

# TAX UPDATE

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## Was It a Gift or Compensation? The Tax Court Knows April 16, 2008



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### Gift or Compensation?

Returning from an end of tax season hiatus, we look at a case that came down a few weeks back that involved an issue of whether a payment was taxable as compensation or represented a gift. The fact pattern in the case goes a bit beyond the often dry set of facts we see in most tax cases, and instead deals with the taxpayer's contention that, in fact, the payment she received was meant to be a gift from a payor motivated by a romantic interest, rather than a payor looking to compensate her for her services as President of the corporation that the suitor controlled.

The case in question is the case of *Larsen v. Commissioner*, TC Memo. 2008-73 that was decided on March 26, 2008.

### Taxation of Transfers

As we are generally aware, the issue of what is income is broadly defined in the

Internal Revenue Code. IRC §61(a) gives us the sweeping statement that “gross income means all income from whatever source derived” and goes on at §61(a)(1) to specifically state that this includes “compensation for services, including fees, commissions, fringe benefits, and similar items.”

As is often the case in tax provisions, this sweeping general rule is subject to a series of exceptions to that rule—and the one we’ll be looking at today is found in §102 that deals with gifts and inheritances. That provides a general rule that provides:

(a) General rule

Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

The Supreme Court in *Commissioner v. Duberstein*, 363 U.S. 278, noted that:

A gift in the statutory sense, on the other hand, proceeds from a "detached and disinterested generosity," *Commissioner v. LoBue*, 351 U. S. 243, 246; "out of affection, respect, admiration, charity or like impulses." *Robertson v. United States*, supra, at 714. And in this regard, the most critical consideration, as the Court was agreed in the leading case here, is the transferor's "intention." *Bogardus v. Commissioner*, 302 U. S. 34, 43 [37-2 USTC ¶9534]. "What controls is the intention with which payment, however, voluntary, has been made." *Id.*, at 45 (dissenting opinion).

Thus the analysis proceeds not from the viewpoint of the recipient (who happens to be the one that will or will not have to pick up the amount in income), but rather from that of the payor. Note that the payor may have a stake in the issue as well—if it’s a gift, there may be a gift tax under §2501, and the standard cited above for the payment being a gift also is going to generally mean it won’t be able to be deducted under §162 as a business expense.

The IRC goes on to apply additional caveats to transfers to employees, noting at §102(c):

(c) Employee gifts

(1) In general

Subsection (a) shall not exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee.

## (2) Cross references

For provisions excluding certain employee achievement awards from gross income, see section 74(c). For provisions excluding certain de minimis fringes from gross income, see section 132(e).

So for the case of a person who bears an employment relationship (direct or indirect) with the payor, the hurdle to be cleared is going to be even higher and more difficult.

These are the issues facing Faith Larsen as she attempts unsuccessfully to exclude from her income a payment of \$160,000.

## Keeping Faith In Seattle

As the issue is going to revolve around the motivation for the \$160,000 payment, the facts obviously are crucial in this case. Faith met Donald Hoiland, the owner of PCI in 1998. Faith was hired as Mr. Holland's executive assistant at PCI in July of 1999 for a salary of \$60,000 per year. After she had been there a year, she was promoted to vice president of PCI and her salary was increased by 50%.

The court noted that as vice president, Faith interacted with a number of different departments within PCI and provided Mr. Hoiland with suggestions regarding the operations of PCI. When Mr. Holland retired in December 2000, Ms. Larsen was promoted to president of PCI.

During his period the court observed the following on their relationship:

The interactions between petitioner and Mr. Hoiland were typically professional. Petitioner often spoke with Mr. Hoiland by phone as she drove to work. The two had lunch together regularly before Mr. Hoiland retired. Their relationship was never intimate.

However, it appeared that Ms. Larsen might want to be the long term president of PCI, and this led to a series of incidents that would give rise to the payment in question (or at least led to them in the court's view—Ms. Larsen, as will become clear, came to a different conclusion about the reason for these actions as the situation progressed).

The court noted that Ms. Larsen refused to sign an employment contract of more than one year because she wasn't certain how long she would stay in the Seattle area. So this led to a series of offers to Ms. Larsen to get her to commit to staying in Seattle. These offers included:

- A \$20,000 raise

- A Jaguar automobile
- A condominium

Despite these increasing inducements to stay in Seattle, Ms. Larsen turned them down and refused to commit to more than one year.

## The \$160,000 Question

In January 2001, Ms. Larsen received a \$160,000 payment from PCI, placing the funds into a bank account she had created to start a commercial photography business. She was assisted in setting up this new business by PCI's accountant, David Skone.

Ms. Larsen's attorney contacted Mr. Skone about receiving this payment. Ms. Larsen and her attorney alleged that Mr. Skone characterized the payment as a gift, but neither of them asked for documentation that the amount was a gift and later PCI issued Ms. Larsen a 1099-MISC for the \$160,000.

The court also noted:

Petitioner and Mr. Hoiland discussed bonuses at Christmas time, a few weeks before PCI paid her the \$160,000. It was petitioner's belief that no other employee of PCI received a bonus as large as \$160,000.

## The Incident and the Decline of the Employment Relationship

Well, things appeared to be looking up for Ms. Larsen in January 2001—but things were going to change rather dramatically later that year that would give rise to her claim that the payment was intended as something that wasn't necessarily related to her employment status, but was rather the rather expensive equivalent of a potential romantic interests sending of an unsolicited gift.

As we noted, Mr. Hoiland had retired from PCI and left the operations to Ms. Larsen. Mr. Hoiland, with this time on his hands, began to travel—and during one trip the following incident occurred:

While traveling, Mr. Hoiland called petitioner and threatened to fire her if she did not sleep with him when he returned. Petitioner feared that Mr. Hoiland, a recovering alcoholic, was drinking again, and she attributed his advances to a relapse. Petitioner called the personnel manager for PCI, who encouraged her to

prepare and file a summary of her conversation with Mr. Hoiland. Mr. Hoiland apologized to petitioner when he returned from his vacation and explained that he had, indeed, been drinking.

Following this incident, things began to turn downhill for Ms. Larsen and her relationship with PCI. The court noted that her “relationship with Mr. Hoiland and PCI deteriorated rapidly after this exchange with Mr. Hoiland.” Indeed, in September of 2001 Mr. Hoiland fired Ms. Larsen.

Not unexpectedly, this firing led to Ms. Larsen asserting a claim against PCI for damages after her employment was terminated, and the parties engaged in mediation to settle the claim. The court noted:

Petitioner, through her counsel, alleged that the \$160,000 payment was a bonus during mediation. The mediation resulted in petitioner's receiving a \$100,000 settlement, of which \$25,000 was allocated to back wages and \$75,000 to general damages, attorney's fees, and costs. Petitioner and PCI also waived all other claims against one another as part of their mediation agreement. The tax treatment of the mediation settlement is not in dispute.

The question for tax purposes became—what was the nature of the \$160,000 payment that Ms. Larsen received back in January.

## 2001 Tax Return

Ms. Larsen had her attorney, Mr. Pettegrove, prepare her 2001 income tax returns. She provided Mr. Pettegrove with the Form 1099-MISC that reported both the \$160,000 payment and a computer she received whose value was set on the 1099 at \$2,662.71—a value that she and the IRS agreed that its true value was \$400.

The \$160,000 was not reported as income on Ms. Larsen's return—she took the position that it was clear to her that this payment resulted from an “unrequited romantic interest” in her, and this was strengthened by the fact that she was the only employee to receive such a generous bonus.. The court noted that Mr. Pettegrove did not ask for any additional information from PCI to confirm that the \$160,000 payment was a gift, and made no independent determination of whether the payment was a bonus or a gift.

Ms. Larsen had no severed her connection with all individuals at PCI—Mr. Skone, the accountant at PCI who had assisted her in setting up her business, also assisted her in filing her state business tax returns with the state of Washington. On that return, Mr. Skone reported the \$160,000 in the category of “Services and Other Activities.”

PCI did not deduct the \$160,000 payment on its tax return, and it issued a 1099MISC rather than a W-2 for its payment to Ms. Larsen. While the court doesn't comment on the fact, experience for many of us would suggest a principal reason for that was because the amount had not had any amounts withheld from it when it was paid to Ms. Larsen, something that might lead us to suspect that PCI's view of the payment "changed" after the situation with Ms. Larsen soured.

As well, Mr. Skone's position in this seems interesting—being involved in the original transaction, it seems likely he knew that taxes were not being withheld and it was not being treated as wages. As well, it seems likely that he was aware the payment was being reported on a 1099MISC and that he likely had input on the corporate tax return where the amount was not deducted. If he was involved, it appears that he wasn't sure what exactly was the proper treatment, but handled it in the government's favor in each case (PCI and Ms. Larsen both effectively paid tax on the \$160,000 payment). While we can't know, it would certainly be understandable that he was simply taking the position that he wasn't going to play referee here between the parties or take responsibility for a tax mess that was the creation of Mr. Hoiland and Ms. Larsen.

## The Court's View

The key question is—why were these amounts paid? The Tax Court outlined the key factors in the following portion of the decision:

Mr. Hoiland rewarded petitioner's performance as an officer and employee of PCI with promotions and raises. Mr. Hoiland arranged to give petitioner the \$160,000 payment after she turned down a \$20,000 raise and an offer of a home and an automobile. The offers that preceded the \$160,000 payment related to petitioner's role as an employee. Those offers were either to reward petitioner's performance or to induce her to remain in the Seattle area.

Although petitioner and Mr. Hoiland worked together and were close acquaintances, there was no romantic relationship between them. Petitioner did not travel with Mr. Hoiland, and their social relationship did not transcend their work relationship. Although Mr. Hoiland made one sexual advance, petitioner flatly rejected it. These facts suggest that the \$160,000 payment was motivated by business exigencies and not by detached or disinterested generosity. See *Duberstein v. Commissioner*, *supra* at 285.

Considering the record as a whole, we find that petitioner's uncorroborated testimony that Mr. Hoiland had an unrequited

romantic interest in her or that she was the only employee to receive a substantial payment at the end of the year is insufficient to support her contention that the payment was a gift. We are not required to accept the self-serving testimony of interested parties without persuasive evidence or corroboration. See *Tokarski v. Commissioner*, 87 T.C. 74, 77 (1986); *Yang v. Commissioner*, T.C. Memo. 2000-263.

The Court appears to be making a distinction that it's not Ms. Larsen's view of the payment now that is crucial, but rather whether she is able to get corroboration of her view from other sources—and there was nothing she could show prior to the payment of \$160,000 that indicated it was not a bonus payment—and that it appears that if she had believed that this payment was contingent on sexual favors, she would have given clear indications that this wasn't acceptable.

As well, Mr. Skone comes back to haunt Ms. Larsen. Her attorney claimed he had indicated the payment was a gift back when it was paid, which seemed to be the only direct evidence they had that PCI did not intend this to be compensation. However, the court noted:

PCI's issuance of a Form 1099-MISC reporting the \$160,000 payment indicates that PCI did not intend this payment to be a gift. Petitioner reported the \$160,000 payment as income under the category "Services & Other Activities" on her State tax return and paid the State tax on the additional income. Mr. Skone, the same accountant who purportedly advised Mr. Pettegrove that the payment was a gift, prepared that return..

As well, the Court found Ms. Larsen also was liable for the accuracy related penalty under §6662(a). The court did not find a reasonable basis for her position that the payment was not taxable, noting:

Petitioner claims that she relied on Mr. Hoiland and Mr. Skone's characterization of the payment. Petitioner presents no credible evidence corroborating her testimony that this was indeed their characterization of the payment. She also presents no credible evidence that Mr. Hoiland or Mr. Skone was competent to advise her on the taxable nature of the payment she received. Petitioner's claims that Mr. Skone told her the payment was a gift are even harder to believe because Mr. Skone prepared her State tax return reporting the payment as income.

She also could not get out of the penalty by claiming she relied on the advice of her attorney—the Court had a couple of problems with that defense, as noted:

Petitioner also claims to have relied upon the advice of Mr. Pettegrove. This is dubious as he offered none. He relied on her characterization of the payment as a gift and made no further inquiry. Particularly troubling is the fact that he completely disregarded the Form 1099-MISC from PCI that petitioner provided to him.

Certainly, the Court did not appear happy with Ms. Larsen.

## Why So Harsh?

While the Court doesn't mention it, it seems likely that her inconsistent position on the nature of the \$160,000 payment when she was negotiating settlement of her claim against PCI most likely weighed heavily in this decision. In that dispute, treating that as compensation for the excellent work she had helped bolster her claim of damages when she later rejected the owner's sexual advances.

That is, if she was worth that level of bonus only a few months earlier, but she is then terminated nine months later after rejecting the owner's sexual advance, it could raise questions about the reason for the termination and the impact of her rejection of the advance on her employment status—especially when that advance had been made with the explicit threat that she would be fired if she didn't agree to the sexual favor.

## Another (Unexpected) Podcast of Interest

In an unrelated aside, during the hectic end of tax season I managed to listen to a podcast that likely most of you have never had a reason to listen to, but which could prove useful. The podcast is the MacBreak Tech podcast and normally deals with deeply "geeky" topics of interest to those who have a geekish bent and own Macintosh computers—not the general makeup of the audience for this podcast I would suspect.

However, the participants in the podcast all operate their own small service businesses, and their April 8 podcast, titled "Making Mac Your Business" deals not so much with starting a business based on a Macintosh, but rather with a real world discussion of business people in a service business about the issues that impact getting small service businesses running—things like getting paid, why it's not quite as simple as it appears to someone working for a large entity to go it alone, etc.

They also talk about the importance of concentrating on your specialty and be ready to use (and pay for) the services of others to take care of those things that aren't your specialty (although one participant has a bit of an issue with attorneys at the start of a business—but it's pretty clear that's not shared by all) and getting

paid properly for the work you do for clients (including not giving away your services with low-ball fees that always end up staying low-ball).

In any event, it's good listen just for those of us in service businesses (and that's what those of us in tax do) or for those who might be currently working as an employee and thinking of going on their own—because what they discuss is incredibly practical and spends very little time on the Mac specific topics listed in the description.

The podcast can be found as the April 8 podcast on their website at <http://www.macbreaktech.com> while the link to the full audio file is at:

[http://macbreaktech.com/podpress\\_trac/web/63/0/mbkt\\_Making\\_Mac\\_Your\\_Buisness.mp3](http://macbreaktech.com/podpress_trac/web/63/0/mbkt_Making_Mac_Your_Buisness.mp3)

You could also subscribe via iTunes, but if you aren't into technical topics on Macintosh computers that might not be your best approach.

We'll even forgive them for their musing on whether accountants can really have a dream and vision...