PILLA TALKS TAXES

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Will The Supreme Court Change Fundamental Tax Policy?

Is There a Disaster in the Making?

The "base" of our federal tax system is "income." That is, the scheme seeks to capture the amount of "income" an individual or business earns over the course of a year, then subtract various deductions, credits and exemptions from that income, and finally, to apply the applicable rate of tax to the remaining income in order to assess the correct income tax liability.

The concept might seem simple enough except for at least three factors that make the system massively complex. The first is that the federal tax code consists of more than 4 million words seeking to define and apply the various deductions, credits and exemptions, etc., expressed in the law; second (and worse), the code has been changed more than 6,000 times just since 2001 alone. Finally, the third, seemingly even more bizarre factor, is the fact that within those more than 4 million words, there is *no comprehensive definition* of the word "income."

The touchstone of the modern income tax is the 16th Amendment, ratified in 1913. It provides no definition of the word. Rather, it merely authorizes Congress to "lay and collect taxes on incomes, from whatever source derived, . . ." The Internal Revenue Code does contain section 61, which purports to be a definition of the term "income" but on careful review, we find that it's merely a tail-chasing exercise which, in the end,

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provides but a list of *possible sources* from which "income" may be derived.

Section 61 begins with the following phrase:

> "…gross income means all income from whatever source derived, including (but not limited to) the following items: * * *"

The law proceeds to list fourteen difference "sources" from which "income" may be derived. We learned in grammar school that you never attempt to define a word using the very word sought to be defined. Yet that is exactly what Congress did when it wrote that "income" means "income." Thus, we are no closer to understanding what "income" is for purposes of the tax law.

This lack of clarity has resulted in non-stop litigation between taxpayers and the federal government from the very start of the income tax code in 1913. Early decisions of the U.S. Supreme Court that addressed the issue defined the term using court authority growing from the Corporation Tax Act of 1909. That law imposed an excise tax, measured by income, on the business of carrying on corporate activity. In *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179 (1918), the Supreme Court said that the purpose of the act was "not to tax property as such, nor the mere conversion of property." Rather, the Court said,

> The act employs the term "income" in its natural and obvious sense, as importing something distinct from principal or capital, and conveying the idea of gain or increase arising from corporate activities. *Doyle*, supra, at 179.

In 1920, the Supreme Court, in the case of *Eisner v. Macomber*, 252 U.S. 189 (1920), addressed the issue again, this time directly in the context of the 16th Amendment. There Court stated that:

> Income may be defined as the gain derived from capital, from labor, or from both combined, including profit gained through sale or conversion of capital. Mere growth or increment of value in a capital investment is not income; income is essentially a gain or profit, in itself, of exchangeable value, proceeding from capital, severed from it, and derived or received by the taxpayer for his separate use, benefit, and disposal. *Eisner*, 252 U. S. at 207.

Thereafter, a myriad of Supreme Court decisions wrestled with the question over several decades. In 1955, the Supreme Court re-visited the question in the case of *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955). In *Glenshaw Glass*, the Court offered a definition applicable to the facts of that case. The

Court stated that in order for an item to be considered income, there must be: "(1) undeniable accessions to wealth, (2) clearly realized, and (3) over which the taxpayers have complete dominion."

This is consistent with the *Eisner* definition and would seem to be a logical and quite simple application of the term. Let's examine the elements one at a time:

1. Accession to wealth. If there's no increase in one's wealth as a result of a transaction, it can hardly be argued that one incurred income. For example, the mere return of capital from a transaction does not increase one's wealth. The sale of a share of stock for $10, which stock was purchased for $10, does not increase one's wealth.

2. Realization. The "realization" of income occurs when all events have occurred that determine the taxpayer's right to receive the income and the amount can be determined with reasonable accuracy. For example, if one purchases a share of stock for $10, and the market value increases to $12, there's no "realization" of a $2 gain until the stock is sold. Only at that point is the amount of gain fixed and determinable because that is when all events have occurred that allow for the calculation.

3. Complete dominion. It cannot be said that one has income if he does not have complete control over the use, enjoyment and disposition of the item alleged to be income. Suppose a corporation in which the taxpayer is a shareholder earns a profit equal to $10 per share but the profit is not distributed. Rather, it's retained by the corporation. Undistributed gain over which the individual taxpayer has no control (he cannot use, enjoy or dispose of it) cannot be income to that taxpayer.

All of this seems logical and introduces some level of simplicity and understanding to the equation. The problem is that no U.S. court, including the U.S. Supreme Court, has fixed the definition of income so solidly as to constitute a universal definition applicable in all situations. In fact, that's exactly the conclusion that the Ninth Circuit Court of Appeals came to in the case of *Moore v. United States*, 36 F.4th 930 (9th Cir. 2022). There the Court stated that the crisp definition provided in *Glenshaw Glass* was never meant to be a "universal definition, or even a broadly applicable test." Instead, it was limited only to the facts specifically before the court at that time.

Citing to its prior decision in *United States v. James*, 333 F.2d 748 (9th Cir. 1964) (en banc), the *Moore* Court observed the difficulty of categorically defining what constitutes income in a simple formula. Rather, *James* observed that, "The courts have given a wide scope to the income tax, but have realized that the borderline content of 'income' must be determined case by case. Essentially the concept of income is a flexible one. . . ."

Said another way, "income" is whatever some court says it is at any given time; and the opinion of such court is most certainly subject to prevailing political and social influences, and not a fixed rule of law such as one would expect in a constitutional republic.

That brings us to the case of *Moore v. United States,* mentioned above. The Moores invested in a "controlled foreign corporation" which increased in value over time. It was considered a "controlled" foreign corporation because the taxpayers owned more than 10 percent of its shares. Specifically, they owned 11 percent. However, they never participated in its day-to-day operations, made no decisions on such operations, and the corporation never distributed any earnings to the shareholders. As such, the Moores never actually received any money from it; they did not "realize" any income from their ownership interest.

The problem for the Moores is the Mandatory Repatriation Tax (MRT), which was imposed by the Tax Cuts and Jobs Act in 2018. This law requires shareholders with more than 10 percent ownership to report income from a controlled foreign corporation even if such income was not received (realized). The taxpayers argued that the MRT was unconstitutional since it ran afoul of the *Glenshaw Glass* definition of income, and the broader general rule that unrealized income was historically never taxed under our tax code.

The Ninth Circuit dismissed the objections, pointing out that the *Glenshaw Glass* definition was not, as explained above, a universal definition, and that it didn't control in this case. Specifically, as to the "realization" argument, the *Moore* court stated:

> The rule that income is not taxable until realized . . . . [is] founded on administrative convenience . . . and [is] not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property. *Moore*, 36 F.4th at 936 (internal citations omitted).

What constituted the "enjoyment" of purported "income" that admittedly was never received was not addressed by the court. One must wonder how one can "enjoy" the fruits of income he does not possess and cannot use or dispose of. Regardless, the Ninth Circuit ruled that the MRT was a constitutional assessment for which the Moores were liable, regardless of the fact that the income subject to the tax is, in a very real way, phantom income.

The *Moore* case is before the Supreme Court right now, and a ruling is expected in June. If the Court agrees with the Ninth Circuit, this will open the door to a wide range of potentially new taxes, including perhaps—and most notably—a wealth tax, imposed on unrealized capital gains from an endless list of assets, such as has been promoted by radical Leftists over the past several years.

If the Supreme Court adopts the Ninth Circuit's opinion, there will simply be no limit to the reach of the federal government's tax assessment arm.

A Tutorial On Innocent Spouse Relief

Tax Court Analyzes Code § 6015 Factors

BY SCOTT MACPHERSON

The case of *Thomas v. Commissioner*, 162 T.C. No. 2 (Jan. 30, 2024) is a tutorial on Innocent Spouse relief under Code *§ 6015(f)*. Petitioner (taxpayer) Mrs. Thomas sought relief of income tax debts for three tax years (2012-2014). She and her husband filed joint returns each of those years and correctly calculated their tax due, but did not fully pay. But they did buy a year-2013 Land Rover, kept two homes, maintained a membership at a country club, and in 2016 vacationed in Europe.

Later in 2016 Mr. Thomas died. For two years thereafter, Mrs. Thomas maintained an expensive lifestyle, including trips to New York and to multiple cities in Europe, trips to Napa for wine tastings, trips to Tahoe for skiing, expensive gifts for her daughters, and college tuition for her daughters. She even maintained an online blog where she advertised this lifestyle.

Then, in late 2018, she filed bankruptcy. In her bankruptcy papers she reported a monthly income from multiple sources which, combined, exceeded $9,000; a disposable monthly income of approximately $2,000; and two homes exceeding $2 million FMV, combined. (The court added in a footnote that at trial she still had a five-carat diamond ring, too.) While the bankruptcy case was ongoing she requested Innocent Spouse relief from the IRS, which was, of course, denied.

In her Tax Court appeal for Innocent Spouse relief, the government moved to exclude letters from third parties that were in the IRS administrative record below, because the letters are hearsay. The court ruled that Fed.R.Evid. 802 provides an exception: hearsay is admissible if a federal statute says it is, and *§ 6015(e)(7)* instructs the Tax Court to review *de novo* "the administrative record established at the time of the [Innocent Spouse] determination."

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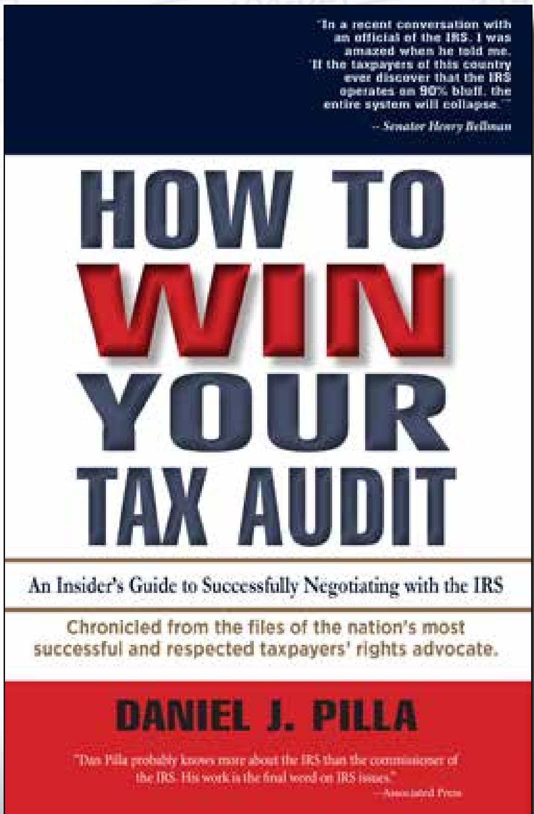

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Therefore, the Tax Court must accept into evidence whatever was in the administrative record below, hearsay or not. *Thomas* at 8.

But that does not necessarily mean the court must give the evidence any weight. The admissibility of evidence is one thing; the probative value of that evidence is something else entirely. The court pointed out, "[T]here may be questions as to whether evidence in the administrative record is probative and reliable." And further, "in determining whether evidence in the administrative record is probative and reliable, we may consider indicia of reliability such as whether a document is or contains hearsay." *Id*. at 10.

Turning then to the substance of the case, the court recited that "§ *6015* provides a requesting spouse with three alternatives: (1) full or partial relief under subsection *(b)*, (2) proportionate relief under subsection *(c)*, or (3) if relief is not available under subsection *(b) or (c)*, equitable relief under subsection *(f)*." *Id*. at 11.

Subsection *(b)* applies to understatements of tax due to errors or omissions in the return, and subsection *(c)* applies to underpayments of tax, that is, tax owed but not paid, neither of which matched this case; thus only subsection *(f)*, which is the catch-all provision for "equitable" relief, applied. *Id*. at 11.

Relief under subsection *(f)* can be granted "if, considering all of the circumstances, it would be inequitable to hold the requesting spouse liable for the unpaid tax, or any portion thereof. *Section 6015(f)* authorizes granting such equitable relief '[u]nder procedures prescribed by the Secretary.'" *Id*. at 12. The applicable procedures are found in Revenue Procedure 2013-34, which begins with "seven so-called threshold conditions that must be satisfied." The IRS conceded that the conditions were met so the court did not discuss them. *Id*. at 12. When "threshold" conditions are met, the IRS and subsequently the Tax Court look next at "streamlined" conditions:

> To be eligible for a streamlined determination, the requesting spouse must establish that she (1) is no longer married to the requesting spouse, (2) would suffer economic hardship if relief were not granted, and (3) did not know or have reason to know that the nonrequesting spouse would not or could not pay the underpayment of tax reported on the joint income tax return. *Id*. at 12.

The first streamlined condition was met by Mr. Thomas' death. The second condition failed, as discussed next, so the court never addressed the third condition.

In the context of Innocent Spouse relief, economic hardship exists "if satisfaction of the tax liability in whole or in part will cause the requesting spouse to be unable to pay reasonable basic living expenses." *Id*. at 13, quoting Rev. Proc. 2013-34, § 4.03(2)(b). The hardship is measured as of the present time, and the burden of proof is on the requesting spouse. *Id*. at 13.

Per the Rev. Proc. there are three ways a requesting spouse can demonstrate economic hardship: "by showing that (1) her annual income is below 250% of the federal poverty guidelines [which was $57,575] or (2) her monthly income exceeds her reasonable basic monthly living expenses by $300 or less." Or, third, through the totality of the facts and circumstances. *Id*. at 13.

Mrs. Thomas failed all three. For example, she provided evidence of rental income for three months that totaled $18,000. Extrapolated over just ten months of the year, that income alone would exceed the threshold of $57,575. She provided a checking account statement for only one month that showed deposits of $9,800. Extrapolated over even half the year those deposits would exceed the poverty threshold. "And Mrs. Thomas has made no effort to explain these deposits." *Id*. at 15.

At trial she testified to doing "'a lot of side hustles,' including catering and home staging, which provide her additional income," but she never said what that income was. *Id*. at 15. And making it worse, her income amounts claimed in the Tax Court brief were inconsistent with the income amounts she reported in her bankruptcy filings. *Id*. at 16.

The court also looked at her assets. Mrs. Thomas argued that after subtracting the mortgages from the fair market value of her two homes, there would not be enough left over to pay her tax debts. The court, however, found that her alleged market values were incorrect. For example, for the first home, Mrs. Thomas offered a real estate listing 3.5 years old and a letter from a friend saying that it was overpriced. But Mrs. Thomas then she testified that the value had "popped up" since then, and she did not call her friend as a witness to explain the overpricing. *Id*. at 17.

The court responded:

> Ms. Thomas has made no effort to quantify this 'pop up,' whereas the Commissioner has submitted an estimate from a well-known commercial website placing the home's value in excess of [$700k higher than what she alleged]. … Indeed, the mere fact that Ms. Thomas' lender has allowed her to remain in the home without making payments for a number of years suggests that the lender views the Moraga Property as significantly appreciated and its position as appropriately collateralized. Ms. Thomas has offered no evidence to fill these gaps or dispel these inferences. *Id*. at 17.

Further, in her bankruptcy filings she valued this property at a "much higher amount," and "accounting for intervening appreciation of the property from 2018 to the time of trial in 2022, Mrs. Thomas' equity would more than cover her debts." *Id*. at 18.

Regarding the second home, Mrs. Thomas' entire argument was based on a county tax assessment made three years before trial. "Moreover," said the court, "there is no indication that the assessed value shown in the letter actually represented the fair market value of the property at the time. It, again, is simply an assessed value for property tax purposes, and nothing in the record indicates that it was backed by a fair market value appraisal." *Id*. at 18. And as before, the government

> submitted an estimate from a well-known commercial website placing the fair market value of the [home] over $1.2 million around the time of trial. And Ms. Thomas herself testified that the "exact same home on the same side of the street" sold for $1.1 million three months before trial — exceeding what she says her property is worth by more than $400,000." *Id*. at 18-19.

"In short," the court concluded, "Ms. Thomas has not demonstrated that her equity in either of her two properties is insufficient to meet her income tax liabilities. And the record does not support her claim that selling either of the two properties to pay her federal tax liabilities would leave her without the ability to pay her reasonable basic living expenses. … Thus, she is not entitled to a streamlined determination." *Id*. at 19.

The court then turned to the last resort, the weighing of the equitable factors listed in Rev. Proc. 2013-34 at § 4.03(2). Seven "nonexclusive" factors are to be considered. They are: (1) the taxpayer's marital status, (2) whether the requesting spouse will suffer economic hardship absent relief, (3) whether the requesting spouse had knowledge or reason to know that the nonrequesting spouse would not or could not pay the income tax liabilities, (4) whether either spouse had a legal obligation to pay the liabilities, (5) whether the requesting spouse significantly benefited from the underpayments, (6) whether the requesting spouse has complied with income tax laws in the years following those to which the request for relief relates, and (7) the mental or physical health of the requesting spouse. Factor #2 was effectively decided by the preceding analysis, and only two other factors were disputed: #5, significant benefit, and #3, knowledge.

The court defined "significant benefit" as "any benefit in excess of normal support, such as owning luxury assets and taking expensive vacations." *Id*. at 23. "This factor weighs against relief if the requesting spouse received a significant benefit due to the unpaid income tax liabilities. Rev. Proc. 2013-34, § 4.03(2)(e); see also Treas. Reg. § 1.6015-2(d). But if the nonrequesting spouse controlled the household and business finances, or there was abuse such that the nonrequesting spouse made the decisions on spending for a lavish lifestyle, then this factor is neutral." *Id*.

The court concluded that Mrs. Thomas significantly benefited: two homes, the luxury vehicle, the vacations, and so on. "And to the extent that she argues that some of these purchases were made when she thought the taxes were paid, Revenue Procedure 2013-34 draws no such distinction between expenses made before a requesting spouse knows about unpaid liabilities and those made after." *Id*. at 24.

Regarding the knowledge factor, the court said, "In the case of an income tax liability that was reported but not paid, this factor weighs in favor of relief if the requesting spouse reasonably expected the nonrequesting spouse to pay the liability within a reasonable period after the filing of the return." Otherwise, this factor weighs against relief. *Id*. at 20. But, knowledge can be negated, and thus the factor will favor the requesting spouse, "if the nonrequesting spouse abused the requesting spouse or maintained control of the household finances by restricting the requesting spouse's access to financial information such that the nonrequesting spouse's actions prevented the requesting spouse from questioning or challenging payment of the liability." *Id*. at 21.

Here the evidence was mixed. Some evidence supported a finding that Mrs. Thomas knew the tax liability was not paid, while other evidence supported a finding that she did not know. And though evidence supported a finding that she was abused by her late husband, the court said it did not matter, because "even if we were to find that this factor favors relief on account of the abuse Mrs. Thomas alleges, we would find that it is outweighed by the significant benefit to her from the unpaid income tax liabilities." *Id*. at 23.

No one factor or even a majority of factors necessarily determines the outcome. The degree of importance of each factor varies depending on the requesting spouse's facts and circumstances. *Id*., quoting the Rev. Proc. at § 4.03(2). With her failure to meet the burden of proof regarding income or assets, this was an easy decision for the IRS.

Scott MacPherson *is an attorney licensed in Arizona, California, and Washington D.C. He is a member of* The MacPherson Group *of tax resolution attorneys, together with his father Mac MacPherson and brother Nathan MacPherson, all of whom are TDI members and past speakers at our* Taxpayers Defense Conference*. Scott can be reached at* maclawpllc@protonmail.com.

EDITOR'S NOTE: Our Innocent Spouse Relief Chart is a detailed "at-a-glance" analysis of the three modes of relief under code § 6015. It is available as a practice tool to all Taxpayers Defense Institute members, on our website at *www.taxhelponline.com*. Our 2018 Taxpayers Defense Conference focused heavily on innocent spouse relief. You can check with our office for availability on that material. My *Taxpayers' Defense Manual* has a chapter that fully and completely describes section 6015 relief and the procedures for obtaining it.

How You Can Ask Dan Pilla a Question

If you have questions or problems you'd like Dan Pilla to address, please write to Dan at:

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