THE TAX ADVISER

New Directions in Individual Taxation

INDIVIDUALS

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EXECUTIVE SUMMARY

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- The Tax Court held that a taxpayer in a community property state whose husband, after the couple separated but before they divorced, formed a company she did not know about, had to report her share of the community income from the company because they were technically still married.
- In a change of position, the IRS announced that qualified Medicaid waiver payments will be treated as Sec. 131 nontaxable qualified foster care payments regardless of whether the care provider is related to the eligible individual.
- The Tax Court found that despite a conciliation agreement that indicated he was not his son's custodial parent, a taxpayer who proved his son spent more nights with him than with the mother was entitled to the dependency exemption.
- The IRS issued a notice on virtual currency that provides that general tax principles that apply to property transactions will apply to virtual currency and discusses the practical results of this treatment.

This article covers recent developments affecting taxation of individuals, including regulations, cases, and IRS guidance. The items are arranged in Code section order.

Sec. 61: Gross Income Defined

In *Nelson*, a Tax Court decision upholding the IRS's deficiency determination was affirmed on appeal.1 The taxpayer was a commercial pilot who earned $154,749 in 2005, and $264,640 in 2008, but reported zero income on his returns. He asserted that his private-sector employment was not subject to federal taxation. The Tax Court held that the taxpayer received compensation in exchange for his services and that his arguments otherwise were frivolous.

Sec. 62: Adjusted Gross Income Defined

In one summary Tax Court opinion, the issue was whether a neurosurgeon's trade or business deductions were properly deducted on Schedule C, *Profit or Loss From Business (Sole Proprietorship),* or as miscellaneous itemized deductions on Schedule A, *Itemized Deductions*.2 The Tax Court determined that, because the petitioner was an employee and not a sole proprietor, the expenses were deductible on Schedule A.

Sec. 66: Treatment of Community Income

Under Sec. 66, married couples in a community property state who do not file joint tax returns are generally required to report half of their community income. State law determines who owns income from community property. In one case, the Tax Court held that the taxpayer was required to report half of the community property income attributable to her ex-husband's share in a new LLC that she was not aware existed.3 Although the husband formed the LLC after they separated, it was before they divorced. All that mattered was whether they were still married at the time the LLC was formed.

Sec. 71: Alimony and Separate Maintenance Payments

An above-the-line deduction may be claimed for alimony or separate maintenance payments during the tax year if that payment meets four requirements under Sec 71(b)(1): (1) The payer must make the payment under a divorce or separation agreement; (2) the agreement must not specifically designate the payment as not includible in the recipient spouse's gross income under Sec. 71 and not deductible by the payer spouse under Sec. 215; (3) legally separated spouses under a decree of divorce or separate maintenance must not be members of the same household when payments are made; and (4) the payer's obligation to make the payment must end at the death of the payee spouse.

In *McNealy*, the Tax Court concluded that a lump-sum equalization payment was a property settlement and not alimony because it did not meet the second and fourth requirements.4 The court found that the marital settlement agreement clearly stated that the equalization payment in question was intended to ensure the equitable division of property and that the obligation to make the payment would not terminate at death.

Sec. 72: Annuities; Certain Proceeds of Endowment and Life Insurance Contracts

The Tax Court upheld an additional 10% tax on an early IRA distribution because the taxpayer failed to prove she was entitled to any of the exceptions under Sec. 72.5

In *Roberts*, the Tax Court held that a divorced taxpayer was not required to include distributions from his IRA in his gross income.6 The taxpayer's ex-wife requested the distributions before their divorce without his knowledge by forging the taxpayer's signature. Since the distributions were not taxable, the 10% additional tax also did not apply.

Under Sec. 72, amounts actually distributed from retirement accounts are taxable income to the distributee in the tax year in which they are distributed. If a taxpayer receives a distribution before retiring, only the amounts allocable to the taxpayer's investment in the contract are excludable from income, and only to the extent the contributions were included in income. In *Cahill,* the Tax Court determined that the taxpayer did not establish that any part of the distribution met either of those requirements.7

In another case, the taxpayer was required to include IRA distributions (including one for $6) in his income in the year he received the distributions.8 The taxpayer claimed the $6 distribution was the result of an accounting dispute, but he failed to provide an explanation of this dispute and acknowledged he had received the money.

In *Black*, the Tax Court held that the taxable amount of a gross distribution under Sec. 72 resulting from the termination of a taxpayer's whole life insurance policy included both the amount of the outstanding loans taken against the policy and the capitalized interest accrued on the loans.9 The court found that the interest was part of the bona fide indebtedness that was satisfied with proceeds of the policy upon termination. The Tax Court concluded in a similar case that income received from the surrender of a life insurance contract was taxable under Sec. 72 to the extent it exceeded the taxpayer's investment in the contract.10

In *Ellis*, the Tax Court found that the taxpayer was liable for the Sec. 72(t) penalty on an IRA distribution because he did not meet any of the exemptions and was not 59½ at the time.11 Also, the court determined that the taxpayer engaged in a prohibited transaction with the IRA because he was a disqualified person with respect to the IRA and he transferred assets to the IRA for his own use or benefit. The IRA under review in this case held a 98% interest in the taxpayer's used car business/LLC and the LLC paid the taxpayer compensation. The court held that the prohibited transaction resulted in a distribution of all the assets from the IRA as of the first day of the year the transaction took place and that the value of the assets was includible in the taxpayer's income in that year.

Sec. 83: Property Transferred in Connection With Performance of Services

The IRS issued final regulations for Sec. 83 relating to property transferred in connection with the performance of services that provide several clarifications regarding whether a substantial risk of forfeiture exists in connection with the transfer of property.12

In Letter Ruling 201405008, the IRS ruled that a Sec. 83(b) election by a taxpayer was valid. The taxpayer mailed the 83(b) election to the IRS as required by the regulations but failed to attach a copy to his or her current-year return as is also required. The Service determined that this failure did not affect the election's validity.

In *Crescent Holdings, LLC*, the taxpayer entered into an employment agreement that provided that, if he served as the LLC's CEO for three years, he would receive a restricted 2% interest in a newly formed LLC/partnership.13 The taxpayer resigned before the three-year period and forfeited his interest. The Tax Court held that the nonvested 2% partnership capital interest was a capital interest transferred in exchange for the performance of services that was subject to Sec. 83. Because the taxpayer did not own the capital interest under Sec. 83, the court further held that the undistributed partnership income allocations attributable to the interest should not be recognized as income to the taxpayer.

In *Austin*, the Tax Court addressed whether a substantial risk of forfeiture existed where S corporation shareholders received restricted stock under an employment agreement that required them to perform substantial future services and also provided that they would receive less than fair market value (FMV) if they were terminated for cause during the stated employment period.14 The Tax Court found that the term "discharged for cause" as used in

Regs. Sec. 1.83-3(c)(2) does not necessarily have the same meaning as the taxpayers gave it in their agreements and that the term referred to termination for serious misconduct, which is highly unlikely to occur. In the taxpayers' case, the court held that, under the terms of the employment agreement, a substantial risk of forfeiture existed.

Sec. 104: Compensation for Injuries or Sickness

In several recently issued private letter rulings, the IRS has ruled that, under Sec. 104, damages or other compensation related to physical injury were properly excluded from the taxpayers' gross income.15

In *Simpson*,the taxpayer received a payment to settle a discrimination claim against her former employer. The Tax Court determined that this payment did not qualify for the Sec. 104(a)(1) income exclusion for amounts received under the worker's compensation law because the settlement agreement did not comply with California statutory requirements and thus the payment was made under a private contract rather than under the worker's compensation statute.16 Because the settlement did contain elements of compensation for physical personal injury and sickness, the taxpayer was entitled to exclude part of the award, however.

The Tax Court held in another case that a payment a taxpayer received from his former employer to settle a discrimination complaint did not qualify for an income exclusion under Sec. 104(a)(2) because it was not made on account of personal physical injuries or sickness.17 Even though the complaint was based on tort-related rights and the taxpayer claimed to have suffered physical illness, the settlement did not specifically allocate any amounts to the claims of physical illness and the employer did not intend the payments to compensate the taxpayer for those claims.

A district court found that the taxpayer's disability retirement benefits were not completely excludable from gross income under Sec. 104(a)(1) since the payments were for both service-connected disability and retirement.18

In *Green*, the Tax Court held that the taxpayer was not entitled to exclude payments from her employer under Sec. 104(a)(1) because the settlement payments were for wages and emotional distress and were not labeled as worker's compensation.19 Further, the payments were not excludable under Sec. 104(a)(2) since they were not on account of personal physical injuries or physical illness.

In a similar vein, the Tax Court determined in *Sharp* that the taxpayer was not entitled to exclude payments received from her employer under Sec. 104(a) since the taxpayer did not establish how much of her settlement was intended as payment for settling a worker's compensation claim and not intended for other claims, including a negligence claim, and the payments were not on account of personal injury or illness.20

Sec. 108: Income From Discharge of Indebtedness

The IRS Chief Counsel's Office advised that a foreclosure on a taxpayer's entire interest in a rental property subject to recourse debt qualifies as a fully taxable disposition under the passive activity rules even though the foreclosure triggers cancellation-of-debt (COD) income that is excluded from gross income.21 Therefore, the taxpayer could exclude COD income and claim his suspended passive activity losses without reduction for the excluded COD income.

The Tax Court held that a couple were not entitled to exclude credit card debt that was discharged from income because they failed to prove that they were insolvent immediately before the discharge.22 Although they testified that they had significant outstanding debt, they failed to submit any evidence of the debt or the FMV of their assets.

In a private letter ruling, the IRS granted a taxpayer a 45-day extension to file an amended return so the taxpayer could make the election under Sec. 108(b)(5), which allows an insolvent taxpayer that excludes income resulting from the discharge of indebtedness to reduce the basis of depreciable property before reducing net operating losses.23 The IRS found that the taxpayer acted reasonably and in good faith and the grant of relief would not prejudice the government's interests.

Under Rev. Proc. 2014-20, the IRS provides a safe harbor that treats a taxpayer's indebtedness (other than a C corporation's indebtedness) that is secured by 100% of the ownership interest in a disregarded entity holding real property as indebtedness that is secured by that real property, if the indebtedness meets the other requirements of Sec. 108(c)(3). The indebtedness will be considered qualified real property business indebtedness (QRPBI), any income from the discharge of the indebtedness will be excluded from the taxpayer's gross income, and the basis of the depreciable real property of the taxpayer will be reduced by the amount of the excluded income, if the following requirements are met:

1. The taxpayer or a wholly owned disregarded entity of the taxpayer/borrower incurs indebtedness;
2. The borrower directly or indirectly owns 100% of the ownership interest in a separate disregarded entity owning real property, and the borrower is not the same entity as the property owner;
3. The borrower pledges to the lender a first priority security interest in the borrower's ownership interest in the property owner;
4. At least 90% of the FMV of the total assets directly owned by the property owner immediately before the discharge must be real property used in a trade or business, and any other assets held by the property owner must be incidental to the property owner's acquisition, ownership, and operation of the real property; and
5. Upon default and foreclosure on the indebtedness, the lender will replace the borrower as the sole member of the property owner.

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

A district court held that the taxpayers could not exclude gain on the sale of an apartment next to the apartment they lived in, which they originally purchased to extend the family home.[24] They never connected the two apartments and later rented the other apartment to their son. The taxpayers reported the rental income from the adjacent apartment, but did not report the apartment sale, claiming they were entitled to exclude the gain as gain from the sale of a principal residence because their son and his family lived there. The court found that the taxpayers were liable for tax on the gain from the sale of the apartment and the substantial underpayment penalty.

The Tax Court held that a taxpayer could exclude only 5% of the apartment building he owned that was used as his personal residence in determining gain on the involuntary conversion of the apartment building.[25] The taxpayer did not introduce any evidence or make any argument regarding whether any portion of the gain attributable to the shared facilities of the apartment building should be excluded under Sec. 121.

Rev. Rul. 2014-2 provides guidance for borrowers with recourse mortgage loans who receive a payment under the National Mortgage Settlement (NMS) due to foreclosure on the taxpayer's principal residence. The revenue ruling states:

1. If a taxpayer includes an NMS payment in the amount realized and it creates or increases a gain on the foreclosure of the principal residence, the taxpayer may exclude the resulting gain from gross income to the extent permitted under Sec. 121, including the limitation that gain attributable to depreciation cannot be excluded from gross income.
2. If the property for which a taxpayer receives an NMS payment contained one or more additional dwelling units that were not used as the taxpayer's principal residence, the entire NMS payment is allocable to the portion of the property that the taxpayer used as a principal residence.
3. A taxpayer who receives any portion of a deceased borrower's NMS payment stands in the borrower's shoes to determine the taxable portion, if any, of the NMS payment. Any taxable amount is income in respect of a decedent.

Sec. 122: Certain Reduced Uniformed Services Retirement Pay

In *Weiss*, the Tax Court held that, even though the Department of Veterans Affairs (VA) determined that the taxpayer was 60% disabled when he retired, all of his retirement pay should be included in taxable income because his retirement pay was computed solely on the basis of his active duty pay rate and years of active service.[26] Also, nothing in the record showed that the taxpayer was incapable of remaining in active duty or that he retired as a direct result of his disabilities.

Sec. 131: Certain Foster Care Payments

In Notice 2014-7, the IRS announced that qualified Medicaid waiver payments will be treated as Sec. 131 nontaxable qualified foster care payments regardless of whether the care provider is related to the eligible individual. Qualified Medicaid waiver payments are payments made by a state or a political subdivision to an entity that is a certified Medicaid provider to an individual care provider for nonmedical support services under a plan of care for an eligible individual living in the individual care provider's home. These Medicaid payments compensate a care provider for providing the additional care required because of an eligible individual's physical, mental, or emotional handicap for which a state has determined there is a need for additional compensation. The notice does not address whether qualified Medicaid waiver payments are subject to tax under the Federal Insurance Contributions Act (FICA) or the Federal Unemployment Tax Act (FUTA).

A district court concluded that a married couple could not exclude foster care payments received from the state for the wife's care of their severely disabled son, for whom the wife had been appointed legal guardian when he turned 18.27 The court reasoned that Sec. 131 applies only when there is no legal duty to care for the child. Since the wife was his legal guardian, the son could not be considered a foster child.

Sec. 152: Dependents Defined

In *Swint*, the Tax Court held that an individual was not entitled to a dependency exemption claimed for the child of her late husband, a noncustodial parent, because the state court document allowing him the deduction did not meet the requirements of Sec. 152(e)(2)(A).28

Swint's late husband had a daughter from a previous marriage that ended in 1998. The parties agreed that the late Mr. Swint would have been entitled to claim the dependency exemption if he remained current on his child support obligations. Mr. Swint's daughter did not live with the taxpayers during the year in question.

Sec. 152(e) provides that a child will be treated as a qualifying child of the noncustodial parent rather than of the custodial parent, if "the custodial parent signs a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such custodial parent will not claim such child as a dependent for any taxable year beginning in such calendar year."29

Under Regs. Sec. 1.152-4(e)(5), if a written declaration was executed in a tax year beginning on or before July 2, 2008, then the requirements for a written declaration in effect at the time would apply. In 1998, a court order or decree or a separation agreement was an acceptable form of written declaration if the other requirements were met. As of Feb. 13, 1998, Sec. 152(e)(2)(A) provided that the noncustodial parent could claim the dependency exemption deduction if "the custodial parent signs a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such custodial parent *will not claim* such child as a dependent for any taxable year beginning in such calendar year" (emphasis added).

Because the custodial parent did not sign the court document, it did not satisfy the signature requirement. In addition, the language "will not claim" in Sec. 152(e)(2)(A) means that the release must be unconditional. Because the custodial parent's release of the dependency exemption was conditioned upon another action, the court found that it was not unconditional.

In *Harris*, an unmarried father was entitled to the dependency exemption for his qualifying child when the court found that the taxpayer was the child's custodial parent during the tax years at issue and the taxpayer and the child's mother did not follow the terms of a conciliation agreement regarding custody of the child in those years.30

The taxpayer and his child's mother lived apart and never married. Both parents claimed dependency exemptions for the child during the years in question. They entered into a detailed agreement in 2003 regarding the child's living arrangements and visitation schedule, but it did not specify which parent was entitled to the exemption. For 2010 and 2011, each parent took the position that he or she was the custodial parent. Neither would agree to give the other the right to the exemption.

The child had a busy school and extracurricular schedule, which required daily travel to and from these activities and often out of town. The child's mother, who was unemployed in 2011 and 2010, did not have a driver's license or own a car.

The taxpayer was able to establish that he regularly took his son to school, attended most of his football and basketball games, and, in 2010, was his son's basketball coach. While the taxpayer lived 65 miles from where his son lived and went to school, his great aunt lived one block from the school. The taxpayer and his son often slept at the great aunt's home, each had his own bedroom there, and they attended church together with the great aunt as well as spending spring breaks, Christmas break, and summer vacation together.

Although the taxpayer and the child's mother had agreed that she would be the custodial parent, the court determined that the son actually spent more nights with the taxpayer than with the mother and therefore the taxpayer could take the dependency exemption.

Sec. 162: Trade or Business Expenses

The IRS continues its attack on tax avoidance schemes. The taxpayer in one Tax Court case was a holding corporation that purchased two corporations that had large capital gains.31 To avoid tax on these gains, the taxpayer set up two LLCs to which it contributed offsetting purchase and sale options and some stock. It increased the LLCs' basis for the purchase options but did not decrease it for the sale options. When the options expired, the company dissolved the LLCs and received the stock, which took the artificially inflated bases of the LLCs. The taxpayer sold the stock, realizing tax losses large enough to offset the gains it inherited from the two

corporations it had purchased. The IRS attacked the scheme as having no economic substance, and the Tax Court upheld the IRS. Although the taxpayer had a potential for a small amount of gain, the primary purpose was tax avoidance and the transactions had no economic substance.

In another case, a neurosurgeon created a wholly owned S corporation.32 For the years in question, she received a Form W-2 from the corporation that she reported as wages on her tax return. After several years, she had a dispute with the medical center for which she provided services and eventually sued. In the year the lawsuit was settled, the taxpayer included a Schedule C with her tax return, reporting gross income of $15,100, expenses of $66,554 (including $60,000 in legal fees), and a loss of $51,454. In addition, she reported wages from an educational institution. The court held that she could not deduct the expenses as business expenses under Sec. 162 on Schedule C, but could deduct them as itemized deductions under Sec. 212.

Over the past several years, the IRS has taken a strict approach toward automobile expenses by requiring a concurrent log to support them. The logs must contain not only information as to miles and business purpose but even odometer readings. Although Congress passed legislation requiring a concurrent log be maintained to support automobile expenses, it was repealed after an enormous uproar in the business community. Taxpayers should be aware that in the authors' experience the IRS has ignored the repeal and is enforcing the rules during audits.

In the *Snellman* case, a taxpayer who normally worked in Florida was sent on a temporary six-month assignment to work in Missouri.33 He claimed $4,060 in mileage and $27,200 for food and lodging related to the assignment. Although the court found that he incurred the expenses as part of a temporary work assignment, it nonetheless disallowed a substantial portion of the expenses for lack of substantiation. In particular, the court, in determining the taxpayer's allowable automobile expenses, disregarded a mileage log that was not concurrent.

Another case involved taxpayers trying to turn their renovation of two houses into a real estate development business.34 The Ohanas, who moved to California in 2003, purchased two houses and invested large amounts in improving the properties. They owned no other properties, however, and Mr. Ohana was a corporate executive who earned between $350,000 and $500,000 a year. The extent of Mr. Ohana's participation in the renovation activities was unclear because he was only able to present time logs created long after the fact. In addition, at some point, the Ohanas lived in both houses as their primary residence. Nonetheless, the Ohanas took substantial deductions for Mr. Ohana's alleged real estate development trade or business.

The Tax Court applied the standard that, to be engaged in a trade or business, a taxpayer must be involved in the activity with continuity and regularity and the primary purpose of the activity must be income or profit. Although witnesses testified that Mr. Ohana was actively involved in remodeling and renovating his homes, the court found that none of the evidence proved that Mr. Ohana was "continuously or regularly" involved in the business of buying and selling real estate. In particular, in the years in question, Mr. Ohana did not sell or buy any real estate properties. The court further found that the evidence did not show that the Ohanas' primary purpose in engaging in the renovation activities was to make a profit. Therefore, it disallowed the expenses the Ohanas claimed for a real estate development trade or business.

The Sixth Circuit held that a doctor could not claim a business deduction for a payment he made to a medical facility that had paid his medical school tuition under an agreement that required the doctor to work for the facility for four years after completing his medical degree or repay the tuition with accrued interest.35 The payment was a nondeductible personal expense because the taxpayer used the funds to meet the initial education requirements for becoming a physician.

Sec. 165: Losses

The taxpayer in *Nacchio* was convicted of insider trading, sentenced to jail, fined $19 million, and ordered to forfeit the gain from the transaction.36 When the taxpayer claimed a deduction under Sec. 165 for the forfeited gain, the IRS argued that the forfeiture was part of the conviction and therefore not deductible because it would violate public policy. The court found that prohibiting a deduction would not violate public policy because the taxpayer's sentence of jail time and a large fine was sufficient punishment for his crime and it would not encourage insider trading or "destroy" the effectiveness of securities law. The court further found that deducting a forfeiture did not violate the Sec. 162(f) prohibition against deducting a fine or penalty because the forfeiture was compensatory in nature and was not a fine or similar penalty.

Sec. 168: Accelerated Cost Recovery System

In *Brown*,the Tax Court disallowedabonus depreciation deduction a taxpayer took in 2003 on an airplane because it determined that the taxpayer had not placed the airplane in service that year.37The taxpayer, a life insurance salesman, sold policies to wealthy individuals who were

very demanding. The taxpayer had his own plane for his business, but decided to purchase a new plane in 2003. The taxpayer signed a $22 million contract for a new plane that he wanted delivered by the end of 2003 to take advantage of the 50% bonus depreciation for business property available under the Jobs and Growth Tax Relief Reconciliation Act of 2003, P.L. 108-27. However, the taxpayer had requested additional modifications, including a conference table and a 20-inch screen to make presentations that could not be completed by the end of the year. He stated that he needed the enhanced features to serve "specific functions" in his insurance business. Thus, the taxpayer took delivery on Dec. 30, 2003, in Portland, Ore., without the additional modifications and then flew the plane to Seattle and Chicago, meeting with business associates in both cities, and then back to Portland. The manufacturer then took the airplane back so that it could make the additional modifications and returned it to the taxpayer in 2004. Believing he had properly placed the airplane in service in 2003, the taxpayer claimed $11.2 million bonus depreciation on the airplane as an expense for his insurance business on his 2003 Schedule C.

The IRS argued and Tax Court agreed that the airplane without the conference table and display screen was not fully functional for the very specific needs of the taxpayer's insurance business and the airplane was not available for its intended use until these modifications were completed. Thus, the court found that the taxpayer did not place the airplane in service until 2004 and held that he could not take bonus depreciation for it in 2003.

Sec. 170: Charitable Contributions

In *Wachter*, the Tax Court held that a North Dakota law limiting easements to 99 years disqualified the taxpayers' deduction for a charitable contribution of a conservation easement because the law caused the easement to fail the requirement that it be granted in perpetuity. Although the taxpayers argued that the possibility that the land would revert to the taxpayers or their successors-in-interest was "so remote as to be negligible" and thus a deduction was allowable, the IRS and the Tax Court disagreed. The reversion of the land was certain, not remote, and therefore the contribution of the easement was not a qualified conservation contribution.[38] As a result, contributions of North Dakota conservation easements cannot qualify as deductible charitable contributions, at least in the Tax Court, because they are all subject to the North Dakota law.

In another case, three partners who each donated a conservation easement to a Colorado nonprofit organization, the Greenlands Reserve, took a charitable contribution deduction on their respective individual returns for the donations.[39] The IRS disallowed the deduction, and the partners challenged its determination in Tax Court. The partners' appraiser of the conservation easement determined that the "highest and best use" of the land was as a gravel mine since it was adjacent to an existing gravel mine operated by the partnership, even though the donated land was not approved for mining. The Tax Court held that the "highest and best use" was the current use of the land, which was agriculture, and that gravel mining on the land was unlikely in the foreseeable future, so it allowed the partners a charitable contribution deduction that was only a small fraction of what the partners claimed. On appeal, the taxpayers argued that if the future development of the land as a gravel mine would result in a higher value than its current use in agriculture, then that amount should be used. The Tenth Circuit agreed with the Tax Court. Since development of a gravel mine was not likely in the near future because there was no demand for gravel, the lower value for current use of the property should be used.

Charitable contribution deductions are generally limited to the lesser of basis or fair market value, with certain exceptions for appreciated property. However, C corporations are permitted a larger deduction under Sec. 170(e)(3) for donations of qualifying inventory to Sec. 501(c)(3) organizations. Under Sec. 170(e)(3)(A)(i), the inventory must be used by the recipient "solely for the care of the ill, the needy, or infants." In one case, certain items did not qualify since they had uses other than for the "necessities of life" as required by Regs. Sec. 1.170A-4A(b)(2)(ii)(D).[40] The donated inventory was personal grooming products, including hair spray, gels, dyes, perfumes, and curling irons.

Sec 262: Personal, Living, and Family Expenses

The cost of a daily commute to and from work is a personal expense, and the Tax Court validated that rule in *Cor.*[41] The taxpayer attempted to deduct as unreimbursed employee business expenses the costs for his daily commute between his house and his job at a remote test site in the desert. Once again, the Tax Court ruled that ordinary commuting expenses are nondeductible personal expenses, no matter how far the commute.

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

The taxpayer in *Austin Otology Associates* was disallowed costs for various hunting trips the neurotologist-owner deducted as business expenses.[42] Although the taxpayer worked on

inventing custom earplugs for shooters, his hunting trips to test the earplugs were not necessary, and he did not prove he took more than a few notes on the trips. Activities qualifying for an entertainment deduction must involve business directly related to the taxpayer's trade or business and have expectations of deriving a business benefit. The court found the hunting trips to be entertainment expenses with no direct relation to the active conduct of the taxpayer's trade or business as required under Regs. Sec. 1.274-2(c)(3).

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

In *Thunstedt*, an art dealer argued that because he spent most of his time working from home, he should be allowed to deduct the business use of 61.9% of his home.43 The taxpayer claimed that his life was his business and "everything revolves around artwork." He declared that he conducted administrative and management activities out of his home office, and accessed the internet frequently for business from his living room, the only room equipped with an internet connection. He also used two extra bedrooms and the garage to store his artwork. Generally, a taxpayer may not deduct personal, living expenses related to his or her residence unless a specific room or area of the home is exclusively and regularly used as the taxpayer's principal place of business under Sec. 280A(c)(1). In this case, the home office expense deduction was disallowed because the taxpayer could not establish that any portion of his home was exclusively and regularly used for his business.

In addition, although Sec. 280A(c)(2) allows a taxpayer a deduction for space in a residence used to store inventory, it is only available if the residence is the "sole fixed location of the trade or business." Because the taxpayer rented another storage facility and used its address on Schedule C as the address of his business, the Tax Court found, his home was not the sole location of his trade or business. Therefore, the home office expense deduction under the storage use rule was not available.

In *Dupre*, the Tax Court held that a part-time math and computer science professor was not entitled to a deduction for his home office expenses.44 The taxpayer testified that he used his home office for other purposes and the colleges he worked for provided him an office to work in. Therefore, the court found that the home office was not used exclusively in connection with his employment and it was not maintained for his employers' convenience.

Sec. 469: Passive Activity Losses and Credits Limited

In *Herwig*, the topic of the allowance of suspended passive losses when an activity is fully disposed of was front and center.45 In that case, a married couple were denied a passive activity loss for 2008 because the foreclosure of the rental properties that would have effectively treated the properties as fully disposed of was not fully completed that year.

Ohana concerns a corporate executive who was not entitled to deduct his rental real estate losses because he was not a real estate professional and renting was not his main business.46 The other issues in the case are discussed under "Sec. 162: Trade or Business Expenses," on p. 639.

The *Tolin* case is a rare win for the taxpayer in the passive activity loss area, especially in the industry of horse breeding and racing, in which the taxpayer's thoroughbred horse breeding and racing were determined to not be a passive activity.47 Although the taxpayer was a practicing attorney in Minnesota and he kept his horse in Louisiana because he thought it had favorable laws for horse ownership, breeding, and racing, he nonetheless proved that he devoted a significant amount of time to the thoroughbred activity. The Tax Court found that the taxpayer satisfied the requirements for material participation under the 500 hours test of Temp. Regs. Sec. 1.469-5T(a)(1). The taxpayer supported his log records, which indicated the hours spent on the activity, with evidence of his many phone calls from Minnesota to Louisiana. He showed he made many trips from Minnesota to Louisiana as well and presented testimony from a number of witnesses he did business with in Louisiana and other contemporaneous evidence that corroborated the extent of his activities.

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

In Rev. Rul. 2014-2, the IRS ruled that a taxpayer who received a National Mortgage Settlement (NMS) payment due to foreclosure of the taxpayer's residence will need to include the payment in the amount realized on the foreclosure under Sec. 1001. This ruling is also discussed above under "Sec. 121: Exclusion of Gain From Sale of Principal Residence," on p. 637.

In *Dudek*, the Tax Court found an $883,250 bonus payment the taxpayers received under an oil-and-gas lease was ordinary income and not capital gain.48 The taxpayers argued that the agreement was not a lease, but a sale of their rights to any oil or gas in the property. The court

found that the taxpayers retained an economic interest in the oil and gas deposits, so the agreement was a lease that generated ordinary income.

Sec. 1012: Basis of Property: Cost

In *Daniels*, the Tax Court found that the bases of collectible gold coins were their original cost and rejected the higher bases the taxpayers claimed.[49] Although the taxpayers produced a bill of sale they asserted was from one taxpayer's brother, they did not offer corroborating evidence, such as proof that the coins they sold were the same ones they purchased.

Sec. 1016: Adjustments to Basis

In *Chandler*, the taxpayers could not increase the basis of their house that they purchased for $755,000 and sold for $1.54 million except for those renovations that they could substantiate.[50] The Tax Court found that photographs of the improvements were not acceptable. The court also upheld the assessment of negligence penalties on the unsubstantiated basis increases because the taxpayers failed to prove they had reasonable cause for not retaining records that substantiated the full amount of basis increases they reported.

In *Curtis*, the Tax Court disallowed the cost of improvements the taxpayer claimed he had made to an apartment building in calculating the gain from an involuntary conversion of the building.[51] Although there was agreement on the original cost of the apartment building, the Tax Court found that the taxpayer's testimony and the receipts and contracts taken together were not persuasive enough evidence to establish the additional basis he claimed for the building.

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

The IRS ruled in Letter Ruling 201416006 that the taxpayer's reverse like-kind exchange using a parking arrangement with two related affiliates was a qualified exchange accommodation arrangement (QEAA). The like-kind exchange also complied with safe-harbor requirements outlined in Rev. Proc. 2000-37. There was no prohibition against an exchange accommodation titleholder serving multiple taxpayers with related entities under multiple and simultaneous QEAAs for the same parked property.

In *Yates*, the Fourth Circuit affirmed a Tax Court ruling in which the taxpayers' bed and breakfast was not used in a trade or business or held for investment at the time of a Sec. 1031 exchange.[52] The Tax Court had previously ruled that the taxpayers failed to prove any intent to use the property in the trade or business of a bed and breakfast. Four days after the purchase date, the taxpayers moved into the property and used it as their primary residence "for an indeterminate time."

Sec. 1221: Capital Asset Defined

In *Boree*, the Tax Court held that income from sales of real property constituted ordinary income instead of capital gain.[53] The taxpayers, who sold a large parcel to a development company, had previously engaged in frequent sales of various lots. In addition, the taxpayers did not segregate the property sold from other real property used in a trade or business.

Notice 2014-21 provides answers to "Frequently Asked Questions on Virtual Currency (Bitcoin)." The notice states that virtual currency is treated as property for U.S. tax purposes and that general tax principles that apply to property transactions will also apply to transactions that involve virtual currency. For instance, the character of gain or loss from the sale or exchange of virtual currency will depend on whether it is a capital asset in the hands of the taxpayer.

In *Kamienski*, the Tax Court held that payments a taxpayer received from providing a client engagement methodology to a former employer was ordinary income and not capital gain.[54] The court found that the taxpayer did not surrender all substantial rights of value in the methodology and did not grant exclusive use to it to the former employer.

In *Patrick*, the Tax Court found that the *qui tam* award a taxpayer received under the False Claims Act was ordinary income and not capital gain.[55] The award was for the taxpayer's exposing his employer's involvement in committing Medicare fraud. The taxpayer claimed that providing the information and documents to the government in the case was a sale of a capital asset. The court found that the transaction was not a sale or exchange because the taxpayer did not sell his information for a fixed amount of money or in return for other property. In addition, the court explained, a general characteristic of property is that an owner has the legal right to exclude others from use and enjoyment of that property. Thus, the court found that the award was not a capital asset because the taxpayer did not have a legal right to exclude others from use and enjoyment of the property.

Sec. 1401: Rate of Tax

The Tax Court held that grant income a graduate student received from a firm to conduct medical research was subject to self-employment tax.[56] The court recognized that some fellowship grants are excludable from self-employment tax, e.g., payments received as part of a fellowship grant that permitted a taxpayer to perform research and studies primarily to further his own education, training, and academic excellence. However, these payments were made to enable the taxpayer to perform medical research in support of a company's pursuit of new therapies for cardiovascular disease and were easily distinguished from exempt payments.

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

The IRS concluded in Chief Counsel Advice 201411017 that a husband could not change the filing status from married filing jointly to head of household on an amended return filed after the time for filing the original return had passed.

The couple timely filed an income tax return electing a filing status of married filing jointly. The husband filed an amended return signed only by him after the time for filing a return for the tax years at issue had passed. Under Regs. Sec. 1.6013-1(a)(1), the election to file a married-filing-jointly income tax return is irrevocable after the time to file has expired.[57] Assuming the election to file a joint return was valid, the husband is not allowed to change his filing status on an amended return.

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

In *Young*, the court concluded that the taxpayer was not entitled to relief from his obligation to pay income taxes for 2005.[58] In 2005, Mr. and Mrs. Young separated and also filed a joint income tax return, reporting Mr. Young's wage and investment income. Mrs. Young did not have any income. The tax return was signed by both taxpayers and reported a balance due, which was not remitted with the return. In 2007, when the couple settled their divorce, Mr. Young agreed to assume responsibility for federal and state income tax liabilities on their jointly filed returns.

After the IRS began collection proceedings, Mr. Young entered into an installment arrangement and also submitted a Form 8857, *Request for Innocent Spouse Relief.* On an attachment to the Form 8857, Mr. Young objected that the IRS was only attempting to collect the tax liability from him and not from his former spouse.

Sec. 6015 provides relief for a spouse seeking relief from joint and several liability. Sec. 6015(f) provides relief for liability for unpaid taxes shown on a joint return if "taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either)." Rev. Proc. 2013-34 provides the rules to determine whether a taxpayer qualifies for equitable relief.

The court looked at the one factor for relief that must be met but was not. "The income tax liability from which the requesting spouse seeks relief is attributable (either in full or in part) to an item of the nonrequesting spouse or an underpayment resulting from the nonrequesting spouse's income."[59]

As all of the income reported on the tax return was attributable to Mr. Young, he was not entitled to equitable relief from the liability. Mr. Young argued that he was not looking for complete relief from the liability, just for it to be split equally between him and his ex-spouse. The court held that the filing of a joint return makes the parties jointly and severally liable. Therefore, the IRS can collect from either party, and the request for equitable relief was denied.

Sec. 7703: Determination of Marital Status

Notice 2014-23 provides guidance on how a victim of domestic abuse, who is married within the meaning of Sec. 7703, but is unable to file a joint tax return, may claim a premium tax credit under Sec. 36B for calendar year 2014.

> For calendar year 2014, a married taxpayer will satisfy the joint filing requirement of Sec. 36B (c)(1)(C) if the taxpayer files a 2014 tax return using a filing status of married filing separately and the taxpayer (i) is living apart from the individual's spouse at the time the taxpayer files his or her tax return, (ii) is unable to file a joint return because the taxpayer is a victim of domestic abuse, and (iii) indicates on his or her 2014 income tax return in accordance with the relevant instructions that the taxpayer meets the criteria under (i) and (ii).

The IRS intends to issue regulations for future years.[60]

Footnotes

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[1] *Nelson*, 540 Fed. Appx. 924 (11th Cir. 2013), aff'g T.C. Memo. 2012-232.

[2] *Vitarbo*, T.C. Summ. 2014-11.

[3] *Carrino*, T.C. Memo. 2014-34.

[4] *McNealy*, T.C. Summ. 2014-14.

[5] *Fields*, T.C. Memo. 2014-48.

[6] *Roberts*, 141 T.C. No. 19 (2013).

[7] *Cahill*, T.C. Memo. 2013-220.

[8] *Phillips*, T.C. Memo. 2013-250.

[9] *Black*, T.C. Memo. 2014-27.

[10] *Brach*, T.C. Summ. 2013-96.

[11] *Ellis*, T.C. Memo. 2013-245.

[12] T.D. 9659.

[13] *Crescent Holdings, LLC*, 141 T.C. No. 15 (2013).

[14] *Austin*, 141 T.C. No. 18 (2013).

[15] IRS Letter Rulings 201340005 (10/4/13), 201342007 (10/18/13), 201343013 (10/25/13), and 201352006 (12/27/13).

[16] *Simpson*, 141 T.C. No. 10 (2013).

[17] *Molina*, T.C. Memo. 2013-226.

[18] *Wyman*, No. EDCV 12-01266 VAP (SPx) (C.D. Cal. 5/21/13).

[19] *Green*, T.C. Memo. 2014-23.

[20] *Sharp*, T.C. Memo. 2013-290.

[21] Chief Counsel Advice 201415002 (4/11/14).

[22] *Adeyemo*, T.C. Memo. 2014-1.

[23] IRS Letter Ruling 201408007 (11/14/13).

[24] *Cohen*, 12 Civ. 5828 (S.D.N.Y. 2/28/14).

[25] *Fields Curtis*, T.C. Memo. 2014-19.

[26] *Weiss*, T.C. Summ. 2014-25.

[27] *Ray*, No. 2:12-cv-677 (S.D. Ohio 1/6/14).

[28] *Swint*, 142 T.C. No. 6 (2014).

[29] Sec. 152(e)(2)(A).

[30] *Harris*, T.C. Memo. 2014-69.

[31] *Humboldt Shelby Holding Corp.*, T.C. Memo. 2014-47.

[32] *Vitarbo*, T.C. Summ. 2014-11.

[33] *Snellman*, T.C. Summ. 2014-10.

[34] *Ohana*, T.C. Memo. 2014-83.

[35] *Dargie*, 742 F.3d 243 (6th Cir. 2/5/14), aff'g No. 12-2169V (W.D. Tenn. 4/1/13).

[36] *Nacchio*, 115 Fed. Cl. 195 (2014).

[37] *Brown*, T.C. Memo 2013-275.

[38] *Wachter*, 142 T.C. No. 7 (2014).

[39] *Esgar Corp.*, No. 12-9009 (10th Cir. 3/7/14), aff'g T.C. Memo. 2012-35 and 136 T.C. 141 (2011).

[40] Chief Counsel Advice 201414014 (4/4/14).

[41] *Cor*, T.C. Memo. 2013-240.

[42] *Austin Otology Associates*, T.C. Memo. 2013-293.

[43] *Thunstedt*, T.C. Memo. 2013-280.

[44] *Dupre*, T.C. Memo. 2013-287.

[45] *Herwig*, T.C. Memo. 2014-95.

[46] *Ohana*, T.C. Memo. 2014-83.

[47] *Tolin*, T.C. Memo. 2014-65.

[48] *Dudek*, T.C. Memo. 2013-272.

[49] *Daniels*, T.C. Summ. 2014-16.

[50] *Chandler*, 142 T.C. No. 16 (2014).

[51] *Curtis*, T.C. Memo. 2014-19.

[52] *Yates*, 548 Fed. Appx. 68 (4th Cir. 2013), aff'g T.C. Memo. 2013-28.

[53] *Boree*, T.C. Memo. 2014-85.

[54] *Kamienski*, T.C. Summ. 2014-22.

[55] *Patrick*, 142 T.C. No. 5 (2014).

[56] *Wang*, T.C. Summ. 2014-39.

[57] See also *Ladden*, 38 T.C. 530, 534 (1962).

[58] *Young*, T.C. Summ. 2014-24.

[59] See Rev. Proc. 2013-34, §4.01(7).

[60] Notice 2014-23.

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