Current Federal Tax Developments

Week of August 19, 2019

Edward K. Zollars, CPA
(Licensed in Arizona)

ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF AUGUST 19, 2019

Published in 2019 by Kaplan Financial Education.

Printed in the United States of America.

Current Federal Tax Developments

Kaplan Financial Education

Table of Contents

SECTION: 162
SLOPPY RECORDS LEAD TO NO INTEREST DEDUCTION, REDUCED DEDUCTION FOR COMMISSIONS AND TAX PENALTIES

Citation: Moore v. Commissioner, TC Memo 2019-100, 8/15/19

A taxpayer could not show that payments he made represented interest on purported loans and, while he was able to deduct some commission expenses, the amount was limited due to issues with his records in *Moore v. Commissioner*, TC Memo 2019-100.[1]

The taxpayer wanted to expand his tax preparation business and was looking for funds. As the decision noted:

> Petitioner approached five individuals with whom he had had prior business relationships and asked them for money to expand his tax return preparation business. Petitioner referred to these advances at varying times both as investments and as loans. Petitioner prepared nine purported promissory notes, which list a "loan period" and also a "return on investment" percentage. Each purported note specifies a return on investment of 100% or more. Only one of the purported promissory notes is signed.[2]

The taxpayer claimed $161,750 in "investment expenses" related to payments under these notes. At trial he conceded his claimed deductions was $39,500. Each of the notes had "return on investment" of 100% or more, which the taxpayer indicated was an interest rate. The IRS argued that the taxpayer had not shown these advances were true loans, that he had not shown the amounts in his bank account actually came from these creditors, and he had not shown that the payments were ordinary and necessary business expenses.[3]

The Tax Court agreed that the taxpayer had failed to show he was entitled to a deduction. The Court started by noting the requirements for payments to be interest expense:

> For payments to be deductible as interest within the meaning of section 163(a), however, they must be made in connection with a bona

---

[1] https://www.ustaxcourt.gov/USTCInOP/OpinionViewer.aspx?ID=12022, August 15, 2019, retrieved August 16, 2019

[2] *Ibid*, p. 3

[3] *Ibid*, p. 9

> fide loan transaction where both parties have an actual, good-faith intent to establish a debtor-creditor relationship at the time the funds are advanced. Id. This relationship exists if the debtor intends to repay the loan and the creditor intends to enforce repayment. *Fisher v. Commissioner*, 54 T.C. 905, 909-910 (1970). We look at various factors in determining whether this relationship in fact exists, including the presence of: (1) a debt instrument, (2) a statement that interest will be charged, (3) a fixed schedule for repayment, (4) collateral to secure payment, (5) actual repayment, (6) reasonable prospects of advancement and repayment of the funds, and (7) the parties' conducting themselves as if the transaction were a loan. See Calloway v. Commissioner, 135 T.C. 26, 37 (2010), aff'd, 691 F.3d 1315 (11th Cir. 2012); see also *Fisher v. Commissioner*, 54 T.C. at 909-910; *Kaider v. Comm*issioner, T.C. Memo. 2011-174, slip op. at 15-16 (citing *Welch v. Commissioner*, 204 F.3d 1228, 1230-1231 (9th Cir. 2000), aff'g T.C. Memo. 1998-121).[4]

The Court found the taxpayer's claim for deductible interest failed for the following reasons:

> We find that petitioner has not met his burden of proving that these transactions represented bona fide loans and that the payments he made with respect to them qualify as deductible interest. The purported notes, save one, are unsigned and bear no indication of a good-faith agreement between the parties. Petitioner has provided no testimony or other evidence from any of the alleged creditors to prove their intent to act as creditors and to enforce repayment, or how the alleged creditors characterized the transactions. The purported notes did not state interest rates or provide for any type of security interests. Petitioner also has not proven that the eight unsigned purported notes were contemporaneous debt instruments, as they have no execution dates. Finally, as to the one signed purported note, petitioner has failed to prove that the funds allegedly deposited in his account actually came from the alleged creditor; he has introduced no canceled check or other evidence tying the funds directly to the alleged creditor. On this record petitioner has failed to prove that these transactions represented bona fide indebtedness, and consequently, we conclude that petitioner is not entitled to a deduction under section 163(a).[5]

The commission expenses he was claiming related to payments to contractors he used as tax return preparers. His company was a clearinghouse for processing the returns. He

---

[4] *Ibid*, p. 10

[5] *Ibid*, p. 11

also provided training and support to the contractors, who maintained and developed their own client base and prepared the returns.[6]

The process of handling tax returns for returns with a refund is described as follows by the court:

> When one of petitioner's return preparers would file a return for a client that generated a tax refund, the refund was deposited into one of petitioner's bank accounts, which petitioner referred to as a third-party bank account and appears to have treated as an escrow account. Petitioner would then take from the client's refund the agreed-upon preparation fee, which would be deposited into another of petitioner's business accounts, and the remainder would be paid to the client. From the preparation fee petitioner would then pay a commission to the individual return preparer, ranging from 60% to 90% of the preparation fee depending on the return preparer's expertise and client base. Petitioner would retain the rest of the preparation fee.[7]

The taxpayer's records accounting for the paying such of fees were, to put it mildly, inconsistent and far short of ideal. Nevertheless, in this case the Court did not agree with the IRS that no deduction should be allowed for any such commissions. Rather, the Court found that the taxpayer had provided enough information to invoke the provisions of the *Cohan* decision.[8]

That decision, involving vaudeville producer George M. Cohan, decided that even where records do not completely document a deduction or provide inconsistent information regarding the deduction, a deduction will still be allowed in some portion if:

- The evidence makes it clear that expenses that would be deductible under the IRC have been incurred and
- There exists a reasonable basis for estimating a deductible amount.

However, in allowing the deduction the Court is going to not allow the taxpayer to benefit from his neglect to keep complete and consistent records—or, to put it more practically, the Court will allow an amount on the low end of the available estimates.

---

[6] *Ibid*, p. 4

[7] *Ibid*, pp. 4-5

[8] *Cohan v. Commissioner*, 39 F.2d 540, 544 (2d Cir. 1930)

As well, Congress, in response to the *Cohan* decision, did add provisions that require certain expenses to be deducted or no deduction will be allowed—see IRC §274(d).[9] But these expenses are not in the list of expenses found in that provision subjected to the heighted documentation rules.

The Court found that the taxpayer met the first test (that such expenses had been incurred), noting:

> Petitioner has demonstrated that he is entitled to a deduction for commissions paid to his contractors in 2013. At trial he testified credibly that he ran a tax return preparation business. He also testified credibly that he retained independent contractors as return preparers throughout the country to whom he paid commissions based on their experience level and clientele. Moreover, he has introduced numerous canceled checks that he or his payroll company wrote to various individual contractors. Petitioner has also introduced payroll reports generated by his former payroll company that identify contractors petitioner paid and list the amounts he allegedly paid each during 2013. Both the checks and the payroll summary identify many of the same contractors, with the handwritten checks listing "commissions" or similar text in the memorandum line. Additionally, respondent's list of Forms 1099-MISC filed by petitioner corroborates the identities of numerous contractors and provides payment amounts that broadly align with the sums in the exhibits petitioner provided. We therefore find that petitioner paid the named independent contractors in furtherance of his business and is entitled to a deduction for commission payments.[10]

Many taxpayers manage to clear this hurdle for expenses when their records are poor or nonexistent—it is clear they operated a business and that such a business would necessarily require a certain expense to be incurred in some amount. Most attempts by the taxpayer to use *Cohan* fail on the second prong of the test—the evidence to allow a reasonable estimate of the expenses.

---

[9] For instance, a taxpayer must have documentation to support claimed business automobile expenses or no deduction will be allowed—the law requires a complete denial of deduction in that case.

[10] https://www.ustaxcourt.gov/USTCInOP/OpinionViewer.aspx?ID=12022, August 15, 2019, retrieved August 16, 2019, pp. 13-14

But Mr. Moore's records, while leaving a more than a bit to be desired and being inconsistent, nevertheless gave the Court enough information to make such an estimate:

> We also find that petitioner has provided a reasonable basis from which we can make an estimate of his actual commission expenses. As noted above, the amounts of the canceled checks and the amounts reflected in the payroll company reports petitioner provided broadly align with the amounts shown on the Forms 1099-MISC list respondent provided. Taken together, these exhibits provide upper and lower limits for a range of potential payment amounts, bracketing our estimate and ensuring that it does not amount to "unguided largesse". *Williams v. United States*, 245 F.2d 559, 560 (5th Cir. 1957).[11]

The Court used the following method to come to an allowed amount of expenses:

> To start, we note that petitioner's business records for tax year 2013 are so woefully disorganized and incomplete that petitioner has not been able to provide a credible and reliable statement of his total commission expenses. Instead, he has asserted three different numbers at varying stages of this case. The exhibits in the record provide no less than nine potential sums, ranging from just over $400,000 to $750,000. We are convinced that petitioner paid commissions to independent contractors, but we also are concerned about the fluid state of the evidence he introduced. Consequently, we will sustain deductions only for amounts clearly established by the record, and we will resolve ambiguities against petitioner.
>
> With that in mind, we find that petitioner's check registry, Exhibit 11-P, and gross pay report, Exhibit 16-R, and the list respondent provided of Forms 1099-MISC filed by petitioner, Exhibit 17-R, to be the most credible evidence in the record.3 While the record provides a wide range of potential sums, we can limit this range by relying on these exhibits. Cf. *Neonatology Assocs., P.A. v. Commissioner*, 115 T.C. 43, 84-87 (2000), aff'd, 229 F.3d 221 (3d Cir. 2002).
>
> On the basis of the records described above and summarized in the appendix, we find that petitioner is entitled to a deduction of $414,157. As shown in the appendix, we limit our dataset to include only those individuals identified in all three exhibits, excluding petitioner. We then look at the totals generated by the exhibits: $536,398, $414,157, and $536,414. Our analysis begins by recognizing [*16] that the totals generated by Exhibits 17-R and 11-P are quite close, but we cannot discard the total provided by Exhibit 16-

[11] *Ibid*, p. 14

> R. To account for the variance, where Exhibit 16-R provides a lesser payment amount for a given contractor, we will consider only that lesser amount. Cf. *Green v. Commissioner*, 66 T.C. 538, 544-549 (1976). Doing so, we conclude that $414,157 is the appropriate amount of the allowable commission expenses deduction because it reflects the substantial amount of commission payments we believe petitioner made, but does not reward petitioner for "inexactitude[s] * * * of his own making." *Cohan v. Commissioner*, 39 F.2d at 544.[12]

While the taxpayer escaped with a partial deduction for commissions, the fact he ran a tax preparation business and held himself out as a tax expert doomed his request for penalty relief. As the opinion notes:

> Although petitioner is not an accountant or an attorney, he organized and ran a multistate tax return preparation business. He held himself out as a tax professional, advising others on preparing returns and otherwise applying the requirements of the Code to individual taxpayers, but he failed to keep accurate documentation about his largest reported expenses: the commissions he paid to his independent contractors and the purported interest payments he made to alleged creditors. Given petitioner's background and business in tax return preparation, this is unreasonable. We find, therefore, that he did not have reasonable cause for his underpayment and that he is liable for the accuracy-related penalty under section 6662 to the extent that the Rule 155 calculations show that he substantially understated his 2013 income tax.[13]

SECTION: 402
RETIREMENT PLAN DISTRIBUTION TAXABLE EVEN IF RECIPIENT DOES NOT CASH THE CHECK

Citation: Revenue Ruling 2019-19, 8/14/19

Not cashing a check received from a retirement plan before year does not change the requirement to report that distribution as income in the year the payment is made per Revenue Ruling 2019-19.[14]

---

[12] *Ibid*, pp. 14-15

[13] *Ibid*, p. 18

[14] https://www.irs.gov/pub/irs-drop/rr-19-19.pdf, August 14, 2019, retrieved August 15, 2019

The ruling provides the following facts that are being analyzed:

> Employer M is the plan administrator of Plan X, a qualified retirement plan under § 401(a) that does not include a qualified Roth contribution program under § 402A(b). A distribution of $900 is required to be made from Plan X to Individual A in 2019. Individual A has no investment in the contract within the meaning of § 72 with respect to her Plan X benefit, has a calendar year taxable year, and has never made a withholding election with respect to her Plan X benefit. Employer M makes the required $900 distribution, a designated distribution within the meaning of § 3405(e)(1), by withholding tax as required under § 3405(d)(2) and mailing a check for the remainder to Individual A. Although Individual A receives the check and could cash it in 2019, she does not do so. Individual A does not make a rollover contribution with respect to any portion of the designated distribution, and no other exception to income inclusion under § 402(a) applies.[15]

A "designated distribution" under IRC §3405(e)(1) refers to one subject to the withholding of federal income taxes rules found at IRC §3405(d).

The ruling finds that simply holding onto the check when she received the check and could have cashed it does not cause the distribution to be exempt from tax in 2019. IRC §402(a) which governs distributions from an employer retirement plan provides:

> (a) Taxability of beneficiary of exempt trust
>
> Except as otherwise provided in this section, any amount actually distributed to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, <u>*in the taxable year of the distributee in which distributed*</u>, under section 72 (relating to annuities).

Note that the provision explicitly names the year in which the distribution is to be taxable to the recipient. Nothing in the provision indicates that the recipient has to actually cash the check. So the IRS notes in the ruling that "[i]ndividual A's failure to cash the distribution check she received in 2019 does not permit her to exclude the amount of the designated distribution from her gross income in that year under § 402(a)."[16]

The ruling notes that, as well, the failure of the participant to cash the check does not relieve the plan administrator from the requirement to have taxes withheld from the

---

[15] *Ibid*, pp. 1-2

[16] *Ibid*, p. 2

distribution,[17] nor does it change the requirement that the distribution must be reported on a Form 1099R for that year.[18]

In a footnote the IRS notes that the ruling applies regardless of whether the taxpayer "keeps the check, sends it back, destroys it, or cashes it in a subsequent year…"[19]

The ruling does indicate that there may be a different answer when the facts are somewhat different. The ruling provides:

> The Department of the Treasury and the Internal Revenue Service continue to analyze issues that arise in other situations involving uncashed checks from eligible retirement plans described in § 402(c)(8)(B), including situations involving missing individuals with benefits under those plans.[20]

SECTION: 6511
ESTATES CANNOT MAKE USE OF THE FINANCIAL DISABILITY RELIEF RULE TO EXTEND THE STATUTE FOR FILING A REFUND CLAIM

Citation: Carter v. United States, US DC ND Alabama, Case No. 5:18-cv-01380, 8/2/17

The tolling of the statute of limitations for filing a claim for refund due to financial disability under IRC §6511(h) does not apply to estates, per a ruling from the US District Court for the Northern District of Alabama in the case of *Carter v. United States*, US DC ND Alabama, Case No. 5:18-cv-01380.[21]

IRC §6511(h) was enacted by Congress to provide relief for a case where a taxpayer fails to file a claim for refund within the time period provided otherwise by that section due to a financial disability. The provision provides "an individual is financially disabled if such individual is unable to manage his financial affairs by reason of a medically determinable physical or mental impairment of the individual which can be expected to

---

[17] *Ibid*, p. 3

[18] *Ibid*, p. 4

[19] *Ibid*, p. 2

[20] *Ibid*, pp. 4-5

[21] https://ecf.alnd.uscourts.gov/doc1/01915164346, August 2, 2019, retrieved from PACER August 13, 2019 (registration required)

result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months."[22]

The law provides the following extension of the statutes found in IRC §6511(a), (b) and (c):

> In the case of an *individual*, the running of the periods specified in subsections (a), (b), and (c) shall be suspended during any period of such individual's life that such individual is financially disabled.[23]

In this case the taxpayer seeking relief was an estate, arguing that the personal representative of the estate was financially disabled for a period of time, thus the fact that the estate's claim for refund was filed after the time period specified in IRC §6511(a) should not bar the estate from proceeding with its claim for refund. The estate argued that it should be treated as an *individual*, and thus be able to obtain relief under this provision.

The estate was looking to claim a refund of estate taxes paid related to the value of stock in Colonial BancGroup held by the decedent on the date she died in late 2007. That stock made up over 45% of the gross estate. What was not known at the time was that a customer of the bank had been involved in a fraud against the bank that eventually led the state of Alabama to shut down the bank, rendering the stock nearly worthless.[24]

The fraud against the bank and subsequent loss of virtually all value of that stock, which represented a large portion of what had passed to the heirs, including the personal representative, took its toll on the personal representative:

> Carter asserts that from Fall 2008 to the end of 2013, she suffered from moderate to severe mental and emotional maladies which rendered her incapable of managing the Estate's financial affairs. She provides the declaration of her treating physician, Dr. William Hahn, to support this contention. Both Carter and Dr. Hahn attest the trauma from the Colonial stock's complete devaluation caused Carter's ailments. For these reasons, Carter maintains her disabilities incited §

---

[22] IRC §6511(h)(2)(A)

[23] IRC §6511(h)(1)

[24] *Carter v. United States,* https://ecf.alnd.uscourts.gov/doc1/01915164346, August 2, 2019, retrieved from PACER August 13, 2019 (registration required), p. 7 (including footnote)

> 6511(h)'s equitable tolling provision so as to excuse the untimely filing of the refund claim.[25]

Unfortunately for the estate, the court held that the term *individual* found in §6511(h)(1) did not include estates. While the IRC often uses "person" as a stand-in for all taxpayers, in this case the law has definitions that clearly indicate a "person" and an "individual" are two separate classes of taxpayers under the law, with "persons" covering a broader class than individual. Specifically, IRC §7701(a)(1) defines a person as "an individual, a trust, estate, partnership, association, company or corporation." The court found this makes it clear that Congress sees individuals and estates as distinct types of taxpayers, and the use of the term individual in IRC §6511(h) limits the relief to natural persons.[26]

While the taxpayer argues that the IRC treats estates and individuals the same, pointing out a number of specific examples of such treatment, the court points out that a number of other provisions, including the imposition of an estate tax and use of different tax rates for estates, make it clear that estates and individuals are not always treated the same under the IRC. Thus, the estate does not qualify for this relief—this is just another situation where the IRC treats estates and individuals differently.[27]

Just for good measure, the Court goes on to hold that even if the claim was not time barred, it would fail on its merits, since the value for estate tax purposes is based on the value at the date of death or alternate valuation date. The fact that facts came to light later that would have impacted the market value of the shares had it been known at that date doesn't change the fact that it wasn't known, and the stock was being actively traded at the higher price on the date that counts for calculating its value for estate tax purposes.[28]

SECTION: 6654
IRS TO SEND REFUNDS OF UNDERPAYMENT PENALTIES TO 400,000 TAXPAYERS

Citation: IR-2019-144, 8/14/19

The IRS has announced that the agency will be sending out refunds to over 400,000 taxpayers who are eligible for relief previously announced from the IRS related to

---

[25] *Ibid*, p.13

[26] *Ibid*,

[27] *Ibid*, pp. 13-14

[28] *Ibid*, pp. 19-21

estimated tax penalties in IRS News Release IR-2019-144.[29] The checks will be issued to taxpayers who were eligible for relief the IRS announced on January 16 and March 22 but who either did not take advantage on that relief on their return or filed their return before the relief was announced and have not filed a claim for refund.

The IRS lowered the threshold for the application of the penalty for underpayment of estimated income taxes from its standard 90% of the current year's tax to 80% of the tax being paid in via withholdings and estimated taxes.

The IRS announced that they will take the following steps to provide this relief:

> Over the next few months, the IRS will mail copies of notices CP 21 granting this relief to affected taxpayers. Any eligible taxpayer who already paid the penalty will also receive a refund check about three weeks after their CP21 notice regardless if they requested penalty relief. The agency emphasized that eligible taxpayers who have already filed a 2018 return do not need to request penalty relief, contact the IRS or take any other action to receive this relief.[30]

For those that have not yet filed, the IRS has the following advice:

> For those yet to file, the IRS urges every eligible taxpayer to claim the waiver on their return. This includes those with tax-filing extensions due to run out on Oct. 15, 2019. The quickest and easiest way is to file electronically and take advantage of the waiver computation built into their tax software package. Those who choose to file on paper can fill out Form 2210 and attach it to their 2018 return. See the instructions to Form 2210 for details.[31]

---

[29] https://www.irs.gov/newsroom/irs-automatically-waives-estimated-tax-penalty-for-eligible-2018-tax-filers, August 14, 2019, retrieved August 15, 2019

[30] *Ibid*

[31] *Ibid*