Losses

Chapter 5

Surgical Center LLC Was Separate Activity from Surgery Practice and No SE Tax

5-2

Hardy, TC Memo 2017-16 (January 17, 2017)

4.2 stars from 11 reviews

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✓CORE

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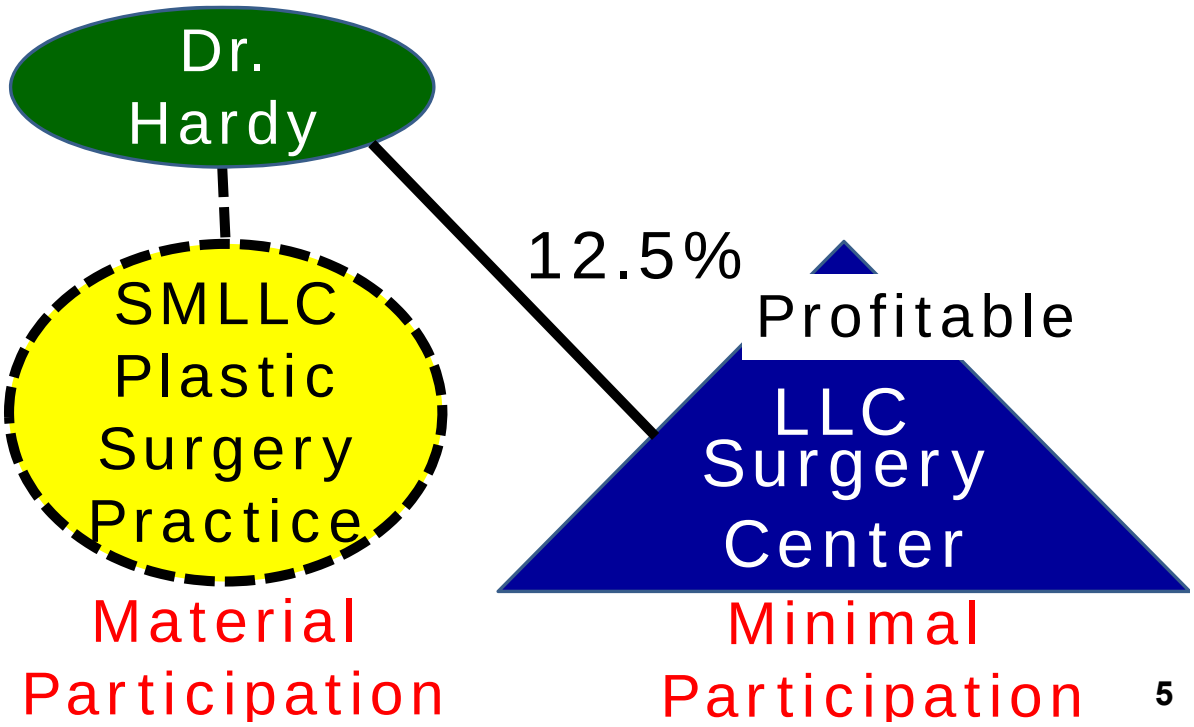
SE Tax Issue (section 1402)



Is Dr. Hardy subject to SE tax on his earnings from the LLC/PSP surgery center?

NO says Tax Court. Dr. Hardy is a "limited partner" unlike *Renkemeyer*.

"Dr. Hardy has never managed [the surgery center], and he has no day-to-day responsibilities there. Although he meets with the other members quarterly, he does not have any input into management decisions."

"The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes."

Renkemeyer (cited in Hardy)

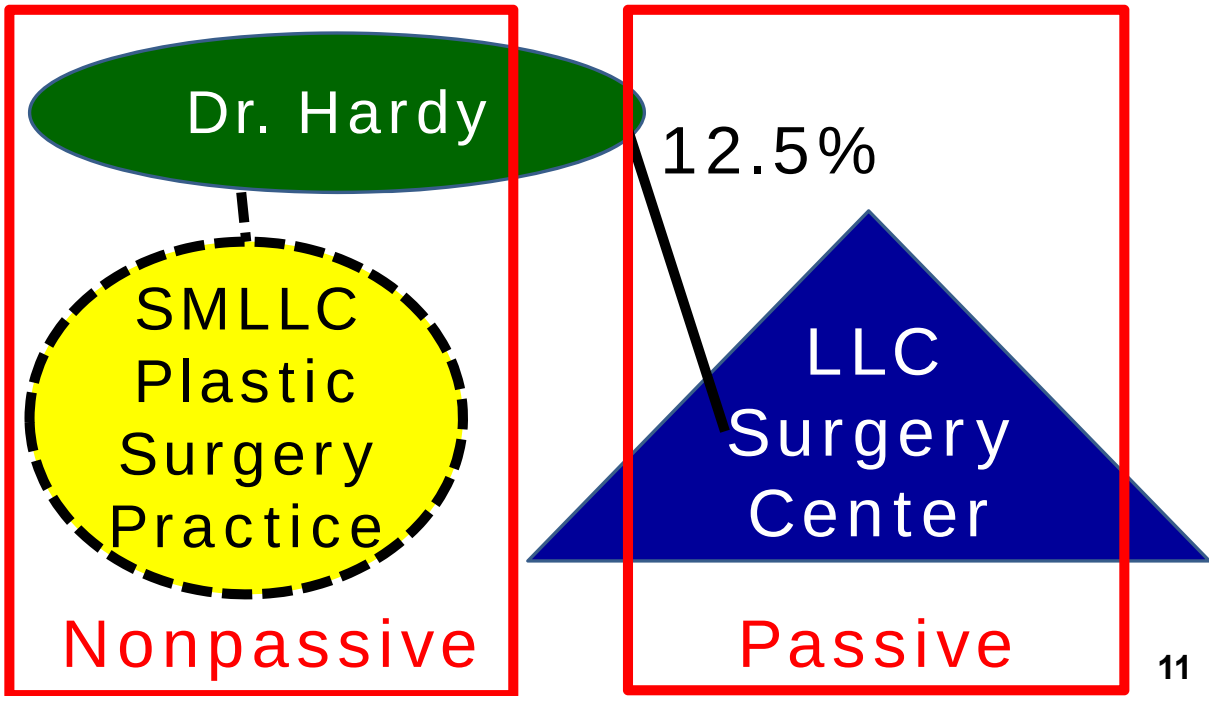
Passive Activity Loss (PAL) Issues (section 469)

What is the activity?

What is the appropriate economic unit?

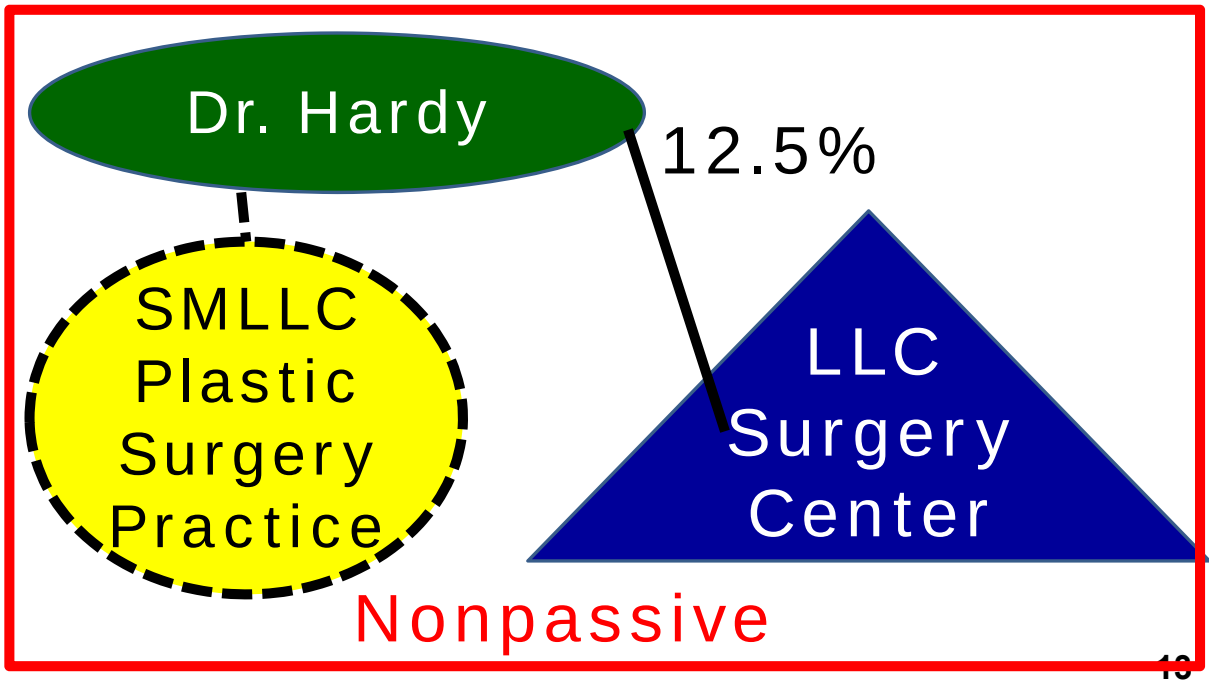
(a facts and circumstances test)

Taxpayer View--
Two PAL Activities



The Hardy's used the passive income from the Surgery Center LLC to offset large passive losses from other sources.

IRS Position--
One PAL Activity



Tax Court:

Treating the LLC and medical practice as separate economic units was appropriate.

(implicitly not a SPA)

Appropriate Economic Unit – Greatest Weight:

1) Similarities and differences in types of trades or businesses;
2) The extent of common control;
3) The extent of common ownership;
4) Geographical location; and
5) Interdependencies between or among the activities

"The facts in this case lend support to more than one reasonable method of grouping Dr. Hardy's ownership interest in MBJ and his medical practice."

Did Hardy Regroup in 2008?

The Hardy's treated the surgery center as nonpassive in 2006 and 2007

Once a taxpayer has grouped activities, the taxpayer cannot regroup those activities unless "it is determined that a taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate". (Reg. 1.469-4(e))

IRS argued that the taxpayer was prohibited from regrouping in 2008.

Tax Court:

"The mere fact that the Hardys reported Dr. Hardy's activity as nonpassive [in 2006 and 2007] is not enough for us to find that they grouped Dr. Hardy's [12.5% LLC interest] with his medical practice [in those prior years]."

Tax Court found the CPA "credible":

"He explained that he determined that the income from [the LLC] was nonpassive [in 2006 and 2007] by applying his training and experience and by relying on the Schedule K-1, which reported income from a trade or business and self-employment tax. Moreover, he stated that he did not consider [reg.] 1.469-4"

The outcome in Hardy helps explain why the IRS issued Rev. Proc. 2010-13, which requires taxpayers to identify PAL groupings for tax years beginning after 1/25/2010.

Malpractice Alert—Failure to Timely Amend Form 1040.

In 2008, the CPA did not recommend that the Hardy's amend 2006 and 2007 to claim a passive loss of <$119,615>. Instead, the loss was carried to 2008.

Tax Court: "Had the Hardys properly reported the [LLC] income as passive for 2006 and 2007, it would have fully absorbed their passive losses and there would have been no passive loss to carry forward to 2008. Accordingly, they are not entitled to the full passive activity loss deduction claimed [in 2008]."

The statute of limitations on refunds for 2006 and 2007 had expired.

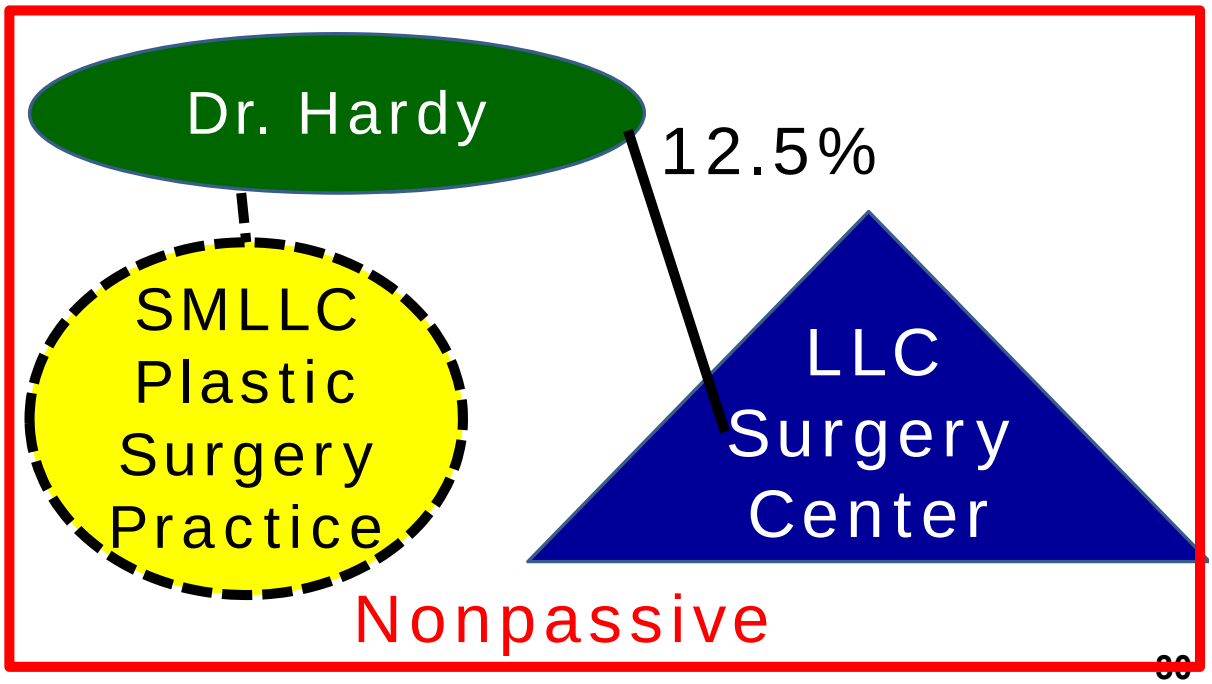
No negligence penalty because the taxpayers relief upon an "experienced" CPA.

Net Investment Income Tax (NIIT) Avoidance Strategy

(move *Hardy* to present day and change the facts)

Assume that in 2017 Dr. Hardy purchases the 12.5% LLC interest and further assume no passive losses from other sources, so the Hardys don't need passive income.

Grouping Into One Activity Does Not Trigger SE Tax on the LLC Income



Why is PAL grouping desirable?

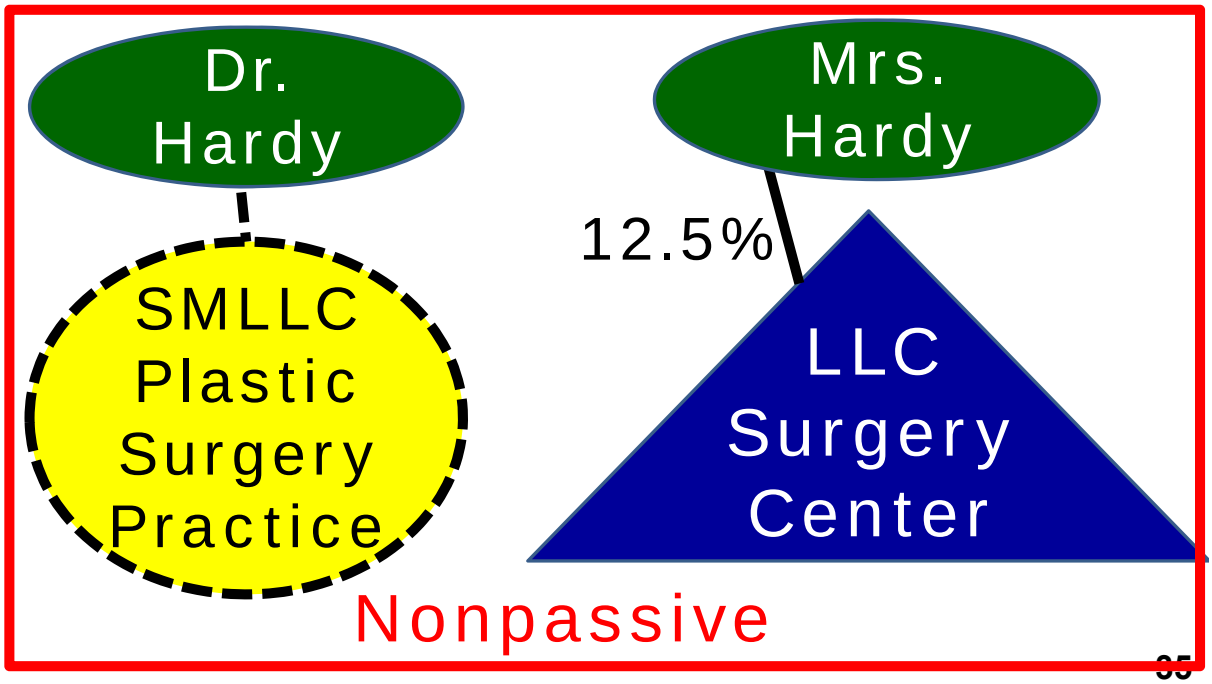
Because the LLC income is nonpassive business income, it also escapes the NIIT.

Next, assume that Dr. Hardy materially participates in the LLC/PSP (surgery center), but not Mrs. Hardy.

Can SE tax and NIIT tax be avoided by Mrs. Hardy?

- If possible, have Mrs. Hardy own the 12.5% interest in the PSP/LLC surgery center.
- The income will be nonpassive for section 469 purposes (H/W are one) and NIIT purposes, but Mrs. Hardy is an investor for SE tax purposes.

One PAL Activity



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Same if community property--no SE income on her 1/2-- provided she is a member of the PSP.

(Reg. 1.1402(a)-(8)(b))

Owens 5-8

TC Memo 2017-157 (8/10/2017) Judge Holmes

Individual In Money Lending Business Allowed A 9.5 Million Bad Debt Deduction in 2008

Tax Court Holding

"Because Owens was involved in the trade of business of lending money during the years at issue and his advances to Lohrey Investments during the years constitute bona fide debt that became worthless in 2008, he is entitled to the claimed [business] bad-debt deduction."

Tax Court Factors To Distinguish If Taxpayer Is In The Business Of Lending Money:

- the total number of loans made;
- the time period over which the loans were made;
- the adequacy and nature of the taxpayer's records;

- whether the loan activities were kept separate and apart from the taxpayer's other activities;
- whether the taxpayer sought out the lending business;
- the amount of time and effort expended in the lending activity; and
- the relationship between the taxpayer and his debtors.

Ninth Circuit Factors To Consider In Distinguishing Debt From Equity

("not to overemphasize any one of them")

- the names given to the certificates evidencing the indebtedness;
- the presence or absence of a maturity date;
- the source of the payments;

- the right to enforce the payment of principal and interest;
- participation in management;
- a status equal to or inferior to that of regular corporate creditors;
- the intent of the parties;
- "thin" or adequate capitalization;
- identity of interest between creditor and stock holder;

- payment of interest only out of "dividend" money; and
- the ability of the corporation to obtain loans from outside lending institutions.

Tax Court "objective criteria that indicate a debt is worthless" (if debtor not bankrupt):

- a decline in the debtor's business;
- a decline in the value of the debtor's assets;
- overall business climate;
- serious financial hardship suffered by the debtor;

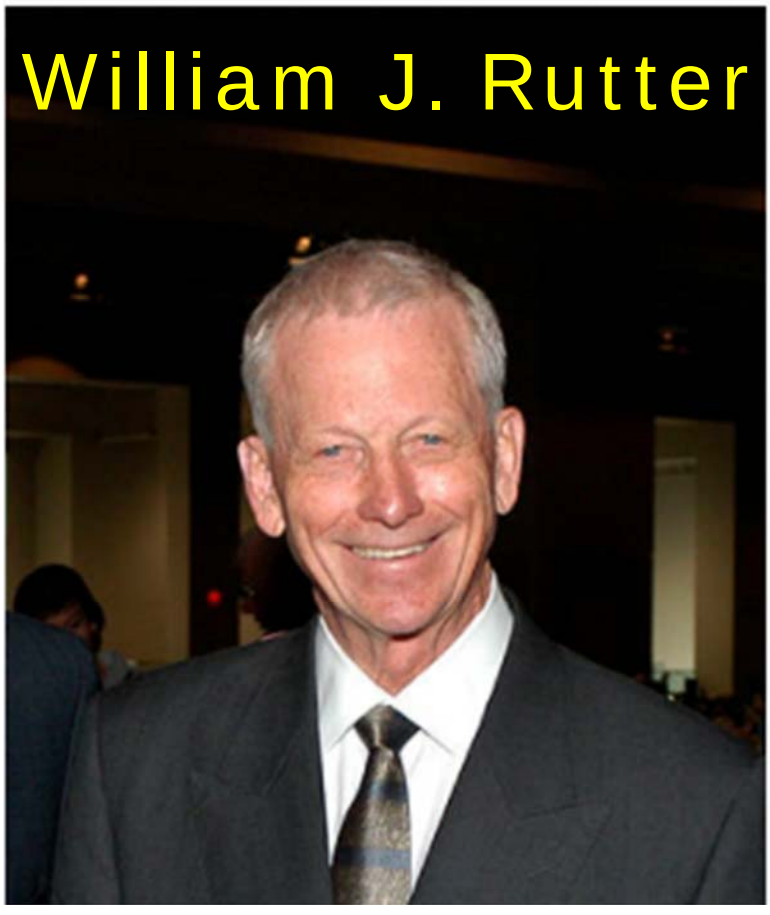
- the debtor's earning capacity;
- events of default;
- insolvency of the debtor;
- the debtor's refusal to pay;
- actions taken by the creditor to pursue collection; and
- subsequent dealings between the creditor and debtor.

Rutter, TC Memo 2017-174 (9/7/2017) 5-10

Tax Court Denies Business Bad Debt Deduction For Advances To Biotech Firm

"[Taxpayer] is a world-renowned scientist in the field of biotechnology."

(holds more than 25 patents)



iMetrikus (IM) was a ‘telehealth’ company that developed technology systems to enable remote monitoring of patients' health.

“IM had an unusual capital structure. Although petitioner was its driving force, he owned no common stock. IM had about 70 common shareholders, including ...some of petitioner's family members. But common stock formed a minuscule portion of its capital structure.

From the time petitioner incorporated IM [2002] through December 2009, IM's primary funding source took the form of cash advances [most undocumented] from petitioner."

The $43.5 million advanced by May 2005 was converted to preferred stock.

"Between May 2005 and December 2009 petitioner made additional cash advances to IM totaling $43.04 million [no notes and no collateral]"

"In March 2010 petitioner and IM executed a debt restructuring agreement, a consolidated promissory note for $34.5 million, and a certificate of debt forgiveness of $8.55 million. All of these documents were backdated to December 31, 2009.

In 2009, on his Form 1040 Schedule C, the taxpayer claimed a business bad debt deduction of $8.55 million for a partially worthless debt.

Issue #1

Whether petitioner's advances to IM constituted debt or equity

Holding #1

"Evaluating the [same 11 Ninth Circuit factors in Owens] overall we find that petitioner's advances, including the advances corresponding to his $8.55 million writedown, were equity investments and not debt.

Issue #2

If the advances constituted debt, is the debt "nonbusiness" debt?

Holding #2

"At best, the advances would give rise to a nonbusiness bad debt which, upon becoming worthless, would generate a short-term capital loss."

Issue #3

If the debt was a business debt, whether the writedown should be characterized as involving a "wholly worthless" or "partially worthless" debt?

Holding #3

"IM's financial condition at year-end 2009 was not materially different from its financial condition at year-end 2008."

The debt was neither wholly nor partially worthless.

5-14

Penley, TC Memo 2017-65 (4/17/2017)

Taxpayer Failed To Sufficiently Document Hours as a Real Estate Professional

Petitioners claim Mr. Penley worked 2,520 hours on his real estate activities. To do so he would have had to work a total 4,714 hours (i.e., 2,194 [as a full-time employee] for HHS + 2,520 on his real estate activities) in 2012.

That means if he worked every day, he would need to have averaged 12.88 total hours per day (i.e., 4,712 ÷ 366 ' 12.88).

We conclude the calendar is untrustworthy, and we will not naively accept it to reach the result petitioners seek.

Makhlouf, TC Summary Opinion 2017-1 (Jan. 11, 2017)

5-16

Taxpayers Failed Prove >750 Hours Of Participation So Were Denied REP Status

Taxpayers own:

(1) One single-family residence in Weston, Mass

(2) Two apartment rentals in Cairo, Egypt – with 18 co-owners.

"The Weston spreadsheet was not prepared contemporaneously, and it is implausible on its face in many respects. ...It is implausible that petitioners spent a total of 64 hours paying bills for a single rental property."

"The ... spreadsheet [for the Cairo, Egypt property] was not prepared contemporaneously, and it also lacks plausibility. ...We do not believe that he devoted on average more than four hours each day [of 73 days in Egypt],..., to a ... property that yielded him only $8,000 in rental income, while also visiting family, touring the pyramids and Luxor, [and vacationing]"

Windham

5-17

TC Memo 2017-68
(April 24, 2017)

Stock Broker Qualifies as a REP and Materially Participates in 10 of 12 Rental Properties

"In addition to her employment as a stock broker, petitioner owned 12 rental properties and a 50% interest in a vacant lot."

"The taxpayer failed to make a REP grouping election so she needed to materially participate in each property in order to claim her renal losses as nonpassive."

She reported a loss of <$307,933>, on Schedule C, from her rental properties.

With respect to the three properties in which her participation exceeded 100 hours, the Tax Court concluded that she met the all facts and circumstances test for material participation in Temp. Reg. 1.469-5T(a)(7).

With respect to the seven of the other nine properties, "[t]he Court is satisfied by petitioner's testimony and other evidence that her participation in each of those activities constituted substantially all of the participation in each."

"With the repairs made and the number of different individuals involved in those repairs, no one individual participated in the rental real estate activities to the extent petitioner did."

Is that the test?

"An individual shall be treated ...as materially participating...if and only if—...

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals ~~any other individual~~ (including individuals who are not owners of interests in the activity) for such year" (1.469-5T(a)(2))

Observation: The Judge appears to confuse the -5T(a)(2) "substantially all" test with the -5T(a)(3) test (over 100 hours and not less than the participation of any other individual).

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual ~~all individuals~~ (including individuals who are not owners of interests in the activity) for such year;

(1.469-5T(a)(3))

For these seven properties, the taxpayer's participation was below 100 hours and all we know is that "no one individual participated ... to the extent petitioner did"

Does this mean that she was doing substantially ALL of the work for each of the seven properties?

Judge Paris also fails to separately analyze each rental property in applying the – substantially all test.

Action On Decision 2017–07

5-20

(October 16, 2017)

IRS Disagrees with Two PAL REP Holdings in Stanley v. U.S. (DC AR) (11/12/2015)

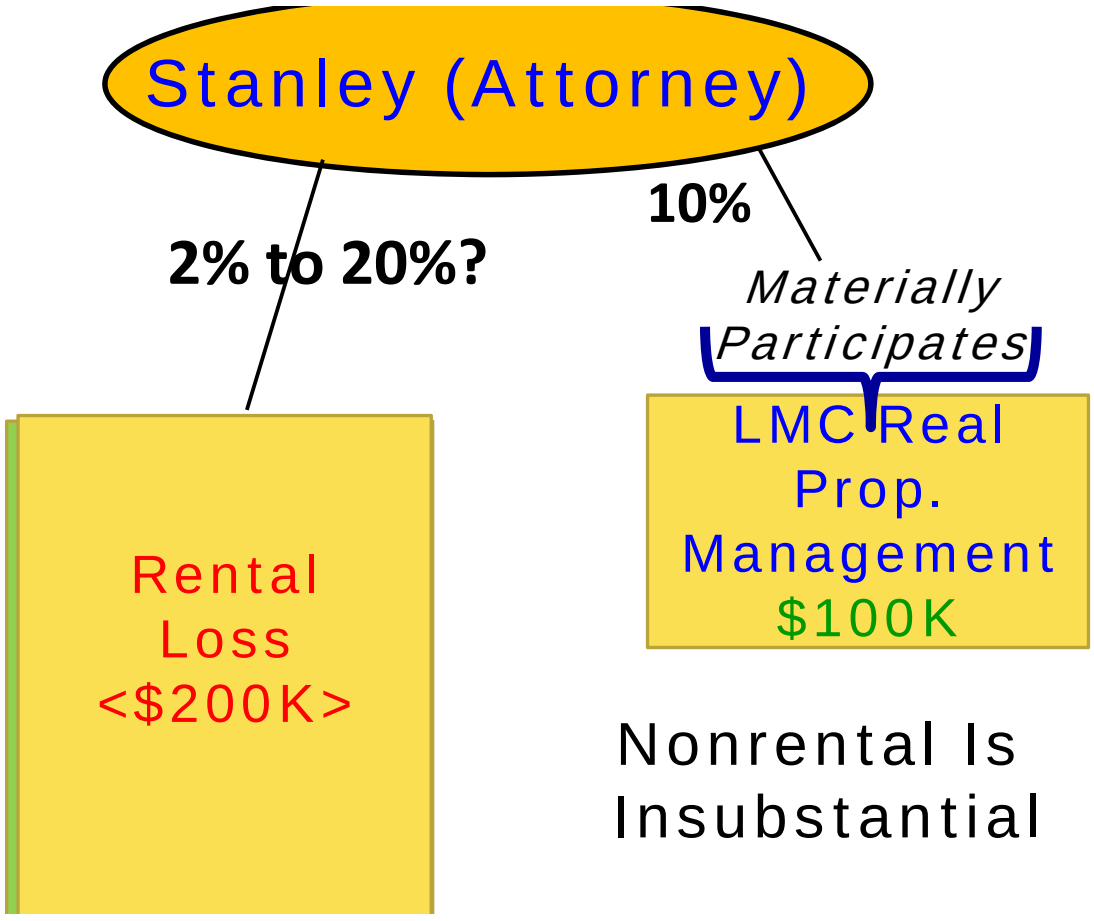
1) IRS did not agree with Dist. Ct. Judge Holmes that Stanley satisfied the 5% ownership requirement to count an employee as REP (section 469(c)(7)(D)(ii))

- Stanley was required by employment agreements to relinquish his 10% stock ownership upon full retirement, for no consideration.
- IRS believes that Stanley lacked an "entrepreneurial stake" in the stock interest was merely a "type of compensation".

2) IRS also disagreed with the District Court's interpretation that a REP can use the material participation in a nonrental activity (grouped under 1.469-4(d) with the rental real estate activity) to count towards material participation in the rental activity.

Stanley (DC AR) 11/12/2015

Fact Pattern



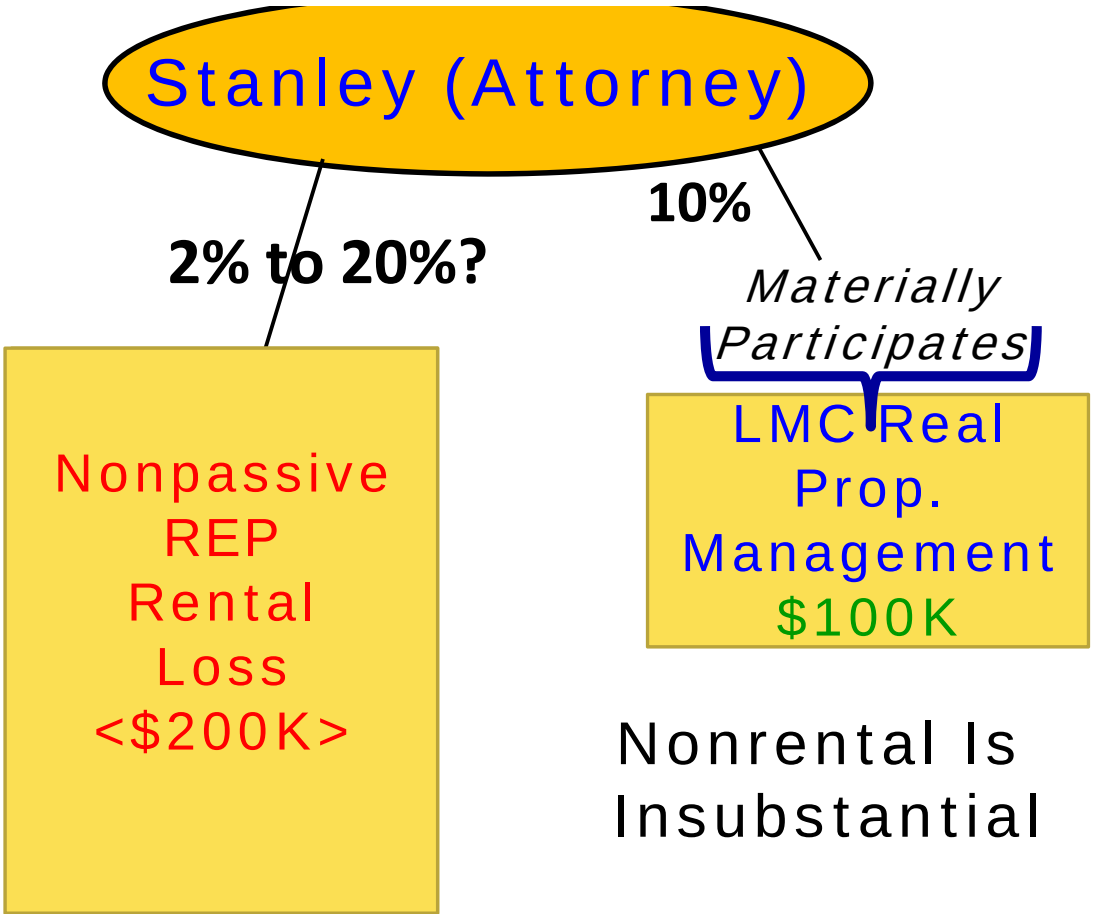
Nonrental Is Insubstantial

The nonrental is grouped with the rental under reg. 1.469-4(d) (matches Glick)

With sec. 1.469-4(d) general grouping, the $100K otherwise nonpassive income can offset the <$300K> passive rental loss thus reducing the PAL to <$200K>

That alone is NOT what the IRS objects to.

IRS objects to the use of the general grouping rule in reg. 1.469-4(d)(1) for a REP which make the <$200> of net rental losses nonpassive.



Judge Holmes concluded that reg. 1.469-9(e)(3)(i) does not prohibit a REP from grouping aggregated rentals with nonrentals.

1.469-9(e)(3)(i)

"For purposes of *this section*, a [REP] may not group a rental real estate activity with any other activity of the taxpayer." (emphasis added)

"For example, if a [REP] develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer's interest in rental real estate may not be grouped with the taxpayer's development activity or construction activity."

"Thus, only the participation of the taxpayer with respect to the rental real estate may be used to determine if the taxpayer materially participates in the rental real estate activity under §1.469-5T."
(Reg. 1.469-9(e)(3)(i))

We [the IRS] believe the statute and regulations require real estate professionals to demonstrate material participation in their rental real estate activities through work they perform directly in the rental real estate activities, and not simply by virtue of the work performed in their other real property trades or businesses (such as real estate construction or development businesses).

Hickam

5-20

TC Summary Opinion 2017-66 (Aug. 17, 2017)

Mortgage Broker Failed To Qualify As Real Estate Professional Under Passive Loss Rules + 20% Penalty

Definition of REP "real property trade or business":

"[T]he term 'real property trade or business' means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." (Section 469(c)(7)(C))

Tax Court's Holding

"Mr. Hickam's argument that his mortgage brokerage services and his loan origination services are performed in trades or businesses in 'real property operation' because the underlying assets are real property is too attenuated.

His argument ignores the words 'real property' that precede the specific activities listed in the statute; those words modify each of those activities, including 'operation'."

Adkins (CA FC 5/8/2017)

5-23

Federal Circuit Disagrees with Lower Court's Harsh Reading of Theft Loss Timing Reg

While the criminal proceedings against the fraudsters were pending, in 2006, the Adkinses attempted to recoup some of their losses by deducting a theft loss of <$2,118,725>

The Court of Appeals for the Federal Circuit, following 6th, 10th, and 3rd Circuit opinions, reversed the Court of Federal Claims

"...the proper year in which to claim a loss is the first year in which ~~[T is certain of no recovery]~~ no reasonable prospect of recovery exists anymore, starting with the year of discovery."

Lewis

5-26

TC Memo 2017-117 (June 19, 2017)

No Expense Deduction For Minister Without Profit Motive + 20% Accuracy Penalty

"Mr. Lewis admitted at trial that he 'didn't charge' for services he performed as a minister. Mr. Lewis likewise did not provide evidence showing that he had any income from his alleged book writing activity."

5-27

Zudak
TC Summary Opinion 2017-41 (6/19/17)

Film Festival is a Hobby

Taxpayer's Schedule C (prepared by "accountant"):

Gross receipts $690
Expenses $32,747 (no details)
Loss ($32,057)

A letter posted at the website notes that the taxpayer is more interested in artistic expression and creativity than generating revenue.

Based on its analysis of the nine factors in the section 183 regulations, , the court found that the taxpayer was not engaged in an activity for profit.

+ 20% Accuracy Penalty

5-29

Stettner
TC Memo 2017-113 (June 14, 2017)

Taxpayer Lacked a Profit Motive For Car Racing Business

Pursuant to section 183(d), an activity is presumed to be engaged in for profit if the activity produces income in excess of deductions for any three of the five consecutive years which end with the taxable year, unless the Commissioner establishes to the contrary.

On October 14, 2013, petitioners filed Form 5213, Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit.

Form 5213 Instructions

If you elect a postponement and file this form on time, the IRS will generally postpone the determination until after the end of the 4th consecutive tax year (6th tax year for an activity that consists mainly of breeding, training, showing, or racing horses) after the tax year in which you first engaged in the activity. This period of 5 (or 7) tax years is called the "presumption period." The election to postpone covers the entire presumption period.

Automatic Extension of Period of Limitations

Generally, filing this form automatically extends the period of limitations for assessing any income tax deficiency specifically attributable to the activity during any year in the presumption period. The extension also applies to partners or shareholders in the activity.

The period is extended until 2 years after the due date for filing the return (determined without extensions) for the last tax year in the presumption period. For example, for an

Taxpayers Schedules Cs for 2011-15

Year	Gross income	Total expenses	Net profit (los
2011	$480	$63,249	($62,769)
2012	2,738	18,754	(16,016)
2013	8,740	4,900	3,840
2014	9,246	4,608	4,638
2015	9,280	6,122	3,158

Presumed for Profit in 2011?

Tax Court Determination

Year	Gross income	Total expenses	Net profit (los
2011	$480	$63,249	($62,769)
2012	2,738	18,754	(16,016)
2013	8,740	4,900	<2,260>
2014	9,246	4,608	<754>
2015	9,280	6,122	3,158

Taxpayers are not entitled to the for profit presumption.

Based on its analysis of the nine factors in the section 183 regulations, , the court found that the taxpayer was not engaged in an activity for profit for 2011.

+ 20% Accuracy Penalty

5-31

Hess
TC Summary Opinion 2016-27 (June 20, 2016)

Part-Time Amway Business Is A Hobby

Based on its analysis of the nine factors in the section 183 regulations, , the court found that Hess was not engaged in an activity for profit.

5-34

Boneparte
TC Memo 2017-193 (10/2/2017)

Lincoln Tunnel Agent Was a Casual Gambler, Not A Professional Gambler

Background

A professional gambler's losses from gambling ("wagering losses"), up to the amount of his/her wagering gains are deductible for AGI on Schedule C.

A professional gambler's nonwagering expenses are not limited to gambling gains and can produce a Schedule C net loss.

Mayo v. Comm'r, 136 T.C. at 97.

Tax Court Example of Casual Gamber

"[C]onsider a casual gambler who makes only the following wagers throughout the year: a wager of $10 for a win of $50, and five losing wagers totaling $50. Gross income is increased by $40. The taxpayer has an itemized deduction of $40 [$50 of losses but limited to $40]."

Key Facts

- Boneparte was employed full-time as a "tunnel bridge agent" at the Lincoln Tunnel.

- The Tax Court found “that he spent 33%-50% of his nights in Atlantic City in 2012 and 50%-67% in 2013. “

- Boneparte gambled at horse racetracks and in casinos.

- “He did not keep a contemporaneous written log of winnings and wagers.”

- He “did not earn a profit from gambling for any of the years 2009-13.”

Tax Court Holding

The Tax Court analyzed the nine factors in the section 183 regulations and determined that Boneparte's gambling activity was not for profit and thus he was not a professional gambler.

Nonwagering Expenses

The Tax Court noted that Boneparte's nonwagering expenses of $89,116 in 2012 and $85,783 in 2013 were not allowed on Schedule C (above AGI) because the taxpayer was a casual gambler.

Tax Court Comment

"The nonwagering expenses of casual gambling often fall into section 183(b)(2); and in this case there is no dispute that Boneparte's nonwagering expenses of gambling would fall into the section 183(b)(2) category if he is considered a casual gambler."

Section 183(b)(1)

(b) Deductions allowable. In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed—(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit.

(i.e. gambling loss to extent of gains)

Boneparte's Gambling Gains and Losses

2012	2013
Gains $18,000 (Other Income)	Gains $12,500 (Other Income)
Losses $18,000 (Itemized Deduction)	Losses $12,500 (Itemized Deduction)

Section 183(b)(2)

(2) a deduction equal to the amount of the deductions which would be allowable ...only if such activity were engaged in for profit [nonwagering expenses], but only to the extent that the gross income ... for the taxable year [gambling gains] exceeds the deductions allowable by reason of paragraph (1) [gambling losses]

Bon Viso

5-33

TC Memo 2017-154 (8/8/2017)

Casual Gambler Not Allowed To Reduce Winnings With Losses and Claim Standard Deduction

Tax Court's Holding #1

"Although petitioners introduced evidence of losses at another casino ... the record contains no evidence specifying how much petitioner husband bet to produce the [$5,060] winnings reflected on the Forms W-2G."

"Since we have no basis for estimating the amounts of petitioner husband's bets, we hold that petitioners must include gambling winnings of $5,060 in their gross income."

Tax Court's Holding #2

In the case of [casual gamblers such as the taxpayer], gambling losses are allowable as an itemized deduction, but only to the extent of gambling winnings.

"If such taxpayers take the standard deduction instead of itemizing their deductions, they may not deduct any gambling losses."

"Because petitioners elected to take the standard deduction [$12,200], we hold that they cannot take an itemized deduction for their gambling losses to offset their [$5,060] gambling winnings."

5-37

Silipigno (DC NY 7/13/2017)

Failure To File Proper Refund Claims Scuttled Two NOL Carrybacks

139

2009 NOL carried back to 2004

- Mr. Silipigno timely filed (with extensions) his 2009 Form 1040 on October 15, 2010, claiming an NOL of <$2,194,793>.

- He also timely filed an Application for Tentative Refund (Form 1045) on October 15, 2010, seeking a refund of $806,586 from his 2004 taxes attributable to his 2009 NOL carryback.

The taxpayer was investigated for "mortgage, bank, and tax fraud"by the IRS and FBI but ultimately, around August 2014, the United States Attorney's Office declined to prosecute Mr. Silipigno.

“On or around December 11, 2014, Plaintiff's tax file was removed from the IRS's fraud suspense.... [Taxpayer] commenced this action soon thereafter on January 7, 2015.”

"On multiple occasions between 2011 and 2014, [taxpayer’s] representatives contacted the IRS-both through phone calls and in-person visits to the IRS office in Glen Falls, New York-to discuss Plaintiff's outstanding refund requests. The IRS informed Plaintiff's representatives that the refund requests were being "held." (citations omitted)

District Court's Holding

"Since [taxpayer] did not duly file a formal or informal claim for refund [Form 1040X] regarding his 2009 NOL carryback as applied to the 2004 tax year, this Court lacks jurisdiction over this claim and it must be dismissed [the S of L on refund claims expired]

2007 NOL carried back to 2005

The taxpayer timely filed (with extensions) his 2005 Form 1040 on October 16, 2006. He reported $8,286,060 in total income and paid $2,630,185 in federal taxes.

- He filed his 2007 Form 1040 on October 4, 2010, claiming an NOL of $1,414,014 (a late filed return).
- He also timely filed Form 1040X on October 15, 2010, seeking a refund of $509,752 from his 2005 taxes attributable to the 2007 NOL carryback.

- With respect to his 2005 return, Schedule C, the taxpayer failed to substantiate his cost of goods sold of $4,510,050.

- The S of L on assessment had expired by 2015 but IRS was allowed to increase the 2005 tax up to the amount of the requested refund. *Lewis v. Reynolds*, 284 U.S. 281 (1932).

Alternatively, regarding his 2007 NOL, the taxpayer failed to substantiate the $2,129,876 loss that generated the NOL.