THE TAX ADVISER

Developments in Individual Taxation

INDIVIDUALS

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EXECUTIVE SUMMARY

- The IRS issued proposed regulations permitting deductions for certain local lodging expenses.
- In *Veriha*, the Tax Court held that the Sec. 469 self-rental rule applied to a taxpayer who owned three companies, a trucking company and two truck-leasing companies, and thus the income from the S corporation truck-leasing company should be recharacterized as nonpassive, while the losses from his LLC truck-leasing company should remain passive.
- In *Quality Stores, Inc.*, the Sixth Circuit held that severance payments paid to terminated employees as a direct result of a workforce reduction are not subject to FICA tax.
- In Rev. Rul. 2012-18, the IRS issued guidance about FICA taxes imposed on tips and the procedures for notice and demand for those taxes under Sec. 3121(q). Under Announcement 2012-50, the rules distinguishing between tips and service charges in the revenue ruling will not apply until Jan. 1, 2014.

This article covers recent developments in individual taxation. The items are arranged in Code section order.

Sec. 1: Tax Imposed

The First and Second Circuits found Section 3 of the Defense of Marriage Act (DOMA) unconstitutional.[1] The effect of Section 3 is to deny federal income tax benefits, such as filing joint income tax returns, to same-sex couples. The First Circuit stayed its mandate that Section 3 not apply pending a likely Supreme Court review. The Supreme Court has granted *certiorari* in the Second Circuit case and will hear arguments on March 27.

Sec. 24: Child Tax Credit

Children of a U.S. citizen and her Israeli spouse, who were born and living in Israel, did not qualify as dependents under Sec. 152(b)(3), which states a dependent must be a citizen or resident of the United States.[2] Therefore, the child care and child tax credits under Sec. 21 and Sec. 24 were denied. The taxpayer also claimed that the IRS's alternative argument that the credits were being denied because she did not file a joint return, as required by Sec. 21(e), was prohibited by Sec. 7522 because the notice of deficiency did not mention Sec. 21(e). The Tax Court noted Sec. 7522 does not require the IRS to identify all of the Code sections applicable to each tax adjustment.

Sec. 61: Gross Income Defined

In Notice 2012-12,[3] the IRS provides that mandatory restitution payments that victims receive from defendants under 18 U.S.C. Section 1593[4] are excluded from income.

Sec. 104: Compensation for Injuries or Sickness

In *Blackwood*,[5] the taxpayer was terminated from her job for accessing her son's medical records at the hospital where she worked. In the taxpayer's unlawful termination suit, she

indicated she suffered from a relapse of depression symptoms. The taxpayer received $100,000 and a Form 1099-MISC, *Miscellaneous Income*, reporting the payment, but the taxpayer did not report it on her tax return because she believed it was excludable under Sec. 104.

The Tax Court held for the IRS that the damages were not excludable under Sec. 104(a)(2) even though the underlying action was based on a tort or tort-type right. The taxpayer was unable to show she received damages for physical injuries. A letter from her doctor did not note any physical symptoms. The flush language of Sec. 104(a) also did not help the taxpayer's case because it states that "emotional distress shall not be treated as a physical injury or physical sickness." She was also unable to benefit from Sec. 104(a) because she did not show that she used any of the damages for medical care for emotional distress.

Sec. 107: Rental Value of Parsonages

The Supreme Court declined to hear the taxpayer's appeal in *Driscoll*.[6] This case involved how the word "a" in the Sec. 107 exclusion from gross income for the rental value of a parsonage should be interpreted when used in the phrase "a home." Does that mean one home or could it mean two homes? The Tax Court held for the taxpayer, noting that "a home" could have a plural meaning. On appeal, the Eleventh Circuit held for the IRS, noting that "home" has a singular meaning and that income exclusions should be construed narrowly.

Sec. 108: Income From Discharge of Indebtedness

In a case decided by the Tax Court, the taxpayers did not qualify to exclude income from discharged credit card debt under the exclusion for insolvency in Sec. 108(a)(1)(B) due to a lack of credible evidence presented regarding the fair market value (FMV) of their assets immediately before the discharge.[7] The evidence they submitted was insufficient to establish FMV for federal tax purposes because the documents (tax bills and loan documents) did not describe the property or explain the methodology used to determine the value, and their testimony regarding comparable sales was uncorroborated and was not based on contemporaneous sales.

Rev. Rul. 2012-14[8] amplifies Rev. Rul. 92-53[9] and explains how partners treat a partnership's discharged excess nonrecourse debt in measuring insolvency under Sec. 108(d)(3). To the extent discharged excess nonrecourse debt generates cancellation of debt (COD) income that is allocated under Sec. 704(b) and its regulations, each partner treats its part of the discharged excess nonrecourse debt related to the COD income as a liability in measuring insolvency under Sec. 108(d).

In Letter Ruling 201228023,[10] the IRS found that a parent corporation's bankruptcy plan was considered a liquidation plan for tax purposes. None of the debtors will recognize COD income with respect to any of the allowed claims until all distributions are made or if the bankruptcy plan ceases to be a liquidation plan.

Sec. 162: Trade or Business Expenses

After the IRS denied a taxpayer's deduction for moving expenses, the taxpayer agreed but then tried a uniquely different approach in Tax Court.[11] He tried to claim meals, lodging, and lease cancellation fees as business expenses related to his employment as a restaurant chef. The IRS and the court both agreed that he had changed his tax home when he moved himself and his family and therefore no deduction was allowed.

The IRS issued proposed regulations[12] that would allow a deduction under Sec. 162 for certain local lodging expenses incurred by employers or their employees. The deduction would be allowed under a facts-and-circumstances test. One factor considered in the test is whether the expense is incurred to satisfy a bona fide requirement imposed by the employer. In addition, the regulations contain a safe harbor allowing the deduction in the following circumstances: (1) The lodging is necessary for the person to fully participate or be available for a bona fide business function; (2) it does not exceed five calendar days or occur more frequently than once

a quarter; (3) the individual is an employee, and his or her employer requires him or her to remain at the function overnight; and (4) the lodging is not lavish or extravagant and provides no significant personal pleasure or benefit. A simplified version of these rules was already in effect under Notice 2007-47[13] (which was made obsolete by these regulations).

DeLima[14] could be used as a teaching tool for all the ways taxpayers can fail to substantiate their Schedule C, *Profit or Loss From Business*, trade or business expenses. The court went through a top 10 list of problems with the claimed expenses including:

- Failure to provide credible evidence on the relative amount of business vs. personal use of her vehicles;
- Failure to establish a business purpose for various expenses, including insurance costs, furniture rental, or lawn maintenance;
- Failure to provide receipts or other proof of equipment purchases and rentals;
- Admitting that her rented home and apartment were entirely mixed personal/business use; and
- Failure to meet the strict substantiation requirements of Sec. 274(d) for travel and entertainment or listed property expenses.

In addition, the taxpayer tried to claim that the IRS examination was barred by statute, even though she had signed a Form 872, *Consent to Extend the Time to Assess Tax*. This argument and her claim that she had signed the Form 872 under false pretenses were not raised until after the actual trial, and the court rejected them both.

Sec. 163: Interest

In *Abarca*,[15] the petitioner claimed mortgage interest expense deductions for various rental properties on Schedule E, *Supplemental Income and Loss*, some of which were purportedly owned in partnership with others. The petitioner was neither named as the borrower for any of the mortgages on these properties nor was he able to prove he was the properties' legal or equitable owner. In addition, it was unclear whether the properties had been contributed to the various partnerships. It was also apparent that the partnership form was not respected as the petitioner reported the properties as if he owned them individually. In addition, the petitioner was unable to prove that he personally paid all of the interest that he claimed. The petitioner was denied the deductions for any of the mortgage interest claimed on Schedule E for the subject properties.

The Tax Court held in *Chrush*[16] that the petitioner failed to substantiate payments of mortgage interest on Form 1098, *Mortgage Interest Statement*, and home mortgage interest not reported on Form 1098. The petitioner co-owned the house with a close friend, but the amount reported on the Form 1098 issued to them was far lower than the deduction the petitioner claimed on his tax return, and no bank statements, canceled checks, or other evidence was produced to substantiate that he paid the claimed interest that was not reported on the Form 1098. In addition, the petitioner was unable to prove that he, and not his co-borrower, paid the interest reported on the Form 1098.

Sec. 165: Losses

In Chief Counsel Advice (CCA) 201213022,[17] an indirect investment in a Ponzi scheme was found to constitute a theft loss under Sec. 165, even though the taxpayer had not invested directly with the organizer (perpetrator) of the Ponzi scheme. The IRS noted that the "[p]erpetrator intended to appropriate Taxpayers' property from Taxpayers."

In *Ambrose*,[18] the taxpayers suffered a loss due to a fire in their home. The damage was repaired by their insurance company, but the following month their home was destroyed by another fire. Insurance claims were filed, but a dispute arose over whether the damage was covered. The taxpayers amended their return to claim a casualty loss deduction, and the IRS denied the loss for failure to file an insurance claim under Sec. 165(h). Although the homeowners had filed a claim within four hours of the fire, they did not timely submit proof of

loss to the insurance company. The court held that the taxpayers were within the statute because they had filed a "claim." This case includes extensive background on the origin of the "file a claim" requirement of Sec. 165(h).

In Letter Ruling 201240007,[19] a taxpayer was charged with insurance fraud and settled a suit with the insurance company by making payments to the company. The taxpayer was also charged under state law and entered into a plea agreement that called for restitution payments. The IRS determined that both of the payments qualified as restitution, which is deductible under Sec. 165(c)(2), as long as the income had been included in the taxpayer's gross income in prior years and he received no contribution from any other party.

Sec. 170: Charitable, Etc., Contributions and Gifts

In *Bentley*,[20] a lawyer tried to deduct his charitable contributions on Schedule C rather than Schedule A, *Itemized Deductions*. At trial, he refused to testify regarding the claimed donations, instead choosing to "rest on the administrative file." Not surprisingly, the court concluded that the deductions were not an ordinary and necessary business expense. Since his itemized deductions, even with the additional charitable contributions allowed on Schedule A, were below the standard deduction, the assessed deficiency was upheld. Somewhat surprisingly, though, the court used its discretion to refuse to impose a sanction under Sec. 6673 (penalty imposed on a taxpayer who instituted a proceeding primarily for delay or whose position is frivolous or groundless), requested by the IRS.

An IRS tax compliance officer was found to have claimed dependency exemptions, medical expenses, and charitable contributions to which she was not entitled.[21] The court also imposed a civil fraud penalty against her. Among those whose testimony contradicted the taxpayer's claim to be unaware of the documentation and other requirements were her husband, her supervisor, and representatives of seven charities to which she had claimed she made contributions. Receipts were found to be "doctored" and her testimony to be inconsistent and implausible.

The adage to "read the instructions" was shown to be vital in *Mohamed*.[22] The court denied a charitable contribution of more than $18 million because the taxpayers failed to get an independent appraisal, attach the proper information to their Form 8283, *Noncash Charitable Contributions*, or obtain the proper documentation before their return was due. The taxpayers attempted to challenge the validity of the regulations as being arbitrary and capricious, and argued that they substantially complied with them. The court ruled against all their arguments. The final paragraph of the ruling is worth reading in its entirety:

> We recognize that this result is harsh—a complete denial of charitable deductions to a couple that did not overvalue, and may well have *undervalued*, their contributions—all reported on forms that even to the Court's eyes seemed likely to mislead someone who didn't read the instructions. But the problems of misvalued property are so great that Congress was quite specific about what the charitably inclined have to do to defend their deductions, and we cannot in a single sympathetic case undermine those rules.

Conservation easement cases continue to occupy a large amount of time at the Tax Court. In a number of these cases, the appraisers relied on an article written by Mark Primoli of the IRS, "Façade Easement Contributions," which indicated that the IRS generally recognized that donation of a façade easement resulted in a loss in value of 10% to 15%. The article has since been revised to omit that statement. In *Scheidelman*,[23] the Second Circuit overturned the Tax Court's rejection of an appraisal that relied on this article and another Tax Court case. (For more on façade easements, see Durant, "First Circuit Breathes New Life Into Façade Easement Deductions," on p. 154.)

The Tenth Circuit upheld the Tax Court's ruling in *Trout Ranch LLC*,[24] saying that the court had used proper discretion in incorporating post-valuation data into its analysis. The appeals panel noted that the Tax Court had been mindful of the risks involved and had given the greatest weight to sales that occurred within a year of granting the conservation easement.

Sec. 179: Election to Expense Certain Depreciable Business Assets

In CCA 201234024,[25] IRS Chief Counsel determined that costs associated with placing a vineyard in service, including prior-year capital expenditures, could be expensed under Sec. 179. In doing so, the IRS declared that Rev. Rul. 67-51[26] no longer applied to Sec. 179. The ruling hinged on the fact that "the definition of §179 property has significantly changed" under the 1986 version of the Code.

Sec. 183: Activities Not Engaged in for Profit

In *Parks*,[27] the Tax Court awarded a rare win to a taxpayer on the question of whether an activity was a trade or business or a hobby when the taxpayer had an extensive history of losses. The taxpayer was a teacher and athletic coach who did private track coaching, for which he had incurred losses, sometimes substantial, in every year from 2003 through 2010. The IRS audited his 2006 through 2008 returns, reclassified his activity as a hobby, and moved his expense deductions from Schedule C to Schedule A while limiting the deductions to the amount of his income. In analyzing the case, the Tax Court used its nine-factor analysis; while the two profit factors weighed against the taxpayer, five of the remaining seven factors were favorable (the other two were neutral). (It is worth noting that one of Parks's trainees was Ryan Bailey, who finished fifth in the 100 meters at the 2012 Summer Olympics.)

Sec. 212: Expenses for Production of Income

In a Tax Court case, the taxpayer invested cash equal to 25% of the total capital of the joint venture he had entered into with a Chinese food production plant.[28] After the plant had serious financial difficulties, the plant recapitalized under Chinese law, requiring additional payments of 200,000 yuan from the taxpayer, which the taxpayer's sister in China paid. On his jointly filed 2007 and 2008 federal income tax returns, the taxpayer attached Schedule C, *Profit or Loss From Business*, for the proprietorship and deducted a debt expense of $27,070.30 and $29,099.80 for 2007 and 2008, respectively. The IRS issued a notice of deficiency and disallowed the claimed debt expenses. The Tax Court upheld the deficiency, finding that the taxpayer did not make any of the debt repayments, but instead claimed that payments his sister made on his behalf should be attributed to him, despite the lack of evidence of an agreement to repay his sister.

Sec. 215: Alimony, Etc. Payments

In *Doolittle*, alimony deductions were disallowed for a husband for amounts that were paid to the wife by a qualified trust under a qualified domestic relations order.[29] In 2008, the petitioner, who had been paying monthly alimony for a number of years after his divorce, entered into a new agreement to pay his former wife $52,000 from a securities account within 30 days. Under the agreement, the qualified trust was obligated to make the payments, not the petitioner himself. On his 2008 Form 1040, *U.S. Individual Income Tax Return*, the petitioner claimed a deduction for alimony of $10,800, which was $900 of monthly payments that were required to be paid to his former wife in 2008. Under Sec. 215, the alimony deduction is allowed only to individuals, and "not allowed to an estate, trust, corporation, or any other person who may pay the alimony obligation of such obligor spouse." Because the petitioner's obligation was paid by a trust, the petitioner was not entitled to claim the alimony deduction.

Alimony deductions were disallowed for a husband even though there was an oral understanding between the husband and his former wife about the alimony payments.[30] The petitioner and his wife had informally separated in 2004 and filed for divorce in 2008. During this time, the petitioner had paid $2,605 per month to his former spouse and their child, which was not separated into spousal or child support payments. On Dec. 1, 2008, a judgment for the dissolution of the marriage provided that $1,400 per month would be paid for alimony to the former spouse, until either party died. Before that time, the parties had a mutual understanding, but because it was not in writing until Dec. 1, 2008, the earlier payments could not be deducted. The court stated that this seemed unjust because the parties had already reached an understanding of the amounts, and that the agreement had already been approved by a court, but Congress had always required a written document.

Sec. 262: Personal, Living, and Family Expenses

A Tax Court case provides a great example of the methods the IRS uses to audit tax returns with Schedule C.[31] The IRS used a combination of methods, including bank account analysis, to reconstruct income and examine the taxpayer's substantiation in the case of expenses. Tax Court Rule 142(a) states that deductions are a matter of legislative grace, and the taxpayer bears the burden of proving that he or she is entitled to any deduction or credit claimed. Additionally, the taxpayer must substantiate all expenses for which a deduction is claimed under Sec. 274(d) (travel expenses for meals and lodging while away from home). Under the *Cohan*[32] rule, estimates can be used for some expenses (although not for Sec. 274 expenses) if there is a basis for the estimation. In this case, however, several checks written to the owner of the company with notations in the memo section, such as "A/C Repair," were not otherwise substantiated and were therefore disallowed as personal expenses under Sec. 262.

Practice tip: With reports of increased Schedule C audits, this case provides a great example for explaining the audit process to a client.

In *Nolder*,[33] the taxpayer was an over-the-road truck driver who completed Form 2106, *Employee Business Expenses*, to deduct expenses he incurred while traveling. Several expenses were disallowed as personal under Sec. 262, including uniforms that were suitable for personal wear, ATM withdrawal fees, and identity theft insurance purchased due to concerns of identity theft while traveling to a town near Mexico (the driver frequently had to show identification). This case is also a good reminder to ask clients if a reimbursement plan for employee expenses is available to them. If a plan is available, employees cannot deduct the expenses even though they do not participate.

Sec. 269: Acquisition Made to Evade or Avoid Income Tax

The husband-and-wife owners of a group of McDonald's restaurants in Utah established two companies, an operating company and a management company, which they both owned equally.[34] The petitioners established a profit sharing plan for the benefit of the management company employees, which performed poorly. It was terminated by establishing an employee stock ownership plan (ESOP) in its place, which in turn owned 100% of the stock of the new management company, which elected to be an S corporation.

In 2002, the management company also created a nonqualified deferred compensation plan (NQDCP) for the benefit of senior officers and employees. The petitioners elected to participate in the NQDCP and deferred $3.066 million over three years. Since a large portion of the management company's profit consisted of the deferred compensation, the money was unavailable for distribution to the ESOP. Even though the management company was profitable, the ESOP, which was the sole shareholder, was not taxed on this income. Due to the large amount of money the management company committed to pay the NQDCP, the stock of the management company had little value. This negatively affected the value of the rank-and-file employees' beneficial interest in the ESOP.

In July 2004, the petitioners made the following decision because regulations under Sec. 409(p) would cause them to include all of the deferred compensation in their income: sell the management company stock to petitioners for FMV and have the management company pay to petitioners the $3.066 million deferred compensation and terminate the ESOP.

By creating two short years for the management company, the management company generated a loss of $2.969 million, mostly for distribution of the NQDCP. The petitioners recognized $3.066 million in ordinary income from the NQDCP and offset the income with the loss.

The IRS argued that the loss generated was prohibited by Sec. 269 as a transaction to avoid or evade income tax. The court, siding with the petitioners, said, "Petitioners were entitled to arrange their affairs so as to minimize their tax liability by means which the law permits."

Sec. 280E: Illegal Sale of Drugs

A taxpayer was not allowed a deduction for cost of goods sold in connection with his medical marijuana business.[35] The taxpayer argued that he was not trafficking in an illegal substance and was operating a caregiving business to indigent individuals in need of medical marijuana. The Tax Court held that the operation of his business still fell under Sec. 280E and, therefore, disallowed the deduction.

Sec. 469: Passive Activity Losses and Credits Limited

In *Veriha*,[36] the petitioner owned three companies: a trucking company (C corporation) and two equipment leasing companies (one operated as an S corporation and the other as a single-member limited liability company (LLC)). The sole customer of the two leasing companies was the petitioner's trucking company. The petitioner's leasing companies had separate lease agreements with the trucking company for each piece of equipment leased from the respective company. For the year in question, one of the leasing companies realized overall net income, while the other company realized a net loss. The petitioner claimed that both the income and losses came from a passive activity and that all the tractors and trailers he owned as a whole should be considered a single "item of property." The court disagreed and stated that each tractor and trailer was an "item of property" of its own under Regs. Sec. 1.469-2(f)(6), which requires income from an item of property rented for use in a nonpassive activity to be treated as not from a passive activity. Therefore, the net income the S corporation generated was recharacterized as nonpassive income, and the net loss from the LLC leasing company continued to be characterized as passive (under the self-rental rule). The IRS did not object to the petitioner's netting the profitable leases with the unprofitable leases within the same company to determine the company's overall net income or loss from leasing activities.

In *Chambers*,[37] the Tax Court held that the petitioner was not a qualified real estate professional and therefore disallowed his losses from rental real estate. In addition, because his adjusted gross income for each year exceeded $150,000, the petitioner was not entitled to deduct $25,000 of losses from rental real estate activities under Sec. 469(i). The court did not uphold accuracy-related penalties because the petitioner had reasonable cause to believe he was a qualified real estate professional. The petitioner and spouse, who both worked full time in civilian positions for the U.S. Navy, owned one rental property directly. In addition, the petitioner owned 33% of an LLC that held four rental properties. Although the petitioner was unable to substantiate that he performed more than one-half of his personal services in real property trades or businesses in which he materially participated as required under Sec. 469(c)(7)(B)(i), his belief that he satisfied these requirements was reasonable.

Sec. 1001: Determination of Amount and Recognition of Gain or Loss

The Sixth Circuit affirmed the Tax Court's decision that a shareholder's transfer of floating rate notes to Optech Limited in exchange for a nonrecourse loan equal to 90% of the loan's FMV was a sale and not a loan because the taxpayer transferred the burdens and benefits of owning the notes.[38] The taxpayer sold over $1 million of low-basis stock in his company to an ESOP and then used the proceeds to purchase floating-rate notes in the face amount of $1 million. He then transferred the notes to Optech in exchange for a payment of 90% of the value of the notes. The loan agreement gave Optech the right to receive dividends and interest on the notes. The court held that the transaction was similar to an option in which the taxpayer retained the right to sell the notes, to transfer the registration in his own name, and to keep all interest. The court also found that the taxpayer was not personally liable on the note because the loan was nonrecourse.

The IRS issued a letter ruling in which it concluded that a conveyance of a perpetual conservation easement in exchange for mitigation credits is a sale or exchange of property under Sec. 1001.[39]

Sec. 1031: Like-Kind Exchange

The IRS chief counsel concluded that federal income tax law, not state law, controls whether exchanged properties are of a like kind for Sec. 1031 purposes.[40]

The Tax Court found that a taxpayer failed to establish that he acquired like-kind property in exchange for three residential properties because the taxpayer's evidence was incomplete.[41]

Sec. 1033: Involuntary Conversions

In Notice 2012-62,[42] the IRS provided a one-year extension of the four-year replacement period for certain livestock under Sec. 1033(e) to certain counties that experienced droughts.

Letter Ruling 201240006[43] involved the involuntary conversion of a taxpayer's principal residence in a presidentially declared disaster. The taxpayer did not report the gain on his return. The IRS noted that under Regs. Sec. 1.1033(a)-2(c)(2), the taxpayer is treated as having elected to defer gain from the conversion because he did not report the gain on the return for the year in which the insurance proceeds were received. The IRS ruled that the taxpayer can file original and amended returns during the replacement period to notify the IRS of the acquisition of replacement property.

Sec. 1221: Capital Asset Defined

The Tax Court rejected the taxpayers' claim that a residential property be allowed ordinary loss treatment because the property was not held for sale to customers in the ordinary course of their trade or business.[44] The court found that the taxpayers did not intend to occupy the property as their personal residence, but the property was never converted from residential to nonresidential property. Because the taxpayers' real estate sales lacked frequency, the court found the loss to be a capital loss.

In another case, the court found that income from the sales of real estate lots was ordinary income instead of capital gain as the taxpayers claimed.[45] The court found that the taxpayers' actions were conducted in the ordinary course of a trade or business and not for investment purposes, even though one of the taxpayers was a day trader. The court found that the frequency, continuity, and substantiality of the sales of the lots were significant in comparison to the day-trader activities.

The Ninth Circuit affirmed a District Court's decision that a *qui tam* award is ordinary income and not capital gain.[46] A *qui tam* award is allowed under the False Claims Act,[47] which permits an individual to bring suit against a defendant that the individual knows has submitted a false claim to the United States. The Ninth Circuit found that the award did not qualify as a capital asset because the taxpayer did not invest capital in return for the right and there was no accretion in value over cost to any underlying asset.

Secs. 1401 and 1402: Tax on Self-Employment Income

Compensation earned from performance of services as an employee is not self-employment income,[48] but compensation earned by a U.S. citizen employed by a foreign government in the United States is an exception to this general rule. In *Weaver*,[49] the taxpayer worked for the Consulate General of Canada in San Francisco. The court held that a payment to the taxpayer after a period of disability was severance pay subject to self-employment tax. The petitioner had reported the payment as "other income" not subject to self-employment tax that was paid on account of disability and therefore did not constitute wages. The consulate had characterized the payment as severance and calculated the payment based on the petitioner's length of service and salary. The court agreed with the IRS that the payment was subject to self-employment tax since severance pay is a form of compensation for services.[50]

In another case, the taxpayer was an employee of the International Monetary Fund (IMF).[51] U.S. citizen employees of the IMF are subject to self-employment tax on that compensation as no payroll taxes are withheld. The taxpayer did not self-assess the self-employment taxes, but the court relieved the taxpayer of the penalties: The accuracy-related penalty does not apply to any portion of an underpayment if there was reasonable cause for, and the taxpayer acted in good faith with respect to, that portion of the underpayment.[52] (This is reminiscent of Treasury Secretary Timothy Geithner who worked at the IMF and was not subject to penalties when he mistakenly did not pay self-employment taxes.)

In an IRS Information Letter,[53] the IRS responded to a taxpayer's question about its position on whether self-employment tax applies to rental payments for farmland by explaining that, although rental payments are normally exempt from the tax, rentals of farmland for agricultural purposes where the farmer materially participates are not exempt. Several years ago, the Eighth Circuit had issued a decision[54] holding that these payments were not subject to the tax, but the IRS issued a nonacquiescence to that decision.[55] In the information letter, the IRS reiterated its intent to continue to litigate the issue in cases outside the Eighth Circuit and explained that its interpretation of the exception in Sec. 1402(a)(1) best promotes Congress's intent that farmers who work for a living have their incomes replaced through coverage under the Social Security system.

The Tax Court held that a trustee should be treated the same as a director and a director is not an employee: The trustee is self-employed and therefore liable for his or her own Social Security and Medicare taxes.[56]

Sec. 3101: Employment Taxes on Employees

The Sixth Circuit ruled in *Quality Stores, Inc.*[57] that severance payments paid to terminated employees as a direct result of a workforce reduction are not subject to FICA tax. In an article discussing the *Quality Stores* decision, Laura Saunders in her *Wall Street Journal* Tax Report of Oct. 27, 2012, suggests: "If the company didn't file a refund claim for FICA taxes but the employee believes she is entitled to one, then often she can file IRS Form 843 [*Claim for Refund and Request for Abatement*] to make her own claim, according to an IRS spokesman. But the worker must make the claim during the statute of limitations period, which is usually three years after the April 15 due date following the year the severance was received."[58] The Sixth Circuit's decision conflicts with the Federal Circuit's 2008 decision in *CSX Corp.*[59]

A U.S. district court held that money an individual received to settle an age discrimination lawsuit constituted wages subject to FICA tax withholding because the individual failed to prove otherwise.[60]

The Tax Court, sustaining penalties and additions to tax, held that a company was liable for employment taxes on wages paid to masons and laborers the company argued were independent contractors, finding that the requirements for relief under Section 530 of the Revenue Act of 1978[61] were not satisfied because the company did not file Forms 1099-MISC treating the laborers as independent contractors.[62] In addition, the court concluded that the masons and laborers were the company's employees, basing its decision on common law principles.[63]

Sec. 3121: Employment Taxes

In Rev. Rul. 2012-18,[64] the IRS issued guidance updating guidelines regarding FICA taxes imposed on tips and the procedures for notice and demand for those taxes under Sec. 3121(q) when employees failed to report or underreported tips to the employer. (The guidelines, in question-and-answer format, modify and supersede guidance originally published in January 1995.[65]) The new guidelines were supposed to be effective immediately when they were issued, but because the tip vs. service charge rules may require businesses to change their automated or manual reporting systems to comply, the IRS announced that its examiners were being instructed, in limited circumstances, to apply the rules prospectively to amounts paid on or after Jan. 1, 2013.[66] These deadlines were delayed further, so they will now apply to amounts paid on or after Jan. 1, 2014.[67]

Sec. 6013: Joint Returns of Income Tax by Husband and Wife

A district court denied a taxpayer's duress defense to joint and several liability for a joint return she claimed she signed while medicated and her husband "threatened to tear apart the family."[68] The denial was based on discovery that showed the spouses remained married while living apart for 12 years before filing the joint return. Therefore, although the court believed the wife's claims that she had been subjected to emotional abuse through most of her marriage, by the time she signed the return at issue, she was no longer under duress. The wife also

admitted she had signed the return believing the husband would pay the income tax liability.

Sec. 6015: Relief From Joint and Several Liability on Joint Return

The Tax Court denied a retired engineer relief under Secs. 6015(b), (c), and (f). The taxpayer claimed that the taxable IRA withdrawals he made should not be taxable to him because he made them to comply with a Colorado court's order to pay spousal and child support.[69] He also claimed that the capital gain on stock he sold to pay his ex-wife should be attributed to his ex-wife. The taxpayer's most interesting claim was that, because he faced jail time if he did not make the court-ordered payments, he was a victim of abuse, which he claimed made him eligible for innocent spouse relief. The court did provide relief for the delinquency caused by the ex-wife's unreported interest income of $37.

Sec. 6673: Sanctions and Costs Awarded by Courts

In the Ninth Circuit, a taxpayer was found liable for tax and penalties under Secs. 6651(a)(1) and (2) and 6654 for the 2006 tax year and sanctioned for making frivolous arguments under Sec. 6673, affirming a Tax Court bench decision.[70] The taxpayer, an employee of SkyWest Airlines Inc. (SkyWest) for 2006, earned $78,758 in wage income reported on Form W-2, *Wage and Tax Statement*, from the airline. Additionally, the taxpayer realized capital gain income of $29,079, as reported on a Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*. Nonetheless, for that year, the taxpayer filed a tax return reporting zero wages and no capital gains, arguing that he was entitled to exclude his income under Sec. 83. The taxpayer claimed that he had basis in his labor, which he traded to SkyWest for compensation of an equal value. As a result, the taxpayer asserted that under Sec. 83(a), "the value of his labor is excluded from gross income." Additionally, the taxpayer argued that his wage income did not qualify as wages under Sec. 3401(a) and Sec. 3401(b) and that he was not an employee under Sec. 3401(c).

The Tax Court found that the taxpayer's arguments were the result of a misguided reading of the Code and that the taxpayer constructed arguments based on portions of the Code and regulations that did not apply to him. Based upon these actions, the court upheld the assessment of tax and penalties under Secs. 6651 and 6654 and imposed sanctions for making a frivolous argument under Sec. 6673. The taxpayer's "actions reflect an appalling lack of competent research and analysis and suggest that he was motivated by goals that are simply not consistent with a good-faith attempt to comply with the obligations imposed on taxpayers by the federal tax system."

Sec. 6702: Frivolous Tax Submissions

In October 2012, a district court upheld the IRS's attempt to collect unpaid federal income taxes and penalties against an individual for late filing, failure to pay, and failure to pay estimated tax penalties under Sec. 6702.[71] Before tax year 2000, the taxpayer filed tax returns and paid tax. In 2000, the taxpayer began filing "zero" tax returns and failed to report complete and accurate information until 2009. Additionally, he requested a refund for the 1999 tax year, claiming that the taxes he paid were illegal.

When the taxpayer did not receive a refund and instead was assessed a frivolous return penalty, he met with an IRS settlement officer and said he would pay in full if the officer could produce the Code section that required him to pay the tax. The taxpayer believed that he had no duty to pay and requested that his employer not withhold any tax for the years in question. In 2009, he began reporting income and expenses properly. The court found that the "zero" returns filed for the years at issue were frivolous and proved that the taxpayer did not make honest and reasonable attempts to comply with the law or exercise ordinary business care and prudence in filing his tax returns and paying the tax.

Footnotes

[1] *Massachusetts v. United States Dep't of Health and Human Servs.*, 698 F. Supp. 2d 234 (1st

Cir. 2012); *Windsor*, No. 12-2335-cv(L) (2d Cir. 10/18/12), *cert*. granted, Sup. Ct. Dkt. 12-307 (U.S. 12/7/12).

[2] *Carlebach*, 139 T.C. No. 1 (2012).

[3] Notice 2012-12, 2012-6 I.R.B. 365.

[4] Added by Section 112(a) of Victims of Trafficking and Violence Protection Act of 2000, P.L. 106-386.

[5] *Blackwood*, T.C. Memo. 2012-190.

[6] *Driscoll*, 669 F.3d 1309 (11th Cir.), *cert*. denied, Sup. Ct. Dkt. 12-153 (U.S. 10/1/12).

[7] *Shepherd*, T.C. Memo. 2012-212.

[8] Rev. Rul. 2012-14, 2012-24 I.R.B. 1012.

[9] Rev. Rul. 92-53, 1992-2 C.B. 48.

[10] IRS Letter Ruling 201228023 (7/13/12).

[11] *Newell*, T.C. Summ. 2012-57.

[12] REG-137589-07.

[13] Notice 2007-47, 2007-1 C.B. 1393.

[14] *DeLima*, T.C. Memo. 2012-291.

[15] *Abarca*, T.C. Memo. 2012-245.

[16] *Chrush*, T.C. Memo. 2012-299.

[17] CCA 201213022 (3/30/12).

[18] *Ambrose*, No. 11-64T (Fed Cl. 8/3/12).

[19] IRS Letter Ruling 201240007 (10/5/12).

[20] *Bentley*, T.C. Memo. 2012-294.

[21] *Quinn*, T.C. Memo. 2012-178.

[22] *Mohamed*, T.C. Memo. 2012-152.

[23] *Scheidelman*, 682 F.3d 189 (2d Cir. 2012).

[24] *Trout Ranch LLC*, No. 11-9006 (10th Cir. 8/16/12).

[25] CCA 201234024 (8/24/12).

[26] Rev. Rul. 67-51, 1967-1 C.B. 68.

[27] *Parks*, T.C. Summ. 2012-105.

[28] *Cheng*, T.C. Summ. 2012-102.

[29] *Doolittle*, T.C. Summ. 2012-103.

[30] *Larievy*, T.C. Memo. 2012-247.

[31] *Onyekwena*, T.C. Summ. 2012-37.

[32] *Cohan*, 39 F.2d 540 (2d Cir. 1930).

[33] *Nolder*, T.C. Summ. 2012-50.

[34] *Love*, T.C. Memo. 2012-166.

[35] *Olive*, 139 T.C. No. 2.

[36] *Veriha*, T.C. Memo. 2012-139.

[37] *Chambers*, T.C. Summ. 2012-91.

[38] *Sollberger*, No. 11-71883 (9th Cir. 8/16/12).

[39] IRS Letter Ruling 201222004 (6/1/12).

[40] CCA 201238027 (9/21/12).

[41] *Zurn*, T.C. Memo. 2012-132.

[42] Notice 2012-62, 2012-42 I.R.B. 489.

[43] IRS Letter Ruling 201240006 (10/5/12).

[44] *Bennett*, T.C. Memo. 2012-193.

[45] *Flood*, T.C. Memo. 2012-243.

[46] *Alderson*, No. 10-56007 (9th Cir. 7/18/12).

[47] False Claims Act, 31 U.S.C. §§3729–3733.

[48] Secs. 1402(a) and (c)(2).

[49] *Weaver*, T.C. Summ. 2012-52.

[50] Regs. Sec. 1.61-2(a)(1).

[51] *Chien*, T.C. Memo. 2012-277.

[52] Sec. 6664(c)(1). In determining whether the taxpayer acted with reasonable cause and in good faith, the guidance in Regs. Sec. 1.6664-4(b)(1) is applicable.

[53] IRS Information Letter 2012-0035 (6/29/12).

[54] *McNamara*, 236 F.3d 410 (8th Cir. 2000).

[55] AOD-2003-03 (10/22/03).

[56] *Blodgett*, T.C. Memo. 2012-298.

[57] *Quality Stores, Inc.*, No. 10-1563 (6th Cir. 9/7/12), reh'g denied (1/4/13).

[58] Saunders, "When Severance Pay Is Subject to Payroll Tax," *Wall Street Journal*, p. B9 (Oct. 27, 2012).

[59] *CSX Corp.*, 518 F.3d 1328 (Fed. Cir. 2008).

[60] *Gerstenbluth v. Credit Suisse Securities (USA) LLC*, No. 2:11-cv-02525 (JS) (GRB) (E.D.N.Y. 9/28/12).

[61] Revenue Act of 1978, P.L. 95-600.

[62] *Atlantic Coast Masonry Inc.*, T.C. Memo. 2012-23.

[63] Id at *13, citing Secs. 3121(d)(2) and 3306(i) and *Weber*, 103 T.C. 378 (1994), aff'd per curiam, 60 F.3d 1104 (4th Cir. 1995).

[64] Rev. Rul. 2012-18, 2012-26 I.R.B. 1032.

[65] Rev. Rul. 95-7, 1995-1 C.B. 185.

[66] Announcement 2012-25, 2012-26 I.R.B. 1032.

[67] Announcement 2012-50, 2012-52 I.R.B. 802.

[68] *Miles*, No. CV 10-2398 CW (N.D. Cal. 3/30/12).

[69] *Yosinski*, T.C. Memo. 2012-195.

[70] *Leyva*, No. 11-71648 (9th Cir. 9/21/12), aff'g No. 25427-09 (Tax Ct. 1/20/11) (order and decision).

[71] *Rodin*, U.S. District Court, No. 1:11 CV 1684 (N.D. Ohio 10/9/12).

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