

UNITED STATES TAX COURT
WASHINGTON, DC 20217

JAY DARYL WAHLIN & KRISTINE M.)	
WAHLIN,)	
)	
Petitioners,)	
)	
v.)	Docket No. 23108-16S.
)	
COMMISSIONER OF INTERNAL REVENUE,)	
)	
Respondent)	

ORDER

Pursuant to Rule 152(b), Tax Court Rules of Practice and Procedure, it is

ORDERED that the Clerk of the Court shall transmit herewith to Petitioner and to respondent a copy of the pages of the transcript of the trial in the above case before Special Trial Judge Diana L. Leyden at San Diego, California, on January 31, 2018, containing her oral findings of fact and opinion rendered at the conclusion of the trial.

In accordance with the oral findings of fact and opinion, decision will be entered under Rule 155.

(Signed) Diana L. Leyden
Special Trial Judge

Dated: Washington, D.C.
February 23, 2018

SERVED Feb 26 2018

1 Bench Opinion by Special Trial Judge Diana L. Leyden

2 January 31, 2018

3 Jay Daryl Wahlin and Kristine M. Wahlin v. Commissioner of
4 Internal Revenue

5 Docket No. 23108-16S

6 THE COURT: THE COURT HAS DECIDED TO RENDER ORAL
7 FINDINGS OF FACT AND OPINION IN THIS CASE, AND THE
8 FOLLOWING REPRESENTS THE COURT'S ORAL FINDINGS OF FACT AND
9 OPINION. THE ORAL FINDINGS OF FACT AND OPINION SHALL NOT
10 BE RELIED UPON AS PRECEDENT IN ANY OTHER CASE. See Rule
11 152(c), Tax Court Rules of Practice and Procedure.

12 This proceeding was heard as a Small Tax Case
13 pursuant to the provisions of section 7463 of the Internal
14 Revenue Code of 1986, as amended, and Rules 170 through
15 175 of the Tax Court Rules of Practice and Procedure.

16 This bench opinion is made pursuant to the
17 authority granted by section 7459(b) of the Internal
18 Revenue Code of 1986, as amended, and Rule 152 of the Tax
19 Court Rules of Practice and Procedure.

20 Hereinafter in this bench opinion, all section
21 references are to the Internal Revenue Code, as amended
22 and in effect for the relevant times, and all Rule
23 references are to the Tax Court Rules of Practice and
24 Procedure.

25 The Court uses the term "IRS" to refer to



1 administrative actions taken outside of these proceedings.

2 The Court uses the term "respondent" to refer to the

3 Commissioner of Internal Revenue, who is the head of the

4 IRS and is respondent in this case, and to refer to

5 actions taken in connection with this case.

6 The trial of this case was conducted on January

7 29, 2018, in San Diego, California. Petitioner husband

8 appeared on petitioners' behalf. Monica Polo appeared on

9 behalf of respondent.

10 In a notice of deficiency dated August 1, 2016,

11 the IRS determined a deficiency in petitioners' 2013

12 Federal income tax of \$34,690 and a section 6662(a)

13 accuracy-related penalty of \$6,938. At trial respondent

14 conceded that the IRS had not asserted the accuracy-

15 related penalty on the basis of negligence or intentional

16 disregard of the rules and regulation.

17 The only issues for decision by the Court are:

18 (1) whether petitioners may claim a deduction for interest

19 on Schedule E, Supplemental Income and Loss, and (2)

20 whether petitioners are liable for the accuracy-related

21 penalty under section 6662(a) and (b)(2) for 2013.

22 Background

23 Some of the facts are stipulated and are so

24 found. The stipulation of facts and the attached exhibits

25 are incorporated herein by this reference. Petitioners

1 resided in the State of California at the time that the
2 petition was filed with the Court. Petitioner husband is
3 a certified public accountant and has been such for 44
4 years.

5 In 2005, petitioners purchased the following
6 three rental properties in Palm Desert, California: (1)
7 73-330 Santa Rosa Way (Santa Rosa property), (2) 73-331
8 Fred Waring Drive (73-331 Fred Waring property), and (3)
9 73-341 Fred Waring Drive (73-341 Fred Waring property).

10 To purchase the properties, petitioners obtained a loan
11 for each property from Countrywide Bank (Countrywide) and
12 secured the loans with the properties. On June 24, 2005,
13 petitioners executed three adjustable rate notes for the
14 following principal amounts: (1) \$316,500 for the Santa
15 Rosa property, (2) \$307,500 for the 73-331 Fred Waring
16 property, and (3) \$319,500 for the 73-341 Fred Waring
17 property. ~~The~~ petitioners executed an adjustable rate
18 note for each of the principal amounts borrowed on June
19 24, 2005. These notes provided for negative interest
20 amortization, which meant that by signing the adjustable
21 rate notes petitioners agreed that their monthly payments
22 would be less than the interest due under the notes and
23 ~~the~~ Countrywide would add the difference to the unpaid
24 principal. Thus, the amount of the principal would
25 increase from the initial amount borrowed.

1 In 2009 Countrywide contacted petitioners and
2 offered a modification of the adjusted^{able} rate notes. *DU*
3 Petitioners applied for a modification of each note and,
4 as a result, were required to pay only interest for ten
5 years. After ten years, the rate under the notes would
6 change and petitioners would be required to start paying
7 the then-principal amount through monthly payments. As of
8 April 20, 2009, after the modifications, the outstanding
9 principal for each modified note was: (1) \$348,516.38 for
10 the Santa Rosa property, (2) \$338,605.74 for the 73-331
11 Fred Waring property, and (3) \$351,819.49 for the 73-341
12 Fred Waring property. Shortly after the modifications,
13 *DU* the Bank of America acquired Countrywide and became the
14 lender on the notes.

15 On January 31, 2013, petitioners sold the 73-331
16 Fred Waring property in a short sale for \$100,000. The
17 purchaser issued a 2013 Form 1099-S, Proceeds from Real
18 Estate Transactions, to petitioners and reported the
19 \$100,000 as gross proceeds from the sale. Petitioners
20 paid the \$100,000 to Bank of America in ~~full~~ satisfaction *DU*
21 of the outstanding note on the 73-331 Fred Waring
22 property. Bank of America issued a 2013 Form 1099-C,
23 Cancellation of Debt, for that note and reported
24 \$246,328.48 as the amount of debt discharged and zero as
25 the amount of interest included in the discharged debt.

1 Bank of America did not issue a 2013 Form 1098, Mortgage
2 Interest Statement, to petitioners with respect to the
3 73-331 Fred Waring property note.

4 On January 31, 2013, petitioners sold the 73-341
5 Fred Waring property in a short sale for \$110,000, for
6 which the purchaser issued a 2013 Form 1099-S reporting
7 the \$110,000 as gross proceeds from the sale. Petitioners
8 paid Bank of America the \$110,000 in ~~full~~ satisfaction of ^{DU}
9 the outstanding note on the 73-341 Fred Waring property.

10 Bank of America issued a 2013 Form 1099-C for that note
11 and reported \$250,233.22 as the amount of debt discharged
12 and zero as the amount of interest included in the
13 discharged debt. Bank of America did not issue a 2013
14 Form 1098 to petitioners with respect to the 73-341 Fred
15 Waring property note.

16 On March 19, 2013, petitioners sold the Santa
17 Rose property in a short sale for \$100,000. The purchaser
18 issued a 2013 Form 1099-S to petitioners and reported
19 gross proceeds from the sale of \$100,000. Petitioners
20 paid Bank of America the \$100,000 in ~~full~~ satisfaction of ^{DU}
21 the outstanding note on the Santa Rosa property. Bank of
22 America issued a 2013 Form 1099-C for that note and
23 reported \$256,551.25 as the amount of debt discharged and
24 zero as the amount of interest included in the discharged
25 debt. Bank of America did not issue a 2013 Form 1098 to

1 petitioners with respect to the Santa Rosa property note.

2 Petitioners timely filed their 2013 Federal
3 individual income tax return, after requesting an
4 extension. On the Schedule E attached to their 2013 tax
5 return, petitioners reported the following as mortgage
6 interest paid with respect to their three properties: (1)
7 \$40,525 for the 73-341 Fred Waring property and (2) a
8 combined amount of \$79,658 for the 73-331 Fred Waring
9 property and the Santa Rosa property. At trial petitioner
10 husband asserted revised amounts of mortgage interest paid
11 (1) for the 73-³⁴¹~~334~~ Fred Waring property of \$32,175 and (2)
12 a combined amount of \$62,976 for the 73-331 Fred Waring
13 property and Santa Rosa property. Petitioners filed a
14 Form 982, Reduction of Tax Attributes Due to Discharge of
15 Indebtedness (and Section 1082 Basis Adjustment), and
16 claimed an election under section 108(b)(5) to reduce the
17 basis of the depreciable property in the amount of
18 \$753,112.

19 The IRS examined petitioners' 2013 tax return
20 and disallowed the reported mortgage interest paid with
21 respect to petitioners' three rental properties. The IRS
22 also determined that petitioners were liable for the
23 accuracy-related penalty under section 6662(a). The
24 asserted penalty was approved by a manager.

25 Discussion

1 Generally, the Commissioner's determination of a
2 deficiency is presumed correct, and the taxpayer bears the
3 burden of proving it incorrect. See Rule 142(a); Welch v.
4 Helvering, 290 U.S. 111, 115 (1933). Moreover, deductions
5 are a matter of legislative grace, and the taxpayer bears
6 the burden of proving entitlement to any deduction
7 claimed. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84
8 (1992); New Colonial Ice Co. v. Helvering, 292 U.S. 435,
9 440 (1934).

10 Under section 7491(a), the burden of proof may
11 shift to the Commissioner if the taxpayer produces
12 credible evidence with respect to any relevant factual
13 issue and meets other requirements. Petitioners have not
14 argued that section 7491(a) applies nor established that
15 its requirements are met. The burden of proof remains
16 with petitioners.

17 A. Section 163 Interest Deduction

18 Section 163(a) allows a taxpayer a deduction for
19 all interest paid or accrued within the taxable year on
20 indebtedness. It is well settled that cash method
21 taxpayers, such as petitioners, are allowed a deduction
22 for interest paid in cash or its equivalent during the
23 taxable year in which it is paid. Davison v.
24 Commissioner, 107 T.C. 35, 41 (1996), aff'd, 141 F.3d 403
25 (2d Cir. 1998); Menz v. Commissioner, 80 T.C. 1174, 1185

1 (1983). When a lender debits the required interest
2 payment to a loan account (i.e., capitalizing the required
3 interest payment by adding it to ~~its amount~~ to the loan's ^{DU}
4 principal), a cash method borrower is not entitled to a
5 current interest deduction for the interest debited.

6 Heyman v. Commissioner, 70 T.C. 482, 485-487 (1978), aff'd
7 without published opinion, 633 F.2d 215 (6th Cir. 1980);
8 Rubnitz v. Commissioner, 67 T.C. 621, 627-628 (1977).

9 The notes allowed the lenders (first Countrywide
10 and then Bank of America) to add the unpaid interest to
11 the principal, which they did in fact do. Starting in
12 November 2012 and until the properties were sold
13 petitioners did not pay any interest on the notes. When
14 petitioners sold the properties, the proceeds from the
15 short sales went to Bank of America, the then-holder of
16 the notes. Nothing in the record shows that Bank of
17 America applied any of the proceeds to deferred or unpaid
18 interest. In fact, the amounts listed as discharged debts
19 on the Forms 1099-C issued by ~~the~~ Bank of America equal ^{DU}
20 the then-unpaid principal amounts under the three notes
21 reduced by the payments from the proceeds from the short
22 sales. Thus petitioners have not proven that any of the
23 payments from the proceeds received from the short sales
24 were applied by Bank of America to pay interest. In fact,
25 Bank of America did not issue Forms 1098, which it would

1 have been required to do if any of the payments were
2 applied to deferred or unpaid interest for 2013.

3 Petitioner husband argued that as a matter of
4 accounting, Bank of America should have accounted for the
5 deferred interest by applying a portion of the payments to
6 the deferred interest on each note. As the Court
7 explained during the trial in this case, what Bank of
8 America may have been required to do for accounting
9 purposes does not control whether petitioners are allowed
10 a deduction for Federal income tax purposes. ~~Nothing in~~ ^{Neither ~~the~~} *DL*
11 the record, ^{or} ~~in the~~ petitioner husband's testimony,
12 supports petitioners' assertion that they were entitled to
13 claim a deduction for deferred interest with respect to
14 any of the three rental properties for 2013.

15 Petitioner husband at trial argued that a
16 reported opinion by the United States District Court for
17 the Southern District of California supports petitioners'
18 claim that they are entitled to a deduction for deferred
19 interest for 2013. See Horn v. Bank of America, N.A., No.
20 3:12 cv-1718-GPC-BLM, 2014 U.S. Dist. LEXIS 51972 (S.D.
21 Cal. 2014). Petitioners' reliance on Horn is misplaced.
22 Horn discusses a settlement between a class of plaintiffs,
23 of which petitioners were not part, and Bank of America.

24 Bank of America confirmed in a letter dated
25 October 11, 2017, that petitioners were excluded from the

1 class action lawsuit in Horn and that their unpaid
2 deferred interest was converted into principal debt when
3 the Countrywide notes were modified. In that same letter,
4 Bank of America informed petitioners that "Current I.R.S.
5 guidance provides that after we modified the mortgages,
6 the original mortgages were extinguished and replaced by
7 new, modified mortgages. The I.R.S. Form 1098 reporting
8 requirements only requires us to report on Form 1098 a
9 customer's payments of interest that accrued on the loan
10 after the modification."

11 The Court holds that petitioners have not met
12 their burden of proof and have failed to show that they
13 were entitled to deduct either the amounts reported as
14 mortgage interest paid on the Schedule E with respect to
15 the three properties or the revised amounts of mortgage
16 interest paid petitioners asserted at trial.

17 B. Accuracy-Related Penalty

18 Section 6662(a) and (b)(2) provides an accuracy-
19 related penalty equal to 20% of the portion of an
20 underpayment attributable to any substantial
21 understatement of income tax. Under section 7491(c), the
22 Commissioner bears the burden of production with regard to
23 penalties. Higbee v. Commissioner, 116 T.C. 438, 446
24 (2001). To meet that burden, the Commissioner must come
25 forward with evidence indicating that it is appropriate to

1 impose a penalty. Id. The Court concludes that
2 respondent has met his burden of production with respect
3 to a substantial understatement of income tax under
4 section 6662(b)(2). Respondent has also presented
5 evidence that the section 6662(a) penalty was "personally
6 approved (in writing) by the immediate supervisor of the
7 individual making such determination." See sec.
8 6751(b)(1); Chai v. Commissioner, 851 F.3d 190, 221 (2nd
9 Cir. 2017), aff'g in part, rev'g in part T.C. Memo 2015-
10 42; Graev v. Commissioner, 149 T.C. __, __ (slip op. at 14)
11 (Dec. 20, 2017).

12 Although respondent bears the burden of
13 production with respect to ^{the} accuracy-related penalty du
14 determined for 2013, respondent "need not introduce
15 evidence regarding reasonable cause, substantial
16 authority, or similar provisions * * * [because
17 petitioner] bears the burden of proof with regard to those
18 issues." Higbee v. Commissioner, 116 T.C. at 446.

19 A penalty will not be imposed under section
20 6662(a) if the taxpayer establishes he acted with
21 reasonable cause and in good faith. Sec. 6664(c)(1).
22 Circumstances that indicate reasonable cause and good
23 faith include reliance on the advice of a tax professional
24 or an honest misunderstanding of the law that is
25 reasonable in light of all facts and circumstances. Sec.

1 1.6664-4(b), Income Tax Regs.; see Higbee v. Commissioner,
2 116 T.C. at 449. Relevant factors for the Court to
3 consider include the knowledge and experience of the
4 taxpayer. Sec. 1.6664-4(b)(1), Income Tax Regs.

5 Petitioner husband credibly testified that at
6 the time petitioners filed their 2013 tax return the Horn
7 decision had been decided and that petitioners believed
8 that the basis of the settlement in that case would apply
9 to their situation. Bank of America's letter informing
10 petitioners of the contrary was not sent until October 11,
11 2017. The Court concludes that petitioners had reasonable
12 cause for reporting the deferred interest as mortgage
13 interest paid. Therefore, the Court concludes that
14 petitioners are not liable for the accuracy-related
15 penalty for 2013.

16 In order to give effect to our disposition of
17 the disputed issues, decision will be entered for under
18 Rule 155.

19 THIS CONCLUDES THE COURT'S ORAL FINDINGS OF FACT
20 AND OPINION IN THIS CASE.

21 (Whereupon, at 9:57 a.m., the above-entitled
22 matter was concluded.)
23
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25