

**ABA SECTION OF TAXATION
2014 LAW STUDENT TAX CHALLENGE**

OFFICIAL J.D. DIVISION PROBLEM

You are an associate in the Houston, Texas, office of one of our nation's most respected law firms. You have just finished helping a client perform due diligence on its planned acquisition, and you now know more about copier leases than you'll ever admit to your friends. You are hopeful your next project will involve more substantive law; you'd particularly like to see some federal income tax issues. Terry, the head of the corporate department, e-mailed you and your fellow associates last night to gauge whether anyone was interested in taking on a small tax project. She asked for volunteers to come see her first thing Monday morning. Ever eager to make your mark, you go directly to Terry's office when you arrive (early) at work on Monday.

To your chagrin you find Kevin, a third-year associate, already talking with Terry about the tax project when you knock on her door. Terry welcomes you and appears happy that two eager, young lawyers want to help. Terry explains that you and Kevin will work together to help Henry, the son of Terry's most loyal client. She tells Kevin to take the lead because he is senior to you. She then tells you both that Henry is waiting in the small conference room.

You and Kevin enter the conference room and find Henry, an affable man, drinking coffee. You introduce yourself, and Kevin begins to ask Henry some questions. Kevin asks you to take notes for the file, and you happily comply. After Henry leaves, you type your notes and email them to Kevin. On your way to Kevin's office, Terry catches you in the hallway and tells you that a truckload of new copier leases had just been loaded in the virtual file room and that you must review them immediately. She tells you that Kevin can manage Henry's project while you finish reviewing the leases.

A week later, you're done reviewing the copier leases. Anxious to get tax experience, you stop by Kevin's office to see how much work is left for you. You are surprised to see Kevin's office is empty. Terry also happens by Kevin's old office while you're standing there and explains that he has left for a position at a competing firm. Kevin had come in over the weekend and cleaned out his stuff, leaving only open files on his shelves. Very impressed that you're in the office on Labor Day, Terry asks if you're up to the task of taking over Henry's project where Kevin had left off; you readily answer "yes, Ma'am." Terry then hands you a memorandum, which she had written for Kevin, and tells you that everything you'll need is in Kevin's files. You grab the memorandum and begin rifling through Kevin's files and find several documents.

Kevin

From: You
Sent: August 25, 2014 10:27 AM
To: Kevin
Subject: Notes from initial client meeting / Henry

Kevin--I've typed my notes from our meeting with Henry this morning. The notes are attached. Are you available later this morning to strategize? Let's talk.

Also, I assume Terry opened a billing code for this project. Do you have it?

Thanks,
You

Notes from initial client meeting--08/25/14

Henry was born and raised in Houston, Texas. He lives in his childhood home on Green Street, which has been in his family for generations. His parents long ago moved to their second home on Lake LBJ. Henry has used the Green Street address for all personal and business purposes, including all of his tax filings.

Henry had been in the welding business since the summer following high school graduation 13 years ago. During that time he had accumulated some expensive welding equipment, which he had kept in a rented shop a few miles from the Green Street home. In 2005 a terrific storm swept through Houston and lightning struck his shop, igniting his engine drive welder. The fire department responded promptly, but not before the fire damaged his welder. Henry was unable to salvage the burned equipment and was forced to discard it. He had no insurance coverage for the welder, and he received no compensation for the damage. Henry also sold some of his equipment in 2005 and 2007. He said he would get us more details on those sales.

Anne is a civil engineer with a good job in Texas. Henry and Anne dated in high school and then went their separate ways. Henry learned to weld and Anne went to college to study engineering. After college and a first job, Anne moved backed to Houston in 2010 and reunited with Henry. Henry was enamored with Anne and wanted to earn some real money so they could begin their lives together on the right foot. He made a decent living with his welding business, but he wanted to earn enough money to buy an engagement ring for Anne and to buy the Green Street home from his parents.

Henry was considering what to do next when he remembered that some of his high school buddies had made some real money working in the Bakken fields in North Dakota. Anne had recently been put on a project that would require her to be in Oklahoma for an indeterminate time, so there was nothing tying Henry to Houston for the time being. Henry, never afraid of hard work, decided that he'd give it a go and try his luck in North Dakota for a little while. Henry and Anne decided they should take a trip together, however, before they parted ways. They both wanted to go to Costa Rica and booked a trip.

Before leaving for Costa Rica, Henry placed the Green Street home on the rental market. He immediately got a tenant, who was an old high school friend. Henry's friend wanted a 24 month lease and was willing to pay an upfront premium for it. Henry decided the premium could help him pay for the Costa Rica trip, so he printed a form lease and had his parents and the new tenant sign it. Henry did not forward his mail to North Dakota through the USPS, and he did not file a Form 8822, Change of Address, with the IRS. He did file his 2010 Federal income tax return by mailing it into the IRS on February 14, 2011; the return provided his address on Green Street. The IRS received his 2010 return on February 18, 2011.

Henry and Anne flew to San Jose, Costa Rica, on March 28, 2011. After having a memorable time together, they departed on separate flights from San Jose on April 9, 2011. Anne flew to Oklahoma to begin work. Henry flew to North Dakota to look for work.

Henry rented a truck at the Bismark airport. He asked for a deal if he paid up front. The clerk told him there was no such deal, but offered an upgrade, which he declined. He drove his rental truck to a local hotel. He again asked for a deal if he paid up front. The manager told him that he could get the rest of the month of April for free if he pre-paid eight months' rent. Henry took this deal.

After tossing his suitcase in his hotel room, he climbed back in the truck and drove off toward Theodore Roosevelt National Park to see some bison. On his way he stopped at a convenience store with a job board covered with postings. He picked a posting for a contract welder in the oil fields. The posting told him to show up in front of the store on Monday, April 11, 2011, if he wanted the job. Henry showed up and met Sam, who had posted the ad. Sam hired Henry for the job, which started immediately. The contract was for seven months, after which the terms of the contract would extend month to month.

Henry asked Sam about any special equipment he'd need and Sam handed him a list of items he'd need for his work in the field. This list included: flame-resistant duck coveralls; flame-resistant rain jacket; and flame-resistant bibs. Henry ordered this equipment from a specialty retailer online and paid \$1,140 for three pairs of coveralls, \$400 for the jacket, and \$1,050 for three pairs of bibs. Instinctively, Henry had the items mailed to the Green Street address. Henry called his friend now living in the Green Street home and asked him to mail his field clothes to him in North Dakota when they arrived. His friend asked if Henry would also like his other mail sent with the package. Henry declined. On April 18, 2011, Henry received his coveralls, jacket, and bibs that his friend had mailed to him.

Henry enjoyed his work in the oil fields. During breaks he talked about how lucky he was to land this job so quickly. All of his co-workers told Henry that jobs were plentiful; he also noticed that the job posting board was always full of new postings. Henry asked Sam why there are always new postings and Sam told Henry that the work in the fields was so taxing that most people simply "wore out" after six months. Sam explained that was why Henry's contract was only seven months long--because workers could not fulfill longer contracts.

Henry was so enthralled with his work that he couldn't understand how anyone would want to leave. After a few weeks on the job he had returned his rented truck and leased a truck instead. The leased truck was the same monthly price but had heated seats, which Henry understood to be a great benefit in the long North Dakota winter. Henry signed a 12 month lease, the shortest option available. The lease included a one month early termination penalty.

When November came, Henry had become keenly aware of the toll the job was taking on his body. Henry, tired from the field, understood Sam's point about workers not lasting and doubted whether he'd make it. Henry talked with Sam about his misgivings, and Sam told him to buy a good winter coat to wear out in the fields to keep him warm. Sam told Henry that a warm core was the key to good spirits in North Dakota. Henry took his advice and bought a \$750 extra warm goose down coat from the same online retailer he had used to purchase his coveralls, jacket, and bibs. Henry would never have purchased such a coat to wear if not for Sam's recommendation and the overwhelmingly positive reviews the coat received online. Most people who had purchased the coat, Henry learned, enjoyed wearing it in both work and personal settings.

Sam also told Henry to take a short holiday down in Houston to refresh himself, so Henry flew to Texas for Thanksgiving. He dropped by the Green Street home to check on things for his parents and found three USPS Forms 3849, Delivery Notice/Reminder/Receipt, from the IRS. The Forms 3849 were in a pile of mail the tenant had set aside for Henry's return. Henry went to the Post Office to retrieve the letter but found it was returned to the sender months previously. Henry asked his friend what he knew about the attempted deliveries, and his friend told him he was not home when the USPS attempted delivery. Henry had to get back to his job in North Dakota, so he left without getting the letter. He figured that if the letter was important, the sender would contact him again. Henry told the renter to forward him any further correspondence from the IRS because he wasn't certain when he'd be back.

Feeling refreshed from his trip, Henry began to think about asking Anne to move to North Dakota with him. He emailed her from the airport and asked her to find out if her firm had any open positions near North Dakota's Bakken fields. Anne replied that she would see what was available, but that she was apprehensive about moving to a part of the country where neither of them had family. Henry responded that he had reconnected with a bunch of his cousins who were living in Bismark and that he already felt as though he was "part of the family." In fact, Henry was planning to (and did) move to one cousin's duplex at the beginning of the year. The duplex was much nicer than his hotel room and it would cost the same amount of rent.

At the beginning of March, 2012, Henry's spirits were at an all-time high. Sam approached Henry to discuss whether he wanted to get off the month-to-month arrangement for a longer-term contract. Henry, having just heard that Anne's project in Oklahoma had been extended, agreed and signed a one-year contract.

Henry finished out his contract in February, 2013. Finally tired of the punishing North Dakota winter, Henry moved back to the Green Street home. He has been rebuilding his welding business since he returned. On Friday, August 22, 2014, he received two letters from the IRS. The first was a Letter 1058, Notice of Intent To Levy and Notice Of Your Right To A Hearing,

which informed him that the IRS was about to levy on his assets to collect unpaid taxes for 2007. The second was a notice of deficiency for tax years 2011 and 2012. The notice of deficiency was dated Monday, August 18, 2014, and the Letter 1058 was dated Wednesday, August 20, 2014. He called his father, who then called Terry.

File Memo -- Letter 1058

After the initial meeting I gathered more facts from Henry and spoke with an IRS representative. I discovered that the Letter 1058 is for tax year 2007. The IRS sent Henry a notice of deficiency for 2007 on March 30, 2011. The USPS attempted to deliver the 2007 notice of deficiency to the Green Street address three times between April 4, 2011, and April 25, 2011. The tracking number on the notice of deficiency matched the tracking numbers listed on all three USPS Forms 3849 that were mailed to the Green Street home. On September 30, 2011, the IRS assessed the deficiency against Henry. I discovered that the IRS, on February 15, 2011, mailed Henry a Form 872, Consent to Extend the Time to Assess Tax, to his Green Street address so that an audit that had just begun on his 2007 tax year could be completed before the period of limitation on assessment ran. The IRS records indicate that the Form 872 was returned to them on February 24, 2011. The letter containing the Form 872 had "Return to Sender" scribbled on it. Henry said he was the only person living at the Green Street address at the time and that he did not receive the Form 872, let alone write "Return to Sender" on it.

The IRS determined in the 2007 notice of deficiency that Henry had reported gains from the sale of business assets in 2007 as capital gains but should have treated the gains as ordinary income. Henry started his welding business in 2001. He reported his welding business income and loss on Schedule C of his Form 1040. Henry sold three pieces of welding equipment to an unrelated party in 2007 and reported the gain as being taxed at preferential capital gain rates. I verified this by looking at his 2007 Federal income tax return, which he filed with the IRS on February 20, 2008. Henry had previously sold a piece of equipment from his business in 2005 to an unrelated party and another piece (the engine drive welder or engine welder) was burned in a fire and was destroyed. Henry reported both dispositions from 2005 as ordinary losses. Henry did not sell or otherwise dispose of any other property from his welding business from 2001 through 2007. He owned all the equipment listed below for more than one year. I attached the tax attributes of the items on the next page.

	Acquired For	Depreciation Taken	FMV when disposed of	Adjusted Basis	Sold For
2005					
Engine Welder	\$10,000	\$4,000	\$0	\$6,000	Destroyed
Machine 1	\$20,000	\$8,000	\$10,000	\$12,000	\$10,000
2007					
Machine 2	\$8,000	\$4,000	\$2,000	\$4,000	\$2,000
Machine 3	\$10,000	\$8,000	\$17,000	\$2,000	\$16,000
Machine 4	\$15,000	\$6,000	\$16,000	\$9,000	\$16,000

Thoughts:

- It does not appear that all gain should be ordinary.
- How to handle depreciation? Are there recapture issues?
- Can I challenge the character of the gain or the assessment itself since the 2007 notice of deficiency was mailed to Henry's Green Street address? Does it matter that he didn't actually receive the notice of deficiency?
- When and how must I respond to this notice of intent to levy?

File Memo -- Notice of Deficiency

The Notice of Deficiency is for 2011 and 2012. Henry took the following deductions, which the IRS has disallowed in full. The IRS determined that the clothing costs were not deductible. The IRS also disallowed deductions for the non-clothing expenses because they determined that Henry was not away from his home when he incurred them; the IRS determined that the non-clothing expenses were otherwise deductible.

	Total	Monthly
2011		
Apartment Rent	\$12,000	\$1,500
Truck Rent	\$2,610	\$300
Fuel for Truck	\$2,610	\$300
Food	\$4,350	\$500
Thanksgiving Airfare	\$700	-
Clothing	\$3,340	-
2012		
Apartment Rent	\$18,000	\$1,500
Truck Rent	\$3,600	\$300
Fuel for Truck	\$3,600	\$300
Food	\$6,000	\$500

Thoughts:

- How can I challenge this determination?
- Can Henry prevail on the merits for all or some of these deductions?

MEMORANDUM

TO: ~~KEVIN~~ YOU

FROM: TERRY

SUBJECT: HENRY (File No. 128-0044)

Please review the attached file and prepare a memo no longer than 10 pages and a client letter no longer than 5 pages. The memo should contain your analysis and recommendations with respect to the federal income tax consequences of the following issues. The client letter should explain your analysis, conclusions, and recommendations in a way that Henry, who is not a tax lawyer, will understand.

1. When and how must we respond to the notice of deficiency for 2011 and 2012 and the Letter 1058 for 2007?
2. Can we challenge the IRS's characterization of Henry's 2007 gains? How would we challenge Henry's underlying tax liability at this point? What amount of these gains, if any, did the IRS mischaracterize?
3. Can we challenge the 2007 assessment on the basis of Henry's not receiving the notice of deficiency?
4. Will we prevail on the merits for all or some of Henry's 2011 and 2012 deductions if we challenge them?

Focus only on the federal income tax issues presented. State and local tax issues are beyond the scope of this assignment. Also, consider Henry to have been an independent contractor, not an employee, throughout the years. Consider the depreciation Henry took on his welding equipment as being correct.

Project File:

Memo; August 25, 2014 email; Notice of Deficiency file memo; Letter 1058 file memo.

END OF PROBLEM