Current Federal Tax Developments

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Section: 86
Social Security Disability Benefits Are Includable in Taxpayer's Income

Citation: Palsgaard and Kelley v. Commissioner, TC Memo 2018-82 , 6/13/18

The taxpayer in the case of *Palsgaard and Kelley v. Commissioner*, TC Memo 2018-82 argued that his social security disability insurance (SSDI) benefits should not taxable under IRC §104. But the Tax Court did not agree with the taxpayer.

The opinion noted that the taxpayer had been disabled by a physical injury:

> *Petitioner had a successful medical practice in California until March 2009, when she suffered a physical injury that left her disabled within the meaning of section 72(m)(7). This injury resulted in a long-lasting physical impairment of indefinite [*3] duration that substantially interfered with her ability to engage in gainful employment. She retired from the practice of medicine shortly thereafter.*

Initially she received payments under a disability policy from an insurance company, but the insurance carrier ceased making such payments. The taxpayer sued the insurance company and received a payment in a final settlement in 2013.

But having had her regular insurance benefits cut off, the taxpayer filed for SSDI benefits. As the opinion continues:

> *While her litigation against LINA was pending, petitioner applied to the Social Security Administration (SSA) for benefits under the Social Security Disability Insurance (SSDI) program. Unlike Supplemental Security Income benefits, which are based on need, SSDI benefits are generally based on work history and the amount of the beneficiary's prior contributions. See 42 U.S.C. secs. 402, 423(c)(1) (2012); 20 C.F.R. sec. 404.130 (2017). The SSA determined that petitioner was disabled and that she was entitled to SSDI benefits. Petitioner received SSDI benefits of $30,274 during 2013.*

While Section 86 generally requires taxpayers with sufficient income to report a portion of social security benefits as includable in gross income, the taxpayer noted that she was not receiving tradition retirement benefits, but rather SSDI payments.

However, the Tax Court pointed out that IRC §86 makes no such distinction for SSDI benefits, noting:

> *Gross income specifically "includes social security benefits," in an amount determinable under a specified statutory formula. Sec. 86(a) and (b). Section 86(d)(1)(A) defines the term "social security benefit" to include "any amount received by the taxpayer by reason of entitlement to * * * a monthly benefit under title II of the Social Security Act." SSDI benefits are paid monthly and have been paid under title II of the Social Security Act since 1956. See Social Security Amendments of 1956, Pub. L. No. 84-880, sec. 103(a), 70 Stat. at 815 (codified as amended at 42 U.S.C. sec. 423).*

She then attempts to argue that, despite IRC §86's inclusion, her case would be excluded under various portions of IRC §104(a). The Tax Court rejects that view, noting:

> *Petitioner argues that her SSDI benefits are excluded from gross income by section 104(a), which covers certain amounts payable on account of physical injuries or sickness. By enacting section 86, Congress stated its clear intent that all forms of Social Security benefits are taxable to the extent set forth in that*

> *provision. See, e.g., Thomas v. Commissioner, T.C. Memo. 2001-120, 81 T.C.M. (CCH) 1653, 1654. We have never recognized an exception to that rule, and we will not do so here.*

Thus, the taxpayer is required to recognize the appropriate portion of her SSDI benefits as includable in gross income.

Section: 280E
Business Consisted Solely of Selling Controlled Substances, No Deductions Other Than Cost of Sales Allowed

Citation: Alterman v. Commissioner, TC Memo 2018-83, 6/13/18

As marijuana has become, at the state level in certain states, legal to sell in some form (medical or recreational) those looking to enter that market find that federal law does not condone this business. In addition to still being treated as an illegal substance under federal law, the Internal Code has a nasty treatment for any such business found at IRC §280E. The taxpayer in the case of *Alterman v. Commissioner*, TC Memo 2018-83, discovered just how harsh the federal tax law is in this area.

IRC §280E provides:

> *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.*

The provision bans a deduction for any business expenses aside from the cost of the product (that is, the marijuana) for such a business.

The taxpayer in this case operated Altermeds, LLC, a disregarded entity. That entity sold marijuana-based products and, after initially buying the marijuana from a third party, began growing its own marijuana for sale.

The Tax Court described the following income and deductions reported by the taxpayer for the years at issue on the Altermeds Schedule C:

> *For 2010, the Schedule C reported gross receipts of $894,922. The Schedule C reduced gross receipts by cost of goods sold of $464,119. The Schedule C also reported business-expense deductions of $385,489.*
>
> *For 2011, the Schedule C reported gross receipts of $657,126. The Schedule C reduced gross receipts by cost of goods sold of $253,089. The Schedule C also reported business-expense deductions of $384,817.*

Obviously, all the expenses aside from the cost of sales were at risk once IRC §280E is considered. Faced with that prospect, the taxpayers presented the following argument:

> *Although Alterman and Gibson concede that Altermeds, LLC, trafficked in controlled substances, they contend that it had a separate business of selling non-marijuana merchandise and that the business-expense deductions of this separate business are not disallowed by section 280E.*

The "other line of business defense" is an acceptable one, but taxpayers must be able to show that there is a separate business and account for those expenses that are tied to each business being conducted (the marijuana businesses and the others). As the Court notes:

> *Whether selling non-marijuana merchandise was a separate business from selling marijuana merchandise is an issue of fact that depends on, among other things, the degree of economic interrelationship between the two activities. See Californians Helping to Alleviate Med. Problems, Inc. v. Commissioner (CHAMP), 128 T.C. 173, 183 (2007). …*
>
> *If, however, selling non-marijuana merchandise were considered a separate business, then the expenses of that business would be deductible. See CHAMP, 128 T.C. at 183-185 (stating that caregiving services were a business separate from provision of marijuana; expenses of providing caregiving services were deductible).'*

The Court, however, did not find that the taxpayers had multiple businesses in this context, noting:

> *Under the circumstances, we hold that selling non-marijuana merchandise was not separate from the business of selling marijuana merchandise. First, Altermeds, LLC, derived almost all of its revenue from marijuana merchandise. Second, the types of non-marijuana products that it sold (pipes and other marijuana paraphernalia) complemented its efforts to sell marijuana.18 Altermeds, LLC, had only one unitary business, selling marijuana. See Canna Care, Inc. v. Commissioner, T.C. Memo. 2015-206, at *12, aff'd, 694 F. App'x 570 (9th Cir. 2017).*

The Court specifically dealt with the taxpayer's amount of claimed "non-marijuana" business related expenses:

> *lterman and Gibson argue that these deductible expense are $54,707.03 in 2010 and $57,517.93 in 2011. These amounts are equal to 40% of a list of subtotals in a table in the brief filed by Alterman and Gibson after trial. Each subtotal bears a vague description, for example "Non-COGS Utilities".*
>
> *However, the brief fails to adequately explain why any portion of those subtotals is deductible. In particular the brief fails to:*
>
> - *identify any specific payments that make up these subtotals;*
> - *provide record citations to support these subtotals; and*
> - *propose findings of facts regarding these subtotals.*
>
> *Alterman and Gibson's argument regarding the amounts of business-expense deductions attributable to a putative second business was not briefed properly. See Rule 151(e)(3) (brief must include proposed findings of fact with references to the record); Rule 151(e)(5) (brief must include arguments regarding any disputed questions of fact). Even if we thought that the sale of non-marijuana merchandise was a separate business, Alterman and Gibson's failure to properly brief the amount of deductions that would be attributable to this business would preclude us from allowing any deductions for the separate business.*

Thus, the Tax Court limited deductions to the cost of goods sold amounts that the IRS had conceded in the case. Even there, the taxpayer's poor and inconsistent records resulted in the allowed deductions being less than the amounts the taxpayer had originally claimed.

Section: 45B
S Corporation Shareholder Could Not Unilaterally Elect for Corporation to Claim FICA Credit

Citation: Caselli v. Commissioner, T.C. Memo. 2018-81, 6/12/18

In the case of *Caselli v. Commissioner*, T.C. Memo. 2018-81, a taxpayer wanted to claim a tax credit related to an S corporation in which he had an interest. Unfortunately, the S corporation in question had not made the election to claim the credit in lieu of a full deduction for payroll taxes on its tax return.

The credit in question is found at IRC §45B related to employer social security taxes paid with respect to employee cash tips. Under IRC §45B(c), a taxpayer claiming this credit must reduce the deduction for taxes paid by the taxes for which the credit is given. Under IRC §45B(d) a taxpayer may elect not to claim the credit for a taxable year, thus preserving the deduction for such tips.

Mr. Caselli was one of three shareholders of Apple Gilroy, Inc. (AGI), an S corporation with multiple restaurants. The Court describes AGI's 2006 and 2007 income tax returns as follows:

> *AGI filed its 2006 and 2007 Forms 1120S, U.S. Income Tax Return for an S Corporation, on September 14, 2007, and August 22, 2008, respectively. It did not claim any FICA tip credits for either year on its Form 1120S or file Form 8846, Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips. Instead, it deducted its payments of the FICA tip taxes on its Forms 1120S. AGI never filed an amended Form 1120S for either year.*

While Mr. Caselli originally reported the income and deduction on the return shown on the K-1, after the IRS had issued a notice of deficiency and petitioned the Tax Court for the years of 2006 and 2007 he decided to amend his returns to claim the tip credit under IRC §45B. The IRS disallowed these changes to the returns in question.

The Tax Court notes that since AGI had not filed any amended returns, the taxpayer was essentially asking the Court to rule that AGI *could* file such an amended return to claim the credits. The Court noted that normally it would refuse to rule on such an issue, but since not much case law exists on IRC §45B the Court would look a bit deeper.

First, the Court found that the failure to claim the IRC §45B credit on the S corporation tax return amounted to an election under IRC §45B(d) not to claim the credit.

> *Section 45B© explicitly provides that "[n]o deduction shall be allowed under this chapter for any amount taken into account in determining the credit under this section." Section 45B(d), titled "Election Not to Claim Credit", further provides that "[t]his section shall not apply to a taxpayer for any taxable year if such taxpayer elects to have this section not apply for such taxable year." In combination, these two provisions suggest that when AGI chose to deduct its FICA tax payments, it had made an election not to claim any FICA tip credits. Indeed, AGI never claimed, or intended to claim, FICA tip credits for 2006 or 2007. Consequently, on the basis of AGI's reporting position, petitioner is not entitled to any flowthrough FICA tip credits for either year.*

But can the shareholder unilaterally decide at a later date to "undo" that election? The Court looks at which entity makes this election, looking at IRC §45B. The Court found:

> *Section 45B(c) explicitly provides that "[n]o deduction shall be allowed under this chapter for any amount taken into account in determining the credit under this section." Section 45B(d), titled "Election Not to Claim Credit", further provides that "[t]his section shall not apply to a taxpayer for any taxable year if such taxpayer elects to have this section not apply for such taxable year." In combination, these two provisions suggest that when AGI chose to deduct its FICA tax payments, it had made an election not to claim any FICA tip credits. Indeed, AGI never claimed, or intended to claim, FICA tip credits for 2006 or 2007. Consequently, on the basis of AGI's reporting position, petitioner is not entitled to any flowthrough FICA tip credits for either year.*

The Court then refuses to allow the individual shareholder to override that choice made at the entity level:

> *Petitioner is essentially asking us to create a new precedent, which will endow each individual shareholder with the power to change an S corporation's tax election unilaterally. Such a unilateral change, if allowed, would not only affect the tax liabilities of the requesting shareholder but could also affect the tax liabilities of the shareholders who have not consented to such a change. Petitioner himself highlighted the danger of this approach by assuring us that "[a]ny change to AGI's tax items for the years 2006 and 2007 will not have any effect" on other AGI shareholders because of their special circumstances and by attempting to persuade us that there is no unfairness in this particular case. We decline to create a new precedent.*

Section: 6015
Tax Petition Filed Late and Case Dismissed, Despite IRS Giving Taxpayer Erroneous Deadline Date

Citation: Nauflett v. Commissioner, CA4, Case No. 17-1986, 6/14/18

The Fourth Circuit Court of Appeals affirmed the Tax Court's determination that an individual who filed her Tax Court petition on the date IRS representatives twice told her was the final day to file had missed the deadline and the case could not be heard. The case in question is *Nauflett v. Commissioner*, CA4, Case No. 17-1986.

The matter that Shari wanted to be heard by the Tax Court is described by the Circuit Court panel as follows:

> *The IRS charged Shari and Derek Nauflett, wife and husband and joint income tax filers, as jointly and severally liable for unpaid taxes, interest, and penalties for tax years 2002–04 and 2008.1 Nauflett requested relief under the innocent spouse doctrine. The letters of final determination from the IRS denying Nauflett's request were dated June 17, 2015, and contained the following statement: "If you disagree with our decision, you can file a petition with the United States Tax Court to review our denial. You must file your petition within 90 days from the date of this letter. . . . [T]he IRS cannot change the time period." E.g., J.A. 15.*

Sheri decided she wanted to challenge the IRS's position and contacted the IRS to determine how to move forward. The Court notes her statements on what the IRS told her:

> *Nauflett alleges that she contacted both the IRS contact person listed on the notification letter and an employee at the IRS Taxpayer Advocate Service for assistance in navigating the review process because*

> *she believed that she was entitled to relief as an innocent spouse. According to Nauflett, both individuals incorrectly informed her that she had until September 22, 2015, to file her petition.*

She filed her petition on that date. However, that was a week after the 90-day period beginning on June 17, 2015 (the date of the final determination letter).

The IRS noted this fact and asked the Court to dismiss her case for lack of jurisdiction:

> *The IRS moved to dismiss Nauflett's petition for lack of jurisdiction, asserting that the petition was untimely. It pointed out that the notification letters were dated June 17, thereby fixing September 15, 2015 — one week before Nauflett filed — as the last day to file a timely petition.*
>
> *The Tax Court agreed with the IRS and dismissed Nauflett's petition for lack of jurisdiction. In doing so, the Tax Court relied on its previous decisions holding that the plain language of I.R.C. § 6015(e)(1)(A) conferred jurisdiction to consider only timely petitions for review. And while it expressed sympathy for Nauflett's circumstances, the Tax Court observed that the erroneous advice she allegedly received from two IRS employees was irrelevant under the plain language of the statute, which created a jurisdictional bar.*

IRC §6015(e)(1)(A) reads as follows:

> *(e) Petition for review by Tax Court*
>
> *(1) In general*
>
> *In the case of an individual against whom a deficiency has been asserted and who elects to have subsection (b) or (c) apply, or in the case of an individual who requests equitable relief under subsection (f)—*
>
> > *(A) In general*
> >
> > *In addition to any other remedy provided by law, the individual may petition the Tax Court (and the Tax Court shall have jurisdiction) to determine the appropriate relief available to the individual under this section if such petition is filed—*
> >
> > > *(i) at any time after the earlier of—*
> > >
> > > > *(I) the date the Secretary mails, by certified or registered mail to the taxpayer's last known address, notice of the Secretary's final determination of relief available to the individual, or*
> > > >
> > > > *(II) the date which is 6 months after the date such election is filed or request is made with the Secretary, and*
> > >
> > > *(ii) not later than the close of the 90th day after the date described in clause (i)(I)*

The Sixth Circuit notes the following about this language in the law:

> *Congress gave the Tax Court "jurisdiction[ ] to determine the appropriate relief available to the [taxpayer]* ***if*** *such petition is filed . . . not later than the close of the 90th day after the date described in clause (i)(I)." Id. (emphasis added). We need not look beyond that mandate because Congress has, in fact, uttered "magic words," expressly conditioning the Tax Court's power on the timely filing of a petition. See Matuszak, 862 F.3d at 196 (pointing to the statutory words "the Tax Court shall have jurisdiction . . .* ***if*** *[the] petition is filed" as proof that Congress "expressly conditioned the Tax Court's jurisdiction on the timely filing of a petition" (internal quotation marks omitted)); Rubel, 856 F.3d at*

> *305 ("[W]e must presume that Congress knows that the term 'jurisdiction' refers to the authority of a court to hear and decide a case and that it deliberately included that word in the statute.").*

The panel notes how the taxpayer's argument that she should have her day in Court despite filing a week late falls short. It begins by dismissing her "fairness" argument as not being relevant:

> *She points to the equitable nature of the innocent spouse doctrine as a reason for believing Congress intended for the filing deadline to be subject to equitable tolling. But "[w]here, as here, Congress has balanced [the] interests and costs and embodied the result in an unambiguous statute, it is not for a court to depart from its words, whatever the equities of a particular case may be." Anderson v. Dalkon Shield Claimants Tr. (In re A.H. Robins Co.), 996 F.2d 716, 720 (4th Cir. 1993).*

The panel also did not find her argument based on grammatical points to be persuasive:

> *Nauflett makes several grammatical arguments, noting, for example, the placement of the jurisdictional language in subsection (e)(1)(A) in a prefatory clause somewhat removed from the clause containing the filing deadline. This argument ignores the natural reading of the subsection as a whole, as well as the proximity of the two within one subsection, even though that subsection is further divided. Contra Kwai Fun Wong, 135 S. Ct. at 1633 ("Congress's separation of a filing deadline from a jurisdictional grant indicates that the time bar is not jurisdictional."). And while it's true that proximity alone is not dispositive, the words here are more than that: they are part of the same sentence. See Rubel, 856 F.3d at 305 n.7 (rejecting petitioner's argument that § 6015(e)(1)(A), like the statute at issue in Auburn Reg'l Med. Ctr., contains both jurisdictional and non-jurisdictional provisions because § 6015(e)(1) "speaks in jurisdictional terms by it[s] use of the word 'shall' and 'jurisdiction' in the same sentence").*
>
> *Nauflett calls attention to the jurisdictional language's placement inside a parenthetical. But this designation has no consequence and does not strip the words of their ordinary meaning. As the Supreme Court has recognized, where there is "compelling textual evidence" that words inside parentheses have a particular meaning read alongside the other words in the statute, the fact that they are in parentheses does not alter that meaning. See United States v. Woods, 571 U.S. 31, 45 (2013).*

The panel concludes that Sheri is simply out of luck, as unfair as that result might be:

> *Because subsection (e)(1)(A) is jurisdictional, the Court lacks discretion to waive compliance based on equitable considerations. See Kwai Fun Wong, 135 S. Ct. at 1631. This is so despite Nauflett's allegation that the IRS employees she contacted for clarification of her obligations contributed to her petition being untimely. A misinformed taxpayer faced the identical obstacle in Rubel. There, the taxpayer relied on a written statement from the IRS that she needed to file her petition for review by a date that turned out to be after the statutory 90-day deadline. 856 F.3d at 303. The taxpayer relied on that advice to her detriment, and the Tax Court dismissed her petition as untimely. Id. Even so, the Second Circuit recognized that subsection (e)(1)(A)'s deadline is jurisdictional and, under Supreme Court case law, "cannot be altered regardless of the equities of the case." Id. at 306 (internal quotation marks omitted). So, too, here. In sum, neither this Court nor the Tax Court can consider Nauflett's equitable arguments in light of the jurisdictional nature of subsection (e)(1)(A)'s 90-day filing deadline.*