



Documents for Podcast 016  
IRA Damage Awards and the Limits of Cohan  
September 24, 2005



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This week's podcast deals with a series of private letter rulings on lawsuit awards and attempts to deposit the proceeds into an IRA, including a recent one that gave a very taxpayer friendly result when the claims involved both IRA and taxable account management issues and an award that wasn't split between the types of accounts in the settlement agreement.

We'll also look at a recent Tax Court case that discusses the limits of using the Cohan rule—the old case involving George M. Cohan where it was held that expenses can be estimated if it is clear the taxpayer incurred the expense but records do not exist—but with limits on how generous the court will be based on the reason why the records don't exist. In this case, the court points out that to invoke Cohan you first have to give some evidence there were expenses, as well as noting the fact that the IRS gave someone a settlement in a similar case doesn't mean they have to do the same in yours.

## Private Letter Rulings

# Private Letter Ruling 200534026, 08/26/2005, IRC Sec(s). 408

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UIL No. 408.00-00; 408.03-00

## IRAs—settlement proceeds from arbitration—allocation of IRA losses—rollover.

### Headnote:

Portion of arbitration settlement proceeds received by taxpayer from his former IRA and non-IRA management co. should be treated as IRA losses incurred by taxpayer, and should be allocated between his IRA and non-IRA accounts in proportion to incurred losses. Also, receipt of portion from settlement and its contribution into taxpayer's IRA constituted valid rollover transaction.

**Reference(s):** Code Sec. 408;

### Full Text:

UICS: 408.00-00 408.03-00

JUN - 1 2005

### LEGEND:

Taxpayer A =

Taxpayer B =

Company C =

Company D =

Company E =

Bank F =

Association G =

Matter in Arbitration =

Company V =

Individual D =

Individual E =

Attorney F =

Law Firm H=

State S =

IRA X =

Date I =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

Month 1 =

Month 2 =

Month 3 =

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

Amount 5 =

Amount 6 =

Amount 7 =

Amount 8 =

Amount 9 =

Amount 10 =

Amount 11 =

Percentage 1 =

Dear

This is in response to a ruling request dated (redacted text) s supplemented by correspondence dated (redacted text) concerning the status of contributions to your individual retirement accounts (IRAs).

The facts upon which you base your request are as follows.

Taxpayer A is married to Taxpayer B. Taxpayers A and B are residents of State S. In 1999, Taxpayer A terminated employment with Company V which sponsored one or more retirement plans represented to be qualified within the meaning of section 401 (a) of the Internal Revenue Code in which Taxpayer A participated. At his termination, Taxpayer A was entitled to receive distributions from said retirement plans.

On or about Date 1, 1999, Taxpayer A opened two accounts with Company C, a firm which is a member of Association G. One of the accounts was a joint account in the names of Taxpayers A and B which was funded with their savings in the amount of Amount 1. The second account was an individual retirement account ("IRA") set up and maintained in the name of Taxpayer A, described in section 408(a) of the Internal Revenue Code ("Code"), and funded with amounts received from the qualified retirement plan(s) maintained by Company V totaling Amount 2. Amounts 1 and 2 totaled Amount 10. Individual D, employed as a financial advisor with Company C, managed Taxpayer A's Company C IRA. As of Month 1, 2000, the value of

Taxpayer A's IRA held with Company C had decreased significantly (by approximately Amount 3).

During Month 2, 2001, Taxpayer A transferred, by means of a trustee to trustee transfer, the amount remaining in his Company C IRA to another IRA set up and maintained in the name of Taxpayer A, described in section 408(a) of the Internal Revenue Code, with Company D, a firm which is a member of Association G. Individual E, employed as a financial advisor with Company D, managed Taxpayer A's Company D IRA. As of Month 3, 2002, the value of Taxpayer A's IRA held with Company D had decreased significantly (by approximately Amount 4).

On or about Date 2, 2002, Taxpayer A transferred, by means of a trustee to trustee transfer, the amount remaining in his Company D IRA to another IRA set up and maintained in the name of Taxpayer A, described in section 408(a) of the Internal Revenue Code, with Bank F.

On or about Date 3, 2003, Taxpayers A and B, instituted an Association G Arbitration proceeding against Company C and Company D ("Matter in Arbitration").

The Matter in Arbitration alleges that Individual D was employed as a financial advisor by Company C. It also alleges that Individual E was employed as a financial advisor by Company D.

The Matter in Arbitration contains a factual allegation to the effect that Company C, through Individual D, advised Taxpayers A and B to invest their funds, including Taxpayer A's IRA, contrary to their "...stated investment objectives and risk tolerance". The Matter in Arbitration also alleges that Company D, through Individual E, although aware that Taxpayers A and B were "...looking for a more conservative investment approach so as to protect the remainder of their life savings...", failed to invest their funds accordingly, but, instead, invested "...in a savings portfolio which was 95% comprised of equities and had no fixed income securities...".

Based on the above allegations and other allegations contained in the Matter in Arbitration, Taxpayers A and B alleged that the actions of Companies C and D constituted: (1) negligent misrepresentation and omission; (2) breach(es) of contract; (3) negligence; and (4) violations of State S securities law. Furthermore, the actions of Companies C and D were the proximate cause(s) of the losses suffered by Taxpayers A and B with respect to the investments (the losses referenced above-in Amounts 3 and 4).

Taxpayers A and B were represented by Attorney F, licensed to practice law in State S.

On or about Date 4, 2004, and Date 5, 2004, Taxpayers A and B entered into settlement agreement(s) with Companies C and D. In one agreement, Company E, the successor in interest to Company C, agreed to pay Taxpayers A and B Amount 5 in exchange for Taxpayers A and B dismissing, with prejudice, their claim against Company E. In the second settlement agreement, Company D agreed to pay Taxpayers A and B Amount 6 in exchange for Taxpayers A and B dismissing, with prejudice, their claim against Company D.

Amount 5 and Amount 6 totaled Amount 11.

From documentation contained in the file, it appears that the above-referenced settlement(s) were the result of "arm's-length negotiations" between various parties with adverse interests, and your authorized representative has asserted, on your behalf, that they were.

Pursuant to the settlement agreement, the Date 3, 2003 Matter in Arbitration against Companies C (now Company E) and D was dismissed.

Pursuant to the provisions of the settlement agreement reached between Taxpayers A and B and Company E, on or about Date 6, 2004, a check in the amount of Amount 5 was sent by Company E to Law Firm H, the law firm with which Attorney F was associated. On or about Date 7, 2004, said check was deposited into a Law Firm H trust account.

Pursuant to the provisions of the settlement agreement reached between Taxpayers A and B and Company D, on or about Date 8, 2004, a check in the amount of Amount 6 was sent by Company D to Law Firm H, the law firm with which Attorney F was associated. On or about Date 7, 2004, said check was deposited into a Law Firm H trust account.

The settlement agreements did not specify the portions of Amounts 5 and 6 that represented Taxpayer A's IRA losses.

On or about Date 9, 2004, Taxpayers A and B's counsel issued and delivered to said taxpayers two separate

checks totaling Amount 7 which reflected the sum of the settlement proceeds paid by Companies C and E less attorneys fees and expenses associated with the Matter in Arbitration and related settlement(s). One check totaled Amount 8, and was payable to Taxpayers A and B (jointly). The second check was in the amount of Amount 9, and was made payable to IRA X, an IRA in the name of Taxpayer A. On or about Date 10, 2004, Taxpayer A delivered said second check (the Amount 9 check) to Bank F to be placed into his IRA.

Date 10, 2004 occurred approximately 10 days after Date 9, 2004.

Date 10, 2004, occurred within 60 days of both Date 6, 2004 and Date 8, 2004.

It is represented that Amount 9 represents approximately Percentage 1 of Amount 7. Said Percentage 1 was intended to equal, or at least approximate, the percentage of losses incurred in Taxpayer A's IRA accounts held in Companies C (now Company E) and Company E as compared to the total losses suffered by Taxpayers A and B during the time Company C (now Company E) and Company D held their accounts (both IRA and non-IRA accounts).

Based upon the foregoing, you request the following rulings:

- (1) That, for purposes of determining how much, if any, of Amount 7 received as settlement proceeds by Taxpayer A, should be treated as representing IRA losses incurred by Taxpayer A, said Amount 7 should be allocated between Taxpayer A's IRA and non-IRA accounts in proportion to the loss(es) incurred in each account; and
- (2) That Taxpayer A's receipt of Amount 9 pursuant to the above described settlement(s) of arbitration proceeding(s), and its subsequent contribution into an IRA set up and maintained in his name with Bank F, constituted a valid rollover transaction within the meaning of section 408(d)(3)(A)(i) of the Internal Revenue Code.

With respect to the requested letter rulings, section 408(a) of the Code provides that, for purposes of this section, the term "individual retirement account" means a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries, but only if the written governing instrument creating the trust meets certain requirements. Among these requirements is the one found in paragraph (1) of section 408(a) which states that, except in the case of a rollover contribution described in subsection (d)(3), in section 402(c), 403(a)(4), 403(b)(8), or 457 (e)(16), no contribution will be accepted unless it is in cash, and contributions will not be accepted for the taxable year in excess of the amount in effect for such taxable year under section 219(b)(1)(A) on behalf of any individual.

Section 408(d)(1) of the Code provides the general rule for the tax treatment of distributions from IRAs. This section provides, in pertinent part, that except as otherwise provided in subsection (d), any amount paid or distributed out of an individual retirement plan or under an individual retirement annuity shall be included in gross income by the payee or distributee, as the case may be, in the manner provided under section 72.

Section 408(d)(3) of the Code establishes an exception to the contribution rules of section 408(a)(1) and the income inclusion rule of section 408(d)(1) for certain transactions characterized as rollover contributions. Under section 408(d)(3), an amount is described in paragraph (3) as a rollover contribution if it meets the requirements of subparagraphs (A) and (B).

Subparagraph (A) of section 408(d)(3) of the Code states, in pertinent part, that paragraph (1) of section 408(d) does not apply to any amount paid or distributed out of an individual retirement account or individual retirement annuity to the individual for whose benefit the account or annuity is maintained if — (i) the entire amount received (including money and any other property) is paid into an individual retirement account or individual retirement annuity (other than an endowment contract) for the benefit of such individual not later than the 60th day after the day on which he receives the payment or distribution.

Subparagraph (B) of section 408(d)(3), in short, provides that this paragraph does not apply to any amount described in subparagraph (A)(i) received by an individual from an IRA account or annuity if at any time during the 1-year period ending on the day of such receipt such individual received any other amount described in that subparagraph from an IRA account or annuity which was not includible in his gross income because of the application of this paragraph.

With respect to the requested letter rulings, it has been represented that Taxpayers A and B initiated an arbitration action against Company C (now Company E) and Company D, relating to significant losses in value of various investments, including an IRA set up and maintained in the name of Taxpayer A. The arbitration action alleged various causes of said losses of value relating to activities taken either by Company C (now Company E), Company D, or other named parties allegedly acting as the Agents of said Companies.

Said arbitration action was settled "in good faith". Pursuant to said settlement, Taxpayers A and B recovered, after attorney's fees were deducted, Amount 7 which represented losses suffered in both Taxpayer A's IRA and in non-IRA property held jointly by Taxpayers A and B. Amount 9 was rolled over into an IRA described in Code section 408(a) set up and maintained in the name of Taxpayer A within 60-days of the date Taxpayers A and B received Amount 7.

In this case, the Service has noted that Amount 1 (non-IRA monies) and Amount 2 (IRA monies) totaled Amount 10. The Service also notes that Amount 2 is approximately (slightly more) than Percentage 1 of Amount 10. Furthermore, Amount 9 (the amount rolled over into Taxpayer A's IRA) is approximately Percentage 1 of Amount 7 (the full recovery under the settlement agreements).

The above reference settlement proceeds were designed to replace a portion of Taxpayers A and B losses (IRA and non-IRA) due to alleged misconduct on the part of the above named respondents. Additionally, in this case, the Service notes that no distribution occurred until the issuance of checks in Amount 5 and Amount 6 by Company E (successor in interest to Company C) and Company D, respectively.

In this case, as indicated above, the Service notes that the settlement agreement(s) did not specify which portion(s) of Amounts 5 and 6 were allocable to Taxpayer A's IRA losses. In the absence of such specification, the Service concludes that it is appropriate to allocate a pro-rata portion of Amount 7 (Amount 9 which is approximately Percentage 1 of Amount 7) to said IRA losses.

Accordingly, based on the particular facts and circumstances presented herein, we hold that Taxpayer A's receipt of Amount 9 from Companies E and D as the replacement of a portion of his original IRA, pursuant to the above-reference arbitration action settlements, and the payment of this amount to the newly-established individual retirement account, IRA X, at Bank F, represented a valid rollover.

Thus, with respect to your ruling requests, we conclude as follows: (1). That, for purposes of determining how much, if any, of Amount 7 received as settlement proceeds by Taxpayer A, should be treated as representing IRA losses incurred by Taxpayer A, said Amount 7 should be allocated between Taxpayer A's IRA and non-IRA accounts in proportion to the loss(es) incurred in each account; and

(2) That Taxpayer A's receipt of Amount 9 pursuant to the above described settlement(s) of arbitration proceeding(s), and its subsequent contribution into an IRA set up and maintained in his name with Bank F constituted a valid rollover transaction within the meaning of section 408(d)(3)(A)(i) of the Internal Revenue Code.

This ruling letter is based on the assumption that all of Taxpayer A's IRAs were described in Code section 408(a) as represented. It also assumes that the contributory IRA set up and maintained in the name of Taxpayer A with Bank F, described above, meets the requirements of Code section 408(a) as represented. Additionally, it assumes the correctness of all facts and representations made with respect thereto.

A copy of this letter has been sent to your authorized representatives in accordance with a power of attorney on file in this office.

If you have any questions concerning this letter ruling, please contact (redacted text) Esquire (ID: (redacted text)) who may be reached a (redacted text) (not a toll-free number) or (redacted text) (FAX).

Sincerely yours,

Frances V. Sloan, Manager,

Employee Plans Technical Group 3

Enclosures:

Deleted copy of this letter

Notice of Intention to Disclose

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## Private Letter Rulings

# Private Letter Ruling 8739034, IRC Sec(s). 408

UIL No. 0408.03-00

## Headnote:

**Reference(s):** Code Sec. 408;

Private Letter Ruling 8739034

Code Sec. 408 EMPLOYEE BENEFIT PLANS -- individual retirement accounts -- rollovers .

In 1980, Employee E's Employer R terminated its profit-sharing Plan P. E rolled over distribution into IRA maintained with brokerage Corp. M, upon whose advice E invested rollover in oil and gas limited partnership, which became virtually worthless. E claimed broker had acted improperly and Stock Exchange arbitration panel awarded E total amount originally deposited in IRA and non-IRA accounts, and costs. E's Lawyer (L) deposited M's check into L's trust account, and later issued check to E from L's account. These funds were deposited in IRA at Custodian X, which characterized account as rollover IRA. RULED: E's receipt of amounts from M as replacement of original IRA, under arbitration order, and payment of these amounts to newly-established IRA at Custodian X represents valid rollover within meaning of Sec. 408(d)(3)(A)(i).

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## Full Text:

Jun. 30, 1987

This is in response to a ruling request submitted on your behalf by your authorized representative in a letter dated January 30, 1987, concerning the status of a contribution to your individual retirement account (IRA).

The facts upon which you base your request are as follows.

In 1980, your employer terminated its profit-sharing plan. You received a distribution of . . . . You rolled over this amount into an IRA maintained with Corporation M, a brokerage corporation.

Upon the advice of your broker at Corporation M, you invested the rollover IRA account in shares of an oil and gas limited partnership. You state that because of reversals in the oil and gas industry these shares became virtually worthless.

As a result of this investment, as well as other actions taken by the broker with respect to non-IRA assets entrusted to him for investment, you filed a claim under the New York Stock Exchange arbitration proceedings. The claim alleged violations of various federal and state laws governing securities trading, as well as several allegations in tort. The claim sought recovery of the total amount lost as a result of the improper actions of the broker, including the total value of the IRA. In addition, the claim sought punitive damages, attorneys fees, and interest.

On . . . , 1986, the arbitration panel awarded a total of . . . . This award consisted of \$ . . . , representing the total amount originally deposited in the IRA and non-IRA accounts, and . . . in costs. On . . . 1986, your attorney received a . . . check from Corporation M. On . . . , 1986, you endorsed the check and your attorney deposited the total amount in his trust account. On . . . , 1986, your attorney issued a check payable to you from his trust account. The amount of this check was . . . , the same amount sought in arbitration to replace the worthless IRA. On . . . , 1986, these funds were deposited in an IRA at Custodian X. Custodian X characterized the account as a rollover IRA.

Based upon the foregoing, you request the following ruling:

That your receipt of those amounts from Corporation M as replacement of the original IRA, pursuant to the order of the New York Stock Exchange arbitrators, and the payment of these amounts to the newly-established IRA at Custodian X, represents a valid rollover within the meaning of section 408(d)(3)(A)(i) of the Internal Revenue Code.

Section 408(a) of the Code provides that, for purposes of this section, the term "individual retirement account" means a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries, but only if the written governing instrument creating the trust meets certain requirements. Among these requirements is the one found in paragraph (1) of section 408(a) which states that, except in the case of a rollover contribution described in subsection (d)(3), in section 402(a)(5), 402(a)(7), 403(a)(4), or 403(b)(8), no contribution will be accepted unless it is in cash, and contributions will not be accepted for the taxable year in excess of \$2000 on behalf of any individual.

Section 408(d)(1) of the Code provides the general rule for the tax treatment of distributions from IRAs. This section provides, in pertinent part, that except as otherwise provided in subsection (d), any amount paid or distributed out of an individual retirement plan or under an individual retirement annuity shall be included in gross income by the payee or distributee, as the case may be, for the taxable year in which the payment or distribution is received.

Section 408(d)(3) of the Code establishes an exception to the contribution rules of section 408(a)(1) and the income inclusion rule of section 408(d)(1) for certain transactions characterized as rollover contributions. Under section 408(d)(3), an amount is described in paragraph (3) as a rollover contribution if it meets the requirements of subparagraphs (A) and (B).

Subparagraph (A) of section 408(d)(3) of the Code states, in pertinent part, that paragraph (1) of section 408(d) does not apply to any amount paid or distributed out of an individual retirement account or individual retirement annuity to the individual for whose benefit the account or annuity is maintained if--(i) the entire amount received (including money and any other property) is paid into an individual retirement account or individual retirement annuity (other than an endowment contract) for the benefit of such individual not later than the 60th day after the day on which he receives the payment or distribution.

You represent that your attorney received the check on . . . , 1986, and that it was delivered to and endorsed by you on . . . , 1986. The IRA was established and the contribution made thereto on . . . , 1986. Consequently, the contribution to the successor IRA was completed within 60 days of receipt of the distribution from Corporation M.

The New York Stock Exchange arbitration order was designed to replace the wasted IRA trust assets. Thus, no distribution occurred until the issuance of the check by Corporation M.

Accordingly, we conclude that your receipt of those amounts from Corporation M as the replacement of the original IRA, pursuant to the order of the New York Stock Exchange arbitrators, and the payment of these amounts to the newly-established individual retirement account at Custodian X, represents a valid rollover within the meaning of section 408(d)(3)(A)(i) of the Code.

A copy of this letter has been sent to your authorized representatives in accordance with a power of attorney on file in this office.

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## Private Letter Rulings

# Private Letter Ruling 7935130, 6/05/1979, IRC Sec(s). 402

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UIL No. 0402.00-00

## Headnote:

**Reference(s):** Code Sec. 402;

Private Letter Ruling 7935130

Code Sec. 402 EMPLOYEE BENEFIT PLANS -- employees' trusts -- taxation of benefits -- funds not actually distributed from terminated plan.

IRS ruled that amount paid to X by corp. in satisfaction of pension obligation under employment contract isn't eligible for tax-free rollover treatment. X signed 4-year employment contract with corp. in 1975, terms of which included certain pension benefits. In 1977, corp. terminated its pension plan and eliminated X's job. In subsequent arbitration proceeding in 1978 corp. paid X \$4,750 representing pension benefits under 4-year contract. IRS ruled that settlement amount can't be imputed to terminated plan because no amounts were actually distributed to X from the plan.

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## Full Text:

June 5, 1979

In letters dated December 23, 1978, and March 28, 1979, you requested a ruling with regard to whether you are eligible for a tax-free rollover into an Individual Retirement Account (IRA) of a payment made by your former employer (Company O) representing your equity in a pension plan which was terminated.

During January and February, 1975, you negotiated an employment agreement with Company O, a wholly-owned subsidiary of Company P. A major factor in this negotiation was your expected benefits from participation in Company O's pension plan. You signed your employment agreement with Company O on April 1, 1975.

In February, 1977, you learned that Company O had dropped its pension trust, apparently in order to avoid the funding requirements of the Employee Retirement Income Security Act of 1974 (ERISA).

On March 31, 1977, you were advised that your job position was being eliminated. In June, 1978, you filed for arbitration with the American Arbitration Association for a number of items owed you under your employment agreement, one of which covered the equity owed you under the pension plan provision of your employment agreement.

On October 10, 1978, a pre-arbitration hearing settlement negotiation was conducted as a result of which you received the value, calculated by an outside actuarial consultant, of the pension assets in the amount of \$4,750. This amount reflects your pension benefits for the 4-year contract of employment. This amount, along with the other settlement claim items, was paid to you by Company O in a check dated November 22, 1978, which you received through your lawyer in early December, 1978. You placed the \$4,750 in an IRA with Bank O as trustee on December 21, 1978.

You agreed in a conference held on April 30, 1979, that only about 50 percent of the settlement could reflect amounts paid to you under the pension plan since you assert the plan was in existence for only two years of the four years covered under your employment contract.

In accordance with the foregoing, you request a ruling that the portion of the Company O settlement

payment reflecting the pension obligation under your employment contract, is eligible for a tax-free rollover into an IRA.

Section 402(a)(1) of the Code provides, as a general rule, that the amount actually distributed or made available to any distributee by an employees trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to him in the year in which so distributed or made available.

An exception to this rule is provided in section 402(a)(5) of the Code. Section 402(a)(5) provides that if the balance to the credit of an employee in a qualified trust is paid to him in a qualifying rollover distribution, and the employee transfers any portion of the property he receives in such distribution, within 60 days of receipt by the employee, to an eligible retirement program (such as an IRA), then such distribution (to the extent so transferred) shall not be includable in gross income for the taxable year in which paid. The term 'qualifying rollover distribution' means one or more distributions within one taxable year of the employee, for example, on account of a termination of the plan of which the trust is a part.

Public Law 94-267 amended section 402(a)(5) of the Code to provide tax-free rollover treatment where the balance to the credit of an employee is paid to him from a qualified trust on account of plan termination. This new Code provision is applicable to plan termination distributions made to employees after July 4, 1974. The 60-day period within which the qualified distribution from a terminated plan must have been rolled over did not expire until December 31, 1976. In other words, the plan termination rollover time period expired on the later of December 31, 1976, or 60 days after the distributee received the distribution from the plan.

However, since the terminated pension plan of Company O did not distribute any amounts to you, the settlement amounts paid by Company O cannot be imputed to the terminated plan based on the retroactive rollover rules. The retroactive rollover rules permit a tax-free rollover of only an amount equal to the amount that was distributed by the plan. In your case, the terminated plan did not distribute anything to you.

Therefore we conclude, with regard to your ruling request, that the portion of the Company O settlement payment made to you in satisfaction of their pension obligation under your employment contract, which amounts to \$4,750, is not eligible for a tax-free rollover to an IRA.

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T.C. Memo. 2005-212

UNITED STATES TAX COURT

CHAY R. STEWART, Petitioner y.  
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 10829-04.

Filed September 12, 2005.

Chay R. Stewart, pro se.

Lorraine D. Masano and Francis C. Mucciolo, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

COLVIN, Judge: Respondent determined deficiencies in petitioner's income tax of \$53,524 for 2000 and \$81,458 for 2001 and that petitioner is liable for additions to tax for failure to file under section 6651(a)(1) of \$13,381 for 2000 and \$20,364.50 for 2001 and for failure to pay estimated tax under section 6654 of \$2,858.96 for 2000 and \$3,255.36 for 2001.

The issues for decision are:

1. Whether respondent's determination of petitioner's income tax deficiencies for 2000 and 2001 is valid. We hold that it is.

2. Whether petitioner was denied equal protection and due process of law because respondent failed to allow business expense deductions based on statistical information. We hold that he was not.

3. Whether petitioner is liable for additions to tax for failure to file under section 6651(a) and for failure to pay estimated tax under section 6654(a). We hold that he is.

4. Whether petitioner is liable for a penalty under section 6673 for instituting proceedings primarily for delay and for maintaining frivolous or groundless positions. We hold that he is not.

Section references are to the Internal Revenue Code.

#### FINDINGS OF FACT

The parties submitted this case fully stipulated under Rule 122.

#### A. Petitioner

Petitioner lived in Ormond Beach, Florida, when he filed his petition. In 2000 and 2001, petitioner sold insurance and financial products for which he received commissions. He received the following payments:

<u>Payor</u>	<u>2000</u>	<u>2001</u>	<u>Type of payment</u>
Midland Natl. Life Ins. Co.	\$129,829	\$221,795	commissions
Lifeusa Ins. Co.	17,812		commissions
Financial Brokerage, Inc.	8,646	3,008	commissions
Fidelity & Guaranty Life Ins.		1,050	commissions
American Equity Inv. Life Ins		6,017	commissions
Charles Schwab & Co.	541	96	interest
Commercial Bank of Volusia County	<u>682</u>	<u>481</u>	interest
	\$157,510	\$232,447	

Petitioner filed no Federal income tax returns and made no estimated tax payments for 2000 and 2001. No Federal income tax was withheld from his income for 2000 and 2001.

B. Respondent's Determination

In the notice of deficiency, respondent determined that petitioner had received but failed to report self-employment income from commissions in the amounts of \$156,287 in 2000 and \$231,870 in 2001 and interest income in the amounts of \$1,223 in 2000 and \$577 in 2001. Respondent determined that petitioner's filing status was single and that he was entitled to claim the standard deduction and one exemption. Respondent determined that petitioner was liable for additions to tax for failure to file

under section 6651(a)(1) and failure to pay estimated tax under section 6654.

OPINION

A. Whether Respondent's Determination of Petitioner's Deficiencies in Income Tax for 2000 and 2001 Is Valid

Petitioner contends that respondent prepared only "dummy returns"<sup>1</sup> for 2000 and 2001, and that respondent's determination of his deficiencies in income tax for 2000 and 2001 is invalid because respondent did not prepare for each year a substitute return that qualified under section 6020(b).<sup>2</sup> We disagree.

Petitioner's contention that the Commissioner must file a substitute for return under section 6020(b) before determining a

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<sup>1</sup> A "dummy return" is generated to open an account for the taxpayer on the master file and normally consists of a first page of a Form 1040, U.S. Individual Income Tax Return, which contains a taxpayer's name, address, and Social Security number. Internal Revenue Manual, Chief Counsel Directives Manual-Tax Litigation, sec. 35.4.27.2 (Nov. 16, 1999); see Spurlock v. Commissioner, T.C. Memo. 2003-124 n.18.

<sup>2</sup> Sec. 6020(b) provides:

SEC. 6020(b). Execution of Return by Secretary.--

(1) Authority of Secretary to execute return.--If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed therefor, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise.

(2) Status of returns.--Any return so made and subscribed by the Secretary shall be prima facie good and sufficient for all legal purposes.

deficiency is frivolous. Schiff v. United States, 919 F.2d 830, 832-833 (2d Cir. 1990).

The Commissioner need not prepare a substitute for return under section 6020(b) in order to determine a deficiency for a taxpayer who has not filed a return for that year. Roat v. Commissioner, 847 F.2d 1379, 1381 (9th Cir. 1988); Hartman v. Commissioner, 65 T.C. 542, 545 (1975); Burnett v. Commissioner, T.C. Memo. 2002-181, affd. without published opinion 67 Fed. Appx. 248 (5th Cir. 2003). Where a taxpayer files no return, respondent may determine the deficiency as if a return had been filed on which the taxpayer reported the amount of tax due was zero; the deficiency is the amount of tax due. Laing v. United States, 423 U.S. 161, 174 (1976); Schiff v. United States, supra; Roat v. Commissioner, supra.

B. Whether Petitioner Was Denied Equal Protection and Due Process of Law Because Respondent Failed To Allow Business Expense Deductions Based on Statistical Information for His Industry

Petitioner contends that he was denied equal protection and due process of law because respondent failed to allow business expense deductions based on statistical information for his insurance and financial products industry. We disagree.

A taxpayer may deduct all ordinary and necessary expenses paid or incurred in carrying on a trade or business. Sec. 162(a). Taxpayers are required to maintain records that sufficiently establish the amount of claimed deductions. Sec.

6001; sec. 1.6001-1(a), Income Tax Regs. Petitioner bears the burden of proof. Rule 142(a).<sup>3</sup>

If a taxpayer establishes that he or she paid a deductible expense but cannot substantiate the precise amount, we may estimate the amount of the deductible expense. Cohan v. Commissioner, 39 F.2d 540, 544 (2d Cir. 1930); Vanicek v. Commissioner, 85 T.C. 731, 742-743 (1985). The taxpayer must present credible evidence that provides a rational basis for our estimate. Vanicek v. Commissioner, supra. We may estimate the taxpayer's expenses bearing heavily against the taxpayer whose "inexactitude is of his own making." Cohan v. Commissioner, supra; Maciel v. Commissioner, T.C. Memo. 2004-28.

Petitioner asks us to estimate the amount of his business expense deductions under Cohan and contends that he is entitled to deductions based on statistical information for the insurance and financial products industries. We disagree. Cohan does not apply because petitioner did not present evidence (statistical or otherwise) that he incurred deductible expenses greater than the amount of the standard deduction allowed by respondent. Thus, we have no basis to estimate the amount of his deductible expenses.

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<sup>3</sup> Petitioner does not contend that the burden of proof shifts to respondent under sec. 7491(a).

Citing Brenner v. Commissioner, T.C. Memo. 2004-202, petitioner contends that respondent routinely allows more than 50 percent of a taxpayer's gross compensation for business expenses for a taxpayer in petitioner's business and location. We disagree. Like petitioner, the taxpayer in Brenner v. Commissioner, supra, was in the insurance business and lived in Ormond Beach, Florida, when he filed his petition. The Commissioner used the bank deposits method to reconstruct his income. The Commissioner allowed the taxpayer to deduct estimated insurance business expenses equal to 54.77 percent of his commissions based on the Statistics of Labor Bulletin, Sole Proprietorship Returns, 1994, Table 2.--Nonfarm Sole Proprietorships: Income Statements, by Selected Groups: Insurance agents and brokers (statistics for insurance agents).

The Commissioner's allowance of business expenses based on Bureau of Labor Statistics figures in Brenner does not establish that respondent routinely allows a business deduction based on statistics or industry averages or that respondent is required to use them. Our responsibility as a Court is to apply the law to the facts of the case before us; how the Commissioner treated other taxpayers is generally irrelevant in making that determination, Davis v. Commissioner, 65 T.C. 1014, 1022 (1976); Teichgraeber v. Commissioner, 64 T.C. 453, 456 (1975), absent proof that a taxpayer has been singled out for adverse treatment

based on impermissible considerations such as race, religion, or other arbitrary classification, and absent contractual agreements to the contrary, Estate of Campion v. Commissioner, 110 T.C. 165, 170 (1998), affd. without published opinion sub nom. Drake Oil Tech. Partners v. Commissioner, 211 F.3d 1277 (10th Cir. 2000), and Tucek v. Commissioner, 198 F.3d 259 (10th Cir. 1999); Norfolk S. Corp. v. Commissioner, 104 T.C. 13, 58-59, supplemented by 104 T.C. 417 (1995), affd. 140 F.3d 240 (4th Cir. 1998); Davis v. Commissioner, *supra*.

We conclude that petitioner is not entitled to business deductions based on statistical information and that he was not denied equal protection or due process of law because respondent did not allow such deductions.

C. Additions to Tax

Section 7491(c) places on the Commissioner the burden of producing evidence that it is appropriate to impose additions to tax. To meet that burden, the Commissioner must produce evidence showing that it is appropriate to impose the particular addition to tax, but the Commissioner need not produce evidence relating to defenses such as reasonable cause or substantial authority. Higbee v. Commissioner, 116 T.C. 438, 446 (2001); H. Conf. Rept. 105-599, at 241 (1998), 1998-3 C.B. at 995. Respondent has met the burden of production under section 7491(c) with respect to the addition to tax for failure (1) to file under section

6651(a)(1) because the record shows that petitioner was required to file but has not filed a return for 2000 and 2001; and (2) to make estimated tax payments under section 6654(a) because the record shows that he did not make estimated tax payments with respect to his tax liability for 2000 or 2001.

Petitioner offers no defense to the additions to tax determined by respondent. We conclude that he is liable for the additions to tax for failure to file under section 6651(a)(1) of \$13,381 for 2000 and \$20,364.50 for 2001 and for failure to pay estimated tax under section 6654(a) of \$2,858.96 for 2000 and \$3,255.36 for 2001.

D. Whether Petitioner Is Liable for a Penalty Under Section 6673

Respondent alleges for the first time on brief that petitioner is liable for a penalty under section 6673 because he made only frivolous arguments. Petitioner contends that he is not liable for a penalty under section 6673 because (1) his arguments are supported by a reasoned argument for a change in case authority, and (2) the majority of cases hold that the Commissioner cannot determine a deficiency for a year for which the taxpayer did not file a return.

The Court may impose a penalty of up to \$25,000 if the position or positions asserted by the taxpayer in the case are frivolous or groundless or the proceedings were instituted primarily for delay. Sec. 6673(a)(1)(B). A position maintained

by the taxpayer is frivolous if it is contrary to established law and is not supported by a reasoned, colorable argument for change in the law. Coleman v. Commissioner, 791 F.2d 68, 71 (7th Cir. 1986); Gilligan v. Commissioner, T.C. Memo. 2004-194.

Petitioner's contention that the Commissioner cannot determine a deficiency for a year for which a taxpayer did not file a return is frivolous. Scruggs v. Commissioner, T.C. Memo. 1995-355, affd. without published opinion 117 F.3d 1433 (11th Cir. 1997); Zyglis v. Commissioner, T.C. Memo. 1993-341, affd. without published opinion 29 F.3d 620 (2d Cir. 1994).

However, not all of petitioner's arguments are frivolous. For example, petitioner contended in his pretrial memorandum that respondent is required to reduce petitioner's gross receipts by the average business expense for the insurance industry. Petitioner pointed out that in Brenner v. Commissioner, T.C. Memo. 2004-202, the Commissioner allowed as a business expense deduction 54.77 percent of the gross receipts of a nonfiling taxpayer from Ormond Beach, Florida, who sold insurance and financial products.

We do not impose a penalty under section 6673 because not all of petitioner's arguments are frivolous. However, we warn petitioner that the Court may impose this penalty in the future if he makes frivolous arguments or institutes proceedings primarily for delay.

To reflect the foregoing,

Decision will be  
entered for respondent.