# Chapter Two

## Income, Capital Gains, Exclusions and Deferrals

**Items Included in or Excluded from Gross Income, and Related Matters**.

Diane Blagaich and Lewis Burns were involved in a romantic relationship from November 2009 until March 2011. In 2010 Blagaich was 54 years old and Burns was 72. In 2010 Burns provided Blagaich with cash and other property totaling in value at least $743,819. Items transferred to her prior to November 29, 2010, included $200,000 in cash through a wire transfer, a $70,000 Corvette automobile, and various

On November 29, 2010, Blagaich and Burns entered into a written agreement intended to “confirm their commitment to each other, and to provide financial accommodation” for Blagaich. Neither party wanted to marry, but the agreement was intended to formalize their respect, appreciation, and affection for each other in the way a marriage “otherwise would do.”

The relationship between Blagaich and Burns quickly deteriorated in the months following execution of the agreement. On March 10, 2011, Blagaich moved out of Burns' residence for the last time. On the next day, Burns sent Blagaich a notice of termination of the agreement. Shortly thereafter, Burns came to believe that Blagaich had been involved in an ongoing romance with another man throughout their relationship.

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In November 2013, the Illinois State court found that Blagaich had fraudulently induced Burns to enter into the agreement, and entered a judgment against her in the amount of $400,000 payable to Burns' estate, as he had died shortly after trial in the case. With respect to the other items worth

$343,819 Burns transferred to Blagaich in 2010 (the Corvette, the $200,000 wire transfer, and the various checks), the Illinois court found that the items were gifts.

After the Illinois court decision, the executors of Burns' estate issued a revised 2010 Form 1099- MISC reducing the amount of compensation reported as paid to Blagaich to $400,000. Blagaich repaid

State court order.

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Meanwhile, the IRS determined that Blagaich had understated her 2010 income by $743,819.

Blagaich took offense and filed a motion requesting a Tax Court order on two issues:

- That the IRS was estopped from claiming that she had income in the amount of $343,819. The Illinois court had held was a gift.
- That she had no income from the $400,000. She had returned that amount to Burns' estate

The Tax Court agreed with the IRS. First, it agreed that estoppel did not apply to the IRS with respect to the Illinois court decision as to what was a gift from Burns to Blagaich. The IRS was not a party to the Illinois case, therefore the IRS was free to claim that the items in question were not gifts to Blagaich.

- Tax Court found, no evidence showed that Blagaich had recognized a liability to return the $400,000 in 2010.
- Therefore the Tax Court held that the rescission doctrine did not apply to bar the IRS from claiming Blagaich had $400,000 of income in 2010.

For a more egregious case involving a similar gift-versus-income issue, see *Alhadi v. Comm'r*, T.C.

Memo. 2016-74, where the Tax Court held in an "elder abuse" case that a woman failed to include more than $900,000 in gross income in 2007-2008. The Court found that she used undue influence in her role as a caregiver to an elderly man to obtain almost $1 million from him before his death, that the money was self-employment income to her, and that she filed fraudulent returns.

In addition to sustaining the notice of deficiency as to unreported income of more than $900,000 in 2007 and 2008, the Court found that the income was self-

Crowdfunding Issues.

“Crowdfunding” is the collective effort of raising funds, usually through the Internet, by or for the benefit of a donee or transferee. Crowdfunding can be used to support business, personal, or charitable purposes, and can be organized for one donee or transferee, a group (such as victims of the Boston Marathon bombing), or through one of the “top 100" crowdfunding sites such as HopeMob, Start Some Good, and Causes. By 2020, crowdfunding is expected to involve more than $90 billion.

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The IRS has provided little guidance. An IRS information letter (GENIN-105817-16) issued March 30, 2016, stated that crowdfunding revenues generally are included in gross income of the recipient if they are not:

a. Loans that must be repaid;

b. Capital contributed to an entity in exchange for an equity interest in the entity; or

c. Gifts made out of detached generosity and without any quid pro quo. The letter warns taxpayers that a voluntary transfer without a quid pro quo is not necessarily a gift, and that amounts received for services are income.

On June 16, 2015, an IRS attorney commented on a webcast that donors to charities on personal fundraising websites like gofundme.com could claim charitable deductions for the contributions provided the money is not earmarked toward particular individuals.

One problem that has arisen is websites like gofundme.com may issue Forms 1099K if a crowdfunding effort reaches reporting thresholds.

Are Fitbit Benefits a De Minimis Fringe?

Inquiring minds want to know: May employees treat the value of incidental personal use of wearable fitness devices as a nontaxable *de minimis* fringe benefit when the devices are employer owned and provided to employees.

Two tax professionals from the firm of Miller & Chevalier Chtd. have requested that the IRS put this issue on its 2016-2017 priority guidance plan.

Note that in ILM 201622031, the IRS concluded that cash or premium reimbursement rewards for wellness program participation are taxable income to the employee.

The IRS explained that a wellness program benefit such as a T-shirt would be de minimis, but if the employer pays for a gym membership or reimburses employees as a reward, that would be treated as taxable income.

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Gift Cards for Both Goods and Services.

In TAM 201610017, IRS has concluded that a company can defer the recognition of advance payment income received from the sale of unredeemed gift cards that are redeemable for goods or services for up to two years, to the extent it can make an appropriate estimate of the amounts that are deferrable under Reg. § 1.451-5 using an allocation similar to that found in under Reg. § 1.451-5(a)(3).

The amount of any item of gross income is included in the tax year in which the taxpayer receives it unless, under the taxpayer's method of accounting, such

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Employer Payment of Employee Coverage Provided Under a Spouse's Group Plan.

In CCA 201547006, The IRS determined that an employer may exclude from an employee's gross income payments for the cost of health insurance coverage provided through the spouse's group health plan, but only to the extent the spouse has paid for all or part of the coverage on an after-tax basis. No exclusion from income is available where coverage is paid through salary-reduction under a § 125 cafeteria plan.

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One situation involved a married couple working for separate employers. The wife's employer offers a group health plan that she declines. Her employer also provides an arrangement under which it will reimburse her for the cost of coverage incurred by her husband, who participates in his employer's group health plan. Under the husband's employer's plan, an employee participating in the plan must make either an after-tax contribution of $100 per month for self- only insured coverage or an after-tax contribution of $175 per month for other than self-only insured coverage. The husband elects other than self-only coverage to cover both himself and his wife under his employer's group health plan.

The wife substantiates to her employer that her spouse has $175 per month deducted from his pay on an after-tax basis, $75 of which represents the cost of her insured coverage. The wife's employer pays her $75 per month in addition to her other compensation.

In this situation, the IRS advised that the amounts paid to the wife by her employer for the health insurance coverage are excluded from her gross income.

State Payments to Care Providers under State Programs Not includable in Gross Income.

In PLR 201623003 and PLR 201624012, the IRS concluded that payments to individual care providers under a State's in-home supportive care programs will be treated as "difficulty of care payments" excludible from the gross income of the providers under § 131. Therefore the State is not required under §§ 6041 or 6051 to report the payments as wages or taxable compensation subject to income tax.

In the PLRs, the IRS examined various State programs referred to as State in-home supportive care programs. It concluded that payments made under the following types

Rollover Waivers.

On August 24, 2016, the IRS issued Rev. Proc. 2016-47 to provide a self-certification procedure that taxpayers may use to claim that they are eligible for a waiver of the 60-day rollover requirement for a distribution from a retirement plan or IRA.

Rev. Proc. 2016-47 provides that a taxpayer may make a written certification to a plan administrator or IRA trustee that a contribution satisfies the conditions set forth below.

The first condition for self-certification is that the IRS must not have previously denied a waiver request with respect to a rollover of all or part of the distribution to which the contribution relates.

The second condition is that the taxpayer must have missed the 60-day deadline because of the taxpayer's inability to complete a rollover due to one or more of the following reasons:

a. An error was committed by the financial institution receiving the contribution or making the distribution to which the contribution relates;

b. The distribution, having been made in the form of a check, was misplaced and never cashed;

c. The distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan;

d. The taxpayer’s principal residence was severely damaged;

e. A member of the taxpayer’s family died;

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f. The taxpayer or a member of the taxpayer’s family was seriously ill;

g. The taxpayer was incarcerated;

h. Restrictions were imposed by a foreign country;

i. A postal error occurred;

j. The distribution was made on account of a levy under § 6631 and the proceeds of the levy have been returned to the taxpayer; or

k. The party making the distribution to which the rollover relates delayed providing information that the receiving plan or IRA required to complete the rollover, despite the taxpayer’s reasonable efforts to obtain the information.

The third condition for self-certification is that the contribution must be made to the plan or IRA as soon as practicable after the reason or reasons listed above no longer prevent the taxpayer from making the contribution. This requirement is deemed to be satisfied if the contribution is made within 30 days after the reason or reasons no longer prevent the taxpayer from making the contribution.

A self-certification is not a waiver by the IRS of the 60-day rollover requirement. A taxpayer, however, may report the contribution as a valid rollover unless later informed otherwise by the IRS.

Affirmed: Prohibited Transaction Occurred When IRA-Owned Business Paid Compensation to Disqualified Person.

Overview. In Ellis v. Comm'r, T.C. Memo 2013-245, aff'd 2015-1 U.S.T.C. (CCH) ¶ 50,328 (8th Cir. 2015), the Eighth Circuit affirmed the Tax Court in holding that a taxpayer engaged in a prohibited transaction when the company he caused his Roth IRA to own paid him compensation, and therefore he received a deemed distribution from the IRA.

Facts and Rules. In 2005, Terry Ellis rolled about $321,000 from his § 401(k) plan into a newly created IRA. He then caused the IRA to acquire 98% of the membership units of an LLC that Ellis had set up to operate a used car business. In 2005 the LLC paid Ellis $9,754 as compensation for his role as general manager. In 2006 the LLC paid Ellis $29,263 as compensation.

Another Case. See also Thiessen v. Comm’r, 146 T.C. No. 7 (2016), where the Tax Court held that by personally guaranteeing loans to a company owned by their IRAs, a couple engaged in a prohibited transaction. The taxpayers decided to buy the assets of a metal fabrication business and rolled over their tax-deferred retirement funds into newly formed IRAs, which acquired the initial stock of a newly formed company (“Elsara”). Elsara acquired the assets of the metal fabrication business and the taxpayers guaranteed the repayment of a loan that Elsara received from the seller as part of the acquisition price.

See, however, McGaugh v. Comm'r, T.C. Memo. 2016-28, where the Tax Court followed *Ancira* and distinguished Dabney in a case where the taxpayer caused his self-directed IRA to purchase stock.

McGaugh maintained a self-directed IRA with custodian Merrill Lynch, and it held 10,000 shares of stock in First Personal Financial Corp. ("FPFC"). McGaugh was a member of that company's board of directors. In 2011, McGaugh requested that Merrill Lynch use funds from his IRA to purchase additional stock of FPFC. For reasons not disclosed in the record, Merrill Lynch would not purchase the stock directly on behalf of the IRA.

The Court noted that there was no "literal distribution" of IRA funds to McGaugh because Merrill Lynch wired the $50,000 in question to FPFC and the money never passed through McGaugh's hands.

The Court found *Ancira* to be similar to McGaugh's situation, and concluded that he did not receive a distribution when Merrill Lynch made the wire transfer of $50,000 to FPFC,

Compare Vandenbosch v. Comm'r, T.C. Memo. 2016-29, where the Court distinguished McGaugh in holding that a doctor received a taxable distribution from his self-directed SEP- IRA when he had the custodian distribute $125,000 to his regular investment account.

## Income and Penalties from Retirement Plan Distributions.

No Modification of Substantially Equal Periodic Payments Causing Recapture, If Additional Distribution Covered by Another Exception. In Benz v. Comm'r, 132 T.C. 330 (2009), the Tax Court held that no 10% penalty applied under § 72(t) when an individual elected to receive substantially equal periodic payments from her IRA and within five years received additional distributions from the IRA that qualified under the education exception.

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You Have to Qualify. See also Garza-Martinez v. Comm'r, T.C. Summ. Op. 2009-38, where the Tax Court held that a taxpayer did make an impermissible modification to periodic payments because she did not prove that an additional distribution qualified for the higher education exception.

You Cannot Rely on Your Financial Advisers.

You Cannot Rely on Your Advisers.

The IRS also stated that the error could not be corrected

## Distributions for Health Insurance Premiums.

This exception applies only to distributions from an individual retirement plan, which is defined as an individual retirement account under § 408(a) or an individual retirement annuity under § 408(b). It does not apply to a distribution from a § 401(k) plan.

The requirement that the individual had received unemployment compensation for 12 consecutive weeks is strictly applied by the courts.

Distributions for Medical Expenses.

This exception applies only to distributions which are used for deductible medical expenses paid in the same taxable year that the distribution was made.

If medical expenses of a taxpayer do not exceed 7.5% of AGI, the exception is not available.

## Qualified Higher Education Expenses.

This exception applies only to distributions from an individual retirement plan, and does not apply to § 401(k) plans or thrifts savings plans under § 401(a).

Only postsecondary schools are eligible educational institutions, and elementary schools and secondary schools do not qualify.

The Disability Exception.

The taxpayer must produce sufficient evidence to show that the disability exception applies, and the mere fact that the taxpayer had qualified for disability insurance benefits under an insurance policy is not sufficient to trigger the exception.

QDRO Exception.

(QDRO). This exception, however, does not apply to distributions from an IRA under the applicable definitions.

No General Hardship Exception.

Only the express exceptions provided in § 72(t)(2) warrant avoidance of the 10% penalty.

Original Intent to Develop Property Is a Killer Under the Factor Test.

In *Fargo v. Comm'r*, T.C. Memo. 2015-96, the Tax Court once again found that a taxpayer who had the original intent to develop real estate and sell it to customers in the ordinary course of its trade or business must recognize ordinary income, even if the taxpayer's plans changed due to market conditions and there ultimately was only one buyer of the property.

*Boree v. Comm'r*, T.C. Memo. 2014-85, *aff'd*, 2016-2 U.S.T.C. (CCH) ¶59,406 (11th Cir. 2016), for a similar result.

In 2002, Greg Boree and Daniel Dukes formed an LLC (Glen Forest) that acquired 1,982 acres of land in Florida for about $3.2 million. Glen Forest intended to develop and sell parcels of the property as West Glen Estates, which was a planned residential development consisting of more than 100 ten-acre lots. Glen Forest obtained exemptions from certain county subdivision requirements that allowed it to sell lots without completing interior roads or submitting plats to county officials. In December 2002, Glen Forest sold one ten-acre lot. In 2003, it executed a declaration of covenants for West Glen Estates, created a homeowners association, and sold about 15 lots, usually ten-acre lots. It built an unpaved road through the

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In 2004, Glen Forest sold about 26 lots.

In 2005 Glen Forest sold about 17 lots.

In 2006, Glen Forest sold four lots.

In February 2007 Glen Forest sold its remaining property, about 1,067 acres, to Adrian Development for about $9.6 million.

On appeal, Boree emphasized his argument that his purpose in holding the West Glenn Estates property changed from development to investment as a result of the county board use restrictions issued in 2005 and 2006.

The Court stated that “we think that a proper analysis of a taxpayer’s primary purpose in holding property should take into account a reasonable period of time prior to the sale.

The Eleventh Circuit did reverse the Tax Court on the accuracy-related penalty, finding that the Tax Court did not adequately explain why a reasonable cause/good faith defense did not apply. Boree relied on long-standing accountants to prepare his returns.

## Issues Related to (COD) Cancellation of Indebtedness Income.

Guidance for Real Estate Developers. In Rev. Rul. 2016-15, the IRS ruled that real property developed and held by a taxpayer for lease in a leasing business is “real property used in a trade or business” for purposes of § 108(a)(1)(D), but real property developed and held by a taxpayer primarily for sale to customers in the ordinary course of business is not. The Ruling provides two situations.

Final Regulations on COD Income and Grantor Trusts and Disregarded Entities. On June 10, 2016, the IRS issued final regulations (T.D. 9771) relating to the exclusion from gross income of discharge of indebtedness income of a grantor trust or a disregarded entity.

Section 108(a)(1)(A) provides for an exclusion of discharge of indebtedness income from gross income of a "taxpayer" if the discharge occurs in a title 11 bankruptcy case. Section

discharge occurs when the "taxpayer" is insolvent.

The final regulations provide that for purposes of applying § 108(a)(1)(A) and (B) to the discharge of indebtedness income of a grantor trust or a disregarded entity, neither the grantor trust nor the disregarded entity shall be considered to be the "taxpayer." Instead, the owner of the grantor trust or the owner of the disregarded entity is the "taxpayer."

For the bankruptcy exclusion, If the trust or entity is under the jurisdiction of the court in a title 11 case as the title 11 debtor, but the owner of the trust of entity is not, the bankruptcy exclusion does not apply.

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The insolvency exclusion. If the trust or entity is insolvent but the owner is solvent, § 108(a)(1)(B) does not apply to the discharge of indebtedness income.

In the case of a partnership, the bankruptcy and insolvency exclusions apply at the partner level.

The final regulations apply to discharge of indebtedness income occurring on or after June 10, 2016.

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Student Loans to Attend Corinthian Colleges. In Rev. Proc. 2015-57, the IRS provided guidance that Federal student loan amounts used to finance attendance at a school owned by Corinthian Colleges, Inc. ("Corinthian") that are discharged under the Education Department's "closed school" or "defense to repayment" discharge process will not be taxable.

The "closed school discharge process" allows the Education Department to discharge a Federal student loan obtained by a student who was attending a school when it closed or who withdrew from the

date.

Remember the Burden-Shifting Rule for Information Return Disputes. In Martin v. Comm'r, T.C. Summ. Op. 2009-121, the Tax Court held that a couple was not liable for COD income because the IRS failed to prove the amount of such income as was its burden under § 6201(d).

"If a taxpayer asserts a reasonable dispute" with respect to any item of income reported on an information return, and the taxpayer has fully cooperated with the IRS, the IRS shall have the burden of producing "reasonable and probative information" concerning the alleged deficiency "in

Short Takes: Other Cases Involving COD Income.

In Dunnigan v. Comm'r, T.C. Memo. 2015-190, the Tax Court refused to find a hardship or other exception to recognition of COD income. He negotiated with the bank, which agreed to take $15,628 to settle the debt. The bank then issued a Form 1099-C reporting COD income of $34,369, but it indicated in Box 5 of the Form that the taxpayer was not personally liable for repayment of the debt.

The Court noted that the burden was on the taxpayer to show why COD income should not be included in his gross income. the credit agreement with the bank provided that the taxpayer was individually and severally liable for

Guidance on the Foreign Earned Income Exclusion;

- Notice 2016-21.

Overview. Section 911 allows a qualified individual to elect to exclude from U.S. gross income the foreign earned income and housing cost amount of such individual, up to limits. In 2016 the maximum amount of the foreign earned income exclusion is $101,300, up from $100,800 in 2015.

Nice Try Award. In Gerencser v. Comm’r, T.C. Memo. 2016-151, the Tax Court sustained a deficiency against an individual who claimed the § 911 foreign earned income exclusion for income he earned while working in Germany, but who also claimed the § 901 foreign tax credit on the same income.

The Court sustained a 20% negligence penalty because the taxpayer did not make a reasonable inquiry to determine whether his return positions were correct.

## Short Takes: Two Taxpayers Not Entitled to Exclusion.

In Co v. Comm'r, T.C. Memo. 2016-19, the Court held that a taxpayer employed by the Office of Overseas Buildings Operations, an agency of the U.S. under the State Department, could not claim a § 911 foreign income exclusion because § 911(b)(1)(B)(ii) provides that foreign earned income for an individual does not include amounts "paid by the U.S. or an agency thereof to an employee of the U.S. or an agency thereof."

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In Hirsch v. Comm’r, T.C. Summ. Op. 2016-37, the Tax Court found that a couple was ineligible for the foreign earned income exclusion despite living in Israel because their tax home was in the U.S. During the relevant taxable years, 2009-2011, Michael Hirsch was employed full time by Merrill Lynch as an investment associate.

Hirsch was limited by firm policy and licensing rules as to where he could conduct business, which was at Lynnvest Group offices located in New Jersey and New York. His home in Israel was not listed as an alternate work location

## Capital Gains and Related Issues.

A. Section 1234A Covers Only Capital Assets, not § 1231 Property.

1. In *CRI-Leslie LLC v. Comm'r*, 147 T.C. No. 8 (2016), the Tax Court held that §1234A applies only to capital assets and not to §1231 property.
2. Facts. The taxpayer ("CRI") is an LLC taxed as a partnership and engaged in the real estate business.

In February 2005, CRI acquired a hotel in Tampa, Florida, for $13.8 million. In July 2006, CRI entered into a contract to sell the hotel to a third party ("RPS") for $39 million. The agreement was revised and amended several times over the following two years, but ultimately RPS defaulted and did not close on the purchase agreement, which terminated in 2008 by its own terms. As a consequence, CRI was entitled to keep $9.7 million of deposits that RPS had made under the agreement.

CRI reported the $9.7 million as net long-term capital gain. Section 1221(a)(2) provides that a capital asset is property held by the taxpayer, but does not include "real property used in his trade or business."

CRI reported the $9.7 million of forfeited deposits as long-term capital gain under § 1234A. That section provides in relevant part that gain or loss attributable to the cancellation, lapse, expiration, or other termination of "a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer.

The parties stipulated that had CRI completed the sale of the hotel in 2008, its gain would have been § 1231 gain.

The IRS argued that the plain and unambiguous wording of the statute controlled, and by definition CRI's hotel was not a capital asset.

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It is Still the General Rule: You Need a Sale or Exchange to Get Capital Gain.

In Duffy v. U.S., 2016-1 U.S.T.C. (CCH) ¶ 50,138 (Fed. Cir. 2016), the Court affirmed a Court of Federal Claims' decision that a settlement for employment discrimination could not be treated as capital gain on the grounds it was payment for goodwill.

His responsibilities included bank compliance with the Sarbanes-Oxley Act. In 2006 Duffy reported to management that he had found instances of

In 2007 Duffy and the bank entered into a settlement agreement under which the bank paid $50,000 to Duffy and $25,000 to his attorney in exchange for his dropping all claims pending with the Labor Department.

Duffy first reported the $50,000 as taxable ordinary income but later filed amended returns, first claiming the settlement was for physical injury, and when that failed, claiming that the damages were for the lost goodwill of Duffy's prior financial consulting business. Duffy claimed capital gain treatment.