

# **TAX ALERTS NEWSLETTER**

## **Decisions from Supreme Court, US Tax Court, Circuit Courts, (October, 2020)**

Welcome to the latest edition of our Newsletter where we share case developments in the legal area of tax decisions. This month we highlight Hobby Losses which features changes in the law and recent decisions so the IRS will not disallow your deductions. The cites of the cases are included so you can look up the complete decision, you can also call Jerry Merola, Esq. if you want to discuss a problem.

*Lauren McDougall, Editor.*

### **BUSINESS TAX**

When you have a side business besides your main source of income and report a loss on the Schedule C of your 1040 return, it raises concerns to the IRS auditors.

This red flag gets set off if you get a majority of your income from a different source. Remember, the Schedule C is the most audited schedule, your tax planning should also consider a different entity.

In a recent Tax Court case, an individual, after reporting his wages of \$176,000 from his regular job, also had a Schedule C loss of \$40,000, the IRS audited him because of the deductions taken.

Ultimately, he was unable to explain his expenses and the IRS disallowed most of the deductions. Business expenses, to be deductible, must be ordinary

and necessary and paid or incurred in carrying on a trade or business, a taxpayer is required to keep records to substantiate items reported or claimed on a return. (Pilyavsky, TC Summ. Op. 2020-20).

It is imperative and legally required to keep good records. Save receipts! *Editor's Note*

### **REAL ESTATE**

When you owe taxes or have entered into an installment payment plan with the IRS, a Tax lien may be filed with the County Clerk on real estate and can follow the property when it is sold. A buyer learned the hard way after buying in a house in a foreclosure sale.

Two years earlier the Service had recorded its notice of tax lien on the property after the former owner was in arrears on income taxes. A District court says the

IRS can enforce its lien against the new owner.

In another case, taxpayers bought property with a large house to renovate it. They expended significant effort and money in restoring the property taking them six years. During this time, no one lived in the house.

Giving up, they sold the property for a substantial loss one year after the renovation was complete and tried to deduct the loss as an ordinary loss as they claimed they were in the rental business. The 2<sup>nd</sup> Circuit said the loss was not ordinary but a capital loss, taxpayers did not engage in any rental activities. (Keefe, No. 18-2357 (2<sup>nd</sup> Cir. 2020).

### **TAX REFUNDS**

Usually there is three year statute-of-limitations filing for a tax refund, this can be extended when taxpayers are unable to manage their financial affairs because of a

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**GREENBERG &  
MEROLA, LLP**

521 Fifth Avenue, Suite 1700, New York, NY 10175  
2280 Grand Avenue, Suite. 202, Baldwin, NY 11510

Additional conference offices: Brooklyn, Queens,  
Bronx, Nassau, Suffolk, Westchester

[www.greenbergmerola.com](http://www.greenbergmerola.com)

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diagnosed serious long-term physical or mental impairment.

Severe mental illness can be grounds for allowing a late-filed refund claim. In this case a taxpayer who was declared legally insane in a criminal trial and is now in a federal psychiatric facility, filed a refund claim with the IRS. (Wattleton, D.C., D.C.)

The court will consider this case even though it is regarding taxes from 20 years ago. We'll keep you posted. *Editor's Note*

## **PENALTY ABATEMENT**

You can get penalties abated by the IRS if you have reasonable cause and this can add up to many thousands of dollars. We have gotten penalties reduced or eliminated based on sickness, addiction, wrong advice from a professional, etc.

In this case, a tax attorney, of all people, was audited by the IRS and was assessed a substantial underpayment penalty (more than 10% of the tax required to be shown on the return or \$10,000 whichever is greater, the penalty will be an additional 20% of the understatement).

The attorney claimed that he relied on the advice in good faith of a tax professional. The Tax Court didn't buy this or his other arguments and the penalty was sustained. (Babu, TC Memo. 2020-121)

## **HOBBY LOSSES**

Historically, deductions from activities that are not engaged in for profit were limited to the gross income from the activity; deductions from hobby losses could be used to show zero income and so no tax.

The Tax Cuts and Jobs Act eliminates deductions for miscellaneous expenses, including those attributable to hobbies. So now you would have to report that income with no benefits from deductions. Now more than ever you would want that hobby (e.g. horse farms) to be considered a business.

Courts have relied on the following factors to distinguish a business from a hobby:

-The manner in which you carry on the activity.

-The time and effort you expend in carrying on the activity.

-Your history of income or losses with respect to the activity.

-Any elements of personal pleasure or recreation.

In a recent case, the taxpayer, a resident of South Dakota, was engaged in the breeding, training and showing of horses. He has claimed annual losses from these activities dating back to 1997.

The Tax Court determined that the taxpayer demonstrated a profit motive, his activities included breeding, raising, boarding, training and selling registered cutting horses. He participated in competitions and achieved national success. Thus, his losses were deductible. (Den Besten, TC Memo 2019-154.)

### **Factors the IRS considers when making audit decisions about hobby losses:**

1. A taxpayer in a hobby suspect operation should make certain that he functions as would any prudent businessperson- maintaining

and periodically analyzing financial records.

2. Taxpayers should be able to prove that they attempted to become knowledgeable.

3. IRS strongly favors taxpayers who have either employed competent workers under their supervision or performed all of the work themselves.

4. It looks like you're trying to make money, you have a profit motive, doing it like a real business e.g. advertising.

## **FILING DEADLINES**

In a recent case, a business received a Notice of Determination sustaining a tax levy against them.

They had 30 days to petition Tax Court to preserve their rights; they mailed the petition on day 31, missing the deadline. (Boechler, P.C. No.19-2003 (8<sup>th</sup> Cir. 2020))

If you receive a Notice of Deficiency you have 90 to file a petition, the Tax Court doesn't mean 91 days. A Notice of Determination is due in 30 days, not 31 days and these are calendar days for both.

There is no appeal from either of these and you will be at the mercy of the IRS. Be careful! This is grounds for a malpractice lawsuit which you will lose.

*Editor's Note*

"... to tax and to please, no more than to love and be wise, is not given to men..."

-- Edmund Burke 1774