THE TAX ADVISER

Individual Tax Report

INDIVIDUALS

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EXECUTIVE SUMMARY

- The American Taxpayer Relief Act of 2012 reestablishes a limitation on itemized deductions for high-income taxpayers beginning in 2013.
- Proposed regulations upon which taxpayers may rely provide guidance on the interplay of the Sec. 121 exclusion of gain from the sale or disposition of a principal residence with application of the new 3.8% surtax on net investment income.
- In Rev. Proc. 2013-16, the IRS provided guidance for exclusion from cancellation-of-debt income of mortgage assistance payments under the government's Home Affordable Modification Program.
- In a case involving investment losses, the Court of Federal Claims held that the meaning of "theft" for purposes of Sec. 165 should be defined by federal law, not state law.

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

Sec. 23: Adoption Expenses

In *Field*,[1] an adoption expense credit was denied to a taxpayer who filed her return using married-filing-separate status. The taxpayer claimed that the denial of the credit was unconstitutional. The Tax Court upheld the joint filing requirement for purposes of the adoption credit as valid under the Equal Protection Clause of the Constitution. It did not matter that the taxpayer had adopted the children before she married and her husband did not adopt them. Generally, if a taxpayer is married at the end of a tax year, the credit can only be claimed if the taxpayer and his or her spouse file a joint tax return.

Sec. 68: Overall Limitation on Itemized Deductions

The American Taxpayer Relief Act of 2012[2] restored a limitation on itemized deductions, but with new thresholds for when the limitation applies. For 2013, the adjusted gross income (AGI) thresholds are $250,000 for single filers, $300,000 for married couples filing jointly, and $275,000 for filers using the head-of-household status. These amounts will be adjusted for inflation in subsequent years.[3]

President Barack Obama's fiscal year 2014 budget proposal[4] includes an expansion of the limitation on itemized deductions for higher-income individuals. This proposal would cap the tax benefit of itemized deductions to 28% of their amount. This cap would also apply to other specified deductions (such as moving expenses), as well as certain exclusions (such as tax-exempt bond interest and employer-provided health insurance).

Sec. 104: Compensation for Injuries or Sickness

Scott[5] involved the question of how much of a firefighter's pension was taxable when his retirement was due to a service disability. The taxpayer was injured on the job when he had more than 36 years of service and was entitled to pension payments. His monthly retirement pension amount was $9,913, and his disability pension was $5,148. He was entitled to collect only the higher amount. In 2006, the payor of the pension reported to the taxpayer and IRS that the difference between these two amounts, $4,765 per month, was taxable (for the year, the reported taxable amount was $61,430). The taxpayer originally reported that amount on his return but then filed an amended return seeking a refund on the position that, because he retired due to a permanent service-connected disability, none of the pension income was taxable under Sec. 104 and Regs. Sec. 1.104-1(b).

The government relied on Rev. Rul. 80-44,[6] which holds that if a person is entitled to receive the greater of a service pension or a service-connected disability pension and the service pension is greater, the difference between the two amounts is taxable. The district court agreed with this interpretation.

The court found that the taxpayer's reliance on the Ninth Circuit's decision in *Picard*[7] was misplaced. In that case, a police officer's disability pay was reduced when he later qualified for retirement pay. In this case, the taxpayer's retirement pay was greater than his disability pay. Thus, the court held, there was no "conversion" of the disability pay into regular retirement pay. The court noted that the taxpayer "receives a portion of both pensions—at least for federal income tax purposes."

In *Smallwood*,[8] the taxpayer received $995,000 to settle her legal complaint alleging workplace race and gender discrimination and related claims. She paid tax on the award less the contingent fee paid to her attorney (almost 50%), but then sought a refund, claiming that the award was excludable under Sec. 104. At issue was whether the award was received for personal injuries.

The court noted that under Sec. 104(a)(2), damages received for emotional distress are excludable only if the distress is due to physical injury or physical sickness or to the extent the damages do not exceed medical costs attributable to the emotional distress. The court had to determine whether the payments to the taxpayer were intended to compensate her for physical injuries, noting that a settlement agreement is important in making this determination. If the agreement is not specific, a court next looks to the payor's intent.

In case pleadings, the taxpayer stated that she developed "Hashimoto's autoimmune disease" due to the stress, as well as a number of other ailments, including vertigo, vomiting, and low blood pressure, that required hospitalization and medication. Based on the evidence presented, the court found that whether any portion of the settlement payment was intended to be for physical injuries or physical sickness was a genuine issue of material fact. However, it held that she could not prevail, as a matter of law, because her complaint did not extensively concern physical injuries or sickness.

Sec. 108: Income From Discharge of Indebtedness

Under Secs. 108(a)(1)(E) and (h), discharge-of-indebtedness income from qualified principal residence debt of up to $2 million ($1 million for married taxpayers filing separately) is excluded from gross income. The American Taxpayer Relief Act of 2012 extended this exclusion to qualified principal residence debt discharged before Jan. 1, 2014.

In Rev. Proc. 2013-16,[9] the IRS provided guidance for homeowners participating in the Home Affordable Modification Program's Principal Reduction Alternative (HAMP PRA). To the extent that a borrower under HAMP PRA uses a property as his or her principal residence or the property is occupied by the borrower's legal dependent, parent, or grandparent without rent being charged or collected, the borrower can exclude from gross income under the general welfare exclusion the PRA payments HAMP makes to the investor in a mortgage loan. But the borrower must include these payments in gross income to the extent the property is used as a rental property or is vacant and available to rent.

Sec. 117: Qualified Scholarships

A series of IRS letter rulings[10] examined exempt private foundations' grant-making procedures for providing scholarships to dependent children of employees of a specified company or other eligible student recipients. The IRS found that the awards constituted qualified scholarships within the meaning of Sec. 117 and were excludable from the gross income of the recipients, subject to the limitations in Sec. 117(b).

Sec. 121: Exclusion of Gain From Sale of Principal Residence

The IRS issued proposed regulations (along with FAQs)[11] that include guidance on the interplay of the new 3.8% surtax on net investment income and gains imposed by Sec. 1411 and the exclusion of gain from the sale of a principal residence under Sec. 121 (up to $250,000 for a single taxpayer and $500,000 for married taxpayers filing jointly). Gain on a post-2012 sale of a principal residence in excess of the excluded amount increases net investment income for purposes of the 3.8% surtax and net capital gain under the general tax rules. This excess gain thus could be subject to the net investment income tax imposed by Sec. 1411. The entire gain on the sale of a home not covered by this exclusion (e.g., a second home) could be entirely includible in net investment income.

Sec. 152: Dependent Defined

In a Tax Court case,[12] the IRS challenged a dependency exemption, child tax credit, and an additional earned income tax credit that a taxpayer claimed for 2008 with respect to the infant son of his half-brother. The child lived with the taxpayer more than one-half of 2008, during which the taxpayer contributed $150 per month for food, diapers, clothing, and shoes for the child. The taxpayer's total income for the year was $9,559.

The court held that the taxpayer's nephew was not a qualifying relative of the taxpayer under Sec. 152(d), but the nephew was the taxpayer's qualifying child under Sec. 152(c). Therefore, the taxpayer was entitled to the dependency exemption deduction and the credits. A qualifying child is an individual who: (1) bears a specified relationship to the taxpayer, (2) shares the same abode for more than half the tax year, (3) meets the specific age requirement, and (4) does not provide over one-half of his or her own support. The court rejected the IRS's position that the child did not live with the taxpayer at least half the year because it was based only on an informal statement the taxpayer made to an unidentified IRS representative and was rebutted by the taxpayer's statements on multiple other occasions. The IRS also argued that the taxpayer was not the correct person to take the dependency exemption deduction under the Sec. 152(c)(4) tie-breaker rules, but the Tax Court found that the taxpayer was the only person who qualified to take the dependency exemption deduction, so the tie-breaker rules did not apply.

Practice tip: This case provides two key points in tax planning. First, the requirements for a qualifying relative versus a qualifying child are different. It is important to ask about the relationship of all household members before determining who may take an exemption. Second, proper documentation of financial support should be maintained in case a dependency issue ever comes into question.

In *Begay*,[13] the taxpayer was a tribal elder of the Navajo Nation and claimed a dependency exemption, head-of-household filing status, an earned income tax credit, and a child tax credit for a "clan relative," claiming the child as a "nephew" on her 2009 tax return, even though the child was not related to her in any of the ways specified for a qualifying child under Sec. 152(c)(2) or for a qualifying relative under Secs. 152(d)(2)(A) through (G). Originally, the IRS sent a notice of deficiency that disallowed the dependency exemption, but after review, the IRS conceded that the taxpayer did satisfy the requirements for the dependency exemption because the child was her qualifying relative as an unrelated household member under Sec. 152(d)(2)(H). The dependency exemption and head-of-household filing status therefore were allowed, but not the tax credits, which require a qualifying child.

The taxpayer claimed that denying qualifying child status for a clan relative violated her constitutional rights under the Free Exercise Clause of the First Amendment to the U.S. Constitution, but the Tax Court did not accept her arguments. With respect to her First Amendment claim, the taxpayer argued that Navajo culture and tradition obligate clan members to provide for children of other members as if they were their own and that the denial of qualifying child status due to the Sec. 152(c) relationship classification hindered the fulfillment of her religious obligations. However, the Tax Court found that the taxpayer had not shown that the denial placed a substantial burden on her in fulfilling that obligation. The court stated that the tax benefit from Sec. 152(c)(2) does not condition the receipt of the benefit on the taxpayer's fulfilling or not fulfilling her obligation to the clan relationships or the specific obligation to the child in question. Therefore, the taxpayer was not forced to choose between following the tenets of her religion and receiving a governmental benefit.

Sec. 162: Trade or Business Expenses

In *Guy*,[14] the IRS denied the taxpayer's deduction for a portion of legal fees incurred for challenging his reassignment from research to clinical pursuits by his university employer. The taxpayer claimed that the legal fees were legitimate business expenses, since his research led to the receipt of a profit-making patent. The court agreed. However, it allowed only a portion of the claimed expenses. The taxpayer deducted $17,600 in legal fees on his 2007 tax return (of which $17,500 was claimed at trial) but had paid $10,000 of that amount in 2006. As a cash-basis taxpayer, he therefore lost the portion of the claimed expenses above those paid in 2006 and was subject to a Sec. 6662(a) accuracy-related penalty as well.

In *Striefel*,[15] a taxpayer received notice from the IRS that his 2008 tax return had been selected for audit, specifically his expenses on Schedule C, *Profit or Loss From Business*, as an independent contractor providing field engineering services. Subsequent to that notice, but before the scheduled audit, he was diagnosed with a fatal medical condition and was told he would likely die shortly. Following his release from a hospital, the taxpayer destroyed all his business records. The court rejected his attempts to use secondary-source records to substantiate his claimed expenses (particularly travel, lodging, and meals and entertainment). In upholding an accuracy-related penalty, the court said, "Although petitioner was understandably upset at the time, his actions were not justifiable, reasonable, or prudent under the circumstances."

Sec. 163: Interest

In Letter Ruling 201316003,[16] the IRS granted an individual an extension of time to make an election on Form 4952, *Investment Interest Expense Deduction*, to treat qualified dividend income and net capital gains as investment income under Sec. 163(d)(4)(B).

The taxpayer, relying on his paid tax return preparer, failed to make a timely election to treat qualified dividend income and net capital gains as investment income. The tax preparer did not advise the taxpayer of the election's availability when preparing his return. In the subsequent year, when the taxpayer questioned the tax preparer about the interest expense carryover, the tax preparer discovered the availability of the election that had been missed in the prior year. He then advised the taxpayer to submit a ruling request to file a late election under Regs. Secs. 301.9100-1 and -3, which the IRS granted.

Sec. 165: Losses

Goeller[17] exhibits a significant change in thinking on how "theft" should be defined for Sec. 165 purposes. Over a nine-year period, husband and wife taxpayers invested about $900,000 in a business that bought and sold residential real estate and invested in mortgages and in tandem investments. The taxpayers received interest income and return of capital from the company over these years. In 2004, the taxpayers requested that the company return $260,000 to them, but it was experiencing financial troubles that escalated to bankruptcy. The taxpayers had an unsecured loss of $708,000, which they argued included a theft loss of approximately $407,000. This loss resulted in a net operating loss (NOL) in 2004 and a carryback. The IRS argued there was no NOL.

In determining whether there was a theft loss for Sec. 165 purposes, the Court of Federal Claims observed that both parties cited *Edwards v. Bromberg*[18] for the proposition that theft is to be determined based on state law. Thus, according to the parties, the issue was whether the appropriate state law should be that of Ohio, where the company was located and where the taxpayers lived when they first started investing in it, or California, where the taxpayers moved in 1998.

The court questioned why state law should control the application of Sec. 165. It noted that Regs. Sec. 1.165-8(d) provides that theft includes "larceny, embezzlement, and robbery." The court observed that other terms used in Sec. 165, such as "storm" and "shipwreck," were not defined by state law but by their ordinary meaning, saying:

> While the court is hesitant to replow a field that has been so extensively cultivated, it is obliged to do so, as none of the precedents adopting state law are binding here. Try as it might, the court cannot resist concluding that the idea that section 165(c)(3) somehow incorporates state criminal law into what is otherwise a federal taxing statute is a *non sequitur.* On close examination, the contrary view—that state law is controlling—appears to be a shibboleth that, by constant repetition, has become embedded in the jurisprudence of section 165. [footnote omitted][19]

The court further noted that "having the deductibility of a theft loss under section 165(c) turn on a specific state's criminal statutes runs counter to the interpretative rules generally applicable to the construction of federal taxing statutes."[20]

In addition, the court considered rules of statutory construction, including:

1. Words should be defined by their "ordinary, contemporary, common meaning."[21]
2. "[W]here Congress uses terms that have accumulated settled meaning under . . . the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms."[22]
3. Deductions are allowed only if "there is a clear provision therefor."[23]

Further, the court observed that, typically, state law is relevant under federal law only in defining property interests. The court found no reason to resort to state law to define theft and that "uniform administration of the federal revenue statutes" justifies use of a standard definition of the term. The court then referred to the definition from *Black's Law Dictionary*. "These well-accepted definitions of 'theft' make reference here to state law unnecessary," the court said, continuing with a lengthy discussion of case law to support not relying on state law to define theft.[24]

The court denied both the IRS's motion for summary judgment and the taxpayer's cross-motion for summary judgment, as more facts were needed to resolve the issues as reframed by the court. The court described an approach for ultimately resolving the issue of whether taxpayers are entitled to a theft loss under Sec. 165(c)(3), under which the court would need to answer four questions:

1. Did the business's conduct constitute a theft?
2. Was the theft loss, if any, discovered by the taxpayers in 2004?
3. In 2004, was there any reasonable prospect of recovering the funds lost?
4. What is the amount of the theft loss, if any?

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

A landfill operator tried to claim a charitable deduction for dirt it sold at a bargain price to the city of Tucson, Ariz., for use in closing another operator's noxious-smelling landfill.[25] Although the settlement agreement between the taxpayer and Tucson qualified as a contemporaneous written acknowledgment under Sec. 170(f)(8)(A), it failed to contain a good-faith estimate of the values of the goods and services received by the taxpayer. The court also accepted the IRS's challenge to the taxpayer's valuation of the provided dirt.

In *Estate of Harvey Evenchik*,[26] the Tax Court continued to make clear its lack of patience with sloppy, poorly prepared appraisals of donated property. In this case, the taxpayer donated approximately 72% of his shares in a corporation that owned two apartment buildings to a nonprofit housing corporation. However, the attached appraisal valued the apartment buildings themselves, not the capital stock donated. It also failed to account for the fact that only a partial interest was donated. The court noted that "the appraisals had gaping holes of required information" as well.

In *Villareale*,[27] the taxpayer was denied deduction of cash contributions that exceeded $250 each to a ferret rescue organization that she co-founded, served as president, and managed the finances for. The organization did not issue the required contemporaneous written acknowledgments for those contributions. The taxpayer acknowledged this failure but argued that it would have been "futile to issue herself a statement." She was allowed to deduct a series of donations of less than $250 each.

In *Minnick*,[28] the taxpayers' agreement for a donated conservation easement falsely stated there was no existing mortgage on the property donated and contained a provision allowing for amending the terms of the agreement. This cost the taxpayers more than $180,000 in additional tax plus a 20% accuracy-related penalty. However, the Tax Court refused the IRS's request to double the penalty to 40%. The taxpayers failed to have the bank execute a subordination agreement until nearly two years after the IRS issued the notice of deficiency and five years after the original donation was made. Their claim that the bank would have been willing to do so at any time was rejected by the court, since the taxpayers had been required to pay down a portion of the mortgage to obtain the bank's agreement. Besides, "intention and willingness are not what matters," stated the court.

In *Crimi*,[29] the Tax Court handed the taxpayers a rare victory in a case where the qualified appraisal and documentation requirements of Sec. 170(f)(11) and associated regulations were not precisely followed. In July 2004, the taxpayers transferred 65 acres of undeveloped land to Morris County, N.J., in exchange for $1,550,000. Based on a 2000 appraisal, the taxpayers claimed the land was valued at $2,950,000 and claimed a charitable contribution of $1,400,000. The IRS denied the deduction based on three arguments: First, it found that the contemporaneous written acknowledgment was faulty because it was not signed by a county official, incorrectly described the property, and did not state whether the donee provided any goods or services to the donors. The court disagreed, stating that the town official who signed acted as an agent for the county (as allowed under Rev. Rul. 2002-67[30]), that a small typographical error in the description did not prevent the IRS from identifying the exact parcel donated, and that the letter did state that a payment of $1,550,000 had been made to the donors in exchange for the property, precluding the need for any further "goods or services" language.

Second, the IRS claimed that the highest and best use of the land was conservation, with a maximum fair market value of $660,000, far below the consideration received by the taxpayer. The court, based on expert testimony (two experts each for the taxpayer and the IRS), concluded that the property's fair market value on the date of contribution was nearly $2,966,000.

Finally, the IRS argued that the appraisal from 2000 was not qualified because it failed to meet the requirements of Regs. Sec. 1.170A-13(c)(3). However, the taxpayers argued—and the court agreed—that they were entitled to reasonable-cause relief under Sec. 170(f)(11)(A)(ii)(II) because the taxpayers had reasonably and in good faith depended on the advice and opinion of their CPA of more than 24 years that the 2000 appraisal satisfied the requirement to attach a qualified appraisal to the return.

Sec. 183: Activities Not Engaged in for Profit

A horse-breeding case, *Dodds*,[31] illustrates several important considerations regarding the hobby loss limitation. The taxpayer owned a successful accounting firm, worked 70 to 80 hours a week during filing season, and earned a substantial six-figure income from his practice. He also started breeding horses in 1995. From then until 2003, he generated zero gross income from the horse-breeding activity and between 1995 and 2011 racked up cumulative net losses of nearly $1.5 million. The Tax Court's decision against him (which involved only 2007 and 2008) was based on the nine-factor analysis under Regs. Sec. 1.183-2(b) of whether an activity is engaged in for profit. Weighing against a profit motive were the taxpayer's unbusinesslike manner of carrying on the activity, his lack of success in similar activities, his history of losses, his lack of even occasional profits, and his financial status.

Interestingly, the court found the "elements of personal pleasure" factor neutral, despite its acceptance of his testimony that neither he nor his family ever rode the horses and that he spent more than 1,500 hours each year doing the "dirty work," such as mucking stalls, feeding the horses, and administering medicine. The court reasoned that to have poured all that money into the activity over the years, the taxpayer must have been getting some satisfaction from it.

The court's critique of the taxpayer's business practices in carrying on his horse breeding is worth noting. The court faulted the taxpayer for not maintaining a separate bank account for the activity, although he did maintain separate financial records for it. Also, the court stated that the taxpayer's lack of a business plan with "more than just generalized goals" showed a lack of effort to reduce his losses. This was despite the fact that, based on expert advice, he changed his mode of breeding in 2004 and that he developed and patented a device to cut down on feed waste. Key takeaways: Always open a separate business bank account and maintain an updated, specific business plan.

Sec. 212: Expenses for Production of Income

In *Heinbockel*,[32] married taxpayers were engaged in several lines of businesses that included the husband's one-airplane transport company and the couple's purported residential rental business and grape farming operations. The air transport company never became profitable due to a lack of sources of revenue. The taxpayers reported losses from this activity totaling about $210,000 for tax years 2005 through 2007 on Schedule C.

As for the purported residential rental activity, the wife gave her brother a loan to purchase and manage real property, for which he would pay her interest and/or rent. When the loan fell through, the couple reported the loss from the loan on a Schedule E, *Supplemental Income and Loss,* for 2005. Other deductions on Schedule E included legal fees related to the loan. Meanwhile, the grape farming venture was also entangled with lawsuits and did not generate any income, so the taxpayers reported net losses of about $49,000 for 2005, $13,000 for 2006, and $8,000 for 2007 on Schedule F, *Profit or Loss From Farming*.

The IRS issued notices of deficiency disallowing the losses from the three activities. The taxpayers challenged the IRS's determination in Tax Court. The Tax Court found that the taxpayers lacked a profit motive in the air transport activity, and they never got beyond the startup phase of grape farming; hence, they were unable to claim any losses or deductions for those activities. The court also found that the taxpayers did not conduct a lending business, because the taxpayers failed to show that they treated the wife's lending activities like a business. However, the court allowed the taxpayers to take a capital loss (subject to the Sec. 1211 $3,000 limitation) related to the activity and to deduct some of the legal fees as miscellaneous itemized deductions subject to the 2%-of-AGI floor.

Sec. 213: Medical, Dental, Etc., Expenses

In *Longino*,[33] the taxpayer claimed medical and dental expenses for 2006 that at trial he asserted totaled $11,949. He also claimed dependency exemptions for four children, three of whom did not reside with him and for whom he did not file Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*, or a substitute. He also claimed deductions for ordinary and necessary business expenses of his law practice, charitable contributions, and tuition and fees.

The taxpayer failed to provide substantiation for the deducted expenses. He was able to furnish evidence for $7,207 of the claimed medical and dental expenses. Included in that amount, however, was $4,421 for an in-vitro fertilization procedure for his former fiancée. Since she was an unrelated person and the taxpayer failed to prove that he had difficulty conceiving children, the court found that he was ineligible to claim the expense. The documentation submitted for the remaining $2,786 of claimed medical and dental expenses did not clearly indicate all were paid to health care service providers for qualifying medical care, so the court did not allow deductions for these expenses.

The court also disallowed the dependency exemptions for three children, most of the claimed business expenses, and all the claimed charitable contributions and tuition and fees deductions. In addition, the court held that the taxpayer was negligent in preparing his 2006 tax return, as he did not demonstrate reasonable care.

Sec. 215: Alimony, Etc., Payments

In *Schuller*,[34] the Tax Court disallowed the alimony deduction claimed by the taxpayer, a former member of the Air Force, for payments to his former spouse made by the Defense Finance and Accounting Service (DFAS).

The taxpayer and his wife divorced in 1994, but the taxpayer did not attend the county court hearing for the divorce settlement, and the county court consequently awarded 60% of his Air Force retirement pay to his former wife as her sole and separate property. In 1998, the DFAS began distributing 50% of the taxpayer's retirement to the taxpayer and the remaining 50% to the former spouse. In 2007 and 2008, both parties each received $15,384 and $15,738 in those respective years. The taxpayer then claimed $15,384 and $15,738 as alimony deductions on his 2007 and 2008 returns; however, the court disallowed these deductions.

Sec. 215(a) allows for a deduction of money paid for alimony if such payments meet the requirements of Sec. 71(b), including that they are made in cash. Transfers of property do not constitute cash paid for alimony purposes. The DFAS made payments directly to the taxpayer's former spouse, and these payments were not owed by DFAS to the taxpayer or otherwise includible in his income. Consequently, the court held that the taxpayer was not allowed to deduct the payments.

Sec. 280A: Business Use of Home

In *Langley*,[35] married taxpayers in 2008 bought a single-family home, intending to remodel and sell it. They were unable to sell the property due to the downturn in the housing market, so they moved the taxpayer's mother into the property. On their Schedule E they reported rental real estate expenses but did not report any rental income.

Under Secs. 280A(a), (b), and (d), a taxpayer cannot take deductions for expenses related to a dwelling unit that the taxpayer used as a residence. A taxpayer uses a dwelling unit as a residence if he or she uses it for "personal purposes" for more than the greater of 14 days or 10% of the number of days during the tax year that the unit is rented at a fair rental value. Personal use by the taxpayer includes uses by a member of the taxpayer's family, including a parent. The Tax Court held that the taxpayers had not used the property as a rental property rather than a personal residence. They did not have a lease on the property, and the rent they said they charged, $600 per month, was well below the fair rental value of between $800 and $1,100 per month. Therefore, the court disallowed the Schedule E deductions the taxpayers claimed for the property. The IRS did allow mortgage interest and taxes on the property as itemized deductions on Schedule A, *Itemized Deductions*.

Planning tip: A deduction for rental property expenses may be allowed in cases with a family member as a tenant if the taxpayer receives a fair market rent from the family member. Fair market rent can be established by rents charged for comparable rental properties.

Sec. 469: Passive Activity Losses and Credits Limited

In *Hudzik*,[36] the taxpayer claimed losses from rental real estate activities, asserting she qualified as a real estate professional. Her returns were self-prepared. She claimed she relied on the questions posed by TurboTax in concluding she qualified as a real estate professional. The Tax Court held that the taxpayer did not qualify as a real estate professional for the years in question, as she did not establish that she performed more than one-half of her personal services in real property trades or businesses. The court did not find the taxpayer's record of hours credible, considering that she had a full-time job in an unrelated occupation. The court therefore did not address whether she materially participated in the rental real estate activities either in total or individually.

Because the court held that the taxpayer was not a real estate professional, it disallowed her rental real estate losses to the extent that she did not qualify under the Sec. 469(i) exception allowing a maximum loss deduction of $25,000, subject to phaseout, for taxpayers that actively participate in rental real estate activities.

The Tax Court also held that the taxpayer was liable for accuracy-related penalties because she had not acted in good faith, primarily because her recordkeeping appeared to have inflated the hours spent in rental real estate activities.

In *Thomas*,[37] the IRS did not adjust a taxpayer's rental loss on its notice of deficiency to the taxpayer but at trial claimed that the taxpayer could not take the losses under Sec. 469. The taxpayer claimed that he was a real estate professional, so the losses were deductible. The Tax Court held that the taxpayer was a real estate professional because the IRS failed to prove otherwise. The Tax Court concurred with disallowing the deductions for some additional expenses related to the rental activities claimed on an amended return filed during the audit of the original return because the taxpayer failed to substantiate the additional expenses. Where the Tax Court found that adequate substantiation was provided, the deductions were allowed.

In *Hoskins*,[38] the Tax Court held that a couple did not materially participate in their rental real estate activities during 2006 and 2007 and therefore were not entitled to deduct losses exceeding the limitations imposed by Sec. 469. In addition, the Tax Court held that the taxpayers were not entitled to deductions for depreciation and other expenses related to certain real properties. Accuracy-related penalties were also upheld.

The taxpayers owned properties in Florida and Ohio that were used as residential rentals or vacation rentals for periods of less than seven days, held for investment, or not completed for occupancy. The taxpayers included in their 2006 return an election to treat all interests in rental properties as a single activity. However, it was determined and agreed that some of the properties that were included were not actually rental real estate but were held for investment. Others were under construction and unavailable for occupancy. Still others had average periods of customer use of seven days or less, which is not considered a rental activity under Temp. Regs. Sec. 1.469-1T(e)(3)(ii)(A).

The taxpayers did not present convincing evidence or contemporaneous records to show that they met any of the seven tests for material participation in Temp. Regs. Sec. 1.469-5T(a). Therefore, the court held that the taxpayers did not materially participate in their rental real estate activities. The court therefore did not need to decide whether one taxpayer's activities as a licensed real estate agent qualified as a real property trade or business under Secs. 469(c)(7)(B) and (C). With respect to the real estate activities not grouped with rental real estate, the court did not find any differently than the IRS did with respect to material participation, for the same reasons as for the rental real estate.

The court further disallowed deductions for depreciation related to properties that were not ready for customer use because they had not been placed into service. It also did not allow deductions for expenses related to one property of which the taxpayers did not have legal ownership.

In *Hassanipour*,[39] the Tax Court held that the taxpayer failed to prove he spent more time on rental real estate activities than on his full-time job as a research associate and therefore did not qualify as a real estate professional. His records of his time spent on rental real estate activities did not appear to be contemporaneous. The court did not look at whether the taxpayer materially participated in the rental property activities, since it had concluded he did not qualify as a real estate professional.

Thus, the Tax Court held that the taxpayer's losses from rental real estate were limited under Sec. 469. The Tax Court held the taxpayer was liable for accuracy-related penalties because he did not show good faith or reasonable cause in his tax reporting positions. The court noted that he did not keep reliable records and that although he purportedly spent many hours studying the law and preparing his returns, he did not consult a tax adviser to assist him with the rules of Sec. 469, whose complexity he claimed should excuse the penalty.

Sec. 1016: Adjustments to Basis

A U.S. district court found that the taxpayers (a foreign national couple) provided sufficient evidence to support their claim that their improved property's tax basis was higher than its purchase price.[40] The court accepted the couple's accountant's entries on an IRS *Adjusted Basis Worksheet* that their lawyer testified was prepared in reliance on contemporaneous documentation, in addition to building permits, settlement statements, and photographs of property improvements.

Sec. 1031: Exchange of Property Held for Productive Use or Investment

The Tax Court found that a couple's real property was not used in a trade or business or as an investment at the time of a Sec. 1031 like-kind exchange.[41] The couple could not provide sufficient evidence for their intent to turn their property into a bed and breakfast. The court also found that the taxpayers' use of the property as their personal residence four days after the sale closed showed a clear presumption of nonbusiness intent.

In another case,[42] the Tax Court found that an individual taxpayer's sale of his house qualified as a like-kind exchange in which the house sold had been rented to an unrelated party, and the house purchased was rented to the taxpayer's son. The Tax Court rejected the IRS's contention that the son's use of the residence did not qualify for nonrecognition treatment because it was used by the son's family for personal purposes and the taxpayer charged his son rent that was below market value. The Tax Court found that the rent paid was sufficient because the son also performed substantial home improvement work on the residence.

Sec. 1211: Limitation on Capital Losses

The Second Circuit affirmed the Tax Court's decision finding an individual taxpayer to be an investor in securities and not a trader, as the taxpayer's activities showed he intended to profit through capital appreciation and not short-term oscillations in stock prices.[43] The Second Circuit agreed with the Tax Court's opinion that the taxpayer did not trade with the "frequency, extent, and regularity" indicating an intent to realize short-term profits by catching "the swings in the daily market movements."[44] The Second Circuit also found that the low volume of the taxpayer's trades indicated that he was not in a trade or business. Therefore, the court held, his losses were capital rather than ordinary and were limited by Sec. 1211(b).

Sec. 1221: Capital Asset Defined

The Tax Court held that a loss realized from the taxpayer's abandonment of an option to purchase real property was ordinary and not capital.[45] The court found that the taxpayer purchased the option with the intent to subdivide and develop the property and that the taxpayer spent approximately 20 hours per week working on the property. The court concluded that the taxpayer would have held the property primarily for resale to customers in the ordinary course of his business and not as an investment.

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

In *Specks*,[46] the taxpayer, a Houston police officer, provided security services to third parties during his off-duty hours. He wore a Houston Police Department uniform and carried his personal firearm when performing the security services. The purchasers of his services did not train, supply, or equip him. The taxpayer reported income he received from providing security services as "other income" on his 2008 tax return. The issue decided by the Tax Court was whether the taxpayer was an employee or an independent contractor with respect to his security services.

The taxpayer contended that he was an employee of those for whom he provided security services and, thus, the amounts paid to him by the third parties were not subject to self-employment tax. The court weighed seven common law factors to determine that he was an independent contractor:

1. Which party possesses the right to control the details and means by which the work is performed;
2. Which party invests in the facilities used in the work;
3. The opportunity of the individual for profit and loss;
4. Whether the principal has the right to discharge the individual;
5. Whether the work is part of the principal's regular business;
6. The permanency of the relationship; and
7. The relationship the parties believe they are creating.[47]

After giving greater weight to the right-of-control factor, the court concluded that the taxpayer failed to meet his burden of proof to establish his status as an employee and sustained the IRS's determination of self-employment tax liability.

In *Howell*,[48] the Tax Court determined that payments to married taxpayers by a limited liability company (LLC) reported as guaranteed payments on the LLC's partnership return were remuneration subject to self-employment tax rather than, as the taxpayers contended, distributions of income to a limited partner. The taxpayers formed the California LLC as a medical technology company that provided software and hardware to hospitals.

The wife was the record owner of a 60% capital interest in the LLC, and an unrelated individual owned 40%. The wife could dissolve the company at any time and could appoint its manager. She was entitled to receive an allocation of net profits or losses in proportion to her capital interest. During the years at issue, the company's principal place of business was the couple's residence. The wife signed company documents and discussed marketing strategies, and her personal credit card was used to make purchases on its behalf.

The company's Form 1065, *U.S. Return of Partnership Income*, reported guaranteed payments to the couple. On their untimely filed joint federal income tax returns, they reported the payments as part of distributive shares of partnership income to the wife as passive income not subject to self-employment tax. The couple argued that under Sec. 1402(a)(13), the wife was a passive investor and not subject to self-employment tax. Subsequently, they argued instead that the payments were distributions from the LLC.

The court cited *Renkemeyer, Campbell & Weaver LLP*,[49] in which the Tax Court held that certain members of a law firm that operated as a limited liability partnership were not limited partners for purposes of Sec. 1402(a)(13) because the distributive shares received arose from legal services they provided on behalf of the firm in their capacity as partners. Sec. 1402(a)(13) provides that a limited partner may exclude his distributive share of income from net earnings from self-employment, except for guaranteed payments for services actually rendered to or on behalf of the partnership to the extent they are established to be in the nature of remuneration for those services.

In the instant case, the Tax Court held that the payments were guaranteed payments that were subject to self-employment tax because the wife was more than a passive investor and provided services to the partnership. Noting that the services provided by the wife were minimal, the court suggested that if the taxpayers had documented the extent to which the payments were not for services rendered, the payments might have escaped self-employment tax.

In a field attorney advice memorandum dated March 29, 2013, and released in early May, the IRS Office of Chief Counsel (OCC) advised that Pennsylvania's elected constables were not subject to self-employment tax but were employees for purposes of FICA and income tax withholding.[50]

The OCC concluded that the constables were covered by an agreement under Section 218 of the Social Security Act.[51] The Social Security Administration had determined that the constables were covered under the state's Section 218 agreement. Secs. 3121(b)(7)(E) and (d)(4) provide that individuals performing services covered by a Section 218 agreement are employees for FICA tax purposes.

The memorandum further concluded that the constables' compensation was not solely fee-based, as described by Sec. 1402(c)(1). If it had been (and the constables had not been covered by a Section 218 agreement) they may have been subject to self-employment tax.

Self-Employment Contributions Act (SECA) tax is imposed on net earnings from self-employment derived by an individual from any trade or business.[52] The general rule is that performing functions of a public office does not constitute a trade or business.[53] However, if compensation for the performance of those functions is solely on a fee basis, it is a trade or business.

With respect to FICA, the memorandum determined, based on a common law analysis, that the constables were employees. They were also considered employees for the purposes of income tax withholding under Sec. 3401(c) because they were elected officials. Since a county controlled the payments to the constables, it was the statutory employer under Sec. 3401(d)(1).

Sec. 6654: Failure by Individual to Pay Estimated Income Tax

In *Brennan*,[54] an individual taxpayer asked the Tax Court to review a collection due process (CDP) appeal determination by the IRS Office of Appeals regarding a levy to collect unpaid income tax and penalties. The court found that the taxpayer was barred from asserting reasonable cause to challenge the penalties imposed under Secs. 6651(a)(1) and (2) and 6654.

The taxpayer failed to file his 2008 income tax return. As a result, in April 2010, the IRS prepared a substitute for return and issued a notice of deficiency in August 2010 that included the tax shown on the substitute for return and penalties. The taxpayer did not request a redetermination of the tax liability and penalties, and therefore the IRS assessed the tax and penalties and later issued a final notice of intent to levy to collect the amount unpaid. In response to the final notice, the taxpayer requested a CDP hearing, claiming that the substitute for return did not consider deductions to which he was entitled. Following the request for a hearing, the taxpayer filed a late 2008 tax return showing an amount due that was less than that assessed on the substitute for return. The IRS accepted the return and adjusted the unpaid liability to reflect the taxpayer's self-reported liability. Additionally, the IRS reduced the penalties and interest to reflect those that would be properly calculated on the reduced liability.

At the CDP hearing, the taxpayer argued that the total amount assessed by the IRS was greater than the amount shown on the self-reported tax return that was filed. The taxpayer was informed that the difference was due to the penalties and interest. The Office of Appeals issued a notice of determination in support of the previously issued levy notice. Upon receipt of the notice of determination, in January 2012, the taxpayer filed a petition for review of the determination, claiming that he had reasonable cause with respect to his failure to file and pay tax and that the penalties should be abated. The Tax Court found that the taxpayer did not timely raise his reasonable-cause defense, which should have been raised in August 2010 upon receipt of the notice of deficiency.

In *Kanofsky*,[55] the Third Circuit affirmed a Tax Court decision upholding the IRS's calculation of a taxpayer's tax liability and penalties. The IRS disallowed certain claimed business and rental expense deductions. The appellate court also found the taxpayer liable for the tax and penalties under Secs. 6651(a)(1) and (2) and 6654.

The taxpayer failed to submit returns or pay taxes for 2006 and 2007. The taxpayer's income during these years included wages, Social Security payments, dividends, capital gains, and pension distributions. On Forms W-4, *Employee's Withholding Allowance Certificate*, filed with his employer, the taxpayer claimed exemption from federal tax withholding, and he did not make estimated tax payments. As a result of his failure to file and pay taxes due, the IRS assessed tax and penalties in a deficiency notice sent to the taxpayer. Upon receipt of the notice, the taxpayer unsuccessfully challenged the assessments in the Tax Court and appealed to the Third Circuit.

Under Sec. 6001, taxpayers bear the burden of establishing that they are entitled to claimed deductions. The taxpayer claimed that he was entitled to deductions under Sec. 162 for ordinary and necessary expenses of a trade or business, but that the IRS and the Tax Court had unfairly prevented him from presenting evidence at trial that proved he was entitled to the deductions. According to the Third Circuit, the taxpayer had been allowed to present numerous documents in his Tax Court trial that substantiated expenses, and the court had properly admitted those that were relevant into evidence. Thus, the appellate court upheld the Tax Court's decision that the taxpayer failed to meet his burden of proof that he was entitled to the disallowed deductions or did not owe the taxes or penalties the IRS had assessed.

In *Christman*,[56] married taxpayers sought a refund of penalties assessed under Secs. 6651(a)(2) and 6654 for tax years 1996 through 1998. In 2000, the taxpayers were audited by the IRS, which determined that, during the years in question, the taxpayers improperly treated losses from securities trading as ordinary rather than capital, and assessed additional tax and penalties. The taxpayers attempted to negotiate with the IRS, which abated the penalties fully for 1996 and partially for 1997 and 1998. The penalties abated were those under Sec. 6651(a)(2) but not those under Sec. 6654. The taxpayers filed suit in the Court of Federal Claims to recover the balance of the penalties.

The taxpayers claimed that under Sec. 6651(a)(2), a reasonable-cause exception should have been deemed by the IRS to excuse their failure to timely pay and that under Sec. 6654, a waiver exception excused their failure to pay estimated taxes. They also claimed that because the IRS had abated the Sec. 6651(a)(2) penalty in full for 1996, it was required to do so for 1997 and 1998.

The court rejected the reasonable-cause claim with respect to both penalties. The arguments in support of a reasonable-cause exception were either erroneous or could not be made under the substantial-variance doctrine because the taxpayers had not made them in their refund claim. The court rejected the second claim regarding inconsistency in the abatement of the penalty because under well-established law, each tax year is treated separately, and the taxpayers had not cited any binding precedent in support of their argument.

Footnotes

[1] *Field*, T.C. Memo. 2013-111.

[2] American Taxpayer Relief Act of 2012, P.L. 112-240.

[3] Sec. 68(b).

[4] *General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (Greenbook)*, pp. 134–5 (April 2013).

[5] *Scott*, No. 2:12-cv-00389-ODW (C.D. Cal. 4/5/13).

[6] Rev. Rul. 80-44, 1980-1 C.B. 34.

[7] *Picard*, 165 F.3d 744 (9th Cir. 1999).

[8] *Smallwood*, No. EDCV 12-00023 VAP, (C.D. Cal. 12/28/12).

[9] Rev. Proc. 2013-16, 2013-7 I.R.B. 488.

[10] IRS Letter Rulings 201310044 (3/8/13), 201310042 (3/8/13), 201308031 (2/22/13), 201306024 (2/8/13), 201306025 (2/8/13), 201304009 (1/25/13), 201304010 (1/25/13), 201302042 (1/11/13), 201252019 (12/28/12), 201251021 (12/21/12), 201250026 (12/14/12), 201249017 (12/7/12), 201245028 (11/9/12), and 201241013 (10/12/12).

[11] REG-130507-11; see Prop. Regs. Sec. 1.1411-4(h), Example (4); FAQ No. 10.

[12] *Oliver*, T.C. Memo. 2013-117.

[13] *Begay*, T.C. Memo. 2013-17.

[14] *Guy*, T.C. Memo. 2013-103.

[15] *Striefel*, T.C. Memo. 2013-102.

[16] IRS Letter Ruling 201316003 (4/19/13).

[17] *Goeller*, No. 10-731T (Fed. Cl. 3/20/13).

[18] *Edwards v. Bromberg*, 232 F.2d 107 (5th Cir. 1956).

[19] *Goeller*, slip op. at 7.

[20] Id., slip op. at 8.

[21] Quoting *Perrin*, 444 U.S. 37, 42 (1972).

[22] Quoting *Neder*, 527 U.S. 1, 21 (1999).

[23] Quoting *INDOPCO, Inc.*, 503 U.S. 79, 84 (1992).

[24] *Goeller*, slip op. at 11.

[25] *Boone Operations Co., LLC*, T.C. Memo. 2013-101.

[26] *Estate of Harvey Evenchik*, T.C. Memo. 2013-34.

[27] *Villareale*, T.C. Memo. 2013-74.

[28] *Minnick*, T.C. Memo. 2012-345.

[29] *Crimi*, T.C. Memo. 2013-51.

[30] Rev. Rul. 2002-67, 2002-2 C.B. 873.

[31] *Dodds*, T.C. Memo. 2013-76.

[32] *Heinbockel*, T.C. Memo. 2013-125.

[33] *Longino*, T.C. Memo. 2013-80.

[34] *Schuller*, T.C. Memo. 2012-347.

[35] *Langley*, T.C. Memo. 2013-22.

[36] *Hudzik*, T.C. Summ. 2013-4.

[37] *Thomas*, T.C. Summ. 2013-5.

[38] *Hoskins*, T.C. Memo. 2013-36.

[39] *Hassanipour*, T.C. Memo. 2013-88.

[40] *Yiu*, No. 11-875 (D.N.J. 9/26/12).

[41] *Yates*, T.C. Memo. 2013-28.

[42] *Adams*, T.C. Memo. 2013-7.

[43] *Van der Lee*, No. 12-226-ag (2d Cir. 10/25/12).

[44] Quoting *Estate of Yaeger*, 889 F.2d 29, 33 (2d Cir. 1989).

[45] *Sutton*, T.C. Summ. 2013-6.

[46] *Specks*, T.C. Memo. 2012-343.

[47] *Weber*, 103 T.C. 378, 387 (1994), aff'd, 60 F.3d 1104 (4th Cir. 1995); *Rosato*, T.C. Memo. 2010-39.

[48] *Howell*, T.C. Memo. 2012-303.

[49] *Renkemeyer, Campbell & Weaver, LLP*, 136 T.C. 137 (2011).

[50] Field Attorney Advice 20131801F (5/3/13).

[51] Social Security Act of 1935, P.L. 74-271, §218, codified at 42 U.S.C. §418.

[52] Secs. 1401 and 1402(a).

[53] Sec. 1402(c)(1); Regs. Sec. 1.1402(c)-2(a).

[54] *Brennan*, T.C. Memo. 2013-123.

[55] *Kanofsky*, No. 12-3738 (3d Cir. 4/5/13).

[56] *Christman*, No. 11-717 (Fed. Cl. 3/6/13).

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