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Gross Income Under IRC § 61 and Related Sections

SUMMARY

When preparing tax returns, taxpayers must complete the crucial calculation of gross income for the taxable year to determine the tax they must pay. Gross income has been among the Most Litigated Issues in each of the National Taxpayer Advocate's Annual Reports to Congress.¹ For this report, we reviewed 81 cases decided between June 1, 2015, and May 31, 2016. Several of the cases involved taxpayers failing to report items of income, including some specifically mentioned in Internal Revenue Code (IRC) § 61 such as wages,² interest,³ dividends,⁴ and annuities.⁵

TAXPAYER RIGHTS IMPACTED⁶

- *The Right to Be Informed*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

IRC § 61 broadly defines gross income as “all income from whatever source derived.”⁷ The U.S. Supreme Court has defined gross income as any accession to wealth.⁸ Over time, however, Congress has carved out numerous exceptions and exclusions from this broad definition of gross income and has based other elements of tax law on the definition.⁹

The Commissioner of Internal Revenue may identify particular items of unreported income or reconstruct a taxpayer's gross income using methods such as the bank deposits method.¹⁰ If the Commissioner of Internal Revenue determines a tax deficiency, the IRS issues a Statutory Notice

1 See, e.g., National Taxpayer Advocate 2015 Annual Report to Congress 476-80 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*); National Taxpayer Advocate 2014 Annual Report to Congress 472-76 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*); National Taxpayer Advocate 2013 Annual Report to Congress 355-61 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*).

2 Internal Revenue Code (IRC) § 61(a)(1). See, e.g., *Green v. Comm'r*, T.C. Memo. 2016-67.

3 IRC § 61(a)(4). See, e.g., *Friedman v. Comm'r*, T.C. Memo. 2015-177.

4 IRC § 61(a)(7). See, e.g., *Bell v. Comm'r*, T.C. Memo. 2015-111, *appeal docketed*, No. 16-70166 (9th Cir. Jan. 19, 2016).

5 IRC § 61(a)(9). See, e.g., *Tobias v. Comm'r*, T.C. Memo. 2015-164.

6 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a), 129 Stat. 2242, 3117 (2015) (codified at IRC § 7803(a)(3)).

7 IRC § 61(a).

8 *Comm'r v. Glenshaw Glass*, 348 U.S. 426, 431 (1955) (interpreting § 22 of the IRC of 1939, the predecessor to IRC § 61).

9 See, e.g., IRC § 104 (compensation for injuries or sickness); IRC § 105 (amounts received under accident and health plans); IRC § 108 (income from discharge of indebtedness); IRC § 6501 (limits on assessment and collection, determination of “substantial omission” from gross income).

10 IRC § 6001. See, e.g., *DiLeo v. Comm'r*, 96 T.C. 858, 867 (1991).

of Deficiency.¹¹ If the taxpayer challenges the deficiency, the Commissioner's notice is entitled to a presumption of correctness; the taxpayer generally bears the burden of proving that the determination is erroneous or inaccurate.¹²

ANALYSIS OF LITIGATED CASES

In the 81 opinions involving gross income issued by the federal courts and reviewed for this report, gross income issues most often fall into two categories: (1) what is included in gross income under IRC § 61 and (2) what can be excluded under other statutory provisions. A detailed list of the cases appears in Table 4 of Appendix 3.

In 32 cases (40 percent), taxpayers were represented, while the rest were *pro se* (without counsel). Represented taxpayers prevailed in full or in part in five of 32 cases (16 percent), whereas *pro se* taxpayers prevailed in full or in part in three of 49 cases (six percent). Overall, taxpayers prevailed in full or in part in eight of 81 cases (ten percent).

Drawing on the full list in Table 4 of Appendix 3, we have chosen to discuss cases involving damage awards, disability benefits, Individual Retirement Account (IRA) distributions, cancellation of debt income, and the recognition of income from participation in a compensatory split-dollar life insurance arrangement.

Damage Awards

Taxation of damage awards continues to generate litigation. This year, taxpayers in at least four cases (five percent of those reviewed) challenged the Commissioner's inclusion of damage awards in their gross income, but no taxpayers prevailed in these cases.¹³

IRC § 104(a)(2) specifies that damage awards and settlement proceeds¹⁴ are taxable as gross income unless the award was received "on account of personal physical injuries or physical sickness."¹⁵ Congress added the "physical injuries or physical sickness" requirement in 1996;¹⁶ until then, the word "physical" did not appear in the statute. The legislative history of the 1996 amendments to IRC § 104(a)(2) provides that "[i]f an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness ... [but] emotional distress is not considered a physical injury or physical sickness."¹⁷ Thus,

11 IRC § 6212. See also Internal Revenue Manual (IRM) 4.8.9.2, *Notice of Deficiency Definition* (Aug. 11, 2016).

12 See IRC § 7491(a) (stating that the burden shifts only where the taxpayer produces credible evidence contradicting the Commissioner's determination and satisfies other requirements). See also *Welch v. Helvering*, 290 U.S. 111, 115 (1933) (citations omitted).

13 In *Smallwood*, the taxpayer appealed the district court's grant of summary judgment in favor of the United States. The Court of Appeals for the Federal Circuit concluded that the district court failed to make a determination of what dollar amount of the taxpayer's settlement proceeds was attributable to her physical injuries or physical sickness within the meaning of § 104(a)(2) and therefore excludible from gross income, and consequently vacated and remanded the case to the district court for further proceedings. While the case is characterized as a win for the taxpayer in Table X.X, whether the taxpayer will prevail on the merits will be determined in a further proceeding.

14 See Treas. Reg. § 1.104-1(c) (damages received, for purposes of IRC § 104(a)(2), means amounts received "through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of such prosecution").

15 IRC § 104(a)(2).

16 Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838 (1996).

17 H.R. REP. No. 104-586, at 143-44 (1996) (Conf. Rep.).

damage awards for emotional distress are not considered as received on account of physical injury or physical sickness, even if the emotional distress results in “insomnia, headaches, [or] stomach disorders.”¹⁸

To justify exclusion from income under IRC § 104, the taxpayer must show settlement proceeds are in lieu of damages for physical injury or sickness, and this is frequently difficult to prove unless explicit in the damage award.¹⁹ In *O'Connor v. Commissioner*, the taxpayer petitioned the Tax Court, and later appealed to the U.S. Court of Appeals for the Ninth Circuit, to exclude from his gross income payments he received from Covance Clinical Research Unit, Inc., for his participation in a gout medical study.²⁰ The taxpayer argued that the payment should be excluded from gross income as compensation received on account of physical injury or physical sickness.²¹ The gout study required the taxpayer to spend ten days confined to a medical facility where he adhered to a strict schedule including blood tests, urine tests, electrocardiograms, and vital screenings. He was also required to participate in outpatient visits after the inpatient stay was completed. The taxpayer received a Form 1099-MISC, *Miscellaneous Income*, from Covance but did not report the \$5,550 received on his 2008 Form 1040, *U.S. Individual Income Tax Return*.

As discussed above, the court looks for a “direct causal link” between the damages received and the physical injury or sickness sustained.²² However, because the taxpayer did not allege that he suffered physical injury or sickness on account of the study and had even suffered from gout before participating in the study, the court determined that he had not established a “direct causal link” between the payment and the gout from which he suffered. Furthermore, the taxpayer failed to produce the written contract with Covance to participate in the study and, due to this failure, the court held that “[m]ere participation in [a] study does not result in compensation for damages received on account of physical injury or physical sickness.”²³ As a result, the Ninth Circuit affirmed the Tax Court’s decision that the payment for the taxpayer’s participation in a medical research study was not excludible from gross income.²⁴ This appellate-level decision demonstrates that the courts look to the specific language of a settlement agreement or contract to determine whether damages are attributable to a physical injury or sickness sustained. Similarly, in *Dulanto v. Commissioner*, the Tax Court looked to the nature of the claim that was the actual basis for the settlement and rejected the taxpayer’s position that the damages the former employer paid as part of the settlement agreement for the resolution of claims in a class action lawsuit were not included in gross income.²⁵

As illustrated by continuing litigation of the characterization of settlement damages, the question of when damage awards can be excluded from gross income continues to confuse taxpayers. Although we did not identify any cases this year in which the courts specifically addressed mental illness, the National Taxpayer Advocate remains concerned that taxpayers continue to disagree with the IRS and courts’ interpretation that mental illness equates to emotional distress as opposed to physical sickness or injury. In the same

18 H.R. REP. NO. 104-737, at 301 (1996) (Conf. Rep.). Note, however, that IRC § 104(a)(2) excludes from income damages, up to the cost of medical treatment for which a deduction under IRC § 213 was allowed for any prior taxable year, for mental or emotional distress causing physical injury.

19 See, e.g., *Green v. Comm’r*, 507 F.3d 857 (5th Cir. 2007), *aff’g* T.C. Memo. 2005-250.

20 *O’Connor v. Comm’r*, 606 F. App’x 390 (9th Cir. 2015), *aff’g* T.C. Memo. 2012-317.

21 In the alternative, the taxpayer argued that the payment should be treated as a gift, under IRC § 102(a), which allows the exclusion from gross income the value of property acquired by gift, bequest, devise, or inheritance.

22 See *Lindsey v. Commissioner*, 422 F.3d 684, 688 (8th Cir. 2005), *aff’g* T.C. Memo. 2004-113.

23 *O’Connor v. Comm’r*, T.C. Memo. 2012-317.

24 *O’Connor v. Comm’r*, 606 F. App’x 390, 391 (9th Cir. 2015), *aff’g* T.C. Memo. 2012-317.

25 *Dulanto v. Comm’r*, T.C. Memo. 2016-34 (citing *U.S. v. Burke*, 504 U.S. 229, 237 (1992), *appeal docketed*, No. 16-72867 (9th Cir. Aug. 29, 2016)).

way that a physical injury or sickness may have mental or emotional side effects, many mental illnesses manifest themselves as physical symptoms. For instance, many people who have severe depression experience the following physical symptoms: stomachaches, indigestion, constant headaches, tightness in the chest, difficulty breathing, and fatigue.²⁶ Physical symptoms occur in other mental disorders, such as Post-Traumatic Stress Disorder (PTSD), which affects people who have experienced a traumatic event, such as mugging, rape, torture, being kidnapped or held captive, child abuse, car accidents, train wrecks, plane crashes, bombings, natural or human-caused disasters, or military combat.²⁷ Current research shows that the experience of trauma can cause neurochemical changes in the brain that create a vulnerability to hypertension and atherosclerotic heart disease, abnormalities in thyroid and other hormone functions, and increased susceptibility to infections and immunologic disorders that are associated with PTSD.²⁸ As discussed in the 2009 Annual Report to Congress, the interpretation that mental illness equates to emotional distress seems particularly outdated when considering the medical advancements in understanding the physical cause and symptoms of mental illness.²⁹

Social Security and Disability Benefits

Taxpayers often litigate the characterization of Social Security and other types of disability benefits because portions of these benefits may be excludible from gross income.³⁰ In *Campbell v. Commissioner*, the taxpayers were retired Los Angeles County firefighters with service-connected disabilities.³¹ The taxpayers were entitled to receive a disability pension and a service retirement pension. The taxpayers argued that all of pension compensation, rather than a portion, should be exempt from tax under IRC § 104(a)(1), which excludes from gross income “amounts received under workmen’s compensation acts as compensation for personal injury or sickness”.³² Under California law, if the firefighter also qualifies for a service retirement pension, based on the length of time worked, in an amount greater than the disability pension, the firefighter will receive the full service retirement pension. Although the taxpayers initially reported the pension payments on their returns, they subsequently filed refund claims on the basis that all the pension payments received were connected to a disability and therefore not taxable. After the IRS denied the refund claims, the taxpayers filed refund suits. The district court concluded that the portion of a firefighter’s service pension amount exceeding the guaranteed disability pension amount is not excludable from income and is therefore taxable. The taxpayers then challenged the IRS’s authority to issue Treasury Regulation § 1.104-1(b), which states that the exclusion under IRC § 104(a)(1) does not apply if the “retirement pension [amount] ... is determined by reference to the employee’s age or length of service ... even though the ... retirement is occasioned by an occupational

26 National Institute of Mental Health, *Signs and Symptoms of Depression*, <https://www.nimh.nih.gov/health/topics/depression/index.shtml> (last visited Sept. 1, 2016).

27 National Institute of Mental Health, *Post-Traumatic Stress Disorder*, <http://www.nimh.nih.gov/health/topics/post-traumatic-stress-disorder-ptsd/index.shtml> (last visited Sept. 1, 2016).

28 See U.S. Department of Veterans Affairs, *National Center for PTSD*, <http://www.ptsd.va.gov/professional/co-occurring/ptsd-physical-health.asp> (last visited Sept. 1, 2016).

29 National Taxpayer Advocate 2009 Annual Report to Congress 351-56 (Legislative Recommendation: *Exclude Settlement Payments for Mental Anguish, Emotional Distress, and Pain and Suffering from Gross Income*). The National Taxpayer Advocate recommended that Congress amend IRC § 104(a)(2) to exclude from gross income payments received as settlement for mental anguish, emotional distress, and pain and suffering. Such change was recommended because mental anguish, emotional distress, and pain and suffering can be caused by a physical condition in the body and can cause physical symptoms. Over the past few years, doctors and researchers have made significant advances in identifying changes that occur in the brain when a person is plagued with mental illness.

30 See, e.g., *Campbell v. U.S.*, 607 F. App’x 697 (9th Cir. 2015), *aff’g* 111 A.F.T.R.2d (RIA) 946 (C.D. Cal. 2013); *Shakir v. Comm’r*, T.C. Memo. 2015-147.

31 607 F. App’x 697 (9th Cir. 2015), *aff’g* 111 A.F.T.R.2d (RIA) 946 (C.D. Cal. 2013).

32 *Campbell v. U.S.*, 607 F. App’x 697 (9th Cir. 2015), *aff’g* 111 A.F.T.R.2d (RIA) 946 (C.D. Cal. 2013).

injury ...” The U.S. Court of Appeals for the Ninth Circuit held that the IRS had the authority to issue this regulation and affirmed the district court’s holding that the taxpayers were not entitled to a refund. As this case demonstrates, the characterization of Social Security and other disability benefits continues to be a disputed issue.

Individual Retirement Account (IRA) Distributions

IRC § 61(a) defines gross income as “all income from whatever source derived, including (but not limited to) ... (9) Annuities; ... and (11) Pensions.”³³ IRC § 408(d)(1) governs the tax treatment of distributions from individual retirement accounts (IRAs) and provides that they are generally included in gross income as amounts received as an annuity under IRC § 72.

Taxpayers in at least 12 cases argued that portions of their IRA distributions, pensions, or retirement accounts were excluded from gross income, prevailing in one case. In *McGaugh v. Commissioner*, the taxpayer had a self-directed IRA with Merrill Lynch as the custodian, and requested that Merrill Lynch purchase additional stock in a corporation; however, Merrill Lynch refused to purchase the stock directly, despite the fact it was not a prohibited transaction.³⁴ The taxpayer requested that Merrill Lynch issue a wire transfer to the corporation in which he wished to purchase stock, and, after sixty days the corporation issued the stock in the name of the taxpayer’s IRA. Merrill Lynch reported the transaction to the IRS due to its determination that the wire transfer was a distribution and not a rollover, and the IRS agreed. The Tax Court found that there was no “literal distribution” of the IRA funds to the taxpayer since he did not receive any cash, check, or wire transfer as the funds were sent to the corporation directly. Additionally, the Tax Court disagreed with the IRS’s assertion that, by wiring the funds at the instructions of the taxpayer, Merrill Lynch had put the funds at the taxpayer’s discretion, and found that at most the taxpayer was simply a conduit of the IRA funds, and thus the money was not includable as gross income.

In at least three cases this year, taxpayers challenged the taxability of distributions, specifically that the “rollover provisions” under IRC § 408(d) applied.³⁵ The “rollover provision” generally excludes from gross income IRA distributions that are transferred into an eligible retirement account within 60 days of receipt.³⁶ Taxpayers are limited under IRC § 408(d)(3)(B) to one nontaxable rollover per year.³⁷ Taxpayers are also only allowed to take advantage of the “rollover provision” as long as the transfer is not a prohibited transaction under IRC § 4975.

In *Thiessen v. Commissioner*, the taxpayers engaged in a prohibited transaction under IRC § 4975(c)(1)(B) and thus their transfer of funds from one IRA to another was not a “rollover” and was deemed to be a taxable distribution.³⁸ In 2003, the taxpayers attempted to “rollover” funds from a preexisting IRA to a self-directed IRA, and use those funds to acquire initial stock of a C corporation, with the taxpayers listed as the only officers and directors, which would in turn purchase a new business, all while the taxpayers

33 IRC § 61(a).

34 *McGaugh v. Comm’r*, T.C. Memo. 2016-28, *appeal docketed*, No. 16-2987 (7th Cir. July 21, 2016).

35 See, e.g., *McGaugh v. Comm’r*, T.C. Memo. 2016-28, *appeal docketed*, No. 16-2987 (7th Cir. July 21, 2016); *Thiessen v. Comm’r*, 146 T.C. 100 (2016); *Vandenbosch v. Comm’r*, T.C. Memo. 2016-29.

36 IRC § 408(d)(3)(A)(i), (ii); *Schoof v. Comm’r*, 110 T.C. 1, 7 (1998).

37 IRC § 408(d)(3)(B).

38 *Thiessen v. Comm’r*, 146 T.C. 100 (2016).

were personally guarantying repayment of the loan from the seller.³⁹ Seven years later, the taxpayers received a notice of deficiency due to the disqualification of the IRA from the “prohibited transaction.” Under § 4975(c)(1)(B), a “prohibited transaction” is “any direct or indirect ... lending of money or other extension of credit between a plan and a disqualified person,” with a “disqualified person” including any “fiduciary,” which is a person who “exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets.”⁴⁰ The court agreed with the IRS’s argument that the taxpayers’ guaranties of the loan were prohibited transactions under § 4975(c)(1)(B) since the guaranties were the taxpayers’ “indirect extensions of credit to [the taxpayers’] IRAs and that [the taxpayers’] participation in the prohibited transactions caused the IRAs to lose their status as IRAs.” Consequently, a taxable distribution occurred.⁴¹ This is an important case due to the challenges surrounding IRA finance structuring and the complexity of rollover rules for IRAs.

The IRS recently issued guidance to address the problem of rollovers that missed this 60-day window.⁴² A taxpayer is now allowed to self-certify (subject to verification on audit) that he or she is eligible for a waiver of the 60-day requirement instead of seeking a costly private letter ruling.⁴³ The revenue procedure provides 11 reasons for missing the deadline that are eligible for self-certification. It also provides a model letter that may be used for the self-certification. The National Taxpayer Advocate applauds the IRS for this change, which promotes taxpayers’ *right to a fair and just tax system*. It is likely that this change to a self-certification process will lead to a decrease in litigation in cases involving the 60-day rollover time frame. For example, had this revenue procedure been in place when the taxpayer in the *McGaugh*⁴⁴ case withdrew funds from his IRA, the taxpayer would probably have been able to self-certify.

Discharge of Indebtedness

We reviewed four cases in which taxpayers disputed the IRS’s determination that discharge of indebtedness was taxable income. A taxpayer’s gross income generally includes income from a discharge of indebtedness.⁴⁵ However, under certain circumstances, a taxpayer can exclude the amount of discharged indebtedness from gross income under IRC § 108(a). IRC § 108(a) provides, subject to limitation, that a taxpayer may exclude income from the discharge of indebtedness if the discharge occurs during bankruptcy, when the taxpayer is insolvent, if the indebtedness is qualified farm or business real estate debt, or if the indebtedness is qualified principal residence indebtedness discharged before January 1, 2017, or subject to an arrangement that is entered into and evidenced in writing before January 1, 2017.⁴⁶ The creditor may issue a Form 1099-C, *Cancellation of Debt*, to the taxpayer for

39 The taxpayers used an IRA funding structure, discussed above, to purchase a business, and did so at the advice of a certified professional accountant. The taxpayers filed a joint Form 1040, *U.S. Individual Income Tax Return*, for 2003 and reported the IRA distributions but stated they were “ROLLOVER,” and had no taxable IRA distributions or tax specifically related to the IRA. An important note is that the joint return did not disclose the personal guarantee of the taxpayers on the loan or put the IRS on notice of the nature and amount of any deemed distribution resulting from the guaranties, nor did it disclose the C corporation or the 2003 Form 1120, *U.S. Corporate Income Tax Return*, filed.

40 IRC §§ 4975(e)(2)(A), (e)(3)(A). See also IRC §§ 4795(e)(2)(F), (e)(6) (stating that the spouse of a “disqualified person” is also a “disqualified person”).

41 *Thiessen v. Comm’r*, 146 T.C. 100 (2016). See IRC § 408(e)(2)(A) (providing that “[i]f, during any taxable year of the individual for whose benefit any [IRA] is established, that individual or his beneficiary engages in any transaction prohibited by [§] 4975 with respect to such account, such account ceases to be an [IRA] as of the first day of such taxable year.”).

42 See Rev. Proc. 2016-47, 2016-37 I.R.B. 346, modifying Rev. Proc. 2003-16, 2003-4 I.R.B. 359.

43 *Id.*

44 *McGaugh v. Comm’r*, T.C. Memo. 2016-28, *appeal docketed*, No. 16-2987 (7th Cir. July 21, 2016).

45 IRC § 61(a)(12).

46 IRC § 108(a)(1)(A)-(E).

canceled debts of \$600 or more.⁴⁷ If a creditor has discharged a debt the taxpayer owes, the taxpayer must include the discharged amount in gross income, even if it is less than \$600 or a Form 1099-C is not received, unless one of the exceptions in IRC § 108(a) applies. The issuance of a Form 1099-C is not dispositive of whether or when the debt is actually discharged.⁴⁸ A debt is deemed to have been discharged, and a Form 1099-C is required, if and only if, an “identifiable event” has occurred.⁴⁹

In *Clark v. Commissioner*, the taxpayer had entered into a retail installment contract with a car dealership to purchase a car in 1999; however, by 2005, the taxpayer had defaulted on the contract and the vehicle was repossessed and sold at auction.⁵⁰ The terms of the retail installment contract provided that the seller could sell the repossessed car and the seller’s ability to assign all rights of the contract, without recourse, to AmeriCredit. After the repossession and sale of the car, AmeriCredit attempted to collect the debt of \$4,496.71, and assigned it to five separate third-party debt collectors between 2006 and June 29, 2011. In 2011, AmeriCredit reported a Form 1099-C discharging the taxpayer’s debt of \$4,496.71, but the taxpayer did not report any discharge of indebtedness income on her 2011 Form 1040.

In the petition to the Tax Court, the taxpayer, who was represented, alleged numerous arguments, with the case turning on the argument about the timing of the “identifiable event.” The taxpayer argued that the “identifiable event” occurred when AmeriCredit failed to receive payment on the debt after 36 months (December 2008), and the cancellation should have applied to 2008, which was the “expiration of the non-payment testing period” under Treasury Regulation § 1.6050P-1(b)(2)(i)(H). Under the relevant legal authority, there is a rebuttable presumption that an identifiable event has occurred during a calendar year if a creditor has not received a payment on a debt at any time during the testing period, generally 36 months, ending at the close of the year.⁵¹ The IRS argued, however, that because AmeriCredit took collection actions during the testing period, the presumption that the identifiable event occurred in 2008 is negated. The IRS relied on evidence of business records showing the debt being assigned, at different times, to five third-party debt collectors. No evidence, however, was introduced regarding what, if any, actions any of the assigned debt collectors took to collect the debt. Due to the IRS’s failure to provide evidence of “any significant, bona fide activity that would indicate an active creditor,” the court found that the IRS had failed to rebut the presumption of the identifiable event discharging the taxpayer’s debt occurring in 2008, and not in 2011.

47 IRS, *Instructions for Form 1099-A and 1099-C Acquisition or Abandonment of Secured Property and Cancellation of Debt*, <https://www.irs.gov/pub/irs-pdf/i1099ac.pdf> (Sept. 30, 2015).

48 *Kleber v. Comm’r*, T.C. Memo. 2011-233 (citation omitted).

49 Treas. Reg. §§ 1.6050P-1(a)(1), (b)(2)(i)(A)-(H) (describing different scenarios that signify when an “identifiable event” has occurred). See also *Friedman v. Comm’r*, 216 F.3d 547-49 (6th Cir. 2000), *aff’g* T.C. Memo. 1998-196.

50 *Clark v. Comm’r*, T.C. Memo. 2015-175.

51 See Treas. Reg. § 1.6060P-1(b)(2)(iv). Note that the IRS has issued final regulations which eliminate the 36-month testing period for information returns required to be filed, and payee statements required to be furnished, after December 31, 2016. 81 FR 78908 (Nov. 10, 2016). See also National Taxpayer Advocate 2010 Annual Report to Congress 383-86 (Legislative Recommendation: *Remove the 36-Month “Testing Period” that May Trigger Cancellation of Debt Reporting*).

Recognition of Income From Participation in Compensatory Split-Dollar Life Insurance Arrangements

In *Our Country Home Enterprises, Inc. v. Commissioner*, the Tax Court reviewed seven consolidated cases relating to income tax deficiencies from the inclusion of income from a “purported” welfare benefit plan, the Sterling Benefit Plan.⁵² The Tax Court first determined that the life insurance policies issued on the shareholders and employees (the individuals) as part of their participation in the Sterling Benefit Plan was a compensatory split-dollar life insurance arrangement.⁵³ A split-dollar life insurance arrangement is an arrangement between an owner of a life insurance contract and a nonowner of the contract (other than group term life insurance), under which either party to the arrangement pays all or part of the premiums, and the party paying the premiums is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the contract.⁵⁴ The Tax Court then turned to the issue of whether the shareholders/employees recognized income from their participation in the arrangement.⁵⁵ In determining the income tax treatment of split-dollar life insurance arrangements, *i.e.*, whether an income has been recognized, courts determine which of the two Treasury Regulation provisions apply: the economic benefit provisions or loan provisions.⁵⁶ The Tax Court found that the economic benefit provisions would apply, and thus, the value, per taxable year, of the economic benefits to a nonowner, *i.e.*, the shareholders/employees, equals:

the sum of (1) the cost of current life insurance protection that the nonowner [individual employee] receives during the year; (2) the amount of the insurance policy cash value to which the nonowner has current access during the year ... ; and (3) any other economic benefit provided to the nonowner (to the extent not previously included in income).⁵⁷

The taxpayers argued that none of the employees (individuals) received an “economic benefit” since they did not have a current or future right to the cash value of the life insurance policies by either direct receipt of cash or by causing the cash to be used to pay other benefits provided under the plan, such as medical or disability benefits, nor could they have caused the policies to be distributed to them.⁵⁸ However, the Tax Court disagreed with the taxpayers’ position and found that since the individuals did not make the premium payments on the insurance contracts and the corporate employers were the owners of the contracts, the employees received an economic benefit, which is includable in gross income, in the value of the death benefit for the life insurance contract minus the amount payable to the corporate employer

52 *Our Country Home Enters., Inc. v. Comm’r*, 145 T.C. 1 (2015). According to the Tax Court, these seven cases were selected as “test cases for issues relating to the Sterling [Benefit] Plan” and the parties in approximately 40 other cases pending before the Tax Court “have agreed to be bound by one or more of the decisions in these cases.” *Our Country Home Enters., Inc. v. Comm’r*, 145 T.C. No. 1 (2015). The petitioners of the cases are split into three groups: (1) Our Country Home Enterprises, Inc., which consists of two petitioners, Mr. Blake and his wholly owned C corporation, Our Country Home Enterprises; (2) Netversity, Inc., which also consists of two petitioners, Mr. Mejia and his wholly owned C corporation, Netversity; and (3) Code Environmental Services, Inc., which consists of three petitioners, Mr. Abramo, Mr. Brown, and Mr. Tomassetti, all of which are equal owners of the S corporation Code Environmental Services, Inc. *Our Country Home Enters., Inc. v. Comm’r*, 145 T.C. 1 (2015).

53 *Our Country Home Enters., Inc. v. Comm’r*, 145 T.C. 1 (2015).

54 Treas. Reg. §§ 1.61-22(b)(1); 1.7872-15.

55 The Tax Court also decided if the corporate employers could deduct the payments to the Sterling Benefit Plan and if the petitioners were subject to an accuracy-related penalty.

56 The economic benefit provisions are described in Treas. Reg. § 1.61-22(d)-(g). The loan provisions are described in Treas. Reg. § 1.7872-15.

57 *Our Country Home Enters., Inc. v. Comm’r*, 145 T.C. 1 (2015) (citing Treas. Reg. § 1.61-22(d)(2)).

58 See Treas. Reg. § 1.61-22(d)(4)(ii) (providing that nonowners are treated as having current access to the portion of the insurance policy’s cash value (1) to which the arrangement gives the employee a current or future right, and (2) that is directly or indirectly currently accessible by the employee, inaccessible by the employer, or inaccessible by the employer’s general creditors).

plus the portion of the cash value taxable to (or paid for by) the employee. For the final set of taxpayers, Netversity and Mr. Mejia, the payments made towards the Sterling Benefit Plan, which had not yet purchased a death benefit insurance plan, were “conferred [as] an economic benefit on Mr. Mejia for his primary (if not sole) benefit.”⁵⁹ Thus, the payment was a “constructive distribution,” which must be included in gross income as a taxable dividend under IRC § 301(c)(1). Although this case is specific to one purported welfare benefit plan and was a “test” case, it demonstrates the continuation of litigation involving “economic benefits” and split-dollar life insurance arrangements in general.

CONCLUSION

Taxpayers litigate many of the same gross income issues every year due to the complex nature of what constitutes gross income. As the definition is very broad and the courts broadly interpret accession to wealth as gross income, the IRS prevailed in full in 73 of 81 cases, and courts continued to narrowly interpret exclusions from gross income.

While the number of cases involving the tax treatment of settlements and awards has fluctuated in past years, it continues to be a steady and perennial area of confusion for taxpayers. The National Taxpayer Advocate has previously recommended a legislative change that would clarify the tax treatment of court awards and settlements by permitting taxpayers to exclude any payments received as a settlement or judgment for mental anguish, emotional distress, or pain and suffering.⁶⁰

59 The court also determined that these payments were not deductible as an ordinary and necessary business expense under IRC § 162(a). See Most Litigated Issue: *Trade and Business Expenses*, *supra*, for a discussion on what constitutes “ordinary and necessary” business expenses.

60 National Taxpayer Advocate Annual 2009 Report to Congress 351-56 (Legislative Recommendation: *Exclude Settlement Payments for Mental Anguish, Emotional Distress, and Pain and Suffering from Gross Income*).