The Tax Adviser

Individual taxation: Report of recent developments

By David R. Baldwin, CPA; Robert Caplan, CPA; Valrie Chambers, CPA, Ph.D.; Edward A. Gershman, CPA; Jennifer S. Korten, CPA; Darren Neuschwander, CPA; Jeffrey A. Porter II, CPA; Kenneth L. Rubin, CPA; David E. Taylor, CPA; and Donald J. Zidik Jr., CPA
3 hours 43 minutes ago

EXECUTIVE SUMMARY

- In several cases, the Tax Court denied deductions for alimony paid other than under a divorce or separation agreement.
- Legislation in 2017 provided tax benefits to victims of hurricanes Harvey, Irma, and Maria, including the ability to receive "qualified hurricane distributions" from retirement accounts.
- The Tax Court decided a number of taxpayer claims relating to passive activity losses, including whether taxpayers qualified as real estate professionals under Sec. 469.
- Controversies involving gains that were decided by courts included determining basis in the sale of a home that was part sale and part gift; an election to calculate the basis of securities sold by a method other than the default first-in, first-out method; and whether an underwriters' commission in a sale of stock pursuant to an employee stock option was a capital or ordinary expense.

This article is a semiannual review of recent developments in the area of individual federal taxation, including issues of deductible alimony, trade or business expenses, and recognition of loss. The items are arranged in Code section order.

This article is a semiannual review of recent developments in the area of individual federal taxation, including issues of deductible alimony, trade or business expenses, and recognition of loss. The items are arranged in Code section order.

Sec. 36B: Refundable credit for coverage under a qualified health plan

On July 24, 2017, the IRS issued final regulations relating to the Sec. 36B premium tax credit and the deduction for health insurance costs for self-employed individuals.[1] The final regulations address issues including eligibility of victims of spousal abuse or abandonment to claim the credit, certain allocation issues that arise in reconciling advance credit payments with the actual credit amount, and the calculation of the Sec. 36B (f)(2)(B) repayment limitation for taxpayers claiming the self-employed medical insurance deduction.

The regulations provide for a certification process for a married victim of domestic abuse or abandonment to claim the Sec. 36B credit. They also provide guidelines for situations involving multiple families or divorced taxpayers covered under a single medical plan.

Sec. 61: Gross income defined

Payments received by a taxpayer because a bank engaged in improper home mortgage foreclosure practices were held to be taxable where the payments were made from a settlement fund for which the taxpayer did not have to show financial harm to be eligible.[2]

Sec. 71: Alimony and separate maintenance payments

Divorce or separation agreement: In 2006, while still married to his wife, the taxpayer in *Mudrich*[3] earned a bonus for services he provided. The taxpayer filed for divorce in January 2007 and received the bonus he earned in 2006 during 2007. In June 2007, the taxpayer executed an agreement with his ex-wife under which she would receive half of the bonus, net of withholding taxes, and he would include the full amount of the bonus in gross income on his 2007 tax return. When the taxpayer filed his 2007 tax return, he included the full amount of the bonus and claimed a deduction for the bonus payment he made to his ex-wife as alimony. The Tax Court concluded that the bonus agreement was not a divorce or separation instrument, so the payment was not alimony because it was not mandated by a divorce or separation agreement as required under Sec. 71 (b)(1)(A).

Oral modification: Another case addressed by the Tax Court involved whether a taxpayer was entitled to deduct as alimony more than the amount he was required to pay by the marital separation agreement.[4] The taxpayer separated from his wife in 2009 and divorced her in 2010. The taxpayer's separation agreement required him to pay his ex-wife $2,000 per month in spousal support until their marital residence was sold, when the payments would increase to $8,000 per month. Given the troubled real estate market in 2009, the taxpayer was unable to sell the home, so the taxpayer and his ex-wife agreed orally to modify the separation agreement. Under this modification, prior to the sale of the marital residence, the taxpayer paid his ex-wife $5,000 per month instead of the amount ordered by the court. The court found that the oral modification of the separation agreement did not meet the requirements of Sec. 71, and, therefore, the amounts the taxpayer paid to his ex-wife in excess of the $2,000 per month required by the separation agreement were not deductible as alimony on the taxpayer's return.

Sec. 83: Property transferred in connection with performance of services

In *Austin*,[5] the Tax Court held that restricted stock was subject to a substantial risk of forfeiture when issued and not substantially vested, as the IRS contended. The court noted that neither of the taxpayers, two men who worked together in a company they founded, held a controlling position in the company, so neither of them could unilaterally remove the restrictions on the stock. Additionally, if either taxpayer failed to perform his duties or left the company before the restrictions ended, the other taxpayer had an incentive to insist on enforcement of the forfeiture provision, which provided that each would lose 50% of the value of his stock if he were to leave the company within five years, so it was likely the agreement would be enforced.

The IRS further contended that the fair market value (FMV) of the stock was taxable income to the taxpayers when the restrictions on the stock lapsed on Jan. 1, 2004. Prior to this date, the taxpayers reorganized their business. They claimed that in the reorganization they had "surrendered" their original shares and acquired replacement shares in exchange for a promissory note, and they reported the difference between the FMV of the replacement shares and the promissory note as compensation income.

The court concluded that the "surrender" and "repurchase" transactions lacked economic substance, and thus each taxpayer was required to report as compensation income an amount equal to the FMV of the stock on the day the restrictions lapsed, to the extent this amount exceeded the taxpayer's basis in those shares.

Also addressed was a "special dividend" received by the taxpayers. The court concluded that, due to the amounts included in income from the lapse of the stock restrictions, the taxpayers received an increase to their basis. Thus, the receipt of the special dividend was a nontaxable event, as each taxpayer had sufficient basis in his shares to absorb the special dividend.

Sec. 162: Trade or business expenses

Travel: In *Barrett*,[6] the IRS denied the taxpayer a deduction for business-related travel expenses because it determined that the city the taxpayer traveled to was his tax home. The taxpayer and his spouse resided in Nevada, where the spouse had a job and the couple had several rental properties. The taxpayer had worked as a self-employed video producer since the mid-1980s. The company for which he primarily worked had video studios in Washington, D.C., and as part of his work agreement with the company, he was required to travel there to use its editing facilities.

The taxpayer testified that 75% of his work related to video production was performed outside Washington and conducted from his office in Nevada. When he was required to travel to Washington, he spent an average of two weeks there. The taxpayer deducted the travel-related expenses for trips to Washington on his Schedule C, *Profit or Loss From Business*. The IRS denied the deduction on the basis that his tax home was in Washington, and his work of over 21 years was permanent rather than temporary.

The court held in favor of the taxpayer. Because the taxpayer performed a substantial portion of his work in Nevada, plus the fact that he and his wife lived together in Nevada and had rental properties that the taxpayer assisted in maintaining, the taxpayer's travel to Washington only to complete the production process for just a few sporadic weeks did not support the position of the IRS that the taxpayer's tax home was in Washington. However, the court disallowed expenses claimed beyond those previously allowed by the IRS, for lack of substantiation.

Substantiation: *Larkin* involved a married couple residing in the United Kingdom during the years in question while the husband was employed by a multinational law firm.[7]

The IRS disallowed many of the deductions claimed by the taxpayers on their Schedule C. In the majority of the instances, the taxpayers failed to provide documentation to support their claims for deductions and credits associated with several of the husband's business endeavors. These claims included home office expenses, depreciation for a home computer, medical expenses, home mortgage interest, casualty losses, and charitable contributions. Of these, the husband provided limited documentation, and the court disallowed most of them. The court allowed the taxpayers to deduct a few expenses for which it found credible support, primarily items stated on the husband's Schedule K-1 from the law firm. The court found the husband's credibility lacking, relying on his testimony only when other evidence supplied additional support.

Business purpose: An individual taxpayer was denied deductions for numerous unreimbursed employee expenses, charitable deductions, and home office expenses claimed on his 2011 income tax return.[8] At trial, the taxpayer failed to address a claim for a deduction of tax preparation and attorneys' fees, and it was disallowed. The taxpayer asserted that his unreimbursed employee expenses fell under his employer's unofficial policy rather than the employer's written reimbursement policy. Due to the taxpayer's failure to

provide either the written policy or proof of this unofficial policy, the deduction for the unreimbursed employee expenses was disallowed. The taxpayer claimed deductions for unreimbursed meals and other travel expenses of donating his services to a charitable foundation, which were disallowed, and expenses of maintaining the foundation's website, which were allowed. The court sustained the IRS's denial of a home office deduction, both with respect to his claimed use of it as an employee, since he presented no evidence the employer required him to use the home office for the employer's convenience, and with respect to his own business activity, since he did not provide evidence of how much time he spent performing the activity there in comparison to other locations. The taxpayer also attempted to deduct expenses for travel and meals associated with his job search within his profession. The taxpayer presented records of the travel but failed to prove its business purpose, so the court held that those expenses were nondeductible.

Sec. 165: Losses

Legislation enacted on Sept. 29, 2017,[9] provided benefits for victims of hurricanes Harvey, Irma, and Maria. For qualified disaster-related personal casualty losses from those hurricanes, the act removes the requirement that personal casualty losses must exceed 10% of the taxpayer's AGI to be deductible and allows nonitemizers to increase their standard deduction by the amount of their net disaster loss. Additionally, victims of the hurricanes can use their 2016 income to calculate the 2017 earned income tax credit and refundable portion of the child tax credit. The legislation waives the 10% penalty on pre-age-59½ retirement account payouts of "qualified hurricane distributions" of up to $100,000 in a tax year, and the income tax due on those distributions can be spread over a three-year period. Any amounts recontributed to the account during the three-year period will be treated as rollovers, and any tax previously paid on those amounts can be recovered by filing an amended Form 1040, *U.S. Individual Income Tax Return*. Victims with Sec. 401(k) accounts can borrow up to the lesser of $100,000 or 100% of the account balance, and loan repayments can be deferred.

Sec. 166: Bad debts

The taxpayer was denied a business bad debt deduction in *Rutter*.[10] The taxpayer was a scientist in the field of biotechnology who in 2002 incorporated a company that developed technology to remotely monitor patients' health. Even though the taxpayer was the driving force behind the newly formed company, he did not own any of its common stock. Between 2000 and 2009, the taxpayer advanced more than $80 million to the company. Promissory notes were executed for, and any interest was paid on, only approximately $14 million of the advances. Additionally, the taxpayer did not seek repayment of any of the outstanding principal.

In 2009, after the company failed to form successful partnerships with health care, pharmaceutical, and technology companies, the taxpayer decided to take a bad debt loss deduction for a portion of his advances to the company on a first-in, first-out basis and reported a business bad debt loss of $8.55 million on his 2009 Schedule C.

The court denied the deduction, determining that the advances were equity investments rather than bona fide debt. The court further found that even if the advances were considered debt, they would be nonbusiness debt and therefore nondeductible under Sec. 166, because the taxpayer was not in the business of lending money.

Sec. 170: Charitable, etc., contributions and gifts

A number of charitable easement cases highlighted the importance of having easement documents that are well-drafted and overseen by legal and accounting professionals. Other cases highlighted proper recordkeeping, substantiation, and valuation requirements when claiming charitable contributions.

Real estate remainder interest: In *RERI Holdings I, LLC*,[11] a partnership was denied a $33 million noncash charitable deduction for a contribution of a remainder interest in real estate because the Form 8283, *Noncash Charitable Contributions*, attached to its tax return failed to include the partnership's original cost of the remainder interest. The failure to disclose the cost of the remainder interest could not be excused on the grounds of substantial compliance, since its disclosure would have alerted the IRS to a potential overvaluation of the remainder interest. Therefore, the partnership's Form 8283 did not satisfy the requirements of Regs. Sec. 1.170A-13(c)(4)(ii)(E).

Facade easement: In *Big River Development, L.P.*,[12] a partnership was allowed a $7 million noncash charitable deduction for a facade easement. Although the written acknowledgment issued by the recipient charity did not indicate that no goods or services were provided, the easement deed explicitly stated that the charity supplied no goods or services in exchange for the gift of the easement, and that the deed reflected the entire agreement of the parties. As such, the easement deed fulfilled the requirements of Sec. 170(f)(8)(B), the Tax Court held.

Contemporaneous written acknowledgment: In *310 Retail, LLC*,[13] the IRS denied a partnership a noncash charitable deduction of a $26.7 million facade easement because no separate contemporaneous written acknowledgment was received from the charity, and the easement deed contained no references to goods or services. In this case, the partnership first argued that an amended Form 990, *Return of Organization Exempt From Income Tax*, filed seven years after the gift, which disclosed the gift and stated that no goods or services were provided, satisfied the requirement. Following *15 W. 17th St., LLC*,[14]which was decided after this case had been filed, the Tax Court found that this alternative reporting measure did not satisfy the contemporaneous written acknowledgment requirement. However, the Tax Court further found that, as was the case in *Big River Development, L.P.* (described above), the deed of easement for the gift satisfied the requirement and held that the taxpayer was therefore entitled to the deduction.

In perpetuity: In *Palmolive Building Investors, LLC*,[15] a partnership's noncash charitable deduction for a facade easement was denied because the easement was subject to a mortgage and therefore not protected in perpetuity. The taxpayer argued that a clause in the easement deed would retroactively amend the deed to cure the defect. However, the Tax Court found that the requirements of Sec. 170 must be satisfied at the time of the gift.

Valuation: In *Gardner*,[16] an avid hunter's noncash charitable deduction for donations of big-game specimens to an ecological foundation was reduced from $1,425,900 to $163,045. The taxpayer's valuation expert concluded it would cost $1,425,900 to conduct 177 safaris to accumulate the specimens the taxpayer donated. The Tax Court noted that replacement cost may be relevant where the property is unique, the market is limited, and there is no evidence of comparable sales; however, the taxpayer's donated specimens were neither world-class trophies nor of museum quality, and there was an active market in specimens like the taxpayer's. The court concluded, therefore, that they were commodities, not collectibles, and that they should be assigned FMV rather than replacement cost. Because the taxpayer provided no evidence that the replacement cost for the specimens exceeded the amount allowed by the IRS, the court upheld the IRS's valuation.

Substantiation: In *Ohde*,[17] the Tax Court reduced a married couple's claimed noncash deduction for 20,000 items given to Goodwill Industries valued at a total of $145,250 to $250. The receipts from Goodwill did not describe any of the items or indicate how many items were donated or their condition, so the court found that

the taxpayers' records were not adequate to support their claimed deductions. The court further found that when similar items were grouped together (e.g., clothing, furniture, etc.), items representing over 88% of the claimed value would have required qualified appraisals since they were valued at more than $5,000 each.

Sec. 183: Activities not engaged in for profit

***Gambling activity*:** In*Boneparte*,[18] the taxpayer worked full time as an employee for the Port Authority of New York and New Jersey, which generated almost all of his annual earnings. However,on his 2012 and 2013 tax returns, the taxpayer claimed net losses on Schedule C of $89,116 and $85,783 from his activity as a professional gambler. Most of the expenses he claimed were for auto expenses, travel, and meals and entertainment incurred while on gambling trips to Atlantic City and other locations. Applying the nine factors of Regs. Sec. 1.183-2(b), the Tax Court determined that the taxpayer failed to prove that his gambling activity was a for-profit business activity, and he could not deduct any expenses for his gambling activities on Schedule C.

***Businesslike manner*:** Experience alone did not prove that a taxpayer engaged in a business activity for profit in *Stettner*.[19] In that case, a taxpayer who had over 20 years of experience in car racing sought to deduct losses from a car-racing activity. In applying the Regs. Sec. 1.183-2(b) test to determine whether he operated the activity with the intent to make a profit, the Tax Court found that the taxpayer's experience in the industry, the substantial time he spent on the activity, and the fact that it was his only significant source of income weighed in his favor.

However, it found that these factors were heavily outweighed by his not running the activity in a businesslike manner, his lack of expertise in running a car-racing business (as opposed to racing cars), the prior failure of his previous similar car-racing business (which had caused the taxpayer to file for bankruptcy), and the personal pleasure he derived from the activity. The court also discounted the fact that the taxpayer reported that the activity had made a profit for three out of its five years, finding that it did not actually make a profit in two of those years and that it was questionable whether it actually did in the third.

Sec. 401: Qualified pension, profit-sharing, and stock bonus plans

The IRS on Aug. 30, 2017, issued News Release IR-2017-138 and Announcement 2017-11, which allowed 401(k) plans and similar employer-sponsored retirement plans to make loans and hardship distributions to victims of Hurricane Harvey and members of their families and relaxed procedural and administrative rules that normally apply to retirement plan loans and hardship distributions. On Sept. 12, 2017, the IRS issued News Release IR-2017-151 and Announcement 2017-13, providing similar relief for victims of Hurricane Irma. The relief applied to loans and hardship distributions made no later than Jan. 31, 2018.

Sec. 469: Passive activity losses and credits limited

***IRS regrouping authority*:** In *Hickam*,[20]the Tax Court upheld the IRS's position that brokering real estate mortgages is not a real property trade or business under Sec. 469(c)(7)(C). The taxpayer worked as a mortgage broker as an employee for a company in which he held no ownership, and as an independent contractor for the years under audit (2011—2012). The taxpayer also managed three rental properties in California.

The taxpayer deducted his losses from the three properties on his returns for 2011 and 2012. The IRS disallowed those deductions, asserting that the taxpayer was not a real estate professional and, therefore, the losses were *per se* passive.

The taxpayer argued that the Tax Court should treat his mortgage brokerage services as performed in real property trades or businesses and that the hours he spent performing those services should be included in determining whether he met the real estate professional test. The court disagreed. The court found that the time spent as a mortgage broker did not constitute a real property trade or business activity, which is defined in Sec. 469(c)(7)(C): "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." The court stated that the mortgage brokering business related to loans, not to real property, so it was not a real property trade or business. Without including those hours, the court determined that the taxpayer did not qualify as a real estate professional, so the losses from his rental properties were *per se* passive.

***Restricted stock ownership and real estate professional status*:** In Action on Decision (AOD) 2017-07, the IRS announced it will not follow the district court's holding in *Stanley*.[21] In that case, the taxpayer husband had claimed that his participation in a real estate activity through a company in which he held at least 5% ownership qualified for purposes of Sec. 469, although his shares were restricted. The IRS argued unsuccessfully that since the shares were restricted and not treated as outstanding under Sec. 83, they did not constitute ownership under Sec. 469(c)(7)(D)(ii), and thus his work for the company could not be grouped with his real estate rental activity for purposes of determining material participation. The court held in favor of the taxpayers, noting that no authority allows applying Sec. 83 to the passive-activity rules of Sec. 469.

In the AOD, the IRS stated that the court also incorrectly held that the taxpayers in *Stanley* could group their aggregated rental real estate activity with other, nonrental trade or business activities under Regs. Sec. 1.469-4. According to the IRS, the court misinterpreted Regs. Sec. 1.469-9(e)(3)(i) and did not adequately reconcile its language with the language in Regs. Sec. 1.469-9(e)(1) and Sec. 469(c)(7)(A)(ii).

***Real estate professional's expenses*:** In another case, the IRS challenged numerous items within the individual taxpayer's tax return. The crucial determination was whether the individual qualified as a real estate professional, which would allow her to offset her otherwise *per se* passive rental losses against her other ordinary income if she materially participated in the rental activities. After considering the strict requirements to be a qualified real estate professional in Sec. 469(c)(B)(7), the court found that she met the requirements.[22] The court further found that she materially participated in the rental activities, so the activities were not passive activities and she could deduct the losses. However, the court sustained the IRS's disallowance of most of the taxpayer's claimed unreimbursed employee expenses for lack of substantiation.

Sec. 1001: Determination of amount of and recognition of gain or loss

The IRS ruled in Technical Advice Memorandum 201737011 that a taxpayer who was the CEO and majority shareholder of a self-clearing broker did not realize losses under Sec. 1001 upon transfer of securities from a hedge fund account to the taxpayer's personal trading accounts held at the broker. Although the broker had legal title to the trading account as well as the securities held in the account, the individual taxpayer had exclusive and complete discretion, voting power, and control over the investments in the trading account. Thus, the individual also possessed the economic benefits and burdens associated with the securities transferred to the trading account, and, consequently, the transfers were not sales.

***Commission as capital expense*:** The Court of Federal Claims held that a commission paid by a taxpayer to exercise employer stock options and sell the stock in an initial public offering (IPO) was a capital expense and not an ordinary expense, as he claimed.[23] The taxpayer claimed that the commission he paid the underwriters of the IPO was an ordinary expense, under four alternative theories: (1) The transaction was a single-step transaction (a cashless exercise); (2) he was entitled to reduce the amount realized when he paid the

underwriters a commission under Sec. 83 or Sec. 1012; (3) the expense was an ordinary and necessary expenditure incurred in a trade or business; or (4) the substance of the transaction should be regarded over its form because he paid the commission to generate ordinary income.

The court concluded that the transaction consisted of two steps — the exercise of the options and then the sale of the stock received in the exercise — and that the commission on the sale of the stock was properly treated as a reduction of the amount received from the sale.

Regarding the taxpayer's arguments for ordinary expense treatment, the court found that although the two steps were executed simultaneously, this did not affect their treatment as separate transactions. The court also found that the exercise was not subject to Sec. 83 or Sec. 1012 because the taxpayer could have exercised his options without paying the commission to the underwriters. The court rejected the argument that the commission was a business expense, as the taxpayer was not in the trade or business of selling securities but was in the trade or business of being an employee. It rejected the taxpayer's substance-over-form claim, because this theory focused only on the exercise of the options, which resulted in ordinary income, and ignored the second step of selling the shares, which resulted in a capital gain.

Sec. 1011: Adjusted basis for determining gain or loss

The Tax Court held in *Fiscalini*[24] that the taxpayer needed to report long-term capital gain on the sale of property to his parents. The taxpayer and his parents had purchased a home in 2003, with the taxpayer paying $234,312 and the parents paying $40,000. Later that year, the parents gave their interest in the home to the taxpayer. In 2007, the taxpayer sold the house back to his parents. The parents did not give the taxpayer any cash in the sale but paid off two outstanding mortgages on the property (in aggregate, $664,048). However, the closing statements for the sale stated that the total consideration the parents paid was $975,000.

The court held that the basis was the amount paid by the taxpayer when the home was purchased in 2003 ($234,312), plus the basis of the parents' interest in the property ($40,000), for a total of $274,312. The court did not allow any increase in basis for improvements claimed by the taxpayer, because the taxpayer was unable to provide adequate substantiation. The court also found that the amount realized was the amount of the two mortgages discharged by the parents (less settlement costs) and not the FMV of the property ($975,000). The court stated that the IRS failed to understand that the taxpayer's sale to his parents was a transfer of property that was in part a sale and in part a gift (Regs. Sec. 1.1001-1(e)(1)). The IRS had previously conceded that the taxpayer could exclude $250,000 of the gain under Sec. 121.

Sec. 1012: Basis of property — cost

***Determining gain using FIFO*:** The Tax Court ruled in *Turan* [25] that an individual taxpayer had to calculate his long-term capital gain and basis of securities sold using the default first-in, first-out (FIFO) method and not the last-in, first-out (LIFO) method, which would have resulted in a smaller gain. The court noted that the taxpayer bore the burden of proving that he adequately identified the stocks that he wished to be sold. The taxpayer claimed that his broker erred in not using the LIFO method and that he attempted to inform his broker of the method change through the broker's internet client portal but was unable to do so because of an error on the broker's website. However, the taxpayer also claimed that he attempted to phone the firm but received no assistance. The taxpayer offered no documentation to corroborate his claim of a computer error on the part of the broker, and the broker also declared that it had no record of being contacted by the taxpayer. Thus, the court found that the taxpayer never instructed his broker to administer his account using any method other than the default FIFO method.

Sec. 1033: Involuntary conversions

The IRS issued Notice 2017-53, which provides an extension of the replacement period under Sec. 1033 for livestock sold on account of drought in specified counties. The replacement period was extended for one year for droughts reported during the 12-month period ending on Aug. 31, 2017.

Sec. 1402: Self-employment tax

In July 1999, the taxpayers in *Martin*,[26] Charles and Laura Martin, purchased a farm and began building poultry houses to meet the specifications of poultry producer company Sanderson Farms Inc. They bought additional equipment for raising young chickens, known as broilers, bringing the total cost to roughly $1.2 million.

In 2000, the Martins entered into a broiler production agreement as "growers" with Sanderson Farms. The 15-year agreement essentially provided that the only discretion the Martins had with regard to operations was the hiring of needed employees. Sanderson would provide all of the chickens and feed while retaining the ownership of both, and the Martins would manage the chickens' 49-day growth cycle according to Sanderson's specifications.

In 2003, the Martins obtained an agricultural appraisal of the farm. The appraisal covered the cost of the land and structures and analyzed the cost of running the farm as an investment, not as active participants. In late 2004, the taxpayers organized an S corporation, C.L. Farms Inc., and entered into oral employee agreements with it and set their salaries consistent with those of other growers. Laura Martin would provide bookkeeping services, and Charles Martin would provide labor and management services. In January 2005, Sanderson approved the assignment of the remainder of the broiler production agreement to C.L. Farms. The agreement with C.L. Farms designated the entity as the grower, with Sanderson ready to step in and raise the chickens should C.L. Farms fail to perform its duties.

Also in January 2005, the Martins signed a five-year lease agreement with C.L. Farms to rent to it the farm and structures, excluding their personal residence and a further 10 acres. The rent was to be paid regardless of whether C.L. Farms was fulfilling its contract with Sanderson Farms. The rent was at FMV and was consistent with amounts paid by other Sanderson Farm growers.

At issue in this case was the treatment of the rental income for purposes of self-employment tax. Sec. 1402(a)(1)(A) provides that rental income received under an arrangement between the owner of property and a third party that includes the production of agricultural or horticultural commodities, including poultry, on the property and the material participation of the property owner results in that rental income's being subject to self-employment tax. The IRS contended that the agreements between the Martins, C.L. Farms, and Sanderson Farms required the Martins to materially participate in the production of the chickens. The Martins contended that the rent payments were consistent with market rates, there was no nexus between the lease and either the broiler agreement or the employment agreements, and their material participation was not required by either agreement.

Relying on *McNamara*,[27] the court sided with the Martins. In *McNamara*, which involved a similar set of facts, the Eighth Circuit reversed the Tax Court's decision in favor of the IRS, noting that the rental agreement "stands on its own" as an independent transaction due to the rents being at or below FMV. Thus, the IRS was required to prove that nexus existed between the rents received and the arrangement that required the owner's material participation. The IRS could not prove such a relationship, and the income was excluded from self-employment income.

Similarly, the court found in this case that the rents' being at or below FMV established that the rental agreement stood on its own. The court also found that, because C.L. Farms only used the single-use structures and roughly 10 acres of the 290 acres available for rent, the agreement functioned more as a return on investment for construction of the facilities. Further, the court examined the compensation agreements and highlighted that they were priced above the cost of management reported in the 2003 appraisal. The court took this as an indicator the compensation agreement and the rental agreement were not designed to avoid self-employment tax. These factors, along with the IRS's being unable to prove nexus between the rental contract and employment contract, led to the decision that the income was not subject to self-employment tax.

Sec. 5000A: Requirement to maintain minimum essential coverage

***Catastrophic health plan reporting*:** The IRS further postponed required reporting by issuers of catastrophic health plans. Under current regulations, neither the exchanges nor issuers are required to report coverage under a catastrophic plan enrolled in through an exchange.[28] Reporting of catastrophic plan coverage was voluntary for 2015 and 2016 coverage. This notice extends voluntary reporting to 2017 coverage.

***Reporting health coverage*:** On Oct. 13, 2017, the IRS updated its webpage on health care reporting requirements[29] to inform taxpayers that it will not accept e-filed returns unless the taxpayer and everyone on the return had health care coverage, qualified for an exemption from coverage, or made a shared-responsibility payment under Sec. 5000A. This was a change from 2016 returns, where the IRS did not reject returns for failure to meet the health care reporting requirement.

Paper returns that do not address the health coverage requirements may be suspended until the IRS receives additional information, and any refund due may be delayed.

Sec. 6013: Joint returns of income tax by husband and wife

For tax year 2012, the taxpayer in *Camara* timely filed his return claiming single filing status.[30] This status was incorrect, as he was married for the entire period. The IRS responded in 2015 with a notice of deficiency and changed his status to married filing separately. After petitioning the court, the taxpayer and his wife filed a joint return for 2012. The IRS contended that his original filing constituted a "separate return" and that the change in status was not allowed, due to the limitations imposed by Sec. 6013(b)(2). The Tax Court disagreed with this stance and sided with the taxpayer.

Sec. 6013(b)(1) provides that if an individual has filed a separate return for a tax year for which the individual and his or her spouse could have filed a joint return, the individual and his or her spouse may nevertheless make a joint return for that year. Sec. 6013(b)(2) lists four limitations on the election to switch filing statuses. Both sections apply only if the taxpayer has filed a separate return. As the court noted, "separate return" in Sec. 6013(b)(1) is not defined in the Code or regulations. By further examining the appellate courts' opinions in *Ibrahim*[31] and *Glaze*,[32] the court determined that "separate return" means a return on which a married taxpayer has claimed the permissible status of married filing separately, rather than a return on which a married taxpayer has claimed a filing status not properly available to him or her.

The court stated that Sec. 6013(b)(1) describes filing a separate return as an "election" and agreed with holdings in both *Ibrahim* and *Glaze* that an erroneous claim to a filing status does not constitute an election for this purpose. The court also pointed to the legislative history of Sec. 6013(b)(1), which it found shows an intention to allow taxpayers to switch from a proper initial election to file a separate return to a possibly more advantageous election to file a joint return and not an intention to foreclose correction of an erroneous initial return.

Bankruptcy Code Section 523: Exceptions to discharge

In general, taxpayers may have tax liabilities discharged in bankruptcy. Under Bankruptcy Code Section 523(a)(1)(C),[33] tax debts are excluded from discharge if the taxpayer has willfully attempted to evade or defeat the tax. The test for evasion or defeat is two-pronged: one concerning conduct and the other concerning mental state. In *Feshbach*,[34] the Bankruptcy Court refused to discharge a tax debt from 2001 due to the taxpayers' excessive spending and extravagant lifestyle. The court found that the spending behavior qualified as a willful attempt to evade or defeat tax, under the conduct element of dischargeability of tax debts, as using available funds for extravagant personal items instead of paying the debt constituted evasion. The court found that the second prong, mental state or willfulness in avoiding payment of tax, was evidenced by the taxpayers' numerous offers in compromise that were unrealistically low in comparison to their ability to pay the tax debt. The court stated that the taxpayers knowingly were deferring payment of the debt and noted the IRS's contention that they "did not work *within* the system but, rather, *worked* the system" to avoid paying the debt.

Footnotes

---

[1]T.D. 9822.

[2]*Ritter*, T.C. Memo. 2017-185.

[3]*Mudrich*, T.C. Memo. 2017-101.

[4]*Bulakites*, T.C. Memo. 2017-79.

[5]*Austin*, T.C. Memo. 2017-69.

[6]*Barrett*, T.C. Memo. 2017-195.

[7]*Larkin*,T.C. Memo. 2017-54.

[8]*Brown*, T.C. Summ. 2017-29.

[9]Disaster Tax Relief and Airport and Airway Extension Act of 2017, P.L. 115-63.

[10]*Rutter*, T.C. Memo. 2017-174.

[11]*RERI Holdings I, LLC*, 149 T.C. No. 1 (2017).

[12]*Big River Development, L.P.*, T.C. Memo. 2017-166.

[13]*310 Retail, LLC*, T.C. Memo. 2017-164.

[14]*15 West 17th Street, LLC*, 147 T.C. No. 19 (2016) (see discussion in Baldwin et al., "Individual Taxation Report," 48 *The Tax Adviser* 634 (September 2017)).

[15]*Palmolive Building Investors, LLC*, 149 T.C. No. 18 (2017).

[16]*Gardner*, T.C. Memo. 2017-165.

[17]*Ohde*,T.C. Memo. 2017-137.

[18]*Boneparte*, T.C. Memo. 2017-193.

[19]*Stettner*, T.C. Memo. 2017-113.

[20]*Hickam*, T.C. Summ. 2017-66.

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

[22]*Windham*, T.C. Memo. 2017-68.

[23]*Hann*, 133 Fed. Cl. 559 (2017).

[24]*Fiscalini*, T.C. Memo. 2017-163.

[25]*Turan*, T.C. Memo. 2017-141.

[26]*Martin*, 149 T.C. No. 12 (2017).

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

[28]Notice 2017-41.

[29]IRS, "IRS Statement on Health Care Reporting Requirement," available at www.irs.gov (https://www.irs.gov/tax-professionals/aca-information-center-for-tax-professionals).

[30]*Camara*, 149 T.C. No. 13 (2017).

[31]*Ibrahim*, 788 F.3d 834 (8th Cir. 2015).

[32]*Glaze*, 641 F.2d 339 (5th Cir. 1981).

[33]11 U.S.C. §523(a)(1)(C).

[34]*Feshbach*, No. 08:11-bk-12770-CPM (Bankr. M.D. Fla. 10/17/17).

Contributors

David R. Baldwin is a partner with Baldwin & Baldwin PLLC in Phoenix. *Robert Caplan* is a CPA at Caplan & Wong CPAs LLC in Foster City, Calif. *Valrie Chambers* is an associate professor of accounting at Stetson University in DeLand, Fla. *Edward A. Gershman* is a managing director with Deloitte Tax LLP in Chicago. *Jennifer S. Korten* is a partner at Kubo Korten PLLC in Seattle. *Darren Neuschwander* is a managing member with Green, Neuschwander & Manning, a virtual CPA firm with members all across the country. *Jeffrey A. Porter II* is a CPA with Porter & Associates CPAs in Huntington, W.Va. *Kenneth L. Rubin* is a partner with RubinBrown LLP in St. Louis. *David E. Taylor* is a partner at Anton Collins Mitchell in Denver. *Donald J. Zidik Jr.* is a director with Marcum LLP in Boston and an adjunct professor of taxation at Suffolk University in Boston. Mr. Zidik is the chair, Mr. Rubin is the immediate past chair, and the other authors are current members of the AICPA Individual & Self-Employed Tax Technical Resource Panel. For more information about this article, contact thetaxadviser@aicpa.org (mailto:thetaxadviser@aicpa.org).