best accounting practice in the trade or business and (2) clearly reflect income. Treas. Reg. § 1.471-2. "Best accounting practice" has been held to be synonymous with GAAP, and GAAP-conforming methods have been held to satisfy the first prong of section 471. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532 [43 AFTR 2d 79-362] (1979).

[*7] Under section 471, an accounting method must also clearly reflect income. In general an accounting method will be held to clearly reflect income if it has been consistently applied and conforms with GAAP. Treas. Reg. § 1.446-1(a)(2). GAAP is a set of accounting principles, rather than stringent rules, so there may be instances in which several accounting methods conform with GAAP but do not all clearly reflect income. Thor Power Tool v. Commissioner, 439 U.S. at 544; *see also* Godchaux v. Conveying Techs., Inc., 846 F.2d 306, 315 (5th Cir. 1988) (stating that generally accepted accounting principles are flexible, and a reviewing court must decide "only whether the accountant chose a procedure from the universe of generally accepted accounting principles"). Such was the case in Thor Power Tool, where the Supreme Court held that GAAP conformity was insufficient to protect the taxpayer against the Commissioner's determination that its accounting method did not clearly reflect income. Thor Power Tool v. Commissioner, 439 U.S. at 539–44. Therefore, although GAAP conformity is not dispositive in determining whether an accounting method clearly reflects income, it is a "pertinent criterion." Am. Fletcher Corp. v. United States, 832 F.2d 436, 439 [60 AFTR 2d 87-5897] (7th Cir. 1987); *see also* RLC Indus. Co. & Subs. v. Commissioner, 98 T.C. 457, 502 (1992) (stating that the Commissioner had appropriately exercised discretion in changing accounting method "where a taxpayer's method was contrary to accounting principles"), aff'd, 58 F.3d 413 [76 AFTR 2d 95-5077] (9th Cir. 1995).

Petitioners argue that the businesses' inventory accounting method is permitted under section 471. Petitioners, however, have stipulated that the businesses' inventory accounting method does not conform with GAAP. They contend that Treasury Regulation § 1.471-11 allows the use of both accelerated and bonus depreciation methods. Petitioners have not provided any evidence to suggest that the businesses' inventory accounting method conforms with the best accounting practice for their trade or business. The businesses' inventory accounting method does not satisfy the requirements of section 471 as defined by Treasury Regulation § 1.471-2.

VII. Section 446

Section 446 provides the general rule for accounting methods. Under section 446(b), the Commissioner may change a taxpayer's accounting method if it does not, in the opinion of the Commissioner, clearly reflect income. The Commissioner's authority to determine whether an accounting method clearly reflects income is not without limit. *See* RLC Indus. Co. & Subs., 98 T.C. at 501. When a taxpayer **[*8]** consistently applies an accounting method explicitly provided to it by the Code or regulations, the Commissioner cannot find that the method does not clearly reflect income and cannot, therefore, change the taxpayer's accounting method. *See* Orange & Rockland Utils., Inc. v. Commissioner, 86 T.C. 199, 215 (1986).

To calculate part of their inventory costs, the businesses used a depreciation method outlined in section 168. Because the method they used is explicitly provided by the Code, petitioners argue that respondent is not permitted to change it. Petitioners' analysis is incomplete.

Section 168 provides a depreciation method for section 167 depreciation deductions. This Court has previously held depreciation deductions under section 167 are unavailable to section 280E-affected taxpayers. San Jose Wellness v. Commissioner, 156 T.C. 62, 67–68 (2021); N. Cal. [pg. 105] Small Bus. Assistants Inc. v. Commissioner, 153 T.C. 65, 73 (2019). By enacting section 280E Congress intended to prohibit affected taxpayers from reducing their taxable income "to the extent of its constitutional authority." San Jose Wellness, 156 T.C. at 72 n.11.

In the absence of new legislation from Congress, the legislative intent of section 280E remains unchanged; shifts in public sentiment and legalization of marijuana do not change the purpose or applicability of section 280E. Olive v. Commissioner, 792 F.3d at 1150. The prohibitions of section 280E apply in full force to state-sanctioned medical marijuana businesses. *See* N. Cal. Small Bus. Assistants, 153 T.C. at 74 (finding that section 280E applies to a "medical marijuana dispensary legally operated under California State law"). Businesses that traffic in controlled substances are denied deductions, including deductions under section 167. Id. at 73. By the same logic, the associated section 168 deprecation method is likewise disallowed to section 280E-affected taxpayers. While the businesses' accounting method is explicitly provided by the Code, it is not available to them because of section 280E, and respondent may determine that it does not clearly reflect income.

We have considered all arguments made by the parties, and to the extent not mentioned or addressed, they are irrelevant or without merit.

To reflect the foregoing,

Decision will be entered under Rule 155.

[1] The parties have stipulated the amounts needed to compute a deduction pursuant to section 199.

[2] If the bonus and accelerated depreciation methods are disallowed, this amount will be adjusted accordingly.

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Tax Court & Board of Tax Appeals Memorandum Decisions

Mohamed H. Elbasha v. Commissioner, TC Memo 2022 -1 , Code Sec(s) 1; 7703; 2.

MOHAMED H. ELBASHA, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 1]

Code Sec(s):	1; 7703; 2
Docket:	Dkt. No. 25192-13.
Date Issued:	01/12/**2022**.
Judge:	Opinion by Wells *J.*
Tax Year(s):	Years 2008, 2009.
Disposition:	Decision for Taxpayer in part and for Commissioner in part.

HEADNOTE

1. Filing status—married, single, and head of househould—non-resident spouse. IRS's challenges to emergency room physician/overseas staffing business owner's filing status for years during which he was married but his wife/nonresident alien lived abroad were upheld in part and

rejected in part. Notably, IRS correctly determined that taxpayer wasn't entitled to single filing status for 1st year at issue given his marital status and that wife's non-residency didn't qualify him to be considered unmarried for Code Sec. 1 and Code Sec. 7703 purposes for that year. However, his wife's non-residency did qualify him as unmarried for Code Sec. 2 purposes and his head of household filing status claim for following year, when his daughter was born.

Reference(s): ¶ 15.01(60) ;¶ 15.04(6) Code Sec. 1; Code Sec. 7703; Code Sec. 2

2. Business deductions—cost of goods sold, continuing education, travel, and office expenses—business vs. personal purpose—substantiation. Emergency room physician/overseas staffing business owner wasn't entitled to business deductions for various items above amounts IRS allowed. Notably, taxpayer's attempt to deduct payments to business broker failed for lack of proof that payments were in fact made to broker or other stated recipients or that they were business related. Similarly, his claims regarding continuing education expenses for various overseas trips, at time when his wife and child lived overseas, weren't sufficiently substantiated or appeared to have at least some personal component. Other travel and office expense claims that were supported only by self-made charts, but no reliable substantiation or business purpose explanation, also failed.

Reference(s): ¶ 1625.012(5) ;¶ 2745.14(85) Code Sec. 162; Code Sec. 262; Code Sec. 274

3. Home office deductions—principal place of business—health professionals—proof. Emergency room physician/overseas staffing business owner, who used his home office to manage emergency room paperwork but didn't see any patients there, wasn't entitled to home office deduction because he failed Code Sec. 280A 's *principal place of business* test. Notably, he didn't provide any contracts from hospital or other evidence showing that he didn't have office space there/that he needed office space outside of hospital. He also failed to substantiate amounts claimed.

Reference(s): ¶ 280A5.01(60) Code Sec. 280A

4. Interest deductions—business interest—proof. Emergency room physician/overseas staffing business owner wasn't entitled to interest expense deduction where he failed to provide any explanation of business nature of this expense or any substantiation showing it was actually paid.

Reference(s): ¶ 1635.025 Code Sec. 163

5. Business deductions—commuting expenses—substantiation. Emergency room physician/overseas staffing business owner wasn't entitled to deduct auto expenses relating to supposed "work miles" driven between home and work or research library: stated expenses were nondeductible commuting expenses. Or even if some amount was potentially deductible, taxpayer

didn't adequately substantiate same under Code Sec. 274(d) where offering only monthly/non-contemporaneous and uncorroborated log.

Reference(s): ¶ 2745.17(5) Code Sec. 274; Code Sec. 162

6. Accuracy-related negligence penalties—burden of proof and production—written approval of assessment—reasonable cause; good faith—reliance on tax professionals. Accuracy-related negligence penalties were upheld against emergency room physician/overseas staffing business owner for years for which he claimed numerous improper or unproven business deductions: IRS met its burden of production on penalties' applicability with proof that it met Code Sec. 6751(b) 's written supervisory approval requirement and that taxpayer [pg. 2] failed to keep adequate books and records; and he was deemed to have conceded penalties, and/or failed in any event to show reasonable cause in that, although he claimed reliance on return preparer, he didn't establish preparer's expertise or that preparer was given all relevant information.

Reference(s): ¶ 66,625.01(20) ;¶ 74,915.03(3) ;¶ 67,515.01(5) ;¶ 66,625.01(45) Code Sec. 6662; Code Sec. 7491; Code Sec. 6751

Syllabus

Official Tax Court Syllabus

Counsel

Ahmed Hassan, for petitioner.

Jason P. Oppenheim and Alexandra Jamel (student), for respondent.

WELLS, *Judge*

MEMORANDUM FINDINGS OF FACT AND OPINION

Respondent determined for tax year 2008 a deficiency in tax of $44,056 and a section 6662 [1] penalty of $8,811, and for tax year 2009 a deficiency in tax of $28,541 and a section 6662 penalty of $5,708.

[*2] Respondent moved at trial in Atlanta, Georgia, for an increased deficiency on the basis of a change in petitioner's filing status for both tax years. After concessions, [2] the issues remaining to be decided are petitioner's filing status; whether and to what extent petitioner can deduct Schedule C expenses; and penalties. [3]

FINDINGS OF FACT

Two stipulations of facts are hereby incorporated. [4] Petitioner purchased a condominium in Atlanta on February 18, 2008, which he owned until 2013.

[*3] Petitioner was born in Sudan and had family there during 2008 and 2009. Petitioner's Sudanese family included his wife, Suzan Ahmed. They married sometime during 2008 and remained married through the end of 2009. They welcomed a daughter in 2009. Petitioner's wife did not move to the United States until 2010. Petitioner resided in Georgia when he filed the petition.

Petitioner timely filed his 2008 Form 1040, U.S. Individual Income Tax Return, claiming single filing status. His 2008 return reported a total tax due of $14,594. He timely filed his 2009 Form 1040 claiming head of household filing status. His 2009 return reported total tax of $3,318. The returns were prepared by Joseph E. Summersgill of Tax Man Diversified, Inc.

Petitioner worked as a contract emergency room doctor at Murray Medical Center between June or July 2007 and 2010. Murray Medical Center is in Chatsworth, Georgia, approximately 177 miles round trip from petitioner's condominium. Petitioner did not see patients at any facility other than Murray Medical Center during 2008 and 2009. For tax year 2008 and part of tax year 2009 petitioner reported the income and expenses related to his medical practice on Schedules C.

[*4] A. *Cost of Goods Sold 2008*

On the basis of his experience in the United States, petitioner decided to start a business overseas staffing emergency room physicians. He turned to Sari Abdelwahab to help in this venture. He deducted, as cost of goods sold for 2008, payments made in cash or through Western Union totaling $32,580. Petitioner placed in the record a list of payment entries showing dates, sender names, recipients, amounts, service charges, totals, and Western Union tracking numbers. None of the recipients on the chart is Sari Abdelwahab. The recipients include Abdelrahman Elbasha Hamoda; Fahmi Elbasha; Susan Abdeeaz; and Ahmed Yassin. Petitioner testified that he never received any jobs through Mr. Abdelwahab. Respondent disallowed this deduction in full. [pg. 3]

B. *Other Expenses Deduction 2008*

Petitioner reported other expenses of $36,897 on his 2008 Schedule C, of which $27,610 was continuing education expenses. Respondent disallowed $18,536 of those expenses.

Petitioner submitted into evidence charts listing the following continuing education expenses: $13,749 spent on "Critical Care of Tropical Diseases" in Khartoum, Sudan; $12,015 spent on "Practi-Med: Critical Care" in Dubai, United Arab Emirates; $847 spent on "Chronic Heart Failure"

in London, United [*5] Kingdom; and $1,000 spent on "Kaplan Medical Course" in Atlanta.[5] The costs of trips to Khartoum and Dubai each include the following categories of expenses, with specific subtotals: registration, flights, accommodations, meals, medical, materials, gifts, entertainment, transportation, and miscellaneous.

C. *Rent/Lease--Other Business Property Deduction 2008*

Petitioner deducted $18,000 for a Schedule C rent/lease—other business property expense on his 2008 Form 1040. This deduction related to the use of petitioner's condominium as a home office. He provided a chart listing the hours each month he worked at home but could not explain how these hours translated to $18,000. Some household expense amounts can be inferred from his deduction of certain home-related expenses on his 2008 Form 1040 Schedule A. Respondent disallowed this amount in full.

D. *Office Expenses Deduction 2008*

Petitioner deducted $9,820 for office expenses on his 2008 Form 1040. Respondent disallowed this amount in full. Petitioner provided a chart listing monthly amounts for office expenses.

[*6] E. *Interest—Other Deduction 2008*

Petitioner deducted $2,030 for interest on his 2008 Form 1040. Respondent disallowed the deduction in full. Petitioner neither explained the business purpose of the interest nor disputed the adjustment. There is no evidence in the record supporting the purpose or amount of the deduction.

F. *Travel Deduction 2008*

Petitioner deducted $14,524 for travel expenses on his 2008 Form 1040. The deduction represents $3,861 for hotels near Murray Medical Center; $3,951 for "items used for travels"; and $6,712 for a business meeting at Cairo Alsalam Hospital in Cairo, Egypt. Petitioner provided a chart showing his monthly hotel and travel items expenses. A second chart shows his Cairo expenses, which include costs for the flight, accommodation, meals, materials, limousine, entertainment, and gifts. Respondent disallowed $12,021 of petitioner's claimed travel deduction.

G. *Car and Truck Expenses Deduction 2008*

Petitioner claimed a car and truck expense deduction of $20,091 on his 2008 Form 1040 for 36,864 miles driven that year. Petitioner provided a chart showing 30,125 miles driven between his condominium and Murray Medical Center and 6,739 miles driven to a library, usually the Northwest

Regional Library in **[*7]** Chatsworth during the 2008 tax year. Respondent allowed $6,801 of this deduction. Petitioner did not provide the Court with a contemporaneous mileage log.

H. *Cost of Goods Sold 2009*

Until March 2009 petitioner continued to operate the Schedule C business related to his medical practice. [6] On his 2009 Form 1040 petitioner claimed cost of goods sold of $28,320. As with 2008, this figure represents payments made to Mr. Abdelwahab. Respondent disallowed the tax year 2009 claimed cost of goods sold in full.

OPINION

The Commissioner's determination of a deficiency is entitled to a presumption of correctness. Welch v. Helvering, 290 U.S. [pg. 4] 111, 115 [12 AFTR 1456] (1933). Income tax deductions are a matter of legislative grace, and it is the burden of the taxpayer to clearly show the right to any claimed deduction. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 [69 AFTR 2d 92-694] (1992). In certain circumstances, if the taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the proper tax liability, section 7491(a)(1) shifts the burden of proof to **[*8]** the Commissioner. Rule 142(a)(2). Petitioner has failed to offer sufficient substantiation of his expenses and consequently has the burden of proof with respect to all of the Schedule C deductions. *See* sec. 7491(a)(2).

Taxpayers must maintain records sufficient to show how they determined their tax liability. Sec. 6001; sec. 1.6001-1(a), Income Tax Regs. This includes showing both the amount and the purpose of a claimed deduction. Higbee v. Commissioner, 116 T.C. 438, 440 (2001). Petitioner therefore bears the burden of proving both the amounts and the purposes of his Schedule C deductions. *See* id.

I. *Filing Status*

On the other hand, if the Commissioner raises a new matter, he has the burden of proof as to that matter. Rule 142(a); Tabrezi v. Commissioner, T.C. Memo. 2006-61 [2006 RIA TC Memo ¶2006-061], slip op. at 8 (citing Shea v. Commissioner, 112 T.C. 183, 190-191 (1999)). The Commissioner raises a "new matter" when he goes beyond the scope of the original deficiency determination. Tabrezi v. Commissioner, slip op. at 8 (citing Shea v. Commissioner, 112 T.C. at 190-191). At trial respondent moved for an increased deficiency on the basis of changes in petitioner's filing status for both years in issue. As respondent did not challenge petitioner's filing status in the notice of deficiency, this is a new matter, and he bears the burden of proof. For tax **[*9]** year 2008 petitioner claimed single filing status, and for tax year 2009 he claimed head of household filing status.

A. *Tax Year 2008*

To file under the single filing status, a person must be unmarried, not a surviving spouse, and not a head of household. *See* sec. 1(c). The test to determine a taxpayer's marital status is set out in section 7703. Sec. 1(a) (1). The determination of whether an individual is married should be made at the close of the taxable year unless that individual's spouse dies during that year. Sec. 7703(a)(1). A person is not considered married at the close of the taxable year if he either (a) is separated from a spouse under a decree of divorce or separate maintenance agreement, or (b) furnishes over half of the costs of maintaining a household that does not include the spouse but does include a certain child or children. [7] Sec. 7703(a) and (b).

Petitioner was married at the close of the 2008 tax year but contends he is entitled to the single filing status because his wife lived abroad. Simply having a spouse living apart or abroad is insufficient for a person to be considered not **[*10]** married. Respondent's motion is therefore granted as to petitioner's increased deficiency due to a change in filing status for tax year 2008.

B. *Tax Year 2009*

Petitioner filed his 2009 tax return as a head of household filing status because his daughter was born that year. *See* sec. 2(b). A person may file as a head of household only if the individual is not married at the close of the taxable year. Sec. 2(b)(1). For purposes of the head of household filing status, a taxpayer is not considered married at the close of the taxable year if that person's spouse is a nonresident alien. Sec. 2(b)(2)(B). Petitioner testified that at the end of 2009 he was married but his wife, an alien, was not present in the United States. Respondent provided no evidence to refute petitioner's testimony. Respondent has not met his burden of proof, and the motion is therefore denied as to petitioner's increased deficiency due to a filing status change for tax year 2009. [pg. 5]

II. *Schedules C*

Section 162(a) allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business". An expense is ordinary if it is "normal, usual, or customary" in the taxpayer's trade or business. Deputy v. duPont, 308 U.S. 488, 495 [23 AFTR 808] (1940). An expense is necessary if it is "appropriate and helpful" in the taxpayer's business, **[*11]** but it need not be absolutely essential. Commissioner v. Tellier, 383 U.S. 687, 689 [17 AFTR 2d 633] (1966) (quoting Welch v. Helvering, 290 U.S. at 113). Whether an expense is deductible pursuant to section 162 is a question of fact to be decided on the basis of all relevant facts and circumstances. Cloud v. Commissioner, 97 T.C. 613, 618 (1991). No deduction is allowed for personal, living, or family expenses. Sec. 262(a).

Taxpayers must maintain records sufficient to show how they determined their tax liability. Sec. 6001; DeLima v. Commissioner, T.C. Memo. 2012-291 [2012 RIA TC Memo ¶2012-291]; sec. 1.6001-1(a), Income Tax Regs. Providing a chart of expenses to the Court is not enough to substantiate a claimed deduction. *See* G.D. Parker, Inc. v. Commissioner, T.C. Memo. 2012-327, at *50 [2012 RIA TC Memo ¶2012-327] ("[A] simple chart of expenses paid without documentation of the actual payments is not enough to substantiate the expenses.").

If a taxpayer has proven that he paid an expense but is unable to prove the exact amount, the Court may apply the Cohan doctrine and estimate the deductible expense. *See* Cohan v. Commissioner, 39 F.2d 540, 543-544 [8 AFTR 10552] (2d Cir. 1930); Robinson v. Commissioner, T.C. Memo. 2011-99 [2011 RIA TC Memo ¶2011-099]. In applying the Cohan doctrine the Court "bear[s] heavily" against the taxpayer whose difficulty in substantiating his deductions is of his own making. Robinson v. Commissioner, slip op. at 19-20.

[*12] "[The **Tax Court**] generally will not estimate a deductible expense, however, unless the taxpayer presents sufficient evidence to provide some basis upon which an estimate may be made." Id., slip op. at 20.

Section 274(d) provides stricter guidelines for some forms of claimed deductions. *See* Leschke v. Commissioner, T.C. Memo. 2001-18 [2001 RIA TC Memo ¶2001-018]. Under section 274, a deduction is generally disallowed for travel, meals and entertainment, gift, and listed property expenses unless the taxpayer can prove by adequate records or sufficient evidence corroborating: "(A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift." Sec. 274(d); Robinson v. Commissioner, T.C. Memo. 2011-99 [2011 RIA TC Memo ¶2011-099].

Generally, a deduction which falls under the strict substantiation rules must be disallowed in full unless the taxpayer meets all four elements. Robinson v. Commissioner, T.C. Memo. 2011-99 [2011 RIA TC Memo ¶2011-099]. While a contemporaneous log may not be required to meet these elements, the taxpayer should put forth "corroborative evidence used to support a taxpayer's reconstruction of the expenditure [which] `must have a high degree of probative value to elevate such statement' to the level **[*13]** of credibility of a contemporaneous record." Id., slip op. at 21 (quoting Larson v. Commissioner, T.C. Memo 2008-187 [2008 RIA TC Memo ¶2008-187], slip op. at 11). In the absence of adequate records, a taxpayer may provide detailed testimony (oral or written) as to each element. Id., slip op. at 22. Even an otherwise deductible expense may be denied without sufficient substantiation. Id. We do not estimate expenses using the Cohan doctrine for section 274 expenses. Id. [pg. 6]

A. *Cost of Goods Sold for Tax Years 2008 and 2009*

Petitioner claimed costs of goods sold of $32,580 and $28,320 for tax years 2008 and 2009, respectively. Respondent disallowed these costs in the notice of deficiency; consequently, they do not constitute a new matter as petitioner contends. Petitioner bears the burden of proving that he is entitled to the costs of goods sold.

Taxpayers may deduct a "reasonable allowance for salaries or other compensation for personal services actually rendered" if they are ordinary and necessary expenses in carrying on a trade or business. Sec. 162(a)(1). Petitioner contends his costs of goods sold are for payments made to Mr. Abdelwahab to help establish a business. Petitioner contends that it is ordinary and necessary for a physician seeking international contracts to pay an employment broker, even when contracts are not ultimately secured.

[*14] Petitioner has failed, however, to substantiate these expenses. Petitioner testified that payments were made directly to Mr. Abdelwahab in cash or to his family via Western Union. The only document in the record corroborating his testimony is a list of payments made in 2008. There are no entries for 2009 on this list, and there is no other evidence in the record regarding payments made in 2009.

There are no entries that show Mr. Abdelwahab as the recipient of these payments. Every recipient has either petitioner's last name or the first or last name of his wife. Petitioner has put forth no evidence to corroborate his testimony that the claimed recipients are Mr. Abdelwahab's relatives, and Mr. Abdelwahab did not testify. Although petitioner provided respondent a copy of an employment contract, a statement from Mr. Abdelwahab acknowledging receipt of the stated amounts, and the nature of work he performed, none of these documents was introduced into evidence during the trial. As a result, this chart is insufficient to prove that petitioner made any payments to Mr. Abdelwahab and that they were made for a business purpose. *See* Hradesky v. Commissioner, 65 T.C. 87, 90 (1975), aff'd per curiam, 540 F.2d 821 [38 AFTR 2d 76-5935] (5th Cir. 1976); G.D. Parker, Inc. v. Commissioner, T.C. Memo. 2012-327 [2012 RIA TC Memo ¶2012-327]. We will not apply the Cohan doctrine to these payments because petitioner has not provided sufficient evidence for the basis of an estimate. *See* Robinson v. Commissioner, T.C. Memo. 2011-99 [2011 RIA TC Memo ¶2011-099]. Even **[*15]** if properly substantiated, these expenses would constitute startup costs and still not be deductible. *See* sec. 195.

Petitioner has not shown how these payments were ordinary and necessary payments for services rendered related to his Schedule C business. Respondent's determination is sustained, and petitioner's 2008 and 2009 costs of goods sold are disallowed in full.

B. *Other Expenses Deduction for Tax Year 2008*

The "Other Expenses" in dispute all relate to continuing education expenses. Respondent disallowed $18,536, the amount petitioner listed for flights, accommodations, registration, materials, meals, medical expenses, [8] gifts, entertainment, transportation, and miscellaneous items such as visa airport fees for his conferences in Khartoum, Dubai, London, and Atlanta.

[*16] Continuing education expenses are generally deductible. Sec. 1.162-5(a), Income Tax Regs. Travel expenses for continuing education may also be deductible. Sec. 1.162-5(e), Income Tax Regs. Travel and related expenses are subject to the strict substantiation requirements of section 274(d). Because these expenses are subject to the strict substantiation requirements, the Cohan doctrine does not apply. *See* Robinson v. Commissioner, T.C. Memo. 2011-99 [2011 RIA TC Memo ¶2011-099].

Petitioner submitted into evidence various charts listing his expenses. Most of his [pg. 7] continuing education expenses fall under the strict substantiation requirements of section 274(d). He is therefore required to provide adequate records or sufficient evidence corroborating his charts or statements. *See* sec. 274(d). He did not provide receipts or proof of payment for these trips; the record does not contain proof of these payments. The charts alone do not substantiate his expenses. *See* G.D. Parker, Inc. v. Commissioner, T.C. Memo. 2012-327 [2012 RIA TC Memo ¶2012-327]. As a result, these deductions are disallowed in full. *See* Hradesky v. Commissioner, 65 T.C. at 90.

Even if petitioner had substantiated these expenses, it is unclear that they are not at least somewhat personal. At all times during 2008 petitioner was a contract emergency room doctor in Chatsworth. During 2008 and 2009 petitioner had family in Sudan. Petitioner did not provide hotel receipts, airline tickets, or any **[*17]** other evidence of the length of his trips. If a trip had a personal component, the amount of petitioner's deduction would be limited. *See* sec. 1.162-5(e), Income Tax Regs. Petitioner's choice to fly from Georgia to Sudan, his home country where he has family, suggests a highly personal motive for this trip.

Respondent allowed $9,074 of petitioner's continuing education expense deduction. For the remaining expenses, petitioner has failed to meet the strict substantiation requirements of section 274 and failed to account for the portion of expenses attributable to personal activity. For these reasons, we sustain respondent's determination as to the other expenses deduction.

C. *Rent/Lease—Other Business Property Deduction 2008*

Petitioner deducted $18,000 for rent/lease–other business property for his home office in 2008. Respondent disallowed this amount in full. Taxpayers may deduct home office expenses relating to a portion of the home that is used exclusively and regularly: (a) as the principal place of business for any trade or business of the taxpayer; (b) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or

business; or (c) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business. Sec. 280A(a), (c)(1).

[*18] During 2008 petitioner worked as an emergency room doctor at Murray Medical Center. He testified that he had no office at Murray Medical Center and so exclusively used one room in, or 50% of, his condominium to do paperwork related to his emergency room duties. He does not contend that he met with patients in his condominium. As petitioner's home office is not a separate structure from his dwelling unit, and no "patients, clients, or customers" met or dealt with him at his home office, the only test he may satisfy is the "principal place of business" test. *See* sec. 280A(c)(1)(A).

The term "principal place of business" may include "a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business." Sec. 280A(c) (flush language). While a home office deduction is not subject to the strict substantiation requirements of section 274(d), the taxpayer s have a "heavy burden

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to establish the deductibility of expenses related to a home office." Crawford v. Commissioner, T.C. Memo. 1993-192 [1993 RIA TC Memo ¶93,192], 1993 WL 133325, at *4. When determining the proper amount of a reported home office expense, taxpayers should provide some proof of how they calculated the deduction. *See* Margolis v. **[*19]** Commissioner, T.C. Memo. 1999-24 [1999 RIA TC Memo ¶99,024] (using the taxpayer's annual rent and the square footage of the home and office space to determine the amount of the allowed deduction), aff'd without published opinion, 213 F.3d 636 (4th Cir. 2000).

Petitioner contends that he had no other fixed location in which to conduct administrative or management activities and that he [pg. 8] used his home office to meet with business consultants and associates; receive his schedules and business calls; and perform administrative and other job-related work. The only home office meetings he testified to were those with respondent's agents. He did not provide any contracts from Murray Medical Center showing that he did not have office space or submit any other documentation that office space would be needed for his job. He did not have any other party testify to the need to have office space outside of the hospital.

We have held that when most of the services a taxpayer performs for patients are performed at hospitals with some followup at the home office, the home office does not constitute a principal place of business. Crawford v. Commissioner, 1993 WL 133325 [1993 RIA TC Memo ¶93,192], at *6. Petitioner also failed to substantiate the amount of his deduction. He could not remember how he calculated the $18,000 **[*20]** home office deduction[9] and did not maintain sufficient

records to decipher it. *See* sec. 6001; DeLima v. Commissioner, at *23 (citing Tokarski v. Commissioner, 87 T.C. 74, 77 (1986)); sec 1.6001-1(a), Income Tax Regs.; *see also* Hradesky v. Commissioner, 65 T.C. at 90. There is no corroborating evidence to show that petitioner's home office occupied half of his condominium. Petitioner did not provide the Court with pictures, floorplans, diagrams, or blueprints of his condominium or home office. We cannot, therefore, know the layout or the percentage of his condominium used as a home office. There is insufficient evidence in the record to form a basis for an estimate. *See* Cohan v. Commissioner 39 F.2d 540 [8 AFTR 10552]; Robinson v. Commissioner, T.C. Memo. 2011-99 [2011 RIA TC Memo ¶2011-099].

[*21] Petitioner has not proven his entitlement to a home office deduction. Even if he had proven he qualified for a home office deduction, he has not proven the amount of the deduction. As a result, petitioner's tax year 2008 rent/lease–other business property deduction is disallowed in full.

D. *Office Expense Deduction 2008*

Petitioner claimed a $9,820 office expense deduction. Respondent disallowed the deduction.

The only substantiation petitioner provided is a chart summarizing the monthly expenses. The record does not include the detailed expense log with accompanying receipts that he mentioned at trial. His chart is insufficient to prove that he incurred the expenses, *see* G.D. Parker, Inc. v. Commissioner, T.C. Memo. 2012-327 [2012 RIA TC Memo ¶2012-327], and insufficient to provide a basis for an estimate under the Cohan doctrine, *see* Robinson v. Commissioner, T.C. Memo. 2011-99 [2011 RIA TC Memo ¶2011-099]. He has failed to substantiate an office expense deduction.

Petitioner has provided no proof he incurred these expenses or that they were incurred for an ordinary and necessary business purpose. *See* secs. 162(a), 6001; sec. 1.6001-1(a), Income Tax Regs. We therefore sustain respondent's determination.

[*22] E. *Interest Deduction*

Petitioner claimed a 2008 other–interest deduction of $2,030. Respondent disallowed this deduction in full. Generally, business interest is a deductible expense. Sec. 163. Petitioner has failed, however, to provide any explanation for the business nature of this interest expense or any substantiation that it was actually paid. He has failed to meet his burden of proof, *see* Hradesky v. Commissioner, 65 T.C. at 90 (disallowing claimed deductions when there was "no substantiation at all"), or provide a reasonable basis for estimating his deduction under the Cohan doctrine, *see* Robinson v. Commissioner, T.C. Memo. 2011-99 [2011 RIA TC Memo ¶2011-099]. Furthermore, petitioner did not object to this disallowance in his petition or at trial. If a taxpayer does not raise an

issue within the assignment of errors on his petition, that issue shall be deemed [pg. 9] conceded. Rule 34(b)(4); Swain v. Commissioner, 118 T.C. 358, 362 (2002). The disallowance of petitioner's claimed interest deduction is therefore sustained. *See* Swain v. Commissioner, 118 T.C. at 362.

F. *Travel Deduction*

Petitioner deducted $14,524 in travel costs for the 2008 tax year, of which respondent disallowed $12,021. A taxpayer may deduct travel expenses while away from home if the expenses are ordinary, necessary, and attributable to the business of the taxpayer. Sec. 162(a)(2); Crawford v. Commissioner, T.C. Memo. **[*23]** 2014-156, at *12. Travel expenses are subject to the section 274(d) strict substantiation requirements. Sec. 274(d)(1). The only support petitioner submitted for his travel expenses were three computer-generated charts detailing that $3,861 was paid for hotels near Murray Medical Center, $3,951 for "items used for travels," and $6,712 for a trip to Cairo.

A taxpayer may deduct lodging expenses while away from home in pursuit of a trade or business if that pursuit is temporary. Sec. 162(a)(2); Chappuis v. Commissioner, T.C. Memo. 1968-48 [¶68,048 PH Memo TC]. A taxpayer's pursuit of a trade or business is no longer temporary after one year. Sec. 162(a); *see* Rev. Rul. 99-7, 1999-1 C.B. 361. Petitioner deducted $3,861 for hotels near Murray Medical Center. Hebegan working at Murray Medical Center in June or July 2007. Once he had worked there for one year, his work was no longer considered temporary. *See* Rev. Rul. 99-7, supra. Furthermore, he did not provide adequate records or sufficient evidence corroborating the amount spent on hotels. *See* sec. 274(d). Respondent allowed a deduction for $2,503, the amount spent on hotel stays until June 2008. Petitioner is not allowed to deduct the $1,358 in hotel stays in excess of the $2,503 already allowed.

Petitioner failed to provide an explanation or business purpose of "items used for travels." His self-made chart is not an adequate record or sufficient **[*24]** evidence that can corroborate the $3,951 business expense. *See* sec. 274(d). As a result, his $3,951 deduction for "items used for travels" is disallowed in full. *See* Hradesky v. Commissioner, 65 T.C. at 90.

Finally, we turn to petitioner's Cairo trip. As discussed above, if a "trip is undertaken for both business and personal reasons, travel expenses are deductible only if the primary purpose of the trip is business." Crawford v. Commissioner, at *12. Determining the purpose of a trip is a fact-based analysis which depends, in part, on the ratio of time the taxpayer spends on personal and business activities. *See* id. Petitioner has not explained or substantiated how the trip benefited his practice. He does not contend this trip provided continuing medical education; he has not explained why it is an ordinary and necessary business expense for a doctor working in rural Georgia to attend a hospital business meeting in Cairo.

Furthermore, petitioner has failed to meet the strict substantiation requirements of section 274(d). He deducted the following expenses for his trip to Cairo: flight, accommodation, meals, materials, transportation, entertainment, and gifts. Other than materials, each expense must meet the strict substantiation requirements of section 274(d). To deduct these expenses, petitioner must meet all elements of section 274(d). However, the record is devoid of corroborating evidence. As a result, his $6,712 deduction for a trip to Cairo is disallowed in full.

[*25] Petitioner has failed to explain how a majority of his travel expenses were ordinary and necessary. He has also failed to substantiate any of these expenses. The Cohan doctrine does not apply as a majority of these expenses require strict substantiation, and petitioner provided no reasonable basis for an estimate. *See* Robinson v. Commissioner, T.C. Memo. 2011-99 [2011 RIA TC Memo ¶2011-099]. As a result, we sustain respondent's determination with regard to the travel deduction.

G. *Car and Truck Expenses Deduction 2008*

Petitioner deducted $20,091 for car and truck expenses for tax year 2008. Respondent allowed $6,801 of this deduction. [pg. 10]

Petitioner calculated that he drove 30,125 miles to work and 6,739 miles to libraries. The amount petitioner deducted totals the appropriate mileage rate applied to the number of days he worked and then multiplied by 177.2, or the approximate round-trip distance between his home and Murray Medical Center. In other words, petitioner's "work miles" are for his commute to work. Commuting expenses are generally not deductible. [10] Secs. 1.162-2(e), 1.262-1(b)(5), Income **[*26]** Tax Regs. Because we determined that petitioner's home office was not his principal place of business within the meaning of section 280A(c)(1)(A), he is not excepted from this general rule. *See* Curphey v. Commissioner, 73 T.C. 766, 777-778 (1980); Rev. Rul. 99-7, supra. Petitioner has not explained the business purpose of his library trips, nor has he provided any evidence that these trips were taken. Petitioner's car and truck expenses do not appear to be ordinary and necessary business expenses under section 162.

Even if petitioner's mileage were deductible, he has failed to meet his burden of proof. Car and truck expenses are subject to the strict substantiation requirements of section 274(d). *See* Renner v. Commissioner, T.C. Memo. 2015-102, at *9 [2015 RIA TC Memo ¶2015-102]. To substantiate mileage, a taxpayer must show: (a) the mileage; (b) the time and place of the car's use; and (c) the business purpose of the car's use. Id. The taxpayer should maintain a contemporaneous mileage log. Id. at *8. A summary of monthly miles driven, without more, is insufficient. *See* id. at *8-*12 (stating the taxpayer's monthly mileage logs did not appear to be prepared contemporaneously with the taxpayer's travel). Petitioner's computerized monthly mileage log therefore does not meet the strict substantiation requirements of **[*27]** section

274(d). Furthermore, there is evidence in the record that strongly suggests petitioner did not drive all the miles listed on his chart. He deducted $3,861 for hotel stays near Murray Medical Center. There is no evidence in the record showing what dates he drove to and from Murray Medical Center and what dates he stayed in hotels near the medical center. It is reasonable to conclude that petitioner stayed in hotels between any shifts that were close together. For each hotel stay between shifts, petitioner would have one less 177.2-mile commute to work.

Petitioner has failed to substantiate his car and truck expenses. Accordingly, he is not entitled to deduct car and truck expenses beyond the $6,801 respondent allowed.

III. *Penalties*

The Commissioner has the initial burden of production when asserting a penalty. Sec. 7491(c). He must show it is appropriate to impose the penalty. Higbee v. Commissioner, 116 T.C. at 446. Once the Commissioner meets his burden of production, the taxpayer must come forward with evidence sufficient to show the Court the determination is incorrect. Id. at 446-447.

The Commissioner must first show that there was written supervisory approval of the initial penalty determination. *See* secs. 6751(b)(1), 7491(c); Chai **[*28]** v. Commissioner, 851 F.3d 190, 221 [119 AFTR 2d 2017-1158] (2d Cir. 2017), aff'g in part, rev'g in part T.C. Memo. 2015-42 [2015 RIA TC Memo ¶2015-042]; Graev v. Commissioner, 149 T.C. 485, 492-493 (2017), supplementing and overruling in part 147 T.C. 460 (2016). After trial respondent moved to reopen the record and attached to the motion a declaration from Chenzira Bohannon and the Civil Penalty Approval Form signed by her supervisor Sharon E. Jones. Respondent's motion will be granted. These documents show the required written supervisory approval of the initial penalty determination.

Secondly, the Commissioner may satisfy his burden of production by showing the taxpayer has failed to keep adequate books and records. Higbee v. Commissioner, 116 T.C. at 449. Petitioner has failed to offer substantiation of his expenses, instead submitting compiled summaries of expenses without supporting documentation. He [pg. 11] failed to keep adequate books and records; and because respondent has met the burden of production, petitioner must come forward with evidence to show that the penalty determination is incorrect. *See* id. at 446-447.

If a taxpayer does not raise an issue within the assignment of errors on his petition, that issue shall be deemed conceded. Rule 34(b)(4); Swain v. Commissioner, 118 T.C. at 362. This provision also applies to penalties. Swain v. Commissioner, 118 T.C. at 365. Petitioner did not raise the section 6662(a) **[*29]** penalties in his petition. As a result, the application of the penalties is deemed conceded under Swain.

Even if the penalties had not been conceded, the record shows that a penalty should apply for each tax year. Section 6662(a) and (b)(1) imposes a penalty equal to 20% of any portion of an underpayment of tax required to be shown on a return that is attributable to, inter alia, negligence or disregard of rules or regulations. [11] Section 6662(c) defines negligence as any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws. The term "disregard" includes any careless, reckless, or intentional disregard. Sec. 6662(c). Negligence is indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances.

A taxpayer is not liable for the section 6662(a) penalty if he establishes that the underpayment on the return was due to reasonable cause and that he acted in **[*30]** good faith. Sec. 6664(c); sec. 1.6664-4(a), Income Tax Regs. Merely having a return preparer does not shield the taxpayer from an applicable penalty. *See* Jasperson v. Commissioner, T.C. Memo. 2015-186, at *12-*13 [2015 RIA TC Memo ¶2015-186] (citing Magill v. Commissioner, 70 T.C. 465, 479 (1978), aff'd, 651 F.2d 1233 [47 AFTR 2d 81-1483] (6th Cir. 1981)), aff'd, 658 F. App'x 962 [118 AFTR 2d 2016-5633] (11th Cir. 2016); Ocampo v. Commissioner, T.C. Memo. 2015-150, at *55-*58 [2015 RIA TC Memo ¶2015-150]. Reliance on a tax adviser may constitute reasonable cause, however, if (a) the adviser is competent, (b) the taxpayer provided requisite information to the adviser, and (c) the taxpayer relied on the adviser in good faith. Neonatology Assocs., P.A. v. Commissioner, 115 T.C. 43, 99 (2000), aff'd, 299 F.3d 221 [90 AFTR 2d 2002-5442] (3d Cir. 2002). Petitioner bears the burden of proving his reliance on a tax adviser provided reasonable cause. *See* Higbee v. Commissioner, 116 T.C. at 446.

Petitioner, an emergency room doctor with no prior tax preparation or tax law background, credibly testified that he relied on his tax preparer because he is the expert. There was no testimony or evidence, however, as to the nature of the preparer's expertise or competence. There was also no testimony as to the information petitioner provided to his preparer. Petitioner has therefore not met his burden on two of the Neonatology Associates reasonable cause elements and is liable for the section 6662 penalties.

[*31] Accordingly,

An order and decision will be entered pursuant to Rule 155.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended and in effect at all relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Procedure. We round all monetary amounts to the nearest dollar.

[2] Petitioner concedes recharacterizing $52,000 of gross receipts reported on Schedule C, Profit or Loss From Business, as wage income for the 2009 tax year and adjustments in the notice of deficiency in the following amounts: $1,669 for a Schedule C meals and entertainment deduction for the 2008 tax year; $2,857 for a capital loss deduction for the 2008 tax year; and $82,269 for a Schedule C commissions and fees deduction for the 2009 tax year. Petitioner also concedes that he made contributions to a nonqualified organization and is therefore not allowed to deduct on his Schedule A, Itemized Deductions, the contributions under sec. 170(a)(1).

[3] Petitioner conceded some statutory adjustments, such as self-employment tax and the correct amount of the additional child tax credit because of income limitations. These adjustments shall be calculated in accordance with our findings herein.

[4] Respondent objects to any addition into the record of unstipulated documents petitioner electronically filed with the Court on August 24, 2015, but failed to present at trial. As the documents were not presented into evidence at trial, they do not form part of the record.

[5] These amounts are separate and in addition to the $27,610 of continuing education expenses and the $14,524 of travel expenses petitioner reported on the 2008 Schedule C.

[6] In March 2009 petitioner incorporated his Schedule C business under the name of Advanced Emergency Medical Coverage, and he became an employee.

[7] Petitioner does not contend that he qualifies as unmarried under sec. 7703(b). He does not satisfy the requirements of subsec. (b) because in 2008 he had no children for whom he was allowed a dependency exemption.

[8] Petitioner reported $2,737 of medical expenses as continuing education expenses for his Sudan and Dubai trips. To deduct medical expenses for 2008, a taxpayer would have to report these expenses on Schedule A and could claim deductions only in excess of 7.5% of the taxpayer's adjusted gross income. Sec. 213(a); 2008 Instructions for Schedules A & B (Form 1040), at A-1. Even if petitioner substantiated the amounts reported, his 2008 tax return shows adjusted gross income of $68,060. Because of the 7.5% adjusted gross income limitation, petitioner could deduct medical expenses only in excess of $5,105 (assuming his reported adjusted gross income was correct). Petitioner's medical expenses therefore would not meet the income limitations set forth on Schedule A.

[9] Petitioner contends that $18,000 was less than half of his yearly mortgage payment. The only mortgage-payment-related information in the record is found on petitioner's Schedule A, as adjusted through pretrial concessions. The figures include property taxes of $12,847, mortgage insurance premiums of $2,196, points not reported on Form 1098 of $3,510, and

home mortgage interest of $12,381. The $18,000 petitioner claimed is more than half of the $30,934 total. The record does not contain any information to substantiate mortgage payments made in excess of $30,934. Furthermore, petitioner already deducted this amount on his Schedule A. A taxpayer cannot deduct the same expense twice. *See* Bailey v. Commissioner, T.C. Memo. 2012-96 [2012 RIA TC Memo ¶2012-096], aff'd without published opinion, 2014 WL 1422580 [113 AFTR 2d 2014-1344] (1st Cir. 2014). Therefore, any allowable home expenses used in determining the amount of a home office deduction would have to be first reduced by the amount petitioner deducted on his Schedule A.

[10] Respondent allowed petitioner $6,801 or approximately one-third of his reported car and truck expenses for tax year 2008. Commuting expenses may be deductible when incurred between a taxpayer's residence and a temporary worksite outside of the metropolitan area. Rev. Rul. 99-7, 1999-1 C.B. 361. As discussed above, petitioner's work at Murray Medical Center ceased to be temporary in June 2008. Respondent may have allowed petitioner's commuting expenses until then; but after his worksite ceased to be temporary, his commuting expenses were no longer deductible. *See* id.

[11] The penalty also applies against underpayments attributable to any substantial understatement of income tax. Sec. 6662(b)(2). An understatement of income tax is substantial when the amount of the understatement for the taxable year exceeds the greater of 10% of the tax required to be shown on the tax return or $5,000. Sec. 6662(d)(1)(A). Respondent proposed an increase in tax of $44,056 for 2008 and $28,541 for 2009. Even with concessions and the adjustment for filing status for 2009, petitioner's understatement for each year exceeds $5,000.

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Raul Romana et vir. v. Commissioner, T.C. Summary Opinion 2022 -9 , Code Sec(s) 62; 63; 67; 162; 6662.

RAUL ROMANA AND MARIA CORAZON ROMANA, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

Code Sec(s):	62; 63; 67; 162; 6662
Docket:	Docket No. 1156-21S.
Date Issued:	06/16/**2022**

HEADNOTE

1.

Reference(s): Code Sec. 62;Code Sec. 63;Code Sec. 67;Code Sec. 162;Code Sec. 6662

Syllabus

Counsel

Steven S. Chung, for petitioners.

Chae M. Kim and Michael E. Washburn, for respondent.

SUMMARY OPINION

CARLUZZO, *Chief Special Trial Judge*: This case was heard pursuant to the provisions of section 7463 of the Internal Revenue Code in effect when the petition was filed. [1] Pursuant to section 7463(b), the decision to be entered is not reviewable by any other court, and this opinion shall not be treated as precedent for any other case.

In a notice of deficiency dated December 11, 2020 (notice), respondent determined deficiencies in petitioners' federal income tax and section 6662(a) accuracy -related penalties for 2016, 2017, and 2018.

After concessions, the issues for decision are whether petitioners (1) are entitled to a miscellaneous itemized deduction for unreimbursed [1] Unless otherwise indicated, statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and Rule references are to the **Tax Court** Rules of Practice and Procedure. **Served 06/16/22**[2] employee business expenses for 2017 [2] in excess of the amount already allowed by respondent and (2) are liable for a section 6662(a) accuracy - related penalty for any year in issue.

Background

Some of the facts have been stipulated and are so found. Petitioners lived in California when the Petition was filed.

During each year in issue Mr. Romana was employed as a stationary engineer; Mrs. Romana was employed as a nurse in a plastic surgery clinic operated by Kaiser Permanente (Kaiser). Both petitioners received most of their formal education in the Philippines although both received additional professional and/or vocational trainingin the United States after moving to the United States from the Philippines. Neither petitioner had any formal training in accounting or federal income taxation.

Kaiser's dress code in effect at the location where she worked required that Mrs. Romana be d ressed in "comfortable" clothes and in a manner that reflected her profession as a nurse. Neither Kaiser nor the collective bargaining agreement for her nursing union had a policy that allowed reimbursement for the expenses she incurred to purchase clothing that satisfied her employer's dress code. While at work, Mrs. Romana wore clothing that resembled scrubs that she purchased at her own expense from local department stores. In the operating room she was required to wear scrubs provided by Kaiser. Routinely, depending upon the operation schedule for any given day, she changed back and forth between her scrublike clothing and the operating room scrubs her employer provided.

During 2017 Mrs. Romana also purchased, at her own expense, a white "lab" coat with "Kaiser Permanente" and her name embroidered on it. The purchase was made as part of a bulk purchase along with similar items purchased by fellow employees. The lab coat cost approximately $45, and it was dry cleaned multiple times during the year. Otherwise, the costs that petitioners paid for Mrs. Romana's work clothing cannot be precisely determined. [2] The Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 11045, 131 Stat. 2054, 2088, amended section 67 by suspending miscellaneous itemized deductions for any taxable year beginning after December 31, 2017, and before January 1, 2026. [3]

Petitioners' federal income tax return for each year in issue was prepared by a paid income tax return preparer. Petitioners return ' preparer, who began preparing federal income tax returns for petitioners around 2003, was hired on the recommendation of petitioners' family and friends. The return preparer assisted petitioners with other financial matters as well. For example, the return preparer advised petitioners to set up an S corporation to manage their rental properties and helped them set up living trusts and living wills.

The Schedule A, Itemized Deductions, included with petitioners' 2017 return shows various deductions, including, as relevant here, unreimbursed employee business expenses relating to Mrs. Romana's employment with Kaiser and Mr. Romana's employment as a stationary engineer. Attached to the Schedule A is a "TY 2017 Unreimbursed Expense Statement" reflecting the detail of the unreimbursed employee business expenses as follows: *Unreimbursed Expense Amount*
Union and professional dues $3,616

Uniforms and protective clothing 1,915

Dry cleaning/laundry 399

Seminars 601

Tools 250

Telephone 263

Internet 1,134 **Total $8,178**

In the notice and as relevant, respondent allowed the miscellaneous itemized deduction for unreimbursed employee business expenses claimed on petitioners' 2017 Schedule A for union and professional dues and for seminars. Otherwise, respondent disallowed the miscellaneous itemized deduction for unreimbursed employee business expenses claimed for uniforms and protective clothing, dry cleaning and laundry, tools, telephone, and internet. As noted, [4] respondent also imposed a section 6662(a) accuracy-related penalty for each year in issue.

Discussion

As a general rule, the Commissioner's determination of a taxpayer's federal income tax liability in a notice of deficiency is presumed correct, and the taxpayer bears the burden of proving that the determination is erroneous. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 [12 AFTR 1456] (1933). [3]

I. Unreimbursed Employee Business Expenses

As we have observed in countless opinions, deductions are a matter of legislative grace, and the taxpayer bears the burden of proving entitlement to any claimed deduction. Rule 142(a); *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 [69 AFTR 2d 92-694] (1992); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 [13 AFTR 1180] (1934). This burden requires the taxpayer to substantiate expenses underlying deductions claimed by keeping and producing adequate records that enable the Commissioner to determine the taxpayer's correct tax liability. § 6001; *Hradesky v. Commissioner*, 65 T.C. 87, 89-90 (1975), *aff'd per curiam*, 540 F.2d 821 [38 AFTR 2d 76-5935] (5th Cir. 1976); *Meneguzzo v. Commissioner* , 43 T.C. 824, 831-32 (1965). A taxpayer claiming a deduction on a federal income tax return must demonstrate that the deduction is allowable pursuant to some statutory provision and must further substantiate that the expense to which the deduction relates has been paid or incurred. *See* § 6001; *Hradesky* , 65 T.C. at 89-90; Treas. Reg. § 1.6001-1(a).

Taxpayers may deduct ordinary and necessary expenses paid in connection with operating a trade or business. § 162(a); *Boyd v. Commissioner*, 122 T.C. 305, 313 (2004). Generally, the performance of services as an employee constitutes a trade or business. *Primuth v. Commissioner*, 54 T.C. 374, 377 (1970). If, as a condition of employment, an employee is required to incur certain expenses, then the employee is entitled to a deduction for those expenses unless entitled to reimbursement from his or her employer. *See Fountain v. Commissioner* , 59 T.C. 696, 708 (1973); *Spielbauer v. Commissioner* , T.C. Memo. 1998-80 [1998 RIA TC Memo ¶98,080]. [3] Petitioners do not claim and the record does not otherwise demonstrate that the provisions of section 7491(a) need be applied here, and we proceed as though they do not. [5]

The deduction for unreimbursed employee business expenses is a miscellaneous itemized deduction. §§ 67(b), 63(d)(1), 62. During the relevant period miscellaneous itemized deductions were allowable only to the extent that the total of such deductions exceeded 2% of adjusted gross income (AGI). § 67(a) and (b). Petitioners' total miscellaneous itemized deductions for 2017, as allowed by respondent in the notice, exceed 2% of their AGI.

As a general rule, if a taxpayer provides sufficient evidence that the taxpayer has incurred a trade or business expense contemplated by section 162(a) but is unable to adequately substantiate

the amount, the Court may estimate the amount and allow a deduction to that extent. *Cohan v. Commissioner*, 39 F.2d 540, 543-44 [8 AFTR 10552] (2d Cir. 1930). However, in order for the Court to estimate the amount of an expense, there must be some basis upon which an estimate may be made. *Vanicek v. Commissioner*, 85 T.C. 731, 742-43 (1985).

All of the disputed deductions relate to Mrs. Romana's employment with Kaiser or Mr. Romana's employment as a stationary engineer. According to petitioners, they are entitled to unreimbursed employee business expense deductions of $1,526 for clothing, $250 for tools, $263 for telephone, and $1,134 for internet. According to petitioners, each expense qualifies as an ordinary and necessary business expense paid by petitioners but not reimbursable by their employers. *See* § 162(a). According to respondent, petitioners have failed to establish that (1) the expenses were paid or, if paid, (2) the expenses were ordinary and necessary business expenses, and if business related, (3) they were not reimbursable by petitioners' employers.

A. Clothing

On their 2017 return petitioners claimed $1,915 in expenses for "Uniforms and protective clothing" and $399 for "dry cleaning/laundry." Petitioners now assert that they are entitled to deduct $1,526 for those items.

Generally, the cost of a business wardrobe, even if required as a condition of employment, is considered a nondeductible personal expense within the meaning of section 262. *See, e.g.*, *Hynes v. Commissioner*, 74 T.C. 1266, 1290 (1980). Those costs are not deductible even when it has been shown that the particular clothes would not have been purchased but for the employment. *Id.* Clothing costs are [6] deductible as ordinary and necessary business expenses under section 162 only if (1) the clothing is of a type specifically required as a condition of employment, (2) it is not adaptable to general use as ordinary clothing, and (3) it is not so worn. *See Yeomans v. Commissioner*, 30 T.C. 757, 767 (1958); *see also Deihl v. Commissioner*, T.C. Memo. 2005- 287 [2005 RIA TC Memo ¶2005-287].

Mrs. Romana was required to dress professionally and comfortably for her job as a nurse. To do so, she purchased shirt and s pants at department stores. Because the clothing resembled scrubs, we find that the clothing was not adaptable to general use as ordinary clothing outside of her employment. Consequently, the cost of the clothing and the cost to dry clean the clothing are deductible. Mrs. Romana also purchased a white lab coat with "Kaiser Permanente" and her name embroidered on it. This lab coat was not appropriate for general use.

According to Mrs. Romana, the lab coat cost around $45. Petitioners provided only generalized estimates for the costs of the scrublike clothing that Mrs. Romana wore at work and the dry cleaning costs paid to dry clean those items. After a careful review of the evidence, and as best we can estimate from what has been submitted, we find that petitioners are entitled to a $500

deduction for the purchases of the clothing that Mrs. Romana was required to wear as a condition of her employment and the related dry cleaning costs paid with respect to those items. *See Cohan v. Commissioner*, 39 F.2d at 543-44.

B. Tools

Petitioners claimed a deduction of $250 for tools for 2017. They did not offer any evidence that identifies the type of tools, the cost of the tools, or the business use of the tools. Furthermore, there is insufficient evidence that would allow for a deduction based on an estimate. *SeeVanicek* , 85 T.C. at 742-43. Accordingly, petitioners are not entitled to a deduction for unreimbursed employee business expenses for tools for 2017.

C. Phone and Internet

Petitioners claimed deductions of $264 for phone expenses and $1,134 for internet expenses. Petitioners did not offer documentary evidence or testimony regarding their business use of the phone and internet, nor did they explain how they arrived at their estimate of business versus personal use. Without such evidence the Court does not [7] have a reasonable basis to estimate the amounts of the expenses related to business use. *See id.* Accordingly, petitioners are not entitled to a deduction for unreimbursed employee business expenses for phone and internet for 2017.

II. Accuracy-Related Penalties

Lastly, we consider whether petitioners are liable for a section 6662(a) accuracy-related penalty for any year in issue. Relying upon various grounds, respondent argues that petitioners are liable for the penalty for each year. *See* § 6662(a)-(d).

Petitioners' paid income tax return preparer prepared petitioners' 2016, 2017, and 2018 returns. Petitioners had retained the same return preparer since approximately 2003 to prepare their returns. Routinely, petitioners met with the return preparer two or three times each year. As was petitioners' practice with respect to their joint f deral income tax e returns filed for other years, Mrs. Romana assembled petitioners' personal and employment information, tax documents, and source documents underlying the deductions shown on their returns and provided them to the return preparer. Mrs. Romana also provided the return preparer with various financial statements related to thei rental r properties.

Petitioners' presentation at trial satisfies us that petitioners reasonably relied upon their return preparer to do what they paid their return preparer to do. Neither petitioner had any formal training in accounting or matters of federal income taxation. To the extent that petitioners claimed

disallowed deductions that they now concede, we find that these deductions were claimed on the advice of their return preparer and further find that it was not unreasonable for petitioners not to have questioned that advice.

Under the circumstances, we find that petitioners had reasonable cause for the underpayment of tax required to be shown on their return for each year in issue and that they acted in good faith with respect to those underpayments. *See* § 6664(c); *Higbee v. Commissioner*, 116 T.C. 438, 446-47 (2001). Petitioners are not liable for the section 6662(a) accuracy-related penalty for any year in issue.

To reflect the foregoing, Decision will be entered under Rule 155.

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Jihad Y. Ibrahim v. Commissioner, T.C. Summary Opinion 2022 -7 , Code Sec(s) 62; 71; 215; 6662; 6664; 6751.

JIHAD Y. IBRAHIM, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Case Information:

Code Sec(s):	62; 71; 215; 6662; 6664; 6751
Docket:	Docket No. 10750-20S.
Date Issued:	05/16/**2022**

HEADNOTE

1.

Reference(s): Code Sec. 62;Code Sec. 71;Code Sec. 215;Code Sec. 6662;Code Sec. 6664;Code Sec. 6751

Syllabus

Counsel

Austin L. Mitchell, for petitioner.

Jamie M. Powers and Philip Edward Blondin, for respondent.

SUMMARY OPINION

WEILER, *Judge*: This case was heard pursuant to the provisions of section 7463 of the Internal Revenue Code in effect when the petition was filed. 1 Pursuant to section 7463(b), the decision to be entered is not reviewable by any other court, and this opinion shall not be treated as precedent for any other case.

The Internal Revenue Service (IRS) determined that petitioner, Jihad Y. Ibrahim, is liable for a f ederal income tax deficiency of $15,786 and an accuracy-related penalty pursuant to section 6662(a) of $3,157 for the 2017 tax year. Dr. Ibrahim invoked the Court's jurisdiction by [1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the **Tax Court** Rules of Practice and Procedure. All dollar amounts are rounded to the nearest dollar. **Served 05/16/22**[2] timely filing a Petition for redetermination pursuant to section 6213(a). Dr. Ibrahim resided in Missouri when the Petition was filed.

The issues for decision are (1) whether certain payments Dr. Ibrahim made during 2017 constitute deductible alimony or separate maintenance and (2) whether he is liable for the accuracy-related penalty pursuant to section 6662(a). *Background* 2 I. *Dr. Ibrahim's Tax Return* On April 17, 2018, Dr. Ibrahim timely filed Form 1040, U.S. Individual Income Tax Return, for the 2017 tax year using "Head of Household" filing status. Dr. Ibrahim's 2017 federal tax return was not amended. He claimed a $50,000 deduction on line 31a for "Alimony paid." On line 31b, "Recipient's [Social Security number]," he included the Social Security number of his ex-wife, Cheryl Edington (formerly known as Cheryl Ibrahim).

II. *Dr. Ibrahim's Separation and Divorce*

A. *Marriage* Dr. Ibrahim and Ms. Edington were married on June 20, 2008.

Both Dr. Ibrahim and Ms. Edington had been previously married. While Dr. Ibrahim and Ms. Edington each had children from prior marriages, no children were born into the marriage between the two.

During the marriage Dr. Ibrahim was continuously employed and worked as a physician, and Ms. Edington was continuously employed and worked as a registered nurse. Dr. Ibrahim and Ms. Edington maintained their respective employments after their divorce.

B. *Separation* On or about August 2, 2016, D r. Ibrahim and Ms. Edington

separated. From the time of their separation, each maintained separate residences in Missouri. After separating from Dr. Ibrahim, Ms. Edington

rented a home and subsequently purchased a residence.

2 Some of the facts have been stipulated by the parties and are incorporated herein.

On September 17, 2016, Dr. Ibrahim and Ms. Edington signed a Marital Separation Agreement (agreement). Paragraph 42 of the agreement states that "[t]he parties agree that neither shall pay maintenance, each will be forever precluded from requesting maintenance as part of their decree of dissolution." Paragraph 43 of the agreement states:

However, Husband agrees to pay Wife the total sum of ten thousand dollars ($10,000), to assist in Wife's relocation and legal fees, payable three hundred dollars ($300) monthly beginning upon execution of this agreement and payable monthly for one year or until a final judgment and decree of dissolution, whichever occurs earlier, at which time Husband will pay the then yet unpaid balance of the ten thousand dollars. C. *Divorce* On January 5, 2017, Ms. Edington filed a petition for dissolution of marriage in Texas County Circuit Court in Texas County, Missouri. Dr. Ibrahim filed his answer to the petition for dissolution of marriage on January 27, 2017.

On May 11, 2017, Dr. Ibrahim and Ms. Edington signed the first amendment to the marital separation agreement (amended agreement). The amended agreement was executed "to allow the Court in its Judgment for Dissolution to refer to the fact that the parties hereby agree that neither party shall pay maintenance to the other party, as expressly stated in Paragraph 42 in the Maintenance section." The amended agreement also states:

Paragraph 43 in the Maintenance section is hereby amended to state that the Husband agrees to pay Wife the total sum of fifty thousand dollars ($50,000), to assist in Wife's relocation and legal fees, payable three hundred dollars ($300) monthly beginning upon the execution of the original agreement and payable five hundred dollars ($500) monthly beginning in June 2017, and payable monthly until a final judgment and decree of dissolution, at which time Husband will pay the then yet unpaid balance of the fifty thousand dollars. Dr. Ibrahim and Ms. Edington's divorce was finalized on June 7, 2017, when the judgment for dissolution of marriage (judgment) was [4] filed in the Texas County Circuit Court. Paragraph 11 of the judgment states that "[t]he parties have entered into a written Marital Separation Agreement that makes full and final disposition of all marital property and provides that neither party shall receive maintenance from the other." The judgment provided that "neither party shall receive maintenance from the other, and this judgment with respect to maintenance is not modifiable ."

The agreement, the amended agreement, and the judgment have not been modified since the judgment was filed on June 7, 2017. III. *Payments in Issue* Dr. Ibrahim made the following

payments, totaling $50,000, via check to Ms. Edington: *Date Check Number Amount* 9/17/2016 1366 $300 10/3/2016 1369 300 11/1/2016 1375 300 12/2/2016 1382 300 1/1/2017 1392 300 2/1/2017 1406 300 3/1/2017 1412 300 4/3/2017 1421 300 5/1/2017 1430 300 5/16/2017 1435 300 6/2/2017 1438 200 6/15/2017 1441 46,800 [5]

Dr. Ibrahim paid Ms. Edington a total of $1,200 during 2016 and a total of $48,800 during 2017. IV. *Notice of Deficiency* On May 10, 2019, IRS examiner Jill Bowden issued Letter 3541 to Dr. Ibrahim, informing him that the IRS was proposing to disallow the $50,000 alimony or separate maintenance deduction he claimed on his 2017 tax return. Mrs. Bowden's supervisor, Laura. L. Sherman, approved Mrs. Bowden's assertion of the accuracy-related penalty on May 8, 2019, in a case note stating : "Assertion of Substantial Understatement Penalty I.R.C. § 6662-(d) approved by manager per IRM 4.19.13.5.2, and IRM 20.1.5.8. CEAS non -action note has been input."

The IRS subsequently issued Dr. Ibrahim a Notice of Deficiency on February 10, 2020, in regard to his 2017 tax year. *Discussion* I. *Summary of the Parties' Arguments*Respondent argues that Dr. Ibrahim is not entitled to an alimony or separate maintenance deduction under section 215(a) for 2017 for three reasons. First, his payments do not qualify as deductible alimony or separate maintenance payments since a divorce or separation instrument did not designate the payments to be includible as income to Ms. Edington and deductible to Dr. Ibrahim and therefore do not satisfy the requirements of section 71(b)(1)(B). Second, since the payments do not qualify as deductible alimony or separate maintenance because the agreement, the amended agreement, and the judgment between the parties are silent as to whether the payments would terminate upon Ms. Edington's death, the requirements of section 71(b)(1)(D) are not satisfied. Third, a portion of the claimed alimony or separate maintenance deducted was paid in 2016 and is thus not deductible for 2017. Respondent also contends that Dr. Ibrahim is liable for an accuracy-related penalty under section 6662(a) and (b)(2).

In his brief Dr. Ibrahim contends, notwithstanding the terms of the agreement, the amended agreement, and the judgment, that the payments to Ms. Edington were in fact alimony or separate maintenance. Citing Missouri state law, Dr. Ibrahim contends that the Court can infer the payments were alimony or separate maintenance. He contends that Ms. Edington's qualification for maintenance under [6] Missouri state law was questionable, and therefore to avoid litigation, he agreed under the amended agreement to increase his payment obligation to Ms. Edington from $10,000 to $50,000. D r. Ibrahim also contends that the payments could not possibly be child support and were not an additional division of marital assets , and accordingly they default to alimony or separate maintenance. Finally, Dr. Ibrahim avers that under Missouri state law his obligation to make payments under the agreement, as amended, would cease upon the death or remarriage of Ms. Edington. II. *Law Governing Alimony or Separate Maintenance Deductions* As a general rule the Commissioner's determination of a taxpayer's liability in a notice of deficiency is presumed correct, and the taxpayer bears the burden of proving that the determination is incorrect.

Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 [12 AFTR 1456] (1933). Deductions are a matter of legislative grace, and the taxpayer bears the burden of proving entitlement to any deduction claimed. Rule 142(a); *INDOPCO, Inc. v. Commissioner* , 503 U.S. 79, 84 [69 AFTR 2d 92-694] (1992); *New Colonial Ice Co. v. Helvering* , 292 U.S. 435, 440 [13 AFTR 1180] (1934). Section 7491(a)(1) provides that the burden of proof may shift to the Commissioner when the taxpayer has introduced credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax. *See also* I.R.C. § 7491(a)(2). Section 7491(c) provides that the Commissioner shall have the burden of production with respect to any penalty asserted against an individual . *See Higbee v. Commissioner*, 116 T.C. 438, 446-47 (2001).

If a taxpayer pays alimony or separate maintenance as defined in section 71(b), then the taxpayer may deduct those payments from gross income if the amounts are includible in the gross income of the recipient under section 71. I.R.C. §§ 62(a)(10), 215(a) and (b). [3]

In pertinent part, section 71(b)(1) defines an "alimony or separate maintenance payment" as any payment in cash that satisfies each of the following four requirements: (A) the payment is received by (or on behalf of) a spouse under a divorce or separation instrument; (B) the divorce or [3] Congress repealed sections 62(a)(10), 71, and 215 for all divorce or separation agreements executed or modified after December 31, 2018. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 11051, 131 Stat. 2054, 2089. Both the agreement and the amended agreement dated September 17, 2016, and May 11, 2017, respectively, are unaffected by this repeal as they were executed before December 31, 2018 (and not modified thereafter). [7] separation instrument does not designate the payment as a payment that is not includible in gross income under this section and not allowable as a deduction under section 215; (C) in the case of an individually legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household when the payment is made; and (D) there is no liability to make the payment for any period after the death of the payee spouse, and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse. I.R.C. §§ 71(b), 215(b); *Okerson v. Commissioner*, 123 T.C. 258, 263-64 (2004). III. *Analysis* Dr. Ibrahim claimed an alimony or separate maintenance deduction of $50,000 for 2017, which the IRS disallowed. Respondent agrees that the payments Dr. Ibrahim made to Ms. Edington were made in cash and that they satisfy the requirements of section 71(b)(1)(A) and (C). Respondent avers, however, that the payments fail to meet the requirements of subparagraph (B) or (D) and therefore do not qualify for a deduction under section 215(a). Accordingly, our analysis will be limited to section 71(b)(1)(B) and (D). A. *Are the Requirements of Subparagraph (B) Met?* Section 71(b)(1)(B) requires that the divorce instrument "not designate such payment as a payment which is not includible in gross income under this section and not allowed as a deduction under section 215." While it is not necessary for the divorce instrument to use the exact statutory text of sections 71 and

215, the requirements of subparagraph (B) will generally be met if there is no "clear, explicit and express direction" in the divorce decree stating that the payment is not to be treated as an alimony or separate maintenance payment. *Proctor v. Commissioner*, 129 T.C. 92, 96 (2007) (quoting *Estate of Goldman v. Commissioner* , 112 T.C. 317, 323 (1999), *aff'd without published opinion sub nom. Schutter v. Commissioner*, 242 F.3d 390 [86 AFTR 2d 2000-7292] (10th Cir. 2000)). We have previously held that payments made pursuant to a divorce or separation instrument do not meet the requirements of subparagraph (B) where the instrument "provides clear, explicit, and express direction that neither party shall receive alimony or a separate maintenance payment." *Shelton v. Commissioner*, T.C. Memo. 2011-266 [2011 RIA TC Memo ¶2011-266], 2011 Tax Ct. Memo LEXIS 260, at *3. [8]

Here, the agreement, the amended agreement, and the judgment each contain statements indicating that neither Dr. Ibrahim nor Ms. Edington would pay maintenance 4 to the other. We find these statements provide "clear, explicit and express direction" that neither party shall receive maintenance payments from the other. [5] Accordingly, Dr. Ibrahim's 2017 payments do not satisfy the section 71 (b)(1)(B) requirements, and thus, he is not entitled to an alimony or separate maintenance payment deduction pursuant to section 215. *See id.* at *3-4.

B. *Are the Requirements of Subparagraph (D) Met?* Having already determined that Dr. Ibrahim fails to meet the requirements of section 71(b)(1)(B) and is not entitled to an alimony or separate maintenance deduction, we need not determine whether the requirements of section 71(b)(1)(D) are met. However, we will briefly address the issue herein since it was briefed by the parties.

Pursuant to section 71(b)(1)(D), for an alimony or separate maintenance payment to be deductible there must be no liability for the payor to make such payments, or for the payor to make substitute payments, after the death of the payee spouse. To determine whether a payor has liability to continue payments after the payee's death, we apply the following sequential approach: (1) the Court first looks for an unambiguous termination provision in the applicable divorce instrument; (2) if there is no unambiguous termination provision, then the Court looks to whether payments would terminate at the payee's death by operation of state law; and (3) if state law is ambiguous as to the termination of payments upon the death of the payee, the Court will look solely to the divorce instrument to determine whether the payments would terminate at the payee's death. *Logue v. Commissioner*, T.C. Memo. 2017-234, at *8 [2017 RIA TC Memo ¶2017-234]-9; *see Hoover v. Commissioner*, 102 F.3d [4] In 1973 the Missouri General Assembly passed the Divorce Reform Act instituting no fault dissolution of marriage. Under the new law, Missouri courts no longer award "alimony" but instead award "maintenance." *See Cates v. Cates* , 819 S.W.2d 731, 734 (Mo. 1991). In the Court's mind, the two awards are synonymous for federal income tax purposes. [5] Regardless of the parties' understanding or intent, our task is to focus on the legal

effect of the agreement in determining whether the payments meet the criteria set out by Congress under section 71. Since section 71(b)(1)(B) requirements are not met, the payments are not considered alimony or separate main tenance for federal income tax purposes. *See Okerson* , 123 T.C. at 265; *see also Rosenthal v. Commissioner* , T.C. Memo. 1995-603 [1995 RIA TC Memo ¶95,603], at *2, 1995 WL 760398 [1995 RIA TC Memo ¶95,603]. [9] 842, 846 (6th Cir. 1996), *aff'g* T.C. Memo. 1995-183 [1995 RIA TC Memo ¶95,183]; *Okerson* , 123 T.C. at 264-65; *Stedman v. Commissioner*, T.C. Memo. 2008-239 [2008 RIA TC Memo ¶2008-239], 2008 Tax Ct. Memo LEXIS 234, at *4.

The parties agree that there is no express termination upon death provision in the agreement, the amended agreement, or the judgment. The parties further agree that relevant Missouri state law, *see* Mo. Rev. Stat. § 452.370(3) (2017), provides that "[u]nless otherwise agreed in writing or expressly provided in the judgment, the obligation to pay future statutory maintenance is terminated upon the death of either party or the remarriage of the party receiving maintenance." Courts have previously ruled that a taxpayer may rely upon state law to comply with section 71(b)(1)(D). *See Johanson v. Commissioner* , 541 F.3d 973, 976-77 [102 AFTR 2d 2008-6099] (9th Cir. 2008), *aff'g* T.C. Memo. 2006-105 [2006 RIA TC Memo ¶2006-105]; *Kean v. Commissioner*, 407 F.3d 186, 191 [95 AFTR 2d 2005-2299] (3d Cir. 2005), *aff'g* T.C. Memo. 2003- 163 [2003 RIA TC Memo ¶2003-163]. However, before Dr. Ibrahim can rely upon state law to meet the requirements of section 71(b)(1)(D), we must determine whether there is an "obligation to pay future statutory maintenance."

Dr. Ibrahim asserts that the payments qualify as statutory maintenance under Missouri state law because it was questionable whether Ms. Edington had sufficient property to provide for her reasonable needs and was unable to support herself through appropriate employment. Under Missouri state law, the Missouri state court can award maintenance only where the court finds that the receiving spouse "(1) [l]acks sufficient property, including marital property apportioned to him, to provide for his reasonable needs; and (2) [i]s unable to support himself through appropriate employment or is the custodian of a child whose condition or circumstances make it appropriate that the custodian not be required to seek employment outside the home." *See* Mo. Rev. Stat. § 452.335(1) (2017). [6]

We decline to accept Dr. Ibrahim's argument, since there was no finding by the Missouri state court that Ms. Edington was eligible for maintenance under Missouri state law. Rather, the evidence demonstrates that Ms. Edington was continuously employed as a nurse [6] Dr. Ibrahim contends that "at least ten [Missouri state law] factors" must be considered in determining the sufficiency of assets and whether a party qualifies for maintenance. Dr. Ibrahim is essentially contending the payments to Ms. Edington qualify as statutory maintenance under Missouri state law; therefore, since the agreement , the amended agreement, and the judgment are silent as to what happens upon Ms. Edington's death, he argues he can rely upon Missouri state law to satisfy

the requirements of section 71(b)(1)(D). [10] during and after their marriage. She was able to rent and later purchase a home during her separation from Dr. Ibrahim. Moreover, Dr. Ibrahim's trial testimony confirms that Ms. Edington was able to support herself financially during and after the divorce. Furthermore, under the express terms of the agreement, the amended agreement, and the judgment, neither party was responsible for maintenance of the other.

On the facts before us, we conclude that Dr. Ibrahim has failed to demonstrate that the payments of $50,000 were made because of an "obligation to pay future statutory maintenance." [7] *See* Mo. Rev. Stat. §§ 452.335(1), 452.370(3). Accordingly, we conclude that it is equally inappropriate for Dr. Ibrahim to rely upon Missouri state law to satisfy the requirement of section 71(b)(1)(D). IV. *Section 6662(a) Accuracy-Related Penalty* Section 6662(a) and (b)(2) imposes a penalty equal to 20% of any portion of an underpayment of tax required to be shown on a return that is attributable to a substantial understatement of income tax. An understatement is "substantial" if it exceeds the greater of 10% of the tax required to be shown on the return for the taxable year or $5,000. I.R.C. § 6662(d)(1)(A).

As indicated above, the Commissioner bears the burden of production with respect to an individual taxpayer's liability for any penalty. I.R.C. § 7491(c); *Higbee*, 116 T.C. at 446. In *Frost v. Commissioner*, 154 T.C. 23, 34 (2020), we held that the Commissioner's initial burden of production under section 7491(c) includes producing evidence of compliance with the procedural requirements of section 6751(b). After the Commissioner has satisfied this initial burden, the taxpayer must come forward with any contrary evidence. *See also* I.R.C. § 7491(c); *Graev v. Commissioner*, 149 T.C. 485, 492-93 (2017), *supplementing and overruling in part* 147 T.C. 460 (2016). Once the Commissioner meets his burden of production, the taxpayer bears the burden of proving that the Commissioner's determination is incorrect. *Higbee* , 116 T.C. at 446-47.

Section 6751(b)(1) provides that no penalty shall be assessed unless "the initial determination" of the assessment was "personally [7] The payments totaling $1,200 Dr. Ibrahim paid Ms. Edington during 2016 are not deductible in the 2017 tax year, the year in issue. *See* I.R.C. § 215(a). [11] approved (in writing) by the immediate supervisor of the individual making such determination." The initial determination to impose the penalty at issue was made by Mrs. Bowden on May 8, 2019. The 30-day letter issued to Dr. Ibrahim on May 10, 2019, constituted the first communication of the IRS's determination to assert the section 6662 penalty for the 2017 tax year. *See Clay v. Commissioner*, 152 T.C. 223, 249 (2019), *aff'd*, 990 F.3d 1296 [127 AFTR 2d 2021-1207] (11th Cir. 2021). Respondent's CEAS program records indicate that Mrs. Bowden's immediate supervisor approved, in writing, her assertion of the accuracy-related penalty for the 2017 tax year on May 8, 2019, before the issuance of the 30-day letter. We hold that evidence is sufficient to show that the IRS complied with the requirements of section 6751(b). *See Belanger v. Commissioner*, T.C. Memo. 2020-130, at *29 [2020 RIA TC Memo ¶2020-130]. A taxpayer

generally is not liable for an accuracy-related penalty if he or she shows that there was "reasonable cause" for the underpayment and that he or she acted in good faith. I.R.C. § 6664(c)(1). This determination is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Treas. Reg. § 1.6664 4(b)(1). In - making that determination, "the most important factor" is usually "the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." *Id.* The taxpayer bears the burden of showing that the underpayment was due to reasonable cause or that some other exception to the imposition of the penalty applies. *Higbee*, 116 T.C. at 446.

Respondent determined a section 6662(a) accuracy-related penalty of $3,157 for the 2017 tax year. Respondent contends that Dr. Ibrahim "did not act with reasonable cause or in good faith, by claiming a deduction for maintenance payments when the agreement, amended agreement, and judgment clearly stated that neither party in the divorce was entitled to receive maintenance from each other" and is liable for the accuracy-related penalty. We agree. The agreement, the amended agreement, and the judgment explicitly state that neither party was entitled to alimony or separate maintenance, yet Dr. Ibrahim claimed an alimony or separate maintenance deduction on his 2017 return. *SeeShelton* , 2011 Tax Ct. Memo LEXIS 260.

On brief Dr. Ibrahim argued that his $50,000 deduction for alimony or maintenance payments "does not constitute negligence" and "the proposed accuracy[-]related penalty should be eliminated because his substantial substantive authority requires the elimination of the tax understatement by virtue of [I.R.C. § 6662(d)(2)(B)]." To satisfy this substantial authority exception, a taxpayer must show that the weight [12] of the authorities supporting the tax return treatment of an item is substantial in relation to the weight of authorities supporting contrary treatment. *Antonides v. Commissioner*, 91 T.C. 686, 702 (1988), *aff'd*, 893 F.2d 656 [65 AFTR 2d 90-521] (4th Cir. 1990); Treas. Reg. § 1.6662-4(d)(3)(i). All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are considered in determining whether substantial authority exits. Treas Reg. § 1.6662-4(d)(3)(i).

Here, Dr. Ibrahim has failed to satisfy this standard. He has not identified the authorities in support of his position, nor has he provided any authorities supporting the contrary. *See Brown v. Commissioner*, T.C. Memo. 2013-275, at *50 [2013 RIA TC Memo ¶2013-275]-53. Accordingly, we will sustain respondent's section 6662(a) penalty determined against Dr. Ibrahim.

We have considered all of the parties' arguments, and to the extent they are not addressed herein, we find the arguments to be moot, irrelevant, or without merit.

To reflect the foregoing, *Decision will be entered for respondent* .

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Eric L. Tracy v. Commissioner, TC Summary Opinion 2011-88

ERIC LYNN TRACY, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent .

Case Information:

Reference(s): Code Sec. 6320;Code Sec. 6323

Code Sec(s):	
Docket:	Dkt. No. 8727-10S,
Date Issued:	07/12/2011.
Judge:	Opinion by Morrison *J*

Syllabus

Official Tax Court Syllabus

Counsel

Eric Lynn Tracy, pro se.

John D. Davis, for respondent.

MORRISON, *Judge*

PURSUANT TO INTERNAL REVENUE CODE SECTION 7463(b),THIS OPINION MAY NOT BE TREATED AS PRECEDENT FOR ANY OTHER CASE.

This case was heard pursuant to the provisions of section 7463 of the Internal Revenue Code in effect when the petition was filed. Pursuant to section 7463(b), the decision to be entered is not reviewable by any other court and this opinion shall not be treated as precedent for any other case. Unless otherwise indicated, all references to sections are to the Internal Revenue Code, and all references to Rules are to the **Tax Court** Rules of Practice and Procedure.

Pursuant to section 6320, Eric Lynn Tracy seeks our review of a determination concerning the filing of a notice of federal tax lien to collect his unpaid 2008 federal income-tax liability. As explained below, we decide that the determination by the IRS Appeals Office was not an abuse of discretion.

Background

On November 5, 2009, the IRS mailed a notice to Tracy that it had filed a notice of federal tax lien to secure Tracy's 2008 income-tax liability of $22,872.82. Tracy requested a collection-review hearing with the IRS Appeals Office. The request, dated November 14, 2009, stated:

> I am currently encarcerated in the Idaho Department of Corrections. I have no property, assets or income. I am completely dependant on the charity of family for support. I don't expect to get out till **2022**. When I do get out, I will be starting my life over completely. Please consider my extreme hardship [illegible] paid my taxes faithfully for many years—I am now begging for mercy. Thank you.

The hearing was assigned to a settlement officer, who conducted the hearing by correspondence. In a notice of determination dated March 10, 2010, the settlement officer determined that all requirements of applicable law and administrative procedure had been met. The settlement officer determined that because Tracy was in prison, his account with the IRS would be placed in "currently not collectible" status. [1] The settlement officer determined that the filing of the notice of federal tax lien balanced the need to efficiently collect tax with Tracy's concern that the collection action be no more intrusive than necessary. The settlement officer also determined that none of the conditions in section 6323(j) for withdrawing the filing of the notice of federal tax lien had been satisfied. [2] In his petition to the **Tax Court**, which he mailed on April 7, 2010, Tracy stated:

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A       On July 31, 2007 I was convicted by the State of
        Idaho for some very poor choices on my part, and
        sentenced for a period of 5 to 15 years in the
        Idaho Department of Corrections.
B       The very few assets, both monetary and non-
        monetary, that I had left after becoming divorced
        in 2006 have subsequently been paid to satisfy
        debts and pay legal fees, reposessed, or sold to
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pay debts--I literally have nothing left to my name of any worth that I know of.

C I have no income other than the paltry $.30/hr that the prison pays me as a braille transcriptionist. I am almost completely dependent upon the charity of family members for support.

D When I finally regain my freedom (earliest, late in 2012), I will be starting over from nothing--I will need every dime to survive and not be dependent upon government assistance.

E I believe these circumstances constitute extreme hardship.

At the time the petition was filed, Tracy was a resident of Idaho. The parties submitted this case without trial under Rule 122. The parties agreed to a stipulation, which the Court adopts. The record consists of (1) the facts that the parties have stipulated and (2) the documents that the parties have stipulated are admissible. The Court ordered the parties to file briefs. The IRS filed a brief; Tracy did not.

Discussion

Section 6321 imposes a lien in favor of the United States on all property and rights to property of a person liable for tax if there has been a demand for payment and the person has failed to pay. The lien arises at the time of assessment. Sec. 6322. For the federal tax lien to have priority over other liens or security interests, the IRS must file a notice of federal tax Sec. 6323(a); Behling v. Commissioner, 118 T.C. 572, 575 lien. (2002). The notice must normally be filed with the appropriate office of the state or local government subdivision in which the property is located. Sec. 6323(f)(1).

Section 6320(a) provides that the IRS must generally give the person against whom a federal tax lien is filed written notice of the notice's filing within five days after the date of its filing. Section 6320(b) provides the person with an opportunity for a hearing before the IRS Appeals Office. The hearing is conducted pursuant to subsections (c), (d) (other than paragraph (2)(B)), (e), and (g) of section 6330. Sec. 6320(c).

At the hearing, the taxpayer may raise any issues relevant to the unpaid tax including: (1) challenges to the appropriateness of the IRS's collection actions; and (2) offers of collection alternatives (e.g., an installment agreement, an offer-in-compromise, the posting of a bond, or the

substitution of other assets). Sec. 6330(c)(2)(A)(ii) and (iii). The Appeals Office must consider the following in making the determination:

(1) whether the requirements of any applicable law or administrative procedure were met; (2) the issues properly raised by the taxpayer; and (3) whether the proposed collection action balances the need for the efficient collection of taxes with the taxpayer's legitimate concern that the collection action be no more intrusive than necessary. Sec. 6330(c)(3).

A taxpayer may appeal the Appeals Office's determination to this Court within the 30-day period starting on the day after the date of the notice of determination. Secs. 6320(c), 6330(d)(1). In reviewing the IRS's determination, the Court applies an abuse-of-discretion standard when the underlying tax liability is not at issue. Sego v. Commissioner, 114 T.C. 604, 610 (2000).

The settlement officer assigned to Tracy's hearing considered the three items that were required by section 6330(c)(3) to be considered. First, the settlement officer determined that all requirements of applicable law and administrative procedure had been met. See sec. 6330(c)(3)(A). Second, the settlement officer considered the issues Tracy raised. See sec. 6330(c)(3)(B). Third, the settlement officer considered whether the collection action (i.e., the filing of the notice of federal tax lien) balanced the need for the efficient collection of taxes with Tracy's concern that the collection action be no more intrusive than necessary. See sec. 6330(c)(3)(C). Although the Court has jurisdiction to determine whether the settlement officer made an error in considering these items, see secs. 6320(c), 6330(d)(1), the Court looks to Tracy to identify these errors, see Rule 331(b)(4) (requiring petition to contain "clear and concise assignments of each and every error which the petitioner alleges to have been committed in the notice of determination"); Rule 151(e) (requiring briefs to state the nature of the controversy, issues to be decided, proposed findings of fact, points on which the party relies, points of law involved, and disputed questions of fact). Tracy does not identify any specific errors made by the settlement officer. He merely repeats (through his petition) the same material he presented to the settlement officer. The settlement officer has already considered this material. We are not required, without guidance from Tracy, to determine which of the various aspects of the settlement officer's determination is erroneous. We therefore sustain the determination.

To reflect the foregoing, *Decision will be entered for respondent.*

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[1] "Currently not collectible" status apparently means that the IRS will not attempt to collect the tax liability. The IRS can remove this status.

[2] Sec. 6323(j)(1) provides that the IRS may withdraw a filed notice of lien, and that the withdrawn notice shall be treated as if it had not been filed, if the IRS determines (1) the filing of such notice was premature or otherwise not in accordance with administrative procedures,

(2) the taxpayer has entered into an installment agreement, (3) the withdrawal of the notice will facilitate the collection of the tax liability, or (4) "with the consent of the taxpayer or the National Taxpayer Advocate, the withdrawal of such notice would be in the best interests of the taxpayer (as determined by the National Taxpayer Advocate) and the United States."

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