Tax Assessments

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The Chair's Comments

Jared Mobley

Before summer arrives and my term as your chair of the North Carolina Bar Tax Section ends, please let me thank you for the opportunity to lead such a wonderful group. It has been an incredible ride, and I have been honored to witness the good work done by so many of you to help promote and advance a wide range of North Carolina tax initiatives.

Also, please let me thank the many members of the North Carolina Bar staff that support and guide the Tax Section. Those bar staff members include Jacquelyn Terrell, Coleta Roscoe, Tina Hughes, Kim Crouch, Courtney Denning and many more. We are very lucky to have such a great group that supports and guides us in so many (often, unnoticed) ways. Thank you, all!

In addition, I would like to invite you to the 12th Annual North Carolina-South Carolina Tax Section Workshops (the "Tax Section Workshops"), which will be held on Kiawah Island from May 24-May 26 (yes, Memorial Day weekend). The annual Workshops (which are typically attended by 80 to 100 tax professionals) give us a unique opportunity to meet and interact with our fellow tax professionals in the Carolinas. In addition, the Tax Section Workshops provide informative continuing legal education by some of the top tax professionals in the Carolinas and beyond. This year's presenters include Chuck Neely (Williams Mullen), Rick Handel (USC School of Law) and David Aughtry (Chamberlain Hrdlicka). We also will have a very timely and important session on North Carolina state and local tax modernization initiatives by Senator Rucho and Mike Hannah (North Carolina Senate Finance). I encourage each of you to attend the Tax Section Workshops, and

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So Your Client Wants to Move to Florida?

Moving Beyond the Basics (and Beyond the Basics of Moving)

By Tommy Holderness

As a North Carolinian prepares to sell her business (or other asset) at a significant gain, she may wish that she was a resident of a state that does not have a state income tax (e.g., Florida). Fortunately, becoming a resident of another state is something that the person controls. Unfortunately, depending on how much is at stake and the specific facts, the North Carolina Department of Revenue (the "Department") may disagree that the person actually has become a resident of another state. The Department's brochure titled Auditing "Nonresidents" reflects its initial skepticism of taxpayers claiming to have moved from North Carolina:

> Residency examinations are usually individual income tax examinations involving people who actually live and have their permanent home in a state which has an income tax, but claim to be domiciled in a state that has no income tax or income tax at a lesser rate.

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Save the Date! May 24-26, 2013 – see page 4 for more details!

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please check the North Carolina Bar website for more information.

As many of you know, the North Carolina legislature has made state and local tax reform a major priority. While the Tax Section is following this process closely, please let me also mention one of the "non-tax" initiatives that the North Carolina legislature is considering. The legislature is considering certain legislation that would permit the formation of captive insurance companies in North Carolina. Our own Alex Webb (Webb & Graves) has been leading the charge. Please feel free to contact Alex if you would like to be part of the legislative efforts relating to captive insurance companies.

As a reminder, the final council meeting is scheduled for May 24, 2013 (in Kiawah), which coincides with the Tax Section Workshops. In connection with the workshops, we will have our North Carolina Bar Tax Section elections, which will include the election of six new Council members. This year, we are excited to have a very solid group of tax professionals that have been nominated to join the Tax Section Council. If you have any interest in serving in a leadership position with the North Carolina Bar Tax Section, please let me know, and we will consider you as part of future nominations and elections. •

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In these difficult economic times, the Department is not likely to let people off its tax rolls without a fight, especially when the amount at issue is significant.

If a taxpayer cuts all ties with North Carolina and lives in Florida year-round, there is little reason to worry about the Department. But given Florida's weather in the summer, the ability to have two or more houses, and long-time relationships within North Carolina, wealthy clients often maintain some ties with North Carolina. Those ties are usually the Department's basis for asserting that a taxpayer is still a resident of North Carolina. This article discusses the law regarding those ties, the Department's analysis, and how to advise clients prior to their move.

The Law

For income tax purposes, G.S. §105-134.1(12) defines a "resident" as follows:

> An individual who is domiciled in this State at any time during the taxable year or who resides in this State during the taxable year for other than a temporary or transitory purpose. In the absence of convincing proof to the contrary, an individual who is present within the State for more than 183 days during the taxable year is presumed to be a resident, but the absence of an individual from the state for more than 183 days raises no presumption that the individual is not a resident. **A resident who removes from the State during a taxable year is considered a resident until he has both established a definite domicile elsewhere and abandoned any domicile in this State.** The fact of marriage does not raise any presumption as to domicile or residence.

(Emphasis added). The Department relies on the abandonment requirement in the third sentence (highlighted) to hold onto many taxpayers. How it has done so, however, has been inconsistent with the law regarding residency.

G.S. §105-134.1(12) provides no guidance as to how one establishes a domicile elsewhere or how one abandons a North Carolina domicile. Furthermore, there are no North Carolina appellate decisions discussing how someone abandons a domicile. The North Carolina Administrative Code (a) (the "Code"), however, does offer some guidance.

> Domicile means the place where an individual has a true, fixed permanent home and principal establishment, and to which place, whenever absent, the individual has the intention of returning.

17 N.C.A.C. 06B.3901(a)

The Code also states: "a mere intent or desire to make a change in domicile is not enough; voluntary and positive action must be taken." *Id.* Thus by its terms, the Code requires three things to establish a domicile:

1. A true, fixed permanent home and principal establishment;
2. An intention to return there, whenever absent; and
3. Some voluntary and positive action.

By not specifying any particular action in subsection (a), the Code appears to contemplate that the required "voluntary and positive action" will vary from case to case.

Despite this language about what constitutes one's domicile, there is no explicit statement in the Code about how an individual abandons a domicile. Nor do the Department's Rules and Bulletins provide any guidance as to how to abandon a domicile. Both the Code and the Department's Rules and Bulletins do, however, state: "a long standing principle in tax administration, repeatedly upheld by the courts, is that an individual can have but one domicile; and, once established, it is not legally abandoned until a new one is established." The logical conclusion from that principle is that once someone establishes a domicile in another state, she has automatically abandoned her domicile in North Carolina. *See* **Revenue of Comm'r v. Stamp**, 296 N.W.2d 867, 870 (Minn. 1980) ("no separate question of abandonment enters into the legal analysis"). The absence of separate requirements or factors in the Code further supports the conclusion that establishing a new domicile and abandoning an old domicile occur simultaneously.

The Department's Analysis

The Department, however, disagrees with that conclusion. The Department takes the position that abandoning North Carolina is distinct from establishing domicile elsewhere. Moreover, the Department requires that a taxpayer abandon the State of North Carolina (as opposed to abandoning her North Carolina domicile). Thus, the Department insists that a taxpayer's lingering ties to North Carolina (such as a house, job, investments, or even charitable contributions) signify that the person has not abandoned North Carolina and has not become a resident of another state. G.S. §105-134.1(12), however, requires only that a taxpayer abandon "any domicile in this State." It does not require a taxpayer to abandon "the State."

In a recent residency case, an administrative law judge held that "when Petitioners established their domicile in Florida on Jan. 20, 2006, Petitioners abandoned their North Carolina domicile on Jan. 20, 2006." I anticipate the Department will reject that conclusion, giving North Carolina's business court and possibly the appellate courts the opportunity to speak on this issue.

When deciding whether a change of domicile has occurred, the court is to "consider the evidence of all the surrounding circumstances and the conduct of the person." **Hall v. Wake County Bd. of Elections**, 280 N.C. 600, 609 (1972); **Farnsworth v. Jones**, 114 N.C. App. 182, 187 (1994).

Instead of requiring the three elements of paragraph (a) of the Code, the Department has created and imposed a new test – a "facts and circumstances test." This supposed test permits the Department to consider everything about a taxpayer and to pronounce from a black box its determination that the taxpayer is a North Carolina resident for the period in question. The Department's test, however, has no standards and is not the law in North Carolina.

The Department has cited **Farnsworth** as authority for its facts and circumstances test. In Farnsworth, the issue was whether defendant sat-

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isfied the residency requirement to run in a municipal election. Farnsworth, 114 N.C. App. at 183. The defendant had changed his residence from one town in North Carolina to another town in North Carolina. The Board of Elections ruled defendant eligible for office. The Court of Appeals set forth a three-part test consistent with the Code. *Id*., at 187. In determining what evidence to consider, the court stated: "we must consider the evidence of all the surrounding circumstances and the conduct of the person in determining whether he or she has effectuated a change in domicile." *Id*.

Farnsworth does not authorize or permit the Department's facts and circumstances test because **Farnsworth** articulated a different test. Farnsworth set forth the three-part test discussed above that is consistent with G.S. §105-134.1(12) and is found in the Code. The Department, by contrast, morphs **Farnsworth**'s statement of what evidence should be considered into its own subjective and undefined test. But considering "all the facts and circumstances" is no test at all. As **Farnsworth** illustrates, it is an expression of what may be evaluated when analyzing a test or making a decision.

The phrase "facts and circumstances" is a familiar one as an expression of what evidence a court will consider. There are numerous cases observing that the universe of relevant evidence is "all the facts and circumstances." E.g., **State v. Medlin**, 333 N.C. 280, 291 (1993); **Great Am. Ins. Co. v. C.G. Tate Constr. Co.**, 315 N.C. 714, 719 (1986); **Ivery v. Ivery**, 258 N.C. 721, 732 (1963). As these authorities show, considering all facts and circumstances holds clear value in the law but provides no guidance as to how to analyze those facts and circumstances. Considering all the facts and circumstances does not allow the government to put everything into a black box from which an edict will later emerge. Yet that is how the Department has historically analyzed residency cases. "Considering all the evidence" and paragraph (b) of the Code concern what to evaluate; **Farnsworth**'s three-part test and paragraph (a) of the Code concern how to analyze what is evaluated.

The absence of any standard in the Department's facts and circumstances test is further illustrated by the recent testimony of three Department officials. None of the officials analyzed the facts and circumstances in the same way. The Assistant Director of the Personal Taxes Section of the Income Tax Division testified that she determines the state with which the taxpayer has the most contacts (weighting some factors more than others). An Administrative Officer testified that a taxpayer cannot establish residency in another state simply by satisfying a majority of the factors set forth in subparagraph (b) of the Code. That official also testified that even if all 16 factors set forth in subparagraph (b) favor a different state, the Department may still consider the taxpayer a resident of North Carolina! A Department auditor would not identify how she analyzed the facts and circumstances, instead simply repeating constantly that she considered all facts and circumstances.

The result of the Department's ambiguous test is that if the taxpayer maintains any ties with North Carolina, the Department has a basis (albeit possibly a shaky one) for concluding that the taxpayer is a North Carolina resident. There is no checklist or scorecard that a taxpayer can satisfy to guarantee that the Department will recognize her new state of residence.

Advising Clients

Because all facts and circumstances are relevant, a residency audit is extremely burdensome, invasive and expensive for clients (as is any ensuing litigation). The goal, therefore, should be not simply to establish Florida residency, but to avoid an audit.

A simple internet search provides suggestions for how to change residency to Florida. Those suggestions, however, frequently focus only on the most basic of tasks (e.g., driver's license and voter registration). Compliance with those tasks alone will not convince the Department that your client has changed her residency. Other times the suggestions are so numerous and detailed that only the most task-oriented clients will complete a majority of them. Even if a majority of the suggestions are completed, the most important suggestions may not be followed. The rest of this article will address how to advise clients in light of these potential problems assuming the client is not cutting all ties with North Carolina.

A. Educate the client about the process.

The first step is to educate the client about how the Department views changing residency (e.g., the Department's perspective from Auditing "Nonresidents") and what an audit and litigation will be like in terms of burden, expense, and time. If the client understands the Department's perspective and the consequences of being sloppy or maintaining ties in North Carolina, the odds will increase that the client will be more diligent about generating and preserving favorable evidence.

B. Specific tasks.

Short of cutting all ties with North Carolina, there is nothing a client can do to guarantee the Department will not audit her. Nor are there any scorecard type requirements the client can satisfy to convince a judge she had the necessary intent to move to Florida. There are, however, certain things that at a minimum should be done – and other things that should not be done – to create a record that will warrant enduring the expense and burden of an audit and ensuing litigation. THIS LIST IS NOT EXHAUSTIVE. It is only a start, but it is an achievable list of important things to do prior to the move. More than likely, your client will need repeated reminders to accomplish these tasks.

1. Official government acts.

Your client should:

• Get a Florida driver's license and turn in her North Carolina license. Be sure your client knows in advance what documentation is required (Florida requires more than just an out-of-state license).

• Register to vote in Florida and inform the North Carolina local board of elections to remove her from its voting rolls.

• File a declaration of domicile in Florida.

• Register one or more cars in Florida. This is one of the events the Code recognizes as indicative of when a change of residency occurs.

• Direct the postal service to forward mail to her home in Florida. This is also one of the events that the Code recognizes as indicative of when a change of residency occurs.

• File for the Florida homestead exemption. File this form before the taxable event to ensure the answer to the question "date you last became a permanent resident of Florida" is not after the taxable event.

2. Houses.

The best approach is to sell the family home in North Carolina. Other acceptable options are to (i) rent the home or (ii) list it for sale (at a reasonable price). If the client refuses to do any of those things, she needs a good reason for her inaction. Such reasons may include (i) needing a place to stay when returning for work; (ii) allowing a family member to live there; or (iii) retaining the property for investment purposes or for a family member (in that situation, it would be best to remove the furniture from the house). Regarding a true vacation home in North Carolina, there is no reason that it must be sold (though doing so is better).

Some clients may already own a vacation home in Florida. Although moving into such a home is technically permissible, it is far better to buy a new home prior to the date of the taxable event (particularly if the old Florida home is in a vacation community or is significantly smaller than the North Carolina home). Regardless of whether she moves into a new or existing home, your client should move some or preferably all of her favorite furniture and family heirlooms (e.g., photo albums, family china, silverware) to the Florida home. This may seem unnecessary and inconvenient if your client's Florida home is already furnished, but taking this step would be very helpful at trial and not doing it would be damaging.

3. Establish (new) ties in Florida.

The Code references family connections, friends, healthcare providers, civic and professional ties, and hometown activities. Having more of these in Florida and fewer of them in North Carolina is desirable. You and your client should discuss how evidence of these ties would be presented at trial. It is far better if there are witnesses from Florida (e.g., club members, friends, doctors and bankers) who can testify about your client's ties to Florida. If memberships in clubs in North Carolina are retained, be sure your client changes her membership status to non-resident status (and any membership in Florida should be a resident membership).

If your client has owned a vacation home in the community to which she is moving, it is helpful for new ties there to be created and old ties there to be strengthened. Otherwise, the Department may effectively argue that your client did not really move but is simply continuing her long-established vacation lifestyle in that community.

4. Work

The best option regarding work is for your client to work in Florida. The reality, however, is that often the significant taxable event is the sale of a company, and your client is required to keep working for the company in North Carolina for some period. If that is the situation, proceed as follows:

• Get a written employment agreement with a limited term (the shorter the better).

• Have the employment agreement specifically provide that your client may work remotely (and then have your client work remotely when possible).

• Begin the search for a replacement for your client as soon as possible.

5. Calendars

This is often one of the more difficult tasks for a person to complete accurately and thoroughly. If done properly, however, the calendars can be very helpful for your client. If done carelessly, the calendars can be very damaging.

People often keep a calendar to prove days outside North Carolina. With that perspective, they mark only when they are not in North Carolina. That method is defensive and makes North Carolina appear to be the default state. In addition, if your client fails to make an entry on a particular day, it appears that she was in North Carolina. The client should use the calendar to keep track of appointments and travels rather than as evidence (though it will be evidence). In addition, your client should view days in Florida as the norm. Although no entries are required for days spent in Florida, entries reflecting what your client was doing there would be helpful because memories fade.

There are numerous applications for smart phones that track one's location. Consider whether such an application would generate

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helpful or harmful evidence before having the client install and use the application. Once created, evidence cannot be destroyed without generating a lot of suspicion and a presumption that the evidence would have been damaging to your client.

6. Time.

The taxpayer should spend more time in Florida than in any other state or have a very good explanation for why that is not the case. When your client is in each state also may be important to an auditor. Visits surrounding typical holidays are more likely to be perceived as vacations rather than ordinary living. Other patterns may indicate where the taxpayer actually lives.

7. Investments.

As the saying goes, put your money where your mouth is. Your client should invest significant dollars consistently with her being a resident of Florida. An easy way to do so is to construct a nationwide municipal bond portfolio.

8. Friends and family.

The Department will attempt to minimize the significance of testimony from friends and family regarding the taxpayer's statements of an intention to move. Nevertheless, those persons – especially if they present well – can provide valuable corroboration testimony. Thus, your client should tell many people of her intention to move. Given that it is frequently years before such witnesses would be asked to testify, written communications that are preserved are very valuable to corroborate oral statements. Your client should keep copies rather than counting on others to do so.

Immediate family can be a very significant factor. It is best for a spouse and minor children to move at the same time as the taxpayer although a later move may be justified in certain circumstances (e.g., end of the school year or completing a job). If the taxpayer has children in college in the North Carolina university system, the benefit of in-state tuition should not be retained. Do not let your client be penny wise but pound foolish.

9. Lawyer or accountant.

Consulting with you about moving is generally good evidence for your client. To ensure its value is not lost, your client needs to follow your advice. Otherwise, it may appear that your client decided not to go through with the move.

10. Minimize contacts with North Carolina.

Emphasize the importance of having fewer contacts with North Carolina. The more ties a person maintains with North Carolina, the better the reasons need be to explain those ties. At some point, a judge will no longer accept the reasons. *See* **Thompson v. Dep't of Revenue**, 16 OTR-MD 229, 236-37 (Or. T.C. 2000) ("Given that the move was planned for some time, and that Mr. Thompson met with an attorney to discuss the matter of residency, Plaintiffs should have more definitively established a break from Oregon. … Plaintiffs have offered reasonable explanations for each item of apparently damaging evidence. However, as the evidence mounts, the weight becomes almost unbearable.").

Conclusion

Advisors should educate clients about the audit process to increase the odds the client will pay attention to details when moving to Florida. Moreover, clients likely will need help (or at least reminders) about what to do. Although the goal is to avoid an audit, your client should prepare for a possible audit and trial by maintaining a paper file of documents regarding Florida and efforts to disengage from North Carolina. The file should include hard copies of electronic documents to ensure evidence is preserved even if a computer crashes or the documents are deleted.

Advisors and clients should remember that litigation essentially starts when the Department begins the audit. Responses to Information and Document Requests should be thoughtful and accurate. If the amount of the dispute is significant, there is little chance the Department will go away quickly (particularly if it receives sloppy, incomplete, or inconsistent responses).

The legal principles for residency cases may not be settled in North Carolina for a few more years. Yet in the meantime you may be asked for advice by someone wanting to become a Florida resident. Given the expense and inconvenience of an audit, remember it is not enough to be right. Your goal is to avoid an audit; doing so is the only complete victory. •

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Guides for Counsel for Oral Arguments Now Available

The NCBA's Appellate Rules Committee has completed work on an Oral Argument Guide for Appellate Counsel, with separate editions for the Supreme Court of North Carolina and the North Carolina Court of Appeals. The guide summarizes key court rules and practices and offers tips and suggestions for attorneys preparing for appellate arguments. The committee has also updated its Style Manual for the North Carolina Rules of Appellate Procedure to reflect the most recent changes in appellate procedure and practice. The style manual provides examples and guidance about preparing appellate records, briefs and motions.

For more information, visit *http://www.ncbar.org/about/committees/appellate-rules-committee.aspx*

In Re Ocean Isle Palms LLC

The North Carolina Supreme Court Enforces Limits on Changing Real Property Valuations in Non-Revaluation Years

By Charles H. Mercer Jr. & Reed J. Hollander

In a case of first impression, the North Carolina Supreme Court determined that a county may not modify its real property appraisal methodologies in non-revaluation years or retroactively label as "error" appraisal methods used in the county's most recent revaluation and endorsed by that county's schedule of values. **In re Ocean Isle Palms LLC**, No. 128A12, 2013 N.C. LEXIS 55 (N.C. Ct. App. Jan. 25, 2013) (the authors were counsel of record to the taxpayers in this case.)

North Carolina law permits counties to appraise and assess real property for taxation only in years in which the county conducts a county-wide revaluation unless a particular property meets the conditions for revaluation described in G.S. § 105-287(a). Typically, most North Carolina counties revalue all property in the county every eight years, although some use a four-year cycle. North Carolina law permits counties to conduct a county-wide revaluation in any year they choose, but counties must do so at least every eight years. G.S. §105-286(a)(3). Effective Jan. 1, 2007, Brunswick County conducted its county-wide real property revaluation. In that revaluation the County appraised undeveloped residential lots using a "condition factor" method that applied a percentage (such as 20% or 40%) to the lot value of each lot. The application of the condition factor was to adjust the lot value to reflect the incomplete infrastructure (lack of paved roads, water, sewer, curbs and gutters, etc.) on each parcel.

As of 2008, a new tax assessor had been hired by Brunswick County. That assessor ordered that the percentages applied through the condition factor method during the 2007 revaluation all be increased to 100%. That had the effect of raising the per-lot appraised values by approximately four to five times, effective for tax year 2008 (a non-revaluation year). Ocean Isle Palms LLC appealed its substantially increased values to the North Carolina Property Tax Commission, which heard cross-motions for summary judgment filed by the taxpayer and the County. The Commission ruled unanimously in favor of the taxpayer, determining that the County lacked authority to change the values of these parcels in a non-revaluation year. The County took appeal to the North Carolina Court of Appeals, which reversed on a 2-1 vote. After appeal to the North Carolina Supreme Court by the taxpayer, the Supreme Court issued its unanimous decision on Jan. 25, 2013.

Once a value of real property is set during a revaluation, the value cannot be changed until the next revaluation unless certain statutory triggers are met. Specifically, G.S. § 105-287 authorizes a county to change values of real property in a non-revaluation year under certain limited conditions. One of the enumerated conditions is that the county can change a value "to correct an appraisal error resulting from a misapplication of the county's [schedule of values]." Counties are required to adopt a "schedule of standards, rules and values" (often referred to simply as a "schedule of values") for each county-wide revaluation. The schedule of values must be "sufficiently detailed to enable those making appraisals to adhere to [the schedule of values] in appraising real property." G.S. § 105-317(b)(1).

Brunswick County's core argument was that its change of the condition factor from 20% to 100% in 2008 was the correction of an appraisal error resulting from a misapplication of its schedule of values in 2007. It contended that its appraisers, during their revaluation appraisals of these undeveloped residential lots, made an appraisal error in applying condition factors to these undeveloped residential lots, and the County's 2007 schedule of values did not expressly authorize its appraisers to use the condition factor method they employed.

Reviewing the undisputed record evidence, the Court found that the condition factor method had been used by Brunswick County since at least 1976 and was applied in a manner consistent with past practices during the 2007 revaluation. The Court further found that the 2007 schedule of values did not contain any details describing the propriety of applying the condition factor, which was neither required nor prohibited in any particular situation. The schedule of values merely described the numerical format for the condition factor and explained how the factor affected the calculation of the total unit price. Finally, the Court noted that the schedule of values expressly states that the County "relies on appraisers' experience and expertise … as well as their personal judgment" in applying the schedule of values.

Depositions of Brunswick County revealed that the two appraisers primarily responsible for the 2007 revaluation were experienced and skilled. The revaluation supervisor had worked for the County since 1996, while the primary appraiser of vacant parcels had been employed by the County for eight or nine years. Both of them had used the condition factor to determine true value of vacant lots throughout their employment with the County. The appraiser had visited the vacant lots, observed their degree of development, determined a condition factor using a manner consistent with the 1999 and 2003 revaluations, and assigned a factor based on those observations and his judgment. Evidence further showed that the County tax office was aware that condition factors of 20% and 40% were being applied to undeveloped residential lots during the 2007 revaluation. Finally, the Court found that the 2007 schedule of values was adopted "with an intention of maintaining consistency with this appraisal practice."

Given this evidence, the Court concluded that the County's attempt to frame its actions in 2008 as the "correction of an error" was not accurate, and the "County instead instituted a new revaluation system":

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Real Property Valuations, *continued from page 7*

According to the record, shortly after the 2007 revaluation, the County's tax assessor ordered appraisers to stop using the condition factor method of appraisal and to reset the value of the parcels at issue here without any consideration of, or adjustment for, the degree to which the property had been developed. In other words, the County's response to the alleged shortcomings of the 2007 appraisals of Ocean Isle's lots was not to correct the application of the condition factor to reflect new information but to throw out the condition factor altogether. Consequently, the County's reaction to the perceived erroneous revaluations cannot be seen as a mere correction of a methodology used with approval in the past. Instead, the County imposed a revised system of valuation.

The final issue for the court was to determine whether imposing this revised system of valuation in a non-revaluation year violated the North Carolina Machinery Act, G.S. § 105-271 *et. seq.* The court recognized that the County's remedy, if it did not want to use the condition factor method for its 2007 revaluation, was to "revise the schedule of values for that revaluation year to reflect a change from its previously approved approach to undeveloped property appraisal. However, when no such timely change was made, the County may not retroactively label as error an historically approved methodology endorsed by the schedule."

The court also rejected the County's argument that the condition factor method had been applied non-uniformly across undeveloped lots in the County, finding that this argument did not apply to the valuation of Ocean Isle Palms' lots. In summary, the court concluded that "if the County seeks to limit appraisers' use of their discretion in future revaluations, it may do so only prospectively."

This is a major case confirming the limits on county assessor authority to change real property tax valuations in non-revaluation years. It strongly supports the consistency, uniformity and predictability goals of North Carolina's cyclical real property tax revaluation system. A contrary ruling could have permitted assessors to change real property values in non-revaluation years merely by reinterpreting language in their county's schedule of values or by exercising their appraisal discretion in a substantially different manner.

The lesson for county tax officials is that their schedules of values should be written to reflect the methods they intend to employ for their revaluations. In particular, where they intend to change a long-standing appraisal practice for an upcoming revaluation, they should include specific language in their new schedule of values alerting taxpayers and county staff to the change and explaining how the methodology is being altered.

North Carolina taxpayers should be on the lookout for real property valuation changes in non-revaluation years and investigate the county's basis for making such a change to determine if the change falls outside the limited grounds for permissible non-revaluation year changes in G.S. § 105-287(a). If so, the taxpayer may have grounds to challenge the altered value, using **In re: Appeal of Ocean Isle Palms** as precedent. •

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A version of this article was published by the Institute for Professionals in Taxation in the April 2013 issue of Tax Report.

Recent Federal Income Tax Case Law Update

By Keith A. Wood

Editor's Note: This is the first installment of this article. The second installment will appear in the next issue of Tax Assessments.

PART ONE | IRS AUDIT STATISTICS

I. Audit Statistics: What Are Your Chances of Being Audited? | The 2011 Internal Revenue Service Data Book (IR-2012-36) contains audit statistics for the Sept. 30, 2011 fiscal year:

A. Audit rates for individual income tax returns. Only 1.1% of filed individual income tax returns were audited, and of those only 25% of tax audits were conducted by revenue agents and about 75% were correspondence audits. The audit rates for Schedule C returns were much higher than for individual returns: a 4.3% audit rate for Schedule C returns showing receipts of $100,000-$200,000, and an audit rate of 3.8% for Schedule C returns showing receipts over $200,000.

B. Audit rates for partnerships and S corporations. The audit rate for partnerships and S corporations was only 0.4%.

C. Audit rates for corporations. C corporation returns had an audit rate of 1.5%, but large C corporations with assets over $10 Million had an audit rate of 17.6%.

D. Offers in compromise. The IRS accepted only 20,000 out of 59,000 offers in compromise.

E. Criminal case referrals. The IRS initiated 4,720 criminal investigations, 3,410 ultimately resulted in prosecutions, and 2,350 resulted in convictions. For convictions, 81.5% were actually incarcerated.

PART TWO | SHAREHOLDER GOODWILL

II. The "King Of Insurance," and Not His Corporation, Sold His Personal Shareholder Goodwill. | In **H&M, Inc. v. Commissioner**, T.C. Memo 2012-290, Mr. Schmeets' C corporation insurance agency, H&M, Inc., sold all its assets. Under the terms of the asset purchase agreement, the buyer purchased all customer lists for $20,000. The agreement was contingent on Mr. Schmeets agreeing to a noncompete agreement and an employment agreement that obligated Mr. Schmeets to work with the buyer for six years, for a modest annual base wage of around $39,000, but with possible annual variable compensation based upon the buyer's future profitability. For the six years after the asset sale, Mr. Schmeets received over $600,000 of compensation under the employment agreement. The IRS sought to reclassify the wage income as additional proceeds for the sale of H&M assets.

The Tax Court held that the employment agreement payments were not disguised payments to H&M for its customer lists and goodwill. The court noted that prior to the sale, Mr. Schmeets had acquired vast experience in operating all aspects of the insurance business, including accounting, management and employee training, and that he had become an expert in all types of insurance lines. In fact, Mr. Schmeets' competitors referred to him as the "King of Insurance." Also, when sale negotiations began, Mr. Schmeets was most concerned with obtaining guaranteed employment with the buyer after the sale transaction, and during his post-sale employment term, Mr. Schmeets' went from a 40-hour work week to almost double that.

PART THREE | DETERMINING TAXABLE INCOME

III. Ordinary Income or Capital Gain on the Sale of Real Property? In **Flood v. Commissioner**, T.C. Memo 2012-243, during 2004 and 2005 Mr. Flood was a day trader in the stock market. Mr. and Mrs. Flood also operated a real estate venture that involved the purchase and sale of undeveloped vacant lots. From 2001 to 2008, Mr. and Mrs. Flood purchased at least 250 lots. During 2004 they sold two lots, and during 2005 they sold 40 lots. The Tax Court concluded that Mr. and Mrs. Flood held the lots primarily for sale to customers in the ordinary course of business, such that all of the taxable gain on the lot sales would be taxed as ordinary income, rather than as capital gains, based upon the following factors:

A. The purpose of acquiring and holding the properties. Even though the Floods only sold a few lots during the years at issue, the Floods earned over $1 million of gain on their sales. The court also noted that the remaining lots not sold in 2004 and 2005 had relatively low value compared to the lots sold in 2004 and 2005.

B. The nature of the taxpayer's everyday business. Even though Mr. Flood's everyday business was a stock day trader, the income from Mr. Flood's day trading activities was modest compared to the gains from the real estate venture.

C. Frequency, continuity and substantiality of sales. Although the Floods sold only two lots in 2004 and 40 lots in 2005, the two lots sold in 2004 had just been purchased in 2003. Of the 40 lots that they sold in 2005, 11 had been purchased in 2001, 15 had been purchased in 2002, and 12 had been purchased in 2003.

D. Development activities of the taxpayer. Even though the Floods did not develop or improve the lots and did not use a business office for their activities, they put considerable time, effort and resources into their real estate ventures.

IV. When Does Cancellation of Debt Income Arise? | In **Kleber v. Commissioner**, T.C. Memo 2011-233, Ms. Kleber defaulted under an agricultural lease in 1998. In January 1999, the Navy sent Ms. Kleber a letter advising her that it was terminating the lease and demanded that she pay past due rent of over $190,000. Although the Navy continued to send demand letters to Ms. Kleber through April 1999, no other debt collection activities took place until November 22, 2005, when the Navy decided to write off Ms. Kleber's debt and to issue Ms. Kleber a Form 1099-C, Cancellation of Debt, reflecting cancellation of debt income of over $260,000. The IRS assessed additional tax deficiencies on Ms. Kleber's 2005 tax return.

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The Tax Court held that, under the 36-month testing period rule of Reg. § 1.6050P-1(b)(2)(iv) — which provides there is a rebuttable presumption that an identifiable cancellation of debt event has occurred during a calendar year if the creditor has not received a payment on an indebtedness at any time during the 36-month testing period ending on the close of that year — there was a rebuttal of presumption that the identifiable event occurred in 2002 and thus the COD income was recognized in that year.

Also see **Abarca v. Commissioner**, T.C. Memo 2012-245, where the court determined there was no cancellation of debt income for the year in question where the taxpayer received a letter from his lender stating that his loan had been charged off, but the borrower still remained obligated for payment of the debt. *Also see* **Stewart**, T.C. Summary Memo 2012-46, where the taxpayer was able to rebut the presumption of correctness that attaches to a Form 1099 by presenting evidence that there had been no collection activity during the 36-month testing period.

V. A Terminated Life Insurance Policy Generated Gain on the Deemed Sale and Not Cancellation of Debt Income. | In **McGowen v. Commissioner**, 108 AFTR 2d 2011-6063, the court ruled that Ms. McGowen, who had purchased a single premium variable life insurance policy for $500,000, but then borrowed against the policy's value over time, had to recognize taxable income of $565,000 when she allowed the policy to lapse when the debt on the policy exceeded the cash surrender value of the policy by $2,000. Although the insurance company had offered to let Ms. McGowen make a minimum loan repayment of over $100,000 to keep the policy in force, Ms. McGowen decided to allow the policy to lapse. After the life insurance company sent Ms. McGowen a Form 1099-R reflecting a taxable gain of $565,000 on the policy lapse (which was equal to the policy debt of $1,065,000 less Ms. McGowen's income tax basis in the policy of $500,000), Ms. McGowen claimed the $565,000 gain was discharge of indebtedness income that was excludable from taxable gross income under the insolvency exception of Section 108. The Tax Court, however, noted that Section 72(e), requires that taxpayers include as taxable income any amount received under a life insurance contract. Ms. McGowen essentially sold her policy for an amount equal to the outstanding policy debt, thus generating gain under Section 72(e) rather than COD income.

VI. Long Term Care Rider to an Annuity Contract was Insurance such that Long-Term Care Benefits were Nontaxable. | In PLR 201213016, the IRS concluded that long-term care benefits provided under a long-term care insurance rider purchased as part of an annuity contract would be excludable from taxable income under Section 104(a)(31) once the annuity owner became chronically ill.

VII. IRS Provides Sample Language for Making a Section 83(b) Election. | Section 83(a) provides that a grant of stock or equity to an employee or independent contractor is currently taxable to the employee/independent contractor, but if the stock/equity award is subject to a substantial risk of forfeiture, the employee/independent contractor will not recognize taxable income until the substantial risk of forfeiture lapses. Nevertheless, where the stock/equity award is subject to a substantial risk of forfeiture, the employee may file a Section 83(b) election with the IRS to have the value of the award currently taxed based on the value of the award at the date of grant, provided that the election is filed within 30 days after the grant is awarded. A Section 83(b) election allows the taxable amount to be based upon the value of the award at the date of grant. Any future appreciation in the value of the award will be taxed at capital gains rates rather than at the ordinary income tax rates.

In Revenue Procedure 2012-29, the IRS provided sample language that a taxpayer may use in making a Section 83(b) election for awards that are subject to a substantial risk of forfeiture.

PART FOUR | REASONABLE COMPENSATION ISSUES

VIII. Accounting Firm C Corporation's Consulting Fees Are Recharacterized as Dividends Based Upon the Reasonable Investor Test. | In **Mulcahy v. Commissioner**, 109 AFTR 2d 2012-2140, the Mulcahy accounting firm, operated as a C corporation, filed its tax return reflecting that during 2001, the three founding members of the firm received salary compensation of over $230,000. Although the IRS did not challenge the salary deductions, the Tax Court and Seventh Circuit disallowed more than $850,000 in consulting fee deductions the firm paid to three entities owned by the founding members and recharacterized those consulting fees as dividends to the founding members rather than deductible compensation.

The Appeals Court ruled that even though the accounting firm was a personal service corporation that relied upon the talents of its owners, the corporation also had significant capital. The firm had over 40 employees and multiple offices in different locations and therefore needed a significant capital structure to support its large operation. Also, the corporation had significant capital in the form of client lists and other intangible assets. The court found that the consulting fee deduction of $850,000 would practically zero out the accounting firm's income for the year, thus providing its shareholders with virtually no return on their investment. Therefore, under the reasonable compensation independent investor test, the consulting fees were recharacterized as nondeductible dividends because there was no return left to provide the owners a reasonable rate of return on their capital investment in the C corporation.

PART FIVE | OTHER DEDUCTIONS

IX. A Charity's Faulty Letters of Acknowledgement Result in Denied Charitable Contribution Deduction. | In **Durden**, T.C. Memo 2012-140, Mr. and Mrs. Durden were denied charitable contribution deductions for cash donations of $250 or more to their church because the letters of acknowledgement from their church did not satisfy the substantiation requirements of Section 170(f)(8). At the Tax Court trial, the Durdens provided copies of the cancelled donation checks together with two letters of acknowledgement from their church. The first letter, dated Jan. 10, 2008, acknowledged the charitable contribution, but did not indicate whether any goods or services were provided to the Durdens in exchange for their contributions. The second letter, dated June 21, 2009, contained a statement confirming no goods or services were provided to the Durdens in exchange for their contributions.

The court ruled that while the first letter (dated Jan. 8, 2008) was contemporaneous with their 2007 contributions, the letter was defective because it failed to state whether the Durdens received any goods or services in exchange for their contribution. The second letter (dated June 21, 2009), which confirmed that the Durdens did not receive any goods or services in exchange for their contributions, nevertheless failed to meet the requirements of Section 170(f)(8) because it was not sent contemporaneously with the 2007 contributions.

X. No Business Bad Debt Deduction Allowed for Shareholder/Employee Who Made Loans to Protect His Investment Rather Than to Protect His Salary. | In **Haury v. Commissioner**, T.C. Memo 2012-215, Mr. Haury was denied business bad debt treatment for worthless loans made to two corporations of which he was an employee and investor. He was a software engineer who designed computer software used by the two corporations. Mr. Haury owned less than 50% of the stock of both corporations. In 2007 the two corporations entered into a software license agreement with the Department of Homeland Security. To perform the contracts, the corporations needed additional funds, and Mr. Haury allowed his IRA to loan funds to the corporations. By the end of 2007, Mr. Haury's loans to the corporations had become worthless. Mr. Haury claimed a business bad debt deduction on Schedule C of his 2007 return, taking the position that he had incurred a business bad debt for his worthless loans.

The Tax Court ruled that because Mr. Haury's dominant motive in making the loan was to protect his investment in the corporations, rather than his salary as an employee, the worthless debt was deductible as a nonbusiness bad debt. *See* **Dagres v. Commissioner**, 136 TC 263 (2011). The court agreed with the IRS that Mr. Haury had made a loan to the corporations to protect his investment as a stockholder rather than to protect his status as an employee. The court noted that Mr. Haury did not receive any employment compensation for 2007 or thereafter, and had only received modest compensation from the corporations in 2005 and 2006 ($147,000 total). In addition, Mr. Haury had substantial investments in both corporations, both in terms of his actual stock ownership and his personal time in developing the computer software used by the corporations.

PART SIX | PASSIVE LOSS CASES

XI. Tax Court Rules That Rental Income Should Be Recharacterized as Non-Passive Income Under the Self Rental Rules. | In **Veriha**, 139 T.C. No. 3, Mr. Veriha was the sole owner of John Veriha Trucking Inc. ("JVT"), a C corporation. JVT was a trucking company that employed Mr. Veriha and his wife. During 2005, Mr. Veriha materially participated in the business of JVT.

JVT leased its trucking equipment from two different entities, Transportation Resources, Inc. ("TRI") and JRV Leasing, LLC ("JRV"). TRI was an S corporation owned by Mr. Veriha and his father. JRV was a single member LLC owned solely by Mr. Veriha. During 2005, TRI generated net income which it reported to Mr. Veriha on a Schedule K-1, and the Verihas treated that income as passive. During that same year, JRV generated a net loss, as reported on the Verihas, Schedule C, and the Verihas treated the loss as passive.

The IRS took the position that the Verihas' TRI income should be recharacterized as non-passive under the self-rental rules of Reg. § 1.469-2(f)(6), which treats as non-passive the rental income from an item of property rented to another business in which the taxpayer materially participates. This meant that the Verihas could not offset their income from TRI by their losses generated by JRV. Although the Verihas argued that all of their tractors and trailers were a single item of property, since Mr. Veriha owned 99% of TRI and all of JRV, the Tax Court ruled that each individual tractor or trailer was a separate item of property under Reg. § 1.469-2(f)(6). •

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