Current Federal Tax Developments

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SECTION: 162
NO DEDUCTION ALLOWED FOR PAYMENT TO RELATED ENTITY WHEN REASONABLENESS OF PAYMENT NOT DEMONSTRATED

Citation: Kauffman v. Commissioner, TC Memo 2017-38, 2/22/17

Whenever taxpayers are paying for services between related entities the same interests control, the IRS is known to be skeptical of the reality of the arrangement. The IRS questioned just such an arrangement in the case of *Kauffman v. Commissioner*, TC Memo 2017-38.

The taxpayer in this case was a realtor and cinematographer who operated several single member LLCs (all of which were treated as disregarded entities) and a C corporation. The IRS was questioning payments made from one of the LLCs to the C corporation of $191, 000 for "consulting fees" and $75,000 in "commissions and fees."

It turned out that the descriptions were not very clear about what was being paid for—the LLC was renting and using a sophisticated camera from the corporation.

There's nothing inherently wrong with paying a controlled corporation for such items—but the fact that the transaction does not involve two unrelated parties, each looking out for that party's interests, eliminates the market based check on reasonableness of the arrangement. This complicates showing that the arrangement is truly an "ordinary and necessary" business expense that would be deductible under IRC §162 based on whether the amount being claimed is reasonable.

As the Court explains:

> Even if an expense is ordinary and necessary, it is deductible under section 162 only to the extent it is reasonable in amount. *United States v. Haskel Eng'g & Supply Co*., 380 F.2d 786, 788-789 (9th Cir. 1967); *Gill v. Commissioner*, T.C. Memo. 1994-92, aff'd without published opinion, 76 F.3d 378 (6th Cir. 1996); *Brallier v. Commissioner*, T.C. Memo. 1986-42. The element of reasonableness is inherent in the phrase "ordinary and necessary" in section 162. *Haskel Eng'g & Supply Co*., 380 F.2d at 788-789.

The mere fact the payment was made does not mean it is reasonable, as the Court pointed out to Mr. Kauffman:

> While petitioner explains on brief that the expenses were ordinary and necessary business expenses, he does not cite any credible testimony or other relevant evidence in the record supporting his assertion. The only evidence petitioner provided was accounting records and bank statements. However, these items merely reflect expenses allegedly incurred by RMH; the accounting records and bank statements do not show why the alleged expenses are ordinary and necessary. We also note that petitioner did not testify or offer other evidence explaining how the expenses were calculated or whether the corporation charged third parties the same amounts for similar services. Therefore, we are unable to determine whether the expenses were reasonable in amount. Consequently, on the basis of the record before us, we cannot find that the expenses were ordinary and necessary business expenses. We therefore sustain respondent's determination on this issue.

As the opinion notes, when clients have different entities that they control that have transactions between them, the taxpayer will need to have more evidence than merely the accounting records. Key will be the ability to demonstrate that the entity paying received something of value and that the payment made was in line with what would normally be charged in a transaction between unrelated parties. As well, the use of vague terms like "consulting fees" or just "fees" will be more likely to raise suspicions about whether there is truly any real transaction taking place, or rather just a shifting of income between taxable entities to achieve some tax effect.

SECTION: 166
NO BUSINESS BAD DEBT NOR PARTNERSHIP LOSS ALLOWED TO TAXPAYER

Citation: Scheurer v. Commissioner, TC Memo 2017-36, 2/21/17

The taxpayer in the case of *Scheurer v. Commissioner*, TC Memo 2017-36 claimed that he either had a large business bad debt loss or a partnership loss related to funds that he stated he had advanced to a business being operating by a friend of his. Unfortunately for Mr. Scheurer, the Tax Court did not accept either claim.

Mr. Scheurer had a friend, Kevin Zinn, who was planning to start a robo-call operation, marketing his company's services to individuals with high credit card debt. For a fee, the organization (Continental Financial Services, referred to as CFS) would contact the individual's bank and attempt to negotiate a lower interest rate. If a prospect agreed to hire CFS, the prospect would be charged an upfront fee that would be charged to the prospect's credit card.

There was one major hitch in this plan. Mr. Zinn had poor credit and was unable to obtain a merchant account in order to receive the credit card payments. Mr. Zinn approached Mr. Scheurer to have him obtain the merchant accounts, since Mr. Scheurer had a significantly better credit history. Mr. Scheurer agreed to do this, forming a partnership with another individual to obtain the merchant accounts through which CFS would receive its fees.

While it was a partnership, Mr. Scheurer was expected to provide all of the capital for the partnership, for which he held a 90% interest. His partner (Mr. Jasikoff) was expected to manage the operations of this entity and prepare financial statements.

CFS ran into financial difficulties rather early on and Mr. Zinn approached the taxpayer to provide additional capital.

The problems with the taxpayer's case begin here, as the record for what was advanced was rather sketchy. As the Court notes:

> First, petitioner alleges that his girlfriend at the time, Jennifer Soden, made wire transfers during 2009 from her personal bank account to CFS in the aggregate amount of $84,000. But she testified that she did not know whether this money went to petitioner, JC, or CFS. Her bank account statements evidence these transfers; but neither she nor petitioner could establish that the account numbers to which the funds were wired belonged to CFS. Ms. Soden clearly advanced these funds to petitioner or on his behalf, because petitioner's father eventually provided Ms. Soden with enough money to make her whole. But there is no evidence, apart from petitioner's testimony, that this $84,000 was actually received by CFS.
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> Second, petitioner alleges that most of the debits to JC's bank account during 2009 represented loans to CFS. But at least $19,800 of these debits represented payments to Ms. Soden and at least $22,600 represented payments to petitioner; many other debits represented payment of Mr. Jasikoff's expenses. Most of the other large debits appeared to be amounts that JC remitted to CFS pursuant to its "merchant processing" activity.

Being unable to prove what had been advanced would itself be enough to stop any deduction—but although the Court would later note that it did not find the taxpayer's testimony convincing, it did find testimony of Mr. Jasikoff credible on one advance:

> Mr. Jasikoff credibly testified that on at least one occasion he withdrew cash from JC's bank account, hand-carried it to Florida, and distributed it to CFS employees when Mr. Zinn could not make payroll. The record includes signed releases from CFS employees evidencing receipt of $19,842 from Mr. Jasikoff.

The Court, finding that the amount that could be documented as paid to CFS was $19,842 then looked to see if a deduction was allowable under either of Mr. Scheurer's theories.

The Court found two fatal flaws with the attempt to claim a non-business bad debt for the $19,842 advanced which was not repaid. First, the taxpayer could not how that what had been paid over was an actual loan for which payment was reasonably expected. If there was no reasonable expectation of repayment at the time of the advance there was no debt, as a rational lender never would have advanced funds under the terms.

In this case the opinion notes:

> There is no evidence to support petitioner's contention that any funds he advanced to CFS gave rise to a bona fide loan. There was no promissory note, no fixed or determinable amount due, no specified interest rate, no principal due date, and no requirement of security. See *Bauer v. Commissioner*, 748 F.2d 1365, 1368-1371 (9th Cir. 1984), rev'g T.C. Memo. 1983-120; *Estate of Mixon v. United States*, 464 F.2d 394, 402-405 (5th Cir. 1972); *CMA Consol. Inc.*, 89 T.C.M. (CCH) at 713-715. It seems obvious that no bank would have lent money to Mr. Zinn or CFS in 2009. Indeed, the reason that Mr. Zinn sought "merchant processing" assistance from petitioner was that his credit was too poor to enable him to open merchant accounts himself.
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> The only advances to CFS that petitioner substantiated were Mr. Jasikoff's payment of wages to its employees when Mr. Zinn could not make payroll. But if Mr. Zinn could not pay his debts as they became due, he was very likely insolvent. Because the prospects of repayment from an insolvent person are quite doubtful, this fact strongly suggests that Mr. Jasikoff's $19,842 advance did not give rise to bona fide debt. See *Road Materials, Inc.*, 407 F.2d at 1125.

As well, to be a business bad debt the debt must arise from a business and be reasonably related to that business. Mr. Scheurer failed that test as well in the view of the Court.

> Petitioner was not engaged in the trade or business of lending money during 2009. He worked full time during that year as a financial adviser, and there is no evidence that he ever lent money to anyone else. We find no evidentiary support for the proposition that his alleged loan to CFS was "a debt created or acquired * * * in connection with a trade or business" of lending money in which he was engaged during 2009. See sec. 166(d)(2)(A). Nor was any alleged loan "incurred in the taxpayer's trade or business," namely, petitioner's occupation as a financial adviser. See sec. 166(d)(2)(B).
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> We find that petitioner's dominant motivation for advancing funds to CFS was personal, stemming from his longtime friendship with Mr. Zinn. He was fully aware that Mr. Zinn had very poor credit, and it is highly unlikely that he would have advanced funds under these circumstances unless Mr. Zinn had been a close personal friend. Because petitioner's primary motivation for advancing funds was personal, we find that the advances, to the extent substantiated, were not proximately related to any business in which petitioner during 2009 was engaged.

The taxpayer claimed that if this wasn't a business bad debt, then he had losses from the partnership of a similar amount. However, the taxpayer had not originally filed a partnership return or reporting any partnership activity on his Form 1040 for 2009.

In 2014 the taxpayer had a partnership return prepared which showed significant losses for 2009.

Although the partnership formation documents provided it was being formed for the purpose of "providing merchant processing services primarily for, but not limited to," CFS, he now claimed that the partnership was formed to perform robo-calling services and had merely hired CFS as an independent contractor to perform the services. Most the loss for that year came from "prepaid expenses" written off during the year, with the opinion noting:

> These "prepaid expenses" corresponded to the funds that petitioner or JC had allegedly advanced to CFS to cover its payroll and other operating expenses, i.e., the same advances that formed the basis for the bad debt deduction that petitioner claimed on his individual return.

The Court did not find this "partnership" theory any more convincing than the bad debt one. As the opinion holds:

> JC clearly was not in the "robocalling" trade or business; that business was conducted exclusively by CFS and its 30 to 40 employees. The partnership agreement between petitioner and Mr. Jasikoff stated that the partnership was being formed for the purpose of "providing merchant processing services primarily for, but not limited to, [CFS]." The agreement recited no other purpose, and "merchant processing" was the only business that JC ever conducted. Petitioner thus has the relationship precisely backwards: It was CFS that hired JC as an independent contractor to act as CFS' agent in setting up merchant accounts to facilitate CFS' "robocalling" business.

Since CFS was the business actually in the robo-calling business, those expenses were CFS's. Generally, a taxpayer cannot deduct the expenses of another taxpayer, though the Court noted one exception to that general rule:

> That exception applies where: (1) the taxpayer's motive for paying the other's obligation is to protect or promote the taxpayer's own business and (2) the expenditure is an "ordinary and necessary expense" of the taxpayer's business. *Lohrke v. Commissioner*, 48 T.C. 679, 688 (1967); *Fargo v. Commissioner*, T.C. Memo. 2015-96, at *26; *Dietrick v. Commissioner*, T.C. Memo. 1988-180, 55 T.C.M. (CCH) 706, 711-712, aff'd, 881 F.2d 336 (6th Cir. 1989).

But the taxpayer failed to show that the partnership met this exception, with the Court noting:

> Petitioner did not carry his burden of proving that JC's motive for defraying CFS' payroll expenses was to promote JC's own business. Petitioner's strong personal motivation for helping Mr. Zinn greatly suggests that this advance was a gift or capital investment, not a business expense. And CFS' dire financial situation made it unlikely that JC would have an ongoing "merchant processing" business to promote. See *Dietrick*, 55 T.C.M. (CCH) at 711-712. Because petitioner has not established that JC's motive for paying CFS' expenses was to protect or promote its own business, we need not address whether the expenses were ordinary and necessary expenses of JC's business. We conclude that petitioner is not entitled to any partnership loss deduction for 2009 because he did not prove the existence or amount of such a loss.

SECTION: 501
IRS MAKES LIST OF ORGANIZATIONS GRANTED EXEMPTION VIA FORM 1023-EZ AVAILABLE FOR DOWNLOAD ONLINE

Citation: IRS News Release IR-17-041, 2/22/17

The IRS announced in News Release IR-2017-41 that it has now made available lists of approved exemption applications that were obtained using *Form 1023-EZ, Streamlined Application for Recognition of Exemption*.

The information, provided in the form of an Excel spreadsheet, provides approved applications by year beginning with mid-2014 when the streamlined form was first released. The IRS will release updated information quarterly.

The information can be found on the IRS website at https://www.irs.gov/charities-non-profits/exempt-organizations-form-1023ez-approvals. The IRS has also published a sheet giving information about each field in the Form 1023-EZ Approval Information Sheet.

The form is filed electronically and, given the disclosure rules that apply to the information on the form, along with the fact it is now much easier to get that information, the IRS reminds those using the form that they should not include social security numbers on the forms.

The release indicates that the IRS had approved 105,000 application using Form 1023-EZ from the inception of the program through the end of 2016.

SECTION: 2031
COURT REJECTS VALUATION OF PAINTING THAT WAS ONLY 20% OF WHAT PAINTING SOLD FOR 3 ½ YEARS LATER

Citation: Estate of Kollsman v. Commissioner, TC Memo 2017-40, 2/22/17

The IRS and the taxpayer in the case of *Estate of Kollsman v. Commissioner*, TC Memo 2017-40 had wildly different values that each ascribed to two paintings. In the view of the estate the paintings in question were valued at $500,000 and $100,000 respectively. But the IRS position was that the paintings were far more valuable, arguing at trial that the proper values were $2,100,000 and $500,000 respectively.

One reason the IRS was skeptical of the estate's value was the that the more valuable of the two paintings was sold 3 ½ years later for a $2,100,000 hammer price and a full price paid by the buyer of $2,434,500, well above the estimated $500,000 value.

Both the taxpayer and the IRS put forward experts to justify each party's claimed value. The taxpayer had consulted with an individual associated with the auction house that eventually held the auction at which the paintings were sold.

While the value at which an asset is sold after the date of death does not necessarily establish the value at the date of death, generally it is considered potentially useful information and normally it is important to explain why the value had changed from the date of death until the date of sale.

The paintings in question had apparently suffered from the fact that the decedent was a heavy smoker, and so a layer of dirt covered each of the paintings. The taxpayer's expert held that this dirt made it very difficult to determine the true quality of the paintings, but that a cleaning of the paintings would be a risky affair. Risky or not, the estate did have the paintings cleaned following the decedent's death, and the cleaning was successful. The taxpayer's expert argued this significant improvement in the quality and condition of the painting from the successful cleaning and a large influx of Russian buyers for Old Masters paintings accounted for the nearly five-fold increase in value.

However, the Tax Court did not find the analysis persuasive. The Court, considering the testimony of the organization that cleaned the paintings, found that this was not a very high risk operation—certainly not enough to justify a discount of the type necessary to explain the price change:

> Bill Santel, chief conservator at Lowy who performed the initial examination of the paintings, testified that when he first examined Maypole it was dirty, appeared to have been cleaned previously but not recently, and was "a pretty good painting to be cleaned". He testified that if he had owned it he would have cleaned it, as doing so seemed "reasonably safe". Mr. Santel similarly stated that Orpheus was dirty but not the dirtiest painting he had ever seen. Even Mr. Shar—the estate's own witness—contradicted Mr. Wachter's assertions about the risk of cleaning the paintings, testifying that although both paintings were quite dirty and discolored, it appeared the dirt and grime could be removed easily, and he therefore recommended to Mr. Hyland that he have the paintings cleaned. The condition report for each painting, prepared after a window test, recorded that the dirt on each was "surface" rather than "embedded", an important distinction according to Mr. Santel, because the former is generally much easier to clean.
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> The cleaning process itself corroborated the Lowy witnesses' precleaning assessments. Mr. Santel and Mr. Shar both explained that only the mildest detergents used for cleaning paintings, Wolbers and naphtha, were required to clean Maypole and Orpheus. Mr. Shar testified that this was unusual and that typically stronger detergents are required. The success of these mild detergents, according to Mr. Santel, confirmed that the paintings were covered in surface dirt only; he testified that if the dirt had been heavily embedded in the varnish or the paint, the mild detergents "could not possibly have achieved the results that they did." Mr. Santel further testified that the duration of the cleaning processes, recorded in the Lowy treatment reports as three hours for Maypole and two hours for Orpheus, indicated

> that these cleanings were comparatively easy and problem free. There is no dispute that the paintings' cleanings were unqualified successes.17 On balance, the Lowy condition and treatment reports and the testimony of the Lowy personnel who also examined the paintings in their precleaning condition convince us that Mr. Wachter exaggerated both the dirtiness of the paintings and the risks inherent in cleaning them.

The taxpayer's expert also cited no comparables to justify the amount of discount that would have been justified even if his premise was accepted.

Similarly, the Court did not find convincing the evidence offered for a large increase in demand for Old Masters' paintings during the period in question.

> As for his claims regarding market demand, the estate introduced aggregate auction sales results demonstrating that 5 of the 10 highest sale totals for Old Masters auctions at Sotheby's and Christie's occurred after 2005 and included the January 2009 Sotheby's Old Masters auction. However, because these are only gross sales figures, they do not demonstrate the extent of appreciation in individual paintings, as the sales figures may reflect a larger volume of paintings sold rather than an increase in sale prices. Consequently, the aggregate sales volume figures fall considerably short of persuading us that either Brueghel paintings, or Old Master paintings generally, experienced a nearly fivefold increase in value between August 2005 and January 2009.

The Court was troubled by what it labeled a conflict of interest for the estate's expert:

> Mr. Wachter first gave his fair market value estimates for the paintings at the time of decedent's death (in amounts that remained unchanged in his expert report prepared for trial). His correspondence with Mr. Hyland during that period demonstrates that the two had previously discussed the disposition of Maypole and Orpheus upon decedent's death and that Mr. Hyland was considering selling the paintings. Mr. Wachter provided his fair market value estimates at the same time he was soliciting Mr. Hyland for the exclusive rights for five years to auction the paintings in the event they were sold. Under Sotheby's terms at that time, an auction sale would have entitled Sotheby's to a 20% commission on the first $200,000 of the hammer price and 12% of the remainder.15 Thus, Mr. Wachter, on behalf of his firm, had a direct financial incentive to curry favor with Mr. Hyland by providing fair market value estimates that benefited his interests as the estate's residual beneficiary—that is to say, "lowball" estimates that would lessen the Federal estate tax burden borne by the estate. The fair market value estimate letter Mr. Wachter provided to Mr. Hyland was in fact used by him as the basis for the values reported on the estate tax return. The fact that Mr. Wachter simultaneously presented Mr. Hyland with these fair market value estimates and his pitch for exclusive auction rights for Sotheby's gives rise to an inference that the latter affected the former.

This case presents a "bad facts" situation for the estate and its expert. The actual sale by the organization that provided the low value estimates created a fact that needed to be explained. Whether fair or not, the Court effectively decided the explanation it found most plausible was that the low estimate was given as an incentive to get the right to sell a highly valuable painting.

Having effectively decided that it didn't buy the theory that the paintings had greatly appreciated following the date of death, the Court had little trouble finding the IRS's expert persuasive—his value for the painting that was sold was much nearer that eventual sales price and the Court accepted as well his higher value for the other painting.

SECTION: 6502
IRS RELEASES LETTER TO BE SENT TO TAXPAYERS ASSIGNED TO COLLECTION AGENCY

Citation: Notice CP40, Publication 4518, 2/21/17

The IRS has released a copy of the letter that they will send when accounts are sent to an outside collection agency. The new letter, Notice CP40, will be used when the IRS forwards accounts to a collection agency in the cases Congress required that step to be taken when it passed the Fixing America's Surface Transportation Act in December of 2015.

The form will assign the taxpayer a "Taxpayer authentication number" which will be found in the upper right section of the first page of the notice. The first five digits of that number will need to be provided to the collection agency before the collection agency will be able to assist the taxpayer. This will serve to confirm to the agency that the person on the phone is the taxpayer. The agency will then recite the final five digits of the taxpayer authentication number to allow the taxpayer to confirm that the collection agency is the party calling.

In addition, the taxpayer will need to provide the collection agency with the name and address of record before any assistance can take place.

The IRS has also issued a new publication, *Publication 4518, What You Can Expect When the IRS Assigns Your Account to a Private Collection Agency*. The publication notes that the collection agency will send the taxpayer a letter initially confirming assignment of the account to that agency.