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Gross Income Under IRC § 61 and Related Sections

SUMMARY

When preparing tax returns, taxpayers must complete the 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 72 cases decided between June 1, 2018, and May 31, 2019. The majority of 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 pensions.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 The concept of “gross income” is to be broadly construed, while exclusions from income are to be narrowly construed.⁹ However, over time, 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.¹⁰

1 See, e.g., National Taxpayer Advocate 2017 Annual Report to Congress 420 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*); National Taxpayer Advocate 2013 Annual Report to Congress 355 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*).

2 IRC § 61(a)(1). See, e.g., *Canzoni v. Comm'r*, T.C. Memo. 2018-130.

3 IRC § 61(a)(4). See, e.g., *Allen v. United States*, 331 F. Supp. 3d 852 (E.D. Wis. 2018).

4 IRC § 61(a)(7). See, e.g., *Smith v. Comm'r*, 151 T.C. 41 (2018).

5 IRC § 61(a)(9). See, e.g., *Castaneda v. Comm'r*, T.C. Memo. 2018-173, *appeal docketed*, No. 19-71793 (9th Cir. July 17, 2019).

6 See IRS, Taxpayer Bill of Rights (TBOR), <http://www.irs.gov/Taxpayer-Bill-of-Rights>. The rights contained in the TBOR are codified in the IRC. See IRC § 7803(a)(3).

7 IRC § 61(a).

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

9 See *Comm'r v. Schleier*, 515 U.S. 323, 327-328 (citations omitted) (1995); *Taggi v. United States*, 35 F.3d 93, 95 (citations omitted) (2d Cir. 1994).

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

If the Commissioner determines a tax deficiency, the IRS issues a statutory notice 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 72 opinions involving gross income issued by the federal courts and reviewed for this report, gross income issues most often fell 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 5.

In 37 cases (51 percent), taxpayers were represented, while the rest were *pro se* (without counsel). In 12 of the 37 cases where taxpayers had representation (about 32 percent), they prevailed in full or in part in their cases, whereas *pro se* taxpayers did not prevail in full or in part in any cases identified during this review period.

Drawing on the full list in Table 4 of Appendix 5, we have chosen to discuss discharge of indebtedness and a case involving the tax treatment of a *qui tam* award.¹³

Discharge of Indebtedness

We reviewed six cases in which taxpayers challenged the IRS's determination that a discharge of indebtedness was taxable income. Taxpayers prevailed in part in one case.¹⁴ Generally, a taxpayer must include income from discharge of indebtedness when calculating gross income,¹⁵ but in certain circumstances cancellation of indebtedness income may be excluded. IRC § 108(a) provides that a taxpayer may exclude, subject to limitations, income from the discharge of indebtedness if the discharge occurs in a title 11 bankruptcy case, when the taxpayer is insolvent, or if the indebtedness is qualified farm indebtedness (for a taxpayer other than a C corporation), qualified real property business indebtedness debt, qualified principal residence indebtedness discharged before January 1, 2018, or subject to an arrangement that is entered into and evidenced in writing before January 1, 2018.¹⁶ The creditor may issue a Form 1099-C, Cancellation of Debt, to the taxpayer for canceled debts of \$600 or more.¹⁷ 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.¹⁸ A debt is deemed to have been discharged for purposes of information

11 IRC § 6212. See also Internal Revenue Manual 4.8.9.2, Notice of Deficiency Definition (Aug. 11, 2016). The Commissioner may identify particular items of unreported income or reconstruct a taxpayer's gross income using indirect methods such as the bank deposits method. IRC § 6001. See, e.g., *DiLeo v. Comm'r*, 96 T.C. 858, 867 (1991).

12 See IRC § 7491(a) (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 *Qui tam pro domino rege quam pro se ipso in hac parte sequitur*: "who as well for the king as for himself sues in this matter." A *qui tam* action is brought under a statute that allows a private individual to sue for a penalty where, if successful, the government or other public institution will receive a portion of the penalty and the individual will share in the recovery. BLACK'S LAW DICTIONARY (11th ed. 2019).

14 See *Bui v. Comm'r*, T.C. Memo. 2019-54.

15 IRC § 61(a)(11).

16 IRC § 108(a)(1)(A)-(E).

17 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> (Oct. 3, 2018).

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

reporting, and a Form 1099-C is required, if and only if, an “identifiable event” has occurred.¹⁹ Form 1099-C may be required even if the discharged amount is not taxable to the debtor.²⁰ Generally, the burden of proof is on the taxpayer to show that any of the exceptions in IRC § 108(a) apply.²¹ However, if a Form 1099-C serves as the basis for the determination of a deficiency, IRC § 6201(d) may apply to shift the burden of production to the IRS. IRC § 6201(d) provides that in any court proceeding, if a taxpayer asserts a reasonable dispute with respect to the income reported on an information return and the taxpayer has fully cooperated with the IRS, then the IRS has the burden of producing reasonable and probative information in addition to the information return.

In one case we reviewed, the taxpayer prevailed in part under the qualified principal residence exclusion in IRC § 108(a)(1)(E) and in part under the insolvency exception in IRC § 108(a)(1)(B). In the case of *Bui v. Commissioner*, the taxpayer excluded over \$350,000 of discharged indebtedness from her gross on her tax year 2011 tax return, indicating that the discharged debt was qualified principal residence indebtedness under IRC § 108(a)(1)(E).²² At trial, the taxpayer further asserted the discharged indebtedness should be excluded under IRC § 108(a)(1)(B) due to insolvency. The court determined that only \$12,000 of the discharged indebtedness was qualified principal residence indebtedness; however, the taxpayer was limited to excluding \$5,299 by operation of IRC § 108(h)(4), which allows a taxpayer to exclude only the amount that exceeds the portion of the debt discharged that is not qualified principal residence debt. The taxpayer’s original loan was \$250,000, of which \$12,000 was determined to be qualified principal residence debt. The total discharged debt was \$243,299, and subtracting the \$238,000 of nonqualified debt allowed the taxpayer to exclude \$5,299.

At trial, the Commissioner conceded that at the time of the discharge of indebtedness, the taxpayer was insolvent by the amount of \$42,852.²³ While the taxpayer asserted the Commissioner was incorrect in this calculation, the taxpayer had already agreed to the calculation prior to trial and thus the court found the taxpayer could exclude \$42,852 from gross income under the insolvency exclusion.

Qui Tam Award

During this review cycle, we identified one case that addressed the tax treatment of a *qui tam* award.²⁴ A *qui tam* action is brought under a statute by a private individual on behalf of the government and if the claim succeeds, the individual keeps a portion of the recovery while the rest goes to the government or other public institution. In the case of *Barnes v. United States*, Mrs. Barnes filed a *qui tam* action under the False Claims Act²⁵ and then reached a settlement agreement with the United States and the defendants for over \$20 million, of which she received over \$3.5 million.²⁶

19 See Treas. Reg. § 1.6050P-1(a)(1). 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 Fed. Reg. 78908 (Nov. 10, 2016). See also National Taxpayer Advocate 2010 Annual Report to Congress 383-386 (Legislative Recommendation: Remove the 36-Month “Testing Period” That May Trigger Cancellation of Debt Reporting).

20 Treas. Reg. § 1.6050P-1(a)(3).

21 U.S. Tax Court Rules of Practice and Procedure, Rule 142(a).

22 T.C. Memo. 2019-54.

23 *Bui v. Comm’r*, T.C. Memo. 2019-54. Under IRC § 108(a)(2)(C), the insolvency exclusion applies only when the taxpayer elects the insolvency exclusion to apply in lieu of the qualified principal residence indebtedness exclusion. In this case, the taxpayer did not elect to do so but had three different loans discharged. The exclusion was applied to one of the loans.

24 *Barnes v. United States*, 353 F. Supp. 3d 582 (N.D. Tex. 2019).

25 31 U.S.C. § 3730(b) (2010).

26 353 F. Supp. 3d 582 (N.D. Tex. 2019).

Mr. and Mrs. Barnes reported the settlement amount on their joint income tax return and paid tax on it. They then filed a refund claim on the basis that settlement proceeds from a *qui tam* action are not taxable. After the IRS disallowed the claim in part, they filed a refund suit under the theory that the award Mrs. Barnes received for her *qui tam* action was not taxable income and further argued that if the court found the award to be taxable income, that it should be taxed as a capital gain rather than ordinary income.²⁷ The court agreed with the government's argument that a *qui tam* award is rightly classified as a bounty or fee rewarding the individual who initiated the *qui tam* action for assisting the government in making and successfully litigating the claim. A bounty or fee is not excluded under IRC § 61 and is thus includable in gross income. Further, the court disagreed with the taxpayer's contention that the *qui tam* award, if taxable, should be taxable as capital gains and found for the government that the award is taxable is ordinary income. The taxpayers argued that the award should be a capital gain based on the accretion of value over the three years between the filing of the claim and the settlement of the action. The court concurred with the reasoning of other courts that a *qui tam* award is more analogous to a contingency fee arrangement or a future payment for services rendered than a capital gain.²⁸

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, most cases (about 83 percent) were decided in favor of the IRS and exclusions from gross income continued to be narrowly interpreted. However, taxpayers in this review cycle raised a less prevalent issue about the tax treatment of *qui tam* awards, and litigation in areas such as retirement plan distributions and settlement proceeds were not as prevalent either.²⁹

Overall, litigation of gross income issues decreased this year, from 79 cases in the 2018 reporting cycle to 72 cases this year, about a nine percent decrease.³⁰ Of note this year, no *pro se* taxpayers prevailed in full or in part in any cases identified for this review cycle, while the number of represented taxpayers increased from 47 percent to about 51 percent this year and had a higher success rate of 32 percent compared to 24 percent in the 2018 review cycle.³¹

27 353 F. Supp. 3d 582 (N.D. Tex. 2019).

28 See, e.g., *Patrick v. Comm'r*, 799 F. 3d 885 (7th Cir. 2015) *aff'g* 142 T.C. 124 (2014).

29 We identified only four cases involving settlement income in this review period compared to seven cases in the 2018 review period and four cases involving retirement plan distributions compared to 18 in the 2017 review period. See National Taxpayer Advocate 2018 Annual Report to Congress 481, 487 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*); National Taxpayer Advocate 2017 Annual Report to Congress 420, 423 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*).

30 National Taxpayer Advocate 2018 Annual Report to Congress 481, 487 (Most Litigated Issue: *Gross Income Under IRC § 61 and Related Sections*).

31 *Id.*