2011 Regional Forums

Employee Benefits & Employment Taxes

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

EMPLOYEE BENEFITS

1. **Business deductions—employee benefit programs; medical care reimbursement plans—farmers—spouses as employees—employee status—burden of proof. SHELLITO v. COMM., Cite as 108 AFTR 2d 2011-5952, 08/24/2011, Code Sec(s) 162; 3121; 7491 © 2011 Thomson Reuters/RIA. All rights reserved**
2. **Federal Taxes Weekly Alert, Trust fund penalties can be assessed against third-party payroll service providers © 2011 Thomson Reuters/RIA. All rights reserved**
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5. **Federal Taxes Weekly Alert, Business deductions—ins. expenses—individual policy—solely owned corps.—accident or health plans—income exclusions. DKD Enterprises, Inc., et al., v. Commissioner, TC Memo 2011-29 , Code Sec(s) 162; 301; 316; 61.© 2011 Thomson Reuters/RIA. All rights reserved.**
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(781) 453-8700 MMisselbeck@KNSCPA.com

EMPLOYEE BENEFITS

1 Business deductions—employee benefit programs; medical care reimbursement plans—farmers—spouses as employees—employee status—burden of proof.

Tax Court decision that wife wasn't bona fide employee of husband's farming business, and thus that they weren't entitled to Schedule F deductions for employee benefit plan expenses/reimbursements made to her for family medical expenses and health ins. premiums, was vacated and remanded: Court's ruling was flawed in various ways, including in improperly relying on Kansas doctrine of necessity, which involved spousal obligations to provide for each other and wasn't determinative of issue here. Court also improperly determined that, because compensation for wife's services came from couple's joint checking account, it didn't provide her any economic benefit and wasn't actually compensation for services. Further, Court's decision to invoke substance over form doctrine was "problematic" under circumstances of this case. Court was instructed on remand to redetermine wife's employee status and to begin its analysis by applying common law agency doctrine. Court was also "urged" to reconsider assigning burden of proof in accord with Code Sec. 7491(a)(2) 's burden shifting provisions. (*Shellito v. Comm*., CA 10, 108 AFTR 2d 2011-5952)

American Federal Tax Reports

SHELLITO v. COMM., Cite as 108 AFTR 2d 2011-5952, 08/24/2011, Code Sec(s) 162; 3121; 7491

Milo L. SHELLITO, Sharlyn K. SHELLITO, PETITIONERS-APPELLANTS v. COMMISSIONER of Internal Revenue, RESPONDENT-APPELLEE.

Case Information:

Code Sec(s): 162; 3121; 7491[pg. 2011-5952]

Court Name: U.S. Court of Appeals, Tenth Circuit,

Docket No.: No. 10-9002,

Date Decided: 08/24/2011.

Prior History: Tax Court, (2010) TC Memo 2010-41, RIA TC Memo ¶2010-041 (opinion by Thornton,, *J.*), vacated and remanded.

Tax Year(s): Years 2001, 2002.

Disposition: Decision for Taxpayers in part.

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Katz, Nannis + Solomon, P.C.

(781) 453-8700   MMisselbeck@KNSCPA.com

Cites: , 2011-2 USTC P 50,595 .

HEADNOTE

1. Business deductions—employee benefit programs; medical care reimbursement plans—farmers—spouses as employees— employee status—burden of proof. Tax Court decision that wife wasn't bona fide employee of husband's farming business, and thus that they weren't entitled to Schedule F deductions for employee benefit plan expenses/reimbursements made to her for family medical expenses and health ins. premiums, was vacated and remanded: Court's ruling was flawed in various ways, including in improperly relying on Kansas doctrine of necessity, which involved spousal obligations to provide for each other and wasn't determinative of issue here. Court also improperly determined that, because compensation for wife's services came from couple's joint checking account, it didn't provide her any economic benefit and wasn't actually compensation for services. Further, Court's decision to invoke substance over form doctrine was "problematic" under circumstances of this case. Court was instructed on remand to redetermine wife's employee status and to begin its analysis by applying common law agency doctrine. Court was also "urged" to reconsider assigning burden of proof in accord with Code Sec. 7491(a)(2) 's burden shifting provisions.

Reference(s): ¶ 1625.282(35) Code Sec. 162; Code Sec. 3121; Code Sec. 7491

2. Accuracy-related substantial understatement penalties—reasonable cause—reliance on professional. This issue wasn't discussed on appeal.

Reference(s): ¶ 66,625.01(45) Code Sec. 6662

OPINION

UNITED STATES COURT OF APPEALS TENTH CIRCUIT,

Before PORFILIO, ANDERSON, and O'BRIEN, Circuit Judges.

ORDER AND JUDGMENT [*]

Judge: Stephen H. Anderson Circuit Judge

(United States Tax Court) (T.C. No. 102223-06)

After examining the briefs and appellate record, this panel has determined unanimously that oral argument would not materially assist in the determination of this appeal. See Fed. R. App. P. 34(a)(2); 10th Cir. R. 34.1(G). The case is therefore ordered submitted without oral argument.

Milo and Sharlyn Shellito, husband and wife, appeal a decision by the United States Tax Court upholding income tax deficiencies of $3,995 and $6,947, respectively, for the years 2001 and 2002. During those years the Shellitos fully deducted their family medical expenses not covered by insurance, plus insurance premiums, by claiming such amounts on Schedule F (Profit or Loss from Farming) of their joint Form 1040 Income Tax return as an ordinary business expense for an employee benefit program. The business expense was justified by designating Mrs. Shellito as her husband's employee for the work she did on their farm, then, pursuant to a medical reimbursement plan for

employees, reimbursing her for the payment of out-of-pocket medical expenses and premiums for the entire family, including her employer-husband.

The question for business expense deduction purposes is whether Mrs. Shellito was a bona fide employee receiving compensation for her services. The Tax Court held she was not a bona fide employee because, among other things, her purported compensation as an employee was illusory. For the reasons stated below, we vacate the decision of the Tax Court and remand the case for further consideration.

BACKGROUND

Mr. and Mrs. Shellito reside on a farm in Kansas. The farming operation conducted there consists of approximately 2300 acres of leased and 47 acres of deeded land used to raise around 200 head of cattle and grow wheat, milo, corn and soybeans. Mr. Shellito commenced farming in 1978, and was joined by Mrs. Shellito in 1982. Mr. Shellito testified at trial that the farm was always his and was so regarded by other farmers in the area. In other words, he did not regard Mrs. Shellito as having a proprietary interest in the farm.

In that connection Mr. Shellito testified that he owned all the numerous pieces of equipment used in the farm operation, including the combines and tractors, as evidenced by bills of sale in his name, and his leased land was solely in his name. For example, in 1990 he leased, in his own name, approximately 1400 acres of land, plus 80 head of cattle, and numerous pieces of farm equipment (five tractors, one combine, two discs, two hoe drills with trailer, one cultivator, one planter, one plow, two V-blades, one grinder, one auger, two swathers, one baler, two trucks and two trailers) from his father, and that lease was renewed through and including the years in question in this case, 2001 and 2002. Stip. of Facts, ¶ 7; Ex. 13-J. He also testified that he made all the decisions regarding the farm operation, including expansion and equipment acquisition, and that he directed his wife in the work she did on the farm. The Shellitos filed joint form 1040 income tax returns for 2001 and 2002, together with Schedule F “Profit and Loss From Farming” forms reporting all farm income and expenses and listing Mr. Shellito as the sole proprietor.

Mrs. Shellito has worked on the farm continuously since approximately 1982, putting in about 40 hours per week on average. Among her other duties she has assisted with planting and harvesting crops, including the operation of tractors and equipment, feeding and caring for the large cattle herd, building and repairing fences, maintaining and performing basic repairs of equipment, running necessary farm errands, handling the farm records and books, and performing all the other tasks relating to the farm. She testified that this work was done for her husband, that he made all the business and operating decisions and did so without her input or consent, that he directed her in her work including means, methods and what was to be accomplished, that the equipment she used belonged to him, and that she did not regard herself as a business partner. On their joint income tax returns for 2001 and 2002 she listed her occupation as housewife.

Prior to and during 2001–02, the Shellitos handled their business and personal income and expenses through a single, joint checking account on which both of them wrote checks. They also financed the farming operations with multiple loans from the Smith County State Bank and Trust Company on promissory notes signed by both Mr. and Mrs. Shellito (one was signed by Mrs. Shellito alone). Mr. Shellito acknowledged that the loans would not have been granted without Mrs. Shellito's signature, and that the farming business would have been impossible without the loans. The only real property owned by the Shellitos, 47 acres, is, according to Mr. Shellito, held in joint tenancy, Aplt. App. at 263, and Mrs. Shellito has an ownership interest in three pick-up trucks used in the farming operations. Additionally, the Shellitos were both named on insurance policies covering the farm and its equipment.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

In 2001, the Shellitos, on the advice of their accountant, recast their business structure to take advantage of the tax deduction businesses could take by having a medical reimbursement plan for employees. [1] For this purpose they purchased a commercially marketed package for family farmers, the AgriPlan/BizPlan [2] , which provided a preprinted medical reimbursement plan, application, year-end administrative services relative to amounts allowed as a deduction under the plan, and advice for implementation.

To implement this arrangement the Shellitos signed a brief employment agreement prepared by their accountant, dated May 29, 2001. The agreement declared that Mr. Shellito was employing his wife as a hired hand to do farm work he directed her to do; but it did not specify either hours or compensation. Aplt. App. at 318. Mrs. Shellito concurrently opened an individual checking account from which she commenced thereafter to pay the family's (including her employer-husband's) medical bills not covered by insurance, as well as insurance premiums. [3] Mr. Shellito paid her $100 per month as wages as well as reimbursing her for the payment of medical bills and expenses out of her account. He made these payments to her by checks signed by him, on their joint checking account, for deposit into her individual account.

Mrs. Shellito kept a daily log of her hours spent in farm work, although not specifying what work was done. The log totals showed 1,169 hours worked after May 29, in 2001, and 2,226 hours in 2002. In addition, the couple kept accurate tax records reflecting this arrangement, deducting and reporting payroll taxes on the $100/monthly wages and issuing W-2's. Thus, they reported wages ($700 plus $54 in employment taxes in 2001, and $1200 plus $92 in employment taxes in 2002) as income on their joint income tax returns—offset by like amounts ($700 and $1200) taken as expenses for labor hired on Schedule F. Finally, the couple transmitted annually to AgriPlan/ BizPlan detailed year-end accountings of amounts claimed for medical expense and insurance premium reimbursements, and they received back a year-end report indicating the total allowable benefit amount which they then reported as a business expense deduction for “Employee benefit programs” on Schedule F attached to their Form 1040 for each year. The amount of that deduction for 2001 was $15,593; for 2002, it was $20,897.

The Commissioner issued a notice of deficiency to the Shellitos with respect to their 2001 and 2002 tax liabilities disallowing the foregoing amounts as business expense deductions. After various adjustments, the resulting deficiency in taxes amounted to $3,995 for 2001 and $6,947 for 2002. [4] The Commissioner also imposed an accuracy-related penalty under I.R.C. § 6662(a) in the amount of $1,389 for 2002. Following a trial, the Tax Court upheld the Commissioner's determination as to the employee benefit plan deductions, but found for the taxpayers on the proposed penalty. The Commissioner does not appeal that ruling.

DISCUSSION

The Tax Court held that Mrs. Shellito was not her husband's employee because she was not compensated. The court reasoned that Mrs. Shellito obtained no economic benefit from funds paid into her individual account from the couple's joint checking account due to the fact that she is presumed to be an equal owner in the funds in that account. And, further, that her payment of medical expenses from her individual checking account was simply an assumption of her husband's liability under state law for the family's medical expenses. Accordingly, the court concluded that the form of the transactions in question did not reflect their substance and did not give rise to a true employment relationship. As additional support for its conclusion, the court pointed to the fact that Mrs. Shellito had done the same farm work for nineteen years without compensation. The Shellitos argue on appeal that the Tax Court failed to undertake a common law agency analysis to determine whether an employer-employee relationship existed, and erred in its “no compensation” reasoning.

A. **[1]** “We review the Tax Court's factual findings under the clearly erroneous standard and review its legal conclusions de novo.” *Wheeler v. Comm'r.*, 521 F.3d 1289, 1291 [101 AFTR 2d 2008-1696] (10th Cir. 2008)

(further quotation omitted). Whether a person is an employee is a question of fact which we review for clear error. See *Marvel v. United States*, 719 F.2d 1507, 1515 [52 AFTR 2d 83-6217] (10th Cir. 1983); *Hockett v. Sun Co., Inc*. (R&M), 109 F.3d 1515, 1525–26 (10th Cir. 1997); *Weber v. Comm'r*., 60 F.3d 1104, 1110 [76 AFTR 2d 95-5782] (4th Cir. 1995). But, we review de novo the standards and tests governing the factual analysis, and the application of the law to the facts. Whether the form over substance, economic substance, or similar doctrines apply, is a mixed question of fact and law; but the ultimate determination that such a doctrine applies is a matter of law which we review de novo. *Sala v. United States*, 613 F.3d 1249, 1252 [106 AFTR 2d 2010-5406] (10th Cir. 2010). See *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 [41 AFTR 2d 78-1142] n.16 (1978) ("The general characterization of a transaction for tax purposes is a question of law ...."); *Keeler v. Comm'r*., 243 F.3d 1212, 1217 [87 AFTR 2d 2001-1224] (10th Cir. 2001) (noting that the ultimate determination of whether a transaction lacks economic substance is a question of law.); *James v. Comm'r*., 899 F.2d 905, 909 [65 AFTR 2d 90-1045] (10th Cir. 1990) ("[W]e review de novo the ultimate characterization of the transactions as shams.") [5]

B. Business expense deductions for medical reimbursement payments to an employee are governed by § 162(a) and (a)(1) of the Internal Revenue Code and accompanying treasury regulations. They provide as follows:

> 162. Trade or business expenses
>
> (a) In general. — There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including —
>
> ((1)) a reasonable allowance for salaries or other compensation for personal services actually rendered;

I.R.C. § 162(a)(1). As the language of the statute indicates, "[t]he test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services." Treas. Reg. § 1.162-7 (emphasis added).

The regulations provide that "[a]mounts paid or accrued within the taxable year for... a sickness, accident, hospitalization, medical expense ... or similar benefit plan, are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business." Treas. Reg. § 1.162-10(a). [6]

The application of those provisions to farming and other small business sole proprietorships where one spouse is employed by the other in a bona fide employment relationship has long been acknowledged by the Internal Revenue Service. Thus, Rev. Rul. 71-588, 1971-2 C.B. 91 (1971) provides as follows: [7]

> Amounts reimbursed under an accident and health plan covering all bona fide employees, including the owner's wife, and their families are not includable in the employee's gross income and are deductible by the owner as business expenses.
>
> The taxpayer operated a business as a sole proprietorship with several bona fide fulltime employees including his wife. The taxpayer had an accident and health plan covering all employees and their families. During 1970 two employees, including the wife, incurred expenses for medical care for themselves, their spouses, and their children, and were reimbursed pursuant to the plan. The reimbursed amounts qualified both as amounts received under an accident or health plan for employees within the meaning of section 105(e) of the Internal Revenue Code of 1954 and as amounts described in section 105(b) of the Code.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

> Held, the reimbursed amounts received by the employees are not includable in their gross income pursuant to section 105(b) of the Code and these amounts are deductible by the taxpayer as a business expense under section 162(a) of the Code.

Id. (emphasis added). [8]

Pursuant to the Commissioner's ruling, arrangements such as the one before us have been widely marketed by tax professionals and organizations providing business management, forms, tips and related matters, leading, inevitably, to challenges by the Commissioner and cases in the Tax Court. There are six decisions out of the Tax Court directly relevant to this case. All involve spouse employees and medical benefit plans, and business expense deductions on either Schedule F or Schedule C. Indeed, four of the decisions involve AgriPlan/ BizPlan tax benefit packages identical to the one before us. And, three of the decisions involve sole proprietor farming operations. While such cases are, admittedly, governed by the "facts and circumstances" principle, and are Memorandum Opinions, the positions taken by the Commissioner in those cases are enlightening. The point here is that not one of those cases materially assists the Commissioner's position, adopted by the Tax Court, in this case.

Frahm v. Comm'r., T.C.M. 2007-351, 2007 WL 4179352 [TC Memo 2007-351] (Nov. 27, 2007), is directly on point. That case involved a sole proprietorship farming business in which the husband employed his wife using an AgriPlan/BizPlan tax package, and reimbursed her for amounts paid for the cost of health insurance premiums, deducting those amounts on Schedule F as payments pursuant to a benefit plan. Mrs. Frahm, the only employee, did farm work similar to that performed by Mrs. Shellito, and had apparently done so for years prior to the years in which she was designated as an employee. The funds in question were drawn on the couple's joint checking account by way of checks issued by Mr. Frahm to Mrs. Frahm. The health insurance premiums were largely paid by Mrs. Frahm from her individual checking account. Some were paid from the joint checking account.

Significantly, the Commissioner conceded that Mrs. Frahm was Mr. Frahm's employee for purposes of the health plan reimbursement deduction, did not dispute the bona fides of payments originating from the couple's joint checking account, or funds flowing thereafter from that account into Mrs. Frahm's individual checking account, and did not even attempt to dispute the deductibility of the noninsurance medical expenses paid by Mrs. Frahm. Id. at 7–8, n.25. He did dispute payments made indirectly by Mr. Frahm. The Tax Court ruled in favor of the Frahms. The Commissioner's concessions in Frahm, and the Tax Court's ruling, are irreconcilable with the case before us.

Speltz v. Comm'r., T.C. Summ. Op. 2006-25, 2006 WL 334296 (Feb. 14, 2006), upheld the deductibility of healthcare reimbursement payments to a husband-employee who worked part time in his wife's day care business conducted in their home. In reaching its decision in that case, the Tax Court applied a common law agency test to determine whether an employer-employee relationship existed, and it placed the burden on the Commissioner to prove that the husband was not a bona fide employee. Significantly, the court emphasized that the taxpayers had substantiated the services provided, including keeping records with respect to the hours spent in performing those services. Speltz is significant also for the fact that the only compensation paid to Mr. Speltz was the medical reimbursement benefit. There was no dispute that such a benefit constituted compensation, and the court found it to be a reasonable amount.

In the case before us, there is evidence of similarly careful recordkeeping. And, Mrs. Shellito was paid in two ways: a wage of $100 per month plus (as in Speltz) substantial medical reimbursement benefits amounting to more than $20,000 in 2002. The Commissioner does not seriously dispute Mrs. Shellito's total claimed compensation package as being adequate in the farm work market for the work performed.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Francis v. Comm'r., T.C.M. 2007-33, 2007 WL 424601 [TC Memo 2007-33] (Feb. 8, 2007), likewise involved a sole proprietorship farm, with an employee spouse, and the adoption of an AgriPlan/BizPlan package. In Francis, the Commissioner did question the spouse's status as an employee, referring to her uncompensated services for many years prior to executing an employment agreement. But the Commissioner did not invoke the sham transaction, substance over form, economic substance or compensation theories. Rather, the Commissioner's primary argument was that no evidence existed showing that Mrs. Francis actually did the work claimed. For instance, she failed to document the number of hours worked. The Tax Court agreed with that argument and found it unnecessary to decide whether Mrs. Francis was a bona fide employee. Such an approach is inconsistent with the Commissioner's central approach in this case and inconsistent with the facts, since in the case before us, Mrs. Shellito, in fact, documented her hours and testified without any serious challenge with respect to her services.

Albers v. Comm'r., T.C.M. 2007-144, 2007 WL 1649090 [TC Memo 2007-144] (June 7, 2007), likewise involved a sole proprietorship farm, wife-employee, AgriPlan/BizPlan package, and claimed medical expense reimbursement deductions on Schedule F. The Commissioner did not challenge the bona fides of the employment agreement, benefit plan, or other matters adopted pursuant to the AgriPlan/BizPlan; nor did he seek to pursue a substance over form or economic substance theory, or any position with respect to the fact that a joint checking account was involved. Rather, the Commissioner's position was a straightforward challenge to the payment or reimbursement of anything by or on behalf of Mrs. Albers with respect to healthcare expenses. The Tax Court held that there was no credible evidence that Mr. Albers paid anything at all, directly or indirectly, to Mrs. Albers pursuant to the medical reimbursement plan. The arguments advanced by the Commissioner in the case before us were not advanced in Albers, and the evidence clearly establishes the payment by Mrs. Shellito in the case before us of the health-related expenses in question, and her reimbursement for those payments.

Snorek v. Comm'r., T.C.M. 2007-34, 2007 WL 424536 [TC Memo 2007-34] (Feb. 8, 2007), likewise involved an AgriPlan/BizPlan health insurance and unreimbursed health expense deduction package; but the business involved was a sole proprietorship upholstery business, and the claimed medical expense reimbursements were listed on Schedule C (Profit or Loss from Business). As in Albers, and other cases, the Commissioner did not attack the claimed spousal employment arrangement (there involving a husband-employee) on substance over form or sham transaction, or similar grounds, nor did the Commissioner attempt to trace funds back to a joint checking account, or trace the history of the claimed spousal involvement in the business. Rather, the claim was simply that the taxpayers did not produce evidence that Mr. Snorek paid anything or was reimbursed for anything. The Tax Court noted: “Petitioners did not, for example, introduce receipts or canceled checks showing that Mr. Snorek paid the health insurance premiums for Mrs. Snorek. Petitioners also did not introduce the premium statement or policy itself, which may have identified the party responsible for making the premium payments for the insured.” Id. at 2. Unlike Snorek, the record before us abounds with documentary evidence and proof of billing and payments which, according to the implication arising from the reasoning in Snorek, would lead to a decision for the taxpayers in the instant case.

Finally, in Haeder v. Comm'r, T.C.M. 2001-7, 2001 WL 40100 [TC Memo 2001-7] (Jan. 17, 2001), the Tax Court upheld a disallowance of business expense deductions for medical benefit reimbursements from the taxpayer to his wife on the ground that she not only did not perform any work in the taxpayer's business, but that the taxpayer did not have any business. Furthermore, the Tax Court relied on the fact that no W-2 was issued, no payments were made directly to the purported employee-wife and there was no documentation of either the work purportedly performed or the time spent performing services, implying, apparently, a favorable outcome for the taxpayer where there is proof of such matters. Such is the case before us.

We have discussed the relevant cases in some detail because it is important to show the inconsistencies in the Commissioner's overall position in these cases, as well as the fact that the Shellitos' case, on its face, is benefitted by

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

the decided cases, and is not harmed by the Commissioner's position taken in any of them. 9 Furthermore, the cases highlight the fact that in tax law form often merges with substance by way of requirements for documentation and proof of a specific structure (e.g., employment agreement, documentation of hours worked, a written plan with a third-party administrator, testimony as to work performed, canceled checks showing payment by the husband to the wife, separate bank accounts, documented payments by the wife out of her account for medical expense purposes, and so on).

C. Faced in the case before us with the fact that the Shellitos crossed all of the T's and dotted all of the I's with respect to an employment relationship, the Commissioner has retrenched, arguing, really for the first time in these cases, that Mrs. Shellito's claimed compensation was illusory because (1) her payment of medical expenses simply relieved Mr. Shellito of his obligation under Kansas law to pay for her medical expenses (the doctrine of necessaries); (2) she obtained no economic benefit from checks written to her by her husband out of their joint checking account in which she was presumed to have an equal ownership interest; and, in effect, that medical expenses were still being paid out of the Shellitos" joint checking account even though the funds passed through Mrs. Shellito's individual account; and reasoning from these propositions that, as the Tax Court stated: "We conclude that Mrs. Shellito received no remuneration under the purported employment arrangement and consequently during the years at issue, as in the preceding years, there was no bona fide employment relationship." *Shellito v. Comm'r.*, T.C.M. 2010-41, 2010 WL 727985 [TC Memo 2010-41], at 6 (Mar. 3, 2010). Then, leveraging that conclusion, the court stated that there being no bona fide employment relationship, the Shellitos' employment agreement failed for lack of economic substance. Id. ("the purported employment agreement was a mere formality.")

1. It was error for the district court to rely on the Kansas doctrine of necessaries. The Kansas doctrine of necessaries applies equally to husbands and wives and imposes upon each a duty to provide for the other's necessities, including medical services. See *St. Francis Reg'l Med. Ctr., Inc. v. Bowles*, 836 P.2d 1123, 1125–28 (Kan. 1992). Thus, the duty only comes into force to the extent that one of the spouses is unable to provide for themselves. Here, Mrs. Shellito's argument is that, by way of compensation received from her alleged employment by her husband's farming business, Mrs. Shellito was able to provide for her own medical services.

It is puzzling that the Commissioner would even attempt to advance the argument that Mrs. Shellito's payments should be disregarded because they convert a legal support obligation into a deductible expense. That position has not been adopted by the Commissioner since it would punish a taxpayer for employing a spouse or family member. Revenue Ruling 71-588, 1971-2 C.B. 91, 1971 WL 26635 (1971), and Rev. Rul. 59-110, 1959-1 C.B. 45, 1959 WL 12187 (1959) (Employee-Dependent), were both based on determinations that an obligation to support does not preclude favored tax treatment in their respective situations. And, although Rev. Rul. 59-110 was superseded by Rev. Rul. 73-393, 1973-2 C.B. 33, 1973 WL 33072, the general conclusion has remained the same: "[F]or wages paid to the child for services actually performed, the fact that there may be a legal obligation to support the child is not determinative of the deductibility of such wages as a business expense." Id. The same reasoning applies to a spouse.

The proposition that the deductibility of medical reimbursement payments depends on whether or not medical expenses might be paid from another source, even if that source has an obligation to pay, is also not supported by any case law, and it would result in inconsistent treatment of benefit plans and a disincentive to employers to provide benefits. Based on the Service's own prior pronouncements, it would be surprising if the Commissioner now endorses the "support obligation" argument as a litigating position in these types of cases. Accordingly, in analyzing whether Mrs. Shellito received compensation, any obligation arising from the Kansas common law doctrine of necessaries must be excluded.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

2. Likewise, the Tax Court's disqualification of any amounts received by Mrs. Shellito as compensation because they originated from the couple's joint checking account, is flawed. If the use of a single joint account disqualifies spousal employment, it is strange that this threshold bar has not been used in the decided cases. Significantly, none of the cases referred to above relied on the existence and use of joint checking accounts, as such, as a disqualifying factor. Whether the joint account-compensation disqualifier appears in the I.R.S. audit guides, internal memoranda or other materials is at least problematic if for no other reason than its omission from Rev. Rul. 71-588, as well as the case law. Furthermore, a separate account requirement would simply invite another structural layer: here, a separate account for the business of the farm, from which funds would simply be transferred to the general joint account and/or to Mrs. Shellito's separate account (plus, the business account would probably be in joint tenancy anyway because the business relied on Mrs. Shellito to do the bookkeeping).

Finally, the argument that Mrs. Shellito owned half of the funds in the joint checking account does not withstand scrutiny in any event. First, it does not address the purported other half of payments she would have received (hard to do since the funds are fungible). More to the point, this argument is based on an improper implicit finding that there was no proof presented to suggest that the Shellitos did not equally own the funds in their joint checking account. As the Shellitos point out, the Kansas Supreme Court has held that "the presumption of equal ownership can be rebutted with evidence regarding the owner's relative contribution to the asset and donative intent." *Brewer v. Schalansky*, 102 P.3d 1145, 1150 (Kan. 2004). There is evidence in the record to rebut the presumption of equal ownership. Mr. Shellito testified that the joint account was the account that was his business account, used for all the business income and expenses, and that it was a joint account because the bank required Mrs. Shellito's name to be on it as well. Aplt. App. at 265. The inequality of contributions to the account is readily apparent from the fact that the family's income came from the sole-proprietorship farming business.

In addition, the argument that Mrs. Shellito received no economic benefit because her financial position with a separate account was the same as without it ignores the reality of spousal employment. Combined gross income would obviously not change. Employment of a spouse in a small business is done to avoid decreasing the couple's income, which would result from paying an unrelated hired hand. And, to narrow these kinds of cases to situations where the employed spouse is setting up a completely separate asset portfolio with her separate account does not find a supporting requirement in the reported cases.

3. The Tax Court also invoked the substance over form doctrine, citing *True v. United States*, 190 F.3d 1165 [84 AFTR 2d 99-5950] (10th Cir. 1999). However, the court's reliance on that doctrine was based largely on its finding that Mrs. Shellito did not receive any compensation—a subject we have addressed above. While the court's reasoning also included the fact that Mrs. Shellito worked for no compensation prior to 2001–2002, the substance over form principle cannot support the Tax Court's conclusion as its decision now stands. On remand, the Tax Court is not required to refrain from the use of doctrines such as substance over form, economic substance, and so forth, to decide this case, provided the doctrine selected is appropriate for the purpose, and supported by the record. See *Rogers v. United States*, 281 F.3d 1108, 1113–19 [89 AFTR 2d 2002-1115] (10th Cir. 2002) (discussing these various doctrines). In this regard, however, it is important to note that the Commissioner did not invoke such a doctrine in any of the cases discussed above. Why such an approach should be adopted now is problematic.

D. For the reasons we have stated, we are compelled to remand this case to the Tax Court for further consideration. On remand, the Tax Court should begin its analysis of whether or not Mrs. Shellito was a bona fide employee by applying the common law agency doctrine. See generally *Zinn v. McKune*, 143 F.3d 1353, 1357 (10th Cir. 1998) (the definition of employee "should be fleshed out by applying common-law agency principles to the facts and circumstances surrounding the working relationship of the parties" (Title VII case)); *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 322–27 (1992) (differentiating between employee and independent contractor); *Clackamas Gastroenterology Assoc., P.C. v. Wells*, 538 U.S. 440, 452 (distinguishing between employee and partner,

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

shareholder, and director); *Marvel*, 719 F.2d at 1514 (determining whether an individual is an employee for federal employment tax purposes); *Hockett*, 109 F.3d at 1526; *Speltz*, 2006 WL 334296, at 5–6 (determination of spouse as employee); *Herr v. Heiman*, 75 F.3d 1509 (10th Cir. 1996); *Carter v. Central States, Southeast and Southwest Areas Pension Plan*, 656 F.2d 575 (10th Cir. 1981) (pension plan); Rev. Rul. 87-41, 1987-1 D.B. 296, 1987 WL 419174 (1987); Treas. Reg. §§ 31.3121(d)-1, 31.3306(i)-1, and 31-3401(c)-1; Restatement (Second) of Agency, §§ 220(1) and (2). [10]

The touchstone is whether the person for whom the services are performed has the right to direct and control the means and manner in which the work shall be done and the result to be accomplished. However, the common law test for describing the conventional master-servant relationship contains no short hand formula or magic phrase that can be applied to find the answer. All of the incidents of the relationship must be assessed and weighed with no one factor being decisive. See Nationwide, 503 U.S. at 324.

The relevant factors to consider in a case like this would not, of course, replicate those used to analyze an employee-independent contractor relationship, for instance. Instead, the factors should concentrate on such things as the right of control, ownership or investment in the business and its assets, risk and reward, financial control, the parties' intent, including the existence of a written employment agreement, [11] work history, nature, extent and documentation of work performed, tax and other formalities relating to worker status, and similar factors.

The common-law test for determining whether Mrs. Shellito qualifies as an employee is not conclusive. Rather, it is highly relevant to, and provides context for, the determination of the overarching statutory requirement governing this case: whether or not the amounts paid to Mrs. Shellito were “compensation for personal services actually rendered.” I.R.C. § 162(a)(1). (See Treas. Reg. § 1.162-7: “[t]he test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.”) The controlling nature of this requirement is highlighted by the fact that the Shellitos claim the health care reimbursements at issue constituted compensation. The determination in question necessarily ties into deductibility as a business expense under § 162(a). [12]

CONCLUSION

Because of the determination set forth above, it is necessary to remand this case to the Tax Court for further consideration, which will entail findings of fact that we cannot make here. We do so reluctantly, in view of the fact that this case has been pending either administratively or before the courts for an inordinate period of time, burdening the taxpayers with uncertainty with respect to their affairs.

For the reasons stated above, the decision of the Tax Court is VACATED and the case is REMANDED for reconsideration in accordance with this opinion. On remand we urge the Tax Court to reconsider assigning the burden of proof in this case in accordance with I.R.C. § 7491(a)(2).

ENTERED FOR THE COURT

Stephen H. Anderson

Circuit Judge

[*] This order and judgment is not binding precedent except under the doctrines of law of the case, res judicata, and collateral estoppel. It may be cited, however, for its persuasive value consistent with Fed. R. App. P. 32.1 and 10th

Cir. R. 32.1.

[1] During 2001, a taxpayer who was self-employed was permitted to deduct only 60% of the cost of health insurance premiums paid for himself, his spouse, and his family. I.R.C. § 162(*l*)(1). That percentage increased to 70% in 2002, and 100% for years 2003 and after. Id. Also in 2001 and 2002 (and continuing to the present), any unreimbursed medical expenses that a taxpayer paid out of pocket could only be deducted to the extent that they exceeded 7.5% of the taxpayer's adjusted gross income. Id. § 213(a). Amounts paid to an employee pursuant to a healthcare reimbursement plan, however, were fully deductible as a business expense. Id. § 162(a)(1); Treas. Reg. § 1.162-10(a).

[2] For the years in issue AgriPlan (for small farms) and BizPlan (for small businesses) were divisions of Total Administrative Services Corporation. Aplt. App. at 54. Although it would seem on the surface that only the AgriPlan was adopted here, the combined references, AgriPlan/BizPlan or AgriPlan/BIZPLAN, are commonly used, and no information contained in the record sheds further light on the subject.

[3] Some out-of-pocket medical bills and some insurance premiums continued to be paid out of the couple's joint checking account, but, as with other discrepancies throughout this case, we do not pursue the point because our decision is not affected by those facts.

[4] The Shellitos agreed to $7,847 in adjustments for 2001, leaving $7,057 in issue before the Tax Court for that year. The Commissioner, contrary to his position on other amounts, allowed a deduction of $689 in both 2001 and 2002 for insurance premiums paid for a health insurance policy in Mrs. Shellito's name, and allowed the deductions for wages. And the Commissioner allowed $2,898 and $3,646, respectively, as deductions for health insurance pursuant to I.R.C. § 162(*l*). There are various discrepancies in the figures throughout the case. They are not material to our decision.

[5] But see *Nicole Rose Corp. v. Comm'r.*, 320 F.3d 282, 284 [90 AFTR 2d 2002-7702] (2d Cir. 2003) (treating the ultimate determination of whether a transaction lacks economic substance as a question of fact); and *Yosha v. Comm'r.*, 861 F.2d 494, 499 [63 AFTR 2d 89-369] (7th Cir. 1988) ("The question whether a particular transaction has economic substance, like other questions concerning the application of a legal standard to transactions or events, is governed by the clearly erroneous standard.").

[6] In addition to the employer being able to deduct such benefit plan payments, they are not includable in the taxable income of the employee. Specifically, employer provided insurance coverage is not included pursuant to I.R.C. § 106(a), and amounts paid directly or indirectly to the employee as reimbursement for expenses incurred by the employee for his or her care or the care of the employee's spouse or dependents, are not includable pursuant to I.R.C. § 105(b). The exclusion from income of the amounts here in question is not in issue.

[7] While revenue rulings are not binding on either the Tax Court or this court, we are entitled to give them consideration and "the public generally has the right to rely on positions taken by the Commissioner in revenue rulings," *Alumax Inc. v. Comm'r.*, 109 T.C. 133, 163 n.12 (1997), aff'd, 165 F.3d 822 [83 AFTR 2d 99-505] (11th Cir. 1999); *Pub. Emps. Ret. Bd. v. Shalala*, 153 F.3d 1160, 1163 [82 AFTR 2d 98-6072] (10th Cir. 1998).

[8] Some have attempted to distinguish Rev. Rul. 71-588 from cases like the one before us on the ground that two employees in addition to the employee-spouse were included in the benefit plan. See, e.g., *Eyler v. Comm'r.*, T.C.M. 2007-350, 2007 WL 4179355 [TC Memo 2007-350], at 3 n.14 (Nov. 27, 2007). We do not see the ruling as being dependent on the number of employees included in the benefit plan, and no pronouncement from the Internal Revenue Service has indicated otherwise. To the contrary, the ruling has been widely applied to single employee-spouse situations.

[9] The government contends that our case of *Folsom v. O'Neal*, 250 F.2d 946 (10th Cir. 1957), supports their position. Aple's Br. at 31. We disagree. Folsom involved an attempt by an individual to qualify for Social Security payments. The Bureau of Old-Age and Survivors Insurance, Social Security Administration determined that the claim was not well founded because the applicant had not demonstrated that he had been employed. After further proceedings, the case made its way to this court, where we emphasized that "[t]he nature and extent of judicial review in a proceeding of this kind is limited in scope," id. at 947, and under that standard, upheld the agency's decision. Furthermore, our decision was both brief and lacking in any developed reasoning with respect to the issue presented. Under these circumstances, Folsom is of little benefit here.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700   MMisselbeck@KNSCPA.com

[10] The Commissioner argues, and the Tax Court found, that the common-law tests relating to employment do not apply because Mrs. Shellito was not compensated and therefore she was not employed at all, citing *O'Connor v. Davis*, 126 F.3d 112 (2d Cir. 1997), *Graves v. Women's Professional Rodeo Ass'n, Inc.*, 907 F.2d 71 (8th Cir. 1990), and *McGuinness v. Univ. of N.M. Sch. of Med.*, 170 F.3d 974 (10th Cir. 1998). Those cases hold that the receipt of compensation by the putative employee is an essential condition to the existence of an employer-employee relationship. However, that proposition begs the question here. In the three cases cited, it was a given that no compensation was paid. Here, the question of compensation is a central issue. The resolution of that question in favor of the Shellitos renders the three cited cases irrelevant.
[11] Of course "the mere existence of a document styled "employment agreement' [does not] lead inexorably to the conclusion that either party is an employee." *Clackamas*, 538 U.S. at 450.
[12] The Tax Court is entitled to view the arrangement in question with a heightened level of skepticism in determining whether payments were made on account of the employer-employee relationship. See *True*, 190 F.3d at 1174, n.6. However, at a certain level of skepticism the Tax Court may very well be required to make credibility findings with respect to the testimony in the record.

Document Header: Checkpoint Contents Federal Library Federal Source Materials Federal Tax Decisions American Federal Tax Reports American Federal Tax Reports (Current Year) 2011 AFTR 2d Vol. 108 108 AFTR 2d 2011-6092 - 108 AFTR 2d 2011-5897 SHELLITO v. COMM., 108 AFTR 2d 2011-5952, Code Sec(s) 162; 3121; 6662; 7491, (CA10), 08/24/2011 **© 2011 Thomson Reuters/RIA. All rights reserved.**

2. Federal Taxes Weekly Alert, Trust fund penalties can be assessed against third-party payroll service providers

IRS's Small Business/Self-Employed (SB/SE) Division has issued an internal memorandum which says that the trust fund recovery penalty (TFRP) may be imposed against third-party payroll service providers as well as the employer.

Trust fund recovery penalty. Code Sec. 6672 imposes the TFRP on any person who: (1) is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility. The amount of the penalty is equal to the amount of the tax that was not collected and paid. The penalty is imposed on a "responsible person." A responsible person may be anyone in a business entity who has the duty to collect, account for, or pay over the tax.

Common law employers. The new IRS memorandum applies to "common law employers." A common law employer is any person who has the status of employer under the usual common law rules applicable in determining the employer-employee relationship.

Factors considered by courts in determining whether an employer-employee relationship exists include:

(1) the degree of control exercised by the principal;

(2) which party invests in the work facilities used by the worker;

(3) the opportunity of the individual for profit or loss;

(4) whether the principal can discharge the individual;

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

(5) whether the work is part of the principal's regular business;

(6) the permanency of the relationship;

(7) the relationship the parties believed they were creating; and

(8) the provision of employee benefits.

Third-party arrangements. Common law employers may designate a third party who is not the common law employer or a statutory employer under Code Sec. 3401(d)(1) to take over some or all of the employer's federal employment tax withholding, reporting, and payment responsibilities and obligations. A third party that could be subject to a TFRP includes a payroll service provider, a professional employer organization, or a employee leasing company that is not the common law or statutory employer. The TFRP may be assessed against the payroll service provider, professional employer organization, or responsible parties within those entities.

New guidance. A third-party payer is considered a responsible person under Code Sec. 6672 if the person had significant control over the payment of its client's employment taxes. A third-party payer is considered to have willfully failed to perform the payroll tax responsibility if the failure to perform the responsibility was intentional, deliberate, voluntary, reckless, or knowing, as opposed to accidental. No evil intent or bad motive is required.

The memo identified a number of factors considered by IRS in determining willfulness in situations involving third-party payers, including whether the client had knowledge of a pattern of noncompliance by the third-party payer at the time the delinquencies were accruing, whether the third-party payer fraudulently concealed the noncompliance from the client, and whether the client had received prior IRS notices indicating problems with its employment tax returns.

Use of a third-party payer does not relieve a common law employer from its responsibilities of ensuring that its tax obligations are met. A common law employer that uses a third party to prepare its employment taxes can still be subject to the TFRP if it satisfies the responsible person and willfulness requirements of Code Sec. 6672(a) . The employees can also be subject to the TFRP**.**

References: For who is a "responsible person," see FTC 2d/FIN ¶ V-1704; United States Tax Reporter ¶ 66,724; TaxDesk ¶ 864,005; TG ¶ 71654. For determining the existence of an employment relationship, see FTC 2d/FIN ¶ H-4250; United States Tax Reporter ¶ 34,014.37; TaxDesk ¶ 535,001; TG ¶ 9160.

Document Header: Checkpoint Contents Federal Library Federal Editorial Materials Federal Taxes Weekly Alert Newsletter 2011 07/14/2011 - Volume 57, No. 28 Articles Trust fund penalties can be assessed against third-party payroll service providers (07/14/2011) © 2011 Thomson Reuters/RIA. All rights reserved.

3. Federal Taxes Weekly Alert, Newly-released information return for "one-participant" plans reflects changes

IRS has released the 2010 version of Form 5500-EZ, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan, which some plans must soon file. The new form reflects a new type of pension plan that first became available in 2010. It also reflects some changed administrative practices. While they generally were first implemented last year, they are worth noting for plans first having to file Form 5500-EZ for 2010.

2011 Regional Forums

Employee Benefits & Employment Taxes

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Purpose of form. Form 5500-EZ is used by one-participant plans that are not subject to the requirements of section 104(a) of the Employee Retirement Income Security Act of 1974 (ERISA) and that are not eligible or choose not to file Form 5500-SF electronically to satisfy certain annual reporting and filing obligations imposed by the Code. For 2010 filings, foreign pension plans that are required to file an annual return must file Form 5500-EZ.

The instructions stress that a one-participant plan (see below) cannot file an annual return on Form 5500, Annual Return/Report of Employee Benefit Plan, regardless of whether the plan was previously required to file an annual return on Form 5500. Therefore, every one-participant plan required to file an annual return must file paper Form 5500-EZ with IRS or choose, if eligible, to electronically file Form 5500-SF (Short Form Annual Return/Report of Small Employee Benefit Plan) using the EFAST2 Filing System (an all-electronic system designed by the Department of Labor, IRS, and Pension Benefit Guaranty Corporation to simplify and expedite the submission, receipt, and processing of Forms 5500 and 5500-SF).

Who must file Form 5500-*EZ.* Form 5500-EZ must be filed for a retirement plan if:

> ... it is a one-participant plan that is required to file an annual return and the taxpayer is not eligible or chooses not to file the annual return electronically on Form 5500-SF; or
>
> ... it is a foreign plan that is required to file an annual return.

A one-participant plan is a retirement plan (that is, a defined benefit pension plan or a defined contribution profit-sharing or money purchase pension plan), other than an Employee Stock Ownership Plan (ESOP), which:

> ... covers only the taxpayer (or the taxpayer and his spouse) and the taxpayer (or the taxpayer and his spouse) owns the entire business (which may be incorporated or unincorporated); or
>
> ... covers only one or more partners (or partners and their spouses) in a business partnership; and
>
> ... does not provide benefits for anyone except the taxpayer (or the taxpayer and his spouse) or one or more partners (or partners and their spouses).

Who may not have to file Form 5500-EZ. A Form 5500-EZ does not have to be filed for the 2010 plan year for a one-participant plan if the total of the plan's assets and the assets of all other one-participant plans maintained by the employer at the end of the 2010 plan year does not exceed $250,000, unless 2010 is the final plan year of the plan. If a plan meets all the requirements for filing Form 5500-EZ and its total assets (either alone or in combination with one or more one-participant plans maintained by the employer) exceed $250,000 at the end of the 2010 plan year, Form 5500-EZ must be filed for each of the employer's one-participant plans including those with less than $250,000 in assets for the 2010 plan year.

EFAST2 Filing system. One-participant plans may satisfy their filing obligation by filing Form 5500-SF electronically under EFAST2 in place of Form 5500-EZ (on paper), provided that the plan covered fewer than 100 participants at the beginning of the plan year. One-participant plans that covered 100 or more participants at the beginning of the plan year are not eligible to file Form 5500-SF, and must file Form 5500-EZ.

Eligible combined plans. The Pension Protection Act of 2006 (P.L. 109-280) established rules for a new type of pension plan, an “eligible combined plan,” effective for plan years beginning after Dec. 31, 2009 (see Weekly Alert

¶ 10 08/20/2009). An eligible combined plan consists of a defined benefit plan and a defined contribution plan that includes a qualified cash or deferred arrangement under Code Sec. 401(k) , with the assets of the two plans held in a single trust, but clearly identified and allocated between plans. The eligible combined plan design is available only to employers that employed an average of at least 2 but not more than 500 employees on each business day during the calendar year preceding the plan year as of which the eligible combined plan is established and that employs at least 2 employees on the first day of the plan year. Because an eligible combined plan includes both a defined benefit plan and a defined contribution plan, the Form 5500-EZ filed for the plan must include all the information that would be required for either a defined benefit plan or a defined contribution plan.

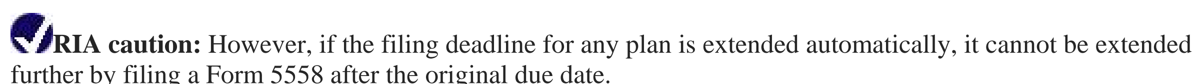
Final plan year. All one-participant plans should file the Form 5500-EZ for their final plan year indicating that all assets have been distributed. The final plan year is the year in which distribution of all plan assets is completed.

Filing due date. Form 5500-EZ must be filed by the last day of the seventh month following the end of the plan year (e.g., normally July 31 for calendar year plans but Aug. 1, 2011 for 2010 calendar years plans because July 31, 2011 falls on a Sunday) unless an extension is granted. A one-time extension to file Form 5500-EZ of up to 2 1/2 months may be obtained by filing Form 5558.

One-participant plans automatically receive an extension of time to file Form 5500-EZ (without filing a Form 5558) if the following conditions are met:

> ... the plan year and the employer's tax year are the same;
>
> ... the employer has been granted an extension to file its federal income tax return to a date later than the normal due date for filing the Form 5500-EZ; and
>
> ... a copy of the application for extension of time to file the federal income tax return is retained with the plan's records..

This exception gives an extension to the extended due date for filing the employer's income tax return.



RIA caution: However, if the filing deadline for any plan is extended automatically, it cannot be extended further by filing a Form 5558 after the original due date.

References: For Form 5500-EZ annual reporting requirements for one-participant pension plans, see FTC 2d/FIN ¶ S-3357; United States Tax Reporter ¶ 60,334; TaxDesk ¶ 813,010; TG ¶ 9101.

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4. **Federal Taxes Weekly Alert, Tax Court says part-time university instructor wasn't employee - Donald T. Robinson, TC Memo 2011-99**

The Tax Court has ruled that a full-time college professor at Rowan University, who also taught classes at Temple University and prepared curricula for Temple's police training programs, should have been classified by Temple as an independent contractor.

2011 Regional Forums

Employee Benefits & Employment Taxes

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Background. Code Sec. 3121(d)(2) defines an "employee" for employment tax purposes as "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee."

Factors considered by courts in determining whether an individual is an employee or independent contractor include:

(1) the degree of control exercised by the principal;

(2) which party invests in the work facilities used by the worker;

(3) the opportunity of the individual for profit or loss;

(4) whether the principal can discharge the individual;

(5) whether the work is part of the principal's regular business;

(6) the permanency of the relationship;

(7) whether the worker is paid by the job or by the time;

(8) the relationship the parties believed they were creating; and

(9) the provision of employee benefits.

Facts. Donald Robinson taught criminal justice classes at Rowan University on a full-time basis. He also worked part-time for Temple University doing curricula design and teaching in Temple's special Criminal Justice Training Program (CJTP). He was paid an hourly rate for teaching and a flat rate for updating curricula. The courses offered through the CJTP were not offered for college credit to regular Temple students. Instead, the students Robinson taught were usually police officers or other criminal justice personnel enrolled in the CJTP's Municipal Police Academy.

From '85 until '96, Temple treated Robinson as an independent contractor and reported his income on Forms 1099-MISC. Then, around '96, Temple began to treat Robinson as an employee and reported his income on Forms W-2. Robinson requested that Temple treat him as an independent contractor, but Temple refused. Robinson continued to report his income from Temple as if he were an independent contractor.

RIA observation: Most individuals who go to court over their worker classification want to be treated as employees rather than individuals. Although the facts in this case don't state why Robinson wanted to be treated as an independent contractor, one possible reason is that he wanted to keep his rather large Schedule C deductions for each year at issue, which included significant home office and automobile expenses.

No common law employment relationship. The Tax Court concluded that Robinson was an independent contractor. This determination was supported by the fact that Temple exercised little control over how Robinson completed his work. The only control Temple asserted over Robinson's work in updating the curricula was to set deadlines and

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

convey the general topics that he was to cover. Temple also did not exercise control over how Robinson completed the curricula.

Other factors supporting the classification of Robinson as an independent contractor include that he didn't have an office at Temple, but instead completed his work at his home office; Robinson could market his services to other businesses; the work performed by Robinson pertaining to police training wasn't a part of Temple's regular business as a university; and Temple did not provide him with any employee benefits,

Also, although the parties failed to provide Robinson's contracts with Temple, thus making it difficult to assess whether it had the authority to discharge him, the record indicated that Robinson was hired under separate agreements to perform discrete tasks. Thus, if Temple was unhappy with Robinson's work, its recourse would likely be to simply not hire him for any additional projects, rather than to fire him. This also supported independent contractor status.

In considering the permanence of Robinson's employment relationship with Temple, the Court found that although Robinson had been involved in the CJTP for many years, his duties had fluctuated significantly over the years and had recently been minimal. While the hourly wage Robinson received for teaching was consistent with an employer-employee relationship, the set fee he received for writing curricula supported a finding of an independent contractor relationship.

One factor that supported the classification of Robinson as an employee was that Temple University believed that it had an employer-employee relationship with Robinson. Since '96, Temple had issued W-2 forms to Robinson, and it had denied his requests to report his income on Form 1099-MISC. However, this factor was outweighed by the others favoring independent contractor status.

References: For determining who is an employee, see FTC 2d/FIN ¶ H-4250; United States Tax Reporter ¶ 34,014.37; TaxDesk ¶ 535,001; TG ¶ 9160.

Tax Court & Board of Tax Appeals Memorandum Decisions - Donald T. Robinson, et ux. v. Commissioner, TC Memo 2011-99 , Code Sec(s) 7491.

DONALD T. AND MARLENE B. ROBINSON, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information**:**

Code Sec(s): 7491

Docket: Dkt. No. 20544-08

Date Issued: 05/5/2011

Judge: Opinion by Wells, *J*.

Tax Year(s): Years 2004, 2005.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700   MMisselbeck@KNSCPA.com

Disposition: Decision for Commissioner

HEADNOTE

1. Tax Court—burden of proof—proof shifting. Criminal justice professor and wife/marketing co. manager weren't entitled under Code Sec. 7491 to shift burden of proving deficiencies to IRS: taxpayers didn't meet Code Sec. 7491(a)(2) 's substantiation requirements.

Reference(s): ¶ 74,915.01(5) Code Sec. 7491

2. Employment taxes—employee vs. independent contractor—professors and instructors. Full-time criminal justice professor for 1 university was treated for tax purposes as independent contractor, not employee, in respect to additional, part-time work he did as vocational instructor at 2d university. Factors showing independent contractor status included that taxpayer wrote his own curricula for 2d university and that 2d university only set deadlines, but otherwise had no control over how taxpayer completed, such curricula. It was also telling that 2d university hired taxpayer repeatedly for separate jobs throughout year; that his instructional work, teaching non-credit classes to police officers, wasn't part of 2d university's regular business of teaching for-credit classes to regularly enrolled students; and that taxpayer received no employee benefits

Reference(s): ¶ 34,015.54(15) Code Sec. 3401

3. Home office deductions—trade or business—professors and instructors— regular use. Marketing co. manager and husband/criminal justice professor who worked full-time as professor for 1 university and as part-time vocational instructor at 2d university were denied deductions for items allegedly relating to husband's teaching-related business use of home office: taxpayers didn't show they met Code Sec. 280A 's regular use requirement.

Reference(s): ¶ 280A5.01(50) Code Sec. 280A

4. Vehicle expense deductions—strict substantiation. Marketing co. manager and husband/criminal justice professor who worked full-time as professor for 1 university and as part-time vocational instructor at 2d university were denied deductions for alleged business use of their vehicles: taxpayers didn't meet Code Sec. 274(d) 's strict substantiation requirements where, although submitting check copies and other vehicle-related receipts, they had no log documenting purported business use of either of their vehicles. Further, they inexplicably claimed 18,000 business miles for husband's vehicle for 1 year during which he taught only 8 classes.

Reference(s): ¶ 2745.14(20) Code Sec. 274; Code Sec. 162; Code Sec. 67

5. Travel expense deductions—unreimbursed employee expenses—business vs. personal purpose—strict substantiation. Marketing co. manager and husband/criminal justice professor who worked full-time as professor for 1 university and as part-time vocational instructor at 2d university were denied deductions for alleged business-related trips and meal and entertainment costs. Taxpayers offered no documentation of or testimony about husband's alleged trips. And while they did submit some receipts for wife's travel-related expenses, those largely reflected trips to tourist attractions or family vacation spots. Self-serving claim that such trips were important "benchmarking" excursions for wife's job and thus that expenses relating thereto were deductible as unreimbursed employee expenses was unpersuasive.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Reference(s): ¶ 2745.12(5) Code Sec. 274; Code Sec. 162; Code Sec. 67

6. Business deductions—publications— ordinary and necessary expenses—substantiation. Marketing co. manager and husband/criminal justice professor who worked full-time as professor for 1 university and as part-time vocational instructor at 2d university were denied deductions for husband's purported business publications: taxpayers didn't show that publications, which included such varied items as joke book, magazine about celebrities, and DVDs of popular TV shows, were business-related. Arguments that things like magazine was business related because it contained news of current events weren't persuasive.

Reference(s): ¶ 1625.012(5) Code Sec. 162

7. Tax preparation expense deductions—substantiation. Married couple/ professor and marketing co. manager were denied deduction for tax preparation expenses: taxpayers didn't provide any receipts to substantiate claimed costs.

Reference(s): ¶ 2125.14(5) Code Sec. 212

8. Failure to timely file returns penalties—burden of proof and production— reasonable cause. Failure to timely file returns penalties were upheld against married couple/professor and marketing co. manager for years for which they filed late returns: IRS met its burden of production on penalties' applicability with taxpayers' agreement that they didn't file on time; and they failed to establish reasonable cause for same, making instead only ineffectual argument that they delayed filing while waiting for decision in another deficiency case that had been rendered well before returns' due dates.

Reference(s): ¶ 66,515.14(5); ¶ 74,915.03(15) Code Sec. 6651; Code Sec. 7491

9. Accuracy-related substantial understatement penalties—burden of proof and production. Accuracy-related substantial understatement penalties were upheld against married couple/professor and marketing co. manager for years for which they claimed multiple unsubstantiated deductions: IRS met its burden of production on penalties' applicability with proof that taxpayers had understatements that were substantial within meaning of Code Sec. 6662(d)(1) for each year at issue; and they didn't offer any substantial authority or other grounds for reducing understatements.

Reference(s): ¶ 66,625.01(10); ¶ 74,915.03(10) Code Sec. 6662; Code Sec. 7491

Syllabus

Official Tax Court Syllabus

Counsel

Donald T. and Marlene B. Robinson, pro sese.

Jason M. Kuratnick, for respondent.

WELLS, Judge

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

MEMORANDUM FINDINGS OF FACT AND OPINION

Respondent determined deficiencies, additions to tax for failure to file timely pursuant to section 6651(a)(1), and accuracy-related penalties pursuant to section 6662(a) with respect to petitioners' Federal income tax as follows: [1]

Year	Deficiency	Addition to Tax Sec. 6651(a)(1)	Penalty Sec. 6662(a)
2004	$7,965	$645.00	$1,593.00
2005	9,634	940.75	1,923.80

The issues we must decide are: (1) Whether the burden of proof has shifted to respondent pursuant to section 7491(a); (2) whether petitioner husband was an employee or an independent contractor of Temple University; (3) whether petitioners are entitled to deduct business expenses reported on their returns on Schedules C, Profit or Loss From Business; (4) whether petitioners are entitled to deduct employee business and miscellaneous expenses reported on their returns on Schedules A, Itemized Deductions; (5) whether petitioners are liable for the additions to tax under section 6651(a)(1) for failure to file timely returns; and (6) whether petitioners are liable for accuracy-related penalties pursuant to section 6662(a).

FINDINGS OF FACT

Some of the facts and certain exhibits have been stipulated. The parties' stipulations of fact are incorporated in this opinion by reference and are found accordingly. At the time they filed their petition, petitioners were residents of Pennsylvania. Petitioners are husband and wife (hereinafter referred to individually as Mr. Robinson or Mrs. Robinson, respectively) who filed joint tax returns for their 2004 and 2005 tax years (the years in issue).

During the years in issue Mr. Robinson was employed as a full-time professor at Rowan University, where he taught classes related to criminal justice. Over the past several decades, Mr. Robinson has earned income periodically from other activities such as writing training curriculums for police officers and providing expert testimony. Since 1985 a large part of his outside work has included teaching classes at Temple University (Temple) and preparing curriculums for Temple's training programs.

Although respondent sometimes characterized Mr. Robinson's position at Temple as adjunct professor, Mr. Robinson was technically a vocational instructor. The courses he taught were not part of the university's regular curriculum; rather, they were part of its Criminal Justice Training Program (CJTP). The courses offered through the CJTP were not offered for college credit to regular Temple students. Instead, the students Mr. Robinson taught were usually police officers or other criminal justice personnel enrolled in the CJTP's Municipal Police Academy. The students usually were assigned to the CJTP's Municipal Police Academy by a Pennsylvania State law enforcement training commission such as the Pennsylvania Commission on Crime and Delinquency or the Municipal Police Officers' Education and Training Commission. In most cases, Temple operated the courses under a contract billed to the Commonwealth of Pennsylvania.

Mr. Robinson was not responsible for managing the enrollment in his classes, and Temple provided him with classroom space. Mr. Robinson bore no risk of loss from underenrollment in the courses, and he had no possibility

of earning a profit in excess of his agreed compensation from Temple. The curricula he wrote were prepared at the direction of Temple, which set the deadline for his finished product. The topics to be covered in the curricula were conveyed to him by Temple, but frequently they were mandated by the State commissions that contracted with Temple. Sometimes Mr. Robinson was responsible for only a portion of the curriculum; at other times he wrote or edited the entire curriculum. The completed curricula became the property of Temple.

Mr. Robinson was paid an hourly rate for teaching and a flat rate for updating curricula. [2] Before 2003 Mr. Robinson earned substantial income from teaching and updating curricula at Temple, sometimes as much as $35,000 per year. However, in recent years he has not been hired as often by Temple. During 2004 Mr. Robinson received $1,295 from Temple for teaching 8 days during the Municipal Police Academy, which met from May to October, and $500 for updating one curriculum. His teaching services and his curriculum updating services were engaged under separate agreements entered at different times. During 2005 Mr. Robinson received $4,145 from Temple for teaching portions of three different courses, and he received $900 for updating curricula. His 2005 income from Temple was paid pursuant to four separate agreements between Mr. Robinson and Temple.

From 1985 until 1996 Temple treated Mr. Robinson as an independent contractor and reported his income on Forms 1099-MISC, Miscellaneous Income. [3] Beginning around 1996, Temple began to treat Mr. Robinson as an employee and report his income on Forms W-2, Wage and Tax Statement. Mr. Robinson requested that Temple treat him as an independent contractor, but Temple refused. Nonetheless, petitioners continued to report Mr. Robinson's income on their Schedule C as if he were an independent contractor. During the years in issue, Temple treated Mr. Robinson as a part-time employee and issued him Forms W-2.

Temple did not provide Mr. Robinson with an office, and he completed his work for Temple out of an office in his home. His office at home occupied 200 square feet of his 3,500-square-foot home. During the years in issue his office was not used by anyone else except to pass through it.

During the years in issue Mrs. Robinson was employed as the general manager for Influence Marketing, a wholly owned subsidiary of QVC, Inc. As general manager, she was in charge of two operations: One in nearby Pennsylvania and one at the Mall of America in Minnesota. Mrs. Robinson's operations are retail locations and also attract tourists who receive tours of the QVC facility. Additionally, the operation in Pennsylvania has an audience venue that hosts a variety of events including interviews with celebrities who endorse QVC products. Mrs. Robinson was responsible for the profitability of both locations and had control over “strategic initiatives”.

Mrs. Robinson was eligible for reimbursement of her employee-related expenses. She made a number of trips to visit the Mall of America in Minnesota, and each of those trips was reimbursed in full by Influence Marketing. In total, she was reimbursed for expenses of $9,886.10 and $8,436.23 during petitioners' 2004 and 2005 tax years, respectively.

Petitioners were involved in a prior dispute before the Tax Court regarding whether Mr. Robinson qualified as an independent contractor when he performed services for Temple. That dispute ended when the Internal Revenue Service (IRS) stipulated that petitioners had no deficiency for the year there in issue. We take judicial notice of the stipulated decision entered in the case at docket No. 10791-04S on November 2, 2004.

Petitioners filed late tax returns for the years in issue. The IRS did not receive petitioners' 2004 tax return until April 19, 2007, and it did not receive their 2005 tax return until June 13, 2007.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700   MMisselbeck@KNSCPA.com

On a Schedule C attached to their 2004 tax return, petitioners reported income of $1,795 and expenses totaling $25,164 relating to Mr. Robinson's services to Temple. On a Schedule A attached to their return, petitioners also claimed a miscellaneous deduction of $23,597, in excess of the 2-percent limitation. The largest portion of that deduction was from employee business expenses Mrs. Robinson incurred in her employment as a manager with Influence Marketing. Mr. Robinson also claimed deductions for employee business expenses from his position as a professor at Rowan University.

Petitioners reported similar expenses on their 2005 tax return. On their Schedule C for 2005, petitioners reported income of $4,045 and expenses totaling $26,826 from Mr. Robinson's work at Temple. On their Schedule A, petitioners claimed a miscellaneous deduction of $24,030, in excess of the 2-percent limitation. Most of the deductions on their Schedule A were from unreimbursed employee business expenses petitioners claimed from both of their full-time jobs.

On November 14 and December 12, 2007, respondent mailed letters to petitioners notifying them that respondent was examining their 2004 and 2005 tax returns. During the examination petitioners did not provide any documentation substantiating their reported expenses. Instead, Mr. Robinson repeatedly insisted throughout the examination that the examining officer needed to first separately consider whether he qualified as an independent contractor with regard to the services he performed for Temple.

On June 3, 2008, respondent issued petitioners a notice of deficiency for the years in issue. In the notice of deficiency, respondent asserted that: (1) Mr. Robinson was an employee of Temple and not an independent contractor; (2) petitioners were not entitled to deduct the Schedule C expenses reported on their returns; and (3) petitioners were not entitled to deduct the employee business and miscellaneous expenses reported on their returns.

Petitioners timely filed a petition seeking redetermination of the deficiencies, additions to tax, and penalties.

OPINION

I. ***Whether the Burden of Proof Has Shifted Under Section 7491(a)***

We consider as a preliminary matter petitioners' contention that the burden of proof has shifted to respondent pursuant to section 7491(a). Generally, the Commissioner's determination of a deficiency is presumed correct, and the taxpayer has the burden of proving it incorrect. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 [12 AFTR 1456] [ER ILC] (1933). Section 7491(a)(1) provides an exception that shifts the burden of proof to the Commissioner as to any factual issue relevant to a taxpayer's liability for tax if: (1) The taxpayer introduces credible evidence with respect to such issue; and (2) the taxpayer satisfies certain other conditions, including substantiation of any item and cooperation with the Government's requests for witnesses, documents, other information, and meetings. Sec. 7491(a)(2); see also Rule 142(a)(2). Taxpayers bear the burden of proving that they have met the requirements of section 7491(a). *Rolfs v. Commissioner*, 135 T.C. 471, 483 (2010).

Petitioners contend that they have satisfied the requirements of section 7491(a) and that the burden of proof as to all factual issues affecting the deficiencies in their taxes should be shifted to respondent. Respondent contends that the burden should not shift because petitioners have not substantiated their claimed expenses and did not cooperate with respondent's requests for documentation. We agree with respondent that the burden of proof remains with petitioners because, as we explain below, we conclude that petitioners have failed to substantiate their reported expenses.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

II. ***Whether Mr. Robinson Qualified as an Employee or an Independent Contractor When He Rendered Services to Temple University***

Whether a taxpayer is an independent contractor or an employee is decided by applying common law principles to the specific facts and circumstances of the case. *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 323-325 (1992); *Weber v. Commissioner*, 103 T.C. 378, 386 (1994), affd. 60 F.3d 1104 [76 AFTR 2d 95-5782] (4th Cir. 1995). For guidance on whether a worker qualifies as an employee under common law principles, courts have generally looked to the Restatement of Agency. *Cmty. for Creative Non-Violence v. Reid*, 490 U.S. 730, 752 n.31 (1989). Relevant factors include: (1) The degree of control exercised by the principal; (2) which party invests in the work facilities used by the worker; (3) the opportunity of the individual for profit or loss; (4) whether the principal can discharge the individual; (5) whether the work is part of the principal's regular business; (6) the permanency of the relationship; (7) whether the worker is paid by the job or by the time; (8) the relationship the parties believed they were creating; and (9) the provision of employee benefits. See *Ewens & Miller, Inc. v. Commissioner*, 117 T.C. 263, 270 (2001); *DeTorres v. Commissioner*, T.C. Memo. 1993-161 [1993 RIA TC Memo ¶93,161]; see also *1 Restatement, Agency 2d*, sec. 220 (1958). We consider all of the facts and circumstances of each case, and no single factor is dispositive. *Ewens & Miller, Inc. v. Commissioner*, supra at 270.

Respondent argues that Mr. Robinson's working arrangement with Temple is similar to the taxpayers' positions as adjunct professors in *Potter v. Commissioner*, T.C. Memo. 1994-356 [1994 RIA TC Memo ¶94,356], and *Bilenas v. Commissioner*, T.C. Memo. 1983-661 [¶83,661 PH Memo TC], and that Mr. Robinson similarly should be treated as a part-time employee. In both of those cases the taxpayers were hired by their respective universities as adjunct professors to teach semester-long classes on a class-by-class basis. The schools determined which courses those adjunct professors would teach and where they would teach them. The schools managed enrollment in the courses and provided classroom space. In both cases the universities treated the relationship as an employer-employee relationship.

However, certain aspects of the instant case are more similar to *Reece v. Commissioner*, T.C. Memo. 1992-335 [1992 RIA TC Memo ¶92,335], in which we held that the taxpayer's position as an instructor for seminars he conducted as part of a university's executive education program was that of an independent contractor, not an employee. In *Reece*, the taxpayer was employed by the university as a full-time professor, and the taxpayer conducted corporate seminar services to multiple clients in his spare time. Some of the seminars he designed and led were taught through the executive education program at the university, in classrooms supplied by the university. The seminars led by the taxpayer were short and were not offered for college credit. The university considered the taxpayer's seminar work separate from his work as a professor and treated him, like its other seminar instructors, as an independent contractor.

The principal's degree of control over the details of the taxpayer's work is the most important factor in determining whether a common law employment relationship exists. See *Clackamas Gastroenterology Associates, P.C. v. Wells*, 538 U.S. 440, 448 (2003); *Weber v. Commissioner*, supra at 387. In an employer-employee relationship the principal must have the right to control not only the result of the employee's work but also the means and method used to accomplish that result. *Packard v. Commissioner*, 63 T.C. 621, 629 (1975); *Youngs v. Commissioner*, T.C. Memo. 1995-94 [1995 RIA TC Memo ¶95,094], affd. without published opinion 98 F.3d 1348 [78 AFTR 2d 96-6993] (9th Cir. 1996). The degree of control necessary to find employee status varies according to the nature of the services provided. *Weber v. Commissioner*, supra at 387. Where the nature of the work is more independent, a lesser degree of control bythe principal may still result in a finding of an employer-employee relationship. *Potter v. Commissioner*, supra; *Reece v. Commissioner*, supra.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

In each of *Potter*, *Bilenas*, and *Reece*, we concluded that the taxpayer's position as a professor (whether adjunct or otherwise) Yet in Potter and required a certain degree of independence. *Bilenas* we concluded that the taxpayer's work as an adjunct professor nonetheless resulted in an employer-employee relationship. In *Reece* we stated that although the taxpayer's full-time job as a professor was no doubt that of an employee despite the degree of independence inherent in that position, the circumstances of the case did not warrant extending that relationship to cover the taxpayer's services as a seminar instructor for the university's executive education program.

The amount of control Temple exercised over Mr. Robinson in his work as a vocational instructor is somewhere between that exercised over the adjunct professors in *Potter* and *Bilenas* and that exercised over the seminar instructor in *Reece*. In both *Potter* and *Bilenas* the university mandated the courses the respective adjunct professors were to teach, and in *Bilenas* the school even selected the textbooks and syllabuses he was to use. In contrast, in Reece the taxpayer wrote his own course materials and syllabuses even though those materials were published by the school and were not permitted to be sold separately. Mr. Robinson prepares the curricula for the courses he teaches. Sometimes he is in charge of writing and editing the entire curriculum; at other times he writes only a portion of it. However, Mr. Robinson does not select the topics to cover in the curricula; they are chosen by the State police commissions that pay Temple. As in *Reece*, Temple publishes the work produced by Mr. Robinson and distributes it with the course materials. Accordingly, Temple exercises less control over Mr. Robinson's teaching work than the universities in *Potter* and *Bilenas*, but more than the university in *Reece*.

A significant distinction between the instant case and the *Potter*, *Bilenas*, and *Reece* cases is that in the instant case part of Mr. Robinson's work for Temple during the years in issue consisted of writing and updating curricula. His work on the curricula was separate and distinct from his teaching, and he was compensated for that work by the job. Although the taxpayer in *Reece* wrote his own curricula, he was not compensated for doing so and wrote the curricula only to facilitate his teaching. The only control Temple asserted over Mr. Robinson's work updating curricula was to set the deadlines for his work and convey the general topics he was to cover. Temple did not exercise control over how Mr. Robinson completed the curricula.

The control test suggests that Mr. Robinson was an independent contractor. See *Packard v. Commissioner*, supra at 629; see also *Bernstein v. Universal Pictures, Inc*., 517 F.2d 976, 980 (2d Cir. 1975) (although composers contracted for a specific output, they worked at their own pace at home and were not subject to day-to-day supervision, suggesting independent contractor status because the principal had no right to control the manner of performance).

As to the second factor, Temple provided the facilities where Mr. Robinson taught but did not provide him an office or any other space in which to write and update curricula.

The third factor asks whether the individual had the opportunity for profit or loss. It is true, as respondent asserts, that Mr. Robinson's opportunity for profit or loss did not depend upon the level of enrollment in his classes. However, petitioners contend that the opportunity for profit or loss in Mr. Robinson's job as a police trainer did not consist of an opportunity for profit or loss in individual courses he taught but rather in how many courses he was hired to teach each year. Mr. Robinson testified that although most of his outside income has come from Temple, he has also received compensation from providing expert testimony, conducting other training, and curriculum writing. In Reece the taxpayer likewise provided services as a seminar instructor both to the university and to other organizations. Unlike the taxpayer in Reece, Mr. Robinson recently has not been successful at soliciting other buy ers for his services. However, the fact that he has not been successful does not change the nature of his business.

The fourth factor requires us to consider whether the principal could discharge the individual. Because petitioners did not provide copies of Mr. Robinson's contracts with Temple, it is difficult to assess the discharge authority factor. However, the record does contain several letters from Temple to Mr. Robinson that suggest he was hired for

individual jobs several times each year. During 2004 he was separately hired to teach eight classes and to update curricula, and during 2005 Temple entered into four separate agreements with Mr. Robinson. Being repeatedly asked to perform discrete tasks under varying payment terms suggests that if Temple had not satisfied with Mr. Robinson's performance, its recourse would have been to not hire him for any more projects, rather than to discharge him.

The fifth factor asks whether the work performed by the taxpayer was part of the principal's regular business. Temple is primarily a university and not a police training academy. Although teaching is part of its business as a university, the type of teaching that is central to its mission is teaching for-credit courses completed by regularly enrolled students. Teaching noncredit courses to police officers through contracts with the Commonwealth of Pennsylvania is not an essential part of Temple's regular business.

The sixth factor requires us to consider the permanence of Mr. Robinson's relationship with Temple. Although he has been involved in the CJTP for many years, Mr. Robinson's duties teaching and writing curricula have fluctuated throughout that period and recently have been very minimal. During 2004, for instance, Mr. Robinson taught only 8 days and updated one curriculum. Moreover, each of those assignments was a separate engagement with Temple governed by different payment terms. During 2005 he engaged in four separate agreements with Temple for remuneration totaling only $5,045. His position at Temple is significantly less permanent than that of the taxpayer in Potter, who had taught semester-long courses for many consecutive years. Again, Mr. Robinson's situation is more similar to that of the taxpayer in Reece, who had been teaching seminars through the university's executive education program for many years but taught multiple small seminars for 12 to 25 days each year.

The seventh factor asks whether the taxpayer was paid by the job or by the time. Mr. Robinson was paid an hourly wage for his teaching duties, but he was paid a set fee for the curricula he wrote. The hourly wage he received for teaching is consistent with an employer-employee relationship, but the set fee for writing curricula suggests an independent contractor relationship. See *C.C. Eastern, Inc. v. NLRB*, 60 F.3d 855, 859 (D.C. Cir. 1995) (that drivers were paid by the job suggested independent contractor status); *Marco v. Accent Publg. Co*., 969 F.2d 1547, 1550 (3d Cir. 1992) (that a photographer was paid by the job suggested independent contractor status); *James v. Commissioner*, 25 T.C. 1296, 1300 (1956) (that a doctor was given an annual salary and was not paid by the job suggested employee status).

The eighth factor examines the relationship the parties believed they were creating. Since 1996 Temple has issued Mr. Robinson Forms W-2, and it denied his requests to issue him Forms 1099-MISC. From Temple's perspective, Mr. Robinson was a part-time employee. Temple's treatment of Mr. Robinson as an employee is different from the taxpayer's treatment in Reece, where the university did not consider the taxpayer's services as a seminar instructor to be within an employment relationship; but it is consistent with the way the universities treated the adjunct professors in Potter and Bilenas.

The ninth factor asks whether the alleged employer provided employee benefits. Mr. Robinson received no employee benefits from Temple.

Considering all of the foregoing facts and circumstances and applying common law principles, we conclude that Mr. Robinson was an independent contractor at Temple during the years in issue.

III. *Whether Petitioners Are Entitled to the Deductions They Claimed for Each Year*

2011 Regional Forums

Employee Benefits & Employment Taxes

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Deductions are a matter of legislative grace, and taxpayers generally bear the burden of proving their entitlement to the deductions claimed. Sec. 6001; *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 [69 AFTR 2d 92-694] (1992). Section 162(a) permits "as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business". To be deductible, ordinary and necessary expenses must be "directly connected with or pertaining to the taxpayer's trade or business". Sec. 1.162-1(a), Income Tax Regs. Additionally, section 212 generally allows the deduction of ordinary and necessary expenses paid or incurred during the tax year for the production or collection of income. Sec. 1.212-1(d), Income Tax Regs. The deduction for such expenses must be reasonable in amount and bear a reasonable and proximate relationship to the production or collection of taxable income. Id. However, a taxpayer may not deduct personal expenses. Sec. 262(a).

Generally, a taxpayer must keep records sufficient to establish the amounts of the items reported on his Federal income tax return. Sec. 6001;, sec. 1.6001-1(a), (e), Income Tax Regs. In the event that a taxpayer establishes that a deductible expense has been paid but is unable to substantiate the precise amount, we generally may estimate the amount of the deductible expense, bearing heavily against the taxpayer whose inexactitude in substantiating the amount of the expense is of his own making. *Cohan v. Commissioner*, 39 F.2d 540, 543-544 [8 AFTR 10552] (2d Cir. 1930). We generally will not estimate a deductible expense, however, unless the taxpayer presents sufficient evidence to provide some basis upon which an estimate may be made. *Vanicek v. Commissioner*, 85 T.C. 731, 743 (1985).

Section 274(d) supersedes the *Cohan* doctrine for certain categories of expenses. *Sanford v. Commissioner*, 50 T.C. 823, 827-828 (1968), affd. per curiam 412 F.2d 201 [24 AFTR 2d 69-5021] (2d Cir. 1969). Generally, a deduction is disallowed for travel expenses, meals and entertainment, and listed property unless the taxpayer properly substantiates: (1) The amount of the expense; (2) the time and place of the expense; (3) the business purpose; and (4) in the case of meals and entertainment, the business relationship between the taxpayer and the persons being entertained. Sec. 274(d). Listed property includes passenger automobiles, any type of property generally used for entertainment or recreation, any computer or peripheral equipment, and any cellular phone or other similar telecommunications equipment. [4] Sec. 280F(d)(4). Generally, deductions for expenses subject to the strict substantiation requirements of section 274(d) must be disallowed in full unless the taxpayer satisfies every element of those requirements. *Sanford v. Commissioner*, supra at 827-828; *Larson v. Commissioner*, T.C. Memo. 2008-187 [TC Memo 2008-187]; sec. 1.274-5T(a), Temporary Income Tax Regs., 50 Fed. Reg. 46014 (Nov. 6, 1985). Deductions for listed property that is used both personally and in the taxpayer's business are disallowed unless a taxpayer establishes the amount of business use of the property. *Kinney v. Commissioner*, T.C. Memo. 2008-287 [TC Memo 2008-287]; *Olsen v. Commissioner*, T.C. Memo. 2002-42 [TC Memo 2002-42], affd. 54 Fed. Appx. 479 [91 AFTR 2d 2003-574] (9th Cir. 2003); sec. 1.274-5T(b)(6)(i)(B), Temporary Income Tax Regs., 50 Fed. Reg. 46016 (Nov. 6, 1985).

Taxpayers may substantiate their deductions by either adequate records or sufficient evidence that corroborates the taxpayer's own statement. Sec. 274(d). To satisfy the adequate records requirement, a taxpayer must maintain records and documentary evidence that in combination are sufficient to establish each element of an expenditure or use. *Larson v. Commissioner*, supra; sec. 1.274-5T(c)(2)(i), Temporary Income Tax Regs., 50 Fed. Reg. 46017 (Nov. 6, 1985). A contemporaneous log is not required, but corroborative evidence used to support a taxpayer's reconstruction of the expenditure "must have a high degree of probative value to elevate such statement" to the level of credibility of a contemporaneous record. *Larson v. Commissioner*, supra (quoting section 1.274-5T(c)(1), Temporary Income Tax Regs., 50 Fed. Reg. 46016 (Nov. 6, 1985)).

In the absence of adequate records, a taxpayer alternatively may establish an element of an expenditure by "his own statement, whether written or oral, containing specific information in detail as to such element" and by "other corroborative evidence sufficient to establish such element." Id. quoting (section 1.274-5T(c)(3), Temporary Income

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Tax Regs., 50 Fed. Reg. 46020 (Nov. 6, 1985)). Even if an expense would otherwise be deductible, the deduction may still be denied if there is insufficient substantiation to support it. See sec. 1.274- 5T(a), Temporary Income Tax Regs., supra. We do not estimate under the Cohan doctrine expenses that are subject to the requirements of section 274(d). Sanford v. Commissioner, supra at 827; *Larson v. Commissioner*, supra.

A. *Schedule C Expenses for Mr. Robinson*

For the years in issue petitioners reported the following expenses for Mr. Robinson on a Schedule C for each year:

Expense	2004	2005
Business use of home	$ 438	$ 457
Office expense	4,222	5,128
Repairs and maintenance	2,760	2,822
Supplies	2,943	2,788
Utilities	3,356	3,765
Car and truck	7,219	7,123
Travel	1,003	1,250
Meals and entertainment	443	393
Other expenses	2,780	3,100
Total	25,164	26,826

Most of petitioners' claimed expenses relate to Mr. Robinson's use of an office in his home. Section 280A generally prohibits the deduction of the costs of a taxpayer's residence. However, section 280A(c)(1) permits a deduction for the allocable portion of a residence that is used exclusively and on a regular basis as a taxpayer's principal place of business. To meet the regular basis test under section 280A(c)(1), the business use must be more than occasional or incidental. *Jackson v. Commissioner*, 76 T.C. 696, 700 (1981). It must be continuous, ongoing, or recurring. *Uphus v. Commissioner*, T.C. Memo. 1994-71 [1994 RIA TC Memo ¶94,071].

Petitioners offered no testimony or other evidence regarding the amount of time Mr. Robinson spent doing work in the office in his home. Mr. Robinson had a full-time job at Rowan University during the years in issue, and he completed only minimal work for Temple during each year. The parties stipulated that Mr. Robinson's work for Temple was completed out of the office in his home, but the amount of work he was required to complete was so minimal that it does not allow us to conclude, in the absence of any other evidence, that Mr. Robinson used the office in his home on a regular basis. Because petitioners bear the burden of proving that Mr. Robinson regularly used the office in his home during the years in issue and because they offered no evidence to prove such regular use, we conclude that petitioners have failed to show that they are entitled to deduct any expenses related to Mr. Robinson's use of an office in his home during the years in issue. Accordingly, because petitioners may not deduct such expenses, we sustain respondent's disallowance of all the expense deductions petitioners claimed for the business use of their home, office expenses, repairs and maintenance, supplies, and utilities, all of which are related to Mr. Robinson's use of an office in petitioners' home, except for cellular phone and computer expenses, which we treat separately.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Cellular phones and computers are listed property under section 280F(d)(4), and therefore related expenses are subject to strict substantiation under section 274(d). Petitioners offered no testimony or other evidence regarding the business purpose of Mr. Robinson's cellular phone or Apple computer. Accordingly, petitioners have failed in their burden of proof, and we sustain respondent's disallowance of petitioners' cellular phone and computer expense deductions.

For the years in issue, petitioners claimed car and truck expenses for Mr. Robinson's 2004 Chrysler Pacifica (Pacifica). Passenger automobiles are listed property under section 280F(d)(4), and expenses associated with their purported business use therefore are subject to the heightened substantiation requirements of section 274(d).

For 2004 petitioners reported car and truck expenses totaling $7,219 for Mr. Robinson's Pacifica. To substantiate those expenses, petitioners provided canceled checks and invoices from Mr. Robinson's payments to Chrysler Financial for the Pacifica, totaling $6,443.67, and miscellaneous receipts from mechanics, body shops, insurance companies, and tolls, totaling $3,014.10. On the Schedule C for Mr. Robinson's business, petitioners reported that Mr. Robinson drove the Pacifica 18,000 miles for business, 3,200 for commuting, and 14,800 for other purposes. However, petitioners did not provide a log documenting Mr. Robinson's business trips, nor did they otherwise explain how he managed to drive 18,000 miles for his business even though he taught class only 8 days during 2004.

For 2005 petitioners claimed car and truck expenses of $7,123 for Mr. Robinson's Pacifica. Petitioners similarly provided invoices substantiating most of Mr. Robinson's payments to Chrysler Financial for the Pacifica, totaling $5,902.78 during 2005. Petitioners reported on the Schedule C for Mr. Robinson's business that Mr. Robinson drove the Pacifica 16,500 miles for business, zero miles for commuting, and 16,500 miles for other purposes during 2005. As with the expenses for 2004, Mr. Robinson did not supply a log or other means to substantiate the purposes of his trips or explain how he calculated his miles. Petitioners provided no other documentation of Mr. Robinson's car and truck expenses for 2005, and it is unclear from the record how he arrived at total expenses of $7,123.

Petitioners offered no testimony or other evidence to explain how they calculated which automobile expenses were related to Mr. Robinson's business and which were not. The very round numbers of miles reported on the Schedules C and the overall lack of any records suggesting how the expenses were allocated significantly detract from the credibility of the expenses reported. We conclude that petitioners have failed in their burden of satisfying the strict substantiation requirements of section 274(d), and we therefore sustain respondent's disallowance of petitioners' car and truck expense deductions.

Petitioners claimed deductions for additional travel expenses, as well as meal and entertainment expenses, related to Mr. Robinson's business during the years in issue. However, they provided no documentation or testimony to support their claimed travel expenses and meal and entertainment expenses. Accordingly, petitioners have failed in their burden of proof, and we therefore sustain respondent's disallowance of deductions for those expenses.

Finally, petitioners claimed deductions for “other expenses” on their Schedules C of $2,780 and $3,100 for their 2004 and 2005 tax years, respectively. Those expenses reflect the costs of publications Mr. Robinson purchased during the years in issue.

Petitioners did not provide any receipts or invoices to substantiate the expenses they deducted for publications for 2004. Instead, petitioners provided only canceled checks and credit card statements, which do not give any details about the items Mr. Robinson purchased.

Petitioners did provide receipts to substantiate Mr. Robinson's expenses for publications for 2005. The receipts they provided show that the "publications" Mr. Robinson purchased included: Laugh Out Loud Knock-Knock Jokes; several books about midwives; several television shows on DVD including Gilmore Girls, Arrested Development, and Friends; several books about origami; several books on the architect Frank Lloyd Wright; a Harry Potter book; Witchcraze; Teen Idol; In Her Shoes; A Christmas Carol; Top Gun; Mary Poppins; 501 Must-See Movies; Good Will Hunting; The Iliad; The Odyssey; subscriptions to People magazine, several books on logic, unknown purchases totaling $68.74 at LexisNexis, and various other publications, some of which were not listed on the receipts, and some of which the parties stipulated were not related to Mr. Robinson's business.

Although Mr. Robinson admitted during his testimony that many of the books listed on the receipts for 2005 were unrelated to his business, petitioners argued that it should not matter because the receipts and statements they supplied total approximately $3,900, and they deducted only $2,780 in expenses. However, petitioners appear to have erred in those calculations; we find that the sum of the receipts they provided falls well short of the expense deduction they claimed. The sum of all the purchases listed on the receipts is $2,201.06, yet petitioners deducted $3,100 on their 2005 Schedule C.

Moreover, although we have examined all of the receipts petitioners provided, we did not find even a single receipt that would have justified deducting the item's cost as a business expense. Most of the receipts were clearly unrelated to Mr. Robinson's business. The few that might conceivably have been related to his business as a police instructor (receipts from LexisNexis and the Pennsylvania State Bookstore) did not list the items purchased, and Mr. Robinson did not testify or provide other evidence about how they were related to his business. During cross-examination Mr. Robinson attempted to justify some of the expenses that were apparently unrelated to his business. For instance, he contended that a subscription to People magazine was a business expense because it contained articles on current events, that purchases of books on midwifery were business expenses because he sometimes taught classes on ethics, and that purchases of books about Frank Lloyd Wright were business expenses because the architect had been involved in a crime. We are not persuaded by Mr. Robinson's testimony that such expenses were related to his business. Accordingly, we conclude that petitioners have failed to substantiate any of the publication expenses they deducted on their Schedules C, and we therefore sustain respondent's disallowance of those expenses.

B. *Schedule A Deductions for Mrs. Robinson's Expenses*

Pursuant to section 162(a), a taxpayer is entitled to deduct all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. However, employees cannot deduct such expenses to the extent that employees are entitled to reimbursement from their employers for expenditures related to their status as employees. *Orvis v. Commissioner*, 788 F.2d 1406, 1408 [57 AFTR 2d 86-1356] (9th Cir. 1986), affg. T.C. Memo. 1984-533 [¶84,533 PH Memo TC]; *Lucas v. Commissioner*, 79 T.C. 1, 7 (1982). The deduction for an employee's unreimbursed business expenses under section 162 is claimed on Form 2106, Employee Business Expenses, and included in the miscellaneous itemized deductions claimed on Form 1040, U.S. Individual Income Tax Return, Schedule A. An individual performing services as an employee may deduct miscellaneous itemized deductions incurred in the performance of services as an employee only to the extent such expenses exceed 2 percent of the individual's adjusted gross income. Sec. 67(a). Expenses incurred in the performance of services as an employee are to be reported as required by the regulations promulgated under section 162. See sec. 1.162-17(a), Income Tax Regs. To satisfy the requirements of section 162(a), an expense must be ordinary and necessary and have the requisite relationship to the taxpayer's business. The taxpayer bears the burden of proving that the claimed expenses were ordinary and necessary under section 162. The employee must show the relationship between the expenditures and the employment. See *Rosemann v. Comm*issioner, T.C. Memo. 2009-185 [TC Memo 2009-185]; *Colvin v. Commissioner*, T.C. Memo. 2007-157 [TC Memo 2007-157], affd. 285 Fed. Appx. 157 [102 AFTR 2d

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700   MMisselbeck@KNSCPA.com

2008-5301] (5th Cir. 2008); *Evans v. Commissioner*, T.C. Memo. 1974-267 [¶74,267 PH Memo TC], affd. in part and revd. in part on another ground 557 F.2d 1095 [40 AFTR 2d 77-5602] (5th Cir. 1977).

Petitioners claimed on their tax returns for the years in issue that Mrs. Robinson was eligible for the following unreimbursed employee business expense deductions:

Expense	2004	2005
Vehicle expense	$337	$444
Parking fees, tolls, and transportation	678	24,876
Travel expenses	22,785	765
Other business expenses	763	3,915
Meals and entertainment	3,258	---
Total	27,821	30,000

Mrs. Robinson was the sole driver of petitioners' 2002 Chrysler Sebring (Sebring) during the years in issue. On their Schedule A for 2004 petitioners reported that Mrs. Robinson drove 22,000 miles, 5,000 of which were for business. They used the corresponding percentage, 23 percent, to calculate the share of Mrs. Robinson's total reported gasoline, oil, repairs, and vehicle insurance expenses of $1,422 that should be allocated to Mrs. Robinson's unreimbursed employee business expenses. In total, petitioners reported $337 as Mrs. Robinson's unreimbursed employee business vehicle expenses during 2004. Petitioners did not supply a log or other means to substantiate the business purposes of Mrs. Robinson's trips in the Sebring, nor did they explain the purposes of such trips during their testimony.

For 2005 petitioners made the same calculation as for 2004, reporting that Mrs. Robinson traveled 23,000 miles in the Sebring, 5,000 of which were for business. For 2005 they claimed $2,044 in expenses for gasoline, oil, repairs, and vehicle insurance, and they reported an unreimbursed employee business vehicle expense of $444. Petitioners provided no evidence or testimony to substantiate the business purpose of the miles they reported on their Schedule A.

As stated above, passenger automobiles are listed property and expenses associated with their purported business use are subject to the heightened substantiation requirements of section 274(d). Petitioners have the burden of proof, yet they provided no testimony or other evidence to substantiate the business purposes of the expense deductions claimed for Mrs. Robinson's vehicle. Accordingly, we conclude that they have failed to prove that they are entitled to those deductions, and we therefore sustain respondent's disallowance of them.

It is unclear from the record how petitioners arrived at the remainder of the expenses they reported for Mrs. Robinson on their Schedule A. Except for invoices from Chrysler Financial and a single receipt from an auto mechanic, petitioners provided no receipts to substantiate the $27,821 in unreimbursed employee business expenses petitioners claimed that Mrs. Robinson incurred during 2004. Instead, petitioners provided a list of uncategorized expenses, culled from credit card statements, totaling $2,024.25. During her testimony Mrs. Robinson explained that three of the charges listed were for visits to tourist attractions: The Metropolitan Museum of Art; the Philadelphia Museum of Art; and the Easton Town Center in Ohio, which Mrs. Robinson explained was a “lifestyle center” that

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

demonstrated the direction retail had taken in the last decade. Mrs. Robinson explained that she made visits to tourist attractions to look for ideas or business opportunities that she might employ in her own business, an activity she labeled “benchmarking”. Although Mrs. Robinson believed such “benchmarking” excursions were important for developing her business, her employer would not reimburse her for them, and they had to be conducted on her personal time. Mrs. Robinson did not testify about or otherwise explain any of the other unreimbursed employee business expenses she deducted for 2004.

To substantiate Mrs. Robinson's reported unreimbursed employee business expenses of $30,000 for 2005, petitioners supplied invoices and canceled checks from Chrysler Financial for their payments on the Sebring and 46 uncategorized receipts totaling $4,270.63. Many of the receipts are from restaurants, yet petitioners reported no expenses for meals and entertainment on Mrs. Robinson's Schedule A for 2005. Other receipts show expenses for parking, airplane tickets, and retail items, including two purchases of doll clothes at American Girl Place in New York. The largest receipt is from a hotel stay at Disney's Grand Californian Hotel at Disneyland in Anaheim, California. Petitioners also included receipts for tickets to Disneyland and receipts from a visit to Disney World in Orlando, Florida. During her testimony, Mrs. Robinson explained that she makes an annual trip to Disney World to “see what's going on”. While there, she visits all of the theme parks to compare the newest attractions and look at Disney's retail establishments. Mrs. Robinson took these trips during 2005 accompanied by Mr. Robinson and their daughter. On at least one of the trips they were also accompanied by Mrs. Robinson's mother and Mr. Robinson's mother. Nonetheless, petitioners claimed that all of the expenses from those trips were unreimbursed employee business expenses because they were important “benchmarking” excursions for Mrs. Robinson's job.

If a trip is primarily personal, expenses are not deductible even if the taxpayer engaged in some business activities at the destination. Sec. 1.162-2(b)(1), Income Tax Regs. Whether travel is primarily related to the taxpayer's trade or business or is primarily personal is a question of fact. Sec. 1.162-2(b)(2), Income Tax Regs.; see also *Holswade v. Commissioner*, 82 T.C. 686, 698, 701 (1984). The amount of time spent on personal activity during the trip compared with the amount of time spent on activities directly relating to the taxpayer's trade or business is an important factor in determining whether the trip is primarily personal. Sec. 1.162-2(b)(2), Income Tax Regs. The taxpayer must prove that the trip was primarily related to the trade or business. Rule 142(a).

Petitioners have failed to show that Mrs. Robinson's trips to visit tourist attractions around the country were ordinary and necessary for her employment. See sec. 162(a). Moreover, the facts suggest that the primary purpose of her trips was personal pleasure: she was always accompanied by other family members and she took vacation time to make the trips. The mere fact that Mrs. Robinson may have garnered some business ideas on her visits to tourist attractions does not permit her to deduct the costs of those trips as unreimbursed employee business expenses. Accordingly, we sustain respondent's disallowance of all expenses associated with those trips during the years in issue. Because we understand petitioners to be claiming that all of Mrs. Robinson's unreimbursed employee business expenses relate to her “benchmarking” excursions, the disallowance of those expenses dispenses with all of the unreimbursed employee business expenses claimed by Mrs. Robinson.

C. *Schedule A Deductions for Mr. Robinson's Expenses*

Petitioners also claimed unreimbursed employee business expense deductions for Mr. Robinson on their Schedules A for the years in issue in the following amounts:

Expense	2004	2005
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Vehicle expense	---	$262

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Parking fees, tolls, and transportation	$380	324
Travel expenses	390	189
Other business expenses	465	1,707
Meals and entertainment	---	160
	-----	-----
Total	1,235	2,642

Petitioners offered no documents, testimony, or other evidence to substantiate Mr. Robinson's Schedule A expenses. Accordingly, petitioners have failed in their burden of proof, and we therefore sustain respondent's disallowance of all such expenses for the years in issue.

D. *Schedule A Deductions for Tax Preparation Expenses*

Petitioners also claimed tax preparation expenses of $70 and $75 for their 2004 and 2005 tax years, respectively. However, they did not provide any receipts to substantiate those expenses. Accordingly, petitioners have failed in their burden of proof and we therefore sustain respondent's disallowance of their tax preparation expense deductions.

IV. *Whether Petitioners Are Liable for Additions to Tax Under Section 6651(a)(1) for Failure To File Timely Returns*

Section 6651(a)(1) provides for an addition to tax where a failure to file a Federal tax return timely is not due to reasonable cause or is due to willful neglect. Pursuant to section 7491(c), the Commissioner generally bears the burden of production for any penalty, but the taxpayer bears the ultimate burden of proof. *Higbee v. Commissioner*, 116 T.C. 438, 446 (2001).

Petitioners do not dispute that they were late in filing their tax returns for the years in issue. Consequently, respondent has met his burden of production under section 7491(c), and in order to avoid the section 6651(a)(1) addition to tax, petitioners have the burden of establishing reasonable cause and the absence of willful neglect for failure to file timely. See *Calloway v. Commissioner*, 135 T.C. 26, 45 (2010); *Gates v. Commissioner*, 135 T.C. 1, 14 (2010).

Petitioners contend that their failure to file timely is due to reasonable cause because they were awaiting a decision in a prior dispute before the Tax Court regarding Mr. Robinson's status as an independent contractor. However, the stipulated decision in that case was entered on November 2, 2004, and petitioners' tax returns for the years in issue were not due until April 15, 2005, and April 17, 2006. Petitioners offered no other explanation for why they filed their returns late. Accordingly, we conclude that petitioners have failed in their burden of proof, and we therefore sustain respondent's determination of the addition to tax under section 6651(a)(1) against petitioners for their failure to file timely returns.

V. *Whether Petitioners Are Liable for Accuracy-Related Penalties Pursuant to Section 6662(a)*

Section 6662(a) imposes an accuracy-related penalty of 20 percent of any underpayment that is attributable to causes specified in subsection (b). Subsection (b) applies the penalty to any underpayment attributable to, inter alia, a “substantial understatement of income tax” or “Negligence or disregard of rules or regulations.”

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

There is a "substantial understatement" of income tax for any tax year where the amount of the understatement exceeds the greater of 10 percent of the tax required to be shown on the return for the tax year or $5,000. Sec. 6662(d)(1)(A). However, the amount of the understatement may be reduced by any portion of the understatement attributable to any item for which there was substantial authority for the taxpayer's treatment, or with respect to which the relevant facts were adequately disclosed on the taxpayer's return and there was a reasonable basis for the taxpayer's treatment. Sec. 6662(d)(2)(B).

Section 6662(a) and (b)(1) also imposes a penalty for negligence or disregard of rules or regulations. Under section 6662(c), "negligence" is "any failure to make a reasonable attempt to comply with the provisions of this title". We have defined negligence as "a lack of due care or a failure to do what a reasonable and prudent person would do under the circumstances." *Bunney v. Commissioner*, 114 T.C. 259, 266 (2000). Failure to maintain adequate books and records or to substantiate items properly constitutes negligence. Sec. 1.6662-3(b)(1), Income Tax Regs. A taxpayer is considered to have disregarded rules or regulations even if such disregard is "careless," meaning that the taxpayer "does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation." Sec. 1.6662-3(b)(2), Income Tax Regs.

Generally, the Commissioner bears the burden of production with respect to any penalty, including the accuracy-related penalty. Sec. 7491(c); *Higbee v. Commissioner*, supra at 446. To meet that burden, the Commissioner must come forward with sufficient evidence indicating that it is appropriate to impose the relevant penalty. *Higbee v. Commissioner*, supra at 446. The Commissioner has the burden of production only; the ultimate burden of proving that the penalty is not applicable remains on the taxpayer. Id.

Respondent contends that petitioners are liable for the penalty pursuant to section 6662 both because they substantially understated their income tax and because they were negligent. Petitioners understated their tax liabilities by $7,965 and $9,634 for their 2004 and 2005 tax years, respectively. The amount by which they understated their tax liability for each year exceeds both: (1) 10 percent of the amount required to be shown on their return for each year ($1,925.20 and $2,858.30, respectively); and (2) $5,000. Petitioners have the burden of proof regarding whether any portion of either understatement should be reduced pursuant to section 6662(d)(2)(B), but they did not address the issue or present any evidence showing that their understatements should be reduced. Accordingly, we conclude that petitioners have failed in their burden of proof, and we therefore hold that petitioners are liable for the section 6662 penalty for both years for substantially understating their income tax. See sec. 6662(d). Because we decide petitioners are liable for the section 6662 penalty on account of their substantial understatements of their tax liabilities for both years, we need not consider whether they were also negligent.

In reaching the foregoing holdings, we have considered all the parties' arguments, and, to the extent not addressed herein, we conclude that they are moot, irrelevant, or without merit.

To reflect the foregoing,

Decision will be entered under Rule 155.

[1] All section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

[2] Although the documents the CJTP submitted to Temple's payroll department to report compensation due to Mr. Robinson provide numbers of hours and hourly rates for his work updating curricula, those documents are inconsistent with the "Curriculum Development Proposal" also in the record, which provides a flat fee for updating

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

curriculums. Because the documents submitted to the payroll department are generic, because the "Curriculum Development Proposal" stated the full amount Mr. Robinson would be paid before the time he had completed the task, and because the "Curriculum Development Proposal" provides significantly more detail about the agreement between the parties, we conclude that Mr. Robinson was paid a flat fee for his work updating curricula.

[3] Petitioner testified that Temple used to report his income on Form 1099-C, but we assume he meant Form 1099-MISC, Miscellaneous Income, and not Form 1099-C, Cancellation of Debt.

[4] Sec. 280F(d)(4) was amended by the Small Business Jobs Act of 2010, Pub. L. 111-240, sec. 2043(a), 124 Stat. 2560, which removed cellular phones and other similar telecommunications equipment from "listed property". However, that amendment is effective only for tax years beginning after Dec. 31, 2009. Id. sec. 2043(b).

Document Header: Checkpoint Contents Federal Library Federal Editorial Materials Federal Taxes Weekly Alert Newsletter 2011 05/19/2011 - Volume 57, No. 20 Articles Tax Court says part-time university instructor wasn't employee (05/19/2011) © 2011 Thomson Reuters/RIA. All rights reserved.

5. Federal Taxes Weekly Alert, Business deductions—ins. expenses—individual policy—solely owned corps.—accident or health plans—income exclusions. DKD Enterprises, Inc., et al., v. Commissioner, TC Memo 2011-29 , Code Sec(s) 162; 301; 316; 61.

Solely owned information technology consulting corp. wasn't entitled to deduct as ordinary and necessary business expenses premium payments made on owner-employee's health ins. policy: corp. didn't show that it had in effect during years at issue any sickness, hospitalization, medical expense or similar employee benefit plan. Also, given foregoing, owner wasn't entitled to individual income exclusion for payments. (*Dkd Enterprises, Inc., et al., v. Commissioner*, (2011) TC Memo 2011-29, 2011 RIA TC Memo ¶2011-29)

Tax Court & Board of Tax Appeals Memorandum Decisions

DKD Enterprises, Inc., et al., v. Commissioner, TC Memo 2011-29 , Code Sec(s) 162; 301; 316; 61.

DKD ENTERPRISES a.k.a. DKD ENTERPRISES, INC., ET AL., Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

Code Sec(s): 162; 301; 316; 611

Docket: Dkt. Nos. 24403-07, 24404-07,10818-08, 10819-08

Date Issued: 01/31/2011.

Judge: Opinion by Chiechi, J.

Tax Year(s): Years 2003, 2004, 2005

2011 Regional Forums

Employee Benefits & Employment Taxes

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Disposition: Decision for Taxpayers in part and for Commissioner in part

HEADNOTE

1. Business deductions—trade or business—profit intent—animal breeding— solely owned corps.—benefit to shareholder—constructive dividends. Solely owned information technology consulting corp. that was run out of owner-employee's personal residence wasn't entitled to business deductions for licenses, rent and various other expenses of cat breeding activity: corp. failed to show that activity was trade or business engaged in by it with profit motive; rather, evidence indicated that activity was incident to hobby that owner and her personal/life partner had been engaged in for years for significant personal pleasure. Evidence included nature of owner's and her partner's personal engagement plus such things as lack of any business plan on part of corp. as to how it intended to boost profits. Also, since corp.'s expenditures for activity went to owner's personal pleasure/benefit, they were constructive dividends to her. Owner's arguments that if expenses weren't deductible by corp., she should be entitled to treat them as her own business expenses or to take partial real estate tax and mortgage interest deductions on Schedule E were belied by fact that in holding that corp. failed to show business activity or right to deductions for activity-related expenses, Tax Court didn't also hold that owner herself engaged in activity as trade or business or otherwise make finding that would support her claims for individual deductions.

Reference(s): ¶ 1625.006(5); ¶ 3015.13(2); ¶ 615.047(10) Code Sec. 162; Code Sec. 301; Code Sec. 316; Code Sec. 61

2. Taxation of corps.—qualified personal service corp.—solely owned corps.—function and ownership tests—information technology. Solely owned information technology consulting corp. that was run out of owner-employee's personal residence was upheld in its claim that it wasn't Code Sec. 448(d)(2) QPSC subject to 35% tax rate under Code Sec. 11(b)(2) : function and ownership tests for QPSCs weren't met because owner, who was sole stockholder and sole employee performing consulting services for corp. and whose time also went in substantial part to unrelated cat breeding activity, didn't spend 95% or more of her corp. work time performing consulting services for corp.

Reference(s): ¶ 4485.01(10); Code Sec. 4485.01(10); Code Sec. 448; Code Sec. 11

3. Deductions for contributions to qualified plans—employer contributions— profit-sharing plans—highly compensated employee—constructive dividends. Solely owned information technology consulting corp. wasn't entitled to deductions for profit-sharing plan contributions: plan discriminated in favor of owner-employee, who was highly compensated employee under Code Sec. 414(q) , and consequently, plan wasn't qualified under Code Sec. 401(a) . Also, stated contributions were includible in owner's income as constructive dividends. Arguments about whether owner's personal/life partner was participant in plan were off base.

Reference(s): ¶ 4045.01(5); ¶ 3165.01(82) Code Sec. 404; Code Sec. 414; Code Sec. 401; Code Sec. 316; Code Sec. 301; Code Sec. 61

4. Business deductions—ins. expenses—individual policy—solely owned corps.—accident or health plans—income exclusions. Solely owned information technology consulting corp. wasn't entitled to deduct as ordinary and necessary business expenses premium payments made on owner-employee's health ins. policy: corp. didn't show that it had in effect during years at issue any sickness, hospitalization, medical expense or similar employee benefit plan. Also, given foregoing, owner wasn't entitled to individual income exclusion for payments.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Reference(s): ¶ 1625.282(15); ¶ 1065.01(10) Code Sec. 162; Code Sec. 106; Code Sec. 105; Code Sec. 61

Syllabus

Official Tax Court Syllabus

Counsel

Catherine S. Tyson, for respondent.

James R. Monroe, for petitioners.

CHIECHI, Judge

MEMORANDUM FINDINGS OF FACT AND OPINION

Respondent determined the following deficiencies in, additions under section 6651(a)(1) [2] to, and accuracy-related penalties under section 6662(a) on each petitioner's Federal income tax (tax):

Petitioner	Year	Deficiency	Addition to Tax Under Sec. 6651(a)(1)	Accuracy-Related Penalty Under Sec. 6662(a)
DKD	2003	$23,458.61	$2,345.86	--
	2004	47,740.00	4,774.00	$9,548.00
	2005	42,376.00	--	8,475.00
Ms. Dursky	2003	17,476.00	--	--
	2004	16,403.00	--	3,280.60
	2005	12,604.00	--	2,520.80

The issues remaining for decision for the years at issue are: [3]

(1) Is DKD Enterprises, Inc. (DKD), entitled to deduct under section 162(a) certain respective amounts relating to its cattery activity that it (a) reimbursed to Debra K. Dursky (Ms. Dursky) and her personal partner, Elizabeth Watkins (Ms. Watkins), (b) paid to Ms. Watkins, (c) paid for certain “taxes and licenses”, and (d) paid to Ms. Dursky? We hold that it is not.

(2) Is Ms. Dursky required to include in gross income as constructive dividends the certain respective amounts that we have held with respect to issue (1) DKD is not entitled to deduct? We hold that she is.

(3) In the light of our holdings with respect to issues (1) and (2), is Ms. Dursky entitled to deduct under section 162(a) the certain respective amounts that we have held DKD is not entitled to deduct? We hold that she is not.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

(4) In the light of our holding with respect to issue (1), is Ms. Dursky entitled to deduct in Schedule E, Supplemental Income and Loss (Schedule E), certain respective amounts of home mortgage interest and real estate taxes that she paid? We hold that she is not.

(5) Is DKD a qualified personal service corporation, as defined in section 448(d)(2), that is subject to the 35-percent tax rate prescribed in section 11(b)(2)? We hold that it is not.

(6) Is DKD entitled to deduct under section 162(a) certain amounts that it paid into a certain account that Fidelity Investments maintained for it? We hold that it is not.

(7) Is Ms. Dursky required to include in gross income as constructive dividends certain amounts that we have held with respect to issue (6) DKD is not entitled to deduct? We hold that she is.

(8) Is DKD entitled to deduct under section 162(a) certain amounts of premiums that it paid with respect to a health insurance policy that Ms. Dursky purchased for herself? We hold that it is not.

(9) Is Ms. Dursky entitled to exclude from gross income the certain amounts of premiums that that we have held with respect to issue (8) DKD is not entitled to deduct? We hold that she is not.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

At all relevant times, including throughout 2003 through 2005 (the years at issue) and at the times Ms. Dursky filed the respective petitions in the cases at docket Nos. 24404-07 and 10819-08, Ms. Dursky resided in a house that she owned (Ms. Dursky's residence) in West Des Moines, Iowa (West Des Moines). For an undisclosed period starting before the years at issue to at least the time of the trial in these cases, Ms. Dursky's personal partner, Ms. Watkins, resided with Ms. Dursky in Ms. Dursky's residence.

At all relevant times, including throughout the years at issue and at the times DKD filed the respective petitions in the cases at docket Nos. 24403-07 and 10818-08, DKD maintained its place of operation at Ms. Dursky's residence.

At all relevant times, Ms. Dursky was the sole owner of Ms. Dursky's residence, which had approximately 2,100 square feet of space. During each of the years at issue, the monthly fair rental value of Ms. Dursky's residence was $1,600.

Dallas County, Iowa (Dallas County), the county in which Ms. Dursky's residence was located, assessed the following real property tax on that residence for the real property tax year indicated:

Real Property Tax Assessed	Real Property Tax Year Ended March 31
$3,976	2003
3,966	2004

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

3,708	2005
3,630	2006

At all relevant times, Ms. Dursky's residence was subject to a home mortgage loan on which Ms. Dursky paid an undisclosed amount of interest (home mortgage interest) during each of the years at issue.

For an undisclosed period starting before 1997 through at least the years at issue, Ms. Dursky was an information technology (IT) consultant. On May 28, 1997, Ms. Dursky incorporated DKD to provide IT consulting services.

At all relevant times, including throughout the years at issue, DKD employed Ms. Dursky, who was the sole stockholder and the sole officer of DKD, to perform IT consulting services for it. [4]

At all relevant times, including throughout the years at issue, DKD provided IT consulting services to a company known as Octagon. At those times, Octagon, in turn, provided IT consulting services to other companies such as Wells Fargo. Octagon paid DKD on an hourly basis for the IT consulting services that DKD performed for it. During the years at issue, Ms. Dursky was the only person whom DKD employed to work on matters relating to DKD's IT consulting business.

Ms. Dursky spent approximately 2,000 hours during 2003 and approximately 2,200 hours during each of the years 2004 and 2005 working for DKD in its IT consulting business. DKD paid Ms. Dursky $80,400 annually as compensation for the IT consulting work that she performed for DKD during each of the years 2003, 2004, and 2005. [5]

For each of the years 2003 through 2005, DKD issued to Ms. Dursky Form W-2, Wage and Tax Statement (Form W-2), in which it reported that it had paid her wages of $80,400. In each of those Forms W-2, DKD also reported certain respective amounts of “Federal income tax withheld”, “Social security wages”, “Social security tax withheld”, “Medicare wages and tips”, “Medicare tax withheld”, “State wages, tips, etc.”, and “State income tax”. DKD did not report any other amounts in each of those forms.

Throughout the years at issue, Ms. Dursky's personal assets consisted primarily of Ms. Dursky's residence, certain retirement accounts, certain automobiles, certain stocks, including her 100-percent stock interest in DKD, a joint checking account that Ms. Dursky maintained with Ms. Watkins, and certain cats, kittens, and equipment (e.g., cat trees, feeding bowls, litter boxes) relating to a cattery.

Cattery Activity of Ms. Dursky and Ms. Watkins

Since at least 1989 Ms. Watkins, and since at least 1994 Ms. Dursky, each was engaged in the hobby of operating a cattery from which each derived significant personal pleasure. That cattery operation included breeding, raising, and offering for sale certain cats and certain kittens, attending certain cat shows, and entering in some of those shows some of those cats and kittens (cattery activity).

At a time not disclosed by the record before the years at issue, Ms. Dursky and Ms. Watkins became engaged in the hobby of jointly operating a cattery (cattery activity of Ms. Dursky and Ms. Watkins) from which they continued to derive significant personal pleasure. Ms. Dursky and Ms. Watkins had at least the following two breeds of cats in the cattery activity of Ms. Dursky and Ms. Watkins: The Maine Coon breed (Maine Coons) and the Norwegian Forest breed (Norwegian Forest cats). [6]

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

The cattery activity of Ms. Dursky and Ms. Watkins took place in Ms. Dursky's residence, except for attending cat shows and visiting veterinarians. The cattery activity of Ms. Dursky and Ms. Watkins required them to spend substantial time and substantial money in operating that activity. As part of the cattery activity of Ms. Dursky and Ms. Watkins, they traveled extensively to certain cat shows in the United States. The money that Ms. Dursky and Ms. Watkins spent in operating that activity was for, inter alia, cat food, cat litter, veterinarians, cat show entrance fees, and transportation, meals, and lodging relating to the attendance by Ms. Dursky and/or Ms. Watkins at certain cat shows.

At a time not disclosed by the record before the years at issue, Ms. Dursky and Ms. Watkins created a Web site (cattery activity Web site) that they maintained for the cattery activity of Ms. Dursky and Ms. Watkins. At the time of the trial in these cases, the general public was able to access that Web site, although it had not been updated since 2002.

The cattery activity Web site stated: “We treat our cats as members of our family”, and “we have invested too much love in our wonderful kittens to risk exposing them to an uncertain and risky environment.” The cattery activity Web site also indicated that kittens were born in one of the bedrooms in Ms. Dursky's residence, that the kittens stayed in the bedroom for five to eight weeks after birth, and that after the kittens were older and well socialized “they are then allowed to run the house with the other cats.” The cattery activity Web site stated that “Our goal *** is to breed healthy, well-socialized Wegies [Norwegian Forest cats] who are at home—whether in the show ring or simply as a beloved member of the family.” That Web site further stated that “Our goal is to breed healthy, large, shaggy coated Maine Coons with a gentle, loving personality.”

As part of the cattery activity of Ms. Dursky and Ms. Watkins, Ms. Dursky and Ms. Watkins participated in certain competitions, clubs, and associations and attended cat shows over much of the United States and developed relationships with cat breeders around the world. In this regard, the cattery activity Web site stated:

We currently show exclusively in the Cat Fanciers Association (CFA). We have shown five of our cats to Regional Wins and two of our female NFC's [Norwegian Forest cats] have produced such outstanding offspring that they achieved the coveted title of CFA Distinguished Merit. Currently less than 10 Norwegian Forest Cats throughout the world have been awarded the title of Distinguished Merit--it is the highest award that CFA presents to a breeding pedigreed cat and we are very proud to [be] the owners of TWO NFC DM's [Distinguished Merits]! We are currently members of two CFA clubs, the Hawkeye Cat Club and the Lucky Tomcat Club. In addition, we are also members of the CFA Norwegian Forest Cat Breed Council and Deb [Ms. Dursky] is a Breeder Member of the Norwegian Forest Cat Fanciers Association. By attending shows over much of the United States we have developed friendships with breeders and exhibitors from around the world. Our success is built on the trust of those breeders who have sold us our cats, permitted us to use their studs, and to all those breeders who came before them. ***

The cattery activity Web site also indicated that the Cat Fanciers' Association (CFA), the largest association for owners of cats in the United States, [7] had designated the cattery activity of Ms. Dursky and Ms. Watkins as a “CFA Approved Cattery of Excellence”. The cattery activity Web site advertised for sale a cat for $75, a cat for $150, a kitten for $200, and a kitten for $400.

Cattery Activity During the Years at Issue

During each of the years at issue, DKD had two activities: A consulting activity and a cattery activity (DKD's cattery activity). [8] Ms. Dursky and Ms. Watkins operated DKD's cattery activity. DKD's cattery activity was the cattery activity in which Ms. Dursky and Ms. Watkins had engaged before the years at issue. While operating

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

DKD's cattery activity during each of the years at issue, Ms. Dursky and Ms. Watkins continued to breed, raise, and offer for sale certain cats and certain kittens at Ms. Dursky's residence [9] and to attend certain cat shows in some of which they entered some of those cats and kittens. [10] As was true while they were operating the cattery activity of Ms. Dursky and Ms. Watkins before the years at issue, Ms. Dursky and Ms. Watkins continued to derive significant personal pleasure while operating DKD's cattery activity during the years at issue.

During each of the years at issue, DKD used, without purchasing, in DKD's cattery activity the assets (e.g., cats, kittens, cat trees, feeding bowls, litter boxes) that Ms. Dursky and Ms. Watkins had used before those years in the cattery activity of Ms. Dursky and Ms. Watkins.

During each of the years at issue, Ms. Dursky spent approximately 800 hours in operating DKD's cattery activity. As discussed above, during each of those years, DKD continued to pay to Ms. Dursky the same amount of wages (i.e., $80,400) that it had paid to her in 2001 and 2002. The wages that DKD paid to Ms. Dursky also remained unchanged in 2006, the year in which DKD discontinued DKD's cattery activity.

During each of the years at issue, Ms. Watkins spent more hours than Ms. Dursky in operating DKD's cattery activity. During each of those years, DKD made payments to Ms. Watkins totaling $7,700. (We shall refer to any, some, or all of those payments as DKD's payments to Ms. Watkins.) For each of the years at issue, DKD withheld Social Security tax and Medicare tax from DKD's payments to Ms. Watkins.

For each of the years at issue, DKD issued Form W-2 to Ms. Watkins in which it reported that it had paid her wages of $7,700. For each of those years, Ms. Watkins filed a tax return in which she included in gross income the $7,700 that she had received from DKD during each such year.

For each of the taxable years at issue, DKD filed Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, and for each quarter during each of those years, DKD filed Form 941, Employer's Quarterly Federal Tax Return. In each of those forms, DKD reported DKD's payments to Ms. Watkins and paid any Federal tax shown due in each such form.

During the years at issue, while operating DKD's cattery activity Ms. Dursky and Ms. Watkins desired to expand on the national reputation of the cattery activity of Ms. Dursky and Ms. Watkins that they had developed before those years. In order to do so, Ms. Dursky and Ms. Watkins relied on their respective years of cattery activity experience and their respective reputations in the so-called cattery world.

While operating DKD's cattery activity during the years at issue, Ms. Dursky and Ms. Watkins bred, raised, and offered for sale Norwegian Forest cats and entered certain of those cats in certain cat shows. [11] Starting at an undisclosed time in 2004, they bred, raised, and offered for sale Abyssinian cats and entered certain of those cats in certain cat shows.

While operating DKD's cattery activity during 2003, Ms. Dursky and Ms. Watkins produced approximately seven to nine kittens from approximately five to seven litters. While operating DKD's cattery activity during each of the years 2004 and 2005, Ms. Dursky and Ms. Watkins produced approximately nine kittens from approximately three litters.

While operating DKD's cattery activity during the years at issue, Ms. Dursky and Ms. Watkins entered at least 62 cats, 49 cats, and 45 cats, respectively, in various cat shows that were typically held on the east coast or the west coast of the United States. In order to enter a cat in any such show, the owner of the cat was required to prepay a nonrefundable entrance fee. Ms. Dursky and Ms. Watkins did not attend all the cat shows in which they entered cats.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

During the years at issue, Ms. Watkins typically attended cat shows without Ms. Dursky, although Ms. Dursky attended some cat shows with Ms. Watkins. [12]

While operating DKD's cattery activity during 2003, 2004, and 2005 Ms. Watkins attended 30 cat shows, 31 cat shows, and 28 cat shows, respectively, and Ms. Dursky attended a relatively small number of those shows with Ms. Watkins. When one or both of them attended a cat show, one or both made arrangements for travel and lodging. If Ms. Dursky and/or Ms. Watkins attended a cat show that was not within driving distance of West Des Moines, it took approximately 40 hours in order to travel to and from, and participate in, the show. If Ms. Dursky and/or Ms. Watkins attended a cat show that was within driving distance of West Des Moines, it took approximately 32 hours in order to travel to and from, and participate in, the show.

As was true of the cattery activity of Ms. Dursky and Ms. Watkins before the years at issue, DKD's cattery activity was designated by the CFA during the years at issue as a “Cattery of Excellence”.

As was true of their beliefs while operating the cattery activity of Ms. Dursky and Ms. Watkins before the years at issue, while Ms. Dursky and Ms. Watkins were operating DKD's cattery activity during the years at issue they believed that the price of any cat or kitten offered for sale would increase if the cats and kittens that they bred won national cat shows. While operating DKD's cattery activity during the years at issue, Ms. Dursky and Ms. Watkins produced a total of four cats that won national championships. [13]

During each of the years at issue, the monthly fair rental value of Ms. Dursky's residence was $1,600. During none of those years was there a written rental agreement between Ms. Dursky and DKD with respect to Ms. Dursky's residence. Nonetheless, during each of the years at issue, DKD paid Ms. Dursky $1,000 monthly, or $12,000 annually (DKD's purported rent), for its claimed partial use of Ms. Dursky's residence for DKD's cattery activity. In arriving at that amount, neither Ms. Dursky nor DKD obtained an appraisal to determine the fair rental value of (1) Ms. Dursky's residence or (2) the portion of that residence used in a cattery activity during each of the years at issue. Instead, Ms. Dursky, DKD, and Howard Musin (Mr. Musin), the tax return preparer of Ms. Dursky and DKD for at least each of the years 2003 and 2004, [14] agreed that DKD should pay each month to Ms. Dursky $1,000 for the use of Ms. Dursky's residence for a cattery activity. Ms. Dursky, DKD, and Mr. Musin also agreed that DKD should pay to Ms. Dursky 10 percent of certain expenses (e.g., utilities, repairs) relating to Ms. Dursky's residence as allocable to a cattery activity. [15]

As was true while they were operating the cattery activity of Ms. Dursky and Ms. Watkins before the years at issue, while Ms. Dursky and Ms. Watkins were operating DKD's cattery activity during the years at issue they continued to incur and pay substantial expenses. As discussed below, at least during each of the years at issue, DKD reimbursed Ms. Dursky and Ms. Watkins for those expenses [16] and also paid directly a very small amount of expenses relating to the operation of DKD's cattery activity.

During each of the years at issue, Ms. Watkins used certain computer software in order to record for each of those years the substantial amounts expended and the insubstantial amounts received while Ms. Dursky and Ms. Watkins were operating DKD's cattery activity during each of those years.

During 2003, DKD reimbursed Ms. Dursky and Ms. Watkins $60,968 for the following amounts (2003 reimbursed cattery expenses) that they had paid:

Type of Expense	Amount
---------------	------

Mileage to cat shows	$4,277
Motels	5,669
Meals (50 percent)	1,151
Entry fees	6,786
Airfares	13,953
Pet sitters	2,566
Rental cars	2,107
Cattery cleaning	1,761
Veterinarian bills	13,576
Postage	150
Litter and food	5,993
Grooming products	1,212
Advertising	1,767

Total	60,968

During 2003, in addition to DKD's payments to Ms. Watkins of $7,700 and DKD's purported rent of $12,000 that DKD paid to Ms. Dursky, DKD paid directly $588 of unidentified “taxes and licenses”.

During 2004, DKD reimbursed Ms. Dursky and Ms. Watkins $66,734 for the following amounts (2004 reimbursed cattery expenses) that they had paid:

Type of Expense	Amount
Mileage to cat shows	$4,643
Motels	8,385
Meals (50 percent)	1,814
Entry fees	6,338
Airfares	7,652
Pet sitters	2,095
Rental cars	1,994
Cattery cleaning	5,080
Veterinarian bills	14,759
Postage	167
Litter and food	7,029
Photos	817
Grooming and misc. supplies	3,004

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700   MMisselbeck@KNSCPA.com

Advertising	1,580
Long-distance telephone	1,327
Misc. travel	50

Total	66,734

During 2004, in addition to DKD's payments to Ms. Watkins of $7,700 and DKD's purported rent of $12,000 that DKD paid to Ms. Dursky, DKD paid directly $588 of unidentified “taxes and licenses”.

During 2005, DKD reimbursed Ms. Dursky and Ms. Watkins $68,329 for the following amounts (2005 reimbursed cattery expenses) that they had paid:

Type of Expense	Amount
Mileage to cat shows	$6,350
Motels	8,121
Meals (50 percent)	1,659
Entry fees	2,848
Airfares	16,885
Rental cars	2,618
Veterinarian bills	13,860
Postage	42
Litter	1,664
Cat food	8,613
Photos	78
Grooming and misc. supplies	4,190
Advertising	1,401

Total	68,329

During 2005, in addition to DKD's payments to Ms. Watkins of $7,700 and DKD's purported rent of $12,000 that DKD paid to Ms. Dursky, DKD paid directly $588 of unidentified “taxes and licenses”.

In addition to reimbursing Ms. Dursky and Ms. Watkins for the amounts described above that they paid during each of the years at issue, DKD reimbursed them (1) $297.84 in 2003 for lodging and food that they had paid in that year for the mother of Ms. Watkins who had attended a banquet honoring them for winning a national cat show, (2) $88.97 in 2003 for restaurant food that Ms. Watkins' mother had paid in that year, and (3) $412 in 2004 for entry tickets to Walt Disney World that Ms. Dursky and Ms. Watkins had paid in that year. (We shall refer to the

reimbursements described in (1) and (2) as DKD's 2003 reimbursements for lodging and food relating to Ms. Watkins' mother. We shall refer to the reimbursements described in (3) as DKD's 2004 reimbursements for entry tickets for Ms. Dursky and Ms. Watkins to Walt Disney World.)

During 2003, Ms. Dursky and Ms. Watkins did not sell any cats or kittens while operating DKD's cattery activity. During 2004, Ms. Dursky and Ms. Watkins did not sell any cats or kittens while operating DKD's cattery activity except for three cats and/or kittens that they sold in December of that year for a total of $250. During 2005, Ms. Dursky and Ms. Watkins did not sell any cats or kittens while operating DKD's cattery activity except for a total of eight cats and/or kittens that they sold in June, July, August, October, and November of that year for a total of $1,525. [17]

In 2006, at an undisclosed time in or before August, Mr. Musin and Ms. Schwartz informed petitioners that the Internal Revenue Service (IRS) was investigating Mr. Musin and Ms. Schwartz and intended to commence an examination of petitioners' respective tax returns for 2003 and 2004. As a result, around August 2006, (1) Ms. Dursky and Ms. Watkins discontinued operating DKD's cattery activity, [18] (2) Ms. Dursky and Ms. Watkins continued operating that cattery activity as the cattery activity of Ms. Dursky and Ms. Watkins, and (3) Ms. Dursky and DKD retained James R. Monroe (Mr. Monroe). [19]

Certain Retirement Accounts

Vanguard

In December 1995, Ms. Dursky executed a document entitled “VANGUARD PROFIT-SHARING PLAN SIMPLIFIED ADOPTION AGREEMENT (006)” (Vanguard plan document) that by its terms was effective on January 1, 1995. The Vanguard plan document stated that Debra K. Dursky was the employer and that the employer was a “Sole Proprietor/ Self-Employed Individual”. That document also stated that Debra K. Dursky was the plan administrator and that Vanguard Fiduciary Trust Company (Vanguard) was the plan trustee. The Vanguard plan document did not identify a beneficiary. The Vanguard plan document also stated:

the Employer [Debra K. Dursky] shall make contributions to the Trust for each Plan Year in an amount determined by the Employer in its sole discretion by resolution duly adopted on or before the last day for filing its federal income tax return, including extensions, for the taxable year with or within which such Plan Year ends.

Pursuant to the Vanguard plan document, on certain dates in 2003 and 2006 Ms. Dursky sent the following checks to Vanguard that she intended to be contributions under that plan document. On December 30, 2003, Ms. Dursky sent a $10,000 check to Vanguard for her benefit that was drawn on DKD's bank account maintained at Bankers Trust (DKD's bank account). In the so-called memo portion of that check, Ms. Dursky wrote, inter alia, “2003 Keogh”. On April 10, 2006, Ms. Dursky sent a $10,000 check to Vanguard for her benefit that was drawn on DKD's bank account.

During none of the years 2003 through 2005 did Ms. Dursky make any contributions under the Vanguard plan document for the benefit of Ms. Watkins.

Fidelity

On December 28, 2001, Ms. Dursky executed on behalf of DKD a document that was entitled “Profit Sharing Plan Application” (Fidelity application document) in order to open an account for a profit-sharing plan at Fidelity (DKD

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Fidelity profit-sharing plan). Ms. Dursky completed and signed that document on behalf of DKD. The Fidelity application document indicated that the employer was DKD Enterprises, Inc. Nonetheless, Ms. Dursky checked the box in that document marked "Self-Employed" and did not check the box marked "Incorporated". In response to the question in the Fidelity application document "**Do you currently have or have you ever maintained another qualified plan? "**, Ms. Dursky stated: "Vanguard - 15% Fidelity - 85%".

On December 28, 2001, Ms. Dursky also executed on behalf of DKD a document that was entitled "Profit Sharing Plan Contribution Form" (Fidelity contribution document). The Fidelity contribution document indicated that the only participant under the DKD Fidelity profit-sharing plan was Ms. Dursky.

On certain dates in 2004, 2005, and 2006 DKD sent the following checks to Fidelity that were intended to be contributions under the DKD Fidelity profit-sharing plan. On April 14, 2004, DKD sent a $10,000 check to Fidelity for the benefit of Ms. Dursky that was drawn on DKD's bank account. In the so-called memo portion of that check, Ms. Dursky wrote, inter alia, "Fidelity Profit Sharing Keogh *** for 2003". On December 27, 2004, DKD sent a $10,000 check to Fidelity for the benefit of Ms. Dursky that was drawn on DKD's bank account. In the so-called memo portion of that check, Ms. Dursky wrote, inter alia, "Keogh *** for 2004". On April 11, 2005, DKD sent a $10,000 check to Fidelity for the benefit of Ms. Dursky that was drawn on DKD's bank account. In the so-called memo portion of that check, Ms. Dursky wrote, inter alia, "2004 Keogh". On April 10, 2006, DKD sent a $5,000 check to Fidelity for the benefit of Ms. Dursky that was drawn on DKD's bank account. In the so-called memo portion of that check, Ms. Dursky wrote, inter alia, "2005".

During none of the years 2003 through 2005 did DKD send any checks to Fidelity that were intended to be contributions under the DKD Fidelity profit-sharing plan for the benefit of Ms. Watkins.

Ms. Dursky's Health Insurance Policy

At a time not disclosed by the record, Ms. Dursky purchased a health insurance policy in her name (Ms. Dursky's health insurance policy) that was in effect at least during each of the years 2003 and 2004 and that required her to pay certain quarterly premiums to the company (health insurance provider) that issued that policy to her. During 2003 and 2004, DKD paid to Ms. Dursky's health insurance provider the following premiums on the dates indicated for Ms. Dursky's health insurance policy:

2003

Date	Amount
Mar. 30	$1,687.50
July 14	1,687.50
Sept. 14	1,687.50
Dec. 30	1,887.60

Total	6,950.10

2004

Date	Amount
Apr. 5	$1,887.60
June 16	1,887.60
Oct. 4	1,887.60
Dec. 27	1,988.70

Total	7,651.50

DKD's Tax Returns

2001

DKD filed Form 1120, U.S. Corporation Income Tax Return (Form 1120), for 2001 (DKD's 2001 return) that Ms. Schwartz signed as return preparer and that Ms. Dursky signed as the sole officer of DKD. In Schedule K, Other Information (Schedule K), of DKD's 2001 return, DKD indicated that it was on the cash method of accounting.

In DKD's 2001 return, DKD reported (1) "Gross receipts or sales" of $2,770, [20] (2) "returns and allowances" of zero, (3) "Cost of goods sold" of zero, (4) "Other income" of $226,923, [21] and (5) "**Total income**" of $229,693.

In DKD's 2001 return, DKD claimed, inter alia, the following deductions: (1) "Compensation of officers" of $80,400, (2) "Salaries and wages" of zero, (3) "Rents" of $19,150, (4) "Taxes and licenses" of $6,307, [22] (5) "Pension, profit-sharing, etc., plans" of $30,000, and (6) "Employee benefit programs" of $8,852. In that return, DKD also claimed "Other deductions" of $55,210. DKD included a schedule with DKD's 2001 return in which it indicated that the "Other deductions" claimed consisted of the following types and amounts of deductions:

Claimed Deduction	Amount
Cattery expenses n1	$19,391
Show fees n1	4,076
Promotional labor	1,850
Accounting	1,100
Postage	541
Insurance	1,966
Insurance - workman's compensation	213
Licenses and permits	50
Meals	1,772
Supplies	9,034
Telephone	2,183
Travel n1	12,680
Utilities	354

Total	55,210

<1>DKD's claimed deductions for "Cattery expenses",

"Show fees", and "Travel" were for amounts that Ms. Dursky and Ms.

Watkins paid during 2001 in operating the cattery activity of Ms.

Dursky and Ms. Watkins.

DKD attached to DKD's 2001 return Schedule L, Balance Sheets per Books (Schedule L), for 2001 (2001 Schedule L). In that schedule, DKD showed the following assets: "Cash", "Trade notes and accounts receivable", and "Buildings and other depreciable assets". DKD did not show any other assets in the 2001 Schedule L, such as cats, kittens, cat trees, feeding bowls, litter boxes, or other assets relating to a cattery activity.

2002

DKD filed Form 1120 for 2002 (DKD's 2002 return) that Mr. Musin signed as return preparer and that Ms. Dursky signed as the sole officer of DKD. In Schedule K of DKD's 2002 return, DKD indicated that it was on the cash method of accounting.

In DKD's 2002 return, DKD reported (1) "Gross receipts or sales" of $800, [23] (2) "returns and allowances" of zero, (3) "Cost of goods sold" of zero, (4) "Other income" of $198,608, [24] and (5) "**Total income**" of $199,408.

In DKD's 2002 return, DKD claimed, inter alia, the following deductions: (1) "Compensation of officers" of $80,400, (2) "Salaries and wages" of $7,350, (3) "Rents" of $19,800, (4) "Taxes and licenses" of $7,354, [25] (5) "Pension, profit-sharing, etc., plans" of $10,000, and (6) "Employee benefit programs" of $6,931. In that return, DKD also claimed "Other deductions" of $58,424. DKD included a schedule with DKD's 2002 return in which it indicated that the "Other deductions" claimed consisted of the following types and amounts of deductions:

Claimed Deduction	Amount
Cattery expenses n1	$26,784
Show fees n1	4,485
Labor	1,245
Accounting	550
Automobile	5,170
Postage	261
Licenses and permits	45
Office	557

Supplies 1,550

Telephone 2,805

Travel and entertainment n1 14,571

Utilities 401

Total 58,424

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n1 DKD's claimed deductions for "Cattery expenses", "Show fees", and "Travel" were for amounts that Ms. Dursky and Ms. Watkins paid during 2002 in operating the cattery activity of Ms. Dursky and Ms. Watkins.

DKD attached to DKD's 2002 return Schedule L for 2002. In that schedule, DKD did not show any assets.

2003

DKD filed late Form 1120 for 2003 (DKD's 2003 return), the first year at issue in these cases, that Mr. Musin signed as return preparer and that Ms. Dursky signed as the sole officer of DKD. In Schedule K of DKD's 2003 return, DKD indicated that it was on a "MODIFIED ACCRUAL" method of accounting but did not indicate what that meant.

In DKD's 2003 return, DKD reported (1) "Gross receipts or sales" of $197,582. None of that amount was from DKD's cattery activity. In DKD's 2003 return, DKD also reported (1) "returns and allowances" of zero, (2) "Cost of goods sold" of zero, (3) "Other income" consisting of an "IOWA TAX REFUND" of $675, and (4) "**Total income**" of $198,257.

In DKD's 2003 return, DKD claimed, inter alia, the following deductions: (1) "Compensation of officers" of $80,400, (2) "Salaries and wages" of $7,700, (3) "Rents" of $19,400, (4) "Taxes and licenses" of $6,861, [26] (5) "Pension, profit-sharing, etc., plans" of $20,000, and (6) "Employee benefit programs" of $10,274. In that return, DKD also claimed "Other deductions" of $75,000. DKD included a schedule with DKD's 2003 return in which it indicated that the "Other deductions" claimed consisted of the following types and amounts of deductions:

Claimed Deduction	Amount
Cattery expenses n1	$69,515
Accounting	2,025
Dues and subscriptions	286
Insurance	1,687
Insurance - workman's compensation	363
Office	26
Travel and entertainment	1,098

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Total	75,000

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n1 DKD's claimed deduction for “Cattery expenses” of $69,515 included the 2003 reimbursed cattery expenses of $60,968. A portion of the claimed deduction for “Cattery expenses” (i.e., $386.81) was for DKD's 2003 reimbursements for lodging and food relating to Ms. Watkins' mother.

DKD attached to DKD's 2003 return Schedule L for 2003 (2003 Schedule L). In that schedule, DKD showed the following assets: “Cash”, “Trade notes and accounts receivable”, and “Buildings and other depreciable assets”. DKD did not show any other assets in the 2003 Schedule L, such as cats, kittens, cat trees, feeding bowls, litter boxes, or other assets relating to a cattery activity.

2004

DKD filed late Form 1120 for 2004 (DKD's 2004 return). [27] In Schedule K of DKD's 2004 return, DKD indicated that it was on a “MODIFIED ACCRUAL” method of accounting but did not indicate what that meant.

In DKD's 2004 return, DKD reported (1) “Gross receipts or sales” of $233,556, [28] (2) “returns and allowances” of zero, (3) “Cost of goods sold” of zero, (4) “Other income” consisting of an “IOWA TAX REFUND” of $1,000, and (5) “**Total income**” of $234,556.

In DKD's 2004 return, DKD claimed, inter alia, the following deductions: (1) “Compensation of officers” of $80,400, (2) “Salaries and wages” of $7,700, (3) “Rents” of $24,700, (4) “Taxes and licenses” of $6,861, [29] (5) “Pension, profit-sharing, etc., plans” of zero, and (6) “Employee benefit programs” of $5,763. In that return, DKD also claimed “Other deductions” of $105,414. DKD included a schedule with DKD's 2004 return in which it indicated that the “Other deductions” claimed consisted of the following types and amounts of deductions:

Claimed Deduction	Amount
Cattery expenses n1	$75,091
Accounting	1,750
Bank charges	143
Conventions and meetings	1,500
Disability insurance	1,145
Dues and subscriptions	20,000
Insurance	3,373
Office	189
Meals	1,367

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Telephone	697
Travel	159

Total	105,414

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n1 DKD's claimed deduction for "Cattery expenses" of $75,091 included the 2004 reimbursed cattery expenses of $66,734. A portion of the claimed deduction for "Cattery expenses" (i.e., $412) was for DKD's 2004 reimbursements for entry tickets for Ms. Dursky and Ms. Watkins to Walt Disney World.

DKD attached to DKD's 2004 return Schedule L for 2004 (2004 Schedule L). In that schedule, DKD showed the following assets: "Cash", "Trade notes and accounts receivable", and "Buildings and other depreciable assets". DKD did not show any other assets in the 2004 Schedule L, such as cats, kittens, cat trees, feeding bowls, litter boxes, or other assets relating to a cattery activity.

2005

DKD filed Form 1120 for 2005 (DKD's 2005 return) that Mr. Monroe, [30] whom, as discussed above, DKD retained around August 2006, signed as return preparer and that Ms. Dursky signed as the sole officer of DKD. In Schedule K of DKD's 2005 return, DKD indicated that it was on a "MOD ACC" method of accounting but did not indicate what that meant.

In DKD's return, DKD reported (1) "Gross receipts or sales" of $212,970, [31] (2) "returns & allowances" of zero, (3) "Cost of goods sold" of zero, (4) "Other income" consisting of "State tax refunds" of $1,000, and (5) "**Total income**" of $213,970.

In DKD's 2005 return, DKD claimed, inter alia, the following deductions: (1) "Compensation of officers" of $80,400, (2) "Salaries and wages" of $7,700, (3) "Rents" of $22,800, (4) "Taxes and licenses" of $6,740, [32] (5) "Pension, profit-sharing, etc., plans" of zero, (6) "Employee benefit programs" of zero, and (7) "Advertising" of $1,240. [33] In that return, DKD also claimed "Other deductions" of $62,942. DKD included a schedule with DKD's 2005 return, in which it indicated that the "Other deductions" claimed consisted of the following types and amounts of deductions: [34]

Claimed Deduction n1	Amount
Automobiles	$6,350
Bank charges	38
Legal and professional	1,175
Meals and entertainment	n2 1,878
Miscellaneous	n3 5,188
Office	52

Postage	n4 41
Telephone	710
Travel	n5 15,730
Utilities	377
Annual report	50
Entry fees	n6 5,363
Rental car	n7 1,214
Veterinarian	n8 13,986
Litter	n9 1,923
Cat food	n10 8,014
Photos	n11 53
Stud service	800

Total	62,942

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n1 The deductions for automobiles, meals, miscellaneous, post-age, travel, entry fees, rental cars, veterinarian, litter, cat food, photos, and stud service related to DKD's cattery activity. We shall refer to those deductions as 'cattery expenses'.

n2 We have found that during 2005 DKD reimbursed Ms. Dursky and Ms. Watkins $1,659 for meals.

n3 We have found that during 2005 DKD reimbursed Ms. Dursky and Ms. Watkins $4,190 for grooming and

miscellaneous supplies.

n4 We have found that during 2005 DKD reimbursed Ms. Dursky and Ms. Watkins $42 for postage.

n5 We have found that during 2005 DKD reimbursed Ms. Dursky and Ms. Watkins $16,885 for airfares.

n6 We have found that during 2005 DKD reimbursed Ms. Dursky and Ms. Watkins $2,848 for entry fees.

n7 We have found that during 2005 DKD reimbursed Ms. Dursky and Ms. Watkins $2,618 for rental cars.

n8 We have found that during 2005 DKD reimbursed Ms. Dursky and Ms. Watkins $13,860 for veterinarian bills.

n9 We have found that during 2005 DKD reimbursed Ms. Dursky and Ms. Watkins $1,664 for litter.

n10 We have found that during 2005 DKD reimbursed Ms. Dursky and Ms. Watkins $8,613 for cat food.

n11 We have found that during 2005 DKD reimbursed Ms. Dursky and Ms. Watkins $78 for photos.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

DKD attached to DKD's 2005 return Schedule L for 2005. In that schedule, DKD did not show any assets.

2006

DKD filed Form 1120 for 2006, the year during which DKD discontinued DKD's cattery activity, that Mr. Monroe signed as return preparer and that Ms. Dursky signed as the sole officer of DKD. In Schedule K of DKD's Form 1120 for 2006 (DKD's 2006 return), DKD indicated that it was on a "MOD ACC" method of accounting but did not indicate what that meant.

In DKD's 2006 return, DKD reported (1) "Gross receipts or sales" of $177,519, [35] (2) "returns & allowances" of zero, (3) "Cost of goods sold" of zero, and (4) "**Total income**" of $177,519.

In DKD's 2006 return, DKD claimed, inter alia, the following deductions: (1) "Compensation of officers" of $80,400, (2) "Salaries and wages" of zero, (3) "Rents" of zero, (4) "Taxes and licenses" of $6,740, [36] (5) "Pension, profit-sharing, etc., plans" of $15,000, and (6) "Employee benefit programs" of $13,458. In that return, DKD also claimed "Other deductions" of $1,759. DKD included a schedule with DKD's 2006 return in which it indicated that the "Other deductions" claimed consisted of the following types and amounts of deductions:

Claimed Deduction	Amount
Dues and subscriptions	$ 35
Legal and professional	1,550
Miscellaneous	124
Annual report	50
Total	1,759

DKD did not claim any deductions in DKD's 2006 return with respect to DKD's cattery activity. [37]

DKD attached to DKD's 2006 return Schedule L for 2006. In that schedule, DKD did not show any assets.

Summary of DKD's Returns for 2001 Through 2006

The following chart summarizes DKD's tax return treatment of all income and certain deductions claimed for each of the years 2001 through 2006:

Income	2001	2002	2003	2004	2005	2006
"Gross receipts or sales"	$2,770	$800	$197,582	$233,556	$212,970	$177,519
"Other						

income”	226,923	198,608	675	1,000	1,000	--
Deductions Claimed						

Deductions claimed relating to DKD's cattery activity						
“Cattery expenses”	55,210	58,424	69,515	75,091	60,540	--
“Salaries and wages”	--	7,350	7,700	7,700	7,700	--
“Taxes and licenses”	588	588	588	588	588	--
“Rent”	12,000	12,000	12,000	12,000	12,000	--
“Compensation of officers”	80,400	80,400	80,400	80,400	80,400	80,400
“Pension, profit-sharing, etc., plans”	30,000	10,000	20,000	--	--	15,000
“Employee benefit programs”	8,852	6,931	10,274	5,763	--	13,458
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Income (loss)	42,643	23,715	(2,220)	53,014	52,742	68,661

Ms. Dursky's Returns

2003

Ms. Dursky filed Form 1040, U.S. Individual Income Tax Return (Form 1040), for 2003 (Ms. Dursky's 2003 return) that Mr. Musin signed as return preparer and that she signed. In that return, Ms. Dursky reported “Wages, salaries, tips, etc.” of $80,400 that she received during 2003 from DKD as compensation for the IT consulting work that she performed for DKD during that year.

In Schedule A—Itemized Deductions (Schedule A) attached to Ms. Dursky's 2003 return, Ms. Dursky deducted “Real estate taxes” of $3,458 and “Home mortgage interest and points” of $5,204.

Ms. Dursky included with Ms. Dursky's 2003 return Schedule E for 2003 (2003 Schedule E). In the 2003 Schedule E, Ms. Dursky described the “**rental real estate property**” to which that schedule pertained as “**OFFICE SPACE WEST DES MOINE** [sic] **IA**”. In that schedule, Ms. Dursky responded in the negative to the following question:

For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of:

- 14 days **or**

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

- 10% of the total days rented at fair rental value?

In the 2003 Schedule E, Ms. Dursky reported "Rents received" of $19,400 [38] and claimed deductions for "Mortgage interest paid to banks, etc." of $1,555 and for "Taxes" of $610.

2004

Ms. Dursky filed Form 1040 for 2004 (Ms. Dursky's 2004 return) that Mr. Musin signed as return preparer and that she signed. In that return, Ms. Dursky reported "Wages, salaries, tips, etc." of $80,400 that she received during 2004 from DKD as compensation for the IT consulting work that she performed for DKD during that year.

In Schedule A attached to Ms. Dursky's 2004 return, Ms. Dursky deducted "Real estate taxes" of $3,098 and "Home mortgage interest and points" of $4,302.

Ms. Dursky included with Ms. Dursky's 2004 return Schedule E for 2004 (2004 Schedule E). In the 2004 Schedule E, Ms. Dursky described the "**rental real estate property**" to which that schedule pertained as "**OFFICE SPACE WEST DES MOINE** [sic] **IA**". In that schedule, Ms. Dursky responded in the negative to the following question:

For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of:

- 14 days or
- 10% of the total days rented at fair rental value?

In the 2004 Schedule E, Ms. Dursky reported "Rents received" of $24,700 [39] and claimed deductions for "Mortgage interest paid to banks, etc." of $1,555 and for "Taxes" of $610.

2005

Ms. Dursky filed Form 1040 for 2005 (Ms. Dursky's 2005 return) that Mr. Monroe, whom, as discussed above, DKD retained around August 2006, signed as return preparer and that she signed. In that return, Ms. Dursky reported "Wages, salaries, tips, etc." of $80,400 that she received during 2005 from DKD as compensation for the IT consulting work that she performed for DKD during that year.

In Schedule A attached to Ms. Dursky's 2005 return, Ms. Dursky deducted "Real estate taxes" of $2,287 and "Home mtg interest and points" of $4,084.

Ms. Dursky included with Ms. Dursky's 2005 return Schedule E for 2005 (2005 Schedule E). In the 2005 Schedule E, Ms. Dursky described the "**rental real estate property**" to which that schedule pertained as "**OFFICE SPACE WEST DES MOINES, IA**". In that schedule, Ms. Dursky responded in the negative to the following question:

For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of:

- 14 days, or
- 10% of the total days rented at fair rental value?

In the 2005 Schedule E, Ms. Dursky reported “Rents received” of $12,000 [40] and claimed deductions for “Mortgage interest paid to banks, etc.” of $2,398 and for “Taxes” of $1,343.

Notices of Deficiency

DKD

On September 26, 2007, respondent issued to DKD a notice of deficiency (notice) for its taxable year 2003 (DKD's 2003 notice). On March 12, 2008, respondent issued to DKD a notice for its taxable years 2004 and 2005 (DKD's 2004 and 2005 notice).

In DKD's 2003 notice, respondent determined, inter alia, that DKD is not entitled to the following deductions claimed for 2003: (1) “Other expenses” of $69,515, (2) “Salaries & wages” of $7,700, (3) “Taxes and licenses” of $588, (4) “Rents” of $19,400, and (5) “Employee benefit programs” of $10,274. In that notice, respondent also determined that DKD is not entitled to a $20,000 deduction claimed for 2003 for “Pension, profit sharing plans” because

The corporation paid the shareholder's expenses for the operation of the cat breeding business. The disallowed business expenses are not ordinary and necessary for the operation of the corporation's business. The business that the shareholder operated was determined to be a hobby and not operated for profit. The corporation's income increased, by the above amount [$20,000] for the tax year ending December 31, 2003 [sic].

In DKD's 2004 and 2005 notice, respondent determined, inter alia, that DKD is not entitled to the following deductions claimed for 2004: (1) Cattery expenses of $75,091, (2) “Salaries & Wages” of $7,700, (3) “Taxes & Licenses” of $588, and (4) “Rents” of $24,700, and (5) “Employee Benefit Programs” of $1,145. In that notice, respondent also determined, inter alia, that DKD is not entitled to the following deductions claimed for 2005: (1) “Meals & Entertainment” of $1,878, (2) “Telephone Expense” of $710, (3) “Advertising” of $1,240, (4) “Auto & Truck Expense” of $6,350, (5) “Travel Expenses” of $15,730, (6) “Miscellaneous Expenses” of $5,188, (7) “Utility Expenses” of $377, (8) “Entry Fees” of $5,363, (9) “Rental Cars” of $1,214, (10) “Veterinarian Bills” of $13,986, (11) “Litter Expense” of $1,923, (12) “Cat Food Expense” of $8,014, (13) “Photo Expenses” of $53, (14) “Stud Service Expense” of $800, (15) “Salaries & Wages” of $7,700, (16) “Taxes & Licenses” of $588, and (17) “Rents” of $22,800. In addition, respondent determined in DKD's 2004 and 2005 notice that DKD was a qualified personal service corporation, as defined in section 448(d)(2), for each of the years 2004 and 2005. In that notice, respondent also determined that DKD is not entitled to the $20,000 deduction claimed for 2004 for “Pension & Profit Sharing” [41] because

It is determined that pension and profit sharing expense is $0.00, rather than $20,000.00 for the taxable year ended December 31, 2004 because it has not been established that more than $0.00 was for an ordinary and necessary business expense, and expended for the purpose designated. Accordingly, taxable income is increased $20,000.00 for the taxable year ended December 31, 2004.

In DKD's 2004 and 2005 notice, respondent also determined that DKD is liable for its taxable years 2004 and 2005 for accuracy-related penalties under section 6662(a) in the respective amounts of $9,548 and $8,475.

Ms. Dursky

On September 26, 2007, March 12, 2008, and March 12, 2008, respectively, respondent issued to Ms. Dursky separate notices for her taxable year 2003 (Ms. Dursky's 2003 notice), her taxable year 2004 (Ms. Dursky's 2004 notice), and her taxable year 2005 (Ms. Dursky's 2005 notice).

In Ms. Dursky's 2003 notice, respondent determined that Ms. Dursky is required to include in gross income as constructive dividends the following deductions that DKD claimed in DKD's 2003 return and that respondent disallowed in DKD's 2003 notice: (1) “Cattery expenses” of $69,515, (2) “Salaries and wages” of $7,700, (3) “Taxes and licenses” of $588, (4) “Rents” of $19,400, (5) “Pension, profit-sharing, etc., plans” of $20,000, and (6) “Employee benefit programs” of $9,695. In Ms. Dursky's 2003 notice, respondent also determined to (1) exclude from Ms. Dursky's 2003 Schedule E the rental income of $19,400 that she reported and (2) disallow the deductions of (a) “Mortgage Expenses” of $1,555, (b) “Other Expenses” of $2,870, and (c) “Depreciation Expense” of $641 that she claimed in the 2003 Schedule E with respect to Ms. Dursky's residence.

In Ms. Dursky's 2004 notice, respondent determined that Ms. Dursky is required to include in gross income as constructive dividends the following deductions that DKD claimed in DKD's 2004 return and that respondent disallowed in DKD's 2004 and 2005 notice: (1) “Cattery expenses” of $75,091, (2) “Salaries and wages” of $7,700, (3) “Taxes and licenses” of $588, (4) “Rents” of $24,700, (5) “Pension” of $20,000, [42] and (6) “Employee benefit programs” of $1,145. In Ms. Dursky's 2004 notice, respondent also determined to (1) exclude from Ms. Dursky's 2004 Schedule E the rental income of $24,700 that she reported and (2) disallow the deductions for (a) “Mortgage Interest” of $1,555, (b) “Taxes” of $610, (c) “Other Expenses” of $730, and (d) “Depreciation” of $641 that she claimed in the 2004 Schedule E with respect to Ms. Dursky's residence. In that notice, respondent also determined that Ms. Dursky is liable for her taxable year 2004 for an accuracy-related penalty under section 6662(a) of $3,280.60.

In Ms. Dursky's 2005 notice, respondent determined that Ms. Dursky is required to include in gross income as constructive dividends the following deductions that DKD claimed in DKD's 2005 return and that respondent disallowed in DKD's 2004 and 2005 notice: (1) “Meals and entertainment” of $1,878, (2) “Telephone” of $710, (3) “Advertising” of $1,240, (4) “Automobiles” of $6,350, (5) “Travel” of $15,730, (6) “Miscellaneous” of $5,188, (7) “Utilities” of $377, (8) “Cat food” of $8,014, (9) “Entry fees” of $5,363, (10) “Rental car” of $1,214, (11) “Veterinarian” of $13,986, (12) “Litter” of $1,923, (13) “Stud Service” of $800, (14) “Photos” of $53, (15) “Salaries and wages” of $7,700, (16) “Taxes and licenses” of $588, and (17) “Rents” of $22,800. In Ms. Dursky's 2005 notice, respondent also determined to (1) exclude from Ms. Dursky's 2005 Schedule E the rental income of $12,000 that she reported and (2) disallow the deductions for (a) “Mortgage Interest” of $2,398, (b) “Taxes” of $1,343, and (c) “Depreciation” of $641 that she claimed in the 2005 Schedule E with respect to Ms. Dursky's residence. In that notice, respondent also determined that Ms. Dursky is liable for her taxable year 2005 for an accuracy-related penalty under section 6662(a) of $2,520.80.

OPINION

DKD and Ms. Dursky bear the burden of proof with respect to the determinations which remain at issue in the respective notices that respondent issued to them. See Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 [12 AFTR 1456] (1933). Moreover, deductions are strictly a matter of legislative grace, and DKD and Ms. Dursky bear the burden of proving entitlement to any respective deductions that they claim. See *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 [69 AFTR 2d 92-694] (1992). Respondent bears the burden of proof with respect to any new matter. See Rule 142(a); *Achiro v. Commissioner*, 77 T.C. 881, 890 (1981).

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700   MMisselbeck@KNSCPA.com

Before turning to the issues presented, we shall comment on the respective testimonies of Ms. Dursky and Ms. Watkins, who were the only witnesses at the trial in these cases. We found those testimonies to be in certain material respects questionable, implausible, unpersuasive, uncorroborated, vague, and/or conclusory. We also found (1) the testimony of Ms. Dursky to be in certain material respects self-serving and (2) the testimony of Ms. Watkins to be in certain material respects serving the interests of Ms. Dursky, her personal partner, and DKD, the corporation that Ms. Dursky wholly owned. We shall not rely on the respective testimonies of Ms. Dursky and Ms. Watkins to establish the respective positions of DKD and Ms. Dursky with respect to the issues to which those testimonies pertained. See, e.g., Tokarski v. Commissioner, 87 T.C. 74, 77 (1986).

Cattery Activity

DKD—Claimed Deductions

It is the position of DKD that for the years at issue it is entitled to deduct under section 162(a) the following amounts relating to DKD's cattery activity: (1) Respective reimbursed cattery expenses of $59,817, $64,920, $66,628; (2) purported salary of $7,700 paid to Ms. Watkins; (3) certain unidentified “taxes and licenses” of $588; and (4) purported rent of $4,333 paid to Ms. Dursky. [43]

Section 162(a) provides in pertinent part:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business ***

In order to be entitled for each of the years at issue to the deductions that it is claiming with respect to DKD's cattery activity, DKD must show that for each of those years that cattery activity constituted a trade or business of DKD within the meaning of section 162(a). In order to establish that for each of the years at issue DKD's cattery activity constituted a trade or business of DKD within the meaning of section 162(a), DKD must show that during each of those years it had the intent or motive to make a profit from that activity. See *Am. Props., Inc. v. Commissioner*, 28 T.C. 1100 (1957), affd. per curiam 262 F.2d 150 [2 AFTR 2d 6292] (9th Cir. 1958). As we explained in A*m. Props., Inc.*, supra at 1111,

The determination of whether the activities of a taxpayer constitute the carrying on of a trade or business requires an examination of facts in each case. Higgins v. Commissioner, 312 U.S. 212 [25 AFTR 1160] [(1941)]. It has been held that whether an enterprise is conducted as a business for profit is a matter of intention and good faith, and all the facts in a particular case are to be considered. ***

Thus, the issues in the final analysis turn upon the question of whether during the years in question the petitioner and the corporation had the requisite intent or motive of making a profit. Intention is a question of fact to be determined not only from the direct testimony as to intent, but a consideration of all the evidence, including the conduct of the parties. The statement of an interested party of his intention and purpose is not necessarily conclusive. ***

DKD contends that for each of the years at issue DKD's cattery activity constituted a trade or business within the meaning of section 162(a) because it conducted that activity during each of those years “In order to produce more income and a profit”. On the record before us, we reject DKD's contention.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Since at least 1989 Ms. Watkins, and since at least 1994 Ms. Dursky, each was engaged in the hobby of operating a cattery from which each derived significant personal pleasure. At a time not disclosed by the record before the years at issue, Ms. Dursky and Ms. Watkins became engaged in the hobby of jointly operating a cattery from which they continued to derive significant personal pleasure. The cattery activity of Ms. Dursky and Ms. Watkins took place in Ms. Dursky's residence, except for attending cat shows and visiting veterinarians. That cattery activity required them to spend substantial time and substantial money, including substantial time and substantial money spent by one or both of them in participating in certain competitions, clubs, and associations and traveling extensively to attend certain CFA [44] cat shows over much of the United States. At least five of the cats of Ms. Dursky and Ms. Watkins won awards during certain competitions, at least two of their Norwegian Forest cats produced such outstanding offspring that they achieved the coveted title of CFA Distinguished Merit, [45] and the CFA designated the cattery activity of Ms. Dursky and Ms. Watkins as a “CFA Approved Cattery of Excellence.”

At a time not disclosed by the record before the years at issue, Ms. Dursky and Ms. Watkins created a Web site that they maintained for their cattery activity. At the time of the trial in these cases, the general public was able to access that Web site, although it had not been updated since 2002. The cattery activity Web site stated: “We treat our cats as members of our family” and “we have invested too much love in our wonderful kittens to risk exposing them to an uncertain and risky environment.” The cattery activity Web site advertised for sale two cats for $75 and $150, respectively, and two kittens for $200 and $400, respectively.

During the years at issue, DKD had a cattery activity, which was the cattery activity in which Ms. Dursky and Ms. Watkins had engaged before those years. While operating DKD's cattery activity during the years at issue, Ms. Dursky and Ms. Watkins continued to engage in the same kinds of activities in which they had engaged before those years while operating the cattery activity of Ms. Dursky and Ms. Watkins. [46] As was true while they were operating the cattery activity of Ms. Dursky and Ms. Watkins before the years at issue, Ms. Dursky and Ms. Watkins each continued to derive significant personal pleasure while operating DKD's cattery activity during the years at issue.

During the years at issue, while operating DKD's cattery activity Ms. Dursky and Ms. Watkins desired to expand on the national reputation that they had developed before those years while operating the cattery activity of Ms. Dursky and Ms. Watkins. In order to do so, they relied on their respective years of cattery activity experience and their respective reputations in the so-called cattery world.

As was true of the cattery activity of Ms. Dursky and Ms. Watkins before the years at issue, DKD's cattery activity was designated by the CFA during the years at issue as a “Cattery of Excellence”.

As was true of their beliefs while operating the cattery activity of Ms. Dursky and Ms. Watkins before the years at issue, while Ms. Dursky and Ms. Watkins were operating DKD's cattery activity during the years at issue they believed that the price of any cat or kitten offered for sale would increase if the cats and kittens that they bred won national cat shows. While operating DKD's activity during the years at issue, Ms. Dursky and Ms. Watkins produced a total of four cats that won national championships.

As was true while they were operating the cattery activity of Ms. Dursky and Ms. Watkins before the years at issue, while Ms. Dursky and Ms. Watkins were operating DKD's cattery activity during the years at issue they continued to incur and pay substantial expenses. During the years at issue, DKD reimbursed Ms. Dursky and Ms. Watkins for those substantial expenses and claimed deductions for those reimbursed expenses and for certain other claimed expenses in its respective tax returns for those years. [47]

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

While operating DKD's cattery activity during 2003, Ms. Dursky and Ms. Watkins produced approximately seven to nine kittens from approximately five to seven litters. While operating DKD's activities during each of the years 2004 and 2005, Ms. Dursky and Ms. Watkins produced approximately nine kittens from approximately three litters.

During 2003, Ms. Dursky and Ms. Watkins did not sell any cats or kittens while operating DKD's cattery activity. During 2004, Ms. Dursky and Ms. Watkins did not sell any cats or kittens while operating DKD's cattery activity except for three cats and/or kittens that they sold in December of that year for a total of $250. During 2005, Ms. Dursky and Ms. Watkins did not sell any cats or kittens while operating DKD's cattery activity except for a total of eight cats and/or kittens that they sold in June, July, August, October, and November of that year for a total of $1,525.

In 2006, at an undisclosed time in or before August, Mr. Musin and Ms. Schwartz, the tax return preparers for DKD and/or Ms. Dursky, [48] informed them that the IRS was investigating Mr. Musin and Ms. Schwartz and intended to commence an examination of petitioners' respective tax returns for 2003 and 2004. As a result, around August 2006, (1) Ms. Dursky and Ms. Watkins discontinued operating DKD's cattery activity, [49] (2) Ms. Dursky and Ms. Watkins continued operating that cattery activity as the cattery activity of Ms. Dursky and Ms. Watkins, and (3) Ms. Dursky and DKD retained Mr. Monroe. [50]

Except for the respective testimonies of Ms. Dursky and Ms. Watkins, on which we are unwilling to rely, there is no reliable evidence in the record to support our finding that during each of the years at issue DKD intended to make a profit from DKD's cattery activity. [51]

Based upon our examination of the entire record before us, we find that DKD has failed to carry its burden of establishing that during each of the years at issue it intended to make a profit from DKD's cattery activity. On that record, we find that during each of the years at issue DKD expended substantial amounts in DKD's cattery activity for the personal pleasure of Ms. Dursky, its sole stockholder, and with the expectation that it would be able to deduct those substantial amounts for each of those years. On the record before us, we further find that during each of the years at issue DKD's cattery activity was incident to the personal hobby of Ms. Dursky, DKD's sole stockholder, who before, during, and after those years derived significant personal pleasure from the cattery activity in which she was involved.

Based upon our examination of the entire record before us, we find that DKD has failed to carry its burden of establishing that for each of the years at issue DKD's cattery activity constituted a trade or business of DKD within the meaning of section 162(a). On that record, we further find that DKD has failed to carry its burden of establishing that for each of the years at issue it is entitled under section 162(a) to deduct with respect to DKD's cattery: (1) Amounts reimbursed to Ms. Dursky and Ms. Watkins, (2) amounts paid to Ms. Watkins as purported salary, (3) amounts paid for certain “taxes and licenses”, and (4) amounts paid to Ms. Dursky as purported rent.

Ms. Dursky—Claimed Constructive Dividends

We have found that during each of the years at issue DKD expended substantial amounts in DKD's cattery activity for the personal pleasure of Ms. Dursky, its sole stockholder, and that during each of those years that activity was incident to the personal hobby of Ms. Dursky. On the record before us, we find that for each of the years at issue Ms. Dursky is required to include in gross income as constructive dividends the amounts of deductions relating to DKD's cattery activity that DKD claimed for each of those years and that we have disallowed. [52]

Ms. Dursky—Claimed Cattery Activity Deductions

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

It is the alternative position of Ms. Dursky that

If this Court finds that the cattery operation was operated by Debra Dursky and not DKD Enterprises, which is contrary to the stipulation between the parties, then Debra Dursky should be allowed to deduct the cattery expenses under I.R.C. §162, since the cattery was operated for a profit.

In holding that DKD is not entitled for each of the years at issue to deduct under section 162(a) the various deductions that it is claiming with respect to DKD's cattery activity, we did not find that "the cattery operation was operated by Debra Dursky and not DKD Enterprises". Instead, we found that DKD failed to carry its burden of establishing (1) that during each of the years at issue DKD intended to make a profit from DKD's cattery activity and (2) that for each of those years DKD's cattery activity constituted a trade or business of DKD within the meaning of section 162(a). Thus, the premise on which Ms. Dursky advances her alternative position is not valid. [53]

On the record before us, we find that for each of the years at issue Ms. Dursky is not entitled to deduct under section 162(a) the deductions relating to DKD's cattery activity that DKD is claiming for each of those years and that we have disallowed.

Ms. Dursky—Claimed Schedule E Deductions

It is the position of Ms. Dursky that she is entitled for each of the years at issue to deduct in Schedule E the respective portions of the mortgage interest and real estate tax that she paid with respect to Ms. Dursky's residence that are allocable to DKD's purported rental of a portion of that residence for DKD's cattery activity.

We have found that DKD failed to carry its burden of establishing (1) that for each of the years at issue DKD's cattery activity constituted a trade or business of DKD within the meaning of section 162(a) and (2) that for each of those years DKD is entitled to deduct under that section any amounts that it claimed as rent for the portion of Ms. Dursky's residence where Ms. Dursky and Ms. Watkins operated DKD's cattery activity. [54]

On the record before us, we find that Ms. Dursky has failed to carry her burden of establishing that for each of the years at issue she is entitled to deduct in Schedule E the respective portions of mortgage interest and real estate tax that she paid with respect to Ms. Dursky's residence that are allocable to DKD's purported rental of that residence for DKD's cattery activity. [55]

Qualified Personal Service Corporation

It is the position of DKD that it is not a qualified personal service corporation, as defined in section 448(d)(2), for each of the years 2004 and 2005 that is subject to the 35-percent tax rate prescribed in section 11(b)(2). [56]

Section 448(d)(2) defines the term "qualified personal service corporation" to mean:

SEC. 448(d). Definitions and Special Rules.—For purposes of this section—

***

(2) Qualified personal service corporation.—The term "qualified personal service corporation" means any corporation—

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

(A) substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and

(B) substantially all of the stock of which (by value) is held directly (or indirectly through 1 or more partnerships, S corporations, or qualified personal service corporations not described in paragraph (2) or (3) of subsection (a)) by —

(i) employees performing services for such corporation in connection with the activities involving a field referred to in subparagraph (A),

Section 1.448-1T(e)(3), Temporary Income Tax Regs., 52 Fed. Reg. 22768 (June 16, 1987), provides in pertinent part:

(3) *Meaning of qualified personal service corporation*. For purposes of this section, the term “qualified personal service corporation” means any corporation that meets—

(i) The function test of paragraph (e)(4) of this section, and

(ii) The ownership test of paragraph (e)(5) of this section.

Section 1.448-1T(e)(4), Temporary Income Tax Regs., supra, provides in pertinent part that the function test is met “if 95 percent or more of the time spent by employees of the corporation, serving in their capacity as such, is devoted to the performance of services” in, inter alia, consulting. Section 1.448-1T(e)(5)(i)(A), Temporary Income Tax Regs., 52 Fed. Reg. 22770 (June 16, 1987), provides in pertinent part that a corporation “meets the ownership test, if at all times during the taxable year, substantially all the corporation's stock, by value, is held, directly or indirectly, by” employees who perform services for the corporation in connection with activities involving the performance of services in, inter alia, consulting.

We have found that Ms. Dursky, the only stockholder of DKD and the only employee of DKD who performed consulting services for it, spent approximately 2,000 hours during the year 2003 and approximately 2,200 hours during each of the years 2004 and 2005 working for DKD in its IT consulting business. We have also found that during each of the years 2003, 2004, and 2005 Ms. Dursky spent approximately 800 hours operating DKD's cattery activity. [57]

On the record before us, we find that during each of the years 2003, 2004, and 2005 Ms. Dursky did not spend 95 percent or more of her time while working for DKD performing consulting services for it. On that record, we further find that for each of the years at issue DKD is not a qualified personal service corporation, as defined in section 448(d)(2), that is subject to the 35-percent tax rate prescribed in section 11(b)(2).

DKD Fidelity Profit-Sharing Plan

DKD—Claimed Deductions

It is the position of DKD that it is entitled to deduct (1) for 2003 a $10,000 contribution under the DKD Fidelity profit-sharing plan that it made on April 14, 2004, by sending a $10,000 check to Fidelity; (2) for 2004 a total of $20,000 of contributions that it made under that profit-sharing plan by sending a $10,000 check to Fidelity on

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

December 27, 2004, and a $10,000 check to Fidelity on April 11, 2005; and (3) for 2005 a $5,000 contribution that it made under that profit-sharing plan by sending a $5,000 check to Fidelity on April 10, 2006. [58]

It is the position of respondent that for each of the years at issue DKD is not entitled to the deduction that DKD is claiming for DKD's contributions under the DKD Fidelity profit-sharing plan. In support of respondent's position, respondent asserts in pertinent part:

If [Ms.] Watkins is determined to have been an employee of the cattery, then the failure to include [Ms.] Watkins in DKD's pension plan is a fatal flaw. A qualified pension plan cannot discriminate in favor of highly compensated employees. I.R.C. § 401(a)(4). "Highly compensated employee" is defined in I.R.C.§ 414(q) as a [sic] employee who was a 5 percent owner at any time during the year or preceding year or was in the top-paid group of employees. As the sole shareholder of DKD, [Ms.] Dursky qualifies as a "highly compensated employee." [Ms.] Dursky and [Ms.] Watkins were both employees. DKD did not offer, or pay, [Ms.] Watkins any pension benefits. The purported pension plan is not, therefore, a qualified pension plan and no pension contributions should be allowed.

DKD counters that the reason stated in DKD's 2003 notice and in DKD's 2004 and 2005 notice for respondent's determinations that DKD is not entitled for the years 2003 and 2004 to the deductions that it claimed in its respective tax returns for those years for contributions under the DKD Fidelity profit-sharing plan was that those contributions are not "ordinary and necessary" expenses. As a result, DKD argues that respondent has the burden of proving that the DKD Fidelity profit-sharing plan did not include Ms. Watkins as a participant. According to DKD, "Respondent presented no evidence, at trial or otherwise, regarding who were the participants in the [DKD] Fidelity pension [sic] plan."

We reject DKD's contention about what the record establishes "regarding who were the participants in the [DKD] Fidelity pension [sic] plan." The Fidelity contribution document that Ms. Dursky executed on behalf of DKD on December 28, 2001, indicated that the only participant under the DKD Fidelity profit-sharing plan was Ms. Dursky. Moreover, petitioners have taken the position at trial and on brief that Ms. Dursky was an employee of DKD during each of the years at issue. [59]

On the record before us, we find that for each of the years at issue the DKD Fidelity profit-sharing plan discriminated in favor of Ms. Dursky, DKD's sole stockholder, who was a "highly compensated employee" as defined in section 414(q). On that record, we further find that for each of the years at issue the DKD Fidelity profit-sharing plan did not constitute a qualified profit-sharing plan under section 401(a). On the record before us, we find that for each of the years at issue DKD is not entitled to a deduction for any contributions made under the DKD Fidelity profit-sharing plan. [60]

Ms. Dursky—Claimed Constructive Dividends

We have found that for each of the years at issue DKD is not entitled to deduct any contributions made under the DKD Fidelity profit-sharing plan. On the record before us, we find that any respective contributions that DKD made under that plan and claimed as deductions in its respective tax returns for the years at issue and that we have disallowed are required to be included in Ms. Dursky's income as constructive dividends for her respective taxable years at issue in which DKD made those contributions. [61]

Ms. Dursky's Health Insurance Policy

DKD—Claimed Deductions

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

It is DKD's position that for each of the years at issue it is entitled to deduct certain premiums that it paid on a health insurance policy issued in Ms. Dursky's name that she had purchased. [62] In support of DKD's position, DKD asserts:

An employer is entitled to deduct, as ordinary and necessary trade or business expense, medical insurance premiums it paid for its employees. I.R.C. § 162(a).

***

Since DKD Enterprises paid medical insurance premiums on a medical insurance policy for its employee, Debra Dursky, DKD Enterprises is entitled to deduct the medical insurance premiums as ordinary and necessary business expenses under I.R.C. § 162(a).

It is respondent's position that DKD is not entitled to the deductions that it is claiming for the premiums that it paid on Ms. Dursky's health insurance policy. [63] In support of respondent's position, respondent asserts in respondent's reply brief:

the medical insurance premiums paid by DKD [on Ms. Dursky's health insurance policy] were not made pursuant to an accident or health plan as required by I.R.C. § 106(a). DKD never had an accident or health insurance plan. DKD simply wrote checks to a health insurer, allegedly on behalf of [Ms.] Dursky.

Also, I.R.C. § 105 states that amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributed to contributions by the employer which were not includible in the gross income of the employee or (2) are paid by the employer. [Ms.] Dursky did not include the health insurance premiums as compensation.

Section 162(a) permits a taxpayer to deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. Sec. 162(a)(1). Section 1.162-10, Income Tax Regs., provides in pertinent part with respect to “Certain employee benefits” as follows:

Amounts paid or accrued within the taxable year for *** a sickness, accident, hospitalization, medical expense, *** or similar benefit plan, are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business. ***

In *Waterfall Farms, Inc. v. Commissioner*, T.C. Memo. 2003-327 [TC Memo 2003-327], we held:

When payments for medical care are properly excludable from an employee's income [under section 105 and/or 106] because they are made under a “plan for employees,” they are deductible by the employer as ordinary and necessary business expenses under section 162(a). ***

Based upon our examination of the entire record before us, we find that DKD has failed to carry its burden of establishing that it had in effect during any of the years at issue a sickness, hospitalization, medical expense, or similar benefit plan for employees. On that record, we find that DKD has failed to carry its burden of establishing that for each of the years at issue it is entitled to deduct any premiums that it paid on Ms. Dursky's health insurance policy.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Ms. Dursky—Claimed Exclusion from Income

It is the position of Ms. Dursky that she is entitled to exclude under section 105 or 106 the premiums that she claims DKD paid during each of the years at issue on Ms. Dursky's health insurance policy. [64] We have found that DKD has failed to carry DKD's burden of establishing that during each of the years at issue it had in effect a sickness, hospitalization, medical expense, or similar plan for employees. On the record before us, we find that Ms. Dursky is not entitled for any of the years at issue to exclude from gross income under section 105 or 106 the amount of any premiums that DKD paid on Ms. Dursky's health insurance policy.

We have considered all of the contentions and arguments of the parties that are not discussed herein, and we find them to be without merit, irrelevant, and/or moot.

To reflect the foregoing, the concessions of respondent, and the concessions of petitioners,

Decisions will be entered under Rule 155.

[1] Cases of the following petitioners are consolidated herewith: Debra K. Dursky, docket Nos. 24404-07 and 10819-08; and DKD Enterprises a.k.a. DKD Enterprises, Inc., docket No. 10818-08.

[2] All section references are to the Internal Revenue Code in effect for the years at issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

[3] In addition to the issues remaining for decision that are listed in the text, there are other questions relating to certain determinations in the respective notices of deficiency with respect to those years that respondent issued to Ms. Dursky and DKD which are computational in that their resolution flows from our resolution of certain of the issues that we address herein.

[4] At least during the years at issue, Ms. Dursky did not have a written employment agreement with DKD.

[5] DKD also paid Ms. Dursky $80,400 annually as compensation for the IT consulting work that she performed for DKD during each of the years 2001 and 2002.

[6] In 1989, a person or persons not identified by the record operated a cattery for Maine Coons. In 1994, Ms. Dursky was operating a cattery for Norwegian Forest cats. In 1997, Ms. Dursky and Ms. Watkins were jointly operating a cattery for Norwegian Forest cats. At a time not disclosed by the record, Ms. Dursky and Ms. Watkins were jointly operating a cattery for Maine Coons.

[7] CFA imposed ethical standards and practices for catteries.

[8] By referring to the cattery activity of DKD as “DKD's cattery activity”, we are in no way implying or suggesting that during any of the years at issue DKD's cattery activity constituted a trade or business of DKD within the meaning of sec. 162(a).

[9] Of the approximately 2,100 square feet of space at Ms. Dursky's residence, Ms. Dursky and Ms. Watkins used approximately 474 square feet in operating DKD's cattery activity during each of the years at issue.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

[10] During each of the years at issue, Ms. Dursky and Ms. Watkins did not attend all of the cat shows in which they entered certain cats and/or kittens while operating DKD's cattery activity.

[11] The number of breeders that bred Norwegian Forest cats in the Midwest region of the United States increased from approximately three at the beginning of 2003 to approximately 10 to 15 by 2005.

[12] The record does not establish how many cat shows during each of the years at issue Ms. Watkins attended with Ms. Dursky and without Ms. Dursky.

[13] National championship winners were determined on the basis of the total number of points earned by a cat during cat show season. Cats earned points by winning cat shows; the number of points earned depended on the number of cats competing in a show. The number of cats competing in a cat show typically was not determined until shortly before the show. Ms. Dursky and Ms. Watkins often waited until the number of cats competing in a cat show was determined before deciding whether to attend the show. Because they waited until shortly before a cat show was scheduled to take place to decide whether to attend it, Ms. Dursky and Ms. Watkins paid a premium for any air transportation costs incurred to attend the show.

[14] Mr. Musin's colleague, Jill Schwartz (Ms. Schwartz), the tax return preparer of DKD for the year 2001, also advised Ms. Dursky and DKD regarding the amount that DKD should pay Ms. Dursky for the use of Ms. Dursky's residence for a cattery activity.

[15] Ms. Schwartz also advised Ms. Dursky and DKD regarding DKD's paying Ms. Dursky 10 percent of certain expenses (e.g., utilities, repairs) relating to Ms. Dursky's residence as allocable to a cattery activity.

The record does not establish whether DKD paid to Ms. Dursky 10 percent of any such expenses.

[16] During each of the years at issue, DKD reimbursed Ms. Dursky and Ms. Watkins for certain amounts that they had expended as shown on certain receipts by issuing checks drawn on DKD's bank account over which only Ms. Dursky had signature authority.

[17] During 2005, while operating DKD's cattery activity Ms. Dursky and Ms. Watkins sold (1) a total of three cats and/or kittens in June for a total of $200, (2) a total of two cats and/or kittens in July for a total of $200, (3) one cat or kitten in August for $100, (4) one kitten in October for $575, and (5) one kitten in November for $450.

[18] Although Ms. Dursky and Ms. Watkins did not discontinue operating DKD's cattery activity until around August 2006, as discussed below, DKD did not claim any deductions relating to DKD's cattery activity in the tax return that it filed for its taxable year 2006.

[19] Mr. Monroe prepared petitioners' respective tax returns for 2005 and is the lead attorney representing petitioners in these cases.

[20] The record does not establish the nature of the “Gross receipts or sales” that DKD reported in DKD's 2001 return.

[21] DKD included a schedule with DKD's 2001 return in which DKD indicated that the “Other income” of $226,923 reported consisted of (1) consulting revenue of $223,796 and (2) an Iowa State tax refund of $3,127.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700   MMisselbeck@KNSCPA.com

[22] DKD included a statement with DKD's 2001 return in which it described the “Taxes and licenses” claimed as “payroll taxes”.

[23] The record does not establish the nature of the “Gross receipts or sales” that DKD reported in DKD's 2002 return.

[24] DKD included a schedule with DKD's 2002 return in which DKD indicated that the “Other income” of $198,608 reported consisted of (1) consulting revenue of $197,466 and (2) an Iowa State tax refund of $1,142.

[25] DKD included a statement with DKD's 2002 return in which it described the “Taxes and licenses” claimed as “payroll taxes”.

[26] DKD included a statement with DKD's 2003 return in which it described the “Taxes and licenses” claimed as “payroll taxes”.

[27] The copy of DKD's 2004 return that is in the record is not signed by a return preparer or by an officer of DKD.

[28] The record does not establish whether the $250 that we have found DKD received in 2004 for the sale of certain cats and/or kittens in December of that year was included in the “Gross receipts or sales” of $233,556 that DKD reported in DKD's 2004 return.

[29] DKD included a statement with DKD's 2004 return in which it described the “Taxes and licenses” claimed as “payroll taxes”.

[30] See supra note 19.

[31] The record does not establish whether the $1,525 that we have found DKD received in 2005 for the sale of certain cats and/or kittens, see supra note 17, was included in the “Gross receipts or sales” of $212,970 reported in DKD's 2005 return.

[32] Unlike DKD's 2001 return, 2002 return, 2003 return, and 2004 return, DKD did not include a statement with DKD's 2005 return or otherwise provide a description of the nature of the “Taxes and licenses” of $6,740 claimed in DKD's 2005 return.

[33] We have found that during 2005 DKD reimbursed Ms. Dursky and Ms. Watkins $1,401 for advertising.

[34] Most of the “Other deductions” were for the 2005 reimbursed cattery expenses of $68,329. However, DKD did not claim a deduction for the $8,121 for which we have found DKD reimbursed Ms. Dursky and Ms. Watkins in 2005 for motels.

[35] The record does not establish the nature of the “Gross receipts or sales” reported in DKD's 2006 return.

[36] Unlike DKD's 2001 return, 2002 return, 2003 return, and 2004 return, DKD did not include a statement with DKD's 2006 return or otherwise provide a description of the nature of the “Taxes and licenses” of $6,740 claimed in DKD's 2006 return.

[37] We have found that Ms. Dursky and Ms. Watkins operated DKD's cattery activity until around August 2006.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

[38] As discussed above, in DKD's 2003 return, DKD claimed a deduction for "Rents" of $19,400.

[39] As discussed above, DKD claimed a deduction in DKD's 2004 return for "Rents" of $24,700.

[40] As discussed above, DKD claimed a deduction in DKD's 2005 return for "Rents" of $22,800.

[41] As discussed above, DKD did not claim in DKD's 2004 return a deduction of $20,000 for "Pension, profit-sharing, etc., plans". DKD claimed in DKD's 2004 return a $20,000 deduction for "Dues and subscriptions". The record does not explain how respondent determined that the $20,000 that DKD claimed as a deduction for "Dues and subscriptions" in DKD's 2004 return was a $20,000 deduction for "Pension & Profit Sharing".

[42] See supra note 41.

[43] DKD conceded certain additional amounts that it claimed as deductions relating to DKD's cattery activity in its respective returns for the years at issue.

[44] The CFA is the largest association for owners of cats in the United States.

[45] The title of CFA Distinguished Merit was the highest award that the CFA presented to a breeding pedigreed cat. At the time the CFA awarded the title of CFA Distinguished Merit to each of the two Norwegian Forest cats of Ms. Dursky and Ms. Watkins, fewer than ten Norwegian Forest cats throughout the world had been awarded that title.

[46] During each of the years at issue, DKD used, without purchasing, the assets (e.g., cats, kittens, cat trees, feeding bowls, litter boxes) that Ms. Dursky and Ms. Watkins had used before those years in the cattery activity of Ms. Dursky and Ms. Watkins. Starting sometime in 2004, while Ms. Dursky and Ms. Watkins were operating DKD's cattery activity they began breeding, raising, offering for sale, and showing Abyssinian cats in addition to Norwegian Forest cats.

[47] In DKD's 2003 return, DKD claimed deductions for cattery expenses of $69,515 and for purported salary of $7,700, "Taxes and licenses" of $588, and purported rent of $12,000 relating to DKD's cattery activity. In DKD's 2004 return, DKD claimed deductions for cattery expenses of $75,091 and for purported salary of $7,700, "Taxes and licenses" of $588, and purported rent of $12,000 relating to DKD's cattery activity. In DKD's 2005 return, DKD claimed deductions for cattery expenses of $60,540 and for purported salary of $7,700, "Taxes and licenses" of $588, and purported rent of $12,000 relating to DKD's cattery activity. See supra note 43.

[48] See supra note 14.

[49] Although Ms. Dursky and Ms. Watkins did not discontinue operating DKD's cattery activity until around August 2006, DKD did not claim any deductions relating to DKD's cattery activity in the tax return that it filed for its taxable year 2006.

[50] See supra note 19.

[51] For example, the record does not contain reliable evidence of a business plan for DKD that described specifically what steps Ms. Dursky, DKD's sole stockholder and sole officer, intended to take during the years at issue in an

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

attempt to increase significantly revenues and/or to reduce significantly expenses in order to generate a profit for DKD from DKD's cattery activity.

[52] Petitioners do not dispute that for each of the years at issue DKD had earnings and profits that were at least equal to the amount of constructive dividends that we have found Ms. Dursky has for each of those years.

[53] Even if the premise on which Ms. Dursky advances her alternative position were valid, on the record before us, we would nonetheless reject that position. If that premise were valid, on the record before us, we would find under sec. 183 and the regulations thereunder that for each of the years at issue Ms. Dursky is not entitled to deduct the amounts that DKD is claiming as deductions for each of those years with respect to DKD's cattery activity and that we have disallowed.

[54] Although respondent determined that Ms. Dursky does not have rental income for each of the years at issue attributable to the purported rent that DKD is claiming as a deduction for each of those years and that we have disallowed, we have held that for each of the years at issue Ms. Dursky is required to include in gross income as constructive dividends that disallowed purported rent.

[55] Respondent determined that for each of the years at issue Ms. Dursky is entitled to deduct in Schedule A the respective amounts of mortgage interest and real estate tax that she paid and that she claimed in Schedule E for each of those years and that we have disallowed.

[56] Respondent determined in DKD's 2004 and 2005 notice that DKD is a qualified personal service corporation for each of the years 2004 and 2005. Respondent did not make any such determination in DKD's 2003 notice. Respondent argues on brief that DKD also is a qualified personal service corporation for 2003. Therefore, respondent has the burden of establishing that DKD is a qualified personal service corporation for 2003.

[57] We have found that during each of the years at issue Ms. Watkins spent more hours than Ms. Dursky operating DKD's cattery activity. We have not found the precise number of hours that Ms. Watkins spent during each of those years operating that activity because we are unwilling to rely on her testimony in that respect.

[58] In DKD's 2003 return, DKD claimed a deduction for the $10,000 contribution under the DKD Fidelity profit-sharing plan that it is claiming here. In DKD's 2004 return, DKD did not claim a deduction of $20,000 for contributions under that plan. It did, however, claim in that return a $20,000 deduction for “Dues and subscriptions”. Respondent determined that the $20,000 that DKD claimed in DKD's 2004 return for “Dues and subscriptions” was a $20,000 deduction claimed for contributions under the DKD Fidelity profit-sharing plan. The record does not explain how respondent made that determination, see supra note 41, but DKD does not dispute it. In DKD's 2005 return, DKD did not claim a deduction for a $5,000 contribution under the DKD Fidelity profit-sharing plan. DKD claims for the first time here a deduction for 2005 for a $5,000 contribution that it made under the DKD Fidelity profit-sharing plan by sending a $5,000 check to Fidelity on Apr. 10, 2006. Thus, DKD has the burden of proof with respect to that claimed deduction for 2005.

[59] For each of the years at issue, DKD issued Form W-2 to Ms. Watkins, in which it reported that it paid her wages of $7,700. For each of those years, Ms. Watkins filed Form 1040, in which she included in gross income the $7,700 that she had received from DKD during each such year.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700   MMisselbeck@KNSCPA.com

[60] In the light of our holding, we need not address respondent's alternative argument that if the DKD Fidelity profit-sharing plan were to constitute a qualified profit-sharing plan under sec. 401(a), DKD would be entitled to deduct for each year at issue only the contributions that it made under that plan during each such year.

[61] See supra notes 52 and 58.

[62] In petitioners' opening brief, petitioners state that DKD paid in 2003 and 2004, respectively, and is entitled to deduct for those years the respective premiums of $6,950 and $7,651 on Ms. Dursky's health insurance policy. In petitioners' reply brief, petitioners claim that, in addition to those claimed respective deductions for 2003 and 2004, it is entitled to deduct for 2005 $7,651 of health insurance premiums that it paid in that year on Ms. Dursky's health insurance policy. We have found that during 2003 and 2004 DKD paid premiums on Ms. Dursky's health insurance policy totaling $6,950.10 and $7,651.50, respectively. We have not found that DKD paid any premiums on that policy during 2005.

[63] In petitioners' reply brief, petitioners argue that respondent conceded in respondent's opening brief that DKD is entitled to deduct for the years at issue any respective premiums that it paid on Ms. Dursky's health insurance policy. We disagree. Although respondent did not offer any reason in respondent's opening brief in support of respondent's position that DKD is not entitled to deduct those premiums, we conclude that respondent did not concede that issue in that brief. Respondent explained in respondent's reply brief, which we quote in pertinent part in the text, why respondent believes that DKD is not entitled to deduct for each of the years at issue any premiums that it paid on Ms. Dursky's health insurance policy.

[64] See supra note 62.

Document Header: Checkpoint Contents Federal Library Federal Editorial Materials Federal Taxes Weekly Alert Newsletter 2011 02/17/2011 - Volume 57, No. 7 In Brief Code Sec. 162 Business deductions—ins. expenses—individual policy—solely owned corps.—accident or health plans—income exclusions. (02/17/2011) © 2011 Thomson Reuters/RIA. All rights reserved

Shareholder-employees taxable on life insurance policies with surrender charges exceeding stated value - Michael Schwab and Kathryn Kleinman, 136 TC No. 6

In a case dealing with novel facts of taxpayers who received life insurance policies from a nonqualified employee-benefit plan that had surrender charges in excess of their stated values, the Tax Court held that they should have reported the distributions on their joint return. However, disagreeing with IRS, the Tax Court held on the facts that only a negligible amount was reportable in income as a result of the distribution of the policies.

Background. Benistar Plans are purported multiple-employer welfare benefit trusts under Code Sec. 419(f)(6) that were promoted ostensibly to provide preretirement life insurance to covered employees with corporate employers getting deductions for the contributions. However, IRS views them as an attempt to funnel pre-tax profits out to shareholders and their spouses.

Under the Code Sec. 402(b)(2) rules that apply to nonqualified plans, the “amount actually distributed or made available” to any distributee by any trust is taxable to him in the tax year in which so distributed or made available under the Code Sec. 72 rules.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700   MMisselbeck@KNSCPA.com

Facts. Michael Schwab and Kathryn Kleinman, husband and wife, were the owner-employees of a successful graphics enterprise called Angels & Cowboys, Inc. In 2000, their accountant pitched to them a Benistar-type nonqualified employee benefit plan that purportedly enabled them to obtain life insurance on a tax-deductible basis. They adopted such a plan in 2001, but in light of IRS's opposition to Benistar Plans, including designating such plans listed transactions, the plans, including the one adopted by Angels & Cowboys, were terminated in 2003. The plan then distributed the life insurance policies to Schwab and Kleinman in October 2003. At the time of distribution, Schwab's policy had a “policy value” of $48,667, and Kleinman's had one of $32,576. “Policy value” was defined as premiums less policy loads, plus net investment return, less policy charges, partial surrenders, and any indebtedness.

Schwab and Kleinman had two options upon distribution: continue paying premiums to keep their life insurance coverage, or surrender the policies for their value less any surrender charges. The problem was that the expected premiums for Schwab and Kleinman on their variable universal-life policies were quite steep. For Schwab, the premium was originally more than $136,000 a year; for Kleinman, it was $120,000. Angels & Cowboys paid the premiums only for the policies' first year, but the policies nevertheless remained in effect pursuant to a “no-lapse provision.”

Schwab's “no-lapse” premium was set at $3,548.77. This meant that the policy wouldn't lapse for the first three years, even if no more premiums were paid, so long as the initial premium payment of $136,000 remained greater than $3,548.77 x N (where N = the number of months the policy had been in effect) or the net cash-surrender value remained greater than zero. Kleinman's “no-lapse” premium was $3,776.69. With the initial premium payment of only $120,000, the net cash-surrender value of her policy would have to exceed zero after only 31 months to avoid a lapse or incur an obligation to pay more premiums. When in 2002 Schwab and Kleinman elected to reduce the coverage, those scheduled premiums shrank, but in both cases to more than $22,000 a year. The “no-lapse” premiums shrank as well: Schwab's to $2,498.31; and Kleinman's to $2,510.34.

The policies' surrender charges were greater than their stated policy values in October 2003, meaning Schwab and Kleinman wouldn't get any cash if they immediately surrendered their policies upon receipt. For Schwab, at distribution, the stated policy value was $48,667, and the surrender charges were $49,225, with a negative net cash surrender value of $558. For Kleinman, the stated policy value was $32,576, and the surrender charges were $46,559, with a negative net cash surrender value of $14,043. Schwab continued to hold his policy and pay his premiums at least until the trial before the Tax Court. Kleinman's policy was so deeply under water that she let it lapse shortly after distribution by not paying the required $108,031 premium. She didn't get any money from the insurance company because her policy's net cash surrender value was negative.

Schwab and Kleinman didn't report any income in 2003 from the distribution of the policies. However, IRS issued a notice of deficiency asserting increases in tax and penalties for Schwab's and Kleinman's failure to include the stated policy values as income. IRS claimed the amount actually distributed was $81,243, the total stated policy value of Schwab's and Kleinman's policies.

Solomonic decision. The Tax Court said that Schwab and Kleinman should have reported income on their 2003 returns as a result of the distribution of the policies, but held on the facts that this income was a negligible amount.

In the absence of regulatory guidance on the situation at hand, the Tax Court held that the term “amount actually distributed” for Code Sec. 402(b)(2) purposes meant the fair market value (FMV) of what was actually distributed. That left the difficult question of how to measure the FMV of the Schwab-Kleinman policies, which were tied to the fluctuations of a broad stock market index and required years more of steep premium payments.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

The Tax Court said it was not persuaded that, at the time of distribution to Schwab and Kleinman, the policies had significant value apart from the small amount of the insurance coverage that was attributable to the single premium that Angels & Cowboys had paid on each policy some three years earlier. After distribution, the premiums covered Schwab for up to 54 days, and Kleinman for 24 days—in Schwab's case, until he paid a premium to keep the policy going, and in Kleinman's, until her policy lapsed. By applying the base rates for the guaranteed maximum monthly cost of insurance rates ($.446 for Schwab, $.4043 for Kleinman) to the days covered, the Tax Court attributed the following amounts: to Schwab, $1,900.33; to Kleinman, $765.62, for a total of $2,665.95. Schwab and Kleinman had a zero basis for the amounts invested in their contracts and, as a result, $2,665.95 was the amount "actually distributed" under Code Sec. 402(b) and therefore includable in their income under Code Sec. 72.

References: For the tax consequence of distributions from a nonqualified trust, see FTC 2d/FIN ¶ H-3246; United States Tax Reporter ¶ 4024.01; TaxDesk ¶ 135,532; TG ¶ 7159.

Tax Court & Board of Tax Appeals Reported Decisions - Michael P. Schwab, et ux. v. Commissioner, 136 TC 120, Code Sec(s) 401; 72.

MICHAEL P. SCHWAB AND KATHRYN J. KLEINMAN, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

Code Sec(s): 401; 72

Docket: Dkt. No. 10525-07.

Date Issued: 02/7/2011

Judge: Opinion by Holmes, *J.*

Tax Year(s): Year 200 **Disposition:** Decision for Taxpayers in part and for Commissioner in part.

HEADNOTE

1. Taxation of employee plan distributions—nonqualified plans—amount actually distributed—life ins. policies— policy value; FMV; computations. Tax Court redetermined tax consequences, to corp.'s married shareholders-employees, of nonqualified terminated employee plan distributions of variable universal life ins. policies that had surrender charges in excess of stated policy values and whose "no lapse premiums" were paid by corp. only for initial year. Court agreed with IRS that distributions were taxable and had to be reported, but disagreed with IRS's position that amount "actually distributed" under Code Sec. 402(b) equaled total policy value, and instead found that amount actually distributed was distribution date FMV, which in turn Court computed to be far less than amount IRS determined after taking into account surrender charges and considering among other things evidence that policies didn't have significant value at distribution apart from small amount of remaining ins. coverage attributable to single premium which corp. had paid in 1st year.

Reference(s): ¶ 4025.01(20) Code Sec. 401 ; Code Sec. 72

2. Accuracy-related penalties for substantial underpayment or negligence— basis for penalty. Accuracy-related penalties for substantial underpayment or negligence weren't upheld against corp.'s married shareholders-employees despite underpayment from unreported life ins. policy distributions from nonqualified terminated employee plan: taking into account Tax Court's

redetermination of taxable amount, which was far less than amount IRS determined, taxpayers' understatement didn't rise to level of substantial under Code Sec. 6662 ; and record otherwise showed that they made reasonable attempt to comply with tax laws and weren't careless, reckless or intentionally disregarding rules and regs.

Reference(s): ¶ 66,625.01(3); ¶ 66,625.01(20); Code Sec. 6662

Syllabus

Official Tax Court Syllabus

Ps received life-insurance policies from a nonqualified employee-benefit plan that had surrender charges in excess of their stated values. Ps did not report the distributions on their joint return. R issued a notice of deficiency based on the unreported stated policy values. *Held* : Pursuant to sec. 402(b), I.R.C., Ps must include in income the fair market value of each of these insurance policies as of the date of distribution. *Held*, *further*, on the facts of this case, the fair market values of these insurance policies properly reflect surrender charges and other conditions imposed on Ps by the insurance company and includes paid-up insurance coverage remaining on the policies as of the date of distribution.

Counsel

Jay Weill, for petitioners.

Brian E. Derdowski, Jr., and Brian Bilheimer, for respondent.

HOLMES, *Judge*

OPINION

When a company winds up an employee-benefit plan and distributes its assets, section 402(b) [1] says an employee receiving his share of those assets has to pay tax on “the amount actually distributed.” Michael Schwab and his wife Kathryn Kleinman both received life-insurance policies as their share of an employee-benefit plan that was ending. They argue that surrender charges on both the policies made them worth nothing at the time of their receipt. The Commissioner argues that we must consider only what the insurance company calculated to be the policies' “stated values” in figuring out what the “amount actually received” by Schwab and Kleinman was. The dispute is a novel one.

Background

Schwab and Kleinman are the sole shareholders of Angels & Cowboys, Inc. [2] They are also employees of the corporation; Schwab works as a graphic designer and Kleinman as a photographer. Schwab has created award-winning logos and posters for clients that include Major League Baseball, the Muhammad Ali Center, Nike, Pebble Beach, Polo Ralph Lauren, Robert Redford, and the San Francisco Opera. One collector described Schwab's work: “Like a clearing in a dark, unfathomable forest, or an island in a turbulent sea, the graphic art of Michael Schwab is a welcome sight, a safe harbor, amidst the enigmatic and increasingly illegible pool of contemporary art and design.” Merrill C. Berman, *Michael Schwab Studio—About Michael*, Michael Schwab Studio, http:// www.michaelschwab.com/studio/studio_about.html (last visited Jan. 1, 2011). Kleinman is also highly talented and has done photography for such high-profile clients as Apple Computer, the GAP, Microsoft, and Wolfgang Puck Foods. *Studio-Clients*, Kathryn Kleinman Studio, http://www.kathrynkleinman.com/html/studio_clients.html (last visited Jan. 1, 2011).

Accountants follow success, and George Stameroff, a Marin County CPA, was the couple's accountant until 2001. He prepared Schwab and Kleinman's tax returns throughout the '90s and also gave them financial-planning advice. In 2000, he recommended

that the couple buy life-insurance policies through a multiple-employer welfare-benefit trust administered by Benistar. The trust was an employee-benefit plan known as the "Advantage 419 Trust," because it was designed to conform with section 419A(f)(6). [3] Benistar was aimed at small-business owners and was the nation's largest administrator of such plans. Stameroff gave Schwab and Kleinman the Benistar marketing brochures that claimed the plan allowed "qualified professionals, entrepreneurs, and closely-held business owners to obtain life insurance for themselves and for key employees on a tax-deductible basis." These promotional materials emphasized that the plan assets (invested, in Schwab and Kleinman's case, in an S&P 500 stock-index fund) would grow tax-free and that the death benefits would be income-tax free. According to Stameroff and the Benistar marketing materials, if the plan were terminated, the policies would be distributed to the participants and their value net of surrender charges would be taxable.

Schwab and Kleinman liked what Stameroff had to say about the Advantage 419 Trust and decided to adopt it. But their relationship with Stameroff would soon come to an end. They found out that he was an authorized agent of Benistar and decided to look for another accountant because Schwab felt they "didn't have a clear rapport with him." In 2001, Sander Stadtler replaced Stameroff as the couple's CPA. Stadtler consulted with the couple regarding tax-return preparation and other financial matters. Part of his consultation included an extensive review of the Advantage 419 Trust. He asked Stameroff several questions about the plan to "better understand the various costs and charges in the plan, required contributions, and projected results." On Stadtler's recommendation, in 2002 Schwab and Kleinman reduced their death benefits from $5.5 million to $2.4 million. Stadtler also opined that if the couple terminated the plan they would be taxed on the net cash-surrender value of the life-insurance policies.

All seemed well. But roiling in the background was the IRS's view, which it had held since at least 1995, that most trust arrangements promoted as multiple-employer welfare-benefit funds "do not satisfy the requirements of the section 419A(f)(6) exemption." Notice 95-34, 1995-1 C.B. 309, 310. In Booth v. Commissioner, 108 T.C. 524 (1997), the Commissioner successfully challenged a plan's reliance on section 419A(f)(6) by showing that it was really a series of single-employer plans rather than a true multiple-employer plan. In spite of Notice 95-34 and the Commissioner's litigation success, most taxpayers continued to take the position that their 419 plans were allowable under the Code. The Commissioner raised the stakes in 2000 by designating 419 plans described in Notice 95-34 as "listed transactions." Notice 2000-15, 2000-1 C.B. 826. [4] Taxpayers are required to disclose listed transactions on their returns, and promoters of such transactions have to register them with the IRS. But many taxpayers took the position that their particular plans weren't described in Notice 95-34 and so were not "listed transactions." The IRS then issued proposed regulations on section 419A(f)(6) plans in 2002, sec. 1.419A(f)(6)-1, Proposed Income Tax Regs., 67 Fed. Reg. 45938 (July 11, 2002), that more or less tracked its litigation position.

The proposed regulations caught the attention of BISYS, the plan's new administrator, who hired outside counsel in 2002 to assess the situation. BISYS eventually concluded that the Advantage 419 Trust would not be able to comply with the proposed regulations. By 2003 it became clear that the Treasury Department would adopt the regulations substantially as proposed; BISYS terminated the plan for all employers, including Angels & Cowboys. The plan then distributed the life-insurance policies to Schwab and Kleinman in October 2003. At the time of distribution, Schwab's policy had a "policy value" of $48,667 and Kleinman's had one of $32,576. "Policy value" is an important term in this case, and it's defined in the plan documents as "premiums less policy loads, plus net investment return, less policy charges, partial surrenders, and any indebtedness." Schwab and Kleinman had two options upon distribution—continue paying premiums to keep their life-insurance coverage, or surrender the policies for their value less any surrender charges.

But there was a catch. The policies were of a type called variable universal life, a relatively new type of contract for this old industry. A key characteristic of universal life-insurance policies is that they disconnect to some degree a life-insurance feature (i.e., payment of money upon death) from an investment feature (i.e., the use of premiums to acquire assets that fund the insurance payment). The insurer selling a universal-life policy typically segregates payments from its customers in separate investment accounts from which it makes deductions to pay for the insurance component of the policy. At death, the customer's beneficiary gets what's left in the separate account. Under a *variable* universal life-insurance contract, the customer typically can choose from a menu of different investments (often set up to closely resemble mutual funds) with varying returns and thus varying payouts upon death, though there is (as was true under the contracts here) a minimum death-benefit guaranty.

The expected premiums for Schwab and Kleinman on their variable universal-life policies were quite steep. For Schwab, the premium was originally more than $136,000 a year; for Kleinman, it was $120,000. In some of the illustrations that the insurance company used, Angels & Cowboys would be paying such premiums for decades; in some, the firm would pay premiums for only ten years. But we find that the firm paid the premiums only for the policies' first year. [5] The policies nevertheless remained in effect pursuant to a "no-lapse provision." This provision states: [6]

During the first 3 policy years if the sum of all premiums paid on this policy *** is greater than the no lapse premium multiplied by the number of months the policy has been in force, the policy is guaranteed not to lapse even if the net cash surrender value is zero or

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

less. If less than the no-lapse premium is paid during the first 3 policy years, the policy will not necessarily lapse provided the net cash surrender value is greater than zero.

Schwab's "no-lapse" premium was set at $3,548.77. This meant that the policy wouldn't lapse for the first three years— even if no more premiums were paid—so long as the initial premium payment of $136,000 remained greater than $3,548.77 x N (where N = the number of months the policy had been in effect) or the net cash-surrender value remained greater than zero. [7] Kleinman's "no-lapse" premium was $3,776.69. With the initial premium payment of only $120,000, the net cash-surrender value of her policy would have to exceed zero after only 31 months to avoid a lapse or incur an obligation to pay more premiums.

When in 2002 Schwab and Kleinman elected to reduce the coverage, those scheduled premiums shrank as well, but in both cases to more than $22,000 a year. The "no-lapse" premiums shrank as well: Schwab's to $2,498.31; and Kleinman's to $2,510.34. [8] One thing did not change: Both Schwab and Kleinman had directed that their premium payments be segregated into accounts whose value fluctuated with the S&P 500 stock index. The death benefit and cash-surrender value depend on those fluctuations in investment returns. [9] And the policies' surrender charges were greater than their stated policy values in October 2003, meaning Schwab and Kleinman wouldn't get any cash if they immediately surrendered their policies upon receipt. Here's how the numbers looked at distribution:

	Schwab	Kleinman
Stated policy value	$48,667	$32,576
Surrender charges	49,225	46,599
Net cash-surrender value	(558)	(14,023)

The surrender charges lasted eleven years and would be reduced by 20 percent a year only in years 8-12 (starting in 2008). But if the S&P 500 were to go up or if further premiums were paid, the policy values would increase as well. Schwab's policy seemed more worthwhile—it could potentially be in the black in a matter of weeks. And by December 2, 2003, when Schwab asked to surrender his policy, he was ahead by approximately $1,100. But he then changed his mind and contacted the insurance company in mid-December to reverse his termination request. The value of the policy net of surrender charges increased in the interim, reaching $1,630 by December 16. Schwab continued to hold the policy and pay his premiums at least until the trial.

Kleinman's policy was so deeply under water that she let it lapse shortly after distribution by not paying the required $108,031 premium. [10] She didn't get any money from the insurance company because her policy's net cash-surrender value was negative.

BISYS did not issue any 1099 forms after it distributed the policies, so when Stadtler prepared the couple's 2003 return, he did not report any income from their distribution. We find that in taking this position the couple was also relying on Stammer-off's, the plan administrator's, and Stadtler's 2001 conclusion that they would be taxed only to the extent of the net cash-surrender value. Schwab provided all the materials that Stadtler asked for and answered all of his questions in the course of pre-paring the return. (Though we do find that he did not specifically ask Stadtler about the tax consequences of the distributions.) The Commissioner issued a notice of deficiency asserting increases in tax and penalties for Schwab and Kleinman's failure to include the stated policy values as income. They timely petitioned the Tax Court as residents of California. We tried the case in San Francisco.

Discussion

This case is about the rules for taxability of property distributed after the termination of employee-benefit plans. Such plans come in "qualified" and "nonqualified" varieties. Qualified plans must meet the requirements of section 401, and all the complicated regulations governing their funding, nondiscriminatory terms, employee coverage, distribution, and other requirements. Meeting such requirements allows for favorable tax treatment of qualified plans, but not all plans can comply; hence the existence of nonqualified plans. Nonqualified plans are generally subject to fewer statutory and regulatory requirements, but they also receive less favorable tax treatment. The rules for taxing distributions from qualified and nonqualified plans differ as well. Section 402(a) governs distributions from qualified plans, and section 402(b) governs distributions from nonqualified plans.

2011 Regional Forums

Employee Benefits & Employment Taxes

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

I. *Determining the Amount Actually Distributed*

The Advantage 419 Trust was a nonqualified plan, so we apply section 402(b)(2). That section reads:

The *amount actually distributed*or made available to any distributee by any trust described in paragraph (1) shall be taxable to the distributee, in the taxable year in which so distributed or made available, under section 72 (relating to annuities) *** [Emphasis added.]

But what amount was “actually distributed” when BISYS transferred he life-insurance policies to Schwab and Kleinman? The commissioner claims $81,243—their total stated policy value. Schwab and Kleinman see things differently and claim that nothing of value was “actually distributed.” They rely first and most insistently on the plain language of the Code. The words “amount actually distributed” appeared in the Code as far back as 1921 in section 219(f), Revenue Act of 1921, ch. 136, sec. 219(f), 42 Stat. 227, 247, which became section 165 in 1928, Revenue Act of 1928, ch. 852, sec. 165, 45 Stat. 791, 839. [11] Schwab and Kleinman point out that the committee reports for both the 1928 and 1932 Acts don't address taxing the stated value of an insurance policy. [12] See S. Rep. No. 72-665, sec. 165 (1932), reprinted in 1939-1 C.B. (Part 2) 496, 520; H.R. Rep. No. 70-2, sec. 165 (1927), reprinted in 1939-1 C.B. (Part 2) 384, 398-99.

Finding no esoteric meaning in the legislative history, Schwab and Kleinman point us to the dictionary, which defines “actually” as “in fact; in reality.” American Heritage Dictionary 18 (4th ed. 2000). Because they are cash-basis tax-payers, Schwab and Kleinman argue they would have to actually or constructively receive income before they would incur any tax liability. See sec. 1.451-1(a), Income Tax Regs.; see also *United States v. George*, 420 F.3d 991, 996 [96 AFTR 2d 2005-5818] (9th Cir. 2005). There's no actual receipt here, and no constructive receipt because no income was credited and made available to them without restriction: In the words of the regulation, Schwab and Kleinman could not “draw upon it at any time,” and their control of the policy's value (if “control” is the right word) was “subject to substantial limitations or restrictions.” Sec. 1.451-2(a), Income Tax Regs. The stated policy values, they argue, had no cash equivalence or economic value upon distribution. Schwab and Kleinman admit that the insurance policies that they got showed “policy values,” but reasonably point out that that “value” is not what they could actually have gotten in hand at the time of distribution. They conclude, therefore, that they received something that had “no economic, monetary or cash surrender value.”

The Commissioner's argument is not nearly as straightforward. He begins with the incontestably true observation that there is no regulation or caselaw directly on point. He then argues that:

- The insurance policies should be treated as if they were annuities;
- treating them as if they were annuities means including in Schwab and Kleinman's income their “entire value;” and
- “entire value” does not include any surrender charges.

The first problem is that section 402(b)(2) says that the “amount actually distributed *** shall be taxable to the distributee *** under section 72 (relating to annuities).” This does not mean that any “amount actually distributed” *is* an annuity, but only that the taxability of whatever amount was “actually distributed” has to be computed by using section 72's rules on recovery of the taxpayer's investment in the contract. The Commissioner nevertheless points to section 1.402(b)-1(c)(1), Income Tax Regs. Like the Code, that regulation includes the phrase “actually distributed,” but it continues with an example of the distribution of an annuity contract:

If, for example, the distribution from such a trust consists of an annuity contract, the amount of the distribution shall be considered to be the entire value of the contract at the time of distribution. ***

Id. This tells us something: When an annuity contract is distributed, it's the “entire value” of the contract that is taxable under the rules governing the taxation of annuities.

And the Commissioner's argument rests in a subtle way on extending the regulation's command that an annuity contract's “entire value” is the “amount actually distributed” to the valuation of life-insurance policies like Schwab's and Kleinman's.

The Commissioner's shifting of our focus to the meaning of the phrase “entire value”—remember, a term taken from an example in the regulation about the valuation of an annuity contract—and away from the phrase “amount actually distributed” aims to take advantage of a regulation that defines “entire value” in a somewhat unusual way. That regulation, section 1.402(b)-1(b)(2)(i), Income

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Tax Regs., provides that the “entire value” does not take into account what the regulations call a “lapse restriction.” The Commissioner then continues his argument by asserting that surrender charges on a life-insurance policy are a type of lapse restriction, an argument he recently won in *Cadwell v. Commissioner*, 136 T.C. ___ (2011). In *Cadwell*, we disregarded surrender charges after looking to Revenue Procedure 2005-95's safe-harbor definition of fair market value for a formula to apply in default of the taxpayer's failure to offer any reason we shouldn't. Id. at ___ (slip op. at 35-36).

That revenue procedure became effective only after the distributions here. And looking to the regulation the Commissioner points us toward, section 1.402(b)-1(b)(2)(i), Income Tax Regs., we see that it uses the word “value” and provides that

The net fair market value of all the assets in the trust is the total amount of the fair market values (determined *without regard to any lapse restriction*, as defined in § 1.83-3(h)) of all the assets in the trust, less the amount of all the liabilities (including taxes) to which such assets are subject or which the trust has assumed *** as of the date on which some or all of the employee's interest in the trust becomes substantially vested. [Emphasis added.]

The thing to notice about the Commissioner's argument on this point is that it is based on language in the part of the regulation governing the valuation of an employee's rights to assets still held in trust at the time those rights become vested. But Schwab's and Kleinman's policies were distributed--they were not still held in trust. The relevant regulation for this situation is not section 1.402(b)-1(b), but section 1.402(b)-1(c), Income Tax Regs., which doesn't even mention “lapse restrictions.”

That leaves us back where we started— trying to find the meaning of the phrase “amount actually distributed.” Schwab and Kleinman point us to regulatory language for qualified plans, telling us that the taxable value of an insurance contract “actually distributed” to a plan's participant is its “policy cash value.” Sec. 1.402(a)-1(a)(1)(iii), Income Tax Regs. (Remember that the Schwab-Kleinman distribution was from a *nonqualified* plan— like the Commissioner they're also pointing to a facially inapplicable regulation and arguing by analogy.)

That's not quite right—it's not just the “policy cash value” but “all other rights under such contract” that count toward fair market value. They do argue by analogy, however, that we should take surrender charges into account here because on this point there is no reason the distribution of a life-insurance contract from a qualified plan should be treated differently from a nonqualified distribution. But there's a problem with the cited regulation--it's effective as of August 29, 2005. The prior version of the regulation--which would have applied to distributions from qualified plans at the time Schwab and Kleinman received their distribution—makes no reference to “policy cash value.” Instead, it provided that the “entire cash value” of a life-insurance contract distributed from a qualified plan is taxable. Sec. 1.402(a)-1(a)(2), Income Tax Regs. And in a development that Schwab and Kleinman couldn't foresee, we recently construed *that* language to mean something different from “fair market value.” See Matthies v. Commissioner, 134 T.C. 141, 150-51 (2010) (construing pre-2005 regulations under section 402(a) as requiring that the “entire cash value” of life insurance policies be determined without regard to surrender charges).

This difference in the regulations may seem odd—both section 402(a) and 402(b) contain the phrase “amount actually distributed,” yet the regulations interpreting each subsection differed before 2005 and continue to differ today. We must apply them as written. In the absence of regulatory guidance, we hold that the “amount actually distributed” means the fair market value of what was actually distributed. One textual clue in the regulation itself that supports this is in the illustration of an annuity contract that is distributed. Section 1.402(a)-1(a)(2) used to say that, in such a case, it's the “entire cash value of such contract at the time of distribution” that is included in income; section 1.402(b)-1(c) says that, if a nonqualified plan distributes an annuity contract, the value of the distribution is the contract's “entire value.” In Matthies, we suggested that this latter phrase—“entire value”—“might plausibly be construed as synonymous with 'fair market value” and represented “a generalized valuation standard.” *Matthies*, 134 T.C. at 150-51.

But the fair market value of insurance contracts can be a slippery concept, and is not necessarily synonymous with net cash-surrender value. Consider, for instance, the case of a taxpayer who buys a single-premium life-insurance contract and immediately gives it to her children. The purchase price obviously represents one good measure of its value but, as is true of many life-insurance contracts, the surrender charges that would apply for a number of years would make the net cash-surrender value less than the purchase price. The Supreme Court analyzed the problem:

Surrender of a policy represents only one of the rights of the insured or beneficiary. Plainly that right is one of the substantial legal incidents of ownership. But the owner of a fully paid life insurance policy has more than the mere right to surrender it; he has the right to retain it for its investment virtues and to receive the face amount of the policy upon the insured's death. That these latter rights are deemed by purchasers of insurance to have substantial value is clear from the difference between the cost of a single-premium policy and its immediate or early cash-surrender value ***

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Guggenheim v. Rasquin, 312 U.S. 254, 257 [25 AFTR 1166] (1941) (citations omitted). In *Guggenheim*, the Court held that the time between purchase and gift was short enough that "cost is cogent evidence of value" and so it was the purchase price of the insurance policy that was the best measure of its value. Id. at 257-58.

But in another case that same term, the Court also held that a paid-up policy that had been in effect for a much longer time—five years—had a value best measured by the cost of a replacement policy on the then-current age of the insured. Un*ited States v. Ryerson*, 312 U.S. 260, 261 [25 AFTR 1164] (1941). In the case of single-premium policies, we summarized the state of the law sixty years ago:

The cash surrender value is the market value only of a surrendered policy and to maintain that it represents the true value of the policy is to confuse its forced liquidation value at an arbitrary figure with the amount realizable in an assumed market where such policies are frequently bought and sold. ***

The rule is, then, that the fair market value of a single premium life insurance policy for the purpose of determining taxable gain derived from exchange of insurance policies is the same price that any person of the same age, sex, and condition of health as the insured, would have to pay for a life policy with the same insurance company on the date the exchange took place. ***

Parsons v. Commissioner, 16 T.C. 256, 262 (1951).

But this caselaw all involves paid-up policies. The Schwab-Kleinman policies were not paid up, but instead required years more of steep premium payments. And substantial parts of their values were tied to the fluctuations of a broad stock-market index. How should a court measure their fair market values? At least in the context of the gift tax, [13] the regulations offer some guidance. For life-insurance policies that have "been in force for some time and on which further premium payments are to be made," the insurer's policy reserves are used to approximate the value. [14] Section 25.2512-6(a), Gift Tax Regs. But this method is not permitted when "the unusual nature of the contract" results in a valuation "not reasonably close to the full value." Id. And the IRS, in Notice 89-25, 1989-1 C.B. 662, modified by Notice 98-49, 1998-2 C.B. 365, and Rev. Rul. 2002-62, 2002-2 C.B. 710 took the position that in the case of distributions from a qualified plan (which, remember, the distribution here was not), taxpayers could use the "stated cash surrender value" unless total policy reserves were "a much more accurate approximation of the fair market value of the policy." Id. Q&A-10, 1989-1 C.B. at 665.

Lacking evidence of the insurer's policy reserves, [15] we begin our look for the fair market value of each policy with what the insurer called its stated policy value, which was $48,667 for Schwab and $32,576 for Kleinman. But, unlike a traditional life-insurance policy's value (which only grows over time), these policy values fluctuated with the stock market. They look more like the net asset value of a mutual fund (with the obvious difference that a mutual fund investment does not provide a death benefit), and the surrender charges look very much like a back-end load. Just as we wouldn't ignore such charges in calculating the value of shares, [16] we don't ignore them here.

The policies had been in effect for three years before distribution, meaning that in eight years the surrender charges would expire. During that time, with the ups and down of the stock market, the stated values of the policies could rise or fall.

The relevant point in time for our analysis is the time of distribution. The policies here were flexible-premium policies— that's one of the reasons why not paying any but the first year's premium didn't end the policy in year two. But by the end of year three—when Angels & Cowboys distributed the policies to Schwab and Kleinman—the "no-lapse" premium period had expired and the fall in the broad stock market meant that they had no positive net cash-surrender value. As the Commissioner admits in his brief, flexible-premium policies like these generally "will not lapse if premiums are paid such that the net cash surrender value remains greater than zero."

But the net cash-surrender values here were less than zero. And because the parties fought mostly about whether surrender charges could be considered at all, they introduced little evidence specifically directed at establishing the fair market values for the policies. What we had was the policies' stated values, the amount of premiums to be paid and the amount of any surrender charges, the terms of the contracts to the extent the parties introduced evidence about them, and the observed behavior of the taxpayers (e.g., the lapse of Kleinman's policy and the greatly reduced coverage for Schwab for which he picked up the premiums himself). The variety of insurance policies is too great to adopt as a general rule either the Commissioner's simple proposition that surrender charges should never count, or Schwab and Kleinman's that such charges should always count, in determining a policy's value. The particular facts of this case feature neither the dramatically springing cash value described in Notice 89-25, Q&A-10, 1989-1 C.B. at 665, nor the ability to use the distributed policy as consideration for a new policy without regard to surrender charges.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

The Commissioner proposes that we find as fact that the Schwab-Kleinman policies had value in addition to surrender value because “accumulated cash value can be used to pay costs relating to maintaining the policies in force, can be borrowed against, or can be obtained in exchange for surrendering the policy, as the policy owner may choose.” But the evidence does not convince us that such options were available to Schwab and Kleinman under the policies so long as the policies had negative net cash-surrender value, as they did on the date of distribution. Cf. *Matthies*, 134 T.C. at 152 (holding that the insurer's acceptance of the stated account value of a life insurance policy as payment in full of a single premium due on a replacement policy supported the conclusion that the entire cash value of the exchanged policy should be determined without regard to surrender charges).

On this record we are not persuaded that at the time of distribution to Schwab and Kleinman the policies had significant value apart from the small amount of the insurance coverage that was attributable to the single premium that Angels & Cowboys had paid on each policy some three years earlier. Though the value is small, the calculation is daunting because of ambiguity in the record, and we make only a tentative effort to ascertain exact figures. [17] After distribution, the premiums covered Schwab for up to 54 days [18] and Kleinman for 24 days [19] —in Schwab's case, until he paid a premium to keep the policy going, and in Kleinman's, until her policy lapsed. By applying the base rates for the guaranteed maximum monthly cost of insurance rates ($.446 for Schwab, $.4043 for Kleinman) [20] to the days covered, we attribute the following amounts: to Schwab, $1,900.33; to Kleinman, $765.62—a total of $2,665.95. [21] Section 72 generally treats as taxable the amount distributed less any amount allocable to a taxpayer's investment in the contract—and for Schwab and Kleinman, whose corporation had paid the premiums without including them in their income, the amounts invested in their contracts were zero. We therefore conclude that $2,665.95 is the “amount actually distributed” under section 402(b) and therefore included in taxable income under section 72.

II. *Penalties*

The Commissioner wants us to impose section 6662(a)'s 20-percent penalty on Schwab and Kleinman's understatement of tax, either because it's a substantial underpayment—in this case, more than $5,000 [22] —or because it arose from their negligence or disregard of rules or regulations. See sec. 6662(b)(1) and (2).

But the Commissioner miscalculated. Our tentative calculations is that the understatement of *income* is less than $5,000. It's clear that although the parties still must make Rule 155 computations, the understatement of *tax* will not exceed $5,000.

We also believe that Schwab and Kleinman made a reasonable attempt to comply with the provisions of the Code, and that they were not careless, reckless, or in intentional disregard of rules or regulations. See sec. 6662(c). Section 1.402(b)-1(c), Income Tax Regs., did not mandate that Schwab and Kleinman relinquish consideration of surrender charges in determining tax. And while they did not account for the lingering benefit of Angels & Cowboys's premium payment, its effect on their income was minimal. We will not sustain the Commissioner's determination of the penalty.

Decision will be entered under Rule 155.

[1] Unless otherwise noted, all section references are to the Internal Revenue Code for the year at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2] Schwab occasionally does design work for the Sundance Institute and is a native Oklahoman. We therefore infer that Kleinman is the Angel.

[3] Sections 419 and 419A are special rules limiting the deductibility of employer contributions to welfare-benefit funds. Section 419 generally limits deductions to the cost of providing current benefits, plus a very limited prefunding of benefits allowable under section 419A. But these limits do not apply to plans that comply with section 419A(f)(6). Thus, the allure of the Advantage 419 Trust was the ability to set money aside in a way that would allow its value to grow without being immediately taxed.

[4] This Notice has been supplemented and superseded several times since. For the most recent changes, see Notice 2009-59, 2009-31 I.R.B. 170.

[5] The parties did not stipulate this. But the only record evidence of any payments is of the first, there is no evidence of any further payments, and the stated policy values by the end of 2003 would make no sense had there been later payments.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

[6] The quoted matter is actually from material from the insurance company that was part of Stameroff's sales presentation. The parties unaccountably introduced only a part of the insurance contracts themselves. We nevertheless find the definitions in the presentation materials more likely than not to apply to the same terms in the contracts.

[7] Note that at the end of three years, N = 36 and $3,548.77 x 36 = $127,755.72.

[8] The changes were effective on May 17, 2002, which was 21 months into the first three-year period of the contract. Kleinman's reduced "no-lapse" premium meant that, like her husband, she could keep the policy in force for that first three-year period without worrying about the net cash-surrender value of her policy: (21)($3,776.69) + (15)($2,510.34) = $116,965.59.

[9] We say "fluctuations", but for the three-year period beginning in September 2000, "swoon" might be more accurate: The S&P 500 index declined nearly 34 percent. See Standard and Poor's Index Services: S&P 500 Monthly Returns, https://www2.standardandpoors.com/ spf/xls/index/MONTHLY.xls (last visited Jan. 1, 2011).

[10] BYSIS advised Schwab and Kleinman that this amount was necessary to maintain the policy, but the Commissioner points out that a smaller payment might have kept the policy alive for some time. It's not clear from the record what minimum amount would have been necessary to keep Kleinman's policy afloat--nor did the parties explain why the premium BYSIS requested was almost five times Kleinman's reduced annual premium, though it is possible that it had something to do with the nonpayment of any premiums after the first.

[11] The words did not appear in the 1928 statute, but Congress added them back in 1932. Revenue Act of 1932, ch. 209, sec. 165, 47 Stat. 169, 221.

[12] While this is true, that doesn't mean the reports had nothing to say about the meaning of "amount actually distributed." Section 219(f) (and later section 165) told us that distributions from employer-created trusts for stock bonus, pension, or profit-sharing plans, less any contributions made by employees, were taxable to employees when distributed. And in these early years, Congress was fiddling with how to value a distribution when it took the form of stock rather than cash—or in other words, how to determine the "amount actually distributed." The 1926 version taxed not only the employer's contributions and any dividends and interest distributed but also the appreciation of the stock, even though that amount hadn't been realized by the employee at that time. H.R. Rep. No. 70-2, sec. 165 (1927), re-printed in 1939-1 C.B. (Part 2) 384, 398-99. Congress decided in 1928 to postpone the employees' recognition of the unrealized stock appreciation until the stock was sold, so the taxable amount at distribution then became the employers' contributions plus dividends and interest distributed. See id.; *Olstad v. Commissioner*, 32 B.T.A. 670, 674 (1935) ("Congress was concerned with an alleviation of what it regarded as an undue tax burden upon the employee resulting from the treatment as gain in his hands of the unrealized increment in the value of the trust property"). The purpose was to relieve the taxpayer of "all possibility of tax upon appreciation in the value of trust securities before such appreciation came to his hand by sale." *Olstad*, 32 B.T.A. at 674.

But that still didn't settle the matter. This definition was also troublesome because employees could be caught paying tax on their employers' contributions, even if the stocks were worthless by the time the employees received them. S. Rep. No. 72-665, sec. 165 (1932), reprinted in 1939-1 C.B. (Part 2) 496, 520. Congress came back to the table in 1932 to correct this "distinct hardship" by implicitly redefining the amount actually distributed as the "fair market value of the stock received," less contributions made by the employee. Id. Although these sections don't mention life-insurance policies, it appears that--at least at this point—Congress decided "amount actually distributed" was best read as "fair market value at the time of distribution."

[13] We recognize that the life-insurance-policy distribution at issue wasn't a gift subject to the gift-tax regulations.

[14] The valuation calls for "adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date." Sec. 25.2512-6(a), Gift Tax Regs. The interpolated terminal reserve "is not cash surrender value; it is the reserve which the insurance company enters on its books against its liability on the contracts. *** The word "interpolated" simply indicates adjustment of the reserve to the specific date in question." *Matthies v. Commissioner*, 134 T.C. 141, 153 n.12 (2010) (quoting *Commissioner v. Edwards*, 135 F.2d 574, 576 [31 AFTR 22] (7th Cir. 1943), affg. 46 B.T.A. 815 (1942)).

[15] The record contains no evidence of the policies' interpolated terminal reserve values; the Commissioner does not expressly argue that we should take into account any such values, and Schwab and Kleinman do not rely on or address the policies' interpolated terminal reserve values. Consequently, we do not consider this issue further. Cf. sec. 25.2512-6(a), Gift Tax Regs.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

[16] See *United States v. Cartwright*, 411 U.S. 546, 552-53 [31 AFTR 2d 73-1461] (1973) (invalidating regulation that failed to value mutual fund shares by using the redemption price—"the only price that a shareholder may realize and that the fund--the only buyer—will pay"); sec. 25.2512-6(b), Gift Tax Regs.

[17] If the parties find the underlying information inadequate feed for our number crunching, they may move to reopen the record when they submit computations under Rule 155.

[18] Angels & Cowboys apparently distributed the policies to Schwab and Kleinman on October 24, 2003. From the record, we find that Schwab made a premium payment in 2003, but can't determine when in 2003. Because this omission is of Schwab's own making, for our tentative calculations we treat Schwab as paying a premium in the last month of the year, on the date a premium would have been due— December 17, 2003—and treat the coverage attributable to the Angels & Cowboys premium as running through the day prior. Cf. *Barnes v. Commissioner*, T.C. Memo. 1992-275 [1992 RIA TC Memo ¶92,275] n.6 (estimating an officer's annual pay in light of insufficient records).

[19] The premiums covered Kleinman through November 16, 2003.

[20] The base rate is for each $1,000 of insurance, and under each policy tracks the "attained age" of the insured.

[21] During the relevant period, both Schwab and Kleinman had $2,400,000 in coverage. Because the base rate is based on $1,000 of insurance, we multiply the base rate by 2,400 to get the monthly benefit, then by 12 to get the yearly, and finally by the a fraction representing the days during 2003 the coverage benefited the insured. Thus for Schwab: .446 * 2,400 * 12 * (54/365).

[22] Based on the Commissioner's assertions, 10 percent of the amount required of Schwab and Kleinman to have shown on the return is only $3,158. Section 6662 requires that we take the greater of the two numbers.

Document Header: Checkpoint Contents Federal Library Federal Editorial Materials Federal Taxes Weekly Alert Newsletter 2011 02/10/2011 - Volume 57, No. 6 Articles Shareholder-employees taxable on life insurance policies with surrender charges exceeding stated value (02/10/2011) © 2011 Thomson Reuters/RIA. All rights reserved.

EMPLOYMENT TAXES

7. Federal Taxes Weekly Alert, IRS FAQs shed additional light on new settlement offer for workers misclassified as independent contractors

IRS has issued a series of new frequently asked questions (FAQs) that provide additional guidance on the Voluntary Classification Settlement Program (VCSP) for employees that have been misclassified as independent contractors (or as other nonemployees). They also provide taxpayers with a more detailed explanation of how to compute the payment that's required to settle with IRS under the VCSP.

Background. As we reported recently, IRS has launched a new VCSP that allows employers to prospectively reclassify—as employees—those workers that they have erroneously treated as independent contractors or as other nonemployees. The new program carries generous settlement terms and provides audit relief for previous years. (See Weekly Alert ¶ 3 09/29/2011 .) The VCSP is available to taxpayers who are currently treating their workers (or a class or group of workers) as independent contractors or other nonemployees and want to prospectively treat the workers as employees. The program is open to businesses, tax-exempt organizations, and government entities.

To be eligible, a taxpayer: (a) must have consistently treated the workers as nonemployees; (b) must have filed all required Forms 1099 for the workers for the previous three years; and (c) cannot currently be under audit by IRS, or currently under audit concerning the classification of the workers by the Department of Labor (DOL) or by a state government agency. A taxpayer that was previously audited by IRS or DOL about the classification of the workers will only be eligible if it has complied with the results of that audit.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Terms of the offer. A taxpayer who applies for and is accepted into the VCSP will agree to prospectively treat the class of workers as employees for future tax periods and in exchange:

> (A) Will pay 10% of the employment tax liability that may have been due on compensation paid to the workers for the most recent tax year, determined under the reduced rates of Code Sec. 3509 ;
>
> (B) Will not be liable for any interest and penalties on the liability;
>
> (C) Will not be subject to an employment tax audit for the worker classification of the workers for prior years; and
>
> (D) Will agree to extend the period of limitations on assessment of employment taxes for three years for the first, second and third calendar years beginning after the date on which the taxpayer has agreed under the VCSP closing agreement to begin treating the workers as employees.

Additional guidance in new FAQs. The new FAQs make the following clarifying points about the new VCSP:

- The VCSP permits a taxpayer to reclassify some or all of the workers, but once it chooses to reclassify certain of its workers as employees, all workers in the same class must be treated as employees for employment tax purposes. For example, consider a construction firm that currently contracts with its drywall installers, electricians and plumbers to perform services at housing construction sites. It wants to voluntarily reclassify its drywall installers as employees, is accepted into the VCSP, and enters into a closing agreement with IRS. Once the VCSP closing agreement is executed, the company must treat all drywall installers as employees for employment tax purposes. (FAQ 2)
- An exempt organization that is currently under a Form 990 series examination is considered to be "currently under audit by the IRS" and is not eligible to participate in the VCSP. (FAQ 7)
- Taxpayers must make full and complete payment of any amount due under the VCSP when they return the signed VCSP closing agreement to the IRS. (FAQ 12)

Calculating the VCSP payment. FAQs 13 through 16 provide more details about how to calculate the VCSP payment, including the following guidance:

Payment under the VCSP is 10% of the amount of employment taxes calculated under the reduced rates of Code Sec. 3509 for the compensation paid for the most recent tax year to the workers being reclassified under the VCSP.

RIA observation: Code Sec. 3509 was added to the Code by the Tax Equity and Fiscal Responsibility Act of '82. The Committee Reports to that Act explain that Code Sec. 3509 was added help alleviate the serious tax burdens that may arise when a worker who has been treated as an independent contractor is reclassified as an employee. It helped by carrying a procedure for determining an employer's liability for failure to withhold income taxes or the employee's share of FICA taxes in certain situations involving worker reclassifications.

Under Code Sec. 3509 , the effective tax rate for compensation up to the Social Security wage base is 10.68% in 2010 or 10.28% in 2011, and 3.24% for compensation above the Social Security wage base.

The amount due under the VCSP is calculated based on compensation paid in the most recently closed tax year, determined at the time the VCSP application is being filed. Accordingly, the 10.68% effective rate applies under the VCSP in 2011 since the most recently closed tax year is 2010. The 10.28% effective rate will apply under the VCSP in 2012 since the most recently closed tax year will be 2011. The rate of 3.24% applies to compensation above the Social Security wage base in both situations.

FAQ 16 carries a table that breaks down the Code Sec. 3509 percentage for federal income tax withholding, employee social security tax, employer social security tax, employee medicare tax, and employer medicare tax.

There are two examples illustrating how the VCSP penalty is figured. In the first of these, a company in 2010 paid $1,500,000 to workers that are the subject of the VCSP. All of the workers that are the subject of the VCSP were compensated at or below the Social Security wage base (e.g., under $106,800 for 2010). The company submits the VCSP application on Oct. 1, 2011, and wants the beginning date of the quarter for which it will treat the class or classes of workers as employees to be Jan. 1, 2012. The

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

company looks to amounts paid to the workers in 2010 for purposes of calculating the VCSP amount, since 2010 is the most recently completed tax year at the time the application is being filed. Under Code Sec. 3509 , the employment taxes applicable to $1,500,000 would be $160,200 (10.68% of $1,500,000). Under the VCSP, the company's payment would be 10% of $160,200, or $16,020.

References: For determining who is an employee, see FTC 2d/FIN ¶ H-4250; United States Tax Reporter ¶ 34,014.37; TaxDesk ¶ 535,001; TG ¶ 9160.

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8. Federal Taxes Weekly Alert, Attorney, as alter ego of his law firm, was liable for its unpaid employment taxes - Western Management, Inc. v. U.S., (Ct Fed Cl 9/9/2011) 108 AFTR 2d ¶ 2011-5261

The U.S. Court of Federal Claims has held that an attorney and his wife couldn't relitigate a Tax Court decision that held his law firm liable for failing to withhold and pay employment taxes for the services he provided it. The law firm had instead treated the attorney (and also sole shareholder, president, and secretary-treasurer) as an independent contractor. Further, the Court found that the attorney, as the alter ego of the law firm, and his wife, under community property law, were both personally liable for the judgment.

Facts. Robert Kovacevich formed a C corporation, Western Management, Inc. (WMI). Its only source of income was providing legal services, and Kovacevich was its sole shareholder, president, and secretary-treasurer. Kovacevich worked 160 to 180 hours per month for WMI and performed all services necessary to generate gross receipts on its behalf, including paying creditors, hiring employees, signing checks, determining employee compensation, renewing its malpractice insurance, and signing its Federal tax returns. No other person performed legal services on its behalf.

Kovacevich received funds from WMI as his needs arose and wasn't compensated for his services at predetermined intervals. In '94 and the first quarter of '95, respectively, WMI paid Kovacevich $132,000 and $33,250. WMI also issued checks to Kovacevich, his wife, and their creditors (e.g., Nordstrom, Teneff Jewelry, Fit and Hollywood, and National Golf). Kovacevich informed WMI's accountant and tax return preparer that the payments were draws. WMI classified the payments as “loans” on its corporate ledgers and did not file Forms 1099-MISC, Miscellaneous Income, for these payments. WMI also paid Kovacevich's law license renewal fees, office expenses, bar dues, and health insurance premiums and deducted most of these expenses on its corporate income tax returns.

WMI treated Kovacevich as an independent contractor who was employed by the firm he owned and operated. Accordingly, it did not withhold or pay any federal taxes in connection with the services he provided. IRS challenged this employment classification, and WMI sought relief in the Tax Court.

Prior litigation. The Tax Court found that Kovacevich was WMI's employee and that his wages were subject to income tax withholding and FICA and FUTA taxes for the four quarters of '94 and the first quarter of '95. He was clearly a “statutory” employee under Code Sec. 3121 . He had sole authority to make major corporate decisions and served at all relevant times as WMI's president and secretary-treasurer, ran all WMI's business, performed substantial services for it in his officer capacity, and received remuneration for those services. (*Western Management, Inc*., TC Memo 2003-162)

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

On appeal, the Ninth Circuit affirmed the Tax Court decision, but remanded for reconsideration of the extent to which Kovacevich had already paid income tax on his wages. (*Western Management, Inc. v. Comm*., (CA 9 1/27/2006) 97 AFTR 2d 2006-1949)

Litigation in the Court of Federal Claims. Kovacevich and his wife, Yvonne, sought a refund of amounts that they paid for the tax periods in question. The government counterclaimed and asserted that the final Tax Court judgment against WMI had established its liability for the income tax withholding, FICA, FUTA, penalties, and interest for the four quarters of '94 and for the first quarter of '95. The government sought a judgment for recovery of these amounts from Kovacevich, as the alter ego of WMI, and from Yvonne as a member of the community with Robert under Washington state's community property law.

Disregard of the corporate entity. The Court of Federal Claims found that Kovacevich, as WMI's alter ego, was personally liable for WMI's tax liabilities.

Looking to Washington state law, the Court determined that disregard of the corporate form (i.e., holding Kovacevich personally liable for WMI's tax liabilities) was appropriate where (1) there was abuse of the corporate form; (2) the corporation had been used to violate or evade a duty to another; and (3) disregard was necessary to prevent an unjustified loss to the injured party. (Meisel v. M & N Modern Hydraulic Press Co., (Wash. 1982) 645 P.2d 689)

Admissions by WMI and the Kovaceviches supported a finding that Kovacevich intentionally used WMI to evade the payment of the taxes at issue. He underreported the amount of income he received from WMI, both in the form of direct wages and payments on lines of credit. WMI was only a “shell” or “nominee,” had no bank account, was dependent on the Kovaceviches for credit and liquidity, and had no assets, furniture, or leases. WMI had no formal or informal meetings to elect officers or otherwise and Kovacevich regarded himself as WMI's alter ego, with all control over the corporation being held by himself and Yvonne. Both the Kovaceviches and WMI admitted that WMI was operated as a “disregarded entity.”

The Court concluded that such actions clearly constituted abuse and intentional use of the corporate form to evade its duty to pay taxes. Further, the government showed that disregard of the corporate entity was necessary to prevent an unjustified loss to the government, as WMI had no assets. Accordingly, Kovacevich, as WMI's alter ego, could be held personally liable for WMI's tax liabilities.

Res judicata bar. The Court found that res judicata barred the Kovaceviches from relitigating the issue of WMI's liability for employment taxes, penalties, and interest stemming from his employment. The Court of Federal Claims determined that the Tax Court, which had jurisdiction to rule on WMI's tax liability, had rendered a final decision on the merits. That decision, which was affirmed by the Ninth Circuit, established WMI's liability for taxes, penalties, and interest related to Kovacevich's employment in '94 and the first quarter of '95. WMI was the named party in that case, and Kovacevich was liable for WMI's taxes because of his status as WMI's alter ego. Kovacevich could not relitigate WMI's liability.

Community property rules. The Court of Federal Claims also found that Yvonne was personally liable for WMI's unpaid taxes because she was the spouse of the defendant and the claim (i.e., the debt) involved community property. The Court determined that the judgment against Kovacevich would be enforceable against the community under Washington state law. It reasoned that the judgment was properly against the community property, as his actions benefited the community (e.g., by payments to the Kovaceviches' personal creditors).

2011 Regional Forums

Employee Benefits & Employment Taxes

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

References: For when a corporate entity will be ignored, see FTC 2d/FIN ¶ D-1200; United States Tax Reporter ¶ 79,006.01; TaxDesk ¶ 600,204.

WESTERN MANAGEMENT, INC. v. U.S., Cite as 108 AFTR 2d 2011-6160, 09/09/2011 , Code Sec(s) 7422; 3111; 3121; 6511

WESTERN MANAGEMENT, INC., Yvonne Kovacevich and Robert Kovacevich, PLAINTIFFS v. THE UNITED STATES, DEFENDANT.

Case Information:

Code Sec(s): 7422; 3111; 3121; 6511

Court Name: U.S. Court of Federal Claims,

Docket No.: No. 08-116T,

Date Decided: 09/09/2011.

Prior History: Earlier proceedings at (2010, CA Fed Cir) 106 AFTR 2d 2010-5928, denying reconsideration of (2009, CA Fed Cir) 106 AFTR 2d 2010-5927, which dismissing appeal per curiam from (2009, Ct Fed Cl) 103 AFTR 2d 2009-1372, 2009-1 USTC ¶50303.

Tax Year(s): Years 1991, 1994, 1995, 2003, 2004.

Disposition: Decision for Govt.

Cites: , 2011-2 USTC P 50,622.

HEADNOTE

1. Court of Federal Claims—jurisdiction— effect of suits in other courts—refunds— damages—counterclaims—employment taxes. Law practice/corp.'s complaint seeking damages and refund of FICA and FUTA taxes, income tax withholding, and penalties and interest paid by its owners, and govt.'s counterclaim on ground that corp. failed to properly classify owner/officer as employee, were dismissed: 28 USC 1500 barred litigation of corp.'s claim because it was filed during pendency of Tax Court suit that involved same claim/arose from same operative facts regarding same underlying taxes for same tax periods; and since there was no jurisdiction for corp.'s claim, there was also no jurisdiction for govt.'s counterclaim against it.

Reference(s): ¶ 74,336.510(15)

2. Refunds—damages—employment taxes—res judicata—collection due process—limitations periods—Court of Federal Claims jurisdiction—summary judgment. Govt. was granted summary judgment on law practice/corp.'s married owners/pres.'s and wife's complaint for damages and refund of FICA and FUTA taxes, income tax withholding, and penalties and interest credited to corp.'s tax account: res judicata barred taxpayers from relitigating appropriateness of IRS's crediting corp.'s account with their tax payments where taxpayers were parties

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

to prior, final, Tax Court CDP litigation regarding another year that established appropriateness of allocating certain of their payments toward corp.'s account; Code Sec. 6511(b) barred recovery of amount paid and credited to corp. for employment taxes for years not at issue; and claims sounding in tort were outside CFC's jurisdiction.

Reference(s): ¶ 74,225.05(40); ¶ 74,337.503(5); ¶ 65,115.04(70); ¶ 74,336.510(5) Code Sec. 7422; Code Sec. 3111; Code Sec. 3121; Code Sec. 6511

3. Employment taxes—refunds and damages—counterclaims—limitations periods— alter ego—res judicata—summary judgment. Govt. was granted summary judgment on counterclaim that it filed in response to law practice/corp.'s married owners/pres.'s and wife's complaint for damages and refund of FICA and FUTA taxes, income tax withholding, and penalties and interest credited to corp.'s tax account: taxpayers' claim that counterclaim was untimely was already considered and rejected in prior litigation; argument that husband wasn't corp.'s alter ego was belied by his own admission that corp. was nominee and/ or disregarded entity with no assets and that he structured corp. and attempted to classify himself as independent contractor of his own law practice in order to avoid paying subject taxes; and because Tax Court had already entered final judgment regarding appropriateness of crediting corp. with amounts paid by taxpayers, husband was bound by that decision and personally responsible for same. Also, under Washington law, wife was liable as holder of community property.

Reference(s): ¶ 31,115.01; ¶ 74,225.05(39) Code Sec. 3111; Code Sec. 3121; Code Sec. 7422

OPINION

In the United States Court of Federal Claims,

OPINION

Judge: NANCY B. FIRESTONE Judge

At issue in this case are "withholding taxes, withholding tax penalty assessments, Federal Insurance Contributions Act ("FICA") taxes, hospital insurance taxes (Medicare), penalties, interest, and damages" in connection with taxes allegedly owed by the individual plaintiffs and Western Management, Inc. ("WMI") for tax year 1994 and the first quarter of 1995. Compl. ¶ A. The plaintiffs claim that they do not owe these taxes and are entitled to a refund of amounts the individual plaintiffs have paid for the tax periods in question. In the counterclaim, the defendant ("United States" or "government") asserts that the United States Tax Court on June 3, 2003 entered a final judgment against the plaintiff corporation, WMI, establishing its liability for the subject income tax withholding ("ITW"), FICA, Federal Unemployment Tax ("FUTA"), penalties, and interest for the four quarters of 1994 and for the first quarter of 1995. In its counterclaim the government seeks a judgment for recovery of these taxes, penalties, and interest from Robert E. Kovacevich, as the alter ego of WMI and from Yvonne R. Kovacevich as a member of the "community" with Robert under Washington law. The United States stated in its complaint that as of March 20, 2008, WMI had a total outstanding liability for the above-noted taxes and penalties in the amount of $86,782.08 [1] plus assessed and statutory interest pursuant to 26 U.S.C. § 6601 (2005), taking into account the ITW credits given to WMI for tax payments made by the individual plaintiffs in 2004.

In the government's pending Motion for Summary Judgment on both the plaintiffs' complaint and the government's counterclaim, the government asserts that WMI was adjudged liable for these taxes and penalties because WMI failed to properly classify Robert E. Kovacevich as an employee of WMI. *W. Mgmt., Inc. v. Comm'r*, T.C.M. (RIA) 2003-162 (Def.'s Ex. 9), aff'd in part, rem'd in part, 176 F. App'x 778 [97 AFTR 2d 2006-1949] (9th Cir. 2006). [2]

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

The plaintiffs argue in response that they are not individually liable for the above-described taxes and penalties and seek a refund of amounts they have paid toward satisfying WMI's liability for the subject tax periods.

For the reasons that follow, the government's Motion for Summary Judgment is GRANTED both with regard to the individual plaintiffs' claim for a refund of the amounts the Kovaceviches have paid toward WMI's tax liability for 1994 and the first quarter of 1995[3] and with regard to the government's claim for a judgment in the amount of $87,879.39 plus statutory interest against the individual plaintiffs stemming from Mr. Kovacevich's status as the alter ego of WMI.

I. BACKGROUND

The court provides the following summary of the material facts and history of this and related litigation, based, in large part, upon previous decisions by this court and the Tax Court. In each of these cases the tax liability stems from WMI's failure to properly classify Robert E. Kovacevich as an employee of WMI.

A. History of WMI's and the Kovaceviches' Tax Litigation

This litigation is closely related to previous litigation in the United States Tax Court and Ninth Circuit Court of Appeals, which established WMI's liability for employment taxes for tax year 1994 and the first quarter of 1995. The plaintiffs in this case are endeavoring to obtain a refund of amounts the IRS has credited to WMI for these tax periods. The government in response is trying to prevent the plaintiffs from relitigating the tax liability previously resolved by the Tax Court in the related suit, as well as to obtain a judgment against Robert and Yvonne Kovacevich so that the government can collect the amounts remaining unpaid by WMI from the Kovaceviches as individuals.

The Tax Court in a 2009 decision in another related case explained much of the relevant background concerning WMI's tax history. As discussed, WMI and the Kovaceviches have been arguing over Mr. Kovacevich's employment status—and the tax implications of that status—for various tax periods over many years in multiple venues.[4] Specifically, WMI has consistently argued that it was not responsible for withholding or paying any federal taxes in connection with the services provided by Mr. Kovacevich on the grounds that he was an independent contractor and was not employed by the firm he owned and operated:

In 1992, Robert's [Kovacevich's] firm (which he had incorporated) was named Robert E. Kovacevich, P.S., and he treated himself as an independent contractor—meaning that the firm did not withhold payroll taxes from what it paid him. This was to the firm's advantage, because employers must generally deduct and withhold payroll taxes—including income tax, Social Security (FICA) tax, Medicare tax, and unemployment (FUTA) tax—from their employees' paychecks. The income tax withheld is a credit against the income tax owed by the taxpayer at the end of the year. FICA tax has two portions, one paid by the employer and one paid by the employee; the employer pays its portion and withholds the employee's. Employers must deposit withheld income and FICA taxes into a bank account within a short time after the employee's paycheck is cut. This is called the "trust fund" system because it is deemed a special fund in trust for the United States under section 7501(a). [footnote and citation omitted] If a corporate employer doesn't pay over the withheld money, the [IRS] Commissioner may collect it from a "responsible person"; i.e., an actual person who was required to pay over the tax. Money that's collected this way is called a trust-fund-recovery-penalty tax. [I.R.C. §] 6672.

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Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

The Commissioner disagreed with the Kovaceviches about whether Robert was an independent contractor.[5] He asserted that Robert was an employee, and sent the Kovaceviches a notice of deficiency based in part on that belief, but also disallowing various deductions and claiming that Robert and Yvonne had failed to report about $45,000 in additional income.

Kovacevich v. Comm'r, T.C.M. (RIA) 2009-160 (Def.'s Ex. 21). Having found that Mr. Kovacevich was improperly classified as an independent contractor and the Kovaceviches had failed to report certain income, the Tax Court entered a judgment against the Kovaceviches for tax year 1992:

The Kovaceviches [as individuals] filed a petition with our Court. After finding in the Commissioner's favor on most issues, we ordered a computation under Rule 155. [footnote omitted] The Kovaceviches asked us to take several checks into consideration as part of this computation process, but we denied those requests and upheld the Commissioner's computations, finding a $13,329 deficiency and an accuracy-related penalty under section 6662 of $2,160 for 1992.[6] The Kovaceviches appealed and the Ninth Circuit affirmed.[7]

Id. During the period of this appeal, the IRS Commissioner assessed the amount the Tax Court had found due, and in April 2005, the Commissioner sent the Kovaceviches a notice that he intended to levy upon their property to collect the amount due. Id. The Kovaceviches requested a collection due process (“CDP”) hearing; the Appeals Officer upheld the levy, denying the Kovaceviches' request to consider whether the IRS had appropriately credited certain checks the Kovaceviches had submitted to the IRS. On appeal, the Tax Court held that the IRS had treated the checks at issue properly. Id. In particular, the court held the following: Check number 3747, for $21,985.48, written on the account of Robert E. Kovacevich, P.S., was applied to the firm's tax account for years preceding 1992. Check number 7438, for $22,583.20, written on the account of Robert E. Kovacevich, P.S. on September 30, 1995, was properly applied as a payment for WMI's first quarter of 1992 tax period. WMI received a refund of $3961.04, the difference between check 7438 and the assessed tax, interest, and penalties for 1992. Check 10161, for $7682.00, writ ten September 29, 2003, was properly allocated to WMI's account equally between the four quarters of 1994. Check 10376, for $7514.40, dated April 28, 2004, drawn from the personal account of Robert and Yvonne Kovacevich, was credited to WMI's account for the first quarter of 1994. Finally, check 7641, for $8276.50, was properly credited to WMI's account for the first quarter of 1995.[8] Id.

At the same time the Kovaceviches were litigating their tax liability for tax year 1992, WMI was separately litigating in the Tax Court its liability regarding the periods now at issue in this case—1994 and the first quarter of 1995:

The Commissioner went after the firm for its failure to pay employment taxes for Robert's services by issuing it a notice of deficiency for 1994 and the first quarter of 1995. Western Management also filed a petition with [the Tax Court], but we again upheld the Commissioner's determination.[9] Part of this case was another computational dispute and the Ninth Circuit remanded it to us to review whether the Commissioner had considered certain credits against the company's liability.[10] We found on remand that, as of 2004, the Kovaceviches themselves had paid all [income] taxes related to the wages Robert earned during the periods at issue. Under section 3402(d), these payments had to be credited to Western Management's account, reducing the firm[']s [withholding] deficiency to zero.[11] Western Management appealed this decision too, claiming we should have abated the FICA and FUTA taxes it owed and should have awarded it attorney's fees. The Ninth Circuit recently affirmed our ruling.[12]

Id.[13]

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Thus, with regard to tax year 1994 and the first quarter of 1995, which is the subject of the government's counterclaim, there is now an existing final judgment against WMI relating to tax year 1994 and the first quarter of 1995 stemming from the Tax Court's June 3, 2003 decision finding that Mr. Kovacevich was a statutory employee and that WMI was liable for employment taxes, penalties, and interest. *W. Mgmt*., T.C.M. (RIA) 2003-162 (Def.'s Ex. 9), aff'd in part, rem'd in part, *W. Mgmt*., 176 F. App'x 778 [97 AFTR 2d 2006-1949]. The Tax Court's decision on remand takes into account certain payments made by the Kovaceviches. *W. Mgmt., Inc. v. Comm'r*, No. 12686-99 (T.C. Aug. 3, 2007) (order and decision) (Def.'s Ex. 18); *W. Mgmt., Inc. v. Com*m'r, T.C.M. (RIA) 2007-211, aff'd, 314 F. App'x 65 [103 AFTR 2d 2009-992] (9th Cir. 2009). Additionally, there is a final judgment in the context of the Kovacevich's CPD action regarding tax year 1992, holding that certain payments by the individual plaintiffs were appropriately credited to WMI's tax account. *Kovacevich,* T.C.M. (RIA) 2009-160 (Def.'s Ex. 21).

B. Factual Background Related to Government's Alter Ego Theory [14]

These facts are taken from sworn statements and other filings made by the plaintiffs before the Tax Court in the above-cited related litigation. WMI began its existence as Robert E. Kovacevich, P.S. in 1981, when it was incorporated by Robert E. Kovacevich. Its first directors were Robert Kovacevich and his wife Yvonne R. Kovacevich. The Kovaceviches owned WMI at all relevant times, including tax year 1994 and the first quarter of 1995, the periods at issue in this suit. Mr. Kovacevich served as its president until 1997. WMI provided legal services for clients of Mr. Kovacevich, who had owned and operated a law business since 1963.

WMI did not have its own bank account. Mr. Kovacevich's personal account was used as the corporate account, the bank signature card was Mr. Kovacevich's personal signature, and WMI checks were signed by the Kovaceviches personally. Indeed, WMI at times had no liquid funds and was dependent on the capital and credit of Mr. Kovacevich. The Kovaceviches procured personal credit to operate WMI, and borrowed from and advanced money to it at various times. WMI had no tangible assets, furniture, or leases; everything was owned personally by the Kovaceviches. WMI never had any meetings to elect officers, nor formal or informal meetings of any kind. Mr. Kovacevich has described WMI as "an unsuccessful attempt to achieve limited liability." Def.'s Ex. 10 at B180. Mr. Kovacevich swore in an affidavit filed in the United States Tax Court that he was the "alter ego" of WMI, Def.'s Ex. 7 at B149, and WMI, in pleadings before the Tax Court has admitted that it acted as the "alter ego" of Robert Kovacevich, Def.'s Ex. 13, B261. WMI has admitted that it considers itself the "shell" or "nominee" of Mr. Kovacevich, Def.'s Ex. 7 at B149; Def.'s Ex. 10 at B180, and Mr. Kovacevich has sworn that the position of director or officer of WMI was "useless[,] as the shell was controlled by the owners," Def.'s Ex. 7 at B153–54. Both the Kovaceviches and WMI have admitted that WMI was operated as a "disregarded entity." Def.'s Ex. 4 at B49– 50; Def.'s Ex. 13 at B257.

Mr. Kovacevich used the existence of WMI to avoid taxation. See *Kovacevich v. Comm'r*, T.C.M. (RIA) 2003-161 (Def.'s Ex. 15); *W. Mgmt*., T.C.M. (RIA) 2003-162 (Def.'s Ex. 9). WMI filed a tax return as a "C" corporation for 1994 and 1995. In 1994, WMI paid Robert Kovacevich $132,000 and reported that amount as "compensation" on its corporate tax return, but the Kovaceviches reported only $90,000 of that amount as income from WMI on their income tax return. *Kovacevich*, T.C.M. (RIA) 2003-161 (Def.'s Ex. 15). WMI also issued checks to the Kovaceviches and their creditors, including Nordstom, Teneff Jewelery, Fit and Hollywood, and National Golf. Id; W. Mgmt., T.C.M. (RIA) 2003-162 (Def.'s Ex. 9). WMI classified these payments as loans to the Kovaceviches on its ledgers, but did not file Forms 1099 or W-2 relating to those payments. Kovacevich, T.C.M. (RIA) 2003-161 (Def.'s Ex. 15); W. Mgmt., T.C.M. (RIA) 2003-162 (Def.'s Ex. 9). The Tax Court has determined that those payments were wages, rather than loans, for tax purposes. Id. In the first quarter of 1995, WMI paid Robert Kovacevich $33,250. *W. Mgmt.,* T.C.M. (RIA) 2003-162 (Def.'s Ex. 9). WMI also issued checks in the first quarter of 1995 to the Kovaceviches and their creditors, again according to the Tax Court, mis-characterizing them as loans when they were in fact wages. Id. The United States Tax Court sustained penalties against the Kovaceviches and

WMI for these periods pursuant to § 6662(a), for Mr. Kovacevich's under-reporting of his income from WMI, and for WMI's misclassifying of its payments to Mr. Kovacevich, finding that Mr. Kovacevich was "an experienced tax lawyer who manipulated income received from [WMI]." *Kovacevich*, T.C.M. (RIA) 2003-161 (Def.'s Ex. 15); see also *W. Mgmt*., T.C.M. (RIA) 2003-162 (Def.'s Ex. 9). It is not disputed that WMI has no assets from which its outstanding tax debt may be satisfied.

C. Present Claims and Counterclaim

The plaintiffs, WMI, Robert E. Kovacevich, and Yvonne R. Kovacevich, filed the present suit on February 29, 2008, seeking a refund of three checks written by the Kovaceviches and applied to WMI's employment tax liabilities for 1994 and the first quarter of 1995. Specifically, the plaintiffs seek a refund of a check for $8276.60, paid on November 23, 2004; a check for $7374.40, [15] paid on April 28, 2004; and a check for $7682.00, paid September 29, 2003. The plaintiffs also seek a sum of $21,995.48, paid on March 31, 1991 [16] "for social security taxes of Robert E. Kovacevich for 1989 through 19[9]0." Compl. 13–14. Additionally, the plaintiffs seek "economic damages" in the amount of $6918.75. The basis of the plaintiffs' claims appears to be their argument that the IRS has "abrogated" or "cancelled" all of the plaintiffs' tax liability related to the periods at issue. Compl. 3. The plaintiffs argue that the IRS "consciously failed, neglected and refused to credit Robert E. Kovacevich with the taxes withheld." Compl. ¶ 4. In sum, it appears that the plaintiffs' contention is that amounts they paid and the IRS has allocated to WMI's tax account should now be refunded to the individual plaintiffs on the theory that the Kovaceviches were never individually liable for paying the tax at issue and the IRS has "cancelled" any tax liability for the periods at issue.

On April 3, 2009, the government filed an amended counterclaim against WMI and the individual plaintiffs. The government contends that the Tax Court, as affirmed by the Ninth Circuit, has ordered that "WMI was liable for FICA, FUTA, ITW, additions to tax, and penalties for all four quarters of 1994 and the first quarter of 1995." Counterclaim ¶ 2. The government argues that the plaintiffs are incorrect in claiming that the IRS has "cancelled" WMI's tax liability for the periods at issue, but acknowledges that the Tax Court recognized that the IRS may not collect ITW for 1994 and the first quarter of 1995 to the extent that Mr. Kovacevich had paid related income tax and that the IRS had abated appropriate amounts from WMI's accounts for these periods. The government claims that WMI has still not satisfied its remaining liabilities stemming from employment taxes, penalties, and interest. The government now seeks a judgment against the individual plaintiffs under the theory that Mr. Kovacevich, as the "alter ego" of WMI, should be held personally liable for the liabilities and Mrs. Kovacevich should be held liable for Robert's tax liability under the law of Washington state regarding community property.

II. DISCUSSION

A. Standard of Review

Summary judgment is appropriate when "the pleadings, the discovery and disclosure materials on file, and any affidavits show that there is no genuine issue as to any material fact and that the movant is entitled to judgment as a matter of law." RCFC 56(c)(1); see also *Anderson v. Liberty Lobby, Inc*., 477 U.S. 242, 247–48 (1986); *Casitas Mun. Water Dist. v. United States*, 543 F.3d 1276, 1283 (Fed. Cir. 2008); *Telemac Cellular Corp. v. Topp Telecom, Inc*., 247 F.3d 1316, 1323 (Fed. Cir. 2001) (citation omitted). In considering a motion for summary judgment, the court's role is not to "weigh the evidence and determine the truth of the matter but to determine whether there is a genuine issue for trial." *Liberty Lobby*, 477 U.S. at 249. "The evidence of the nonmovant is to be believed, and all justifiable inferences are to be drawn in his favor." Id. at 255; see also *Matsushita Elec. Indus. Co. v. Zenith Radio Corp*., 475 U.S. 574, 587–88 (1986); *Lathan Co., Inc. v. United States*, 20 Cl. Ct. 122, 125 (1990); *Casitas Mun. Water Dist*., 543 F.3d at 1283. Cross-motions for summary judgment do not constitute admissions that no genuine issues of material fact remain. See *Massey v. Del Labs., Inc*., 118 F.3d 1568, 1573 (Fed. Cir. 1997). "Each party

carries the burden on its own motion to show entitlement to judgment as a matter of law after demonstrating the absence of any genuine disputes over material facts." Id.

Where as here, the plaintiff corporation is challenging a tax assessment, the burden is on the taxpayer to prove that the taxes assessed were erroneous. See *WMI*, 45 Fed. Cl. at 549; *Consolidated Flooring v. United States*, 38 Fed. Cl. 450, 454 [80 AFTR 2d 97-6100] (1997) (citing *United States v. Janis*, 428 U.S. 433, 440 [38 AFTR 2d 76-5378] (1976). "[I]n a refund suit, a taxpayer has the burden of proving by a preponderance of the evidence that the assessment or determination is incorrect and the correct amount, if any, of tax." Cook v. United States, 46 Fed. Cl. 110, 116 [85 AFTR 2d 2000-1017] (2000) (citing *Helvering v. Taylor*, 293 U.S. 507, 515 [14 AFTR 1194] (1935) ("[u]nquestionably the burden of proof is on the taxpayer")).

B. Dismissal of WMI's Claim and the Government's Counterclaim Against WMI

In their response to the government's Motion for Summary Judgment, the plaintiffs argue following the Supreme Court's decision in *States v. Tohono O'Odham Nation*, 131 S.Ct. 1723 (2011), that 28 U.S.C. § 1500 bars this court from considering the government's counterclaim. The plaintiffs contend that 28 U.S.C. § 1500, as interpreted by the Supreme Court in Tohono, bars the government's counterclaim because "[t]wo other cases on the same operative facts between Western Management, Inc.[] and the Commissioner of Internal Revenue were also pending" at the time the government filed the counterclaim. Pls.' Resp. 2.

In its reply brief, the government acknowledges that at the time the plaintiffs filed their complaint in this court, WMI's suit in the Tax Court regarding its liability for employment taxes for Tax Year 1994 and the first quarter of 1995 was still pending in the Tax Court. The government thus asserts that WMI's claim in this court was barred by section 1500, and it is for this reason that the court lacks jurisdiction over the government's counterclaim against WMI.

It is not disputed that WMI's suit in the Tax Court regarding the tax periods at issue in this case was not final until the Ninth Circuit affirmed the Tax Court for the second time in the case's history in 2009. See *W. Mgmt*., 314 F. App'x 65 [103 AFTR 2d 2009-992]. This fact is significant because 28 U.S.C. § 1500 bars the jurisdiction of the Court of Federal Claims where a plaintiff has a case pending for or in respect to the same claim against the United States in another court:

The United States Court of Federal Claims shall not have jurisdiction of any claim for or in respect to which the plaintiff or his assignee has pending in any other court any suit or process against the United States or any person who, at the time when the cause of action alleged in such suit or process arose, was, in respect thereto, acting or professing to act, directly or indirectly under the authority of the United States.

28 U.S.C. § 1500; see also *Tohono*, 131 S.Ct. 1723. It is also not disputed that WMI's claim regarding 1994 and the first quarter of 1995 in the Tax Court arose from the same operative facts as does WMI's claim in this court, which was filed in 2008, before the Tax Court action was final. Thus, WMI's claim in this court was "for or in respect to" a pending claim against the United States at the time it was filed, and thus this court has no jurisdiction over WMI's complaint. See 28 U.S.C. § 1500; see also *Tohono*, 131 S.Ct. 1723. For this reason, WMI's action must be dismissed for lack of subject matter jurisdiction.

Further, the government's counterclaim against WMI must be dismissed for the same reason. It is well recognized that "[a] prerequisite to this [court's] counterclaim jurisdiction is ... the existence of a claim filed against the United States within the jurisdiction of the Court of Federal Claims." *Talbot v. United States*, 40 Fed. Cl. 801, 805 (1998)

(citing *Triton Group, Ltd. v. United States*, 10 Cl. Ct. 128, 134 (1986), aff'd, 818 F.2d 876 (Fed. Cir. 1987); J*oseph Morton Co. v. United States*, 3 Cl. Ct. 780, 782 (1983). Thus, "When a plaintiff's claim is rejected for lack of jurisdiction, the defendant's counterclaim must be dismissed along with plaintiff's complaint, without regard to the merits of the counterclaim." Id. at 806 (citing *Triton Group*, 10 Cl. Ct. at 134; *Joseph Morton*, 3 Cl. Ct. at 783). Accordingly the court lacks jurisdiction over the government's counterclaim against WMI, and the counterclaim against WMI must be dismissed.

Dismissal of WMI's claim and the government's counterclaim against WMI does not, however, affect the status of the government's counterclaim against the individual plaintiffs, Mr. and Mrs. Kovacevich. Section 1500 bars a plaintiff from bringing suit against the United States when another suit "for or in respect to" the same claim is pending against the United States in another court. The Kovaceviches did not have another case pending in another court "for or in respect to" the claims they filed as individuals in this case. Thus, the Kovaceviches' claims in the present complaint need not be dismissed, and the government's counterclaim is also not barred by section 1500.

C. The Government is Entitled to Summary Judgment on the Individual Plaintiffs' Complaint.

The remaining plaintiffs—Mr. and Mrs. Kovacevich—seek a refund of three checks written by the Kovaceviches and applied to WMI's employment tax liabilities for 1994 and the first quarter of 1995. Specifically, the plaintiffs seek a refund of a check for $8276.60, paid on November 23, 2004; a check for $7514.40, paid on April 28, 2004; and a check for $7682.00, paid on September 29, 2003. The plaintiffs also seek a sum of $21,985.48, paid on March 31, 1991, "for social security taxes of Robert E. Kovacevich for 1989 through 19[9]0." Compl. 13–14. Additionally, the plaintiffs seek "economic damages" stemming from "tortuous [sic] action" in the amount of $6918.75. The Kovaceviches appear to claim that amounts they paid and the IRS has allocated to WMI's tax account should now be refunded to the individual plaintiffs on the grounds that the Kovaceviches were never individually liable for paying the tax at issue. In addition, they claim that the IRS has "cancelled" any tax liability for the periods at issue.

For the reasons that follow, the government is entitled summary judgment on the remaining plaintiffs' complaint because the plaintiffs are barred from relitigating the IRS's treatment of certain of these payments, certain claims are untimely, and certain claims are outside this court's jurisdiction. The plaintiffs are not entitled to the tax refund they seek as a matter of law.

1. The Kovaceviches may not relitigate the appropriateness of crediting WMI's tax account with their tax payments.

The government argues it is entitled to summary judgment on the plaintiffs' refund claim because the Tax Court has established the appropriateness of the IRS's decision to apply the individual plaintiffs' tax payments as credits toward WMI's existing tax liability. The court agrees. Although the individual plaintiffs were not parties to the Tax Court litigation that established WMI's liability for FICA, FUTA, penalties, and interest for tax year 1994 and 1995, the Kovaceviches were parties to the Tax Court CDP litigation regarding tax year 1992 that established the appropriateness of allocating certain of the plaintiffs' tax payments toward WMI's account. In that case, the Kovaceviches argued that the IRS had inappropriately credited WMI's account with certain checks the Kovaceviches had submitted to the IRS. The Tax Court held that the IRS had treated the checks at issue properly. Kovacevich, T.C.M. (RIA) 2009-160 (Def.'s Ex. 21). In particular, the court held the following: Check number 3747, for $21,985.48, written on the account of Robert E. Kovacevich, P.S., was applied to the firm's tax account for years preceding 1992. Check 10161, for $7682.00, written September 29, 2003, was properly allocated to WMI's account equally between the four quarters of 1994. Check 10376, for $7514.40, dated April 28, 2004, drawn from the personal account of Robert and Yvonne Kovacevich, was credited to WMI's account for the first quarter of 1994. Finally, check 7641, for $8276.50, was properly credited to WMI's account for the first quarter of 1995. [17] Id.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Mr. and Mrs. Kovacevich are barred by the doctrine of res judicata from relitigating the issue of the appropriateness of the IRS crediting WMI's account with the above-described payments. As the Supreme Court has explained, once parties have an opportunity to fully litigate an issue and obtain a final judgment on the merits, they may not relitigate that issue:

A fundamental precept of common-law adjudication, embodied in the related doctrines of collateral estoppel and res judicata, is that a "right, question or fact distinctly put in issue and directly determined by a court of competent jurisdiction ... cannot be disputed in a subsequent suit between the same parties or their privies...." Under res judicata, a final judgment on the merits bars further claims by parties or their privies based on the same cause of action.... To preclude parties from contesting matters that they have had a full and fair opportunity to litigate protects their adversaries from the expense and vexation attending multiple lawsuits, conserves judicial resources, and fosters reliance on judicial action by minimizing the possibility of inconsistent decisions.

Mont. v. United States, 440 U.S. 147, 153–54 (1979) (citations omitted). As the Federal Circuit has explained, "res judicata applies if (1) the prior decision was rendered by a forum with competent jurisdiction; (2) the prior decision was a final decision on the merits; and (3) the same cause of action and the same parties or their privies were involved in both cases." *Carson v. Dep't of Energy*, 398 F.3d 1369, 1375 (Fed. Cir. 2005) (citation omitted).

In this case, the government is correct that res judicata bars the Kovaceviches from relitigating the crediting issue. First, the Tax Court had jurisdiction to rule on the IRS's allocation of the Kovaceviches' payments in case No. 14545-06; second, the Tax Court decision was final on the merits; [18] third, the Kovaceviches were the named parties in that case. See *Kovacevich*, T.C.M. (RIA) 2009-160 (Def.'s Ex. 21). As such, the Tax Court's July 1, 2009 decision established that the IRS treated the Kovaceviches' payments correctly when it applied those payments toward WMI's existing tax liability. The plaintiffs may not now relitigate this issue. Thus, the government is entitled to summary judgment on this portion of the plaintiffs' claim.

2. Plaintiffs' other claims are also barred.

To the extent the plaintiffs seek recovery of the $21,995.48 paid in 1991 and credited to WMI (then Robert E. Kovacevich, P.S.) for employment taxes in 1988, 1989, and 1990, the statute of limitations for such a recovery is barred by I.R.C. § 6511(b). Even if the plaintiffs timely filed a claim with the IRS—and it is not clear whether they did—that provision limits recovery to amounts paid in the last three years:

Limitation on allowance of credits and refunds. —

> ((1)) Filing of claim within prescribed period.—No credit or refund shall be allowed or made after the expiration of the period of limitation prescribed in subsection (a) for the filing of a claim for credit or refund, unless a claim for credit or refund is filed by the taxpayer within such period.
>
> ((2)) Limit on amount of credit or refund. —
>
>> ((A)) Limit where claim filed within 3-year period.—If the claim was filed by the taxpayer during the 3-year period prescribed in subsection (a), the amount of the credit or refund shall not exceed the portion of the tax paid within the period, immediately preceding the filing of the claim, equal to 3 years plus the period of any extension of time for filing the return. If the tax was required to be paid by means of a stamp, the amount of the credit or refund shall not exceed the portion of the tax paid within the 3 years immediately preceding the filing of the claim.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

> ((B)) Limit where claim not filed within 3-year period. — If the claim was not filed within such 3-year period, the amount of the credit or refund shall not exceed the portion of the tax paid during the 2 years immediately preceding the filing of the claim.
>
> ((C)) Limit if no claim filed. — If no claim was filed, the credit or refund shall not exceed the amount which would be allowable under subparagraph (A) or (B), as the case may be, if claim was filed on the date the credit or refund is allowed.

I.R.C. § 6511(b). Thus, the government is entitled to summary judgment on the plaintiffs' claims stemming from this 1991 payment.

Further, to the extent the plaintiffs have attempted to state a tort claim, see Compl. ¶¶ 29–31, this court lacks jurisdiction over such claims. The plaintiffs' complaint includes allegations that the IRS has committed "tortious [sic] action" and that the IRS's actions have been "wrongful, negligent, intentional and malicious." These claims sound in tort. The Tucker Act expressly bars this court's jurisdiction over such claims. See 28 U.S.C. § 1491(a)(1) ("The [Court of Federal Claims] shall have jurisdiction to render judgment upon any claim against the United States ... for liquidated or unliquidated damages in cases not sounding in tort." (emphasis added)); see also *Alves v. United States*, 133 F.3d 1454, 1459 (Fed. Cir. 1998) ("To the extent that [plaintiff's] allegations sound in tort, the Court of Federal Claims lacks jurisdiction under the Tucker Act to determine this question.") As such, the court has no jurisdiction over such claims and they must be dismissed pursuant to RCFC 12(b)(1).

D. The Government Is Entitled to Summary Judgment on its Counterclaim Against Mr. and Mrs. Kovacevich

The court now turns to the government's counterclaim, in which the government seeks a judgment against Mr. and Ms. Kovacevich in order to satisfy WMI's outstanding employment tax liability stemming from tax year 1994 and the first quarter of 1995.

The plaintiffs' response to the government's motion is largely incomprehensible, but the court ascertains that the plaintiffs' remaining objections to the government's counterclaim are (1) the counterclaim is untimely; (2) Mr. Kovacevich is not WMI's alter ego or otherwise may not be held personally liable for amounts owed by WMI; (3) WMI is not liable for taxes stemming from Mr. Kovacevich's employment; and (4) Mrs. Kovacevich may not be held personally liable for WMI's tax liabilities under Washington law. The court will address each of these issues in turn.

1. The court has previously held, and declines to reconsider, that the government's counterclaim is timely.

The plaintiff again contends, as it did in its December 10, 2008 Motion to Strike, that the defendant's counterclaim is "too late." Pls.' Resp. 14. As the court held in its March 20, 2009 decision granting-in-part and denying-in-part the plaintiffs' motion, "the counterclaim is not time-barred and that the assessment against WMI may properly serve as an assessment against the individual plaintiffs, to the extent the government can establish that the individuals are liable under an alter ego theory." Order Granting in Part & Den. in Part Mot. to Strike Def.'s Countercl. 15, Mar. 20, 2009. The court has already heard the plaintiffs' arguments regarding the timeliness of the government's counterclaim and declines to revisit that issue today.

2. Mr. Kovacevich is the alter ego of WMI and is liable for WMI's tax liabilities.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

As explained in the court's previous orders in this case, the government's alter ego theory is supported by the Ninth Circuit's decision in Wolfe v. United States, 798 F.2d 1241, 1245 [58 AFTR 2d 86-5678] (9th Cir. 1986), amended on denial of reh'g, 806 F.2d 1410 (9th Cir. 1986), cert. denied, 482 U.S. 927 (1987). Order Granting in Part & Den. in Part Mot. to Strike Def.'s Countercl. 6–7, Mar. 20, 2009; see also Order Den. Mot. to Strike Def.'s Am. Countercl. 5, Sept. 26, 2009. In Wolfe, the Ninth Circuit stated, "[U]nder alter ego theory, the assessment against the corporation was effective against [the shareholder] as well." 798 F.2d at 1245 (citation omitted). The Ninth Circuit explained that this view did not undermine the integrity of the corporate form, stating:

It is not necessarily inconsistent to view a corporation as viable for the purpose of assessing a corporation tax, while disregarding it for the purpose of satisfying that assessment.... A corporation could have a valid business purpose (giving it separate tax status) and at the same time be so dominated by its owner that it could be disregarded under the alter ego doctrine.

Id. at 1243 (citations omitted).

As the Ninth Circuit explained in Wolfe, "State law governs the determination of whether there exists an alter ego from whom the government may satisfy the obligation of a taxpayer." *Wolfe*, 798 F.2d at 1244 n.3 (citations omitted). In Washington, the relevant state in this case, the test for evaluating whether to disregard the corporate form was set forth in *Morgan v. Burks*, 611 P.2d 751 (Wash. 1980). In Morgan, the Supreme Court of Washington explained that for the corporate form to be disregarded, the corporate form must be used to violate or evade a duty:

The corporate entity is disregarded and liability assessed against shareholders in the corporation when the corporation has been intentionally used to violate or evade a duty owed to another. This may occur either because the liability-causing activity did not occur only for the benefit of the corporation, and the corporation and its controllers are thus "alter egos," or because the liable corporation has been "gutted" and left without funds by those controlling it in order to avoid actual or potential liability ....

Morgan, 611 P.2d at 755 (internal citations omitted). Further, "disregard must be "necessary and required to prevent unjustified loss to the injured party."" *Meisel v. M & N Modern Hydraulic Press Co*., 645 P.2d 689, 692 (Wash. 1982) (en banc) (quoting *Morgan*, 611 P.2d at 756). In other words, disregard of the corporate form—in this case, holding Mr. Kovacevich personally liable for WMI's tax liabilities—is appropriate where (1) there is abuse of the corporate form; (2) the corporation has been used to violate or evade a duty to another; and (3) disregard is necessary to prevent an unjustified loss to the injured party.

The government has presented a considerable mass of admissions by WMI and Mr. and Mrs. Kovacevich that support a finding that Mr. Kovacevich intentionally used WMI to evade the payment of taxes at issue. [19] As set forth in Part I.B. of this opinion, WMI was by Mr. Kovacevich's own admission a "shell" or "nominee" and an "unsuccessful attempt to achieve limited liability." WMI had no bank account, was dependent on the Kovaceviches for credit and liquidity; and had no assets, furniture, or leases. WMI had no formal or informal meetings to elect officers or otherwise and Mr. Kovacevich regarded himself as WMI's "alter ego," with all control over the corporation being held by himself and Mrs. Kovacevich. Both the Kovaceviches and WMI have admitted that WMI was operated as a "disregarded entity."

The Tax Court has found in multiple cases that Mr. Kovacevich manipulated income received from WMI to avoid taxation. See *Kovacevich*, T.C.M. (RIA) 2003-161 (Def.'s Ex. 15); *W. Mgmt*., T.C.M. (RIA) 2003-162 (Def.'s Ex. 9). Mr. Kovacevich underreported the amount of income he received from WMI, both in the form of direct wages and as payments on lines of credit held by the Kovaceviches. See *Kovacevich*, T.C.M. (RIA) 2003-161 (Def.'s Ex. 15);

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

W. Mgmt., T.C.M. (RIA) 2003-162 (Def.'s Ex. 9). As discussed above, the Tax Court has assessed penalties resulting from this underreporting of income and misclassification of payments. *Kovacevich*, T.C.M. (RIA) 2003-161 (Def.'s Ex. 15); *W. Mgmt*., T.C.M. (RIA) 2003-162 (Def.'s Ex. 9). The Tax Court also found that Mr. Kovacevich was "an experienced tax lawyer who manipulated income received from Western." *Kovacevich*, T.C.M. (RIA) 2003-161 (Def.'s Ex. 15).

In sum, the admitted facts and holdings of this and other courts in related litigation establish that Mr. Kovacevich structured WMI and attempted to classify himself as an independent contractor of his own law practice for the purpose of avoiding payment of the taxes at issue in the counterclaim. Such actions clearly constitute intentional use of the corporate form to evade the duty to pay taxes and clearly satisfy the first two factors weighing in favor of disregarding the corporate entity under Washington law.

The government has also shown that disregard of the corporate entity is necessary to prevent an unjustified loss to the government. As the plaintiffs have admitted numerous times in their pleadings in related litigation, WMI has no assets. Thus, the government has also pled sufficient facts to satisfy this factor of the corporate disregard test. Accordingly, the government has established that Mr. Kovacevich, as WMI's alter ego, may be held personally liable for WMI's tax liabilities. [20]

3. Mr. Kovacevich may not relitigate the issue of WMI's liability for employment taxes, penalties, and interest from 1994 and the first quarter of 1995.

The government argues it is entitled to summary judgment on its counterclaim because the Tax Court has ruled on the tax liability and crediting issues that the plaintiffs now seek to relitigate in this court. The government is correct that the Tax Court on June 3, 2003 ruled that Mr. Kovacevich was a statutory employee of WMI, WMI was not entitled to relief from employment taxes, and WMI was thus liable for employment taxes with respect to Mr. Kovacevich—as well as interest and penalties—for tax year 1994 and the first quarter of 1995. *W. Mgmt*., T.C.M. (RIA) 2003-162 (Def.'s Ex. 9). On January 20, 2004, the Tax Court issued an Order establishing the amount of WMI's liabilities related to ITW, [21] employment taxes, and penalties:

Tax Period	FICA/FUTA tax	§ 6656 Penalty	§ 6662 Penalty
Q1 1994	$5049.00 (FICA)	$252.45	$2857.80
Q2 1994	4379.40 (FICA)	218.97	2723.88
Q3 1994	957.00 (FICA)	47.85	2039.40
Q4 1994	957.00 (FICA)	47.85	2039.40
1994	434.00 (FUTA)	43.00	87.00
Q1 1995	5087.25 (FICA)	254.36	2879.45

W. Mgmt., Inc. v. Comm'r, No. 12686-99 (Jan. 20, 2004) (Order and Decision) (Def.'s Ex. 23). The Court of Appeals for the Ninth Circuit upheld the Tax Court's liability determinations, but remanded for the purpose of determining which, if any, of the Kovaceviches' individual income tax payments should be credited to WMI, relieving it from

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

collection to the extent the IRS received amounts from the individual plaintiffs. See *W. Mgmt*., 176 F. App'x 778 [97 AFTR 2d 2006-1949]. On remand, the Tax Court held that acknowledged that in 2004 the Kovaceviches had paid all outstanding individual income tax liabilities related to wages paid to Mr. Kovacevich in 1994 and the first quarter of 1995, and held that the IRS could not collect ITW liabilities related to those wages. W. Mgmt., No. 12686-99 (T.C. Aug. 3, 2007) (Def.'s Ex. 18). Thus, the Tax Court has also entered a final judgment regarding the appropriateness of crediting WMI with amounts paid by the individual plaintiffs. Id.; see also *Kovacevich*, T.C.M. (RIA) 2009-160 (Def.'s Ex. 21). That decision appears to be the basis for the plaintiffs' contention that WMI's tax liability was "abrogated" or "cancelled," but that decision did not alter the Tax Court's earlier determination regarding WMI's liability for employment taxes, penalties, and interest related to the mischaracterization of Mr. Kovacevich for tax purposes, as included in the chart above. As such, the Tax Court's judgment on WMI's liability and the crediting of payments by the individual plaintiffs still stands.

In this case, the government is correct that res judicata bars Mr. Kovacevich from relitigating the issue of WMI's liability for employment taxes, penalties, and interest stemming from Mr. Kovacevich's employment. First, the Tax Court had jurisdiction to rule on WMI's tax liability in case No. 12686-99; second, the Tax Court decision was final on the merits; third, WMI was the named party in that case, and Mr. Kovacevich is liable for WMI's taxes because of his status as WMI's alter ego. See *W. Mgmt*., T.C.M. (RIA) 2003-162 (Def.'s Ex. 9). As such, the Tax Court's June 3, 2003 decision, which was affirmed by the Ninth Circuit, established WMI's liability for taxes, penalties, and interest related to Mr. Kovacevich's employment in 1994 and the first quarter of 1995. Mr. Kovacevich may not now relitigate WMI's liability for the taxes owed by the Tax Court in its June 3, 2003 decision. Thus, as WMI's alter ego, Mr. Kovacevich is bound by that decision and personally responsible for WMI's tax liability for tax year 1994 and the first quarter of 1995 as established therein.

4. Mrs. Kovacevich is liable as a holder of community property.

As stated above, Mr. and Mrs. Kovacevich are residents of Washington, which is a community property state. The government claims that Mrs. Kovacevich should be held personally liable for WMI's unpaid taxes because a spouse should be named as a defendant where the claim (here, the debt) involves community property.

The court finds that this judgment against Mr. Kovacevich will be enforceable against the community. As the court explained in its prior decision in this case, under Washington law, debts of one spouse will often be held against the other:

In Washington State, plaintiffs' attorneys will usually name both spouses to avoid any uncertainty about whether the action is intended against the community. See 14 Karl B. Tegland, Washington Practice, Civil Procedure § 11:19 (2d ed. 2009) ("To be cautious, and to avoid any question about whether the action is intended to be against the community, most plaintiff's attorneys will simply name both spouses as defendants from the outset, in all cases involving married persons."). Indeed, in actions concerning real property owned by the community and certain other community assets, both spouses must be named as parties. Id.

Order Den. Mot. to Strike Def.'s Am. Countercl., 8–9, Sept. 25, 2009. In the tort context, Washington courts hold both the tortfeaser and the community liable when the wrongful act is "done in the management of community business, or for the benefit of the community." *deElche v. Jacobsen*, 622 P.2d 835, 840 (Wash. 1980); see also *Clayton v. Wilson*, 227 P.3d 278, 281 (Wash. 2010). [22] Based on this clear precedent, the court agrees with the government that the judgment here is properly against the community property, as the plaintiffs' actions were made to benefit the community—for example, WMI made payments to Mr. and Mrs. Kovaceviches' personal creditors, including Nordstrom and Teneff Jewelry. For this reason, the government is entitled to summary judgment on its counterclaim against Mrs. Kovacevich as a holder of community property.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

5. The government has properly calculated the extent of WMI's tax liabilities.

As stated above, the Tax Court in 2004 established WMI's employment tax liabilities and relevant penalties as follows:

Tax Period	FICA/FUTA tax	§ 6656 Penalty	§ 6662 Penalty
Q1 1994	$5049.00 (FICA)	$252.45	$2857.80
Q2 1994	4379.40 (FICA)	218.97	2723.88
Q3 1994	957.00 (FICA)	47.85	2039.40
Q4 1994	957.00 (FICA)	47.85	2039.40
1994	434.00 (FUTA)	43.00	87.00
Q1 1995	5087.25 (FICA)	254.36	2879.45

W. Mgmt., No. 12686-99 (Jan. 20, 2004) (Order and Decision) (Def.'s Ex. 23). In its briefing regarding its counterclaim, the government provided a table showing the amounts it seeks, reproduced in part here:

FICA Tax Period	Self Assess.	Add'l Empl. Tax	§ 6656 Penalty
Q1 1994	$2300.00	$5049.00	$252.45
Q2 1994	2889.98	4379.40	218.97
Q3 1994	3319.37	957.00	47.85
Q4 1994	2983.48	957.00	47.85
Q1 1995	2302.91	5087.25	254.36
FUTA Tax Period			
1994	208.40	434.00	43.00

(For additional columns, see below.)

FICA Tax	§ 6656	Assessed	Payments	Total

Period	Penalty	Interest	& Credits	Balance
Q1 1994	$2857.80	$19,754.92	$11,734.90	$18,530.55
Q2 1994	2723.88	18,182.17	4810.48	23,583.92
Q3 1994	2039.40	13,065.22	5239.87	14,188.97
Q4 1994	2039.40	12,496.85	4903.98	13,620.60
Q1 1995	2879.45	16,193.03	10,579.41	16,857.59
FUTA Tax Period				
1994	87.00	533.76	208.40	1097.76
			Total Balance	$87,879.39

Def.'s Ex. 19. [23] The court has compared this table to the Tax Court's ruling on WMI's liability and WMI's IRS transcripts from the periods in question. See Def.'s Exs. 17, 19, 23. After review, the court concludes that the government's calculations of WMI's—and the Kovaceviches'—liability are correct with respect to all quarters of FICA tax and FUTA from tax year 1994. As such, the court finds that the government is entitled to recover against Mr. and Mrs. Kovacevich WMI's outstanding tax liability from 1994 and the first quarter of 1995, totaling $87,879.39 plus statutory interest.

III. CONCLUSION

For the reasons set forth above, plaintiff Western Management, Inc.'s claims and the government's counterclaims against Western Management, Inc. are DISMISSED; the government's Motion for Summary Judgment with respect to the claims of Robert E. Kovacevich and Yvonne R. Kovacevich is GRANTED, disposing of the plaintiffs' complaint; and the government's motion for summary judgment with respect to its counterclaim against Robert E. Kovacevich and Yvonne R. Kovacevich is GRANTED. [24] Accordingly, the clerk is directed to enter judgment in favor of the government against Robert E. Kovacevich and Yvonne R. Kovacevich in the amount of $87,879.39 plus statutory interest.

IT IS SO ORDERED.

NANCY B. FIRESTONE

Judge

[1] In its briefing on its Motion for Summary Judgment, the government stated that it sought an amount totaling $89,094.58. Upon review, this amount includes FICA, interest, and penalties from all quarters of 1994 and the first quarter of 1995, as well as FUTA for tax years 1994 and 1995. The previous Tax Court judgment included liability for FICA, interest, and penalties from 1994 and the first quarter of 1995 as well as FUTA for tax year 1994, but the

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

counterclaim did not include a claim for FUTA liability for 1995, and the Tax Court judgment did not address WMI's liability for FUTA for 1995. Therefore, as discussed, infra n.23, the claim for 1995 FUTA is outside the scope of the government's counterclaim.

[2] That case became final in 2009 when the Ninth Circuit affirmed the Tax Court's decision to not revisit WMI's FICA liability on remand and its denial of the plaintiff's claim for attorney fees. *W. Mgmt., Inc. v. Comm'r*, 314 F. App'x 65 [103 AFTR 2d 2009-992] (9th Cir. 2009), aff'g, T.C.M. (RIA) 2007-211.

[3] As discussed infra Part II.B, the court does not possess jurisdiction to hear WMI's claim nor the government's counterclaim against WMI.

[4] In addition to the present case, WMI's and the Kovaceviches' litigation has produced multiple opinions in many of the following cases: *Western Management, Inc. v. United States*, No. 97-340T (Fed. Cl. filed May 15, 1997); *Western Management, Inc. v. Commissioner*, No. 12686-99 (T.C. filed July 19, 1999); Kovacevich *v. Commissioner*, No. 12815-99 (T.C. filed July 21, 1999); *Kovacevich v. Commissioner*, No. 14545-06 (T.C. filed July 28, 2006); and *Western Management, Inc. v. Commissioner*, No. 9745-08 (T.C. filed Apr. 28, 2008).

While only the Tax Court litigation concerning WMI's liability for tax year 1994 and the first quarter of 1995 (Western Management, Inc. v. Commissioner, No. 12686-99 (T.C. filed July 19, 1999)) and the crediting of the Kovaceviches' tax payments toward WMI's tax liability (Kovacevich v. Commissioner, No. 14545-06 (T.C. filed July 28, 2006)) are directly relevant to this case, the other cases provide context for the dispute now before this court.

[5] The Tax Court explained the effects of re-characterizing Mr. Kovacevich as a statutory employee, as follows:

The first was to eliminate the Kovaceviches' liability for Robert's self-employment tax, but also eliminate their right to deduct half that tax as a personal deduction.

The second important effect was to cast the entire obligation to pay employment taxes onto Robert's firm, which [in 1997] had changed its name to Western Management, Inc.

Kovacevich v. Comm'r, T.C.M. (RIA) 2009-160 (Def.'s Ex. 21).

[6] *Kovacevich v. Comm'r*, T.C.M. (RIA) 2003-161 (Def.'s Ex. 15); Kovacevich v. Comm'r, No. 12815-99 (T.C. Jan. 15, 2004) (order and decision) (Def.'s Ex. 20).

[7] *Kovacevich v. Comm'r*, 177 F. App'x 561 [97 AFTR 2d 2006-1952] (9th Cir. 2006).

[8] As noted above, the plaintiffs are now seeking refunds of amounts paid via certain of these checks.

[9] *W. Mgmt*., T.C.M. (RIA) 2003-162 (Def.'s Ex. 9).

[10] *W. Mgmt*., 176 F. App'x 778, 781 [97 AFTR 2d 2006-1949].

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

[11] This decision found that WMI's IWT deficiency was reduced to $0 because of the payments Mr. and Mrs. Kovacevich had made individually. The Tax Court on remand did not alter its earlier decision regarding WMI's liability for FICA and FUTA taxes, nor the penalties owed. W. Mgmt., Inc. v. Comm'r, No. 12686-99 (T.C. Aug. 3, 2007) (order and decision) (Def.'s Ex. 18).

[12] *W. Mgmt.*, 314 F. App'x 65 [103 AFTR 2d 2009-992].

[13] Unsurprisingly, the plaintiffs' litigation regarding their tax liability did not end with the Tax Court. Rather, the plaintiffs continued to try to litigate the same issues the Tax Court has addressed in the Court of Federal Claims:

But the Kovaceviches' 1992 individual income-tax case and Western Management's 1994-and-a-bit-of-1995 employment-tax case were only two fronts in their war with the IRS. The Commissioner also determined that Western Management owed employment taxes for 1991, 1992, and 1993. Western Management paid up and sued for a refund in the Court of Federal Claims. [citation omitted] The key issue in that case was the same as it was in the earlier Tax Court cases: Was Robert an employee or an independent contractor? And the Claims Court answered that question the same way we had—finding that he was an employee.

Kovacevich, T.C.M. (RIA) 2009-160 (Def.'s Ex. 21) (citing *W. Mgmt., Inc. v. United States*, 45 Fed. Cl. 543 [85 AFTR 2d 2000-591] (2000)).

Earlier this year, this court held in the refund action concerning tax years 1991 to 1993 that because Mr. Kovacecich was a statutory employee during that period, WMI is liable for all employment taxes and penalties. *W. Mgmt., Inc. v. United States*, 97 Fed. Cl. 29 [107 AFTR 2d 2011-490] (2011). The court found that, after applying WMI's payments and appropriate credits, WMI owed $94,446.99 in unpaid taxes, assessed interest, and penalties related to tax years 1991 to 1993. Id. at 40. That decision is presently on appeal to the Federal Circuit.

[14] These facts are drawn from the defendant's proposed findings of uncontroverted facts. The facts are based in large part upon statements made by the plaintiffs in filings before the Tax Court in related litigation. The plaintiffs have responded to these proposed findings of uncontroverted fact by arguing that all of these admissions should be disregarded because Mr. Kovacevich has previously been found to be not credible by the Tax Court. This argument is devoid of merit. As the Supreme Court has noted, courts have "held with virtual unanimity that a party cannot create a genuine issue of fact sufficient to survive summary judgment simply by contradicting his or her own previous sworn statement (by, say, filing a later affidavit that flatly contradicts that party's earlier sworn deposition) without explaining the contradiction or attempting to resolve the disparity." *Cleveland v. Policy Mgmt. Sys. Corp.*, 526 U.S. 795, 806 (1999). Here, the plaintiffs have offered no explanation for their contradictory statements and have presented no new evidence to support their new assertions. As such, the court accepts the government's proposed findings of uncontroverted fact to the extent they are—and they are in large part—based upon the plaintiffs' previous submissions to the Tax Court in related litigation.

[15] While the amounts are different, this check for which a refund is claimed appears to correspond to a "subsequent payment" on WMI's tax account for the first quarter of 1994 in the amount of $7514.40; this also seems to correspond with check 10376, written April 28, 2004 for $7514.40, as discussed by the Tax Court in Kovacevich, T.C.M. (RIA) 2009-160. As the plaintiffs have not provided proof that there is a separate check, written April 28, 2004 in the amount of $7374.40, the court finds that the applicable check for which the plaintiffs now claim a refund is identical to the check for $7514.40 discussed by the Tax Court and corresponding to the IRS's "subsequent payment" notation on WMI's account.

[16] Though the amounts are $10 off, the check referenced in the plaintiffs' complaint appears to correspond to the check for $21,985.48 that the Tax Court determined was properly credited to WMI for years 1988 to 1990. See *Kovacevich*, T.C.M. (RIA) 2009-160 (Def.'s Ex. 21); *Kovacevich*, No. 12815-99 (T.C. Jan. 15, 2004) (order and decision) (Def.'s Ex. 20).

[17] Further, the Tax Court in WMI's suit regarding tax year 1994 and the first quarter of 1995 also addressed certain of these payments, acknowledging that in 2004 the Kovaceviches had paid all outstanding individual income tax liabilities related to wages paid to Mr. Kovacevich in 1994 and the first quarter of 1995, and held that the IRS could not collect ITW liabilities related to those wages. W. Mgmt., No. 12686-99 (T.C. Aug. 3, 2007) (Def.'s Ex. 18). The court will address the binding effect of this suit, infra, in the context of the government's counterclaim.

To the extent the plaintiffs contend that WMI was not credited with these amounts, that contention is incorrect. The IRS transcripts for WMI's account for 1994 and the first quarter of 1995 show credits marked “prior tax abated” on October 29, 2007 in the amounts of $9240.00 for each quarter of 1994 and $9310.00 for the first quarter of 1995. See Def.'s Ex. 17 at B363, B368, B373, B377, and B382.

The Tax Court also ruled that check number 7438, for $22,583.20, written on the account of Robert E. Kovacevich, P.S. on September 30, 1995—which does not appear to be at issue in this case—was properly applied as a payment for WMI's first quarter of 1992 tax period. WMI received a refund of $3961.04, the difference between check 7438 and the assessed tax, interest, and penalties for 1992. *Kovacevich*, T.C.M. (RIA) 2009-160 (Def.'s Ex. 21).

[18] Indeed, the Kovaceviches did not even appeal this decision.

[19] As noted above, the plaintiffs may not create a triable issue of fact by raising issues regarding the credibility of their past admissions. See *Policy Mgmt. Sys. Corp*., 526 U.S. at 806) (noting that courts have “held with virtual unanimity that a party cannot create a genuine issue of fact sufficient to survive summary judgment simply by contradicting his or her own previous sworn statement (by, say, filing a later affidavit that flatly contradicts that party's earlier sworn deposition) without explaining the contradiction or attempting to resolve the disparity.”).

[20] The plaintiffs' contention that disregard of the corporate form and Mr. Kovacevich's status as WMI's alter ego have been rejected by the Tax Court is incorrect. As the court explained in its previous order, the fact that Mr. Kovacevich was found to be a statutory employee of WMI has nothing to do with his status as WMI's alter ego, nor of his abuse of WMI's corporate status. See Order Granting in Part & Den. in Part Mot. to Strike Def.'s Countercl. 7 n.2, Mar. 20, 2009.

[21] For the sake of simplicity, the amounts attributable to ITW are not reproduced in the table below.

[22] The Washington Supreme Court cited in *Clayton* an “influential” article that explains the application of community liability in a variety of factual situations:

Community liability has been imposed in a variety of factual situations. A continuing altercation initially related to community property interests will impose community liability. An assault on a minor child in the care of a husband and wife created community liability. Negligent injury occurring during a spouse's recreational activity similarly created community liability on the reasoning that the activity was beneficial and contributed to the welfare of the community relationship. If the tort, for example, conversion, could confer a direct property benefit on the community, the basic community property presumption would dictate that the asset acquired would be community property, and hence the liability incurred in acquiring (or attempting to acquire) it would be a community liability.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700   MMisselbeck@KNSCPA.com

Community liability attaches to tortious acts committed in connection with employment by which community funds are earned, whether or not the employment is as a public official.

Harry M. Cross, The Community Property Law (Revised 1985), 61 Wash. L. Rev. 13, 139 (1986) (emphasis added; footnotes omitted).

[23] FUTA from tax year 1995 has been omitted from this chart and the "Total Balance" on the final line has been adjusted to reflect this deletion. The Tax Court did not have before it WMI's liability for FUTA stemming from 1995, and the government's counterclaim did not include a claim for FUTA for 1995. Thus, the government cannot rely on the Tax Court judgment against WMI to support a claim regarding the plaintiffs' FUTA liability for 1995. See *Allen v. W. Point-Pepperell, Inc*., 908 F. Supp. 1209 (S.D.N.Y. 1995) ("A motion for summary judgment is not the appropriate place to present new claims which effectively amend the complaint."). If the government wishes to obtain a judgment against the Kovaceviches related to WMI's liability for 1995 FUTA, it will have to initiate a separate action.

[24] The plaintiffs' November 17, 2009 "Motion to Strike False, Frivolous and Inapplicable Material from the Amended Counterclaim" appears to be in the nature of a response to proposed findings of uncontroverted fact, and the court has treated it as such. To the extent that it is indeed a motion to strike, that motion is DENIED as baseless.

The plaintiffs' October 29, 2009 "Reply and Third Party Complaint to Defendant's Counterclaim" is procedurally defective to the extent the plaintiffs' have attempted to bring a lawsuit against a party other than the United States. As the government correctly notes, only the United States may bring in a third party under the rules of this court. As such, the plaintiffs' Third-Party Complaint is DISMISSED.

Finally, the plaintiffs' August 29, 2011 "Motion to Vacate Court's Order of August 16, 2011 Granting Defendant's Motion to Stay Briefing on Plaintiffs['] Motion for Summary Judgment" is DENIED. The plaintiffs appear to allege that an ex parte communication between the court and counsel for the defendant took place. This allegation is baseless. Further, as the court has discussed in this opinion, the plaintiffs are not entitled to recovery of the funds they seek in their complaint. The plaintiffs have had a full opportunity in their brief responding to the government's Motion for Summary Judgment to explain their claims and why judgment should not be entered against them. As such, the plaintiffs have suffered no prejudice from the court's decision to stay briefing on their Motion for Summary Judgment.

Document Header: Checkpoint Contents Federal Library Federal Editorial Materials Federal Taxes Weekly Alert Newsletter 2011 09/22/2011 - Volume 57, No. 38 Articles Attorney, as alter ego of his law firm, was liable for its unpaid employment taxes (09/22/2011) © 2011 Thomson Reuters/RIA. All rights reserved.

9. Federal Taxes Weekly Alert, Employment tax collection action could begin more than 10 years after assessment - U.S. v. Booher, et al., (DC NV 7/22/2011) 108 AFTR 2d ¶ 2011-5113

A district court has ruled that IRS could pursue a collection action against an employer even though it began after the 10-year time period generally allowed by law. The court found that IRS produced sufficient evidence to establish that the employer had an outstanding tax liability on its third quarter 2001 Form 941 and that IRS didn't improperly apply the employer's tax payments.

The facts. Michael Booher owned Hillcrest Enterprises (Hillcrest), a remodeling and renovation business which he operated as a sole proprietorship. Throughout the relevant time period, Booher filed quarterly Forms 941, Employer's Quarterly Federal Tax Return, and reported owing federal employment taxes. Based on these returns, IRS made an assessment against Hillcrest for the relevant tax periods. While he didn't pay the amounts owed, Booher conceded that the company owed federal taxes on certain

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

quarterly returns. However, he contested the total amount owed claiming that: (1) he didn't owe any tax for the third quarter of '98 because the applicable statute of limitations has passed; (2) IRS had failed to show that he owes tax for the third quarter of 2001; and (3) IRS had misapplied certain payments and so caused him to incur penalties on assessments that should have been paid.

Collection time limits. Under Code Sec. 6502 , IRS must generally begin a civil action to collect federal tax within 10 years after assessment. The return at issue was Hillcrest's third quarter '98 Form 941. The tax assessment on this return was made on Sept. 14, '98. IRS collection action began on Sept. 30, 2009, which was more than 10 years after the tax assessment. However, under Code Sec. 6331(i)(5) , the 10-year statute of limitations period is temporarily suspended while there is a pending offer in compromise (OIC). In this instance, Booher had submitted two OICs that took more than a year for IRS to reject. As a result, the district court ruled that IRS could still collect the unpaid tax, since the 10-year statute of limitations period had not expired.

Evidence supporting tax liability. IRS had submitted Form 4340, Certificate of Assessments and Payments, as proof that Hillcrest had an outstanding tax liability on its 2001 third quarter Form 941. Booher claimed that because IRS didn't submit the original third quarter 2001 Form 941 with its motion for summary judgment, there was no evidence before the court that Hillcrest had a tax obligation in this quarter.

The district court ruled in favor of IRS on this issue. It cited the U.S. Court of Appeals for the Ninth Circuit's ruling in *U.S. v. Jones.*, (CA 9 8/29/1994) 74 AFTR 2d 94-6128 , in which the court held that Form 4340 was a self-authenticating document establishing a “prima facie case” of a tax liability. Once IRS establishes its prima facie case of a tax obligation, the burden shifted to the taxpayer to provide “countervailing proof” that there was no such obligation. In this instance, Booher did not submit any evidence that IRS's assessment for this period was inaccurate or not owed.

Misapplied payments. For the remainder of the tax periods at issue, Booher did not contest the tax assessments themselves, but claimed that the payments he made weren't properly applied to certain assessments which would have reduced the company's overall tax liability and eliminated related interest and penalties. The district court reviewed the documents and pleadings on file and found that Booher's claim was without merit.

Code Sec. 6402 allows IRS to apply a taxpayer's overpayment of a tax obligation to any federal tax liability of the taxpayer, as long as the statute of limitations for collecting on that liability hasn't expired. In addition, IRS has the authority to allocate proceeds from tax levies or other involuntary payments, including tax reimbursements, among any unpaid assessments in any manner it sees fit. The district court also noted that Booher hadn't submitted any evidence that he made specific, directed payments to any particular tax obligation, or any evidence that his overpayments for certain tax quarters weren't applied within IRS's statutory authority.

References: For effect of offer in compromise on collection limitation period, see FTC 2d/FIN ¶ V-5610; United States Tax Reporter ¶ 71,224.045; TaxDesk ¶ 842,032; TG ¶ 70372.

American Federal Tax Reports

U.S. v. BOOHER, ET AL., Cite as 108 AFTR 2d 2011-5434, 07/22/2011 , Code Sec(s) 6502; 6331; 7403

UNITED STATES OF AMERICA, PLAINTIFF v. Michael BOOHER, ET AL., DEFENDANTS.

Case Information:

Code Sec(s): 6502; 6331; 7403

Court Name: U.S. District Court, Dist. of Nevada,

Docket No.: 3:09-cv-0576-LRH-VPC,

2011 Regional Forums

Employee Benefits & Employment Taxes

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Date Decided: 07/22/2011.

Tax Year(s): Years 1998, 1999, 2000, 2001, 2002, 2003, 2004, 2005, 2006, 2007, 2008.

Disposition: Decision for Govt

HEADNOTE

1. Limitations periods on collection—suspensions and tolling—offer-in-compromise— collection actions—summary judgment. Limitations periods didn't bar govt. from pursuing collection action against remodeling-renovation business sole proprietor for unpaid employment taxes pertaining to multiple periods: although assessment for 1 period was made more than 10 years before govt. filed suit, suit was still timely in respect thereto when taking into account Code Sec. 6331(i)(5) suspension for time when OICs were pending.

Reference(s): ¶ 65,025.03(3); ¶ 63,315.01(50); ¶ 74,035.03(90) Code Sec. 6502; Code Sec. 6331; Code Sec. 7403

2. Collection actions—assessments reduced to judgment—application of payments— IRS authority to make credits and refunds— summary judgment. Govt. was granted summary judgment on its complaint to reduce to judgment assessments for remodeling-renovation business's sole proprietor's employment tax debts for multiple periods. Argument that govt.'s failure to submit Form 941 for 1 period meant that it failed to prove taxpayer owed anything for that period was belied by fact that govt. submitted sufficient evidence, via Forms 4340, to show that taxpayer did owe taxes for stated period; and alternate claim, that govt. misapplied payments for other periods, was belied by facts that taxpayer didn't make specific, directed payments to any particular tax obligation or show that IRS's application of his overpayments for certain quarters was outside IRS's authority to direct same as it saw fit.

Reference(s): ¶ 74,035.01(25); ¶ 64,025.28(15) Code Sec. 7403; Code Sec. 6402; Code Sec. 6342

OPINION

UNITED STATES DISTRICT COURT DISTRICT OF NEVADA,

ORDER

Judge: LARRY R. HICKS UNITED STATES DISTRICT JUDGE

Before the court is plaintiff the United States of America's ("United States") motion for summary judgment to reduce to judgment federal tax assessments against defendant Michael Booher ("Booher") and to foreclose related tax liens on certain real property. Doc. #55. [1] Defendant Booher filed an opposition (Doc. #61) to which the United States responded (Doc. #62).

I. Facts and Background

Defendant Booher owns Hillcrest Enterprises ("Hillcrest"), a remodeling and renovation business which he operates as a sole proprietorship. Hillcrest presently employs six permanent employees and four part-time employees.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

Throughout the relevant time period, [2] Booher filed standard Employer's Quarterly Federal Tax Returns using Form 941 and reported owing federal employment taxes. Based on these returns, the United States assessed tax obligations against Booher for the relevant tax periods. However, Booher did not pay the amounts owed and became delinquent on certain tax obligations.

On September 30, 2009, the United States filed the underlying action against Booher. Doc. #1. Thereafter, the United States filed the present motion for summary judgment to reduce to judgment federal tax assessments against Booher and to foreclose related tax liens on certain real property. Doc. #55.

II. Legal Standard

Summary judgment is appropriate only when "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(c). In assessing a motion for summary judgment, the evidence, together with all inferences that can reasonably be drawn therefrom, must be read in the light most favorable to the party opposing the motion. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986); *County of Tuolumne v. Sonora Cmty. Hosp.*, 236 F.3d 1148, 1154 (9th Cir. 2001).

The moving party bears the burden of informing the court of the basis for its motion, along with evidence showing the absence of any genuine issue of material fact. *Celotex Corp. v. Catrett*, 477 U.S. 317, 323 (1986). On those issues for which it bears the burden of proof, the moving party must make a showing that is "sufficient for the court to hold that no reasonable trier of fact could find other than for the moving party." *Calderone v. United States*, 799 F.2d 254, 259 [58 AFTR 2d 86-5703] (6th Cir. 1986); *see also Idema v. Dreamworks, Inc.*, 162 F. Supp. 2d 1129, 1141 (C.D. Cal. 2001).

To successfully rebut a motion for summary judgment, the non-moving party must point to facts supported by the record which demonstrate a genuine issue of material fact. *Reese v. Jefferson Sch. Dist. No. 14J*, 208 F.3d 736 (9th Cir. 2000). A "material fact" is a fact "that might affect the outcome of the suit under the governing law." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986). Where reasonable minds could differ on the material facts at issue, summary judgment is not appropriate. *See v. Durang*, 711 F.2d 141, 143 (9th Cir. 1983). A dispute regarding a material fact is considered genuine "if the evidence is such that a reasonable jury could return a verdict for the nonmoving party." *Liberty Lobby*, 477 U.S. at 248. The mere existence of a scintilla of evidence in support of the plaintiff's position will be insufficient to establish a genuine dispute; there must be evidence on which the jury could reasonably find for the plaintiff. *See id.* at 252.

III. Discussion

In his opposition, Booher concedes that he owes outstanding federal tax related to his filing of the related quarterly returns. *See* Doc. #61. However, Booher contests the total amount owed and argues that certain tax obligations have been paid or are not outstanding. *Id.* In particular, Booher argues that (1) he does not owe any tax for the Third Quarter 1998 because the applicable statute of limitations has passed; (2) the United States has failed to put forth evidence that he owes tax for the Third Quarter 2001; and (3) the United States misapplied certain payments thereby causing him to incur penalties on assessments that should have been paid. *Id.* The court shall address each argument below.

1. Third Quarter 1998

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700   MMisselbeck@KNSCPA.com

[1] A civil action to collect on federal tax obligations must be initiated within ten (10) years of the tax assessment. 26 U.S.C. § 6502. Here, the obligation in contention was assessed on September 14, 1998. *See* Doc. #55-4, Exhibit 1. Therefore, the statute of limitations would have run on September 14, 2008.

However, the ten (10) year statute of limitations period is tolled while there is a pending Offer in Compromise. 26 U.S.C. § 6331(k)(i)(5) and (i)(5). On October 12, 2000, Booher submitted an initial Offer in Compromise which was rejected on April 25, 2002. *Id.* Subsequently, on November 29, 2005, Booher submitted another Offer in Compromise which was rejected on September 13, 2006. *Id.* Thus, the statute of limitations was tolled for more than a year while the Offers in Compromise were pending. Because this action was filed on September 30, 2009, within the tolled statute of limitations period, the 1998 tax assessment is timely and not barred by the statute of limitations. Therefore, the court finds that the United States is entitled to summary judgment on this assessment.

2. Third Quarter 2001

[2] In his opposition, Booher claims that because the United States did not submit the original Form 941 Employer's Quarterly Tax Return for the Third Quarter 2001 with its motion for summary judgment, there is no evidence before the court that he owes any tax obligation for this quarter.

In stark contrast to Booher's contention, however, the United States has submitted evidence of Booher's tax obligation for the Third Quarter 2001 in the form of a Form 4340, Certificate of Assessments and Payments. Doc. #55-4, Exhibit 2. Certificates of Assessments and Payments are self-authenticating documents establishing “a *prima facie* case” of a tax liability. *United States v. Jones*, 33 F.3d 1137, 1139 [74 AFTR 2d 94-6128] (9th Cir. 1994). Therefore, the court finds that the United States has submitted sufficient evidence that Booher owes federal tax for the Third Quarter 2001.

Once the United States establishes its *prima facie* case of a tax obligation, the burden shifts to the tax payer to proffer “countervailing proof” that there is no such obligation. *United States v. Strebler*, 313 F.2d 402, 403 [11 AFTR 2d 792] (8th Cir. 1963). Here, Booher has submitted no evidence that the United States' assessment for this period is inaccurate or not owed. Thus, the court finds that the United States is entitled to summary judgment on this tax assessment.

3. Misapplied Payments

[3] For the remainder of the tax periods at issue, Booher does not contest the tax assessments themselves, but claims that payments he made were not properly applied to certain assessments which would have reduced his overall tax liability and eliminated related interest and penalties.

The court has reviewed the documents and pleadings on file in this manner and finds that Booher's claim is without merit. The IRS may apply a taxpayer's overpayment of a tax obligation to any federal tax liability of the taxpayer so long as the statute of limitations for collecting on that liability has not run. 26 U.S.C. § 6402. Further, the IRS has the authority to allocate proceeds from tax levies or other involuntary payments, including tax reimbursements, among any unpaid assessments in any manner it sees fit. *See Tull v. United States*, 69 F.3d 394, 397 [76 AFTR 2d 95-7312] (9th Cir. 1995); *see also*, 26 U.S.C. § 6342. Morevoer, Booher has not submitted any evidence that he made specific, directed payments to any particular tax obligation or any evidence that his overpayments for certain tax quarters were not applied within the IRS's statutory authority. Therefore, the court finds that the United States is entitled to summary judgment on the remaining tax assessments.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

IT IS THEREFORE ORDERED that plaintiff's motion for summary judgment (Doc. #55) is GRANTED. The clerk of court shall enter judgment in favor of the United States and against defendant Michael Booher in the amount of $167,705.90, plus accruing interest pursuant to 26 U.S.C. §§ 6601, 6621–22 and 28 U.S.C. § 1961(c).

IT IS FURTHER ORDERED that the United States shall have ten (10) days to file a proposed order regarding foreclosure of certain non-residential real property of Hillcrest Enterprises and defendant Michael Booher and submit the same for signature.

IT IS SO ORDERED.

DATED this 22nd day of July, 2011.

LARRY R. HICKS

UNITED STATES DISTRICT JUDGE

[1] Refers to the court's docket number.

[2] The tax periods at issue in this action involve various quarterly tax periods from 1998 through 2008.

Document Header: Checkpoint Contents Federal Library Federal Editorial Materials Federal Taxes Weekly Alert Newsletter 2011 08/18/2011 - Volume 57, No. 33 Articles Employment tax collection action could begin more than 10 years after assessment (08/18/2011) © 2011 Thomson Reuters/RIA. All rights reserved.

10. Federal Taxes Weekly Alert, Trust fund penalty applied even though no funds existed when owners discovered embezzlement - Oppliger v. U.S. (CA 8 3/29/11), 107 AFTR 2d ¶2011-631

The U.S. Court of Appeals for the Eighth Circuit has granted summary judgment to IRS, finding that the owners of a company were responsible persons that had willfully failed to remit employment taxes. The Court rejected their argument that, when they regained control of their companies after their accountant had embezzled funds, their potential liability as responsible persons was limited to the unencumbered funds available at that time.

Responsible person penalty. Under Code Sec. 6672(a) , if an employer fails to properly pay over its payroll taxes, IRS can seek to collect a trust fund recovery penalty equal to 100% of the unpaid taxes from a “responsible person,” i.e., a person who: (1) is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility. In determining whether there is “willfulness” for purposes of Code Sec. 6672(a) , the courts have focused on whether a taxpayer had knowledge about the non-payment of the payroll taxes, or showed reckless disregard with respect to whether the payments were being made.

The facts. In '92, James and Gayle Oppliger formed Double O, Inc. (Double O), a trucking business, and served as the sole owners and primary officers of the company. In '97, the Oppligers formed Livestock Feed Company, LLC (LFC). The Oppligers were the sole members of LFC.

In '96, the Oppligers hired Mary Kerkman to perform accounting and bookkeeping services for the companies. The Oppligers delegated to Kerkman the tasks of filing employment tax returns and paying payroll taxes. Kerkman provided the Oppligers with weekly reports that informed them of the companies' financial situations. Kerkman

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700   MMisselbeck@KNSCPA.com

committed suicide on Apr. 3, 2002. After her death, the Oppligers learned that Kerkman had embezzled $10,000 from the companies.

On Apr. 4, 2002, the day after Kerkman's death, an IRS revenue officer informed the Oppligers that LFC employment taxes were not paid to the government for 13 consecutive quarters and Double O employment taxes were not paid for 17 quarters. The Oppligers claimed that this was when they first learned that Double O and LFC had not been paying employment taxes.

The Oppligers subsequently sold the assets of Double O on Sept. 1, 2002. Between Apr. 4, 2002 and Sept. 1, 2002, LFC paid $2,117,640.43 to its employees and $3,240,138.60 to third-party creditors. IRS then assessed penalties under Code Sec. 6672 against the Oppligers for LFC's unpaid taxes in the amount of $2,363,704.25, and Double O's unpaid taxes in the amount of $27,013.21. The Oppligers went to court to get relief.

District court decision. The Oppligers argued that they were not liable for the unpaid taxes because on Apr. 4, 2002, when IRS informed them of the outstanding tax responsibilities, they had bank balances of only $3,426.29 and $4,632.73, and had outstanding checks on both of the accounts. Relying on the Supreme Court's decision in Slodov v. U.S., (S Ct 1978) 42 AFTR 2d 78-5011 , they claimed that their potential liability as responsible persons was limited to the unencumbered funds available on Apr. 4, 2002. They asserted that when they reassumed control of their companies, unencumbered funds didn't exist to pay the taxes owed.

In *Slodov,* the taxpayer assumed control of three corporations with outstanding trust fund tax liabilities and acquired funds which he used to pay employees' wages and other creditors. The Supreme Court held that a person responsible to collect taxes does not willfully fail to pay in withholding taxes by using funds for purposes other than payment of taxes when, at the time he assumed control, no funds existed to pay the outstanding tax obligations. The Supreme Court reasoned that the money generated after he became a responsible person wasn't directly traceable to the unpaid taxes and that a contrary interpretation would discourage changes of ownership and management of financially troubled corporations.

The district court granted summary judgment to IRS, stating that there were no genuine issues of material fact regarding whether the Oppligers were responsible persons under Code Sec. 6672 . The district court further determined that the Oppligers willfully failed to pay the employment (trust fund) taxes because they admitted that after IRS informed them of their outstanding tax liabilities, they paid employees and third parties over $5 million. The Oppligers appealed the district court ruling.

Appellate Court decision. The Eighth Circuit held that the Oppligers were responsible persons under Code Sec. 6672 because they had the status, duty, and authority to pay the trust fund taxes. The Eighth Circuit refuted the Oppligers' claim that Kerkman's misconduct deprived them of the opportunity to make informed decisions by noting that whether Kerkman may have been a responsible person under Code Sec. 6672 is immaterial to the Oppligers' liability since they were both responsible persons for purposes of the penalty.

Further, the Eighth Circuit concluded that the Oppligers had willfully failed to pay the trust fund taxes. The Court found the Oppligers' reliance on *Slodov* to be misplaced. *Slodov* considered only the situation in which a change of control occurs within the corporation and a new person takes control at a time when a tax delinquency for past quarters already exists. In this case, the Oppligers were responsible persons during each of the quarters in which they failed to pay the employment taxes. Accordingly, the Oppligers' decision to pay employees and other creditors in lieu of IRS constituted a willful failure to pay taxes as a matter of law.

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Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

References: For who is a "responsible person," see FTC 2d/FIN ¶ V-1704; United States Tax Reporter ¶ 66,724; TaxDesk ¶ 864,005; TG ¶ 71654.

OPPLIGER v. U.S., Cite as 107 AFTR 2d 2011-1518 (637 F.3d 889), 03/29/2011, Code Sec(s) 6672

James H. OPPLIGER, Gayle OPPLIGER, PLAINTIFFS-APPELLANTS v. UNITED STATES OF AMERICA, DEFENDANT-APPELLEE; UNITED STATES OF AMERICA, PLAINTIFF-APPELLEE v. James H. OPPLIGER, Gayle OPPLIGER, DEFENDANTS-APPELLANTS.

Case Information:

Code Sec(s): 6672

Court Name: U.S. Court of Appeals, Eighth Circuit,

Docket No.: No. 10-2011,

Date Decided: 03/29/2011.

Prior History: District Court affirmed. Earlier proceeding at (2010, DC NE) 105 AFTR 2d 2010-898, 2010-1 USTC ¶50245.

Tax Year(s): Years 1998, 1999, 2000, 2001, 2002.

Disposition: Decision against Taxpayers.

Cites: 637 F.3d 889, 2011-1 USTC P 50,307.

HEADNOTE

1. 100% penalty for failure to pay over trust fund taxes—responsible person—willfulness—summary judgment. District court properly granted govt. summary judgment on its Code Sec. 6672 penalty liability claims against married trucking co. sole owners/payroll LLC sole members: taxpayers' responsible person status was shown by facts that they formed co., acted as its officers and directors and managed day-to-day business, that they created LLC of which husband was manager and had hiring/firing authority, and that they signed returns, payroll checks and served as personal guarantors for co. and LLC; and claim that bookkeeper's misconduct deprived taxpayers of opportunity to make informed decisions regarding co.'s and LLC's finances was immaterial to their liability. Also, taxpayers acted willfully where they knew of tax debt and paid employees and other creditors ahead of IRS; claim that their potential liability was limited to unencumbered funds available on day that IRS informed them of their tax debt was rejected.

Reference(s): ¶ 66,725.02(30) Code Sec. 6672

OPINION

2011 Regional Forums

Employee Benefits & Employment Taxes

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

United States Court of Appeals FOR THE EIGHTH CIRCUIT,

Appeal from the United States District Court for the District of Nebraska.

Before WOLLMAN, BRIGHT, and COLLOTON, Circuit Judges.

Judge: BRIGHT, Circuit Judge.

James and Gayle Oppliger appeal from a summary judgment entered against them, which ordered them to pay the United States over $2 million in trust fund recovery penalties under 26 U.S.C. § 6672. The IRS assessed these penalties because the Oppligers' companies, Double O, Inc. ("Double O") and Livestock Feed Company, LLC ("LFC"), withheld taxes from their employees but did not remit those taxes to the government for approximately four years. The district court[1] granted summary judgment, concluding that undisputed facts established that the Oppligers qualified as "responsible persons" under § 6672 and willfully failed to pay the taxes. We affirm.

I.

In 1992, James and Gayle Oppliger formed Double O, a trucking business, and served as the sole owners and primary officers of the company. In 1997, the Oppligers formed LFC, a payroll company for Double O. The Oppligers were the sole members of LFC. All of Double O's employees, except Gayle, became LFC employees after the Oppligers established LFC. LFC only provided payroll services to Double O.

In 1996, the Oppligers hired Mary Kerkman to perform accounting and bookkeeping services for the companies. The Oppligers delegated to Kerkman the tasks of filing employment tax returns and paying payroll taxes. Kerkman provided the Oppligers with weekly reports that informed them of the companies' financial situations. Kerkman committed suicide on April 3, 2002. After her death, the Oppligers learned that Kerkman had embezzled $10,000 from the companies.

On April 4, 2002, the day after Kerkman's death, an IRS revenue officer visited the companies' offices and asked the Oppligers why they had not appeared at a meeting with her. The IRS officer informed the Oppligers that LFC employment taxes were not paid to the government for thirteen consecutive quarters and Double O employment taxes were not paid for seventeen quarters. The Oppligers stated that they did not know of a meeting and later claimed that this was when they first learned that Double O and LFC had not been paying employment taxes.

The Oppligers subsequently sold the assets of Double O on September 1, 2002. Between April 4, 2002 and September 1, 2002, LFC paid $2,117,640.43 to its employees and $3,240,138.60 to third-party creditors.

Pursuant to § 6672, the United States assessed penalties against the Oppligers for LFC's unpaid taxes in the amount of $2,363,704.25 and Double O's unpaid taxes in the amount of $27,013.21. The Oppligers each paid $15,015 toward LFC's tax obligations. They then filed claims for a refund with the IRS, arguing that they were not liable for the unpaid taxes. The IRS denied their claims. The Oppligers brought this suit seeking a refund of the money paid and a ruling that they were not liable for the § 6672 penalties. The United States counterclaimed to have the LFC-related assessments reduced to judgment and filed a separate suit to reduce to judgment the Double O assessments. The district court consolidated the suits.

The United States moved for summary judgment. The district court granted the United States' motions. The court determined that, even assuming Kerkman provided the Oppligers with false reports and embezzled from the companies, there were no genuine issues of material fact regarding whether the Oppligers were responsible persons under § 6672. The court also determined that the Oppligers willfully failed to pay employment taxes because they admitted that after the IRS informed them of their outstanding tax liabilities, they paid employees and third parties over $5 million.

[1]II.

The Oppligers claim the district court erred in granting summary judgment in favor of the United States because disputed material facts exist. Summary judgment is appropriate when "the movant shows that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(a). We review the district court's grant of summary judgment *de novo*, viewing the record in the light most favorable to the nonmoving party. *Keller v. United States*, 46 F.3d 851, 853 [75 AFTR 2d 95-721] (8th Cir. 1995).

III.

Employers must withhold income, Social Security, and Medicare taxes from employees' wages. 26 U.S.C. §§ 3101; 3102(a), (b); 3402; 3403. The law requires the employer to hold those taxes in trust and remit them to the IRS at the appropriate intervals. 26 U.S.C. § 7501. An employer holding the taxes in trust may not use the taxes for any other purpose. *Slodov v. United States*, 436 U.S. 238, 243 [42 AFTR 2d 78-5011] (1978). When an employer fails to remit the taxes, § 6672 imposes liability against any person [2] who is (1) a "responsible person" and (2) "willfully fails to pay over withholding taxes to the United States." *Keller*, 46 F.3d at 854.

A.

Under § 6672, "[a] responsible person is someone who has the status, duty and authority to avoid the corporation's default in collection or payment of the taxes." *Ferguson v. United States*, 484 F.3d 1068, 1072 [99 AFTR 2d 2007-2486] (8th Cir. 2007) (internal quotation and citation omitted). More than one person may be a responsible person under § 6672 and delegating the responsibility of managing funds does not relieve one of his responsibilities. *Keller*, 46 F.3d at 854. When determining responsible person status under § 6672, courts often consider a non-exhaustive list of factors, including whether the individual:

((1)) serves as an officer or member of the board of directors;
((2)) owns substantial stock in the company;
((3)) manages day-to-day operations;
((4)) possesses the authority to hire or fire employees;
((5)) makes decisions as to the disbursement of funds and payment of creditors;
((6)) controls bank accounts and disbursement of records; and
((7)) possesses check-signing authority.

See, e.g., Erwin v. United States, 591 F.3d 313, 321 [105 AFTR 2d 2010-505] (4th Cir. 2010); *Smith v. United States*, 555 F.3d 1158, 1163 [103 AFTR 2d 2009-880] (10th Cir. 2009); *Vinick v. United States*, 205 F.3d 1, 7 [85 AFTR 2d 2000-1177] (1st Cir. 2000); *Kinnie v. United States*, 994 F.2d 279, 283 [71 AFTR 2d 93-1979] (6th Cir. 1993); *Barnett v. I.R.S.*, 988 F.2d 1449, 1455 [71 AFTR 2d 93-1614] (5th Cir. 1993); *Fiataruolo v. United States*, 8

F.3d 930, 939 [72 AFTR 2d 93-6550] (2d Cir. 1993); *Brounstein v. United States*, 979 F.2d 952, 954–55 [71 AFTR 2d 93-1714] (3d Cir. 1992); *Williams v. United States*, 931 F.2d 805, 810 [67 AFTR 2d 91-1024] (11th Cir. 1991).

Here, the district court considered these factors and determined that the Oppligers qualified as responsible persons under § 6672. In granting summary judgment, the court relied on the following undisputed facts:

The Oppligers formed the companies, held offices and managed the day-to-day business. The Oppligers each owned 50% of Double O, were the only shareholders, and were the directors of Double O. Jim Oppliger was the president and Gayle Oppliger the secretary of Double O. The Oppligers were also the creators of LFC. Jim Oppliger was the manager of LFC and the Oppligers had authority to hire and fire employees. The Oppligers attended executive and partnership meetings, called the meetings, and signed the minutes. Both Oppligers possessed the authority to sign tax returns on behalf of both Double O and LFC. They signed payroll checks for both companies. They also signed for bank notes and on security agreements and served as personal guarantors.

Given these undisputed facts, we hold that the Oppligers were responsible persons under § 6672 because they had the status, duty, and authority to pay the trust fund taxes. The Oppligers claim that Kerkman's misconduct deprived them of the opportunity to make informed decisions regarding the finances of their companies. But whether Kerkman may have been a responsible person under § 6672 is immaterial to the Oppligers' liability. *See Colosimo v. United States*, 630 F.3d 749, 2011 [107 AFTR 2d 2011-622] WL 207933, at 1, 2 (8th Cir. Jan. 25, 2011) (holding that the taxpayer was a responsible person even though he may have “been duped” by a dishonest bookkeeper). Thus, we agree with the district court that no genuine issue of material fact exists as to whether the Oppligers qualified as responsible persons.

B.

We next consider whether the Oppligers willfully failed to pay the trust fund taxes. An individual willfully fails to pay over employment taxes if he “acts or fails to act consciously and voluntarily and with knowledge or intent that as a result of his action or inaction trust funds belonging to the government will not be paid over but will be used for other purposes, or by proceeding with a reckless disregard of a known or obvious risk that trust funds may not be remitted to the government.” *Keller*, 46 F.3d at 854 (internal quotations and citations omitted). “The term willfully does not connote a bad or evil motive, but rather means a voluntary, conscious, and intentional act, such as the payment of other creditors in preference to the United States.” *Elmore v. United States*, 843 F.2d 1128, 1132 [61 AFTR 2d 88-975] (8th Cir. 1988).

The district court determined that the Oppligers willfully failed to pay the taxes because, after Kerkman's death, an IRS revenue officer informed them of their outstanding tax liabilities and, despite this knowledge, the Oppligers failed to pay the taxes. The district court noted that within six months of Kerkman's death, the Oppligers sold the assets of Double O, and paid employees $2,117,640.43 and third party creditors $3,240,138.60.

The Oppligers argue that on April 4, 2002, when the IRS officer informed them of the outstanding tax responsibilities, they had bank balances of $3,426.29 and $4,632.73 and had outstanding checks on both of the accounts. Relying on *Slodov v. United States*, 436 U.S. 238 [42 AFTR 2d 78-5011] (1978), the Oppligers claim that their potential liability as responsible persons is limited to the unencumbered funds available on April 4, 2002. They assert that when they reassumed control of their companies, unencumbered funds did not exist to pay the taxes owed.

Mark H. Misselbeck, C.P.A., M.S.T.

Katz, Nannis + Solomon, P.C.

(781) 453-8700 MMisselbeck@KNSCPA.com

In *Slodov*, the United States Supreme Court considered whether Slodov, who assumed control of three corporations with outstanding trust fund tax liabilities, should be personally responsible for the unpaid taxes. 436 U.S. at 240. During Slodov's control of the corporations, he acquired funds and used those funds to pay employees' wages and other creditors. *Id.* The United States sought to impose personal liability on Slodov, claiming that during his control of the corporations, the corporations generated sufficient receipts to pay the taxes back, but that he used the funds for other purposes. *Id.* at 250. The Supreme Court disagreed with the United States, holding that a person responsible to collect taxes does not willfully fail to pay in withholding taxes by using funds for purposes other than payment of taxes when, at the time he assumed control, no funds existed to pay the outstanding tax obligations. *Id.* at 251. The court reasoned that the money generated after he became a responsible person was not directly traceable to the unpaid taxes and that a contrary interpretation would "discourage changes of ownership and management of financially troubled corporations." *Id.* at 253, 256.

The Oppligers' reliance on *Slodov* is misplaced. *Slodov* considered only the situation in which a change of control occurs within the corporation and a new person takes control "at a time when a tax delinquency for past quarters already exists." *Id.* at 246. As we have already addressed, the Oppligers were responsible persons during each of the quarters in which they failed to pay the employment taxes. Therefore, the Oppligers' decision to pay employees and other creditors in lieu of the United States constituted a willful failure to pay taxes as a matter of law. *See Anuforo v. C.I.R.*, 614 F.3d 799, 806 [106 AFTR 2d 2010-5596] (8th Cir. 2010) (holding that paying other creditors instead of the United States constitutes willful failure to pay as a matter of law); *see also Olsen v. United States*, 952 F.2d 236, 240 [69 AFTR 2d 92-395] (8th Cir. 1991) ("[I]n the case of individuals who are responsible persons both before and after the withholding tax liability accrues[,] ... there is a duty to use unencumbered funds acquired after the withholding obligation becomes payable to satisfy that obligation" (internal quotation and citation omitted)).

IV.

We affirm the judgment of the district court.

[1] The Honorable Joseph F. Bataillon, Chief Judge, United States District Court for the District of Nebraska.

[2] For purposes of § 6672, 26 U.S.C. § 6671(b) defines "person" as including "an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs."

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