Individual Tax Update

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EXECUTIVE SUMMARY

- The PATH Act of 2015 imposes new requirements for claiming the child tax credit, earned income tax credit, and American opportunity tax credit. The latter, in tandem with law changes earlier in 2015, has new reporting requirements affecting both taxpayers and educational institutions.
- New York state's characterization of state economic incentive payments as refunded excess tax credits is not controlling where they are not attributable to taxes previously paid.
- The Ninth Circuit reversed a district court's ruling that mutual insurance policyholders had a tax basis in their mutual rights that had been converted to stock in the company's demutualization.
- Several recent cases illustrate the importance of meeting complex technical requirements and exacting substantiation rules for deducting charitable contributions of conservation easements.
- Whether a taxpayer engages in an activity with the objective of making a profit—crucial when the taxpayer attempts to offset a trade or business loss against other income—is determined by factors including whether the taxpayer carries on the activity in a businesslike manner.

Sec. 24: Child Tax Credit

Under the Protecting Americans From Tax Hikes (PATH) Act of 2015,[1] a taxpayer may not claim a child tax credit by retroactively amending or filing a return for a prior year in which the qualifying child did not have a taxpayer identification number (TIN). The TIN must have been issued on or before the due date for filing the return for the tax year and must be included with the qualifying child's name on the return. Also, taxpayers who fraudulently claim the child tax credit are barred from claiming it for 10 years, similar to the treatment of fraudulent claims of the earned income tax credit (EITC). Taxpayers who recklessly or with intentional disregard for the rules claim the child tax credit are barred from claiming the credit for two years. The IRS may disallow improper credits without a formal audit when a taxpayer claims the child tax credit during a period he or she is barred from doing so.[2]

The child tax credit also is now added with the EITC as a credit for which preparers may be subject to a penalty for failure to comply with due-diligence requirements.[3] Although, as of this writing, no procedures have been issued for documenting due diligence in claiming a child tax credit, the EITC requirements include submitting a

completed checklist with the tax return, completing a prescribed worksheet, maintaining records for three years that document the due diligence, and not knowing or having reason to know that any of the pertinent information for the credit was incorrect.

Sec. 25A: Education Credits

The PATH Act also imposed new reporting requirements for the American opportunity tax credit. Taxpayers must now report the employer identification number of the educational institution paid for purposes of the credit.[4]

Also, higher education institutions are now required to report on Form 1098-T, *Tuition Statement*, only qualified tuition and related expenses actually paid. Previously, Form 1098-T allowed the institution to choose either box 1 or box 2 to report qualified tuition and related expenses paid or billed, respectively. Beginning Jan. 1, 2016, institutions may report expenses paid only, although the IRS has granted penalty relief for institutions that continue to report amounts billed for Forms 1098-T required to be filed by Feb. 28, 2017 (or March 31, 2017, if filed electronically), and furnished to recipients by Jan. 31, 2017.[5] Earlier in 2015, Sec. 25A(g)(8) was amended[6] to require taxpayers claiming an education credit to have received a written payee statement containing certain prescribed information, including the amount of payments received for qualified tuition and related expenses (generally, a Form 1098-T).

Together, these changes may be problematic for students who incur other educational expenses, such as for books, in the year after payment of the last tuition bill, as would be the case with graduating seniors. These seniors may receive no Form 1098-T from their institution in the final year because tuition was paid in the December preceding graduation, and they will therefore have difficulty claiming education credits. CPAs should watch for developments in this area.

Additionally, a taxpayer may not claim an American opportunity tax credit by retroactively amending or filing a return for a prior year in which the eligible student did not have a TIN. Similar to the change to the child tax credit described above, the TIN must have been issued to the taxpayer (or, if different, the student) on or before the due date for filing the return for the tax year. Taxpayers who fraudulently claim the American opportunity tax credit are barred from claiming the credit for 10 years, similar to the treatment of fraudulent claims of the EITC. Taxpayers who recklessly or with intentional disregard for the rules claim the American opportunity tax credit are barred from claiming the credit for two years. The IRS may disallow improper credits without a formal audit when a taxpayer claims the American opportunity tax credit during a period he or she is barred from doing so.[7]

Return preparers are now subject to the same due-diligence penalty as for the EITC with respect to returns that claim the American opportunity credit.[8] As with the child tax credit, the IRS has not issued guidance as of this writing.

Sec. 32: Earned Income

The PATH Act also made permanent the higher 45% rate for taxpayers with three or more qualifying children that had been scheduled to expire in 2018 and higher credit phaseouts originally enacted in 2009. However, similar to the child tax credit and American opportunity tax credit described above, a qualifying child's Social Security number must have been issued before the due date of the return for the tax year; thus, retroactive claiming of qualifying children who did not have a valid Social Security number for the period for which the tax return is filed is now prohibited.[9]

Sec. 61: Gross Income Defined

Targeted economic development payments: In a Tax Court case, the husband and wife taxpayers, each at various times the sole shareholder of an S corporation, were required to include in gross income targeted economic development payments in the year they received them from the state of New York.[10] The state labels the payments as tax credits and treats them as refunds of overpayments of state income tax. However, the court ruled that the credits were undeniable accessions to wealth, clearly realized, over which the taxpayers had complete dominion. Accordingly, the refunded portions of the credits in excess of the taxpayers' New York state tax liability were not attributable to taxes previously paid and therefore were held includible in gross income in the year received.

Identity protection services: In Announcement 2016-2, the IRS addressed exclusion from gross income of the value of identity protection services. The Service issued the announcement in response to comments it requested in Announcement 2015-22, which provided guidance with respect to identity protection services provided to data breach victims. Announcement 2016-2 extends Announcement 2015-22 to include identity protection services provided to employees and other individuals before a data breach has occurred. In addition, an employer providing these services to an employee is not required to include the value of the identity protection services in the employee's gross income or wages. Announcement 2016-2 does not apply to cash received in lieu of identity protection services or proceeds received from an identity theft insurance policy.

Attorneys' fees: In Letter Ruling 201552001, the taxpayer requested a ruling that an award of attorneys' fees paid by a defendant to two legal aid organizations representing the plaintiff taxpayer in the settlement of a lawsuit would not be includible in the taxpayer's gross income. Typically, a taxpayer must include in gross income under Sec. 61(a) fees recovered as a prevailing plaintiff, the letter ruling noted. However, in this instance, since under the retainer agreement the taxpayer had no obligation to pay for the legal services received, the attorneys' fees paid were excludable from the taxpayer's gross income.

Insurance company demutualization: In *Dorrance*,[11] the Ninth Circuit overturned a district court's ruling and concluded that a mutual insurance company's policyholders had no tax basis in the stock they received upon a demutualization of the insurance company. The Ninth Circuit noted that the taxpayers' insurance premiums were not reduced after the demutualization, thus implying that no portion of the premiums had been paid for their membership rights. The court further noted that the demutualization was a tax-free reorganization, so that the taxpayers exchanged the membership rights directly for stock without any recognition of gain or loss.

Shortly after its *Dorrance* opinion, the Ninth Circuit issued *Reuben*,[12] an unpublished ruling in which it cited its holding in *Dorrance* to affirm a district court opinion that had concluded that stock received by a taxpayer from an insurance demutualization had no tax basis.

These decisions create a split with the Federal Circuit, which had previously affirmed a Court of Federal Claims opinion that held that, while the value of a policyholder's ownership rights was not completely determinable, the taxpayer did have a tax basis in his policy.[13]

Sec. 103: Interest on State and Local Bonds

The IRS issued proposed regulations[14] providing guidance on the definition of a political subdivision for the exclusion of interest income from state or local tax-exempt bonds. The proposed regulations specify that, taking into account all facts and circumstances, an entity must meet three requirements to qualify as a political subdivision: sovereign powers, governmental purpose, and governmental control.

Sec. 104: Compensation for Injuries or Sickness

The IRS issued Letter Ruling 201544019 in response to a taxpayer's request for guidance on the treatment of no-fault payments the taxpayer made to the parents or legal guardians of children who sustained birth-related neurological injuries. The ruling states that no-fault benefits may include items such as "a one-time cash payment or death benefit to parents, medically necessary therapy and equipment for the injured child, house modification and upgrade, a specially equipped vehicle, transportation costs, attendant and nursing care, medically necessary drugs and other medically necessary expenses of the child not otherwise reimbursed by insurance." The letter ruling concludes that such payments made to a parent or legal guardian are excluded from the recipient's gross income under Sec. 104(a)(3) and that the taxpayer is not required to issue information returns or other tax forms related to them.

Sec. 108: Income From Discharge of Indebtedness

Closed schools: In response to the U.S. Department of Education's having begun a process for settling and discharging federal student loans financing attendance at schools owned by Corinthian Colleges Inc., the IRS ruled that taxpayers whose federal student loans were discharged under the "closed school" or "defense to repayment" discharge process will not realize taxable income under Sec. 108 as result of their discharges.[15] Further, the IRS will not assert that these taxpayers must increase their taxes owed in the year of a discharge as a result of either discharge process if, in a prior tax year, they received an education credit under Sec. 25A or took a deduction under Sec. 221 for interest paid on education loans or under Sec. 222 for payments of qualified tuition and related expenses. The Department of Education has estimated that over 50,000 Corinthian borrowers may be eligible for discharges under this program.

Reacquisition of debt instruments: In another cancellation-of-debt (COD) issue, a Chief Counsel Advice (CCA) memorandum encourages field attorneys and revenue agents to contact the National Office for taxpayer-specific advice concerning discharges of business indebtedness in connection with a reacquisition under Sec. 108(i) of an applicable debt instrument occurring in 2009 or 2010.[16] The CCA ruled that in certain factual situations, the IRS may adjust the amount of COD income deferred by an election under Sec. 108(i) for reacquisition of a debt instrument.

Sec. 162: Trade or Business Expenses

Personal clothing: In a Tax Court case, the taxpayer worked in sales for Ralph Lauren Corp.[17] He was required to dress in the designer's clothing. He bought suits, shirts, ties, and pants sold by the designer. He claimed an itemized deduction for the cost of the clothing as an unreimbursed expense related to his employment.

The court noted that clothing generally is considered a personal expense that is nondeductible under Sec. 262, but that it may be deductible as an ordinary and necessary business expense when (1) the clothing is required or essential in the taxpayer's employment; (2) the clothing is not suitable for general or personal wear; and (3) the clothing is not so worn. The court agreed the clothing was required as a condition of employment but held it was appropriate for general wear and, therefore, did not pass the test.

Automobile expenses: In another case, the taxpayer was in an oil purification business that required him to visit clients regularly.[18] He kept index cards on which he recorded where and when he met clients and their telephone number and business address. Based on the taxpayer's testimony and the index cards, the court determined the taxpayer could claim some automobile and truck expenses but not the entire amount he claimed. The court based the allowed amount on the shortest mileage between his home office and the clients' locations.

The IRS continues to scrutinize automobile expense deductions. Taxpayers should maintain a contemporaneous log that includes the destination, business purpose, date, and miles traveled for each trip.

Substantiation: In another Tax Court case, the taxpayer was required to provide substantiation and a pretrial memorandum regarding her claimed deductions for travel expenses, auto expenses, telephone expenses, and business gifts, as well as bank fees, postage, shipping and fax expenses, printing and photography expenses, dues and subscriptions, and marketing expenses.[19] She failed to provide the substantiating documents for the expenses by the deadline the court imposed. As a result, the court did not allow her to introduce documentation of the expenses at trial. She was limited to oral testimony regarding the claimed expenses, which, as a matter of law, was not sufficient to substantiate them, and the court therefore denied the deductions.

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

Several cases involving conservation easements highlighted the complexity of this area, along with the need to meet its many technical requirements.

Contemporaneous written acknowledgment: In *French*,[20] the Tax Court denied the married taxpayers' deduction for a contribution of a conservation easement, due to lack of a contemporaneous written acknowledgment from the charitable organization. For all charitable contributions exceeding $250, Sec. 170(f)(8) requires donors to obtain a written acknowledgment from the donee before filing their tax return for the year of the contribution. The acknowledgment must, among other things, indicate whether the donee organization provided any goods or services in consideration for the contribution.

Two earlier cases[21] held that conservation deeds effectively substantiated that the taxpayers had received no goods or services, since those deeds specifically stated that they represented the entire agreement between the taxpayers and the exempt organization. In this case, however, the deed did not contain language indicating either that the taxpayers received no goods or services in exchange for the easement or that it was the entire agreement. Therefore, the deed failed to fulfill the contemporaneous written acknowledgment requirement, the court held.

Easement drafting: In *Carroll*,[22] the Tax Court denied a couple's charitable deduction for a conservation easement contribution because of a technical drafting error in the easement. Sec. 170(h)(5)(A) requires that the easement be protected in perpetuity. Regs. Sec. 1.170A-14(g)(6)(ii) provides that a contribution is not protected in perpetuity unless the donee organization receives a property right with a fair market value at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift bears to the value of the property as a whole at that time.

The easement filed by the taxpayers expressed this proportionate formula by reference to the tax deduction allowable for the easement rather than the value of the easement restriction. While these two amounts would be the same, assuming all other requirements under Sec. 170(h) were met, the court noted that any number of things might cause the tax deduction to be zero. For example, if the taxpayers did not obtain a contemporaneous written acknowledgment or if the easement were deemed not to meet the conservation purpose requirement, no tax deduction would be allowable. Since the easement's proportionate value thus could conceivably be zero, the court disallowed the taxpayers' deduction.

Qualified appraisal: In *Gemperle*,[23] the Tax Court denied a husband and wife a charitable contribution deduction for their contribution of a façade easement on their Chicago residence because they failed to attach a copy of a qualified appraisal to their return. In general, Sec. 170(f)(11)(C) requires a qualified appraisal for contributions of property for which a deduction of more than $5,000 is claimed. In the case of any contribution of a qualified real property interest that is a restriction with respect to the exterior of a building, Sec. 170(h)(4)(B)(iii)(I) specifically requires a copy of a qualified appraisal of the property interest to be attached to the return.

Sec. 179: Election to Expense Certain Depreciable Business Assets

In *Cartwright*,[24] the Tax Court denied an orthopedic surgeon a Sec. 179 deduction for his use of a motor home while he was on duty at a hospital. The taxpayer was required to work a 24-hour shift three times per month. He drove the motor home from his residence to the hospital, where he parked it during his shifts. He testified he used the motor home as an office and for sleeping and reading medical books while not needed in the hospital. He calculated his deduction based on a business use of the motor home of 85% and 100% for tax years 2008 and 2009, respectively. The IRS recalculated the taxpayer's business use of the motor home based on his mileage logs, odometer readings, and service invoices, noting he also used it for volunteering with charities, personal camping trips, and camping trips with colleagues. The Tax Court found that the IRS properly computed the business use based on business miles driven rather than, as the taxpayer argued at trial, on his time spent in the vehicle.

Sec. 183: Activities Not Engaged in for Profit

Operating in a businesslike manner: In *Kantchev*,[25] the taxpayer operated a photography activity he reported on Schedule C, *Profit or Loss From Business*. He continually used losses to offset income from other sources including his wife's wages. The court held that the activity was not a bona fide business, so it denied the deductions. The IRS claimed and the Tax Court agreed that the taxpayer did not operate his photography activity in a businesslike way. He did not have a business plan or keep books and records and used his personal accounts to pay his business expenses. Those and other factors analyzed under Regs. Sec. 1.183-2(b) failed to establish that the taxpayer engaged in the photography activity with the requisite objective of making a profit.

Business plan: In *Kaiser*,[26] the taxpayer had a successful financial planning and insurance business. She also operated a horse-training business that incurred losses that offset the income from her other business. She had little or no income from the horse-training business in the years in question. The Tax Court found that the taxpayer did not have a business plan for the horse-training activity or indication of how she intended to make a profit from it. While she hoped to generate income, she did not keep proper books and records. For part of the period in question, she was recovering from two automobile accidents that left her unable to walk or ride a horse. The court also noted she experienced substantial pleasure from owning her horses.

Sec. 212: Expenses for Production of Income

Repair expenses: In a Tax Court case, married taxpayers were denied unsubstantiated business deductions.[27] The taxpayers claimed deductions for significant repair expenses on Schedule E, *Supplemental Income and Loss*, of their joint return for several rental properties, which the IRS denied. The taxpayers also did not keep adequate records for a business operated by the wife, so the IRS used the bank deposits analysis method to reconstruct the taxpayers' income from that source. In the process, the IRS also found a few checks that could be identified as insurance proceeds for damage to the taxpayers' rental properties. However, without any other evidence (e.g., receipts, invoices, or purchase orders), the Tax Court ruled that the repair expenses were not deductible under Sec. 212. The taxpayers did not provide evidence to substantiate the actual repairs'

cost or the amount of the expenses covered by the insurance proceeds or other third-party payments, such as security deposits. Further, the Tax Court found that some of the claimed repair expenses were on the taxpayers' personal residences.

Investment-related travel: In another case, the Tax Court denied married taxpayers deductions for certain expenses related to their interest income.[28] The taxpayers had a bank account in Dubai, where they traveled to withdraw the funds and accumulated interest. The Tax Court allowed the taxpayers to deduct a currency loss as well as additional expenses related to the production of this interest income under Sec. 212. However, even though the taxpayers provided a printout of an email discussing fixed interest rates for the account and plane tickets to Dubai to substantiate their travel costs to withdraw the funds, these expenses did not exceed the amounts already allowed by the IRS. Therefore, the Tax Court ruled that, due to insufficient records and substantiation, the taxpayers were not entitled to deduct expenses for the production of their taxable interest in excess of amounts already allowed by the IRS.

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

Over-the-counter medicines: The Tax Court disallowed claimed medical expenses of married taxpayers under Sec. 213.[29] The taxpayers deducted as medical expenses on Schedule A, *Itemized Deductions*, a considerable sum for over-the-counter pharmacy items, such as pain relievers, diet products, eye drops, skin care products, and allergy medications, as well as the full cost of heating and cooling their home and expenditures for lawn service. The Tax Court deemed the over-the-counter pharmacy items personal expenses under Sec. 213(b), which treats amounts paid for medicine and drugs, including over-the-counter medications, as deductible "only if such medicine or drug is a prescribed drug or is insulin."

The court also deemed the heating and cooling costs and lawn service expenditures as nondeductible personal expenditures. The taxpayers were unable to provide support for the medical necessity of these items and establish that these expenses exceeded what was required for their general comfort or establish that they otherwise would not have been incurred for nonmedical reasons. While the taxpayers were able to establish that they incurred valid medical expenses for the treatment of scoliosis and for testing blood sugar, these expenses did not exceed 7.5% of their adjusted gross income after the court disallowed the other expenses.

Medical transportation: In another case, the Tax Court held a taxpayer was not entitled to a deduction for medical transportation costs under Sec. 213.[30] The taxpayer presented a letter from his doctor that indicated that he needed help traveling. The taxpayer claimed medical expense deductions on Schedule A mainly consisting of amounts he paid others to drive him to and from work and medical appointments and for medical insurance premiums. The court denied a deduction for the transportation costs because the taxpayer failed to provide support for them. He did not present any records or sufficient evidence (e.g., receipts or mileage logs). The expenses were deemed personal and nondeductible.

Substantiation: Married taxpayers were denied unsubstantiated medical expenses in another Tax Court case.[31] The taxpayer was a pastor of a church who received a salary for his services. During an audit examination he provided compensation records from his church that indicated certain amounts designated as "health" had been deducted from his compensation. The petitioner claimed that these deductions were for medical insurance premiums for his wife and were allowable medical tax deductions. However, the amounts shown on the petitioner's tax return were not consistent with the compensation records from the church presented at the audit examination. Therefore, the Tax Court ruled that without further evidence, these expenses, in excess of amounts already allowed by the IRS, were nondeductible.

Sec. 215: Alimony, etc., Payments

The Tax Court allowed an alimony deduction for payments made to the taxpayer's ex-wife pursuant to a state court's pretrial order to maintain the status quo until a judgment of divorce was entered that would dissolve the taxpayer's marriage.[32] The taxpayer made electronic transfers to his ex-wife's bank account from January through September 2010. The court did not enter the judgment of divorce dissolving the marriage until November 2010. This judgment stated that the taxpayer was to begin alimony and property settlement payments in October 2010. However, on the taxpayer's 2010 tax return, he claimed an alimony deduction for the payments starting in January 2010. The IRS disallowed deductions for the payments made before October 2010, and the taxpayer petitioned the Tax Court for a redetermination.

To qualify as alimony, payments must meet four stringent requirements under Sec. 71(b)(1), which the Tax Court found the payments met. The taxpayer argued, and the court agreed, that the pretrial order was a divorce or separation instrument under which the payments were received, as required by Sec. 71(b)(1)(A). The taxpayer testified that the payments were not voluntary and he would not have made them if the state court's pretrial order had not required him to do so.

Although the pretrial order was silent as to whether the payments met the requirement under Sec. 71(b)(1)(D) that there be no requirement to make payments or substitutes for them after the payee spouse's death, the taxpayer argued the alimony payments would cease upon the death of the payee spouse under Alabama state law (where the taxpayer resided when he filed his petition). According to Alabama law, the taxpayer's payments were periodic alimony payments and would end upon the death of either spouse. Therefore, the final requirement under Sec. 71(b)(1)(D) was met to qualify the payments as alimony, and, thus, they could be deducted on his return under Sec. 215, the court held.

Sec. 217: Moving Expenses

The Tax Court allowed a portion of a taxpayer's contested deduction for moving expenses.[33] The petitioner was moving from Pennsylvania to Maryland, and, to save money, he moved his personal property himself instead of hiring a moving company. He made approximately 20 round trips, incurring expenses for transportation, storage, trailer rental, and lodging, that he deducted.

The IRS took the position that the taxpayer could deduct only the cost of one trip to his new residence. However, the Tax Court said this would essentially limit the application of Sec. 217 to instances where taxpayers paid to have their personal property moved commercially or by someone not a member of their family. The court allowed the taxpayer to deduct the cost of all the trips except for the return leg of the final trip, which it disallowed because the final trip was the taxpayer's travel to his new residence. The court also approved the deduction for trailer rental and one month of storage fees. However, the court found that the lodging expenses were nondeductible, since the taxpayer incurred them after he arrived at his new residence while he waited to gain access to it.

Sec. 263: Capital Expenditures

In *Schank*,[34] the taxpayer's roofing company leased land from another entity also owned by the taxpayer and his family. In 2011, the two businesses entered into an amended lease agreement for additional land adjacent to the tract covered by the preexisting lease. Pursuant to the lease amendment, the roofing company prepaid the full amount of additional rent for the next 18 years. The taxpayer attempted to rely on Sec. 267's related-party provision, arguing that because the two entities were related, the roofing company should be able to deduct the entire prepayment on its 2011 return if the other entity included the rent in its income for the

same tax period. However, the court rejected this argument, relying on a number of cases that affirmatively state that the prepayment of rent for a lease with a duration of over one year is a capital asset subject to amortization over the period of the lease as covered by Sec. 263.

Further, the court reasoned that for accrual-method taxpayers such as this one, the all-events test determines when an expense is deductible. The test requires that the liability be clearly established, the amount of an expense be reasonably determinable, and economic performance to have occurred. Economic performance under a lease occurs over the period the taxpayer is entitled to use the property. Also, because economic performance under the lease did not begin until after the end of the 2011 fiscal year, the taxpayer could not deduct the lease prepayment in that year for this reason as well.

Sec. 274: Disallowance of Certain Entertainment, etc., Expenses

In *Avery*,[35] the IRS disallowed automobile expenses claimed in connection with a husband and wife's information technology service corporation. The corporation provided on-site technician support services to its clients, for which the husband, as an employee of the corporation, drove his personal automobile daily to client work sites. The corporation did not reimburse the automobile expenses, and the husband claimed a $39,991 deduction on Schedule C.

The IRS conceded that if the taxpayer could substantiate the claimed automobile expenses, then he could deduct them on Schedule A as unreimbursed employee expenses. However, the taxpayer was unable to provide substantiation required under Sec. 274(d)(4), which disallows any deduction with respect to any listed property (as defined in Sec. 280F(d)(4)) unless adequate records establish the amount of the expense or other item, the time and place of the property's use, the business purpose of the expense, and the business relationship to the taxpayer of the person using the property. The Tax Court agreed the taxpayer failed to satisfy the adequate-records requirements under Sec. 274(d) to support the amount of the expenses and disallowed the automobile expenses.

Sec. 280A: Disallowance of Certain Expenses in Connection With Business Use of Home, Rental of Vacation Homes, etc.

In *Niemann*,[36] a sole owner of multiple limited liability companies (LLCs) improperly included home office expenses as part of the cost basis of properties sold at a gain. The taxpayer was a certified professional engineer who advised large commercial lenders about possible environmental problems with real estate loans. As the demand for his services declined in 2008 due to an economic slowdown, he decided to use his talent of identifying real estate to purchase distressed properties to hold until he could sell them for a profit. The taxpayer and an LLC he formed and managed purchased properties. The taxpayer reported short-term capital gains of $129,000 on his Schedule D, *Capital Gains and Losses*, from the sale of several properties. In calculating his gains from the sales of the properties, he included home office expenses of $29,000 in the basis of the properties.

The taxpayer claimed the home office expenses were attributable to the cost of acquiring the properties, but the IRS disagreed and held to the rules under Secs. 1012 and 1016 that basis in any property is the purchase price plus the cost of any improvements. Rather, it argued that the home office expenses were costs of doing business under Sec. 280A and that he should have reported them on Schedule C. However, the IRS tried to block the taxpayer from simply moving the $29,000 to Schedule C by asserting that the home office expenses were "double-claimed." When the taxpayer proved that he did not double-claim the expenses, the IRS then

asserted at trial that the taxpayer could not deduct the home office expenses because he could not substantiate them. The court found that the taxpayer was unfairly prejudiced by this argument because the IRS had not previously asked him for substantiation of the expenses, and allowed the deduction for them.

Sec. 280E: Expenditures in Connection With the Illegal Sale of Drugs

In *Canna Care, Inc.*,[37] a nonprofit organization in California was denied deductions of various expenses of its medical marijuana dispensary business. The Tax Court held that the business activities constituted trafficking under Sec. 280E, even though distribution of marijuana for medical purposes, if not for profit, is legal in the state. The organization argued that California law permitted its sale of marijuana to individuals with written recommendations from their doctors, and therefore it should be allowed to deduct the expenses it incurred during the normal course of carrying on its business. The court rejected the argument because Sec. 280E does not allow a deduction for any amount paid or incurred in connection with trafficking in controlled substances. Since the federal Controlled Substances Act classifies marijuana as a controlled substance,[38] Sec. 280E disallows deductions in connection with its sale even when state law permits such sale, the court held.

Sec. 469: Passive Activity Losses and Credits Limited

Substantiation: The importance of communicating to clients their need to keep well-supported logs for their participation in business activities has been well-established. Under Sec. 469(a), net passive losses of individuals are limited, unless the taxpayer materially participates in the activity by involvement on a regular, continuous, and substantial basis.[39] In *Calvanico*,[40] the Tax Court upheld the IRS's denial of loss deductions on the 2010 return of the taxpayers (husband and wife) for losses from three rental properties. On examination, the IRS had denied the loss, finding that the taxpayers did not meet the material participation requirements for nonpassive losses under Sec. 469(c).

The taxpayers testified they had each met the requirements for real estate professional status of performing more than 750 hours of services in the rental real estate activities and that those hours constituted more than one-half of personal services performed by each of them in all trades or businesses during the tax year.[41] The court upheld the IRS's findings that the taxpayers did not adequately or credibly substantiate their participation in the activities,[42] as they presented a log for the wife that had been created only after their return had been selected for examination and that was judged insufficient in detail and inconsistent with other evidence.

The husband, a licensed real estate appraiser, argued that his full-time employment as a director of real estate valuation and property tax at two national tax and accounting firms in 2010 counted toward his status as a real estate professional. The court found that, as the taxpayer had no ownership in either of the firms, his hours of employment could not be taken into account for participation purposes under Sec. 469(c)(7)(D)(ii), which requires at least 5% ownership for employee services to be counted.

Ownership and activity grouping: Conversely, in *Stanley*,[43] an Arkansas federal district court upheld the taxpayer's real estate professional status for his hours worked for a property management company, an S corporation of which he owned 10% of the stock. On the taxpayer's and his wife's joint 2009 and 2010 returns, they grouped all rental and nonrental real estate activities, which included services performed for the property management company and for over 100 other entities in which they held ownership interests that owned or operated rental and other real properties. The taxpayer provided legal services and property management services to the corporation, for which he was also president and general counsel. His salary was reported on Form W-2, *Wage and Tax Statement*, and he received a Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.*, for his passthrough income from the corporation.

Relying upon its interpretation of Sec. 83, the IRS argued that the taxpayer's ownership in the corporation should not count toward the 5% minimum ownership under Sec. 469(c)(7)(D)(ii), as the shares were restricted and were required to be returned to the company upon his retirement, which occurred at the end of 2010. The court rejected that argument, finding that the IRS presented no authority that would permit or require application of Sec. 83 to Sec. 416(i)(1)(B), which defines ownership for purposes of Sec. 469(c)(7)(D)(ii).

The IRS also argued that the taxpayer could not group his rental activities with his property management company employment, using two theories. First, the IRS cited Regs. Sec. 1.469-9(e)(3)(i), which states that "a qualifying taxpayer may not group a rental real estate activity with any other activity of the taxpayer." The court also rejected that argument, holding that the subsection prohibits the grouping only for purposes of determining material participation and does not limit applying Sec. 469 passive loss rules for other purposes.

Second, the IRS argued the activities grouping was not appropriate under Regs. Sec. 1.469-4. The court upheld the taxpayer's position that the grouping of most of the activities was appropriate, as it met the requirements under this regulation as an "appropriate economic unit." The court excluded certain activities from the grouping, including a construction management company.

Material participation: In *Leland*,[44] the Tax Court upheld the taxpayers' losses from a farming activity, finding that they met the test for material participation under Temp. Regs. Sec. 1.469-5T(a)(3) of participating in the activity more than 100 hours and at least as much as any other individual during the tax year. The husband worked full time as an attorney in Mississippi, and he and his wife's joint 2009 and 2010 returns deducted losses from the farm operation in Texas. The taxpayer did not keep contemporaneous records but presented reconstructed records documenting 360 hours and 210 hours for 2009 and 2010, respectively, and testified that no other person performed more hours in those years. His documented hours included travel to the farm and up to six hours per day at the farm hunting and trapping wild hogs, which had damaged crops and equipment. He based his reconstructed logs on a calendar in his law office and credit card and vendor receipts.

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

The IRS Chief Counsel's Office ruled on whether an aircraft owned by an individual who held it partly for productive use in a trade or business or investment but also used it for personal purposes was one asset or two (separated by personal versus business use) when it was exchanged for another aircraft in a like-kind exchange.[45] A second, related, issue raised was whether the taxpayer held the airplane for productive use in a trade or business if only a low percentage (with no specific amount stated) of its flights were business- or investment-related.

The Chief Counsel's Office concluded that the exchanged airplane should be considered one property that was either (1) held for productive use in a trade or business or for investment or (2) held for personal use. The Chief Counsel also concluded that the low percentage of flights in the tax year in which the taxpayer relinquished the plane suggested that he did not hold it for productive use in a trade or business or investment under Sec. 1031. However, the office added, other facts should also be considered, including flight hours during the year of the exchange and the immediately preceding year, "repositioning" flights and flight hours, and the nature of flights immediately following repositioning.

Sec. 1035: Certain Exchanges of Insurance Policies

The Tax Court ruled in *O'Connor*[46] that the taxpayer, an employee of his wholly owned S corporation, was substantially vested in the employer's plan and therefore received taxable income with respect to the cash value of the life insurance policy held in a nonexempt welfare benefit trust in which the employer terminated its

participation. The trust sent the taxpayer a change-of-ownership form designating the trust as the old policy owner and with the new owner left blank. The form was then completed and executed by a new welfare benefit trust to which the policy was to be transferred. However, the policy was not actually transferred until the next year.

The court held that the taxpayer recognized income from the policy either when the employer terminated its participation or when the taxpayer received the partially blank change-of-ownership form. The court rejected the taxpayer's argument that he never owned the policy because there was not a substantial risk of forfeiture for it. In addition, Sec. 1035 did not apply, the court held, as the insurance policy was merely transferred from one owner to another, and there was no constructive exchange of one policy for another.

Sec. 1221: Capital Asset Defined

Loss from foreclosure sale: The Tax Court ruled in *Evans*[47] that a loss from a foreclosure sale of the taxpayer couple's Newport Beach, Calif., property was capital and not ordinary, as the taxpayers claimed. The court rejected the taxpayer husband's claim to have held the property for sale in the ordinary course of his trade or business as a property developer. The court analyzed the taxpayer's real estate development activities under the factors of *Redwood Empire Savings & Loan Association*, 628 F.2d 516 (9th Cir. 1980), and concluded he was not in the trade or business of developing properties. The record indicated the taxpayer's development of properties was sporadic and isolated, their sales did not produce a substantial portion of his income, and he supplied only vague testimony concerning his real estate transactions and few records, the court said. The taxpayer was also unsuccessful in his claim that the loss was deductible in 2009, when he received excess proceeds from the foreclosure sale, instead of 2008, when the sale took place.

Mezzanine loan: The Office of Chief Counsel advised that a note evidencing a "mezzanine" loan for an investor taxpayer would be a capital asset if it met other criteria of Sec. 1221.[48] The cancellation of the note upon the surrender of the property by a deed in lieu of foreclosure would satisfy the sale-or-exchange requirement of Sec. 1222. The excess of the amount realized over the taxpayer's basis would result in a capital gain. The Chief Counsel's Office also suggested that the process of a deed in lieu of foreclosure be described on Form 886-A, *Explanation of Items*, instead of being described as a foreclosure sale.

Merger proceeds: The Fifth Circuit affirmed the Tax Court's decision in *Brinkley*,[49] in which the taxpayer's payout resulting from a corporate merger was considered ordinary income and not capital gain, as claimed by the taxpayer. The court found that the merger consideration required the exchange of shares and the taxpayer's execution of a "key employee offer letter" and a "proprietary information and inventions assignment" with the acquiring company, Google Inc. The court also found that the merger agreement identified the taxpayer as a recipient of deferred compensation. The taxpayer signed the shareholder consent form, which affirmed that he had read the merger agreement that bound him to accept its terms.

Sec. 5000A: Requirement to Maintain Minimum Essential Coverage

The state of Ohio was denied a refund of certain tax contributions mandated under the Patient Protection and Affordable Care Act (PPACA)[50] that it unsuccessfully argued were unconstitutionally required of state and local governmental employers.[51] Ohio, like other states, has contributed to a temporary PPACA-required Transitional Reinsurance Program (TRP), which is designed to reduce premiums for individuals and ensure market stability for insurers. The TRP collects contributions from health insurance issuers and group health plans, including those maintained by state employers, and then uses those contributions to fund reinsurance payments to individual-market issuers that cover high-risk (and thus, high-cost) enrollees.

Ohio sued the federal government in district court, claiming that the health plans it provided to its employees were not required to make reinsurance contributions because the plans are not "group health plans" within the meaning of PPACA. The state sought remittance of its TRP payments, to set aside regulations applying the program to state and local government entities, and to enjoin the federal government from collecting any further payments (which were required for plan years 2014 through 2016) from the state under the program.

The court rejected the state's argument, noting that Sec. 5000A(f)(2)(A) explicitly states that minimum essential coverage includes an employer-sponsored group health plan "which is . . . a governmental plan." As such, Congress and the Department of Health & Human Services did not violate the U.S. Constitution when they subjected health plans offered by state and local government employers to the same requirements as those offered by private-sector employers, the court held.

Sec. 6402: Authority to Make Credits or Refunds

In early 2000, the IRS assessed a 100% trust fund recovery penalty against a taxpayer for failure to deposit withheld employment taxes.Because of withholding and another credit, the taxpayer had a refund due from her 2007 income tax return. The IRS applied the refund to the trust fund penalty liability, and the Tax Court sustained that action.[52]

Sec. 7345: Revocation or Denial of Passport in Case of Certain Tax Delinquencies

With passage of the Fixing America's Surface Transportation Act of 2015,[53] individuals with over $50,000 in assessed, unpaid federal taxes may have their U.S. passports revoked or denied if the IRS has filed a notice of federal tax lien or levy with respect to the liability (with certain exceptions).

Footnotes

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[1]Sec. 24(e)(1), as amended by Section 205(a) of the PATH Act (Division Q of the Consolidated Appropriations Act, 2016, P.L. 114-113).

[2]Sec. 24(g), as added by the PATH Act.

[3]Sec. 6695(g), as amended by the PATH Act.

[4]Sec. 25A(i)(6)(C), as amended by the PATH Act.

[5]Announcement 2016-17.

[6]By Section 804(a)(1) of the Trade Preferences Extension Act of 2015, P.L. 114-27.

[7]Secs. 25A(i)(7) and 6213(g)(2)(Q), as added by the PATH Act.

[8]Sec. 6695(g), as amended by the PATH Act.

[9]Sec. 32(m), as amended by the PATH Act.

[10]*Rivera*, T.C. Memo. 2016-35.

[11]*Dorrance*, 807 F.3d 1210 (9th Cir. 2015).

[12]*Reuben*, 628 Fed. Appx. 509 (9th Cir. 2016).

[13]*Fisher*, 333 Fed. Appx. 572 (Fed. Cir. 2009).

[14]REG-129067-15.

[15]Rev. Proc. 2015-57.

[16]CCA 201604017.

[17]*Barnes*, T.C. Memo. 2016-79.

[18]*Charley*, T.C. Memo. 2015-232.

[19]*Nkonoki*, T.C. Memo. 2016-93.

[20]*French*,T.C. Memo. 2016-53.

[21]*Averyt*, T.C. Memo. 2012-198, and *RP Golf, LLC*, T.C. Memo. 2012-282.

[22]*Carroll*, 146 T.C. No. 13 (2016).

[23]*Gemperle*, T.C. Memo. 2016-1.

[24]*Cartwright*,T.C. Memo. 2015-212.

[25]*Kantchev*, T.C. Memo. 2015-234.

[26]*Kaiser*, T.C. Summ. 2016-13.

[27]*Lawson*,T.C. Memo. 2015-211.

[28]*Garada*, T.C. Summ. 2016-1.

[29]*Garcia*,T.C. Memo. 2016-21.

[30]*Chaudry*,T.C. Summ. 2015-74.

[31]*Brown*, T.C. Memo. 2016-39.

[32]*Anderson*, T.C. Memo. 2016-47.

[33]*Parmeter*,T.C. Summ. 2015-75.

[34]*Schank*, T.C. Memo. 2015-235.

[35]*Avery*, T.C. Memo. 2016-50.

[36]*Niemann*, T.C. Memo. 2016-11.

[37]*Canna Care, Inc.*, T.C. Memo. 2015-206.

[38]Controlled Substances Act of 1970, P.L. 91-513, as amended.

[39]Sec. 469(h)(1).

[40]*Calvanico*, T.C. Summ. 2015-64.

[41]See Sec. 469(c)(7).

[42]See Temp. Regs. Sec. 1.469-5T(f)(4).

[43]*Stanley*, No. 5:14-CV-05236 (W.D. Ark. 11/12/15).

[44]*Leland*, T.C. Memo. 2015-240.

[45]CCA 201605017.

[46]*O'Connor*, T.C. Memo. 2015-244.

[47]*Evans*, T.C. Memo. 2016-7.

[48]CCA 201602005. A mezzanine loan is generally a subordinated debt coupled with an overriding royalty or net profits interest (IRS Letter Ruling 200532032).

[49]*Brinkley*, 808 F.3d 657 (5th Cir. 2015).

[50]Patient Protection and Affordable Care Act of 2010, P.L. 111-148.

[51]*State of Ohio*, No. 2:15-cv-321 (S.D. Ohio 1/5/16).

[52]*Bean*, T.C. Summ. 2016-16.

[53]Section 32101(a) of Fixing America's Surface Transportation Act of 2015, P.L. 114-94, adding Sec. 7345.

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