Current Federal Tax Developments

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SECTION: 165
TAXPAYER PENALIZED FOR FAILING TO PRODUCE ADEQUATE EVIDENCE TO SUPPORT VALUE CLAIMED FOR THEFT LOSS

Citation: Partyka v. Commissioner, TC Summ. Op. 2017-79, 10/25/17

The Tax Court found that, in the case of *Partyka v. Commissioner*, TC Summ. Op. 2017-79, that while the taxpayer had sustained a theft loss that was properly deductible in 2012, the taxpayer had not taken sufficient care to obtain proper values for the property stolen, assessing the accuracy related penalty of 20% under IRC §6662 in addition to the tax due.

This case involves a combination of the sale of household furnishings and the rental of a residence to a tenant who ended up giving the taxpayer a check that bounced to pay for the furnishings and initial rent. The tenant did not make good on the amount due, so the taxpayers undertook proceedings to evict the tenant.

When the taxpayers finally took back possession of the house as part of the eviction proceedings, they found that the tenants had left not only with the furniture they had attempted to buy, but also with virtually everything else in the home.

As the Court described it:

> *When petitioners gained access to the rental home, they discovered that all of the furnishings had been removed by the tenant and her husband, including furniture, window coverings, draperies, and accoutrements. In addition, petitioners discovered some damage to the home, including chipped grout and broken doors, and the house interior needed to be repainted. Petitioners took photographs of the interior and exterior of the home on the day (November 15) they gained entry. Those photographs show the rooms photographed earlier but without the furniture and accoutrements. They also show damage or abuse to the interior and exterior of the home.*

The taxpayers then sought the help of the local Sheriff's office to obtain their goods, resulting in the following situation:

> *After discovering that furniture was missing, petitioners contacted the Sheriff's Office and made a formal complaint that the tenant had illegally removed petitioners' personal property from the rental home. The tenant had left a rental truck in front of the rental home which contained some of the items, including artwork, but some of the items had been "damaged and destroyed." Later that day, a deputy sheriff found the tenant and her husband, who had another rental truck and a pickup truck, both containing petitioners' household items along with some of the tenant's own items. The tenant and her husband confirmed that they had removed furniture and items from the rental home that the tenant had not agreed to purchase. The tenant agreed to return them.*
>
> *Petitioners were permitted to look through the trucks in front of the rental home and to remove their items in the presence of the deputy sheriff. The process was complicated and time consuming because petitioners' and the tenant's property had been commingled. They worked at this task for some time, and the deputy sheriff decided that the process would be finished the next day after the tenant had removed her personal property from the trucks. Upon petitioners' return the next day, the trucks and the remaining items were gone. Ultimately, the tenant did not make any further payments and did not return any other items. Petitioners did not receive the report of the Sheriff's Office until late in December 2011. No criminal charges were made or filed against the tenant or her husband.*

Though the theft took place in 2011, the taxpayers properly delayed claiming the deduction until 2012, since at the end of 2011 they were attempting to evaluate their options for recovering the

remaining property or getting reimbursement for their loss from the tenants. As the Court describes their continuing saga:

> *Early in 2012 petitioners completed their cataloging of the items that were removed from the rental home, and they consulted with a couple of attorneys regarding their legal options to recover the items and/or to seek damages. During 2012 petitioners were in touch with attorneys and law enforcement officers in an attempt to determine whether they would be able to recover their furnishings or seek monetary damages. Petitioners discovered that the tenant and her husband had been involved in this type of activity before and had routinely made offers to purchase furniture and then disappeared without making payment. During 2012, after petitioners were able to assess the tenant's financial situation, they determined that it would be a "waste of time" to pursue the tenant and her husband, either civilly or criminally. It was at this point in 2012 that petitioners became aware that they would not recover their furniture and other household items.*

The Court did not dispute that they had suffered a casualty loss and, frankly, had been drawn into a rather nasty situation. But the fact they had a casualty loss did not mean they could claim the amount of loss they claimed on their 2012 return.

The taxpayers had claimed a total loss of $29,979 on their tax return. But the court found there was no evidence whatsoever that could be used to estimate certain items they listed as worth $6,785. As well, the Court found that the taxpayers had claimed excessive values for other items, using replacement for draperies and valuing two beds at $6,000 with no information on their age or condition. Eventually the Court found that the allowed deduction was to be $9,194, or over $20,000 less than initially claimed.

The IRS had asked the Court to apply the substantial underpayment penalty under IRC §6662 to the tax due and the Court agreed it was appropriate. As the opinion concluded:

> *Although petitioners sought advice about how to report a theft loss, they have not shown the specific source of the advice and whether it was reasonable for them to rely on the advice received. We accordingly hold that petitioners, on account of their negligence or disregard of rules or regulations, are liable for a section 6662(a) accuracy-related penalty with respect to the underpayment.*

SECTION: 280E
EXPERT'S TESTIMONY CANNOT SUBSTITUTE FOR RECORDS TAXPAYER FAILED TO PRODUCE

Citation: Feinberg v. Commissioner, T.C. Memo 2017-211, 10/24/17

In the case of *Feinberg v. Commissioner*, T.C. Memo 2017-211, a taxpayer attempted to use the expert opinion of a CPA whom was claimed to be an expert in cost accounting, with an emphasis in the marijuana industry.

The taxpayers were shareholders in an LLC that ran a marijuana dispensary in Colorado. On the original tax return filed for their S corporation, the taxpayers had claimed several deductions as ordinary trade or business deductions that the IRS determined were costs of sales—an important issue, since under IRC §280E only costs of goods sold may be deducted by a business that traffics in controlled substances under federal law. Despite being legalized in Colorado, marijuana remains a controlled substance under federal law.

All expenses not so reclassified by the IRS were disallowed pursuant to IRC §280E.

At trial the taxpayers recognized that expenses that were cost of goods sold were clearly much more valuable if IRC §280E applied to the operation, so the taxpayer took the position that even though

the IRS was now allowing more cost of goods sold than were originally claimed on the return, that number was below the "real" cost of goods sold for their operation.

However, there was a complication with the taxpayer being able to prove that assertion—the entity did not produce any business records to support these claimed expenses. Instead they brought forward a CPA as an expert to give his expert opinion on the proper cost of goods sold for this business.

The Court opinion describes the expert report as follows:

> *The report states that during the tax years in issue the average wholesale purchase price for medical marijuana remained between $2,000 and $3,000 per pound. The report later posits an average purchase price of $2,500 per pound and reconstructs an income and expense schedule for THC "assuming" that COGS equaled 55% of gross sales. The report does not explain how or on what basis Marty determined these sales figures, and the exhibits do not include any sales records or other documents that would support them. The report asserts that tax returns Marty's firm prepared show that "actual" COGS for medical marijuana businesses during the tax years in issue was between 66% and 100% (or more) of gross sales.*

The Tax Court was not impressed by this evidence of the cost of goods sold. The Court's opinion first notes:

> *The Marty report is brief and summary, and its content is unreliable. Multiple statements in the report refer to no underlying source of information. For other statements that do cite an underlying source, Marty has failed to include the information or data on which he relied. In many instances the report does not reference or provide sufficient information or data for us to conclude that the opinions expressed are based on anything other than his own conjecture.*

The Court objects as well to the fact that this report was not based on any knowledge of the taxpayer's business:

> *The conclusions in the Marty report are an attempt to present reconstructed income tax returns as evidence of petitioners' correct tax liabilities. The report is not based on personal knowledge of THC's business. To determine the correct COGS for THC, substantiation of THC's expenses is necessary. A reconstructed income tax return based on industry averages does not take the place of substantiation and does not help determine a fact in issue.*

Finally, the Court concludes that the expert committed what is the unforgivable sin for an expert witness—giving testimony about the proper application of the law, a responsibility reserved to the Court:

> *By relying on returns that Marty and his firm prepared for other businesses, the Marty report provides the Court with legal conclusions as to which types of expenses may be treated as COGS. Expert testimony about what the law is or that directs the finder of fact on how to apply the law does not assist the trier of fact. Stobie Creek Invs., LLC v. United States, 81 Fed. Cl. 358, 364 (2008). Expert opinions on law are inadmissable. Fed. R. Evid. 702(a); see Hosp. Corp. of Am. v. Commissioner, 109 T.C. 21, 59 (1997).*

The Court concludes that the report was not admissible in the case, thus removing from the case all evidence the taxpayer had submitted. The IRS's computation of tax due was therefore sustained.

This case is instructive about the limits of using "expert testimony," especially to attempt to reconstruct records that either the taxpayer didn't want to make available or failed to keep. It also gives a good outline of the types of information any expert needs to be able to provide for his/her report to be useful in a tax matter.

SECTION: 280E
COURT FINDS IRS ALLOWED TO ENFORCE SUMMONS TO OBTAIN INFORMATION FROM STATE OF COLORADO TO SHOW BUSINESS SOLD CONTROLLED SUBSTANCES

Citation: Rifle Remedies, LLC v. United States, USDC Colorado, Case No. No. 1:17-mc-00062, 10/26/17

A taxpayer seeking to quash a summons from the IRS to the Colorado Department of Revenue's Marijuana Enforcement Division (MED) failed to obtain the requested relief in the case of *Rifle Remedies, LLC v. United States*, USDC Colorado, Case No. No. 1:17-mc-00062.

The taxpayer had claimed that this subpoena was really a front for conducting a criminal investigation into the taxpayer's marijuana business and, if the court didn't accept that objection, the taxpayer had a series of other objections.

But the Court found none of them met the requirements to quash a summons. The standard that would apply is the one outlined by the Tenth Circuit Court of Appeals (who would hear any appeal in this case). The burden is first on the IRS but, as the Tenth Circuit noted in the case of *Villareal v. United States*, 524 F. App'x 419, 422-423 (10th Cir. 2013), that burden is slight. The IRS must simply initially show:

- The investigation is being conducted pursuant to a legitimate purpose;
- The information being sought may be (as opposed to will be) relevant to that purpose;
- The information is not already in the possession of the IRS; and
- The IRS has followed the administrative steps required in the IRC.

Once that is shown the burden shifts to the taxpayer, a burden the Tenth Circuit labels a "heavy one," to show enforcement would constitute an abuse on the court's process or that the IRS lacked institutional good faith in issuing the summons.

The opinion notes:

> *The declaration from IRS Revenue Agent Jean Walker ("Walker") satisfies respondent's slight burden of establishing a legitimate purpose for its investigation. Notably, in her declaration, Walker stated that she is investigating petitioner's federal tax liabilities, and the purpose of the summons is to verify petitioner's financial records and to determine whether information reported in petitioner's tax returns can be substantiated. (ECF No. 5-1 at ¶¶ 4, 15.) The Court, thus, finds the IRS' investigation to have a legitimate purpose.*

The taxpayer objected that the IRS' "real" motivation was to obtain information for a criminal investigation. The Court rejected this position, noting:

> *Suffice to say, the Court does not find that the IRS is engaging in a criminal investigation when it investigates, for purposes of 26 U.S.C. § 280E ("§ 280E"), whether a business involves trafficking in a controlled substance. The purpose of such an investigation, as the statutory provision provides, is to determine whether a business is entitled to a deduction or credit; not to determine whether a business (or its proprietors) may be subject to criminal prosecution. See 26 U.S.C. § 280E. Moreover, none of the arguments that petitioner makes in this case have changed the Court's opinion. As such, the Court rejects petitioner's argument in this regard.*

IRC §280E is an interesting provision in the law, providing that:

> *No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.*

This provision denies deductions for expenses (other than cost of sales) for carrying on a trade or business where the business traffics in items that are controlled substances under federal law. As the Court notes here, the question of whether this entity traffics in controlled substances is important in deciding if the entity is entitled to deductions for things like office supplies, rent, utilities, etc. Obtaining information from the state of Colorado regarding the entity's reporting of sales of what is controlled substance (marijuana) would seem clearly relevant in determining if IRC §280E applies to this business.

The taxpayer then advances a series of additional arguments about why this summons should be quashed, all of which the Court also rejected.

SECTION: 403
IRS MEMO ADDRESSES PROHIBITED INDIRECT LOANS TO EMPLOYER FOR 403(B) PLAN

Citation: Chief Counsel Advice 201742022 , 10/20/17

In Chief Counsel Advice 201742022 the IRS considered whether certain arrangements related to a church's §403(b)(9) retirement plan amount to loans to the employer prohibited under Reg. §1.403(b)-9(a)(2)(i)(C).

Reg. §1.403(b)-9(a)(2)(i)(C)'s exclusive benefit rule provides the following requirement for a program to be considered a valid IRC §403(b)(9) retirement account:

> *(C) The assets held in the account cannot be used for, or diverted to, purposes other than for the exclusive benefit of plan participants or their beneficiaries (and for this purpose, assets are treated as diverted to the employer if there is a loan or other extension of credit from assets in the account to the employer).*

The CCA considers two fact patterns to determine if they would create such a direct or indirect loan to the employer.

The first situation is described as follows:

> *Situation 1. One of the investment options offered by the Plan is an investment in shares in a limited liability company (LLC 1). LLC 1 is structured so that its primary function is to offer loans to Church, and the investment return to the Plan participants from LLC 1 is the interest paid by the Church on the loans. LLC 1 is not controlled directly or indirectly by Church.*

The CCA concludes that this results in an indirect loan to the employer, noting:

> *In Situation 1, a participant's investment in shares in LLC 1 would be an indirect loan to Church because LLC 1's primary function is to make loans to Church, and LLC 1 is funded, in part, by Plan assets in the form of investments made at the direction of participants of amounts in their Plan accounts. While not a direct loan, the arrangement has been structured so that Church receives a substantially similar loan using the assets of the retirement income account as it would have under a direct loan. Such an indirect loan would violate the exclusive benefit requirement of § 1.403(b)-9(a)(2)(i)(C), and cause the Plan to no longer be treated as a retirement income account plan under § 403(b)(9).*

The loan is indirect because the employer does not control the LLC. But since the LLC's primary function is to loan money to the employer the result is effectively the same as if the plan had directly loaned the money to the employer. That is, putting an independent entity between the plan and the employer did not change the result when the entity's purpose is to loan the funds to the employer.

The second situation involves an entity whose function is not primarily to loan money to the employer, but which is controlled by the employer and does make such a loan:

> *Situation 2. One of the investment options offered by the Plan is an investment in shares in a limited liability company (LLC 2). LLC 2 is structured so that it is controlled, either directly or indirectly, by Church. Offering loans to Church is not LLC 2's primary function. LLC 2 makes a loan to Church.*

The fact that the entity's primary purpose is not to loan money to the employer does not protect it from the problem that the employer controls the entity. As the CCA reasons:

> *In Situation 2, a participant's investment in shares in LLC 2 followed by a loan by LLC 2 to Church would also be an indirect loan to Church because LLC 2 is controlled by Church. This is true regardless of whether LLC 2 provides loans to other entities not related to Church. While not a direct loan, the arrangement has been structured so that Church may cause itself to receive a substantially similar loan using the assets of the retirement income account as it would have under a direct loan. Such an indirect loan would violate the exclusive benefit requirement of § 1.403(b)-9(a)(2)(i)(C), and cause the Plan to no longer be treated as a retirement income account plan under § 403(b)(9).*

As a practical matter the CCA makes it clear that an entity offered as an investment vehicle for a participant must have a primary purpose other than loaning money to the employer and cannot be controlled by the employer for it to be possible for a loan to be made to the employer without automatically disqualifying the plan. But note that this does not mean that other facts could not still be imagined that would still create an indirect loan. For instance, as agreement by the entity to make a loan to the employer if the employer will agree to allow plan participants to invest in the entity would clearly be a bad fact situation that would risk disqualification of the plan.

In a footnote, the CCA does note a situation that would <u>not</u> be a problem:

> *In contrast, if the assets of a retirement income account are invested in the publicly traded stock of a financial institution and the employer receives a loan from that financial institution, there is not an indirect loan from the retirement income account to the employer. In that case, the arrangement has not been structured to provide the employer a loan using the assets of the retirement income account substantially similar to a direct loan.*