Current Federal Tax Developments

Nichols Patrick CPE, Incorporated

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SECTION: 61
MINISTER'S VOW OF POVERTY BY ITSELF NOT SUFFICIENT TO EXEMPT INCOME FROM TAX

Citation: White v. Commissioner, TC Memo 2016-167, 9/12/16

The taxpayer in *White v. Commissioner*, TC Memo 2016-167 looked back to a 1919 IRS ruling in support of his position that his payments from a church was not taxable to him due to having taken a vow of poverty. In what is a citation form that most taxpayer likely have never seen, the taxpayer cited O.D. 119, 1919-1 CB 82.

As the Tax Court noted:

> In part, O.D. 119 stated: "A clergyman is not liable for any income tax on the amount received by him during the year from the parish of which he is in charge, provided that he turns over to the religious order of which he is a member, all the money received in excess of his actual living expenses, on account of the vow of poverty which he has taken."

While some may be thinking this might be one of those where someone is "ordained" in a "church" of their own creation, this is not the case here—this case does involve someone with a long history of church work.

As the opinion notes:

> Petitioner has been a pastor for over 30 years. In 1983 petitioner established the World Evangelism Outreach Church (WEOC) in DeFuniak Springs, Florida. During the years at issue petitioner was the pastor of WEOC. As WEOC's pastor, petitioner ministered from the pulpit and at nursing homes, helped build churches on foreign soil, established a feeding program for children, and supported widows and orphanages.

However, the taxpayer did decide his relationship with the church should be restructured. As the opinion continues:

> In 2001 petitioner recommended to WEOC's board of advisers that WEOC be restructured to include a corporation sole as an office of the church. The board of advisers unanimously agreed with petitioner's recommendation, and on October 5, 2001, a domestic nonprofit corporation sole of WEOC registered as "The Office of Presiding Head Apostle, of Ronald Wayne White" was created in the State of Nevada. Although the corporation sole was registered as a Nevada entity, WEOC continued to operate in Florida.
>
> On November 27, 2001, petitioner signed a document entitled "Vow of Poverty" detailing that he agreed to divest his property and future income to WEOC and in turn WEOC would provide for his physical, financial, and personal needs. By resolution, WEOC resolved in part that "[t]he church accepts * * * [petitioner's] declaration and * * * will provide all his needs as Apostle of this church ministry * * * [WEOC] shall pay his housing, all ministry expenses, and any other needs necessary for his care." WEOC established an apostolic bank account, and petitioner had "signatory authority over this account for his use."

The Tax Court, however, did not agree that in his situation that a minister who takes a vow of poverty and receives payments from the church for his support is exempt from taxation. The Court noted that the 1919 ruling he cited was superseded by a 1977 Revenue Ruling which the Court notes:

> Rev. Rul. 77-290, 1977-2 C.B. 26, supersedes O.D. 119. Rev. Rul. 77-290, supra, states that income earned by a member of a religious order on account of services performed directly for the order or for the church with which the order is affiliated and remitted back to the order in conformity with the member's vow of poverty is not includible in the member's gross income. As was the case with the taxpayers in *Cortes* and *Rogers*, the critical difference in this case is that petitioner did not remit income to WEOC pursuant to his vow of poverty. Petitioner had signatory authority over the WEOC apostolic bank account, and the payments WEOC made on his behalf served only to benefit petitioner in meeting

his living expenses. The compensation petitioner received from WEOC -- in the form of payments WEOC or its related entities made on his behalf -- must be included in his gross income. See *Pollard v. Commissioner*, 783 F.2d at 1065-1066; *Cortes v. Commissioner*, at *9-*10; *Rogers v. Commissioner*, at *9-*10.

SECTION: 71
FORMER SPOUSE'S SHARE OF CONTINGENT LEGAL FEES FOUND TO BE ALIMONY

Citation: Leslie v. Commissioner, TC Memo 2016-171, 9/14/16

Determination of what is alimony is known to be a contentious issue in taxes, especially because Congress in 1984 created a full independent federal definition by which payments are tested for classification as tax alimony, regardless of the intent of the parties or what state law may call a payment. In the case of *Leslie v. Commissioner*, TC Memo 2016-171 the payments involved amount to $5,568,200.

These payments represented 10% of the fee the taxpayer's former spouse received for his work as an attorney in litigation related to the failure of Enron. There were three payments made, one for $4,000,000 in November of 2008, one for $1,560,000 in December of 2009 and a final payment of $8,200 made in June of 2010.

The Enron litigation was in process as Ms. Leslie was going through her divorce, and the marital separation agreement had a special provision regarding the fee, the amount of which was not knowable at that time. The provision was contained in the portion of the agreement related to the division of property, but was worded as follows:

> With respect to any and all fees distributed to Mr. Georgiou as a result of his involvement in the Enron securities litigation through the firms, Mr. Georgiou shall receive ninety percent (90%) as his sole and separate property and Ms. Leslie shall receive ten percent (10%) of all net fees distributed to Mr. Georgiou by the Lerach Coughlin firm or Milberg Weiss firm "the firms". [sic] Ms. Leslie's ten percent (10%) interest in the Enron fee is a spousal support award from a contingent liability, the amount of which could not be definitely set at the time of this agreement, since Mr. Georgiou cannot be certain of the amount of fees that he will receive from the Enron litigation. This ten percent (10%) distribution to Ms. Leslie is taxable to Ms. Leslie and deductible to Mr. Georgiou as spousal support.

As well, the 2009 payment did not go directly to Ms. Leslie. Rather, as the Court notes:

> The 2009 payment had some twists. Georgiou definitely segregated this money from his distribution, and directly deposited it into an account at California Bank & Trust. That account had both his name and Leslie's on it, but she credibly testified that she had no control over it. She was not given any checks to sign from the account, and her impression of the payment was that it wasn't yet legally hers. In January 2010 she tried to gain control by filing a declaration in support of the "Release of Enron Payments from Trust Account" with the San Diego Superior Court. Georgiou opposed her petition, and the state court at first refused to grant it. It's not clear from the record when or if Leslie ever gained control over the account containing the 2009 payment.

Maria did not treat the payment as alimony, but rather argued that the payment represented a property settlement—after all, it was in the part of the agreement labeled as property settlement.

As the Court summarized her position:

> Leslie argues that we should turn to a set of factors under *Beard v. Commissioner*, 77 T.C. 1275 (1981). Beard requires the Court to examine the facts of these cases under a set of seven subjective factors -- largely the intent of the parties -- to determine if a payment is more in the nature of alimony or in the nature of a property settlement. *Id*.

The problem, as the Court notes, is that in 1984 Congress changed the law specifically to eliminate this sort of inquiry into the intent of the parties, replacing it with a subjective test. As the Court notes that takes *Beard* out of consideration, holding "will analyze the treatment of the Enron payments under section 71(b)."

IRC §71(b) imposes a four-part test to determine if a payment is alimony. If all four tests are passed the payment is treated as alimony, while even if one is not satisfied the payment will not treated as alimony.

The four tests are:

- The payment is received by (or on behalf of) a spouse under a divorce or separation instrument,
- The divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,
- In the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and
- There is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

Ms. Leslie's payments clearly meet the first three tests—it came per the separation agreement, the agreement did not specific it would not be treated as alimony, and they were not members of the same household. Note that the fact the agreement says it shall be taxable to Ms. Leslie is relevant only to the extent it shows the parties did not agree it would not be so treated—but it does not mean it will be alimony.

Rather the last test is the key—would these payments still be required to be paid if Ms. Leslie had died in the interim? The agreement did not provide one way or the other with regard to this issue, so the Court had to look to the application of state laws (in this case California), with the question being whether the payment would still have been required had Ms. Leslie died.

The Court concluded the following in its analysis of the application of California law to this matter:

> Under California law, "[e]xcept as otherwise agreed by the parties in writing, the obligation of a party under an order for the support of the other party terminates upon the death of either party or the remarriage of the other party." Cal. Fam. Code sec. 4337 (West 2013). "A written agreement to waive section 4337 'must be specific and express.'" *Johanson v. Commissioner*, 541 F.3d 973, 977 (9th Cir. 2008) (quoting *In re Marriage of Thornton*, 115 Cal. Rptr. 2d 380, 383 (Ct. App. 2002)), *aff'g* T.C. Memo. 2006-105. The parties here have not produced any such agreement. The mere failure to include language terminating support upon death is not enough to constitute a waiver. *Id*. By operation of California law, then, payments from the Enron settlement would have terminated upon Leslie's death.
>
> The requirement that any liability to make payments terminates upon the death of the payee spouse is central in distinguishing between alimony and [*17] property settlements. See H.R. Rept. No. 98-432 (Part 2), at 1496 (1984), 1984 U.S.C.C.A.N. 697, 1138; *Hoover*, 102 F.3d at 845-46. Its presence here by operation of state law means the contingent Enron payments were alimony taxable to Leslie.

However, the Court found that Ms. Leslie did not have constructive receipt of the 2009 payment based on the facts in this case. Ms. Leslie testified that she was not even aware of the funds until after the end of 2009, thus they could not be taxable in that year.

The Court notes that it is generally required that a taxpayer have knowledge of the funds in order to have constructive receipt. And even after she finally had that knowledge, she still was denied access to the funds when she tried to have the funds released, something the California court refused to do when she petitioned that court in 2010.

The IRS argued that her ex-spouse was acting as her agent, but the Tax Court did not accept this view:

> The Commissioner's argument that Georgiou acted as Leslie's agent is also faulty. Receipt by an agent is receipt by the principal, *Gale v. Commissioner*, T.C. Memo. 2002-54, but the Commissioner has provided no evidence, nor does there exist on the record any evidence suggesting that Georgiou had any authority to act as Leslie's agent. Georgiou's interest was adverse to Leslie's: When Leslie tried to get the court to release the 2009 payment to her, he opposed it.

SECTION: 162
CORPORATION, AND NOT SHAREHOLDERS, ACTUALLY ENTITY OPERATING THE BUSINESS AND WHERE LOSS HAD TO BE REPORTED

Citation: Barnhart Ranch Co. et al. v. Commissioner, T.C. Memo. 2016-170 , 9/14/16

The question that had to be decided in the case of *Barnhart Ranch Co. et al. v. Commissioner*, T.C. Memo. 2016-170 was whether the income and deductions from the cattle operations in question was actually the income of the Barnhardt brothers (as they had reported on their 1040s for the year in question) or rather the operations of the corporation. And, unfortunately for the taxpayers, this is once again a case where the taxpayers, being in charge of the form of a transaction, are not generally going to succeed arguing the substance of the transaction was different.

The brothers had reported net losses from the cattle operation for the years under exam of approximately $860,000 for 2010, $685,000 for 2011 and $970,000 for 2012, using those losses to offset other income reported on their returns. The IRS contended that those losses rather belonged on the return of BRC, Inc., a C corporation formed by the brothers in September 1994.

The brothers argued that they were the actual owners of the cattle in question and that the corporation either merely functioned to handle the accounting for their cattle operation or that it operated as their agent. In either case, the cattle activities should be reported on their individual returns in their view.

However, there were some problematical facts. First was that the employees working in the cattle operation were employees of the corporation. As the Court noted:

> From 2010 to 2012 the cattle operation had 17 employees, and BRC, using ADP Payroll Services, paid these employees. The employees included Sronce, his son Matt, who helped supervise operational activities, and his wife Sharon, who served as an office manager, maintaining financial, operational, production, and employment records. The remaining employees consisted of ranch hands, a housekeeper, and a part-time employee of the Hebbronville ranch who provided security and oversaw the employees working there. BRC filed Forms 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, Forms 943, Employer's Annual Federal Tax Return for Agricultural Employees, and Forms W-3, Transmittal of Wage and Tax Statements, with respect to these employees and issued to them Forms W-2, Wage and Tax Statement.

As well, other significant transactions were undertaken in the name of the corporation, as the Court continues:

> BRC held a workers' compensation and employer's liability insurance policy in its name with respect to the cattle operation employees. It purchased and held farm and ranch insurance in its name that covered both the Westhoff and Hebbronville ranches. It also purchased in its name a buckskin gelding, bought a utility task vehicle equipped with a winch, and held title to several other vehicles.

Finally, the corporation was the recorded buyer and seller for the cattle operation during the years in question:

> BRC, as the recorded buyer or the recorded seller, also bought and sold cattle for the cattle operation. These sales and purchases, made at livestock auctions and other venues, occurred under the names "Barnhart Ranch Company", "Barnhart Ranch Co.", and "Barnhart Ranch". In 2010 the cattle operation sold about 600 cattle, in 2011 it sold about 1,500, and in 2012 it sold about 800.

Generally, the funds from any cattle sales would be deposited into the corporation's account and accounted for as a payable in ½ of that amount for each brother. The corporation would pay any expenses from those funds, including both business related expenses and personal expenses. The corporation would then issue the brothers a check if the income exceeded the expenses for that month. Because it emptied out is bank account under this procedure, the brothers from time to time had to advance the corporation funds to pay bills.

The Tax Court first looked at the "accounting services" entity view of BRC and rejected it. The Court noted:

> It is unclear from testimony and other evidence what petitioners mean when they describe BRC as an "accounting agent", i.e., whether they are attesting that BRC actually performed the joint interest billing for the cattle operation or whether it was used simply as a strawman to provide a temporary repository for the operation's income and expenses to accomplish joint interest billing. Other than self-serving testimony—which we need not and do not accept, see *Tokarski v. Commissioner,* 87 T.C. 74, 77 (1986)—the evidence does not show that BRC actually provided accounting services. (Borowski, the only accountant that testified about BRC's accounting practices, appeared to be an employee of Barnhart Interests, Inc., or, less likely, Barnhart Co.) To the contrary BRC appears to have been charged for receiving accounting services.

The court noted, as well, that even if it had been performing accounting services that would be merely one part of the business purpose of managing the cattle operation, the activity that the corporation showed as is its business activity on its 2012 and 2013 federal income tax returns.

The Court also found that BRC was the owner of the cattle in question, noting:

> It deposited all income from the cattle sales into its BRC account, directly paid cattle operation expenses from that account, and even exercised its power of ownership over the funds by directing payment of the excess thereof to its stockholders—all recognizable economic benefits.

As well, the Court noted that BRC was held out to the public as the owner of the cattle, specifically indicating that to livestock auctions, brokers, buyers, sellers and vendors. The Court found no evidence the brothers ever sought to advise other parties that BRC wasn't the actual owner of the cattle.

The Court also found there was no evidence that an agency relationship existed.

The Court closes by noting:

> On brief petitioners recognize that they "could have transferred the cattle business to an S corporation or a limited partnership with the same tax result", and in reality they have realized this goal with the McDermott-Barnhart Partnership. For whatever reasons, however, the Barnhart brothers chose to run BRC not as a flowthrough entity but as a corporation. Petitioners "cannot now escape the tax consequences of that choice, no matter how bona fide * * * [their] motives or longstanding * * * [their] arrangements." *Nat'l Carbide Corp. v. Commissioner*, 336 U.S. at 438-439. We sustain respondent's adjustments to the returns of petitioner and Karol Ann Barnhart and Irvin Barnhart for their respective tax years in issue, in which they inappropriately reported income and expenses and the resulting net losses of BRC.

SECTION: 501
ORGANIZATION THAT PRIMARILY BENEFITTED FOUNDERS' ILL CHILD DENIED EXEMPT STATUS

Citation: PLR 201637017, 9/9/16

The private inurement prohibition applies to an exempt organization, even if that organization is clearly serving an individual that would otherwise been a reasonable recipient of benefits from a charity. The IRS pointed that out in denying an application for tax exempt status in PLR 201637017.

Private inurement is an issue for many potential organizations that a client may be motivated to form, as often a personal experience and a problem of a specific individual will be the genesis of the idea to form the organization. But the regulations under §501(c)(3) provide a strict prohibition on "private inurement" as the IRS points out in the ruling:

> Treas. Reg. Section 1.501(c)(3)-1(c)(2) states regarding the distribution of earnings that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

In this case the organization in its application for exempt status stated it was formed "to assist adolescent children and families in coping with undiagnosed and/or debilitating diseases." On the surface that would seem a worthy charitable purpose.

But the problem was how the organization actually operated. As the IRS notes:

> You were formed by D and E and named after their minor son, who suffers from an unidentified illness. Your activities consist primarily of conducting various fundraising events to provide financial support to designated recipients. Your fundraising material specifically requests funds to help D and E's son. The funds are made available to recipients to assist with unexpected and unreimbursed medical, travel and other related expenses. Since your inception the only individual that has received funds from you is the minor child of D and E.

The organization claimed that it planned to serve other beneficiaries. But, as the IRS noted, this process hadn't yet found any other appropriate beneficiary:

> You indicated that selected recipients will be required to provide a detailed explanation of the needy recipients' medical condition. Your governing body or designated committee will review the request for assistance submitted by any needy individual, organization and/or the family of a needy individual to determine if the distribution meets your qualification as a charitable purpose. However, to date no individual has been a recipient other than D and E's child.

As the IRS notes, the statute and case law does not allow for such private charity to be given tax preferred treatment.

> In *Carrie A. Maxwell Trust, Pasadena Methodist Foundation v. Commissioner*, 2 TCM 905 (1943) a trust established for the benefit of an aged clergyman and his wife was a private trust and not an exempt activity despite the fact that the two individuals served were needy.

As well, even using less than 100% of the organization's fund for a "preferred" individual will cause a denial of exempt status.

> In *Wendy Parker Rehabilitation Foundation, Inc. v. Commissioner*, 52 T.C.M. (CCH) 51 (1986), the organization was created by the Parker family to aid an open-ended class of "victims of coma." However, the organization stated that it anticipated spending 30 percent of its income for the benefit of Wendy Parker, significant contributions were made to the organization by the Parker family, and the Parker family controlled the organization. Wendy's selection as a substantial recipient of funds substantially benefited the Parker family by assisting with the economic burden of caring for her. The benefit did not flow primarily to the general public as required under Treas. Reg. Section 1.501(c)(3)-1(d)(1)(ii). Therefore, the Foundation was not exempt from federal income tax under Section 501(c)(3) of the Code.

In denying the request for exempt status, the IRS points out:

> Since your inception, the only individual that has received funds has been the minor child of D and E. As described in Treas. Reg. Section 1.501(c)(3)-1(c)(2), you are not operated exclusively for one or more exempt purposes because your net earnings have inured to private shareholders or individuals.

The payments made for the benefit of the minor child of D and E inures to their benefit. The prohibition on inurement under Section 501(c)(3) of the Code is absolute, precluding you from exemption.

SECTION: 6651
TAXPAYER'S DEMENTIA POSSIBLE REASONABLE CAUSE FOR LATE FILING, BUT FAILURE OF POA HOLDER TO ACT WOULD NOT BE

Citation: CCA 201637012, 9/9/16

An IRS memorandum discusses the potential facts that would and would not be relevant in determining if a taxpayer can have failure to file and failure to pay penalties abated for reasonable cause (CCA 201637012).

In this case a taxpayer had appointed a person to act under a durable power of attorney. She later filed her tax return late for a year, subjecting her to failure to pay and failure to file penalties. However, the holder of the power of attorney petitioned a state court for appointment of an Emergency Guardian and Conservator for the taxpayer because the power holder believed she suffered from dementia. A court found that the taxpayer was an "incapacitated person."

The question arose about whether, under these facts, the IRS should grant relief from the penalty either because:

- The taxpayer's dementia provides reasonable cause for the late filing or
- The power of attorney's failure to insure the return was timely filed creates reasonable cause for the late filing on behalf of the taxpayer.

However, the author of the memorandum suggested that before any of these issues were considered, the IRS should consider if the taxpayer qualifies for the "First Time Abatement" (FTA) relief. That relief is found in Internal Revenue Manual 20.1.1.3.6.1.

A taxpayer can qualify for relief from certain penalties if they meet the following qualifications:

- The taxpayer has not previously been required to file a return or has no prior penalties (except the estimated tax penalty) for the preceding 3 years, and
- The taxpayer has filed, or filed a valid extension for, all currently required returns and paid, or arranged to pay, any tax due.

The relief applies to failure to file penalties (IRC §6651(a)(1), IRC §6698(a)(1) and IRC §6699(a)(1)), failure to pay penalties (IRC §6651(a)(2) and IRC §6651(a)(3)) and failure to deposit penalties (IRC §6656).

Thus, if the taxpayer had been compliant in the prior three years, the taxpayer would appear to qualify for FTA relief and the question of reasonable cause would not arise.

But if the taxpayer did not qualify for FTA relief, the author of the memorandum noted that the dementia may have created a situation where the taxpayer would qualify for reasonable cause relief.

The applicable regulation provides the following test to determine if reasonable cause exists:

> …If the taxpayer exercises ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause. A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for the payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship (as described in § 1.6161-1(b) of this chapter) if he paid on the due date…. (Reg. §301.6651-1(c)(1))

The memorandum notes that if the taxpayer can show she was suffering from dementia during the early part of the year when she should have filed the return she failed to file, and was therefore unable to handle her financial affairs, that would support a finding of reasonable cause for the late filing. That determination is a factual one.

However, the memorandum rejects the idea that the failure of the holder of the power of attorney to act could serve as an alternative reasonable cause.

The memorandum points out:

> In *United States v. Boyle*, 469 U.S. 241 (1985), the Supreme Court opined that Congress placed the burden of prompt filing of tax returns on the taxpayer, not on some agent or employee of the taxpayer. The Court rejected the argument of an estate's executor that the estate should be excused from the addition to tax for late filing under section 6651(a)(1) because it relied in good faith on an attorney to timely file the return. The Court held that "[t]he failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not "reasonable cause" for a late filing under § 6651(a)(1)." 469 U.S. at 252.

Thus, if she cannot show that she was suffering from dementia and unable to handle her affairs, the fact that another person who could have acted failed to do so would not represent reasonable cause.