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March 2016

Monthly Journal of Tax Controversy

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Minimizing Tax Consequences of Debt Forgiveness and/or Cancellation of Indebtedness

By Frank Agostino, Esq.
Tara Krieger, Esq.[1]

The taxation of cancellation of indebtedness income is continually at issue in tax controversies. In her 2010 report to Congress, National Taxpayer Advocate Nina Olson observed that over two million taxpayers were issued cancellation of debt notices in 2008, almost half of whom were low-income, nearly double the amount issued in 2003.[2] Such debt cancellations were often attributed to home foreclosures, credit card defaults, or automobile debts.[3]

The general rule is clear that taxpayers must include such cancellation of indebtedness income in gross income, but various exceptions to the general rule, as well as a host of timing and valuation issues, make the general rule difficult to apply in practice. This article provides taxpayers and practitioners with practical advice to resolve issues concerning cancellation of indebtedness income (sometimes "CODI").

First, this article introduces readers to core concepts about the taxation of debt and CODI. Next, it discusses key forms required to be filed with the Internal Revenue Service ("IRS") with respect to CODI, which informa-

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tion returns typically serve as the genesis of related litigation. Third, this article explores the nuances of valuing cancelled debt, a necessary determination in virtually any CODI case. Then, this article explains in detail the various instances in which CODI will not be includible in the taxpayer's gross income. Finally, this article explores ways in which a taxpayer may dispute CODI issues, as well as the most common CODI issues litigated before the United States Tax Court ("Tax Court"), offering practical advice on how to resolve those disputes.

I. General Rules About the Taxation of and Cancellation of Debt

When an individual or a business borrows money from a creditor, the borrower is not subject to income tax so long as there remains an obligation to repay the debt.[4] This rule makes sense because the Internal Revenue Code (the "Code") levies a tax only on "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[5] Receipt of the proceeds from a loan is not a true accession to wealth because the taxpayer stays liable for the debt. However, once a debt is cancelled or forgiven, the Code generally requires the taxpayer-debtor to include in his or her gross income "income from discharge of indebtedness."[6] Again, this rule makes sense because the taxpayer has realized an accession to wealth to the extent of the debt forgiven.[7] In this regard, the amount includible as gross income is equal to the difference between the amount due on the loan and the amount paid, if any, for the discharge.[8] A fairly simple concept, akin to erasing a negative number on a balance sheet; less debt means more wealth.

A complication to this fairly straightforward rule arises under section 108 of the Code, which generally excludes from gross income the following discharges of indebtedness (discussed more fully below):

(A) A discharge that occurs in a bankruptcy case under title 11 of the United States Code;

(B) The discharge occurs when the taxpayer is insolvent;

(C) The indebtedness discharged is qualified farm indebtedness;

(D) In the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness; or

(E) The indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2015.[9]

Anecdotally, the most frequently litigated cancellation of indebtedness issues in the Tax Court usually revolve around the amount of income realized as a result of the cancellation of a debt, the

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timing of the cancellation, whether the CODI can be excepted from gross income or excluded via section 108 of the Code, and whether the debt is enforceable as a matter of State law (and therefore includible in gross income).[10]

II. What is CODI?

As noted, "gross income means all income from whatever source derived, including (but not limited to) ... [i]ncome from discharge of indebtedness."[11] The phrase "income from discharge of indebtedness" is not defined under Code section 61(a)(12) (where income from discharge of indebtedness is included), but courts continually look to section 108 to interpret the phrase's operative term, "indebtedness."[12] Section 108(d)(1) defines the term "indebtedness of the taxpayer" to mean "any indebtedness—(A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property." Thus, a discharge of indebtedness broadly includes relief from any indebtedness for which the taxpayer is liable or relief from any indebtedness subject to which the taxpayer holds property.[13]

In addition, a taxpayer may realize CODI, as the Treasury Regulations say, "by the purchase of his obligations at less than face value. In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt."[14] The amount of income realized by the repurchase of a debt instrument (*e.g.*, a bond or note) for an amount less than its adjusted issue price (in short, its adjustment in value over time)[15] is equal to the excess of its adjusted issue price over the repurchase price.[16] For instance, if a company issues a bond that will mature to $1,000 to a creditor for $500, and then later buys it back for $600 when its adjusted issue price is $750, the company has realized $150 in income, because the creditor has "forgiven" that amount of debt to the company.

The failure of a certain creditors to pursue payment does not automatically constitute CODI that is taxable to the taxpayer. In *Cozzi v. Commissioner*, a leading case on CODI, the Tax Court stated: "Whether a debt has been discharged is dependent on the substance of the transactions. Mere formalisms arranged by the parties are not binding in the application of the tax laws."[17] Just because, for instance, a creditor surrenders a note is not indicative that the debtor is released from liability.[18] Nor is an agreement to cancel debt in the future "if the cancellation is contingent on future events."[19]

Interestingly, although CODI is recognized federally, not all states recognize debt cancellation as income. New Jersey, for instance, has a much narrower definition of "income" than the Code does for individual taxpayers,[20] and discharge of indebtedness is not included among its specifically enumerated categories.[21] New York, on the other hand, which defers to the federal definition of

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gross income if not otherwise specified, recognizes CODI as includible in gross income.[22] Tax practitioners should be mindful of state distinctions, and adjust gross income computations as necessary on a taxpayer's state income tax return if that state does not recognize CODI.

III. Forms and Filing

Government agencies and many financial institutions[23] wishing to cancel any debts exceeding $600 must notify both the IRS and the debtor by issuing a Form 1099-C, *Cancellation of Debt*.[24] Forms 1099-C must be filed with the IRS by February 28 (or March 31, if electronically filed) of the calendar year after the "identifiable event" leading to the debt cancellation occurs.[25] A discharge of indebtedness greater than $600 must be reported regardless of whether the debtor is subject to tax on the discharged debt.[26] Likewise, the debtor's mere receipt of a Form 1099-C does not mean that the debtor has any recognized taxable income. As discussed below, if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return, including a Form 1099-C filed by a third party, the IRS bears the burden of producing reasonable and probative information concerning the deficiency in addition to information on the information return.[27] On the flip side, whether or not a taxpayer receives a Form 1099-C, the taxpayer is generally still liable for the tax from the discharged debt, provided that no exception or exclusion applies.[28]

Individual taxpayers must report taxable CODI as ordinary income on line 21 of their Form 1040, *U.S. Individual Income Tax Return*, if the debt is a nonbusiness debt; on line 6 of Schedule C, *Profit or Loss From Business*, if the debt is related to a nonfarm sole proprietorship; on line 3 of Schedule E, *Supplemental Income and Loss*, if the debt is related to a nonfarm real property rental; on line 8 of Schedule F, *Profit or Loss From Farming*, if the debt is a farm business debt; or on line 6 of Form 4835, *Farm Rental and Expenses*, if related to a farm rental activity.

Taxpayers whose debt is cancelled via foreclosure on or abandonment of their personal residence may also receive a Form 1099-A, *Acquisition or Abandonment of Property*, in addition to a Form 1099-C. The gain or loss due to the foreclosure or abandonment of the property should be reported on IRS Form 8949, *Sales and Other Dispositions of Capital Assets*, and Schedule D, *Capital Gains and Losses*.

Importantly, and an often overlooked requirement, is that if a taxpayer qualifies for an exclusion described in section 108 (see Part V), the taxpayer must report the exclusion and the reduction of certain tax attributes on Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, which must be attached to the taxpayer-debtor's income tax return. Indeed, the failure to include this form on the individual's tax return results in considerable unnecessary litigation.

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IV. Value of Cancelled Debt

Valuation of CODI can be tricky, as a loan may not necessarily be worth its face value plus accrued but unpaid interest. A default on a nonrecourse debt, for instance, may result in the seizure of property that is valued differently than the debtor's liability—the value of a car upon repossession, for instance, is less than its purchase price, and potentially the remaining loan balance. Interest—particularly that which negatively amortizes—may also affect the face value of a note. We discuss some of the more complex valuation issues related to CODI in turn.

A. Recourse vs. Nonrecourse Debts

Differences in valuing recourse and nonrecourse debt is an issue that continually frustrates practitioners. As noted, section 61(a)(12) generally requires a taxpayer to include as gross income CODI if the taxpayer is liable for a particular debt or if a taxpayer holds property subject to a particular debt.[29] The distinction between recourse and nonrecourse debts is especially important in this regard.

Both recourse and nonrecourse debts are dependent on whether the creditor seizes the property securing the debt. In terms of valuation, if a creditor cancels a recourse debt—that is, a debt for which the debtor is personally liable—and the debtor retains possession of the secured property, intuitively, the debtor realizes CODI of the amount of the cancelled debt, barring an exception or exclusion.[30] However, in cases of home foreclosures—or other instances where the debtor cedes possession of the property to the creditor—the debtor may realize two sources of income—any gain on the property to the extent its fair market value exceeds its adjusted basis (subject to the principal residence gain exclusion outlined in section 121),[31] and income arising from the excess of the cancelled debt after the property has been disposed of.[32]

To illustrate: say a creditor forecloses on a property with a recourse mortgage, of which $133,000 remains unpaid. The debtor's adjusted basis in the property at the time of foreclosure was $100,000, and the property sold for $73,000. The creditor then opts to discharge the remaining $60,000 (the difference between the mortgage balance and the selling price) for which the debtor remains personally liable. Assuming the property does not qualify for an exemption or an exclusion (and is not the debtor's principal residence), the debtor would report on his or her tax return a loss of $27,000 (the selling price minus the adjusted basis) as a result of the sale, and an additional $60,000 in CODI, from the mortgage discharge.[33]

Nonrecourse debts are limited to the seizure of collateral upon default, rather than the amount of the loan; the debtor, in essence is thus given the option of either satisfying the balance of a non-

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recourse debt with cash or with the secured property.[34] Therefore, discharge of a nonrecourse debt would *not* result in CODI if the debt is discharged unless the taxpayer-debtor retains the collateral *and* the creditor either offers a discount on early payment, or the creditor agrees to a modification of a loan resulting in the reduction of the principal balance of the debt.[35] Such a result was emphasized in *Gershowitz v. Commissioner*, where a debtor settled for $40,000 a $250,000 nonrecourse debt secured by shares of stock worth $2,500 at the time of the debt discharge. The Tax Court ruled that the debtor realized $210,000 of CODI, despite the collateral which otherwise would have been seized in the event of a default being worth less than the debt.[36]

If the debtor does not retain the property securing a nonrecourse debt—*i.e.*, the creditor forecloses on the property and sells it—the debtor would realize a gain based on the difference between the amount of debt and the property's basis.[37] For instance, take the facts of our previous example, except that the property foreclosed upon involved a *non*recourse mortgage. Under a recourse mortgage, the debtor would realize a loss of $27,000, but under a nonrecourse mortgage, the debtor would realize a gain of $33,000, representing the difference between the value of the debt instrument at the time of foreclosure ($133,000) and the adjusted basis in the property ($100,000). Note that this gain is included in gross income, but it is *not* considered CODI, and thus not negated by the exceptions or exclusions of section 108 described below.[38]

B. Treatment of Accrued, But Unpaid Interest and Penalties

Accrued but unpaid interest can be included in the debt cancellation, but that decision is left to the creditor. The instructions for Form 1099-A and 1099-C state that reporting interest is not required, but if the creditor chooses to report it, the creditor should report the full amount of debt discharged, including interest in Box 2, and the interest itself in Box 3.[39] Whether or not to include in the debt cancellation penalties, fines, fees, and administrative costs is also a decision left to the creditor.[40]

It should be noted, however, that Treasury Regulations discussing the items a creditor needs to report for discharge of indebtedness purposes define the word "indebtedness" to include "stated principal, fees, stated interest, penalties, administrative costs, and fines," and that the amount discharged "may represent all, or only a part, of the total amount owed to the applicable entity."[41] Such a definition would seem to imply that as a default, if a debt is wholly discharged but the amount not specified, the debtor would include interest, penalties, and other costs within his or her CODI.

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C. Joint and Several Liability

Another valuation issue arises with respect to debts for which more than one person is liable. For example, if two people were jointly and severally liable for a cancelled debt, they will typically both receive Forms 1099-C reporting the full amount of debt as discharged. However, the amount for which each person may actually be liable depends on the laws of different states regarding the allocation of the discharge, who received what portion of the debt proceeds, whether one of the debtors claimed an interest deduction, how much of the basis in the property was allocated to each owner, and whether the debt qualifies for any exception or exclusion, such as whether one partner or both partners were insolvent.[42] Because these issues are necessarily determined on a state-by-state basis, we do not discuss these distinctions here. Nevertheless, practitioners must make appropriate state law inquiries to understand how joint and several liability of a debt affects the valuation of the CODI.

V. When Cancelled Debt Is Not Considered Income

As noted, taxpayers should not assume that receiving a Form 1099-C makes them automatically liable for CODI. The facts of a particular case may qualify the reported CODI for an exception or exclusion from gross income under the Code. Importantly, debts qualifying under “exceptions” to CODI are not considered “cancelled” debt and may be eliminated from gross income entirely.[43] As noted above, other cancelled debts may be “excluded” from gross income under section 108. An exclusion from gross income under section 108 may require a reduction in taxpayer’s tax attributes, *i.e.*, losses or tax credits reduced as a result of the exclusion of debt cancellation from a taxpayer’s gross income, including carryover losses, capital losses, and foreign tax credit losses.[44]

A. Exceptions

There are numerous exceptions to the requirement that a taxpayer must include CODI in gross income. These exceptions apply before the enumerated exclusions in section 108 (discussed below). Thus, when calculating gross income with respect to one of the following exceptions, it is not necessary to reduce the taxpayer’s tax attributes by the amount of the CODI.

1. Gifts, Bequests, Devises, and Inheritances

Loans forgiven as gifts, bequests, devises, or inheritances—including debts cancelled in an individual’s Will upon death—are generally not considered CODI. However, the creditor-turned-grantor of the gift should be vigilant as to whether he or she might be responsible for any taxes on the value of the gift if the amount forgiven is above his or her annual exclusion or lifetime exemp-

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tion.[45] For example, self-cancelling installment notes, or SCINs—*i.e.*, obligations that automatically cancel upon the death of the creditor—among family members are also generally treated as gifts for estate tax purposes unless there is evidence to the contrary.[46]

2. Certain Student Loans

Although the cancellation of loan debt is generally considered taxable income, the discharge of certain student loans is not included as CODI if certain requirements are met. First, to not be considered CODI, the loan must be from a federal or state government; a tax-exempt organization under section 501(c)(3) that assumed control of a public hospital whose employees are considered "public" under state law; or an educational organization with a regular faculty, curriculum, and enrolled students pursuant to a program designed to encourage students to follow careers in government or public interest.[47] Second, to not be considered CODI, the loan must contain a provision that the indebtedness would be discharged if the individual worked for a certain period of time, in a certain profession, or for any of a broad class of employers.[48] However, if a taxpayer-debtor is discharged from a loan made by an education organization for services performed for that organization, such a discharge is considered taxable income.[49] The discharge of a loan to refinance a qualified student loan can also qualify as nontaxable if it was made by one of the foregoing qualifying institutions or organizations.

3. Deductible Debt

A taxpayer does not realize CODI if the payment of the debt would have been a deductible expense.[50] Such an exception is made with careful consideration as to whether the taxpayer uses the cash receipts and disbursements or accrual methods of accounting; some business expenses, for instance, are not deductible under the accrual method if they are for different years.[51] Consider the example of a debtor who receives accounting services for his farm on credit and the creditor forgives a portion of the bill early the following year. Under the cash receipts and disbursements method, such an expense would have been a business expense were it paid, so the taxpayer simply does not take the deduction for the forgiven portion of the debt in the year the debt was forgiven. Under the accrual method, on the other hand, because the debt was first incurred in the previous year, it would have been deductible on the previous year's tax return (when the debt was incurred), and thus, the forgiven portion must be included as income the year it was forgiven.[52]

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4. Purchase-Money Debt Reduction

In purchase-money loan situations—*i.e.*, when a taxpayer purchases property via borrowed funds from the seller—if the seller later reduces the taxpayer's debt when the taxpayer is not insolvent, and if the reduction is not due to bankruptcy, the reduction does not result in CODI.[53] Instead, the taxpayer must reduce his or her basis in the property by the amount of the reduction.[54] Special rules that apply to bankruptcy and insolvency will be discussed later.

5. Home Affordable Modification Program

Recent government programs have also created a number of issues regarding the taxation of CODI. Pay-for-Performance Success Payments and Principal Reduction Alternative ("PRA") investor incentive payments that reduce the principal balance of the taxpayer's home mortgage under the Home Affordable Modification Program ("HAMP")[55] are generally not taxable.[56] HAMP, which was enacted in 2009 to aid struggling homeowners modify their mortgage payments, allows lenders or investors to make annual incentive payments for homeowners who have made timely payments on loans that have been modified to avoid foreclosure or have the outstanding principal on their mortgage reduced.[57] The IRS has stated that such payments should not be taxable because they "promote the general welfare by helping homeowners who are at risk of losing their homes pay the mortgage loans on their primary residences and do not involve the performance of services."[58] On the other hand, reductions of *principal* balance of a taxpayer's home mortgage under HAMP's PRA may be taxable as cancellation of debt income.[59]

6. Release of a Contingent Liability

The Tax Court created a limited exception to CODI for a guarantor that did not realize a contingent liability in *Landreth v. Commissioner*.[60] There, the taxpayer sold production payments to an investor who financed the purchase via a bank loan secured by the production payments. As an incentive for the bank to make the loan, the taxpayer agreed to buy the note from the bank if he could not find a purchaser for it upon maturity. The taxpayer was never called upon to purchase the note, and the IRS assessed a deficiency upon the extinguishment of his guarantee. The Court stated that a guarantor differed from a debtor because he gained "no previous untaxed accretion in assets" that would have resulted in an increase in net worth. Thus, such payment was excepted from the definition of CODI.

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7. Refinancing a Debt

An exception to cancelled debt income has been recognized, at least in dicta,[61] when a debt has been refinanced—that is, one debt substituted for another. Such an exception relies on the principal of borrowed money not being taxable—that assets released from an encumbrance by a discharged debt remain offset under a new debt because the taxpayer merely "swapped" obligations; the assets are not "freely available for the borrower's use and enjoyment."[62] The taxpayer would realize no new income by such a refinancing unless the debt is reduced by the refinancing.

8. September 11 and Hurricane Katrina

Two specialized exceptions have been passed by Congress for those affected by the terrorist attacks on September 11, 2001, and Hurricane Katrina. Any debt cancellation resulting from the death of an individual in the September 11 attacks, or as a result of the anthrax scare in the ensuing months (before January 1, 2002) need not be reported as gross income.[63]

Similarly, the Katrina Emergency Tax Relief Act of 2005[64] provided that an individual whose principal residence was within the disaster area of and affected by Hurricane Katrina could exclude from gross income amounts of nonbusiness debts discharged between August 25, 2005, and December 31, 2006. Note that the Act provided that such CODI be *excluded* (not excepted) from gross income, in that the taxpayer's tax attributes would be reduced.

B. Exclusions

After applying the above exceptions, taxpayers may exclude from gross income otherwise taxable CODI in certain situations. As noted above, and as detailed below, such exclusions generally apply when the discharge involves (1) bankruptcy, (2) taxpayer insolvency, (3) qualified farm indebtedness, (4) qualified real property business indebtedness, or (5) qualified principal residence indebtedness.[65]

Generally, these exclusions will also require taxpayers to reduce tax attributes, in the following order on Form 982:

(1) Net operating loss for the taxable year of the discharge, and any net operating loss carryover;
(2) Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a general business credit;
(3) Amount of the minimum tax credit available for prior taxable years;

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(4) Net capital losses for the taxable year of the discharge, and any capital loss carry-overs;
(5) Basis of the property;[66]
(6) Passive activity loss or credit carryovers from the taxable year of the discharge;
(7) Foreign tax credit carryovers to or from the taxable year of the discharge.[67]

All reductions of tax attributes for an exclusion shall be dollar-for-dollar with the exclusion, with the exception of credit carryovers, which are 33 1/3 cents for each dollar excluded.[68]

1. Bankruptcy Exclusion

Debts discharged when a taxpayer files for bankruptcy under Chapters 7, 11, or 13 of the U.S. Bankruptcy Act (Title 11 of the U.S. Code) are normally excluded from taxable income,[69] with proof that the indebtedness was actually discharged in the bankruptcy.[70] Such discharges include those that are the result of adjudication in bankruptcy, or by virtue of an agreement among a taxpayer's creditors not consummated under any provision of the Bankruptcy Act "if immediately thereafter the taxpayer's liabilities exceed the value of his assets."[71] Income is also not realized by a taxpayer in case of a cancellation or reduction of indebtedness under a plan of corporate reorganization under Chapter 10 of the Bankruptcy Act; an "arrangement" under Chapter 11; a "real property arrangement" under Chapter 12 of the Bankruptcy Act; or a "wage earner's plan" confirmed under Chapter 13 of the Bankruptcy Act, "unless one of the principal purposes of seeking a confirmation under the Bankruptcy Act is the avoidance of income tax."[72]

Note that when prioritizing exclusions, discharge of bankruptcy takes precedence over any others claimed.[73] This is particularly important because other exclusions limit the amount of CODI that can be excluded, whereas the bankruptcy exclusion has no upper limit.[74]

2. Taxpayer Insolvency

If a taxpayer is insolvent immediately before a debt is cancelled, some or all of the cancelled debt may be excluded from gross income; however, the amount excluded shall not exceed the amount by which the taxpayer is insolvent.[75] A taxpayer is insolvent when his or her total debts exceed the fair market value of his or her total assets, as determined immediately before discharge.[76]

An insolvent taxpayer may only exclude the amount of CODI up to the amount that the taxpayer to was insolvent immediately before the discharge. For instance, assume that a taxpayer has assets with a combined fair market value equal to $100,000 and debts totaling $140,000, and a creditor allows a taxpayer to pay $10,000 to discharge a $60,000 debt.

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The taxpayer cannot exclude the entirety of the $50,000, because immediately after the discharge the taxpayer would have become solvent (*i.e.*, $90,000 in assets, $80,000 in debt). Instead, the taxpayer may exclude up to $40,000, and report the remaining $10,000 as taxable CODI.

Taxpayers sometimes have difficulty showing that they were insolvent immediately before the discharge. This is because a Court is not required to rely on a taxpayer's unsubstantiated testimony to determine whether he or she was insolvent immediately before the discharge if that testimony is "vague, conclusory, or questionable."[77] A taxpayer who alleges mere "hardship" on his or her return without evidencing insolvency may not exclude CODI from gross income.[78] In establishing a taxpayer's insolvency, we generally suggest using as a starting point the worksheet contained in Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*.[79]

As mentioned above, the insolvency exclusion does not apply to debts canceled via bankruptcy.[80] Likewise, the insolvency exclusion does not apply if the debt is qualified principal residence indebtedness (discussed below), unless the taxpayer elects to apply the insolvency exclusion instead of the qualified principal residence indebtedness exclusion.[81]

3. Qualified Farm Debts

If certain requirements are met, a taxpayer can exclude a limited amount of canceled farm debt from gross income.[82] Specifically, the debt must be incurred directly in connection with taxpayer's operation of the farm, at least 50 percent of the taxpayer's total gross receipts over the previous three years must be from the trade or business of farming, and the cancellation must be made by a qualified person (*i.e.*, individuals or entities, including government agencies, who actively and regularly engage in the lending business that are not related to the taxpayer, the individual or entity from whom the taxpayer acquired the property, or the receiver of a fee with respect to the taxpayer's investment in the property).[83]

The amount a taxpayer can exclude from gross income under the qualified farm debt exclusion is limited to the sum of adjusted tax attributes and the total adjusted basis of qualified property taxpayer held at the beginning of the tax year following the one where the discharge occurred.[84] All canceled qualified farm debt exceeding this amount must be reported as taxable income, unless another exclusion applies.

Notably, the farm debt exclusion does not apply to any debts cancelled in a bankruptcy case or to the extent that the taxpayer was insolvent immediately before the cancellation.[85] If qualified farm debt is cancelled via bankruptcy, the taxpayer must first apply the bankruptcy exclusion to the debt.[86] Similarly, if the taxpayer was insolvent immediately before the cancellation of qualified

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farm debt, the taxpayer must apply the insolvency exclusion first. This matters because, as explained above, the bankruptcy exclusion has no ceiling, and the scope of the insolvency exclusion is more extensive, in the sense that all CODI can be excluded up until the taxpayer is no longer insolvent. For purposes of the qualified farm debt exclusion, the taxpayer's adjusted tax attributes and adjusted basis of qualified property are then determined after any reduction of tax attributes required under the insolvency exclusion.[87]

4. Qualified Real Property Business Debts

Taxpayers may also exclude a limited amount of canceled qualified real property business indebtedness from income.[88] Such debt must have been (1) incurred or assumed in connection with real property used in a trade or business and (2) secured by that real property (3) either before January 1, 1993 or, if afterward, to acquire, construct, reconstruct, or substantially improve such property, and (4) the taxpayer must *elect* for such an exclusion to apply.[89] Taxpayers must make such an election on the Form 982 attached to their federal income tax return for that year. The electiveness of the qualified real property business debt exclusion is important as it influences which tax attributes should be reduced and includes its own set of limitations. The amount excluded as a qualified real property business debt must be applied to reduce the basis of any of the debtor's depreciable real property; according to section 108, this is the only tax attribute that is reduced under this exclusion.[90] Likewise, then, the amount excluded as a qualified real property business debt cannot exceed the adjusted bases of all depreciable real property held by the debtor immediately before discharge. As an additional limitation, the amount of debt excluded cannot exceed the difference between the excess of the outstanding principal debt and the real property's fair market value.[91]

Similar to most of the other exclusions discussed above, the exclusion for qualified real property business debts does not apply to any debts cancelled via bankruptcy or to the extent the taxpayer was insolvent immediately before the cancellation.[92]

5. Qualified Principal Residence Debts[93]

This exclusion, which was created by the Mortgage Forgiveness Debt Relief Act of 2007,[94] applies to most homeowners.[95] Specifically, qualified principal residence indebtedness is any debt incurred in acquiring, constructing, or substantially improving the taxpayer's principal residence, which is secured by the taxpayer's principal residence and which does not exceed more than $2 million.[96] Such qualified debt also includes any debt secured by the taxpayer's principal residence resulting from the refinancing of debt incurred to acquire, construct, or substantially improve the taxpayer's principal residence, but only to the extent that the amount of the debt does not exceed the amount of the refinanced debt. Such an exclusion does not apply "to the discharge

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of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer,"[97] for instance, if the taxpayer uses the equity proceeds from a refinancing a mortgage to pay off credit card debt. The taxpayer's principal residence can also not be used as rental property for the taxpayer to use this exclusion.

The caveat to the qualified principal residence debt deduction is that the taxpayer must, as a result, reduce his or her basis of the principal residence (not below zero) by the amount of the exclusion.[98] However, exercising the qualified principal residence debt exclusion can be a powerful tool for taxpayers looking to refinance their personal residences or make improvements on their property via home equity loan proceeds, transactions which might normally be taxable.

VI. Administrative Disputes

As mentioned above, a Form 1099-C (or Form 1099-A) is not always proof of a cancelled debt. Sometimes, a creditor may issue an erroneous Form 1099-C. For instance, IRS automated systems identifying taxpayers who receive such forms cannot distinguish if the taxpayer is insolvent or if another exception or exclusion would apply that would exclude the debt discharge from gross income.[99] Taxpayers should also verify that the amount of debt listed as cancelled on the Form 1099-C is correct; the State of California in 2011 reported that more than half the state taxpayers had received an inaccurate Form 1099-C.[100]

A taxpayer who disagrees with a Form 1099-C (or Form 1099-A) issued should immediately contact the creditor about correcting the error or amount reported. If the creditor is responsive, the taxpayer should report the corrected amount (if any), and retain the erroneous Form 1099-C in the event there is a lag in processing the correction. If the creditor is not responsive, but the taxpayer believes that the error exists, the taxpayer should report the CODI as the taxpayer believes it to be and attach an explanation to the income tax return for that year of why such figure differs from the Form 1099-C issued. Although the difference in the amount reported on the return and on the Form 1099-C could trigger an audit, if the taxpayer retains all documentation to support his or her contention, it will assist the IRS's final determination.[101]

Furthermore, cases exist, often involving credit card companies attempting to make good on consumer defaults, in which the creditor issues a Form 1099-C, but continues to collect from the debtor. Such a problem can exist because companies either send out the Form 1099-C in an attempt to exert pressure on debtors to pay by threatening to "sic the U.S. government" on them, or because the creditor issued the Form 1099-C independently of cancelling the debt.[102] Debtors receiving a Form 1099-C but on whom their creditors are still collecting need not pay taxes on the amount stated; however, the IRS has little way of knowing that the debt was cancelled. Thus,

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creditors will likely eventually have to substantiate before the IRS that such an amount was not cancelled debt.

If the IRS decides to issue an audit or examination regarding the cancelled debt and determines an amount on the Form 1099-C which the taxpayer still disputes, the taxpayer can appeal the decision. If the examination took place at an IRS office, the taxpayer may request to speak with the examiner's supervisor and settle the case on the spot.[103] If the examination took place offsite, or if the taxpayer and the supervisor cannot agree, the case will be forwarded for processing.[104]

Soon after the conclusion of the meeting with the examiner, the IRS will typically send a form "30-day letter," along with a copy of the examination report, notifying the taxpayer of the right to appeal.[105] The title of the letter is somewhat intuitive—the taxpayer will have 30 days from the date of the letter to appeal the IRS's proposition. Often, taxpayers must file a written protest with the request for appeal.[106] The protest should include: (1) the taxpayer's name and address and a daytime telephone number; (2) a statement that the taxpayer wishes to appeal the IRS findings to the Office of Appeals ("Appeals"); (3) a copy of the letter showing the proposed changes and findings with which the taxpayer does not agree (or the date and symbols from the letter); (4) the tax periods or years involved; (5) a list of the changes with which the taxpayer does not agree, and why; (6) the facts supporting taxpayer's position on any disputed issue; (7) the law or authority, if any, on which the taxpayer relies; and (8) the taxpayer's signature under penalties of perjury.[107] Tax practitioners should note if they submitted the documents on behalf of taxpayer, and whether they have any further personal knowledge regarding the issues at hand.[108]

If the taxpayer is unable to settle the matter at Appeals (or if the period of limitations on assessment is set to soon expire), the IRS will issue a notice of deficiency (*i.e.*, a "90-day letter") from which the taxpayer may petition the Tax Court.

VII. Tax Court Litigation

The IRS typically makes its determinations with respect to CODI in a notice of deficiency, which can be redetermined by the Tax Court. This section discusses key aspects of Tax Court litigation that may apply to CODI and discusses practical application of the CODI, as well as ways to resolve those conflicts.

A. Who Has the Burden?

As most practitioners know, the IRS's determination in a notice of deficiency is generally presumed correct, unless the taxpayer can prove otherwise.[109] The burden of proof, including the burden of going forward, also ordinarily rests with the taxpayer,[110] and the taxpayer also generally bears the burden of substantiating claimed deductions.[111]

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However, the burden may shift to the IRS when the taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining income tax liability, provided that the taxpayer has substantiated all items at issue and has generally maintained books and records with respect to the item at issue.[112] If a taxpayer has not filed returns or kept adequate records, the IRS may be given "great latitude in determining the method to be utilized in determining income."[113]

Importantly, the taxpayer can also shift the burden of production to the IRS under section 6201(d). There, if the taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return, such as a Form 1099-C, and the taxpayer has fully cooperated with the IRS, the IRS has the burden of producing reasonable and probative information concerning the deficiency in addition to the information return.[114] Reasonable disputes have also been defined as producing "credible evidence to support her or his position as to a factual issue,"[115] and with respect to an item reported on an information return. Examples under which the Tax Court has determined that a reasonable dispute exists that would shift the burden include (but are not limited to): evidence that a payment might be an advance instead of a loan,[116] claims that the Form 1099-C was issued in the wrong year,[117] claims that a taxpayer did not own property giving rise to the issuance of a Form 1099-C,[118] and disputes over the amount of debt properly discharged.[119] Ways in which the taxpayer has fully cooperated with the IRS include providing, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer as reasonably requested by the IRS.[120]

The burden may also shift when the taxpayer can show that the notice of deficiency was "arbitrary and excessive."[121] This issue has been regularly raised in CODI issues, but usually not in favor of the taxpayer.[122]

B. Practical Application of CODI Issues

The Tax Court routinely decides issues involving the taxation of CODI. The broader CODI issue may be subdivided into three groups. The first group of cases involves improper timing of the CODI inclusion, also known as *Cozzi* issues. The second group of cases involves a debt that was not necessarily enforceable under state law, also known as *Zarin* issues. The third group of cases, discussed above, involves an insolvent taxpayer who is entitled to exclude the CODI from gross income under section 108(a)(1)(B). This article discusses each in turn.

1. *Cozzi* Issues – Timing of the CODI

The timing of CODI inclusion is a frequently litigated issue. When a debt was discharged is not always clear, and accordingly, neither is when the taxpayer must include the CODI in his or her gross income. The test to determine whether a debt is discharged "requires a practical assess-

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ment of the facts and circumstances relating to the likelihood of payment."[123] The seminal case on when a debt is discharged is *Cozzi v. Commissioner*.[124] There, the Tax Court ruled as follows:

> The moment it becomes clear that a debt will never have to be paid, such debt must be viewed as having been discharged. The test for determining such moment requires a practical assessment of the facts and circumstances relating to the likelihood of payment. Any 'identifiable event' which fixes the loss with certainty may be taken into consideration.[125]

The tension in CODI timing cases is often created by the misreporting of Forms 1099-C. Treas. Reg. § 1.6050P-1 instructs that a Form 1099-C *should* be issued on or before February 28 of the year following the calendar year in which the identifiable event occurs. It also allows a lender to issue a Form 1099-C three years *after* an identifiable event. Some financial companies, relying on Treas. Reg. § 1.6050P-1, perhaps as a way to avoid a failure to file information return penalty under section 6721, might issue a Form 1099-C years after the discharge. The IRS, in turn, relies on the issuance of the Form 1099-C in a year other than the year of the discharge to impute income to the taxpayer. This practice has been heavily criticized, and indeed, the U.S. Department of the Treasury and the IRS recently favored a repeal of Treas. Reg. § 1.6050P-1.[126] This is because the issuance of the Form 1099-C is not the "identifiable event" giving rise to the CODI; the discharge of the debt is.

The natural defense is (or should be) that the IRS is requiring the taxpayer to include the CODI in gross income in the wrong year, and therefore, that the IRS should bear the burden of production under section 6201(d) that the CODI is includible in gross income for the year of the Form 1099-C (assuming the Tax Court even has jurisdiction over that year). Treas. Reg. § 1.6050P-1(b)(2)(iv) serves as the specific basis for this argument. It provides:

> (iv) Expiration of non-payment testing period. There is a rebuttable presumption that an identifiable event ... has occurred during a calendar year if a creditor has not received a payment on an indebtedness at any time during a testing period (as defined in this paragraph (b)(2)(iv)) ending at the close of the year. The testing period is a 36-month period increased by the number of calendar months during all or part of which the creditor was precluded from engaging in collection activity by a stay in bankruptcy or similar bar under state or local law. The presumption that an identifiable event has occurred may be rebutted by the creditor if the creditor (or a third-party collection agency on behalf of the creditor) has engaged in significant, bona fide collection activity at any time during the 12-month period ending at the close of the calendar year, or if facts and circumstances existing as of January 31

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> of the calendar year following expiration of the 36-month period indicate that the indebtedness has not been discharged. For purposes of this paragraph (b)(2)(iv)—
>
> (A) Significant, bona fide collection activity does not include merely nominal or ministerial collection action, such as an automated mailing;
>
> (B) Facts and circumstances indicating that an indebtedness has not been discharged include the existence of a lien relating to the indebtedness against the debtor (to the extent of the value of the security), or the sale or packaging for sale of the indebtedness by the creditor; and
>
> (C) In no event will an identifiable event ... occur prior to December 31, 1997.

Anecdotally, the IRS routinely does not press for the inclusion of the CODI when presented with a *Cozzi* issue. This is because the Tax Court has routinely placed the burden of production on the IRS with respect to the CODI.[127] However, even if the IRS has the burden, tax practitioners should routinely subpoena the issuer of the Form 1099-C for the circumstances surrounding the form's preparation. If the issuer—*i.e.*, a bank or another financial institution—sent the Form 1099-C under the motivation to take a tax deduction on bad debts or to comply with regulatory filings (before the official cancellation of the debt), the issuance would not necessarily constitute the "identifiable event" giving rise to the CODI for that particular tax year.

Treasury Regulations identify various identifiable events which may support a finding of CODI inclusion, in addition to the expiration of the nonpayment testing period under which the bank or certain other specified entities cannot collect discussed above. Such identifiable events include: (1) discharge of indebtedness via bankruptcy; (2) cancellation of debt in a receivership, foreclosure, or similar court proceeding; (3) cancellation of a debt upon the expiration of the statute of limitations for collection of that debt, or for filing a claim or commencing a deficiency judgment proceeding; (4) cancellation of a debt pursuant to an election of foreclosure remedies by a creditor that extinguishes a creditor's right to collect the debt; (5) cancellation of a debt pursuant to a probate proceeding; (6) discharge of indebtedness where a debtor pays at less than full consideration; (7) when a creditor decides to discharge a debt or stop collection.[128]

The timing of CODI inclusion may also depend on the method of accounting the taxpayer uses. If the taxpayer uses the cash receipts and disbursements method of accounting (as individuals and some small businesses generally do), which requires that the cash exchange hands to report income or expenses, CODI is included for the year the liability is actually released.[129] Under the accrual method of accounting (which large businesses above a certain threshold must use), revenues are reported when earned and expenses when charged—*i.e.*, when goods are ordered or

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the service is performed—regardless of whether the cash exchanges hands at that moment. CODI would thus be includible "when all the events have occurred which [1] fix the right to receive such income *and* [2] the amount thereof can be determined with reasonable accuracy."[130] At its simplest, in other words, if an agreement to cancel a debt was signed in 2013, and the agreement stated that the debt would be forgiven unconditionally in 2015, the taxpayer using a "cash" method would report the cancellation of debt income on its return for tax year 2015, whereas the taxpayer using the "accrual" method would report it on its return for tax year 2013.

However, agreements to cancel debts when a taxpayer uses the accrual method of accounting are not so always so simple as looking to the date the agreement was signed; sometimes, on the date of the agreement, the right to receive income is not necessarily "fixed," nor the amount to be paid "reasonably determinable." Agreements contingent on further actions by the taxpayer, or on further events occurring—for instance, that a taxpayer repay a certain amount of the debt by a certain date in order for the remainder to be forgiven, or that the taxpayer make regular payments until a certain date, at which point the remainder would be forgiven—raise the possibility that the debt may not be cancelled. In such cases, a taxpayer's right to receive such income is not "fixed," nor would the amount of income necessarily be "reasonably determinable" until it satisfies that condition precedent—*i.e.*, makes the payments. The year the condition precedent was satisfied would thus be the year the taxpayer would report cancellation of debt income if it were using the accrual method of accounting.[131]

2. *Zarin* Issues – Enforceability of the Debt Under State Law

The burdens of production and persuasion may also be placed on the IRS pursuant to *Zarin v. Commissioner*. In *Zarin*, the U.S. Court of Appeals for the Third Circuit said that the Government bore the burden of producing evidence that the taxpayer had indebtedness within the meaning of section 108(d)(1). As noted above, section 108(d)(1) defines the term "indebtedness" to mean a debt for which the taxpayer is liable—and thus enforceable under state law.

Consider the example of a repossessed car in New Jersey and the later-issued Form 1099-C following its repossession and the cancellation of the debt. There is no doubt that New Jersey law allows a secured creditor to sell a repossessed vehicle.[132] But auction sales have boundaries, the most important of which under New Jersey law is that the sale takes place on "commercially reasonable terms." In New Jersey, and many other states, the lender has the burden to prove that the terms of the sale were reasonable.[133] Normally, this occurs in a state law action, but often due to costs associated with such an action, lenders might not bring such an action.[134] The term "commercially reasonable" seems nebulous, but the New Jersey legislature has defined it to mean: (1) a sale which occurs in the usual manner on a recognized market; (2) at the price cur-

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rent in any recognized market at the time of the disposition; or (3) otherwise in conformity with reasonable commercial practices among dealers in the type of property to be sold.

Under *Zarin*, where there is not a state law determination, the IRS effectively steps in the shoes of the creditor to prove that the taxpayer was liable for the debt and by how much. As it applies to New Jersey law, this means the IRS must show (1) the calculation of the cancelled debt, and (2) that the sale was made on commercially reasonable terms. Clearly, this is a huge impetus placed on the IRS that, depending upon the case, might help the case settle or force the IRS to concede its case altogether.

3. Insolvency Issues

The methods for proving insolvency in a CODI case are discussed at-length above. It is important to remember that in order to claim the insolvency exclusion, the taxpayer must prove he or she was insolvent—and not simply victim of mere hardship—*immediately* before the discharge. Knowing when the discharge took place—the so-called identifiable event described in Part V.B.1 that would fix the loss with certainty—thus becomes particularly important to proving insolvency. Furthermore, tax practitioners should remember that when the amount by which the taxpayer was insolvent is at issue, that the taxpayer excluded no part of a debt that would render him or her solvent.[135]

As a practical matter, proving insolvency frequently depends on the valuation of the taxpayer's assets and liabilities. In appropriate cases, the taxpayer should hire an expert to appraise all property if he or she has the funds to do so.[136] If not, tax practitioners should assist taxpayer to lay the foundation for lay opinion as to the value of the taxpayer's own property. Tax practitioners should specify in the pretrial memorandum that the taxpayer is relying on Rule 701 of the Federal Rules of Evidence, Opinion Testimony by Lay Witness.[137] Although lay testimony cannot be "based on scientific, technical or other specialized knowledge," the Tax Court has suggested that lay opinions can be used to establish the value of property assets or losses.[138] Acceptance of lay valuation opinions can be crucial in cases involving low-income taxpayers, where the government is frequently skeptical of the taxpayer's own asset and business valuation and cannot afford a professional appraisal.

4. Miscellaneous Issues

A broad range of other issues may arise in practice that are worth mentioning. For one, a taxpayer can claim that the three-year period of limitations on assessment has expired, and therefore, that the IRS is time-barred from assessing additional tax relative to the CODI. Second, a tax-

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payer can claim that the ten-year period of limitations on collection has expired, and therefore, that he or she is not liable for a deficiency attributable to CODI.[139]

Although failure to receive a Form 1099-C is not a defense to CODI being taxable, often, creditors issue Form 1099-C's which contain incorrect information or which do not contain necessary information. For example, when the CODI arises from a secure debt, such as a car loan or a mortgage, the creditor must report the fair market value used to make their calculations as this impacts the amount of CODI.

VIII. Conclusion

In order to minimize the tax consequences associated with debt forgiveness, it is important for taxpayers to carefully work through the codified exceptions and exclusions when calculating their gross income. More importantly, taxpayers should keep reliable accounting information and obtain the most favorable valuations of their property before litigating in Tax Court. If those steps fail and a CODI issue is litigated, there are an abundance of defenses available to negate the existence of a deficiency.

Footnotes:

1. Frank Agostino, Esq., is principal of, and Tara Krieger, Esq., is an associate at Agostino & Associates, P.C. Lawrence Sannicandro, Esq. assisted in the writing of this article.
2. Nina Olson also noted that the majority of those cancelled debts were credit card defaults under $10,000. TAXPAYER ADVOCATE SERVICE, 2010 ANNUAL REPORT TO CONGRESS 149 (2010), *available at* https://www.irs.gov/pub/irs-utl/vol_1_msp_6_15_taxpayerrights.pdf; Connie Prater, *Canceled debt tax notices riddled with problems, advocate says*, CREDITCARDS.COM, Feb. 14, 2012, http://www.creditcards.com/credit-card-news/1099_C-canceled_debt-income-notices-confusing-tax_advocate-1282.php.
3. TAXPAYER ADVOCATE SERVICE, *supra* note 2 at 149, 150, 153.
4. *See, e.g.* Commissioner v. Tufts*,* 461 U.S. 300, 307 (1983)("When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer. When he fulfills the obligation, the repayment of the loan likewise has no effect on his tax liability.").
5. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 427 (1955).
6. IRC § 612(a)(12); *see also* Treas. Reg. § 1.61-12(a).
7. *See* Clark v. Commissioner, T.C. Memo 2015-175 ("[t]he concept of discharge of indebtedness income is that a taxpayer has realized an accession to income—to the extent that she has been released from indebtedness—because assets previously offset by a liability arising from indebtedness have been freed."), *citing* Cozzi v. Commissioner, 88 T.C. 435, 445 (1987); *see also* United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931).
8. Cronin v. Commissioner, 77 T.C.M. (CCH) 1293 (1999). *See also Kirby Lumber Co.*, 284 U.S. at 3 (If an obligation is paid at less than face value, "the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.").
9. IRC § 108(a)(1).
10. *See generally* IRC § 108.
11. IRC § 61(a)(12).

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12. *See, e.g.*, Merkel v. Commissioner, 109 T.C. 463, 481 n.15 (1997) (stating that there is "no indication that the term 'indebtedness' in sec. 61(a)(12) with respect to a particular taxpayer differs from the definition provided in sec. 108(d)(1)"), *aff'd*, 192 F.3d 844 (9th Cir. 1999).
13. Note also that cancellation of stockholder debt—*i.e.*, if a taxpayer's obligation to pay back a loan to a corporation in which it owned stock is cancelled—is considered a constructive distribution and is reportable as such on the stockholder's return. *See* IRS Pub. 542, *Corporations*, at 19 (rev. Mar. 2012) *available at* https://www.irs.gov/pub/irs-pdf/p542.pdf.
14. Treas. Reg. § 1.61-12(a).
15. See Treas. Reg. § 1.1275-1(b) for a definition of the "adjusted issue price."
16. Treas. Reg. § 1.61-12(c)(2)(ii).
17. 88 T.C. 435, 445 (1987) (citing Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945)).
18. *Id.* (citing Seay v. Commissioner, T.C. Memo 1974-305).
19. *Seay*, T.C. Memo 1974-305 (citing Walker v. Commissioner, 88 F.2d 170 (5th Cir. 1937), *cert. denied* 302 U.S. 692 (1937)).
20. *Compare* IRC § 61 ("[G]ross income means all income from whatever source derived, including (but not limited to) ... [i]ncome from discharge of indebtedness.") *with* N.J.S.A. 54A:5-1 (limiting gross income for individuals in New Jersey to "the following categories of income"). Note that *corporate* taxpayers still must report CODI in New Jersey. *See* N.J.S.A. 54A:5-1(b) (including "the net income from the operation of a business, profession or other activity ... determined either on a cash or accrual basis in accordance with the method allowed for federal income tax purposes....").
21. *See, e.g.*, Weintraub v. Dir., Div. of Taxation, 19 N.J. Tax 65 (2000) (recognizing that discharge of indebtedness income is not taxable individually for New Jersey gross income tax purposes).
22. *See* N.Y. Tax Law §§ 612(a) (defining adjusted gross income for a New York resident as "federal adjusted gross income as defined in the laws of the United States for the taxable year, with the modifications specified in this section"), 631(a) (defining nonresident New York source income as, *inter alia*, "the net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income, as defined in the laws of the United States for the taxable year, derived from or connected with New York sources").
23. For more specific rules on which financial entities are required to issue Forms 1099-C, see IRC § 6050P(c)(2).
24. IRC § 6050P(a), (b). Government agencies may also submit the debt cancellation to the U.S. Treasury "information sufficient for the Secretary to complete such a return on behalf such agency." § 6050P(e). For a more detailed, box-by-box explanation of Form 1099-C, see Kelly Phillips Erb, *Understanding Your Tax Forms 2016: Form 1099-C, Cancellation of Debt*, FORBES, Feb. 10, 2016, http://www.forbes.com/sites/kellyphillipserb/2016/02/10/understanding-your-tax-forms-2016-form-1099-c-cancellation-of-debt.
25. Treas. Reg. § 1.6050P-1(a)(4)(i). There is one exception for indebtedness discharged in bankruptcy, which "must be reported for the later of the calendar year in which the amount of discharged indebtedness first becomes ascertainable, or the calendar year in which the identifiable event occurs." Treas. Reg. § 1.6050P-1(a)(4)(ii).
26. Treas. Reg. § 1.6050P-1(a)(3).
27. *See* IRC § 6201(d). Additionally, the burden of proof may shift to the IRS in any court proceeding where the taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the taxpayer's income tax liability. *See* IRC § 7491(a)(1).
28. *Clark*, T.C. Memo 2015-175; Rinehart v. Commissioner, T.C. Memo 2002-71.
29. IRC § 108(d).
30. *See, e.g.,* In re Taylor, 3 F.3d 1512 (11th Cir. 1993) (bankruptcy debtor in default not allowed to retain collateral without redeeming property or reaffirming debt).
31. In short, a taxpayer may exclude up to $250,000 in gain from gross income from the sale of his or her principal residence. For married taxpayers who file joint returns, the exclusion is $500,000. See IRC § 121 for further specifications.
32. Treas. Reg. § 1.001-2(a)(2). Note, however, that the creditor might opt not to cancel the debt after the property is sold, and instead, hold the debtor liable for the remaining balance after the sale. *See, e.g.*, Aizawa v. Commissioner, 99 T.C. 197 (1992), *aff'd*, 29 F.3d 630 (9th Cir. 1994) (Court enforces deficiency judgment against debtor on excess unpaid mortgage debt after foreclosure sale.).
33. Note that these facts are a variation of the ones in the *Aizawa* case, *supra* note 32.

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34. "In essence, the [nonrecourse] borrower has a put by which he has the option to sell the property to the lender at a price equal to the amount of debt that is outstanding at the time in which the sale takes place." Douglas A. Kahn & Jeffrey H. Kahn, *Cancellation of Debt and Related Transactions*, 69 TAX LAWYER 161, 209 (2016).
35. *See* Rev. Rul. 91-31, 1991-1 C.B. 19 (principal reduced on an undersecured nonrecourse debt results in realization of CODI for the amount by which it was reduced); Rev. Rul. 82-202, 1982-2 C.B. 36 (taxpayer who prepaid nonrecourse mortgage on residence at less than principal balance realizes ordinary income at amount of discount).
36. Gershkowitz v. Commissioner, 88 T.C. 984 (1987). Note, however, that the basis in the retained property *is* adjusted in accordance with the amount of the gain.
37. *See Tufts*, 461 U.S. 300.
38. Bankruptcy provides one exception. In a property foreclosure via bankruptcy, if the nonrecourse debt exceeds the fair market value of the property, the excess portion is treated as a recourse mortgage for tax purposes, meaning the taxpayer can exclude it from gross income. *See* 11 U.S.C. § 506.
39. *2016 Instructions for Forms 1099-A and 1099-C*, *available at* https://www.irs.gov/pub/irs-pdf/i1099ac.pdf. *See also* Treas. Reg. § 1.6050P-1(d)(2) ("The discharge of an amount of indebtedness that is interest is not required to be reported under this section.").
40. *2016 Instructions*, *supra* note 39; *see also* Treas. Reg. § 1.6050P-1(d)(3). The IRS actually says that reporting these so-called "nonprincipal amounts" optional only in a "lending transaction"—that is, "when a lender loans money to, or makes advances on behalf of, a borrower (including revolving credit and lines of credit)." In a "nonlending transaction"—a term which is not defined—nonprincipal amounts must be included in the debt; however, "until further guidance is issued, no penalties will be imposed for failure to report these amounts in nonlending transactions."
41. Treas. Reg. § 1.6050P-1(c).
42. This issue is very common in partnerships. Courts have debated in partnership situations whether insolvency should be attributed to the partnership or the partner; such a debate is beyond the scope of this article. *Compare Gershkowitz*, 88 T.C. 984 (attributing insolvency to the partner), *with* Estate of Newman v. Commissioner, 934 F.2d 426 (2d Cir. 1991), *rev'g*, T.C. Memo 1990-230 (attributing insolvency to the partnership).
43. *Tax Topic 431—Cancelled Debt—Is It Taxable or Not?*, IRS.GOV (last reviewed or updated Feb. 25, 2016).
44. *See* IRC § 108(b).
45. The lifetime federal gift tax exemption for 2016 is $5.45 million per person (or $10.9 million for married couples exercising the portability option); the annual gift exclusion is $14,000. For further information on estate taxation guidelines, see IRC § 2001 *et seq*.; for gift tax guidelines, see IRC § 2501 *et seq.*
46. *See, e.g.*, Estate of Costanza v. Commissioner, 320 F.3d 595 (6th Cir. 2003).
47. IRC § 108(f)(2).
48. IRC § 108(f)(1). Generally, such professional employment consists of some sort of government or public interest work, or jobs in low-income areas—the heralded Public Service Loan Forgiveness Program, for instance, mandates 10 years in public service, at which point the remaining student loan debt is forgiven without any CODI. More information on the Public Service Loan Forgiveness Program is available at https://studentaid.ed.gov/sa/sites/default/files/public-service-loan-forgiveness.pdf.
49. IRC § 108(f)(3).
50. *See* IRC § 108(e)(2) ("No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.")
51. *See, e.g.*, Schrott v. Commissioner, T.C. Memo 1989-346 (For taxpayers who use the accrual method of accounting, "cancellation of the unpaid liability results in the realization of taxable income only if, and to the extent that, the taxpayer derived a tax benefit from the prior deduction."); Rev. Rul. 67-200, 1967-1 C.B. 15 ("Any part of the interest forgiven [of a taxpayer who previously deducted it from income via the accrual method] ... may be excluded from gross income under section 108 of the Code for the taxable year of forgiveness....").
52. United States Dept. of Treasury. Internal Revenue Service. *Publication 4681: Canceled Debts, Foreclosures, Repossessions, and Abandonments*. Internal Revenue Service, 2014¸ *available at* https://www.irs.gov/pub/irs-pdf/p4681.pdf.
53. IRC § 108(e)(5).
54. *See id.* ("[S]uch reduction shall be treated as a purchase price adjustment.").
55. Pub. L. 111-203, title XIV, § 1482, July 21, 2010, 124 Stat. 2203.

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56. Rev. Rul. 2009-19 *available at* https://www.irs.gov/pub/irs-drop/rr-09-19.pdf.
57. *Id*.
58. *Id.*; *see also* Rev. Rul. 74-205, 1974-1 C.B. 20; Rev. Rul. 98-19, 1998-1 C.B. 840 (general welfare exceptions).
59. *Principal Reduction Alternative Under the Home Affordable Modification Program*, IRS.GOV, https://www.irs.gov/uac/Principal-Reduction-Alternative-Under-the-Home-Affordable-Modification-Program (last reviewed or updated Oct. 13, 2015).
60. 50 T.C. 803 (1968).
61. Zappo v. Commissioner, 81 T.C. 77, 86 (1983) (court agrees with taxpayer's argument that refinancing a debt is not considered CODI, but that the agreements in question were not allegedly substituted for each other); *see also* Rev. Rul. 77-437, 1977-2 C.B. 28 (taxpayer realizing gain on substitution of bonds transaction only to extent face value of new bonds exceeded that of old bonds); Rev. Rul. 58-546, 1958-2 C.B. 143 (substitution of corporate bonds considered gain only to the extent accrued interest liability cancelled).
62. *Zappo*, 81 T.C. at 86; *see also Jelle v. Commissioner, 116 T.C. 63, 67 (2001) ("*When one obligation has merely been substituted for another, there has been no consequent freeing of assets so as to justify application of the rule" of discharge of indebtedness.).
63. Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, Title I, § 105, .Jan. 23, 2002.
64. Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, Title IV, § 401, Sept. 23, 2005.
65. IRC § 108(a)(1).
66. Reduction of basis in property is beyond the scope of this article; however, for insolvent or bankrupt taxpayers, the IRS will not allow a property's basis to be reduced beyond the value of the taxpayer's current aggregate basis in assets plus cash in hand immediately after the discharge of indebtedness minus the taxpayer's liabilities. The IRS did not want to lave taxpayers with inadequate funds to pay their liabilities in the event they had to sell such property to pay their liabilities. For further information on reduction of basis in property, see generally IRC § 1017; Kahn & Kahn, *supra* note 34, at 174-75.
67. IRC § 108(b)(2).
68. IRC § 108(b)(3).
69. IRC § 108(a)(1)(A).
70. For purposes of this exclusion, the IRC states that bankruptcy includes only those cases where "the taxpayer is under the jurisdiction of the court and the cancellation of debt is granted by the court or occurs as a result of a confirmed plan." IRC § 108(d)(2).
71. Treas. Reg. § 1.61-12(b)(1).
72. *Id.*
73. IRC § 108(a)(2)(A).
74. A taxpayer need not be insolvent to file a Chapter 7 Bankruptcy petition. For more of the benefits of filing for bankruptcy, see Frank Agostino & Patrick Binakis, *Evaluating Collection Alternatives: Whether to File for Bankruptcy or Request and Offer in Compromise*, AGOSTINO & ASSOCIATES MONTHLY J. TAX CONTROVERSY, Jan. 2016, at 1, *available at* http://files.ctctcdn.com/f7d16a55201/11d1f7e4-92e8-45c9-bcf0-a1c696aa823a.pdf.
75. IRC § 108(a)(1)(B), (3).
76. IRC § 108(d)(3).
77. *Rinehart*, T.C. Memo 2002-71; *see also* Lerch v. Commissioner, 877 F.2d 624 (7th Cir. 1989) , *aff'g* T.C. Memo 1987–295 ("The Tax Court is not bound to accept a taxpayer's uncontradicted testimony, however, if it is found to be 'improbable, unreasonable or questionable.' The Tax Court may disregard uncontradicted testimony by a taxpayer where it finds that testimony lacking in credibility. Once the Tax Court makes that finding, if the taxpayer has offered no other evidence in support of his position, the Tax Court has no choice but to rule for the Commissioner, since the taxpayer has failed to carry his requisite burden of proof.") (citations omitted).
78. *See* Dunnigan v. Commissioner, T.C. Memo 2015-90 (taxpayer unable to exclude cancellation of debt income despite including a note of "hardship" with his tax return indicating that he was elderly with a "serious cancer problem").
79. IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)* 8 (Jan. 11, 2016), *available at* https://www.irs.gov/pub/irs-pdf/p4681.pdf.
80. IRC § 108(a)(2)(A).

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81. IRC § 108(a)(3)(B),(C). For a detailed discussion of insolvency properties, see Kahn & Kahn, *supra* note 34, at 171-90.
82. IRC § 108(a)(1)(C).
83. IRC § 108(g)(1), (2); *see also* IRC § 49(a)(1)(D)(iv), (v).
84. IRC § 108(g)(3)(A).
85. IRC § 108(a)(2)(A), (B).
86. IRC § 108(a)(2)(A).
87. IRC § 108(a)(2), (g)(3)(D).
88. IRC § 108(a)(1)(D). Note that C corporations may not take the qualified real business property exclusion.
89. IRC § 108(c)(3), (4).
90. IRC § 108(c)(1)(A). Procedures in making qualified real property basis reductions are beyond the scope of this article. For more information, see IRC § 1017.
91. IRC § 108(c)(2)(A), (B).
92. IRC § 108(a)(2)(A), (B).
93. IRC § 108(a)(1)(E).
94. Pub L. 110-142, 121 Stat. 1803 (2007).
95. The statute had initially expired for any debts discharged after 2014, but it was retroactively extended to Jan. 1, 2017—"subject to an agreement that is entered into and evidenced in writing" for any discharges made in 2016—via Pub. L. 114-113, Div. Q, § 151 (Dec. 18, 2015).
96. IRC § 108(h)(2). If taxpayer is married filing separately, that amount is $1,000,000.
97. IRC § 108(h)(3).
98. IRC § 108(h)(1).
99. TAXPAYER ADVOCATE SERVICE, *supra* note 2, at 149, 154.
100. State of Calif. Franchise Tax Bd., *Cancellation of Debt Review by Audit*, TAX NEWS, Oct. 2011, https://www.ftb.ca.gov/Archive/Professionals/Taxnews/2011/October/Article_2.shtml.
101. For further information on errant IRS Forms 1099, see Robert W. Wood, *Dear IRS, That Form 1099 Is Wrong! (Yes, That Can Work)*, FORBES, Feb. 19, 2016, http://www.forbes.com/sites/robertwood/2016/02/19/dear-irs-that-form-1099-is-wrong/; Robert W. Wood, *If Form 1099 Reports Too Much To IRS, Now What?* FORBES, Jan. 29, 2016, http://www.forbes.com/sites/robertwood/2016/01/29/what-to-do-if-irs-form-1099-reports-more-than-you-received.
102. TAXPAYER ADVOCATE SERVICE, *supra* note 2, at 149. Banks must write off credit card debt after 180 days. Prater, *supra* note 2.
103. IRS Pub. 556, *Examination of Returns, Appeals Rights, and Claims for Refund* 4 (Sept. 23, 2013), *available at* https://www.irs.gov/pub/irs-pdf/p556.pdf.
104. *Id.*
105. Disputes over Forms 1099-C can be settled in Appeals similar to most tax disputes, with the alternative dispute resolution mechanisms generally available—including fast-track settlement, fast-track mediation, and post-appeals mediation. Such remedies are beyond the scope of this article. For more information on IRS alternative dispute resolution, see Frank Agostino & Matthew Turtoro, *Why Can't We All Just Get Along? Alternative Dispute Resolution in Tax Matters*, AGOSTINO & ASSOCIATES MONTHLY J. TAX CONTROVERSY, Aug. 2015, at 10.
106. IRS Pub. 556, *supra* note 103, at 9. All partnerships and S corporations must file a written protest. However, taxpayers for whom the amount in dispute is under $25,000 can make a "small case" request that need not include a written protest.
107. In particular, the IRS instructs that the statement signed under penalties of perjury read: "Under the penalties of perjury, I declare that I examined the facts stated in this protest, including any accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete." IRS Pub. 5, *Your Appeal Rights and How To Prepare a Protest If You Don't Agree* (Jan. 1999), *available at* https://www.irs.gov/pub/irs-pdf/p5.pdf.
108. *Id.*
109. Tax Court Rule 142; Welch v. Helvering, 290 U.S. 111, 115 (1933).
110. *Id.*
111. *See, e.g.,* Roberts v. Commissioner 62 T.C. 834, 836 (2004).

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112. IRC § 7491(a). Courts are split on whether the taxpayer simply introducing "credible evidence" to support a position is enough to shift the burden, or whether the burden-shifting is merely a tiebreaker if the sides are "equally weighted," and that normally a "preponderance of evidence" *Contrast, e.g.,* Del Monico v. Commissioner, T.C. Memo 2004-92 (deciding that the shifting the burden under § 7491 in a deficiency case was irrelevant because the "record in this case is not evenly weighted," and that the court could "render a decision on the merits based on a preponderance of evidence") *with* Estate of Elkins v. Commissioner, 767 F.3d 443, 449-50 (5th Cir. 2014) (determining that the burden in a valuation case should have shifted to the IRS because "the petitioning taxpayer adduces sufficient evidence to establish the material facts").
113. Jackson v. Commissioner, 73 T.C. 394, 403 (1979).
114. IRC § 6201(d).
115. Brinkley v. Commissioner, T.C. Memo. 2014-227.
116. Starke v. Commissioner, T.C. Summ. Op. 2015-40.
117. Kleber v. Commissioner, T.C. Memo. 2011-233.
118. Marchiso v. Commissioner, T.C. Summ. Op. 2011-39.
119. *Clark*, T.C. Memo. 2015-175.
120. IRC § 6201(d).
121. *See id.* (deficiency notice "based solely ... on a secondhand report of peripheral statements made by an unreliable informant" ... considered "arbitrary and excessive," thus shifting the burden), *citing* Helvering v. Taylor 293 U.S. 507 (1935).
122. Some background regarding the "arbitrary and excessive" defense: To determine whether a notice is "arbitrary," courts will generally not look beyond the notice itself to determine the IRS's motives in issuing such a notice, unless the case involves "unreported illegal income where the Commissioner has relied upon a 'naked' assessment without *any* foundation whatsoever." *Cozzi*, 88 T.C. at 444 ("As a general rule, this Court will not look behind the statutory notice to examine the evidence used by the Commissioner in making his determination"; also citing United States v. Janis, 428 U.S. 433, 441 (1976); *Jackson*, 73 T.C. at 401); Riland v. Commissioner, 79 T.C. 185, 201 (1982) ("[A]bsent substantial evidence of unconstitutional conduct on respondent's part which would impugn the integrity of this Court if he were allowed to benefit from it, we generally will not look behind a deficiency notice to examine respondent's motives or procedure leading to his determination.); *Jackson*, 73 T.C. at 400 ("As a general rule, this Court will not look behind a notice of deficiency to examine the evidence used or the propriety of the Commissioner's motives or administrative policy or procedure in making the determination."); Greenberg's Express, Inc. v. Commissioner, 62 T.C. 324 (1974) (similar wording). The Court considers a notice of deficiency arbitrary "if it involves a reconstruction of income based on evidence which does not link the taxpayer to the tax-generating activities." *Cozzi*, 88 T.C. at 444 (citing Dellacroce v. Commissioner, 83 T.C. 269, 280-83 (1984)). The Tax Court has held that disputes only over the year to which the alleged income from a discharge of indebtedness should be attributed does not satisfy the standard of being "arbitrary"; on the other hand, the Court has held "deficiency notice, based solely as it was on a secondhand report of peripheral statements made by an unreliable informant [that] turns out to be sheer gossamer" would satisfy the arbitrary standard and shift the burden to the IRS. *Compare Cozzi*, 88 T.C. at 444 (for disputes over year of income) *with Jackson*, 73 T.C. at 403 (regarding secondhand reports that are "sheer gossamer").
123. *Cozzi*, 88 T.C. at 445.
124. 88 T.C. 435 (1987).
125. *Id.* at 445 (citations omitted).
126. *See* Prop. Treas. Reg. § 1.6050P-1, 79 Fed. Reg. 61791 (Oct. 15, 2014).
127. *See Clark*, T.C. Memo. 2015-175 (agreeing that the government bore the burden of production that the debt was in the year of the cancellation and not another year, and finding that the IRS did not prove that the debt was not cancelled in a year earlier than the year for which the Form 1099-C was issued).
128. Treas. Reg. § 1.6050P-1(b)(2)(i). For more information on a "nonpayment testing period," which generally lasts 36 months, *see* Treas. Reg. § 1.6050P-1(b)(2)(iv). *See also Clark*, T.C. Memo 2015-175 (discussing "expiration of the nonpayment testing period" as an identifiable event).
129. *See* IRC § 451(a) ("The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period."); *Seay*, T.C. Memo 1974-305.

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130. Treas. Reg. § 1.451-1(a) (emphasis added).
131. *See* IRS Tech. Adv. Mem. 81-20-014 (Jan. 29, 1981).
132. *See* N.J.S.A. 12A:9-610(a).
133. Sec. Sav. Bank v. Tranchitella, 249 N.J. Super. 234, 239 (App. Div. 1991).
134. N.J.S.A. 12A:9-610(a).
135. Where the insolvency should be attributed is also an issue beyond the scope of this article. *See supra* note 42.
136. *See* Fed. R. Evid. 702 for expert testimony qualifications.
137. Fed. R. Evid. 701 reads: “If a witness is not testifying as an expert, testimony in the form of an opinion is limited to one that is (a) rationally based on the witness’s perception; (b) helpful to clearly understanding the witness’s testimony or to determining a fact in issue; and not based on scientific, technical, or other specialized knowledge within the scope of Rule 702 [Testimony by an Expert Witness].”
138. See Worth v. Commissioner, T.C. Memo. 2014-232, slip op. 29-31 (lay witness testimony regarding reconstruction of taxpayer’s income based on taxpayer’s bank records admitted under Fed. R. Evid. 701 because witness “simply did the math”); CNT Investors, LLC v. Commissioner, 144 T.C. 161, 191 n.32 (2015) (Court admitted as lay opinion an exhibit explaining how taxpayer’s accountant would have prepared taxpayer’s returns had certain transactions not occurred in which taxpayer realized gain. “No special expertise is needed for a witness to opine on how that witness would have applied undisputed rules differently under hypothetical, alternative situations.”). But see Compania Administradora de Recuperacion de Activos Administradora de Fondos de Inversion Sociedad Anonima v. Titan Int’l, Inc. 533 F.3d 555 (7th Cir. 2008) (Valuation testimony by witness, despite being CEO of defendant corporation, inadmissible under Fed. R. Evid. 701 because it was “based on his special experience in the tire industry, not on his personal knowledge of the goods in question,” and thus considered expert testimony.).
139. Miller Trust v. Commissioner, 76 T.C. 191, 195 (1981). Treas. Reg. § 1.6050P-1(b)(2)(ii).

HOW TO REPRESENT REAL ESTATE INVESTORS, REAL ESTATE PROFESSIONALS, AND EVERYTHING IN BETWEEN

By Frank Agostino, Esq.
Patrick Binakis, Esq.[1]

Routinely at issue in tax controversies is the extent to which (if at all) a taxpayer who is involved in rental real estate activities may deduct losses related to that activity. Not surprisingly, because the ability to use passive losses to offset active income, taxpayers who own rental real estate activity frequently (and often improperly) treat themselves as "real estate professionals" when they are in fact real estate investors. Given the prevalence of this issue at United States Tax Court calendars, tax controversy professionals must frequently prove a client's qualification for real estate professional status. Effective trial representation of a client faced with this issue requires familiarity with the relevant statutes, case law, trends, and factors courts will consider when determining whether a taxpayer is a real estate professional or a real estate investor. This article begins with an overview of often-overlooked rules that can apply to taxpayers with rental real estate activities. Then, this article discusses the most common ways that these issues arise in litigation, namely, satisfying the 50% and 750-hour requirement under section 469(c)(7)(A) of the Internal Revenue Code, and ensuring that the election to aggregate rental real estate activities is properly made.

I. Overview: Passive Activity Loss Rules and Exception for "Real Estate Professionals"

A. General Rule: Deductions

Under sections 162 and 212, taxpayers are generally allowed deductions for all the ordinary and necessary expenses paid or incurred in connection with a trade or business or for the production of income.[2] Section 469, however, may limit the deductibility of losses from these activities where the losses arise from passive activities.[3] A passive activity is any activity which involves the conduct of any trade or business and one in which the taxpayer does not materially participate.[4] Rental real estate activity is generally treated as a *per se* passive activity regardless of whether the taxpayer materially participates.[5] The disallowed passive activity loss equals the excess of the aggregate losses from all passive activities for the year over the aggregate income from all passive activities for that year.[6]

A taxpayer may avoid having his or her real estate activity classified as a *per se* activity if the taxpayer is a qualifying real estate professional.[7] In such cases, the taxpayer may deduct losses from rental real estate activities without regards to the passive activity loss limitations.[8] Also, a taxpayer who actively participates in a rental real estate activity may deduct up to $25,000 in rental real estate losses so long as the taxpayer actively participates in the rental real estate activity and his or her adjusted gross income is $100,000 or less.[9] For taxpayers who actively participate in the rental real estate activity and whose adjusted gross income is above $100,000 but less than $150,000, the $25,000 amount is reduced by 50% of the amount by which the taxpayer's adjusted gross income exceeds $100,000.[10]

The difference between material participation and active participation is fine and distinct. Material participation is involvement in the activity that is regular, continuous, and substantial.[11] As applied to a rental real estate activity, active participation is involvement in the making of management decisions or arranging for others to provide services in a significant and bona fide sense.[12]

B. Exception to Passive Activity Loss Rules: Real Estate Professionals

The first exception to the general rule that rental real estate activities are per se passive activities is found in section 469(c)(7). Pursuant to that section, the rental activities of a taxpayer who is a real estate professional are not per se passive activities but are treated as a trade or business subject to the material participation requirements of section 469(c)(1).[13] In order for a taxpayer to qualify as a real estate professional, the following two tests must be met:

> (1) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
>
> (2) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.[14]

The 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."[15] In the case of a joint return, the requirements for qualification as a real estate professional are met if either spouse separately satisfies the requirements.[16] Note that the taxpayer must prove that more than one-half of the services the taxpayer performs must be in real property trades or business *in which the taxpayer materially participates*.[17] As noted, section 469(h)(1) generally (and somewhat amorphously) provides that a taxpayer shall be treated as materially participating in an activity if the taxpayer is involved in the operation activity on a basis which is regular, continuous, and substantial. The Temporary Treasury Regulations clarify this amorphousness insofar as they generally provide that a taxpayer can establish material participation if any one of the following seven tests is satisfied:

(1) The individual participates in the activity for more than 500 hours during such year;

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;

(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 (including individuals who are not owners of interests in the activity) for such year;

(4) The activity is a significant participation activity ... for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;

(5) The individual materially participated in the activity ... for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(6) The activity is a personal service activity ..., and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

(7) Based on all of the facts and circumstances ..., the individual participates in the activity on a regular, continuous, and substantial basis during such year.[18]

The extent of an individual's participation in an activity may be established by any reasonable means.[19] Although courts have expressed a preference for contemporaneous daily time reports, logs, or similar documents, such documents are not the exclusive means by which material participation can be proven.[20] The work performed by the taxpayer's spouse in a rental real estate activity is treated as work performed by the taxpayer, regardless of whether the spouses file a joint return for the year.[21]

For taxpayers with multiple rental properties, the general rule is that each property is treated as a separate activity for which the taxpayer must separately satisfy the material participation requirement.[22] However, an important exception to this general rule is that a taxpayer may elect to treat all interests in rental real estate as a single rental real estate activity pursuant to section 469(c)(7) in the manner required by Treas. Reg. § 1.469-9(g)(3).[23] As discussed below, whether a taxpayer is a real estate professional has been an issue which has engendered considerable litigation.

C. Exception to Passive Activity Loss Rules: Active Participation

The second exception to the general rule that rental real estate activities are *per se* passive activities is found in Section 469(i). This exception allows eligible taxpayers who actively participate in a rental real estate activity to deduct up to $25,000 of losses arising from the activity.[24] As explained above, the active participation standard is a lower bar to meet than the material participation standard.[25] The full $25,000 loss is permitted if the taxpayer's adjusted gross income (AGI) is less than $100,000.[26] This permitted loss is reduced by 50% of the taxpayer's AGI in excess of $100,000, and as modified income exceeds $100,000, the allowable $25,000 offset is phased out as AGI, with a full phase-out occurring when modified AGI equals $150,000.[27] As discussed below, especially for middle-income families who do not rise to the level of real estate professionals, the active participation requirement can create significant tax savings for such taxpayers.

D. Net Investment Income Tax and Real Estate Professionals

Section 1402 of the Health Care and Reconciliation Act of 2010[28] outlines the unearned income Medicare tax, which went into effect on January 1, 2013.[29] Under that provision, taxpayers with modified adjusted income over $200,000 if filing individually or $250,000 if filing jointly as a married couple could be subject to this tax.[30] The provision imposes a 3.8% tax on unearned income—income from all passive activities, including interest, dividends, annuities, royalties, and rents. The tax does not apply to income from an actively conducted business.[31]

Individuals who qualify as real estate professionals are not liable for this tax.[32] That is, they are not subject to the 3.8 percent tax on rental income if they "materially participate" in the real estate activity and the activity qualifies as a business for tax purposes.[33] In this regard, the new regulations establish a "safe harbor" rule for when a rental activity conducted by a real estate professional is a business: So long as a real estate professional devotes a minimum of 500 hours per year to the rental real estate activity, such activity will automatically qualify as a business for these purposes and the rental income will not be subject to the section 1402 tax.[34] Alternatively, if a real estate professional has participated in rental real estate activities for more than 500 hours per year in five of the last 10 tax years, the rental activity will qualify as a business.[35] There are currently no cases interpreting these provisions.

II. <u>Often-Litigated Issue #1: Failure of Substantiation as to Real Estate Professional or Active Participant</u>

A. Proving Qualification as a Real Estate Professional

Substantiation (or lack thereof) is routinely at issue in tax cases involving taxpayers with rental real estate activities. Indeed, one of the biggest stumbling blocks taxpayers run into in attempting to qualify a real estate professional is the inability to substantiate the time spent in their activity to show that the requirements of section 469(c)(7)(B)(i) and (ii) are met. As previously noted, the Temporary Treasury Regulations provide that

> the extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.[36]

In a number of recent cases, taxpayers have had difficulty providing records to support that they engaged in the rental real estate activity on such a continuous basis as to meet the requirements of section 469(c)(7)(B)(i) and (ii). For example, in Coastal Heart Medical Group, Inc. v. Commissioner, the taxpayers testified (without supporting documentation) that they spent 14-to-16 hours a day, seven days a week negotiating the purchase of hospitals in a particular year.[37] The United States Tax Court ("Tax Court") held that even though the regulations permit some flexibility regarding the records to be maintained by taxpayers, the Court is not required to accept a post-event "ballpark guesstimate" or the uncorroborated testimony of taxpayers.[38] Thus, although the Treasury Regulations do not strictly required it, the taxpayer is advised to offer a log, calendar, or other contemporaneous writing to prove the amount of hours he or she worked in his or her rental real estate activity.[39]

In Moss v. Commissioner,[40] the married taxpayers contended that, in addition to the time one of them actually worked, the hours that the husband was "on call" for work on the rental properties should also count towards determining whether the taxpayers met the requirements of section 469(c)(7)(B). The Tax Court disagreed and held that the taxpayer's "on call" hours may not be used to satisfy the 750–hour requirement of section 469(c)(7)(B)(ii).[41] The Court reasoned that, although the taxpayer could have been called in to perform services, he never performed such services, and section 469(c)(7)(B)(ii) requires the Court to look to the hours actually performed by the taxpayer.[42]

In Jafarpour v. Commissioner, the Tax Court comprehensively analyzed why the taxpayer did not qualify as a real estate professional.[43] The Court looked to a number of facts to support the finding that the records produced were not reasonable or reliable, including the illegibility of the taxpayer's appointment book, the lack of contemporaneousness of the logbook, inconsistencies between the taxpayer's phone records and the time recorded in the logbook, her claim of taking one hour to read a one-sentence e-mail on multiple occasions, and suspect entries in her logbook claiming she toured an area "to get a feel" for the schools and shopping, and overall. The Court characterized these entries as "unreasonable assertions ... so pervasive that the entire log is tainted with incredibility."[44] Thus, Jafarpour compels the conclusion that taxpayer's must not only have records of the hours they spent on a particular activity, but that the records must be reasonable and reliable.

An issue which often arises in the real estate professional context is that the taxpayer's records may have been destroyed.[45] The Tax Court has not left such taxpayers without recourse. The Tax Court has held that a taxpayer "is entitled to substantiate deductions by reconstructing his expenditures through other credible evidence."[46] Thus, in appropriate circumstances, the Tax Court may be willing to accept post-event reconstruction from contemporaneous documentation rather than post-event reconstruction from memory.[47]

In Escalante v. Commissioner,[48] the Tax Court held that the taxpayer's logs recording the number of hours spent annually on rental real estate activity versus the hours he spent in his regular profession as a teacher were insufficiently reliable to establish he met the requirements to avoid the passive loss limitations on deductions for rental real estate activity. When reviewing the taxpayer's hours spent on non-real estate activity as a teacher, the Court concluded that the failure to include any hours outside the minimum time required under the teacher's contract made it indeterminable whether the taxpayer spent more time as a teacher or in his real estate activities.[49] In addition, the reliability of the logs were also called into question by what appeared to be exaggerated amounts of time shown for relatively routine, recurring events, such as check writing.[50]

In sum, the following key points can be derived from the various case law:

1. Even though the regulations permit some flexibility regarding the records to be maintained by taxpayers, the Tax Court is not required to accept a post-event "ballpark guesstimate" or the uncorroborated testimony of taxpayers.
2. The taxpayer's "on call" hours may not be used to satisfy the 750–hour requirement.
3. The taxpayers must not only have records of the hours they spent on a particular activity, but the records must be reasonable and reliable.
4. With regard to taxpayer records that may have been destroyed, the Court may be willing to accept post-event reconstruction from contemporaneous documentation rather than post-event reconstruction from memory.
5. Failure to include any hours outside the minimum time required under a taxpayer's non-real estate job can make it indeterminable whether the taxpayer spent more time at that job or in his real estate activities.

B. Proving Active Participation

If a taxpayer does not have records to support that he or she meets the two-prong test in section 469(c)(7)(A), tax professionals should next consider whether the taxpayer qualifies under the active participation exception of section 469(i)(1).[51] Litigation on this topic is scarce, most likely because the active participation threshold is so easily met, but courts have generally been willing to find the existence of active participation. In this regard, the Internal Revenue Service ("Service" or "IRS") instructs as follows: "As long as a taxpayer participates in management decisions in a bona fide sense, he actively participated in the real estate rental activity."[52] The standard to prove active participation is a lot less stringent for a taxpayer to meet in comparison to how the courts review the evidence needed to prove qualification as a real estate professional.[53] Taxpayers usually do not qualify for the $25,000 deduction under this exception, not for the inability to substantiate their expenses, but because their modified gross income is over $100,000.[54]

III. Often-Litigated Issue #2: Failure to Make the Aggregation Election

A. Background: How to Make and Revoke the Aggregation Election

Another issue that is often litigated is whether the taxpayer is able to treat multiple rental real estate activities as a single rental real estate activity. As noted above, for taxpayers with multiple rental real estate properties, meeting the material participation requirement for each property separately can be difficult. This is because the default rule is that each property is treated as an independent activity for which the taxpayer must satisfy the material participation test, unless the taxpayer elects to treat all interests in the rentals as a single activity.[55]

A taxpayer makes this election by filing a statement which explicitly declares that the taxpayer is a qualifying taxpayer (*i.e.,* the taxpayer meets the requirements to be a real estate professional) for the tax year and is making the election under Section 469(c)(7)(A).[56] After making this election, it is binding for the tax year in which it is made and for future years in which the taxpayer is a qualifying real estate professional, even if there are intervening years in which the taxpayer does not qualify as a real estate professional.[57] This election can be revoked by the taxpayer only in the tax year in which "a material change in the taxpayer's facts and circumstances occurs or in a subsequent year in which the facts and circumstances remain materially changed from those in the taxable year for which the election was made."[58] To revoke the election, the taxpayer must file a statement with an original return for the year of revocation containing a declaration the taxpayer is revoking, and an explanation of the nature of the material change.[59] The IRS also allows certain taxpayers to file a late election after filing their original tax return by attaching a statement to the amended return for the most recent tax year and mailing the amended return to the IRS service center where the taxpayer will file the current-year return.[60]

B. Effect of Failure to Properly Make the Aggregation Election

In Kosonen v. Commissioner, the Service conceded that the taxpayer materially participated in his rental real estate activities and was able to deduct expenses without application of the passive activity loss limitation rules if the activities were treated as one activity, because the taxpayer elected under section 469(c)(7) to treat his various rental real estate activities as one activity.[61] The Tax Court found that the taxpayer did not properly make the election, and that he did not separately meet the requirements of section 469(c)(7)(A)(i) and (ii) for each rental activity. The Tax Court ruled that, in order to make an election, a taxpayer, must clearly notify the Service of his or her intent to do so.[62] Specifically, the Court stated, "The taxpayer must exhibit in some manner ... his unequivocal agreement to accept both the benefits and burdens of the tax treatment afforded" by the statute.[63] The Court did not agree with the taxpayer's contention "that he treated his net losses as active [and intended to make the election because] he reported on lines 22 through 26 and 42 of Schedule E, line 1d of Form 8582, and statements in support of Form 8582 of his 1994 return that, except for one property, none of the properties had a passive gain or loss and that he did not add his 1994 losses to previously suspended losses."[64]

Furthermore, the Court observed that the taxpayer's mere reporting of his losses as active losses is not clear notice that he made the election because he also would have reported that his net losses were active if he had materially participated in each of the seven rental real estate activities and had not made the election under section 469(c)(7).[65] In addition, the court refuted the taxpayer's claim that his intent to make the election should be taken into consideration and held that a "taxpayer's intent is irrelevant to making an election."[66] Thus, it is important that the taxpayer memorialize his or her intent to make the aggregation election under section 469(c)(7) by filing the statement required by Treas. Reg. § 1.469-9(g)(3).

C. Filing a Late Election

Rev. Proc. 2011-34 allows certain taxpayers to file an election after filing their original tax return by attaching a statement to their amended return for the most recent tax year and mailing the amended return to the IRS service center where the taxpayer will file his or her current-year return. Stated simply, in addition to the information required by Treas. Reg. § 1.469-9(g)(3), a taxpayer filing a late amendment must include:

1. An explanation of why the election was not timely made;

2. Designation of the tax year for which the taxpayer seeks to make the late election;

3. Representations that the taxpayer:

- Failed to make an election under Treas. Reg. § 1.469-9(g) solely because the taxpayer failed to meet timely the requirements in that section;
- Filed consistently with having made an election under Treas. Reg. § 1.469-9(g) on any return that would have been affected if the taxpayer had timely made the election;
- Timely filed each return that would have been affected by the election if it had been timely made; and
- Has reasonable cause for failing to meet the requirements in Treas. Reg. § 1.469-9 (g).

4. A declaration that the representations are made under penalties of perjury; and

5. A statement at the top declaring: "FILED PURSUANT TO REV. PROC. 2011-34." The individual or individuals who sign must have personal knowledge of the facts and circumstances related to the election.

There are currently no reported cases where the Court has accepted a Rev. Proc. 2011-34 election filed after the issuance of a notice of deficiency. It should be noted that we have been involved in cases where the Tax Court judges have continued cases of pro se taxpayers set for trial so that the IRS could consider a late-filed election and have indicated that the rejection of the election may be reviewable by the Court under an abuse of discretion standard.

D. Downside of the Aggregation Election

The aggregation election is not always beneficial. One of biggest drawbacks of making the aggregation election, is the adverse impact such an election may have under the section 469(g) "complete-disposition rule." This section provides that passive losses that have been suspended are generally allowed when the taxpayer "disposes of his entire interest in any passive activity."[67] Under this rule, all the suspended passive losses allocable to the electing taxpayer's aggregated rental real estate interests cannot be "freed up" until after the taxpayer disposes of substantially all of the interests.[68] As a result, if a taxpayer has suspended passive losses allocable to multiple properties that are likely to be sold in the near future, it is sensible for a tax controversy professional to advise the taxpayer to defer making the aggregation election until after the sales are completed (or to revoke an otherwise effective election).

IV. Taxpayer Qualifies as a Real Estate Professional

A. Factors Considered to Qualify as a Real Estate Professional

When determining whether a taxpayer can avoid the passive activity loss rules by using the exception for real estate professionals, courts often consider the taxpayer's duties and responsibilities with respect to the rental properties. The following duties may help support a finding that the taxpayer materially participated in the rental real estate activity:

- interviewing and performing background checks on new tenants;
- preparing leases and answering questions of new tenants;
- sending or posting eviction notices and initiating eviction proceedings as needed;
- cleaning rental units following tenants' departures and in furtherance of securing new tenants;
- repairing rental units following tenants' departure and in furtherance of securing new tenants; changing locks and related security issues;
- purchasing supplies, paint, and repair items for each rental unit;
- repairs of rental properties for existing tenants and in preparation of new tenants;
- maintenance of common grounds, parking areas, and doors for units;
- meeting, communicating, and supervising contractors, agents, and agencies;
- coordinating landscaping with hired landscaper/gardener;
- inspecting grounds and maintaining grounds on a weekly basis;
- bookkeeping, accounting, and banking activities with respect to the rental properties;
- payment of costs and expenses with respect to each of the rental properties;
- coordinating filings and bookkeeping with professionals, including accountants and attorneys; and
- collecting and depositing rent.[69]

This list of factors is not intended to be exhaustive; however, it can give tax practitioners a good idea of what to look for when faced with the issue of trying to prove a client's qualification for real estate professional status.

B. Recent Cases

Taxpayers with corroborative documentary evidence have succeeded in litigating real estate professional cases. For example, in the non-precedential Brown v. Commissioner, the Tax Court ruled in favor of the taxpayer and held that the taxpayer's losses from rental activities were not passive.[70] The taxpayer in this case resided on the first floor of a three-unit multi-family house and rented out the remaining floors.[71] In 2010 alone, the taxpayer spent 1,284 hours — 1,008 of which were ultimately allowed — "working on" the property.[72] In 2011, the taxpayer spent 1,082 hours — 752 of which were ultimately allowed — "working on" the property.[73] A takeaway from this case[74] is that the taxpayer kept contemporaneous logs of the hours worked in relation to the property which was instrumental in the Court holding that the rental activities were not passive for the years at issue.[75] This case also offers some lessons on how to properly document records for current real estate professionals. With regard to the total hours logged each year, some hours were disqualified for two reasons: (1) the taxpayer counted hours attributable to her own unit and (2) the taxpayer counted hours attributable to common spaces without pro-rating the hours (one-third of the time spent on the common areas to her family's residence was removed).[76] Even after removing that time, the taxpayer was held to have materially participated in the rental real estate activity because she met the more–than–500–hour requirement of Treas. Reg. § 1.469–5T(a)(1) for both of the years at issue.[77]

Similarly, in Leyh v. Commissioner, which is also non-precedential, the Tax Court recently held that the taxpayers were entitled to apply losses from the real estate activity against their non-passive income.[78] The focal point of the controversy in this case was whether one taxpayer's revised log was sufficient to show that she met the 750-hour requirement of section 469(c)(7).[79] The record reflected that the taxpayer kept a contemporaneous log and activity.[80] The total hours originally recorded on the log, however, did not account for the total amount of travel time.[81] Accordingly, the taxpayer identified those days and added them in to meet the threshold 750-hour requirement.[82] The Service, however, contended that the times on the original log were inclusive of all of travel activity, and cited other precedent where there was inadequate records and evidence to meet the 750-hour requirement.[83] The Court held that the taxpayer's original log and her revised log were well within the guidelines of Treas. Reg. § 1.469–5T(f)(4).[84] The Court reasoned that the cases that the Service cited did not involve a contemporaneous log as in this case, and that the taxpayer was very specific in her explanations.[85] Thus, Leyh v. Commissioner stands for the proposition that the reliability of the records relied upon to establish real estate professional status can be as important (if not more so) than the contemporaneousness of those records.[86]

C. Airbnb – Can a Temporary Landlord Be a Real Estate Professional for Tax Purposes?

One can expect litigation in this area to persist as temporary landlords offer to rent their homes on popularized apps that offer an alternative to the traditional hotel. Launched in 2008, Airbnb is a popular app where people list, find, and rent lodging. Most people who use this app to rent properties may not consider the potential tax consequences or that there are limitations that may apply to their rental losses.

This area of the law is fraught with technicalities that can be troubling to temporary landlords. An issue which is outside the scope of this article, for example, is Section 280A. That section disallows otherwise allowable deductions with respect to a dwelling unit used as a taxpayer's residence. Section 280A(d)(1) provides that a taxpayer is considered to have used a dwelling unit as a residence where the property is used for personal purposes for a time which exceeds the greater of 14 days or 10% of the number of days during which the property is rented at a fair rent. Thus, while temporary landlords may want to claim a loss with respect to their temporary rental properties, if they used the rental property as a dwelling unit as a resident, these deductions may be altogether disallowed (never even implicating the passive activity loss limitation rules of Section 469).

This demonstrates how the real estate professional rules can effect and create tax consequences for sporadic landlords who have been opened up to the rental market from fairly new technology, such as the Airbnb app.

V. Recommendations for Volunteers Assisting Pro Se Litigants

Avoiding the passive activity loss rules using the exception for real estate professionals ultimately is a challenging exercise for tax controversy professionals, let alone the pro se taxpayer, as the Service's determinations in a notice of deficiency are presumed correct, and the taxpayer bears the burden of proving by a preponderance of the evidence that the determination is improper.[87]

The facts surrounding many recent tax court decisions demonstrate the issues pro se taxpayers can encounter. For example, in Oderio v. Commissioner, the taxpayer was a pro se petitioner who claimed she was entitled to a rental loss deduction for 2008.[88] The taxpayer conceded that she did not separately satisfy the requirements of section 469(c)(7)(B); however, she argued that her spouse does, and therefore she satisfies them, too.[89] The Court examined the language in the relevant Temporary Treasury Regulations and determined that while the Regulations that the taxpayer cited do allow for spousal attribution with respect to the material participation requirements of section 469(c)(7)(B), they do not, as she contended, allow for spousal attribution for purposes of meeting its other requirements, namely, that a taxpayer perform more than one half of his or her personal services and more than 750 hours in real estate trades or businesses in cases where a joint return is not filed.[90]

In addition, in Almquist vs. Commissioner, a pro se taxpayer provided the Court with self-serving testimony, but did not provide any of the purported supporting documentation, logs, or emails.[91] The Court again ruled against the pro se litigant citing the petitioner's testimony as being nothing more than "a post event 'ballpark guesstimate.'"[92]

Moreover, in Flores v Commissioner, the pro se taxpayer even testified that his entries indicating that he spent four hours doing bookkeeping were inaccurate.[93]

In contrast, in Fitch v. Commissioner, when determining whether the taxpayers (who were represented by counsel) were entitled to deduct rental real estate losses for the property in question, and whether these and other rental real estate losses are limited by the passive activity loss rules of section 469, the Court solely relied upon the credibility of the taxpayer testimony.[94] One taxpayer testified extensively as to the activities he performed with respect to his rental properties, and the Court held that the taxpayer qualified as a real estate professional and satisfied the second enumerated test for material participation.[95] Surprisingly, the Court made no reference to any evidence presented, and the Respondent unsuccessfully argued that the court should disregard the taxpayers' testimony as self-serving.[96]

Tax controversy professionals assisting self represented taxpayers at calendar calls should understand the errors pro se taxpayers made in cases such as Oderio, Almquist, and Flores in seeking achieve the same result as the petitioners in Fitch. For instance, Oderio serves as a good example of a pro se taxpayer misinterpreting and misusing the language of a statute (which seemed on its face would work to her benefit), leading to a ruling against her.

VI. Conclusion

Taxpayers who attempt to avoid the passive activity loss rules using the exception for real estate professionals can present a challenge for tax controversy professionals. The IRS and Tax Court have been very skeptical of taxpayers who have presented testimony and documentation that is not nearly "spot-on" when it comes to satisfying the "more than half" and 750 hour tests of section 469. As a result, tax controversy professionals are encouraged to advise their clients to keep contemporaneous documentation of time they claim they spent, and to prepare their clients in advance of providing testimony so that it is consistent with documentation they are providing to the Court. Ensuring reasonable and reliable documentary evidence is the best medicine for being successful on a real estate professional issue.

Footnotes:

1. Frank Agostino, Esq., is principal of, and Patrick Binkakis, Esq., is an associate at Agostino & Associates, P.C.
2. I.R.C. §§ 162, 212.
3. I.R.C. § 469(a)(1).
4. I.R.C. § 469(c)(1). IRS, *Passive Activity Losses – Real Estate Tax Tips*, https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Losses-Real-Estate-Tax-Tips (last updated Jan. 7, 2016).
5. I.R.C. § 469(c)(2), (4).
6. I.R.C. § 469(d)(1); *see also* Treas. Reg. § 1.469-2T(b)(1) (1993).
7. I.R.C. § 469(c)(7).
8. I.R.C. § 469(c)(7)(A).

9. I.R.C. § 469(i). Where certain rehabilitation or low-income housing credits are at issue, there is not an active participation requirements, and the phase-out applies if adjusted gross income is between $200,000 to $250,000 (as opposed to $100,000 to $150,000).
10. I.R.C. § 469(i)(3)(A).
11. I.R.C. § 469(h)(1).
12. Madler v. Commissioner, T.C. Memo. 1998-112 (quoting S. Rept. 99-313 (1986), 1986-3 C.B. (Vol. 3) 1, 737-38). Management decisions that may support a finding of active participation are approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions. Active participation, unlike material participation, does not have to be involvement that is regular, continuous, and substantial.
13. Income Tax Reg. § 1.469-9(e)(1).
14. I.R.C. § 469(c)(7)(B).
15. I.R.C. § 469(c)(7)(C).
16. *Id.*
17. I.R.C. § 469(c)(7)(B)(i).
18. Treas. Reg. § 1.469-5T(a).
19. Treas. Reg. § 1.469-5T(f)(4); *see also* IRS, *Passive Activity Loss Audit Technique Guide*, Feb. 2005, *available at* https://www.irs.gov/pub/irs-mssp/pal.pdf.
20. Treas. Reg. § 1.469-5T(f)(4).
21. Treas. Reg. § 1.469-5T(f)(3).
22. I.R.C. § 469(c)(7)(A).
23. *Id.* Treas. Reg. § 1.469-9(g)(3) provides as follows:

    > A qualifying taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's original income tax return for the taxable year. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to section 469(c)(7)(A).
24. I.R.C. § 469(i)(1).
25. Azimzadeh v. Commissioner, T.C. Memo. 2013-169.
26. I.R.C. § 469(i)(3).
27. *Id.*
28. Pub. L. 111-152, 124 Stat. 1029 (2010).
29. Congressional Health Care Caucus - New 3.8% Medicare Tax on “Unearned” Net investment Income, http://health.burgess.house.gov/uploadedfiles/one_page_on_unearned_medicare_tax.pdf.
30. *Id.*
31. *Id.*
32. Stephen Fishman, *Real Estate Tax Talk – Real Estate Professionals May Be Exempt From 3.8 Percent ‘Obamacare tax’ On Rental Income*, INMAN, Dec. 9, 2013, https://www.inman.com/2013/12/09/real-estate-professionals-may-be-exempt-from-3-8-obamacare-tax-on-rental-income/.
33. *Id.*
34. *Id.*
35. Treas. Reg. § 1.469-5T(a)(5).
36. Treas. Reg. § 1.469-5T(f)(4).
37. T.C. Memo. 2015-84.
38. *Id.* (citing Moss v. Commissioner, 135 T.C. 365, 369 (2010)).
39. *Id.*
40. 135 T.C. 365.
41. *Id.* at 371.
42. *Id.*
43. Jafarpour v. Commissioner, T.C. Memo. 2012-165.
44. *Id.*
45. Merino v. Commissioner, T.C. Memo. 2013-167.
46. *Id.* (citing Villarreal v. Commissioner, T.C. Memo. 1998-420; Malinowski v. Commissioner, 71 T.C. 1120, 1125 (1979)).
47. *Id.*
48. T.C. Summ. Op. 2015-47.
49. *Id.*

50. *Id.*
51. Moss v. Commissioner, 135 T.C. 365, 369 (2010).
52. IRS, *Passive Activity Loss*, *supra* note 19.
53. Azimzadeh, T.C. Memo. 2013-169.
54. *Id.*
55. I.R.C. § 469(c)(7)(A).
56. Treas. Reg. § 1.469-9(g)(3).
57. Treas. Reg. § 1.469-9(g)(1).
58. Treas. Reg. § 1.469-9(g)(3).
59. *Id.*
60. IRS, *Internal Revenue Bulletin: 2011-24, Section 4*, https://www.irs.gov/irb/2011-24_IRB/ar07.html (June 13, 2011).
61. Kosonen v. Commissioner, T.C. Memo. 2000-107.
62. *Id.*
63. *Id.* (citing Young v. Commissioner, 783 F.2d. 1201, 1206 (1986)).
64. *Id.*
65. *Id.*
66. *Id.* (citing Young, 783 F.2d. at 1206).
67. I.R.C. § 469(g).
68. Daniel Rowe, *Activity Grouping: The Impact of Recent Developments*, THE TAX ADVISER, Feb. 1, 2013, http://www.thetaxadviser.com/issues/2013/feb/rowe-feb2013/.
69. Anecdotally, we have seen the following factors taken into consideration when the taxpayer has been able to avoid the Passive Activity Loss Rules by using the exception for real estate professionals.
70. Brown v. Commissioner, T.C. Summ. Op. 2015-62.
71. *Id.*
72. *Id.*
73. *Id.*
74. Note that although this opinion can be used for guidance, it was decided under the rules of I.R.C. § 7463(b) (Disputes involving $50,000 or less), and is thus not considered binding precedent in the Tax Court.
75. *Id.*
76. *Id.*
77. *Id.*
78. Leyh v. Commissioner, T.C. Summ. Op. 2015-27.
79. *Id.*
80. *Id.*
81. *Id.*
82. *Id.*
83. *Id.*
84. *Id.*
85. *Id.*
86. Leyh is also not considered binding Tax Court precedent.
87. Tax Ct. R. Prac. & Proc. 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933).
88. Oderio v. Commissioner, T.C. Memo. 2014-30.
89. *Id.*
90. *Id.*
91. Almquist v. Commissioner, T.C. Memo. 2014-40.
92. *Id.*
93. Flores v. Commissioner, T.C. Memo. 2015-9.
94. Fitch v. Commissioner, T.C. Memo. 2012-358.
95. *Id.*
96. *Id.*

LOW-INCOME TAXPAYER CLINICS TO ASSIST TAXPAYERS IN NEED

Low Income Tax Clinics (LITCs) are valuable services across the country for taxpayers with limited funds who need federal assistance. These not-for profit, federally funded organizations provide representation in federal tax disputes, tax education, and outreach to taxpayers who speak English as a second language for free or for a nominal fee.

Via the Internal Revenue Service Restructuring and Reform Act of 1998, Congress authorized the IRS to make grants to provide matching funds or the development, expansion, or continuation of these LITCs. On February 26, 2016, the IRS announced $10.72 million in matching grants to 129 Low-Income Taxpayer Clinics (LITCs) across the U.S. The New Jersey clinics were among those funded, with $90,000 donated to Legal Services of New Jersey (Edison); $85,000 to Northeast New Jersey Legal Services Corp. (Jersey City); and $100,000 to Rutgers, the State University of New Jersey (Newark).

For any taxpayer needing such assistance, here are the contacts for all Legal Services offices and other low-income assistance organizations in New Jersey:

Legal Services of New Jersey
P.O. Box 1357
Edison, NJ 08818-1357
1-732-572-9100
1-888-LSNJ-LAW (576-5529)
https://lsnjlawhotline.org/ (to apply for legal services)
https://www.lsnj.org/ (for general information)

Rutgers University School of Law – Newark
Federal Tax Law Clinic
Center for Law and Justice
123 Washington Street
Newark, NJ 07102
1-973-353-1685
www.law.newark.rutgers.edu

1. Pub. L. No. 105-206, 112 Stat. 685 (July 22, 1998); *see also* IRC § 7526.
2. IRS Announces Low Income Taxpayer Clinic Grant Recipients, IRS News Release IR-2016-32 (Feb. 26, 2016) *available at* https://www.irs.gov/uac/Newsroom/IRS-Announces-Low-Income-Taxpayer-Clinic-Grant-Recipients-2016.
3. *Id.*

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Northeast New Jersey Legal Services
NNJLS@lsnj.org
www.lsnj.org/nnjls
http://www.northeastnjlegalservices.org/
Office Hours: 8:30 a.m. – 5:00 p.m.

Regional Offices:

Bergen County
190 Moore Street
Hackensack, NJ 07601
1-201-487-2166 (phone)
1-201-343-1837 (fax)

Hudson County
574 Summit Avenue
Jersey City, NJ 07306
1-201-792-6363 (phone)
1-201-798-8780 (fax)

Passaic County
152 Market Street
Paterson, NJ 07505
1-973-523-2900 (phone)
1-973-523-9002 (fax)

Make the Road New Jersey
42 Broad St.
Elizabeth, NJ 07201
1-908-768-4991
www.maketheroadnj.org

Make the Road New Jersey (MRNJ) supports low-income immigrant communities to achieve dignity and respect through high quality legal and support services, community organizing, policy innovation and transformative education. Founded in November 2014 in Elizabeth, New Jersey, MRNJ is a sister organization to the longstanding, successful Make the Road New York, which, in its 18 year history, has become a strong voice for immigrant and workers' rights in New York City and Long Island.

Bergen Small Business Development Center
C/O Ciarco Learning Center
Bergen Community College
355 Main Street,
Hackensack, NJ 07601
1-201-489-8670 (phone)
1-201-489-8673 (fax)
http://www.bergen.edu/sbdc

The New Jersey Small Business Development Centers (SBDC) network, comprised of 11 centers across the state, assists businesses to expand their operations, manage their growth and start

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new ventures via ongoing confidential consultations and low cost or no cost training. SBDC network is partially funded by the U.S. Small Business Administration. SDBC at Bergen Community College is a non-profit organization that assist small to medium sized businesses (start-ups and established businesses) with succeeding in today's environment. SBDC offers one-to-one counseling (at no cost to the client) to business owners seeking information on a variety of topics including how to finance, market and manage their companies. Clients are assisted in exploring the feasibility of their business ideas, developing and assessing their business plans, making cash flow projections and accurate financial statements, formulating marketing strategies, developing the loan package and finding capital. SBDC assists small businesses with the formulation of strategies to meet challenges, provide resources to achieve objectives and act in a mentoring capacity. SBDC also offers no/low cost training seminars on topics including legal, accounting and bookkeeping, marketing, financing, management, and human resources.

FIRM NEWS

Our firm welcomes Rob Dennerlein, Esq. to the Agostino & Associates, P.C. team. Mr. Dennerlein is an attorney admitted to practice law in New Jersey. He earned a BA in Communications from Rutgers University. After completing his undergraduate degree, Mr. Dennerlein obtained his JD from Rutgers School of Law.

Upcoming United States Tax Court Calendar Calls

All Calendar Calls Are Held at:

Jacob K. Javits Federal Building
26 Federal Plaza
Rooms 206, 208
New York, NY 10278

April 25, 2016 - New York City

June 7, 2016 - Westbury, NY & Newark, NJ

June 13, 2016 - New York City

June 20, 2016 - New York City

Upcoming Events: The 8th Annual NYU Tax Controversy Forum

On June 23-24, the annual NYU School of Professional Studies Tax Controversy Forum will be held at the Crowne Plaza in Times Square. The Forum features interactive presentations delivered by expert practitioners who cover a broad range of issues regarding tax audits and tax litigation at all levels.

For more information and registration information, please see http://www.sps.nyu.edu/academics/departments/finance-tax-and-law/conferences-events/tax-controversy-forum.html

Agostino & Associates, P.C. Contact Information

Frank Agostino, Esq. Fagostino@agostinolaw.com	Ext. 107
Patrick Binakis, Esq. Pbinakis@agostinolaw.com	Ext. 125
Jairo Cano, Esq. Jcano@agostinolaw.com	Ext. 144
Robert Dennerlein, Esq. Rdennerlein@agostinolaw.com	Ext. 131
Jeffrey Dirmann, Esq. Jdirmann@agostinolaw.com	Ext. 119
Eugene Kirman, Esq. Ekirman@agostinolaw.com	Ext. 142
Jeremy Klausner, Esq. Jklausner@agostinolaw.com	Ext. 130
Dolores Knuckles, Esq. Dknuckles@agostinolaw.com	Ext. 109
Tara Krieger, Esq. Tkrieger@agostinolaw.com	Ext. 118
Lawrence Sannicandro, Esq. Lsannicandro@agostinolaw.com	Ext. 128
Michael Wallace, EA Mwallace@agostinolaw.com	Ext. 143
Caren Zahn, EA Czahn@agostinolaw.com	Ext. 103

Taxpayers Assistance Corporation- Of Counsel

Desa Lazar, Esq. Lazar@tac-nj.org