Current Federal Tax Developments

Week of August 30, 2021

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SECTION: 195
LOOKING FOR A NEW TRADE OR BUSINESS IS NOT A TRADE OR BUSINESS

Citation: Estate of Morgan v. Commissioner, TC Memo 2021-104, 8/23/21

The Tax Court found that the taxpayer was neither continuing operating a prior trade or business nor had begun the conduct of a new trade or business in the case of *Estate of Morgan v. Commissioner*, TC Memo 2021-104.[1]

Mr. Morgan was a real estate developer whose homebuilding business he had operated for 26 years ran into the real estate crash, going into receivership in 2009. The Court described the receivership and Mr. Morgan's actions following the transfer of the operations to the receiver as follows:

> Appointed to manage all the affairs of the Morgan entities, LS Associates' task was to identify, take possession of, and liquidate the Morgan entities' assets. During the pendency of the receivership proceedings — which included tax years 2010 through 2012 — LS Associates was in sole control of the Morgan entities, under the supervision and subject to the approval of the Indiana superior court. It immediately exercised that exclusive control and did not relinquish it until the receivership concluded in 2013. Given the depressed market and the lenders' unwillingness to fund the Morgan entities' operations going forward, LS Associates did not consider using the receivership to retool and find a new buyer.
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> Mr. Morgan was prohibited from infringing on LS Associates' authority or incurring expenses on behalf of the Morgan entities, and he never sought permission to incur any expenses. Following the appointment of the LS Associates, Mr. Morgan spent about six months relaxing and spending time with his family. But Mr. Morgan was a hard worker who was not interested in retirement or remaining idle. In September 2009 he wrote:
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>> I am really focused on what my next career is. I[t] has been six months since I shut the Company down and it has been a great summer of rest and time with my family. Career 2 will almost certainly involve acquiring a company * * * or starting another company probably in the real estate building field but approaching it differently than I did in my first career.[2]

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[1] *Estate of Morgan v. Commissioner*, TC Memo 2021-104, August 23, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/insolvent-developer-was-not-carrying-on-a-trade-or-business/77792 (retrieved August 24, 2021)

[2] *Estate of Morgan v. Commissioner*, TC Memo 2021-104, August 23, 2021

Mr. Morgan established a new entity, Legacy, LLC in December of 2008. The Court described this entity and its operations as follows:

> Mr. Morgan conducted a search for a trade or business through Legacy, a single-member limited liability company (LLC) he had formed in December 2008 and which was taxed as a disregarded entity for 2010 through 2012. He was looking for businesses that met certain financial and logistical parameters, and he did not confine his search to any one industry.
>
> Legacy employed certain former CPMC employees, including Kristen Coyer as director of finance. Legacy employees kept timesheets, allocating time not just to Legacy's business search but also to the Morgans personally and to Falcon. For 2011 and 2012 Mr. Morgan recorded 100% of his time spent working for Legacy as "business search/forward looking".
>
> In addition to hiring former CPMC employees, Legacy hired various outside consultants to assist in its search for new business opportunities. Generally, the consultants would contact Mr. Morgan with business opportunities; and if he was interested, he would enter into a nondisclosure agreement with the selling entity to discuss the specific opportunity further. Despite these efforts Mr. Morgan did not make an offer to purchase — nor did he acquire or otherwise form — a new business as a result of Legacy's search before the end of 2012.[3]

Mr. Morgan became involved with a project undertaken by a former vice president of his old operations, as the Court noted:

> Apart from Legacy, Mr. Morgan indirectly maintained contact with the homebuilding industry. In 2009 Mr. Pyatt, the former vice president of CPMC and a close friend and business partner of Mr. Morgan, became aware that a number of partially developed properties owned by the Morgan entities were available for [*7] purchase from the receiver. He approached Mr. Morgan about partnering to purchase and develop the properties. Mr. Morgan instead lent Pyatt Builders $180,000 so it could purchase the property from the receiver, using a single-member LLC he owned and used as a vehicle for lending money. Mr. Morgan did not hold an ownership interest in Pyatt Builders and was not involved in the daily activities of the business. The loan was repaid, timely and with interest, in July 2010. Mr. Morgan's close relationship with Mr. Pyatt influenced his willingness to extend the loan.[4]

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[3] *Estate of Morgan v. Commissioner,* TC Memo 2021-104, August 23, 2021

[4] *Estate of Morgan v. Commissioner,* TC Memo 2021-104, August 23, 2021

Mr. Morgan also continued to operate an entity he had formed in 1996 (Falcon, LLC):

> Finally, throughout this time Mr. Morgan continued to fly aircraft owned by Falcon, an entity he had formed in 1996 to hold, operate, and maintain aircraft.
>
> Before the receivership proceedings, Mr. Morgan used Falcon's aircraft to further the Morgan entities' real estate development business; he visited potential building sites, researched development strategies, and checked on current developments. CPMC had an aviation department that employed the pilots, mechanics, and recordkeepers that flew, serviced, and kept track of the books and records for the aircraft held by Falcon.
>
> During the receivership proceedings Mr. Morgan continued to use Falcon's aircraft in his search (through Legacy) for new business opportunities. Falcon did [*8] not lease its aircraft or provide services to any unrelated third parties at any time. Mr. Morgan had a passion for aviation and both before and during the receivership proceedings often would pilot the aircraft himself.
>
> For 2010 and 2011 Falcon was taxed as a partnership, and its partners included Mr. Morgan and an S corporation. For 2012 Mr. Morgan was Falcon's sole owner, resulting in the partnership's termination and Falcon's taxation as a disregarded entity. Falcon's principal business activity was listed as "Consulting" on its 2010 and 2011 Forms 1065, U.S. Return of Partnership Income, and on petitioners' 2012 Schedule C.[5]

Mr. Morgan claimed losses from all of these operations for the years before the Court, and net operating losses arising from prior years.

But the IRS claimed that none of these operations constituted a trade or business for the years in question, and that all claimed expenses were either start-up expenditures under IRC §195 or non-deductible personal expenses under IRC §262.

IRC §195(c)(1) defines a "start-up" expenditure as follows:

> The term "start-up expenditure" means any amount—
>
> (A) paid or incurred in connection with—
>
> (i) investigating the creation or acquisition of an active trade or business, or
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> (ii) creating an active trade or business, or
>
> (iii) any activity engaged in for profit and for the production of income before the day on which the

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[5] *Estate of Morgan v. Commissioner,* TC Memo 2021-104, August 23, 2021

> active trade or business begins, in anticipation of such activity becoming an active trade or business, and
>
> (B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.

If Mr. Morgan was merely continuing his existing business of homebuilding, then IRC §195 would not apply. And Mr. Morgan argued this was exactly what he was doing:

> Petitioners argue that Mr. Morgan need not begin a new trade or business because the last one — homebuilding — never ceased. They point to his continued engagement with the Morgan entities and his new activities, such as the loan to Mr. Pyatt.[6]

The Court rejected the view that this was a continuation of the old business, finding that business had been abandoned by Mr. Morgan when the receiver took control:

> As for Mr. Morgan's continued engagement with the Morgan entities, the on-the-ground cessation of homebuilding activity and the order appointing LS Associates as receiver indicate that his prior homebuilding trade or business ceased in 2009. All CPMC employees were terminated in February 2009, and CPMC did not build additional homes after that point. This practical shutdown is consistent with the Morgan entities' financial situation and the Indiana superior court's March 2009 order appointing LS Associates as receiver, which gave it broad and exclusive powers to manage and liquidate assets.
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> …
>
> Mr. Morgan's actions and words support our conclusion that he was no longer carrying on a homebuilding trade or business. From his perspective in September 2009, the receivership proceedings "shut the company down" and began a period of transition in his life. And his focus shifted to starting or acquiring a new trade or business. After decades, Mr. Morgan's homebuilding business had ceased.
>
> …
>
> We therefore find that Mr. Morgan was no longer carrying on a homebuilding trade or business following the appointment of LS Associates as receiver for the Morgan entities. After that time Mr. Morgan was no longer regularly and actively undertaking homebuilding activity with the intent to earn a profit. Appointment of a receiver does not always spell the end of a taxpayer's trade or business. But here it did. Petitioners recognize this reality, noting that CPMC "did cease its operations". Their argument that "Mr. Morgan

[6] *Estate of Morgan v. Commissioner,* TC Memo 2021-104, August 23, 2021

> did not likewise cease or abandon his interest in continuing to stay in business, but rather uninterruptedly attempted to continue in business" is unavailing given our finding that petitioners did not commence another homebuilding trade or business before the end of 2012. We therefore reject petitioners' first theory for an active trade or business to which to attribute Falcon's aircraft maintenance expenses and Legacy's business search expenses.[7]

Similarly, the taxpayer's single loan to Mr. Pyatt was not a continuation of his prior business, nor an establishment of a new lending trade or business:

> And as for petitioners' argument that Mr. Morgan's lending activity was a continuation of his homebuilding business, his $180,000 loan to Mr. Pyatt in 2009 did not demonstrate regular and continuous activity in a homebuilding trade or business but rather a one-time loan to a friend so the friend could pursue a development opportunity and then repay the loan with interest. If anything, the loan would be part of a lending trade or business, but isolated and irregular loans to trusted individuals do not support that conclusion either. See *Imel v. Commissioner*, 61 T.C. 318, 323 (1973) (holding that a taxpayer's eight or nine loans over a four-year period was not a lending trade or business); *Heinbockel v. Commissioner*, T.C. Memo. 2013-125, at *31-*32 (holding that a taxpayer's occasional loans to her brother was not a lending trade or business).[8]

The taxpayer argued that even if he had not continued his old business, his search for a new trade or business was itself a trade or business:

> We next consider Mr. Morgan's activities related to Legacy and Falcon. Petitioners argue that Mr. Morgan's search for a new trade or business to acquire was itself an active trade or business in 2012. They point to the formation and use of Legacy, noting that it hired employees and engaged outside consultants. And they point to the support that Falcon provided Legacy in conducting that search, noting that it facilitated Legacy's business search as it once facilitated the Morgan entities' homebuilding — that "Falcon * * * [did] for Legacy what Falcon once did for CPMC." Respondent characterizes petitioners' argument as one that Mr. Morgan was "simply in the business of being in business" in an attempt to avoid section 195 by using Legacy and Falcon as "vehicle[s] to deduct all business investigation expenses."[9]

But the Tax Court finds that looking for a trade or business does not itself constitute a trade or business:

> Beginning with Legacy, we conclude that its general business search does not meet the "carrying on any trade or business" requirement of section 162. The "business investigation expenses" that petitioners

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[7] *Estate of Morgan v. Commissioner,* TC Memo 2021-104, August 23, 2021

[8] *Estate of Morgan v. Commissioner,* TC Memo 2021-104, August 23, 2021

[9] *Estate of Morgan v. Commissioner,* TC Memo 2021-104, August 23, 2021

> claimed and attributed to Legacy for the 2012 taxable year fit the definition of start-up expenditures in section 195©(1)(A)(i) as "amount[s] * * * paid or incurred in connection with * * * investigating the creation or acquisition of an active trade or business". Legacy paid employees and outside consultants to research a variety of industries and Mr. Morgan listed his time on his Legacy timesheets as 100% "business investigation/looking forward", both of which indicate that Legacy's activities were carried out in anticipation of beginning a trade or business. And because Mr. Morgan did not acquire a new business by the end of 2012, no business is deemed to have begun in that year under section 195(c)(2)(B).
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> …
>
> In sum, Mr. Morgan was not carrying on a trade or business through his search for a new trade or business to acquire. We agree with respondent that petitioners cannot squeeze into section 162 and avoid section 195 by claiming that Mr. Morgan's trade or business was searching for a trade or business.[10]

Nor did Falcon have any reason for being at this point other than to support the "non-business" of looking for a trade or business:

> Nor can they squeeze into section 162 by arguing Falcon was in the consulting business during the year in issue; its activities by themselves did not constitute an active trade or business independent of the Morgan entities. Before 2009 Falcon aircraft were used by Mr. Morgan to further the Morgan entities' real estate development business. He would fly to various locations to view potential building sites, research development strategies, and check on current developments. Falcon serviced a broader homebuilding trade or business.
>
> Petitioners attached Schedule C for Falcon to their 2012 Form 1040 and listed its principal business as "consulting", but they never established that the term encompasses anything other than transporting them and related individuals; Falcon did not lease its aircraft or provide services to any unrelated third parties at any time, and its only gross receipts came from petitioners and Legacy.[11]

The Court thus found that Mr. Morgan had no current operating business. Nothing he was doing had yet begun operations to allow for a current deduction of expenses under IRC §162, nor beginning to amortize start-up costs capitalized under IRC §195.

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[10] *Estate of Morgan v. Commissioner,* TC Memo 2021-104, August 23, 2021

[11] *Estate of Morgan v. Commissioner,* TC Memo 2021-104, August 23, 2021

SECTION: 6656
PMTA ARGUES THAT TAXPAYERS WHO MAKE MINOR ERRORS IN DEPOSITING DEFERRED FICA UNDER CARES ACT TIMELY OWE PENALTY ON ENTIRE AMOUNT DEFERRED

Citation: PMTA 2021-007, 8/23/21

The IRS issued PMTA 2021-07[12] that addresses a problem taxpayers who deferred employer FICA under the CARES Act may run into this year or next—with a consequence far more negative than they would believe would happen for what to them appears to be a minor error.

The question to be answered by this PMTA is the following:

> If any portion of an employer's section 3111(a) (employer portion of social security) taxes or so much of the taxes imposed under section 3221(a) as are attributable to the rate in effect under section 3111(a), the payment and deposit due dates of which are deferred under CARES Act section 2302, is not deposited by the applicable installment due date, is the deferral of the deposit due date invalidated for all of the employer's deferred section 3111(a) or 3221(a) tax, rather than just the remaining delinquent portion? Is the result that the section 6656 penalty for failure to deposit taxes is applicable to the entire deferred amount, assuming that no exception to the penalty applies?[13]

The answer to this question may come as a major (and not positive) surprise to those who took advantage of this deferral:

> Yes to both questions. CARES Act section 2302(a)(2) conditions the deferral of deposits on the timely deposit of all amounts deferred by the applicable due dates of December 31, 2021 and December 31, 2022.2 For example, if an employer defers the deposit of its portion of the section 3111(a) tax (the employer's portion of social security tax) in the amount of $50,000, and deposits and pays $25,000 on December 31, 2021 but fails to make any additional deposits or payments by December 31, 2022, the employer is liable for a section 6656 penalty on the entire $50,000 if no exception to the penalty applies.

Since the penalty under IRC §6656 for failure to timely deposit payroll taxes that are paid more than 15 days after the date due is 10% of the amount due, a penalty equal to

[12] PMTA 2021-07, August 23, 2021, https://www.irs.gov/pub/lanoa/pmta-2021-07.pdf (retrieved August 24, 2021)

[13] PMTA 2021-07, August 23, 2021

10% of the *total amount deferred* would be due if the taxpayer makes a minor error in getting the proper amount deposited by December 31, 2021, *or* December 31, 2022.

The PMTA points out the details of the deferral provision that was found in the CARES Act as follows:

> Section 2302(a)(1) of the CARES Act changes the due date for the payment of certain employment taxes to the applicable date defined later in the statute. Section 2302(a)(2) provides that deposits of those taxes will not be treated as due on the dates required by Treas. Regs. §§ 31.6302-1 and 31.6302-2, if certain conditions are met. Specifically, CARES Act section 2302(a)(2) provides that:
>
> > Notwithstanding section 6302 of the Internal Revenue Code of 1986, an employer shall be treated as having timely made all deposits of applicable employment taxes that are required to be made (without regard to this section) for such taxes during the payroll tax deferral period if all such deposits are made not later than the applicable date.[14]

The *applicable date* is defined as follows as noted by the PMTA:

> The term "applicable date" means December 31, 2021, with respect to 50% of the eligible deferred amount of tax deferred under CARES Act section 2302(a); and December 31, 2022, with respect to the remaining tax so deferred. CARES Act § 2302(d)(3). If an employer pays any amount before the applicable dates, any such payment is first applied to reduce the employer's liability for an amount due on December 31, 2021 and then to the amount due on December 31, 2022.[15]

The PMTA summarizes the rules as follows:

> In other words, CARES Act section 2302(a)(2) allows an employer to defer, without incurring a penalty under section 6656, its deposits of the applicable employment taxes until December 31, 2021 and December 31, 2022, provided that the conditions stated in CARES Act section 2302(a)(2) are satisfied.[16]

But the problem is that the provision conditions allowing for the late deposit on the entire deferred amount only if the required payments are made timely and in at least the amounts required:

> CARES Act section 2302(a)(2) conditions the deferral of deposits on the deposit of all deferred amounts by the applicable installment due

[14] PMTA 2021-07, August 23, 2021

[15] PMTA 2021-07, August 23, 2021

[16] PMTA 2021-07, August 23, 2021

> dates. Specifically, the deferral of the deposits is valid provided "all such deposits are made not later than the applicable date."[17]

Thus, any failure to make at least the cumulative amount of the payments due by the appropriate December 31 deadline triggers a penalty on the *entire amount deferred* with the due date of the deposit going back to the date the taxes originally would have been due in 2020 or very early in 2021 (more than 15 days before either December 31, 2021, or December 31, 2022):

> If any portion of the deposit is not made by the applicable date, whether December 31, 2021, as to the first installment, or December 31, 2022, as to the second installment, then the deferral is completely invalid. In that event, the deposits were due on the usual deposit due dates provided in Treas. Regs. §§ 31.6302-1 and 31.6302-2, which would be the due dates used in determining any penalties under section 6656.[18]

The IRS gives the following examples of the application of these penalties:

EXAMPLE ONE-INSUFFICIENT PAYMENT ON DECEMBER 31, 2021, PMTA 2021-007

Assume that an employer is liable for section 3111(a) tax, the employer's share of social security tax. Under CARES Act section 2302(a), these taxes are not due until the applicable due dates of December 31, 2021 and December 31, 2022. The employer is also required to deposit these taxes by section 6302 and its implementing regulations. Assume that any failure to deposit is not due to reasonable cause, and no other exception is applicable. Additionally assume that an employer has deferred, under CARES Act section 2302(a)(2), the deposit for the maximum amount of the employer's section 3111(a) tax for the 2020 tax year allowed to be deferred, and that this maximum amount deferred is a deposit of $50,000 of section 3111(a) taxes. As a result, under CARES Act section 2302(d)(3), the employer must deposit $25,000 by December 31, 2021, and the remaining $25,000 by December 31, 2022.

If, for the 2020 tax year, the employer deposits $5,000 on December 31, 2021, and makes no other deposits before December 31, 2021, the 10% penalty under section 6656(b)(1)(A)(iii), for failure to deposit tax for more than 15 days, applies to the entire $50,000, and the penalty amount would be $5,000. Because the first installment of $25,000, due on December 31, 2021, was not deposited by that date, the deferral is invalidated as to the entire $50,000. If, on February 7, 2022, the IRS issues a notice demanding payment of the balance of the first installment, and the employer does not pay the full amount demanded by February 17, 2022, the penalty rate increases to 15 percent.

EXAMPLE TWO-LATE PAYMENT FOR DECEMBER 31, 2022, PMTA 2021-007

Assume the same facts as in the first example, except that the first deposit of $25,000 was timely made on December 31, 2021.

If the employer deposits the remaining $25,000 on February 28, 2023, the 10% penalty under section 6656(b)(1)(A)(iii), for failure to deposit tax for more than 15 days, applies to the entire

[17] PMTA 2021-07, August 23, 2021

[18] PMTA 2021-07, August 23, 2021

$50,000, and the penalty amount would be $5,000. Because the second installment of $25,000, due on December 31, 2022, was not timely deposited, the deferral is invalidated as to the entire $50,000. If, on February 6, 2023, the IRS issues a notice demanding payment of the second installment of $25,000, and the employer does not pay the full amount demanded by February 16, 2023, the penalty rate increases to 15 percent.

Note that in both cases, a full $5,000 penalty (10% of the total $50,000 deferred FICA taxes) is due assuming the payment is made before the date 10 days after the IRS issues a demand for payment—and if the payment isn't made until after that date, the penalty will grow to $7,500 (15% of $50,000).

While the taxpayers can argue for reasonable cause for failing to timely pay the balances due, advisers should probably begin to warn any clients that deferred the payroll taxes of the importance of making sure the deposits are made in the proper amount and on or before each due date. It is not likely a taxpayer stating "I forgot about the payment being due" is going to be deemed to have provided reasonable cause for failing to pay the taxes timely.