

Gross Income

Chapter 3

AOD 2017-06 (8/14/17) on
Estate of Bartell, Jr.
147 TC No. 5
(Aug. 10, 2016)

3-2

IRS Nonacquiescence on
Bartell Drug Reverse 1031
Exchange

Bartell Drug Tax Court

Alderson (9th Cir. 1963), and *Biggs* (5th Cir. 1980), establish the principle that a **third-party exchange facilitator** "need not assume the benefits and burdens of ownership" of the replacement property in order to be treated as its owner for section 1031 purposes before the exchange."

3

IRS View

Alderson and *Biggs* do not apply to transactions outside the scope of the deferred exchange regulations for forward exchanges and Rev. Proc. 2000-37 for reverse exchanges.

4

Background

A Forward Section 1031 Exchange

5

Bartell
Drug



Exchange
Facilitator

Bartell
Drug



Exchange
Facilitator

Transfer from BD to EF **starts**
the statutory 45/180 day
I.D. period/Exchange period

Bartell
Drug



EF must transfer
replacement property
to BD within 180 Days

Bartell
Drug



Exchange
Facilitator

Deferred
Exchange
Complete

The EF **need not
even take title** to
the relinquished
or replacement
properties

Reg. 1.1031(k)-1(g)(4)(iv)

Reverse Section 1031 Exchange

“Exchange [the
relinquished property]
Last”

11

Preamble to 1991 §1031 Final Regs.

The deferred exchange rules
“do not apply to transactions
in which the taxpayer receives
the replacement property prior
to the date on which the
taxpayer transfers the
relinquished property.”

12

“Reverse” Section 1031 Exchanges

Rev. Proc.
2000-37
Safe Harbor

13

If the conditions of
the Rev Proc are
met, then the EF is
treated as having the
burdens and benefits
of ownership
(by merely holding title)

14

- EF must convey to T within 180 days of EF's acquisition of the replacement property.
- T must identify the relinquished property within 45 days of the EF's acquisition of the replacement property.

15

"The combined time period that the relinquished property and the replacement property are held [by the EF cannot] exceed 180 days."

(Rev Proc 200-37)

16

EF must have
“qualified indicia of
ownership” (title).

17

The EF is **treated**
as the beneficial
owner of the
property for all
federal tax
purposes.

18

Additional Clarity in Rev. Proc. 2000-37

- EF can lease the prop. to T.
- T can guarantee debt of EF.
- T can manage construction, etc.

19

The IRS position
(in the **AOD**)
is that without Rev. Proc.
2000-37, in a “reverse
exchange” **the EF must
have the burdens and
benefits of ownership
(BBO)
(not mere title)**

20

Per the 2017 IRS AOD:

21

“Taxpayers that use accommodating parties outside the scope of Rev. Proc. 2000-37 have not engaged in an exchange if the taxpayer... acquires the benefits and burdens of ownership of the replacement property before the taxpayer transfers the relinquished property.”

22

Rev. Proc. 2000-37
(effective on or
after 9/15/2000),
was **not yet**
effective for the
Bartell Drug
transaction.

23

Bartell
Drug



Exchange
Facilitator

EF agrees to borrow money
guaranteed by BD
and purchase replacement
property

Bartell
Drug

WELLS
FARGO



Exchange
Facilitator

Loan Guaranteed by BD

Bartell
Drug

WELLS
FARGO



Exchange
Facilitator

Bartell
Drug

WELLS
FARGO



At that moment,
says IRS, **BD had**
the burdens and
benefits of
ownership
(No exchange)

Bartell
Drug

WELLS
FARGO



"Parked" With the EF

The statutory 45/180 day period
has still NOT started if EF is
deemed to have the BBO.

EF takes title
(in an SMLLC)
to the
replacement
property.

17 months pass
while
construction is
complete on the
replacement
property

31

Bartell
Drug

WELLS
FARGO



Different Relinquished
Property

Bartell
Drug

WELLS
FARGO



A simultaneous exchange

Bartell
Drug

WELLS
FARGO



Bartell
Drug



\$2,804,863
Deferred Gain
(per Sec. 1031)

The Tax Court
addressed the
17 month time-
period:

37

“ [C]ase law
provides no
specific limit
on the
period....”

38

“ ...[W]e are satisfied that the [Bartell Drug] transaction qualifies for section 1031 treatment under existing caselaw principles.”

39

IRS Chief Counsel declined to appeal **Bartell** to the Ninth Circuit

40

Schieber

3-6

TC Memo 2017-32
(2/9/2017)

Bakersfield Police
Officer's CalPERS Pension
Plan Ignored In COD
Insolvency Calculation

41

Background

Whether and by how much a taxpayer is insolvent is "determined on the basis of the taxpayer's assets and liabilities immediately before" the cancellation of debt.

Sec. 108(d)(3)

42

Facts

The Schieber's
GMAC Mortgage of
\$418,596 was
canceled and
generated COD
income.

43

If his CALPERs pension
plan
were considered an asset
for the purpose of the
insolvency exclusion,
then the taxpayers were
solvent so no COD
exclusion.

44

Tax Court Holding:

Not an asset!

45

The "Schiebers **could not access the value in the plan.** They could not convert their interest in the plan to a lump-sum cash amount, sell the interest, assign the interest, **borrow against the interest,** or borrow from the plan."

46

*PLR 201743011
(10/30/2017)*

Supp

No COD Income When
Employer Waived
Employee Repayment of
Pension Overpayment

47

IRS said ignore the From
1099-C, no COD income,
when gov't employer
allowed employee to keep
excess retirement plan
payments where
employee properly paid
income tax on the excess
plan payments.

48

PLR 201742017 **Supp**
(10/20/2017)

Court Ordered Injunction
Barring Collection of
Financial Institution Debt
Was Not a Debt Discharge
Reporting Event

49

As the result of a class action lawsuit, because the financial institution's **collection notice to defaulting debtors was deficient** under state law, a state court ordered the financial institution to **write-off the loan deficiencies**.

IRS says no Form 1099-C needed.

50

Bullock,
TC Memo 2017-219
(11/6/2017)

Supp

Mistakenly Cosigned
Loan, Like Guarantee,
Does Not Generate COD
Income

51

- Taxpayer accidentally signed documents indicating the she was the primary obligor on Son's car loan.
- Lender viewed her as a guarantor (with secondary liability), not as primary obligor.

52

The car was stolen and the son's theft insurance paid all but \$8,164 of the debt.

The balance "was discharged" by the lender.

53

- Lender did issue a 1099-C showing \$8,164 of COD income to taxpayer.
- The case does not indicate that the lender pursued the taxpayer for payment of the balance.

54

Tax Court Holding

- Tax Court viewed her as a guarantor, not as primary obligor.
- No COD income.

55

- "Such a discharge creates **no previously untaxed accretion in assets** that would result in an increase in net worth."

56

Citing Landreth v.
Commissioner, 50 T.C. 803,
812-813 (1968):

'The guarantor no more realizes income from the transaction than he would if a tornado, bearing down on his home and threatening a loss, changes course and leaves the house intact.'

57

Hann

3-7

(Ct Fed Cl 8/16/2017)

Underwriter's Fee Paid
in Combined NQSO
Exercise and Stock
Sale Reduced Sales
Proceeds

58

In order to participate in an IPO, the taxpayer (CFO of Wesco Aircraft) exercised his NQSOs and immediately sold the stock to the underwriter of the IPO.⁵⁹

Ordinary Income on Exercise of 89,139 NQSOs at \$6.2933/share:

FMV of Stock \$1,337,085.00*
- Exercise Price \$560,981.44**
= Ordinary Inc. \$776,103.56

*\$15 per share x 89,139 Shares
**\$6.2933 per share

But Hann only received \$14.1375 per share from the underwriter because the underwriter's commission was the spread of .8625 (\$15 per share sales price to public minus \$14.1375 = .8625)

61

Hann wanted to reduce his ordinary income by the underwriter's commission of \$76,882.39 (.8625 X 89,139) (via an amended return)

62

Ct. Fed. Claims Holding

- The stock sale was a “separate taxable step” from the NQSO exercise.
- Immediately before the sale to the underwriter, Hann’s stock basis was \$15 per share.

63

Hann’s sale to the underwriter for \$14.1375 per share produced a **STCL of**
<\$76,882>
(<\$3,000> limit against ordinary income)

64

Olson

3-10

TC Memo 2017-33
(Feb. 13, 2017)

Tax Court Rules CalSTRS
Retirement Payments Were
Taxable Despite Taxpayer's
Disability

65

Background

Section 104(a)(1) and the regulations thereunder provide that retirement payments are **excludable from gross income if they are** received pursuant to a workmen's compensation act or **a statute in the nature of a workmen's compensation act.**

66

From August 26, 2000, until her 60th birthday in 2009, Mrs. Olson received disability payments from CalSTRS relating to a service-connected disability.

67

When Mrs. Olson reached the “normal retirement age” of 60 her disability payments were terminated, and she began receiving service retirement benefits calculated by reference to her age and years of service

68

Tax Court Holding

The retirement payments were **not excludible** as payments in the nature of a workmen's compensation act.

69

Taylor

3-11

TM Memo 2017-132
(July 5, 2017)

Disabled Fireman's
Retirement Allowance
Not Excludable

70

Same analysis as
Olson applied to
North Carolina
fireman who retired
on disability after
24 + years.

71

Keeter, TC Summary
Opinion 2017-36
(May 30, 2017)

3-11

Military Disability
Retirement Income
Was Excludible

72

Exclusion allowed because the taxpayer demonstrated that he would be entitled, upon application to the Veterans Administration (VA), to receive disability benefits.

73

Maciujec, TC Summary
Opinion 2017-49 (July 12, 2017)

3-12

Settlement Of
Emotional Distress
Claim Not Excludable
Under Sec. 104(a)(2)

74

Her CPA attached a statement to the return that “she had sustained ‘sexual abuse injuries’ at Home Depot, and, therefore, she considered the \$104,500 settlement payment to be nontaxable under section 104(a).”

75

Tax Court Holding:

No Exclusion

76

Taxpayer “may have suffered physically as a result of the battery described in the complaint, there is no indication in the settlement agreement ... that she was compensated for a **physical injury or physical sickness, or emotional distress attributable thereto.**”

77

*Rajcoomar, TC Memo
2017-129 (July 3, 2017)*

3-13

Disability
Discrimination
Settlement Claim Was
Not Excludible

78

The claims against his employer related solely to the employer's failure to offer "reasonable accommodations" for his disability.

79

Although the taxpayer's disability resulted from a major car accident (clearly physical injury), that injury was unrelated to his employment as a college campus safety officer.

No Exclusion!

80

Fiscalini

TC Memo 2017-163

(8/24/2017)

3-14

Home Sale To Parents
Was Part Sale, Part Gift

81

In 1993, Taxpayer purchased a home for \$274,312; he paid \$234,312 (with debt financing) and his parents paid \$40,000.

82

In 2003, his parents
gifted him their equity
interest.

Donee basis = \$40,000

83

In 2007, to avoid foreclosure,
Taxpayer sold the home to
his parents:

\$664,048.43 Debt Paid by Parents
-\$16,751,24 Settlement Costs
=647,297.19 Amt. Realized

The Form 1099-S Showed
Gross Proceeds of \$975,000
which the IRS endorsed.

84

Tax Court Holding

647,297.19 Amt. Realized
-274,312 Cost + Donee Basis
- 400 Unexplained
=372,585.19 Realized Gain
- 250,000 121 Exclusion
=122,585.19 Recognized Gain

85

Gaylor v. Mnuchin,
(DC WI 10/6/2017)

3-16

Wisconsin District
Court Again Holds
Parsonage Allowance
Exclusion is
Unconstitutional

86

Ritter, TC Memo 2017-185 (9/19/2017)

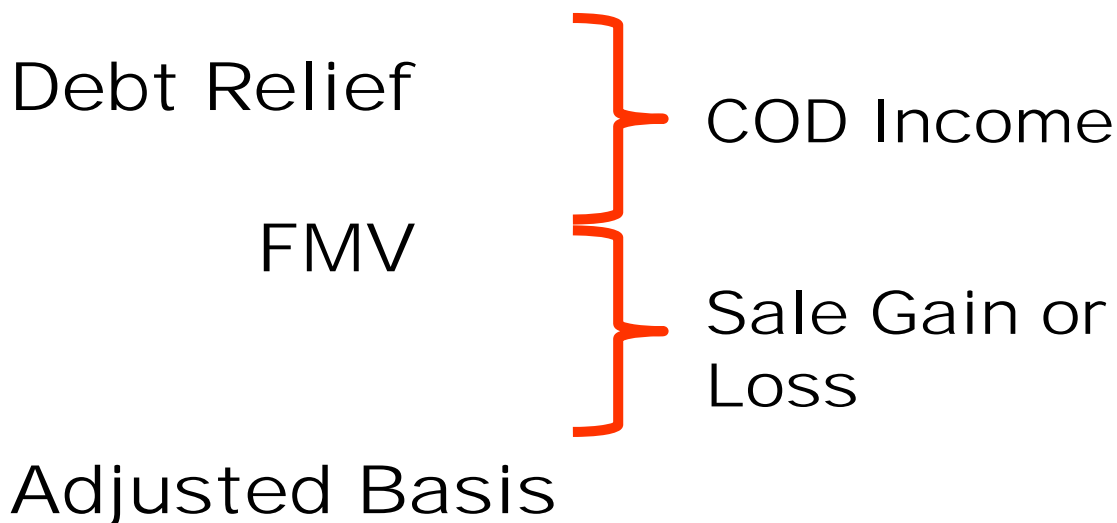
3-18

Settlement Payment To Borrower For Bank's Improper Mortgage Practices Is Gross Income

87

Background

Foreclosure on residence with recourse debt where debt exceeds FMV:



88

Background

Payments under the “National Mortgage Settlement” are treated as additional amount realized on the foreclosure--
Rev. Rule 2014-2

Tax Free:

(1) Reduction of nondeductible loss or (2) exclude under 121 if a gain.

89

Ritter: ~~Rev Rule 2014-2~~

- Ritter’s settlement was not an NMS settlement.
- The payment of \$31,250 for flawed mortgage practices “did not reflect financial injury or harm suffered”.
- **Gross Income (Sec. 61)**

90

PLR 201701009
(Released 1/6/2017)

3-18

Long-Term Capital Gain
Treatment Allowed to
Individual Partners On
Final Payment For
Patent

91

Background

- Payments received in exchange for a transfer of all substantial rights to a patent, by a **holder (creator)**, generate long-term capital gain. (section 1235)
- Each **individual partner** is a **holder** of his/her share of a patent created by the PSP.

92

PLR

- **Individual partners** in the LLC partnership were eligible for LTCG treatment on payments received by the PSP for final payments on a transfer of **all rights to a patent owned by the partnership.**

93

*Greenteam Materials
Recovery Facility PN,
TC Memo 2017-122
(6/21/17)*

3-20

*Sale of Contract Rights
Generated Capital Gain
Treatment Per §1253*

94

Background

Sale of a “franchise” generates LTCG if transferor does not retain an interest (section 1253).

95

“The term ‘franchise,’ includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area.”
(section 1253(b)(1))

96

Tax Court Holding

The Greenteam PSP
contracts to provide
landfill, waste-disposal,
and recycling services
meet the definition of
franchise in section
1253(b)(1)

LTCG

97

Estate of McKelvey,
148 TC No. 13 (4/19/17)

3-21

With VPFCs Open
Transactions When
Executed And No Gain
Or Loss Until Future
Delivery.

98

Decedent (D), founder and CEO of Monster Inc., entered into **variable prepaid forward contracts** (original **VPFCs**) with two investment banks in 2007 and received about **\$51 million from BofA.**

99

“In exchange, decedent agreed to **deliver to BofA,** over the course of **10 separate settlement dates in September 2008,** up to 1,765,188 Monster shares **or the cash equivalent**”.
(similar deal with Morgan Stanley for \$142 mil.)

100

July 24, 2008, D paid
BofA \$3.5 mil. to
extend the deal to
2010.

(similar with Morgan
Stanley, but D paid
\$8.2 mil.)

101

Following decedent's death,
the estate settled the BofA
VPFC by delivering to BofA
1,757,016 shares of Monster
stock on or about May 8,
2009.

(similar with Morgan
Stanley)

102

IRS Arguments:

1) D recognized **STCG** of **\$88,096,811** in 2008, from his **exchange** of the **VPFC** extensions for the original **VPFCs**

103

2) D recognized **\$112,789,808** of **LTCG**, in 2008, from the constructive sales of Monster shares pledged under the **VPFCs**.

104

Tax Court Holding

In Rev. Rul. 2003-7 the IRS recognized that VPFCs are open transactions when executed and **do not result in the recognition of gain or loss until future delivery.**

105

Both sides agreed that **Rev. Rul. 2003-7 was satisfied in 2007** so the dispute was over the significance of the extensions (in 2008).

106

Tax Court: at the time decedent extended the settlement of the original VPFCs, he had **only obligations, not property.**

107

The **open transaction treatment continued** when decedent **executed the extensions** (section 1259 did not apply).

The Estate Wins!

108

Austin, TC Memo 2017-69 (April 24, 2017)

3-21

S Corporation Stock
Was Subject To
Substantial Risk Of
Forfeiture Until
Restrictions Lapsed

109

In 2000, Taxpayers (100% owners of the S corporation), in exchange for services, received stock but to incentivize them, they executed reciprocal agreements whereby each would **lose 50% of the value of his stock if he left the company within five years**

110

Tax Court Holding #1

This restriction
was a substantial
risk of forfeiture
so no income in
2000

111

When the stock vested in
2004, each taxpayer, in
order to avoid reporting the
compensation income,
entered into simultaneous
"surrender" and
"subscription" agreements
with a new S-Corp.

112

Tax Court Holding #2

The "surrender" and
"repurchase"
"transactions were
palpably lacking in
economic
substance."

113

Each taxpayer's 2004
compensation income:

Stock FMV	\$45,857,434
- <u>Cost Basis</u>	<u>\$142,566</u>
= Comp. Inc.	\$45,714,868

114

Each taxpayer
had
compensation
income of
\$45,714,868
in 2004

115

*Turan, TC Memo 2017-
141 (7/17/17)*

3-24

*Stock Sales: FIFO vs.
Specific Identification*

116

The taxpayer
sought to use
LIFO on stock
sales **via**
Scottrade

117

Background

The regulations
determine basis using
FIFO (the default),
unless the taxpayer
can identify the shares
sold.

118

Regulatory Safe Harbor

For the "adequate identification" approach, **at the time of the sale, (1) the owner must designate the particular stock lot being sold and (2) the broker must confirm those instructions in writing** within a reasonable time after the sale.

119

The regulation is a safe harbor--
illustrative, not exclusive-- and **standing orders to a broker** may suffice

**Concord Instruments Corp.,
T.C. Memo. 1994-248**

120

Scotttrade had **no record of being contacted by the taxpayer** directing the firm to determine his pertinent stock bases in any specific manner.

121

Tax Court Holding

The taxpayer is stuck with FIFO--

Tax Deficiency **\$45,454**

+

Penalty **\$9,091**

122

*Robb Evans &
Associates v. U.S.,
(CA 1 3/3/2017)*

Fraudulently Obtained
Funds Don't Qualify for
section 1341 Relief

123

A financial fraud
committed by the Puccio
brothers and Cambridge
Credit Counseling
Corporation (CCCC)
resulted in about \$500
million being swindled
from the victims.

124

Following a successful class action lawsuit against the fraudsters, a receiver was appointed who managed to **recover (barely) \$2.5 million from the fraudsters.**

125

The **\$2.5 mil. paid to the Receiver/victims was deductible under section 162 (not a fine),** but the taxpayer/fraudsters had no income to offset it against in the year of repayment.

126

The receiver sought a tax refund (on behalf of the fraudsters) – of **\$9,387,235*** -- based upon section 1341 relief (a refundable credit).

***total taxes paid on ill-gotten income**

127

To qualify for section 1341 relief, the taxpayer **must subjectively believe that the taxpayer has the unrestricted right to the funds**, so IRS denied the refund claim.

(impossible for the fraudster)

128

The Receiver argued that the fraud should not be imputed to the receiver and the district court agreed with the Receiver.

129

The district court did limit the section 1341 refund to the tax paid by the fraudsters on the \$2.5 million actually recovered by the receiver.

(1st Circuit agreed)

130

1st Circuit Holding

“Nothing in the discernable legislative intent justifies carving out a special exemption from the ‘unrestricted right’ requirement for parties in either the Receiver's or the underlying plaintiffs' position.”

No Refund to Receiver

131

Yoklic and Ross, 3-29
T.C. Memo 2017-143
(July 19, 2017)

Unemployment Benefits
Are Compensation in Year
of Receipt Despite
Repayment

132

Taxpayer received \$3,360 in unemployment benefits from Arizona in 2012, but in 2013 it was discovered that taxpayer did not qualify for the benefits and the \$3,360 was repaid in 2013

133

Tax Court Holding

Income in 2012
under the
claim-of-right
doctrine

134

Though not at issue, the couple could, in 2013, either:

- 1) Deduct the \$3,360 or
- 2) Claim sec. 1341 Relief

135

Powers, TC Memo
2017-179 (9/14/2017)

3-30

Taxpayer Proves that
NQSOs in Dispute Were
Exercised in 2007 and
Not 2008

136

*Hurford Investments
No. 2, LTD v. Comm.*
(Apr. 17, 2017)
(Judge Holmes)

3-31

Tax Court Order on
Treatment of Inherited
Phantom Stock Plan

137

Phantom-stock agreement

- In early 1999, Gary is entitled to be paid the FMV of Hunt Oil Stock **five years following a "qualified termination of service"** (deferred comp. to Gary)
- Gary's death in 1999 triggers the five-year countdown.

138

- Thelma (spouse) inherits the phantom stock and transfers it to a FLP in 2000 – **FMV \$6,411,000**
- Thelma dies Feb. 2001 – **FMV \$9.6 mil. and that is in her gross estate (earlier case)**
- Phantom stock account is cashed out by Hunt Oil in 2006 – **FLP gets \$13 mil.**

139

If the Phantom Stock were Not Transferred to FLP

Taxpayer	Character of Phantom Stock Income
Gary (Employee)	Deferred Comp. – O.I.
Thelma (Spouse)	IRD – O.I.
Thelma's Beneficiaries	IRD – O.I. (no basis step-up)

140

With Transfer of the Phantom Stock to FLP

Taxpayer	Character of Phantom Stock Income
Gary (Employee)	Deferred Comp. - O.I.
Thelma (Spouse)	IRD - O.I.
FLP	LTCG per Sec. 1234A (Proceeds - DOD FMV)

141

Tax Court Orders

142

1) The phantom stock was deferred compensation to Gary, but **IRD to his spouse** (Thelma) who thus inherited it **without a basis step-up.**

143

2) The phantom stock **was was a capital asset to the partnership** to which Thelma transferred the phantom stock. It is unlike a winning lottery ticket which would trigger the "substitute-for-ordinary-income doctrine."

144

3) When Thelma transferred the Phantom Stock (IRD) to the FLP, it triggered \$6,411,000 of IRD (the FMV of the phantom stock).

(Section 691(a)(2))
(the gain was erroneously report on Form 1065 as STCG)

145

4) When the FLP received \$13 mil. cash for the phantom stock, the FLP's basis was the date-of-Thelma's-death FMV of \$9,639,588.

About \$3,360,412 of gain

(in her gross estate per a 2008 Tax Court case).

146

5) The \$3,360,412 of gain to the FLP was LTCG because it was a "termination of a right to buy or sell a capital asset" under 1234A(1).

147

*T.D. 9824, Regs.
31.3402(q)-1 and
3406(g)-2 (09/25/2017)*

3-33

Final Regs. on Gambling
Winnings Withholding on
Horse Races, Dog Races,
And Jai Alai

148

CCA 201703013
(Released 1/20/2017)

3-33

Chief Counsel Explains
Taxation of Employer
Provided Fixed
Indemnity Health Plans

149

CCA 201719025
(5/12/2017)

3-35

Benefits Paid Under
Self-Funded Plan Are
Includible In
Employee's Income

150

CA-2017-001 (8/17/17)

3-37

Shell Oil Payments to
Carson, CA
Homeowners

151

3-38

Perkins, et ux. v. U.S.,
(DC NY 8/4/2017)

Native American Land
Sale Gain is Exempt
from U.S. Tax.

152

CCA 201729001
(Released July 21,
2017)

3-38

Gaming Revenues
Distributed To Indian Tribe
Members Are Unearned
Income so Subject to "Kiddie
Tax"

153

3-41

Chief Counsel Memo
AM 2017-001

No Closing Agreement
For Employer Untimely
Treatment Of NQDC For
FICA Purposes

154

Information Letter
2017-0012
(Released 6/30/2017)

3-43

FICA Tax Rules For
Nonqualified Deferred
Nonaccount Balance
Plan